



## newnet investor profile, Scott Barrington, Managing Partner, Piper Jaffray Private Capital

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Scott Barrington

**Scott Barrington discusses the key issues facing investors into clean energy funds, the increasing interest institutional investors are taking in the sector and why the global financial crisis could yet prove an advantage for private equity.**

Piper Jaffray is a global investment bank and asset manager with approximately \$30bn under management. Founded in 1895, Piper Jaffray began investing in private equity in the early 1980s, before raising its first direct investment fund for outside investors in 1992. The Private Capital Group was established in 2000 to extend that experience into the fund of funds arena. Piper Jaffray Private Capital currently manages in excess of \$600m in fund of funds and direct investment capital. The firm raised its first cleantech fund of funds in 2005, the first such fund in North America.

Scott Barrington is the managing partner of the Private Capital group and was the principle architect of the group's cleantech fund of funds and co-investment strategy. Prior to joining Piper Jaffray, he practiced law at Dorsey and Whitney for five years, where he was a member of the emerging companies group and the M&A group. At Dorsey, he advised start-up companies and private equity firms regarding LBO and venture capital deals, M&A and IPOs. Previously, he was an analyst in the M&A department of Citigroup in New York.

### Why clean energy?

'Back in 2003, we were asked by a large family office client to look at clean technology. We did an intensive study but came to the conclusion that cleantech was not ready for institutional investment capital at the time. The technology often was not fully ready for commercialisation or was still too expensive. The quality of the management teams were not on par with other venture capital-orientated companies in the technology and healthcare sectors. The same could be said for most of the cleantech venture capital community in 2003, many of whom seemed to be investing as much for social, political or intellectual reasons. Those are admirable pursuits, but our investors demand a high return on their investment capital. We typically are targeting a 20 per cent or higher IRR for everything we do. We want to change the world for the better as much as the next guy, but we couldn't do it in 2003 and achieve a high return.

That changed in 2005. We recognised that the world demographics were being reshaped, demand for resources were significantly increasing in developing countries and a number of other macro variables were going to rapidly accelerate the adoption of clean technologies.

These factors included the rising global population and the massive movement of people from rural to urban areas; growing concerns about the cost, source and reliability of traditional energy (oil, gasoline and natural gas); and water shortages in London, parts of Australia and the American West-to name but a few. We also began to see climate change really coming to the forefront of peoples' minds. We also witnessed first-hand the improvement in the technology and the management teams in the two years that had lapsed.

We launched our first cleantech fund of funds back in 2005.'

#### **What kind of investments do you look for?**

'We committed that first fund of funds to ten managers, and it is now a little over 50 per cent drawn down, and invested in about 110 companies so far. Our focus has always been a very pragmatic one and we tend to invest in later stage companies. We like late stage, growth equity and buy-out type transactions in companies that have proven their technology is ready for commercialization and typically already have great management teams in place. We have a strong preference for investing in companies that are already generating revenue.

More than half of the companies in our first cleantech fund of funds are generating revenue. If you compare that to a typical fund of funds in the technology or healthcare sectors, that percentage might be 30-35 per cent.

For all those considering cleantech today, there is a misconception that we are investing in early stage technologies and risk-laden companies with very long-term horizons. Everyone is of course free to invest in those sorts of companies if they choose to do so, but we see no need to take an extraordinary amount of technology risk to achieve the kind of returns we are targeting.

We are seeing a lot of companies that have been around for a long time, with solid management teams and revenue and are really just looking for growth capital. They have been waiting for the world to catch up to them. Their time has come. Businesses such as these are often found in the energy efficiency, recycling, water or building materials spaces and to a lesser extent in energy generation.

When you mention cleantech, most people immediately think of solar, wind or fuel cells, but the space is so much broader than that. The areas where we see some of the biggest opportunities tend not to be the headline-grabbing ones.'

#### **Could you tell me more about your investors?**

'A traditional fund of funds investor base is made up of small and mid-sized pension plans and endowments, foundations and high-net worth individuals. Our cleantech investor base is similar but has also attracted the attention of some of the largest pension plans in Europe and the USA. Typically the biggest pension plans and other institutional investors have their own private equity capability in-house but many of them are recognising that cleantech is a rapidly developing and complex investment sector and that we can help them take advantage of the opportunities in it, while avoiding many of its potential pitfalls. Although they normally would not use a fund of funds for private equity investments, they see that we are fully five years ahead of them in terms of cleantech insights and access to the top managers worldwide-a subset of about ten managers in a universe of 300.

