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Funding Sustainability: Beyond the Spreadsheet with Stephen Arrivello and Brad Molotsky

I'm Helena Carmel, and welcome to another episode of *Beyond the Spreadsheet*.

We've got a team of all-stars on the pod today. Regular listeners already know Bill Harbeson, Capstan's Director of Energy Incentives.

I'd like to introduce you to Stephen Arrivello of PACE Equity. When it comes to real estate, Steve's done it all - development, financing, brokerage – and he's done it all right here in Philadelphia, his hometown.

Our third musketeer today is Brad Molotsky, a partner at Duane Morris who practices real estate law. Brad also brings a wealth of experience to the pod, with special interests in Opportunity Zones, commercial leasing, and acquisitions.

Now what brings Bill, Steve, and Brad together today? It's their shared passion for energy-efficient development. In their day-to-day, these gentlemen *make sustainable construction deals happen* by facilitating the necessary funding. Steve is an expert on C-PACE and front-end funding. Bill is an expert on the tax incentives employed on the back end. And Brad – he's an expert in everything, so he'll function as our moderator today.

With no further ado Brad – it's your show. Take it away.

Brad A. Molotsky (01:25.645)

Thanks, Helena. And Steve and Bill, thanks for joining and participating in this fun that is the discussion of C-PACE and 179D. I can't think of a more scintillating topic on a Tuesday afternoon [Laughter]. So without further ado, we're going to talk about how one funds sustainability. C-PACE feels like a great place to start, a great place to leap off and hopefully land on our feet. Steve, kick us off. Talk to us a little bit about C-PACE. What is it? Where did it come from? Give us some basic building blocks.

Stephen Arrivello (02:16.033)

Excellent. Yeah. Thank you, Brad, Bill and Helena. It's nice to be here. And right. If we're not going to put our audience to sleep on a Tuesday afternoon with C-PACE and all the Capstan stuff, I don't know what will, but let me try to keep people awake and alive here.

C-PACE very simply is a financing source that can be layered into any project really. It'll fund just about any asset class. It's long-term fixed rate non-recourse financing that can really be accretive to a lot of deals. It can fund residential, can fund commercial, industrial, just about any asset class that you can think of that's privately owned real estate.

Brad A. Molotsky (03:04.211)

Okay, good start. Let me probe a little bit more though. Long term, what are we talking? How long?

Stephen Arrivello (03:11.992)

Well, we can go 30 years in most asset classes. And let me step back and talk a little bit about how C-PACE does fund. We can fund new construction projects, we can fund renovations, we can fund standalone energy projects. So that's a good place to start.

And in terms of how long we can finance, our term is generally tied to the weighted average usable life of what it is we're financing. Let me give an example.

You want to put solar on a shopping center, a solar array. We can fund that 100 % hard and soft costs for up to 30 years. If you're going to alternatively replace your HVAC and windows, we'll take a weighted average usable life. That'll be closer to 20 or 22 years just out of the gate. On new construction, we fund a chunk of the costs and that will generally be on a 30-year amortization.

Brad A. Molotsky (04:09.577)

Okay, so term you're talking somewhere between 20-25 years and 30 years depending on the equipment. You said fixed rate. What is it fixed off of?

Stephen Arrivello (04:19.492)

Well generally C-PACE lenders will generally fix off a 10-year treasury yield, and based on credit and other considerations that spread will be anywhere from 350 to 450 basis points. So today's world we're in this sort of high sevens low eights fixed for whatever the term is.

Brad A. Molotsky (04:39.539)

Okay, high sevens, low eights. How's that compare with kind of conventional construction financing that's out there that's SOFR-based?

Stephen Arrivello (04:46.573)

Yeah, great question. So we're going to be a little bit more expensive than your traditional banks. We'll certainly be less expensive than a bridge lender and certainly less than equity and any sort of MES rate. So we have a sweet spot where we can fit into the capital stack and really be accretive.

Brad A. Molotsky (05:05.484)

And to your point earlier, the term is much longer than typical bank financing, which would be five or seven years. You said non-recourse of course. What about guarantees? Does the principal or the borrower have to guarantee the loan?

