KEYNOTE INTERVIEW

Striking a sustainable balance

The energy transition is creating an abundance of opportunity and maintaining discipline is essential, say partners and co-heads of Ares Infrastructure and Power, Andrew Pike and Keith Derman

Q How have definitions of the energy transition evolved over time?

Keith Derman: There was a time when the energy transition primarily referred to renewable generation and the decarbonisation of the power sector. Today, the energy transition is something much more expansive, and much more significant. It does start with renewables, of course. The decarbonisation of the power sector is critical and that also implies the need to introduce battery storage to firm the intermittency. But in addition to a focus on producing green electrons, we are also now talking about the downstream opportunity to decarbonise the transportation sector and heavy industry – in short, the decarbonisation of the entire economy.

SPONSOR
ARES

Andrew Pike: If you look back over the last several years, the emphasis has overwhelmingly been on the production and storage of green electrons. But the energy transition is now quickly evolving into a much broader theme of sustainable investment through the life cycle. This has led to interesting environmental scopes across climate finance, including water, or agricultural technology; or waste-to-energy or recycling. The definition of the energy transition has widened considerably. We are now thinking about investment for the broader ecosystem rather than simply about green electrons.

Q How do you expect the energy transition to continue to evolve in the years ahead?

KD: The decarbonisation of the power sector, alongside the broader economy, is going to take decades, and the role of sustainability has never been more important, nor has it ever received such widespread attention. Renewables are going to continue to grow at incredible volumes, consistent with previous years. I won't say that growth will continue unabated, because there are some near-term hiccups that will need to be managed around the supply chain and, to a lesser extent, inflation. But renewables cost curves are so compelling, and demand for renewables from both corporates and consumers is so substantial, that there is no doubt that renewables penetration will continue to increase.

What then needs to take place – and we have a lot of confidence that it will – is developments in long-term storage and green hydrogen that see those sectors mimic the cost curves that have occurred in wind and solar and lithium ion storage over the past 10 to 15 years. That is going to increase the number and size of investable opportunities substantially.

As we decarbonise the economy, we also need to be thinking about the resilience to the impacts already felt, including preservation of precious and finite resources such as water. In particular, we are playing close attention to what is happening in agriculture. We expect to see meaningful change geared around sustainability in that sector and a lot of the technology required is already here. In short, the market opportunity is huge, durable, and evolving. And it will be impactful, but we believe the returns are not concessionary.

Q Which of those opportunities do you think are particularly interesting right now?

AP: As a value-add investment team, we are fairly agnostic in terms of a transaction's sector. We are finding interesting opportunities across all market segments by virtue of the flexible capital approach that we have. We have purposefully built a strategy around the broad theme of climate and sustainable investment, and we have done so in a way that is sufficiently flexible to capture the broadest possible set of dealflow.

KD: Definitely. There is no one sector of sustainable investment that we focus on more than any other. We are seeing surplus activity in all segments. This surplus is an opportunity, but it is also a risk. There is just so much to review and look at. There are so many projects out there – so many businesses starting up and looking for capitalisation.

Discipline, a hallmark of our team for years, has never been more important. Our investors expect and deserve that discipline in any market, but I would argue that it is even more important given the level of activity happening right now.

Q What changes have you noted in terms of LP attitudes to infrastructure and to the energy transition in particular?

AP: It comes back to definitions again. Ten years ago, LPs defined the asset class in terms of traditional infrastructure such as ports and toll roads. Then thinking around the energy transition started to evolve, and those assets, which also benefit from contracted and stable cashflows, were captured within the infrastructure definition. Today, LPs' understanding of the energy transition is evolving alongside their managers. In fact, they are pushing their managers to continue to evolve and broaden their definitions. That traditional infrastructure thesis is still interesting, but I would argue it is somewhat limited. Investors need to cast their nets wider to capture the full potential that the asset class offers.

KD: The infrastructure sector has matured. LP appetite for infrastructure, and for the energy transition in particular, is booming. Investors are attracted to the resilient performance of the asset class and its lack of correlation to broader markets, as well as the inflation hedge that infrastructure can provide.

Meanwhile, as I noted earlier, the silver lining of the pandemic is that focus on sustainability has increased significantly and infrastructure is, of course, a perfect fit for that. And investors don't just have one manager managing their infrastructure capital anymore. They are building large and sophisticated infrastructure portfolios, with defined allocations for core, for sector specialists and for international mandates. That is a big change that has taken place over the past 15 years.

