Lowenstein Sandler's Real Estate Podcast: Terra Firma

Episode 18:
The Ins-and-Outs of PACE Financing

By Stacey Tyler

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Stacey Tyler: Welcome to Terra Firma, Conversations on Commercial Real Estate. I'm Stacey Tyler, counsel in Lowenstein Sandler's real estate practice group and deputy chair of our cannabis practice. Today's episode will focus on a specialized loan product known as Property Assessed Clean Energy, or PACE financing. I am joined by Bali Kumar, currently Chief Operating Officer of PACE Loan Group and formerly CEO of Lean and Green Michigan, that state's PACE administrator. Thanks for joining me today, Bali.

Bali Kumar: Thanks for having me.

Stacey Tyler: So, for some of our listeners, this might be the first time they're hearing about PACE or CPACE financing. Can you please start by just giving us a high-level overview of what that is?

Bali Kumar: Definitely. So, PACE financing, PACE is an acronym. It stands for Property Assessed Clean Energy, or in some states, property assessed capital expenditures. I guess technically also in certain states they add resiliency. And so, in places like Washington State, it's PACER property assessed clean energy and resiliency. It's a type of financing that's available state-by-state in about 40 states, where someone can take a voluntary special assessment on their property taxes to finance, quote, clean energy or capital expenditures projects.

So, if they have an existing building, they're using it to finance the big CapEx projects, right? So HVAC, lighting, roof or the big-ticket items that have super long paybacks, and for new construction projects, which is the majority of the deals that we see. Basically, if you're building a building above code, it is, quote, energy efficient or, you know, cleaner energy and therefore it qualifies for PACE financing.

Stacey Tyler: And when you're talking about financing, what exactly is the value? What are we financing here? What are we talking about?

Bali Kumar: Yeah. So, for new construction projects it's a reasonable sized chunk of the capital stack. Typically, people are going to banks or other lenders to get a mortgage. Maybe that mortgage is 50 or 55% loan to cost. Then what are they going to do? How are they going to finance the rest of it? Are they going to raise equity or are they going to put money out of pocket?

You know, that's expensive. If you'd rather save your equity to do multiple deals instead of sink it all to one deal. You can go get mezzanine debt, that's double-digit interest. So that's not super appetizing, but it does fill the gap. You can raise equity that commands double digit returns. People like PACE financing because, you know, PACE financing is around plus or minus 8% interest, and it's fixed for up to 30 years. So, you're already so solving a bit of your construction to perm debt issue because you're getting some permanent debt. It's relatively low loan to value because we're coming in with a senior lender on the new construction project so we can bridge folks from 55% to 70%. And so even though it's only 15% loan to cost, it's helping fully capitalize the deal and it's helping make sure that the cost of capital doesn't balloon, because if you're getting construction debt at SOFR Plus 250, 300 and then you're getting PACE around 8%, then that's a reasonable cost of capital for 70% of your stack.

Stacey Tyler: Right.

Bali Kumar: So what it does is replace more expensive debt and bring down your cost of capital.

Stacey Tyler: And when you're sizing up PACE loan, is that just based on the energy efficient improvements part of the project, or are you talking about the entire project cost?

Bali Kumar: What's interesting is besides it two different ways, we do have to ensure that an energy audit shows that whatever's being put in is, quote, energy efficient. And so, anything in excess of code, or if the whole building is in excess of code, or replacing something old with something new, so it's limited to that type of stuff. So, if someone has an apartment building and they're just replacing, you know, carpet and paint and stuff like that, then none of that stuff is PACE eligible.

So besides, it's zero. But, if you're replacing windows and lighting and, toilets and sinks, all that stuff becomes PACE eligible. So that's, that's one way to size it. And then the other way to size it is whatever doesn't kill the debt service coverage ratio. And so typically when we work with a bank or another lender and we're like jointly assembling a capital stack, we're trying to figure out what the combined debt DSR is.

And whoever has, the stricter rule of the two we underwrite to that and that sort of sizes up the whole capital stack. Maybe they'll qualify for a 30% loan to cost for PACE. And the senior lender says, we think 20% is the right number. So that way we don't kill our DSCR Covenant, but we say, yep, 20% it is.