Stephen Arrivello (05:23.075)

Only to the extent there's a construction portion, we do require completion guarantee. So if your client's got a GNP, if they're bonded, that's all taken care of. But you're essentially right, this is non-recourse financing.

Brad A. Molotsky (05:35.687)

Okay, so completion guarantee, but no kind of personal guarantee, which I think most borrowers would like. How does it work, Steve, with conventional financing? Because it feels like what we're saying is it's non-recourse, it's fixed rates, 30 years, but you're not taking a mortgage, you're not taking security in the property. So how's that work with my conventional construction loan?

Stephen Arrivello (05:56.355)

Yeah, that's a great question and that's where if there is any sort of downside to C-PACE potentially this is where it is. Brad you alluded to the fact of what C-PACE actually is -- it takes the form of an assessment, which means it's recorded on the tax rolls. It's not a mortgage or any other type of loon of lien. It's a specific assessment, and so as a result, it sits above the lenders in the capital stack.

Now, before anybody has a heart attack, it's important to realize two things about C-PACE's preference above a senior lender. First is that C-PACE is senior to a senior lender only one year at a time. So in that regard, it functions just like taxes.

Secondly, if there's a default in C-PACE, it can't be accelerated. In other words, let's say you owe a $10 million C-PACE over 30 years and your current portion is half a million dollars. If you don't pay the half a million dollars, the lender -- myself or whomever it is -- comes after the borrower for the half a million dollars. The rest of the balance just travels with the property and is due year by year. So it can't be accelerated. And that gives senior lenders a lot of comfort in terms of consenting to C-PACE.

Brad A. Molotsky (07:19.505)

Okay, so senior lenders were a little bit nervous back in the day when C-PACE got started, but they are starting to get more used to it. Some don't get it, but many do. I've heard that 350 or so medium and large lenders around the country -- names that we would all know -- have used it. And so it's a question of or a matter of getting to the right person in the organization to say, *Hey, you have done this before. You may not have done it in my location, but you've done it before*. Is that a fair assessment?

Stephen Arrivello (07:50.858)

Exactly right. And further to that, it generally tends to be relationship driven. So if I've got a borrower at say a local or regional bank, and we will often have the conversation, even if the bank hasn't consented before, if it's a strong relationship with a borrower, they're much more willing to consider it and then consent from a relationship standpoint. So it's coming, it's coming more on board from both those aspects.

Brad A. Molotsky (08:15.908)

And do you find that lenders are taking C-PACE and taking conventional financing and adding them together? We would typically get 65% on a kind of construction loan and the C-PACE, you said, is between 20 and 30%. Are we saying that we're at 95% or do people look at it differently?

Stephen Arrivello (08:35.046)

Yeah, close to what you're saying, Brad. I mean, look, we're not going to get to 95% in today's market. But to the extent that there's NOI that can support all the debt -- stabilized NOI that is -- then yes, then fundamentally, it's a good deal. And fundamentally, lenders are generally willing to look at additional C-PACE on top of their leverage to allow a project to get started, to get to completion and sort of allow the developer to keep more equity in their own pocket.

Brad A. Molotsky (09:03.778)

Got it. I've been involved in a couple of transactions where the senior lender looked at C-PACE and said, *Look, that's fine. You can borrow that. But if you're borrowing 30% there, we're not going to give you 65%*. We want to make sure that A, we can get paid and B, the C-PACE lender can get paid because we don't want any risk that somebody defaults. So, you know, they size it accordingly. So you end up with kind of 65% all in or 70%.

But I hear you, it's all based on NOI and coverage.

Stephen Arrivello (09:33.186)

No. Yes. And you're right, as the lender, it's very frustrating when, as a C-PACE lender, it's very frustrating when the senior lender comes back and has that approach. But hey, listen, it's the golden rule, right? They've got the gold and they make the rules. I'm sure.

Brad A. Molotsky (09:50.985)

Yes, I've never heard that before, yes. [Chuckles]

All so let's talk states. So C-PACE, it's not a federal program, it's kind of done state by state. Round numbers, how many states have approved it? And when we're talking about states, do you find that the C-PACE legislation is all the same or is it slightly different depending on where you go?

