

# **STRATEGIES TO ADDRESS EXISTING MORTGAGEE CONCERNS IN IMPLEMENTING PACE FINANCING**

May 2009

**DRAFT**

# WHAT IS THE LENDER CONSENT ISSUE?

DRAFT

- Special tax assessments generally have a super-priority lien
  - Lien securing an assessment is on parity with the lien securing ad valorem taxes under California law
  - Other states have similar provisions; a comprehensive analysis of state law is required
  - Using voluntary assessments to finance improvement on private property to achieve a public benefit may give rise to differing interpretations
  - Assuming seniority of PACE lien, do lenders have legal rights under existing loan documents?
- Lenders may have a right to exercise remedies under existing loan documentation
  - Typical mortgage provides for real estate *taxes*, and no consent is required
  - However the voluntary nature of the assessment may give lender basis to challenge the lien
  - Most commercial loans have provisions that prohibit the borrower from “further encumbering the property” without consent
  - Some commercial loans have DSC requirements that need to be maintained
  - Loan terms vary by type, lender and market conditions
- There are obvious risks to property owners of not seeking consent
  - Could be a default under loan docs
  - Could trigger acceleration; force untimely refinancing

Objective is to find scalable solutions to address this risk to wide-scale use of PACE financing

# WHAT ARE THE REASONS FOR A LENDER TO GIVE CONSENT?

- Opportunity to increase NOI – this has the effect of increasing lender’s debt service coverage ratios
  - Reduce energy costs, possibly other costs such as water
  - Potential to increase rents, occupancy rates
- Opportunity to increase the value of the real estate – this lowers lender’s LTV thus reducing overall risk
- Energy price protection
  - In the event of rising energy prices, the value of the efficiency investment increases and building operating expenses will remain lower than comparable non-efficiency buildings
  - In the event of lower energy prices, savings will diminish but overall expenditure on energy will be lower
  - National policy direction bodes for higher electricity costs over time
- Avoided capex improves adequacy of reserves, thus lowering risk
- ESCO guarantee of savings substantially offsets possibility that savings will not materialize
- With a trend towards mandates (e.g., NYC), lender’s risk profile is improved if building owners can comply using a long-term financing mechanism that does not stress property owner’s financial health

Mortgage lenders may initially resist this approach – especially in today’s credit environment – but there is a strong fact base supporting the value proposition of energy efficiency retrofits, and lender inaction may increase lender risk

