When the markets lead

When the people lead, the leaders will follow.
– Mahatma Gandhi

Sometimes a revolution happens not with a blare of trumpets but through a thousand small actions in the same direction. Without actually sensing movement, one suddenly realizes the world has become quite different than it was – and is never going back.

In the area of green retrofits of existing multifamily affordable housing properties, what once was insubstantial has now become the next best thing to mandatory in a little over the past half-decade – at least for acquisition/rehab transactions. That is a revolution. This sea change happened because of the following four parallel and mutually reinforcing trends:

1. **The emergence of standards.** Starting with the launch of the Enterprise Green Communities criteria less than a decade ago, several of us in the industry recognized that capital will never flow without metrics. This, in turn, led us to work in the following two directions:

   - *Standards of achievement.* Enterprise Green Communities and LEED for Multifamily gradually both became recognized as worthwhile proxies for some level of green achievement. They did so because the sponsors of both standards systems (Enterprise and the U.S. Green Building Council) were seen as objective, analytical, and transparent about their standards-making process.

   - *Functional quantitative yield analysis.* Launched 3½ years ago, the Green Capital Needs Assessment (designed by Enterprise and Recap's affiliate On-Site Insight) is both an open-source protocol and a quantitative, verifiable calculation of the relevant underwriting standards – true incremental Net Present Value or IRR for choosing green versus non-green improvements.

   These objective standards shifted the decision-making about green improvements from faith (the will to believe) to science (belief founded on evidence).

David A. Smith

2. **Not federal but state policy innovation**. In view of of the Obama Administration's stated priorities, many of us expected the federal government to show leadership by developing financial products to facilitate the flow of capital into green improvements. Yet despite thousands of warm words, HUD, Fannie Mae, and Freddie Mac have all been leading from behind. Meanwhile, as thoroughly documented by Global Green in its annual reports, and spurred in part by federally-mandated energy efficiency requirements, state low-income housing tax credit Qualified Allocation Plans have marched steadily toward green metrics. If measured using a scorecard developed by Global Green (note the value of a standard), the average state QAP has nearly tripled in green-ness over the last seven years, from 24% of their maximum possible score to 69%, a trend that shows no signs of slowing down.

3. **The "next available opportunity" approach to green.** The economics of a structural green retrofit solution today seldom work in isolation. Green improvement opportunities are physically embedded inside large building structures (e.g., walls, roofs) and financially embedded inside our over-engineered capital structures (too many mortgages each claiming all rights). To unleash green upgrades, we have to pry open both building and

Guru, continued on page 19

Guru, continued from page 18

financing. But that entropy costs too much to be carried just by the green savings.

Although the stand-alone economics don't work, when the green package is readily available, *and the right transaction opportunity comes along*, then it's almost automatic to include the green retrofits in that underwriting. Precisely this phenomenon has already emerged in the Rental Assistance Demonstration (RAD), HUD's underfunded but immensely promising public and assisted housing innovation program.

4. **The ability to calibrate "just enough marginal subsidy."** With objective standards, rapid state-level policy innovation, and the next-available-opportunity mentality influencing both sponsor and capital provider motivations, those whose decisions shape the resource environment can now be precise in adding just the right extra amount of subsidy, tax credits, soft financing, or rents – to shift the economics of green retrofits from No to Go. Precision encourages innovative developers and innovative state agencies to pitch their applications for resources in the context of incremental greening.

What of the future? Even with all the progress so far, we're still a long way from a mature, properly functioning green retrofit industry. We continue to lack good post-installation performance data; have no nationally applicable standards; and, primarily due to the lack of performance data, have no loan product that will underwrite the "engineerable" cost savings from an energy retrofit.

Nevertheless, compared to five years ago, the evolution so far has been revolutionary. With continuing strong public interest in going green, we'll be much further ahead in five years. When the markets lead, the leaders eventually follow. TCA

David A. Smith is Chairman of Recap Real Estate Advisors, a Boston-based real estate services firm that optimizes the value of clients' financial assets in multifamily residential properties, particularly affordable housing. He also writes Recap's free monthly essay State of the Market, available by emailing dsmith@recapadvisors.com.