Metropolitan Washington Council of Governments

PACE Financing Workgroup

Glossary of Terms

Property Assessed Clean Energy (PACE) Financing – a mechanism for financing energy efficiency and renewable energy upgrades to buildings repaid through a municipal assessment (usually a property tax bill) over a period of up to 20 years. PACE loans can provide 100% upfront financing, low interest rates, and transfer repayment obligations to a new owner upon sale, overcoming several challenges that have hindered adoption of energy efficiency and related projects in existing buildings.

CAPITAL MARKET TERMS

Security - a fungible, negotiable instrument representing financial value, usually falling into one of three categories: debt securities, equity securities, and derivative contracts. In most cases, the purpose of issuing a financial security is to generate new capital. This is accomplished by attracting investors due to the potential (or guarantee) for generating new capital in the form of interest.

- **Bond** – a debt security in which an investor loans money to an entity (typically corporate or governmental), which borrows the funds for a defined period of time at a variable or fixed interest rate.
- **Note** – a debt security that generally has a longer term than a bill, but a shorter term than a bond. Notes are similar to bonds in that they are sold at, above or below face (par) value, make regular interest payments and have a specified term until maturity.

Loan term – period over which a loan agreement is in force, and before or at the end of which the loan should either be repaid or renegotiated for another term. Generally, PACE loan terms cannot be longer than the useful life of the improvement or equipment.

Interest rate - the proportion of a loan that is charged as interest to the borrower, typically expressed as an annual percentage of the loan outstanding.

- **Fixed interest rate** – an interest rate that remains fixed for either the entire or part of the loan term. Attractive to borrowers who feel that the interest rates will rise.
- **Variable interest rate** – a rate tied to an underlying benchmark interest rate or index, and which change if the index changes. Variable interest rates are often based on the prime rate of a country, the London Interbank Offered Rate (LIBOR) Index or U.S. Treasury bond yields. Variable interest rates often charge the borrower a spread above the index depending on a number of factors, such as credit worthiness.
- **Coupon** – interest rate stated on a bond when issued, typically paid semiannually.

Basis point (BPS) – common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001). Therefore a 1% change = 100 basis points.

Securitization – creation of a financial instrument by combining and repackaging other financial assets into smaller pieces that are marketed to investors. For example, by pooling a number of PACE loans, dividing the pool into "buckets" based on risk profile, and selling smaller pieces to investors. Securitization creates liquidity by enabling smaller investors to purchase shares in a larger asset pool, but requires that project design and/or evaluation is standardized.

Liquidity – 1) the degree to which an asset or security can be bought or sold in the market without affecting its price. Liquidity is characterized by a high level of trading activity, and assets that can be easily bought or sold are known as liquid assets. (This is the definition most commonly used with reference to PACE). 2) The ability to convert an asset to cash quickly.

Real Estate Investment Trust (REIT) – a company that owns or finances income-producing real estate and sells shares like a stock on the major exchanges. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.

- **Equity REIT:** invests in and owns properties, and is thus responsible for the equity or value of their real estate assets. Revenues primarily come from properties' rents.
- **Mortgage REIT:** loan real estate owners money for mortgages, or purchase existing mortgages or mortgage-backed securities. Revenues primarily come from interest earned on mortgage loans.
- **Hybrid REIT:** combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages.

PROPERTY TAX/ASSESSMENT TERMS

Special assessment – a unique charge that government units can assess against real estate parcels for certain public projects. This charge is levied in a specific geographic area known as a special assessment district (SAD). In the case of a PACE assessment, the SAD is one property.

Property tax – taxes on real estate (land and improvements, e.g. buildings) levied at the municipal level as a percentage of the appraised or assessed property value. Rates vary from 0% - 4% of the property value across states.

Lien – the legal right of a creditor to sell the collateral property of a debtor who fails to meet loan contract obligations. The lien holder is the bank that grants the loan, and the lien is released when the loan is paid in full. If the debtor never pays, the property can be auctioned off to pay the lien holder.