Stacey Tyler: That's interesting. So is it usually kind of a collaborative approach with the other lenders in the stack?

Bali Kumar: I would like for it to be a collaborative approach. In many cases it is. Ultimately, because PACE stands for Property Assessed Clean Energy. It is a special assessment to property taxes, which means that property taxes always get paid before the mortgage, but only the current portion of property taxes get paid before the mortgage. So, in the event of default, which is the thing we're all trying to avoid, but if that happens, we can accelerate the entire PACE loan and call that doing payable.

The only thing that happens in the event of a property tax default is you need to come current. And so realistically, the senior lender is underwriting the additional property tax burden that someone's taking on with the PACE financing and making sure that doesn't kill their DSCR because that's the only portion that is truly senior to the senior lender.

And as long as that is current always, then the senior lender would probably just protect and make a protected payment, pay the property taxes. That way there's no like county property tax foreclosure. And then they preserve their rights to do a mortgage foreclosure.

Stacey Tyler: Right. And then it just becomes an increased carry cost essentially than they have to until they can resell. Interesting. So, are you seeing this in particular property class or is this is--where are you seeing these kinds of deals happen mostly?

Bali Kumar: Our top three in the top three asset classes for deals that we see are market rate, multifamily, senior living, and hospitality. And I think the case for PACE is different across each asset class. We've seen a lot of multifamily deals where the senior lender comes in and they're looking for a participant bank and they can't find a participant bank.

And so, there's naturally a gap because they're hitting their cap, and we can come in and fill that gap. So, if they can come in, let's say they hold out $20 million of debt, and their cap is 12 million, and they can't find a participant to come in with the other eight. We can come in with eight, and they're still at a reasonable debt on the whole value of the property.

So multifamily deals great deals, hospitality deals, a lot of folks are not trying to lend to new construction hotels. So, people are forced to go the debt fund route, and the debt fund route is double digit interest. And so, we're having a lot of hotel owners reach out to us and say, hey, we'd like to use as much PACE as possible because the PACE dollars are cheaper than a construction debt, and that blends down the cost of capital.

So, let's say you have to get so for 600 money, and you got PACE coming in around 8%, then you're blending down your cost of capital to maybe a ten, which is much less painful than borrowing it all at 12.

Stacey Tyler: Right.

Bali Kumar: So that's sort of the case for hospitality, and for senior living, I think the markets for construction loans for a senior living are much tighter. And so, PACE's emerge is really a key way to finance a lot of senior living projects.

Stacey Tyler: Right. So, I'm curious to hear your thoughts in the office space, especially those of us who practice in New York, we have seen so much uncertainty in the office market, given Local Law 97, which is a New York City regulation that requires buildings to do really significant, retrofitting essentially over the next several years just to achieve, better, more efficient green operation.

Are you seeing this kind of lending in those kind of really, you know, retrofitting projects?

Bali Kumar: All right. A lot to unpack there. New York City, Office and, local law 97. So just starting with New York City, the PACE program in New York City had a bit of a soft launch, and then they closed it up. So, they did two loans. One was 111 Wall Street, and one was, an office building in Midtown Manhattan. After that, after those two deals were completed, the city said, oh, let's just take a break from the PACE program and let's figure out, like, what we want it to look like.

So, they took a bit of a break.

Stacey Tyler: That's a good time to think about that: after it starts, then decide how it should work.

Bali Kumar: I know, so that was interesting. And they were really grappling with how do we use PACE as a tool to push people toward fully electrified buildings? And so, they came back out with the program and they said, great, you can use PACE, but if the building build, if the building uses fossil fuels, you can't use PACE.

And so, there was a bit of a pushback saying, well, if I'm just using PACE to pay for my windows, then why does it matter that we burn fossil fuels, right? Like code doesn't require us to build a fully electric building. Why are you forcing us to do something that's above code? And so that's sort of where they landed.

So, the New York City PACE program is open, but tougher to transact in than many other places. Now let me dovetail this into local law 97. We've spoken to a bunch of folks who say we understand local law 97 exists, but we can just model into our pro forma paying the fines.

