KEYNOTE INTERVIEW **CAPITAL DYNAMICS**

An illuminating strategy

*When Capital Dynamics, better known for its funds of funds business, launched a unit dedicated to direct investments in clean energy and infrastructure last year, the group appeared to be going out on a limb. But **David Scaysbrook**, managing director of the new team, explains why his team is pursuing investments in solar energy*

Private asset manager Capital Dynamics' bold step last year, launching a clean energy and infrastructure unit to make direct investments rather than fund commitments, was based on extensive examination of the sector and came in response to the firm's limited partners' increasing interest in the segment. David Scaysbrook, appointed managing director to lead the specialist team, told *Private Equity International* Capital Dynamics had been eyeing clean energy for several years.

"It was in response to investor clients asking for more information about the underlying investment thesis and risk return profile of these types of assets because, increasingly, they were interested in how they might participate," he said.

Scaysbrook: *operational expertise*

But why clean energy, and why now? Capital Dynamics first indentified clean energy as an under-invested sector, and then began defining in detail an investment strategy it believed would deliver attractive returns. "There's still not much money coming into the sector from the institutional investment community, despite the significant capital demand and attractive returns available," Scaysbrook explained. "Private equity is a pretty mature asset class in the northern hemisphere, but infrastructure less so. We're seeing increasing appetite however from Asian, European and North American investors, who are coming relatively late to infrastructure."

Scaysbrook's team have a well-established pedigree. "The team we've been assembling has been investing private capital in energy since the late 1980s, and we've focused on renewable energy since 1998. We've done that not as financial managers but as owners, industry investors and operators."

Scaysbrook for example was the founder of and built British energy company Novera Energy from its inception in 1997. Novera Energy was acquired by buyout group Terra Firma in 2009 and merged with its portfolio company Infinis. Yet the firm's approach to infrastructure investing - adopting an operational approach and focusing on creating assets rather than acquiring established ones - means its investments share many similarities with private equity. "We see it as high-yield infrastructure, with private equity-like characteristics, which gives these assets a great deal of flexibility from an investor's asset allocation perspective," Scaysbrook said.

"A lot of the larger infrastructure funds focus on the acquisition of existing assets, which tend to be sold through auction processes. There's also a significant transaction cost attached to those types of deals. We're interested in the creation of assets, getting involved with the late stage development and construction phases where we can use our prior industry experience, having been acquirers, developers and builders of these sorts of assets."

Creating diversity within a niche sector

Capital Dynamics plans to invest in, among other clean energy sectors, solar PV (photo-voltaic cell) projects in the US. In October 2010, the firm also assumed responsibility for managing California pension fund CalPERS' clean energy and technology fund, a $480 million portfolio. That harbours a whole range of different investments from venture capital and private equity fund commitments to direct investments, according to Scaysbrook.

Yet the firm's initial focus on solar power is interesting for its specificity. Perhaps a more obvious strategy for a new team would be to pursue a generalist approach within the renewables space, but Scaysbrook insists a narrow focus on solar projects is the right one. "Some might argue it's too narrow or niche, but in our view it's not – there's no other renewable technology you can introduce to lower the technical and operating risk profile. We've chosen the lowest-risk technology and we're using portfolio diversification to further reduce investment risk," he said.

That diversification comes through investing in multiple projects, alongside multiple partners rather than targeting several different technologies. In the future, the team plans to target multiple jurisdictions to add a further layer of diversity. "We were early moving into a new component of the US renewables industry. Why? The first reason was that we felt the risk-adjusted return opportunity for PV was exceptional – the US will become the largest market for PV in the world in the next few years, with nearly $5 billion invested last year alone. The second reason was that we regard PV as the lowest-risk option within renewables and therefore the best option for pension fund investors to understand and get comfortable with the underlying assets."