Delinquency – when a borrower has failed to make loan payments as required by contract, or tax / special assessment payments as required by the taxing authority.

Tax sale – a sale (usually an auction) of properties by a taxing authority to recover delinquent taxes.

- Tax deed sale – sale of the property itself, involving transfer of title through a form of limited warranty or quitclaim deed. The minimum bid is usually the amount of delinquent taxes, plus interest and costs associated with the sale. If the property is not purchased, title may revert to the government entity.
- Tax lien sale – sale of a lien on the property, generally for the amount of delinquent taxes, plus interest and costs associated with the sale. The tax sale purchaser (holder of the certificate of sale) must wait a specified period of time, referred to as the "redemption period", during which time the lien (plus interest and any other fees) may be repaid, before the tax sale purchaser can begin foreclosure proceedings.
    - The District of Columbia and Maryland use the tax lien sale process. Virginia uses a tax deed sale. See “” for more information.

Foreclosure – the process of taking possession of a property as a result of the borrower's failure to keep up payments. Foreclosure is typically a last resort for lenders, because it is an expensive procedure and lenders often lose money in foreclosure proceedings.

- Judicial foreclosure – lender must file a civil lawsuit against the borrower and foreclosure process is handled by the court. This process helps to protect equity the debtor may have in the property. Judicial foreclosures can be further divided into two types:
    - Foreclosure by sale – requires the home to be auctioned to the highest bidder with the lender placing the first bid. (Also called a sheriff sale).
    - Strict foreclosure – court sets a date by which the owner must pay the mortgage, and awards ownership to the lender with no auction taking place if the owner fails to pay.
- Non-judicial foreclosure – lender is allowed to advertise and sell the property at a public auction, without court involvement, by following a process specified by the state. A key requirement is that the borrower agreed to the process when they took the loan via a power of sale clause. 28 states have non-judicial foreclosure, including the District of Columbia, Maryland and Virginia. (Also called statutory foreclosure or foreclosure by power of sale.)
    - Power of Sale – language added to a mortgage or deed of trust that pre-authorizes the sale of property to pay off the balance on a loan in the event of a default.

Deficiency judgment – monetary judgment against a borrower whose mortgage foreclosure sale did not produce sufficient funds to pay the underlying loan in full.

Lender consent – PACE liens to secure the loan are at parity with general property taxes and, therefore, senior to mortgage liens. PACE programs generally require lender consent to ensure that property owners will not be in violation of existing mortgage covenants if a PACE lien in placed on the property.

COMMERCIAL REAL ESTATE – CAPITAL BUDGETING TERMS

Appraised value – evaluation of a property's value performed by a professional appraiser during the mortgage origination process. The appraiser is usually chosen by the lender, but the appraisal is paid for by the borrower.

Assessed value – value assigned to a property by a municipality for purposes of calculating applicable taxes. Assessed value takes into consideration comparable property sales and inspections, and in general tends to be lower than the appraised value of a property.

Building Classes:

- Class A – Most prestigious buildings competing for premier office users with rents above average for the area. Buildings have high quality standard finishes, state of the art systems, exceptional accessibility and a definite market presence.
- Class B – Buildings competing for a wide range of users with rents in the average range for the area. Building finishes are fair to good for the area. Building finishes are fair to good for the area and systems are adequate, but the building does not compete with Class A at the same price.
- Class C – Buildings competing for tenants requiring functional space at rents below the average for the area.

Net operating income – annual income generated by an income-producing property after taking into account all income collected from operations, and deducting all expenses incurred from operations. NOI can either be based on historical financial statement data, or based on forward-looking estimates for future years (also known as a proforma). Expenses that are specific to the owner/investor (e.g. income taxes) or not an actual in- or out-flow of cash (e.g. depreciation) are not included in NOI. The calculation is at right. (Source: https://www.propertymetrics.com/blog/2014/03/05/net-operating-income/)

Net Operating Income Formula

	Potential Rental Income
-	Vacancy and Credit Losses
	Effective Rental Income
+	Other Income
	Gross Operating Income
-	Operating Expenses
	Net Operating Income

Potential Rental Income (PRI) – income that could be generated if the property were 100% leased.