Stacey Tyler: Right.

Bali Kumar: The fines ratchet up over time. I think at some point people will either have to make the improvements or sell the property to someone who's willing to make the improvements. I think that results in impairment value. I think about, you know, people always talk about, oh, this what's the green premium for me? Making my building very green.

I don't really know. There's lots of studies out there, you know, 3% on rent and 5% on rent. Can you even really calculate it, or are we just sort of guessing and making it a relatively precise number to make us feel like it's not a guess? I'm not sure, but I'll tell you, the brown discount is real, so you don't improve your building, Local law 97 fines keep piling up. If I'm buying a building in ten years in New York City, I’m just figuring out what discount I'm applying to it. You know, you're just going to keep your building running until it's essentially valueless. So, I think it's a bit of a short-term strategy. And I wonder if maybe some people's play is just waiting for a policy change

Stacey Tyler: I've seen a lot of people trying to get—bide some time also, just by passing along those kinds of costs and operating expenses to their tenants as much as they can. But we're seeing in the market, tenants are getting smarter about that and excluding penalties from an expense that's really not something that's a cost that they should have to reimburse or proportionate share.

So yeah, very interesting. There's a lot of people just trying to buy time.

Bali Kumar: That's yeah, that's brilliant because I would hate, as a tenant, to have to pay because my landlord opted out of something that benefits me, but also try to pass it off to me. I do think that tenants, you know, the office. Oh yeah. That's the third piece to dovetail too, is office. Everyone says, oh, office is a really top asset class, but I think the data shows that class A, class A+ office is doing great, class B and C office is doing really poorly.

And so, if you're improving your building to comply with local law 97, you're probably going to end up with a class A or A plus office building, thus ensuring the longevity of your asset, thus ensuring that tenants are more willing to choose you. Because if I have the option of working from home and working in an office, it better be a great office.

My office building in Minneapolis here just threw in a pickleball court, cold plunge, sauna. They're doing a whole new amenity space. They're trying to make it a place where people want to come in, in a world where hybrid work is really taking over. And we appreciate that.

Stacey Tyler: Yeah. Like, to your point that that chasm in New York City between class and class B is just getting wider every day, that the vacancy rates are not going to get better until people really invest some serious money. But like you said, it's just that it's all about the cost of capital. Who's landing on that.hea

Bali Kumar: Yeah, and we look at certain office deals. We're not closed to office because we think that not all office deals are bad deals, just like not all multifamily deals are good deals. I think that's a that's a lazy way of underwriting. We try to be really smart about do we think this loan, as a pure real estate play, has a high likelihood of paying back?

Stacey Tyler: Right. So, it seems like this. And I know from your government background, you have some kind of insight into, you know, how this is somewhat of, a political or at least governmental related program. So, I'm curious if you think that this kind of program long term is going to change now that we're looking at a new presidential administration?

Bali Kumar: PACE is a state-by-state statute. And so, there's nothing federal about it. There's no federal money that goes into it. It's actually all pretty much all private money. And the states that have passed it are on all sides of the political spectrum. I'd say two of the strongest PACE states in the nation are California and Texas.

And the positioning is just very different. You can say PACE financing helps a municipality and property owners in the municipality meet their sustainability goals. You can also say PACE financing is private financing for commercial properties to be able to upgrade their buildings without using taxpayer dollars. And it's the same program and they're very different political pitches. So, I think these programs are sort of here to stay where they are.

There are only about ten states left that need to opt in. I'd say the two most important states where people are focusing on getting them to opt in are South Carolina and Arizona. And then otherwise you got the Dakotas, you know, West Virginia. You got places where if there's a property owner that's desperately trying to build the capital stack with PACE financing, maybe they can get their state rep to sponsor a statute to, like, start the process.

But it seems like we've saturated the market of commercial property buildings.

Stacey Tyler: I'm surprised to hear you say South Carolina, figuring that this these kinds of investments would cover flood risk. Right?

Bali Kumar: Yeah, I think it's always a matter of legislative priorities. And I think now it'll be more of a legislative priority based on, you know, recent floods, recent events. I think we're trying to make it a legislative priority in Arizona. Similarly, because we're saying you're in a desert, anything that we can do that helps with water conservation, your property, and help you pay for it like water is just going to get more and more expensive.