Stephen Arrivello (10:11.48)

Yeah, here's the complicating factor and to your point it there’s really nothing *governing* C-PACE other than the adoption at the state level. So you referred to enabling legislation. Each state has to approve the enabling legislation which allows C-PACE lenders like myself to basically file our positions on the tax rolls. Once that enabling legislation is approved for the state, then there's an administrator in each jurisdiction and they handle the paperwork to make sure that these loans comply with the local statutes.

Now, those statutes, state by state, they are all slightly different. I'll give you an example. When Pennsylvania first approved their program about six years ago, they specifically excluded multifamily for some odd reason, which we won't go into here.

But then they changed that legislation and now multifamily is probably the most funded asset class in Pennsylvania. And another example is, New Jersey, which just approved their program last year and they're going through adoption now, they require that all projects are subject to prevailing wage. So there are, you know, differences around the country.

There's about 38 states with enabling legislation, about 33 or 34 with active programs. And to date, we've seen close to $10 billion in C-PACE has been funded cumulatively.

Brad A. Molotsky (11:49.841)

The vast majority of states have C-PACE, but not every one. And there's some states that don't, so you gotta be a little bit careful there, but most of the states where there's an aggregation property have C-PACE legislation.

Talk to us a little bit about what one can use the C-PACE funds for. Are there specific types of projects that fit within the four corners of C-PACE and stuff that doesn't? Tell me where you tend to loan proceeds to.

Stephen Arrivello (12:14.964)

Yeah, for sure, for sure. When C-PACE started about 12 years ago in California, it was intended to fund only standalone energy projects, meaning only improvements to buildings that increase their efficiency. So think about new windows in an old leaky office building, new HVAC, new roofing with insulation, that kind of thing. That's how C-PACE got started.

And so it's morphed into a way to fund new construction. What it funds is sort of regulated -- or at least identified -- by each state's program. And it's generally what you would think about -- it's all the energy efficiency measures such as the roof, the windows, insulation, electric and plumbing. And it's come to be where just new construction now can identify about 30% of a new construction's ground-up costs, the hard costs, that will be funded by C-PACE. We roll it all together into a single amount, and then we fund just like a construction lender would, in conjunction with a senior lender if there is one. So we fund through the construction period. We maintain an interest reserve so that we get the client to stabilization, and then once they're stabilized, they start paying the C-PACE.

Brad A. Molotsky (13:41.095)

OK, let's talk timing and then retroactivity, and then we'll jump over to 179D. How long does it take to kind of close a C-PACE loan soup to nuts? What are you thinking realistically?

Stephen Arrivello (13:51.839)

It doesn't really take any longer than a traditional senior loan will. There's one specific extra step that needs to be completed for each C-PACE financing, and that's called an energy audit. Most engineering firms do this very efficiently. My firm happens to do this in-house, so it is an extra step, a small additional charge, but we can generally close within 45 to 60 days, just similar to a senior lender.

Brad A. Molotsky (14:18.743)

Okay, that's good. We talked about kind of the projects that it applied to, so kind of energy efficiency within the built building, or the building to be retrofitted.

Stephen Arrivello (14:35.871)

There's a piece that we didn't talk about yet, which is retroactive financing. And this is unique to C-PACE. C-PACE can fund up to two or three years after a building gets a CO, their certificate of occupancy. And so it's a really important type of financing in today's market. We are seeing much more retroactive financing than new construction, just given the parameters of the marketplace.

Brad A. Molotsky (15:04.283)

Gotcha. So it feels like, you know, that C-PACE is relatively new, but it's growing in, you know, interest and it's growing in places that one can do C-PACE. Is that a fair assessment?

Stephen Arrivello (15:16.976)

It really is. Yeah, it's really gaining a lot of traction.

Brad A. Molotsky (15:20.142)

Okay, and as we talked about a little bit a moment or two ago, more and more senior lenders seem to be open to it and amenable to it.

Stephen Arrivello (15:28.35)

They really do. have a lot of conversations with banks and more and more they're sort of at the end of the conversation it's more like, *Hmm, I think we can do this* rather than what I used to get, which was, *Nah, we'll never do that*. So I think the tide is kind of turning. I think lenders are seeing the benefit, sponsors are certainly seeing the benefit, and I think it's just a really good fit for a lot of projects.

