Northland Power Inc. (NPI)

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Company Description

Northland Power Inc. (NPI) develops, builds, owns, and operates clean and green power projects, primarily in Canada and Europe. NPI has economic ownership in 2,266 megawatts (MW) of installed capacity, and a project pipeline of 2,322MW over the next 10 years. NPI is focused on renewable power, with 60% of the installed capacity coming from renewables, and 40% from offshore wind.

Investment Thesis

NPI has a business model that has significant optionality for future growth, however, this model has been misunderstood due to confusion over its leverage. From our credit analysis, NPI's leverage is not a concern, as it has a stronger balance sheet than it appears.

Catalysts

- NPI makes new investments leading to EBITDA growing more than the 30% already forecasted by management over the next 10 years.
- Benefit from ESG tailwind, as the portion of NPI's business that is not renewable will become smaller in the future.

Will these Preferred Shares be Called?

No, NPI will not be calling their preferred shares. Based on how NPI's management is currently running the business, the preferred shares will not be replaced with debt, equity, or internally generated funds. The preferred shares are a cheap source of permanent capital that helps NPI's business.

Risk

NPI is exposed to wholesale electricity prices for its offshore wind assets. NPI's average Power Purchasing Agreement (PPA) contract term for offshore is 11 years, the debt term is 12 years, and the remaining life of offshore wind farms is 28 years. The mismatch is not as significant as 92% of the offshore wind debt, which will be paid off by the time offshore is exposed to wholesale prices, but it will affect the return potential of the investment.

Offshore wind farms are increasing in size and cost, which could affect NPI's reinvestment risk as NPI may not have a balance sheet large enough to take on larger projects.

Sections:

Company Analysis

Why does the Opportunity Exist?

NPI's business model can be overlooked by investors' screens because of its return metrics and leverage. Investors traditionally screen for return on invested capital, but for NPI the more relevant metric is return on equity (ROE) because of how its debt is set up.

The leverage concern comes from a lack of understanding around project-level financing. Even NPI's former Chief Financial Officer (CFO) commented that he had to spend time educating investors about how project-level financing works because it is a new form of financing. NPI currently has a DEBT/EBITDA ratio of 6.7, which for a standard company is significant and can cause NPI to be removed from screens. Using project-level financing reduces the debt risk as we will explain more in the capital structure section.

NPI has a focus on renewable energy with 70% of its EBITDA coming from renewables. In 2018 60% of the company's EBITDA came from offshore wind. Looking to 2020 offshore wind will jump to 68% of EBITDA and is expected to drive 60% of NPI's EBITDA growth from 2019 to 2026.

Business Situation

NPI has a focus on renewable energy with 70% of its EBITDA coming from renewables. In 2018 60% of the company's EBITDA came from offshore wind. Looking to 2020 offshore wind will jump to 68% of EBITDA and is expected to drive 60% of NPI's EBITDA growth from 2019 to 2026. NPI has a weighted average of 11.1 years of contracted cash flows.

NPI was building renewable facilities in North America but transitioned to offshore wind in 2014.The move to offshore wind was driven by the reduction of investment returns for onshore. The onshore wind business became commoditized as building and financing onshore windfarms became less risky. Once an industry becomes commoditized, investors must focus on the cost curve. For onshore wind, the cost curve that is the most important is the cost of capital.

As onshore wind became less risky to invest in there was more institutional capital chasing returns. The average cost of equity for the 10 largest pension funds in Canada is 5.6% and the average cost of 10-year debt is 2%. For NPI, the cost of equity is 10%, and the 10-year debt cost is 5%. Wind projects are typically financed with 80% debt and 20% equity, which gives the pension fund a weighted average cost of capital (WACC) of 2.32%, and NPI a WACC of 5.00%. Institutional investors have a 2.68% capital advantage, which might not sound like a lot, but it makes a significant difference.

As an example, in 2018 the Canadian Pension Plan Investment Board (CPPIB) bought a basket of wind farms on a valuation of

6.6% yield on enterprise value. With CPPIB's lower cost of capital, CPPIB should earn a 21.9% ROE. If NPI were to acquire the same basket of assets, their ROE would be 15.2%, and if NPI wanted to have the same ROE as CPPIB, the basket of assets would need to be purchased at an 8.3% yield. Opportunities like an 8.3% yield are being competed away because why wouldn't CPPIB want that same asset at an 8.3% yield? CPPIB makes an even higher return on its equity then. As investors can see, NPI cannot and does not want to compete with cheap capital and as it is not in the best interest of its shareholders. That is why NPI has moved into offshore wind.

Focusing on the top ten with a business model of developing, owning and operating (DOO) offshore wind market share for the top 10 DOO's is 44.8%.

Unlike onshore wind, offshore wind has a different business model that reduces the number of builders competing in the market. The reduction in offshore developers arises from a need to have a combination of engineering/design expertise and a strong balance sheet, which has led to a concentration of developers.

