Green Deals in a Dry Season

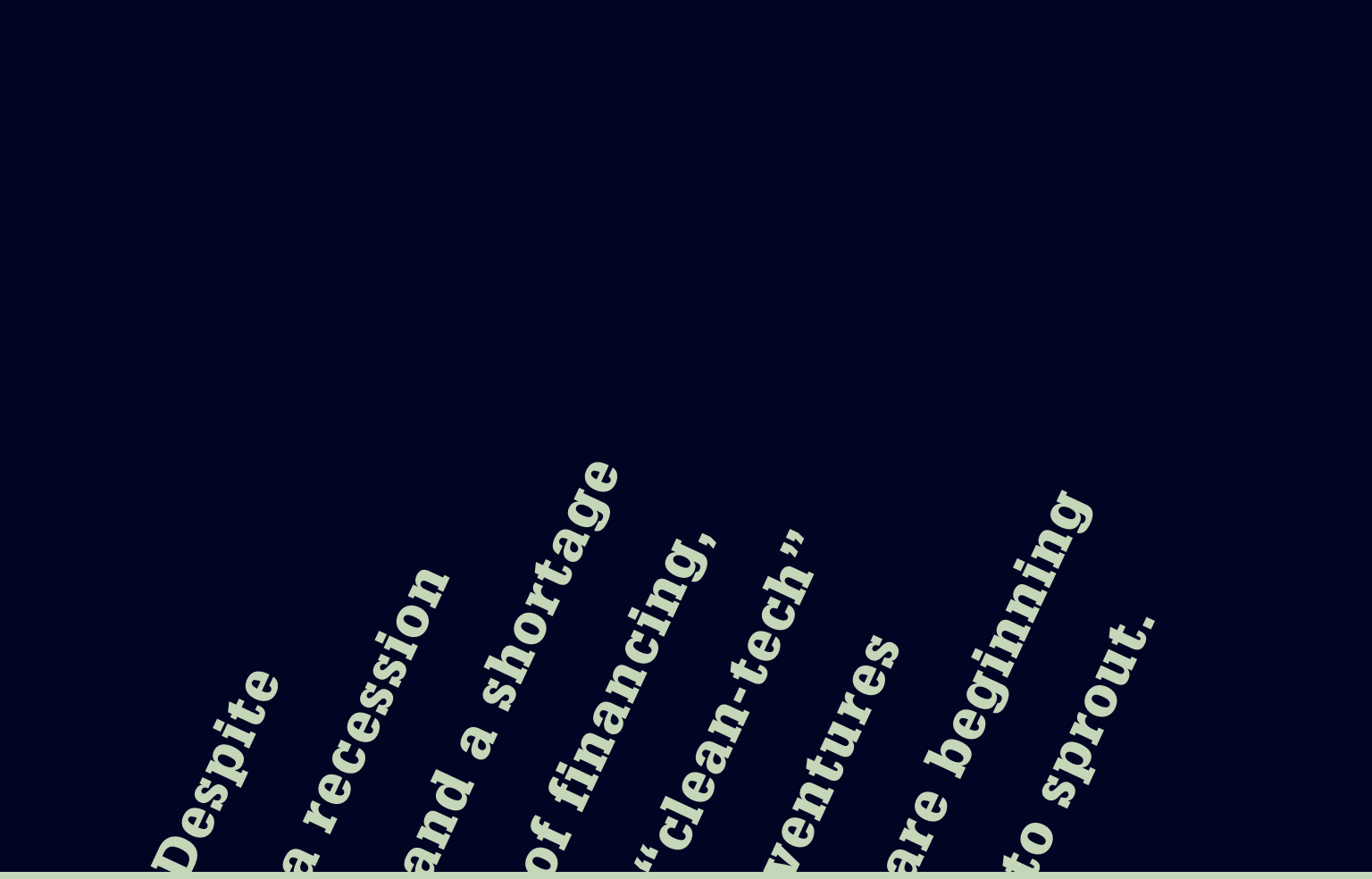
by RENE CIRIA-CRUZ

EARLY THIS YEAR SUSAN MAC CORMAC, a corporate partner at Morrison & Foerster in San Francisco, closed a clean-tech venture capital transaction and posted the news internally. Surprised colleagues peppered her with emails: "Really? There's money flowing in? What kind of company is it? What are the terms of the closing?" "They really wanted to know" about it, Mac Cormac recalls.

