www.pwc.com/us/sustainability
http://www.pwc.com/us/en/asset-management/real-estate/index.jhtml

Key sustainability trends driving business value in the real estate sector

July 2013

This article originally appeared in *"US Real Estate Insights"*

pwc

Key sustainability trends driving business value in the real estate sector

By Don Reed and Cope Willis

Environmental, regulator y and market trends pose growing material risks and opportunities for real estate asset managers. Investors, tenants and regulators are increasingly seeking energy efficiency, green building attributes and greater disclosure of environment al, social and governance (ESG) performance. By applying leading sustainability or ESG practices, asset managers are cutting costs by reducing energy and water use and improving their market competitiveness among tenants and investors. In this article, we highlight key drivers spurring action among real estate asset managers and how leaders are creating value for their funds.

Regulatory and disclosure drivers

Real estate investment funds are receiving an increasing number of inquiries from a growing group of institutional investors who want to better understand ESG practices and performance of their real estate investments. Institutional investors most actively engaged on sustainability include a mix of US and European pension funds, such as APG Investment, CalPERS and CalSTRS. Investor relations officers and fund managers are fielding questions from investors such as:

- How are ESG considerations factored into your investment decisions?
- Do you have ESG policies?
- Do you understand the ESG issues material to your business?
- How do you communicate your ESG activities to your stakeholders?

We also see real estate funds receiving a growing number of inquiries from research analysts and ratings groups seeking to rank or rate funds' ESG performance, including GS Sustain, TruCost, Sustainalitics, EIRIS, Newsweek and others. The latest example is a collaboration between the FTSE Group, the National Association of Real Estate Investment Trusts (NAREIT) and the US Green Building Council (USGBC) which is developing a family of green property index funds that will rate the indexes' fund constituents based on the proportional value of their holdings that have achieved USGBC's Leadership in Energy and Environmental Design (LEED) certification or Energy Star labelling.[1] The groups expect to launch the indexes in the first half of 2013.[2]

1 http://www.prnewswire.com/news-releases/ftse-group-nareit-and-us-green-building-council-develop-the-first-investable-green-property-indexes-179316671.html

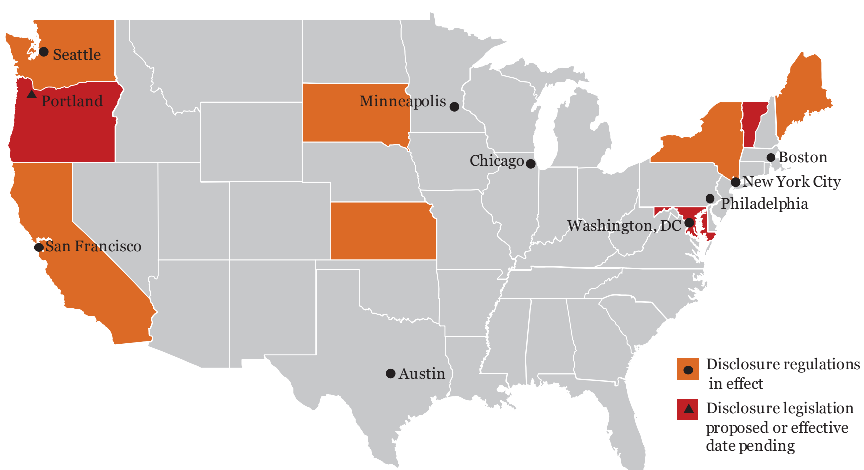
2 http://www.usgbc.org/articles/friday-roundup-green-property-indexes-leed-hospital-net-zero-retail-space

Publicly traded real estate funds also face sustainability related shareholder proposals and potential exchange listing requirements. Between 2011 and 2013, seventeen Real Estate Investment Trusts (REITs) and development companies received shareholder proposals requesting annual sustainability reporting, greenhouse gas emissions reductions goals and linking executive pay to ESG performance.[3] These shareholder requests have spanned a range of real estate sectors, including office, single-family, multi-family, hospitality, and retail.

A group of nearly a dozen institutional investors recently engaged US and international stock exchanges in discussions on developing sustainability disclosure requirements for listed companies.[4] The investor group is planning to present its recommendations on sustainability reporting standards at the World Federation of Exchanges in October 2014.

Another important driver prompting action on energy management at the asset level are a growing number of state and municipal laws requiring property owners to disclose or benchmark building energy performance. Figure 1 shows the cities and states where energy disclosure laws for commercial or multi-family buildings are in effect, proposed or pending their effective date.[5] While all of them require building owners to track their properties' energy use, the laws vary regarding the size and type of buildings they affect, whether the energy use data must be disclosed publicly or only to potential lenders, tenants or buyers, and other factors. These new laws pose compliance obligations for asset managers as well as potential risks to asset performance. For assets with poor energy performance, greater transparency into building energy use and the associated operating costs for prospective tenants or buyers may increase lease up times, reduce effective rental rates and reduce asset value at disposition.