Brad A. Molotsky (15:52.401)

Super. It looks like, you know, C-PACE again is relatively new, but starting to become more in vogue, accepted by more types of lenders. And projects are pretty open relative to what will qualify as more and more states sort of get into the mix. One of the complications -- as noted -- each of the States rules are a little bit different. So you need to have somebody like Steve that understands the differences between Pennsylvania, Jersey, Delaware, Ohio, each of them have slight nuances. But those programs are alive and kicking in a particular where we've got kind of a challenging financing market. Still lenders want to lend, but with tariffs and with coverage and with costs going up, it's tricky. And so this provides a nice piece of capital that's long term in nature, non-recourse, no mortgage, that can fit into the capital status as Steve said earlier and give you some long term financing.

Steve, last question, you know, if I borrow at kind of mid sevens and rates go down, they keep hearing they're going to go down, but it's been three years. But if they go down to like below seven, can I prepay these loans off without too much pain?

Stephen Arrivello (17:00.477)

You can. There are structured prepayment penalties. I mean, this is intended to be long term to sort of meet the term of the assets you're financing, but you're not locked in. There's no yield maintenance. There's generally prepayment penalties that decline over time. So when the environment changes, folks can certainly prepay and then refinance out with a lower cost of capital.

Brad A. Molotsky (17:23.247)

So it's more like a couple hundred basis points at beginning, but as time goes on, it's down to like one or two.

Stephen Arrivello (17:28.86)

Exactly right. Exactly right.

Brad A. Molotsky (17:31.246)

Okay, so it feels like C-PACE, a good piece of paper upfront, it's a loan, it gets me money to do the project. And then potentially, Bill, we've got a different program that we'll talk about, 179D, which is more akin to a tax incentive to help maximize benefits to a project. So let's talk a little bit about 179D. Bill, what is 179D and what's it relate to?

Bill Harbeson (17:58.38)

Well, 179D, there's many energy incentives out there -- especially thanks to the Inflation Reduction Act that has expanded and enhanced them -- that could play pretty well with C-PACE. But 179D is the most obvious. And I say that because 179D, the full name of it is the Energy Efficient Commercial Building Deduction. And it rewards building owners that newly constructed, renovated, or expanded upon a building with certain energy-efficient features. So the reason why it works so well with C-PACE is any kind of project that C-PACE is able to fund, we can on the back end identify and implement some specialty tax incentives surrounding those energy-efficiency upgrades. Once again, 179D being the most obvious.

Brad A. Molotsky (18:53.063)

Okay, so we're talking about then we can borrow money under C-PACE to do these improvements or do this kind of construction.

Once we do that, we can take this 179D Deduction for purposes of energy-efficiency. So we catch it on the way in and on the way out, as they say. Is that fair? Okay.

And talk to me a little bit about the Inflation Reduction Act. Current administration, not a big fan, at least of renewables on the wind side. Solar remains to be seen.

Brad A. Molotsky (19:29.568)

But 179D, is it a credit or is it a deduction and what's the difference?

Bill Harbeson (19:37.102)

It is a deduction. It's an accelerated depreciation. We won't get into all that during this conversation, but it is a deduction in that it is an above the line reduction in taxable income versus a credit, which is a reduction in tax liability dollar for dollar. So when you're considering the amount of a deduction, you have to factor in your nominal tax rate when actually calculating the total cash benefit.

Brad A. Molotsky (20:06.379)

Okay, so let me probe for a minute though. So we just, we're gonna hit 179D in more detail, but we're talking 179D as a tax deduction versus some of the other incentives under the Inflation Reduction Act. So let's talk a little bit about solar. So if you've got solar, how does solar fit in with C-PACE?

Bill Harbeson (20:38.638)

Sure, Stephen even made an example of funding a solar project with C-PACE. So using that same information, the same data that you went and actually applied for and received a C-PACE loan, you will then use that same data to calculate what's known as an Investment Tax Credit, which is now morphed into the Clean Energy Investment Credit, which for a solar project is nominally a 40% credit for the cost of installing a solar or related energy property. 30% of project could be funded through C-PACE on. Then you can get a 40% percent credit on the backend for these exact same projects.

