michigan saves SM

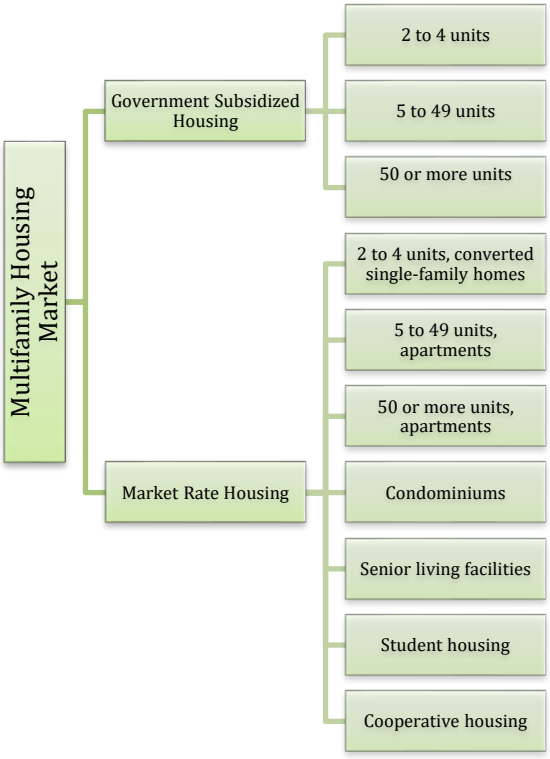
A nonprofit organization dedicated to making energy improvements easy and affordable.

Market Segmentation Strategies to Increase Demand in the Multifamily Market in Michigan

Background

The multifamily housing market is a challenging environment for the implementation of energy efficiency improvements. Multifamily buildings are both residential and commercial structures, characterized by multiple building types, utility services and ownership structures.[1] Because of the complexity of the multifamily structure, this market is often "underserved by utility- and government-funded energy efficiency programs."[2]

The multifamily market can be characterized by two distinct segments — government subsidized housing and market rate housing. Government subsidized housing is usually comprised of multilevel apartment buildings, commonly segmented by the number of units, e.g., 2 to 4 units, 5 to 49 units, and 50 or more units. Government subsidized housing complexes also tend to be older, with most constructed in the 1960s, 1970s, and 1980s.[3]



Market rate housing has much more variability in the types of structures. Market rate housing ranges from converted single-family homes to apartment complexes, multi-unit condominiums, senior living facilities, student housing, and cooperative housing (co-ops). Market rate housing also shows greater variability in the age of the structures. Converted single-family homes could date to the early 1900s, while condominiums gained popularity in 1970s, 1980s and 1990s. Senior living facilities have been growing in popularity since the 1990s. The latest trend in multifamily housing is mixed-use properties, with retail or offices on the ground floor and housing above.

[1] Abigail Corso, Margaret Garascia, and Rachel Scheu. 2017. *Segmenting Chicago Multifamily Housing to Improve Energy Efficiency Programs*. Chicago: Elevate Energy. Page 3. Accessed February 14, 2017. http://www.elevateenergy.org/wp/wp-content/uploads/Chicago-Multifamily-Segmentation.pdf
[2] Ibid.
[3] Charles L. Edson. 2011. "Affordable Housing: An Intimate History." *The Legal Guide to Affordable Housing Development*. Accessed June 20, 2017. http://apps.americanbar.org/abastore/products/books/abstracts/5530024%20chapter%201_abs.pdf

Each segment of the multifamily housing market presents its own set of challenges and opportunities. Gaining a better understanding of the multifamily market, and the different market segments, can help utilities and policymakers design effective energy efficiency programs.[4]

Project Summary

As a green bank, Michigan Saves stimulates and supports investment in energy efficiency and renewable energy measures in Michigan homes, businesses, and public buildings. Working through our industry and community partners, Michigan Saves makes innovative, affordable financing available for energy-focused building and equipment improvements, and accelerates demand for greater efficiency through education and communication.

