A root cause analysis

Renewable energy investment globally had a bumper year in 2022 with USD 495bn of investments[1], a 14% increase from the USD 434 billion invested in 2021. Outside of developed countries and mature renewable energy markets (India, China, Chile), renewable energy project finance in emerging and developing markets (in this instance, the focus is on Sub-Saharan Africa and Southeast Asia as SCAF regions) still forms a sliver of the global market. From 2019 to 2021 of the USD 160bn in emerging and developing country investments, three markets (India, Vietnam and Brazil) accounted for 60%. Why is that?

Southeast Asia and Sub-Saharan Africa have exhibited similar characteristics when it comes to renewable energy deployment. Investments are concentrated in single markets (e.g., Vietnam and South Africa) and for the remainder, investments are extremely inconsistent. The stop-start nature of these markets specifically refers to the public sector and can include governmental signaling, introduction of policies that are not implemented or implemented policies that are then put on-hold. Markets that fall into the latter category include Indonesia, the Philippines and Kenya which have all shown strong prospects and solid investment years to follow-on with low delivery. Markets outside of these have proven to be even more inconsistent, with one or two transactions taking place (Senegal and Laos are recent examples of this), followed by years of solitude.

Emerging markets have some consistent barriers to development of renewable energy projects which are then priced into investor return expectations for these markets. Investors can balance out these risks through a broadly diversified pipeline, however, this has the impact of spreading capital more thinly and leading to longer development timelines. Most risks projects face (political, financial, socio-cultural, technical, environmental and legal) can be overcome but have time and capital costs associated with them. Furthermore, risks have to be distinguished in real and perceived risks, the latter being responsible for adding irrational risk premia. From a private capital allocator perspective, the capital for a renewable energy fund or project in emerging markets is competing with equivalents in Europe or the US. The risk-adjusted premium that an emerging market fund or project requires to compete with developed markets, are as much as 10% higher to compensate for the risk, which has a major impact on project economics.

The risk premium together with the additional time and cost of developing a project due to the barriers faced means that insufficient funding is going into development resulting in a lack of early-stage pipelines and causing a chain reaction. Developers, the most crucial players in the value chain and the main drivers of projects, are left with limited resources to develop strong bankable projects. Fund managers that are seeking to enter projects late in the project lifecycle once the risk profile has come down substantially are unable to deploy meaningful amounts of capital. Lastly, capital from large institutional investors will not flow to these markets as the addressable investment universe lacks deal pipeline.

To sum it up: **Capital does not attract pipelines, pipelines attract capital.**

In markets where some of these risks have reduced, investors can demonstrate consistent exceptional returns and larger portfolios of assets can be developed, large investors have shown a willingness to invest. Evidence of this can be seen in Vietnam, where KKR (one of the largest private equity investors globally) launched Aster Energy to develop, build and operate renewable energy projects. A similar example is Copenhagen Infrastructure Partners (AUM of EUR 19bn in renewable energy assets) that recently acquired a majority stake in South Africa-based Mulilo.

[1] Renewable energy investments include venture capital, corporate investments and other forms of financing