



# The Texas Independent Banker

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**Identity** is  
Everything



*The  
Crafting  
of a New  
IBAT Logo*

# IBAT

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Texas Sets the PACE

# Texas Sets the PACE

CHARLENE HEYDINGER

Texas' transformation of Property Assessed Clean Energy into TX-PAVE is setting the stage as a nationwide commercial & industrial (C & I) PAVE model.

## What is TX-PAVE?

TX-PAVE is a financial tool that enables businesses to upgrade facility infrastructure. Property owners lower operating costs and use the savings to pay for eligible water conservation, energy efficiency, and distributed generation projects.<sup>1</sup>

TX-PAVE financing is repaid through and secured by a voluntary property assessment imposed by a county or municipality with a TX-PAVE program. PAVE assessments attach to and follow title to the property, are non-recourse, and are not subject to acceleration upon sale or foreclosure. The assessment lien securing the PAVE loan has priority over other liens on the property. The PAVE capital provider can only foreclose on installments that are past due and may not accelerate future installments of the PAVE loan. The property remains subject to the assessment lien for future installments until the total PAVE assessment has been paid.

The length of a TX-PAVE assessment can be stretched over any number of years not to exceed the projected useful life of the improvements, provided the projected savings exceed the cost of the repayment. Projected savings are calculated using a rigorous Technical Standards Manual<sup>2</sup> and two statutorily required reviews by an independent third-party engineer.

## TX-PAVE Advantages for Businesses (and their Lenders)

TX-PAVE enables property owners to overcome traditional up-front cost barriers for capital investments with long ROI. Without PAVE, property owners delay maintenance and sell property with aging infrastructure, making the weakened property the new owner's problem.

TX-PAVE programs enable investment while preserving capital and credit lines and empowering owners to retain their available capital for revenue-generating expenses. Since future PAVE assessments transfer to a new owner at sale, owners can address deferred maintenance without overinvesting.

## Why TX-PAVE Matters to Community Banks

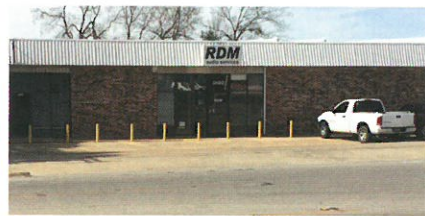
"A real benefit for independent bankers is that with limited geographic markets, they will likely only cover a limited number of municipalities with a PAVE program. This puts them for now in a competitive advantage with regional and national banks who face numerous variations in local PAVE programs across their entire market, making their active participation in PAVE programs less likely until true secondary markets emerge for PAVE loans," notes Tom Nida, Regional Executive of Washington, D.C. for John Marshall Bank, a community bank investing in several PAVE projects. "Independent bankers can more effectively add PAVE loans to their current financial services offerings to compete against their larger rivals."

## TX-PAVE PROJECT HIGHLIGHTS

TX-PAVE serves urban and rural Texas with projects big and small.



R.J. Liebe Athletic Lettering Company  
– Corsicana, TX  
Investment: \$324,559  
Projected Utility Savings: \$500,610  
Project completed August 2017



RDM Pros – Bryan, TX  
Investment: \$129,356  
Projected Savings: \$240,000  
Project completed January 2017

In September, the nation's first rated commercial PAVE securitization closed for \$75 million. To date, \$500 million have been invested in PAVE projects to improve over 1,000 commercial buildings. C & I PAVE investment in the U.S. doubles every year.<sup>3</sup> Eleven Texas PAVE projects ranging from \$130,000 to \$24 million have facilitated \$33.5 million of new investment since TX-PAVE began 34 months ago.



“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,” noted Rick Davis in the November/December 2016 issue of *The Texas Independent Banker*.

### Mortgage Consent is a TX-PACE Prerequisite

The Texas PACE Act requires a mortgagee’s written consent as a precondition to TX-PACE financing. Morningstar “views the lender’s consent requirement as a credit positive because it imposes borrowing discipline on commercial property owners.”<sup>4</sup>

More than 200 mortgage holders granted consent for commercial PACE projects in the U.S.<sup>5</sup> The U.S. Small Business Administration has also given consent for PACE funding on owner-occupied commercial properties financed under the SBA 504 program.<sup>6</sup> Forward-thinking mortgagees who set evaluation policies and authorize and train local loan officers on how to assess requests for TX-PACE project consent will have an advantage as the TX-PACE infrastructure and economy expand throughout Texas.

