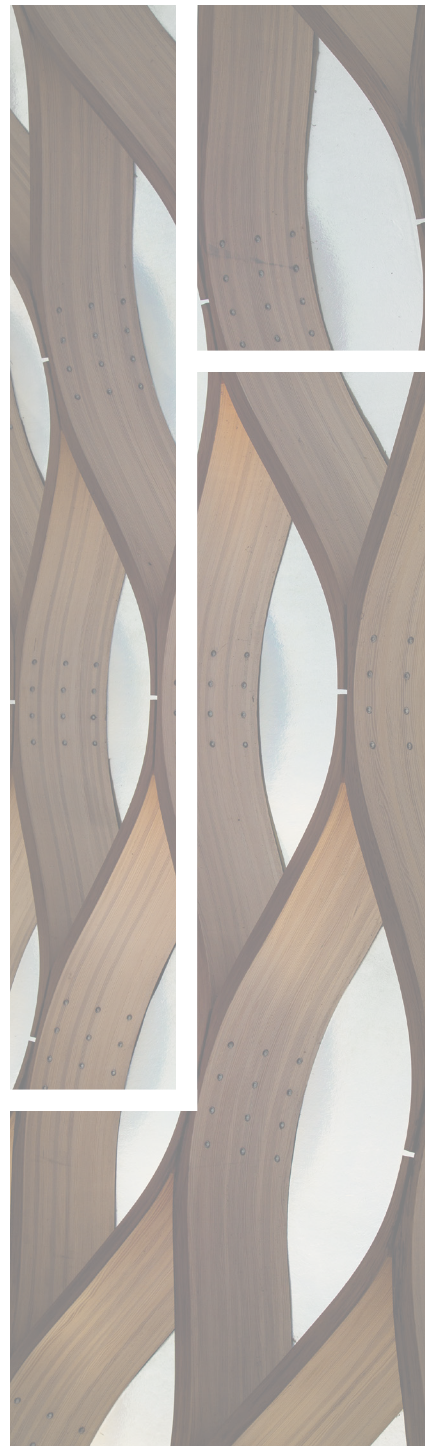
Sustainable Energy Investment Trends: Insight from Private Equity

As stakeholder priorities on environmental, social and governance (ESG) continue to crystallize at a rapid pace, investors are often allocating capital aligned with sustainable energy efforts to incorporate more environmental responsibility into their portfolios.

Lincoln International recently polled a subset of our private equity clients and investors in the sustainable energy space to understand their priorities, how they are identifying sustainable energy investment opportunities and the challenges associated with reporting and measuring impact.

Based on those insights, below is our perspective for sustainable energy investors.



Sustainable energy software and service providers hold wide appeal for investors

For investors evaluating opportunities in the sustainable energy field, there are a multitude of options to assess. The sustainable energy sector has been ripe for innovation and new technologies in recent years, giving rise to investment opportunities in everything from energy storage to battery recycling to smart grid technology.

Software providers are a highly attractive area of interest due to the growth potential they possess. Renewable energy software is a market in its early innings of development and possesses massive growth potential. At the same time, renewable software businesses offer the same benefits that make software businesses attractive: high margins, recurring revenue streams and high retention.

Recent deal activity in the renewable energy software provider market has caught the attention of software investors. As many of them have already spent time developing an investment thesis for the sector, they're looking to leverage their knowledge and deploy capital.

In addition, in our conversations with investors, we have observed steady and significant interest in sustainable energy service providers that perform tasks like monitoring, operations and maintenance, financing and installation. Service providers can provide a steady stream of recurring revenue that can't be found in other areas of sustainable energy.

Where investments in systems and solutions can be attractive, ongoing maintenance of those systems by service providers means stability from a long-term investment perspective. Service providers also generally offer fewer capital expenditures and cash flow expenses than manufacturers and other players.

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Solar provides an entry point for many exploring sustainable energy investments

In our discussions with investors, solar technology proved to be an even more attractive opportunity than nuclear, hydro, geothermal and wind technologies.

Unlike other renewable technologies, solar has advanced beyond initial adoption and faces fewer challenges in deployment and maintenance. Wind technology in particular requires substantial space to deploy, whereas solar technology can be applied on various scales from small residential systems (distributed generation) to large-scale utility systems. From our perspective, solar has advanced beyond other renewable technologies due to the maturation of the market in the last few years.

Solar is likely to continue to be a sustainable, long-term investment as systems are already becoming more cost effective than traditional energy generation and governments globally continue to set new standards and provide incentives for use of solar energy. As solar technology continues to develop, becoming less costly and more efficient, new white spaces will emerge — like energy storage.

High valuations and lack of quality targets are the biggest obstacles for investors in the space

When asked about the challenges of deploying capital in sustainable energy, investors consistently pointed to two obstacles: high valuations and lack of quality targets. From a dealmaking perspective, these challenges indicate that more companies in the sustainable energy space will realize their value and pursue mergers and acquisitions (M&A) to capitalize on the high prices that assets are commanding today.

While ESG is not yet truly factored into most company valuations, the poll responses lead us to forecast that a key component of future valuation processes will be the inclusion of environmental impact assessments. Notably, investors have found that the return on investment in sustainable energy is consistent with other investments in their portfolios, meaning that returns are not a hindrance to future investment in the space.

Target companies need to address lack of measurement and accountability for environmental impact

The lack of consensus around measuring companies' environmental impact and competing reporting frameworks has made consistent accountability challenging. We expect environmental impact measurement to become a larger part of the sales process as investors aim to understand impact during due diligence. Rising concerns about green-washing may mean that outside validations from a third-party will become the norm.

Dealmakers are currently making opportunistic investments in sustainable energy, but many have yet to develop explicit key performance indicators. As a first step, Lincoln recommends that companies and investors begin to create their own definition of ESG success and accountability. Existing standards and frameworks can provide helpful criteria to leverage as companies launch their own measurement criteria internally.

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