Vacancy and Credit Losses – income lost due to vacant units or unpaid leases. Vacancy and credit factors can be calculated based on current lease expirations and/or market conditions.

Other Income – income from the property aside from rents, e.g. parking, laundry, vending, antenna fees.

Leasing Commissions – fees paid to real estate agents/brokers involved in leasing the space.

Operating Expenses - all cash expenditures required to operate the property and command market rents, such as taxes, insurance, management fees, maintenance, and utilities.

Common Area Maintenance (CAMs) – fees for any commonly shared area or service, e.g. sewer, water, trash collection, janitorial services, property management fees, landscaping, parking, etc.

Tenant Improvements – construction within a tenant's usable space to make the space viable for the tenant's specific use.

Replacement Reserve – amount budgeted for expected recurring replacements, such as replacing appliances, flooring or the roof at the end of its useful life.

Capital Expense Budget – one-time amount budgeted when acquiring a property, used to make repairs or upgrades that cannot be covered by the typical replacement reserve.

Debt Service – amount required to cover the repayment of interest and principal on a debt, usually calculated on a yearly basis.

Depreciation – 1) a method of allocating the cost of a tangible long-term asset over its useful life, usually for tax and accounting purposes. (This is the definition most commonly used in reference to PACE). 2. A decrease in an asset's value caused by unfavorable market conditions.

COMMERCIAL REAL ESTATE – LEASING TERMS

Gross Lease – all-inclusive lease; owner pays all operating expenses related to the property.

- Landlord cannot pass through PACE payments to tenant(s) without re-negotiating lease(s), but landlord receives all operating cost savings.

Net Lease – tenant is required to pay for all or some of three "nets" – property taxes, insurance, and common area maintenance (CAMs) – in addition to base rent, utilities, and janitorial services. Usually each tenant is charged on a pro-rata basis, e.g. based on the proportion of total building space leased by the tenant.

- Landlord is able to pass through PACE payments to tenants (in their share of the property tax bill).

Single Net Lease (N Lease) – tenant pays base rent plus a share of the building's property taxes.

Double Net Lease (NN Lease) – tenant pays base rent plus a share of property taxes and property insurance.

Triple Net Lease (NNN Lease) – tenant pays base rent plus a share of three "nets"- property taxes, insurance, and common area maintenance. NNN leases are the most popular type of net lease for commercial freestanding buildings and retail space.

- Landlord is able to pass through PACE payments to tenants (in their share of the property tax bill), and tenants receive a share of operating cost savings.

Absolute Triple Net Lease – uncommon, more rigid and binding than the NNN lease. Tenants carry every imaginable real estate risk (also called "hell-or-high-water lease").

Modified Gross Lease – rent is requested in one lump sum, which can include any or all of the "nets" based on negotiation between tenant and landlord. Utilities and janitorial services are typically excluded from the rent.

UNDERWRITING TERMS

Underwriting standards – guidelines established to ensure that loans issued are safe, secure and maintained.

- **Financial underwriting standards** – guidelines for how much debt may be issued to an entity, the terms of the loans, how much debt a specific company is willing to issue, and what interest rates will be charged.
- **Technical underwriting standards –** guidelines for determining if a project is a good investment, calculating the expected results and/or savings, and evaluating performance risk.

Leverage – 1) the use of various financial instruments or borrowed capital to increase the potential return of an investment. Leverage is most commonly used in real estate transactions through the use of mortgages to purchase a property. 2) The amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged. (This is the definition most used with reference to underwriting.)

