SPECIAL REPORT

Marcus & Millichap

CAPITAL MARKETS

JUNE 2023

Between a Rock and a CPACE: Financing Alternative Gaining Attention

The Current Financing Landscape

The 10-Year Treasury sits in the upper-3 percent range, with one-month Term SOFR in the low-5 percent zone. The cheapest interest rates for new origination are almost 6 percent, with max leverage agency debt constantly pricing north of that for non-mission executions. CMBS debt for riskier property types, such as office and hospitality, is often in the 7.0 percent to 8.0 percent band or more. Inflation has yet to be fully curtailed, and the Federal Reserve has not yet formally announced an end to raising rates although they did not hike in June. Borrowers are ravenous for cheaper debt solutions as lending market liquidity continues to dwindle, forcing spreads higher and leverage levels lower from the active debt funds and banks that still have allocation. Bank allocation has been challenging with a severe lack of payoffs, as borrowers continue to extend and have little motivation to refinance because of the challenging rate environment. Banks are trying to shore up their balance sheets as they lose depositors, given higher yielding alternative options for placing capital and recent regional bank failures.

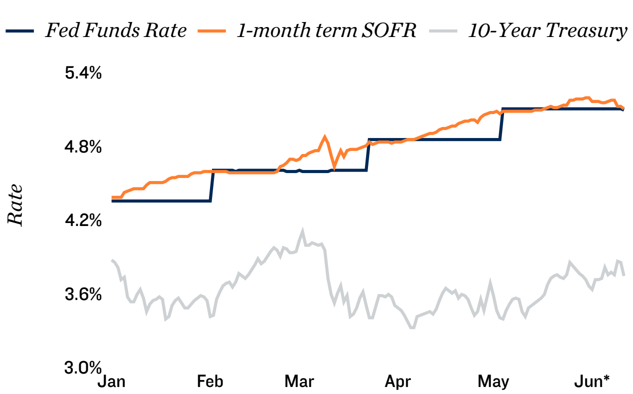
For some transactions, a new champion has emerged to provide some rate relief and, in some circumstances, provide leverage that is otherwise unattainable. That hero is CPACE: an alternative financing strategy that was formerly difficult to deploy in ways that made sense to borrowers. CPACE is now at the forefront as a capital markets solution — particularly for construction and construction take-out bridge financing — to fill the gap in the lending markets previously saturated with non-recourse banks, money center banks and regional banks.

What is CPACE?

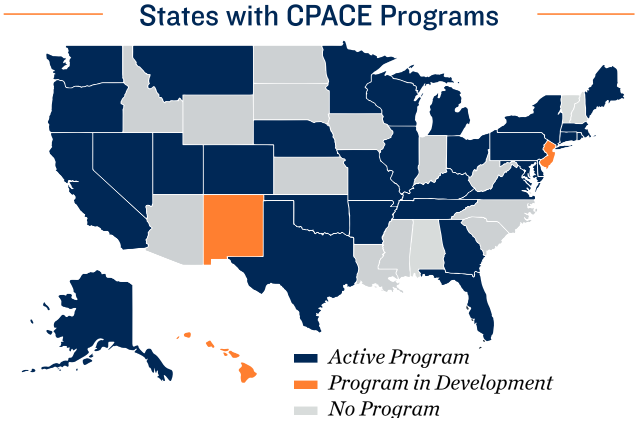
CPACE is a state policy-enabled financing alternative that provides developers access to capital for construction, renovation and other building upgrades. The financing is fixed-rate and long-term. It runs with the property so it can be easily assumed by the next buyer, and its debt service is paid as a state property tax. Thus, the CPACE payment is akin to an operating expense. For some commercial buildings, this means an owner could potentially pass through the expense to the tenants as part of a triple-net lease. Not every state has agreed to allow for CPACE, but so far 31 states and the District of Columbia do allow for CPACE. The ease of the process to obtain them and for various costs to qualify does, however, vary drastically by state.

Originally pitched by CPACE originators as a cheap mezzanine/preferred equity alternative, lenders quickly caught on to the fact that this was not quite the case. The debt was indeed "in front" of lenders in the capital stack, with the debt service payments priming their senior loan debt service as it came in the form of a state tax liability. While CPACE cannot accelerate its loan upon default, it also encumbers the collateral with an additional expense that will run with the collateral for a long time, or until the CPACE loan is repaid. Lenders noted that their last dollar basis exposure included the CPACE encumbering the property, and then either lowered their leverage or increased their spread accordingly. CPACE was indeed a very expensive senior loan, instead of the cheap subordinate debt that it was intended to be. Today's capital market environment has re-framed this dynamic.

