U.S. Yieldcos Must Evolve to Survive

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Last year yieldcos were heralded as renewable energy's hottest new financing structure. But the model must adjust.

On March 10, 8point3 Energy Partners, a joint venture between First Solar and SunPower, filed a registration statement with the Securities and Exchange Commission (SEC) for an initial public offering (IPO) of its class A limited partnership shares. If the IPO goes forward as planned, 8point3 Energy Partners will become the seventh yieldco to launch since NRG Yield debuted the structure with its own IPO nearly two years ago.

Other early movers in this space include NextEra Energy Partners, TerraForm Power (a subsidiary of SunEdison) and Pattern Energy Group, as well as Canadian-based TransAlta Renewables and Spanish multinational Abengoa's UK-based subsidiary, Abengoa Yield. A number of other utilities, developers, private equity funds and hedge funds have also indicated that they are contemplating or actively pursuing the launch of their own yieldco vehicles. This has led many industry watchers to predict that the number of yieldcos in the market could more than double in the coming year.

This increasing interest is understandable, as the original six yieldcos have, somewhat ironically given their moniker, been able to attract capital at relatively low yields (currently, around the two to three percent range), making them an enticing mechanism for sponsors to monetise existing assets. Initial investors have, in turn, been rewarded with higher total returns once the post-IPO increases in share prices have been factored in. Going forward, however, the low yields demanded by investors imply significant growth expectations. If the yieldcos are unable to deliver that growth, yields will almost certainly have to rise to maintain investor interest. So far, the yieldcos have largely been delivering on their promise to expand their asset portfolios while still hitting distribution targets that are based on paying out the bulk of their cash available for distribution (CAFD).

Of course, there is a fundamental tension in a strategy that calls for both continuous asset accumulation and ongoing, ever-increasing distributions of most available cash. Achieving both goals simultaneously requires that acquisitions be funded with outside capital and that the net cash flow from the new assets exceed the cost of that capital. In recent years, several factors (including historically low interest rates and the availability of various tax benefits) have combined to create a favourable environment for that scenario in the case of U.S.-based renewable energy projects,

which form the bulk of the yieldcos' portfolios. But these factors may be unlikely to persist over the medium to long term. In a changed interest rate environment with reduced tax advantages, finding a sufficient supply of dividend-accretive acquisition opportunities to sustain the yieldco model in its present form will be challenging, particularly as the field becomes more crowded. In light of that concern, certain features of the existing model may begin to evolve as the second generation of yieldcos comes to market over the next 12-18 months.

Challenges for today's model

Broadly speaking, under the existing model, a yieldco is a publicly-traded vehicle that:

- houses a portfolio of mostly de-risked, pure-play project assets (typically operational, utility-scale power projects, mostly in the U.S. and Canada, with long-term contracted cash flows from credit-worthy offtakers);
- is subject to entity-level corporate tax but manages the tax profile of its asset portfolio to maintain a near-zero level of taxable income;
- regularly distributes the bulk of its CAFD to shareholders and grows that CAFD over time through accretive acquisitions both from the sponsor (usually pursuant to a right-of-first-offer (ROFO) or similar drop-down arrangement) and from third parties; and
- is structured to divide the economics and some voting rights between the sponsor and public shareholders while preserving overall sponsor control.

By segregating the sponsor's operational, contracted projects from its higher-risk development and construction activities, and listing itself on a public exchange, the yieldco gains access to a large pool of dividend-focused investors who typically require greater investment liquidity and more predictable cash flows than traditional sources of project capital. To appeal to these investors, yieldcos regularly distribute most of their available cash, which they attempt to maximise by, among other things, using accelerated depreciation, carry-forwards of net operating losses (NOLs), renewable energy tax credits, and other tax benefits to avoid incurring entity-level tax liability.

Over time, however, this approach could leave the yieldco with minimal reserves and flat or declining net cash flows as its fully- contracted assets age and positive tax attributes are consumed. To maintain and increase its distributions, therefore, the yieldco has to raise additional capital to acquire new projects, and that dynamic represents the core challenge to the existing model. Although the existing yieldcos do set aside certain reserves from their operating revenues, most observers agree that those reserves are not sized to fund the maintenance and capital expenditure needs of their existing portfolios as well as the acquisitions required to achieve the level of growth investors are expecting. The net cash flows and positive tax attributes from the new acquisitions must be sufficient to offset both the cost of the capital for the acquisition itself, and any accumulated drag on CAFD from older assets with rising capital expenditure needs and tax attributes that have been fully consumed.

Most first generation yieldcos have some form of ROFO or other drop-down agreement with their sponsors to help provide a pipeline of projects for acquisition. A number of such drop-down transactions have already taken place. Several yieldcos have also successfully closed significant third party acquisitions. However, certain factors over the last two years have been uniquely favourable. Of particular note are the low interest rate environment, which helped keep the cost of capital down, and the short-lived cash grant programme under Section 1603 of the American Recovery and Reinvestment Tax Act of 2009 (Cash Grant Programme). The Cash Grant Programme, which provided a 30% upfront tax credit (Cash Grant) to qualifying U.S. renewable energy projects, triggered a rapid build-up of projects with cash flows not tied to existing tax equity deals, and which likely still have some depreciation value. This makes them useful drop-down options to yieldcos despite the tax credit having already been fully monetised. In addition, the U.S. Production Tax Credit (PTC) and Investment Tax Credit (ITC) have enabled renewable energy projects that did not elect to take the Cash Grant to generate positive tax attributes that can still be monetised over time to free up cash flow and boost distributions.