Focusing on the global top ten companies with a business model of developing, owning, and operating (DOO) offshore wind, their combined market share is 44.8%, which is based on those companies' percentage of ownership in facilities. Investors can see in Figure 1 that NPI is the fifth largest DOO with 2.78% market

Figure 1

Leading Market Players in the Offshore Wind Industry, 2018

Organisation	Main activities	Assets (GW)			Market share	Headquarters	Ownership
		In operation	Under construction	In development			
Ørsted	DOO	2.97	2.79	5.23	12.86%	Denmark	Private
RWE	DOO	2.41	0.51	1.83	10.44%	Germany	Private
China Longyuan	DOO	1.23	0.40	1.00	5.34%	China	Public
Vattenfall	DOO	0.88	1.01	4.92	3.82%	Sweden	Public
Macquarie Capital	Investor	0.87	0.07	0.10	3.78%	Australia	Private
Northland Power	DOO	0.64	0.27	0.63	2.78%	Canada	Public
Global Infrastructure Partners	Investor	0.63	0.61	-	2.73%	United States	Private
Iberdrola	DOO	0.55	0.97	0.81	2.36%	Spain	Private
Equinor	DOO	0.48	-	2.17	2.10%	Norway	Public
Siemens Financial Services	Investor	0.46	-	-	1.98%	Germany	Private
Public Pension, Denmark	Investor	0.45	-	-	1.97%	Denmark	Public
Électricité de France	DOO	0.43	-	1.67	1.85%	France	Public
Stadtwerke München	Investor	0.41	-	-	1.79%	Germany	Public
China Three Gorges	DOO	0.40	0.88	6.87	1.74%	China	Public
Scottish and Southern Energy	DOO	0.34	0.24	0.52	1.49%	United Kingdom	Public

Source: IEA Analysis Based on BNEF (2019)

share. Some of NPI's DOO peers will build an offshore wind farm and sell a portion to investors hiding the true builder market share data, which from our research increases the true market share number of the top ten builders to more than 70%.

Sell side research from 2016 showed that the players in the market have not changed much. In fact, to highlight the importance of a strong balance sheet from the 2016 top ten DOOs there were two mergers trying to improve their balance sheet and one player dropped out of the market because it did not have the balance sheet to compete. In 2018, two of the three new companies in the top ten came from China, which was just starting to develop offshore wind. The other was from France, which from our research is a market with its own issues that only a French company can conquer.

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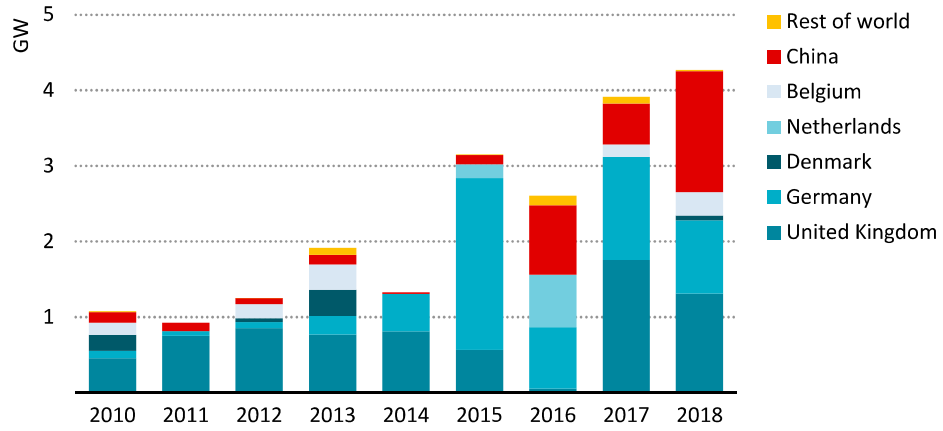
The broker research discussed how change in the European market of governments doing the predevelopment work of offshore wind sites would open the market up to more competition. We read this in an offshore wind market analysis for the largest company in the space and NPI was used as a prime example of how the change would reduce the barriers to entry. As NPI entered the offshore wind market in 2014 with its acquisition of Gemini. It turns out the change that the analyst was concerned about has slightly increased competition. If we take the top ten DOOs from 2016, the market share of building was 67%. Using the same group today, their market share is 64%. Over this past 3-year period, the Chinese market emerged, which was only starting to take off in 2016 as investors can see in Figure 2.

The first barrier to offshore wind market entry can be the ability to access the necessary design and build expertise, because building offshore platforms and dealing with the weather is a risk exposure not seen in onshore wind. In the past, when NPI first entered the offshore market, it was knocked because they did not have the expertise. Strategically, in order to learn how to build and operate offshore wind, NPI bought into a project where they

Figure 2

Annual Offshore Wind Capacity Additions by Region 2010-2018



Deployment of offshore wind has increased by nearly 30% per year since 2010, second only to solar PV, as the technology and industry have matured

Source: IEA Offshore Wind Outlook 2019

were the majority owner but had local partners who knew how to build. After their first learning, they went from buying a 60% ownership to buying into a predevelopment for 85% and building the project. NPI then went on to buy 100% of a predevelopment and building the project on their own. All three initiatives came in at or under budget, and on time.

Going forward, we believe duplicating such a model will be hard because in 2014 when NPI entered the market, DOOs were having financing issues and investors were not ready to step in to help with financing. NPI capitalized on the opportunity, bringing their expertise negotiating PPAs and financing to the table as they already had the experience from their own power facilities.

Today, large investors can go to companies like Orsted who is the dominate market player and have a co-build agreement. Orsted will either build a wind farm for the investor and sell it back to the same investor for a profit, or Orsted will take on a partner, and each shares the development costs and co-owns the facility. Orsted has ownership of 12.9% of the global installed capacity and has the balance sheet to develop more projects for others, but in 2014 the business was dealing with a weak balance sheet and was only slowly getting its finances in order, which created the opportunity for NPI.

By looking at NPI's Deutsche Bucht project, investors can gain a better understanding of this investment process. Deutsche Bucht was built for $1.9B CAD and will have an EBITDA of $249M CAD, which translates to a 7.6 EBITDA multiple of building the offshore wind farm.