# DEMONSTRATING THE ECONOMICS OF RETROFITS USING PACE FINANCING

DRAFT

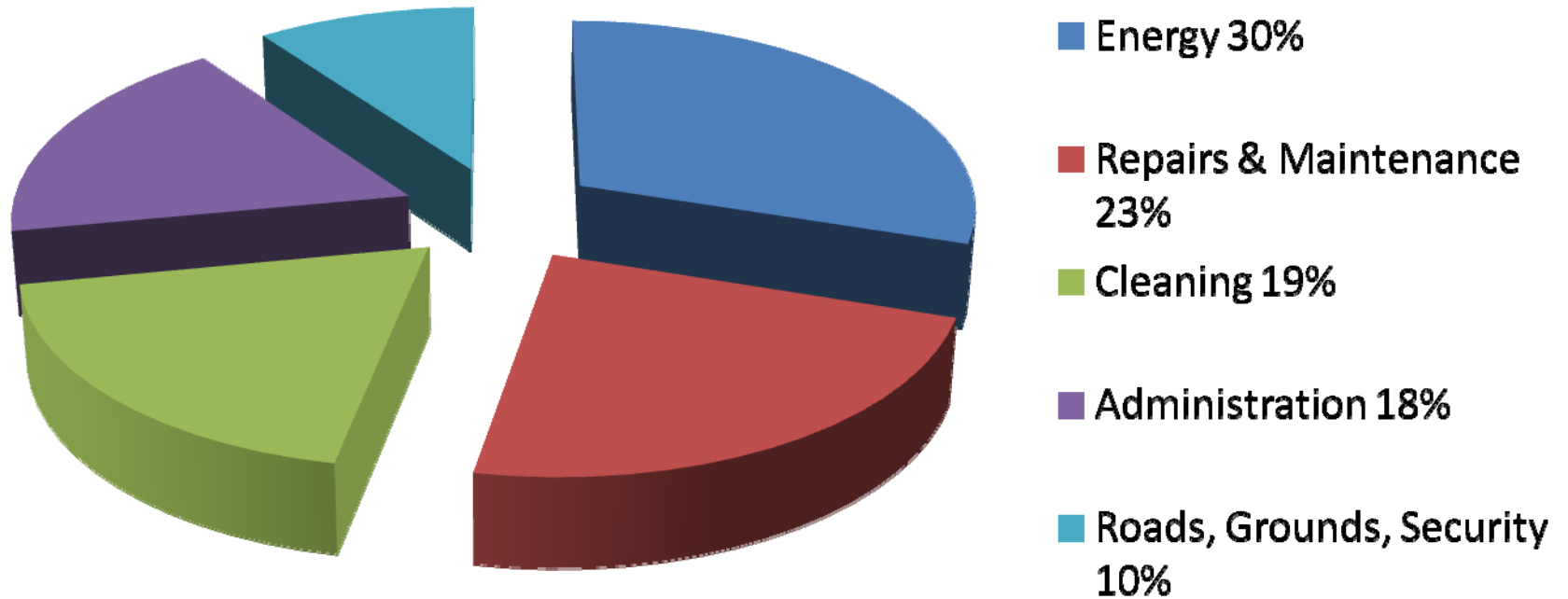
- The following page provides an analysis of a range of different retrofit projects
- Analysis demonstrates positive cash flow achieved using PACE financing to pay for retrofits
- PACE financing assumptions
  - 6% interest rate, conservative assuming US government guarantee
  - 20-year amortization period – long amortization is key to economically feasible financing
- Analysis is illustrative and conservative
  - Reduction in capex is a major source of value that has not been taken into account
  - Energy prices are held constant; no benefit given to increased savings in a rising energy price environment
  - No inclusion of “soft savings” associated with energy efficiency improvements – greater occupant comfort, impact of potential rent and occupancy increases
  - Lease terms can impact analysis on commercial multi-tenanted properties

All projects benefit from longer term financing; longer payback projects tend to involve deeper retrofits with greater GHG reduction impact and need longer term financing to be economically feasible

# RETROFIT ECONOMICS USING PACE FINANCING – ILLUSTRATIVE FIGURES

Project Type	Project Cost	Annual Savings	Simple Payback	Annual PACE Payment	Annual Net Cash Flow	DSC
Office	\$20,000,000	\$4,400,000	4.4	\$1,550,870	\$2,849,126	2.84
Multifamily	\$73,323	\$15,657	4.7	\$5,686	\$9,971	2.75
Mixed	\$2,331,394	\$339,283	6.9	\$180,785	\$158,498	1.88
Hotel	\$6,722,335	\$624,984	10.8	\$521,274	\$103,710	1.20
Residential (temperate)	\$22,500	\$1,965	11.5	\$1,774	\$221	1.13
Multifamily	\$216,520	\$17,119	12.6	\$16,790	\$329	1.02

# ENERGY ACCOUNTS FOR 30% OF US OFFICE BUILDING OPERATING COSTS



(Source: BOMA)

# Improved Energy Management Yields Direct Operating Cost Savings

- Energy Star v. average office building
  - Nation: 35% lower consumption, \$0.50/ft<sup>2</sup> average savings
  - New England: 39% lower consumption, \$0.75/ft<sup>2</sup> average savings
- Payback and ROI from energy retrofits
  - Nat'l study: 3.1 year payback, 32.4% ROI
  - Arden Realty: 3.5 year payback

(Sources: EPA; Innovest/Energy Cost Savings Council)

# Energy Cost Savings Lead to Net Operating Income Improvement

- Energy savings of 25-45% → NOI increase of 4-8%
  - Even in buildings with triple-net leases, owner can capture value of savings over time
- Better energy mgmt. also yields improved HVAC and lighting performance and resulting benefits
  - Improved employee productivity
  - Higher occupancy of leased buildings -- anecdotal evidence from REIT managers suggests correlation with Energy Star labeling

(Sources: BOMA, Institute for Market Transformation, EPA)

# NOI & Performance Improvement → Increased Building Value

- Energy performance can continue improving over years following retrofit – real NOI impact can be documented
- Appraisers' recognition of energy efficiency has historically been inconsistent, but heightened awareness of energy costs and risk may reinforce NOI data
- Energy cost reduction of \$0.50/ft<sup>2</sup> → asset value increase of \$5.90/ft<sup>2</sup> @ 8.5% cap rate