The Benefits of PACE Financing for Commercial Real Estate Companies

May 2016

PACENation
Saving Energy & Creating Jobs

Executive Summary

Property managers often struggle to get technically sound energy efficiency and renewable energy projects approved for financial reasons. Sometimes the split incentive embedded in leases makes projects uneconomic for the building owner. Other times, property managers simply cannot get internal capital allocated to clean energy efficiency projects or cannot gain approval for the use of external financing.

For commercial real estate property owners, Property Assessed Clean Energy (PACE) financing can remove the typical barriers to the implementation of energy efficiency improvements:

- The cost of PACE financing, and the benefits generated, can be shared with tenants.
- 100% of project costs, including soft costs such as development fees, can be financed through PACE.
- PACE financing allows terms up to 20 years, which makes it possible to generate increased net operating income from projects with simple paybacks reaching almost 12 years.
- PACE is strictly property-based financing and requires no personal or corporate guarantees.
- The obligation to repay the PACE financing automatically transfers to the new owner upon the sale of the property.

Challenges to Investing in Energy Efficiency and Renewable Energy

Property managers who strive to make their buildings more energy efficient often struggle to get capital expenditures approved for technically sound projects. Sometimes the split incentives[1] embedded in certain leases make projects uneconomic for the building owner. Other times, property managers must face the fact that they simply cannot get internal capital allocated to clean energy projects, despite their projected cost effectiveness.

In the real estate world, many desirable capital expenditures compete for the allocation of limited funds. Investments to build revenue and market share typically trump those intended to cut costs. Almost always, core-business investments are seen as less risky. They are also viewed as making a critical long term contribution to the income growth

[1] There is a so-called split incentive, for example, when an investment is made by the landlord, but the benefits of the investments accrue to the tenants.

expected by shareholders, and therefore face a lower hurdle rate for return on capital expenditures. On the other hand, capital expenditures for energy efficiency and renewable energy projects face high risk-adjusted return requirements because savings estimates in such non-core activities are thought to be less certain[2] and are heavily discounted or are simply not seen as being material or scalable. For small business owners, this situation is compounded by a lack of funds.

If an energy retrofit project makes economic sense, and internal capital won't be allocated to it, textbooks suggest the use of external capital (borrowing) instead. In practice, it's not that easy. For small business owners, getting third-party financing often requires personal guarantees, some equity investment, or other onerous conditions. For larger companies, the downside of borrowing when a building's holding period is up in the air, the cost of project capital versus corporate debt, and the balance sheet impact of the borrowed funds present barriers to the use of external capital.

For commercial real estate property owners, PACE financing removes these barriers to the funding of energy efficiency and renewable energy projects.

Overview of PACE Financing

PACE is a recent adaptation of property tax based assessment financing that state and local governments have used for decades to pay for improvements that benefit property owners and meet a specific public purpose. Throughout the United States (and even abroad), buildings are often assessed to pay for water and sewer facilities, parks, street lighting, business district improvements and many other projects. With PACE, the improvements are for clean energy upgrades that make buildings more energy efficient or enable them to generate renewable energy[3].

PACE starts with state enabling legislation, and to date, 30 states and the District of Columbia have authorized PACE financing for commercial properties (which includes just about every building type other than single family homes or multi-family units of four or less). Because PACE financing is repaid as a line item on the property tax bill, a unit of local government must choose to operate or host a PACE program. Today, PACE financing is offered in over 2,000 municipalities in 16 states, ranging from small towns to major urban centers, including Atlanta, Cincinnati, Los Angeles, and St. Louis.

[2] Savings guarantees offered by energy services companies and/or savings insurance are not commonly used by commercial real estate companies, despite their availability.

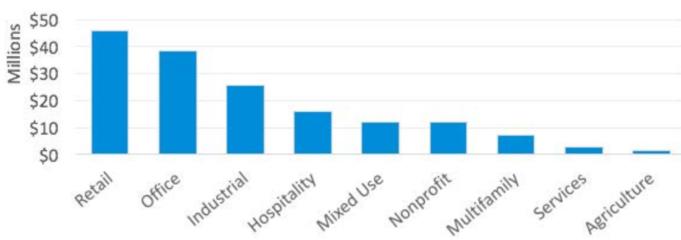
[3] In several states, PACE financing is also used to promote water conservation. Other states have allowed it to be used in limited ways for projects that promote resiliency, such as earthquake and hurricane strengthening.

