ABS Research

New Construction Is Poised to Expand Commercial PACE

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Morningstar Perspective

Morningstar Credit Ratings, LLC has seen an uptick in interest in new construction commercial property assessed clean energy deals as property owners strive to make their buildings more energy efficient or resilient to natural disasters and are increasingly considering PACE programs to meet those objectives. Moreover, as the conversation among property owners has expanded beyond solely climate change concerns, to proactively planning resiliency measures, these discussions are also increasingly taking place at the onset, with property owners using C-PACE to help finance new construction projects. From a credit perspective, we believe there are several benefits associated with new construction C-PACE, including the lender's consent, their senior lien status, and their attachment to the property instead of the borrower, but there are also risks investors should consider, such as construction completion and environmental concerns.

Strengths

The benefits of new construction C-PACE are like those for C-PACE overall. In most C-PACE programs and in some state legislation, the lender's consent is required before providing PACE financing. It's worth noting though that we have seen a small number of C-PACE assessments in securitizations where lender's consent may not have been obtained. Morningstar considers the lender's consent a credit positive because it encourages borrower discipline. Additional future PACE assessments, however, are generally permitted without prior lender approval. Program administrators typically impose limits on PACE financings through underwriting requirements, setting a threshold for not exceeding a certain percentage of the property's value. In new construction, these conversations with the lender can often occur earlier in the process relative to projects involving existing properties because developers have more flexibility with incorporating green-energy upgrades without having to deal with legacy systems.

In addition, the PACE assessment enjoys a senior lien status, either equal to or lower than other tax assessments, but higher in priority than the mortgage debt obligation. PACE assessments, like property taxes, cannot be accelerated upon foreclosure. Only the delinquent payment is due then, not the outstanding PACE balance. The lien is also considered nonrecourse, with the obligation tied to the property and not the borrower.

Concerns

Construction cycles are relatively long, so risks need to be managed proactively. Construction completion and environmental concerns are two main risks in new construction projects. While the land value and approval of all required permits can help alleviate new construction risk, even if a developer has all the required permits, the progress of the project may still go awry. To alleviate concerns about timing, a project manager may require that construction reaches certain development milestones before additional funds are released. An administrator's experience has an impact as well, where an experienced construction lender will likely be able to better navigate such financial draws, relative to a smaller regional bank.

An additional oversight measure is tracking disbursements, where the PACE lender coordinates with a bank loan officer to apportion the funds for energy renewal, efficiency, HVAC, and resiliency purposes. In other instances, there may be a completion guarantee. We view a completion guarantee as beneficial because a third party, in many cases a bank, pledges its support in getting the project finished. This guarantee helps to alleviate the construction completion risk because an additional party has a vested interest in the project's completion. Nonetheless, the guarantor's financial condition is also relevant because the backstop is only as strong as the guarantor's financial wherewithal, especially relative to its existing leverage.

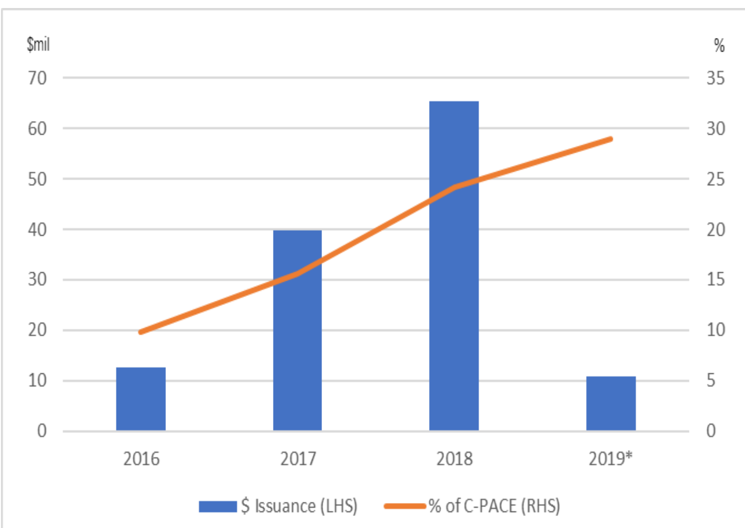
Other additional requirements may also include reaching certain efficiency levels. Indeed, in some instances, PACE originators will require that a building meet certain targets to make the property eligible for C-PACE financing. Select states have savings-to-investment ratio requirements or mandatory energy savings guarantees. Therefore, the lender may require an independent review of the cost-benefit analysis to determine the project's financial feasibility. In addition, location comes into play because Morningstar considers properties in infill locations and major metropolitan cities as having a more established track record and less variability in sustainable cash flow than that of properties in rural or tertiary markets.

