



Analyzing YieldCos and Other Financial Engineering

North American Power Credit Organization Credit Conference

Agenda

1. Overview
2. Importance of Sponsor
3. Basic Corporate Finance Model
4. Analytical Approach
5. Q & A

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Overview

YieldCo: An Alternative Financing Vehicle

- » A corporation designed to pay a high rate of dividends (yield) to shareholders
- » A type of financial engineering, which also includes MLPs and REITs
- » Brings MLP corporate finance model to power sector
- » Unproven finance model, with 2 YieldCos rated, both non-investment grade:

| Sponsor | Rating | YieldCo | Rating |
|------------|---------------|-------------------------|-----------|
| NRG Energy | Ba3 | NRG Yield | Ba1 |
| SunEdison | Not Rated | TerraForm | Ba3 |
| NextEra | Baa1 | NextEra Energy Partners | Not Rated |
| TransAlta | Baa3/Negative | TransAlta Renewables | Not Rated |
| Abengoa | B2 | Abengoa Yield | Not Rated |

Source: Moody's

Similarities and Differences Among Yield Vehicles

- » Yield vehicles differ in their treatment under the tax code, which determines eligible assets, but corporate finance strategies are similar

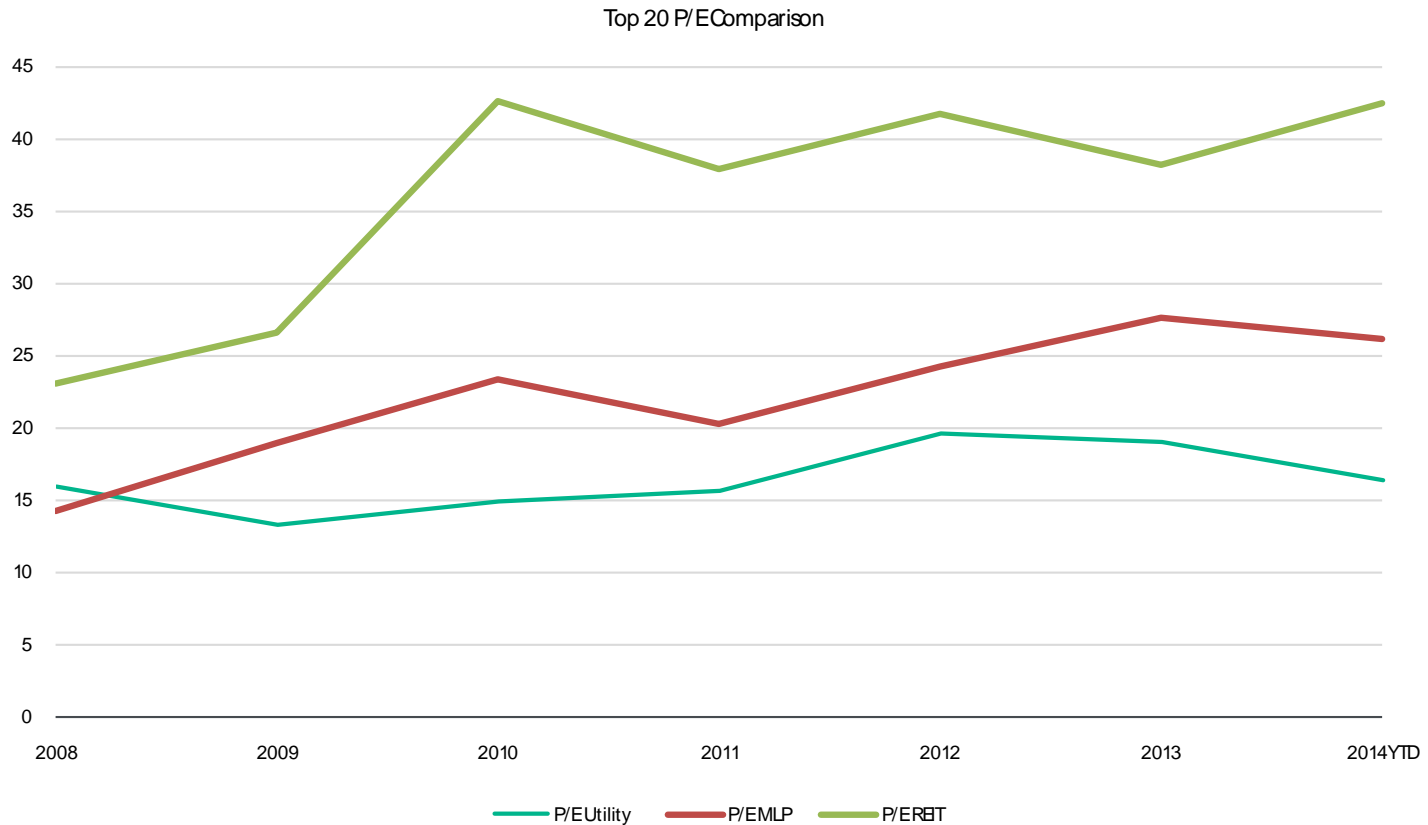
| | MLP | YieldCo | REIT |
|-----------------------|--|---|--|
| History/ Industry | 30 years/ energy | <2 years/ renewables | 50 years/ real estate |
| Corporate structure | Partnership | C-Corp | Corporation, trust, association |
| Tax status | Not taxable at entity | Taxable, but depreciation from acquired assets shields taxes | Not taxable at entity |
| Qualifying assets | “Exhaustible” resources that generate “qualified income” per IRS (exclude renewables, utilities) | Unrestricted | “Real property” per IRS (excludes renewable generating equipment considered “personal property”) |
| Dividends | Partnership agreement requires payout of Distributable Cash Flow | Unrestricted | IRS requires payout of 90% of income |
| Other characteristics | Ongoing businesses; typically unencumbered assets | Assets are contracted revenue streams without organic growth; portfolio of projects with non-recourse amortizing debt | |