Being a builder is important to the offshore investment process because building reduces the cost to the final end owner which then increase the Internal Rate of Return (IRR) of the project. By looking at NPI's Deutsche Bucht project, investors can gain a better understanding of this investment process. Deutsche Bucht was built for $1.9B CAD and will have an EBITDA of $249M CAD, which translates to a 7.6 EBITDA multiple of building the offshore wind farm. We calculate the levered IRR on the project to be 14.8% for NPI. Looking up recent transactions around Deutsche Bucht in 2019, we found the average purchase multiple was 9.9 times EBITDA. If NPI bought the asset at a 9.9 times EBITDA multiple, the levered IRR on the investment would drop to 4%.

The Deutsche Bucht facility has a PPA for 13 years and then is exposed to market prices for the last 17 years of the wind farm's life. In our IRR analysis, we assumed EBITDA was 75% lower once the PPA ended to be conservative for our 14.8% levered IRR. If the facility was just for the life of the PPA, the levered IRR is still 13.9%. Going back to the example of NPI buying Deutsche Bucht for 9.9 times, for NPI to just receive a cost of equity levered IRR of 10% the EBITDA, when the PPA ends, can only be 40% lower. This example highlights our point that being a builder, reduces the company's market risk exposure for when PPAs end. Risk management is something that NPI's management takes very seriously.

The second aspect to overcome barriers to offshore wind market entry is the requirement of a strong balance sheet to help enhance returns. NPI uses project-level financing for its investments. As a reminder project-level financing amortizes debt, which is fully repaid back once a PPA is over. As such, the debt will have a low interest rate because the financing is piggybacking off of the buyer of the electricity's credit rating. NPI is selling its electricity to governments and government run utilities, which have strong credit ratings, and allows for lower financing costs.

S&P has assigned a credit rating of BBB to NPI. We looked at how S&P evaluates companies that use project-level financing credit metrics to test what would happen to the credit rating if NPI did not start taking on debt for Deutsche Bucht which wasn't producing cash flow. What we found was that NPI's credit rating moves up to an A- rating, which means because NPI's balance sheet is so strong it can take on extra debt to build an offshore wind farm and still maintain an investment grade rated balance sheet.

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The need for the availability of both a combination of expertise and a strong balance sheet explains why the industry is so concentrated. NPI separates itself from other DOOs in that it is not a utility that is tied down to one region. In the top ten market share DOOs, eight are utilities. By contrast, NPI's business model is essentially a franchise model where they are constantly looking around the world trying to build new offshore wind farms for a higher return on investment.

The International Energy Agency (IEA) estimates that offshore wind capacity will increase 15-fold between 2018 and 2040. Right now, offshore wind is only accounting for 25% of all wind investments, but the IAE expects that amount to grow. From the IEA's "Offshore Wind Outlook 2019" report, "cumulative investment in offshore wind is about $840 billion (USD) from 2019 to 2040. Annual investment in the offshore wind power sector averages $38 billion, double the level in 2018." Europe and China are expected to lead the growth and should account for 70% of the installed capacity.

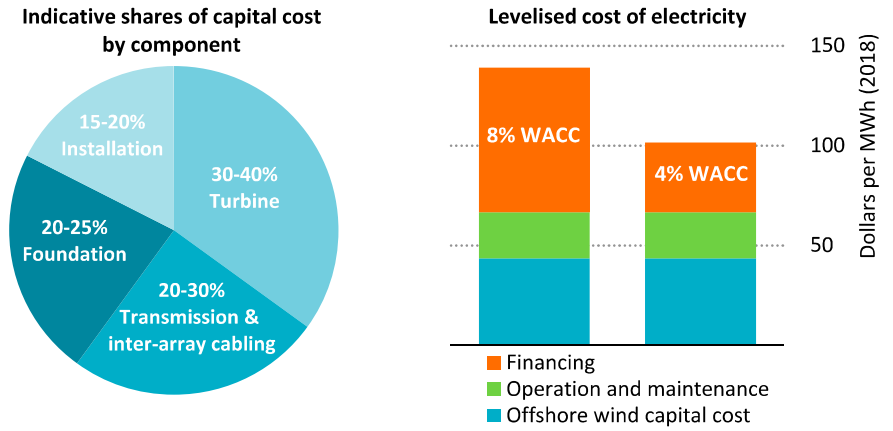
Europe is leading the way for offshore growth, which is already attracting more investments. As we have discussed, the effect of increasing competition effect for onshore wind is the lowering of returns in North America. The same situation is starting to take place for offshore wind in Europe. The IEA says the number one factor affecting the lowering of the price for PPA's is the cost of capital. The IEA's Offshore Wind Outlook 2019 report also stated, "… with lower perceived risk from investing in offshore wind assets being underpinned by supportive policies. This has led to the

cost of equity nearly having over the last decade for companies operating in the most mature markets."

In Figure 3, investors can see that new offshore wind farms are not receiving lower PPA contract prices because of the lower cost of construction, but instead due to investors' willingness to take a lower return on the project. We analyzed several projects that are coming online in the future and are confusing because of the investment rationale, where returns are below our estimated cost of equity of 10%. We think that the builders must be looking to flip the asset to institutional investors, which does provide a high return, but makes cash flow lumpier.

Figure 3

Offshore Wind Indicative Shares of Capital Costs by Component & Levelised Cost of Electricity for Projects Completed in 2018



Offshore wind generation costs are heavily influenced by the cost of capital and were about $100/MWh for projects completed in 2018 based on low financing costs

Source: IEA Offshore Wind Outlook 2019

As returns are shrinking in Europe, the runway for NPI could be reduced, if NPI only continues to focus on Europe. Asia is a region where NPI is looking to set up their offshore wind franchise. Asia excluding China is expected to add 60GW of installed capacity by 2040, that is 2.6 times the installed capacity globally in 2018 and will account for 1/6 of the current forecast capacity. There are still several countries that have yet to make up their mind on offshore wind, with New Zealand and South Africa being prime examples that have the wind resource to support additional growth.