While there are many ways in which PACE can be implemented, most programs outsource (third-party) administration, and financing is typically arranged with a growing number of specialty finance firms that use private sector capital to invest in PACE funded projects. The specific process varies from state to state, but the elements of every PACE project are simple: 1) a property owner, working with a contractor, determines which clean energy upgrades make sense and opts to receive financing through the local PACE program, 2) 100% financing for both hard and soft costs is provided by an investor, and 3) a unit of local government "services the loan" by placing an annual assessment on the property, invoicing it alongside the real estate tax and other assessments on the property tax bill, collecting it, and forwarding it to the project funder. The local government will enforce or assign its enforcement rights to the investor in the event of non-payment.

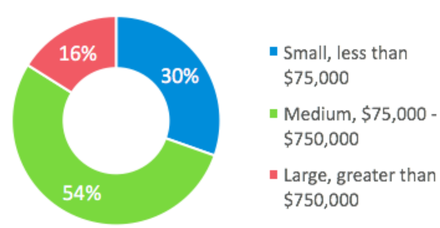
Like other property taxes and assessments, the PACE lien is senior to other non-tax liens, including mortgages. In almost all PACE jurisdictions, an existing mortgage lender is given the right to consent to a project before it can be undertaken. To date, well over 100 mortgage lenders have consented because PACE projects make good business sense: they increase interest coverage ratios and building value, and PACE assessments do not accelerate upon a default. A mortgage lender's only exposure to the senior PACE lien is for a payment in arrears.

We know, from the hundreds of projects completed to date, that PACE financing works for all types of commercial real estate, including nonprofit owned buildings: office, retail, industrial, agricultural, multi-family, and more. Its appeal spans the broad spectrum of building ownership, from companies like Simon Property Group, Prologis, and Forest City, to small single building enterprises.

PACE Funding by Property Type



PACE Funding by Project Dollar Amount



Prologis used PACE to finance lighting upgrades, HVAC, and solar PV at its corporate headquarters in San Francisco. The upgrades saved Prologis 32% in energy costs.

Simon Property Group chose PACE for the Santa Rosa Plaza shopping center, which made use of a $463,000 assessment to finance a cool roof.

The Benefits of PACE Financing for Commercial Real Estate Owners

This exciting form of third-party financing provides unique benefits to building owners:

- The cost of PACE financing, and the benefits generated, can be shared with tenants under most lease forms, thus eliminating the split incentive issue that derails so many energy efficiency projects.
- 100% of project costs, including soft costs such as development fees, can be financed through PACE, which removes the requirement for out-of-pocket expenses for owners.
- PACE financing is available with flexible terms up to 20 years, making it possible to increase net operating income by implementing projects with simple paybacks reaching almost 12 years. This increased net operating income translates to higher property values for building owners.
- PACE is strictly property-based financing secured by a lien on the property[4]. As a result, the owner of the property is not personally obligated to repay the tax assessment.
- PACE is attached to a property tax bill, and the obligation to repay the financing automatically transfers to the new owner upon the sale of the property, along with the energy-saving benefits generated by the project. This eliminates any holding period concern owners may have, i.e., it encourages energy production and

[4] The secure nature of PACE backed by a senior lien on the property not only makes it possible for providers of capital to feel comfortable with financing terms up to 20 years, but also means that the cost of PACE financing is typically lower than the cost of other sources of external financing, such as leases.

efficiency and water conservation improvements even if a property owner does not expect to retain the property for the duration of repayment.[5]

- It's generally accepted that PACE does not affect a building owner's typical loan covenants, such as debt to equity ratios.

PACE Aligns Landlord and Tenant Interests

One unique benefit of PACE financing is that the resulting real estate tax assessment, along with the cost savings generated by a sustainability project, can be shared with tenants under most lease forms. This alignment of landlord and tenant interests is a key benefit of PACE financing.

Under triple net leases, for example, real estate taxes, building insurance, and common area repair and maintenance expenses are passed through to tenants on a pro-rata basis, based on the relative size (square footage) of the area occupied by each tenant. Conversely, any energy efficiency savings generated from investments by the landlord in the common area go directly to the tenants' bottom line. For the landlord, the resulting cash-on-cash return is negative. This split incentive – the investment is made by the landlord, but its financial benefits accrue to the tenants – is a reason why so few sustainability projects are undertaken by landlords at properties with triple net leases.

With PACE financing, however, the resulting special tax assessment is recovered from the tenants. PACE makes it possible for the landlord to improve a property's energy efficiency with no negative effect on EBITDA or cash flow. At the same time, tenants' EBITDA and cash flow can be increased by selecting the proper tenure for PACE financing, hence ensuring that the annual energy savings enjoyed by the tenants exceed the annual PACE assessment. PACE provides a win-win solution for landlords and tenants.

