THE CHANGING DYNAMICS OF RENEWABLE ASSET SELL-DOWNS

MINI BRIEF 2019

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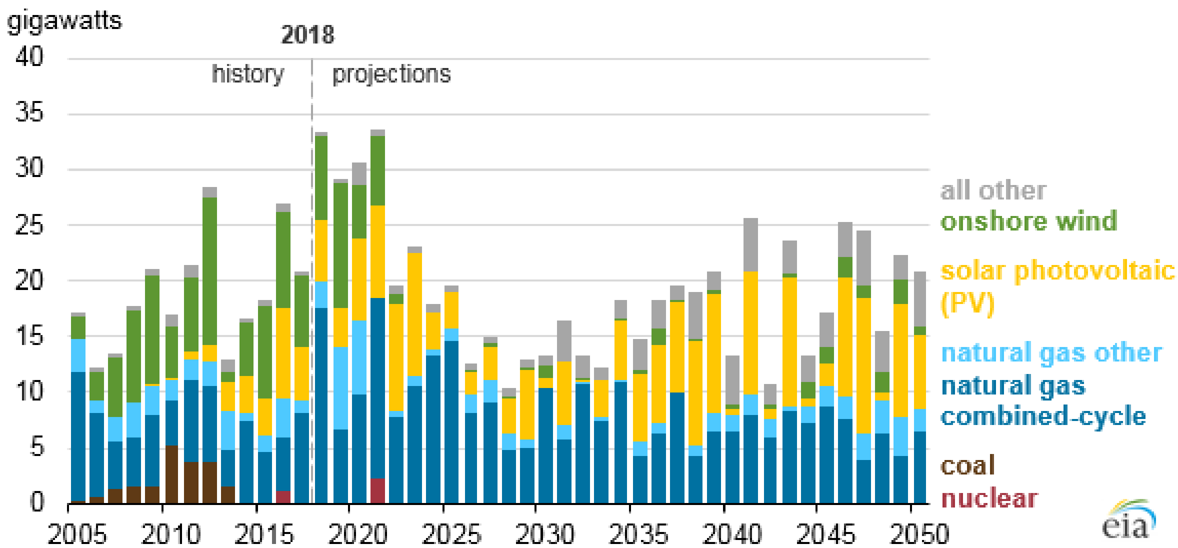
Asset sell-downs are nothing new in the renewable energy industry. But as the scale and number of renewable projects have grown, the appetite for buying and selling major stakes in U.S. solar and wind projects has also increased.

Annual electricity utility-scale generating capacity additions (AEO2019 reference case)



Source: EIA

In the past, CohnReznick and CohnReznick Capital saw leading independent power producers (IPPs) sell stakes as high as 50 or 51 percent in some of their large solar and wind projects to third-party investors.

Now, insurers, more international players and even institutional investors are getting into the game. For example, in 2016, EDF Renewable Energy, the U.S.-based IPP subsidiary of the French EDF Group, sold a 50 percent interest in both the 250-megawatt Roosevelt Wind Project and the nearly 50-megawatt Milo Wind Project to a fund managed by BlackRock, the world's largest investment manager. In 2018, Recurrent Energy sold a 49 percent stake in two of its solar projects to Pensionskassernes Administration (PKA), one of Denmark's largest pension service providers for $307 million.

Earlier in 2019, GE Capital sold its stake in 650 megawatts of renewable assets to Enel, including wind, geothermal and solar. Also in 2019, Duke Energy Renewables, the competitive renewables arm of U.S. utility giant Duke Energy, offloaded 1.2 gigawatts of its nearly 3-gigawatt wind and solar portfolio to insurer John Hancock in a $1.25 billion deal.

Historically, there have been two primary rationales for these sell-downs by large IPPs.