A recent example of NPI setting up a new franchise is their work in Taiwan. NPI appears to be running the same playbook where it has partnered 60% with a local company on their first offshore wind farm in the region. The total wind farm size is 1,044MW, with 300MW already approved for construction. NPI acts like an investment company so it is always looking for the best return, the 300MW that has been approved has signed a 20 year PPA at an average price of $172/MW USD, projects in Europe that will come online at the same time have an average PPA price of $87/MW USD. Taiwan is expected to add another 30% growth in EBITDA as investors can see in Figure 4.

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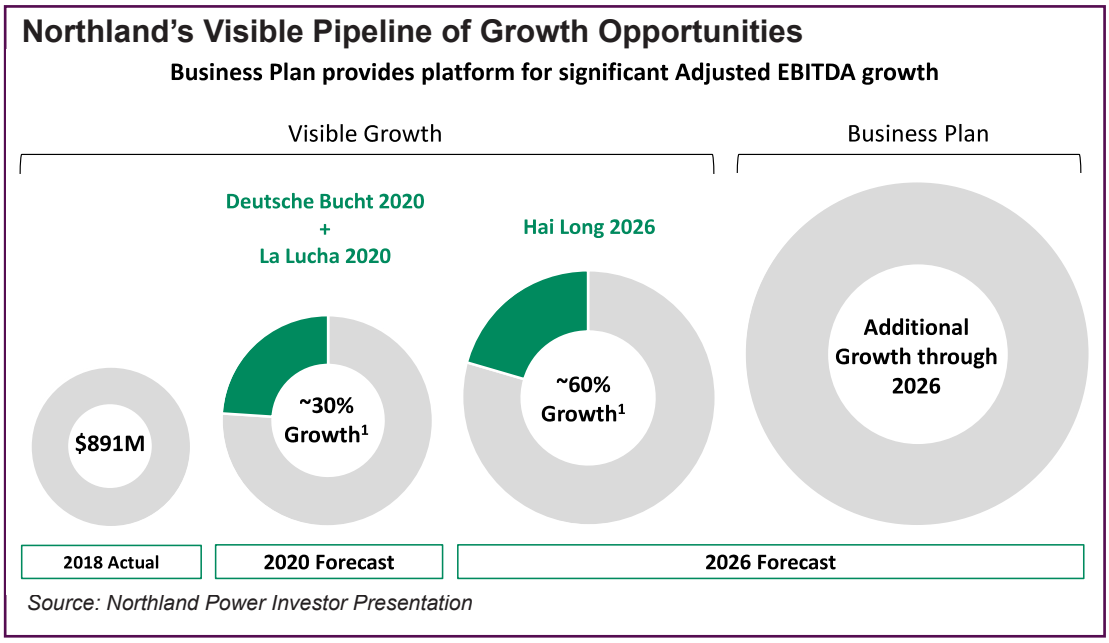
Figure 4



Something that stood out to us, from the top ten DOOs by market share, is that only NPI and Orsted were operating in Taiwan. The rest of the builders were either smaller builders that have a history of flipping projects once completed, or local Taiwan utilities. The reason they stand out to us is that the DOOs were not operating in Taiwan, as compared to all of the other top ten DOOs, which are all utilities in the European region. Looking ahead, NPI and Orsted will be the only DOOs taking on new projects globally. If that is the case, then NPI and Orsted's expertise should be an advantage that can be duplicated as more markets open up. It also means that when other markets open the local utilities will not have the experience bidding on projects leading to NPI collecting higher prices and returns.

NPI could essentially continue to operate in one market in offshore until returns are competed away and then move to a new market. For NPI's offshore business that means there is a large runway for growth ahead of them.

NPI has also been looking for opportunities as seen by their recent purchase of a Colombian regulated utility Empresa de Energía de Boyacá (EBSA). To acquire the project NPI had to issue additional equity. To make sure that issuing equity was the right choice we compared the projects Free Cash Flow to Equity (FCFE) yield to NPI's stock FCFE yield. NPI's stock was trading at a forward FCFE yield of 9.8%. We estimate the FCFE yield for the Colombian Utility to be 12.3%. Right off the bat, the acquisition makes sense to us as issuing a lower yielding stock to buy a higher yielding asset, but there are three factors that EBSA offers which further increase the value of the acquisition.

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First, on EBSA's Property, Plant and Equipment (PPE) the utility is allowed to earn a WACC of 11.5%. We estimate that the Return on Equity (ROE) is 16.1%. For reference, Canadian Utilities earn 8.5% to 10% ROE. If we measure the return for inflation adjusted in Colombia, NPI will earn 12.6% vs 6.6% to 8.1%. On average, NPI is earning a ROE 71% higher than Canadian utilities.

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Second, there are $2.6B in transmission projects to be tendered in Colombia in the coming years, which means there are significant reinvestment opportunities for NPI to reinvest EBSA's cash flow back into the business at a very high rate of return.

Third, EBSA is grandfathered into the Colombian utility system under old rules that allows EBSA to be vertically integrated. EBSA gives NPI a doorway into Colombia to start building renewable energy projects. This doorway allows NPI to leverage its renewable expertise against less sophisticated competition, as Colombia in 2019 held its first every auction for renewable energy.