Returns – two bites of the cherry

The beauty of such investments is that they have the potential to deliver capital gains as well as recurrent income distributions throughout their lifespan, Scaysbrook said. "Well-structured projects deliver both strong cash yields and capital appreciation. These assets have economic lives of 20 years or more. The character of the assets means a lot of up-front capital investment, but an attractive return profile. Assuming you invest in proven assets, not unproven technologies, you've got well-structured, well-negotiated, well-put together projects. They have a return profile which is very attractive to institutional investors."

But there remains a tension between the character of such assets and the close-ended structures used by many managers to invest in them. "The Australian model is based on open-ended funds, where you're not driving an asset towards an exit to deliver a return, but relying on yield. We're likely to see more open-ended and hold-to-maturity structures as the asset class grows. We don't build capital appreciation into our investment models, but we do have exit plans for our assets, based around trade sales to strategic buyers. The principle driver of returns for us is yield – so any capital gains made on exit will be pure upside."

Regulatory risks

One persistent criticism of the energy sector is its reliance on government subsidies, which can be easily reduced or snatched away altogether. That could have catastrophic effects for an unwary investor. Managing regulatory risks is therefore a key part of any energy-focused investment strategy.

"The business opportunity in clean energy has historically been sponsored heavily by government policy. It varies from jurisdiction to jurisdiction. You can have feed-in tariff systems or tradable certificated markets (such as renewable energy credits). The regulatory momentum and flavour changes over time," Scaysbrook said. He identifies two principle types of regulatory change: prospective, and retrospective. The latter is by far the most dangerous from an investor's perspective, Scaysbrook explains, but is thankfully very unusual.

A prudent manager still factors in the possibility of punitive retrospective action by regulators however, something Capital Dynamics does routinely. "Our objective is to manage things so that, in a worst-case scenario, our investors will enjoy capital protection, even in the unlikely event of punitive retrospective action taken by regulators. Our investments, in most cases, sell electricity, which provides a reliable source of revenue," Scaysbrook said.

"We generally prefer de-regulated markets with certificated trading incentives, because the pricing tends to follow what's going on in the underlying energy markets in that jurisdiction. Energy is one of the most heavily-regulated sectors out there. But those incentives can and do change relative to politicians' whims, especially after catastrophes and in response to changing attitudes to things like climate change," he said.

Scaysbrook also pointed out that conventional power producers are actually more heavily subsidised than their renewable counterparts, despite popular perception to the contrary. He cited a study by the International Energy Agency last year which showed that renewables and alternative energy producers occupied a relatively small portion of total public subsidies. In 2009, incentives provided to fossil fuels totalled $312 billion compared to just $57 billion for renewable energy and biofuels, the study found.

He pointed out the fact that the net effect of fossil fuel incentives was to distort energy prices to below their true cost, which he said created misconceptions about the competitiveness of renewable energy and that the hidden subsidies in fossil energy are unlikely to be unwound in coming years.

Looking to the future

Scaysbrook is still recruiting for his team - currently 10 strong, he hopes to double that figure over the next 12 months. The firm plans to pursue other strategies with different mandates in the clean energy sector. "The second strategy we have is broader than solar and focuses on developed markets – North America, Western Europe and Australia – and will be multi-technology," Scaysbrook said.

Yet he sees no value in taking a punt on unproven technologies. "We won't invest in emerging technologies. In our view, over the next years, when we look at the investment demand in the trillions for clean energy infrastructure, it will be proven bankable technologies that deliver most of that needed capacity. The emerging innovations in energy technology will start to see market penetration around the end of that time period, which is when they'll have enough track record for us to begin taking them seriously with regard to investments. At the moment, we're focusing on technologies we know and have worked on before."

He also predicted there would be increasing confluence between clean and conventional energy in the way they were priced: "You can't look at clean energy as a silo apart from conventional power. Increasingly it's viewed as a viable alternative. Soon, markets will start pricing in emissions, which will factor through to higher energy prices. So pricing-wise, renewables are going to become cost competitive faster than many currently believe." ■

COMPANY PROFILE **CAPITAL DYNAMICS**

Capital Dynamics[1] is an independent asset management firm focusing on private assets, including private equity, clean energy and infrastructure, and real estate. The firm offers a wide range of products and services including funds of funds, direct investments, separate account solutions and structured private equity products. With more than 20 years of experience[2] and over 160 employees, the firm serves a diverse group of institutional investors including pension funds, endowments and family offices, as well as high net worth individuals and their advisors. Headquartered in Switzerland, Capital Dynamics has offices in London, New York, Zurich, Tokyo, Hong Kong, Silicon Valley, Rio de Janeiro, Munich, Birmingham (UK) and Zug.

