ADLER & STACHENFELD LLP

Picking up the "PACE"

A&S Real Estate Finance Group
July 2019

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On May 19, 2019, a series of groundbreaking bills were passed by the New York City Council, collectively known as the Climate Mobilization Act ("CMA"), compelling NYC building owners to reduce carbon emissions. Local Law 96 of 2019, one of the bills that is a part of the CMA, enabled PACE financing in New York City for the first time. What, however, is PACE financing? This White Paper explores what PACE financing is, and what real estate owners, developers, and lenders, in both New York City and beyond, should know about it. In addition, this White Paper will briefly discuss PACE financing's inclusion in the CMA, and discuss how PACE financing can help property owners in New York City finance improvements that might be necessary to come into compliance with the CMA.

Property Assessed Clean Energy financing, or PACE financing, is an innovative method of financing that enables property owners to obtain funding for certain energy efficient building improvements (referred to here as "Qualified Improvements"). It is secured by a special real estate tax assessment on the property and repaid through the property's regular tax bill. Borrowers are able to obtain 100% financing of the cost of the Qualified Improvements. This financing is at a fixed competitive interest rate and fully amortizes over the useful life of the Qualified Improvements. The priority of the PACE assessment is analogous to the priority of a sidewalk or sewer assessment, and like these and other special assessments, a PACE assessment is senior to any mortgages also encumbering the property. Although PACE programs are available for both residential and commercial properties, this White Paper will focus on Commercial PACE financing (and we will refer to it simply as "PACE").

How does PACE Financing Work?

The first step to obtain PACE financing is to determine if the jurisdiction of the property has passed PACE enabling legislation which provides for the PACE special assessment on the property's tax bill. PACE enabling legislation establishes the framework for how the PACE program will work in that jurisdiction. Although PACE financing is available in many states, it is not available in every state. As of now, PACE-enabling legislation is active in thirty-six states as well as Washington D.C.[1] In addition, twenty of those states, as well as Washington D.C., have active programs – i.e., programs that have both been launched and are currently operating.[2] Although these programs vary by jurisdiction and there are distinct differences between these programs, common characteristics of the PACE legislation include: authorization for local governments to participate in PACE financing, defining what projects qualify for PACE financing, and explaining how the program can be funded. Please note, however, that although a State may have enabled PACE, it may not have been adopted in certain cities or counties in that State.

[1] "PACE Programs Near You." PACENation, 2017, https://pacenation.us/pace-programs/. Accessed June 2019
[2] *Id.*

For example, PACE had previously been enacted in New York State but until now, was not available in New York City.

Once it is established that PACE financing is available in the jurisdiction that the property is located in, the next step is to determine if the improvements in a particular project are eligible for PACE financing and constitute Qualified Improvements. The local legislation will address the specific requirements of Qualified Improvements. However, PACE financing generally relates to the financing of energy efficiency and renewable energy projects, i.e. "green" projects. Examples of common PACE eligible projects include new HVAC systems, new doors and windows, lighting, insulation, and solar panels.

In order to determine what improvements constitute Qualified Improvements and what PACE financing might be available, a property owner would be well served at this point to work with a PACE lender (hereinafter, the "PACE Provider"). Although PACE financing is paid back through a special real estate tax assessment, private lenders ultimately provide the funding for the project and become the PACE Provider. The PACE Provider can help guide the property owner through the PACE process (including the evaluation of Qualified Improvements) and act as a liaison between the property owner and the local PACE authority. It is at this point the PACE Provider can also provide the technical assistance that is needed to underwrite the energy savings that that proposed green improvements will generate which will determine the amount of PACE financing that will be available.

Generally, PACE enabling legislation authorizes municipalities or counties to work with the PACE Providers to fund the PACE loan. In some instances (such as California), the PACE Providers are then paid back through bonds that are issued by the municipality and are backed by such municipality's assessment on the property's tax bill. The PACE Provider essentially purchases the bonds with the funds it provides for the PACE loan. These bonds are transferrable and can be sold to third parties.

Why Should Property Owners Use PACE Financing?

Why should a property owner choose PACE financing rather than just fund the Qualified Improvements together with the other improvements through mortgage and mezzanine construction financing? The answer is that PACE financing has a number of potential benefits not obtained through traditional construction financing, including the following:

- Unlike traditional construction financing for new improvements, PACE enables a property owner to borrow 100% of the costs of the Qualified Improvement.

- PACE financing is based solely on the value of the asset (not the credit of the sponsor) and therefore does not require personal guaranties.

