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SFA Research Corner

Bringing Private Funding to the Decarbonization of Commercial Real Estate — C-PACE ABS

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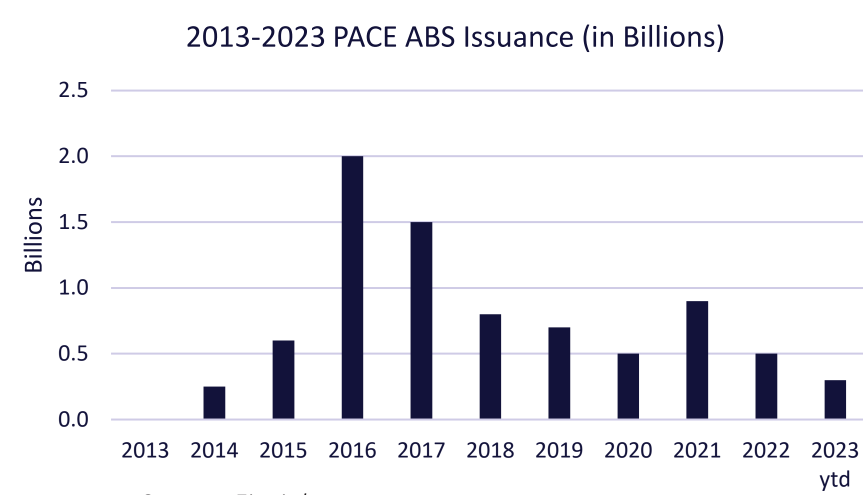
Bringing Private Funding to the Decarbonization of Commercial Real Estate — C-PACE ABS

On March 31, Greenworks Lending issued C-PACE 2023-1, a $256 million transaction backed by Commercial Property-Assessed Clean Energy (C-PACE) loans. In the collateral pool are loans to hotel, multifamily, office, retail, industrial, and esoteric properties across 16 states. Since proceeds from the loans have been used to reduce the carbon footprint of the buildings that secure them, C-PACE ABS has been considered by many impact investors as a green investment opportunity.

PACE programs, which are public-private partnerships for residential (R-PACE) and commercial properties (C-PACE), facilitate the financing of energy efficiency and renewable energy improvements on private property. Property owners who choose to participate in a PACE program repay the clean energy improvement's costs over 10 to 20 years. The loan is secured by the property and paid as an assessment to the owner's tax bill. A failure to pay may result in a property tax lien, which has priority over all other liens, or a tax sale.

According to Finsight, roughly $8 billion of ABS backed by PACE loans have been issued in the 144a market since 2014. Recent top issuers include Greenworks Lending LLC, Ygrene Energy Fund Inc., and Beach Point Capital Management. Reporting metrics include the effectiveness of the financed improvements as measured by a savings-to-investment ratio (SIR), a qualification requirement for C-PACE programs, and the carbon reduction projections associated with the financed upgrades.



Source: Finsight

Greenworks, one of the largest C-PACE issuers, goes beyond the inherently green use of funds and adds a review of their transactions' collateral, verifying alignment to the Green Bond Principles (GBP) as defined by the International Capital Market Association (ICMA). The GBP has four core components—use of proceeds, project evaluation and selection, management of proceeds, and reporting—and was updated in 2022 to provide specific guidance on evaluating the use of proceeds for securitizations, asset-backed commercial paper, and other secured structures. Aligning with the GBP means following a pre-issuance checklist, using an information template, and following transparency, disclosure, and reporting guidelines intended to provide an investment opportunity with transparent green credentials. Greenworks has gone still one step further with their issuance by also acquiring a separate party opinion (SPO) attesting to the GBP alignment.