Going forward we see substantial optionality for NPI because every year the excess cash flow after dividends that NPI produces can either be used for dividend increases, buybacks or investing in new projects. To facilitate growth NPI has set up regional offices to find projects in Europe, Asia, US and Mexico. Since our initial writing on NPI, NPI has made two purchases (Korea and British Columbia) and one new joint venture (Japan) that have added 1,696MW to future development. With additional optionality of pairing up with private capital to take on larger projects, or NPI could transition to building offshore wind farms and flipping them to investors. NPI's business model still has several levers to pull that investors appear to be ignoring.

Management

James C. Temerty is the founder of NPI, the former Chairman of the Board, and still owns 6.7% of the company. Mr. Temerty from our research has instilled a culture/mindset within management that puts common shareholders first, and because of that we consider management at NPI to be excellent.

Starting with capital allocation, which affects everything in the business, management is always focused on the best possible return and not growing for the sake of growing. Whenever the management is making an investment decision, they focus on the price of a project based on their cost of capital. When investment opportunities in North America started to drop below their cost of capital, NPI pivoted its business to offshore wind where we calculated the average levered IRR for NPI's three projects at 17%, compared to 6% to 8% for onshore wind in North America.

When investment opportunities in North American started to drop below their cost of capital, NPI pivoted its business to offshore wind where we calculated the average IRR for NPI's three projects is 17% compared to 6%-8% for onshore wind in North America.

NPI's capital allocation decision-making considers many factors that we have not seen peers consider when thinking about their common shareholders. Peers have been selling their offshore wind farms and taking significant gains, but NPI is not doing that because it is a one-time gain. NPI's CFO at the 2018 Investor Day explains the thought process, "Now, you say, well, yeah, but somebody is willing to pay a lower cost of capital for that than yours, and you get the money, but remember we also have to pay tax. If we make a gain, we have to pay some tax. Now I've got an after-tax set of proceeds that I've got to invest in another cash flow stream to keep everybody even. Well, with Northland, because our gestation period is a long time between develop and when the cash flow starts spinning, the time value of money sort of eats away any arbitrage for that." We tested such a situation out by assuming Deutsche Bucht is sold and found that there is a slight IRR improvement of 0.8% from selling but that means NPI has found a new suitable project. With increasing competition in European offshore wind, the same return stream is most likely not possible, making the decision not to sell the correct one.

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Financing capital allocation is another point that stood out to us. Many peers in the space are taking on private capital to build or buy projects. For example, Innergex Renewable Energy (INE) has taken money from Desjardin's pension plan through special preferred shares as it helps lower the cost of capital rate for the time when INE makes an investment. NPI currently does not want to take on private capital because they feel that it is not in the best interest of common shareholders. NPI's CFO sums up their thinking on the topic at their 2018 Investor Day, " And if you think about it, we bring in private equity even if that cost of equity is a bit lower, it still takes out some of the free cash flow steam that we're trying to provide to our common shareholders. So that means you just have to do a heck of a lot more development to get the same quantum out to the common shareholders." NPI has not ruled out such financing but does not feel that it is suitable currently.

On NPI's Q4 2019 earnings call there was a change in attitude around selling partial interest in future offshore wind facilities. Management said that they would look to sell future interest in new offshore wind sites, but not on any of their current facilities. The change has come since we first started following NPI in November 2019, as NPI has increased its development prospects from 626MW to 2,322MW. We model out that over the next 10 years NPI could finance internally the construction of 70% of the facilities. To complete all of the projects and to not issue additional equity partial sales of assets will be needed. Looking at the economics it also makes sense. Deutsche Bucht was built to

deliver an 8.4% unlevered IRR, currently the market is build/buying assets at a 4% unlevered IRR. We showed that pension funds right now have lower costs of capital than 4%, which is why NPI should be able to sell partial stakes at 4% unlevered IRRs. For NPI to recoup all of their investment after tax they would need to sell a 55% stake. We have no issue with this because that money will be reinvested in a new project that should return 8%+ unlevered IRRs. We do not expect NPI to begin selling partial stakes until NPI builds its Korean and BC assets, as Taiwan and Japan are already JVs.

The additional positive of starting to sell partial internet in offshore wind farms is it does not tie down NPI down to its current development pipeline. NPI on its Q1 2020 earnings call said it was currently looking to take advantage of its strong balance sheet and scoop up assets at distressed valuations.

The return culture has been reinforced by how management is compensated. NPI issues Deferred Rights Units (DRU) instead of options. Management uses DRU because they respect their shareholders and do not want to issue equity unless it is their last resort. DRU are units that track the stock price that are eventually settled with cash. DRU only vest once a new project has been completed and the project can be evaluated to determine that it will earn the acceptable return that was forecasted. DRU enforce that management will only be investing in high returning projects, as the economic incentives are significant. For example, once Gemini was completed in late 2017, the CEO and CFO's compensation rose by 78% and 70% respectively from the previous year via DRU being earned. NPI's compensation style has led to disciplined execution with all three of their offshore wind projects being delivered on time and at or under budget.

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There is slight concern with management as the old guard that led NPI to where they are today have all retired in the last year. The new CEO has an impressive resumé. He previously worked at a competitor and NPI scooped him up when the competitor was bought out. The concern is alleviated as the board of directors still needs to approve any new projects or acquisitions. The board includes Mr. Temerty and the former CEO who was Mr. Temerty's right-hand man while building NPI. With such a structure there is no fear that the new CEO will try to change NPI and acquire assets that do not fit in NPI's portfolio.

In the end, the way in which management operates NPI causes us to think of NPI as more of an investment company, which happens to invest in power generation, and is carefully building a portfolio of assets that it plans on holding for the life of the asset.

