

Supporting the Clean Energy Transition: Opportunities in Emerging Markets Debt



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Emerging markets are missing out on the wave of clean energy investment seen since 2020, according to the International Energy Agency (IEA):

“Global clean energy investment has risen by 40% since 2020, reaching an estimated \$1.8 trillion in 2023, but almost all the recent growth has been in advanced economies and in China. By contrast, other emerging and developing economies account for less than 15% of total investment, despite being home to 65% of the world’s population and generating about a third of global gross domestic product.”

As the IEA points out, all pathways to a successful transition require expanding capital flows to clean energy in emerging economies, many of which have fast growing energy demand. It identified five priorities to keep “1.5°C alive” in its 2023 World Energy Outlook. Most notable was the need for three times the current level of investment in clean energy in emerging markets ex-China by 2030 versus 2022.

Bond opportunities in renewable energy

At Lazard, we have identified several investment opportunities in both emerging markets equity and debt (EMD) — our focus in this article — created by the clean energy transition.

Among the transition-related investment openings in EMD, some of the most significant arise from the growth in renewable power projects. Many emerging economies benefit from material solar and/or wind generation potential. This could help these countries meet their growing energy demands and accomplish the global aim of a just transition. A combination of major wind and/or solar generation potential, improving regulatory frameworks, the de-risking of renewable technologies, and growth in power demand suggests genuine possibilities in this space.

Ramping up renewables in India

We believe India’s drive towards renewable energy generation, in particular, offers the potential for attractive risk-adjusted returns for fixed income investors. Based on our proprietary EMD climate risk scores, which cover around 85 emerging economies, India is one of the highest scoring countries in terms of its economic solar potential. This is reflected in the large number of domestic and international companies investing in renewables within the country.

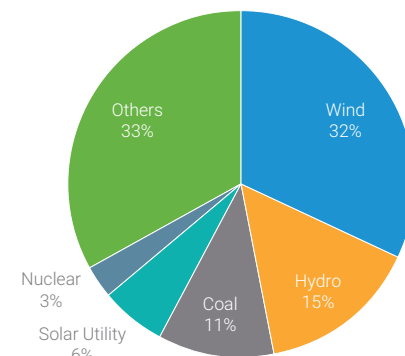
In response to population and economic growth, Indian electricity demand is expected to grow rapidly. According to CRISIL MI&A Research (CRISIL), demand is expected to rise by 7.0% - 7.5% in FY2024 to 1,615-1,620 terawatt hours and will expand at a compound annual growth rate of 5.0% - 6.0% between FY2024 and FY2028, with further growth expected beyond this period.

Historically, India has relied on coal-fired electricity generation, given its relatively low cost as well as the fact that the country has little domestic natural gas production. However, the government is pushing to increase renewable generation for environmental, economic and energy independence reasons. Its target is to grow non-fossil fuel-based energy capacity from ~200GW (gigawatts) to ~500GW and meet 50% of its energy demand through renewables by 2030.

Hitting these targets would require new wind and solar installations of ~300 GW by 2030, including ~235GW of solar and ~65GW of wind. Although these capacity addition targets appear ambitious, it is worth noting that renewable energy development in India has already moved beyond being driven by government incentives, as coal-based generation costs are nearly twice renewable energy costs. From 2018 to 2023, renewables’ share of total capacity across India increased from 30% to 40%, while coal’s share fell from 55% to 49%. This is still high compared to many countries, but it does not give full credit to the scale of India’s efforts. Renewable generating capacity has increased from 100GW to 165GW over those five years and accounted for some 90% of capacity growth in the period.

Looking ahead, CRISIL expects this increased renewable focus to limit conventional capacity additions to 46GW - 48GW over the next five years. Over the same period, renewable energy capacity is anticipated to more than double from current levels of ~165GW to ~340 - 350GW by FY2028, excluding battery storage and hydropower additions (Exhibit 1). Renewables would account for around 49% of total electricity capacity, which is expected to reach ~700GW by FY2028.

Exhibit 1: Projected Indian electricity capacity additions FY 2024-2028



Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.
Source: Central Electricity Authority (CEA), CRISIL

The need for external capital

India’s large build-out of renewable energy generation has and will need financing; CRISIL expects investment in the power sector to surge 25% - 45% to INR17 - 19 trillion (US\$200 billion - US\$225 billion) between FY2024 and FY2028, with generation forecast to account for 60% - 70% of overall investment.

Historically, the main source of financing for renewable generation projects has been credit lines taken from domestic banks. Looking ahead, despite the need for massive investment, CRISIL anticipates funding from banks will be subdued, with banks expected to adopt a cautious approach in lending to the power sector. This presents a need and opportunity for international bond investors, primarily in US dollars, as India looks for

external capital to fund a sizeable portion of the country’s renewable energy development.

While we have identified several Indian companies with robust growth opportunities in renewables, there are, of course, risks. These include the availability of transmission infrastructure, funding availability, counterparty risks, political risks, and debt levels. To that end, we believe active management is essential as it gives us the opportunity to review individual bond deals and assess each of these risks.

