Looking for Returns South of the Border: Examining the Investment Potential for Renewable IPPs in Mexico

Event
In the following Research Update we take an in-depth look at the potential attractiveness of Mexico’s evolving renewable power market for Canadian independent power producers (IPPs).

Highlights
- **We see the Mexican renewable power markets as a potentially attractive source of long-term growth for Canadian IPPs.** Mexico has the potential to become one of the most attractive power markets for new renewable investment, driven by (1) recent energy market reforms that have restructured the country’s power market, (2) strong underlying economic and power demand growth (estimated at 3-4%/year), (3) a historical reliance on legacy fossil fuel power supply (~83% of supply), (4) national targets for renewable power supply as a way to reduce greenhouse gas (GHG) emissions (a 35% target by 2024), (5) sizable renewable resources that could theoretically generate over 15GW from hydro, over 50GW from wind, and over 5,000GW from solar, and importantly, (6) the development of a clean energy auction system that awards long-term power contracts to renewable power developers.

- **A watershed moment: The country’s first clean energy auction awarded competitively-priced long-term power contracts to renewable IPPs.** Mexico recently held its first successful clean energy auction, where renewable IPPs were awarded long-term power contracts for ~5.4TWh/year of renewable energy supply and associated renewable energy credits to be sourced from an estimated 2GW of new wind and solar capacity. Winning bids in the auction were competitively priced at an average US$42/MWh, indicating significant confidence from renewable IPPs in underlying investment conditions. We see the auction as a watershed moment for the Mexican power market, signalling that renewable IPPs are eager to compete in Mexico. The second clean energy auction is expected to come this fall (with details to be revealed shortly).

Recommendations
**We believe that several Canadian IPPs are looking closely at the opportunity to secure long-term contracts in Mexico.** We highlight AQN, BLX, BEP, INE, NPI and PEG as renewable IPPs in our coverage universe that we believe are looking at future potential investment opportunities in Mexico. Although we believe that it is early days for Canadian IPPs in the rapidly evolving market, we would not be surprised to see one or more of the aforementioned companies involved in the second clean energy auction, either alone or in conjunction with local developers. At this point, we believe that investors have not yet ascribed any value to these companies for their development activities in Mexico to date. Refer to page 9 for company-specific details.
Renewable Power in Mexico

Mexico’s Energy Reforms

La Reforma Energética and Mexico’s electricity market reforms. In 2013, Mexican President Enrique Peña Nieto announced the Reforma Energética (Energy Reform), a broad set of reforms targeting the country’s energy sector. Over the next two years, legislative changes were made to Mexico’s constitution allowing for the reforms to take place. As part of the broader reform process, Mexico has enacted several changes specific to the electricity sector, including a restructuring of the power market and the national electric utility (the Comisión Federal de Electricidad, or CFE). Importantly, CFE has become a state-owned enterprise (rather than a government entity), and the utility’s functions have been unbundled (i.e., independent CFE-owned subsidiaries are now responsible for power generation, transmission, distribution and retail operations). Elsewhere, the reforms have created a new wholesale power market for private IPPs to sell power on a merchant basis; the market is operated by an independent system operator (ISO), the Centro Nacional de Control de Energía (CENACE).

The effect of Mexico’s reforms has been to open up its power market to outside competition and investment. The reforms have reduced the role of the state (CFE) in the power sector and allowed for competition in the market by way of greater private sector participation in investment opportunities, particularly in the generation and sale of electricity. As we highlight below, the energy reforms have (so far) also created an opportunity for renewable IPPs to enter a new market.

Exhibit 1: Snapshot of Mexico Electric Market

Source: Secretaría de Energía, IA Securities Inc.
The Renewable Power Opportunity in Mexico

Power Market Drivers

Electricity demand in Mexico is expected to grow by 3-4%/year (2015-29). According to the Secretaría de Energía, Mexican power demand is expected to grow by 3-4%/year through 2029, driven primarily by steady population growth (2-3%/year) and GDP growth (4-5%/year over the term; 2.6% in 2016, according to the IMF). Forecasts indicate that Mexico will require ~20GW of new power generation capacity in the next decade and ~60GW required by 2029 to meet expected demand growth. Demand growth is expected to drive investment of ~US$116B over the next 15 years across all components of Mexico’s electricity infrastructure (generation, transmission and distribution).

