Restructuring in the renewable energy sector:

What does the future hold?

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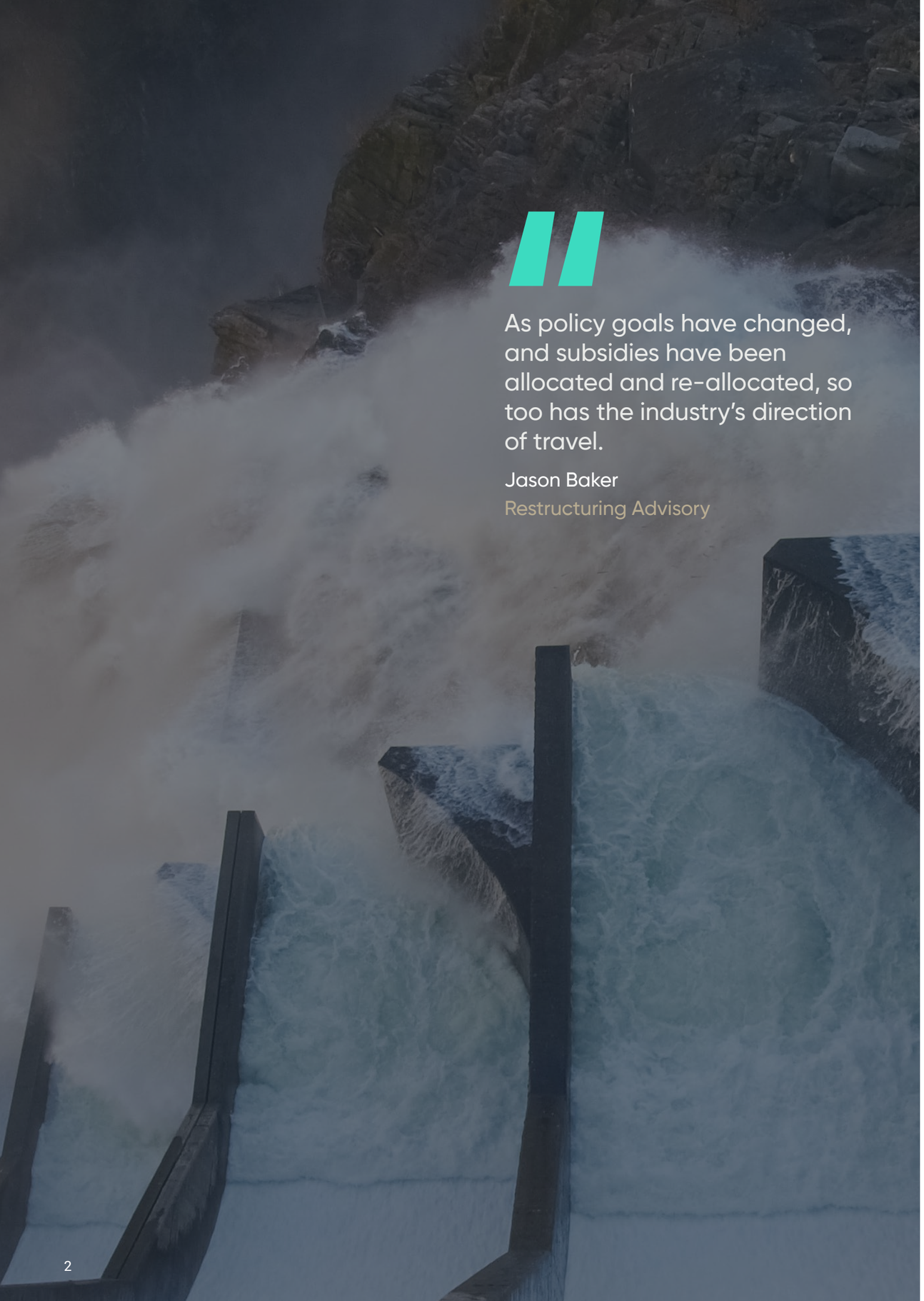

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> Jason Baker
> Restructuring Advisory

Publication

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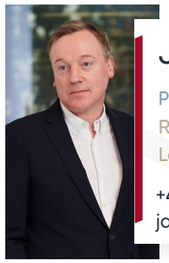
Synopsis

Renewables overtook fossil fuels for the first time in 2020 to become Britain's biggest electricity source for the year. Together, wind, solar, hydro and biomass provided 104 TWh of electricity, or 39 per cent of all electricity consumed.

