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Hannon Armstrong Sustainable Infrastructure Capital, Inc. (HASI)

Q4 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to Hannon Armstrong's Conference Call on its Q4 and Full Year 2016 Financial Results. Management will be utilizing a slide presentation for this call, which is available now for download on their Investor Relations page at investors.hannonarmstrong.com. Today's call is being recorded and we have allocated 30 minutes for prepared remarks and Q&A. All participants will be in a listen-only mode. [Operator Instructions]

At this time, I'd like to turn the conference call over to Ms. Amanda Cimaglia, Investor Relations Director for the company.

Amanda Cimaglia

Director, Investor Relations & Corporate Communications, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

Thank you, Tom. Good afternoon everyone, and welcome. Earlier this afternoon, Hannon Armstrong distributed a press release detailing its fourth quarter and full year 2016 results, a copy of which is available on our website. This conference call is being webcast live on the Investor Relations page of our website, where a replay will be available later today.

Before the call begins, I would like to remind you that some of the comments made in the course of this call are forward-looking statements and within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended. The company claims the protections of the Safe Harbor for forward-looking statements contained in such sections.

The forward-looking statements made in this call are subject to the risks and uncertainties described in the Risk Factors section of the company's Form 10-K and other filings with the SEC. Actual results may differ materially from those described during the call. In addition, all forward-looking statements are made as of today, and the company does not undertake any responsibility to update any forward-looking statements based on new circumstances or revised expectations.

Please note that certain non-GAAP financial measures will be discussed on this conference call. The presentation of this information is not intended to be considered in isolation or as a substitute for the financial information presented in accordance with GAAP. A reconciliation of GAAP to non-GAAP financial measures is available on our posted earnings release and slide presentation.

Joining me on today's call are Jeffrey Eckel, the company's President and CEO and Brendan Herron, our CFO.

With that, I'd like to turn the call over to Jeff, who will begin on slide 3. Jeff?

Jeffrey W. Eckel

Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

Thanks, Amanda, and good afternoon everyone. Thank you for dialing in.

Today we are announcing core earnings of $13.1 million for the quarter or $0.29 per share, and $50.5 million or $1.20 per share for the year, 15% growth year-over-year, consistent with our guidance range for 2016.

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For the quarter, we closed approximately $350 million of transactions, taking our full year volume to approximately $1.1 billion for 2016, up 14% from 2015. Leverage is presently at 1.7 to 1, fixed rate debt at 67%, close to the top of our previously stated 50% to 70% target, and we'll be providing an update on this target in a bit. And we expect low double-digit core EPS growth for 2017, consistent with prior guidance and our dividend increase in December.

Turning to slide 4, we address the three questions we are getting consistently from investors; interest rates, the election and REIT regulations. First, interest rates. We fully expect and are prepared for rising interest rates. We've operated for over 35 years in various interest rate environments and our experience shows we will see spreads on new assets widen as rates rise, improving our asset yields.

On the liability side, given our bias towards higher rates, we are increasing our fixed rate debt target to 60% to 85%, from 50% to 70%. This will, of course, reduce our floating rate exposure. Bottom line, we expect rising rates to be a positive for the business.

The change in administration has created uncertainty in investors' minds as well. We believe federal ESPCs continue to enjoy widespread bipartisan support and our ESCO clients are continuing to book new business. As for the Trump infrastructure plan, we and our clients have engaged with the transition team working on this topic, and believe there are significant opportunities for us in many of the infrastructure proposals.

In addition, there are actionable paths to expand the use of performance contracting to increase federal efficiency beyond just federal buildings. And why not? These transactions create jobs all around the country, save the U.S. treasury money, and provide updated infrastructure.

Finally, at PTC and ITC, we're eliminated in tax reform, less than 10% of our $2.5 billion pipeline would be affected. And most of the renewable energy industry does not think it is going away because 87% of all 2016 wind installations were in red states and because solar generated 1 in 50 new jobs in 2016. We have very little exposure to this low-probability event.

There has been significant interest in our REIT status, which I would like to address head on. Hannon Armstrong is a REIT, has always qualified as a REIT since our first REIT tax return and fully expects our REIT status to not be questioned by the IRS. But let me put some numbers to this issue. If Hannon Armstrong chose to not be a REIT, we forecast there would be no impact on the dividend or core earnings, we would not pay taxes for more than five years, and we would still have approximately $70 million of NOLs at that point. When potential tax reform is clear, we will look at the tax impact on our business and determine whether it is still in our investors' best interest to be organized as a REIT.

Finally, if our REIT status was challenged today and we do not believe it will be, we would owe $5 million of tax for the last four years. That's it. This has been a $5 million problem. I hope we have framed the REIT status and are sufficiently clear in quantitative fashion for investors to fully evaluate the perceived risk.

