BRAD NORDHOLM & HIMANSHU SAXENA, STARWOOD ENERGY GROUP

Taking advantage of America's energy boost

With power generation in the US already having undergone deregulation, and the focus increasingly on transmission, Starwood Energy is seeing plenty of opportunity for its strategy of hands-on involvement at the development stage. **Andy Thomson** finds out more from Brad Nordholm and Himanshu Saxena

With a market size of more than $1 trillion, there is no doubting the scale of opportunity within the power generation and transmission space in North America. But while the rapid shift from coal-fired generation to natural gas generation and renewable energy has brought in its wake a wide array of potential investments, the key to investing successfully may be summed up in one word as far as Starwood Energy Group (Starwood) is concerned: 'specialisation.'

The Greenwich, Connecticut-based firm closed its most recent energy infrastructure fund at $1 billion – plus $550 million in co-investment commitments – in December 2013. Formed by Chairman Barry Sternlicht back in June 2005, it now has a decade's experience in developing energy infrastructure projects through the construction phase – playing an early-stage, hands-on and value-added role that other investment firms have tended to eschew.

Brad Nordholm, chief executive officer and managing director, joined the firm as its first CEO with a mandate to build its team and fundingLooking back, he says the opportunity then was "very different. There was not as much underlying change," he recalls. "The market was mainly secondary deals where investors bought existing power plants." He adds: "The big change has been in developing new projects. We're very fortunate because since inception we have taken on new energy generation projects, and been active in their creation. Others were not doing that. We have been practising it for over a decade and it has only really taken off over the last couple of years."

Nordholm: ability to execute deals is vital

SHALE REVOLUTION

Some 'big themes' have been driving today's opportunity set. Himanshu Saxena, managing director and member of the investment committee, points out that with coal as much out of favour as renewable energy is in favour – and with the shale revolution driving the generation of cheap natural gas – one-third of the current power generation capacity is set to be retired over time. It's a set of circumstances that provides a "big opportunity" Saxena insists. In tandem with this, deregulation has enabled the opportunity to be opened up to fund managers such as Starwood.

"This is a relatively new investment opportunity," Nordholm points out. "Twenty years ago, 100 percent of the generation and transmission assets were owned by utilities. Because of deregulation, that figure fell to 50 percent 10 years ago, and today it's less than that. As a result, we've really seen a new asset class open up for investors."

But, despite representing a potential feast for investors, not many appear to have an appetite – or at least not for some of the options on the menu. "More investors want to acquire operational assets," says Nordholm. "We find that there is more competition when we sell the assets rather than when we get in early to develop them."

"We certainly avoid competing head-on for operational assets," Saxena emphasises. "When we acquire operating assets, we generally look for a value-added angle. We like development because we understand development risk and manage it, and we come to it with a risk management-focused, value-added approach."

EXPERIENCE

The ability to add value might sound hollow coming from some quarters, but for Starwood, playing in the development arena means having people within the team with a huge amount of experience in the field. Without that, the strategy would lack credibility. Nordholm points to staff members who have spent some of their earlier careers at utilities including Con Edison, American Electric Power, Public Service Enterprise Group and Pacific Gas and Electric Company.

"We believe that hands-on experience is critical to effective execution," insists Nordholm.

"We have also worked hard to hone a reputation for doing deals that are fair, with a high degree of execution certainty. Developers may have just one shot at a project and they need a trustworthy partner. We agree to terms and conditions upfront and we do what we say."

Saxena comes back to the point made at the outset about specialisation. "We need to be experts at a number of different things because the number of variables in this sector is significantly more than in many others. So we have experts who are keenly aware of what is happening in the marketplace. We find the right opportunities with the right risk/return and where we can add value."

The ability to find the "right opportunities" demands considerable expertise, given the major differences between regional power markets within the US. "In the US 30 years ago, every market looked the same, as they all had their local monopolies," says Saxena. "The local power plants were built by these monopolies and then the customers were charged for the cost of building it."

But then along came deregulation – and some very different outcomes. Some states such as Texas and California fully deregulated, introducing open markets and allowing new entrants to come in and buy and sell power as they pleased. But other states, such as those in the southeast of the country, did not open up to anything like the same degree. "You could have the same plant in California and Georgia and the value would be materially different," notes Saxena.

The complexity is not for everyone. "Some European investors ended up exiting the market because they found it too complicated," says Nordholm. "We will consider any market but we will not invest where we can't secure long-term revenue contracts or execute in liquid energy and capacity markets. The southeast would be an example. Utilities still have undue control of the market so it's not an open-field opportunity. You need a lot of customers, not just a few – you don't want to be beholden to just one counterparty."