That's because by last fall the recession had finally subdued one of the livelier sectors of the dormant economy, and deal makers were expecting fewer transactions. "Compared with *hundreds* of [clean-tech] VC financings in the first quarter of 2008, there were all of 14 in the first quarter of 2009," Mac Cormac says.

By the second quarter of 2009 total new investment in clean energy had dropped by almost half compared to the same period the year before. Venture capitalists saw the fewest companies in 30 years go public, reports a survey by the tax and auditing firm KPMG. Instead of seeking and propelling new ventures, many VC firms are now making safer bets, according to New Energy Finance, a London-based carbon markets research firm. Sometimes

Rene Ciria-Cruz is an associate editor for California Lawyer.



this means switching to companies in later stages of development—the better to make a quick exit.

But however sobered they are by the recession, many clean-tech players remain confident of their prospects. The price of oil may drop and briefly revive SUV sales, but consumers and governments are increasingly seeing the light; clean, renewable energy is here to stay. The trick for start-ups is to find ways of staying alive and gathering strength until the economy picks up. And so lawyers are in the thick of devising good deals in a bad market.

Only recently the clean energy field seemed to be building a head of steam in California. The industry—comprising the production of alternative fuels; innovation in energy generation, storage, and efficiency; environmental protection; safe waste management; and improvements in water treatment and conservation—brimmed with start-ups like Achates Power in San Diego (engine technology); Marquiss Wind Power in Folsom; Solazyme in South San Francisco (biofuels); eSolar in Pasadena; Altarock Energy in Sausalito (geothermal); and Fat Spaniel Technologies in San Jose (smart grid). And earlier this year the Obama administration anointed the industry as the best hope for freedom from dirty, non-renewable fossil fuels to combat global warming, and as the foundation of a new American economy.

But the global financial crisis—epitomized by the collapse of Lehman Brothers, which was a prominent wind-farm investor—halted the flow of new capital. It also didn't help that the price of natural gas dropped as well, making clean energy less competitive with fossil fuels and less attractive to investors in the short term.

"Early investors in clean tech couldn't know all the conditions that would emerge," explains Mac Cormac. "Some got hurt in ventures that eventually weren't viable, and they started pulling back."

Crossing the Valley

Unlike the dot-com companies that boomed in the 1990s, clean-tech start-ups need more than just computers and sophisticated programming to get up and running. They require huge amounts of capital to cross what's called the "valley of death"—the gap between setting up shop and finally bringing a new product to market. These capital requirements, exacerbated by the credit crisis, have forced entrepreneurs and investors to stop and gasp for air. A recent Cooley Godward Kronish survey of 72 clean-tech entrepreneurs found that only a third expect

start-ups to get financing through debt or private equity in the coming months.

Solar energy, once the industry's brightest star, has suffered most visibly. Both late-stage solar and wind power valuations have plummeted. "Huge solar projects and new technologies like solar thermals or desert-based solar plants are tough to finance because of the huge capital requirements," says Edwin Feo, a partner and cochair of the project finance and energy practice at Milbank, Tweed, Hadley & McCloy in Los Angeles.

Hundreds of millions of dollars are needed to produce smart electrical grids, massive solar plants, and wind turbines. Many millions of dollars more are required to transmit that power from generating plants in remote areas to the purchasing electric utilities. "Large-scale solar projects with innovative technology are having a difficult time attracting private capital," Feo explains. "So the Department of Energy's loan-guarantee program is a realistic alternative." Even windmill enthusiast T. Boone Pickens had to pull the plug on his proposed giant wind farm in Texas, which was undercut by plummeting natural gas prices and a lack of investor interest.

"Early investors in clean tech couldn't know all the conditions that would emerge. Some got hurt, and they started pulling back."

—SUSAN MAC CORMAC

Betting on the Long Haul

But while the recession has dampened forecasts of a clean-tech boom, its pioneer entrepreneurs and investors are still hanging on for very compelling reasons.

