

**Strafford**

*presents*

# **Renewable Energy Projects: Alternative Financing**

## **Legal Strategies for Evaluating Financing Options and Structuring the Deal**

### **A Live 90-Minute Teleconference/Webinar with Interactive Q&A**

#### **Today's panel features:**

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### **Tuesday, September 28, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

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# Renewable Energy Projects: Alternative Financing Structures

September 28, 2010

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## **OVERVIEW**

- Critical Components of Renewable Energy Financings
- Current Renewable Energy Financing Market
- Debt and Tax Equity Structures
- Tax Equity: Detailed Structures and Features



## **CRITICAL COMPONENTS OF RENEWABLE ENERGY FINANCINGS**

- Regulatory Issues
  - Electricity industry is a regulated industry
  - Federal and state regulation
    - Exemptions (EWG, QF)
  - Typical regulatory approvals
    - Seller
    - Rates
  - Other regulatory approvals
    - Changes in beneficial ownership/passive ownership
  - Offtake arrangements
    - Rate approval/RFP
    - Feed-in-tariffs
    - Net metering arrangements



## **CRITICAL COMPONENTS OF RENEWABLE ENERGY FINANCINGS (cont'd)**

- Permits
  - Final, nonappealable permits typically needed
    - Timing
    - Approval risk
  - Conditions that could affect operations
    - Noise
    - Sight
    - Avian
    - Antiquities
    - Mitigation measures
  - Renewal risk



# RENEWABLE ENERGY PROJECTS: ALTERNATIVE FINANCING STRUCTURES

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# **FINANCEABILITY OF RENEWABLE ENERGY PROJECT: RISK ALLOCATION**

## **RISK ALLOCATION**

- **Early Development Risk**
  - **Land Control**
  - **Permitting**
  - **Transmission Access**
    - **Location**
    - **Early Cost**
    - **Time**
  - **Off-Take Agreement**
    - **Can You Get One?**
    - **Credit of Off-Taker**
    - **Financeable Terms and Conditions**



# **FINANCEABILITY OF RENEWABLE ENERGY PROJECT: RISK ALLOCATION**

- **Structuring and Transaction Risk**
  - **Construction Risk**
    - **Completion**
    - **Delay**
    - **Performance**
    - **Reliability**
    - **Minimum Output**
  - **Permitting**
  - **Force Majeure**



# **FINANCEABILITY OF RENEWABLE ENERGY PROJECT: RISK ALLOCATION**

## **■ Operational Risks**

- Intermittent Weather
- Fuel (for Biomass Projects)

## **■ Other Risks**

- Change in Law
- Change in Regulatory Policy
- Expiration of Incentives
- Transmission and Transmission Constraints
- "NIMBY" and Political



# **FINANCEABILITY OF RENEWABLE ENERGY PROJECT: SOURCES OF REVENUE**

## **SOURCES OF PROJECT REVENUE**

- **§ 1603 Cash Grant In Lieu of Tax Credit**
  - **Must commence construction on project by December 31, 21010**
  - **Likelihood of extension**
- **Payments from Off-Take Agreement**
- **"Spot" and Other Non-Contractual Sales**



# **FINANCEABILITY OF RENEWABLE ENERGY PROJECT: SOURCES OF REVENUE**

- **Sale of Renewable Energy Credits (REC)**
- **Pre-Paid PPAs**
- **Cost-Savers (Indirect Revenue)**
  - Tax Incentives Other than §1603 Cash Grant in Lieu of Tax Credits
    - ITC, PTC and MACRS
  - DOE and Other Federal Agency Loan Guarantee Programs

# CURRENT RENEWABLE ENERGY FINANCING MARKET

- Debt Market
  - Lenders are in business
    - Led by European banks
  - Continued flight to “quality” projects
    - Brand-name sponsors
    - Proven technology
    - Creditworthy, well-structured offtakes
    - Conservative financing model assumptions
  - Tenors lengthening (up to 17 years for wind; up to 20 years for solar)
  - Pricing still robust (275-400 over LIBOR including periodic step-ups; 300 bps upfront for structuring and lead arranger)
  - Most important market feature: cash grants
  - DOE loan guaranty program: multiple programs; some recent success for renewables

