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Q3 2019 TerraForm Power Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 12, 2019 / 2:00PM GMT

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the TerraForm Power 2019 third quarter results webcast and conference call for investors and analysts. As a reminder, this conference is being recorded. I will now turn the conference over to Sherif El-Azzazi, Head of Investor Relations. You may begin.

Sherif El-Azzazi ***TerraForm Power, Inc. - Head of IR***

Thank you, Kevin. Good morning, everyone, and thank you for joining us for our 2019 third quarter results conference call and webcast. I'm joined today by John Stinebaugh, our Chief Executive Officer; Michael Tebbutt, Chief Financial Officer; and Valerie Hannah, our Chief Operating Officer. Before we begin, I'd like to remind you that a copy of our earnings release, supplemental information and letter to shareholders can be found on our website. Note also that we may make forward-looking statements on this call. These forward-looking statements are subject to known and unknown risks, and our actual results may differ materially.

For more information, you're encouraged to review the Risk Factors section in our SEC filings, which can be found on our website. In addition, we will refer to our non-GAAP financial measures. For more information on the reconciliation of these non-GAAP measures to comparable GAAP measures, please refer to our earnings release and supplemental information.

With that, I'll now turn the call over to John.

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

Thanks, Sherif. During and subsequent to the third quarter of 2019, we continued to execute our business plan, and we closed several financings that significantly bolster our liquidity, paving the way for our next phase of growth. I'll briefly go through few highlights.

First, we generated a $0.23 per share of CAFD, a 5% increase over the same period in 2018. We closed the acquisition of an approximately 320-megawatt Distributed Generation portfolio in United States for $720 million.

In addition, we executed a 10-year outsourcing Framework Agreement with SMA Solar Technology to provide operations and maintenance for our North American solar fleet, which is expected to reduce costs by $5 million per annum and mitigate operational risk of the portfolio through performance guarantees. We also executed upon various financing initiatives and currently have $1.2 billion of corporate liquidity. Michael will discuss these initiatives in further details in his prepared remarks. Combined with expected proceeds from our previously announced capacity recycling initiatives. We believe we are well positioned to capitalize on the robust pipeline of acquisition opportunities in North America and Europe, and we are actively pursuing. Turning to operations. Earlier this month, we executed a 10-year framework agreement with SMA to provide O&M services on a full wrap basis, for our North American solar fleet. I expect that we will be able to enter into LTSAs for approximately 50% of the fleet in the next 3 months. For the remainder, we will enter into LTSAs over the next 9 months pending receipt of consents from lenders and tax equity partners and transition operations to SMA. The 10-year agreement covers approximately 1 gigawatt, excluding the AltaGas DG portfolio that we recently acquired of our existing solar capacity and locks in pricing that is approximately $5 million less than our 2018 cost base. In addition, it will reduce our operating risk through performance guarantees that are consistent with our Long-term Average Generation. The Framework Agreement provides incentive for SMA to identify opportunities to make accretive investments in our fleet such as repowering and upgrades of inverters. The

Framework Agreement also includes a volume discount, whereby we can add additional assets such as the Altagas DG portfolio, and benefit from discounts on pricing provided we meet or exceed certain volume thresholds. We also executed LTSAs with Vestas, GE and Siemens Gamesa to replace the legacy O&M operators of all of our European wind fleet. All of our European one fleet is now being operated by original equipment manufacturers. The LTSAs have availability guarantees that will incentivize operators to perform at levels at or above industry standards and will yield approximately $4 million in annual cost savings.

With respect to the implementation of the LTSAs for our North American wind fleet, we made good progress completing required CapEx in order to fully transition operations to GE. We've now completed nearly 100% of blade repairs, excluding Clipper turbines that we're repowering, identified in our 2018 inspection program. And we plan to complete the additional blade repairs identified during our 2019 blade inspection program by mid-2020.

We've also completed all required repairs to gear boxes and pitch drives. Going forward, CapEx to maintain our fleet of this nature will be GE's responsibility under the full-wrap LTSAs.

In addition, we made progress on our wind repowering program. We received a special use permit to commence the repowering of our 125 megawatt Cohocton wind farm in New York and we expect to receive a similar permit for the 35 megawatt Steel Winds repowering by the end of this year. We've also received the vast majority of lease consents from landholders for Cohocton and are currently negotiating lease amendments with 2 major landowners for Steel Winds.