Tax equity consolidation considerations. Large renewable energy projects in the U.S. have traditionally relied on tax equity financing. Under the International Financial Reporting Standards (IFRS) that many large non-U.S. IPPs adhere to, tax equity is typically classified as debt due to the preferences and put/call features. Having significant debt obligations in the form of tax equity on an IPP's books can give the appearance of being over-leveraged. Sell-downs are an effective tool for IPPs to deconsolidate and get a significant percentage of tax equity off of their books. Under generally accepted accounting principles, tax equity is typically classified as equity as non-controlling interest, which is a component of equity, or redeemable non-controlling interest, which falls between senior debt and equity (i.e. mezzanine debt). Sells-downs are also being used by many U.S.-based IPPs, but careful consideration needs to be given to the accounting impact of these transactions (as will be discussed in a subsequent section of this mini brief).

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WHILE RENEWABLE ASSET SELL-DOWNS HAVE BEEN A PART OF THE FINANCING LANDSCAPE FOR YEARS, COHNREZNICK HAS SEEN RECENT CHANGES TO HOW THEY ARE STRUCTURED AND APPLIED IN THE PAST FEW YEARS.

Capital for growth. Another significant driver of sell-downs has been the pursuit of growth strategies on the part of IPPs. Sell-downs have been one way for IPPs to recycle cash that can be used for promising new investments.

While renewable asset sell-downs have been a part of the financing landscape for years, CohnReznick has seen recent changes to how they are structured and applied in the past few years. One key driver of these changes is the market consolidation that has occurred over the past 18 months.

For example, Denmark-based wind developer Ørsted and the France-based utility Engie acquired U.S.-based wind developers in 2018 to capture robust project portfolios in North America. Another driver is large pension funds and other institutional investors with low-cost capital that are eagerly seeking out projects that meet their unique investment criteria. CohnReznick currently forecasts about 5 gigawatts of large deals in the U.S. wind and solar market in late 2019.

These developments are propelling several shifts in sell-downs, including a move from single-asset transactions to more of a portfolio-based approach. For example, from 2017 to 2019, Wood Mackenzie Power & Renewables tracked an upward shift in the percentage of publicly disclosed wind asset transactions in North America comprising more than three projects, increasing from less than 9 percent to 13 percent. CohnReznick has pegged a shift to a mix of technologies, where both wind and solar projects are more frequently being combined in single transaction.

Although the percentage increase of multiple-project transactions is only a few points, the volume of publicly disclosed wind asset transactions has grown considerably in that time, by about 66 percent.

In this paper, we will examine how and why renewable asset sell-downs have changed and what the implications are for IPPs, institutional investors and U.S. utilities. Among the topics we will cover are:

- The changing landscape
- New players seeking scale
- Tax equity considerations
- What the next 18 months hold

THE CHANGING LANDSCAPE

Installed capacity numbers for wind, solar and increasingly solar-plus-storage, in both the U.S. and globally, paint a compelling picture of the mainstreaming of renewable energy.

Another indication of maturity is the increasingly fierce competition among large pension funds and other institutional investors keen on making significant investments in renewable energy projects. This is a result of a mix of factors that are familiar to anyone following the renewable energy industry in recent years, including dropping prices and improvements in the performance and reliability of the equipment used in renewable energy projects.

In the U.S., for instance, institutional investors Brookfield and BlackRock made significant acquisitions from 2017 to 2018 that propelled both into WoodMac's rankings of the top 15 U.S. wind asset owners. Overall, WoodMac expects the role of institutional investors in wind asset ownership to more than double from 2017 to 2022. For solar, IPPs affiliated with a utility made up 40 percent of the utility-scale solar asset owners in 2018, according to WoodMac. Across the globe, WoodMac sees IPPs looking to institutional investors to recycle their capital and fuel further growth. Solar investment for institutional investors, in particular, is seen as a mature asset.

THE EMERGENCE OF LARGE INSTITUTIONAL INVESTORS INTERESTED IN RENEWABLE ENERGY PROJECTS HAS ALREADY HAD ONE MAJOR IMPACT ON THE MARKETPLACE

The interest in renewables is not purely economic. Many large investors also have ambitious sustainability goals. A recent survey of institutional investors conducted by BNP Paribas Securities Services found that over 65 percent of them have aligned their investment approach with the United Nations' Sustainable Development Goals. Taken together, these factors have engendered both motivation and confidence among large investors, boosting the belief that money directed at renewable energy projects can deliver a stable return for many years.