Tim Teske, Senior Vice President of Financial & Government Institutions Banking for Texas’ Green Bank, NA, states, “A PACE loan must have break-even or better cash flow relative to the energy savings created and the debt service to repay it. The program stipulates that the proposed project and projected savings must be verified by a licensed and certified third-party engineer who can scientifically and mathematically substantiate or reject the project.”

“The loan (note) is secured by the creation of a special tax assessment that is assigned to the lender at closing and is “at par” with all other ad valorem taxes within the taxing authority. Once assigned, the collection of the note is indisputable and a legal obligation of the building owner or future owners who assume the obligation to pay property taxes. Giving consent by a first lien lender to allow a PACE Loan and assessment can improve the first lien lender’s position by creating

CAPITAL STACK COMPARISON					
		BEFORE	AFTER		
CONVENTIONAL FINANCING	Senior Debt (EB-5) \$49.5MM	6.25%	6.25%	Senior Debt (EB-5) \$49.5MM	PACE FINANCING
	Historic Tax Credits \$21.9MM	3%	3%	Historic Tax Credits \$21.9MM	
	Mezzanine Loan \$22MM	15%	6.13%	PACE \$23.9MM	
	Equity \$22.4MM	10%	10%	Equity \$22.4MM	
			9.29% Weighted Average Cost of Capital	7.46% Weighted Average Cost of Capital	
<p>The inclusion of \$23.9 million in energy and water-saving measures in the redevelopment capital stack of the historic building demonstrates the low-cost, long-term PACE alternative to expensive equity-partner financing.</p> <p><b>Butler Brothers Building, City of Dallas</b> Project Completed July 2017</p>					

cash flow for the existing owner, increasing the value of the building, or both.”

Morningstar “considers metrics typically associated with commercial mortgage-backed securities (CMBS) as a starting point for our C-PACE analysis.”<sup>7</sup> This evaluation includes debt service coverage ratios, total debt-to-value ratio, and property type.

Mortgagee consent should be based on a business plan demonstrating how a proposed TX-PACE project will enable the mortgagee to benefit through its own portfolio, its collateral, and its customer’s financial health. The business case should include enhanced community relationships and ancillary benefits that will result from a lender enabling improvements to local building stock.

An existing mortgage holder can set reasonable conditions for consent, such as requiring the property owner to escrow funds for PACE payments.

### Economic Opportunity for Local Banks

Many financial institutions are drawn to the creative options of Texas PACE.

#### Becoming TX-PACE Lenders. TX-PACE

offers three key benefits to banks. First and foremost, TX-PACE expands lending opportunities within the bank’s market, potentially increasing its cash flow and bottom-line profitability; its natural lending market suddenly becomes bigger. Second, TX-PACE provides financial institutions with a collateral position superior to any other possible lien position available on a commercial property. Finally, becoming a PACE lender allows a bank to strengthen and deepen its relationships to the businesses and communities it serves.

Green Bank is the first bank in Texas and the third in the nation to become a C & I PACE lender. “The PACE program is a great tool for our bank officers to make more connections; it is a program that finally has all the elements needed to induce an owner to update his or her building’s energy and water use, with 100% long-term fixed-rate financing,” says Teske.

“The completed projects often create operational cash flow from the cost reductions. Once our lenders were able to see the potential benefits, Green Bank chose to offer PACE loans that qualified for the program as directed by the legis-



1225 North Loop Investments, Houston PACE Program  
Project Completed November 2017  
Financing Scenario Comparison Summary

	Self-Funded	Conventional Loan	PACE
Out-of-Pocket Investment	(\$1,300,000)	(\$260,000)	\$0
Savings (First Year)	\$200,000	\$200,000	\$200,000
Annual Payment	\$0	(\$282,803)	(\$118,437)
Cash Flow Impact Year 1	(\$1,100,000)	(\$342,803)	\$81,563
Net Project Cash Flow Year 2	(\$900,000)	(\$425,607)	\$163,126
Years to Positive Project Cash Flow	6.5	8.4	IMMEDIATE
Debt Service Over Finance Term	0	(1,414,017)	(2,368,742)
10-Year Project NPV	\$172,017	\$20,747	\$600,310
Property Value Increase (20-Year NPV)	\$993,984	\$842,714	\$935,520

lation and Texas PACE Authority (TPA), the established third-party administrator for the program. TX-PACE can become an excellent financial product local banks can offer customers even if the assessment financing term extends 20 or more years.”

