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Impact Investing with Energy Efficiency: Achieve Climate Goals, Invest Economically and Meet Regulatory Requirements

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The efficient use of energy, together with the development of renewable electricity production, is one of the most important pillars for achieving global climate goals. Europe has recognised the potential of increasing energy efficiency and is progressively creating a regulatory environment that, in addition to delivering attractive returns for institutional investors, makes it easier for them to make a substantial contribution to achieving the "Net Zero" goal.

Energy efficiency is an important building block for the 2050 Net Zero goal

Groundbreaking goals were agreed in the 2015 Paris Climate Agreement, which the EU formalised in the European "Green Deal" and the "Energy Efficiency First" principle with the aim of limiting global warming to 1.5 degrees Celsius. In 2019 the UK became the first major economy to pass laws to reduce its greenhouse gas emissions to Net Zero by 2050. Improving energy efficiency, together with the expansion of renewable energy, is the most important measure to achieve this goal, true to the motto: "The best kilowatt hour is the one that we don't use."

In the International Renewable Energy Agency (IRENA) scenario, energy efficiency measures represent around 40% of the total CO2 savings required to achieve Net Zero by 2030.[1] The 2022 Bloomberg Energy Report estimates that planned updates on energy regulation in the EU will lead to an annual investment gap of EUR 177-185 billion[2]. Energy efficiency not only substantially contributes to the energy transition, but also promotes energy independence. This topic has become particularly important since the Russian invasion of Ukraine in 2022.

Buildings hold great potential for increasing energy efficiency

Buildings currently consume around 40% of all energy in the EU and the UK. Strategies for optimising energy consumption in buildings and supplying them with decentralised renewable energy are "low-hanging fruit", whose implementation can achieve the greatest possible impact in a short time. Numerous public buildings alone will have to be renovated in the next years and, provided financing is available, they have the potential to deliver significant CO2 savings. The UK's "Heat and Buildings Strategy" which was published 2021 lays the foundation for Net Zero building in the UK by 2050. In addition, reducing energy consumption brings a significant increase in the value of the buildings, meaning that the investments deliver multiple economic benefits.

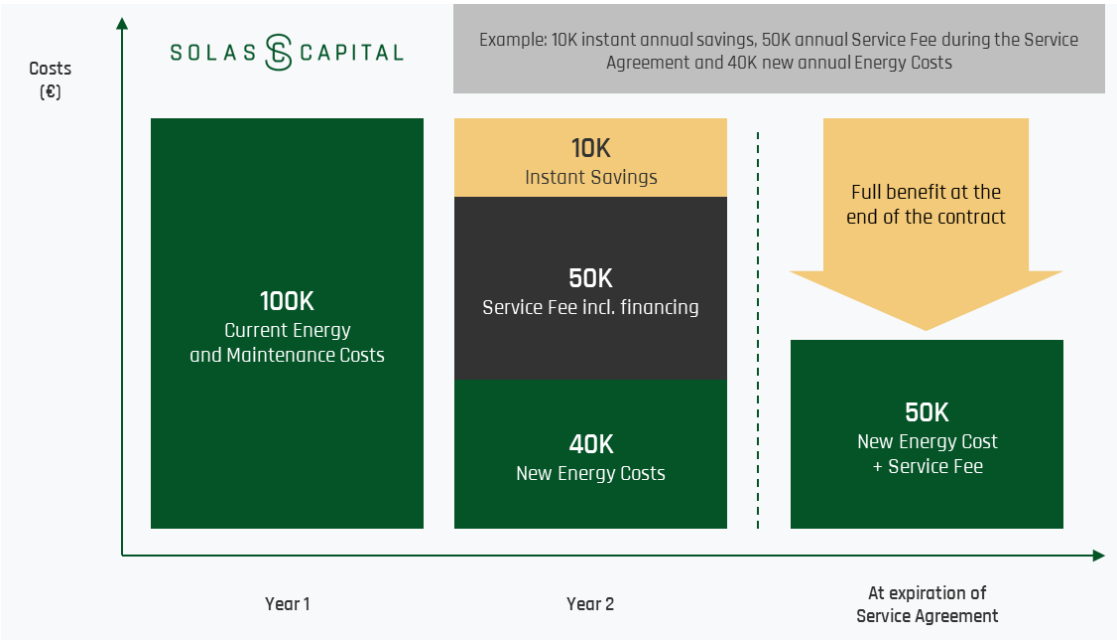
These points demonstrate the important role that specialised energy efficiency and decentralised renewable energy generation financing will play in the energy transition over the next few years. Energy efficiency investments offer institutional investors attractive returns and stable distributions paired with measurable CO2 savings and positive social effects – this is the true spirit of impact investing.

How do we increase energy efficiency and who can help us do it?

Investments in energy efficiency and decentralised renewable energy generation, especially in the areas of buildings and industry, are currently either very fragmented or form part of larger infrastructure projects. Energy Service Companies (ESCOs) are an important driver for the development and standardisation of projects. ESCOs implement measures for their customers using established and reliable technologies which dramatically reduce energy

[1] IRENA, «A roadmap to 2030, World Energy Transitions Outlook», 2022
[2] Bloomberg, «New Energy Outlook», 2022

consumption, such as LED lighting, heat pumps, rooftop PV, and waste heat recovery systems. With the right financing partner, such measures can be implemented via an "Energy-as-a-Service" contract, without upfront investment costs for the energy consumer. During the contract term (typically 8-15 years), the investment is repaid via a service fee. The cost savings often exceed this service fee and the energy consumer thus realises a positive cash flow from year one. After the contract expires, the consumer receives the full benefit of the energy cost savings delivered by the installed technology.



