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Higher interest rates overshadow IIC/REIF prospects

By Nigel Hawkins, Hardman & Co Renewables Analyst

Executive summary

- Hardman & Co Research's focus is on the nine quoted infrastructure investment companies (IICs) and on the 22 renewable energy infrastructure funds (REIFs), most of which saw their share prices fall during 2022, while the FTSE 100 rose by just 0.9%. In our *Quoted UK Infrastructure and Renewable Energy – Prospects for 2023* publication, we have addressed the three key issues of recent months – higher inflation, extremely volatile power prices and rising interest rates.
- The stocks analysed are all members of the Association of Investment Companies (AIC). As a 31-strong group, their combined market capitalisation is currently £30.0bn. Aside from the planned IPO of AT85 Global Mid-Market Infrastructure, which is now due to take place by early June 2023, no IIC/REIF IPOs have been undertaken since 2021.
- Within the 31-member grouping, the most valuable IICs are HICL Infrastructure and 3i Infrastructure – currently capitalised at £3.2bn and £2.9bn, respectively. The equivalents in the REIF sector are Greencoat UK Wind and TRIG, which are capitalised at £3.6bn and £3.1bn, respectively.
- Although many established funds have high inflation linkage, the inflation issue remains a real concern for many investors. In fact, IICs and REIFs, to varying extents, derive material benefits from higher inflation, providing – in an admittedly unlikely scenario – that this is not accompanied, in time, by higher interest rates.
- However, as expected, it has been the sharp rise in interest rates of late that has had distinctly negative NAV implications for the sector through higher fund discount rates; not surprisingly, share price ratings have fallen as a result. Plus, while many REIFs involved in renewable generation have the benefit of rising energy prices as an offset, this feature does not generally apply to IICs (GCP Infrastructure excepted).
- Soaring gas prices during 2022, which have reversed very sharply of late, have had a pronounced upward impact on long-term REIF valuations, since long-term power price assumptions are a key factor – along with discount rates – in determining the NAVs of most REIFs. The NAV volatility of Foresight Solar provides a telling illustration. It reported a 27.4% increase in its NAV between March 2021 and March 2022, while its September 2022 NAV was hit by an 8.6p per share decline due to the proposed Electricity Generator Levy (EGL), although the latter was broadly offset by other factors.
- Around 50% of the REIF sector's current £15.8bn valuation is accounted for by wind power generation. Owing to generous subsidies, the UK wind power sector has expanded; it now exceeds 25GW of capacity, while UK solar capacity is currently ca.15GW. The removal of subsidies for new solar plants from 2017 remains challenging, although unit costs have plummeted.
- Offshore wind power is booming. Given the sea change in costs, the government is seeking a quintupling of offshore wind capacity by 2030. The pivotal 2019 auction for the development of some North Sea sites saw several Contracts for Difference (CfDs) being awarded. The lowest, on the Dogger Bank, was struck at just £39.65p (2012 prices) per MWh, while an auction in July 2022 saw a record low price of just £37.35p per MWh.
- With rising interest rates, it is no surprise that the underlying premia over NAVs have, with very few exceptions, disappeared. Even BBGI, whose premium was ca.25% for much of 2021, is now trading at a small discount to its latest NAV; 3i Infrastructure is in a similar position. Shares in the two IIC digital stocks, Cordiant Digital and Digital 9, are now trading at discounts of 18.8% and 26.4%, respectively.

