

SEISMIC CHANGES AND NEW US DEBT PLAYERS

Borrowers and lenders have now had time to assess the seismic changes in the market introduced by the Inflation Reduction Act of 2022, including the ability to transfer tax credits. By **CHRIS GLADBACH, JIM SALERNO, JOEL HUGENBERGER and JEESEON AHN**, *partners, MCDERMOTT WILL & EMERY LLP.*

Traditionally, options for tax credit monetisation were limited to the tax appetite of sophisticated tax equity investors, with the vast majority placed with a dozen (more or less) large financial institutions.

With transferability, a broader market has emerged, creating innovative pathways to monetise these incentives, posing both challenges and opportunities for debt financing structures overlaid on top of them. There are now new debt structuring options and considerations for developers, investors, and financial institutions looking to capitalise on clean energy projects.

Another trend is taking place: the robust expansion of the private credit market. In infrastructure financing particularly, private credit is filling a space previously occupied by bank lending, at the same time banks are retreating from the space due to regulatory and institutional constraints. These lenders can also provide more flexible capital solutions for projects and platforms.

For all lenders to renewable projects and platforms, flexible tax credit transfer structures are reshaping the financing market.

RESPONDING TO NEW STRUCTURES

Before IRA transferability, the debt financing structure for renewable energy projects was relatively staid and predictable. Sponsors that could attract traditional tax equity generally followed a tried and true playbook – construction lenders provided bridge loans that were sized to approximately 90%–95% of the tax equity commitment once it was signed (or, for certain sponsors who could attract lenders without a dedicated tax equity commitment in place, lenders would size loans to a lesser percentage of an assumed tax equity commitment if no tax equity investor had yet been lined up).

That bridge loan was usually paid off with the proceeds of the tax equity investment. Though there was some variation in the structure if the sponsor wanted to aggregate back-leverage positions across multiple projects, or obtain warehouse financing, the basic mechanics and structure did not differ much from deal to deal.

Post-IRA, financing structures vary substantially. Transferability impacts everything from the sizing and timing of the bridge loan component to the risk allocation among the parties. Traditional structures are still available for the portion of the market that still attracts tax equity. But a significant portion of post-IRA financing structures involve a tax credit transfer and

is not specifically financing the tax credits, which will be sold by the partnership to one or more third-party buyers.

The third-party investor may be willing to take anywhere from 1% to 99% of the cashflows – depending on the comfort level that the structure is still respected as a partnership for tax – and is usually in the structure for two purposes to accommodate the step-up in basis; and hit a cash return hurdle.

In these hybrid or T-flip structures, the bridge loan may require a tenor that extends to when the tax credit transferee pays for the tax credits, which can be months after substantial completion and may not align with term conversion. This creates timing complexities that are absent from the pre-IRA structures. Both the timing of the takeout and the involvement of a tax credit buyer in the financing structure create challenges for both lenders and borrowers to overcome.

LEVERAGE

Sponsors often seek to lever as much as possible while generating sizable returns. Lenders always look for the source of repayment (including any take-out). The character and nature of the likely repayment source largely depends on how the sponsor intends to monetise these tax benefits.

Traditional tax equity investors pay for accelerated depreciation benefits as well as tax credits and some cash return. They will typically commit up to 1.20x the value of an investment tax credit (ITC) upfront and will often provide upwards of 40% of total capital needed for a project. Tax equity investors may take a significant portion of the project cashflow as well.

By contrast, tax credit buyers only purchase the tax credits at a discount. That discount recently has been around 4%–9% of the overall credit. Because tax credit buyers preserve more cash for the sponsor, there is typically a significant increase in cashflow available for debt service (CFADS), enabling a project's senior debt leverage capacity to increase.

Moreover, production tax credit (PTC) buyers present the time element of PTC credits paid out annually over a 10-year period, resulting in a greater discount on the face value of the PTC credits by such buyers.

IMPACT OF PRIVATE CREDIT

Private credit has exploded in popularity as an asset class. Infrastructure debt, of which renewable energy projects is a part, has been gaining a larger total share of that market.

This debt historically has had lower default rates than traditional direct lending. Investors in credit funds like the generally predictable cash yield. And these lenders are feeding in a significant demand for debt financing.

Private credit has been accelerating while bank lending is retreating, especially the lending capacity of regional banks. After the Silicon Valley Bank collapse in March 2023, regional banks have pulled back on renewables lending, due in part to a pullback on deposits, increased interest rates and more stringent capital requirements, let alone internal concentration worries. Significantly, commercial real estate, a significant share of regional banks' business, creates more risk to regional banks, triggering a more conservative approach across all industry sectors.

Also, while not adopted yet in the US, the proposed implementation by the Fed, Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) of the Basel III Endgame – aimed to make a safer banking industry after the 2008 great financial crisis and the March 2023 banking crisis – will lead to higher capital requirements that will continue to lead to a migration to non-bank lenders who are not subject to these capital requirements.

