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# The Inside Story of How Connecticut Became So Influential in Energy Efficiency Finance

## The state's green bank executed a landmark securitization of efficiency loans. Will lessons learned in Connecticut spread?

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Back in May, news broke in Connecticut that CEFIA, the state's green bank, had inked a deal with specialty investor Clean Fund to bundle and securitize $30 million of PACE loans for energy retrofits in commercial buildings.

For a small group of people, it was very big news. Could this event be the key that unlocks vast stores of institutional capital sitting on the sidelines? Did it signal to the investment community that energy efficiency as a standalone asset class has arrived?

It's still too soon to know if this really will be the deal that opens the floodgates of the capital markets. But, turning point or not, it will certainly have an impact on the broader landscape of the energy efficiency industry.

The story of how the deal came to be highlights just how far energy efficiency finance has come.

Jessica Bailey, CEFIA's Director, has a long history with PACE. She first learned about it while she headed up the sustainability and clean energy grant portfolio for the Rockefeller Brothers Fund. One of the organizations funded by RBF during Bailey's tenure there was PACENow, the national PACE advocacy group directed by David Gabrielson.

Less than two years after her introduction to the model, Bailey found herself up in Connecticut leading the charge to get PACE-enabling legislation passed, drawing on the insights she gained watching other programs roll out across the country.

Connecticut’s policy took a different approach than some of the early PACE programs, establishing a state-level policy that municipalities had to opt into in order to participate, rather than simply allowing municipalities to establish their own policies.

Another key characteristic is the open market model, allowing private capital providers to negotiate and fund projects directly with building owners and project developers rather than hewing to a prescribed standard financing product with uniform rates.

The goal was for CEFIA to play as minimal a role as possible in each transaction, simply enabling a robust private market through credit enhancements.

Given how uncharted the territory was, CEFIA’s policy was bold and ambitious, and the methodical approach proved key to its eventual success.

“We’ve worked across the board with every stakeholder you could imagine," said Bailey. “We had to get municipalities to opt in, and so we went out and got 83 towns on board."

"We went out to contractors and let them know what we needed to see from them to approve projects, and we got mortgage lenders comfortable with projects so they knew what to expect and didn’t stop deals in their tracks. We got capital providers signed up, and then we met with building owners to explain what PACE is and what it can do for them," she said.

After signing up the necessary stakeholders, the next step was to identify projects and get a deal done to open the market. Bailey’s deal team crisscrossed the state to put some initial projects together for the program and push them toward the finish line. But, to their disappointment, capital providers were slow to step up.

It was a head-scratcher for Bailey, who, for years, had been hearing from the investment community that if they put the right policy in place, the projects would be there and the money would come. Now, with what seemed to be the consensus “right” policy in place, projects were indeed there, but the money just wasn’t coming.

“We had two things working against us initially,” said Bert Hunter, CEFIA’s chief investment officer. “One is that capital providers were reluctant to take on construction period risk, and the other thing is that we had an imperfection in our statute that did not allow us to put a lien on the property until the project was completed. So even if lenders could get over a project not being complete, they were effectively unsecured through the construction period."

Not wanting to put hard-won projects on hold, CEFIA leaned on its own balance sheet to fund them one by one, opting for a warehouse approach.

"We had some funding from RGGI proceeds," explained Bailey, referring to themulti-state cap-and-trade program for power plants in the Northeast. "We took those proceeds that had just been sitting on our balance sheet and used them for our own little internal warehouse, and started financing deals ourselves. We told our board that in the worst case scenario, we'll sit on this twenty-year paper at 6 percent, and in our goal scenario, we'll sell these out to a capital provider and revolve ourselves."

Not wanting to see the program stall out, they did all the underwriting in-house, using the program partner firm SRS as a technical advisor, and originated their own C-PACE loans.

Capital providers thus found themselves relegated to the sidelines in the early going, left only to watch momentum build. As deal flow and dollar figures grew, lenders signaled interest in larger deals in increasing numbers, and CEFIA saw that the goal scenario presented to its board was now within reach. A public RFP for the first-ever sale of securitized commercial PACE loans was issued in July 2013, and the transaction that resulted in May's landmark deal formally began.

In many ways, the process CEFIA designed looked like every other asset-backed bond sale. Bidding was done in two rounds, with the second round populated by serious bidders selected by CEFIA to submit revised final bids, from which CEFIA would choose the best offer and commence final negotiations.

In one way, though, this bidding process was unique. Bidders were given the option to submit two bids side by side, such that CEFIA could review and move ahead based on one of a bidder's two distinct packages.

Ben Healey, a senior manager on the CEFIA deal team, explained: "The two most serious bidders offered multiple bids, including straight-up bids with no credit enhancements, bids with requests for a loan loss reserve, and bids suggesting senior/subordinated structures with CEFIA in the subordinated role over the life of the portfolio. This approach not only gave us a strong sense of who was most willing to work creatively with us to achieve an attractive price, but it also served to give us insight into the risk-return analysis the bidders were working through on their end."

It's a small, simple feature, but in a market with so few players, it was an ingenious mechanism to double the number of possible bids and extract some additional market intelligence on the way to closing a deal.

"We realized that this is a new asset class and that folks were still trying to figure out how to value it," explained Healey. "Giving bidders the opportunity to actively demonstrate their tradeoffs between risk and return seemed the best way to provide transparency and create a shared basis for conversation between the CEFIA team and our potential partners. I would say that this multiple bid approach was key to our final decision."

In late October, after carefully reviewing all final bids and meeting with bidders, CEFIA chose Clean Fund as the counterparty it would move ahead with. But it would take another seven months to negotiate the final terms of the deal, and to structure it with the issuer, Public Finance Authority.