Michigan Saves has been providing low-interest financing to the multifamily market since 2012 by partnering with Cinnaire, Michigan's leading community development financial institution. Michigan Saves gained a better understanding of the multifamily market and crafted a financing product that addressed several market barriers to meet the needs of property owners. Since 2012, Michigan Saves and our lending partners have financed energy efficiency improvements at 38 market rate multifamily properties for a total of $1,875,344.

The purpose of this report was to research and develop market segmentation strategies to increase demand for financing energy efficiency projects in the multifamily market in Michigan. The scope of this research was limited to market rate, multifamily properties because property owners in this market segment tend to have a greater need for financing.[5] To accomplish this purpose, Michigan Saves interviewed several contractors and representatives of nonprofit organizations who serve the multifamily housing market. Michigan Saves asked participants to identify impediments to market demand and barriers to financing, as well as opportunities to increase market demand and financing. These interviews provided valuable insight into how contractors and nonprofit housing organizations approach this market and sell energy efficiency equipment and services.

Michigan Saves expects to share our findings with contractors, nonprofit housing organizations, and utility partners working in the multifamily market to stimulate greater investment in energy efficiency improvements. This report can also serve as a guide that helps public and private sector investors to more effectively deploy loan capital. By understanding the impediments to public and private investment in energy efficiency improvements and implementing the recommended strategies, federal and state agencies, utilities, nonprofit organizations, and other partners can design more effective multifamily energy waste reduction programs.

Key Findings

Michigan Saves uncovered a number of findings as it interviewed contractors and representatives from nonprofit housing organizations to gain insight into impediments and opportunities that influence the demand for energy efficiency improvements in the multifamily market as well as the demand for the financing needed to make those improvements.

Demand for Energy Efficiency Improvements

- Impediments

[4] Abigail Corso et al., page 4.
[5] Unless noted otherwise, all occurrences of "multifamily," "multifamily properties," or "multifamily market" refer to market rate, multifamily properties.

- Because most market rate property owners pay only for energy charges associated with common areas, there is little financial incentive for the owner to install high-efficiency equipment outside of the common areas.
- The price gap between high-efficiency equipment and standard equipment can be high for certain improvements that serve common areas, such as HVAC equipment, water heaters, or boilers. If this price gap cannot be closed with incentives, the high-efficiency equipment is less attractive to property owners. If the property owner is paying for heating, cooling, or hot water to the individual units, the price gap is not as critical, since the property owner can recoup the cost through rent.
- Older buildings have fixtures and equipment is that more difficult to retrofit, while still meeting building codes. Instead of exchanging inefficient light bulbs for LEDs, contractors must replace entire light fixtures to meet current building codes. This increases project costs, which makes it more difficult to sell high-efficiency equipment.
- Contractors must work directly with the building owner or decision maker to be successful. However, finding the owner or decision maker in a multifamily property can be difficult because of the myriad ownership structures common in such properties. Some properties have multiple owners, including passive investors, who have little incentive to spend more money on higher-efficiency equipment.
- Building owners often express skepticism when lighting contractors present project financials that have short payback periods and high return on investment figures. Building owners often have a "too good to be true" response that needs to be overcome for the contractor to sell an LED lighting project.
- Many property owners "auto-pay" utility bills, which often means that no one is assigned to review the bills or manage utility data. It is difficult to sell high-efficiency equipment when neither the building owner nor the property manager understands the extent of utility expenses.
- Contractors are frustrated with an overly complicated utility incentive process, in which incentive applications are shuttled back and forth between the multifamily incentive program and the commercial and industrial incentive program, based on the type and location of the measures. Utilities sometimes consider multifamily incentive applications on a case-by-case basis, which creates uncertainty as to whether the incentives will be approved. To close deals, contractors must have confidence that all financial components will be available. Without robust incentives, and the certainty in obtaining those incentives, contractors are missing opportunities to install higher-efficiency equipment.
- Engineered utility allowances—calculated through the subsidized housing property owner's annual review of tenant utility bills to determine the average cost, which is presented to the U.S. Department of Housing and Urban Development for its approval to set utility rates—are not used in market rate properties because for those there is no obligation for the tenant to share utility data with the property owner.[6]