Exhibit 2: Forecast Population Growth, GDP and Electricity Consumption (through 2029)

Source: Secretaría de Energía, IA Securities Inc.
Historically, Mexico has relied heavily on fossil fuels for electricity generation. As indicated below (Exhibit 3), fossil fuels have historically represented an important component of Mexico’s overall generation mix, with ~83% of the power supply derived from gas, and to a lesser degree coal and oil. By comparison, as of 2013, total installed wind power capacity stood at less than 2GW, while solar capacity was ~100MW (vs. ~64GW total installed capacity). Historically, Mexico’s dependence on fossil fuels for power generation has put upward pressure on power prices when fuel prices have increased, particularly for power prices in the non-subsidized commercial and industrial sectors.

Exhibit 3: Capacity and Generation Overview Compared to North America


Exhibit 4: Average Price of Electricity by User (2004-14)

Source: Secretaría de Energía, IA Securities Inc.
Mexico aims to diversify its power supply and reduce GHG emissions with a 35% renewable power target by 2024. Mexico recently reiterated its long-term climate change commitment at the COP21 proceedings in Paris, where the country committed to a 22% reduction in GHG emissions by 2030.¹ As part of its climate change strategy, and in an effort to diversify its power supply, Mexico has established a target for 35% renewable power generation by 2024, with interim targets set at 25% by 2018, and 30% by 2021. Based on the country’s forecasted demand growth, we estimate that the renewable power target could translate into ~161TWh of energy supplied from renewable sources by 2024 (vs. just ~51TWh in 2013).

Exhibit 5: Renewable Power Targets in Mexico (TWh/year)

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<tr>
<th>Year</th>
<th>Target</th>
<th>Source</th>
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<tr>
<td>2013</td>
<td>51 (17%)</td>
<td>Mexico's renewable energy potential</td>
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<tr>
<td>2018E</td>
<td>271 (75%)</td>
<td>Mexico's renewable energy potential</td>
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<tr>
<td>2024E</td>
<td>297 (83%)</td>
<td>Mexico's renewable energy potential</td>
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Source: iA Securities Inc.

Significant availability of onshore wind, hydro and especially solar resources in Mexico. Mexico’s overall renewable power potential is significant, particularly for solar development, according to the International Renewable Energy Association (IRENA).

- **Hydro.** Large-hydropower potential in Mexico is estimated at ~6GW (based on economic projects greater than 30MW in capacity), while small-hydropower could produce a further ~9GW (installations of up to 30MW in capacity).² Potential capacity lies mainly on the rivers of the Pacific Rim, and in Veracruz, Oaxaca, and Chiapas.

- **Onshore wind.** Meanwhile, onshore wind power potential has been estimated at ~50GW capacity. IRENA has identified three primary regions with the greatest wind potential, including (1) the Isthmus of Tehuantepec (particularly Oaxaca, southeast of Mexico City), (2) the states of Tamaulipas (in northeast Mexico) and Baja California (northwest Mexico).

- **Solar.** Most significant, however, is Mexico’s solar power potential. The daily average solar irradiation for Mexico as a whole is estimated at ~5.5KWh/m², while the northwestern region of the nation has a higher solar potential with average irradiation in the region exceeding ~8KWh/m². Based on the significant solar resource, IRENA estimates technical potential capacity at up to 5TW (i.e., 5,000GW, which could theoretically generate more than enough power to supply all of North America combined).

Exhibit 6: Wind and Solar Resources in Mexico

Source: GHI Solar Map, AWS Truepower, iA Securities Inc.