Several large pension plans have approached us about creating cleantech separate accounts for them for precisely these reasons. I expect we may do one of these in 2009 but it would have to be on behalf of the right long-term strategic partner.'

#### **Do you make co-investments?**

'Yes. They are an important part of the value we deliver to our investors. All of the senior

partners and investment committee members of the Private Capital group are seasoned private equity investors and valuation experts, having come from backgrounds that include investment banking, venture capital and buy-outs. So we are geared for direct investments and strategically positioned to proactively take advantage of the co-investment opportunities that arise from our fund of funds business and from the direct investment position we have created for ourselves over the last decade.

The key is being proactive. Most fund of funds managers seem to be reactive. They wait for their underlying managers to bring them a deal. Call me a cynic but those types of deals are often the dregs of the portfolio, the walking wounded. In contrast, we proactively identify key investment themes and then pursue the best companies within those investment themes—growth businesses in the recycling sector or the cheapest commercially viable energy storage company for wind and solar energy that can be used for peak load shaving, for example. We are in constant communication with our underlying managers and others in the industry in order to communicate the kinds of companies we are looking for and to identify the best ones for investment.

The Private Capital team's deal sourcing capabilities, valuation knowledge and investment insights are augmented by a group of about 50 other Piper Jaffray professionals across Europe, US and Asia. These other resources add capital markets and liquidity insights, regional investment and regulatory expertise and industry sub-sector knowledge. For example we regularly tap into the wind, solar, water, energy efficiency and advanced materials expertise of Piper Jaffray's equity research teams to help us investigate particular companies in which we might invest and also to broadly identify investment themes for potential new areas of investment. These additional global resources give us a significant advantage over standalone funds of funds and newcomers to the sector.

We typically structure our investment programmes to provide a menu of choices so investors can invest in whatever subset of private equity they need at the moment. For example, in any programme we may offer several fund of funds options (cleantech, VC, buy-out, distressed, secondary, etc.) and a co-investment option. We are currently investing out of a cleantech-focused co-investment fund. We have a pragmatic, some would say almost sceptical approach to cleantech investing. This co-investment fund is focused on late stage and growth equity opportunities, typically in companies that are already generating substantial amounts of revenue, that have little or no technology risk and that are addressing very large global markets.

Today, we have several hundred investment opportunities that meet these criteria under review, but we are focused on about 20 distinct opportunities at the moment, including investments in the following areas: direct drive wind turbines, thin film solar cells designed to replace roofing shingles, flow batteries for storing solar and wind power, energy efficiency (tech and services), LED lighting, waste-to-energy, optical coatings to improve solar cell efficiency, transportation fuel catalysts, third generation biofuels (not from feedstocks), hydro power and aquaculture. The environment for making new late stage investments is as favorable as we have seen it in several years in terms of valuations and deal terms.'

#### **Which areas are of particular interest?**

'We already have made investments in the recycling sector and the electric transportation sector, so I didn't name those specifically just now. But the transportation industry is an area that we are looking at very closely for additional investments. It is clearly shifting to an electric mode. We previously had avoided biofuels because of the commodity risk, price volatility and other issues surrounding it. However, there is a real need for biofuels, at least in certain limited roles like jet fuel and commercial trucking and distribution. We are cautiously reviewing about 30 biofuels deals looking for the right one. But more importantly we are

believers in the eventual electrification of personal transport. Relatively soon, perhaps by the end of 2010, you and I will think nothing of plugging our car in each night as we return from work, just like we do with our cell phones. There is a vast landscape of opportunity in electric cars and the mechanical and software systems and infrastructure that goes with them.

Solar also is an area of deep interest to us, although there are a lot of companies and technologies from which to choose. The solar sector is undergoing significant and very rapid innovation. The public is going to begin to see amazing breakthroughs in conversion efficiencies, resulting ultimately in very cheap solar power, within the next three years. Right now, we are parsing through several low-cost, high conversion efficiency companies that we think can scale to become significant businesses in 12 months or less. We also are looking further downstream to installation service businesses because we can invest in companies that are already generating substantial revenues.