Turning to slide 5, we continue to enjoy a robust diversified pipeline of more than $2.5 billion of investment opportunities. All consistent with our investment thesis, if better risk-adjusted returns will be achieved by investing on the right side of the carbon line.

In addition to our investments in efficiency, wind and solar, we have increased our focus on opportunities on infrastructure assets. If you remember back 14 months ago or so, very few in the renewable industry expected the

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PTC and ITC to be extended. And with that in mind, we started then exploring opportunities in transmission, water system upgrades and storm water remediation, which we have now broken out into a new pipeline category.

We also provide a bit more detail on the multiple submarkets in each category. It is important to understand that a growing part of our efficiency business is in state and local governments and commercial properties, all with little access to U.S. federal energy and tax policy. Similarly, wind enjoys diversity with the legacy operating projects for tax equity tail transactions and new build preferred equity investments.

And the solar asset class is actually three separate markets. Land for utility-scale solar, commercial and residential markets, and taken together we are continuing to find strong, uncorrelated investment opportunities, many of which are beyond the influence of federal energy and tax policy.

Turning to the right-hand side of the page, the portfolio increased 16% this quarter, consistent with our plan, and yields have remained fairly constant over the last several quarters. To clear up a common investor question, let me clarify that these are forward-looking yields before leverage with our investment decision based largely on the levered return on equity.

Turning to slide 6, we want to highlight four Q4 transactions. The top-right project is an $85 million micro-grid system, Ameresco, designed to ensure that Marine Corps base at Parris Island, South Carolina can still operate for extended periods with grid outages. The micro-grid includes a 3.5 megawatt cogeneration plant, a 6.7 megawatt solar array, and an 8 megawatt-hour battery energy storage system and a control system capable of optimized dispatch and fast load shedding. This is an example of the military's need for investment in resiliency and this represents our second investment in a military base that combines solar and battery storage. This one uses the Tesla Powerwall and the other uses the Johnson Controls battery storage system.

Top left we feature two California schools choosing to go solar at scale, using the SunPower Helix system. Both Parris Island and the schools are on the retail side of the meter, which insulates our investment from the pressure of low wholesale power prices due to inexpensive natural gas.

The bottom two projects, land for a 400 megawatt utility-scale solar project in Minnesota and our preferred equity investment in a 120 megawatt wind project in Texas by Invenergy, highlight how we help a developer optimize the capital stack of a project and add value to their business. All four investments have attractive returns on equity, are diversified by geography, technology, operator and obligor.

Turning to the next page, we think it's useful to look back at how our business has developed over the last three years. Our business model, which is building a balance sheet of a diversified set of relatively small and uncorrelated assets with long durations and attractive risk-adjusted returns, is working. With each investment we add, we strengthen our ability to sustain our dividend, given the 11-year weighted average life of the assets, the strong credit quality, and the diversification provided by an ever-increasing number of projects.

On the liability side, we're using modest leverage, approximately 2 to 1 and largely fixed rate debt. We will continue to work on adding appropriate leverage to get to our target of 2.5 to 1, as we increase our fixed rate debt. The net result is, we are locking in strong returns on equity in a rising rate environment.

Now I'll turn it over to Brendan to detail our financial performance.

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J. Brendan Herron

Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

Thanks, Jeff. Turning to Q4 and full year results. For the year, we generated $51 million of core earnings or $1.20 per share, as compared to $34 million last year or $1.04 per share, a 15% increase on a per share basis. For the year, we generated GAAP interest income, rental income and income from equity method investments, which we've labeled investment income, of $68 million, an increase from approximately $48 million last year, as a result of the continued growth in the portfolio.

For the quarter, investment income grew to $19 million from $13 million in the same quarter last year. We also generated gain on sale and fee income, which we have labeled other investment revenue, of $19 million, up from $11 million last year, as a result of higher other investment revenue in the first half of the year.

On a full year basis, interest expense grew to $45 million from $27 million last year. Currently, 67% of our debt is fixed. However, as Jeff mentioned earlier, given potential Federal Reserve rate increases, we're increasing our fixed rate debt target to 60% to 85% from 50% to 70%, despite the higher associated interest rate cost.

Comp and general and administrative expenses remained consistent for the quarter as compared to this time last year. For the full year, comp, G&A expenses grew by approximately $3 million, due to higher staffing cost and higher professional fees. The staffing cost includes additional head count. We're now up to approximately 40 people from approximately 32 people at this time last year.

In total, we have $15 million or $0.32 per share of GAAP income, a 52% increase from the $0.21 per share last year. As many of you know, the GAAP earnings do not include the full effect of the cash we receive from our renewable energy equity investments, especially where we've invested alongside of the tax equity and receive a limited allocation of profits and losses, although a much larger allocation of cash.