Clean-tech dominance of the energy markets is just a matter of time. Consumer culture—especially in developed economies—is shifting away from oil, coal, and other non-renewable fuels. Popular fears about the harmful ecological effects of non-renewables have also grown. Many state governments, therefore, are promoting energy independence and sustainability. They're now wielding the stick of environmental regulation, along with dangling the carrot of more public spending for clean-tech projects.

The Cleantech Group, a San Francisco information network, reports that the world's governments are expected to disburse more than $200 billion in clean-tech project funding in 2009. Worldwide private capital spending was $150 billion last year. In the United States, federal incentives already include $60 billion in direct spending and subsidies, $7.6 billion in bonds and loan programs, and a variety of tax credits. And both the federal Energy Independence and Security Act of 2007 (42 U.S.C. §§ 17001–17386) and renewed federal tax incentives in 2008 are spurring states toward sustainable energy exploration.

California stands to benefit both from federal enthusiasm for clean tech and from the state's own development policies. The California Renewables Portfolio Standard—arguably the most ambitious clean-energy measure in the country—requires utilities to boost the amount of electric power they buy annually from alternative energy sources by at least 1 percent of retail sales, until such purchases amount to 20 percent by 2010. In addition, the Global Warming Solutions Act of 2006 (Cal. Health & Saf. Code §§ 38500–38599) requires the state to push back carbon dioxide emissions to 1990 levels by 2020, and to replace MBTE, a toxic gasoline additive, with ethanol.

California also wants to expand its "feed-in tariff" program for clean-energy producers, which prices renewable energy at above-market rates to spur further industry growth. And CalPERS and CalSTRS, the state's two giant public pension funds, have done their part by investing $500 million in clean-tech projects.

With such powerful cultural, political, and financial drivers behind the industry, no wonder it's popular. Clean tech continues to entice venture capitalists such as Silicon Valley's Khosla Ventures and Kleiner Perkins Caufield & Byers, as well as private-equity funds and corporate investors. Six years ago only 7 investment funds had clean-tech holdings; by 2008, 117 were investing in the growing number of clean-tech companies, according to Preqin, a private-equity intelligence firm. In 2003 only 43 clean-tech operations raised venture capital; last year 171 companies did so, reports the professional-services firm Ernst & Young.

Globally, renewable energy led all other sectors in attracting venture capital for the first time last year, the Cleantech Group reports. California start-ups hogged $3.3 billion of the $5.9 billion invested in North American alternative-energy companies ($8.4 billion was the total global VC investment). And Silicon Valley is clearly at the center of the action, with 74 private venture-backed companies, according to Ernst & Young.

Consolidation

Still, tight credit, thinner investment portfolios, and greater risk aversion among institutional investors have taken a toll. "Certain areas, especially solar, will see more

mergers and acquisitions," predicts Stephanie S. Brecher, a corporate partner at Sheppard Mullin Richter & Hampton in Orange County. "It makes sense to consolidate—for companies with more money to acquire smaller ones with great technology but with fewer chances of getting funds."

A good example is the recent acquisition of Hayward-based OptiSolar Technology's planned massive solar-power project in Central California. OptiSolar, which manufactures thin-film solar photovoltaic panels, had raised $200 million, but much more was needed to transmit the power it had contracted to deliver to Pacific Gas & Electric Co. Last March Alan Bernheimer, OptiSolar's vice president of corporate communications, told the *San Francisco Chronicle,* "It's going to take a buyer with resources, cash flow, and the ability to invest in research and development."

First Solar, a publicly traded company based in Tempe, Arizona, fit the bill. "First Solar is known as the Google of solar," says David Lazerwitz, an environmental partner at San Francisco's Farella Braun + Martel and a member of the legal team that represented OptiSolar in negotiations. "It's a $400 million stock transaction that turns over development of the utility-scale project to First Solar."

David Stoll, Farella's team leader, worked with five corporate partners and associates, two tax partners, and two real estate associates in addition to Lazerwitz. "It was a very complex transaction involving the sale of the company's project-development business, separating those assets from the manufacturing operations, and dealing with tax issues and interests in Canada," Stoll says. Farella has been OptiSolar's "soup to nuts" outside general counsel since it helped the company incorporate in 2005.

