Securitized Products Special Topics

Commercial Solar ABS: Emergent Segment to Alleviate Headline Risks

Investors May Leverage Existing Expertise in Assessing Solar Exposures

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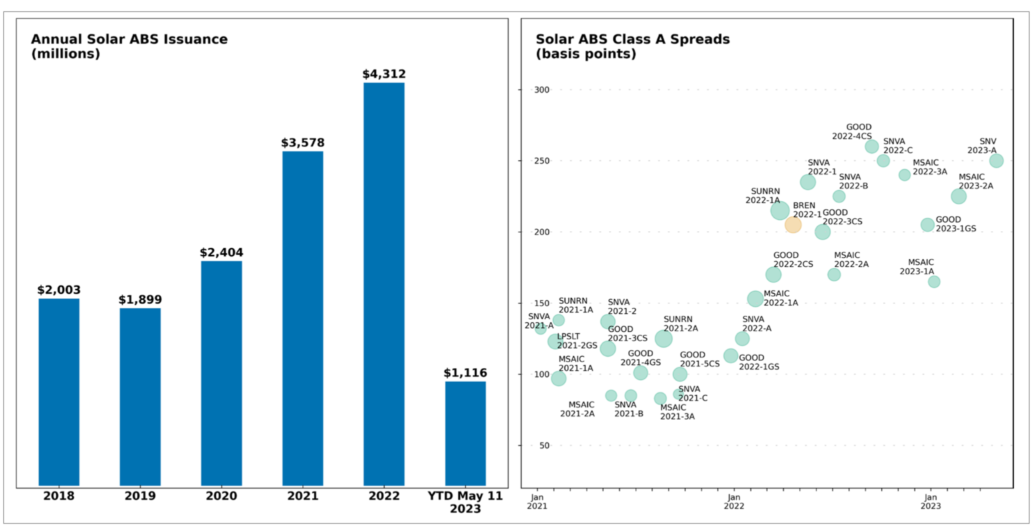
The emergence of commercial solar securitizations should allow both ABS and CMBS investors to deploy their expertise to diversify into a new segment. CRE-oriented investors could leverage existing views on market fundamentals and property type performance as solar increasingly becomes ingrained in commercial properties. In turn, ABS investors already comfortable with residential solar exposure could apply their investment approach to commercial solar power purchase agreements (“PPA”) or alternative contract types such as community solar. Solar deals also feature credit enhancement mechanisms and structural features common in other ABS segments, such as overcollateralization or liquidity reserve accounts. All told, investors may find interest in solar collateral as they look to reduce exposure to segments exposed to headline risks such as office, consumer loan ABS, or single-family rentals.

We expect to see more commercial solar deals popping up on the heels of the two transactions priced in recent months. DSD 2022-1A issued $112.5 million single-A-minus class and $42.5 million single-B class back in December 2022 (Figure 1). Earlier last year BREN 2022-1 priced its $266.5 million single-A-minus and $135.5 million triple-B-minus classes to the tune of 205bp and 320bp over Treasury benchmark. Both sponsors should have programmatic issuance. Other commercial solar operators, such as Pivot Energy, reportedly are also gearing up to tap securitized markets soon.

Figure 1. Solar ABS Issuance and Spreads



Source: Bloomberg and Academy Securities

Secular Trends Support CRE Solar, Amid Some Incentive Hurdles

Secular trends and ample anecdotal evidence suggest investors increasingly will see solar components across multiple CRE property segments. Commercial solar operators client lists include notable retail and hotel companies such as Home Depot, Whole Foods, Marriot, IHG and others. [Self-storage]() and [data center]() landlords may be particularly interested in adding solar panels to their properties to reduce operating costs.[1] For example, Public Storage highlighted in recent filings its investments in solar power as helping to decrease utility costs. PSA, the largest self-storage facilities owner, installed solar at 200+ properties in Q1 2023. The REIT will look to complete 1,000+ property installations in the next three years.

In turn, office landlords may face strong incentives, or even regulatory requirements, to put in on-site solar panels. A recent example is Boston's administration initiative to adopt a strict new energy code that would prod landlords to install solar panels, among other requirements. The code can reportedly become effective in January 2024. California and New Jersey are also set to include solar-ready requirements for commercial buildings. On-site solar currently accounts for less than 1% of commercial electricity demand, according to Wood Mackenzie/SEIA.

