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Q1 2019 TerraForm Power Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the TerraForm Power 2019 First Quarter Results Webcast and Conference Call for Investors and Analysts. (Operator Instructions) As a reminder, this conference is being recorded. I would now like to turn the conference over to Chad Reed, Head of Investor Relations. You may begin.

Chad Reed ***TerraForm Power, Inc. - Head of IR***

Thank you, operator. Good morning, everyone, and thank you for joining us for our 2019 First Quarter Results Conference Call. I'm joined today by John Stinebaugh, our Chief Executive Officer; and Michael Tebbutt, our Chief Financial Officer.

Before we begin, I would 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 non-GAAP financial measures. For more information on a 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, Chad. In the first quarter of 2019, TerraForm Power generated CAFD of $44 million compared to $23 million in the same period the prior year. In addition to the contribution from the Saeta acquisition, the increase in CAFD reflects the ramp up of the completed margin enhancement initiatives that we began implementing last year.

In August 2018, we secured a framework O&M agreement with GE to whom we are transitioning the operations of our entire North American wind fleet. Also in late 2018, we completed our solar performance improvement plans. We're pleased to report that these initiatives contributed $6 million of CAFD in accordance with expectations.

First, compared to the first quarter of 2018, the O&M expense for our North American wind fleet declined by $2 million as a result of turning over operations of 6 wind farms to GE at the beginning of the quarter.

Second, we accrued $2 million of incremental margin under our long-term service agreements at a number of wind farms, including KWP in Hawaii demonstrating the performance-related benefit of these new contracts.

And finally, adjusting for resource and curtailment, our solar farms produced 14-gigawatt hours more electricity in the first quarter than in [the same period of] (added by company after the call) the prior year. This translates to approximately $2 million in incremental revenue. Once fully implemented, which we expect will occur by mid-2019, we anticipate that these completed margin initiatives will increase CAFD by over $40 million per year.

Note that the progress summarized above does not include additional cost savings from our Spanish wind fleet. As a result of terminating the O&M contract with the prior service provider earlier than expected, we realized $1 million of savings in the first quarter, excluding transition costs, reflective of the terms of the LTSAs with the new service providers that we are in the process of finalizing.

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

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

Thanks, John, and good morning, everyone. In the first quarter of 2019, TerraForm Power delivered net loss, adjusted EBITDA and CAFD of $36 million, $178 million, and $44 million, respectively. This represents a decrease in net loss of $40 million, an increase in adjusted EBITDA by $82 million and an increase in CAFD of $21 million compared to the same period 2018.

The improvement in our results primarily reflects the Saeta acquisition, improved availability in our wind fleet, and the contribution from our margin-enhancement initiatives.

Performance during the quarter further demonstrated the benefits of diversification of our renewable power portfolio. In Europe, strong wholesale market prices more than offset resource that was below normal, yielding results that were above expectation.

This offset performance in North America, that was below expectation due to lower average wind and solar resource and availability that was negatively impacted by icing and blade repair work.

In the second quarter, we plan to finish all blade repair work that is required prior to turning over operations of the remainder of our wind fleet to GE as well as finalizing the transition to new O&M providers for our Spanish wind fleet. This will negatively impact the availability across certain wind projects. However, beginning in the third quarter, we expect to operate at the availability level that underpins our long-term average.

In addition, we continue to progress the execution of $350 million nonrecourse debt component of our financing plan for the Saeta acquisition.

We expect to close our third project financing in May, raising proceeds of $100 million and the fourth and final project financing by the end of the second quarter. In May, we also closed the refinancing of our wind farm in Uruguay, raising $65 million of incremental proceeds. To further support corporate liquidity, we also released $23 million of cash in the first quarter by collateralizing project-level reserve accounts with letters of credit primarily at a number of our European projects.

Upon application of proceeds from these liquidity initiatives, we anticipate that we will reduce the drawn balance of our revolving credit facility by $300 million, which will help to reduce our corporate debt to cash flow ratio to our target of between 4 to 5x by the end of 2019.

