NORTON ROSE FULBRIGHT

How wind developers raise equity in public markets

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Many wind developers regularly require additional capital infusion and keep their eyes peeled for opportunities to raise it. Three recent trends in public equity transactions for developers are yieldcos, listing on the Toronto Stock Exchange (TSX) and the declining use of real estate investment trusts (REITs).

There have been two high-profile and successful yieldco offerings by U.S. developers: NRG and Pattern Energy Group. As a general finance matter, a yieldco refers to corporations that use most of their earnings to pay quarterly dividends, thus producing a relatively predictable stream, much like a bond, but with a higher yield than is available in the bond market.

NRG's yieldco, NRG Yield Inc., has a dividend yield of 3.5%. Pattern's yieldco, Pattern Energy Group Inc., is not quite as diversified and its sponsor is smaller than NRG's, so its dividend yield is 4.5%. A dividend yield is roughly equivalent to a cost of equity, and most wind developers would give their right arms for a 4.5% cost of equity.

Pattern's yieldco has the benefit of geographic diversification with projects in the U.S., Canada and Chile. However, yieldco investors place more emphasis on technology diversification, and the Pattern yieldco's portfolio consists of only wind projects; therefore, it has a higher dividend yield than NRG's yieldco.

Unfortunately, few developers will have a sufficient portfolio to satisfy the investment banking rules of thumb for a yieldco.

First, the yieldco needs to be of a sufficient size to merit the cost of the initial public offering (IPO) and ongoing costs incurred by public companies, such as compliance with Sarbanes-Oxley. This roughly translates to raising at least $150 million in equity in the IPO.

However, a $150 million portfolio will not suffice because the markets demand that the sponsor have material skin in the game. This generally means that less than half of the value of the portfolio can be monetized in the IPO; NRG monetized only 40% of the value of the assets it included in its yieldco. Thus, a developer considering a yieldco needs a portfolio available for the yieldco of upwards of $300 million.

In addition, the market will require consistent cashflows to enable the yieldco to pay the quarterly dividend. Therefore, the portfolio will need to be able to withstand "stress tests," whereby the dividend can still be paid even if a significant project runs into problems. NRG Yield's portfolio has different technologies: wind, solar and natural gas. Pattern's yieldco portfolio is all wind, and thus, it has a higher dividend rate than NRG, but it does have geographic diversification with projects in the U.S., Canada and Chile.

Further, many developers' projects are financed using tax equity structures. Pattern's yieldco portfolio included only one project structured as a tax equity transaction. NRG Yield has no tax equity transactions in it, as the renewables projects included in it had opted for the 1603 Treasury cash grant. It remains to be seen if the public markets will embrace a yieldco whose portfolio includes significant tax equity deals. SunEdison will be testing the public equity market with a solar yieldco that predominantly includes projects subject to tax equity financings. SunEdison may not be able to execute a public offering at the 4.5% dividend yield that Pattern achieved; however, even a 9% dividend yield would be a meaningful improvement on its cost of capital.

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A yieldco will be subject to two layers of tax: The public entity, as a corporation, will pay corporate income tax, and the shareholders will owe taxes on dividends and capital gains upon disposition of their stock. For individual shareholders, the tax rate with respect to qualified capital gains and dividends is currently 23.8%.

To avoid the corporate income tax (and defer the second layer of tax on distributions), the yieldco needs to keep growing by adding assets that provide additional depreciation, interest expenses associated with the financing of those assets and possibly tax credits. After the yieldco stops growing and has used the tax losses or credits it has carried forward, it will start paying income taxes. That tax bill will take a large bite out of the cashflow available for distribution. Thus, potential yieldco investors will want to see a "growth story" and not just a one-off portfolio monetization. NRG fulfilled this need for its yieldco by granting it a right of first offer with respect to any proposed sale, transfer or other disposition by NRG itself of six large specified assets for a period of five years following the completion of the IPO. Similarly, Pattern Energy Group LP provided its yieldco, Pattern Energy Group Inc., a right of first refusal with respect to its 3 GWdevelopment pipeline for five years.