Energy efficiency for homes, businesses and public places is another big area of opportunity. Often these opportunities revolve around more efficient lighting or HVAC systems. Batteries and other forms of energy storage are other areas of related investment opportunity for us. Water purification, waste energy - all of those areas are ones that we are closely looking at right now both for our fund of funds programme, and also for our direct investment programme.'

#### **Are there any sectors that you feel are played out?**

'There are a couple of areas that we seek to avoid. We do not like technology risk, or at least not an excessive amount of it. We also tend to avoid companies that are heavily dependent on subsidies or other government support, although that is growing increasingly difficult in the wind and solar sector these days.

We also dislike carbon offset programmes and carbon trading markets. There is an inherent and significant risk of fraud in those businesses and no practical way to police them on the world stage.'

#### **What challenges do you face?**

'The lack of tax equity and debt financing for capital-intensive projects like wind and solar farms is a big problem right now. The problem resulted from the global credit crisis. The lack of available financing has slowed or stopped many projects and that has ripple effects all the way up the supply chain to the wind turbine manufacturers and solar ingot manufactures. Financing will return in the relatively near term, perhaps in other forms like government guarantees or direct government loans. But for now this is a challenge many cleantech investors are striving to overcome.

Another challenge is the misconception that the success of the cleantech industry is somehow tied to the price of oil. We think a link between the two is unjustified because cleantech industry is so much broader than biofuels or other substitutes for oil. To demonstrate this you only need to look at our 2005 cleantech fund of funds. Less than five per cent of that fund was invested in biofuels or oil-related sectors, while the other 95 per cent is invested in wind, solar, energy efficiency, energy storage, water, transportation and other sectors. The price of oil only matters in that high prices galvanize support for cleantech and drives additional investor interest in it. But recognise that our few biofuels investments are designed to be cost competitive with oil at just about any price-they have to be in order to justify investment in them. So I guess we should root for high oil prices when we are raising a new fund, but otherwise we don't care much what it is. It isn't irrelevant but it also isn't the dominant factor for the broader industry.'

#### **What are the advantages?**

'As odd as it may sound, the clear advantage for our direct investment fund right now is the dislocation the entire private equity industry is experiencing due to the global economic slowdown. The IPO window has closed and investment capital, as a general rule, is relatively scarce. A number of companies that were making very good progress, generating revenue and on a great growth trajectory were filing for IPOs and planning to raise their next round of financing publicly. Those plans are on hold and many of those companies need growth equity. We and a handful of others are able to provide it to them. We will make growth equity investments in this market and be very well positioned for when the IPO window opens up later in 2009 or perhaps 2010.

An advantage for our fund of funds programme is that periods of economic stress tend to thin the herd of its weakest members. The politically motivated fund managers and dabblers will be unable to raise new funds, ultimately resulting in less competition and lower pre-money valuations for our stable of underlying managers. At some point in the future, I'm confident we are going to look back on the next 18 months and see that they were a very good time for putting money out the door. While many inexperienced managers are sitting on the sidelines or returning to their prior investment strategies, our underlying managers are busy building the next generation of great cleantech companies.'

#### **How can you see the space evolving?**

'We learned a number of things from our prior cleantech fund of funds. One of those was that we do not need to take a lot of technology risk in order to make outsized returns at this point in time in this particular sector.

There has also been this long-standing perception that when you are investing in anything that is venture capital-oriented, the best opportunities often come out of Silicon Valley. Cleantech doesn't fit that perception. The best cleantech opportunities are widely dispersed geographically. Our first two big homeruns came out of Wisconsin and New Hampshire in the US (Orion Energies, ticker: OESX and GT Solar, ticker: SOLR). In recognition of this, only one of our underlying fund managers is based in Silicon Valley, while the rest are spread across the US, Europe and Asia. We are very optimistic about the opportunities in Asia, particularly China where the government fully understands the environmental and demographic challenges it faces and is vigorously and effectively addressing them.

In China, the opportunity set runs from cutting edge to the mundane, from next generation solar companies to fish farms to decades old hydro power technology. Frankly, we prefer the "mundane" high growth businesses to cutting edge risky ones. That kind of mundane is just fine with us.'

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