**Providing Construction Funding.** Equity PACE lenders willing to make 20-year financing agreements may seek a local bank to provide construction financing.

**Servicing Assessment Installments.** In Texas, the local government delegates the servicing of the PACE assessment installments to the capital provider in lieu of adding the assessments to a tax bill. Private equity TX-PACE capital providers can outsource this function to a Texas bank creating a fee income source for the bank.

**Providing Capital.** Local lenders looking for alternative safe investments, but not yet ready to be direct TX-PACE lenders can provide capital to private, non-bank TX-PACE capital providers.

### Evaluating a Proposed TX-PACE Assessment

Whether a local lender is evaluating a request for lender consent or for TX-PACE financing, here’s what to look for in the proposal:

- Does the customer have a good relationship with the mortgagee?

- How would the TX-PACE project affect the property’s debt ratio?
- Is there enough equity in the property to protect the mortgage if consent is granted for a TX-PACE project? Since TX-PACE assessments don’t accelerate, only past due installments can be collected ahead of the mortgage. For example, in a \$1 million improvement to property to be repaid over 10 years with annual TX-PACE assessment installments of \$100,000, only a past-due \$100,000 installment can be collected in a senior position. Future installments stay with the property until the PACE assessment has been paid in full.
- What is the lien-to-value ratio? Morningstar notes, “Although a PACE assessment raises a property’s lien-to-value ratio, the increased risk to the underlying mortgage is likely minimal, as the obligation is usually small in comparison to the mortgage. In addition, the property owner reaps the benefits of cost savings and potential increase in property value thanks to the upgrades.”<sup>8</sup>
- What is the impact of a TX-PACE project on net operating income (operational savings and/or estimated rental increases resulting from the improvements)?
- What is the impact on the customer’s

cash flow? Typical loans have a negative cash flow impact because of the improvement’s long ROI. However, TX-PACE assessments have a savings to investment ratio of greater than one (SIR>1); the savings exceed the cost of the TX-PACE financing over the life of the assessment.

- Will addressing deferred maintenance reduce the mortgagee’s risk? A study of commercial buildings in six major U.S. metro areas from 2000 – 2012 found that commercial buildings with higher energy consumption or higher energy costs had a higher default rate than more energy-efficient buildings.<sup>9</sup>

If the TX-PACE option is superior to a second mortgage for both the mortgagee and the property owner, should the mortgagee consider providing the TX-PACE assessment capital or granting consent?

### Why the TX-PACE Program Works

“Green Bank supports sustainable and eco-friendly projects in the communities it serves,” says Teske. “Green Bank supports these concepts universally throughout Texas and nationwide. When PACE was signed into law by Governor Perry and because of the ideals we support, we were asked to help develop a standardized set of documents to implement and finance the PACE program in Texas. The initiative was called ‘PACE in a Box.’”<sup>10</sup>

One hundred thirty volunteer stakeholders established best practices and uniform model documents for *PACE in a Box*—a vetted, user-friendly, free-market, small government C & I PACE program for Texas.<sup>11</sup> Every local government establishing a TX-PACE program uses *PACE in a Box*.<sup>12</sup> State-wide uniformity will eventually foster a secondary market, making it easier for local banks to help their communities benefit both economically and environmentally.

Local lenders’ interests are built into the Texas model. As more independent banks become involved, businesses will choose to partner with their current bank. TX-PACE enables property owners to do business with the parties of their choosing. Capital providers negotiate



terms and interest rates directly with property owners. TPA is the non-profit administrator of the PACE in a Box model programs.