For 2016, we collected $56 million in cash from our equity investments as compared to GAAP income on these investments of approximately $6 million. Since we have based our investment on future cash flows, discounted back to a present value, we believe the cash we receive reflects both a return of capital and a return on our investment. Thus, we make a core adjustment of approximately $24 million to recognize the return on investment, which year-to-date when added to our GAAP $6 million income gives a total core return of $30 million and, thus, the other $26 million of cash received is treated as a return of capital.

After adding in the equity method and the non-cash stock comp adjustment, we had $13 million of core earnings or $0.29 a share, as compared to $9 million last year or $0.25 per share, a 16% increase on a per share basis. And for the full year, we had $51 million of core earnings or $1.20 a share, up 15% from the $1.04 last year. All the earnings per share numbers reflect the impact of the dilution from our November offerings.

Turning to slide 9, our focus on high credit quality assets is reflected in our portfolio which, excluding the equity method investments, consist of 44% of our assets from government obligors and 54% commercial transactions with only two projects representing 2% of our assets or $22 million not considered investment grade. Our portfolio is widely diversified with over 130 projects and an average outstanding balance of approximately $12 million per project.

As we have said, we invest in assets that are neutral to negative on greenhouse gas emissions. As such, we analyze each investment for its greenhouse gas impact prior to taking to our Investment Committee and in Q4,

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the aggregate investments reduced greenhouse gases by approximately 155,000 metric tons or equivalent to 76,000 metric tons of coal.

Turning to slide 10, we want to focus on the balance sheet. Presently, 67% of our assets are fixed rate debt investments, with the remaining consisting of equity method investments and real estate, with largely preferred and predictable returns. As we have discussed, new assets are originated at current rates, which is in effect similar to a bond ladder.

On the debt side, we are at approximately 67% fixed rate and our leverage is 1.7 to 1 against our 2.5 to 1 leverage target. As you know, our equity raises, like the one in November, are based on our expectation of future business and we announced a large transaction earlier this quarter. As of December 31, 2016, before considering any improvement in asset yield, we estimated that a 25-basis point increase in LIBOR would increase quarterly interest expense by approximately $200,000 or less than $0.005 a share, certainly a manageable number.

I will now turn it back to Jeff who will wrap up the presentation.

Jeffrey W. Eckel

Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

Thanks, Brendan. To close, we continue to execute on our business plan of investing our capital and assets that enable the growth of the best efficiency, renewable and infrastructure companies in the business. By aggregating these assets, like the energy storage assets at Parris Island or the land for solar farm, that are otherwise not accessible to public shareholders, we are building a business that allows our shareholders to participate in attractive yielding assets generated by an increasingly diverse portfolio and managed by a team that owns 5% of the business and is dedicated to good governance.

We thank our clients for the opportunity to support their businesses, and I thank my colleagues at Hannon Armstrong for keeping our clients top of mind as we continue to invest in the future of energy.

We appreciate you listening to our update and we'll now open the call for a few questions.

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QUESTION AND ANSWER SECTION

Operator: [Operator instructions] We'll take our first question from Philip Shen with ROTH Capital Partners.

Philip Lee-Wei Shen
Analyst, ROTH Capital Partners LLC
Q

Hey guys, thanks for the questions. Seems like your NIM experienced some compression in Q4. Was this, in part, related to rates taking a meaningful step higher after Trump was elected? And as we look at your guidance for 2017, you guided 14% to 19% of core earnings growth in 2016, which was 8% to 12% in 2017. To what degree are the higher rates impacting this outlook?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Hi, Phil. There's two things going on. We're forecasting higher fixed rates, which are definitely higher, but obviously we're taking some risk off the table. We're certainly seeing the possibility of spreads going up as rates go up. I think growth slows in most businesses, particularly when you're increasing your fixed rate portion. Brendan, do you have anything to add to that?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Yeah, I think forward-looking yields stayed about the same, Phil. They were down 10 basis points, but I think that's mostly rounding the fact that we had more energy efficiency in the portfolio. We did have more fixed rate debt now. Last year if you remember, we put a lot of fixed rate debt on in the quarter, in December of last year. So, if we do want to comp this quarter to last quarter, we only had about a month of the fixed rate debt in last year, where this year we have all three months – or of a full year of the fixed rate debt. We put quite – $250 million or so on in fixed rate debt in December of last year.