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

Thanks, Michael. Now I'll provide an update on our operations. To date, we've turned over operations of 10 of 16 wind projects in our North American fleet and successfully transferred all system-control functions to GE. In addition, we have received all required consents from tax equity partners and nonrecourse vendors for 3 projects. For the remaining 3 projects, we are in the process of securing the required consents and anticipate that we will receive them shortly. We expect to complete the transition of operations to GE by July, which will be a significant milestone for TerraForm Power as we will begin realizing the full benefits of the LTSAs.

In late 2018, we solicited proposals for LTSAs for our 540-megawatt Spanish wind fleet, which is comprised of turbines manufactured by Vestas, GE, Siemens and Gamesa. Previously, these assets had been operated by a third party who had subcontracted O&M services to the original equipment manufacturers. During the first quarter, we reached an agreement to terminate the existing O&M agreement, and we have turned over operations to the OEMs under letters of intent in which we've negotiated the main commercial points of the agreements. We are now finalizing LTSAs, which, along with renegotiated O&M agreements for our wind fleets in Portugal and Uruguay are expected to yield approximately $4 million in annual cost savings going forward.

Late last year, we launched an RFP to improve the contract terms for the O&M of our North American solar fleet. Our goal is to lower our cost and improve the alignment of interests by implementing production guarantees with penalties and bonuses based upon performance.

We currently shortlisted a number of providers who recently submitted proposals following completion of their due diligence.

We're seeking to award contracts to one or more providers sometime in the second quarter and expect $2 million of annual cost savings from this initiative.

In terms of growth initiatives, in March, we entered into a letter of intent to negotiate exclusively with the seller of a 4 project 15-megawatt solar portfolio in Massachusetts. These assets are being acquired pursuant to a right of first offer with the seller. TerraForm Power has been operating these assets under a management service agreement since 2015, affording us a high degree of familiarity with the projects and markets.

Under the terms of the nonbinding offer, the deal is expected to close in 2 phases. The first 11 megawatts in May and the balance of 4 megawatts in December.

In the first quarter, we also completed the acquisition of the tax equity interest in a 10-megawatt solar portfolio located in Ohio and California and a minority interest in a solar asset located in Nevada. In total, the purchase price for these acquisitions is approximately $30 million, and they're expected to generate returns on equity within our targeted range.

Moving onto regulatory updates. In the Spanish general election on April 28, Spain's center-left Socialist Workers Party won 123 seats in Congress, which was far more than any other party and an increase of 38 seats from the number that they previously held. While this is short of the 176 seats required to unilaterally establish a government, PSOE, which is led by current Prime Minister Pedro Sánchez, now enjoys a stronger political mandate and is in the driver seat to form a coalition government. We believe this is a positive result for the regulated return as the previous Sanchez-led government proposed maintaining the regulated return at its current level of 7.4% for the next 12 years commencing 2020 for all renewable assets in operation before September 2013, including all our Spanish assets.

In light of the election results and broad-based support for renewable power amongst Spanish political political parties, we're optimistic that the newly formed government will pass a constructive solution to the regulated return in a timely fashion.

As we look forward, with modest economic growth, minimal signs of inflation and more accommodative central bank policy, including the policies of U.S. Federal Reserve, investors have shifted expectations to an environment of low interest rates for the foreseeable future. As a result, there has been strong investor appetite for yield, which has caused price appreciation for high dividend paying securities. Separately, as evidenced by the oil and gas sector, investors are penalizing companies that do not live within their means and must raise outside capital to support their growth plans.

We believe that TerraForm Power is well positioned in such an environment. TerraForm Power has unique diversification amongst renewable power companies. Under most power purchase agreements, wind or solar farms must produce electricity to generate revenue.

Thus, resource risk is one of the greatest risks of the asset class. But with renewable power assets in over 7 regions on 2 continents, TerraForm Power enjoys significant geographic diversification. Furthermore, our revenue mix is evenly split between wind and solar. Resources, which are not correlated from a time of day or seasonal perspective.

