ALTERNATIVES WATCH

Napier Park harnesses the real asset opportunity

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L-R: Manu Rana, Chris Sparrow at Napier Park Global Capital

Napier Park Global Capital's Manu Rana and Chris Sparrow have a handle on facts and figures that are poised to reshape not only the world but economic realities for generations to come — and that's only part of the real asset story the pair are focused on now.

Over the next decade or two, the global aircraft fleet is expected to grow to roughly 40,000 planes, said Rana, senior managing director and head of real assets at Napier Park Global Capital in a recent interview with Alternatives Watch. As of March 2023, Rana and his team oversee over $6 billion in equipment assets — but that is a drop in the hat for a sector opportunity that is poised to grow into the trillions of dollars.

The business is complementary to the New York firm's well-known credit and CLO strategies and centers on equipment assets and seeks to generate attractive returns through investments in long-lived essential use renewable energy and transportation equipment. The firm's existing investments include JVs with operating partners, including Air Lease Corporation, Trinity Industries, Inc., AAR Corp., Ethical Power Ltd. and Heritage Global Inc.

"We move things, people and electrons," Rana said, adding that in the firm's "meat and potatoes" approach to buying equipment, such as rail cars, moves industrial products, scrap steel, paper and pulp. Airplanes and rail move people, while power generation and storage segments move electrons.

The aim is to provide long-dated cash-based returns that are attractive and that are sensitive to interest rates and inflation. It is compelling in that the investment program is not only not correlated with financial markets but is also reflective of global consumer demands.

According to Chris Sparrow, a managing director who joined Napier Park in 2019 from the aviation principal investment team at DVB Bank, there are number of key trends in the last year he has seen that are setting up the real assets portfolio for the next decade.

One of those key trends are the positive relation between inflation and interest rates. “We think inflation will be set at a higher rate than it’s been over the last 10 years,” he said. In turn inflation is linked to CPI and effects energy contracts or the cost of building something like a new rail car.

Capital expenditure — or Capex — in the U.S. and Europe is expended to be at much higher level than in the years past. In Sparrow’s view, it will likely be 7-8% going forward. Higher Capex means more materials being transported.

Whether it is the global supply chain, transportation or renewable energy, Napier Park owns the physical equipment is able to lease or contract it out to commercial counterparties for 10-15 year timeframes. The investment methodology is sensitive to inflation. As inflation goes up, typically so does the value of the underlying assets, should they need to be sold.Rana added that over last 10 years, Napier Park has tracked low to negative correlation to financial markets and private credit, because ultimately the firm owns the metal. He said that the firm is often the lead investor in the sector in terms of scale and scope after nearly 15 years in managing real assets. The track record has helped them to drill down to specific details, helping them to extract higher quality returns, such as through being able to access financing through ABS and debt markets at low absolute and relative levels.

Institutional investors have been piling into real asset strategies in the last 12-18 months as a hedge to persistent inflation. While some allocators include real estate and infrastructure under the real asset label, it seems to be a straight-forward definition of any strategy that includes ownership of real, tangible assets.

In the second half of 2022, *Alternatives Watch* tracked a notable pick up in real assets allocations. As mandates begin to be filled in early 2023, a focus on sustainability is starting to pick up as well with renewable energy taking center stage even among investors that are not active within the ESG space.

In December 2021, Napier Park and Ethical Power’s joint venture, Lyhner Energy, was established to invest in large utility-scale solar and battery storage assets in the UK and Europe.

Ethical Power acts as a servicer to the joint venture, including the provision of services relating to development, construction, operations and maintenance, and asset management. The partnership invests in development assets to which Ethical Power can bring its experience in the design, optimization and construction of renewable energy projects to build high-quality, valuable assets.

The venture’s aim is to invest directly in the assets that serve a critical function in the reduction of carbon consumption and transition to green energy sources. The global green energy transition has been a key focus for the Napier Park team in their long-term view on real assets.

The decarbonization theme is continually front and center in the Napier Park playbook. The cost of delivering renewable energy is now below that of traditional energy sources, added Sparrow. Until very recently, nearly all renewable energy assets were backed by government subsidies. This means that investing in those assets required a 20-year contract with the U.K. government, for instance.

Now the story is one about access as those subsidies fade and the war in Ukraine has sharpened the focus on access to secure power, leaving corporations seeking to hedge out energy prices and meet net zero commitments.

Sparrow has seen the number of corporate power purchase agreements (PPAs) soar since 2019 to 2022. For Napier, the investment in the generator is exchanging market generation risk with contraction to a highly rated corporation. “What that means now for portfolio construction is that these portfolios are diversified assets with multiple creditworthy counterparties,” Sparrow observed.

For instance, if Napier owns a solar farm they can provide the capital for that asset to be built, and once it generates electricity then they are paid by a corporation for the energy. Napier would then own the facility and the equipment used to run it. Entering into a 10-year PPA would allow them to generate cash returns.

Looking at the energy generation market itself, it represents potentially a multi-trillion-dollar market, the pair estimates.

"The last 12 months has brought energy security to be an even higher priority than decarbonization," Sparrow said. "There will be a real drive of governments to make policies for more affordable decarbonized energy."

This trend will continue to drive Napier Park's acquisition of pre-construction renewable energy projects directly from greenfield developers after all the binary risks for project approval have been overcome. They see the project through the late stages of development, where they can add significant additional value through design enhancement, grid connection capabilities and superior execution.

They've also acquired new-build, fuel efficient aircraft, which in a way is uncorrelated from the electrical generation play which will rise in value as energy prices rise as aircrafts will become more valuable as oil prices decline. They have also focused on energy storage which adds additional long-term depth to the portfolio.

It is hard to ignore the attractiveness of the assets in the portfolio as the world economy continues to shift with Central Banks raising interest rates in tandem.

"For us, it is a pretty exciting time in that we've seen physical assets takes center stage post COVID," Rana said. "Holding physical assets has been profitable for a long time and now people have recognized that value."