Figure 1. Status of state and municipal commercial and multi-family building energy disclosure laws in the US



3 http://www.ceres.org/investor-network/resolutions
4 http://www.ceres.org/investor-network/incr/sustainable-stock-exchanges
5 http://www.buildingrating.org/content/us-policy-briefs

In response to the growing investor, shareholder and market interest, real estate investment funds are developing ESG reporting strategies. Funds are increasingly participating in voluntary sustainability reporting forums like the Carbon Disclosure Project (CDP) and the Global Real Estate Sustainability Benchmark (GRESB) to proactively communicate their sustainability activities and enhance their reputation on ESG issues. GRESB, in particular, is becoming a key sustainability reporting venue for the real estate investment industry. GRESB launched in 2009 and in 2012 over 400 real estate investment funds voluntarily reported to over 40 institutional investor members who pay to access GRESB's data, ratings and benchmarking of funds' ESG performance against their peers.[6] To perform well in these reporting frameworks, companies need overarching sustainability strategies and policies, energy, waste and water efficiency goals and systems and processes in place to track and report these sustainability metrics, often a challenging proposition across large and diverse real estate assets within a portfolio.

Value drivers

Asset managers are increasingly seeking opportunities to improve the energy and water efficiency of existing properties to improve their market competitiveness or operating margins. While lease structures in office and industrial sectors often pass through energy costs to the tenant, tenants are increasingly paying attention to the total cost of ownership including energy costs. As a result, asset managers often target energy and water efficiency improvements as part of larger renovation projects to attract or retain tenants and increase asset value. Lease structures in other sectors, like retail or multi-family, often enable operating costs savings from reduced energy or water use to accrue directly to the property owner. Depending on the building age and other factors, utility costs can typically be reduced 10-20% with relatively low capital investments and payback periods on the order of one to three years.

Commercial tenants are increasingly demanding green building features, particularly corporate and government tenants who often have policies for minimum LEED or other green building standards to qualify for leasing. For example, the General Services Administration has established a policy of a minimum of LEED Silver certification for all federal leases of new construction projects of 10,000 square feet or more.[7] As a result of these tenant trends, LEED has become a baseline standard for new development, particularly in the office segment, in many metro markets (e.g., New York City, Washington, DC, and Chicago have the most LEED certified projects with over 2,500 as of May 2012). In these markets, developers need to deliver green office buildings to be competitive in the market and protect long-term asset value.

There have been a limited number of well respected studies that provide empirical evidence of the enhanced value of green commercial buildings, but a recently published study by researchers at Maastricht University in the Netherlands and University of California provides some of the most compelling research to date.[8] This study included a sample of over 2,500 LEED or Energy Star office buildings and nearly 20,000 control buildings across the US, and they used statistical methods to control for variations in

6 http://gresb.com/survey/

7 http://www.gsa.gov/portal/content/197325

8 Eichholtz, P. Kok, N. and J. Quigley, 2013. The economics of green building. The Review of Economics and Statistics. March 2013, 95(1): 50–63.

building attributes (e.g., age, on-site amenities, proximity to public transit) and macro-economic factors (e.g., metropolitan job growth). Their analysis showed an average 3% rental rate premium, 8% effective rental rate premium, and sales premium of 13% for Energy Star or LEED certified buildings. While the enhanced value can be challenging to demonstrate empirically, there is growing evidence to suggest that asset managers can create competitive advantage in attracting and retaining tenants and achieve above average asset value appreciation by understanding and delivering on key sustainability market demands.

Federal, state, and local tax credits and incentives are also providing a catalyst for energy efficiency and renewable energy investments in commercial property. At the federal level, for example, the IRS Section 179D provides a tax deduction of up to a $1.80 per square foot for energy efficiency retrofits. At the local level, states, municipalities and utilities offer energy efficiency or renewable power incentives in the form of income tax credits, property tax abatements, bond financing, grants or rebates. For example, we've seen instances of utility rebates for upgrades to lighting, energy management systems and HVAC systems that cover up to 60% of the total capital investment. Many property owners are capturing federal, state and local tax credits and incentives to enhance the return of energy efficiency and renewable energy investments in their assets.

Taking action

With market and regulatory demands for sustainability disclosure and performance on the rise, we recommend that asset managers consider the following action items:

- Evaluate opportunities to communicate proactively on your fund's ESG practices, and respond to analysts' and investors ESG information requests. This is particularly important for large public funds, funds with institutional investors and funds contemplating an IPO;
- Develop a strategy to respond to the emerging state and municipal energy disclosure requirements;
- Improve your understanding of the sustainability demands of tenants in your market to inform your capital investments in major renovations and new development;
- Ensure you take advantage of all available tax credits and incentives to improve the economics of your investments in energy efficiency and renewable energy.

Don Reed is a Managing Director in PwC's Sustainable Business Solutions Practice
He can be reached at
donald.j.reed@us.pwc.com

Cope Willis is a Director in PwC's Sustainable Business Solutions Practice
He can be reached at
cope.m.willis@us.pwc.com

www.pwc.com/us/sustainability