SUSTAINABILITY Investors will prosper when they treat sustainability as an integral part of real estate asset value, writes **Scott Muldavin**

Capturing the full value

Sustainability has evolved over the past 10 years to become a key factor in improving real estate returns, value and risk management. Its penetration rate for investment-grade office properties in the US has risen from approximately 5% in 2005 to over 40% today, with similar increases in many global office centres. Adoption in other property types and smaller properties has been slower, but has accelerated in recent years.

Despite the increased adoption of sustainability, at a property level it has been constrained by decision-making practices that have generally limited investment to energy-efficiency projects that can be paid off by cost savings alone over a short timeframe of 3.5 years.

Such strategies ignore growing evidence of increasing tenant demand for sustainability and positive revenue and risk implications. If these factors are incorporated into investment decisions, they are likely to lead to investments in a wider range of sustainability measures and boost profits.

Tenants can now realise many benefits from sustainability beyond energy cost savings, including: improved employee health, productivity, and satisfaction; enhanced customer access and retention; tax, finance, and entitlement subsidies; reduced investment risk; and lower non-energy-related operating costs. Investors benefit from the enhanced value delivered to tenants through higher rents, occupancy, and tenant retention. Sustainability investment can also protect investors against economic and functional obsolescence due to changing demands from regulators, tenants and investors.

Capturing the full value of sustainability investments requires an understanding of dramatic changes in the investment market over the past few years that have increased the value of sustainability investment possible with improved investment decision-making.

A wide range of factors have increased the return potential of property sustainability investments, including: worldwide concern over climate change; technical innovation; significant new capital from green bonds and property-assessed clean energy (PACE) financing programmes; new 'green' leases and energy service company (ESCO) business models; and improvements across the board in sustainable procurement, design, and construction.

However, three recent market changes stand out as game changers in driving occupant demand and the value of sustainability investment.

The healthy buildings movement. Over the past two to three years, the issue of healthy (and productive) buildings has soared in the real estate industry, with organisations like the Urban Land Institute, the US and World Green Building Councils, the American Institute of Architects, CoreNet Global, BOMA International and many others elevating the issue of healthy buildings and communities to the top of organisational priority lists.

Substantive new certification systems have emerged, such as the Delos Well Building Standard which provides performance-based standards that merge best practices in design and construction with evidence-based health and wellness interventions. Proper and careful application of building-based health science will be key to bringing healthy improvements to the building sector.

There is growing evidence that properly built, retrofit, and maintained buildings can generate positive health and productivity outcomes. And practical methods for calculating and presenting how such outcomes can increase property returns and profits have been developed. The value proposition of health and productivity improvements for office tenants is powerful and likely to propel this industry trend forward.

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Surging concern over water availability. The diminishing supply of water is the fundamental issue behind the emergence of water as an investment issue. Global demand for freshwater is projected to exceed supply by 40% by 2030.

Future projections are even more challenging: by 2025, 1.8bn people are expected to be living in countries or regions with absolute water scarcity, and two-thirds of the world's population could be living under water-stressed conditions.

The growing importance of water to business was highlighted in a 2013 report by Deloitte and the Carbon Disclosure Project that analysed the water disclosures of 148 of the S&P 500 companies. Nearly half of US respondents (46%) had already experienced detrimental impacts related to water, with costs for some as high as $400m and projected impacts as high as $1bn.

Companies are subject to varying risks related to water that can affect tenant demand and real estate investment performance. Some businesses, like agriculture or energy companies, are directly affected by cost and availability. Other businesses are affected by reliance on suppliers or customers in regions with water supply or water quality problems. Businesses with active measurement and monitoring of corporate sustainability practices or in areas of water scarcity may also be highly sensitive to building water use – resulting in the most direct threat to property investment.

Improved measurement of sustainability performance. The value of sustainability investment increases if the investor can measure the performance and communicate it to key stakeholders such as tenants, employees, regulators, and capital providers. Real estate sustainability performance measurement systems have dramatically improved over the past few years. Organisations like the Global Reporting Initiative (GRI), the Carbon Disclosure Project (CDP), Urban Land Institute Greenprint, and the Sustainability Accounting Standards Board (SASB) have improved and expanded.

However, it is the emergence and growth of the Global Real Estate Sustainability Benchmark (GRESB) that is most directly having an impact on the value of sustainability for institutional real estate investors. GRESB, formed just five years ago, is a quantitative tool that benchmarks a real estate company or fund's energy efficiency and broader sustainability performance at the portfolio level.

With the European Parliament's passing of a law in 2014 that requires companies with more than 500 employees to address "policies, risks and results" regarding environmental, social and governmental issues, the number of companies reporting will increase from the voluntary level of 2,500 companies to over 7,000 by 2017.

Work by the SASB and the US Securities and Exchange Committee is also moving towards more integrated reporting of sustainability as part of SEC Disclosure filings that will put further pressure on companies to improve the quality and quantity of their sustainability activities and measurement.

How to maximise sustainability returns. Investors will prosper through development of a culture of sustainability that treats it as an integral part of real estate asset value. As such, investment decisions should not be limited by cost-saving hurdles, short-term return goals, or compliance requirements, but based on customer (tenant) demands, competitor pressures, and typical equity hurdle rates. Investment decisions should be based upon a full assessment of costs, revenues, and risks – not just energy cost savings.

In addition to a more appropriate and accurate process for evaluating sustainability investments, investors can help maximise returns by developing carefully considered property and portfolio-level strategies to guide the timing and allocation of sustainability capital improvements among existing assets.

Research departments can add value by tracking sustainability trends and applying findings to forecasting models and due diligence. Appraisal management systems can also be updated to properly assess and recognise sustainable value creation. Given the amount of money and attention investors are allocating to sustainability, it makes sense to do it in a way that maximises portfolio returns.

Scott Muldavin is executive director of the Green Building Finance Consortium