Stacey Tyler: Right.

Bali Kumar: Same thing with heat, right? Only getting hotter and hotter in Arizona. So, you're going to be running the air conditioning more and more. Anything that helps you pay for, upgrading your HVAC. Yeah, we're here for that. And so, I think maybe that's the winning sell because that's like the politics behind it. Yeah. I think it's sort of a common sense policy, but you have to frame it in a way that it makes it politically feasible.

Stacey Tyler: Right. Makes it sound more business-y, less environmental, maybe. Yeah. So, can you talk a little bit about your experience dealing with different types of lenders as senior and mezz lenders in deals like this?

Bali Kumar: Yeah. So, I think the, the main thing is that the statutes all require that a senior lender, whoever has a mortgage on the property, has the consent to the borrower taking out PACE financing, and therefore the amount of PACE financing that the borrower takes out. Sometimes this requires a ton of education. There's a list on the PACE Nation website of 400 consenting senior lenders nationwide that have consented to deals all the way from like giant mega banks to, you know, local and regional banks, credit unions.

But just because someone at U.S. Bank has consented to PACE doesn't mean the US bank consents to PACE. They meant that the banker on that deal for that borrower, and that asset class allowed PACE financing for the deal in some respect. So, I think that list is directionally helpful, but not precisely helpful.

Stacey Tyler: Right.

Bali Kumar: I think that it is much easier to get the credit unions and local and regional banks to consent, I think for credit unions, they think, you know, if I'm lending to you and you bank with us, you are a member, right? Like they're credit union stakeholders are very different than like bank stakeholders. And so, you're going to be a bit more flexible in your underwriting.

You're going to be a bit more creative to help your member get their deal done. And for the smaller, local and regional banks, I think a developer can be a pretty sizable client for a more regional bank, in the same way that a billionaire is a sizable client for a huge bank, and sometimes it requires the borrower to nudge the bank to really take seriously their request to add based on the capital stack. I think it's easy for underwriters to be like, oh no, this complicates my underwriting, we're just going to say no. But it's harder to say no to a borrower who has a few million dollars in deposits for your bank, especially in a day where banks are really starving for deposits.

Stacey Tyler: Right. So, it sounds a little bit like some lobbying with your help. And then maybe also just having a business case be made on behalf of the customer or the borrower.

Bali Kumar: Yeah. And just like convincing the banks what PACE is, but like educating them on what PACE isn't because the first instinct and our CEO, Rafi Golberstein, his whole background is in commercial real estate lending. And when he was writing mortgages in 2016, when people started to reach out to him and say, hey, I want to throw some PACE into my capital stack, he's like, no, it sounds like you're trying to prime my mortgage.

Don't even want to have this conversation. So obviously, now that he's on the PACE side, he knows how to have the conversation, for folks to say, oh, you think that PACE is going to prime your home mortgage? Trust me, I used to think that too. But only let's say you're doing a 30-year loan, two payments a year, really only 1/60 of it primes your loan, and at 10% loan to cost in your deal, 1/60 of 10% of the cost to construct this property like, isn't really that scary. You can underwrite around it.

And they're like, well, we'll really like what happens in an event of default. Like then suddenly 60 payments jumped me. I was like, no, no, no, actually nothing jumps you. The amortization schedule as the amortization schedule, the payment that's due 1/1/25 can't jump ahead. The payment that's due one 1/1/2055 can't jump ahead.

That just comes due when it comes due. You just need to come current. And so, it's really still just that 1/60 payment. Or maybe you know by that time 2/60 payments. And so as long as folks start to understand like that, there's not that big of a risk ever. And no matter how much PACE comes in, they can never jump the queue.

Then I think people start to feel comfortable. They start to be able to underwrite around it. Maybe they bump the number down a bit. And that's fine. That's a bit of a back and forth. But I think if PACE consents not as an on off switch, but more as a dimmer.

Stacey Tyler: Interesting. And then I guess if there's a default situation, it’s, do you typically have an inter creditor agreement with the senior and mezz lenders.

