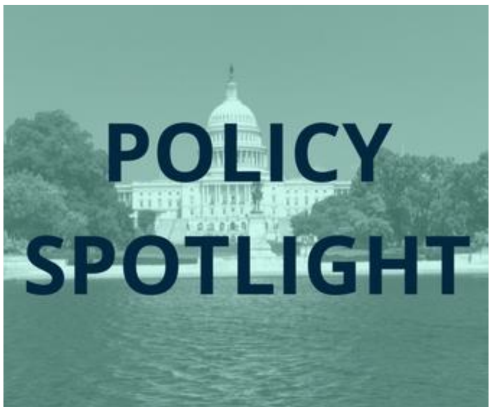
POLICY SPOTLIGHT

HASI: Renewable Energy Tax Credits

EVENT SHARES

Volume 2 / Issue 4

April 11th, 2018



EventShares was built on the investment philosophy that policy is an untapped asset class. In Policy Spotlight, we break down current policies and their potential impact on company fundamentals and investment returns.

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PAST ISSUES

- *Tariffs & U.S. Steel (X)*
- *The Dodd-Frank Regulatory Agency: CFPB*
- *Tariffs & First Solar (FLSR)*

HASI: Renewable Energy Tax Credits

This week we highlight the impact of the December 2017 tax reform bill on renewable energy tax credits.

Company: Hannon Armstrong Sustainable Infrastructure Capital

Ticker: HASI

Policy: Deducibility of certain investment tax credits, including renewable energy tax credits, against a company's calculated Base Erosion Anti-Abuse Tax (BEAT)

Period: October 31, 2017 – April 11, 2018

Figure 1 | Returns:
Market Impact from Renewable Energy Tax Credits

Tax Equity Financing Explained

Renewable energy sponsors earn tax credits when they build certain projects. Two of the more well-known credits are the solar Investment Tax Credit (ITC) and the wind Production Tax Credit (PTC). The credits can be used to offset taxable income and help finance the project. However, not all sponsors earn a profit, which means the ITC and PTC tax credits may have no value to the company.

How can the tax credits be monetized? Sponsors enter into "tax-equity" financing arrangements with investors who can utilize the tax credits against their own income. The investors purchase the tax credits for a negotiated price from the sponsor.

One common structure is called the "partnership flip". In this structure, the sponsor and tax equity investor form a joint venture. The tax profits, cash, and tax benefits are allocated, with the tax equity investor receiving most of the tax benefits. The sponsor is typically allowed to repurchase 100% ownership of the assets after the tax equity investors uses all the tax credits.

2017 Tax Reform

The December 2017 tax reform bill impacted ITC and PTC usability. Under the regulation, companies must calculate both their routine and base erosion taxes. The base erosion tax calculation prevents multinational companies from reducing their U.S. taxes by making interest and royalty payments to foreign affiliates.

If a company owes more tax after not deducting interest and royalty payments to foreign affiliates, they must pay the higher tax. The company can offset the higher base erosion tax with tax credits, including ITC and PTC. However, it can only offset 80% of its credits against the base erosion tax.

The limitation creates an issue for the tax equity investor. Because the base erosion tax calculation is performed annually, a company can owe it one year and not the next. This prevents an investor from reliably forecasting its ability to use the credit. If 20% of the credit can't be used, the investor's return is lowered, and the investor may not purchase the credit.

Company Implications

Hannon Armstrong Sustainable Infrastructure Capital (HASI) is a company that invests in renewable energy projects. It's the tax equity financer. The below section is an excerpt from the company's 2017 10-K under the section "Core Earnings" (emphasis ours):

> *"Certain of our equity method investments in renewable energy projects are structured using typical partnership "flip" structures where we…receive a pre-negotiated preferred return consisting of priority distributions from the project cash flows, in many cases, along with tax attributes. …* ***We typically negotiate the purchase prices of our equity investments, which have a finite expected life, based on our assessment of the expected cash flows we will receive from these projects discounted back to the net present value…****"*

In our view, the 2017 tax reform bill introduced uncertainty in the HASI business model. HASI's inability to forecast if it can utilize the full credit directly impacts its required return. In addition, HASI securitizes, or repackages and resells, certain of its investments to generate gains and arranges financings between third parties for a fee. If tax credits decrease in value, HASI may generate less securitization gains and lower fee income form arranging financings.

Investors didn't wait long after the passage of tax reform to react by selling HASI. The stock is down 20% since December 20, 2017, the day tax reform was passed, as uncertainty over the renewable energy tax credit industry remains high. A lack of volume may negatively impact HASI. In our view, policy investing can be used to highlight stocks to avoid.

About EventShares

EventShares is an asset manager located in New York City focused on the impacts created by legislation, regulation, and fiscal policy. The firm is founded on the belief that policy is a powerful leading indicator for companies. We seek out investments with embedded policy catalysts believed to offer better-than-expected return opportunities (alpha).

EventShares offers numerous educational resources to help investors connect the worlds of Washington, D.C., and the stock market.

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