Key Lending Benchmarks in 2023



States with CPACE Programs



*As of June 15

Sources: IPA Research Services; Federal Reserve; ICE Benchmark Administration Limited; Moody's Analytics; Pace Nation

Hybrid CPACE Financing Produces Lower Rate over Debt Fund Alternative — A Comparative Example

	Debt Fund Alternative 2021*	Debt Fund Alternative Today	Hybrid CPACE Today
A Note Amount/ CPACE Amount	$65,000,000	$55,000,000	$30,000,000
LTV	65%	55%	30%
Spread**	300 bps	400 bps	340 bps
Base Rate/Rate Floor	25 bps	515 bps	370 bps
All-In Rate	3.25%	9.15%	7.10%
Debt Fund Hold Piece/ Senior Debt Fund	$20,000,000	$20,000,000	$50,000,000
Last Dollar LTV	85%	75%	80%
Implied Spread	1,150 bps	1,150 bps	660 bps
Base Rate/Rate Floor	25 bps	515 bps	515 bps
All-In Rate	11.75%	16.65%	11.75%
Whole Loan Amount/ Hybrid CPACE Total	$85,000,000	$75,000,000	$80,000,000
LTV	85%	75%	80%
Spread	500 bps	600 bps	
Base Rate/Rate Floor	25 bps	515 bps	
All-In Rate	**5.25%**	**11.65%**	**10.01%**

Example assumes $100 million Capital Stack

** Before Federal Reserve rate hikes*

*** Spread over 1-month Term SOFR for Debt Fund; Spread over 10-Year Treasury for CPACE*

Source: IPA Research Services

Amid Higher Capital Costs, CPACE Financing Becoming More Viable

Why is CPACE more Attractive Now?

Before the Fed began hiking the overnight lending rate in March of last year, CPACE was priced around 5.5 percent to 7.0 percent as a senior loan when SOFR/LIBOR was 25 basis points or less, and spreads for even non-recourse senior debt were down in the 200 basis point to 400 basis point range. That made CPACE, marketed as cheaper-than-mezz subordinate debt, a "fool's bargain." Fast forward to 2023, the same non-recourse senior debt has spreads 100 basis points or more higher with lower leverage attachment points, and SOFR is now over 500 basis points. With all-in rates on floating rate debt generally from 8 percent to 13 percent or above, CPACE suddenly becomes a viable option, particularly on transactions where no non-recourse senior debt bid exists. With the A note, note-on-note and senior financing markets backing down on leverage, increasing spread and being more selective on lending, CPACE became a lower leverage, fixed-rate affordable alternative senior lending option and a potential replacement for these senior lenders. CPACE rates are currently in the 7 percent fixed-rate range, but are generally capped at 25 percent or 30 percent LTV. Depending on the state, more or less costs can qualify to maximize the leverage.

The Emergence of Hybrid CPACE Financing

The use of CPACE is also evolving in other ways. A subset of funds has been raised to originate senior financing to go on top of the CPACE financing, and either partner with established CPACE funds or originate the CPACE on their own behalf. This is what is now colloquially known as "hybrid CPACE financing," blending a CPACE loan with a fund senior mortgage that is priced more like mezzanine debt for the balance. The table above compares what traditional debt fund financing looked like in 2021, what debt fund financing might look like now, and what hybrid CPACE financing might look like today.

Creativity in a Struggling Capital Markets Environment

As borrowers' loans mature, they are faced with the illiquidity of more traditional financing sources commonly utilized in the marketplace, including commercial banks, regional banks, life insurance companies, and others. CPACE is just one of many potential financing alternatives to solve these current capital stack issues. It may take some creativity, but financing options are still out there for borrowers if they know where to look.

Prepared by:

Steven Buchwald

Senior Managing Director, IPA Capital Markets
Tel: (310) 595-4373 | sbuchwald@ipausa.com

For information on national commercial real estate trends, contact:

John Chang

Senior Vice President, Director | Research & Advisory Services
Tel: (602) 707-9700 | john.chang@marcusmillichap.com

Marcus & Millichap Capital Corporation

Evan Denner

Executive Vice President, Head of Business

Tel: (212) 430-5100 | evan.denner@marcusmillichap.com

Sources: Marcus & Millichap Research Services; Federal Reserve; ICE Benchmark Administration Limited; Moody's Analytics; Pace Nation

Price: $1,500