With the government recently setting out plans for a green industrial revolution that will see it invest £12 billion in creating hundreds of thousands of new 'green' jobs, the UK is set to become the world's number one centre for green technology and finance.

Government direction is a key driver behind the UK's renewable energy sector, with many projects supported by subsidies for renewable, or 'green' energy. However, despite support, planning and developing, a renewable project is not without its risks – risks that have been exacerbated by COVID-19.

Here, we explore the current state of play for the sector, the impact the pandemic has had, and the risks businesses in the industry will face as it continues to grow and develop.



Jason Baker
Partner
Restructuring Advisory
London
+44 (0)7760 164 308
jason.baker@frpadvisory.com

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What is the current state of play?

The renewable energy sector is in a constant state of flux. Currently, the primary driver of development in the UK has been the availability of government subsidies, made accessible as part of the UK's efforts to improve its energy security, and to meet its targets of reaching net zero greenhouse gas emissions by 2050, as well as reducing emissions to 68 per cent of 1990s levels by 2030.

As policy goals have changed, and subsidies have been allocated and re-allocated, so too has the industry's direction of travel. However, some form of subsidy or incentive available for renewable or green energy will most likely continue to be a mainstay of government policy for a considerable time yet.

Technologies that receive subsidy or incentive support tend to see large spikes in activity as developers move quickly to take advantage of financial incentives. This has contributed to technology-specific periods of growth, often followed by periods of restructuring and consolidation as some projects stall or fail to adapt, or as the subsidy landscape changes.

Currently, the energy sector's focus is moving towards the widespread installation of battery storage technology and offshore wind and solar installations. This is attracting significant levels of investment from both inside and outside the UK.

The government has set out its ambition to quadruple the UK's offshore wind capacity by 2030, and the world's largest offshore wind farm is currently under construction in the North Sea, set for completion in 2026. Meanwhile, there is significant attention on the possibilities in hydrogen as a fuel for the future.

Other factors influencing the UK renewable and green energy sector include the availability of skilled workers and the short-term difficulties of import and export while the industry adjusts to the UK's departure from the European Union.

Esther Kiddle, Partner at Thomlinson Kiddle Law, specialists in supporting transactions, disputes and environmental clean-ups in the renewables industry, said:

"UK energy policy isn't just about energy – it is all about the drivers and interdependencies between the UK's objective of attaining energy security, European and energy policy in other jurisdictions, the global market economy and the availability and demand for natural resources, including energy. Understanding all of these interactions is key to understanding the market as a whole."

Julie Thomlinson, Partner at Thomlinson Kiddle Law, said:

"There are large amounts of third-party capital available for the development of renewable and green energy projects. However, due to the perception of high risk involved in project development, lending is often at relatively high interest rates. We repeatedly see broad assumptions in financial models that are unrealistic over the medium to long-term, and that do not reflect the inherent risk of change in the critical elements of income sources or costs to the project. This makes it particularly challenging for projects to meet costs resulting in financial under performance and losses. This is where seeking specialist advice can assist both the project developer and the funder."

How has the COVID-19 pandemic affected the sector?

COVID-19 will likely be remembered as both a disruptor and an accelerant.

For projects that are seeking funding or are ready to fund, ongoing uncertainty is, in some cases, delaying decision making and effectively suspending projects until further capital can be found. In other areas of new technology we are seeing increased foreign investment in the UK.

The pandemic has heightened public awareness around environmental sustainability and brought new efforts to manage and reduce our environmental impact. Calls from early in the pandemic's course for a green recovery have continued into 2021, with the coming months and years likely to see more money invested at a government level into decarbonisation. Recently, there has been public encouragement of large investments into global decarbonisation – a reflection of institutional investors' direction of travel.

The focus should now be on how money is spent. Policymakers will be keen to maximise returns for the public by investing in 'quality' projects, although it remains to be seen where their focus will be.

What will this mean for the future restructuring landscape?

Several risks are contributing to a repeating cycle of growth, collapse and consolidation across many industry sectors.

We are likely to continue to see a number of projects become distressed, with a higher risk of collapse in developments that rely on complex technologies with many variable factors.

Financiers tend to be informed relatively quickly when there is good news, but more slowly if there are any issues on a project, and in some instances, only after a project is in severe difficulty. This is a result of project developers being wary of disclosing bad news, and fearing that they will affect a funder's faith in them and the project. Some project developers will play down issues or their significance in order to buy time. When such issues are eventually brought to the attention of funders or come to light unexpectedly, trust between the parties is invariably affected and finding solutions can be harder to achieve.

