

# Capitalize on Opportunity With C-PACE Loans

Tapping a convenient financing product to save on energy costs isn't 'too good to be true'

By Brian McCarter

**C**ommercial property assessed clean energy, or C-PACE, loans, are an innovative financing mechanism designed to help commercial building owners and real estate developers fund energy-efficiency projects. If they haven't already, it's likely that your customers will soon ask for your help with a C-PACE assessment lien.

Across the country, a growing number of lenders have not only consented to this funding mechanism, but also are stepping up to finance these deals, which they can then package and sell on the secondary market. Here's what commercial mortgage brokers need to know about this emerging opportunity.

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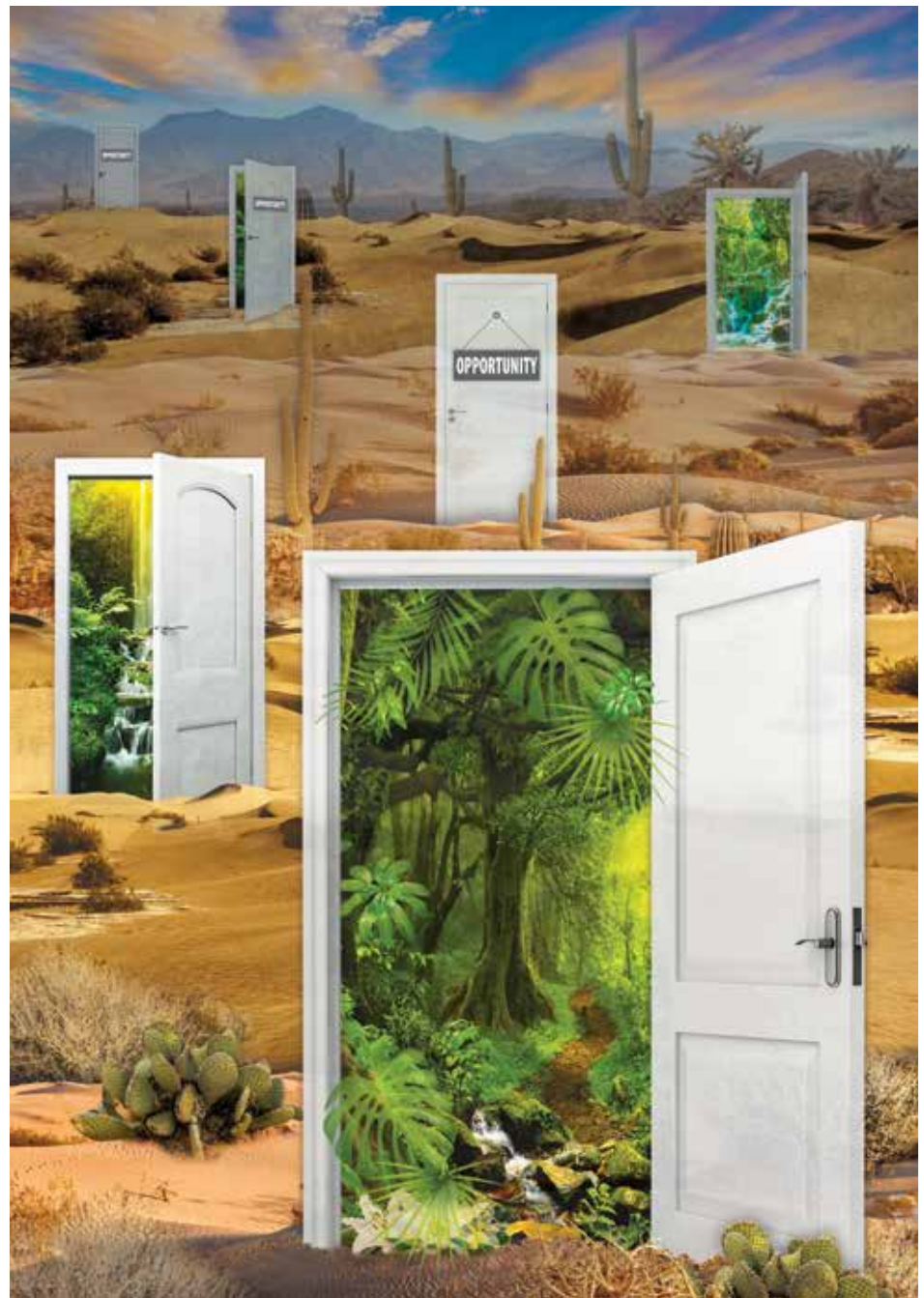