### The Bottom Line

Local banks will play a vital role in the new TX-PACE paradigm. "Texas PACE presents significant opportunities and unique challenges for community banks," explains Steve Scurlock, Executive Vice President of Independent Bankers Association of Texas. "Bankers need to be cognizant of this alternate financing tool and prepared to take advantage of the benefits that it can provide for their banks as well as their customers."

Who in your organization will evaluate TX-PACE and train your loan officers to support your current customers and attract new customers with TX-PACE? ★

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<sup>1</sup> Distributed generation includes solar, wind, geothermal, combined heat and power (CHP), microgrids, and other technologies that create power onsite. This equipment can enable hospitals, factories, and hotels to maintain operations, support life-saving operations and pump flood water after a loss of power from the grid – an increasingly important subject after Hurricane Harvey.

<sup>2</sup> Texas PACE Authority User Guide and Technical Standards Manual, <https://www.texaspaceauthority.org/Documents/Program%20Guide%20Version%202.0.pdf?dl=0>

<sup>3</sup> <http://pacenation.us/pace-market-data>

<sup>4</sup> Morningstar ABS Research, *Risk Evaluation of Commercial PACE Securitizations Differs From Residential Deals*, September 2017 <http://lending-times.com/wp-content/uploads/2017/09/ABS-Research-Risk-Evaluation-of-Commercial-PACE-Securitizations-Differs-From-Residential-Deals.pdf> (Morningstar).

<sup>5</sup> For a list of consenting lenders in the U.S., see: <http://pacenation.us/wp-content/uploads/2017/10/List-of-Consenting-Lenders-07.2017.pdf>

<sup>6</sup> <http://urbaningenuity.com/includes/storage/brio/files/44/Menkiti-Annie's%20ACE%20PR%20DRAFT%20-%202017-6%20Final.pdf>

<sup>7</sup> Morningstar notes that, "Standardization across the C-PACE sector also would be beneficial."

<sup>8</sup> Morningstar

<sup>8</sup> *Impact of Energy Factors on Default Risk in Commercial Mortgages*, June 28, 2017; <https://cbs.lbl.gov/sites/default/files/docs/Mortgage%20Default%20Risk%20and%20Energy%20-Technical%20Report%206-28-17.pdf>

<sup>10</sup> <https://www.keepingpaceintexas.org/pace-in-a-box>

<sup>11</sup> Steve Minick, VP, Texas Association of Business chaired the Underwriting Working Group. The Financial Platform Working Group, chaired by John Fleming, General Counsel, Texas Mortgage Bankers Association, established the first policy and process for financing PACE projects with private capital in lieu of bonds and established an open market for all lenders. The Technical Standards Working Group, chaired by Dub Taylor, director, State Energy Conservation Office, wrote the Technical Standards Manual that is similar to the State's policies for state buildings. Hon. Kip Averitt, former Senate Natural Resources Committee chair, and Steve Wiese, former Texas Renewable Energy Industry Association chair co-chaired the Design Working Group. The Education, Marketing and Training Working Group was chaired by Calley Jones, Commercial Market Manager, Way Service, Ltd. The collaborative process took 1½ years to complete.

<sup>12</sup> Morningstar

### Yes, CECL Affects Taxes, Too

*continued from pg. 31*

- Selling loans or securities with losses
- Deferring the sale of loans or securities with gains
- Accelerating charitable contributions
- Selling Other Real Estate Owned property with post-foreclosure write-downs
- Increasing depreciation and expensing of qualified fixed assets through bonus depreciation and Section 179 expense
- Performing a cost segregation study on new and existing buildings

While these are available regardless of CECL, banks may find themselves searching for extra tax deductions in the year of adopting CECL to help soften the income statement and capital effect and lower the cash outflow to cover income tax. In addition, if tax reform is passed and tax rates are reduced, accelerating these temporary deductions could result in a permanent tax savings. The best advice for truly understanding and mitigating CECL's tax effect is to start planning as soon as possible. ★

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**Looking forward to another year of serving you!**

**No matter how much we grow in size and sophistication, we take your bank's success personally.**

**Together there's nothing we cannot do.**

**Best wishes for a fantastic 2018.**

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