Finally, approximately 23% of TerraForm Power's revenue is a capacity payment under Spanish regulation with no resource or curtailment risk.

This unique diversification provides considerable stability for TerraForm Power's dividend, which was evidenced in our results in the first quarter. In addition, TerraForm Power's margin enhancement initiatives are expected to cover approximately 75% of the growth required to achieve its targeted 5% to 8% annual dividend increase through 2022, at a payout ratio of 80% to 85% of CAFD. Thus, TerraForm Power needs only a modest amount of organic growth investments and add-on acquisitions to fill the remaining gap. These investments should be fundable through internally generated cash flow. As a result, TerraForm Power should not need to issue any debt or equity capital to meet its growth target over the next 4 years. This does not mean that we will not execute an acquisition that requires us to issue equity. However, we can afford to be patient and wait for an accretive transaction with our ability to achieve our growth target and enhance shareholder value remaining in our own hands. This concludes our formal remarks. Thank you for joining us this morning. We'd be pleased to take questions at this time.

QUESTIONS AND ANSWERS

Operator

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

Kristen E. Owen ***Oppenheimer & Co. Inc., Research Division - Associate***

This is Kristen on for Colin. So 2 questions related to the rooftop solar portfolio. Are you seeing any opportunities to optimize that portfolio? And how far are you into that evaluation? And then are you seeing any need to begin replacing the inverters in the rooftop portfolio?

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

Kristen, we've recently brought on board at Brookfield as part of the manager a distributed generation development team. And one of the big priorities that we're tasking was this, to basically comb through the 400 megawatts of DG that we've got in our portfolio and look for opportunities to optimize those assets. So we'll be looking for opportunities to potentially deploy batteries. We will also be looking for opportunities to expand solar arrays. And the ultimate objective would be a win-win solution where we can deploy more capital and provide greater savings for our customers. It's early days though, so I don't have anything to report specifically. But as we progress that, we will certainly provide updates on our progress.

Kristen E. Owen ***Oppenheimer & Co. Inc., Research Division - Associate***

Okay. And then this is maybe sort of related. But do you have any strategy around EV charging infrastructure, is that something that you've considered?

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

We have looked at EV charging. I would say that it's certainly an area of interest for us but we haven't really firmed up any business plans that TerraForm Power is going to pursue. But it's an interesting sector. It's evolving very quickly. And there should be some potential synergies with Brookfield's real estate portfolio, but we don't have any business plans that we firmed up and are in the process of executing at this point in time.

Operator

And our next question comes from Nelson Ng with RBC Capital Markets.

Nelson Ng ***RBC Capital Markets, LLC, Research Division - Analyst***

I had a few questions on M&A. So regarding the Massachusetts solar project that you're looking to acquire, I think the price is like $24 million. Has that price being agreed to or can that number still move around given that it was more of a letter of intent?

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

We've agreed on price, and we're basically finishing confirmatory due diligence and executing documentation at this point.

Nelson Ng ***RBC Capital Markets, LLC, Research Division - Analyst***

Okay. And can you give a bit more color on those assets in terms of the remaining contract lengths?

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

Those are small-scale solar assets as well as DG assets. And the asset life is consistent with the average asset life for the portfolio. So it's got mid-teens remaining asset life for contract. But this basically is an acquisition pursuant to a right of first offer that TerraForm had with a utility company. And we bought some assets from them about a year ago. And these assets are coming off the recapture [period] (added by company after the call) for them, so we were able to negotiate a price and are in the process of finalizing documentation for this acquisition that we just disclosed.

Nelson Ng ***RBC Capital Markets, LLC, Research Division - Analyst***

Okay. Got it. And then on the other investments. I think roughly $6 million of investments in Ohio, California, Nevada in terms of tax equity and minority interest. Are these projects ones that you already have a majority interest in? Or are they new projects that you don't have an existing stake in?