Philip Lee-Wei Shen
Analyst, ROTH Capital Partners LLC
Q

Okay. Great. Thanks. As it relates to Dodd-Frank, let's say that hypothetically gets eliminated and I think you've highlighted in the past that the banks are forced to sell down their preferred equity positions as a result of Dodd-Frank. If this restriction is removed on the banks, how does that impact the outlook for your wind business?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

I think if the banks don't have to sell it and they like the assets, I believe they do like the assets, then we'll obviously do less of that. There are other reasons for the banks to sell that other than Dodd-Frank or sell off the asset. And if we take a step back and look at our business plan at the IPO, we never envisioned doing this business. It is good business. We like it, but I'm quite confident if it went away due to Dodd-Frank going away, we can replace it.

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

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And I think, the other thing to add to that is, we are increasingly doing deals on the sponsor side. In the newer flavor of tax equity, the cash kind of flows 50-50. So, there's an opportunity to do preferred leverage on the sponsor side.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Like the transaction we featured with Invenergy.

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Correct. So, it doesn't go away totally, it may just shift the nature of the transactions that we do.

Philip Lee-Wei Shen
Analyst, ROTH Capital Partners LLC
Q

Okay. Great. One more, if I may. As it relates to C-PACE, it seems like in the past this has not been a big part of your business, but I was wondering if you could kind of give us an update on how that relationship with CounterPointe is going, what the outlook might be for C-PACE in 2017 and your view on overall as we think longer term, three to four years out, how big of a mix of business could C-PACE be for you guys.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

I think it's – we consider it the market with a single biggest opportunity for us. The business with CounterPointe is developing nicely. These are inherently smaller transactions, so it's going to take a while to get to a lot of zeros, but it's effectively addressing 20% of the U.S. energy bill which we have, heretofore, not addressed at all. So, we're very excited about the prospects for PACE.

Philip Lee-Wei Shen
Analyst, ROTH Capital Partners LLC
Q

Great. Thanks, Jeff. Thank you, Brendan.

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Thanks, Phil.

Operator: And we'll take our next question from Noah Kaye with Oppenheimer.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.
Q

Thanks. Good afternoon. Jeff, you made good points about the diversity of the investment set that you look at and invest in. But since you talked about some of the possibilities for kind of expanding the federal business, can you maybe expand a little bit on what some of those possibilities might be?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

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Well, I mean if you look at the Trump infrastructure plan, there's – I believe they have 50 high-profile infrastructure projects. Some of them like bridges and dams, that's probably not our kind of deal. Some of them are transmission lines for wind, you'd have to say that's kind of an interesting opportunity for us. They also talk about re-powering hydroelectric dams, Army Corps of Engineers dams, the average turbine at an Army Corps dam is over 50 years old, I think. And clearly more power could be generated.

And then we've made a nice business on the ESPC market, but it is limited to buildings. If that were to change, that unlocks another probably 70% of the government's energy bill that could be used for performance contracting. And again, we're not forecasting that will happen, there's a lot of complexities with that, but it certainly is a – something it would be consistent with the administration's views on what's a good public-private partnership and good for the war fighter and good for the taxpayer.

Noah Kaye Q
Analyst, Oppenheimer & Co., Inc.

Interesting. Just turning to the 2017 guidance, the 10% core EPS growth at midpoint, how should we be thinking about kind of level of originations and what needs to stay on the balance sheet to kind of get to that point? I mean you just put on $1.1 billion, but what do you kind of need to do this year in the range to kind of get you to that midpoint?

Jeffrey W. Eckel A
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

Well, what we suggest is, we'll keep the business model of $1 billion a year of volume, $300 million securitized for gain on sale and fee income, and we show that in the pipeline chart and the portfolio chart that there's a delta. And then $700 million gross goes on the balance sheet, of course there's some amortizations, there may be some prepays and things like that, and the net growth may be smaller. That's the basic model. Obviously, more originations help and the mix of securitizations versus additions to the balance sheet gives us a lot of ways to get to the right answer.

Noah Kaye Q
Analyst, Oppenheimer & Co., Inc.

Understood. And then you talked before to interest rates and we've seen [ph] BB, BBB, A (25:07) spreads relatively flattish for a bit of time now. But since you're investing in certainly more niche markets, maybe you could talk to what are you seeing in your markets thus far to start the year with respect to pricing.

Jeffrey W. Eckel A
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

There's so many different markets, it's hard to make a blanket statement. But let me reiterate your point. I think investment grade spreads have come in, but those are on liquid traded bonds and that's definitely not the market we're in. We think, as I've said to a few investors, as the price of money goes up, those who are selling money generally will do better.

That said, the 10-year is coming back in pretty significantly from over the last month. So, to say we know which way interest rates are going, it would be silly, we don't. But we certainly are protecting against a risk, an asymmetric risk, that we think rates have a lot more opportunity to go up and down. We'll make money on the assets and we'll hedge our bet on the liability side.

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Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Thank you very much.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Thank you.

Operator: We'll take our next question from Joel Houck with Wells Fargo.