Why Power Turning Now to Financial Engineering

- » Strong growth prospects for renewables
 - Falling costs, EPA's Clean Power Plan carbon reduction beginning 2020,
- » Find new funding source to meet construction deadlines to receive tax incentives: PTC by Y-E 2015, reduction in ITC by Y-E 2016
 - Replace tax equity, a traditional form of financing for renewables
- » Matches power developers' **need for capital** with investors **demand for yield** in low-interest rate environment
- » Raise cheaper equity capital for growing, secondary business

Looking to Drive Cost of Capital Down

What goes up must come down

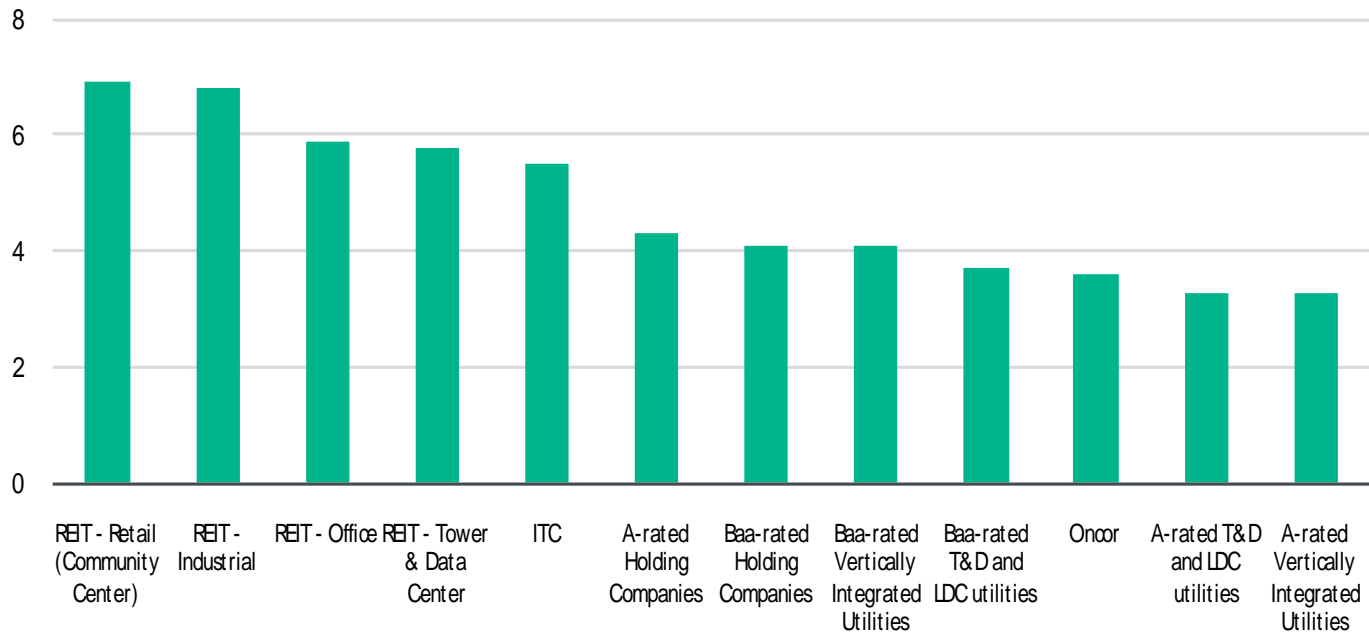


Upside of Financial Engineering

- » Diversify sources of capital to a growing class of yield-oriented investors
- » Boost stock price by bringing transparency to undervalued business
 - Clearly delineate business lines, by growth and return expectations
- » Monetize portion of assets while retaining control and potential upside
- » Growth delivered by the finance department
 - Shareholder growth amidst anemic sales volume prospects

Unlocking Incremental Debt Capacity