Saxena: about adding more than just capital

> "FERC [the Federal Energy Regulatory Commission] is trying to create more competition in transmission and provide more of a level playing field with local monopolies for firms like us" **Saxena**

'HOTCHPOTCH'

Perhaps the biggest complication in understanding how the regional power markets work is the interplay between federal and state governments – which leads to what Saxena describes as a "hotchpotch of regulations."

"Depending on the political climate, the federal government can be more or less active in governing the power sector, such as through new environmental regulations," says Saxena. "Certain states will invariably challenge these new rules about emission reductions, and environmental laws created by the federal government may or may not hold up in court."

The Obama administration has been particularly active in promoting a clean energy agenda, presenting the states with a range of choices on how to cut emissions by a certain amount within a given timeframe. The choices include more renewable energy, greater energy efficiency, the retirement of coal or the adoption of more efficient coal. The choice also extends to states being able to band together to reduce emissions on an aggregate basis rather than individually.

Whichever approach is taken, Saxena maintains that it presents a big opportunity for investors such as Starwood. "There are basic supply-and-demand issues in meeting these new standards, and the states will need new renewable energy and gas-fired plants as well as more transmission lines to bring power from other areas," he says.

Nordholm makes the point that operating in what might be described as the "mid-market" – though a precise definition of the mid-market may remain elusive – enables the firm to capitalise on the majority of deal flow in the space without having to battle it out in overly competitive bidding processes. "Our fund is sized and designed to enable us to invest in any power transmission or generation asset that we want to invest in," he says. "A lot of the investments are in the $20 million to $250 million range, although we could handle deal sizes outside this range, and we can also do portfolios of projects." He adds: "If you're smaller than us, you may be removed from most of the deal flow. You could operate in the solar space, for example, but that is dominated by low cost of capital. Being larger than us means buying portfolios, and they don't come along very often, so you are competing for fewer deals where it can be a cost-of-capital shootout."

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PARTNERSHIPS

Asked how Starwood evidences its value-added approach, Nordholm points to the partnerships it is able to form with developers and the way in which it is able to lower costs through better purchasing and a more disciplined and timely approach to development and construction.

Saxena adds that the firm often seeks to identify "interesting" development projects that have requirements extending beyond merely the need for more capital. He provides an illustration: "A project may have hit a road block where, for example, the original developers don't have the relationships and the experience to take a deal from point A to point B. They may have identified land and done some interconnection work and begun to set up offtake arrangements, but they ultimately don't have the experience to bring it all together. So we bring our own resources and take it forward." A specific example is provided by the Stephens Ranch Wind Project in Texas, a 377-megawatt project that Starwood acquired from joint developers Wind Tex Energy and Mesa Power (created by business magnate T. Boone Pickens) in August 2013.

"We put together a long-term offtake with a bank, so there was certainty of revenue and it was bankable," says Saxena. "We optimised the tax arrangements and put in place fixed-price turnkey contracts to minimize construction risk." He continues: "It was a puzzle and every piece needed to fit together perfectly. The project ended up being delivered on time and under budget."

Nordholm adds that having fixed-price contracts, and the placing of construction risk with the developer, is a good way of dealing with risks that some other investors find unsettling. He says there should always be committed revenue contracts. "You should never build it and see if they will come," he advises.

He also thinks it's important to look for the best opportunities at a given time rather than being wedded to particular allocations. "By not being a single-technology investor, we avoid micro cycles and the times when returns are not so good. We look at what is the most attractive opportunity in any given year."

THE TRANSMISSION OPPORTUNITY

Increasingly, such opportunity is being found in transmission. For example, in July of this year, Starwood and a partner were selected by the California Independent System Operator (CAISO) to finance, construct, own, operate and maintain a 114-kilometre, 500kV transmission line between California and Arizona – a project with an initial outlay of around $300 million.

"Most of the deregulation has focused on the generation side," says Saxena. "In most regional markets, it's still difficult to compete with the utilities and, until the last few years, it was difficult for independents to build new transmission. But FERC [the Federal Energy Regulatory Commission] is trying to create more competition in transmission and provide more of a level playing field with local monopolies for firms like us."

Saxena adds that he expects similar opportunities to the one in California to crop up across the country. "We are right at the beginning of a big new stage of development," he enthuses. "There are multiple places where this is happening, in the Midwest for example, so California is not unique."

With a decade of energy infrastructure investing under its belt, the firm is confident that it has built the relationships necessary to succeed. "We know the major players and we're good at building relationships, which means we get the calls," says Nordholm.

The firm cannot comment on fundraising due to regulatory constraints, but it is clear it is beginning to turn its thoughts to life beyond the current fund, which is largely committed. "We have a decade of history, we have been able to prove the benefits of value-added investing, and we are in this for the long run," says Nordholm. "We will be back in the fundraising market again at some point in the future." ■

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