LOW COST EQUITY GETS DIFFERING SOLUTIONS

THE MARKET PERFORMANCE OF NRG YIELD INC, NEXTERA ENERGY PARTNERS LP, PATTERN ENERGY GROUP INC AND OTHER YIELDCOS SINCE THEIR LAUNCHES IN THE LAST SIX TO 18 MONTHS HAS LED MANY IN THE RENEWABLE INDUSTRY TO FOCUS ON THE YIELDCO AS A SIGNIFICANT FINANCING SOURCE FOR PROJECT PORTFOLIOS. BY **CHRIS FORRESTER** AND **ROBERT FREEDMAN**, PARTNERS, AND **MONICA LAMB**, ASSOCIATE, **SHEARMAN & STERLING**.

There continues to be a lure for low-cost publicly traded equity – it is rumoured that approximately five more yieldcos will launch this year. It is also expected that the type of assets being packaged into US-listed yieldcos will continue to evolve. Existing and announced portfolios are mixing in distributed solar projects in the US as well as assets outside the US.

However, the varying structures and performance of the first wave of yieldcos demonstrate that the yieldco is not a one-size-fits-all solution for sponsors that want to monetise their project portfolios or raise cash for additional development. As shareholders have learned, yieldcos come in many flavours, and among financing alternatives yieldcos have a unique market-driven demand for growth and dividends.

Alternative forms of financing might eventually prove more popular for sponsor-developers. And, as one executive aptly put it, transferring projects from the parent to the yieldco leads to inevitable "arm-wrestling" over the terms of the sale transaction and the allocation of financial attributes in the long term.

Yieldco track record

Sponsors considering a yieldco to raise cash have a steadily growing dataset to compare the yields and outcomes for various yieldcos and their sponsors. In addition to commercial differences, underlying the different yield requirements and prices is a variety of legal structures that allocate risk and opportunity between the parent company's shareholders and the yieldco's shareholders.

Structuring the relationship between parent and yieldco will be critical to ensure positive outcomes for the shareholders of both entities. This includes sourcing agreements, management services agreements, incentive distribution rights and independent board committees. The following sections review certain of the legal obligations in these categories for the yieldcos listed in the US in the last year and a half.

Sourcing agreements

A yieldco's claim to assets developed and owned by the sponsor company is determined by the provisions of the sourcing agreement between them (US yieldcos launched to-date can also acquire, and have acquired, assets developed and owned by independent third parties). They have sourcing agreements with their sponsors that cover, from narrowest to broadest:

- Specified projects listed in the agreement,
- All operating projects located in certain geographies,
- All projects developed in certain geographies, and
- All projects owned (wholly or partially) or developed in the world, and the sponsor company itself.

The claim on the relevant project most frequently takes the form of a right of first offer, with a negotiating period between 20 and 60 days, with 30 days being the most common. In every case the parent must negotiate in good faith and may exercise its sole discretion in deciding to consummate a sale to the yieldco.

If the parties fail to reach an agreement regarding any particular project offered, the sponsor may sell the project to a third party, during a period of time from 120 days to 18 months, on terms no less favourable to itself than (and in at least one case, above a threshold premium to) the terms offered to the yieldco.

While there may be a fee on the purchase price of transferred projects on which the yieldco had a right of first offer, an explicit fee has not been common.

Absent a material breach or default under the sourcing agreement or a transaction agreement for the sale of a project pursuant to the right of first offer, a yieldco typically maintains its right of first offer for five or six years with a variety of termination and extension provisions, ranging from none to the following:

- Termination if the sponsor ceases to own or control the affiliate that is the general partner of the yieldco, or ceases to own specified voting and economic interests of the development company,

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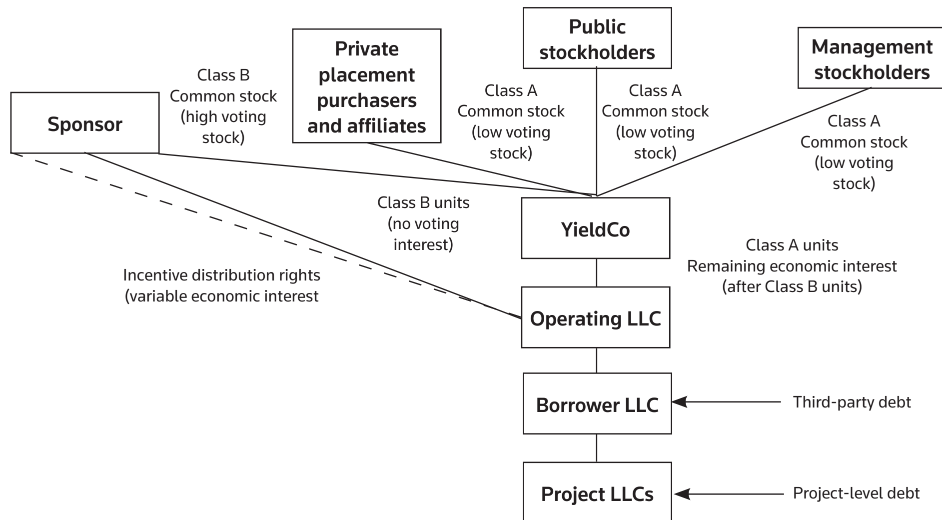
FIGURE 1 - YIELDCO IDR STRUCTURE



Source: Shearman & Sterling LLP

- Unilateral extension for as many additional three-year terms as desired, provided that at least one ROFO project in the previous two years has been acquired (unless it has not been offered at least four), and
- Automatic renewal for five-year terms unless either party dissents, but the sponsor company may also terminate the ROFO within 90 days after its third sale of an operational or construction-ready project to an independent third party, following the yieldco's election not to exercise its ROFO.