- For the REIFs, the standout performer in 2022 was Gresham House Energy Storage. Its shares are currently trading – driven by winning T1 and T4 contracts in a recent capacity auction and by its very conservative 10.8% discount rate – at a 7.5% premium to its latest published NAV; its shares rose by a formidable 23.3% during 2022. By contrast, shares in HydrogenOne Capital Growth and the struggling Aquila Energy Efficiency fell by 33.8% and 25.9%, respectively, during 2022 – they are now trading at discounts to their NAVs of 26.0% and 24.5%, respectively.
- While all established IICs and REIFs have avoided nominal dividend cuts, any increases, with a few exceptions, have been modest. 3i Infrastructure, whose dividend rose by 6.7% in 2021/22, is planning a similar rise in 2022/23, while Greencoat UK Wind, which links its dividend payments to movements in the RPI, is planning to raise its payment by a formidable 13.5% for 2023. By contrast, HICL now seems set to pay the same dividend in nominal terms, namely 8.25p per share, for five successive years.
- Underlying prospective dividend yields for most established IICs and REIFs now lie within ranges of 4.5%-6.5% and 5.5%-6.5%, respectively. Lower dividend cover, however, has become a notable trend. GCP Infrastructure, HICL Infrastructure, NextEnergy Solar and Sequoia Economic Infrastructure have been among those preferring to build up their cover by holding their dividend on a nominal basis. In the latter two cases, this policy has recently changed.
- Although no sector IPOs were completed in 2022, fundraising for the IICs and REIFs has continued in earnest – with Digital 9 Infrastructure, despite the tech sell-off in the US in 1H'22, being very much to the fore. There have been recent fundraising setbacks, most notably the pulling of Pantheon Infrastructure's planned £250m C-share issue and major shortfalls for equity issues by both Harmony Energy Income and ThomasLloyd Energy Impact. Overall, though, IICs and REIFs have raised ca.£10.3bn of new funds – at modest discounts to their prevailing share prices – since January 2020.
- Recent IPOs in the REIF sector have expanded well beyond the standard UK-based onshore wind and solar models of the past: Battery Energy Storage Systems (BESS) businesses, led by Gresham House Energy Storage and Gore Street Energy Storage, now feature more prominently. Furthermore, TRIG and the three quoted solar stocks are among the longer-established REIFs that have recently invested in BESS projects.
- While an Energy Profits Levy (EPL) was announced in 2022 – it is targeted at leading oil and gas producers – the EGL is also being introduced shortly. Long-established REIFs are adversely affected, although full details of the many proposed exemptions are still awaited. However, Bluefield Solar's 3Q'22 announcement concluded that the EGL would cut its NAV by 14.0p (gross) per share, but it was largely offset by reversing an 11.0p per share power price contingency figure set up previously.

Current market ratings of UK IICs

IIC	Share price (p)	Shares in issue (m)	Market cap. (£m)	Year-end	NAV per share (p)	Prem./disc. to NAV (%)	Prosp. dividend (p)	Prosp. yield (%)
3i Infrastructure	319	922	2,941	Mar	325.8	-2.1	11.15	3.5
BBGI	148	713	1,055	Dec	149.8	-1.2	7.63	5.2
Cordiant Digital Infrastructure	90	774	697	Mar	107.5	-18.8	4.00	4.4
Digital 9 Infrastructure	80	865	692	Dec	105.1	-26.4	6.30	7.9
GCP Infrastructure	95	885	841	Sep	113.6	-16.4	7.00	7.4
HICL Infrastructure	159	2,035	3,236	Mar	164.3	-3.2	8.25	5.2
INPP	148	1,910	2,827	Dec	157.3	-5.9	7.93	5.4
Pantheon Infrastructure	87	480	418	Dec	99.3	-12.2	4.00	4.6
Sequoia Economic Infrastructure	85	1,740	1,479	Mar	93.6	-9.2	6.57	7.7
Total			**14,185**					

Source: Hardman & Co Research

Current market ratings of UK REIFs

REIF	Quoted price	Exchange rate	Share price (p)	Shares in issue (m)	Market cap. (£m)	Year-end	NAV per share (p)	Prem./disc. to NAV (%)	Prosp. dividend (p)	Prosp. yield (%)
Aquila Energy Efficiency	72	1.00	72	100	72	Dec	95.4	-24.5	5.00	6.9
Aquila European Renewables	85	1.00	85	403	343	Dec	97.3	-12.6	4.85	5.7
Atrato Onsite Energy	93	1.00	93	150	140	Sep	92.8	0.2	5.00	5.4
Bluefield Solar	138	1.00	138	611	843	Jun	141.4	-2.4	8.40	6.1
Downing Renewables and Infrastructure	103	1.00	103	185	191	Dec	117.7	-12.5	6.50	6.3
Ecofin US Renewables	65	1.00	65	138	90	Dec	78.3	-17.0	4.98	7.7
Foresight Solar	114	1.00	114	610	695	Dec	126.5	-9.9	7.30	6.4
Gore Street Energy Storage	104	1.00	104	481	501	Mar	111.1	-6.4	8.00	7.7
Greencoat Renewables	110	0.88	97	1,141	1,104	Dec	98.9	-2.1	5.60	5.8
Greencoat UK Wind	156	1.00	156	2,320	3,619	Dec	167.1	-6.6	8.76	5.6
Gresham House Energy Storage	163	1.00	163	541	879	Dec	151.2	7.5	7.70	4.7
Harmony Energy Income	123	1.00	123	227	279	Oct	125.5	-2.0	8.00	6.5
HydrogenOne Capital Growth	72	1.00	72	129	93	Dec	97.3	-26.0	0.00	0.0
JLEN	117	1.00	117	662	774	Mar	123.5	-5.3	7.14	6.1
NextEnergy Solar	108	1.00	108	590	637	Mar	120.9	-10.7	7.52	7.0
Octopus Renewables	96	1.00	96	565	542	Dec	109.4	-12.2	5.79	6.0
SEEIT	93	1.00	93	1,110	1,032	Mar	106.1	-12.3	6.00	6.5
ThomasLloyd Energy Impact	102	1.00	102	176	179	Dec	83.7	21.9	5.00	4.9
TRIG	125	1.00	125	2,480	3,100	Dec	134.6	-7.1	7.18	5.7
Triple Point Energy Transition	69	1.00	69	100	69	Mar	100.3	-31.2	5.50	8.0
US Solar	68	1.00	68	332	226	Dec	80.5	-15.5	4.73	7.0
Victory Hill GSEO	98	1.00	98	423	415	Dec	108.2	-9.4	5.52	5.6
Total					**15,823**					