With regards to interconnection, we received a determination of non-materiality from the New York Independent System Operator for both Cohocton and Steel Winds. As a result, we are well underway towards achieving notice to proceed status for both of these repowering projects. Over the next few months, we are focused on following milestones: executing a Framework Agreement with GE that governors the key commercial terms of the turbine supply agreements and tax equity contribution agreements; entering into power purchase agreements or long-term financial hedges and closing construction loan agreements.

We remain very excited by these projects, as we believe we will be able to earn returns that exceed our target range with the current regime for renewable energy credits in New York and a hedge or power contract based upon current wholesale market pricing with no premium for renewable power. Finally, the repowering will reduce risk going forward due to replacing obsolete Clipper equipment with GE equipment under a full-wrap of LTSAs.

Now I'll turn the call over to Michael to discuss our financial results and provide an update on liquidity.

Michael Tebbutt ***TerraForm Power, Inc. - CFO & CAO***

Thanks, John, and good morning, everyone. In the third quarter of 2019, TerraForm Power delivered net loss, adjusted EBITDA and CAFD of $62 million, $195 million and $48 million, respectively. This represents an increase in net loss of $43 million, a decrease in adjusted EBITDA of $2 million and an increase in CAFD of $2 million compared to the same period in 2018. On a per share basis, CAFD of $0.23 reflects an increase of 5% compared to the same period in 2018.

Our results are primarily driven by high SREC solar incentives, O&M cost saving initiatives and higher production at our regulated wind farms in Spain, partially offset by higher management fees, lower market prices in Spain and lower realized prices in Texas. TerraForm Power's generation this quarter was approximately 9% lower than our LTA, primarily due to lower availability in North America, in particular at our Central and Texas wind portfolios, and to a lesser extent, lower wind resource in Hawaii where we have higher-priced contracts. Availability in our Central and Texas wind portfolios was negatively impacted due to downtime related with blade repairs and other maintenance activities associated with transitioning operation to GE.

In Texas, our average realized price reflect the generation profile which was weighted towards off-peak hours. During periods of extreme heat, our generation was less than our hedge obligation, which required us to cover our position at a loss and in September we were impacted by negative basis caused by maintenance outages on ETT transmission system in the Panhandle.

Over the coming 2 years, we expect market conditions in Texas to moderate as 15,000 megawatts of renewals, including 5,000 megawatts of solar, are expected to come online, which should improve reserve margins to more normalized levels. Furthermore, the maintenance of ETT transmission system should be completed by the end of 2021.

Turning to our liquidity. In October, we leveraged attractive market conditions to bolster our corporate liquidity and position ourselves for additional growth. First, we raised $300 million of equity comprising of a $250 million public offer and a $50 million concurrent private placement to Brookfield. We priced the equity offering at $16.77 per share, which represents a 50% premium to the stock price as of the beginning of the year. In addition, we closed a $700 million offering of 10-year senior notes. The notes priced at a coupon of 4.75%. And net proceeds were used to repay our $300 million notes due 2025 and our $344 million Term Loan B due 2022.

The refinancing will lock in debt service savings of $6 million per year and extend our maturity profile such that we have no corporate maturities until 2023. We also increased commitments under our corporate revolving credit facility from $600 million to $800 million and extended the maturity date by 1 year to October 2024. Upon completion of these transactions, as John mentioned, our corporate liquidity as of the end of October stands at $1.2 billion, including our $500 million sponsor line with Brookfield. At the project level, we closed the final tranche of our permanent financing plans for the Saeta acquisition in August comprising of 3 wind farms totaling 111 megawatts. The $131 million senior secured notes had a 13-year term and are priced at a spread of T plus 175. Overall, the financing plan associated with our acquisition of Saeta raised $390 million in non-recourse debt, $40 million in excess of our target.

Now I'll turn the call back over to John.