Joel J. Houck
Analyst, Wells Fargo Securities LLC

Q

Good afternoon guys, and thanks for the color around the REITs, particularly the quantitative information. So, you talked about the Trump infrastructure plan, I'm wondering if you could maybe update that further as it pertains to clean energy and energy efficiency under the Trump administration.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Well, yeah, Joel, I tried to address that with the federal ESPC, that really is the tool that the U.S. government uses to add efficiency assets, so Parris Island, the Marine Corps base at Parris Island was done under an ESPC contract. As we've said before, I think Hannon and myself that our first federal energy deal under the Reagan administration, the federal Energy Savings Performance Contract program has started under Bush I, supported by Clinton, Bush II and Obama. There's nothing that we're hearing from anybody that says that's changing.

These are really good transactions for the treasury, really good job creators and really good and necessary improvements to the infrastructure. The reason the Marine Corps wants to do energy efficiency in micro-grid isn't really because of climate change, it's for security at Parris Island. If they lose power, then an increasingly electrified military is really a challenge to operate. So, having a cogeneration plant that replaces a very old and inefficient boiler and having the PV field and the battery energy storage gives them a terrific security. So, there's lots of reasons to like these Energy Savings Performance Contracts, whether you like the climate change thesis or not.

Joel J. Houck
Analyst, Wells Fargo Securities LLC

Q

But I guess the key point, Jeff, is that there's a lot more where this came from regardless of who's in the White House.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Absolutely.

Joel J. Houck
Analyst, Wells Fargo Securities LLC

Q

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Okay. Thanks. And then if I may, another one. So, you didn't have $144 million land investment a few weeks ago. Can you help us think about the economics and accounting? Specifically, how should we think about the returns from that investment and whether there will any variance in accounting between core and GAAP earnings for that investment?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

So, I think it's relatively consistent with other land investments, we don't specifically break out transactions. The only difference between GAAP and core on a land investment is that GAAP assigns value to land intangible that they then amortize over the life of the lease, and we would add back for that in core. So, you can see the lease amortization adjustment in core, it's not typically a large adjustment. But so, there will be some of that. Rough order of magnitude is, it would roughly double what we're doing today.

So, I think this year our real estate intangible add-back for the full year was about $1 million. So, I think you could assume that we would probably go up and be almost double next year. We haven't finished the appraisals and the full accounting yet, but that would be a rough guess.

Joel J. Houck
Analyst, Wells Fargo Securities LLC

Q

Okay, got it. Then the last one is, help us think about the expense base in 2017 and whether 4Q comp and G&A expenses represent kind of the run rate going forward or as you kind of ramp up the base, how we should think about expenses in our model in 2017?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Yeah. I think we've guided – if you look at the full year, it moves around a little bit, 2017 on a core basis. So, I think if you put a little bit of growth on that, you're probably in the right range. But it moves around quarter to quarter just depending on professional fees and some other things. But I think taking the full year and adding 3% to 5% growth gets you a reasonable number.

Joel J. Houck
Analyst, Wells Fargo Securities LLC

Q

Okay. Any plans to add – I know you added eight in 2016, how about 2017, what are the plans in terms of additional people, if any?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

We continue to add people when it makes sense. So, I think as we continue to grow the business and build the business, we look to add appropriate people.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

But clearly, we're unlikely to add eight on top of growth, in addition it should be slowing and all of the staffing is going to grow much more slowly than assets on the balance sheet.

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Joel J. Houck
Analyst, Wells Fargo Securities LLC

Q

Okay. Great. Thanks. Thanks a lot guys.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Thank you, Joel.

Operator: We'll take our next question from Benjamin Kallo with Baird.

Benjamin Joseph Kallo
Analyst, Robert W. Baird & Co., Inc.

Q

Thank you. I would say that was the – it's the only company in my list that I go work for, so hopefully my boss isn't with me on that last question. So, in seriousness, Brendan, the $5 million liability on the refi, I thought there wasn't a clawback. And so, how do we square that?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

There's not a clawback, Ben. All we're doing is, we're taking the REIT taxable income over the four-year period and multiply by 40% and coming up to that number is what we would owe and putting a little bit interest cost on it when we say less than $5 million. So, we're just trying to quantify maximum exposure for people.

Benjamin Joseph Kallo
Analyst, Robert W. Baird & Co., Inc.

Q

Sure. Thank you. And then the mix between renewables and energy efficiency, I know that with the uncertainty in renewables right now or perceived uncertainty, people worry about that and in the last call, I think I asked the same question and you said, you could move the portfolio back to energy efficiency. But it's a big difference now versus a couple of years ago in the amount of investments you have in renewables. So, is that still the case? And do you guys – is that still the case, I guess, is the question.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Well, I mean the pipeline is 54% efficiency and then 11% sustainable infrastructure. So, I think it's always been dominated by efficiency and, as I said, last – end of 2015, we were all shocked to see the ITC and the PTC extended for five years. While we have our transactions we do in wind and solar, it is not the core focus relative to efficiency.