Source: Hardman & Co Research

Overview of 2022

Undoubtedly, 2022 was a mixed year, at best, for the 31 quoted IICs and REIFs that are being reviewed. During 2022, the FTSE 100 Index rose by 0.9%, while – over the same period – the FTSE 250 fell by almost 20%.

Since January 2020, the 31 funds have raised almost £10.3bn of proceeds. However, with no sector IPOs in 2022 – the AT85 Global Mid-Market Infrastructure IPO has been delayed until June 2023 – it came as no surprise that the amount of money raised was well down on the 2021 figure. In fact, a comparatively modest £2.3bn (excluding the delayed AT85 Global Mid-Market Infrastructure IPO) of new equity was raised by the 31 funds.

Inevitably, the sector has been affected by both high inflation – some IICs have very high inflation linkage – and rising interest rates, which put upward pressure on fund discount rates and ultimately depressed their NAVs.

Despite many long-term PPAs being in operation, the war in Ukraine, which has seen gas prices soar – although they have fallen back sharply of late – has had a major impact on some of the older established REIFs.

Furthermore, many funds, including HICL – expected to pay an 8.25p dividend per share for the fourth year in succession, as well as in 2023/24 – held their dividend in nominal terms; none actually cut it during 2022. At the other end of the scale, Greencoat UK Wind increased its dividend per share by 7.5% in 2022 – and aims to increase it by 13.5% per share in 2023, while 3i Infrastructure's dividend per share rose by 6.7% in 2021/22.

Within the 31 funds, the most impressive share price performance was reported by Gresham House Energy Storage, rising by 23.3% during 2022. Harmony Energy Income, boosted by the energisation of its 98MW Pillswood project, and ThomasLloyd Energy Impact, with its substantial – and recently completed – SolarArise generation acquisition in India, reported similar share price increases during 2022.

By contrast, several of the more recently quoted REIFs failed to meet some of their shareholders' expectations. HydrogenOne Capital Growth, down by no less than 33.8% over the year, was – by some way – the worst performer. However, Aquila Energy Efficiency and the two leading IIC digital players, Cordiant Digital Infrastructure and Digital 9 Infrastructure, all lost around a quarter of their value during 2022.

The table below highlights the share price performance of the 31 funds during the 2022 calendar year.

IIC/REIF share price performance over 2022	
IIC/REIF	Share price performance over 2022
Gresham House Energy Storage	+23.3%
Harmony Energy Income	+23.2%
ThomasLloyd Energy Impact	+21.7%
Foresight Solar	+17.2%
JLEN	+13.9%
Bluefield Solar	+9.9%
Downing Renewables and Infrastructure	+9.7%
NextEnergy Solar	+9.0%
Greencoat UK Wind	+7.5%
Greencoat Renewables	+1.8%
TRIG	-3.3%
Gore Street Energy Storage	-4.7%
Aquila European Renewables	-4.8%
Victory Hill GSEO	-5.6%
3i Infrastructure	-5.9%
GCP Infrastructure	-5.9%
HICL	-6.9%
Octopus Renewables Infrastructure	-9.4%
BBGI	-10.5%
INPP	-10.5%
Pantheon Infrastructure	-10.9%
US Solar	-11.5%
Atrato Onsite Energy	-13.1%
Ecofin US Renewables Infrastructure	-13.1%
SEEIT	-17.9%
Sequoia Economic Infrastructure	-18.1%
Triple Point Energy Transition	-21.4%
Digital 9 Infrastructure	-24.2%
Cordiant Digital Infrastructure	-25.6%
Aquila Energy Efficiency	-25.9%
HydrogenOne Capital Growth	-33.8%

Source: Bloomberg

Recent events

The sharp rise in interest rates over the past six months has seen a distinct pause in corporate activity within the IIC/REIF sector, as the prospects of securing acceptable returns on new investments have receded. Importantly, share price ratings have fallen back, with most REIFs/IICs now trading at a discount to their NAVs; indeed, some are at very pronounced discounts.