Thanks to their technological expertise and proximity to consumers, ESCOs are the ideal partners for energy efficiency investments. In order to implement the project pipeline in buildings and industry, ESCOs need reliable financing partners who offer scalable solutions. In addition, if the projects are set up as project financing without recourse to the corporate customer, they can be structured off-balance sheet for both the consumer and the ESCO.

Big impact with investments in energy efficiency

In addition to attractive returns and long-term plannable distributions without exposure to electricity price risks, energy efficiency investments deliver other major impacts, including:

- Measurable CO2 reduction
- Increase in building value
- Reduction of energy poverty[3]
- New jobs
- Health benefits

The return on investment of energy efficiency measures for society as a whole is estimated by the International Energy Agency at 1:4 when health benefits are taken into account.[4] However, the economic effects are not just limited to energy cost savings. The advantages for companies at the operational level and in the area of productivity are up to 2.5 times greater than the energy cost savings themselves. For example, the enhanced quality of light provided by LED lighting greatly improves working conditions and consequently increases productivity.[5] Many investors are already

[3] Naomi Lloyd, «Was tut die EU gegen die Energiearmut?», 26.1.2022, URL (https://de.euronews.com/next/2022/01/26/was-tut-die-eu-gegen-energiearmut), November 2023
[4] IEA, «Capturing the Multiple Benefits of Energy Efficiency», 2015
[5] IEA, «Capturing the Multiple Benefits of Energy Efficiency», 2015

considering energy efficiency as a complementary component within their ESG strategy, highlighting that this asset class is very suitable for institutional investors.

Turn your back on greenwashing

The EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR) have created a framework that allows investors to effectively distinguish truly sustainable investments from those that engage in greenwashing. Article 9 Funds, also called "Dark Green Funds", must have a predefined and measurable sustainability goal according to the SFDR. However, only 3.6% of EU funds currently meet these highest sustainability standards, despite institutional investors' increasing ambition to make their portfolios ESG-compliant through Article 9 funds.

The EUR 220 million Solas Sustainable Energy Fund (SSEF), an SFDR Article 9 classified energy efficiency infrastructure debt fund, launched by Solas Capital in 2022 and supported by the European Investment Bank, the Irish Sovereign Wealth Fund ISIF and Munich Re, aims to achieve market-driven returns and significant CO2 reductions while creating roughly 3,500 new jobs within the EU. As of December 2024, the SSEF has signed credit facilities totalling over EUR 255 million with 15 project partners. The projects financed with this investment will reduce greenhouse gases by 100 kilotons of CO2.

Economic return in today's environment

Due to rising inflation and the resulting increase in interest rates, the environment for investors has changed significantly, which requires an adjustment of their investment strategy. While private equity investments have proven to be attractive alternatives for institutional investors in a low interest rate environment, their future value gains now must be discounted more heavily due to high interest rates and inflation, which has a negative effect on this asset class. Against this backdrop, project financing for energy efficiency projects represents an attractive alternative to compensate for inflation-related real loss of returns, although it can be observed that banks have become more reluctant to engage in this business due to economic uncertainties and the associated default risks.

While the rise in interest rates tends to curb demand for project financing in the infrastructure sector, a high level of resilience can be observed in the energy efficiency sector. Decreasing energy price volatility, reducing energy costs, meeting regulatory requirements, or increasing potential value of buildings through better energy efficiency classification are strong drivers of the demand for energy efficiency investments. Therefore, this asset class offers a greater number of attractive investment opportunities than ever before, despite significantly higher interest rates.

Investments in energy efficiency and decentralised energy generation have many advantages

Alongside return targets, high ESG scores have been become increasingly relevant for institutional investors. The financing of energy efficiency and decentralised renewable energy generation projects offers investors important benefits.

Electricity price risk:

- No market price risk thanks to long-term purchasing agreements
- Fixed and long-term cash flows, usually independent of energy savings
- Cash flows that depend on energy savings receive additional compensation appropriate for the risk

Production and credit risk:

- Diversified counterparty portfolio with SMEs, large corporates, public institutions and private households
- Low risk of default as the assets which are financed are typically essential for the operation of the building and payments are very likely to continue even in the event of insolvency
- Asset-backed and with the possibility of feeding into the power grid as additional security

Risk-reward profile

- Little competition, asset manager must be highly specialised
- High diversification: countries, technologies, energy consumers, etc.

By assuming the credit risk of energy consumers, specialised financing solutions relieve the burden on ESCOs, allowing them to focus on the technology and its associated risks. The portfolio effect of many small projects cushions economic uncertainties. In addition, the financing costs form part of the operating costs (senior to other creditors) and must continue to be paid even in the event of insolvency as long as business operations are not completely stopped. Good examples of this include LED lighting in factory halls and the use of heat pumps for heat generation in production processes. Furthermore, the projects are structured such that they are insolvency-remote from the ESCO, so that in the event of insolvency, the operation of the project can be transferred to another ESCO. In addition, SSEF benefits from a credit default guarantee at project level, provided by the EU's "Private Finance for Energy Efficiency" programme.

Energy efficiency, a future-proof investment opportunity that is currently underutilised

The energy efficiency asset class offers investors:

- Excellent ESG scores
- Higher & more predictable cash flows
- Risk diversification
- Compliance with UN Sustainable Development Goals, Paris Agreement and EU Climate Goals

In order to achieve the Net Zero goal, it is essential that the financial barriers to the implementation of energy efficiency and decentralised renewable energy generation projects are further reduced with specialised financing solutions. The shift away from high investment costs towards ongoing service costs, offset by energy savings, will increase the willingness of energy consumers to implement these projects. The need for financing will therefore continue to grow. In addition to their significant contribution to achieving climate goals, energy efficiency investments offer institutional investors attractive returns and minimise the greenwashing risk, making this asset class an attractive addition to institutional portfolios.

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