Investment Grade REITs Maintain Higher Debt / EBITDA Than Utilities



Source: Moody's, 2013 data

Risks of Financial Engineering

- » Trade-off of near-term benefits at the expense of long-term financial flexibility
- » Getting on the treadmill – pressure to keep raising dividends per share
 - PPA-backed assets have finite cash streams, organic growth
 - Mind the distribution coverage: grow cash-producing assets in tandem with distributions
- » Feeding the beast – acquisition event risk
 - Reliable long-term forecasting not possible because uncertainty in what might be acquired when
 - Our analysis of YieldCos and their sponsors will evolve as they make acquisitions and change their capital structure, the level of structural subordination, and business risk
- » Typically comes with increased leverage across consolidated family
- » Structural subordination / complexity
 - Cash leakage
 - May be neutralized by paydown of Sponsor debt or more cash flow from other assets
 - Debt covenants could restrict free flow of capital up/down organization

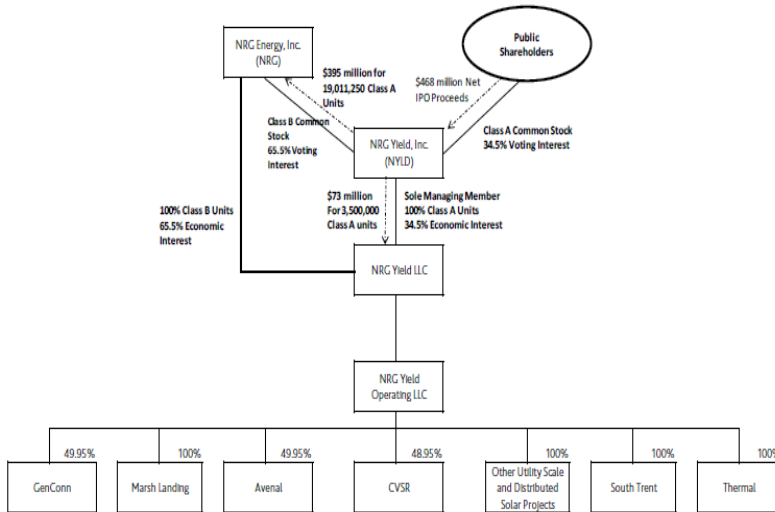
Increased Capital Structure Complexity

Can you follow the cash flows?

