ABS Research

Risk Evaluation of Commercial PACE Securitizations Differs From Residential Deals

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Authors:

Stephanie K. Mah | Director of Research | stephanie.mah@morningstar.com | +1 646 560-4571
Phoebe Xu | Senior Vice President | phoebe.xu@morningstar.com | +1 646 560-4562

Analytical Manager:

Brian Grow | Managing Director | brian.grow@morningstar.com | +1 646 560-4513

Morningstar Perspective

Morningstar Credit Ratings, LLC believes the next iteration of property assessed clean energy securitizations will be in the commercial sector. While securitization of residential PACE assessments tops $3 billion, there have been no public transactions consisting primarily of commercial liens. These programs allow property owners to make energy-efficient, energy-renewal, water-conservation upgrades, as well as improvements to mitigate for seismic damage, flooding and wind resilience without an initial capital outlay. Instead of property owners having to pay upfront for the improvement, the obligation is spread over a five- to 30-year period and repaid through installments on the property tax bill.

So-called C-PACE should be evaluated differently than its more established cohort, residential PACE. Earlier this year, Morningstar published a report addressing misconceptions regarding residential PACE and asserted that because assessments are asset-based obligations, lien-to-value ratios are an appropriate risk indicator. While Morningstar uses lien-to-value ratios to gauge the credit risk of both R-PACE and C-PACE obligations, there are important distinctions between the two, with a lender's consent requirement being the most prominent. In addition, Morningstar considers metrics typically associated with commercial mortgage-backed securities as a starting point for our C-PACE analysis. Specifically, we evaluate debt service coverage ratio, total debt-to-value ratio, and property type along with specific pool characteristics, which can be atypical and require case-by-case analysis, in contrast to the more homogeneous asset composition in residential PACE transactions.

Required Lender's Consent a Credit Positive

Most commercial programs require borrowers to obtain the mortgage lender's consent before providing PACE financing, though the addition of future energy-improvement assessments is generally permitted without approval. An independent review of a cost-benefit analysis may also be required to determine the project's financial feasability. Two major providers have required lender's consent in all of their C-PACE financings to date. More than 200 institutions have given lender consent to C-PACE projects, according to PACENation, an industry trade group. This is in contrast to residential obligations, where the Federal Housing Finance Agency prohibits Fannie Mae and Freddie Mac from buying mortgages with PACE liens because of the supersenior lien position that a PACE obligation has over a mortgage loan. It's important to note, though, that if a property owner defaults on a PACE payment, only the overdue amount, not the entire balance, is due.

When a property is sold, the PACE obligation is transferred to the new owner, as the lien stays with the property. Homeowners with mortgages owned by Fannie Mae or Freddie Mac, as well as commercial property owners, can add a PACE lien but may have to pay it off before refinancing or selling the property. Morningstar views the lender's consent requirement as a credit positive because it imposes borrowing discipline on commercial property owners.

Evaluating Property Income Generated to Pay Debts

In analyzing the credit risk of transactions backed by commercial assessments, Morningstar considers the debt service coverage ratio, because PACE lending is tied to the property rather than the owner's creditworthiness. Morningstar evaluates a property's net operating income in relation to its annual debt-service payments. Among securitized commercial mortgages, the average DSCR is approximately 2.14x, according to Morningstar. C-PACE lenders and aggregators typically require a minimum total DSCR in the 1.00x to 1.15x range. Although, in some cases, the DSCR has dipped below 1.00x, especially if total debt-to-value is low when operating expenses are higher than revenue. Factors possibly mitigating a lower DSCR, which include county support, property ownership affiliations within a network, liquidity account and equity position require case-by-case analysis. In addition, DSCR of the lien is more important than the DSCR of the overall debt.

Because C-PACE reporting requirements are not standardized, some issuers report pro forma DSCR and others report actual DSCR, and there are different approaches for the DSCR calculation. Some issuers include the energy-efficient savings or estimated rental increases resulting from improvements, both of which should increase the property's cash flow and DSCR. Morningstar prefers actual ratios to pro forma estimates, because they are less subject to interpretation, assuming stabilization of the property is not a factor. In some cases, we make adjustments if we believe the provided pro forma DSCRs were made with aggressive assumptions. Morningstar is working with industry participants to standardize residential PACE data-reporting requirements. Standardization across the C-PACE sector also would be beneficial.

Evaluating Divergent Leverage Metrics

The lien-to-value ratio is another leverage metric that Morningstar analyzes. 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. Aggregators may examine leverage ratios in several ways, including PACE lien to property market value or annual tax and assessment to property market value, but the combined mortgage loan and PACE assessment to property market value has been used most often, as it gives a more accurate account of total debt-to-value.

It can be more challenging to calculate the lien-to-value ratio for C-PACE levies, because the properties can run the gamut from hotels, farmlands, nursing homes, and gas stations to nonprofit buildings such as churches. Across residential PACE deals, we have seen lien-to-value ratios around 6.7% and combined PACE-lien-plus-mortgage-to-value ratios at around 62.7%. In C-PACE, lien-to-value ratios hover around 25.0%, not including mortgage debt. These ratios tend to be higher, and third-party due diligence can fluctuate because higher-valued properties may require a formal appraisal, while smaller properties may be assessed using comparative modeling techniques. As a result, appraisal values are less certain. Like DSCR, lien-to-value ratios are more difficult to calculate because of these more ambiguous appraisal values. In evaluating commercial PACE deals, Morningstar uses property values provided by the aggregator as a starting point.