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

These are assets that we already own the cash equity and in the case of tax equity buyouts. So it's a programmatic plan that we've got to basically buy out as much of the tax equity as we can once they go off recapture.

And think that we're the logical buyer and have been proactively combing through the portfolio, talking to tax equity players and trying to just get as much of this cleaned up because we think it's a good use of capital. We can earn good rates of return. Maybe other one is, a GP interest that SunEd had, and we ended up borrowing that from the SunEd estate.

Nelson Ng ***RBC Capital Markets, LLC, Research Division - Analyst***

Okay. So I guess over time, as your solar assets age, you would look to essentially buy out the tax equity on solar. And I presume, it's also the case for wind assets as well after -- I guess after they are 10-years old, or 9 or 10 years?

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

That's exactly right. And in our corporate profile under the growth initiatives, we do have an estimate of the potential opportunity to buy out a tax equity as well as other noncontrolling interests. So that's basically the opportunities that we're going out after, and we're trying to basically systematically execute those transactions.

Nelson Ng ***RBC Capital Markets, LLC, Research Division - Analyst***

Okay. And then just one more question before I get back in the queue. In the past, you've talked about doing some tuck-ins in Spain. With the recent elections, which are favorable, do you expect asset prices to increase, and do those opportunities still look favorable?

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

Asset prices have clearly increased since we bought Saeta. I'd say, when we bought Saeta, the view was the regulated return was probably going to be treasuries plus the 300 basis points that the regime had been talking about. Now the view is triangulating in between the 7.1% that the CNMV put forth as a recommendation in their white paper and the 7.4%.

So on the positive [side] (added by company after the call), if the asset values appreciated a lot on the Saeta acquisition since we executed it, the prices for assets going forward are going to be higher. But we still do think there are opportunities to make acquisitions of smaller assets better within our 9% to 11% return on equity range in US dollars. So we are looking at those. There's been a bit of a pause in activity as people are waiting for the election and understanding the implications that would have on the regulated rate of return. But what we do, it's an endeavor that we're actively pursuing and think that we should be able to acquire more assets and returns within our target range.

Operator

And our next question comes from Moses Sutton with Barclays.

Moses Nathaniel Sutton ***Barclays Bank PLC, Research Division - Research Analyst***

Wind operating cost improvements on a unit basis, they seem to be trending even better or perhaps faster than originally guided, it would seem based on 1Q and the $20 million run rate savings maybe could even prove conservative once the remaining 6 projects are turned over. Any potential upside to the original cost improvement guidance? Or is it really too early to accept that?

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

We still think the $20 million is a good number for the North American fleet. We did get savings earlier than expected for the Spanish wind fleet, the $1 million that we referenced in our disclosure, and I think that the numbers that we stated thus far in terms of O&M savings across wind and solar of $20 million for the North American wind fleet roughly $4 million for the Spanish wind fleet, including the assets in Portugal, in Uruguay as part of the Saeta portfolio. And finally, $2 million of O&M savings for solar. We feel confident that we're on track to achieve this.

Moses Nathaniel Sutton ***Barclays Bank PLC, Research Division - Research Analyst***

And then with the solar growth initiatives, any chance you could provide maybe even a range of the commulative CAFD uplift? I know you note in the release that it's the return profile you're looking for. But is it around -- the $30 million that you invest -- is it around a $3 million uplift in CAFD, something around there?

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

Those assets we acquired are going to generate an IRR in the midpoint of our target range - around 10%. So as a rule of thumb, typically that should be around 11% CAFD yield.

Moses Nathaniel Sutton ***Barclays Bank PLC, Research Division - Research Analyst***

Okay. That's good. And then last one for me. The other line contributed a sizable $8 million from wind to reach the $44 million company CAFD and you've had a similar benefit in 1Q '18 and 1Q '17. Is this wind contributions from tax equity partners? Maybe if you could probably a little more detail?

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

It's Michael here. That's correct. There's some PayGo contribution and also CAFD receipts from transmission reimbursement.