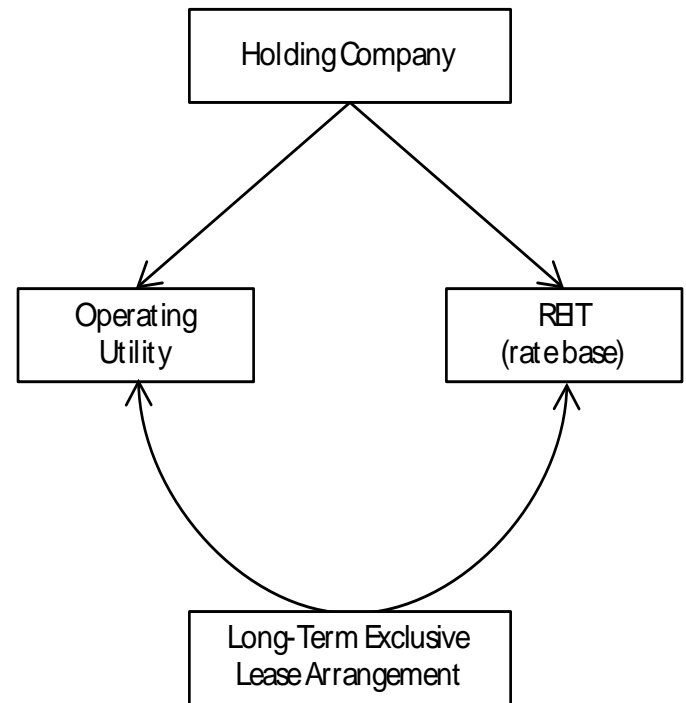
YieldCo

Illustrative Utility (Transmission) REIT

EXHIBIT 1
NRG Yield Inc. Organization Chart



Source: NRG Yield S-1 dated 07/08/2013 and NRG Yield 06/30/2013 10-Q



Source: Moody's

Potential Candidates for Yield Vehicles

» YieldCos – Mostly unregulated, non-investment grade candidates

– Utilities

- » Diverse holdco, but utility is core business. Raise capital for growing secondary business.
- » Example: Sempra

– Renewable/Infrastructure Developers

- » Long -term players. Lower cost of capital is prime motive.
- » YieldCo adds stable cash flows to the consolidated credit profile. Recycle equity capital.
- » Example: Acciona

– Solar Panel Manufacturers

- » Many entered project development to capture PPA value vs being limited to commodity market for panels.
- » YieldCo provides balance sheet strength to retain more value – keep project rather than sell before construction.
- » YieldCo maybe more creditworthy than parent.
- » Examples: First Solar, SunPower

– Aggregators

- » Opportunistic financial investors

» REITs

– Electric transmission owners

- » InfraREIT, Oncor

Long-term Risks to Corporate Finance Model

- » Yield Vehicle valuations unlikely to keep rising indefinitely

- » Potential constraints:
 - Higher interest rates
 - Taxes – YieldCo eventually uses up tax benefits and starts paying taxes
 - Regulation that slows / stops renewables momentum

- » Downside scenario (e.g., Atlantic Power):
 - Assets generate less cash flow
 - » Weak power prices, recontracting risk, asset underperformance
 - Dividend cut
 - Stock prices drop, reducing market access to make acquisitions to grow cash flow, refinance debt
 - Liquidity profile weakens due to covenant restrictions

Potential End-Games: Sponsor and Case-Specific

- » Sponsor response to Downside Scenario will be case-specific
- » Downside Scenario affects stockholders first
- » Dividend reductions will be an important tool to manage credit impact
- » Strong sponsor could re-absorb the Yield Vehicle (e.g., Kinder Morgan share exchange to restructure as C-corp, Spectra Energy taking private its income fund)
- » Renewable developers / panel manufacturers may need to recalibrate business model
 - Cost of capital may go up
 - Projects maybe sold to utilities again rather than retained
- » Financial sponsors will stop growth and may slowly wind down their funds, sell assets
- » Sponsor can sell the Yield Vehicle
- » Some sponsors may position the Yield Vehicle as non-recourse

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Importance of Sponsor

Sponsor's Impact on Yield Vehicle

- » Sponsor creates a Yield Vehicle: provides it with assets, manages it.
- » Sponsors of MLPs own a 2% GP equity stake which gives them almost full control of the MLP. MLPs have less corporate governance protections than a typical public company.
 - YieldCos have replicated this corporate governance model, through majority share ownership and/or dual-class voting structure.
- » Can raise corporate governance conflicts, if economic interests diverge
- » Symbiotic relationship between Yield Vehicle and Sponsor results in close ratings (usually 0-2 notches above/below)
- » Sponsor could be positive or negative influence on Yield Vehicle credit quality
 - Sponsor rated higher: Sponsor larger, more mature
 - Yield Vehicle rated higher:
 - » Sponsor is simply a holding company for Yield Vehicle as principal subsidiary
 - » Yield Vehicle has lower business risk than Sponsor (e.g., NRG Yield, TerraForm)