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

Thanks, Michael. I'll now provide an update on our growth initiatives. In September, we closed the acquisition of approximately 320 megawatts of DG from AltaGas, drawing on a $475 million bridge facility. The facility is a senior secured term loan with a 1-year term and an initial spread of L plus 100. We plan to refinance this loan with permanent project-level debt in the first half of 2020. In total, we now own approximately 750 megawatts in DG in North America. In light of the growing scale of this portfolio, we're in the process of making DG a standalone business within TerraForm Power. We believe that this will ensure that we provide the level of focus on this business-line in order to execute our strategy of enhancing the value of our existing assets, and with the support of Brookfield, developing a pipeline of new development projects and driving growth through M&A.

Over the past months, we've been pursuing 2 investment themes. We believe that there is a consolidation play in this Spanish renewables market as the sector is fragmented with many assets owned by private undercapitalized developers. In addition, we continue to focus on distributed generation where we see attractive risk-adjusted returns. In North America, we're seeing returns on DG at a premium level to utility solar as a result of the scale of our existing platforms and potential for operating synergies. As a result of our business development initiatives, we have a robust pipeline of opportunities, including solar acquisitions in Spain totaling nearly 150 megawatts, that would require over $150 million of equity investments in which we are in advanced stages of negotiations.

Moving onto legal and regulatory updates. New elections were held in Spain on November 10. As with the previous elections, the Spanish Socialist Workers' Party won the largest number of seats in Congress, yet again they were unable to win a majority of the seats to form a government. They will now have to negotiate with the other parties with regards to next steps, and a resolution is not expected before early 2020. We are actively monitoring political developments in Spain, but we continue to believe that the political environment is positive for the regulated rate of return as renewables enjoy broad support across the political spectrum.

As we look forward, one factor that has negatively impacted our business in past quarters, including the third quarter of this year has been below average generation of our North American wind fleet. The main driver of this generation shortfall has been the performance of the fleet, principally due to underinvestment by our previous sponsors, rather than wind resource.

Historically, in the wind industry, there has been greater margin of error in resource reports commissioned pre-commercial operation. However, the LTAs for our North American wind fleet are more reliable as they are based upon resource reports, which were commissioned by Brookfield during due diligence prior to its investment in October of 2017. These resource reports factored in 2 to 4 years of historical operational data for the wind portfolio and reflect approximately a 3% haircut from pre-commercial operations resource reports.

Year-to-date, wind resource has been 99% of LTA for our North American wind fleet, the most significant underperformance has been Hawaii, which was 83% of LTA during this time period. Excluding Hawaii, year-to-date wind resource rate for the fleet was a 100% of LTA.

Wind resource in Hawaii is more variable than in North America and is impacted by an El Niño-like pattern called the Pacific Decadal Oscillation. This pattern has historically resulted in weather cycles of approximately 20 years in Hawaii. We estimate that we're currently around 3 to 4 years after the low wind extreme portion of the cycle and resource should begin increasing to levels at or above LTA. Rather than resource, we believe the underperformance of our North American wind fleet is predominantly due to a shortfall in production, mainly driven by underinvestment by Terraform's previous sponsor.

Over the past 2 years, we've invested significant capital to address this issue. Furthermore, for our Framework Agreement with GE, we're required to remediate certain pre-existing conditions prior to effectiveness of the performance guarantee under the LTSAs. Over the past 2 quarters, we accelerated our blade repair and maintenance program in order to take advantage of more temperatures conducive for maintenance activities as well as seasonally lower wind conditions. As of October 1, performance guarantees are in effect for all 15 wind farms that have been transferred to GE. For these assets, GE has assumed performance risk under the LTSAs with performance guarantees that will be consistent with our LTAs on a wind adjusted basis. Over the past 9 months, we've commissioned independent engineering reports to support financings and plan capital recycling that comprise 56% of our North American wind fleet including 2 of our Hawaiian projects. We are pleased to report that our LTA's and the benefit of our performance guarantees have been validated under these reports.

Going forward, our portfolio will continue to benefit from its unique diversity by geography, by technology and by revenue framework with a significant amount of regulated revenues that have a high percentage of demand charges that do not vary with production. In general, our wind and North American solar fleets are now largely insulated from performance risk as a result of the recently negotiated LTSAs, and we have aligned incentives with our outsource providers to find opportunities to invest in our assets that are accretive to value.

