

Fully Bankable Deep Commercial Retrofits

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Market Barriers

- Noise around standards and practices
- Fluctuating energy markets
- (Mental) reliance upon guarantees, subsidies, tax incentives
- Corporate motivation – opportunity vs. risk
- Lender motivation - highest and best use of time
- Impatience – “We need to close in 3 weeks”
- Split incentive issues – green leases, renegotiated rents
- Paradigm Shift – payback as inferred cap rate
- $1 / .08 = 12.5$ OR $8\% \text{ cap rate} = 12.5 \text{ year payback}$
- *Any ECM resulting in better than 12.5 year payback is accretive to an 8% cap rate deal*

Product Type	Cap Rate	Maximum Acceptable Payback Period (1 / cap rate)
Apartments	5.80%	17.2
CBD Office	6.84%	14.6
Malls	7.23%	13.8
Suburban Office	7.43%	13.5
Warehouse	7.48%	13.4
Flex / R&D	8.71%	11.5

Financing Scenario

- Owner is refinancing a 125K SF office building
- Total baseline loan request is just over \$13MM
- Owner wants to implement a retrofit strategy
- Property commands 6.84% cap rate in the market
- Therefore, lender requires ECM returns which are accretive ($1 / .0684 = 14.6$ year simple payback or less)
- Consideration is also given to cash flow and debt service coverage levels
- Energy Audit (BEPA standard) ordered by the Bank indicates a total *estimated* project cost of \$1MM, resulting in 50% *estimated* utility savings
- Owner engages contractor to complete work under a Guaranteed Maximum Price (GMP contract)
- Payback of ECMs is *estimated* at 8 years – lender approves

Office Retrofit

	Success		Failure
	Baseline	50% Utilities Savings	No Savings
Revenue (gross)	\$2,500,000	\$2,500,000	\$2,500,000
Utilities	\$250,000	\$125,000	\$250,000
Other Expenses	\$750,000	\$750,000	\$750,000
Net Operating Income	\$1,500,000	\$1,625,000	\$1,500,000
Loan	\$13,157,895	\$14,157,895	\$14,157,895
Cap Rate	6.84%	6.84%	6.84%
Value	\$21,929,825	\$23,757,310	\$21,929,825
LTV	60.0%	59.6%	64.6%
Debt Service Coverage - 7%, 30 Yr.	1.43x	1.44x	1.33x
Refinanceable	Yes	Yes	Yes
Client Equity	\$8,771,930	\$9,599,415	\$7,771,930
Equity Increase		\$827,485	
% Increase		9.4%	

* *Potential split incentives not analyzed*

Result – Best Case

- Retrofit adds value to the project
- Increase in owner's equity
- Lower LTV
- Higher debt service coverage
- Improved value for refinance or sale

Result – Worst Case

- Retrofit does not add value
- Decrease in owner's equity
- Higher LTV
- Lower debt service coverage
- **Still eligible for refinance or sale to make loan whole!**

Why Bank Debt

- If a 60% LTV loan turns out to be 65%, the bank is still OK
- First mortgage eliminates ambiguity regarding cash flows, collateral, repayment quality – simpler is better
- Reasonable leverage is critical
- Entrepreneur takes the risk AND reward
- Interest rates comparatively low vs. other market options
- Remaining workflow issues – *Underwriting Process*

Underwriting Process

- Entrepreneur conception prior to refinance or acquisition
- Bank underwriting, initial feasibility analysis
- 3rd party verification (bank-ordered energy audit)
- Report shows projected cost and savings quantified
- Apply to appraisal - * *adds a few weeks to process OR use proxy valuation internally*
- Value creation = as-improved stabilized value – baseline stabilized value
- “Book end” risk with GMP contract
- Fund within 1st mortgage
- Track improvements the same as a construction loan
- Liquidity event (refinance or sale) pays back loan, ideally based upon a higher valuation
- **The loan term does not need to match the payback period**

5 Key Points

1. **Cash Flow Is King:** banks finance cash flow – a signed lease makes financing deep retrofits and green building “easy”
2. **Carrots & Sticks:** banks need both in this space
3. **Silver Bullets:** increased worker productivity and tenant demand far outweigh utility cost reductions
4. **Participation Not Optional:** require energy audit at refinance or sale, under one required standard
5. **Green Leases & Appraisals:** process of leasing and appraising must mature to allow for shared savings in the leasing process and accepted valuation principles in the appraisal process

Thank You

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