

Putting “Green” in Your Pocket

Sustainable property investing represents a structural shift in the investment market for both new and existing properties. Because of the dynamic nature of sustainable investment trends, green properties represent an opportunity for investors to gain a competitive edge. Observations on potential acquisition and underwriting implications of the sustainability “movement” are offered below.

Underwriting Considerations

The process for valuing and underwriting sustainable properties should not differ fundamentally from the process for valuing and underwriting properties without sustainable features. A property’s fundamental risk and value considerations – location, submarket conditions, and property type – independent of sustainability concerns, will continue to drive underwriting and investment decisions.

The starting point in thinking through this issue is to better understand what constitutes a sustainable property or development. The terms “green,” “sustainable,” and “high-performance” are three of the most commonly-used terms that refer to a building with some combination of sustainable features – water-efficient landscaping; low-flow lavatory toilets and faucets; use of natural light through “daylighting;” high-performance window glazing; high-efficiency heating, venting, and air-conditioning systems; high-efficiency interior lighting with daylight dimming and occupancy sensors; use of low-emitting paints, flooring, and carpet adhesives; and other such environmentally-friendly characteristics.

The most widely-used measure to certify a property and its particular combination of features as sustainable in the U.S. is the U.S. Green Building Council’s Leadership in Energy and Environmental Design (LEED) rating system. This whole-building approach to sustainability is achieved by earning a series of points from five categories: sustainable sites, water efficiency, energy and atmosphere, materials and resources, and indoor environmental quality. While there are numerous other certifications and standards used in the U.S. and internationally, the LEED rating system is the most recognized.

However, none of the current ratings or definitions available provides an evaluation of the economics or value of a property, and as such, cannot serve as the primary basis for fiduciary-based underwriting decisions. While labels or ratings do have value, the fiduciary-based underwriting best practices will evaluate the risks and value of a property based on its specific combination of sustainable features. This approach also will enable an investor to adapt more easily to the dynamic changes that still are underway in sustainable rating-certification systems.

Profit Opportunities for Investors

Substantial profit opportunities exist with sustainable property investing. However, it would be a mistake to think that sustainable building features can cure or fully-mitigate fundamental real estate risks incurred by inexperienced or undercapitalized developers or operators, poor location, building cost increases, or market decline.

The most immediate profit opportunities will be with office properties in the larger markets where sustainable investing has gained momentum, given that real estate decisions of government and larger corporate tenants are beginning to be influenced or driven by green considerations. Many existing buildings can profit immediately by undertaking a phased approach to improved energy efficiency (typical savings is 5 to 15 percent). In addition, investments in lighting system changes, better energy monitoring, occupancy sensors, cool roofs, and daytime maintenance and cleaning provide almost immediate payback. Other sustainable features like water-efficient landscaping, low-impact cleaning, ventilation of copy machines, and recycling, also can be added at little or no cost. Besides substantial energy and water cost savings, a property casualty insurance savings of 5 percent can be obtained for LEED projects from certain insurance companies.

Substantial government incentives also are available, particularly for new or substantial rehabilitation. In many areas, up to 5 percent or more of the capital costs of sustainable development can be subsidized, and many more such programs are under development. In addition, creative investment managers are working with service



companies to enable non-taxable investors to capitalize on the many tax breaks available. Even more valuable incentives, including expedited permitting and density bonuses, are becoming more common.

The most important upside opportunity by far is the potential to increase revenues by charging premium rents, accelerating lease-ups on newly constructed or renovated properties, improving occupancy levels, and increasing tenant retention.

Limited quantitative data providing direct support for higher revenues and valuations of green properties has been used by critics to argue against sustainable investment. While better information will be available over time, this apparent limitation must be put into context. The lack of data is partly due to the relatively few private multi-tenant buildings that have been completed to date, and also the fact that precise quantitative analysis is typically not possible in real estate investment. For example, office investors find it difficult to perform an attribution analysis on the relative contribution of a building's lobby, location, transportation access, design features, or its attractiveness to tenants. Yet investors make decisions based on their qualitative assessment of these issues when underwriting or valuing a property. Sustainable features will be handled in much the same way.

What the evidence does show is that there has been a dramatic increase in the demand for sustainable property by users. Corporations have demonstrated a dramatic change towards sustainable buildings. In May 2007, a McGraw Hill/Siemens Survey of 190 corporate real estate executives (84 percent of respondents were CEOs or CFOs) showed that 60 percent of respondents saw value in sustainability now and 88 percent of respondents expected to see value within 3 years. These survey results have been confirmed in a number of more recent surveys and research conducted by the Green Building Finance Consortium, indicating leasing decisions are being influenced by sustainability concerns, including energy costs, recruiting, leadership, and other value propositions at the corporate level.

In addition, health and productivity benefits will continue to drive increases in tenant demand. There are numerous studies which show improved employee productivity

and health advantages associated with various sustainable building features, but due to challenges in collecting conclusive hard statistical data, precise quantification of these benefits for a particular building is not, and will not, be possible for some time, if ever. However, evidence of an employer's willingness to invest in potential benefits without precise scientific or quantitative evidence, given the relative magnitude of potential productivity or health benefits, is growing and is expected to be more important in the future.

Perhaps the most important investment consideration for sustainable properties is the consideration of risk-adjusted returns. Every investment decision involves assessment of a return on investment for a given stream of cash flows in the context of the risk involved. While energy cost savings, insurance savings, health considerations, and other direct benefits are important, the more significant issue is potential loss of value due to reduced competitiveness if a property is not well-positioned to cost-effectively adapt to the trends in user requirements, government regulations, investor objectives, and energy prices. Real estate decisions are typically long-term decisions, and these rapidly-emerging sustainability trends are likely to become even more significant in the future.

Sustainability is certainly the issue du jour, but investors who take the time to look beyond the hype and make their own assessments of the importance of such changes to their organizations and portfolios will likely be better-positioned to compete in the future.

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