Sale-Leasebacks– Deep Dive

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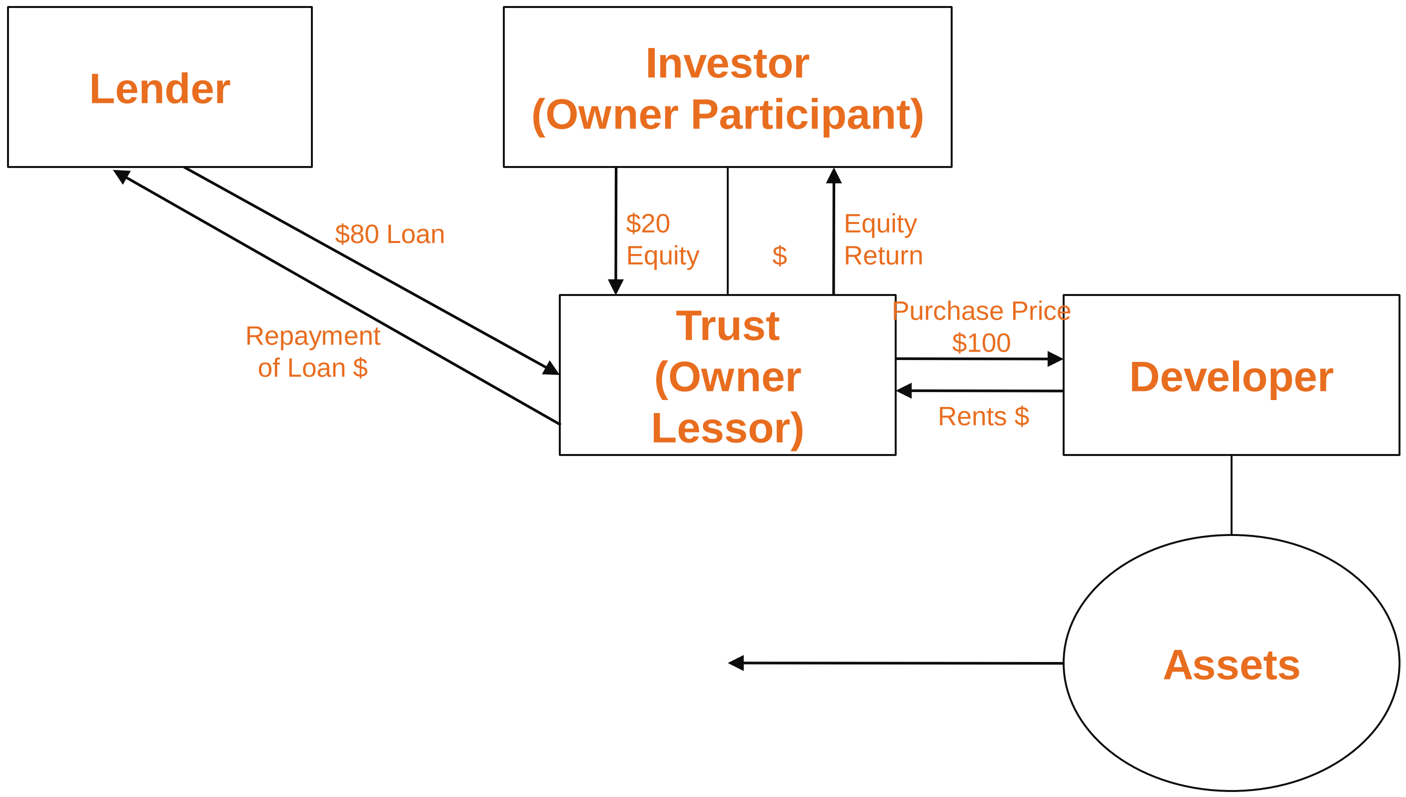
Basics of Leasing