Yield Vehicle's Impact on Sponsor

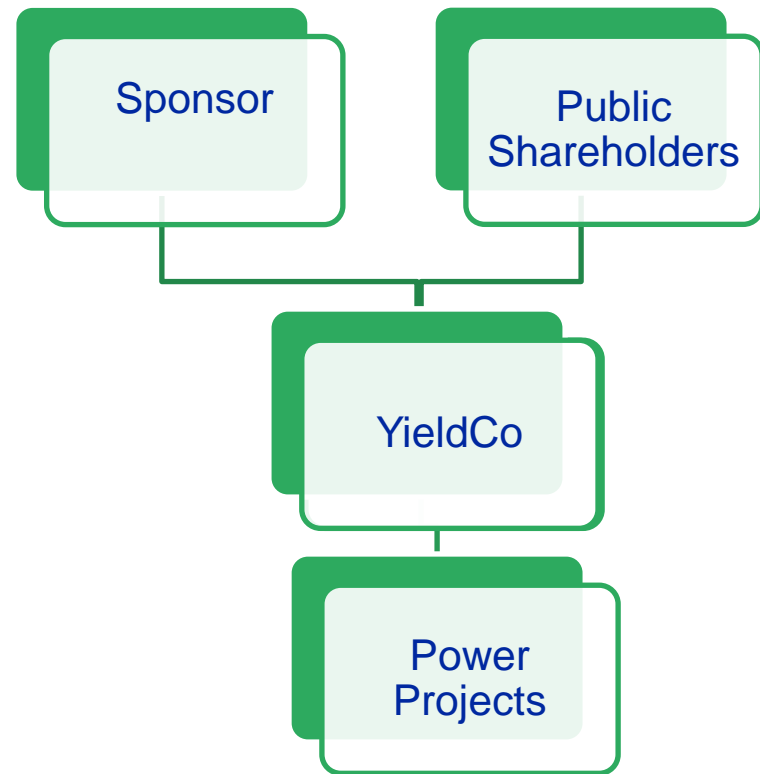
- » Focus on cash leakage and structural subordination, but overall impact on Sponsor is case-specific
- » NRG / NRG Yield (NYLD)
 - High quality cash flow moved to NYLD, but these are mostly new cash flows after NYLD's formation, so neutral to our assumptions for NRG
 - NYLD necessary for NRG because of lower cost of capital
 - NYLD makes contracted generation a viable business for NRG
 - NYLD allows NRG to grow contracted cash flows, though NRG parent debt holders structurally subordinated
- » NextEra / NextEra Energy Partners (NEP)
 - NEP incrementally adds to dividend payout and structural complexity, but too small to have significant impact on NEE
 - NEE has strong access to capital - will not risk its rating over this minor affiliate
 - NEP brings alternative source of equity capital for secondary growing business
 - NEP allows NEE to recycle capital while retaining control and potential upside

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Basic Corporate Finance Model

Illustrative YieldCo

- » Sponsor provides assets, management and employees
- » Sponsor can have significant holdco debt, which becomes more structurally subordinated
- » NRG and TerraForm have OpCo level in between YieldCo and Power Projects that hold rated debt
- » Power projects leveraged with project finance debt, with restrictive covenants
- » Projects could be JVs that also be leveraged with project finance debt



Illustrative YieldCo Measures

| Measures | Typical | Significance |
|-------------------------------|--|---|
| Dividend Yield | 2% - 5% dividend % stock price | Strength of stock price, cost of equity capital |
| Target Distribution | 80% - 85% Cash Available for Distribution | Reverse of 1.2x Distribution Coverage Ratio |
| Yield Growth Guidance | 12% - 15% annual growth for first 3 – 5 years | |
| Drop-Down Eligible Assets | Rights of First Offer assets for first 3 – 5 years | Future drop-downs; visibility for growth |
| Incentive Distribution Rights | Yes | Replicates MLP feature |
| Asset Contract Life | 20 years | |
| Debt / EBITDA | 6x – 7x | |