## CURRENT RENEWABLE ENERGY FINANCING MARKET (cont'd)

- Tax equity market
  - Market is very thin for ITC/PTC/MACRS deals
  - Mostly insurance companies and financial institutions
  - Returns have increased since credit crunch
  - Stimulus Bill
    - PTC in-service periods extended (2012 (wind); 2013-16 (others))
    - ITC/lease structures now available to all PTC technologies (previously not for wind)
    - Cash grant in lieu of ITC available for projects completed in 2009-2010 or projects in construction by such dates and completed by otherwise applicable PTC credit expiry dates (administered by Treasury)
      - Will cash grant be extended?



## DEBT AND TAX EQUITY STRUCTURES

- Debt Structure
  - Project Company – SPV or holding company of multiple SPVs (LLC or LP)
    - Sometimes bankruptcy remote
  - Limited or no recourse to sponsors
    - Exception: PTC monetization structure
    - Exception: Cash grant indemnity for disqualifying transfers
  - Security for Lenders
    - All assets of project company (including contract rights)
    - Pledge of ownership interests in project company



## **DEBT AND TAX EQUITY STRUCTURES (cont'd)**

- Debt Structure (cont'd)
  - Disbursement Waterfall
    - All revenues collected in collateral account and disbursed in specified order of priority: expenses, debt, equity
  - Lease structure for ITC/MACRS deals
    - May be single-investor or leveraged
    - Cash grant also available in MACRS deals

## DEBT AND TAX EQUITY STRUCTURES (cont'd)

- Tax Equity Structure--LLC/Partnership Flip
  - Tax investor sizes investment to an after-tax return
    - Investment may be combination of upfront or deferred payment
  - Tax investor receives tax benefits and cash
    - Sponsor typically receives initial cash until return of (not on) capital
  - Once tax investor return achieved, benefits "flip" back to sponsor
    - Cash grant tax equity deals often include multiple flips and larger cash sharing by Sponsor in order to extend average life and produce full term yield
  - Safe harbor--Rev Proc 2007-65
  - Can be leveraged or unleveraged

## DEBT AND TAX EQUITY STRUCTURES (cont'd)

- ITC/MACRS Lease Structure for Solar (and, via Stimulus Bill, Wind and Other Renewables)
  - Tax investor (lessor)/sponsor (lessee)
  - Tax benefits utilized more efficiently, but larger residual
  - Traditional leasing and ITC (if applicable) rules apply
    - maximum lease term not to exceed 80% of useful life
    - maximum PV of rentals not to exceed 90% of FMV
    - minimum residual of 20%
    - residual and early buy-outs at actual or projected FMV
    - recapture on change in control for five years after in-service date
  - Cash grant may run to lessor or lessee
  - State tax credits/benefits can be important

## DEBT AND TAX EQUITY STRUCTURES (cont'd)

- Cash Grants (in lieu of ITC)
  - Highly successful program to date (over \$2 billion disbursed in 2009)
    - large wind projects have taken bulk of grant dollars to date
  - Project owner (or lessee) eligible to receive lump-sum cash grant equal to 30% of eligible costs (essentially costs available for ITC)
  - Not included in owner's federal gross income; possible state tax issues; reduces depreciation by 50% of grant amount
  - May be applied for on a per unit (e.g., per turbine or solar panel) or aggregate (i.e., project) basis
  - Paid within 60 days after later of application date or project COD

