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A Brisker PACE

'Tax-Lien' Financing Supports Deeper Retrofits, Longer Paybacks

If you are a sustainability- or energy efficiency-minded commercial property executive and are not yet familiar with the emerging property assessed clean energy (PACE) retrofit financing alternative—well, you are not paying close enough attention.

While this complicated and innovative structure predictably has not yet become the silver bullet long-term tool its more optimistic adherents are anticipating, momentum is building at a pretty hefty clip.

As tends to be the case with newfangled financial mechanisms like PACE's tax-lien structure, it is taking a while for the transaction count to take off. PACE logically faces a few sticky issues: standardization of underwriting, authentication of efficiency improvements, uncertainties about passing costs (and benefits) through to tenants—not to mention plain old familiarity and track record.

Hence, even while legislation continues to give rise to new municipal, county and statewide PACE programs (approaching 30 states at this point, plus the District of Columbia), the iteration in a green-minded city and county like San Francisco is off to a surprisingly slow start.

But momentum is clearly building, and the first high-profile deal recently consummated through San Francisco's GreenFinanceSF program can only help, proponents suggest. Ditto for the new multi-jurisdictional CaliforniaFIRST PACE program, which teams another 14 Golden State counties and 126 cities (and more to follow), with its private-sector administrator authorized to issue $14 billion in bonds backing the effort.

In fact, no fewer than 500 professionals participated in a recent webinar introducing Connecticut's already active new program known as C-PACE. Anthony Buonicore, whose namesake building energy consultancy is acting as C-PACE's program administrator, succinctly explained the strong interest.

"It's an extremely attractive model" for financing commercial building energy retrofits with reasonably priced long-term debt, the Buonicore Partners principal stressed.

And Brian McCarter, CEO of C-PACE's data management platform provider Sustainable Real Estate Solutions, characterized PACE's potential as no less than a "proving ground to accelerate the large-scale adoption of commercial real estate energy-efficiency investment."

Why such superlatives? Well, the clean energy and commercial property sectors have long sought that silver bullet: a long-term financing mechanism funding highly beneficial upgrades that may not pay for themselves in energy savings for a decade—or maybe two.

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As so many owners have focused primarily on the short-payback low-hanging fruit such as lighting and HVAC upgrades to date, they have typically funded them mostly with capital expenditures. Indeed, PACE expert Eric Bloom, senior research analyst at Pike Research, estimates less than 15 percent of commercial building energy retrofits are financed with debt, due in great part to the paucity of attractively priced longer-term financing.

The beauty of the PACE structure is that entire costs of efficiency-enhancing investments can be financed for as long as 20 years—allowing for immediate improvements to property cash flows as debt is paid off long term through lien-secured property-tax assessments. In fact, C-PACE appears to be setting the trend in requiring that upgrade-driven savings exceed the PACE debt-service obligations right from the start. As a practical matter, that requirement is arguably redundant. With most programs, existing first-priority lenders must consent to the lien assessment—a logical rule, given that the PACE lien obligation is superior to any recorded mortgage, though just to the amount of the PACE debt due.

PACE programs generally prohibit transactions at properties underwater, with existing mortgage debt. With C-PACE the recommendation is to go with properties securing mortgage debt of no more than 75 percent loan-to-value.

A related feature is that PACE liens are tied to the property, not the owner, and hence need not be reconveyed or refinanced with a sale or recapitalization. And while interest rates typically in the 6 to 8 percent neighborhood are generally above prevailing short-term rates, that is a pretty attractive neighborhood, considering all costs, including energy audits and upgrade underwriting, can be financed.

Add it all up and PACE is now spawning more comprehensive, multi-faceted energy retrofit programs, rather than the more singular upgrades (window, solar PV arrays and the like) seen with most of the pioneering transactions in recent years, related clean energy finance veteran John Kinney.

“It’s a paradigm shift in the making,” commented Kinney, CEO of Clean Fund, the clean energy investment operation that late last year funded the $1.4 million transaction (at 6.9 percent) financing big industrial REIT Prologis Inc.’s comprehensive San Francisco headquarters property retrofit.
Programmatic Approach

Rather than limiting energy-efficiency improvements to isolated investments, owners tapping PACE programs today are migrating toward comprehensive programs that boost cash flows from year one, Kinney elaborated.

“That’s a much more attractive approach” to funding clean-energy upgrades, he observed. “I see a lot of sophisticated property owners looking into PACE and concluding that energy investments that immediately improve cash flows provide better returns than investing in fancier lobby signage and such.”

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Owners pursuing PACE transactions these days might combine window and lighting upgrades with building management system installations, and in some cases PV arrays and other on-site energy generation systems.