- Leasing is a form of asset based financing that effectively uses the tax base of an investor to provide low-cost financing
  - Works best with a tax advantaged asset
    - MACRS Depreciation
    - Bonus Depreciation
    - ITC
- Renewable Energy Assets (wind, solar, geothermal, biomass)
- Leveraged when a lender supplies most of the capital

Basic Legal Structure



Tax Principles of Leasing

- A lease qualifies as a true lease for tax purposes if the lessor retains the benefits and burdens of ownership
- Key criteria:
  - Lessor expects the leased asset to have substantial residual value and useful life at the end of the lease term (20/20 test)
  - The Lessee does not have a bargain purchase option to buy the leased asset
- In a true lease, the lessor claims all the tax benefits in the project

Market Dynamics

- Leasing competes with partnership flips
- Very cheap back-leverage debt makes leasing less attractive when compared to a flip partnership with back-leverage debt
- Rising interest rates and higher spreads on back-leverage may make leasing more attractive
- Can be leveraged in a leveraged lease but transactions are complex to arrange and document
- Many tax equity providers offer both products depending on needs of customers
- Sale-leasebacks sometimes used to free up capital on existing assets.

Sizing the Purchase Price and Lease Rents

- The lessor's purchase price is generally equal to the FMV of the Project
  - Role of a qualified appraiser
- In practice, the purchase price is limited by a rent coverage ratio
  - 1.2x-1.5x
  - Contracted payments with strong credit off-taker
- The "gap" is frequently plugged with a rent prepayment on the purchase date
  - Complex tax rules govern the size and accrual of this prepayment (467 loan)

Lessee Economics

- P.E. funds (or developers owned by them) tend to look at their pre-tax rate of return.
  - Development Costs
  - Purchase Price (net of prepayment) +Lessee revenue
  - 12-15% pre-tax ROR
- Utility Lessees may focus more on the implicit rate of financing in the lease (with/without tax benefits).
  - Traditional lease vs. buy analysis
- Lessee fixed price buyouts makes the return computation more certain.

Lessor Economics

- Leases are generally booked as direct financing leases under FAS 13
- Proposed changes to FAS 13 requiring asset consolidation make lease accounting more uncertain, especially for leveraged leases
    - Proposed solutions to deconsolidate:
        - Lessors as minority owned partnerships
        - Partnerships where no party has effective control

Fixed Price Purchase Options

- Leases frequently offer the lessee the right to buy back the project during or at end of lease term
  - Most solar projects have buyouts at end of lease
- Buyout options are sanctioned by the IRS if they are priced at or above expected FMV
- Buyout options enable lessees to accurately calculate an implicit rate, an NPV or after-tax IRR
- Many lessors permit buyout options at FMV only (not fixed price).

The Role of the Tax Indemnity Agreement

- Tax Indemnity Agreements are common in lease structures
- The indemnity runs from the lessee to the investors
- Protects against the lessee taking actions that could harm the investor’s tax profile
  - Damage to the Project
  - Breach of representations (includes basis risk)
- Typically do not contain “structural” indemnities
  - Lessor assumes tax risk that lease is structured correctly