Savings-to-investment ratio (SIR) – overall project savings / overall project cost. A requirement that SIR be greater than or equal to 1 means that savings must be at least equal to cost. The final SIR value is usually a weighted average based on the relative costs and lifetimes of each piece of equipment.

Debt service coverage ratio (DSCR) – net operating income / total debt service. Net operating income is yearly gross revenue minus operating expenses. A DSCR of 1 means that there is just enough income to over debt payments, so PACE programs may require that DSCR be greater than or equal to 1.

- This metric is important because it describes the feasibility of a property to repay debt and is one measure of the risk of delinquency.

Loan-to-value (LTV) – PACE loan value / property value. This ratio can also apply to (PACE + other debt) / property value to show how leveraged the property is overall.

- This metric is often used to set a maximum loan size (e.g. 80% of property value), and is important because too large of a loan relative to the property value makes the notes less attractive to capital providers, bond investors and potential future buyers. Virginia uses **voluntary special assessment to assessed value ratio**, which specifies assessed rather than appraised value.

Energy audit (or assessment) – an assessment of building energy performance. An energy audit will evaluate how building energy systems are currently performing, how performance can be improved, and the costs and benefits of those improvements in financial and non-financial terms. Energy audits vary in depth, often designated ASHRAE Level 1, 2 or 3, depending on property owner needs.

AFFORDABLE HOUSING TERMS

Area Median Income (AMI) – the median income in a specified area. HUD calculates AMI annually for metropolitan and non-metropolitan areas, and uses this to determine eligibility for various housing programs. The median divides the income distribution in two: half falling below and half falling above.

Low Income – a household whose income does not exceed 80 percent of the AMI, with adjustments for smaller or larger families.

Fair Market Rents (FMR) – the rent amount that a property would command if it were open for leasing. FMR is calculated and used by HUD to determine how much affordable housing program administrators will subsidize housing units.

Committed Affordable Units (CAFs) – guaranteed by agreement with the federal, state, or County Government, or through mechanisms such as tax-exempt financing, to remain affordable to low and moderate income households for a specified period of time; generally 30 to 60 years. Rents in most cases are affordable to households earning 60% or less of AMI, although some CAFs have rents affordable to households earning up to 80% of AMI.

Market-Rate Affordable Units (MARKs) – owned by the private market and tend to have higher monthly rents. Affordability fluctuates with factors impacting housing market conditions, including employment trends, economic stability and basic supply and demand. Rent prices are at 50-60% and 60-80% of AMI.

Low Income Housing Tax Credit (LIHTC) – the federal government's primary program for encouraging private investment in development of affordable rental housing. LIHTC allows investors to claim a tax credit on federal income tax returns, calculated as a percentage of costs incurred developing the affordable housing property. The credit is taken over 10 years, but the project must satisfy low-income housing compliance rules for 15 years compliance.

Housing Choice Voucher Program (formerly Section 8) – a federally administered program through which HUD provides rental housing assistance to private landlords on behalf of approximately 3.1 million US low-income households.

- HUD pays the power bills (heat, hot water, electricity) either directly or via a utility allowance, which limits the incentive for owners to lower energy costs (beyond those of common areas). However, HUD has piloted a "benefit share" program whereby building owners and HUD share the benefits of lowering energy costs.

Sources

Definitions were compiled from multiple pages within the following sources:

- 42 Floors: http://42floors.com/edu
- Bigger Pockets: http://www.biggerpockets.com
- Buildings: Smarter Facility Management: http://www.buildings.com
- Foreclosure Law: http://www.foreclosurelaw.org
- Investopedia: http://www.investopedia.com
- Nolo: http://www.nolo.com/legal-encyclopedia
- Office of the Comptroller of the Currency http://www.occ.gov

- PACE*Now*: http://www.pacenow.org
- Property Metrics: http://www.propertymetrics.com
- U.S. Department of Housing and Urban Development: http://portal.hud.gov
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