For example, with the landmark Prologis bayfront headquarters office building at Pier 1, improvements overseen by mega-contractor Johnson Controls will include building energy monitoring systems, LED lighting upgrades and a 200-kilowatt rooftop solar array. The expectation is that the investments will reduce the 151,600-square-foot property's consumption of grid-sourced electricity by more than 30 percent from its 2011 baseline measurement.

And it certainly bodes well for additional PACE activity that Prologis owns many square miles of American rooftops potentially housing solar arrays, Kinney added.

As PACE transactions go, the Pier 1 program is on the larger side, although Buonicore noted that PACE-financed retrofits around the country to date typically cost at least $150,000—and far more in select cases. For the most part they are highly effective, with energy efficiency gains usually exceeding 25 percent—"and more often 30 percent and above."

C-PACE allows for financing of building modifications, as long as they are directly related to energy improvement programs and do not account for more than 25 percent of the overall cost. Logically, the useful lives of the improvements need to exceed or at least match the corresponding assessment period.

Another retrofit just underway, tapping the new Clean Energy Sacramento PACE program, is the $513,000 chiller upgrade at BTV Crown Equities' 94,200-square-foot, early-1960s-vintage 520 Capitol Mall office property. The more efficient equipment is expected to reduce energy costs by approximately $47,000 annually.

The Sacramento program also illustrates further evolution in PACE funding models—in its case known as the "fully funded" model, through which a private investment entity agrees to provide all the up-front cash needed for approved retrofits. Clean Energy Sacramento's private administrator, Ygrene Energy Fund, in partnership with Barclays Capital and other members of the PACE Commercial Consortium, has agreed to fund any qualifying project if the property owner is not able to secure PACE financing from another source.

This contrasts somewhat with the "owner-arranged" model seen with C-PACE, GreenFinanceSF and others—and through which (as the moniker suggests) property owners negotiate rates and terms most appropriate for the borrower and whatever lender it brings to the table. In either case, the PACE jurisdiction issues long-term lien-secured bonds the lender group agrees to purchase.

C-PACE is actually becoming something of a hybrid, as administrators have lined up eight pre-qualified lenders that might agree to step in if the property owner has a tough time securing a private debt source. A compelling feature of both models is that no tax dollars are tied up funding PACE transactions. “It’s a smart way to use the good auspices of government without using government coffers,” said Jessica Bailey, director of the commercial and industrial component of Connecticut’s PACE authority. The more models, the merrier, added Kinney. “There’s no reason they can’t coexist.”

As the program count continues to grow and participants gain experience, Kinney and others expect more owners, capital providers and energy contractors to become active PACE players. Greater standardization and reliability of energy-efficiency measurement, monitoring and savings projections—not to mention transaction financial underwriting—should likewise push the PACE case forward.

Meanwhile, owners and tenants will also need to work through passthrough-related issues in order to make PACE transactions more financially attractive to all parties. Landlords can generally pass on the added debt service to tenants on net leases, which will be beneficiaries of the operating-cost savings.

And despite accounting uncertainties pertaining to escalation clauses and operating expense qualifications, enlightened owners of properties subject to gross leases realize PACE-related improvements help them over the longer term, as the lowered energy costs allow them to economically charge lower rental rates as lease terms expire.

At Pier 1, for instance, Prologis was able to allocate some 70 percent of the PACE upgrade costs to five other tenants, based on their occupancy square footage.

Institutional Involvement

As participants continue working out any kinks that come along, PACE programs should attract more institutional capital, Kinney expects. While the PACE Commercial Consortium does include some institutional participation, Clean Fund’s investors today are mostly conservative individuals and family-type investors attracted to clean energy investments and optimistic about prospective secondary-market arbitrage opportunities.

Of course, existing lenders will play key roles, given their exposure to tax-lien subordination and corresponding right of consent. In fact, Kinney’s advice is that “if the mortgage holder doesn’t approve a transaction, you should take that as a signal that it’s not an advisable transaction as structured.”

And as he and others are also quick to point out, some of these lenders are bound to see solid new lending opportunities in providing the PACE funding, along with senior mortgage debt. Indeed, as Buonicore noted, there has been so much deferral of needed energy improvements and equipment replacements in recent years, capital providers should encounter "plenty of pent-up demand" for PACE financing ahead.

And as Bloom observed, retrofit activity is bound to be brisk in jurisdictions establishing PACE programs as well as the new energy benchmarking mandates taking effect in major markets across the country. Likewise, Kinney expects burgeoning PACE-related activity to induce vendors performing the energy upgrades to commit additional resources as they look to meet the stronger market demand. That in turn should generate scale efficiencies that reduce retrofit costs.

In other words, more property pros will become what he calls "PACE-aholics."