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**Hospitality Law**

# Beyond the Twice-Used Towel: Using PACE Financing to "Green" Hotels

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It is no secret in the hospitality industry that a tremendous amount of energy, water and other resources is required to serve guests. However, the industry as a whole has taken steps to become more energy and resource efficient within the last ten years. We are all familiar with the placards found in most hotel rooms today, asking guests to indicate whether they want their sheets and towels changed on a daily basis or whether they will use them again. While hotels historically washed sheets and towels every night even when there was no turnover in the room. Now, many hotels will leave sheets and towels unchanged as the default, requiring guests to call the front desk if they want more frequent service. Notwithstanding the changes that hotels have implemented to become more efficient in their use of energy and other resources, hotels still are huge consumers of energy. This is particularly true of hotels with around-the-clock amenities, such as multiple food and beverage venues, a pool, fitness center, conference center and ballroom.

For these reasons, hotel owners and operators have focused on implementing building improvements that increase energy efficiency (e.g., energy efficient windows, automated lighting and climate control in guest rooms that only turn on when an occupant is in the room), provide renewable energy sources (e.g., solar panels), and conserve water (e.g., upgraded plumbing including low flow fixtures) since such improvements generate significant cost savings. Older hotel facilities can be especially costly to operate from an energy use/energy efficiency perspective, because they generally lack newer technology designed with sustainability in mind.

Despite the potential benefits the hospitality industry may enjoy with the implementation of sustainability improvements, historically, there have been significant obstacles to the development of these energy efficiency and water conservation measures. The most obvious obstacle is simply the significant up-front capital investment required from a hotel owner. Additionally, the hotel owner may have concerns regarding its ability to recoup its investment within an acceptable time frame. For hotel owners facing these concerns, Property Assessed Clean Energy (PACE) financing is becoming an increasingly popular option to finance the cost of sustainable improvements. Since its inception in 2008, PACE financing has grown as a method of financing sustainability improvements in commercial properties, and some consider hotels to be the ideal candidates to take advantage of this public-private financing vehicle.

**What is PACE Financing?**

PACE financing is specifically designed to incentivize property owners to make energy efficiency, renewable energy and water conservation improvements to their properties, for the purpose of lowering emissions and utility bills, thereby providing an economic stimulus to the local economy. PACE financing is intended to provide up to 100 percent of the cost of these improvements (which can be as much as 20 percent of the value of the property), and is paid back over a period of up to 30 years through a voluntary assessment on the property. Depending on the PACE program established by the local government pursuant to state enabling legislation, PACE financing can be used for window and door replacements, HVAC systems, lighting upgrades, cool roofs, water conservation measures, seismic improvements (in California) and wind-hardening improvements (in Florida). As of this writing, PACE has been used almost exclusively for retrofits to existing buildings, but it can also be used for new construction, and there is an expectation that the market for PACE for new construction will increase over the coming years.

**What are the Potential Benefits?**

- Reduction in Utility Costs - The most obvious benefit of PACE financing, in addition to the availability of up-front costs, is the reduction in utility bills that should result from the improvements. With a significant overhaul of the HVAC system, lighting, roofing, insulation etc., a hotel owner can expect to see a significant reduction in its energy costs. It should be noted that part of the application process for PACE financing involves an analysis of the economics of the individual project, and if the project will not result in sufficient reductions, the financing may not be approved.
- Sustainability Branding - Even more so than other commercial property types, hotels often incorporate a sustainability mission into their branding, which could potentially make a “green” hotel a more desirable destination for guests that are increasingly concerned about the condition of our environment. As such, a hotel which can point to concrete energy efficiency features can

potentially command higher room rates, resulting in increased property value. Moreover, many hotels which have been renovated with a PACE component are able to include an additional room fee to offset the annual tax assessment levied on the property.

- Break-Even Point - A property owner considering paying for capital improvements out of its own pocket, or taking out a standard commercial loan (likely with a term of ten years or less) to finance such improvements, often concludes that it will take so long to break even on the investment, that the improvements cannot be implemented part of the property owner's business plan. PACE can alleviate this problem because of the potentially longer repayment term, which can be up to thirty years (the length of the term depends on the useful life of the specific improvements made) and borne by successor owners of the property (see "Assumability" herein). This longer amortization period can, depending on project particulars, permit the property owner to break-even on the investment more quickly than it would with conventional financing.

- Assumability - Most commercial property loans are not transferrable, as they include restrictions on transfers of the property, and if a prohibited transfer occurs, the lender has the right to call the loan. With PACE, the underwriting focuses on the property itself rather than on the creditworthiness of the property owner, and if a sale of the property occurs, the lien can remain on the property and the associated repayment obligation transferred to the new owner. This assumability provides flexibility to sellers and purchasers of property financed with this vehicle.