PACE increases Property Values

Whereas common area repair and maintenance expenses are passed through to tenants under triple net leases, there are many situations in which the landlord/property owner – not the tenants – is responsible for all costs in the common area. This is the case for owner-occupied buildings. It is also true for hotel owners, who rent rooms at a fixed price, and for owners of multi-family properties who recover common area energy and water costs through base rent. Other examples include properties with gross

[5] In contrast, the basis of a typical loan is the borrower's personal promise to repay the principal amount advanced by the lender, and the loan often has to be repaid in full upon the sale of a property.

leases, and to a certain extent, properties with modified gross leases. In these cases, PACE financing can increase net operating income and property values for owners.

To help understand how PACE increases property values, we use the following hypothetical project:

Landlord/Building owner is financially responsible for common area cooling and lighting
Project is a $200,000 energy efficiency retrofit in the common area that is non-disruptive to operations, uses proven technology and is to be implemented by a reputable contractor
Annual forecast energy and operational savings are $33,000 (6.1 years simple payback)
PACE funding is available for 20 years at 6% interest rate[6]

Table 1

If internal funds were allocated to complete the hypothetical project, the savings would generate a 13.4% internal rate of return (IRR) over a period of ten years, and have a net present value of $36,000 over the same period, using a discount rate of 8% (see Table 2 below).

While many lighting projects have a simple payback of three years or so and get funded readily, many more energy efficiency or renewable energy projects have simple paybacks similar to the hypothetical project described in Table 1. More often than not, internal funds are not allocated to these projects on the basis of forecast energy savings, as they do not meet the required risk-adjusted hurdle rate, or return required for investment in non-core activities[7].

On the other hand, financing our hypothetical project with PACE would generate annual savings of $33,000 (not taking into account inevitable energy cost increases), and result in an annual assessment payment of $17,400. This means that the project would generate over $15,500 in additional net operating income. The present value of the cash flow generated would be $104,000, or nearly three times greater than it would be

[6] As of the date of publication, there are many examples of PACE financing with a 20-year term and an interest rate below 6%.

[7] Sometimes, projects that are seen as marginal from a savings point of view may still be implemented if the state of the equipment demands immediate action to avoid liability claims or to keep the property competitive in the market place (e.g., a poorly lit parking lot).

with the use of internal capital. Using a capitalization rate[8] of 6%, the project would increase the property value by nearly a quarter of a million dollars.

Table 2 below contrasts the financial impact of using internal capital to fund the hypothetical project versus PACE financing[9].

	Self Funding	20-yr PACE Funding
Investment by owner	($200,000)	$0
Decrease in operating costs	$33,000	$33,000
Increase in real estate tax	$0	($17,440)
EBITDA impact	$33,000	$15,560
Cash flow – year 1	($167,000)	$15,560
Cash flow – year 2 thru PACE term	$33,000	$15,560
Cash-on-cash IRR	13.4%	NA
NPV of cash flow (at 8% discount rate)	$36,000	$104,000
Property Value increase at 6% cap rate (during the PACE financing term)		$225,000

Table 2

A project with a simple payback of 11.5 years would generate some $17,400 in annual cost savings, equivalent to the annual assessment payment in the example above. In others words, deep energy retrofit projects[10] with simple paybacks reaching almost 12 years can generate positive cash flow when financed through PACE. Stated otherwise, if an energy efficiency or renewable energy investment has a simple payback that is too long to meet the hurdle rate for the use of internal capital, financing the project with PACE provides an avenue to increase a property's value with no use of internal capital.

Conclusion

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8 The capitalization rate, or cap rate, is a real estate valuation measure used to compare different real estate investments. It is the calculated by dividing the net operating income by the the price of the asset.

9 Simplifying assumptions include: no increase in operating costs over the period of analysis, PACE financing interest rate of 6%, and a 10-year horizon for IRR and NPV calculations (despite the longer useful life of the investment). The investment is also shown net of rebates and incentives.

10 Deep energy retrofits typically include longer payback projects, such as the replacement of obsolete HVAC equipment, the upgrade of windows, or the replacement of a roof.

Property owners across the US are using PACE because it saves them money and makes their buildings more valuable. PACE pays for 100% of a clean energy project's costs and is repaid for up to 20 years with an assessment added to the property's tax bill. PACE financing stays with the building upon sale and is easy to share with tenants.

PACE is a simple and effective way to facilitate the investment in energy efficiency, renewable energy and water conservation projects. Building owners who want to take advantage of PACE financing can find out where PACE is available at **www.PACENation.us**, a recognized source of impartial, independent and consensus based information on PACE.

About the author: George Caraghiaur is the Managing Director of Energy & Sustainability Services, LLC and the author of "A Guide to Energy Service Companies" published by Fairmont Press. George advises PACENation as a Senior Fellow and serves on its Board of Directors.

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