

Despite Rising Popularity, Medium-Size PV Projects Face Financing Difficulties

Developers of solar installations under 10 MW may find a shortage of lenders willing to finance these types of transactions.

■ Chris Diaz

Medium-size solar systems - approximately 750 kW to 10 MW - are having a difficult time finding financing right now. The capital markets appear to be open, so why are lenders still hesitant to provide financing for these types of installations?

The simple answer may be that the loan size is cost-prohibitive for a lender, or the lender has not developed comfort with providing this type of financing. If a lender does not fully understand the technology or the process, it is difficult to evaluate the risk.

Given these limitations, what lenders are willing to finance solar transactions, what type of security and assignments will be required, and what are the key issues these companies will be considering?

It is no secret that large-scale solar transactions (\$40 million or more) have an easier time finding financing than medium-size solar systems do. Investment banks, insurance companies and other large banks have the capital and the expertise to lend in the large-scale solar space.

These institutions have dedicated teams that understand the technology and the risks associated with large-scale solar transactions. Most of the developers and/or off-takers are utilities or AAA-rated corporations, and

the loan sizes are large enough to meet profitability requirements of these institutions.

Meanwhile, distributed-generation systems qualifying as “medium-size” have historically relied on non-traditional boutique lenders, European banks, terms from solar panel manufacturers, state programs and a few regional banks.

The pool of potential lenders has become even smaller now that European banks have pulled back on the U.S. market to focus their attention on their issues back home. In the past year, it has become much harder to find lenders that have a good understanding of 750 kW to 10 MW solar transactions. Most of these lenders, with the exception of state programs and solar panel manufacturers, have minimum loan requirements starting at \$5 million and do not want to take construction risk.

There are a few ways to attract lenders to medium-size solar systems: First, borrowers should develop a pipeline of similar transactions. If multiple projects are similar in structure, the transaction costs for a lender will go down, helping smaller loans meet profitability requirements. Similarly, bundling multiple small projects under one power purchase agreement (PPA) and one

partnership can help loan amounts meet minimum size requirements.

Borrowers should also assemble an experienced development team, including the engineering, procurement and construction (EPC) contractor. Finally, the technology selected for the transaction should be a bankable one with a well-established track record.

The investment tax credit (ITC) and the U.S. Department of the Treasury’s Section 1603 grant in lieu of the ITC have been extremely helpful in the financing of medium-size solar systems. Tax credit equity makes up 30% or more of a transaction’s capital structure.

Now that the grant has expired, it is critical for tax credit investors to embrace the ITC as part of their tax strategy. A key to investor interest will be the evolution of a best-practices standard for the solar sector. Such a standard will give tax credit investors a consistent approach to evaluating solar transactions.

The New Market Tax Credit (NMTC) is another helpful tool in the financing of solar transactions. It can make up approximately 20% of the capital structure. The NMTC is an economic development tax incentive, IRS Section 45D, designed to encourage investment in impoverished communities throughout the U.S. by giving the investor tax credits to improve its return on relatively risky investments in Community Development Entities. This credit has a number of restrictions associated with it.

When negotiating the various contracts needed to put a distributed-generation commercial solar project together, borrowers must make sure to keep the lender’s needs in mind. Most of the time, it is easier to negotiate terms and conditions up-front than go back six months later asking to change the documents.



Chris Diaz

The site lease, PPA, interconnection agreement, equipment purchase contract, and operations and maintenance (O&M) contract must be assignable to the lender, allowing for a first security interest. When the site lease is structured, the parties may need to include provisions for easement rights, allowing uninterrupted access to the site. Proper entitlements, a ground lease estoppel and a subordination/non-disturbance agreement might be required.

The PPA and the site lease should be coterminous, and the panel manufacturer's warranty should be assignable to the lender. The requirements of each source of capital - as well as the partnership structure - can affect the loan, so borrowers should be sure to get an experienced attorney and an experienced CPA involved in the process as early as possible. Being proactive will save time and money later on in the process.

Contract details

To protect its interest in the unlikely event a problem arises during construction, the construction lender will need rights to complete the project if the developer cannot do so, as well as access to anticipated repayment sources and the ability to operate the project and derive income from operations, cure defaults and sell the project.

The construction lender will need a first-lien position on all equipment associated with the solar development and improvements to the site, in addition to a leasehold mortgage or deed of trust.

As lenders evaluate solar transactions, they will take certain points into consideration. A developer's experience is at the top of the list. A number of developers with little or no experience are trying to build solar projects, but lenders prefer to see developers that have done multiple solar transactions.

How can inexperienced developers find financing? The best way to mitigate this potential problem is to partner with an experienced EPC contractor that can provide a payment

and performance bond and, in some cases, an experienced consultant. Lenders will check references during underwriting to confirm experience. An inexperienced EPC is much more difficult to mitigate, but there are a few options that might work.

Nonrecourse financing is very rare for this segment of the solar project market. Therefore, developers should be prepared to provide guarantees (personal and/or corporate). Lenders want to see a strong net worth and liquidity. If a developer does not have strong financials, it may want to consider bringing in a development partner to strengthen its financials.

The Section 1603 grant has provided a tremendous amount of support for the financing of solar transactions. A number of developers have met the safe harbor requirements to preserve their ability to continue utilizing the grant.

During the due diligence process, lenders will require an opinion from a CPA and/or a tax attorney to verify that the project has met the safe harbor requirements, thus qualifying for the 1603 grant. When borrowers are applying for the grant, lenders will require the developer to use an experienced CPA and will likely factor in a 10% cushion in case the anticipated full amount is not funded.

It is important to keep in mind that the construction lender will require a first-lien position until the loan is repaid, and the permanent lender will require a clear first-lien position prior to funding the loan. It is critical to coordinate the timing of the ITC grant payment, any state grant/loan program payments, and the permanent loan funding so that the construction lender and the permanent lender are able to secure their needed lien positions.

As mentioned, having bankable technology is an important requirement for getting a project financed. Lenders will want to see a proven solar technology with an established track record. They need to have a high level of comfort that the modules will perform as promised and that, if there is

an issue, the manufacturer will honor their warranty.

If the chosen solar panel does not have an extensive track record, one way to mitigate this shortcoming is to reinsure the manufacturer's warranty with a reputable insurance company. Doing so will give the lender some additional comfort.

Having a strong PPA with a credit worthy off-taker is vital to finding long-term financing. The permanent lender wants to know that if the solar panels produce as expected, the PPA off-taker will have the capital to make the monthly payments for the power, thereby allowing the developer to repay its loan.

Because not all PPAs are signed with AAA credit off-takers, it is important that the off-taker have good credit and can easily be underwritten by the lender. A well-established business with a good history or a public utility may not have AAA credit, but it can be considered a good credit risk by the lender.

As the project moves from the letter-of-intent stage to the closing stage, coordinating the timing of approvals is key to ensuring a smooth closing. Permits, zoning, equipment delivery and interconnection all take time, and all are needed in order to close the construction loan.

Starting the process for these approvals as early as possible will speed up the timeline. It is also important to coordinate the partnership documents, construction loan documents, permanent loan documents and tax credit documents. Having all these documents negotiated and signed at a simultaneous closing will prevent any financing issues from occurring later in the process. All of the parties will know what their rights are and what is expected of them. ☞

Chris Diaz is a senior vice president for Seminole Financial Services, a full-service national investment management and financial services organization. He can be contacted at cdiaz@seminolefinancialservices.com or (727) 331-8453.