## DEBT AND TAX EQUITY STRUCTURES (cont'd)

- Cash grants (in lieu of ITC) (cont'd)
  - Subject to ratable five-year clawback for disqualifying dispositions by original tax owner(s) to tax-exempt entities or cessation/change in nature of operations
    - recourse to project owner/grant applicant; no look through
    - compare ITC recourse to taxpayer and recapture upon any change in control
  - Utilized in leveraged and unleveraged structures, often to bridge construction costs
    - if leveraged, advance rates of 75-100% but same financing costs
  - “Start of construction” requires physical work of a significant nature
    - 5% of project costs safe-harbor (excludes land and engineering)
  - Extension of program uncertain



## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES**

- Partnership (LLC) Structures
  - Originated in wind projects, have been applied to solar and other renewables
- Lease Structures
  - Sale/leaseback; historically not available for wind or most other PTC structures due to PTC owner/operator requirement; under Stimulus Bill, now available for wind and other renewables too
- Common Partnership Structures (typically implemented through LLC vehicle)
  - Pro-rata
    - Sale of a partial, pro-rata interest in the partnership
    - Not really a true “tax financing”
    - Rare; requires both partners to have tax capacity as well as an interest in underlying project rather than just tax benefits

## TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)

- Common Partnership Structures (cont'd)
  - Pro-rata with a flip (most common structure pre-2003)
    - Tax equity initially receives substantially all (99%) of value of the project
    - When a specified hurdle return is reached, allocations “flip” to cash equity (80-95%)
    - Typically (not always), initial financing is set to reach hurdle return in 10 years
    - Maximizes amount of day-1 financing from tax equity
    - Target hurdle rates have ranged from 6%-10% AT depending on details (leverage, etc.)
    - Sometimes referred to as the “99/1” or “partnership flip” structure

## TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)

- Common Partnership Structures (cont'd)
  - Disproportionate allocations (most common post-2003) (see also Rev Proc 2007-65 discussion)
    - Functionally minimizes tax equity financing while still maximizing transfer of tax benefits to tax equity
    - Similar to 99/1, except that it bifurcates cash distributions from taxable income and tax benefits in early years (“disproportionate allocation”)
      - Generally speaking, 100% of first few years of cashflow get distributed to cash equity and are treated as return of principal (no tax consequences; no PTC consequences (PTC follows income))
      - Otherwise same as 99/1 structure after first few years
      - Extent of cashflow redirection is generally the maximum permitted by IRS regulations
    - Target hurdle rates have ranged from 5.5%-9% AT depending on details (leverage, etc.); 2010 rates higher
    - Sometimes referred to as a “partnership flip” or “PAPS”

## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)**

- Rev Proc 2007-65 for disproportionate allocation wind structure
- Elements of safe harbor
  - initial allocation of all items other than cash no more than 99/1 to tax investor
  - flip to no more than 95/5 to cash investor
  - no more than 25% of purchase price can be contingent “in amount or certainty of payment;” at least 20% of purchase price paid up front
  - cash investor purchase option only at FMV at time of exercise and no sooner than 5 years after COD
  - no guaranteed return by cash investor to the tax investor
- Has been applied to non-wind PTC structures (e.g. solar)



## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)**

- Common partnership structures (cont'd)
  - Other disproportionate allocations
    - Not very common
    - Generally are developed to satisfy specific goals from a cash partner standpoint (a “sale-focused” mentality)
    - Most common manifestation is a hybrid between the standard three structures to allow cash equity to receive either constant cashflow, GAAP earnings, or a small amount of tax benefits
    - Many cashflow-type goals might be satisfied more easily with cashflow swaps outside of partnership transaction



## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)**

- Common features in financing structures
  - PPA
    - “Intercreditor” issues for tax equity
  - Energy Hedge
    - Typically necessary for transactions without PPAs
    - Often coupled with “intercreditor” provisions for tax equity
  - REC Sales
    - Stipulated pricing is critical in order to get financing credit

## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)**

- Common features in financing structures (cont'd)
  - Leverage
    - Disfavored at the project level due to perceived heightened risk of tax recapture; “forbearance light” provisions often sought by tax equity
    - Back-leverage more common
    - Generally uses a coverage ratio of 1.4-1.5, depending on quality of wind resource and fixed-price nature of power sales
    - Historically, LIBOR-based spreads, often escalating over time; typically will be swapped to a fixed rate at the behest of lender or tax equity
    - If transaction includes pay-as-you-go aspects (see next slide), tax equity and lender typically negotiate cure rights/limited forbearance for the 10-year PTC period
    - Depending on term of contracted power sales/hedges, tenor typically ranged historically from 10-18 years; now mini-perms (5-7 years)

## TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)

- Common features in financing structures (cont'd)
  - Pay-as-you-go
    - Partner receiving tax credits (tax equity) agrees to contribute additional equity into partnership on an ongoing basis, tied to receipt of tax credits
    - Typically 85-95% of value of credits received are contributed back in the form of cash, often only if needed to support DSCR
    - Accomplishes three main goals
      - Allows project to monetize tax credits, supporting additional debt financing
      - Provides a form of wind resource hedge for the tax equity, as low wind output results in lower investment and vice versa, but limited by PTC safe harbor in tax equity sale/financing context
      - Provides a hook to encourage lenders to forbear on foreclosing out tax equity
    - Some pay-as-you-go structures take slightly different forms, such as payment directly to developer/cash equity in lieu of contribution to partnership
      - Generally used to accomplish ancillary objectives for cash equity in terms of book treatment, cashflow, or back-leverage
    - Structure significantly limited by IRS safe harbor (no more than 25% of purchase price can be contingent “in amount or certainty of payment”; at least 20% of purchase price paid up front)

## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES** **(cont'd)**

- Lease Structures
  - Basic Structure
    - Tax investor purchases project from developer and immediately leases it back to the developer
    - Developer pays net rent under “hell-or-high-water” lease
    - Project reverts to tax investor at end of lease but developer typically has purchase option (often at multiple intervals) which may be FMV at time of exercise or projected FMV (contrast PTC which must be FMV at exercise)
    - Traditional lease rules apply regarding maximum residual, maximum term, and early buy-outs



## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)**

- Lease Structures (cont'd)
  - Lease vs. Partnership Structure
    - Financing can close up to 3 months after “in service” date
    - More efficient financing of tax benefits (100%); developer often not needed to fund capital gap
    - Developer gets immediate benefit of operating upside above rental payments
    - Established parameters for governance, operating control
    - Possible accounting advantage (mitigates book losses)
    - Developer’s purchase option more expensive (per leasing guidelines, residual must be at least 20% of initial cost)
    - Heightened default risk due to “hell-or-high-water” lease payments

## TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)

- Ownership and Substantial Economic Effect
  - Ownership: risk that tax equity is construed as debt
    - Control – does the tax equity have sufficient control/voting rights?
      - typically negative control through major decision consent rights in partnership structure
    - Residual – does the tax equity have a residual interest?
      - generally, a floor of a 5% share of the economics as a residual interest is applied for partnerships; leases require 20% floor
      - issue if non-FMV purchase options
    - Guarantee – is the tax equity's return too debt-like in terms of guaranteed return?
    - True Lease – length of lease, total rental payments, residual, purchase options

# TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)

- Ownership and Substantial Economic Effect (cont'd)
  - Substantial Economic Effect (cont'd)
    - General term given to summarize an extensive and explicit set of IRS regulations regarding partnership distributions and allocations
    - Allocations of cash items and tax items are generally unfettered, though subject to a few overarching rules, some of which come into play in project financing
  - Depreciation
    - Depreciation is typically capped at a partner's capital account; basically equal to such partner's basis in the partnership
    - Certain structures/leverage allow for more depreciation; many disproportionate allocations allow tax equity to receive substantially all depreciation available
    - Some structures allow tax equity to receive depreciation temporarily in excess of basis (though realization is still delayed) if accompanied by a deficit restoration obligation
  - Tax Credits
    - Production tax credits must follow allocation of gross taxable income (excluding depreciation)
    - Actual rules for tax credits vary depending on nature of tax credit



## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)**

- Ownership and Substantial Economic Effect (cont'd)
  - Substantial Economic Effect (cont'd)
    - Tax Credits
      - Production tax credits must follow allocation of gross taxable income (excluding depreciation)
      - Actual rules for tax credits vary depending on nature of tax credit
    - Cash Distributions
      - Can either function as a return of capital or a distribution of profits
      - Return of capital is a nontaxable event but is typically capped at such partner's basis in the partnership
      - Distribution of profits is not capped at partner's basis, but is taxable and draws an allocation of tax credits, which may not be desired
        - » This is what limits distributions of cash to cash equity in disproportionate allocation structures



## **TAX EQUITY: DETAILED STRUCTURES AND FEATURES (cont'd)**

- Ownership and Substantial Economic Effect (cont'd)
  - Substantial Economic Effect (cont'd)
    - Minimum Gain
      - Transactions with sufficient nonrecourse debt can “break” the limitation on depreciation of tax basis, typically resulting in additional depreciation for tax equity
      - Extra depreciation is not “free”; it is reattributed to the beneficiary parties upon repayment of debt
        - » Post-flip repayment of debt creates “minimum gain chargeback” for tax equity; cash equity often needs to somehow reimburse tax equity for this liability, generally through adjustments to partnership distributions



**ALTERNATIVE FINANCING STRUCTURES:  
TAX EXEMPT FINANCING**

**TAX EXEMPT FINANCING (AND TAXABLE  
EQUIVALENTS)**

- **Clean Renewable Energy Bonds (CREBs)**
- **Build America Bonds (BABs)**
- **Exempt Facility Solid Waste Disposal  
Private Activity Bonds (for Biomass and  
Waste-to-Energy Projects)**



## **ALTERNATIVE FINANCING STRUCTURES: RULE 144A OFFERINGS**

### **RULE 144A CAPITAL MARKETS OFFERINGS**

- **Provides an exemption from registration requirements under the Securities Act of 1933**
- **Requires that securities only be sold to Qualified Institutional Buyers (QUIBs)**
- **Provides a means of raising debt and, hypothetically, equity in capital markets**



## **ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP**

### **DOE LOAN GUARANTEE PROGRAM**

- **ARRA provides for a \$787 billion economic stimulus package, including \$60 billion of loan guarantees by the DOE for certain renewable energy projects and transmission projects**
- **The ARRA creates a new § 1705 to Title XVII of the Energy Policy Act of 2005 as an add-on to the DOE's Innovative Technology Loan Guarantee Program. It temporarily directs the Secretary of Energy to use \$6 billion in appropriated funds to pay credit subsidy costs for certain renewable energy projects with conventional technology**



# **ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP**

## ■ **Eligible § 1705 Projects**

- Renewable energy systems (including incremental hydro) that generate electricity or thermal energy, and facilities that manufacture related components
- Electric power transmission systems, including upgrading and "reconductoring" projects
- "Leading edge" biofuel projects that will use technologies performing at pilot or demonstration scale that the Secretary determines are likely to become commercial technologies and will produce transportation fuels that substantially reduce life-cycle GHG emissions compared to other transportation fuels (separate guarantee limit of \$500 million)



## **ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP**

- **Eligible § 1705 Projects (continued)**
  - Do not have to comply with the requirements of § 1703 regarding "Eligible Projects"
    - No "new or significantly improved technology" test
    - No "commercial use" test
    - Borrowers are not required to pay credit subsidy costs
  - Must "commence construction" not later than September 30, 2011



# ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP

- **Eligible § 1705 Projects (continued)**
  - "Factors" for transmission projects
    - Viability of project without guarantees
    - Availability of other Federal and State incentives
    - Importance of project in meeting reliability needs
    - Effect of the project in meeting a State or region's environment (including climate change) and energy goals