Exhibit 7: Map of Mexico’s Major Rivers

Source: Maps of World, iA Securities Inc.
Mexico’s First Clean Energy Auction

Mexico’s first competitive clean energy auction procures ~5.4TWh/year. Mexico announced an initial auction for clean energy (which includes renewables plus certain types of efficient natural gas), with the intent to award 15-year contracts for up to 6.3TWh/year of energy, 20-year contracts for the same amount of clean energy certificates (known as CELs), and 15-year contracts for up to 500MW of capacity. After receiving significant interest (227 bids from 69 participants, for an estimated 800-900MW and 100-110TWh/year), CENACE announced preliminary results to the auction on March 31, 2016 (later updated to correct a bidding error). A total of 11 winning bids were selected from 7 companies, representing a total of ~5.4TWh/year of energy and CELs, or ~85% of the auction target and ~2% of total energy supply in Mexico. The bidders are expected to achieve commercial operations dates in Q1/18.

Pricing came in much lower than expected, leaving some IPPs to scratch their heads. The winning contracts and CELs were sold at an average price of US$41.80/MWh, with prices for solar contracts averaging US$40.50/MWh and wind contracts averaging US$43.90/MWh. The lowest bid in the auction was US$35.44/MWh for a ~427MW solar block submitted by Enel Green Power (EGP). According to various industry sources, this is currently the lowest auction price on record, globally, for solar power (illustrated below); for further comparison, we note that Ontario recently awarded contracts for solar capacity at a weighted average price of $156.67/MWh (~US$120/MWh).

We believe that pricing was very competitive for several reasons, including (1) the availability of USD indexing in the PPAs, (2) a credit-worthy counterparty in CFE (rated BBB+ by S&P), (3) access to low-cost capital by renewable IPP developers (i.e., 10-year yields are <2% in the US and several European countries), (4) declining technology costs (i.e., currently <US$1.50/W for utility PV, on an installed basis, which is expected to decline further3), and (5) an expectation for follow-on investment opportunities in the growing Mexican renewable power market in future auctions. Still, we believe the low sticker price left some developers scratching their heads, asking what expected rate of return is built into those record-low prices.

Second Clean Energy Auction to be held in August 2016. Mexico is expected to release details for its second clean energy auction in April 2016, with the auction scheduled to be held in August 2016. The second auction is expected to offer contracts for up to ~50% more power than the first instalment (i.e., potentially up to ~9.5TWh/year). Meanwhile, media reports indicate that there will be greater encouragement for hydro and natural-gas fired power projects, potentially by way of higher minimum bid prices for those technologies.

Exhibit 8: Winning Bids in Mexico’s First Clean Energy Auction (Energy, CELs & Price)

Source: Bloomberg New Energy Finance, IA Securities Inc.

3 http://www.seia.org/research-resources/solar-market-insight-2015-q4
Exhibit 9: Lowest Stated PPA Prices at Auction

Source: GTM Research, iA Securities Inc.
Canadian IPPs in Mexico

Algonquin Power & Utilities Corp. (AQN-T, Strong Buy, Target $15.00)

- **AQN is watching Mexico, but from a distance for now.** We believe that AQN is paying close attention to developments in the Mexican power market, particularly results from the recent clean energy auction. The Company continues to hold a preference for low-risk, long-term contracted renewable assets within its power division. However, with major near-term investments in its utility business (e.g., the Empire District Electric Co acquisition), and strong opportunities for investment in renewable power in its core markets (Canada and the US), any opportunities in Mexico are likely a lower priority at this point.

Brookfield Renewable Energy Partners LP (BEP.UN-T/BEP-N, Buy, Target US$30.00)

- **BEP is watching the Mexican power market develop with interest, but waiting for the right opportunity to invest.** BEP has previously stated that it is watching the Mexican power market. Mexico could present an interesting market in the future, in light of the recent reforms, and in anticipation of greater opportunities for renewable power investment. However, at this point the Company is not directly involved in project development in Mexico, to our knowledge.