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## How does it work?

C-PACE is a voluntary program that enables commercial building owners to finance up to 100 percent of eligible energy-efficiency, renewable-energy and water-efficiency improvements. The nonrecourse, fixed-rate financing is secured by an assessment, or lien, that is recorded on the property, similar to a sewer assessment, except that it's voluntary program. The loan is repaid through the local property-tax collection process. Finance terms are driven by the useful life of the equipment and extend up to 20 to 25 years.

Because the financing is tied to the property, it is the building's financial health, not the property owner's creditworthiness, that is the main consideration in underwriting these deals. To date, financing has typically been provided by private specialty-capital companies.

Most C-PACE projects are designed so the energy-cost savings that result from the building improvements exceed the C-PACE payments, enabling a cash flow-positive project. To building owners, this often seems "too good to be true." It's not.

With 100 percent financing, no upfront costs and no personal guarantees, C-PACE is ideal for funding capital-intensive improvements. Once a C-PACE project is completed, the building owner has a lower utility bill and, assuming the project has been designed to be cash-flow positive, a healthier net operating income. The building, which serves as collateral, also is more efficient, more comfortable and more valuable. If and when the building is sold, the buyer has the option of retaining the assessment-repayment obligation or negotiating with the seller for it to be paid off at closing.

Multiple property types are eligible for C-PACE financing, including commercial, industrial and multifamily buildings (the latter with five or more units); churches; and schools. In many states and counties, C-PACE is available to developers of new construction projects, provided they design their buildings to exceed the current energy code by a certain percentage. This amount varies by program, but is typically around 15 percent to 20 percent.

## At a Glance Things to consider with C-PACE financing

As a mortgage broker accustomed to dealing with commercial mortgages, you may be tempted to incorporate typical commercial lending clauses into a C-PACE financing agreement. Here are four proposals that may not fit with a C-PACE deal:

■ **Requiring a credit review.** Because the property serves as collateral in a C-PACE project, underwriting is largely based on the financial health of the building, such as its loan-to-value and lien-to-value ratios. Requiring a credit check is unnecessary and removes one of the benefits of C-PACE — namely, that no personal guarantee is required. Plus, you'll be competing for deals against lenders that don't require one.

■ **Proposing adjustable interest rates.** Fixed interest rates are necessary to evaluate whether the energy-cost savings will likely outweigh the C-PACE payments, thereby generating a cash flow-positive project and gaining the confidence of building owners. Introducing a variable rate means introducing greater uncertainty into the forecasting of the financing payments. Given the longer term, most building owners prefer a fixed rate.

■ **Insisting on an escrow account.** In a C-PACE transaction, the specialty assessment priority-lien status, as well as the billing and collections process, are managed by the local taxing and assessment jurisdiction. Cash from collections are transferred to a trustee account that, in turn, forwards the payment to the lender. An escrow account is unnecessary.

■ **Requiring the outstanding balance to be paid if the property is sold.** Requiring the outstanding balance on a C-PACE loan to be paid at the time of sale is at odds with the standard C-PACE practice and would erode its value proposition for stakeholders. Nevertheless, a building owner, if they decide to sell later, may choose to pay off the C-PACE assessment at the closing.