NEW PLAYERS SEEK SCALE

The emergence of large institutional investors interested in renewable energy projects has already had one major impact on the marketplace: The cost of capital is now extremely low. One survey from U.K.-based financial services firm Octopus Group found that global institutional investors planned to invest an additional $210 billion into renewables in the next five years. Of course, institutional investors are just one category, and Bloomberg New Energy Finance has found that there has been nearly $2.6 trillion of renewable investment in the decade ending this year, with the U.S. responsible for $356 billion.

The increasing role of big institutional investors has had a significant impact on sell-downs.

- **Appetite for a portfolio approach.** For both IPPs and the investors they partner with to finance projects, there are powerful transaction efficiencies that come from a move away from single-asset investments. Big pension funds and other institutional investors also need to make large investments, usually in the $150 to $200 million range.
- **Sell-downs push past 80 percent.** Older renewable energy sell-downs have targeted individual projects, hovering in the 49 to 51 percent range. WoodMac reports that nearly two-thirds of wind asset transactions in North America in the last two years involve at least a 70 percent stake, even as the number of overall transactions has grown substantially as well. According to CohnReznick, a portfolio approach with larger stakes is far more attractive to institutional investors that want to make substantial upfront investments.
- **Forward commitments become the norm**. In the not-too-distant past, CohnReznick saw sponsor equity investors select large solar and wind projects that were as close as possible to being fully operational. Today, big investors are confident about the quality of renewable energy investments, and there is also a great deal more heated competition for renewable assets. This changing dynamic means that sell-downs are occurring at all stages of project development, including those in actual operation, those with a notice to proceed or a commercial operation date, and even early-stage developments. Most sell-downs taking place in the market today include portfolios of projects at varying stages, including what are known as forward commitments. A select group of buyers, including pension and infrastructure funds, are willing to participate in sell-downs that include an upfront investment in the $150 million to $200 million range, as well as an assurance that they can invest another equally large amount in projects in a developer's pipeline.
- **Capital arbitrage.** Another primary driver of sell-down activity is the simple fact that financial investors in today's market have a lower hurdle rate and cost of capital than do strategic investors. CohnReznick notes that partnering with passive financial investors allows for strategic investors to blend their cost of capital to improve their competitiveness on acquisitions and PPA pricing. For example, if a strategic investor is pricing at a 10 percent required return and a financial investor requires 7 percent, they can now acquire and price an offtake agreement to achieve an 8.5 percent project return.

IMPROVEMENTS TO TAX EQUITY PARTNERSHIP STRUCTURES IN RECENT YEARS ARE ALSO A FACTOR COMPELLING MORE PENSION AND INFRASTRUCTURE FUNDS TO ENTER THE MARKET.

TAX EQUITY CONSIDERATIONS

Under International Finance Reporting Standards (IFRS), tax equity has long been regarded as debt. A key reason why big IPPs have been eager to pursue sell-downs is that they didn't want to consolidate the debt on their books. While that has not changed, a more recent development is the increasing importance IPPs place on recycling cash to pursue growth strategies.

Improvements to tax equity partnership structures in recent years are also a factor compelling more pension and infrastructure funds to enter the market. Historically, tax equity partnerships allocated 100 percent of the project cash flows to the sponsor until they achieve a return of capital. At that point, the partnership cash allocation flips and the tax equity investor receives 100 percent of project cash flows until it garners its target yield and achieves the flip point. In the past, inaccurate production estimates have meant that predetermined tax equity flip points have been missed by a material margin, further exacerbating the choppy profile of cash returns to sponsors.

CohnReznick has witnessed firsthand how the uncertainty of flip points and the lumpy sponsor cash distribution profile have made these types of sell-down structures difficult to execute, which for some time largely precluded pension funds from investing in renewable energy projects.

Over the past five years, however, there have been structural changes to deals that reduce the likelihood that tax equity flips are missed by more than one or two years, or three at most. There are two primary changes: removing the interim cash flip between sponsor and tax equity investor, and the addition of a deferred contribution from the tax equity investor known as pay-as-you-go. Furthermore, there has been an increase in time-based flip structures being utilized in solar deals. Pension fund capital that requires consistent cash flows can now participate at scale in sell-downs that benefit from these structural improvements, now with steady annual cash distributions and lower risk of a sustained period of cash sweeps to tax equity investors.