We are proud of our distinguished reputation within the private equity community. In 2010, we were named "Fund of Funds of the Year in Europe", and "Private Equity Firm of the Year in Switzerland" for 2009 by *Private Equity International*; "Fund of Funds Firm of the Year" for 2009 by Dow Jones' *Private Equity News*; and "Fund of Funds House of the Year" for 2009 by the *European Venture Capital & Private Equity Journal*.

Capital Dynamics' clean energy and infrastructure (CEI) business was established in 2010 to address the attractive investment opportunities emerging in this new class of real assets and as part of an ongoing commitment to offering innovative products and services. The CEI team comprises highly experienced owners, developers and operators who have been investing and building businesses in clean energy since 1998[3]. CEI investments directly target climate change mitigation while enhancing energy security and providing economic stimulus. Unlike more venture-oriented 'cleantech' investments, real assets in the CEI class can offer attractive risk-adjusted returns from regular income yield as well as capital appreciation. Capital Dynamics' strategy focuses on investments in clean and renewable energy supply using mature and proven technologies.

ASSET CLASSES AND INVESTMENT TYPES[2]

Private equity

Primary fund investments – We have invested in private equity funds since the late 1980s, spanning all geographies and strategies, and have developed solid relationships with over 350 General Partners in more than 800 funds.

Secondary fund investments – Active in the secondary market since the early 1990s, we raised one of the first dedicated secondary funds. The combination of our large number of existing fund investments and proprietary databases often provides an information advantage when evaluating secondary transactions.

Direct investments – Our extensive relationships with the globe's top-tier fund managers provide a consistent volume of high-quality investment opportunities. Our co-investment strategy is focused on buyouts, but also includes select development capital and special situations.

Clean Energy and Infrastructure

This new direct investment strategy focuses on a diverse mix of clean and low-carbon energy assets that can offer attractive risk-adjusted returns and compelling diversification benefits.

Real Estate

Our Real Estate team has been investing in real estate funds since 1990 and maintains relationships with fund managers around the globe.

STRUCTURES

Funds of funds

We offer private equity primary, secondary and real estate funds of funds. With our funds of funds, investors can implement a global allocation strategy through access to premier private equity managers, plus diversify their portfolios across region, industry and development stage.

Separate accounts

Establishing separate accounts gives our clients the ability to customize individual programs to meet unique risk profiles and liquidity constraint parameters. We offer legal structuring services to meet the regulatory, tax and compliance requirements of each separate account client.

Structured products

We customize solutions one client at a time. Every structured solution is designed to deliver compelling benefits like early liquidity, enhanced return on investment, reduced risk, lower open commitments and/or decreased risk-weighted capital reserves.

Capital Dynamics has extensive quantitative risk management experience, an essential component of successful private equity investing. Our Portfolio and Risk Management team conducts in-depth client portfolio analysis using sophisticated tools. Our Portfolio Servicing team provides comprehensive and dedicated back office services like solving investment accounting and auditing issues, providing compliance and regulatory support, and delivering reliable data for effective portfolio management.

Capital Dynamics is a signatory to the United Nations Principles for Responsible Investment (PRI). We put the highest emphasis on quality throughout every division and level; our efforts have been recognized with the International Standard ISO 9001:2000 certification of compliance.

1. "Capital Dynamics" comprises Capital Dynamics Holding AG and its affiliates.

2. History includes 2005 acquisition of Westport Private Equity Ltd., and the Real Estate team's prior experience.

3. Experience prior to joining Capital Dynamics.