Benjamin Joseph Kallo
Analyst, Robert W. Baird & Co., Inc.

Q

And on the land deal, just to add on to the last question. How do I think about the opportunity going forward in those type of land deals and could you just talk about how those are sourced a little bit more?

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Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Yeah. You look at the top-10 developers and that's – where 90% of the businesses that we'd be interested in and we talk to them about the benefits to the developers' IRR, like having us own the land and we don't make every sale. But it's accretive for virtually every developer, whether they choose to transact is another question, but we should be able to make everybody money by owning the land and leasing it back to them.

Benjamin Joseph Kallo
Analyst, Robert W. Baird & Co., Inc.

Q

And so, there's still opportunity there I guess was my question.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Yeah. I mean, I think everybody is well aware that utility-scale solar, First Solar and SunPower have talked about the challenges in that market, but if you look at our pipeline, it's one of our three solar markets and solar is 13% of our pipeline. So, it's not like we've ever really had a big pipeline for utility-scale solar land. But we have a nice market share in it and they're good yielding assets and good credit quality assets. So, we'll do them what we can find them, but it's certainly not something that we're saying is going to grow through the roof like we expect PACE to.

Benjamin Joseph Kallo
Analyst, Robert W. Baird & Co., Inc.

Q

Yeah. And so just on that topic, could you talk about PACE and any type of regulatory stuff that we should be aware of on the federal side or local side that could slow that down, because it seems like that could be [ph] thus far (36:00) the growth opportunity you got?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

I think Commercial PACE has no nexus with the federal government on either energy policy or tax. These are local or state initiatives. They don't need to ask Washington for permission to do this. It fundamentally goes to the entity that has the right to tax on property and then we attach a lien to the property tax bill, that is a very local business. So, for us that's a perfect answer to the question of what might happen to us with the Trump administration, but at this point we also feel that federal business is going to do just fine.

Benjamin Joseph Kallo
Analyst, Robert W. Baird & Co., Inc.

Q

And I have just a couple more on the asset-backed security side, SolarCity just did a – or Tesla and SolarCity did a deal. What's that market look like and what are your expectations there? Number one.

And then, two, if I just – maybe Jeff – [ph] maybe last (37:14) for you Brendan. Jeff, if I kind of back up three years ago or maybe just through September or October before the election, how does your visibility change or opportunity set change going forward?

And then the third one is, as you try to get your returns to work, you want them to be, I guess, or if that's a proper way to say it, but are you going to reach into a different asset class or a different type of project to try to get

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returns where they need to be versus what you've done in the past? And how do we think about that in adding people and risk? And then I'll hop off. Thank you.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

So, on the ABS, SolarCity does it for residential solar and good for them. We do ABS transactions and have since 2000 on a variety of asset classes. So, I'm actually not at all crisp on what SolarCity did. We continue to find very good investor appetite for any of our long-dated, high-credit quality, fixed rate ABS deals and really don't expect that could change.

In terms of the pipeline, pre- and post-election, sort of the good thing about our pipeline is, it moves rather glacially. We don't see a lot of change. We've been building up leads and qualifying them in the sustainable infrastructure category and quite unrelated to the election result, but really related to expectation that tax-driven renewables were going to be in a downward trend, that's actually not happening.

But meanwhile we've developed another pipeline slice that we're quite attracted to. And then I think the last question you asked is, are we chasing yield and other asset classes or do we need to? I don't you think you need to chase for yield and other asset classes. We'll continue to look for the best risk-adjusted returns and we're very, very consistent on our business model.

We have to find programmatic assets that we can do over and over with the leading companies, whether that's in water, wastewater – storm water remediation or transmission/distribution systems. We have an opportunity to add new clients and we are actively talking to them. Hopefully, that got you covered there, Ben.

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

So, I want to add one to the debt for one second. Obviously, we've said we're going to increase our fixed rate debt. So, one of the ways we've done that is ABS. So, I think you could look for us to do more of those. An example of that is the land transaction we just did. Last time when we got to pull land together, we were able to put that out in the securitization and a long-term very attractive fixed rate securitization. So, we had success in that model one. So, I think that's something we'll look at to pursue again, so.

Benjamin Joseph Kallo
Analyst, Robert W. Baird & Co., Inc.