Boralex Inc. (BLX-T, Buy, Target $18.00)

- **BLX has kicked the tires, but has not committed to Mexico just yet.** In its Q4/15 update, BLX management discussed Mexico (and potentially Chile) as a jurisdiction for potential expansion outside of its core markets in Canada, the US, and Europe. Strategically, BLX would likely aim for a portfolio acquisition that offered a combination of operating assets and a development pipeline, in the vein of previous acquisitions in France, if the opportunity were to present itself. That way, any acquisition would have an immediate impact on cash flows, while offering the Company access to longer-term growth opportunities in a rapidly expanding market.

Innergex Renewable Energy Inc. (INE-T, Buy, Target $14.50)

- **INE’s Mexico strategy centres on small-scale hydro developments in partnership with CFE.** On October 13, 2015, INE announced that it had signed a memorandum of understanding (MOU) with CFE to jointly study small- and medium-sized (<200MW) hydro projects in Mexico. The partners aim to identify and prioritize attractive prospects, and define the terms by which INE and CFE could cooperate on development over the next three to five years. Given Mexico’s attractive hydro resources (highlighted previously) and a willingness on the part of the government and CFE to move forward with development, we believe that INE will be able to secure long-term contracts for new hydro projects in the future.

Northland Power Inc. (NPI-T, Strong Buy, Target $22.00)

- **NPI’s Mexico strategy is focussed on contracted development, with an eye to natural gas plants and renewable energy.** Strategically, NPI sees Mexico as a potentially attractive market due to its strong economic growth and robust forecasted power demand growth. In its Q4/15 update, NPI commented that it has established an office in the country, and was in the process of expanding the development team located there. Previously, NPI had stated that it was looking at various opportunities, with a focus on greenfield thermal sites (i.e., new natural gas-fired power plants), advanced-stage wind projects and any other opportunistic prospects that came along. We expect to see NPI’s development spending increase in Mexico as the Company works to secure PPAs and potentially acquire development projects.

Pattern Energy Group Inc. (PEG-T/PEGI-Q, Hold, Target US$20.00)