Bali Kumar: There is no intercreditor agreement because it's a property tax lien. And so, in the same way you don't have an intercreditor agreement with the county when they have a sewer assessment or sidewalk assessment, you don't have an intercreditor related to a PACE assessment.

Stacey Tyler: So just as the tax lien, if you don't pay and then we are never having a separate, kind of enforcement action as the lender.

Bali Kumar: Exactly.

Stacey Tyler: Interesting.

Bali Kumar: I was going to say it's a nifty little thing that the, the local governments created.

Stacey Tyler: Yeah. I'll say. So, what, what markets are you seeing the most activity right now? What states?

Bali Kumar: PACE, the first PACE statute happened in California in 2008. A bunch of the Midwest states passed PACE in 2010. And so just because the programs are old enough and people are more educated on it, the banking community understands it a bit more, and the rules were written in a way that that work. I'd say the Midwest is very fertile PACE ground.

I say California, it's pretty easy to do a PACE deal. So those places are huge. I'd say the newer places are just sort of getting off the ground. So, New Jersey, for instance, passed PACE and just recently is finalizing their guidance on how to run the program. So, although there's a lot of pent up demand in places like New York City, New Jersey, it just doesn't have the acceptance and track record that it has in other places.

So, I think those places, there's pent up demand, but there aren't that many deals transacting. Whereas in the Midwest and California and Texas, places where they're just it's just been there for a while, you know, they've built up a ton of volume.

Stacey Tyler: That's great. That doesn't surprise me. I feel like there's demand for this type of financing. And as soon as these kinds of marketplaces and states like the great state of New Jersey, I'm sure we'll be seeing a lot more deal activity in that space.

Bali Kumar: Definitely. I think it's interesting because PACE seems to work well in all sorts of capital markets. Like right now, liquidity is a bit tight. It's harder to get, you know, you're not getting your bank to give you 70% loan to costs in a deal. Banks don't have deposits so they can't lend as much. So, PACE is stepping in to fill the gap there.

But even like three years ago, when you would go to the bank and get a 70% loan, to cost loan, then people are using PACE to juice up to 80 or lever up to 85%. And so nowadays it's a cost of funds reducer than it was an equity reducer. During the pandemic, people really started to dive into the retroactive use of PACE, where we can use PACE on a proactive basis.

You're building a building, and you use PACE financing as a part of your construction finance. Great. What if you have a hotel and you did a big Pip and you paid for it out of pocket because you were doing well in 2019 and then 2020 hits and nobody's staying at your hotel. You have staff today. You can retroactively use PACE and let's say you had a $5 million Pip and 3 million of it would have been PACE eligible. Then suddenly you reach back, you borrow 3 million, you put that in your pocket, and that helps you ride through the pandemic, and you're paying that back over the next 25 or 30 years.

Stacey Tyler: That's cool. So, is that lookback period? Does that vary from state to state?

Bali Kumar: It does. Generally, it's three years, but I always say 1 to 3 years because there are a couple of states don't give you a one year lookback or maybe a two year lookback. But I think the lookback provision is super useful. In scenarios where people were flush with cash, and they're no longer flush with cash.

Stacey Tyler: Yes.

Bali Kumar: It also helps on the purchase side, we've done a couple deals where one of our borrowers who are super savvy on PACE, evaluates anything they want to buy. By looking back at the last three years of CapEx projects. And let's say they can identify about 5 million in PACE that they could finance retroactively immediately upon purchasing the building, then they know that's basically 5 million equity they don't need to raise. So, it helps choose their IRRs for that deal. So when they're looking to purchase a property, they're like, all right, let me see your CapEx for the past three years. and they incorporate that into their IRR analysis.

Stacey Tyler: That's great. Get credit for the last guy’s improvements.

Well, thank you so much, Bali. That about wraps it up for us today. Thanks for joining me and helping our listeners get smarter about CPACE financing. And thank you, listeners for tuning in today. Be sure to like, subscribe, and follow Terra Firma wherever you're listening to this episode. I'd love to hear from you, so feel free to reach out at Terrafirma@lowenstein.com.

Until next time, Ciao!