Q

All right. Maybe I'll add one more if I can. Then I'll hop off. In competition, it's always some people ask every once in a while, so can I ask it again, is there anyone – I see some of these private companies are trying to do something similar, maybe taking more risk in storage type projects or things like that. How has that changed just over the past couple of years?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Ben, it really hasn't. It's been pretty static. I know there are people looking at it. It's a tough business to get to scale and then we think we have a very competitive cost of capital with respect to any of the private equity funds. The pension funds and insurance companies, they may look at it and say, hey, that's a really attractive business and then I think they ultimately conclude, [ph] shoot (41:48), we can't aggregate these tiny deals and make money

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in our present situation, why don't we talk to Hannon? So, that's not to say we never stop worrying about competitors, but the best defense is for us to service our clients and we've got a great team doing that.

Benjamin Joseph Kallo
Analyst, Robert W. Baird & Co., Inc.
Q

All right. Thanks, guys.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Yeah.

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Thanks, Ben.

Operator: And we'll go next to Julien Dumoulin-Smith with UBS.

Jerimiah Booream
Analyst, UBS Securities LLC
Q

Hey, good afternoon guys. It's actually Jerimiah Booream on. I just wanted to delve a little bit more into the sustainable infrastructure part here. Since it's kind of new that you're breaking out, I guess two things. One, is this 8.6% yield that is in your portfolio, is that kind of a typical return profile or is there more so just because you found the right investment there and what are the future opportunities?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Sure. So, I mean that's a very specific transaction. It is actually a couple of them in there, but the main one is a fiber-optic link that we own between Guam and Kwajalein serving the Reagan missile defense command. That's a legacy pre-IPO asset.

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Originated in different interest rate environment.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
A

Right. In terms of what we see in sustainable infrastructure, transmission and distribution systems, some on federal properties, some not, are completely under-invested in this country and represent a good opportunity to decrease line losses, improve overall system efficiencies, they actually have a great carbon story.

Storm water remediation, we're starting to see particularly around the Chesapeake Bay where EPA compliance and Supreme Court tested compliance requirements are creating need for $5 million, $10 million, $15 million storm water remediation projects, which are government credit, but they're really public-private partnerships. And seismic retrofit is a California requirement that can be PACE financed.

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Jerimiah Booream
Analyst, UBS Securities LLC

Q

Okay. That will make sense. I mean, I guess really what I'm getting at is, is there any change in the risk profile to these investments versus anything else or is it basically the same?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

In some respect, it may be less risky. These are pretty well-trod, well-proven assets.

Jerimiah Booream
Analyst, UBS Securities LLC

Q

Okay, great. That was all from me. Thank you.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Thank you.

Operator: We'll take our next question from Carter Driscoll with FBR.

Carter Driscoll
Analyst, FBR Capital Markets & Co.

Q

Hi, guys. Just going back to some of your early comments, Jeff, in terms of your direct engagement with the transition team, I just want to clarify, so this is – maybe trying to change the scope of the [ph] SGEC (45:03) program beyond buildings to include other types of projects and – or maybe you could characterize any other types of discussions you might have had in terms of the nuance and helping the new administration kind of support your core business.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Let me be clear, it's our clients that are really leading this. They're the ones [ph] with the most to gain (45:25) and we certainly support them and have engaged where appropriate. But this performance contracting model that is limited to energy efficiency in buildings can be expanded to water, it can be expanded to, as I said, hydroelectric upgrades, hotel load on Navy ships, current law doesn't allow it. I have zero view on whether there'll be any appetite to change it, except I can say it is being discussed.

And anything in this area is complicated and takes some time, so it's not like it's going to create a huge new market for us overnight. But it is a – I think a nice fact that this isn't – there isn't any perceived hostility to the performance contracting ESPC model, quite the opposite there's some interest and, hey, this really fits the public-private partnership philosophy of the administration.

Carter Driscoll
Analyst, FBR Capital Markets & Co.

Q

And then given the administration's policy of really trying to, I think, increase transparency and [ph] yet introduce (46:50) regulation, do you think – there was a former cabinet member that put out [ph] an op-ed in a (46:54)

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journal a few weeks ago, talking about how a carbon tax would actually be a more streamlined way of driving more renewable investment. Do you think there's any appetite whatsoever in the current administration for that approach?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

I have no idea. We haven't engaged at that level.

Carter Driscoll
Analyst, FBR Capital Markets & Co.

Q

Got you. And then your movement towards raising your fixed rate debt percentage, is this in anticipation of a gradual increase from the Fed Reserve or are you potentially anticipating a sudden shift or maybe additional couple of rate hikes this year and trying to get ahead of that curve or is it really just terming out on a more gradual basis?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

I think it's just us and this has been consistent with what we've done in the last couple of years is, we respect what the Fed says they're going to do and want to be conservative in that approach. So, I think the Fed did three rate hikes this year, the market is probably at two. So, that certainly indicates there's going to be – likely to be something and we're trying to adjust the portfolio and the debt side of the portfolio to be ready for that.

