Wanted, a new green capital form to make a market

Today's debt finance for green improvements is stymied by two problems, the unprovability of faith and the immovable fragility of the capital stack. As neither is likely to be solved soon, it may be up to the industry to create new capital forms outside the classical real estate mortgage finance system.

Faith versus proof. Green improvements have proven technological models; they do not have proven business models. Between these two points lies the gap between faith and proof.

Few would dispute that many individual forms of green technology show reliable technological performance. Boiler efficiency is quantifiable; reduced heat loss can be observed; electrical savings are measured via meters. Thus, for any given property, there is little difficulty (via a professional green capital needs assessment) developing a menu of particular capital improvements for which the energy case can be proven.

But that leaves the business model gap. We know the gadgets can be installed. But do we know that they will be maintained? That the residents will not sabotage them, or neutralize their effectiveness by behavioral changes? Lenders are not physicists; they trust not in engineering studies but in financial statements. And, as our report on green portfolios showed, the data sets are insufficiently large, incomplete, or proprietary. We have numerous examples of successful installations, and post-installation operations tracking projections with heartening correlation. But our belief doesn't make the lenders believe, and it's their rules that govern, not ours.

Debt is the capital we access when performance is proven. The unproven we finance with equity, and up to now the price of equity has been way too high to make the numbers work at any scale.

The tottery capital stack. A mortgage is a wrapper around a bundle of collateral, staking a priority claim on everything inside it. And if there were not enough, many if not most LIHTC properties done today also have junior financing. Further, no matter how soft these junior liens' cash-flow payment provisions, they too are secured by mortgages (second or third or even fourth) and they too tend to accelerate upon sale or refinancing.

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Stack them one atop the other and the result is a property so encumbered by priority claims that any scintilla of potential collateral is already multiply hypothecated. If we come in and install new improvements in a property that will be repayable from a dedicated stream of energy cost savings, then we need to get the consent of all those line-standers in front of us – and there's always somebody who won't consent or insists on being paid to consent. The capital stack is so tottery that any disturbance sets off reverberations, and general partners are understandably loathe even to touch it.

(The tottery capital stack explains the lure of PACE financing – which, by the way, isn't practical because it compromises these secured creditors' rights, and they being unbelievers are unwilling to allow the nifty new gadgets to prime their position.)

Between the faith problem and the tottery capital stack, currently available debt, inculcated with love of mortgages, are never going to embrace green technology fast enough to create a marketplace we can use. We need something else, and there are three candidates: tax-advantaged equity, pay-for-performance equity, or a revival of the chattel-lien loan.

The essential difference is in movability, and hence in repossessability. Real property cannot be moved; chattel can, whether it is a car, a television set, or a solar panel.

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Thus, in chattel-lien finance, the creditor takes a security interest not in the real estate, but in the gadgets themselves. The property mortgagee has no beef because (assuming we didn't punch holes in the roof or otherwise damage the structures) it has the same collateral it had before, and the chattel lien holder has the legal right to reclaim the collateral, providing it with security.

Of course, chattel liens have their own problems. Enumerating which lights, switches, panels, and systems belong to the real estate and which to the chattel is both administrative and extensive. The collateral is sometimes embedded into the real estate, so repossession isn't as simple as mere removal. (For instance, if the gadgets are in the apartment, then the lienholder has to gain a right of entry consistent with the resident's lease, and that may not be easy.) And it's no simple matter to have a clearly traceable and assignable cash flow path from the chattel lender to a repayment stream. If the repayment is part of the rent rather than being a separate bill, then it may be caught in the mortgagee's assignment of rents. All this implies a higher cost of capital and a much shorter loan term than the typical real estate mortgage. So chattel liens, although certainly feasible in theory, have been used only intermittently, not at scale.

