WAREHOUSES ARISE FROM YIELDCOS

ONE SIGNIFICANT OUTGROWTH OF THE YIELDCO MODEL HAS BEEN THE EMERGENCE OF WAREHOUSE FINANCING FACILITIES – SPECIAL PURPOSE VEHICLES TO HOLD AND/OR FINANCE RENEWABLE ENERGY PROJECTS ON A RELATIVELY SHORT-TERM BASIS. BY DAVID ARMSTRONG, MEGAN KULTGEN AND ADAM GRIFFIN, SKADDEN ARPS SLATE MEAGHER & FLOM LLP.

The rise of yieldcos as vehicles for holding renewable energy assets has been one of the most discussed and interesting developments in the renewable energy industry in recent times. In 2014 and the first half of 2015, it often seemed like every proposed renewable energy transaction was a planned yieldco, with renewable energy companies taking advantage of low interest rates to provide investors with investment opportunities in renewables along with the desired strong dividend yield.

One significant outgrowth of the yieldco model has been the emergence of warehouse financing facilities – special purpose vehicles to hold and/or finance renewable energy projects on a relatively short-term basis.

The renewable energy industry originally viewed warehouses as a tool to raise debt and equity capital in order to warehouse construction projects, and to a lesser extent, operating projects, before they could be sold to a yieldco.

However, as the yieldco market has cooled since mid-2015 and commodity prices have remained very low, warehouse facilities have begun to take various forms. As such, warehouse facilities also now provide potential investment opportunities for non-yieldco investors interested in renewable energy, as well as flexibility to sponsors to continue acquiring new projects while waiting for conditions to improve in the yieldco sector or for sale to third parties.

Original function and structures

Initially, warehouse facilities gained prominence as a structure to support and manage a yieldco's growth. During the 18-month yieldco boom, one of the essential selling features of a yieldco was its ability to show future growth and predicted payouts of 80%–85% of its cashflow in the form of dividends. Future growth is based on the yieldco's ability to raise debt and equity financing to acquire operating projects, as a yieldco is not designed to own construction projects.

As project developers and sponsors acquired development and construction projects, which was essential to demonstrate to yieldco investors that a pipeline of future projects existed, a need for construction financing developed. Warehouse facilities, which provided an ongoing and identified source of non-recourse, third-party bridge equity and debt financing for project construction, emerged to fill that need.

In their first iterations, warehouses also provided some limited ability to finance the acquisition of operating projects to allow developers and sponsors to manage the timing of the drop-down of such operating projects to yieldcos. Additionally, warehouses provided, and continue to provide, an opportunity for developers and sponsors to finance projects off-balance sheet, thereby lowering their overall cost of capital.

The original warehouse facilities, which were based on the fundamental principle that projects in the warehouse would be sold to a related yieldco, typically have a three to five-year term and are structured with the sponsor participating as an equity owner and as the managing member of the warehouse investment vehicle.

The remainder of the equity in the warehouse investment vehicle is held by a third-party investor, who owns an economic interest in the vehicle, but only votes on fundamental decisions. The sponsor contributes or sells finance-ready projects to the special purpose warehouse borrower and the third-party investor makes equity contributions indirectly into the warehouse, with such equity contributions being used to finance a portion of the construction costs of the contributed project.

Generally, there is an investor committee, led by the sponsor, that establishes the criteria for the types of projects that will be contributed into the warehouse facility to receive construction or acquisition financing (the criteria includes that the projects in question have a contract for output already in place). The specific projects then must be approved by the equity investor and a majority of the lenders.

To the extent the structure includes financing for the acquisition of operating projects, the terms are generally similar to holding company or mezzanine portfolio financings. For construction projects, the terms typically are subject to customary project finance-style covenants, defaults and conditions precedents, such as delivery of budgets, construction schedules, permits, engineering

and environmental reports, mortgages, security documents and legal opinions.

The debt sizing is based on project-level projections using contracted cashflows and/or committed tax-equity take-out arrangements. There is usually a debt service reserve account, which is the main source of debt repayment and is topped off at each contribution and project sale, and which may include a separate interest reserve and liquidity reserve funded at closing and by cash available for distribution to support debt payments.

One of the key features of the original warehouse facilities was the ability to recycle equity and debt capital. In a typical term loan financing, the sale of a project would result in a mandatory prepayment of the term loans, with no ability to borrow such term loans again. In a warehouse financing, on the other hand, the equity capital and term loans associated with a sold project are recycled into a secured account and are available to finance a future project.

In this way, a warehouse financing provides an ongoing and continuous source of capital to finance a sponsor's pipeline of projects. Additionally, when a project is sold, subject to equity distribution conditions (including, typically, repayment/recycling of loans attributable to sold projects, fully funded debt service reserve account, all funded projects on schedule and budget, no material project defaults and historical debt service coverage tests for all operating projects), the third-party equity investor receives a return on its invested equity.

