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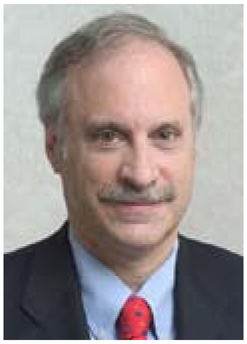

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The New Business Model for the Green Space

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Having run an energy and environmental venture fund for two years and seeing many well intentioned but uncommercial alternative energy projects, it occurred to me that something new needed to enter the "Green Finance" space. Things tend to happen when you least expect them. Call it serendipity or just dumb luck, but that's what's been revealed to me recently as I entered the energy & environmental hedge fund world a year ago. Venture capital wants returns. Hedge funds want those returns even faster. So, what's a poor entrepreneur to do? Impatient investors want returns and don't want to hear that you didn't make your numbers.

It may be helpful to review what is now occurring in the "Clean Technology" also called Clean Tech space recently. When mainstream press like *Business Week*, *Forbes* and *The Economist* all have articles in one week on this topic as it did in June 2005, the time has arrived for green technology for main street to take a hard look. But the space is very different than many envision. Unfortunately, it is now frankly over-hyped, and I am seeing poorly conceived business plans getting funded. So-called "science experiments" don't cut it on Wall Street where I live. The mantra of good venture projects for the clean technology space, as with any other venture capital project, is "revenue stream, seasoned management team or repeater CEO, exit strategy." Science experiments in this space today are mostly funded by the Pentagon as they have the deep pockets to fund financially unsustainable technologies (since when has the government ever been run like a business with a P&L). Many of these technologies are so debt ridden that they will never be commercially viable. They depend on government funding to continue their research and perfect their commercial applications. I would add to this equation all those hydrogen economy projects that the United States' DOE is now so fond of should be included in this science experiment group.

As has been stated in this column before, we should be ramping up both hybrid engines and gasification of coal technology for rapid deployment and commercialization. These are two fundamental energy technologies that work and would contribute most effectively to the dual goals of energy efficiency and emissions reductions using today's technology.

Another more interesting play to savvy investors is second stage investments that do have revenue and will make money for investors. Several venture funds are focused on these. And it's now the turn of energy and environmental hedge funds to focus on them as well.

Then, what about angel investors? The angels will fund these start ups in the green space but many are a "wing and a prayer" and not well conceived. Already, we are starting see some congestion in the Photovoltaic nanotechnology space as the hype outpaces the accomplishments. That is not to say that that they don't get their money and launch their IPOs. What it is to say is that most are not good investments, but you can't stop the nano wave hype that is now upon us.

Two weeks ago in New York, Euromoney and Acore (American Council on Renewable Energy) ran their second highly successful Renewable Finance Forum with over 600 attendees. There is plenty of capital available but few good deals was the consensus of those in the know. Merchant wind which was hot six months ago now looks over banked as a banker colleague remarked. So, what's the outcome of all this confusion?

Well, for one thing, the timing is right for the clean tech space as higher energy are now sustainable due to underinvestment in the oil and gas industry globally. Higher demand growth will drive return on investment (ROI) higher in the clean tech space. But, what about the trading markets and the reduction of project costs? Well, the new model that has emerged for lack of a better term is hybrid that is somewhere between venture capital and hedge funds. They require a capital commitment of investors of two to four years (called a lock down) and a capability to trade the renewable energy credits and emissions reductions (SO_2, NO_X and carbon). These green streams of revenue reduce the cost of capital for the project, but also bring liquidity to much needed emerging environmental financial markets.

This model also makes sense for institutional investors, who tend to be more conservative and want established metrics before they invest. Well, in an emerging market we have emerging metrics. The criteria has changed. This hybrid model makes sense and some pension funds that have loudly announced that they want to invest in this space need to understand what is really happening in this space. Noble intentions on greenness notwithstanding, the point is investments must show returns and that counts for green investments as well. It's called fiduciary responsibility

Today, both green trading and green finance have converged to bring forth a new business model for the green sector. The ability to bank finance these investments is of critical importance as venture capital and hedge fund investment will never be as large, liquid and fundamental as bank financing. The capital markets now have too much capacity chasing LNG deals and some of that capacity needs to be directed to this sector. I recently met with a $15 billion hedge fund in New York that is looking seriously at these illiquid markets. I asked them if they wanted to club deals (syndicate with others), they said no, and that they don't do business that way. They want the first mover advantage in illiquid markets. They are smart, well-capitalized and understand the meaning of arbitrage. Welcome to the green club!

The true convergence of the capital markets and the environment is now upon us. In Europe, the focus is on renewable and the over hyped carbon markets now reaching almost 30 euros for a ton of compliance carbon. In the U.S., its venture capital and hedge funds plus Goldman Sachs. When Goldman bought the 4,000 MW Zilkha wind energy portfolio in 12 states, it was a wake up call to Wall Street. They smell the coffee and see the money. The recently passed energy bill is just icing on the cake with production tax credits and all manner of subsidies.

And it is not too farfetched to start seeing Green MLPs (Master Limited Partnerships) peddled to high net worth individuals just like oil and gas limited partnerships. The time is now. The business model has changed. Stop funding science experiments and start to focus on the real green revenue stream in solar, wind, and biomass investments. That's where the real green is!

Peter C. Fusaro is chairman of New York-based Global Change Associates, creator of the term Green Trading, adviser to both VC and hedge funds, co-author of the new book, *Green Trading Markets: Developing the Second Wave* (Elsevier, July 2005), and author of the GCA-UtiliPoint® consulting report *Green Trading Markets: How Environmental Financial Markets Work* (April 2005). Go to www.global-change.com for more information.