Source: Moody's

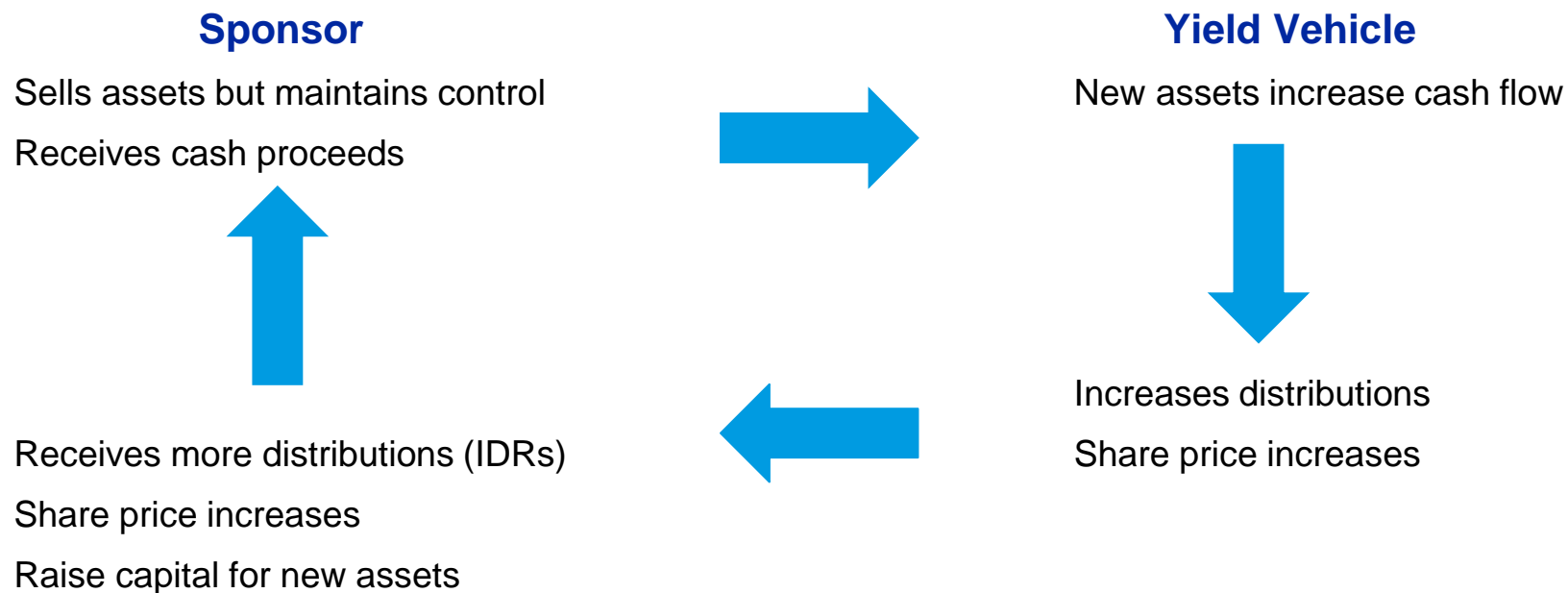
Yield

- » Lower cost of capital for investments
 - High stock market demand for Yield Vehicles lowers cost of raising equity vs. Sponsors
 - Low yield = high stock price
 - » fewer shares that need to be issued, dividends need to be paid on fewer shares
 - C-Corps pay taxes which raises hurdle rate for new investments vs. Yield Vehicles that don't pay taxes
- » Illustrative example of cost of capital arbitrage

| | Yield Vehicle | Sponsor |
|-------------------------------------|---------------|---------|
| Debt | 3% | 3% |
| Equity | 5% | 8% |
| Weighted Avg Cost of Capital | 8% | 11% |

Drop-downs

- » Sponsor sells, or “drops-down,” additional assets to its Yield Vehicle
- » ROFO assets (“pipeline” of potential drop-downs) could benefit Yield Vehicle stock price
- » Virtuous circle that could benefit both Yield Vehicle and Sponsor (illustrative)



Incentive Distribution Rights (IDRs)

Incentive for Sponsor to create Yield Vehicle

- » Replicates MLPs: GP initially retains 2% GP stake, but has opportunity to get 50% of distribution increases through IDR mechanism

Tiered structure – tops out at 50% “high splits”

- » Illustrative example: 100 units at \$2/dpu

| | Distributions per LP unit | LP% | GP% | Distributions to LP | Distributions to GP | Total Distributions |
|---------------|---------------------------|-----|-----|---------------------|---------------------|---------------------|
| First Target | up to \$1.00 | 98% | 2% | \$ 100.00 | \$ 2.04 | \$ 102.04 |
| Second Target | above \$1.00 up to \$1.20 | 85% | 15% | 20.00 | 3.53 | 23.53 |
| Third Target | above \$1.20 up to \$1.50 | 75% | 25% | 30.00 | 10.00 | 40.00 |
| "High Splits" | above \$1.50 | 50% | 50% | 50.00 | 50.00 | 100.00 |
| | | | | \$ 200.00 | \$ 65.57 | \$ 265.57 |
| | | | | 75% | 25% | 100% |

Cash Available For Distributions (CAFD)

- » Equity-oriented calculation to measure dividend growth, the driver of stock price
 - EBITDA: non-GAAP accrual accounting metric, not indicative of liquidity
 - “Maintenance capex” determined by management
 - Rely on external financing for “growth capex”