Finally, upon completion of our financing program in October, we now have substantial dry powder to invest in organic growth opportunities such as our repowerings and our robust pipeline of acquisition opportunities to further drive growth.

This concludes our formal remarks. We will be pleased to take questions at this time.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Colin Rusch with Oppenheimer.

Colin William Rusch ***Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst***

As you work through the -- lower your cost of capital, can you talk about the addressable acquisition opportunities that -- has these opportunities set expanding for you guys at this point? And how much so?

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

Colin, it's John. It is -- you know we try to be pretty opportunistic about the opportunities that we're targeting. We're targeting absolute returns of 9% to 11%. So as our stock has increased, we have not changed those goalposts. We're still targeting the same 9% to 11%. And I'd say that where we see the best risk-adjusted returns right now are the commentary we provided in the letter. We're looking at a number of opportunities in Iberia as well as Southern Europe, where we think the risk-adjusted returns are particularly attractive. And we also are looking at opportunities in North American solar, and we continue to focus on the DG opportunities similar to the AltaGas DG portfolio that we recently closed on.

Colin William Rusch ***Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst***

And then, I guess, I'd be remiss in not talking about energy storage with some of the distributed assets. Are there opportunities to come in and provide some resiliency services to some of those DG customers and renegotiate PPAs? Is that something that you guys would pursue or is interesting at this point?

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

We definitely think there's an opportunity to do that. So that's a big part of the business plan that we're putting together for our DG business to basically work with our customers, identify needs to broaden the offering of products that we got with them and we think storage is a big part of that particularly for behind-the-meter customers that can help reduce their coincident peak demand. It can provide resiliency and also there's potential opportunities to redispatch that back into the wholesale grid. But those are all the things that as we develop our DG plan and hone our execution capabilities to be able to position ourselves for that business plan. That's -- those are all things we are looking to do.

Operator

Our next question comes from Praful Mehta with Citigroup.

Praful Mehta ***Citigroup Inc, Research Division - Director***

So maybe first on M&A that the capital allocation that you're talking about and the dry powder you have. Are you looking at minority stakes as well? Because I know utilities may be looking to monetize some portion of their renewable portfolios, as they look to recycle capital. Is that something that you would be interested in? Or is it only full ownership is kind of you're, kind of, focused on?

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

We are generally not interested in acquiring minority stakes. I would say that we could buy assets where we don't buy 100% if it's a controlled stake and we have operatorship. One of the big things, as you know that we are looking to do, is to drive value creation through improvement of operations. And you can't really do that if you've got a nonoperating minority stake. What I think you'll see us do more likely is sell nonoperating stakes in assets where we've extracted value and we've stabilized the cash flows to institutional buyers.

Praful Mehta ***Citigroup Inc, Research Division - Director***

Got you. Fair enough. And then maybe on ERCOT, I wanted to just understand the hedge profile you have or what it is that kind of help or triggered the position you were in this summer because there was, obviously, extreme volatility? And why do you believe that volatility will go away because the expectation is, even though you have more renewables coming in, in Texas, you probably have some coal that does leave the system keeping markets relatively tight and volatile. So any color on that would be helpful?

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

Sure. The issue in the summer in ERCOT basically had to do with the profile of our hedges. We've got a commitment to deliver a certain amount of volume and it's on an hourly basis. And to the extent that during extreme periods of time when wind tends to not be as strong, we were in a situation during some of those hours where we were short production and as a consequence had to buy power to cover the obligation. So that was one of the causes, and I'd say that, that was more of an issue at our Rattlesnake wind farm where it had weaker wind resource during extreme periods of temperature. The other issue that impacted us was primarily in September, which was the maintenance outage of the ETT transmission system. So those were the 2 factors that impacted the quarter. And we do think, though, that if you look at the queue of renewables in the next 3 to 4 years, there's estimates of up to 20,000 megawatts of renewables that are expected to come online. And anecdotally, we are seeing tons of renewable projects where people are looking for capital in Texas. So it's, by far, the region where there is the most development activity and deal flow. And in particular, a good amount of generation, we think, roughly 10,000 megawatts is solar, which will provide generation during peaks periods of time where reserve margins are particularly low. So that's basically what we're seeing that we think will offset that. It's probably a couple of years. I think if you look at forward markets, 2020 is -- prices are indicating that participants -- things are going to be still somewhat tight, but we think by '21, things will moderate.