Operator

And our next question comes from Brian Lee with Goldman Sachs.

Brian K. Lee ***Goldman Sachs Group Inc., Research Division - VP & Senior Clean Energy Analyst***

I might have missed this, but you mentioned the blade repair work, was there any impact on the Q1 results? And then how should we be modeling the impact on availability, which you said would be negative impact to what would have any kind of quantification of what we should expect there?

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

It's Michael here. Yes. There was some impact in terms of the first quarter result because of the blade repair as well as icing, in particular, in our Central Wind. And as we said in our earlier remarks.

I don't have a quantification, but we're expecting some availability decreasing because of the continuation of the repair program prior to transitioning to GE.

And sorry, just to give you some further context, it was probably about a 4% reduction in availability compared to the expectation for those repairs.

Brian K. Lee ***Goldman Sachs Group Inc., Research Division - VP & Senior Clean Energy Analyst***

Okay. Great. And similar level in 2Q? Or is it less significant as it trails off here? Just trying to get a ballpark sense of what the 2Q impact might be?

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

In terms of Q2 impact, Brian, the blade repair work we have to wait until winter conditions end up warming up. So we are doing more blade repair work now than we were doing in Q1. So it's probably going to be a bit more of an impact in Q2.

Brian K. Lee ***Goldman Sachs Group Inc., Research Division - VP & Senior Clean Energy Analyst***

Okay. That's helpful. And then just second question here and I'll pass it on. The revenue per megawatt hour was up about 15%, it looked like year-on-year for the wind side. Is that how you'd expect pricing trends to persist moving through the year, just wondering the pretty strong result, but wondering how you're thinking about that for the rest of the year.

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

In terms of the price per megawatt and I think there was a couple of impacts year-over-year. The first is that the Texas basis was not as wide as it was last year. Last year, transmission system maintenance and repair work in the panhandle was being done in January and February, peak wind months. And this year, they basically have scheduled those for spring.

So that the basis in January and February was much less than it was last year. So that impact I think is going to be one that you'll see continuing because I think the Texas ISO is so pathetic to the arguments that wind producers have made to try to schedule the transition repairs in more shoulder seasons.

But that was probably one of the main drivers. The other thing that will impact our price per megawatt hour is production from Hawaii, and we had a pickup in generation from Hawaii versus the prior year.

Operator

(Operator Instructions) Our next question comes from Rachel Lei with Deutsche Bank.

Rachel Lei ***Deutsche Bank AG, Research Division - Research Associate***

Could you give us an update on the repowering progress step? I know that you target a 2021 commercial operating date for the 3 projects you identified last quarter. Just wondering, are you still thinking of that timing. Are there factors that could potentially pull the timing forward?

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

We're still working with that timing, Rachel. We have made progress on the repowerings. Probably one of the things that we've been really focused on is the permitting. And in New York, it looks like we're not going to fall under the Article 10 permitting regime, which is pretty time-intensive.

It looks like based on what we're hearing is that we will be able to get sign off locally on the permits required, which we think will accelerate the process. So we look at that as a positive, that could potentially impact the time frame, but at this point in time, we're not changing the guidance we've given in terms of the time frame for COD for repowerings. But as things progress, if there are any improvements in the time, we'll certainly communicate that.

Rachel Lei ***Deutsche Bank AG, Research Division - Research Associate***

Great. So also in New York, in terms of the kind of revenue expectation that some of the contracts on the wind side are going to expire, I think towards the end of this year. So have your expectations changed? Or what's your expectation in terms of revenue impact there?

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

The projects that are coming on contract are the ones we're looking to repower. And in terms of how we've looked at the repowering is, we can earn attractive returns on capital if we are able to put wholesale hedges in place. So essentially, prices based on the wholesale market.

To the extent that we are already are able to negotiate a contract with utilities or corporate customers at a premium to that then that would be upside. But the repowerings are economic based on hedges in the current wholesale market.

Operator

Thank you. And this concludes our Q&A session. Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Everyone, have a great day.