One hurdle for wide adoption of solar in commercial properties could be divergent incentives among landlords and tenants. Solar installations typically require significant capital investments. Because it is mostly the tenants that benefit from utility cost reductions, landlords may have limited incentive to pursue solar projects. In a similar vein, interested tenants may not be able to force or negotiate installations on properties they do not own. This "split incentive" challenge might be particularly knotty in net lease situations, where the tenants are responsible for all utility costs. Still, market participants may develop economic arrangements to address the issue. Solar panel operators could offer programs that reduce or eliminate landlords' capex requirement. Landlords may also now find it advantageous to pursue installations to attract tenants with the promise of lower energy bills or to meet ESG goals.

Solar Deals May Feature Familiar Properties or Submarkets

Some of the sites the recent commercial solar ABS deals featured suggest how investors can incorporate CRE views as they analyze new exposures. For example, one of the DSD 2022-1A top exposures is Windward Mall in Kaneohe, HI. The property itself is not securitized. But several other malls in the area are, including Ala Moana Center ($2.4 billion, BPR 2022-OANA), which is about 13 miles away. Another solar project in the DSD deal is in a Home Depot location in Hackensack Commons, NJ. The 111K sf store is the largest tenant (40.4% of NRA) in the shopping center, the fifth largest exposure in BANK 2017-BNK9. Other large, securitized retail locations have also installed solar panels, with Garden State Plaza ($525 million, RBSCF 2013-GSP and WFRBS 2013-C18) as one example.

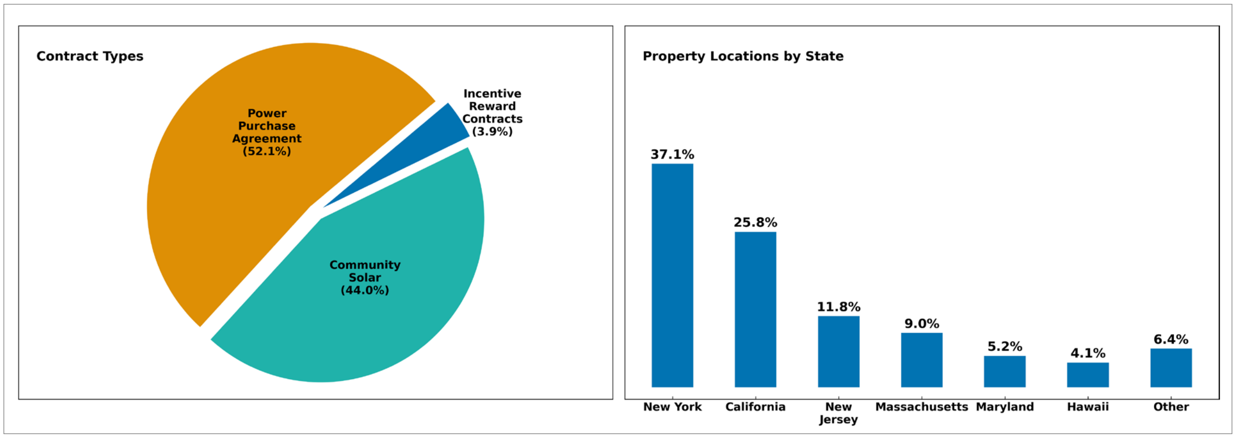
1 See "Self-Storage: Aspects to Watch as Performance Decelerate," Securitized Products Special Topics, Academy Securities, February 2, 2023, and "Data Centers: A Strong Segment Juggles ABS and CMBS," Securitized Products Special Topics, Academy Securities, October 4, 2022

At the same time, assessing solar collateral will feature distinctive aspects compared to traditional property analysis. Notably, the recovery value on the underlying solar equipment could be minimal or zero. It may be difficult to find a replacement tenant for commercial solar locations, according to rating agencies. Solar rating models typically do not assume reassignments or recoveries on solar defaults.

Shifting Collateral Composition

Solar ABS deals may continue to see shifts in their pool compositions. Residential solar pools included loans, leases, and PPAs. Commercial deals may also include community solar cashflows following the DSD issuance. A little over 44% of DSD pool was backed by community solar programs, where the panels reside off-site (Figure 2). Community solar is poised to grow by 11% annually through 2027, according to Wood Mackenzie/SEIA.

Figure 2. Solar Collateral Breakdown by Contract Type and State - DSD 2022-1A



Source: Bloomberg and Academy Securities

The DSD collateral geographical composition alludes to the elevated concentration of commercial solar. Four markets – California, Illinois, New Jersey, and New York – accounted for 62% of commercial solar installations in 2022. Community solar has also been concentrated, with New York making up 52% of installations last year. But new state markets such as Virginia, New Mexico, and Delaware should see projects coming online in 2023, potentially diversifying the geographic exposure of commercial solar deals.

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