Renewable Energy Project Warehouse Facilities Are on the Rise

Skadden

January 2016

This article is from Skadden's *2016 Insights* and is available at skadden.com/insights/2016-insights.

Contributing Partners

Lance T. Brasher
Washington, D.C.

Paul S. Kraske
Washington, D.C.

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

An important development in the financing of solar, wind and other renewable energy projects in 2015 was the use of a flexible investment and financing vehicle referred to as a "warehouse." Akin to traditional warehouse financing in a number of respects, it is a vehicle to provide financing for a portfolio of energy projects, in the form of debt, equity or both. Initially an outgrowth of the yieldco sector, the benefits of warehouse facilities have led sponsors to begin considering other applications, which could lead to an expansion of their use in the year ahead.

Warehouses and Yieldcos

Warehouses hold assets similar to those acquired by yieldcos — renewable energy assets with long-term power purchase agreements. These agreements between the generators and buyers of the energy produced are crucial to the funding of renewable energy projects; they allow the generators to more easily secure loans as well as tax and cash equity to cover the costs of developing and constructing the project while ensuring lenders and other investors that a market exists for the power that will be generated.

Realizing the flexibility of these structures and the availability of debt and equity capital, sponsors are pursuing other applications for warehouse facilities.

By holding these projects with long-term contracts, yieldcos generate predictable cash flows and ultimately pay distributions to their investors. To grow distributions, yieldcos rely principally on having access to a pipeline of new projects, known as "drop downs." Warehouses can provide a bridge for the acquisition and related financing of these assets, giving yieldcos more flexibility to address mismatches in timing between the availability of an asset in the market and the schedule for a drop-down and, in today's market, mitigate the reliance on accessing equity capital markets.

The warehouse also may be designed to provide construction financing for assets a sponsor develops or development assets the sponsor wants the warehouse to acquire. The projects can then be transferred from the warehouse to the yieldco at their completion with minimal construction risk to the yieldco. The warehouse also allows the sponsor to provide investors in the related yieldco with greater confidence in the yieldco project pipeline.

The Warehouse Facility Structure

A warehouse typically is managed by the sponsor, which also is an equity owner in the warehouse and often provides equity capital. Some warehouse facilities have third-party investors, who commit to making equity contributions to fund the acquisition or construction of qualifying projects over a period of time.

An investor committee led by the sponsor is often used to make investment decisions. The committee sets criteria, including project type and contracted output, that a project must satisfy to be eligible for acquisition or construction financing. Investors want their equity commitment to be used fully and timely; consequently, they may require a commitment fee or seek support from the sponsor if commitments are not utilized or returns not met, including through subordination of the sponsor's right to distributions.

Renewable Energy Project Warehouse Facilities Are on the Rise

Warehouses can design debt facilities to support the acquisition of operating projects; these contain many terms similar to holding company or mezzanine portfolio financing. Warehouses also can obtain construction loan facilities, which they in turn provide to project companies through downstream loans. Construction loans contain project finance-like conditions, covenants, defaults and other terms. The warehouse also has the ability to recycle capital from project sale proceeds and project company distributions for additional acquisitions and project construction financings.

Warehouses typically have a term of three to five years. An important issue for investors and lenders is the arrangements and expectations for the disposition of assets from the warehouse. Some warehouse facilities require these arrangements to be in place at the time the warehouse acquires the asset, including arrangements for tax equity financing, drop-down to the yieldco or sale to a third party. Others focus on the terms of the sale, placing minimum floors on sale prices. Investors may require asset calls for themselves or puts to sponsors or third parties. It is important to note that acquisition and disposition arrangements must include all relevant tax considerations.

Potential Uses for Warehouses

Sponsors, realizing the flexibility of the warehouse structure and the availability of debt and equity capital, are pursuing other applications for it. The large drop in yieldco stock prices in the latter half of 2015 has made current conditions inopportune for yieldcos to access the equity capital markets. Warehouse facilities offer a convenient structure to hold assets pending market recovery or sale of assets to a third-party buyer. Sponsors looking to create affiliated yieldcos are using warehouse facilities for a similar purpose: to hold the portfolio of assets pending creation and initial public offering of the yieldco. Certain sponsors are looking to warehouse facilities to create a portfolio specifically for the purpose of selling assets or groups of assets to third parties. Others are looking to warehouse construction financing features to support their affiliates engaged in construction, equipment supply, and operations and maintenance.

There is some debate about the cost-effectiveness of warehouse financing. Proponents point to the ability to recycle capital and the efficiency of a single facility and common agreed-upon terms applicable to multiple qualifying projects. Others assert that the cost of equity and debt is expensive and point out that one-size-fits-all may not be efficient, as equity and debt investors price operating and construction projects differently. What is clear is that an increasing number of sponsors — whether yieldco sponsors, strategic investors, manufacturers, contractors or financial players — are looking seriously at warehouse facilities, which may lead to more of them in 2016.