Brad A. Molotsky (21:41.809)

Okay, so can you stack these benefits? Meaning, can we borrow money from Steve, build a building and create a solar array? So we would borrow C-PACE. At the end of building the building or retrofitting it, we would get a 179D deduction for lights and air conditioning and then we would get an ITC investment tax credit for a solar rig. Can you do that?

Bill Harbeson (22:07.539)

Absolutely. There are some funding sources that would preclude you from claiming a deduction or a credit against some of this property. C-PACE is not one.

Brad A. Molotsky (22:17.04)

Okay, so good news is C-PACE works hand in glove with the ITC, Investment Tax Credit, also works hand in glove with 179D. It's not one or the other, but it's both. Okay.

Bill Harbeson (22:28.217)

Yeah, absolutely. And Brad, I would say that while this is not the case, you would think that they had been created with the other in mind. Stephen mentioned that there are some states that require C-PACE lending to be done paying prevailing wages to laborers, subcontractors, et cetera. Well, 179D, ITC, *all* of the energy incentives tied to the Inflation Reduction Act have similar riders. That if you pay prevailing wages to everybody on the project and you participate in an apprenticeship program on that same project, the credit or deduction is 5X the normal amount. So if you are qualifying for C-PACE and you're doing the things that your state requires to get that C-PACE, well, you're automatically going to qualify for these 5X.

And then Stephen also mentioned that a lot of C-PACE programs require an energy audit of the building. Well, 179D is an energy audit. So at the end of the day, the extra effort it takes to claim these credits or deductions once you're already doing everything you have to for C-PACE, it's almost no effort. All you got to do is hire a company like Capstan to actually do the analysis for you.

Brad A. Molotsky (23:42.985)

Okay, so let me probe what you just said for a half a sec. In order to get...

in order to get C-PACE, they're going to do an energy study of the project, of the property, of the improvement. Would you, could you use that energy study for purposes of a cost segregation study?

Bill Harbeson (24:04.416)

Yes, it will inform the study a great deal. But what's really important is that we also analyze the building following those planned upgrades. So the upfront analysis, data collection, things like that will funnel into that after the fact review. But there is that extra step. Yes.

Brad A. Molotsky (24:26.678)

Okay, so we've got - it helps, it informs it, but we've got to do a little bit more in order to get a cost segregation study done. As you indicated before the cost segregation study allows one to get accelerated depreciation. So why would we care about that? We as developers, owners, care about that because it reduces taxable income and allows us to then have more dollars to distribute on a tax incentive effective basis to our investors. So that's good.

When one does a class segregation study, it's not free, meaning, when we do that our basis in the property gets reduced. The IRS is willing to allow us to accelerate the depreciation get that deduction, pay out our investors, because it knows that when one goes to sell the property later the basis has been reduced and so therefore there's going to be gain that will be payable to the IRS. So they're benevolent, but you know, at some point they sort of say, *where's mine?*

Okay, so we've got a cost seg study that gives us accelerated depreciation. How is that different than this 179D thing?

Bill Harbeson (25:44.411)

Well, they're different in the best ways, which is to say that 179D picks up where cost segregation leaves off, and that was done by design. So for those of you listening that know or are familiar with cost segregation, you're going to take all of your costs and you're going to put it into different class lifes so you can get your depreciation back faster. So you're left with 5-year, 15-year, et cetera. Well, you're always left with 39-year property class life that you just can't accelerate the depreciation on.

That 39-year class life includes things like HVAC, building envelope, and some interior lighting. Well, 179D focuses specifically on those three systems. So if I'm going and I'm claiming a 10 million dollar cost segregation, I'm still going to be left with some 39-year property. I can go in via 179D and claim another one or two million dollars worth of accelerated depreciation out of that 39-year bucket, which otherwise would go untouched.

Brad A. Molotsky (26:41.049)

So what we're talking about is kind of the same thing as we were alluding to a couple of minutes ago. These things are additive. It's not you have to pick C-PACE or cost seg or 179D. Rather, they're all additive. We can do C-PACE. On top of that, we can do Cost Seg. On top of that, we can do 179D.

Bill Harbeson (26:53.632)

Right, right, absolutely.

Brad A. Molotsky (27:03.809)

And so if somebody is doing only one of those or two of those things, they're leaving, you know, an additional benefit on the table, on the ground, in the air, that they're not effectively utilizing. Okay.