While the Farella team handled due diligence and separated OptiSolar's operations, the company brought in Covington & Burling attorneys to focus on deal structure. "It was a great combination that worked very well," Stoll adds. "Between a New York–based M&A specialist and us—a regional team that thoroughly understood the client's business and state regulatory, tax, environmental, and land-use issues—it was great coordination."

MoFo's Mac Cormac says she is currently handling three more clean-tech M&As. Last year she closed the sale of Altra Biofuels' cellulose division to a spin-off, Eden IQ, and she recently completed "a recapitalization with venture-backed debt-to-equity conversion."

They're Out There

That deals can still be made despite the slump doesn't surprise Milbank's Feo. "It's a conservative market, but funds can be had for the right size [deal] and for the right technology," he says. Last June Milbank closed four privately backed deals—three in wind power and one in solar. The firm represented San Jose's SunPower in a $100 million partnership with Wells Fargo Bank to lease commercial-scale solar systems. "We have twelve deals in the house," Feo says. "So, obviously, there are deals to be made and financing available."

These even include a few big ones, such as Exxon Mobil's new $600 million stake in an alliance with Synthetic Genomics in La Jolla to develop biofuels from photosynthetic algae. Tesla Motors, the San Carlos–based electric car company, recently acquired a new strategic backer when Germany's Daimler AG sold 40 percent of its equity stake in the company to Abu Dhabi's Aabar Investments.

"In 2010, investor confidence will rise and funds from government energy programs will start to kick in as additives."

—EDWIN FEO

Last year BrightSource Energy of Oakland raised $115 million from key investors, including Google and BP Alternative Energy. The start-up needs $2 billion to $3 billion to build five large solar thermal plants in the Mojave Desert; these will use an array of mirrors to direct sunlight to a central water-filled tower, creating steam to power a turbine. BrightSource already has purchase contracts with PG&E and Southern California Edison.

Mac Cormac, who specializes in handling transactions for private clean-tech companies, acknowledges that strategic backers and project financing are hard to find, but she insists that deals are available. She recently closed a round of VC-backed financing for Carbonetworks, a Canadian carbon-tracking firm with an office in San Francisco. And she closed a non-VC, strategic investment in VeriSteel, which produces efficient, environmentally friendly prefab sidings for mobile homes. By Mac Cormac's estimate, MoFo revenue from its clean-tech-related practice has risen 67 percent from 2008, and 127 percent last year above the year before.

Sheppard Mullin's Brecher recently represented Energy & Power Solutions (EPS) of Costa Mesa in a $30 million Series B venture capital financing. Venture capitalists already on the company's board from its Series A funding

Continued on page 56

Green Deals in a Dry Season, continued from page 31

identified prospective Series B funders, and Brecher—who had done corporate work for EPS before joining Sheppard Mullin late last year—did the work "from term sheet to finish" with one Sheppard Mullin associate.

Green Shoots Appear

According to the Cleantech Group, second-quarter 2009 financials hint at an economic rebound: 94 energy companies sopped up $1.2 billion in venture capital that quarter. In addition, there were 138 M&A transactions, 40 of which disclosed deals with a total value of $12.2 billion. Alternative vehicles, energy storage, and biofuels took the lion's share; solar didn't do as well.

The IPO market, however, remains depressed. Cleantechbrief.com reports that there were only 13 clean-tech IPOs in the United States by midyear 2009, compared with 35 during the same period last year. But some VCs are optimistic. Steve Westly, a former eBay marketing chief who heads The Westly Group in Silicon Valley, predicts the launch of a dozen IPOs in the coming months.

"Certain areas, especially solar, will see more mergers and acquisitions."

—STEPHANIE S. BRECHER

Some of them will be "blockbusters," he told a recent financing conference in Palo Alto, naming likely candidates that have raised substantial venture capital.

Given the current financial market, some clean-tech ventures have succeeded by using guerrilla financing. Milbank's Feo cites the example of Clipper, a Carpinteria-based manufacturer of wind turbines. Clipper—which is not a Milbank client—sought financing from lenders the firm represents who were initially reluctant to invest. "The solution was to encourage large sponsors to mix Clipper machines with other big-name turbines in their systems," recalls Feo. "BP bought some Clipper machines, so Clipper was able to establish a record and inspire confidence from potential financiers. Since then Clipper shares have doubled."