Liquidity is a primary risk in commercial PACE-backed securitizations because of potential concentration of large obligors and less certainty about recovery time periods due to diverse property types. When borrowers default, cash flow to the deal could be disrupted. Liquidity risk is mainly associated with the timing and amount of recoveries. Morningstar uses DSCR, total debt-to-value, lien-to-value, and other factors as inputs in our credit model, or we use a qualitative assessment of historical performance when data is insufficient to rely on a model to estimate the probability of and percentage of borrowers defaulting on PACE obligations.

While we scrutinize total debt-to-value, the distribution of leverage offers insight into the financial health of the property. For example, we view a property with a 90% debt-to-value ratio that is composed of an 89% mortgage loan and a 1% PACE assessment more favorably than a property whose debt is composed of an 89% PACE obligation and a 1% mortgage because of higher subordination levels. It's important to note that there is the risk that a new PACE assessment may be added to a property, which would increase the total debt-to-value.

Liens Across Various Property Types

As mentioned, PACE programs are used with many property types, including office, nonprofit, retail, industrial, mixed use, hospitality, multifamily, agricultural, and healthcare. Within securitizations though, we have seen commercial assessments tied mostly to hotels, multifamily, industrial, and retail centers.

Compared with other securitizations, PACE transactions have been geographically concentrated. C-PACE programs exist in California, Connecticut, Texas, Minnesota, Ohio, Florida, Wisconsin, other states, and the District of Columbia, whereas California and Florida have the most R-PACE activity. Therefore, there may be less geographic concentration risk compared with R-PACE, but less homogeneous property types and greater obligor concentration risk for C-PACE. In addition, there may be instances of property concentration with only a single C-PACE asset, which would require a more qualitative assessment. This type of single C-PACE asset structure may be more suitable for mainstream properties, such as hotels and offices.

Government Oversight

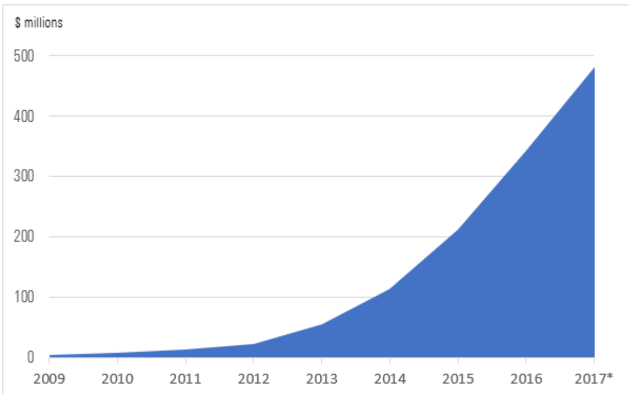
State and local governments typically enact PACE programs, with municipalities providing guidelines on policies, eligibility criteria, fee structure, and interest rates. Private companies, sometimes referred to as PACE aggregators because they are not always the originator of all the assessments, administer the programs. However, a recent legislative development at the federal level may change the landscape of the PACE industry. In April, Senator Tom Cotton of Arkansas introduced the Protecting Americans from Credit Entanglements Act of 2017, proposing that the Truth in Lending Act of 1968 be revised to include PACE obligations.

Although it appears the legislation would mostly affect residential programs, its passage would have a detrimental effect on commercial programs, because local governments would likely have to alter their collection procedures for assessments and, in some cases, might have to become registered mortgage lenders. Most industry participants expect that the bill will face an uphill battle, as the Truth in Lending Act applies to debt such as credit cards and mortgages, not tax liens or assessments. Separately, the industry has come under scrutiny of federal authorities, with investigations by the Federal Bureau of Investigation and the SEC. Renovate America, which no longer does business with one contractor being investigated by the FBI, stated the company, primarily known for its residential program, is fully cooperating with authorities.

Growing Market Size

C-PACE financing has grown to about $482 million as of Sept. 1, encompassing 1,097 commercial projects, according to PACENation. More than 2,500 municipalities have C-PACE programs. New York City recently enacted legislation authorizing a program to help property owners comply with a mandate to reduce greenhouse gas emissions.

Cumulative C-PACE Financing



*As of Sept. 1, 2017

Source: PACENation

Compared with residential programs, C-PACE is in its infancy, as R-PACE financing totaled about $3.67 billion and R-PACE securitizations totaled around $3.40 billion. A sliver of commercial assets was included in one of those securitizations, GoodGreen 2016-1, with commercial PACE levies representing approximately 4.8% of the pool's assets.

Key C-PACE Credit Metrics

As commercial PACE programs become more commonplace, the credit risk of securitizations backed by these assessments must be evaluated differently from their residential counterparts. Morningstar uses CMBS metrics such as DSCR, total debt-to-value, lien-to-value, and property type as a starting point in our C-PACE analysis. Investors should take note of the credit features that distinguish C-PACE from R-PACE, including lender's consent, less geographic concentration risk, less homogeneous property types, and greater obligor concentration risk.

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