Praful Mehta ***Citigroup Inc, Research Division - Director***

Got you. Fair enough. So if '20, there is volatility, do you expect that if you have some of these obligations, where you have -- would you be forced to buy power again in the market? Or you kind of have a different hedge profile going into '20?

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

It all depends. Last year was pretty similar to this year. And one of the differences was, this year, there was some forced outages of generators during extreme periods, which created more stress on the system. So it will depend on the particular circumstances. We are looking to do different things to mitigate the risk. So that's something that we'll actively evaluate as we did this year going into next year.

Operator

Our next question comes from Mark Strouse with JP Morgan.

Mark Wesley Strouse ***JP Morgan Chase & Co, Research Division - Alternative Energy and Applied & Emerging Technologies Analyst***

Most of them have actually been answered. But John, I was just hoping you could give a bit more color on your commentary regarding the premium returns that you're seeing for DG and North America. Is that fairly broad based? Or are there particular states or regions that are stronger than others? And then on top of that, is it in mostly resi or C&I? Or just kind of any color you can give on the generating assets would be helpful?

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

Sure. I wouldn't say that phenomenon is in any one particular region. I think more generally, we are seeing higher returns on DGs than utility scale. Part of it is that it is bit of a different animal in the sense that, particularly the behind the meter, you basically got customers who are -- buy power from you, and you're competing against the retail tariff as opposed to the wholesale prices. So it's one where, I think, it's not as well understood as the wholesale market. So because of that, we see somewhat less competition. And then, also what we've been able to see is particularly with the scale that we have got we were able to negotiate very favorable terms with the O&M contract that we've got with will SMA and are able to bring value to the table by being able to drive down O&M costs as we're looking at portfolios. And for DG assets, which individually tend to be pretty small, the ability to impact the cost side of things, can be a real driver of value.

Operator

Your next question comes from Ben Pham with BMO.

Benjamin Pham ***BMO Capital Markets Equity Research - Analyst***

Two questions for me, M&A's hot topic on this call, and I don't want to deemphasize your organic growth. And that's still very strong. My question is really related to the first one that was asked in terms of has your M&A opportunities, have they broadened? Have they increased your recent stock pricing? It sounds like you're keeping to your target returns. It sounds like it's no. But I'm curious though now, has it more increased potentially because maybe you're more willing to do bigger transactions and when your stock was at $11?

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

Particularly with Brookfield as our sponsor, we will look at all transactions and we think we are uniquely positioned, similar to the Saeta transaction we did last year, where -- with Brookfield as a sponsor, we were able to put together the capital and the capital on a firm basis to do a transaction required a $1.2 billion equity check. So I don't think that's really changed at all. I think we've always sort of looked at within our target markets of North America and Europe, opportunities that are of scale or of more smaller bite-sized portfolios. And we're just trying to find where we can see the best risk-adjusted returns. But I will say that when you do look at larger scale opportunities they tend to be fewer and farther between, but we also think there's less competition in going after them.

Benjamin Pham ***BMO Capital Markets Equity Research - Analyst***

That's good to clarify that. And then second question on your dividend growth guidance, of 5% to 8%. It sounds like you'll be in that range, just given all the leverage for growth. How are you guys feeling in terms of where you hit there? I mean is it low end, midpoint, high point or maybe not sure yet?

John Marcus Stinebaugh ***TerraForm Power, Inc. - CEO***

I think we'll provide a little more guidance on that next quarter. As we typically do when we -- that's your -- that's the quarter when we have signaled to the market that we'll take action on the dividend and provide a little more commentary after getting approval of our 5-year business plan. I'd say that we -- would definitely say that we'll be within the 5% to 8% range. But at this point, I wouldn't really give much commentary in terms of more precision than that.

Operator

And I'm not showing any further questions at this time. I'd like to turn the call back to our host.

Sherif El-Azzazi ***TerraForm Power, Inc. - Head of IR***

Thank you, Kevin. And thank you, everyone, for joining us today. This concludes our call.

Operator

Ladies and gentlemen, that concludes today's presentation. You may now disconnect. And have a wonderful day.