YieldCo Math

EBITDA

-/+ Adjustments affiliate
income/distributions

- Interest

- Principal

- Maintenance Cpx

= CAFD

- Growth Cpx

+ Debt financing

+ Equity financing

Exercise – Applying the YieldCo Math

- » Calculate CAFD and Dividend based on the below financial statements
 - Maintenance capex is \$30
 - YieldCo finances with 50/50 debt/equity
 - Payout is 85% of CAFD

| | | | |
|--------------------------|-------------|----------------------------|-------|
| Income Statement | | EBITDA | _____ |
| Op Inc | 1230 | -/+ Affiliate adjs | _____ |
| Depreciation | -300 | - Interest | _____ |
| <u>Interest</u> | <u>-100</u> | - Principal | _____ |
| Net Inc | 830 | - <u>Maintenance capex</u> | _____ |
| | | = CAFD | _____ |
| CF Statement | | - Dividend | _____ |
| Net Inc | 830 | - <u>Growth capex</u> | _____ |
| Depreciation | 300 | = Financing Need | _____ |
| Affiliate inc | -30 | + Debt financing | _____ |
| <u>Affiliate distrib</u> | <u>30</u> | + Equity financing | _____ |
| CF from Ops | 1130 | | |
| Capex | -1180 | | |
| Principal | -100 | | |

Exercise – Applying the YieldCo Math

- » Calculate CAFD and Dividend based on the below financial statements
 - Maintenance capex is \$30
 - YieldCo finances with 50/50 debt/equity
 - Payout is 85% of CAFD

| | | | |
|--------------------------|-------------|----------------------------|--------------|
| Income Statement | | EBITDA | 1230 |
| Op Inc | 1230 | -/+ Affiliate adjs | <u>0</u> |
| Depreciation | -300 | - Interest | <u>-100</u> |
| <u>Interest</u> | <u>-100</u> | - Principal | <u>-100</u> |
| Net Inc | 830 | - <u>Maintenance capex</u> | <u>-30</u> |
| | | = CAFD | <u>1000</u> |
| CF Statement | | - Dividend | <u>-850</u> |
| Net Inc | 830 | - <u>Growth capex</u> | <u>-1150</u> |
| Depreciation | 300 | = Financing Need | <u>-1000</u> |
| Affiliate inc | -30 | + Debt financing | <u>-500</u> |
| <u>Affiliate distrib</u> | <u>30</u> | + Equity financing | <u>-500</u> |
| CF from Ops | 1130 | | |
| Capex | -1180 | | |
| Principal | -100 | | |

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Analytical Approach

Analytical Approach – YieldCos

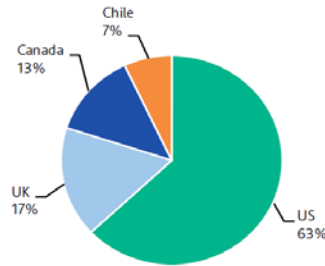
- » Basic credit analysis applies but also consider risks arising from corporate finance model
- » Apply Moody's rating methodology for Unregulated Power Companies

| Factors | Sub-Factor | % weight | Measures | Typical Positioning |
|-----------------------|--|----------|--|---|
| SCALE | Scale (\$ in total assets) | 10% | diversification | YieldCos still relatively small |
| BUSINESS PROFILE | Market Diversification | 5% | geographic or market region diversification | rated YieldCos have some concentration but are reasonably diverse |
| | Hedging and Integration Impact on Cash Flow Predictability | 10% | cash flow visibility due to contractual arrangements or hedges | long life of contract, good diversity and credit quality of counterparties |
| | Market Framework and Positioning | 15% | stability of markets and degree of fuel concentration risk | most assets in established markets |
| | Capital Requirements and Operational Performance | 5% | capex needed for maintenance and environmental | mostly renewable assets with limited capex, low business risk; operational record of Sponsor considered |
| FINANCIAL POLICY | Financial Policy | 15% | conservatism in financial policy | weak due to high payouts; consider Sponsor's record in balancing shareholder and creditor interests |
| LEVERAGE AND COVERAGE | (CFO Pre-W/C + Interest) / Interest | 10% | ability to meet interest with internally generated cash flow | leveraged profile |
| | (CFO Pre-W/C) / Debt | 20% | cash flow generating ability vs. debt load | leveraged profile |
| | RCF / Debt | 10% | dividend policy | leveraged profile |

Analytical Approach – YieldCos

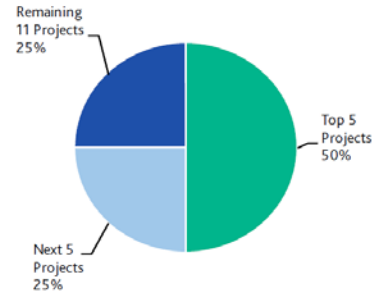
» Asset diversity, business risk differentiate business profiles