This landscape, however, is shifting. To be eligible for the Cash Grant Programme, a project must have commenced construction in 2009, 2010 or 2011 and an application must have been submitted by October 1,

2012. So the pool of available projects that claimed the Cash Grant and still have some depreciation value is fixed and will soon begin to dry up. In addition, the PTC for wind projects expired at the end of 2014, and the ITC for solar projects will be reduced from 30% to 10% for commercial-scale projects, and eliminated entirely for residential solar installations at the end of 2016. There are still ample numbers of PTC/ITC-eligible projects in the pipeline, but unless Congress acts to extend those deadlines again (which is far from certain given the prevailing political landscape), that supply will be capped and acquisition prices may begin to climb.

As for the interest rate environment, although rates have not yet begun to rise significantly, they will eventually increase again. When that occurs, yieldcos' cost of capital will rise, making it more difficult for them to acquire new assets at a rate of return that is dividend-accreting to existing shareholders. Even planned drop-down transactions with sponsors may become more challenging—if potential buyers with lower costs of capital or more flexible distribution policies are able to significantly outbid the yieldco, sponsors may be reluctant to reject such bids to support their yieldco.

Adjusting the model

Changes are already beginning to appear in the profile of assets that yieldcos target for their portfolios. With the supply of tax-advantaged, utility-scale renewable energy projects expected to shrink, yieldcos will have to pursue a more diverse mix of projects with higher potential rates of return in order to maintain growth. Distributed generation (DG) solar systems (which, at the moment, do still qualify for the ITC in the U.S.) have been widely discussed as a likely first step in that direction, and several yieldcos now include DG systems in their portfolios. Assets outside of North America and Europe are another likely option for yieldcos to obtain additional cash flows, particularly as U.S. renewables begin to lose their comparative tax advantages. Abengoa Yield already includes a large number of Latin American projects in its portfolio, and SunEdison has announced plans to launch a second yieldco focused on assets in Africa and Asia. Finally, yieldcos may look beyond power-generation projects entirely for other types of assets with stable, contracted cash flows. Abengoa Yield, for instance, already owns several transmission lines and has announced plans to pursue desalination plants as well.

Evolving sponsors

The sponsors behind the yieldcos may also be evolving. 8point3 Energy is the first likely entrant that is a joint venture of two separate project sponsors. In addition to various synergistic advantages, this structure increases the pipeline of projects available to be dropped down to the yieldco, helping to alleviate some of the need to pursue third party acquisitions. On the opposite end of the spectrum, a variety of private equity funds have indicated they are assembling project portfolios (via third-party acquisitions) for the purpose of launching their own yieldcos. However, hedge fund-backed SolWind Renewable Power, which was recently pursuing its own launch, is reported to have postponed its IPO in late-February in response to disappointing price indications. While multiple factors were no doubt at play, this could suggest that the market is indeed concerned about sustainability. Private equity groups may need to secure project pipelines for their proposed yieldcos—perhaps by borrowing a page from 8point3 Energy's playbook and forming a joint venture with a traditional project sponsor—to satisfy the market's expectations.

In addition, as the availability of projects that claimed the Cash Grant declines, tax equity financings are likely to rise in prominence again, and yieldcos may need to incorporate a larger share of projects with tax equity investors into their portfolios. However, in a typical tax equity financing, the tax equity investors would represent a significant, front-loaded drain on the very tax attributes and cash flows the yieldco requires. For the two to coexist, a sharing arrangement that allows the yieldco to retain a larger portion of those benefits will likely be necessary. Alternatively, yieldcos themselves may begin to act as tax equity investors in some transactions, allowing them to acquire only the tax attributes and cash flows they need to shield their portfolio assets and shore up their distributions.

Yieldcos may also opt for a period of retrenching after the initial flurry of portfolio building is complete. This would temporarily halt the growth of their distributions or even ratchet those distributions down for a time in order to build up reserves. This approach has been used to some success in the closely-related master limited partnership (MLP) space over the years. Though it may prove to be a more difficult transition for the market to accept in the case of

yieldcos, the early appeal of which is based, in large part, on a narrative of continuing growth.

Finally, it is possible that a legislative solution may present itself, at least in the U.S. context. In many ways, first generation yieldcos were designed to approximate significant elements of the structure and economics of MLPs, which are permitted by federal statute to be publicly-traded and still receive pass-through tax treatment.

Because MLP status is only available to entities that derive at least 90% of their income from qualifying real property, natural resources and commodities sources—which do not include renewable energy projects (other than some geothermal)—yieldcos arose as an attempt to achieve a similar result for renewable energy portfolios through transaction structuring rather than statute. In early 2013, the Master Limited Partnerships Parity Act (MLP Parity Act) was introduced in the U.S. Senate and House of Representatives to, among other things, extend MLP treatment to renewable energy projects. The MLP Parity Act has meaningful support among both Democrats and Republicans, but Republican support is generally conditioned on the elimination of the PTC and ITC, which has to-date been unacceptable to Democrats. It is unlikely that Congress will pass the MLP Parity Act until agreement is reached on a more comprehensive tax reform package, which few expect to occur in the near term. Nevertheless, it is probable that some version of the basic policy will be implemented in the medium to long-term.

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