



PACE:

New Lending Opportunity/Threat

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PACE (PROPERTY ASSESSED Clean Energy) is an innovative financing program that allows owners of commercial, industrial and multi-family properties to obtain low-cost, long-term loans for renewable energy projects and efficiency improvements, including maintenance upgrades.

The PACE Act (now Tex. Local Gov't Code Ch. 399) authorizes municipalities and counties in Texas to work with private sector lenders and property owners to finance qualified improvements using contractual assessments voluntarily imposed on the property by the owner. In exchange for funds provided by a lender to pay for the improvements, the property owner voluntarily requests that the local government place an assessment secured with a senior lien on the property until the assessment is paid in full.

Commercial PACE programs are active in 16 states with over 1,000 municipalities participating. The PACE Act was enacted by

the State of Texas in 2013, and Travis County became the first jurisdiction to implement a PACE program in 2015. The City of Houston has followed and the City of Dallas is in the process of launching its program.

Property Owners

PACE was developed to overcome the challenges that property owners typically face when seeking financing for clean/efficiency improvements. PACE changes the game for property owners through a simple underwriting process (based primarily on the underlying property's stated value) and 100 percent project financing, requiring no up-front capital and no personal guarantee.

A PACE loan is unique in that it transfers with the sale of the property at no cost (as the new/improved assets remain with the property) and loan payments do not accelerate upon default. Notably, PACE often allows property owners to address deferred maintenance issues (which almost all buildings have) as well as more traditional efficiency and "wish list" items (e.g., solar).

PACE loans are also effective with complicated ownership or development/capital structures, allowing landlords to pass on costs/savings to tenants (in triple net leases). Because PACE requires that savings from the PACE project be greater than the direct investment, new cash flows are generated for the property owner; while loan terms as long as 20 years allow owners to tackle broader, strategic improvements instead of merely “low hanging fruit” with short-term paybacks.

Banks

A number of banks around the country have jumped on the PACE lending bandwagon recognizing the security inherent in the property tax assessment, which acts like a property tax lien with priority over other liens. Banks are uniquely well positioned to serve their customers with PACE loans due to banks’ pre-existing lending relationships and familiarity with the underlying real estate assets. Making a PACE loan also has no impact on a bank’s ability to foreclose on its property loan.

PACE loans are attractive investments for banks, with long-term, fixed-rate financing and loans transferring upon the sale of the underlying property at no cost and with no paperwork. Because PACE project savings must exceed the costs, real estate loan customer cash flows improve as do debt coverage ratios. Of course, with substantial property improvements being made, the value of the underlying property increases as well, enhancing a bank’s loan security.

Opportunity

PACE loans are an appealing new product that banks can offer to their existing real estate customers while also attracting new customers that need additional capital for property improvements. There is almost universal pent-up demand for property equipment modernization, and a PACE project may spur other project financing or lending opportunities for the bank beyond just the PACE loan.

In fact, a PACE loan can serve as a key tool in a property developer’s toolbox by offsetting the role of traditional, high cost partner equity in the overall capital stack, thereby lowering the development’s weighted average cost of capital. In this respect, banks should not overlook the powerful role that PACE can play not only in helping build a new, secure loan portfolio but also as a business development strategy to attract and expand traditional commercial real estate lending.

Finally, the positive environmental branding potential of PACE lending should not be underestimated. Banks making PACE loans will have a collection of appealing, measurable projects (e.g., solar, water conservation, etc.) to trumpet to customers, partners, and shareholders. Building a portfolio of “green” lending projects will only strengthen a bank’s image with the public. PACE loans may also be a way to satisfy a bank’s Community Reinvestment Act requirements but coupled with the security inherent in the property assessment.

Threat

Despite the well-deserved attention PACE is receiving in Texas, the market is currently dominated by third-party (i.e., non-bank) lenders frequently in partnership with contractors offering commercial construction or efficiency/clean energy solutions. Because property owners seeking PACE loans must (under Texas law) obtain approval from the property mortgage holder before a PACE loan

can be executed, banks may incorrectly assume that they have the final word on whether their customer can execute a PACE loan with another lender.

While technically correct, as evidence suggests from other PACE lending districts around the country, banks will ultimately get on board or get left out. Remember, customers are seeking approval for loans that will generate additional cash flows while making meaningful property improvements and benefiting the environment. What bank wants to be on the other side of that argument with its customer?

Historically, in other jurisdictions around the U.S., banks have initially been reluctant to approve PACE loans brought to them by their customers, and then over time (as the terms and impact are better understood) banks support the projects. Of course, while the banks then benefit from the improved property values supporting their mortgages and the better debt ratios of their customers, they also have lost the PACE lending opportunity (and, in part, the customer relationship). In fact, many third-party lenders in other states have been quick to offer customers “substitute lenders” to refinance the property mortgage if a bank does not support a PACE project.

Banks may also incorrectly assume that they can supplant the third-party lender in the deal, but often “letters of intent” or equivalent documents have been signed locking in the PACE lender and contractor to the bank customer’s project. In these instances, banks are forced to either support or extinguish the deal. There are already online publications reporting on which banks support PACE lending (either by offering loans directly or approving their customers’ loans from third-party lenders). It will not be long before “black lists” appear targeting banks that do not support PACE lending, highlighting the damage caused to their commercial real estate customers and the environment.

Conclusion

Third-party lenders and contractors (from in-state and out-of-state) are aggressively marketing their services and the PACE opportunity to commercial property owners in the active (or soon to be active) PACE jurisdictions of Austin, Houston and Dallas. This is a good thing for commercial property owners who have been limited for too long in their ability to make meaningful and environmentally impactful efficient and clean property improvements.

However, banks should not assume that their real estate customers will knock on their doors asking about PACE loans. Someone is knocking on their customers’ doors already, educating and engaging these property owners on the real benefits of PACE.

Banks should proactively approach their real estate customers (or prospective customers) about PACE lending or assume someone else will and forfeit the chance for an expanded customer relationship. The Texas legislature did banks a favor by enacting the PACE Act. Banks, leveraging their pole position with real estate customers, need only take advantage of this exciting new commercial lending opportunity, both financially and by burnishing their public images environmentally. ■

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