## **ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP**

- **Eligible § 1705 Projects Still Must Meet § 1702 Requirements**
  - Guarantee limited to 80% (with FIPP 64%) of project cost
  - Secretary must determine there is a reasonable prospect of repayment – current heavy emphasis on "creditworthy" projects
  - Secretary must determine there are sufficient funds to carry out the project
  - No sub debt



## **ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP**

- **Eligible § 1705 Projects Still Must Meet § 1702 Requirements (continued)**
  - Appropriate interest rate taking into account prevailing rates in the private sector
  - Maturity not to exceed lesser of 30 years or 90% of estimated useful life
  - "Superior rights" of liens – co-lender and intercreditor issues
  - Borrower must pay administrative fees in amounts the Secretary determines are sufficient to cover administrative expenses



## **ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP**

- **Sunset for entire § 1705 Program is September 30, 2011**
- **There are no new or additional rules for the § 1705 Program**
- **"Rule-making" for § 1705 has been accomplished essentially through the Solicitation process, (e.g., FIPP in the October 22, 2009 Solicitation)**
- **The revised rules issued in December 2009, purported to cover only § 1703 Programs but are being interpreted to also cover the § 1705 Program**



## **ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP**

### **Financial Institution Partnership Program (FIPP)**

- FIPP consists of a streamlined set of standards designed to expedite DOE's loan guarantee underwriting process for the § 1705 Program.
- FIPP does not replace or change any of the § 1705 Program fundamental requirements. The DOE envisions the FIPP acting as a "set of additional standards and procedures."
- The general purpose of FIPP is to leverage the human and financial capital of private sector financial institutions and to expand their ability to support the financing of construction of eligible § 1705 projects.
- It does so by expanding the senior credit capacity of private sector financial institutions to support the efficient and prudent financing of the types of conventional projects that they financed before the credit crisis while also assuring a proper alignment of risks between DOE and the private sector financial institutions.



## **ALTERNATIVE FINANCING STRUCTURES: § 1705 DOE LOAN GUARANTEES & FIPP**

### **FIPP Limitation**

- **Under FIPP, the DOE loan guarantee will only cover 80% of the maximum aggregate loan principal and interest during the loan term (i.e., 80% of 80%).**
- **The remaining 20% debt must be non-guaranteed and loaned by the financial institution "partners."**
- **In contrast, the DOE solicitations under § 1703 allow for loans equal to 80% of eligible project costs.**

# MERCER THOMPSON LLC



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## Washington, D.C.

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## Overview of CP Energy Group, LLC



- ▶ Founded in 2004, CP Energy Group, LLC (“CP Energy”), a CP Global Partners company, provides financial advisory and asset management services to project sponsors and institutional investors in the energy sector.
- ▶ CP Energy’s product focus is (i) project development and construction financing; (ii) tax-advantaged and other operating-stage related term financings; and (iii) corporate financings and M&A (development stage and operating projects).
- ▶ Through its affiliates, CP Energy is also a principal investor and currently manages in excess of \$300 million of energy related investments on behalf of its institutional partners.
- ▶ Renewable technology experience includes wind (land-based and offshore), solar thermal, solar photovoltaic (DG and utility scale), geothermal, biomass and biofuels.
- ▶ Other energy experience includes natural gas and coal-fired electric generation, gas pipeline, gas storage and pipeline compression services.
- ▶ Since 2004, CP Energy has represented buy-side and sell-side clients on transactions representing in excess of \$10 billion in equipment value, over 6,000 MW of installed electric capacity and involving over 40 separate projects.
- ▶ Additional information on CP Energy and its affiliates can be found at [www.cpglb.com](http://www.cpglb.com), or by contacting Ben F. Jacoby, Managing Director, 415-789-5040 ([bjacoby@cbglb.com](mailto:bjacoby@cbglb.com)) .