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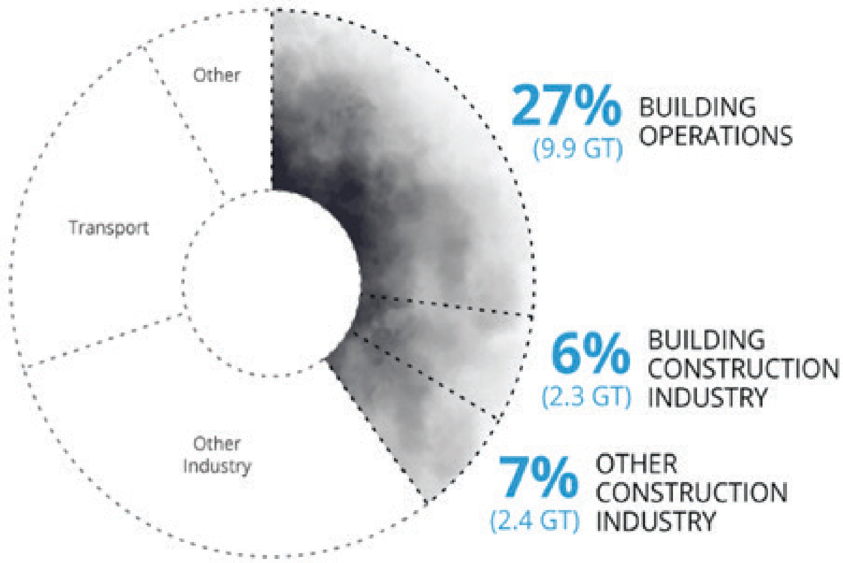
Built environments are responsible for 40% of greenhouse gas emissions (GHGs) and two-thirds of the buildings that will be generating those emissions in 2040 are already built today. A large part of President Biden's 2050 goal for reaching net-zero carbon emissions will include retrofitting existing buildings like the historic Butler Brothers building in downtown Dallas, TX. With a $23.9 million C-PACE loan in its capital stack, the 1910 Butler building was redeveloped with an energy efficiency plan that reduced its annual consumption by 40%. Approximately 83% of C-PACE loans have financed upgrades to existing structures.

New construction has seen some very impactful C-PACE projects, too. When Washington, DC's Audi Field, a 20,000-seat soccer stadium, was first planned in 2018, it included $25 million of C-PACE loans in its $300 million financing stack. The building now boasts a green roof, water consumption reduction measures, and a solar collection system that generates 841kw, enough to power 95 homes. The stadium's 25% lower energy consumption earned it a Leed Gold certification.

The Built Environment GHG Emissions as of 2022



Source: Architecture 2030

Audi Field's C-PACE financing also significantly decreased the project's cost of capital, with its C-PACE loans at a much lower interest rate (~7% compared to equity debt in the teens) for much longer repayment periods (20-30 years compared to 5-10 with equity debt), leaving it with lower operating expenses and better cashflows. Additionally, the expense of the energy efficiency upgrades stay on the tax assessment of the property in the event of a sale. This overcomes a huge hurdle for developers and property owners—the ROI for energy efficiency is often further out than planned ownership.

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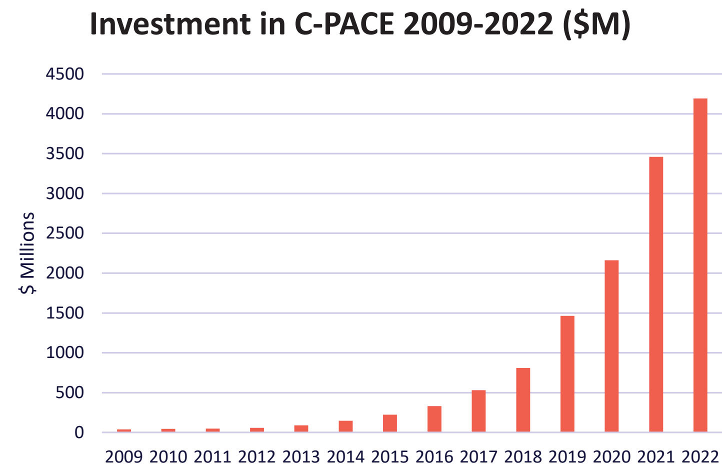
While PACE ABS still a very small asset class, hitting $2 billion in issuance in its busiest year, C-PACE originations have picked up in recent years according to a DBRS Morningstar commentary, with $1.3 billion and $1.51 billion being recorded in 2021 and 2022, respectively. The report states that C-PACE has "largely remained out of the broader public capital markets

New York C activity" and suggests the lack of uniformity between jurisdictions creates a significant stumbling block to wider acceptance of this funding source. New York City's original C-PACE program was an example of this. According to an article in the Commercial Observer, NYC's C-PACE had first been enacted in a limited way—not available on new construction, no fossil fuels allowed in the building being financed, not available for ground-leased properties—within a state that has a more flexible program statewide. The program was intended to help NYC building owners finance the retrofits that will be necessary to meet new strict GHG emissions caps but will present challenges for projects to qualify.



Source: PACE Nation

The largest deterrent, however, may rest in lender approval and market acceptance. All other lenders must consent to the C-PACE loan and many object to its senior position to all other liens. However, as more states and municipalities enact net-zero rules, building stock will have to come into compliance with caps on GHGs and energy consumption. The DBRS Morningstar commentary predicts a wider acceptance of C-PACE as a critical source of funding and proposes that "properties securitized in CMBS are likely to benefit from resulting efficiencies."