ACCOUNTING HOT TOPIC

Under both U.S. generally accepted accounting principles (GAAP) and IFRS, IPPs need to be diligent when assessing the impact of sell-down activity as complex accounting literature needs to be considered depending on the facts and circumstances of the particular transaction. Control, or loss thereof, of the subsidiary/project entity as a result of the sell down transaction must be assessed and will have a significant impact on the resulting accounting treatment.

From a U.S. GAAP perspective, any of the following literature may govern the transactional accounting:

- **ASC 606** - Revenue from Contracts with Customers
- **ASC 810** - Consolidation
- **ASC 860** - Transfers and Servicing of Financial Assets
- **ASC 610** – Other Income-Gains and Losses from the Derecognition of Non-Financial Assets

From an IFRS perspective any of the following literature may govern the accounting:

- **IFRS 15** - Revenue from Contracts with Customers
- **IFRS 10** - Consolidated Financial Statements
- **IFRS 9** – Financial Instruments: Derecognition of Financial Assets and Financial Liabilities

Key considerations regarding these sell-down transactions surround whether the sales of interests in project entities would be considered to be the output of the IPP entities ordinary activities, thus making the counterparty a "customer" as defined by ASC 606/IFRS 15; whether the sale is of a business or an asset; whether the IPP is selling a non-financial asset or an in substance non-financial asset, and whether a contract exists and control has been transferred to the buyer. All of these considerations are central to the resulting accounting treatment and the timing of the recognition of the results of the sell-down transaction.

OVER THE NEXT 18 MONTHS, THERE WILL BE CONTINUED GROWTH IN SELL-DOWN ACTIVITY.

CONCLUSION: WHAT THE NEXT 18 MONTHS HOLD

While sell-downs are nothing new in financing renewable energy projects, there have been some notable changes in how they are used and what type of entities are using them. As we have discussed, some of the most significant developments include:

- The emergence of pension funds and other big investors is a crucial driver of a portfolio approach to sell-downs. Many institutional investors need to make significant upfront investments, which is not possible when sell-downs occur on an individual project basis or the share of the project is too small.
- Large institutional investors, particularly pension funds, can provide low-cost capital and are especially eager to access renewable energy projects through sell-downs.
- Risk is a factor on multiple fronts. Some players are seeking to manage their exposure in different markets, especially Texas' energy-only ERCOT market and the Southwest Power Pool. Other investors are making moves based on the pending economic cycle, trying to capture gains while the getting is good.
- The influence of institutional investors is also driving the popularity of forward commitments, where investors can provide upfront investments as well as the assurance that they can invest in a portfolio of future projects.

One trend seems certain: Over the next 18 months, there will be continued growth in sell-down activity. This is due in large part to ongoing consolidation among renewable energy developers, with international utilities and IPPs continuing to gobble up smaller developers.

The result of that activity, combined with the increasing interest among institutional investors, is that a smaller group of IPPs and utilities will control a large inventory of projects, especially in the wind market. This will lead to more aggregated sell-down activity, because scale offers efficiency and capital stack optimization benefits for both buyers and sellers. With the increased demand for capital deployed to clean energy based on environmental, social and governance criteria, combined with the shrinking inventory of projects stemming from market consolidation of the largest developers under a build-and-hold IPP model, investors ranging from pensions to infrastructure funds will need to quench their thirst by participating in the sell-down market alongside IPPs, as opposed to being the sole project sponsor with a controlling interest.

One development worth watching closely is how active U.S. utilities will become in this realm. Over the long term, it seems clear that U.S. utilities need to become more active players; for purely financial reasons, they can't exclusively be renewable energy offtakers via power-purchase agreements. Owning and operating renewable assets is critical to meet the increasing demand for clean energy among their corporate customers. How U.S. utilities navigate the complexities of sell-downs, including their ability to take in third-party capital and financings and address regulatory barriers, will go a long way toward determining how sizable a role utilities will play.

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