To date, more than 30 states have PACE-enabling legislation and several, including Delaware, Montana, Pennsylvania and South Carolina, are considering it. Many utility companies also offer attractive rebate programs, which make projects even more attractive. Eligible improvements for C-PACE financing include almost anything that will lower utility bills and is permanently affixed to the building, such as high-efficiency lighting; boilers; heating, ventilation and air conditioning (HVAC) units; low-flow faucets; solar systems; and even new roofs to support solar panels.

## How big is the market?

In the United States, an estimated 580,000 Class B and C buildings with less than 100,000 square feet of space contain outdated energy equipment. Building owners know that aging boilers and leaky windows drive up their utility bills and reduce their net operating income, a point their service contractors make when they recommend equipment upgrades.

Nevertheless, deferred maintenance backlogs continue to swell because most owners want to preserve surplus cash for core operations. The alternatives, a traditional bank loan or self-funding, are seen as expensive. As a result, a third option — do whatever it takes to keep the equipment running — is often viewed as the least costly choice.

In new construction, the C-PACE value proposition may be even greater. It can reduce or replace the typical 20 percent owner-equity contribution required by lenders or reduce other, more costly financing sources in the capital stack.

## What should lenders know?

In a C-PACE project, the assessment lien that secures the financing, while junior to all general property-tax liens, is senior to all commercial liens, including mortgages and deeds of trust. And C-PACE has equal footing, expressed as *pari passu* in legal terms, with other special assessments on the property.

As such, C-PACE programs require that property owners receive the written consent

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of mortgage holders prior to securing financing. Some programs, including those in Colorado, Connecticut, Rhode Island, and Arlington County, Virginia, to name a few, require an independently prepared review of the project's technical and financial projections so that all stakeholders can determine whether cost-savings projections are likely to materialize.

To date, more than 140 lenders — among them national, regional, and local banks and credit unions — have consented to C-PACE assessments. That's because well-designed C-PACE projects provide many benefits for mortgage holders. They include the following:

- **An increase in a borrower's ability to repay** the mortgage, because the savings from reduced energy costs will exceed the loan payments, driving up their net operating income;
- **A reduced risk of loan default** because a borrower has more cash to pay their bill; and
- **An increase in the value of the collateral**, since the project will modernize the building.

### What is the market outlook?

Pent-up demand to replace capital-intensive, outdated energy-consuming equipment in commercial and industrial buildings continues to grow. Each year, equipment failures drive about 20 percent of building owners to undertake improvement projects. The rest instruct their contractors to, in essence, duct-tape the equipment until it finally fails.

A meaningful solution requires capital-intensive, energy-consuming equipment replacements with longer payback periods. Since long-term financing options, lasting 15 to 25 years, from traditional lenders are largely unavailable, C-PACE is a welcome and viable solution. The opportunity in new construction may be even bigger, affecting more than 60,000 buildings annually — accounting for \$61.6 billion in construction costs that are eligible for C-PACE financing.

To date, many, but not all, C-PACE projects have been financed by specialty-capital providers. Recently, some mortgage lenders have chosen to finance C-PACE projects in-house. Most of these financings have been for projects in the \$100,000 range, which fills a financing gap as specialty-capital providers typically prefer to fund larger amounts in excess of \$100,000.

Banks providing C-PACE financing have found a ready secondary market to sell such loans — as the Connecticut Green Bank did in 2014, when it sold the C-PACE industry's first portfolio, valued at \$30 million. It is noteworthy, however, that the Connecticut Green Bank served as a warehouse fund for these projects for more than a year before aggregating them.

The market for clean-energy financing is growing and seems to present little risk. "We are looking at it through the lens of how much credit risk are these assessments going

to have, and do we have enough protection for investors in the notes that are backed by these assessments," Morningstar Credit Ratings Managing Director Brian Grow said this past February. "From that perspective, there is very little credit risk."



The bottom line is that a growing number of building owners and property developers are turning to C-PACE financing. Partnering on these deals lets commercial mortgage brokers expand their product lines, meet their borrowers' needs, and fund attractive, finance-ready projects. It's worth looking into. ■