

US Alternative Energy

Burned by Cheap Solar

Equities

Americas
Electric Utilities

SPWR's malaise tied to limited tax appetite from Bonus Depreciation at Utilities

We believe pressures cited by SPWR on its 2Q call on Tuesday evening are not limited to the company, as concerns raised on the limited remaining tax appetite in the market following bonus depreciation has modestly reduced anticipated project selldown prices. This is consistent with stated efforts of SO, ED, D, and others who appear to be deemphasizing solar acquisitions in favour of wind deals with less upfront tax attributes (as can be seen in the recent sharp tact by SO towards wind in recent quarters). Were it not for the ability to recognize ITCs in GAAP earnings upfront, we think the utility shift away from solar would have been even sharper. As we look across the utility landscape we see few companies with meaningful tax appetite, largely through the decade. Further, the higher cost of tax equity appears to be only adding to desirability of owning cash-absorbing utility assets – and making the latest bid for Oncor by NEE look all the more credible as an exercise to avoid the use of tax equity.

Will the SPWR drop around 2Q results set a bottom on utility-scale pricing?

The latest SPWR datapoints could well prove yet another cautious datapoint on pricing utility-scale volume deals too narrowly to achieve adequate returns. We expect at least US players will take note of the sharp share price reaction—and as such, provide a floor on the PPA price for solar, which has broached the \$40/MWh level. SPWR emphasizes deals broadly below \$50/MWh appears to provide limited economics. We believe the higher cost of tax equity and limited appetite across the sector is likely to be reflected in the latest round of bids by at least 25-50 bp in IRR, driving up PPA prices on the margin (as such, we suspect SPWR's 2018 vintage PPAs will reflect these improved terms). While this should in theory be reflected in international developer bids as well (who clearly don't have meaningful US tax appetite), we note the likes of Enel and others have been the low-bids of late in a variety of contexts across the Americas.

Is there a slowdown in solar? The focus in the renewable landscape is on wind

We're not surprised by the paucity of utility-scale solar projects as much of the focus in the sector on incremental wind given the PTC extension and IRS clarification on repowering. Many solar developers have noted opportunities have proven slower and more competitive than originally contemplated heading into 2016 (with existing orders slipping as well). We see the slowdown in projects as only bolstering the logic for the manufacturers such as SPWR and FSLR to diversify away from this lumpy business towards not just panel+equipment sales, but also resi and commercial efforts too. We don't see easy answers to meaningful returns available anywhere within the sector, although resi & commercial do offer higher nominal returns for the risk.

But there's a wave of RPS expansions coming too that offer some comfort

We emphasize some solar RPS expansion potential specifically in AZ as well as execution on the latest GA procurement RFP expansion are both positive datapoints on the margin following a substantial pushout of many utility-scale procurement plans given the extension of the federal ITC. We perceive the next 'boom' to be in the ~2019 timeframe as the next sunset on the full 100% ITC approaches.

What can 'save' solar from this malaise? Election focus remains key in 2H

We emphasize the key 'binary' variable to sentiment this fall remains the outcome of the upcoming election cycle into November. While the candidates have contrasting views, we see the principle focus on details around any eventual implementation of the Clean Power Plan (CPP) and corresponding procurement into the ~2019 timeframe. While we don't see an immediate upside arising from Clinton win as CPP (and any other complementary programs) would still likely take some time, we do see risks under a Trump administration around ITC election framework under 'Fair Market Value'.

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What is SPWR doing *now*? It's a core resi and commercial biz

Mgmt effectively guided towards zero gross margin from its Utility-scale solar business globally in 2017, suggesting doubts on both achieved volumes as well as margins on prior deals (this is at least the case at the low end of its \$300-400 Mn EBITDA range). By contrast, drops to CAFD (such as Stamford) could well drive volumes as well as contributions from delayed projects (of which there is clearly at least one). Mgmt's guidance for resi and commercial appears to reflect +30% on volumes, consistent with overall growth contemplated in the sector. Beyond this focus, the question is whether SPWR's focus on module only sales will also prove palatable.

[See our earlier SPWR note with a full write up on 2Q results.](#)

The Strategic Pivot: Can SPWR and FSLR shift towards equipment sales?

We emphasize each company appears to be taking a slightly different strategic pivot away from utility-scale sales. For SPWR, the focus remains on lumping together its specialized high-efficiency panels alongside a ramp in cheaper "p-series" panels alongside an electronics equipment overlay. The focus is to expand abroad to largely capture incremental sales rather than development opportunities. In contrast, FSLR's focus appears to be going even further, adjusting its latest panels to fit with a wide array of deployment equipment technology – competing more directly head on with foreign panel makers for market share. The question on this pivot for both is not just the lower margin potential, but more importantly the lower all-in margin on a nominal basis due to lower all-in sales costs. We emphasize SPWR's 2017 EBITDA guidance appears to largely eliminate expectations for the utility-scale segment (seemingly implying excess panels produced beyond those needed for Resi and C&I would be sold into other developer utility-scale projects), whereas FSLR would have effectively indicated it would simply sell the bulk of its volumes (excl ~1GW) as 'panels-only'.