Carter Driscoll
Analyst, FBR Capital Markets & Co.

Q

Okay. I'll take the rest of mine offline. Thanks guys.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Thank you.

Operator: We'll take our next question from Stephen Byrd with Morgan Stanley.

Stephen Calder Byrd
Analyst, Morgan Stanley & Co. LLC

Q

Hi, good afternoon. Thank you very much.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Hi.

Stephen Calder Byrd
Analyst, Morgan Stanley & Co. LLC

Q

Most of my questions have been addressed. I just want to close the loop on your marks on the REIT status. In terms of the portion of the earnings that qualify for REIT status, what portion is that and can you just help us

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understand what would happen to the extent that [ph] you did – would have REIT (48:38) qualification for that part of that earnings stream?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

So, I think what we tried to quantify with the $5 million, Stephen, is that number. So, the $5 million is – it's less than $5 million. So, it's a relatively small portion of our overall core earnings. So, the way we got to the $5 million, and you can [ph] reverse engineer (49:04) is we – we took 40% of the REIT's taxable income for each of the years and aggregated together.

And so, that'll give you a sense of what it is. It's a relatively small portion of the overall earnings. As I think we've explained to people, we do a lot of business with TRSs and we also have lots of tax attributes both in the REIT and the TRSs, that gives rise to a difference between book income and then taxable income.

Stephen Calder Byrd
Analyst, Morgan Stanley & Co. LLC

Q

Okay, understood. So, that $5 million, so the aggregation since you've been able to qualify as a REIT status, so obviously on an annualized basis it's a much smaller number than the $5 million?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Correct. That's right. The $5 million is the sum of the four years.

Stephen Calder Byrd
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Is that the case because you do have a large tax position that helps you anyway, in other words, do you burn through that at some point or is it [indiscernible] (50:05) it's not material for the foreseeable future?

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

That's what we're trying to say is, if we ran a forecast of future income and assume that the REIT was combined with the rest of the business, we wouldn't pay tax, we wouldn't effect the dividend. And at the end of the five years, we would actually be at the same NOL level or even higher. And right now, we have about $70 million of NOLs built up in the TRSs. So, REIT – if the whole business was taxable in the five-year forecast that we ran, it wouldn't matter.

Stephen Calder Byrd
Analyst, Morgan Stanley & Co. LLC

Q

Understood. Okay. That's all I had. Thank you.

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Thank you.

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Operator: And we'll take our next question from Michael Morosi with Avondale Partners.

Michael Morosi
Analyst, Avondale Partners LLC

Q

Hi there. Thanks for taking the questions. Many of mine have also been already answered, but looking at the Commercial PACE opportunity, or are you primarily viewing that as a securitization product, or is that going to be an asset that you'd like to hold on your balance sheet?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Yeah. No, we definitely – well, there's two ways to answer that. We definitely want to hold it on our balance sheet. We like the risk, we like the return and we can securitize it and keep it on our balance sheet by bundling a lot of transactions. And we actually can do that on the federal ESPC transactions as well. So, we have a fair bit on the balance sheet now and hopefully we'll be able to lever them up with some kind of ABS transaction, but keeping the piece that we want to own still on the balance sheet and keeping the debt on the balance sheet.

Michael Morosi
Analyst, Avondale Partners LLC

Q

And then in the deals that you're involved in, have you seen any change in the behavior of the tax equity investors, just given the prospect for tax reform? Have you seen any change, I know that's not exactly a market that you play in, but you're certainly around it?

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

I think there's been a growing anticipation of some form of tax reform for a number of years. What we understand about the tax equity market is, the leading suppliers of tax equity have pushed tax reform risk on the developers over the last several years, probably not universal and not in every transaction, but – so I wouldn't say that post-election there is a significant shift that's obvious to us.

Michael Morosi
Analyst, Avondale Partners LLC

Q

Great. Thanks.

Jeffrey W. Eckel
Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

Thank you, Michael.

Operator: And that is the final question we have in the queue at this time. So, Mr. Eckel, I'll turn the call back over to you for any closing remarks.

J. Brendan Herron
Chief Financial Officer & Executive Vice President, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

A

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I just want to add, this is Brendan. I just want to go back to one point that we talked about with Joel earlier. In modeling G&A, we've been in the low-4s on a core basis quarter to quarter. I think modeling, think of it being closer to 5% than mid-4s. So, I just want to get that correction out there.

Jeffrey W. Eckel

Chairman, President & Chief Executive Officer, Hannon Armstrong Sustainable Infrastructure Capital, Inc.

Okay. Thanks, everybody. Good questions. We look forward to speaking with you again soon.

Operator: And this does conclude today's conference. We appreciate your participation.

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