There are additional factors favouring private credit. Structures without traditional tax equity allow for more leverage. Front leverage allows for more senior debt, which is important as senior debt is a larger pool of capital for private credit than mezzanine or portfolio debt. As the variety of non-traditional tax equity structures proliferate, private credit lending (both on the senior and mezzanine/portfolio level) will increasingly play a larger role.

TAX CREDIT BUYERS

Lenders to these projects need to understand the structure and motivations of the parties to the anticipated tax credit transfer. Tax credit sales often involve heavy negotiation around allocating risks.

Tax credit buyers are usually large corporations with substantial federal tax income that want to take zero risk on the tax credits they purchase. For ITC credits, recapture risk is paramount. If the project is sold or disposed of, damaged beyond operation or abandoned within its first five years of operations, the IRS will claw back the ITC pro rata over those five years. Also, tax credit buyers are liable for recapture penalties – a potential for real cash losses to the buyers. For PTC transfers, a buyer will want a floor on production in the form of a guarantee so they can plan on some minimum level of tax credits annually.

To safeguard against these risks, tax credit buyers may ask for but typically will not be able to rely on any cash sweep from the project cashflows, as neither the lenders nor the equity investor want the buyer to have recourse to their source of repayment. Instead, buyers will require a robust credit backstop in the form of a guarantee (usually from the sponsor, or, in a limited number of instances, from the tax equity investor if they arranged the transfer) or tax insurance.

We are now seeing extensive diligence by the tax credit buyers to assure themselves that all tax law requirements are met and to close off all loopholes the sponsor or seller may have.

CHARACTERISTICS OF BRIDGE LOANS

Since payment for tax credits must be in cash and only in respect of tax credits generated during the present tax year until the date of filing of the buyer's tax return, including the date of any extension, buyers cannot provide a bridge in respect of unearned tax credits nor typically prepay for the tax credit. This creates a timing mismatch absent from traditional tax equity transactions.

This limitation has spawned tax credit transfer bridge loans provided by senior debt in a financing. These bridge loans add a complication to debt sizing of project construction and back-leverage loans that relies on construction milestones, completion risk and projected debt service cover ratio (DSCR) and cash sweeps once a project reaches operation.

In hybrid structures, senior financing on operating projects, the opco financing, is ahead of the sponsor entity partner in the tax equity partnership but structurally subordinate to the tax equity investor, back-leverage. The tax equity partnership is the regarded owner of the projects for tax purposes and therefore has the right to any tax credits generated. The bridge financing necessarily must rely on the projected sale price of tax credits and the probability that the tax credit transfer closes on time, if at all.

Given the timing mismatch, senior debt puts a premium on tax credit buyer credit quality, as well as the terms of the tax credit purchase agreement and any risk of recapture in an ITC financing. Senior debt in some instances has also required additional safeguards from buyers, particularly in respect of PTCs running over a long term, such as guarantees if the seller is subject to indemnity obligations under the transfer agreement.

In addition, interparty agreements between lender and buyer, providing for forbearance and cure rights, including the lenders' right to enforce the buyer's purchase commitment under the transfer agreement so long as the conditions thereto have been satisfied, are often requested by the lenders. Lenders as well as buyers will look for LDs in the transfer agreement and typically output thresholds.

SIZING OF BRIDGE LOAN

Tax credit transfer bridge loans are typically sized based on the expected purchase price of the tax credits, which is the source of repayment of such loans. Depending on the existence of the transfer agreement, the creditworthiness of the buyer, and the timing of the ultimate transfer – the bridge loan may be sized at 50%–75% all the way to 92%–95% of the estimated tax credit likely to be sold, depending on the firmness of the tax credit sale on that spectrum. For example, lenders have become comfortable, given the liquidity in the tax credit transfer market, to lend based on no transfer agreement at all. A term sheet at financial close of the senior debt facility (with a creditworthy sponsor guaranty) or a fully executed transfer agreement will get a much higher advance rate.

These ITC bridge loans are often coupled with a DSCR of no less than 1.15x–1.20x. PTC bridge loans, given their tenor, will be priced similarly but a DSCR of 1.30x typically will be imposed, based on one-year P50 energy generation projections.

If parties close on a loan without a transfer agreement, and a transfer agreement is later executed prior to the term

conversion date, the then-committed transfer price will typically be given more credit in the advance rate. At term conversion, outstanding bridge loans typically convert to back-leveraged term loans and will mature on the earlier of the date certain under the EPC contract and the funding date by the buyer under the transfer agreement. Pricing of the term loan will reflect the risk profile for the tax credit transfer agreement, seller and buyer.