If debt won't do, or won't do at scale, what about equity? Unfortunately, we're unlikely to be creating any new or improved tax credits soon – quite the reverse. We need a new form of capital, either a specialized debt product that will underwrite at least some of the projected savings, or pay-for-performance equity (about which more in a future Guru). TCA

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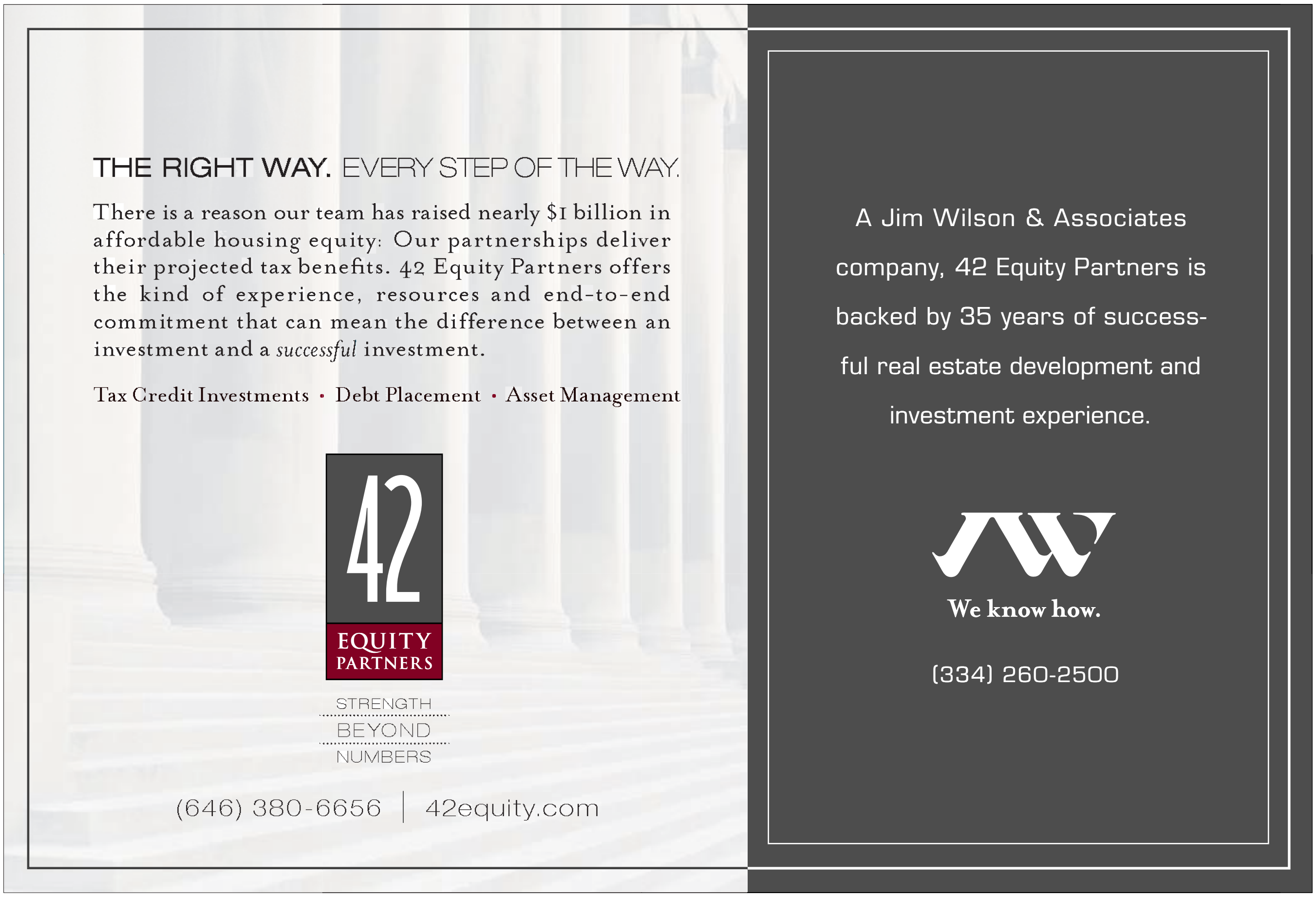

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