- The interest rate is a competitive fixed interest rate (currently rates are typically between 5.5% - 6.5%).

- PACE financing fully amortizes over the useful life of the Qualified Improvements unlike traditional construction financing which is short term and has to be refinanced.

- Because the PACE financing attaches to the property and not the owner, it is fully assumable by successor owners.

- The installation of Qualified Improvements will reduce the energy costs of the property.

Finally, PACE financing can drive down the over-all blended cost of construction capital for a project. For example, if a property owner were to undertake a construction project, the traditional capital stack might look something like this: 60% of the cost of the project funded by a mortgage construction loan; 20% funded by a mezzanine construction loan and the balance (20%) funded by equity. In this example, it can be expected that the interest rate on the mezzanine financing would be approximately 12%. If all or part of the mezzanine financing is replaced with a PACE loan at a fixed rate of approximately 6%, it is obvious that the overall cost of capital for the construction of the project will be significantly reduced.

Mortgage Lenders' Concerns Regarding PACE Financing

Although PACE is an innovative method for financing Qualified Improvements, it has historically been resisted by mortgage lenders because of its priority. This is because as PACE financing is a special real estate tax assessment, it is superior to any other debt on the property. Mortgage lenders are accustomed to holding a first lien position subject only to property taxes. The special real estate tax assessment of the PACE financing primes the mortgage loan and mortgage lenders have pushed back against PACE for this reason. For example, some mortgage loan documents expressly prohibit PACE financing. The resistance by mortgage lenders has prompted some local PACE authorities to require the following: (a) that the property owner obtain written consent from the mortgage lender for the PACE financing, and (b) that the PACE documents expressly advise property owners that even if their current mortgage lender consents to the PACE loan, future mortgage lenders may not consent and therefore the property owner may have difficulty refinancing the PACE loan.

As they say, however, "the times, they are a changin". Currently, more and more institutional mortgage lenders are becoming comfortable with PACE financing and permitting PACE liens that prime their lien. As outlined previously, one of the reasons for this may be the benefits of PACE are now becoming more widely known (particularly the benefit resulting from the lower cost of financing and over-all reduced debt service). Additionally, it is clear that the installation of green infrastructure in both the retrofitting of buildings and new construction is the way of the future. This is evidenced by the passage of the CMA and the emergence of similar legislation throughout the county (i.e., after the CMA was passed in New York City, New York State also passed carbon reduction legislation). Accordingly, there will be more and more demand for the financing of Qualified Improvements and the "invisible hand of the market" will weigh in. Indeed, Lenders who prohibit PACE may find themselves at a distinct competitive disadvantage to the growing roster of lenders that do permit it. This is particularly the case as PACE has now been enacted in New York City. One may argue that once PACE takes root here, lender opposition to PACE shall whither like leaves in winter.

PACE and the CMA

As discussed briefly at the beginning of this white paper, the New York City Council recently passed the CMA, which consisted of a series of groundbreaking bills passed in order to combat the effects of climate change. The centerpiece of the CMA, Local Law 97 of 2019, sets forth annual building emissions limits that effectively require large building owners to reduce carbon emissions. Through the CMA, New York City is setting goals to decrease carbon emissions 40% citywide by 2030 and 80% by 2050. A more in-depth analysis of the CMA, and Local Law 97 specifically, can be found here.

Another part of the CMA was the passing of Local Law 96 of 2019. This enabled PACE financing in New York City for the first time. This is an important aspect of the CMA, as the CMA will require many property owners to make "green" improvements to their buildings in the upcoming years. These improvements may be very costly. PACE was specifically enacted together with the CMA to provide property owners with the ability to finance 100% of those costs. In short, PACE financing in New York City provides an attractive solution to the carbon reduction standards that property owners in New York City will be required to comply with in the up-coming years due to the emissions standards of the CMA.

PACE in the Future

PACE financing is an innovative form of financing that is likely to become an integral part of the capital markets. As of June 2019, over $880,000,000 of PACE financings have been funded since the creation of the first PACE program.[3] This is an increase from approximately $280,000,000 at the end of 2016 and approximately $12,500,000 at the end of 2011.[4] As these increases demonstrate, PACE financings have significantly expanded in the last seven years. With more and more legislation like the CMA making its way through State legislatures, this trend is only going to continue.

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[3] "PACE Market Data." PACENation, 2017, https://pacenation.us/pace-market-data/. Accessed June 2019.
[4] *Id*.