During the bridge loan construction period, prior to term conversion, the sponsor/borrower will pay a margin of 1.25% to 1.50% unless the transfer agreement has been signed, reducing risk to the lenders, in which case the margin should decrease by 10bp–20bp. If the bridge loan converts to a term loan, the margin will typically increase by 20bp–50bp. Lenders usually require an upfront fee as well.

FRONT-LEVERAGE STRUCTURES

Tax equity typically requires structural subordination of the term debt (the back-leverage discussed above). In some T-flip structures that utilise transferability without a typically tax equity investor, that subordination is no longer required – and we have seen more project financing term debt remain at the project-level.

This has recently introduced some added complexity around forbearance arrangements – insurance and tax credit buyers will require lenders to forbear from exercising foreclosure remedies to avoid recapture. As a compromise, lenders have recently been seeking pledges of “management rights” or entities holding just the managing member of the project company. Thus, if the senior lender is unable to foreclose on the project entity during the recapture period, it can still take over management of the project and replace contractors, cure defaults, etc while it waits to foreclose on the assets and project itself until the recapture period has passed.

MEZZANINE AND PLATFORM FINANCING

While most bank and private credit lending continues to be asset-based senior financing for construction or operating projects, lending at both the platform and mezzanine level has picked up substantially – especially for structures beyond the typical single project-supported back-leverage debt. These financings are often supported by the collateral from a portfolio of projects and are structurally subordinate to senior financing.

Many projects in the portfolio often have their own senior project financing, others are development projects. This type of financing can be attractive to a sponsor, especially those seeking a substitute for equity raises, which are dilutive. And for credit investors, they can present more attractive return thresholds (often in the mid-teens) than senior debt.

Some mezzanine structures may contain an equity component such as warrants or convertibility. In what is becoming more common, several private credit lenders are both lending at the mezzanine level and – through a sister equity fund – also participating as preferred investors in the T-flip structure.

For credit lenders in this space, there are several customary key issues to keep in mind, including intercreditor issues and coordinating with the senior debt, preventing cash sweeps at the senior level and watching out for dividend restrictions. With the IRA and transferability, these lenders also need to consider the risk of the portfolio and projections related to realising proceeds from tax credit sales.

This is especially true if the lender and its affiliates are acting as both debt and equity investors. Lenders need to stress-test the financial model and scrutinise the appraisals and tax credit insurance policies – as those tax credit sales proceeds are often critically important to support ongoing service of the facility.

45X MANUFACTURING CREDIT FACILITIES

Activity has also increased in financing related to the IRA Section 45x Advanced Manufacturing Production Tax Credits (45x credits) which add accretive value to domestic clean energy manufacturing facilities. 45x credits are earned for each unit of clean energy component manufactured, sold and delivered to an unrelated third party as part of a US manufacturer’s trade or business.

45x credits may be monetised by the manufacturer either (i) by a tax credit transfer arrangement or (ii) by a direct pay election. A transfer arrangement would call for the manufacturer to sell the 45x credits generated to a third-party for cash. The direct pay option provides tax refunds from the US Treasury for up to five years in lieu of the tax credits.

A popular 45x financing structure calls for the manufacturer to elect for the direct pay option for the first five years and then to arrange a 45x transfer transaction with third-party buyers. Some manufacturers leave open the transfer arrangement during the first five years for added flexibility when arranging a senior credit facility.

Debt sizing for a term loan facility is typically based on five to seven years of 45x proceeds and on a target DSCR. The DSCR will vary depending on whether the structure contemplates a transfer arrangement or direct pay. If a transfer arrangement, the DSCR will be set based on whether contracted or merchant PTCs. A minimum equity requirement will depend on the credit quality of the sponsor and the likely 45x credit forecast for the upcoming year. There is usually mandatory amortisation based on (i) sculpted repayment in line with the base case financial model and (ii) an additional cash sweep based on a contracted life coverage ratio test based on 45x credits associated with contracted orders. 45x credit facilities typically are fully secured by the assets of the manufacturer, including 100% of all tax credits generated. Collateral includes all assets of the borrower used in the manufacturing process (including inventory, spares, equipment, vendor and sales contracts).

CONCLUSION

The post-IRA world has proliferated a variety of new opportunities and concerns for lenders and borrowers. Financing structures now frequently need to take into account the credit quality and timing mismatch of receipt of tax credit buyer proceeds, which may not align with term conversion. Front-leverage structures, all but absent in the pre-IRA renewables world, have been making a comeback, as have development loans and aggregated mezzanine financing structures.

Private credit has stepped in to fill a void left by traditional banks, and has contributed to the rise of alternative financing arrangements as these lenders seek higher returns than are afforded from traditional construction and back-leverage loans. Although the future of the IRA under a new administration is not entirely clear, in the meantime, financing participants are grappling with this strange new world and taking advantage of the array of options while they can. ■