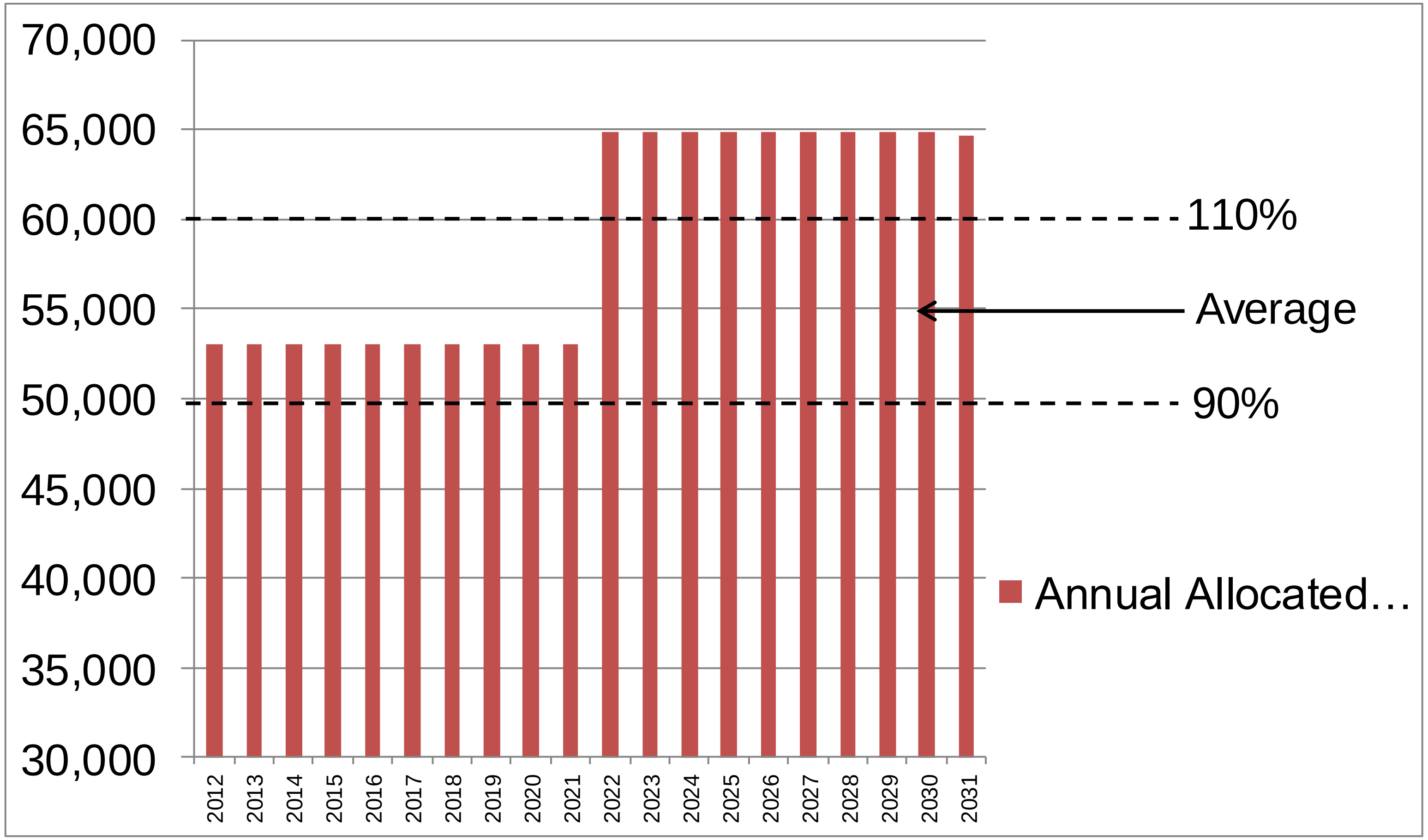
Key Debt/Equity Provisions

- There is a natural tension between the lender and lessor in any leveraged lease
  - Lender is senior in the capital structure
  - Lease defaults cause loan defaults
- Lessors negotiate for:
  - Rights to cure defaults under the lease (how many?)
  - Standstill agreements
  - Equity squeeze protection
- Dealing with a lessee bankruptcy “stay” is often heavily negotiated.

Lease Rental Structures

- There are two widely used rent structuring techniques to improve lease economics
  - Uneven rental patterns
  - Cash rentals separated from rental accruals
- Uneven rental patterns – low-high patterns where payments of rent step-up during the lease
  - IRS requires a range of 90-110% in all years
- Deferred/Prepaid structures – allow rents to be paid in one year and taxed in another year.
  - 467 loan structures
  - Two rental schedules