In addition to the equity investors' and lenders' right to approve the inclusion of specific projects, investors and lenders, historically, have required arrangements for the disposition of such projects from the warehouse to be in place at the time of acquisition of the project – whether as a drop-down to a yieldco, sale to a third party or via a tax equity take-out arrangement.

That said, some investors and lenders have gotten comfortable without specific disposition plans, instead setting minimum sale prices and/or requiring asset calls for themselves or puts back to the sponsor or third-party investors. These modifications to the initial warehouse structures set the stage for the many alternative types of financings now being labelled as warehouses.

Alternative structures

The complicated equity and debt structure of the warehouses that were first completed in late 2014 and early 2015 has been evolving as the interest in warehouse facilities has increased. In fact, the term "warehouse facility" has developed to refer to a broad number of financings that allow sponsors and developers to find short-term or long-term capital, in the form of debt, equity or both, to help fund the development of projects.

Solar panels covering 900 acres are seen at the Comanche Solar facility in Pueblo, Colorado April 6, 2016. REUTERS/Rick Wilking

Financings that have been referred to in the market as "warehouse facilities" have been structured in a number of different ways, many of which bear little resemblance to the original structures and that raises the question "Why is this structure being called a warehouse?"

These structures include: the original warehouse financings for sponsors to complete the construction of pipelined projects, a third-party equity financing with a possible subordinated sponsor equity backstop, an intermediate vehicle for construction projects to be refinanced with a tax equity investment facility, a holding vehicle to optimise the timing of drop-downs into yieldcos, a sponsor mezzanine-level portfolio financing when there is no third-party equity, and aggregation facilities to ultimately sell to third parties, among others.

This evolution has meant that some warehouse structures have become simplified as opposed to the yieldco-based warehouses that closed in late 2014 and early 2015, but such simplified structures are often less flexible and tied more closely to specific projects. It also has blurred the lines between warehouse facilities and other back-leverage or even portfolio project financings.

For example, some sponsors have closed transactions with special purpose vehicle borrowers that hold equity interests in a number of projects that are in different stages of construction, but have their own construction financing and/or tax equity financing, and in which the warehouse facility has been used as a way for the sponsor to recoup its development costs sooner than it would through distributions from the applicable projects. Such a facility can include:

i) A revolving or term facility that allows for recycling of the same commitment of debt (and in some cases equity capital),

ii) Delay-draw mechanics or an incremental facility to allow for additional borrowings when more projects are added to the warehouse, and

iii) Certain cross-collateralisation and deferral of equity returns to sponsor and third-party equity until the projects are sold.

Additionally, some sponsors have looked to the popularity of warehouses to address a specific need with small numbers of specific projects, essentially financing their cash equity commitment in a project with debt. The underlying projects usually have project-level debt or tax equity associated with them that are structurally senior to the loan.

Certain of these financings, while sometimes referred to as warehouses, really have characteristics that make them look very much like back-leverage financings or holdco loans. For example, a financing may ultimately only relate to a single project, or possibly a few projects, but not include any flexibility for substitution of projects or additional projects to be added to the facility.

A few key features of warehouses distinguish them from simpler holdco loans or pure portfolio financings. As noted, one key feature is the recyclability of capital in connection with multiple projects. The recyclability of warehouses necessitates that there be a pool of projects that can be added to a warehouse vehicle over time. Such a pool could be based on projects meeting predetermined criteria and, in such cases, projects would not need to be specifically identified.

On the other hand, a warehouse facility could contemplate specific projects that are pre-approved and that can be cycled through the warehouse as existing projects are sold or added to the warehouse via additional draws on debt commitments. The ability to substitute projects within a structure allows developers and sponsors to use a single facility to house multiple projects that are eventually sold, so long as the value of the lenders' collateral remains relatively the same over time. Without such a feature, a facility would look very much like a traditional portfolio financing – which often has target prepayment amounts for sales of individual projects.

Another key feature of warehouse facilities has been the reliance on yieldcos to purchase projects, either through a call right or otherwise. However, some lenders were unwilling to take yieldco take-out risk and did not invest in early yieldcos, and the chilled yieldco market has led others to focus on alternatives to the yieldco take-out assumption.

Warehouses can be structured as closed-ended vehicles, with committed take-out, or as vehicles that own assets and are geared against cashflow from operating projects. The reliance on sales of projects is key to the recyclability feature discussed above, as it is the only mechanism to create capacity within debt and/or equity commitments for application towards new projects coming into a warehouse vehicle.

What's next

Regardless of whether a sponsor looks to develop a warehouse using only third-party debt, third-party equity or both, any debt or equity investor will need to consider the underlying assets that exist at the time of the warehouse's origination and the scope of assets that the warehouse can acquire. Of course, if the yieldco market returns in the coming months, the originally structured warehouses could once again gain traction, but until investors are confident that yieldcos are able to acquire projects, warehouses will continue to evolve as closed-ended asset-holding vehicles or vehicles that look solely to cashflows from operating projects. ■

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