[6] Michael Semko. 2016. "Calculating Utility Allowance: The New Rules." *Units Magazine*, August 2016. Accessed June 20, 2017. https://www.naahq.org/news-publications/units/august-2016/article/calculating-utility-allowance-new-rules

- Opportunities
    - The size of the multifamily market is large; all facilities need some energy efficiency improvements. Lighting is one of the largest electric expenses for a multifamily property, which allows for significant opportunities to install LED lighting and reduce the expense.
    - Multifamily property owners are often in investment groups with other property owners. A contractor who can build a relationship and trust with a single owner could get access to other owners and properties that are within the investment group.
    - Tax credits and deductions for market rate multifamily properties are underutilized because of the time and expense required to document the project. Contractors can present a greater value proposition to building owners if they understand and can navigate the tax credit/deduction process.
    - Multifamily properties are a confusing mix of residential and commercial building codes. A building code specific to multifamily properties could lead to greater investment in energy efficiency.
    - Contractors can help building owners understand equipment obsolescence schedules by proposing a schedule of equipment replacement as current equipment reaches the end of its useful life.
    - There is a need for closer collaboration with commercial building inspectors, who can distribute information about high-efficiency measures, financing options, etc., when working with building owners.

Demand for Financing

- Impediments
    - Terms for financing smaller projects are not long enough. The Michigan Saves Multifamily Energy Financing (MEF) Program extended terms from five to seven years specifically to serve this market. This is sufficient for lighting upgrades and other improvements that have a shorter payback period. Property Assessed Clean Energy (PACE) financing has 20- to 25-year terms, which works well for projects with a capital outlay greater than $300,000; however, PACE is not authorized in all counties in Michigan. Missing is an intermediate-term (8- to 15-year) loan product, which would provide a greater incentive for smaller projects with longer payback periods. An intermediate-term loan product would also serve those property owners who cannot or do not want to finance their projects using PACE.
    - The standard interest rates for the Michigan Saves MEF Program, which average 8 percent for many property owners, are not competitive with other forms of financing available to building owners. Building owners will explore less expensive options, or choose to delay work when interest rates are perceived as high.
- Opportunities
    - Building owners are often “cash poor” and look for low-interest financing to pay for the improvements. However, building owners often have access to other sources of capital, so it is important that a financing product like the Michigan Saves MEF Program differentiate itself from other financing products. Building owners often need to be educated on financing products and the value that each product brings. For example, some financing products use

only credit-based underwriting criteria and do not provide much leeway for businesses to deviate from those criteria. Other financing products, like the Michigan Saves MEF Program, allow for cash flow to be considered as part of underwriting, creating more flexibility for customers, which leads to more credit approvals.

- Low-interest or zero-interest financing is a deal closer for contractors. A program like Michigan Saves, with interest rate buydown funds from the utilities or from other sources, allows cash-poor property owners to make efficiency improvements with no cost for capital. Some lighting projects can even have a positive cash flow—where the monthly utility bill savings exceeds the monthly loan payment—during the debt-service period.

Strategies to Drive Demand

Several key themes emerged during our discussions with contractors. Those themes provide a backdrop for the formulation of several strategies intended to drive demand both for energy efficiency improvements in the multifamily housing market and for the Michigan Saves Multifamily Energy Financing Program.

Strategy 1—Increase contractor access to building owners

It is difficult for energy efficiency contractors to meet building owners, particularly in a setting that is "sales free." Contractors who have successfully navigated the multifamily market have invested time and money into building relationships and trust with building owners before a sales call is ever made. Contractors should consider memberships in organizations that interest property owners, such as the Small Business Association of Michigan (SBAM; www.sbam.org), which advocates for small businesses. The mission of SBAM is to help small businesses in Michigan succeed by promoting entrepreneurship and leveraging buying power. SBAM regularly hosts networking events for its members and encourages members to do business with each other.