Lease Rental Structures



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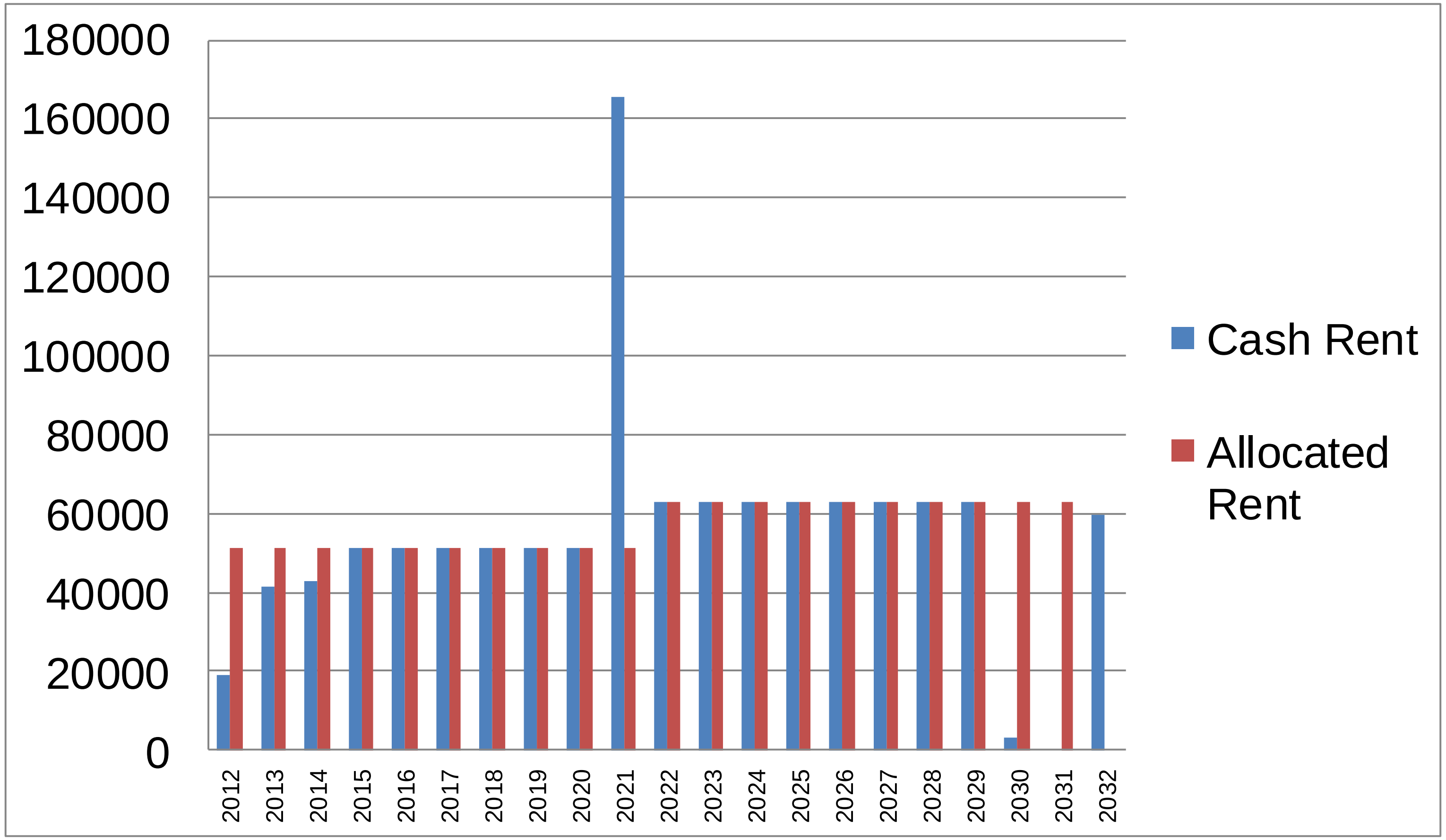
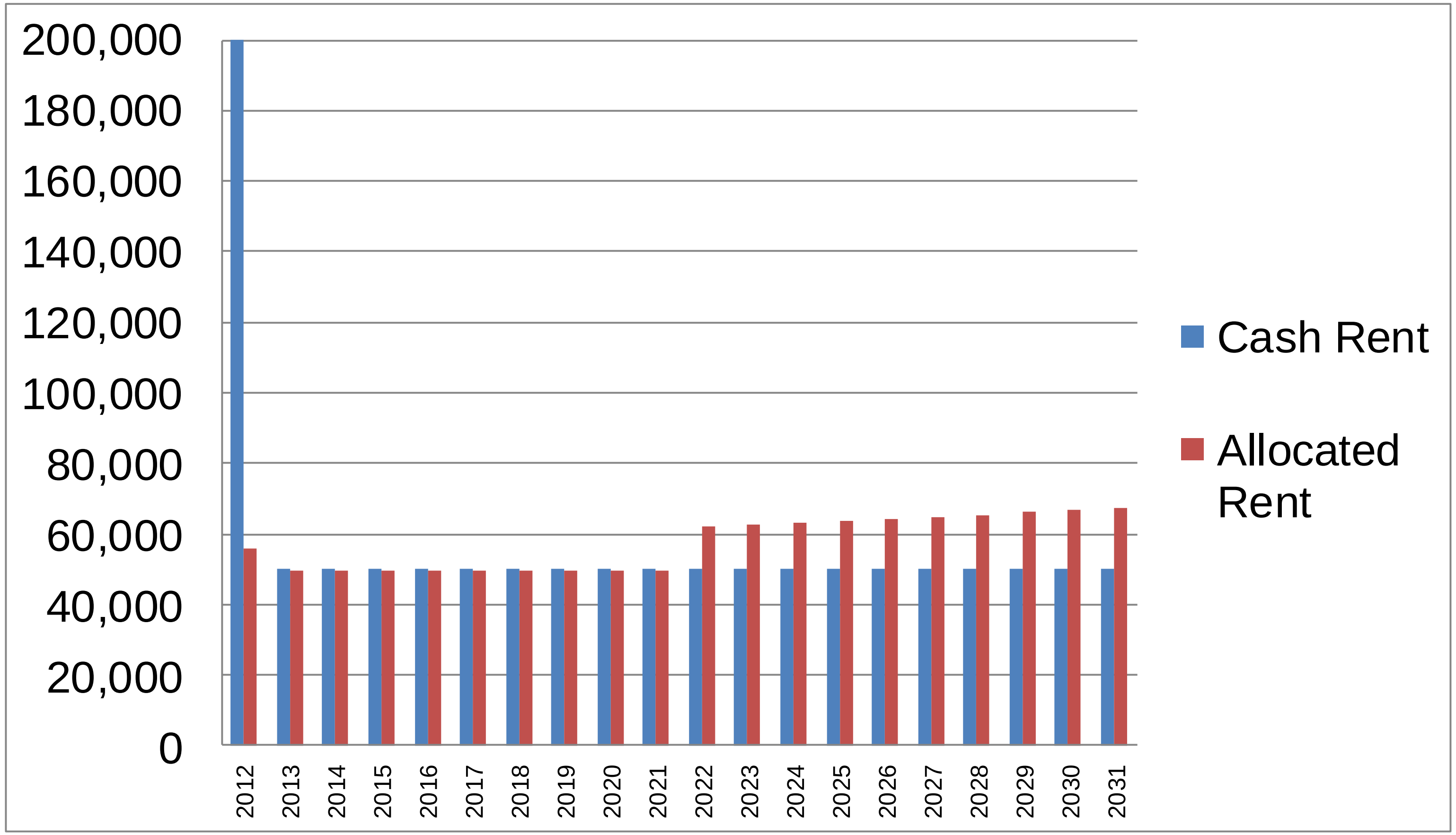
3-Year Window Structure



