Sustaining Generational Wealth

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Families who perpetuate generational wealth have always embraced a strategy of seeking yield, tax mitigation, and avoidance of volatility. They have also always known that their money shapes the world. Today, more than ever families are investing to meet their return targets while purposefully considering the impact on future generations.

Participating in the $250B global market for sustainable infrastructure projects can achieve those goals.

Generating fundamental value in the current decoupled economic times.
On March 14th Family Office Review published an article summarizing Somerset Capital's survey, which found that, "family offices are rotating out of cash and bonds, favoring public and private equities and real assets."1 The survey results demonstrate what some would say is a direct response to the Fed's actions to stimulate the economy. Operation twist and QE 'infinity' have injected cash, but depressed bond yields to the benefit of stock prices, which at the time reached all time high on March 5th.2 On March 6th the Economist reported that that the current public equity rally occurred in the weakest GDP growth period since WWII. The article suggests that the rally is not based on fundamental strength of companies or the economy, but rather as a derivative effect of confidence that tail events such as the break up of the Eurozone have been averted and furthermore as a move away from fundamentally unattractive bond yields.3

Investments in real assets that produce water and energy using sustainable methods generate regular cash distributions, demonstrate an attractive tax profile, and are an economical way to produce critical resources in a predictable manner. "A solar power project with a long-term sales agreement could be viewed as a machine that generates revenue," said Marty Klepper, an attorney at Skadden Arps Slate Meagher & Flom LLP, which helped arrange a solar deal for [Warren] Buffett. "It's an attractive investment for any firm, not just those in energy."4

The opportunity is neither experimental nor simply a hope and a dream. Once constructed, a project will produce and sell the necessities of our everyday lives - electricity and water - while decreasing the reliance on increasingly scarce resources. Direct investments in these commodity-generating facilities often include an agreement to sell 100% of the production to a committed buyer, and have proven the ability to distribute attractive annual cash flows for up to twenty years and beyond. With proper expertise and structuring, they present a solid investment akin to bonds and real estate.

Historically, direct access to these assets had been concentrated with strategic participants, due to regulations, specialized knowledge domains and limitations imposed on who can use the tax attributes. The past ten years have experienced an increase in participation through direct investments from major financial institutions like TIAA-CREF, Berkshire Hathaway, KKR, Goldman Sachs and MetLife. However, direct investments require an experienced in house team, who understand the complex nature of power and water markets, to uncover specific project's risks and to generate meaningful deal flow. More recently, three options have come on the scene providing a conduit for family offices to participate meaningfully: private equity vehicles like sustainable infrastructure funds, publically traded green REITs, and "green bonds". Private equity infrastructure funds target annual yields between 7% - 10%, the first green REITs seem to trade at a yield of 5% - 7% (compared to traditional REITs currently at 2% - 4%), and triple A rated green bonds, if you can get them, yield around 15bps higher than comparable US Treasuries (the green bonds tend to be oversubscribed in initial offerings frequently by large institutionals with very long investment horizons).

Commercially Viable Projects - not Clean-Tech R&D

greenfield Stories abound of well-intentioned attempts to invest in clean energy that end badly. For some of these investments, it was not clear if or when the technology would work or be commercialized (think Solyndra's failed attempt to sell a novel type of solar panel, which ultimately lost a low cost war with more heavily subsidized Chinese panels). For other investments, it was not clear if a project would receive the appropriate approvals and commercial agreements to be built (think Cape Wind's decade long battle to build a wind farm in Nantucket Sound, which is still not resolved).

Prudent sustainable infrastructure project investments differ from "clean-tech" R&D investing. First, projects utilize commercially viable technology, often sold by industrial giants like General Electric and Siemens, whereas clean-tech venture typically funds a startup company's attempt to commercialize a new piece of technology. Second, the economic profile of a project requires an upfront capital expenditure for equipment (with an expected life of 20 years or more), which will generate annual yield from the sale of an essential commodity (often under a long-term contract). Clean tech venture seeks to maximize gain sometime in the future by inventing a new way of producing or using a commodity. Venture investing can be exciting and immensely rewarding when successful, but the economic profile and risks are quite different from infrastructure project investments.

Project investments are not risk proof; however with experience as a guide, a fundamental understanding of power and water markets, and sound legal contracting, many concerns can be mitigated. Risk of principle loss is managed through appropriate contracting with creditworthy counterparties, utilizing only proven technology, and securing acceptable property rights. Volatility, like that seen in public equity markets will be less, simply because asset valuation is based on discounted cash flows. Commodity price risk and inflation impacts can decrease the available cash flows from a project, and are minimized through a production sales contract that contains appropriate escalation and indexing provisions.

In the US, renewable energy projects generate attractive tax credits and accelerated depreciation provides a tax shelter in the early years. Generally, projects will qualify for one of two federal tax credits, the Investment Tax Credit (ITC) or the Production Tax Credit (PTC), which are similar in concept but not identical to Low Income Housing Tax Credits (LIHTC). These tax credits can be used to offset certain current tax liabilities dollar for dollar. Non-corporate entities and individuals can apply these credits against passive income liabilities only, while corporations that are widely held can use these credits more broadly. The rules are well defined and a number of specialized CPA firms have considerable experience maximizing an entity's ability to monetize these credits. Additionally, these projects qualify for "accelerated depreciation" (aka MACRS) and at times "bonus depreciation" just like to the oil and gas industry, which reduces the amount of current income in early years subject to taxation. The tax code allows partnerships in these projects to allocate cash and tax attributes favorably permitting pure cash investors, pure tax investors, or blended cash and tax investors to participate.

Quoting Todd Foley, SVP of ACORE in a recent Bloomberg Businessweek article, "We're going to see more and more investors entering this sector.... There's a great opportunity here for institutional investors, insurance companies and pension funds as an alternative to bonds."4

Mr. Foley is quite right, but he should have included family offices to the list.

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1Family Office Review, Staff 3/14/2013, "Public and Private Equities and Real Assets Favored By Investors: Somerset Capital" http://www.familyofficereview.com/family-balance-sheet t/investments/article/794/public-and-private-equities-an nd-real-assets-favored-by-investors-somerset-capital

2Note: As of May 10th, both the DOW and S&P have reached higher peaks of 15,000 and 1,600 respectively.

3The Economist, Staff, 3/6/2013 "America's Stockmarket, Better than the Alternatives" http://www.economist.com/blogs/schumpeter/2013/03/ /america%E2%80%99s-stockmarket

4Bloomberg Businessweek, Christopher Martin, 3/19/12, "Solar 15% Returns Lure Investments From Google to Buffett," http://www.businessweek.com/news/2012-03-19/solar-1 15-percent-returns-lure-investments-from-google-to-buff fett#p2