Strategy 2—Train contractors to sell financial solutions, not technology

Successful contractors do not sell the "technology." Rather, they sell solutions to the building owner's problems. To do so, contractors must have strong financial acumen and be able to articulate the financial benefits to the property owner. Simple payback and return on investment (ROI) are the most important considerations for a building owner when considering an energy efficiency project. Savvy contractors are also adept at presenting available utility incentives and financing options like Michigan Saves or PACE.

Contractors must also be aware that the financial analysis is different for each client. Contractors will usually get pushback from building owners on energy efficiency improvements, particularly when the building owner does not have a pressing need. Thus, contractors must spend time educating the building owner and leading them down the path toward a solution that meets their needs in an economically attractive manner. Whenever possible, contractors should focus on the lifecycle of the equipment and the long-term financial benefits, rather than the initial cost. Even in emergency replacement or break-fix scenarios, when the building owner is more interested in fixing the problem quickly than understanding the project's ROI or simple payback, contractors should not ignore the financial analysis for a building owner.

Strategy 3—Develop new financing products to address market gaps

Market rate property owners have a greater reliance on financing than do affordable rate property owners, but they find that current financing products are not well aligned with their needs. As mentioned earlier, the Michigan Saves MEF Program works well for energy efficiency improvements that have a short

payback period; PACE financing, with loan terms greater than 20 years, is appropriate for large projects that exceed $300,000, and in areas where PACE is authorized by a PACE district. A loan product with an intermediate term that bridges the gap between Michigan Saves and PACE would be valuable to contractors. More important, it would fill a niche in the market, as commercial financing products with low interest rates and intermediate terms are not common. A revolving loan fund with flexible terms and low rates could be developed to fill this gap.

Additionally, it is often difficult for market rate property owners to react to emergency repairs or unexpected capital expenses because they do not have cash readily available. In these situations, there is a premium on financing products that provide immediate funds without the contractor having to navigate a loan application process. It would be interesting to explore whether an energy efficiency fund could be developed to provide immediate financing to multifamily property owners for emergency repairs.

We could envision two structures for this energy efficiency fund. The first structure would enable property owners to apply for and be approved for a certain amount of unsecured funding, much like a traditional revolving line of credit. There would be minimum efficiency requirements for the types of measures, and a loan loss reserve, which should keep the interest rates low. Property owners could tap the line of credit as needed to make efficiency improvements.

A second structure would make the energy efficiency fund available to authorized contractors, who would then act as merchant lenders. Contractors would be allocated a certain amount of funds that they could offer to property owners for emergency situations. This would give contractors the ability to provide financial solutions in a matter of hours, rather than days as required in a traditional financing process. The fund would be backed by a loss reserve to keep interest rates low.

Strategy 4—Reimagine utility incentives for the multifamily market

Across the board, contractors are disappointed with the utility incentives that are currently available for multifamily properties, and with the process for obtaining them. Utility incentives are an important component of the financial solution for energy efficiency projects. Contractors rely on incentives to make the economics of a project more attractive. Without robust utility incentives, it is more difficult for contractors to sell high-efficiency equipment to market rate property owners who may not have interest in upgrading to such equipment, even when existing equipment fails.

It would be interesting for the utilities to work with contractors and financial entities, like Michigan Saves, to reimagine their multifamily incentive programs to be more holistic and better integrated with other financial and market elements. Additionally, utilities might consider joint marketing campaigns to target those property owners who have single meters and are likely to have great ROIs or payback periods. Perhaps the best approach is not to just provide a rebate, but rather to work with contractors, property owners and financing entities to create comprehensive financing solutions that work in the complicated and often confusing multifamily market.

Conclusion

The multifamily market is complex and calls for the development of innovative, flexible, and robust approaches, financing products, and incentives that can meet its demands. There are significant opportunities within this market to promote energy efficiency improvements that not only save energy and money but also improve the value of the property and the comfort and security of the tenants.