"The initial structure took some time to work through," explained Hunter, "because we had to balance out the three parties' interests in the structure, and there was a question of indemnity, and that's always a tricky area when you're dealing with multiple parties. When it's just two people at the table, well, it's either your responsibility or it's mine. It's trickier when there are three people, and we spent a lot of time making sure the conduit issuer was protected, how they would be protected, and who would be protecting them."

Knowing that this deal would set a new precedent for efficiency finance transactions, Hunter and his team took care to think through every penny of the cash flows and resisted the temptation to hurry to just get a deal done and tell the world about it.

While the deal was complex, the primary factor slowing it down, according to Hunter, was actually the pace of the projects underlying the deal.

“Because of the structure, we had to make sure that the payments against the projects were completely dispersed. We wanted our first sale of bonds to be in a number sufficient to justify the issuance, and because there were a number of projects slowed up by the harsh winter we were having here in Connecticut, we didn’t really hit that mark until the end of April.”

By the beginning of May, as a result of the methodical approach taken by the CEFIA team and its counterparties, the deal was finalized, and news of their accomplishment quickly spread.

The final deal, as reported in May, includes $30 million in portfolio loan funding an estimated twenty to thirty projects. The assets have an average life of 8.77 years, the senior bonds issued have a coupon of 5.1 percent, and Clean Fund’s price net of discount equates to 96 percent of par.

The selldown will take place in three separate events in tranches of approximately $10 million apiece between now and the end of 2015. Clean Fund has agreed to purchase $24 million of the issuance, and CEFIA will hold on to the remaining $6 million of bonds as a first loss position, with the intent to place $3 million of that position with a mezzanine investor at some point in the future.

So what does this deal mean for the greater energy efficiency community? What can we expect now that Connecticut has cracked the code and delivered a securitization model for others to emulate across the industry?

One beneficiary will certainly be the policy community. CEFIA is already sharing its work and resources with other agencies and organizations that have come calling as a result of this deal. And while this is, after all, the entire point of market development programs, it’s also true that helping other state green banks design programs that mimic C-PACE could pay dividends down the road.

“Any documentation that we’ve created to support our program, we readily hand over to other programs,” said Bailey. “And frankly, that’s partly self-serving, because it would be terrific if New York and Massachusetts and New Hampshire and New Jersey’s PACE programs all looked enough like ours that several years from now when we start talking about a secondary market for these products, we would be able to get access to that market and that cheap capital with partners from other states."

Another obvious beneficiary is the intelligent efficiency community. Startups and their VC investors alike stand to gain enormously from the tailwinds of capital flowing into projects that employ their services and technologies.

"We really think this is going to be a huge assist for many of the innovative cleantech companies," noted John Kinney, CEO of Clean Fund. "If PACE works, then all the technologies for battery storage, fuel cells, building management systems -- all these things that have a cash-flow-positive impact but are not essential for buildings to do -- don't have to compete with lobby renovations and tenant upgrades. Suddenly, a whole new source of funding is available for building owners to make these smart investments now, instead of putting them off in favor of more visible needs."

Green banks, PACE programs, and privately raised funds are springing up across the country. But it's unclear whether this is a watershed event. It's now quite clear that the policy and investment communities understand the value that intelligent efficiency brings to both the environment and the economy. What's less evident, however, is if the real estate community will come along to provide the necessary demand. Without its eager embrace, the prospects of a liquid market for clean energy securities would be dim.

If CEFIA's experience thus far is any indication, there is a promising segment right in the middle of the real estate market that has warmed to PACE quickly, populated by older buildings owned by a fragmented network of cash-strapped independent owners. While this wasn't necessarily the vision that CEFIA set out with, Bailey has found the sector appreciative of the benefits that PACE has to offer.

"The idea with efficiency programs has been that you would go into markets where there's concentration of ownership and you meet with owners of large portfolios and you do all their buildings. We haven't seen that with PACE. What we're seeing is independent building owners who are looking to upgrade their buildings but don't have the ability to self-finance, and this is attractive financing," said Bailey.

In some ways, this is logical. Well-heeled REITs and real estate operators can fund these upgrades out of pocket and avoid the headaches and costs of a third-party transaction, while smaller-scale operations don't have that luxury. But it's precisely these kinds of sophisticated owners that stand to gain the most from the two primary benefits of the PACE structure: the separation of investment payback periods with asset hold periods through the tax lien that binds only to the property, and the ability to pass on the cost of upgrades through a triple-net lease.

What we're really seeing in the slow adoption of PACE or PACE-like vehicles in the real estate communities, it seems, is an aversion to the risks and costs of being first mover in a new market. But if those middle-market owners that are in a position to take on those risks refine the transaction process while proving the concept to the wider market, it's hard to imagine other savvy building owners not following suit.

After all, PACE can be as much as 100 percent financing at attractive rates for building upgrades that in most cases would be done as part of typical capital planning cycles. Plus, those projects don't need to pay back before they want to sell, and owners can pass those costs on to their tenants anyway.

The only real obstacle is convincing a mortgage lender to consent to subordinating to the PACE lien, but CEFIA has found that lenders come along once they realize that PACE liens in arrears don't accelerate at sale, and that the asset value increases immediately from the NOI benefits of reduced operating costs. To owners and lenders who understand PACE, it's found money.

There is still a lot of space between where we stand today and that happy scenario of the future, and it's far from certain that we'll even get there. But if we do, it seems likely that the work of Bailey and the CEFIA team over the last eighteen months will have laid a foundation for the larger market.

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