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Risks

Exposure to Wholesale Electricity Price: NPI tries to match the project-level financing that it takes on with the PPA that it has signed. Focusing on the offshore segment, the EBITDA can drop by an average of 58% and the FCFE will not change. That is because once the PPA is over, in most cases the debt is paid off, so interest expense and yearly repayments are removed. We model in a 75% drop in EBITDA after the contract is over to be on the safe side. There is a negative exposure with Nordsee One and Deutsche Bucht, each has debt due past the PPA term. Nordsee One has a 3-year mismatch in debt and PPA, but still has 20 years of useful life, which limits the wholesale price exposure. For Deutsche the mismatch is only 1-year between the debt and the PPA, but still has 17-years of useful life which limits the wholesale price exposure.

Increasing Size of Offshore Wind Farms: Offshore wind farms are growing in size quite dramatically. The builders are increasing the size of the farms to get better scale so that they can compete with a lower price PPA. For example, off the coast of the UK one of the largest offshore wind farms with 714MW of installed capacity will cost $3.9B and signed a PPA that is 25% lower than what NPI signed for Deutsche Bucht. If Deutsche Bucht took the UK PPA price, the IRR drops below NPI's cost of capital. NPI does not have the balance sheet to handle a project of that size, the equity component would be $978M. If the market starts to migrate to larger offshore wind farmers, there could be a reinvestment risk for NPI. The risk can be avoided if NPI pairs up with institutional investors to build such a project, but right now NPI is not pulling that lever.

Offshore wind in Europe is seeing more competition, which is leading to new offshore wind projects taking on projects that have IRRs at 10% or less. When NPI originally started investing in offshore wind the industry was earning 15% IRRs on projects.

Increasing Competition in Offshore Wind: Offshore wind in Europe is seeing more competition, which is leading to new offshore wind projects taking on projects that have levered IRRs at 10% or less. When NPI originally started investing in offshore wind the industry was earning 15% levered IRRs on projects. The increase in competition may limit the runway for offshore wind investments for NPI, which would affect the long-term sustainability of NPI's business. The concern is mitigated by the fact that offshore wind has only recently become commercially accepted in Europe, which is the only major market right now. It is difficult to tell if the trend will continue into newer markets. In Taiwan, NPI signed a PPA that was almost double the rate that was being signed in Europe. NPI's runway could be longer if the trend in new markets is to incentivize renewable investment by offering better returns.

NPI is constantly looking for the best return for its common shareholders and will pivot to areas that it can operate in while still providing similar returns. NPI has taken the first steps to diversify its business by acquiring a perpetuity asset with EBSA that will provide real returns on equity of 12.6% in perpetuity. NPI also discussed other areas it can invest in, at its 2018 Investor Day, "Other things that we may look at, if you think about future, not necessarily this year or next year, but water desalination where the skill set is still building large equipment that's very energy intensive." NPI has pivoted from thermal to onshore renewables to offshore renewables, NPI's track record speaks for itself.

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Financials Section

Capital Structure

Reviewing how NPI's management thinks about their capital structure is just another example of how NPI has extortionary management. Every decision the management makes with the capital structure is about figuring out how common shareholders will benefit from the decision.

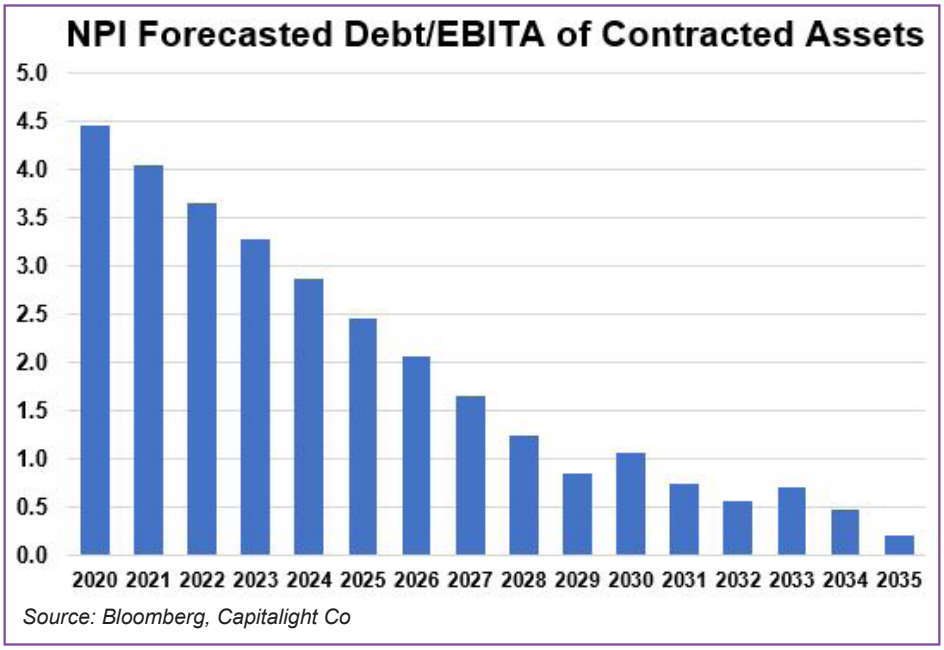
To understand NPI's capital structure we first must look at how NPI funds growth. NPI's CFO at their 2018 Investor Day says it best, "And I think we all know from discussions and from courses and everything we've taken that internally-generated cash is the best way to fund whatever you can fund. And we certainly want to make sure that we keep that top of mind, while we're balancing the equation between dividends and use of cash." "I don't need to run many people through the equation, but you pay a dividend, it's taxable to many people. We have to go raise that capital, again, as equity and we pay discounts to the bankers sometimes commission. It's not very efficient." NPI was able to fund the equity portion of Deutsche Bucht without having to tap the capital market, and without affecting the common shareholders. By focusing on internally financing the business they keep a capital structure fairly consistent.