Q How would you describe competitive dynamics on the buy-side?

KD: There is no question that there is more money coming into the market. That has accelerated over the past few years and particularly over the past 24 months. In many respects, covid has provided an extra push. That has been a silver lining of the pandemic… more dollars looking to invest in sustainability. This is because of the performance of the asset class through covid but also because of an increased concern around climate change.

A lot of that capital has been directed at the core infrastructure universe – that capital wants to own de-risked, annuitised, decarbonised assets that are operational or nearing operations. It might be counterintuitive, but that increase in capital in the core market has actually been a positive for our value-add strategy because it means there is increased demand in the buyer pool for our projects.

Of course, we're also taking into account the range of potential market impact resulting from the considerable additional capital flows into the private equity, venture capital and SPAC markets. That impact has been more varied with both similarly positive implications and, in some cases, more competitive situations.

Q What sort of competitive advantage does the flexible capital mandate give you?

KD: We believe it represents real differentiation in terms of what we are able to execute. It gives us a number of routes into transacting with a third party. Ultimately, we are looking for the best risk-adjusted returns, of course. We are looking for downside protection and capital appreciation for our investors. Having those structuring capabilities, and the wherewithal to consider alternative structures, allows us to find capital solutions with assets and companies that we want to be in business with and sometimes those structured opportunities do lead to equity-orientated, control investments down the road.

> *"The definition of the energy transition and the set of opportunities encompassed within that is broadening all the time"*
>
> **ANDY PIKE**

So, by having the team that executes that strategy in-house, we are able to pivot up and down the capital structure. We have found the volume and quality of dealflow that we can access in this way is increasing. That is exactly how our acquisition of Apex Clean Energy evolved. We started out lending them money for projects. We then provided them a secured corporate loan. Next, we transacted on a few projects as developers and owners. And then we acquired the company. Pretty amazing how the relationship and transactions evolved.

Q Do you expect your strategy to continue to evolve going forward?

AP: The market is evolving rapidly and as a team we have to keep pace with that change, or be one step ahead of it, so it will absolutely be necessary for our strategy to evolve as well. As I said earlier, the definition of the energy transition and the set of opportunities encompassed within that is broadening all the time. That means we need to stay current in our thinking, but also keep an eye on where we need to be a year, or three years, from now. So that is an emphatic yes. Our strategy and team are always evolving and will continue to do so.

KD: We have to move with the times. No one is bigger than the market. And we have a track record of doing just that, of recognising a shift in the market and responding to it. Seven or eight years ago, we were building natural gas plants across the US. That thesis was predicated on the shale gas revolution, on the fact that the US had not built gas plants in more than a decade and, of course, on the coal retirement story. But we also recognised when that window began to close and we shifted our strategy, taking our capabilities, relationships and understanding of the market and redirecting our focus onto the energy transition. And we like to think we have had a lot of success as a result of that change.

Q What are some of the challenges that investors face when deploying capital in this market and how can they be overcome?

AP: As Keith said, the level of change that we have seen across the industry has created a huge amount of dealflow. That means that remaining disciplined and having conviction around the deals that are the best fit for your strategy is key. There are a lot of opportunities out there, but good managers must remain disciplined and be prepared to pass on deals. We believe that is absolutely critical to success.

KD: That's exactly right. The growth in mainstream interest in accelerating the energy transition is exciting and reflects what many of us have been pushing toward for years. To serve that, we've invested in building our team and platform to take advantage of the opportunity set and be a true driver of this shift. And more than simply financial returns, we're looking to lead by example in unlocking the range of benefits for companies and communities. ■

ARES

We are pleased to be recognized for our leadership in global infrastructure flexible capital investing and we want to thank our partners and clients for their continued support.

Infrastructure Investor
AWARDS 2021
Renewables Deal of the Year, Global

Infrastructure Investor
AWARDS 2021
Private Lender of the Year, Global

Infrastructure Investor
AWARDS 2021
Renewables Investor of the Year, North America

Ares Management is a leading global alternative investment manager offering clients primary and secondary investment solutions across credit, private equity, real estate and infrastructure asset classes.

SCALE | **FLEXIBILITY** | **EXPERIENCE**

www.aresmgmt.com

The selection of Ares Management to receive these awards was based in part on subjective criteria and may not be representative of any given client's experience. The award should not be viewed as indicative of Ares' past performance or its funds' future performance. All investments involve risk, including loss of principal.

REF: AM-01448