- **PEG takes a joint-venture approach to build its presence in Mexico’s renewable power market.** Strategically, PEG has identified Mexico as an attractive market for renewable power investment driven by underlying demand growth, its mandate for renewable energy, and a relatively high cost of power for large-scale consumers. PEG sees bilateral negotiations with large-scale corporate counterparties as a good means to underpin the economics for new development projects (similar to what PEG has achieved in the US in contracts with Amazon and Walmart). Meanwhile, in February 2015, Pattern Development (the privately owned parent of PEG) signed a joint-venture agreement with CEMEX Energia, a subsidiary of CEMEX (CM-N, Not Rated), a global building material company and one of the country’s largest power consumers in Mexico. Under terms of the JV, CEMEX and Pattern Development aim to develop up to 1GW of new renewable capacity by 2020. PEG is expected to have access to the JV’s pipeline of growth opportunities as they are developed.
| Company                        | Ticker | Rating  | Ytd ($) | Exp. rtn (%) | Share price (C$) | Share price (US$) | Market cap (C$) | EV (C$) | Debt/EBITDA 4 | Dividend yield | P/EBITDA FY15 | P/EBITDA FY16 | P/EBITDA FY17 | P/EBITDA FY18 | EV/EBITDA 1 (x) | iAS P/FCF 2 (x) | Dividend paid ($) | Dividend yield (%) | Payout (%) | Credit Rating/Outlook |
|-------------------------------|--------|---------|---------|-------------|-----------------|-----------------|-----------------|---------|--------------|----------------|----------------|----------------|----------------|----------------|----------------|-----------------|----------------|-------------|---------------------|
| Algonquin Power & Utilities Inc. | AQN   | STRONG BUY | 15.75 | 43.7% | $10.75 | $15.00 | $2,737 | $4,836 | 13.6 | 10.8% | 6.4% | 5.6% | 25.4 | 7.0% | 6.4% | 5.6% | 17.8 | 10.4% | 5.6% | 81.4% | BBB+/Stable |
| Atlantic Power Corporation | ATP    | HLD | 15.5% | $0.08 | $1.19 | $1.20 | $520 | $1,122 | 5.9 | 5.8% | 5.7% | 5.9% | 10.4 | 2.0% | 2.4% | 1.8% | 10.0% | 7.0% | 81.4% | BBB+/Stable |
| Brookfield Renewable Energy Partners LP | BWF   | BUY | 15.0% | $0.21 | $0.23 | $0.26 | $506 | $1,178 | 16.2 | 12.3% | 12.5% | 12.6% | 17.4 | 15.1% | 14.4% | 14.5% | 17.4 | 15.1% | 14.4% | 14.5% | BBB+/Stable |
| Brookfield Inc. | RXA    | BUY | 15.9% | $1.86 | $3.54 | $1.66 | $1,044 | $2,581 | 13.6 | 10.3% | 9.5% | 9.3% | 17.6 | 7.3% | 6.6% | 6.9% | 17.4 | 15.1% | 14.4% | 14.5% | BBB+/Stable |
| Capital Power Corporation | CPL    | DIV | 14.9% | $1.60 | $2.33 | $1.60 | $1,759 | $3,167 | 16.6 | 15.7% | 15.6% | 15.7% | 17.4 | 15.1% | 14.4% | 14.5% | 17.4 | 15.1% | 14.4% | 14.5% | BBB+/Stable |
| Innergex Renewable Energy Inc. | IFN   | DIV | 16.0% | $1.43 | $2.97 | $1.35 | $1,415 | $3,050 | 17.7 | 15.0% | 15.4% | 15.4% | 17.4 | 15.1% | 14.4% | 14.5% | 17.4 | 15.1% | 14.4% | 14.5% | BBB+/Stable |
| Mauki Power Corp. | MGH   | SPEC | 14.0% | $1.95 | $3.81 | $1.62 | $1,044 | $2,581 | 13.6 | 10.3% | 9.5% | 9.3% | 17.6 | 7.3% | 6.6% | 6.9% | 17.4 | 15.1% | 14.4% | 14.5% | BBB+/Stable |
| Northland Power Inc. | NPI   | STRONG BUY | 12.52 | 7.2% | $3.94 | $6.99 | $8,840 | $20,465 | 20.3 | 18.8% | 19.3% | 19.3% | 21.4 | 17.6% | 16.0% | 16.1% | 21.4 | 17.6% | 16.0% | 16.1% | BBB+/Stable |
| Innergex Group Inc. | KG     | HLD | 19.0% | $1.38 | $2.33 | $1.50 | $1,249 | $2,480 | 19.3 | 17.6% | 17.1% | 17.1% | 21.4 | 17.6% | 16.0% | 16.1% | 21.4 | 17.6% | 16.0% | 16.1% | BBB+/Stable |
| TransAlta Renewables Inc. | RWI   | BUY | 13.8% | $1.07 | $2.10 | $1.07 | $1,050 | $2,100 | 15.8 | 13.0% | 13.0% | 13.0% | 17.4 | 15.1% | 14.4% | 14.5% | 17.4 | 15.1% | 14.4% | 14.5% | BBB+/Stable |
| TransAlta Corp. | TA     | YC | 10.5% | $0.61 | $1.09 | $1.50 | $1,550 | $4,100 | 8.5 | 8.3% | 8.7% | 8.7% | 2.5 | 2.3% | 2.4% | 2.4% | 2.5 | 2.3% | 2.4% | 2.4% | BBB+/Stable |

*-market data as of April 11, 2016

1. Based on Capital IQ consensus estimate
2. Based on iAS securers' annual dividend (annualized)
3. Payout ratio for IPPs based on iAS securers' FCF estimates; payout ratio for utilities based on consensus EPS estimates
4. Net debt/EBITDA
5. iAS corporate credit rating/ outlook

Source: Capital IQ, iA Securities Inc.
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Under Review: Currently available information is inadequate to provide an investment rating.

Tender: Investors should tender their shares to the current offer.

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