Growing the business while maintaining an investment grade rating is significant for NPI. To achieve the growth, NPI uses a corporate credit facility at the holding company level. Why the corporate credit facility is used is explained by the CFO at NPI's 2018 Investor Day, "…not trying to lever up the balance sheet to use permanent debt. We're trying to make sure we have a lot of dry powder for some things like security deposits and other obligations." The facility allows NPI to put down security deposits in Taiwan and Deutsche Bucht. The corporate credit facility has increased by 60% since Gemini and Nordsee One came into operation.

Having permanent debt at the corporate level would affect NPI's credit rating, with a recent example at NPI's peer INE. INE acquired assets in 2018 and took on corporate level debt, which lead S&P to put INE on credit watch negative at the end of 2018, which could lead to a downgrade if the debt was not repaid. INE would eventually have to sell other assets to remove the debt.

INE's situation leads us into the number one-way NPI finances its projects, project-level financing. All the debt that is not at the corporate level is project-level financing, which is non-recourse to the parent company. That means that if one asset begins to underperform there is no cross default that takes place. Management has also done hedging to lock in interest rates on floating rate debt so that cash flow is more predictable. NPI tries to match its project-level financing maturity structure to the facilities' PPA. Investors can see in Figure 5, Debt/EBITDA for PPA contracted facilities matches up, taking the multiple down to zero by 2036.

Figure 5



Source: Bloomberg, Capitalight Co

NPI's assets are all over the world and to reduce its risk exposure NPI uses debt in the local currency that the asset is in. By matching the currency, the debt risk exposure is reduced, but the return potential can be affected, NPI manages the currency risk with currency hedging strategies.

Since the project-level financing is secured by the asset it makes the project-level financing the highest in the capital structure. After the project-level financing comes the corporate credit facility at the holding company, and then the preferred shares. The face value

of the preferred shares at the holding company are $270M, right under the corporate credit facility at the company level.

NPI has not issued a new preferred share since 2012 and we do not expect them to issue a new one anytime soon. The preferred share issued in 2012 was to fund the equity portion of NPI's solar farm. The preferred share was issued with a 5% yield, and the common shares would have been issued at a 6.6% yield. Issuing the preferred share stands with NPI's culture of only issuing equity as a last resort.

Underneath the preferred shares at the end of Q1 2020 there is $489.5M related to non-controlling interest in projects of which NPI does not own 100%. At the bottom of the capital stack is the common equity, in Q1 2020 the value was $1.4B. The equity cushion may seem small, but it does not reflect the true value of NPI's assets. If NPI sold all of its offshore wind projects the equity would jump to $3.1B and remove 71% of the project-level financing, which provides a significant cushion for preferred shareholders.

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In Figure 6, we highlight the transition of the Enterprise Value of the capital structure to show the change once Deutsche Bucht is fully operational in 2020.

Figure 6

NPI Capital Strucutre - EV/EBITDA

	2018 Actual	*2020 Forecast*
Non-Recourse	6.17	4.52
Recourse	6.65	5.01
Preferred Shares	6.89	5.20
Non-Controlling Interest	7.30	5.55
Common Equity	8.01	6.55

Source: Bloomberg, Capitalight Co

Credit Rating

To evaluate NPI's credit metrics, we had to go through how S&P evaluated companies that use project-level financing. S&P has assigned NPI a rating of BBB with their "Stable" outlook. Evaluating NPI under the project-level financing credit metrics from S&P we found that there is additional optionality for the credit rating to improve as NPI grows.

S&P determines the amount of debt to be included in the credit rating by evaluating the concentration of the cash flow profile of the company's assets. For NPI, the concentration of the cash flow

profile is very high as three assets in 2020 will produce 68% of its EBITDA. That means to evaluate NPI, we need to include all the debt at the company, which is typically how a credit rating is done.

If NPI had a cash flow profile where each of the 16 assets, each contributed 6.25% of the cash flow, the only debt that would be included in the credit analysis would be debt at the corporate level. The reasoning from S&P is that with a concentrated cash flow profile there is a risk that the company will only focus on the concentrated cash flow assets, which could lead to the smaller cash flow assets defaulting.

To highlight NPI's balance sheet strength, we are going to walk you through how the future rating profile changes as assets are added. In Figure 7, we highlight the credit rating for NPI with Deutsche Bucht starting to produce cash flow in 2020.

As we discussed earlier NPI truly has an A- rated balance sheet because it is able to take on debt 2-3 years early for the development of a project. Investors can see in Figure 7 that once Deutsche Bucht comes online in 2020 this will be visible and push the official credit rating back to A-. Which means that NPI has additional capacity to take on more debt to add another project, that is the Taiwan offshore wind farm.

In Figure 8, NPI has an A- rating with the additional debt taken on to build the Taiwan offshore wind farm. The reason the debt capacity has grown is because Gemini and Nordsee One have paid off a significant portion of their debt, which leaves room for additional debt to be taken on for another project.