Additionally, there may be call rights on certain projects at fair market value (which may be determined by third-party appraisal). This right may cover certain specified operating projects at any time between the first and second anniversaries of the IPO.

For the other, the call right covers (i) certain specified solar projects and (ii) other projects to be identified in the future that are both (a) located in certain countries and (b) subject to a fully executed PPA with a creditworthy counterparty. The sponsor in that case must add qualifying projects from its development pipeline to the list of call option projects quarterly until the yieldco has been offered projects that will produce a minimum required amount of cash available for distribution in each period.

Management services agreements

Each of the yieldcos has a type of management services agreement with its sponsor affiliate. These agreements cover the expenses of the entity providing management services and provide revenues to the sponsor for a certain period of time.

They range in term from one year to indefinite, usually allow the manager the exclusive right to provide services (though in certain cases a yieldco may opt out and elect to provide the services itself), and may be subject to termination by the yieldco when the yieldco reaches a certain size, level or profit, when the manager experiences a change of control or ceases to own or control the yieldco, or not at all absent a breach by the manager.

The fees provided to the manager by the yieldcos range as follows:

- A set fee per year, in some cases adding a percentage of enterprise value or a share of revenues above a certain performance threshold;
- A fixed percentage of cash available for distribution, with an increasing cap for a definite number of years, and thereafter actual cost; and
- Fees for project development, construction, marketing and environmental management equal to a percentage of the cost of services.

Notably, in some instances the management fees are structured to facilitate the yieldco's ability to retain cash in early years so that it can achieve targeted distribution levels. Further, several of the yieldcos contain subordination provisions that preclude the distribution of dividends to the corporate sponsor until the yieldcos are able to achieve certain minimum distribution levels to the public shareholders.

A management services agreement may also contain a provision that the yieldco will not compete with the sponsor in solar development and construction for a certain time period.

Several of the operating company agreements also provide rights to cash distributions (known as incentive distribution rights, or IDRs) to the sponsor companies for the yieldcos' performance above certain thresholds. At present, these IDRs have come in two categories.

One category of IDR arrangements allocates the yieldco's cash available for distribution in minimum threshold quarterly amounts (and arrearages for previous quarters) that benefit all unit holders. Above those amounts, the IDRs have rights to an increasing percentage of the distributable cash, up to a maximum percentage.

The thresholds may be reset by the sponsor to raise the minimum quarterly distributions each

time the highest threshold has been reached for three consecutive quarters, and in exchange, the sponsor receives additional yieldco units (allowing it to participate in the minimum distributions along with other unit holders).

Under the other category of IDR arrangements, the IDRs receive cash paid from "operating surplus", which is defined to include cash from operations as well as a certain amount of cash generated from sources other than operations, such as asset sales, issuances of securities and long-term borrowings.

The sponsor's IDRs receive a progressive allocation of eligible distributions after quarterly minimum distributions to unit holders have been satisfied in arrears. Meanwhile, 100% of the yieldco's capital surplus is distributed initially to unit holders, and the minimum quarterly distribution is decreased in proportion to the percentage of the initial unit price that has been distributed as capital surplus. Once the entire initial unit price has been distributed as capital surplus to unit holders, the minimum quarterly distribution reaches zero, and the IDRs receive 50% of all further capital surplus distributions.

Independence of decision-makers

The corporate governance documents, the sourcing agreements and the management services agreements include various provisions intended to ensure the independence of individuals making decisions in which both the yieldco and the sponsor company have an interest. This has been framed in different ways:

- Any material transaction between the sponsor company and the yieldco must be approved by the independent members or conflicts committee of the yieldco's board; or
- For as long as the sponsor company has voting control over the yieldco, any action taken by the yieldco under the sourcing agreement requires approval of the yieldco's independent board members.

Some of the yieldcos' management services agreements provide that the manager must be supervised by the yieldco's independent directors or its board. Most of them also require a yieldco board's independent committee or conflicts committee to approve transactions with the manager or amendments to, or the termination of, certain management services.

Financing alternatives

While the yieldco will remain an appealing option for strong sponsors with recognised track records and identifiable pipelines of future projects, they and other sponsors have a growing range of alternative financing strategies available to them, at least for as long as interest rates remain stable.

Alternative forms of low-cost debt financing have proven successful for sponsors with renewable energy portfolios, including bank debt, asset-backed notes, and public bond offerings. Additionally, we expect to see more unique convertible or combination debt and equity investments as project development portfolios become more scarce, and thus more valuable. In these financings, investors are willing to take on a bit more development risk in order to capture the project pipeline and some potential upside. ■

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