- Replaces Equity at Competitive Rates - Assuming that a property is already encumbered by a mortgage at a 60 percent loan-to-value ratio, a property owner is likely to have trouble taking out additional debt for the construction of energy improvements. Typically, such an owner would have to turn to equity or mezzanine financing to secure additional capital. With PACE, rather than obtaining a mezzanine loan at a rate in the 13 percent range, a property owner is often able to access another 10 to 20 percent of the property's value, effectively allowing PACE to take the place of equity in the capital stack, generally at a much lower rate.

- Potential for Off-Balance Sheet Treatment - PACE financing generally cannot be accelerated, and because of how it is repaid, the assessment is similar to a property tax. As a result, some property owners are accounting for PACE financing off balance sheet, potentially keeping total debt-to-equity ratios low, and leaving sponsor equity available to invest in other projects. Note, however, that accounting guidelines have not confirmed this approach and the author does not recommend this approach, so property owners should consult with their accountants to determine the appropriate treatment of PACE financing.

**How Does PACE Financing Work?**

- Eligibility - In order for a project to be eligible for PACE financing, the state where the property is located must have adopted enabling legislation, and a local government must have formed a PACE district with its own PACE "program." Each program specifies the types of eligible improvements, the source of capital and the mechanics of the approval, underwriting and funding processes. Currently there are 32 states with enabling legislation, of which about 17 (including California, Colorado, Texas, Ohio, Florida and New York) have active programs and funded projects.

- Repayment - PACE financing is secured by an assessment lien on the property. This lien is senior to the lien of any mortgage, and the local government includes the payments as a line item on the property tax bill. Thanks to the senior position of the PACE lien, together with the secure repayment mechanism serviced by the local government, PACE financing is typically available at a significantly lower cost than equity or mezzanine financing.

Mortgage Lender Consent - Assuming PACE is available in a given location, the primary obstacle to the use of this financing mechanism is typically that consent of the existing (or prospective) mortgage lender must be obtained. The lender must analyze the risk of the senior lien and the additional property tax-like expense against the potentially reduced operating expenses and increased value of the collateral to determine if the anticipated economic benefits justify the downsides.

**Examples of Hospitality Projects with a PACE Component**

Although the use of PACE to "green" the hospitality industry has not yet fully taken off, there are a handful of examples of hotel renovation projects which have included a PACE-financed energy efficiency component. For example, it was recently reported by Los Angeles County PACE that the Hilton Los Angeles/Universal City was renovated in 2014 with $7 million of PACE financing*(1)*, which funded the payment of, among other things, energy efficiency glass installation and LED lighting (expected to reduce energy use by 50 percent), low-flow shower fixtures, upgraded elevators, HVAC upgrades, and electric vehicle charging stations. Additionally, Los Angeles County PACE published a case study highlighting the historic Constance Hotel in Pasadena, California, built in 1926, which was renovated with PACE in 2014. The renovation of the Constance Hotel involved $6.8 million of PACE financing (about 10 percent of the overall project cost), and the funds from the PACE financing were used to pay for the costs of new heating and air-conditioning equipment, LED lighting, elevator motors and controls, a water system overhaul, and insulation, resulting in reduced electricity usage of approximately 200,000 kWh and reduced water consumption of approximately 3.2 million gallons per year.

With each additional successful PACE-financed hotel project, the use of PACE financing for sustainable hospitality should continue to grow. And with sustainability becoming more and more important to prospective environmentally-conscious guests, the increased use of PACE could benefit both the environment and the hospitality industry as a whole.

*References:*

*(1) http://pace.lacounty.gov/pdf/Hilton_Case_Study.pdf*

*Anne Alexander joined national real estate law firm, Pircher, Nichols and Meeks, in 2012 and is Of Counsel in the firm's real estate department. Her practice covers a wide spectrum of real estate, finance and land use issues, including representation of banks, CMBS lenders and a variety of other institutional lenders in connection with mortgage and mezzanine financing of office buildings, hotels, shopping centers, healthcare facilities, multi-family apartment projects and industrial properties throughout the United States. Among the highlights of her professional career include the representation of lender in connection with mezzanine financing for pre-development of boutique hotel in West Hollywood, California, and the representation of preferred equity holder in connection with redemption of equity interest and replacement mezzanine loan on an upscale office building in Santa Monica, California. Ms. Alexander can be contacted at 310-201-8927 or [aalexander@pircher.com](mailto:aalexander@pircher.com)*