TSX Listing

Pattern Energy Group Inc. is listed on both the NASDAQ and the TSX. In having a dual listing, it is following in the footsteps of wind developer Atlantic Power (NYSE: AT and TSX: ATP) and U.S. Geothermal (AMEX: HTM and TSX: GTH). The reason renewable energy developers are drawn to the TSX is that the Canadian retail market is perceived as having a greater level of acceptance of renewable energy; however, with SolarCity (NASDAQ: SCTY) up eightfold since its public offering, that perception could be changing.

Ram Power (TSX: RPG) and newly public OneRoof Energy (TSX Venture: ON) are U.S. renewable energy companies listed solely in Canada. OneRoof is listed on the TSX Venture Exchange. TSX Venture is an exchange for small and micro capital stocks that do not meet the requirements for a TSX listing.

By being listed only in Canada, companies may seek to avoid application of the U.S. securities laws and be under only Canada's more user-friendly securities laws. For instance, Canada has not adopted its own version of Sarbanes- Oxley, the post-Enron reforms enacted in the U.S. that imposed substantial compliance costs on public companies. Further, the disclosure documents that must be prepared for a TSX Venture listing have a more limited scope than that of a Form S-1 that is required for a public offering in the U.S.

Additional steps must be taken to ensure that the listed company does not fall under U.S. securities law. For instance, a Canadian holding company must be used, Canadian directors are required, and the stock certificates must contain a legend that they are not intended to be sold to U.S. investors.

The formation of a Canadian holding company that owns an existing U.S. corporation can raise issues with the Internal Revenue Service (IRS). In 2004, Congress enacted "anti-inversion" rules to prevent U.S. corporations from escaping the U.S. policy of worldwide taxation by moving their parent entity offshore. The anti-inversion rules are highly technical and can be triggered by a corporate migration, even when the move is not motivated by tax but is a result of pursuing a friendly securities regulation regime and investors with an appreciation of renewable energy as an asset class.

REIT Decline

A year ago, renewable energy conferences were abuzz with talk of REITs being an attractive format for renewable energy developers. This talk was spurred by press reports that Renewable Energy Trust Inc. had requested an IRS private letter ruling that solar projects constitute "real estate" for purposes of the REIT rules, and Hannon Armstrong, with renewable energy operations, had gone public as a REIT. Quickly the fad hit its peak, and it became clear that REITs were likely not the future of renewable energy.

First, Jeff Eckels, the chief executive of Hannon Armstrong, stated, "We did not ask the IRS about renewables, and we did not receive anything from the IRS that mentions renewables." When the ruling was made public, it was apparent that it applied to environmentally friendly "structural improvements" to buildings, rather than wind or solar projects.

Second, the IRS announced a moratorium on new REIT rulings. Although the agency has since lifted the moratorium, there have been no recent rulings issued.

Heather Zichal, who recently resigned as President Obama's energy and climate advisor, gave a speech on Jan. 21 suggesting that the Treasury Department may issue a revenue ruling that renewable energy projects qualify as REIT assets. The renewable energy trade associations are not pressing for the issuance of that ruling because, to be REIT-eligible, an asset must be "real property." Therefore, such a ruling could draw into question a renewable energy asset's eligibility for investment tax credits and five-year accelerated tax depreciation, both of which are not available for real property. If the Treasury were to rule that renewable energy projects are "real property" for REIT purposes but not any other tax purposes, it could raise a concern that it was legislating as opposed to merely implementing the tax law.

The IRS announced on April 2 that it was developing proposed regulations to refine the definition of "real property" for REIT purposes. Neither the announcement nor the commentary that followed suggested that the refinement was intended to include renewable energy projects.

In light of the land mines for renewable energy with respect to REITs, large developers have moved on to mastering yieldcos, while smaller developers are looking to markets like the TSX Venture Exchange for their equity.

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