It has also been the case that new fundraising has become more challenging, as several IICs/REIFs found last year, including Harmony Energy Income, Pantheon Infrastructure and Victory Hill GSEO. However, it is now very likely – after several previous attempts – that AT85 Global Mid-Market Infrastructure will secure enough financial backing to meet its 6 June 2023 date for a stock market quotation; it is seeking, initially at least, to raise £300m. The success – or failure – of this significant fundraising initiative will have important implications for the sector generally, as it will indicate the level of financial appetite to invest in REIFs/IICs, despite the pronounced rise in interest rates in recent months.

Importantly, since the start of the January 2023 calendar year, there have been various developments, mainly concerning updated NAVs and adjusted dividend targets, in the 31-strong IIC/REIF sector that warrant comment. The most important are:

- 3i Infrastructure raised £100m of net proceeds when it issued 30.9m new shares in February 2023. The discount for this issue, when compared with the pre-announcement share price, was a modest – and, for the sector, reassuring – 3.4%.

- Gore Street Energy Storage is continuing its US expansion, having agreed terms to acquire a 75MW plant in Texas and the 200MW Big Rock facility in California. Both BESS plants are expected to be operational by late 2024.

- Greencoat Renewables has now completed its acquisition of a 22.5% stake in Butendiek, an offshore wind farm to the west of Sylt in the German sector of the North Sea.

- Greencoat UK Wind updated its NAV to 167.1p per share at December 2022; this is a 25.2% increase on the 133.5p per share figure as at December 2021. It also reported net cash generation (group and wind farm SPVs) of a very impressive £560m during 2022. Furthermore, Greencoat UK Wind has set out a dividend target for 2023 of 8.76p per share, an increase of 13.5% – and, uniquely within the sector, its dividend payments are linked directly to the RPI inflation rate.

- Harmony Energy Income confirmed that its now energised 98MW Pillswood plant in Yorkshire is the largest BESS project in Europe, as measured by MWh. Moreover, it reaffirmed its 8p dividend per share target for 2022/23.

- HICL announced that it had abandoned plans to secure a 55% stake in ADTIM SAS, an independent wholesale fibre network in France.

- Octopus Renewables Infrastructure announced an enhanced dividend target of 5.79p per share for 2022/23 – up by 10.5% over its 2021/22 payment.

- ThomasLloyd Energy Impact confirmed the completion of its acquisition of the remaining 57% of the 434MW SolarArise business in India – it now has full ownership of this core asset.

- TRIG reported a NAV of 134.6p per share for 2022, a 12.8% increase on the 2021 out-turn. However, generation output during 2022 was 5% below budgeted levels.

Looking forward to the remainder of 2023, the 31 IIC/REIF funds – due to be supplemented shortly by AT85 Global Mid-Market Infrastructure, and possibly others – will need to persuade investors that a combination of higher interest rates, lower inflation, and the likelihood of falling energy prices, will not give rise to material falls in their NAVs and consequential cuts in their nominal dividend payments. Current share price ratings suggest that the market is far from convinced that some funds will be able to avoid this scenario.

For this article, closing stock market prices as at 23 February 2023 have been used, unless otherwise specified.

The following exchange rates used in this article are:

£ to € – €1.14

£ to US$ – US$1.20

About the author

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Nigel specialises in the energy sector, with a particular focus on the expanding renewable generation market, in both the UK and overseas, about which he has written several reports assessing the sector's finances. He has been involved in analysing the utilities sector since the 1980s. He covered the privatisation of the water and electricity companies for Hoare Govett between 1989 and 1995. Subsequently, he researched the UK and EU telecoms sector for Williams de Broe. He has also written many feature articles for Utility Week magazine since the mid-1990s. Between 1984 and 1987, Nigel was the Political Correspondence Secretary to Lady Thatcher at 10 Downing Street. Nigel joined Hardman & Co in February 2016. He holds a BA (Hons) in Law, Economics and Politics from the University of Buckingham, and is a senior fellow of the Adam Smith Institute.

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