An IP Minefield

Another way cash-starved start-ups can survive the financing drought is to license valuable IP assets. Ausra, an Australian solar thermal systems producer with an office in Mountain View, began licensing its technology to other companies and turning to equipment sales. Similarly, Pasadena's eSolar inked an exclusive licensing agreement with the ACME Group, which will build solar thermal power plants in India.

According to a report by Mountain View–based Collaborative Economics, California secured 607 patents last year in solar, wind, and battery development—more than any other state. But providing access to patents through licensing agreements may be only a short-term strategy. Some observers predict that as the market for clean energy grows, the present culture of collaboration will shift to one that is more proprietary.

"IP litigation will rise," says MoFo's Mac Cormac. "Companies big and small—and not just directly cleantech-related—have sprinted to the patent office. That alone spells a lot of overlapping claims, because new technologies often are based on the older ones."

Federal Stimulus

Until private lenders gain more confidence in the economy, of course, the major source of clean-tech funding is the American Recovery and Reinvestment Act of 2009 (Pub. Law 111-5), which Congress passed in February. In late July the Department of Energy announced $30 billion in new loan guarantees to help get solar, wind, geothermal, and biofuel projects off the ground.

Currently, many clean-tech practice groups are shepherding clients toward the most promising of available federal grants, tax credits, and loan guarantees. Feo says Milbank helped one client apply for loan guarantees to help finance a coal-gasification project. Similarly, Tesla Motors recently received a $465 million loan guarantee from the Department of Energy, and Solyndra Inc. of Fremont got a $535 million guarantee to expand its solar-panel manufacturing capacity.

Farella's Lazerwitz says start-ups need help not only in seeking grants and loan guarantees but also in monetizing tax credits. "Start-ups usually don't have enough earnings to use tax credits to offset tax liability," he explains. "So project developers offer those credits to tax-equity investors." Tax-benefit buyers—such as Morgan Stanley, Union Bank, and Wachovia—then use the credits as income tax shelters.

In addition, the federal stimulus package offers clean renewable energy tax credit bonds, or CREBs. Applicants must describe their projects and propose a financing plan. After a review, the IRS allocates the bonds, starting with the smallest amount requested.

Warren Diven, public finance partner at Best Best & Krieger's San Diego office, recently helped the Cucamonga Valley Water District in San Bernardino County acquire tax-credit bonds that the district could sell to finance a solar project. "Because it's new ground, the Cucamonga CREB process took four months," says Diven, who worked with a tax partner to ensure compliance with

federal regulations. The bonds were then sold to investors, who can use them for federal income tax credit.

Diven notes, "The feds have another stimulus bond program—Qualified Energy Conservation Bonds—that gives a state's largest cities an automatic allotment of substantial portions. But the public agency responsible for the allocation has yet to be designated."

Expert legal guidance also will be required for new clean-tech regulations and compliance mazes—both domestic and international. Among them are regulations governing public lands, which could become home to large-scale wind and solar projects. "The sudden growth in wind and solar energy has produced a federal public land rush," says Lazerwitz. "The Bureau of Land Management is swamped with applications for the use of federal lands, and applicants—as well as the BLM—have to wrestle with a lot of environmental and endangered-species rules."

Aura of Inevitability

Like many lawyers in the alternative-energy field, Mac Cormac is enthusiastic about clean-tech development despite its present funding problems. The aura of inevitability around the industry is hard to resist. There's no question that perceptions and values among consumers, corporations, and governments are evolving and increasing demand for clean energy. Smart grids—the digital calibration of more efficient energy usage—will heat up, especially as the concept gains federal support, says Mac Cormac. "Energy efficiency will become hot, because it will be regulation-driven," she adds. "Carbon reduction, tracking, trading, sequestration will definitely be big. Listen, Honeywell's production is already 55 percent geared towards energy efficiency and carbon reduction. Water-use reduction will also be in demand."

Feo is equally enthusiastic. "In 2010 we'll see a period of renewed and robust growth," he predicts. "That's when investor confidence will rise and funds from government energy programs will start to kick in as additives."

"Green Deals in a Dry Season" originally published in the October 2009 issue of ***California Lawyer.***