



C-PACE – a Primer for Mortgage Lenders



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Background on C-PACE

C-PACE (Commercial Property Assessed Clean Energy) financing refers to public/private programs that use voluntary, real estate special assessments to fund the costs of clean energy projects. C-PACE capital is supplied by commercial banks or other private capital providers to private property owners, in collaboration with local governments. The underlying value of long-term C-PACE financing is that the costs of installing and financing equipment is typically more than offset by the savings on utility, operating and maintenance costs.

C-PACE covers most commercial buildings—industrial, office, retail, 5+ unit multifamily, hospitality, self-storage and senior living facilities. C-PACE funding is typically used in retrofit or new construction of energy efficiency, renewable energy projects, and water efficiency projects.

Sonoma County, CA, implemented the first C-PACE program in 2009. As of January 2018, 33 states and the District of Columbia have passed C-PACE legislation and there are active programs in 19 states plus DC. Over 500 counties and local governments participate in C-PACE programs and more than 1,200 C-PACE projects have been funded nationwide, exceeding \$580 million. Since 2009, C-PACE financing has grown at an annual rate of 90%. The Clinton Climate Initiative estimates U.S. C-PACE potential at \$100 billion.

The rapidly increasing use of C-PACE financing, its market potential, and the fact that special assessments have statutory lien priority over existing debt points to the need for mortgage lenders to become familiar with C-PACE programs.

Why C-PACE is Popular with Building Owners

The tenure of C-PACE financing is based on the useful life of the eligible assets being funded, and can generally extend up to 25 years. Owners using C-PACE financing generate additional positive cash flow from comprehensive clean energy projects with long simple paybacks, which translates to higher property values. And owners with triple-net leased properties can pass through the higher property special assessment fees to tenants, who typically enjoy reduced utility expenses that exceed the higher assessment reimbursement.

C-PACE is non-recourse financing, underwritten to a property's assessed or appraised value. C-PACE does not accelerate in the event of an assessment payment delinquency or default and it runs with the property in the event of an ownership transfer. Because the repayment of C-PACE financing is made through property assessment payments, and cannot be accelerated, owners typically do not classify C-PACE as debt that adversely impacts loan covenants on a property.

Why C-PACE is Popular with Local Government

For public officials, C-PACE isn't a brand-new concept, as in most states it uses the same assessment mechanism used to fund beneficial public infrastructure projects, such as sewers and sidewalks. C-PACE appeals to local government because it creates local jobs without the use of government funds and with no financial risk to taxpayers (program administration costs are covered by fees paid by the property owner, and project funding comes from commercial banks and private lenders). To date, C-PACE investments have created an economic impact on local communities estimated to be as high as \$1.4 billion.

The Case for Lender Consent to C-PACE Financing

Understandably, the most significant issue for many commercial mortgage lenders is that C-PACE special assessments have lien priority over existing mortgage debt. However, most state PACE statutes require mortgagee consent to C-PACE financing. Historically, lenders have acquiesced to non-voluntary special assessments such as those mandated for Business Improvement Districts. Lenders with concerns about payments of future assessment bills can require that funds be escrowed with them to make the annual or semi-annual payments and ensure timely payment. Further, commercial mortgages often have provisions for protective advances for payment of taxes or property insurance premiums.

Most importantly for mortgage lenders, C-PACE financing funds projects that improve collateral value by reducing a building's operating costs. Coupled with long-term C-PACE funding, projects typically result in cost savings that exceed the amount of the C-PACE assessment, increasing cash flow and the debt coverage ratio. To the extent that this value is created without encumbering the property with additional conventional debt, the loan-to-value (LTV) will be lower, thus improving the risk rating for the mortgage lender. In cases where C-PACE is used to fund key infrastructure resilience projects (e.g., protecting the asset against seismic or weather-related events), C-PACE protects a mortgagee's underlying security. In addition, improvements to the energy systems of a building can result in higher worker productivity, greater tenant comfort and satisfaction. This helps with tenant retention, reduces tenant attrition, and increases the competitiveness of the property in the local market.

Lenders already factor property taxes and assessments into their underwriting models and can easily evaluate how an incremental C-PACE assessment would affect a credit decision. C-PACE projects typically comprise no more than 20% standalone LTV, and 80%-90% combined LTV, as dictated by each state statute. In addition, since C-PACE assessments do not accelerate upon a repayment default, a mortgage lender's only exposure to the senior C-PACE lien is for a C-PACE payment in arrears. Since the average annual C-PACE payment typically represents just 1-2% of the property value, C-PACE contributes minimal, if any, incremental risk to a lender. To date, there has been not been a single reported case of a C-PACE payment being collected through a municipal tax sale.

A Roadmap for Lender Consent

A lender presented with a request to acknowledge that a prospective PACE assessment would not trigger a non-monetary default in its existing 1st lien financing should consider these underwriting criteria:

- How will cash flow (either at the property level or for the property owner globally) and the DSCR be affected by the combination of PACE financing expenses and project savings? A qualified engineer independent of the approval process can readily determine the cost-benefit of a project and whether the projected savings in utility/maintenance/other costs will more than offset payments for the C-PACE special assessment.
- Are the improvements discretionary - e.g., installation of more efficient lighting systems or solar PV - and generate higher cash flow? Or are they mandatory - e.g., the replacement of a failed roof or HVAC system – and protect asset value and a mortgagee’s underlying security?
- What is the incremental property value increase that results from the PACE-funded improvement? Lenders may require a current appraisal of the property to be improved, to update “as is” and “as if completed and stabilized” valuations, and to verify property owner equity. The projected decrease in operating costs divided by the property’s market cap rate will provide a good estimate of the increase in property value.
- How material is the C-PACE assessment? The average annual C-PACE payment typically represents just 1-2% of the property value and contributes minimal, if any, incremental risk to a lender.
- Will the improvements to the energy systems of a building result in higher worker productivity and/or greater tenant comfort and satisfaction? This helps prevent tenant attrition, and increases the competitiveness of the property in the local market.
- What is the nature of the borrower’s relationship with the lender? Relationships do matter. Especially when a C-PACE project involves a long-term customer without any payment delinquencies, and the project makes good business sense for the building owner.

Summary

State and local governments have identified C-PACE as an important financing tool to incentivize property owners to implement clean energy projects. While mortgage lenders may find legitimate reasons to object to a proposed C-PACE project in certain cases, surveys by PACENation, a national not-for-profit organization representing all PACE market participants, indicate that the majority of projects submitted to lenders are being approved. Standardization of review and approval procedures within lending institutions and the lending industry is expected to accelerate this trend.

In many urban centers across the nation, there are many commercial buildings that need updating to remain competitive with new or newly renovated properties, and to protect lease spreads and occupancy rates. Such properties often have significant equity and adequate cash flow to cover commercial mortgages that may have been in place for years. These properties are strong candidates for C-PACE funding. They are also candidates for refinance of existing mortgages if those mortgage holders will not approve C-PACE funding for these properties.

PACE legislation is authorized at a State level, but C-PACE regulations are enacted locally and vary from one jurisdiction to another. While this can be problematic for national lenders who do not want to contend with local program variations, it has created a market opportunity for local commercial lenders, or private capital providers who can more readily tailor their lending to local conditions and fund their clients' C-PACE projects,