And so as Bill had indicated, you know, 179D sits there and picks up the ball once the accelerated depreciation runs out. So once the accelerated depreciation has been used by the project, 179D is sitting there. If you've done the 179D analysis and you file the paperwork that you need to with the IRS, it provides you with additional reduction of your taxable income to allow for a larger distribution to your shareholders, your owners, your investors.

Okay, so that's where Bill's saying these things are additive and accretive. It's because they work hand in glove with each other.

Whether that was intent or not, who knows. But the good news is they do. And having folks like Steve and folks like Bill around to help one with A, the analysis and the loan, B, with the accounting that goes with it, very relevant and very timely.

So Bill, just a quick question as we wrap up. Are you seeing your clients take advantage of kind of all three pieces or are they still kind of just picking at one or two?

Bill Harbeson (28:28.562)

Yes, more and more. 179D I've been working with for about 10 years and for the entire time I've been doing that, it's been pretty unknown. Right. The first time I'm approaching somebody about 179D, it's often the first time they're hearing about this. C-PACE is even *lesser known than that*. So more and more of our clients are getting interested in alternative funding, C-PACE chief among them, because they *do* work so well together. While we're doing these energy improvements, why not get a C-PACE loan for it? So yeah, more every day, every week, we get questions about it. We get asked to make introductions. I've made a few to Stephen already. And I anticipate that this is only gonna get bigger as these programs get bigger and more involved.

Brad A. Molotsky (29:22.626)

Yeah, look, I couldn't agree more. I think that alternative sources of financing, the more alternatives a developer has, an owner has, the better it is. And so somebody might want medium-term financing or short-term or long-term. The ability to ladder financing and use C-PACE to do that and provide you with some long-term money at a decent rate, is very good. The ability to reduce taxable income appropriately, but know that on the way out you're going to pay, but you'll pay when there's gain, a good way to get dollars back to your shareholder, a time-honored tale relative to real estate.

But I find most real estate owners are very much paying attention to cost seg, like 95 % of the people have heard of that, if not use it, but they don't know what the heck we're talking about when you start to talk about 179D and they're like, *Well, we can't use that*. And the reality is not only can you use it, it's very accretive to you.

And because the rules changed, you know, last two years ago, know, nonprofits can assign that 179D benefit to their designer, designer/installer. And even like, nonprofits, hospitals, higher education, universities, they don't pay tax. So a tax deduction isn't overly helpful to them. But the ability to assign that and get lower project costs, that's real. And yet many people are still kind of out in the wilderness on this and have not heard of it.

So I appreciate kind of Steve, you and Bill taking a couple minutes today to sort of educate folks on the benefits and what kind of the attributes are of not only C-PACE, but of 179D and of how 179D fits in together with a cost seg study. To the extent there's follow on questions, obviously feel free to reach out to Helena or to Steve, to me, to Bill. We're always happy to have that kind of conversation and to chit chat about these, what some would call wonky tax benefits, but others would call kind of the nerve blood, nerve blood? [Laughter] No, the life's blood of what makes these projects go. So without further, you know, commentary, we can go into this for another two hours, Helena, but I think our time is up and we greatly appreciate you making these arrangements to have us on.

Bill Harbeson (31:38.72)

Absolutely. Brad, Steve and Helena, it has been a pleasure. Always love talking about this stuff.

Stephen Arrivello (31:45.244)

Yeah, thank you all for your for having me on. I appreciate it. You know, Brad, Brad is truly an expert at everything. And I say that not lightly because I've seen Brad dig into all of the esoteric weird stuff that's going on out there and C-PACE just being one of them as well as the 179D. So thanks very much for having us.

Brad A. Molotsky (32:05.87)

Dude, you need to get out more if you think I'm an expert. [Laughter]

Stephen Arrivello (32:08.467)

HA HA HA!

Helena Carmel (32:11.061)

Gentlemen, thank you so much. I'm going to put your contact info in the show notes, so I'm sure people will have follow-up questions. We appreciate your time. And thanks so much listeners, for tuning in to Beyond the Spreadsheet. If you liked what you heard, why not subscribe? We're on Apple Podcasts, Google Podcasts, and Podbean, or just visit capstantax.com/podcasts. Thanks for joining us – we'll see you next time.