2015E CAFD by Geography

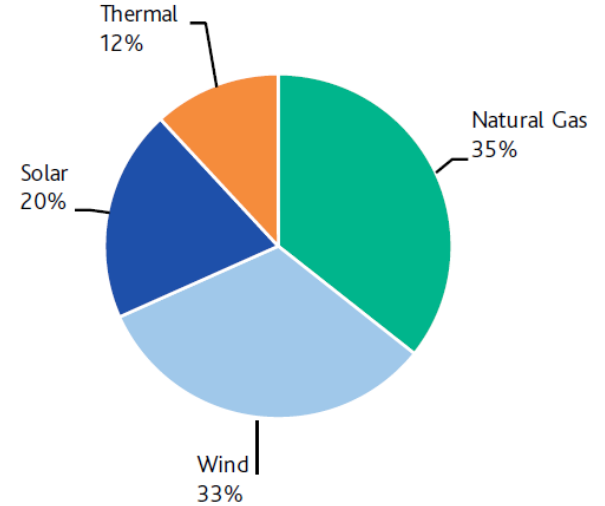


Source: Moody's, TerraForm Power Inc

2015E CAFD by Project Concentration

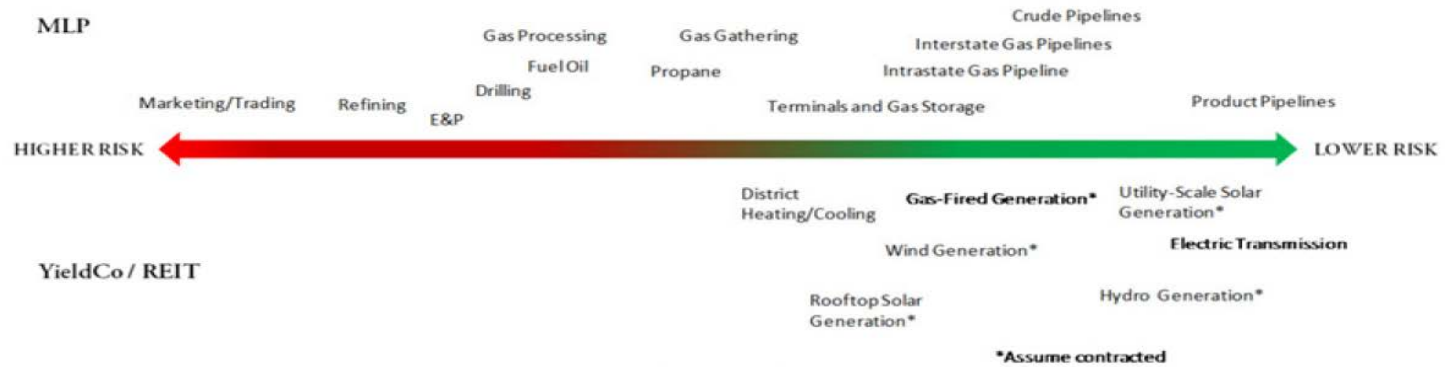


Source: Moody's, TerraForm Power Inc



2015E NYLD CAFD by Technology;
Source: Moody's

Business Risk Spectrum



Source: Moody's

Analytical Approach – utility REIT

- » Likely to apply rating methodology for Regulated Utilities or Regulated Networks
- » Credit considerations, in order of importance: impact on regulatory relationships, impact on retained cash flow, complexity of capital structure
- » Regulatory relationships
 - Regulators may question taxes currently included in rates, since REIT doesn't pay taxes
 - Regulators may question cost of capital, allowed returns, cost allocations, affiliate transactions
 - Utility's lease payment to REIT will be the utility's debt
 - Regulators may treat utility and REIT together for rate-making purposes
- » Retained cash flow
 - Dividends become non-discretionary (required payout of 90% of income)

Summary

- » Basic credit analysis applies but also consider risks arising from corporate financial model
- » Attractive industry environment but unproven business model
- » Credit quality differentiated by sponsor and by asset diversity, business risk
- » Sponsor could be positive or negative to YieldCo credit quality
 - Impact on Sponsor: focus on cash leakage, structural subordination
 - Impact on YieldCo: focus on potential drop-downs, track record in operations and financing
- » Potential reduction in long-term financial flexibility: higher payouts, increased leverage across consolidated family

Q & A

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