Investing in the energy transition through sovereign bonds

Sovereign sustainable and green bonds also present a growing opportunity to invest in energy transition initiatives in several emerging market countries. Sustainable bonds give investors the chance to invest in projects directly linked to a just transition, as their proceeds can be used to fund either green or social projects.

In determining whether we believe a sustainable bond framework is robust, we initially consider several factors. These include whether the framework meets the appropriate International Capital Market Association (ICMA) guidelines; national policy frameworks for environmental and social issues; external party reviewers; independent environmental project reviews; inclusion of relevant ministries in project selection; and work with international organisations on designing projects.

Chile: A leader in labelled bond issuance

Chile stands out as a leader in sustainable bond issuance. Based on the country’s sustainable bond framework and taking into consideration the bottom-up macroeconomic and valuation factors for Chilean assets, we find some of Chile’s ESG-labelled bonds appealing.

In our evaluation of the issuer’s framework, we noted positively that Chile had initially identified six eligible green sectors, including a variety of industries in the project selection group. Chile also has several national initiatives on social and environmental issues, while the Chilean government is committed to having an independent assessment of all environmental projects. On the downside, the country has limited plans to partner with international organisations.

With respect to reporting, the Chilean Ministry of Finance has committed to both an annual allocation report and an annual impact report. To date, annual reporting has met expectations, confirmed by an audit by Ernst & Young. Most of the proceeds from Chile’s sustainable bonds have been directed towards social projects rather than green projects. However, given our view that in many emerging markets economies investment in a just transition is crucial to achieve economic and political stability, this, among other factors, should help support positive investment returns.

Chile’s robust commitment to sustainability is evidenced by the fact that the government has issued over \$30 billion of dollar or euro-denominated sustainable, green, social, and sustainability-linked bonds

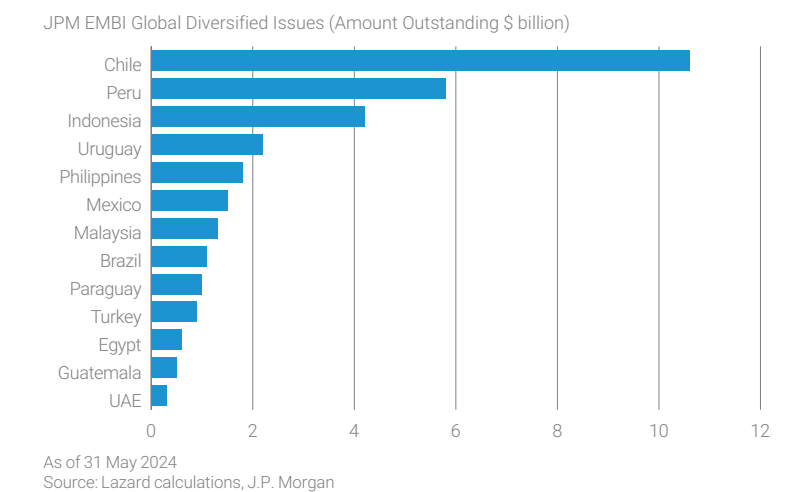
Past performance is not a reliable indicator of future returns and does not guarantee future results.

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since 2019. Chile was also the first sovereign to issue a sustainability-linked bond, and it has issued more bonds eligible for the JP Morgan EMBI Global Diversified index than any other country in the index (Exhibit 2).

Exhibit 2: EM hard currency sovereign labeled bonds



In addition to the country’s focus on sustainability through its debt issuance, Chile is well endowed with many of the natural resources that we believe will help the country to become a leader in energy transition, both domestically as well as in supplying natural resources and products to global markets.

Our EMD and Sustainable Investment & ESG teams have developed a sovereign climate risk scoring tool to better understand a country’s willingness and ability to transition, as well as its vulnerability to physical climate risks. Currently, our model looks at 21 variables across willingness (e.g. policy and regulatory environment, actions taken and employment), ability (e.g. natural resources and trade), and vulnerability (e.g. susceptibility to the physical risks of climate change).

In our analysis focusing on transition, willingness and ability, Chile emerges as a top performer, with a number of significant opportunities in energy transition. In our view, this makes an investment in the country’s sustainable bonds potentially more attractive.

The shift to a world powered by clean energy is under way, but with the exception of China, the emerging economies need to play a greater role in this transition. This will require a substantial increase in external investment. From a debt perspective, we believe active investment can identify the companies, including Indian renewables companies, and countries, such as Chile, making the clean energy drive possible while potentially providing attractive risk-adjusted returns for investors.

¹<https://www.iea.org/news/bringing-down-the-cost-of-capital-is-key-to-unlocking-clean-energy-growth-in-emerging-economies>

²<https://www.iea.org/reports/world-energy-outlook-2023>

³World Bank ESMAP Global Solar Atlas

⁴Ministry of New and Renewable Energy, Government of India

⁵Central Electricity Authority (CEA), CRISIL, “Industry Overview”, Adani Green Energy Offering Memorandum February 2024

⁶CRISIL, “Industry Overview”, Adani Green Energy Offering Memorandum February 2024

⁷CRISIL, “Industry Overview”, Adani Green Energy Offering Memorandum February 2024

⁸Bloomberg, May 2024

⁹BNP Paribas, March 2022