Lastly, environmental risk is also a concern in new construction projects. While air, water, noise and waste pollution are inherent in any new construction project, environmental risk in C-PACE is generally caused by pre-existing issues such as underground storage tanks, or by type of development being proposed (i.e. industrial manufacturing), such that the environmental liability could step in front of the PACE lien. Environmental risk underscores the importance of site selection and an active project manager to mitigate pollution damage to surrounding areas.

New Construction Plays a Larger Role in C-PACE

While 2019 is off to a relatively slow start, with $10.8 million in new construction C-PACE financings through the end of May, per industry nonprofit PACENation, several other projects will likely close before the year ends. Nonetheless, new construction C-PACE has been increasing sharply over the past couple years, with volume totaling $65.3 million in 2018, more than a four-fold increase over the $12.5 million reported in 2016. The proportion to overall C-PACE issuance has also surged, with new construction accounting for roughly 29% of issuance through May, already exceeding the 24% proportion reported for full-year 2018. The dollar magnitude of new construction C-PACE deals is clearly driving this proportion though, as the share is much smaller when examined from a deal number perspective, accounting for about 7% through May, compared with 4% for full-year 2018.

Annual New Construction C-PACE Issuance



*As of May 31

Source: PACENation

Developer Attraction

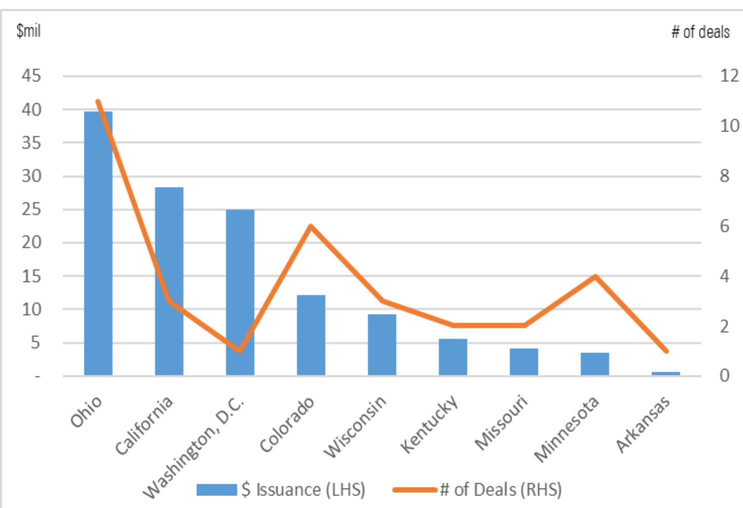
We have seen activity in new construction C-PACE projects concentrated across hospitality and multifamily property developments. Developers may turn to PACE as an additional source of financing, with the ability to amortize costs over a 20- to 30-year period, in lieu of large up-front costs. PACE assessment financing costs, which have generally been in the 6% to 7% interest rate range, can be more cost-effective than mezzanine debt, which can run around 15% to 20%. In addition, PACE can also be used in conjunction with other special incentives, including opportunity zones, tax incremental financing, and other tax abatements.

Legislation Advances PACE

Developers need to be aware of the legislative nuances of each state and local region because certain measures may qualify for PACE financing in some areas but not in others. According to PACENation, PACE-enabling legislation has been passed in 36 states plus the District of Columbia. Some legislation is written broadly enough to accommodate use with new construction projects, with 12 states specifically allowing for PACE to be used in new construction. In contrast, Illinois and New Hampshire expressly forbid PACE as a financing mechanism for use in new construction projects.

As can be seen in the chart below, Ohio has the most activity, with 11 new construction C-PACE deals, dwarfing the single-digit deal volume across seven other states and the District of Columbia. Delaware, Michigan, and Virginia have each passed legislation permitting new construction PACE projects but have yet to complete any deals.

Cumulative New Construction C-PACE Issuance by State



Source: PACENation

In May, Minnesota became the latest state to expand its PACE legislation to specifically accommodate new construction projects, after previously only mentioning retrofits. Since its original legislation did not expressly forbid new construction projects, there were four new construction projects completed via the St. Paul Port Authority, according to PACENation, further illustrating how legislation can often be written broadly enough to accommodate PACE use with new construction projects. With the expanded legislation, however, a legal opinion stating that new construction is permissible will no longer be needed.

Longevity in PACE

We see longevity in the PACE sector because it helps provide capital to get new construction projects built and incentivizes developers to add efficiency upgrades and renewables to lower operating costs. In addition, as natural disasters increase, developers are also being more proactive in their resiliency efforts to safeguard their buildings from such potential calamities.