Keeping PACE

Property-assessed clean energy financing is a game changer for commercial real estate

by Robert Johnson Jr.

Property-assessed clean energy, or PACE, financing originally was conceived to fund deep sustainability retrofits to existing property, but it has emerged as an ideal source of mezzanine capital to fund new construction or major renovations. PACE financing can serve as an off-balance-sheet, voluntary special improvement district for commercial property owners to finance up to 20 percent of value for all project improvements that involve utility-cost impact or disaster resilience. More specifically, qualified PACE projects include energy/water efficiency, renewable energy, and seismic- or hurricane-strengthening-related property improvements.

PACE financing is an innovative public-private partnership, enabled by state legislation. It uses a land-secured bond that is repaid via semi-annual or annual assessments on the property tax bill — a feature that facilitates pass-through to tenants or hotel guests. The longer repayment terms (often 20 or more years), help make such investments more profitable than funding via seven- to 10-year terms from traditional (debt and equity) financing sources.

Key features of PACE

PACE significantly lowers the overall cost of project capital, and it functions like mezzanine debt in that it replaces or reduces equity in the capital stack. But in contrast to mezzanine financing, PACE is priced far more favorably, with 20-year fixed rates in the 5.0 percent to 6.5 percent range (versus 11.0 percent to 14.0 percent for short-term mezzanine debt). In addition, PACE financing does not come with restrictive operating covenants. PACE should not be compared to mortgage debt, as it is meant to fund alongside mortgage debt, with consent of the lender (see chart on page 6).

As another benefit, PACE-financed improvements increase property value. Because of the extended repayment term and low interest rates, PACE-qualified improvements increase NOI and cash flow — often in year one. And many improvements, such as solar or attaining LEED certification, are known to increase occupancy and tenant retention.

Sustainability improvements modernize buildings and reduce potential price concessions that buyers may seek during the disposition phase. PACE-qualified improvements include all direct and indirect costs to secure LEED, WELL or similar certifications. Many of the property improvements qualified for PACE financing are integral parts of a value-added retrofit strategy an owner would pursue to modernize a building and make it more marketable, efficient and comfortable.

There may be no balance sheet impact from PACE financing, as it is levied on the same basis as property taxes. In the event of default, as for recurring property taxes, there is no mechanism to accelerate the PACE principal loan balance. And in the event of a foreclosure, the unpaid principal balance passes to the new buyer, and the special assessment payments remain on the tax bill until the balance is fully amortized.

The use of PACE financing can lower the overall cost of employed project capital by 100 basis points or more.

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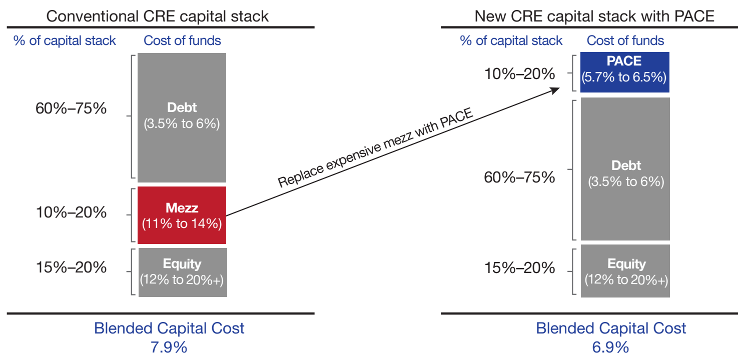
PACE financing is designed to pass through costs to tenants and/or occupants. Although most triple-net leases do not allow pass-through of interest or principal on debt-financed property improvements, PACE assessments qualify as operating expenses, allowing property owners to pass through the assessment to tenants as an increase in property

A hypothetical placement of PACE in the capital stack



Source: Off-Grid Capital Advisors

taxes. For hotels, subject to market conditions, owners can characterize all or some portion of the PACE assessment payments as a below-the-line room surcharge, similar to a tourism improvement fee.

PACE financing is designed to fully amortize over the selected term, which means it does not carry refinancing risk for the owner. But PACE can be prepaid, subject to a modest premium. PACE bond terms are equated to the weighted average estimated useful life of the underlying improvements. This means seismic strengthening would qualify for 30 years, while LED lighting might qualify for five or 10 years.

The PACE assessment obligation is fully assumable, as it remains on the property tax bill until the unpaid balance is fully amortized. This feature makes PACE the most "patient" capital source in the capital stack. Generally, all other forms of debt and equity are fully paid off upon sale of the underlying real estate assets. With PACE, the property owner has the option of paying off the outstanding principal balance upon sale (subject to prepayment penalty terms that may apply), but otherwise, the financing was designed to fully amortize to term.

PACE allows building owners to dramatically modernize their building infrastructures and frees them from having to choose between such projects and other capital investments, which often have higher returns on investment. PACE funds 100 percent of all qualified-project hard and soft costs, including labor; design or engineering analysis; capitalized (prepaid) interest; all costs incurred to attain LEED, WELL or related certifications; and all financing closing costs.

PACE for ground-up construction

PACE financing also can play a role in funding ground-up construction. Most developers seek to maximize construction-to-permanent-mortgage debt for a new construction project (up to 60 percent to 75 percent) and then fill the remaining 25 percent to 40 percent gap with equity and/or mezzanine debt. Other institutional investors or large REITs might employ lower leverage, often less than 50 percent, with favorable pricing in the 3.0 percent to 3.5 percent range, but then fund a larger percentage with equity. In both cases, the use of PACE financing can lower the overall cost of employed project capital by 100 basis points or more, such as from 7.9 percent to 6.9 percent, as illustrated in the graphic to the left.

Secured lender consent required

Because PACE financing is secured by a tax lien, and the repayment of the fixed principal and interest is via property taxes, all commercial PACE transactions require the secured lender to acknowledge the proposed PACE transaction does not constitute an event of default, or directly or indirectly cause the exercise of any remedies under any documents related to the secured mortgage loan.

It is important lenders understand the PACE principal balance is *not* senior to their loan. Like any other tax assessment, only the current (unpaid) property tax installment due can comprise a lien in front of the first mortgage — not the outstanding principal on the PACE bond. There is no mechanism to accelerate the PACE principal balance, and no local municipality can lien future property taxes. Only delinquent property tax installments, including the fixed PACE P&I payments that attach as a special assessment, can form a senior lien in front of a mortgage holder.

Also, PACE P&I payments may be escrowed by the lender in the same manner as other real estate taxes. PACE contains no technical defaults nor owner recourse of any kind. In addition to the positive attributes noted above, a recent study published by Trepp analyzed a significant sample of CMBS loans and found properties with energy-efficient and sustainability improvements defaulted at rates nearly 10 percent lower than average.

As of July 2017, 162 mortgage-lending institutions have consented to one or more PACE transactions, with some national lenders having provided numerous such consents.

Funding the future

In recent years, limited partners have demonstrated their commitment to sustainable and responsible investing. Measuring and benchmarking sustainability is an important element of that. PACE financing is positioned to be a component of this movement, as it helps to fund property-level sustainability and resiliency improvements profitably.

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