Prepayment Structure
Uses 467 Loan



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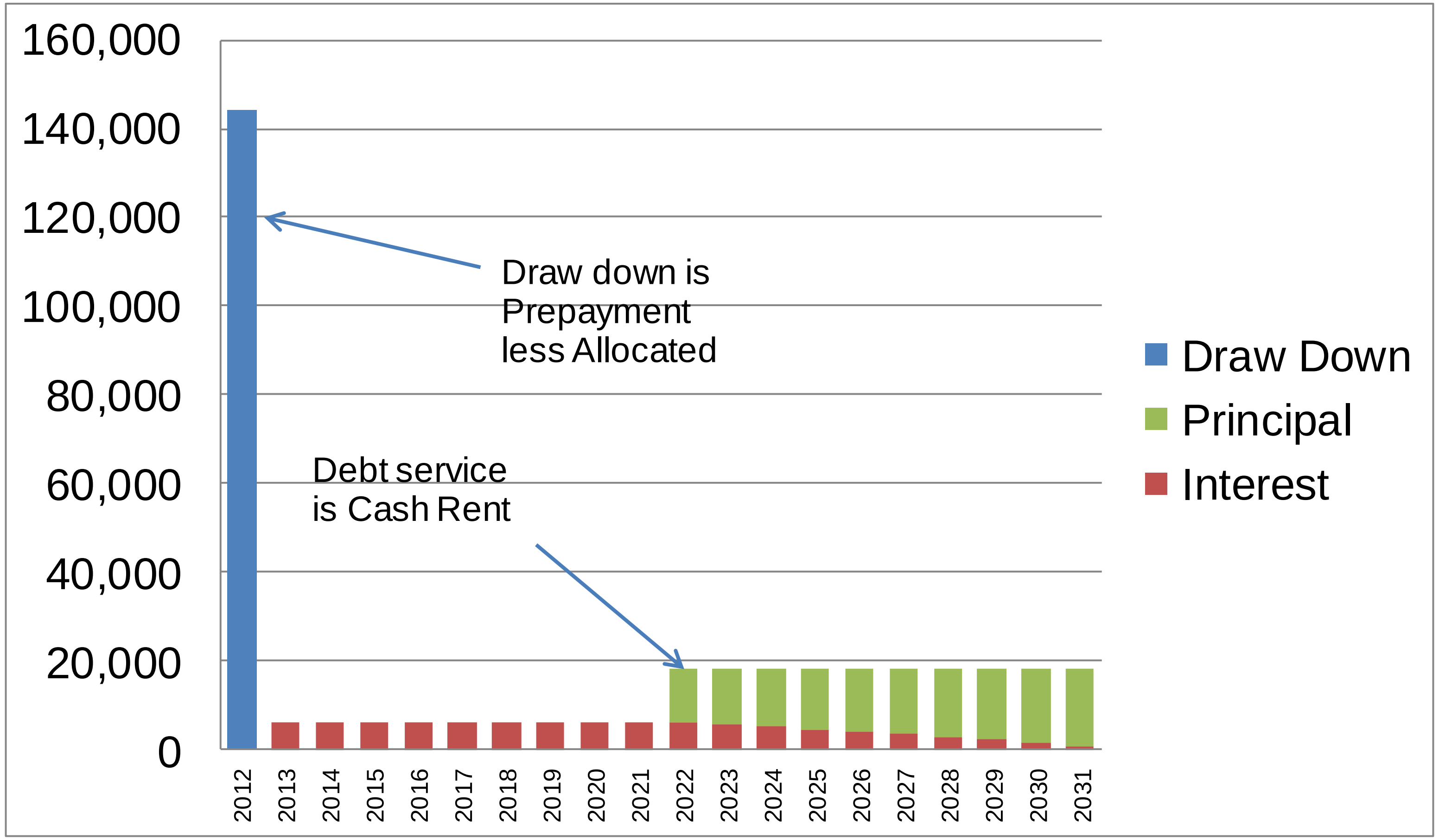
467 Loan Amortization



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