The right path forward for a distressed project will depend on the specific circumstances. In some cases, this could involve identifying opportunities for a management buyout (MBO) or a sale to an aggregator in order to allow a new funder to complete a project or fix a technological problem. In others, it might be necessary to refinance existing loans or right-sizing debt by converting some of it into equity or where required, the restructuring of the project to preserve and extract as much value as possible.

Unfortunately, when projects run into intractable financial difficulty, a solvent solution may be difficult to find, leaving financial restructuring or administration the only realistic solutions. This is because projects that fail are often incomplete or performing substantially below forecasts, and usually require further capital investment to reach the point at which regulatory approval is obtainable, and gas or electricity can begin or continue to be generated.

However, there is an important gating item – specific to the sector – to contend with. Some renewable benefits, depending on how the original application was made, may not survive an insolvency process. The financial impact of these accreditations is significant for such projects as they underpin a plant's viability. Accreditations typically account for over 70 per cent of a biogas project's revenue stream over a 15 to 20 year lifecycle, making losing them a significant roadblock to its ongoing viability.

It may be possible to exit an administration if a project can be returned to solvency. This could be through shareholders loans, or alternatively, if a lender were to provide a working capital facility. However, a solvent exit is unfortunately rarely feasible. An alternative option to exit from administration may be a Company Voluntary Arrangement (CVA).

A CVA is a binding formal agreement with a company's creditors that provides an opportunity to address any operational issues within the business at the same time. Although a CVA is implemented under the supervision of an insolvency practitioner, it allows the new owners or funder to maintain management, if offers clean balance sheet and enables the project to remain Ofgem accredited and still able to claim subsidy income. Through these procedures, solvency can be restored and new working capital injected; new shareholders can replace or become joint owners, and new management could be appointed, giving control of the company to the new owner(s) or funder of the project.

Taking action and seeking early advice at the first signs of trouble will maximise the options available, giving a project's stakeholders the opportunity to work together to find a sustainable way forward. Where possible, investors may be more inclined to work to identify a solution, rather than risk their stake. Funders will also often continue to invest if they can see a credible and robust recovery plan.

Esther Kiddle, Partner at Thomlinson Kiddle Law, said:

"The renewable energy market is very much characterised by this pattern of growth and consolidation. Targets are set, often at a governmental level, for the production of a certain type of energy or for the use of a particular technology. This is often followed by a market rush towards the new direction of travel, but this involves risk as these can be complicated technologies, and many participants won't have extensive experience in the sectors. Some projects will ultimately fail and as the sector matures, it will consolidate. Crucially, there are opportunities at every stage for businesses and lenders to seek support to ensure their projects start, and remain, on a stable footing."

What are the risks the sector could face?

New technologies are always high risk. Identifying and managing them is critical in any market, whether a renewable, or any other energy project.

Risks consistently seen include:

- Errors in financial models arising from a lack of experience or knowledge, or misplaced optimism in financial forecasts;
- Poor management and failure to alert the funder to early issues and engage collaboratively to find solutions;
- Oversupply or undersupply;
- Competitive pressure favouring larger operators; and
- Lack of reactivity to changing markets.

New and emerging risks include:

- Future pandemics and crises;
- Resource security for example the availability of rare earth metals;
- Climate change and the resulting environmental challenges;
- Aging infrastructure and lack of long-term investment until critical points of failure; and
- Availability of insurance.

Conclusion

There is no doubt that renewable energy and green energy sources are important in securing sustainable growth. The sector has seen significant development and is set to continue to grow, with pace likely accelerated as the UK rebuilds in the wake of COVID-19.

The availability and reliance on subsidies and the identification of stable alternative revenue streams, the complexity of the technology, and the required infrastructure to support energy projects will all pose risks that businesses and lenders will need to carefully manage as they plan and put projects in place.

It is undisputable from an economic, business and legal perspective, the scope for action and chances of success for distressed companies decrease over time, and in turn, the potential losses for the creditors increases. Timely intervention is, therefore, a key success factor. Funders and owners should obtain specialist technical, commercial, regulatory and project construction advice, both at the planning stage and throughout buildout and deployment.

Many projects that fail do so due to insufficient knowledge, rather than from a lack of funding. The consequence is often that avoidable technical, regulatory or environmental issues are not picked-up in planning and lead to further issues later down the line.

Bringing fresh eyes to review such complexities that arise when taking any project from planning, through to implementation and development, is a tried and tested way to reduce these risk factors and increase a project's prospects of succeeding.

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FRP Advisory Trading Limited

110 Cannon Street

London EC4N 6EU

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