Our analysis shows investors should not be concerned about NPI's leverage level. In fact, as NPI's cash flows become less concentrated in the future the credit rating will increase. For example, if NPI's cash flows were not

Figure 7

NPI Current Asset Base Future Credit Rating

Year	*Rating*
2018	BBB
2019	BBB
2020	BBB
2021	A-
2022	A-
2023	A-
2024	A-
2025	A-

Figure 8

Taiwan Effect on Credit Rating

Year	*Rating*
2019	BBB
2020	BBB
2021	A-
2022	A-
2023	A-
2024	A-
2025	A-
2026	A-
2027	A-
2028	A-

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concentrated the credit rating would be A- right now, once again highlighting the optionality in NPI's business. It also means that until 2026, management's 30% EBITDA growth forecast will be understated.

What we believe is being missed by investors on the leverage levels is the true value behind the project-level financing. We would agree that if NPI had a 6.7 Debt/EBITDA with bonds we would be concerned. However, the questions are becoming as follows: Will management have the cash when the bullet payment is needed? Will the capital markets be open in the future to refinance the debt? How is management's capital allocation ability, and could it lead to a dividend that will need to be cut in the future for debt repayment? None of these concerns develop with project-level financing. Each year an equal portion of the debt must be paid back, so there are no concerns about bullet payments, or whether the capital markets be open. NPI's dividend is then calculated on the cash flow available after that year's debt repayment. So, we have no concern of an unsustainable dividend. Using project-level financing the debt is compartmentalized with an asset so there is no cross-default risk.

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Will these Preferred be Called?

The preferred shares will never be called, due to NPI's capital structure. NPI does not want to have debt at the corporate level except their revolving credit facility, which they use to help finance acquisition. Using the credit facility to repurchase the preferred shares would give NPI less flexibility to pounce on new investments. New debt will not be taken on to replace the preferred shares either, as having debt at the corporate level reduces NPI's flexibility. NPI's CFO sums up the reasoning at their 2018 Investor Day " So, that's why you don't see us really levering up trying to get cheap debt as a permanent source of capital in our balance sheet any more than we have, because if you start using up that dry powder, your development business suffers on that."

Equity/Internal cash flow will not be used to call the preferred shares because NPI gets a substantially higher return on equity than the cost of these preferred shares.

Valuation

Details on Valuation

In valuing the preferred share, our analysis is based on a Bear, Base and Bull outcome for interest rates. For our Bear case scenario, we assume that the benchmark yield (Government of

Canada 5-year yield) is zero for the rest of the life of the preferred share. For our Base case scenario, we assume that the benchmark yield stays the same as the current (5-year yield 0.38%). For our Bull case we forecast the benchmark rate will reach the target overnight rate by the BoC of 1.00%.

Figure 9

NPI Preferred Share Valuation Range

	Bear	*Base*	*Bull*
Series A	$13.21	$14.95	$17.80
Series B	$13.18	$14.92	$17.77
Series C	$17.18	$18.73	$21.25

Source: Bloomberg, Capitalight Co

NPI is rated P-3 by S&P which equals to a DBRS rating of Pfd-3. We do not use Pfd-3's discount rate since as we have shown NPI's balance sheet is stronger than it appears. Instead, we are using the 5.45% midpoint between Pfd-2 and Pfd-3 representing 439 Basis Points over the Government of Canadian 30-year bond yield.

The common shares draw one positive and negative concern. The positive, NPI's common stock benefits from a pension plan buyout protective put. What we mean is that a pension fund could easily scoop up NPI for a higher return than buying already built offshore wind farms, while also acquiring an expert team with a large pipeline for growth. We highlight this effect with the coronavirus sell-off in stocks, NPI since February 20, 2020 is down 7% compared to the TSX 17%. A better way of thinking observing the pension fund protective put is that NPI got down to $20/share at the bottom and has rallied back to $30/share in less than a month. The pension plan buyout protective put should help support NPI's valuation going forward.

If NPI's common shares traded at INE's forward yield, NPI's shares would have 27.2% upside

Our negative concern for NPI is its investor base. NPI's investor base craves only income, 66% of the float is with retail investors. Another 10% is held by institutions, with some kind of income/yield/dividend moniker. Therefore, at least 76% of the shareholder base is focused on dividends. It is hard to convince NPI's investor base that NPI should trade at a lower dividend yield than it currently does. That same concern about the investor base also creates the opportunity to buy a misunderstood company.

To value NPI we used an unlevered FCF model and modeled it out for the weighted average remaining life of all of their assets, 27 years. We discounted back at a 7% weighted average cost of capital, using a higher equity cost of 11.5% to be conservative. For EBSA we used a residual income method to value the utility, as it is difficult to use a discounted cash flow to value a utility. We provide two valuations in Figure 10, one valuing NPI based on their current assets and a second based on adding Taiwan to their asset base.

Figure 10

NPI Common Share Valuation

Current Business	$33.28
NPI With Tiawan	$39.00

Source: Bloomberg, Capitalight Co

The other way we think about NPI is investors are purchasing NPI at 11.3 times FCFE. We think 11.3 times FCFE is a fair multiple to pay when considering investors are buying a company that can double its installed capacity, obtain 15%+ levered IRRs on new investments and has a management team always looking for new optionality to invest in. Not to mention ESG tailwinds at their back.

For reference Orsted, the only other company with the same business model as NPI in the world trades at 17.5 times EBITDA, while NPI trades at 11.7 times. Orsted's business involves more development and selling of projects, which causes its return metrics to be lumpier. In 2019 Orsted did not sell any assets, so we get a true sense of a comparable business to NPI. For 2019 Orsted's ROE was 9.2% compared to 38.3% for NPI. If we compared to 2018 when Orsted sold partial interest Orsted's ROE is 28.9%. As investors can see NPI's is a much higher returning business, that has not been discovered by the world market because of its size. Orsted's market cap is $46B USD compared to NPI's $4.1B USD market cap.