Valuation Method and Risk Statement

Risks for Utilities and Independent Power Producers (IPPs) primarily relate to volatile commodity prices for power, natural gas, and coal. Risks to IPPs also stem from load variability, and operational risk in running these facilities. Rising coal and, to a certain extent, uranium prices could pressure margins as the fuel hedges roll off Competitive Integrations. Further, IPPs face declining revenues as in the money power and gas hedges roll off. Other non-regulated risks include weather and for some, foreign currency risk, which again must be diligently accounted in the company's risk management operations. Major external factors, which affect our valuation, are environmental risks. Environmental capex could escalate if stricter emission standards are implemented. We believe a nuclear accident or a change in the Nuclear Regulatory Commission/Environment Protection Agency regulations could have a negative impact on our estimates.

Risks for regulated utilities include the uncertainty around the composition of state regulatory Commissions, adverse regulatory changes, unfavorable weather conditions, variance from normal population growth, and changes in customer mix. Changes in macroeconomic factors will affect customer additions/subtractions and usage patterns.

FSLR price target derived via SoTP.

SPWR - PT derived via 2018E EV/EBITDA-derived SOP in addition to proportional stake in 8point3, SPWR / FSLR's yieldco.

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Neutral	FSR is between -6% and 6% of the MRA.	38%	25%
Sell	FSR is > 6% below the MRA.	15%	21%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 June 2016.

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First Solar Inc ¹⁶	FSLR.O	Neutral	N/A	US\$38.66	10 Aug 2016
SunPower Corp ¹⁶	SPWR.O	Buy	N/A	US\$10.31	10 Aug 2016

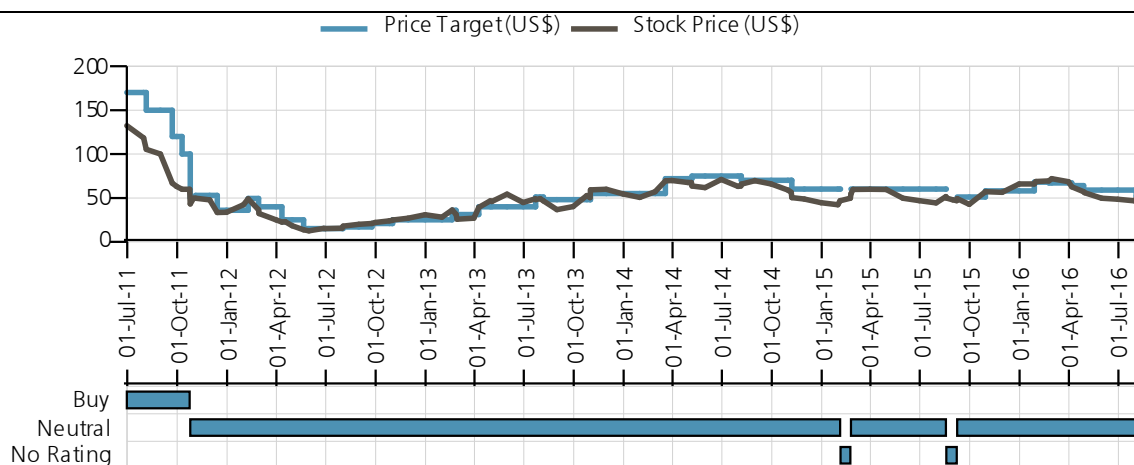
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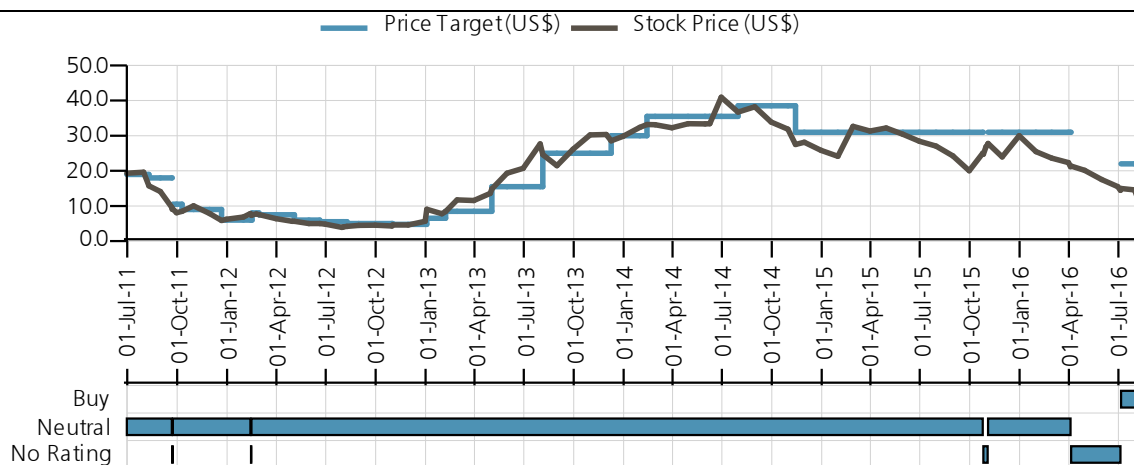
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First Solar Inc (US\$)



Source: UBS; as of 10 Aug 2016

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