

The Value Proposition of Sustainability: It's in the Eye of the Beholder

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INTRODUCTION

BEFORE THE FIRST DIME IS COMMITTED TO A SUSTAINABILITY initiative, the spender has already determined a priority lens through which “value” will be judged. Real estate is a dynamic asset with multiple stakeholders, investor/owners, tenants and employees as well as the communities in which the real estate is located. This means there will surely be multiple definitions of sustainability representing varied elements and prioritization of the value derived thereof. Sustainability, as an overarching concept, is easy enough to understand—keep the focus on boosting efficiency in the use of materials and operations that constitute a real estate asset. From this basic premise, however, have emerged a variety of views as to priority, necessity and value of certain sustainability actions.

With the continued advancement of sustainability initiatives, both mandated and voluntary, has come the rise of differing sustainability priorities and measures of success attributed to the same asset by various stakeholders. The minefield for an asset owner then becomes how best to address these varying value propositions for maximized long-term asset value. To do so, owners and investors must understand the sustainability value propositions of others, including the broader community, represented by government agencies and users of an asset. These stakeholders may have differing priorities for specific sustainability initiatives. Without understanding the measure of success through their “value lenses,” asset owners can wind up spending on measures that carry less weight or, even worse, falling behind other assets by not spending in

essential areas. This could result in economic obsolescence over time. The focus of examination in this article is on areas of common ground and variability when it comes to sustainability initiatives, their priority and perceived value from differing stakeholder perspectives.

COMMON GROUND

Are there sustainability initiatives emerging that owner/investors ignore at their peril when it comes to government mandates and tenant/user expectations for sustainable business and operating practices? The expectations are becoming fairly settled in the world of new design and construction. The U.S. Green Building



About the Author

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Council's LEED (Leadership in Energy and Environmental Design) system for establishing and measuring a project's level of sustainability has served to coalesce the focus and direction for those involved in the design, construction and operation of real estate assets. These initiatives historically focused predominantly on an owner or owner/user's perspective but are rapidly being adopted by the broader public as part of overall sustainability efforts.¹

Research is now yielding evidence of the positive impact of adoption of certain sustainability initiatives as represented by a building meeting LEED® or ENERGY STAR certification requirements. There is a clear consensus among most asset stakeholders that LEED certification standards, measures and initiatives are the direction to follow when it comes to new building design and construction.² This is being adopted in both the public and private sectors. But what is occurring as attention is turned to non-LEED certified existing buildings that represent 99 percent of today's total existing building stock?³ This is where variations in focus and priority of importance in sustainable operating practices begin to emerge as key value differentiators and potential costly stumbling blocks in the future. There are LEED certifications centered on the construction of interior space retrofits of existing buildings. Many tenants now are either requiring owners to obtain such certification for their space or they are pursuing these initiatives on their own. In either case, the standards and measurements are the same for all (new as well as existing buildings) because they are part of the same LEED certification process. Buildings will also have to obtain LEED recertification by presenting actual performance data documenting the actual results obtained.⁴ This process provides industry data on the impact of sustainability actions taken.

GOVERNMENT MANDATE AND REGULATION

The ultimate levelers of the playing field are federal mandates enacted through law and regulation. Governing bodies at all levels are promoting sustainability or green initiatives to varying degrees. The expectations of the federal government, as both owner and tenant/user of real estate, are emerging with clear implications. Executive Order 13514, signed by President Barack Obama on Oct. 5, 2009, establishes numerous sustainability requirements for federal government agencies to meet, including:

- 26 percent improvement in water efficiency by 2020;
- 50 percent of construction, recycling and waste materials must be diverted from landfills by 2015;
- 95 percent of all applicable contracts will meet sustainability requirements;
- Implementation of the Department of Energy's 2030 net zero energy building requirement for new buildings;
- Implementation of the storm water provisions of the Energy Independence and Security Act of 2007, section 348; and
- Development of guidance for sustainable federal building locations in alignment with the Livability Principles proffered by the Department of Housing and Urban Development (HUD), the Department of Transportation (DOT) and the Environmental Protection Agency (EPA).

This order makes it clear that success will be measured through broader operational criteria, not building construction.⁵ This should make building owners take note that the current and future government regulatory environment will encompass requirements well beyond enhancing asset efficiency. The last part of the executive order specifically addresses employee work force conditions, traditionally an area of tenant, not owner, concern except for maintaining asset desirability. The potential for conflict here could emerge when work force or customer requirements require added expense to the owner, either in design and construction or in operating cost. Leases will have to address who will bear the cost of these types of regulation as they are enacted.

The extent of government involvement continues to grow. With commercial and industrial buildings using at least 49 percent of all energy consumed in the U.S. annually, the Department of Energy and the current administration have announced continued focus on energy saving and resource saving sustainability practices in both the public and private sectors.⁶ The focus goes beyond energy and water efficiency to lighting, indoor air quality, greenhouse gas and other emissions control and landfill use reduction. This focus involves all stakeholders of real estate assets, though the potential impact will not affect all equally. Thus, the value of pursuing one sustainable practice versus another will vary, depending on the magnitude of implications for a stakeholder, including cost to that stakeholder.

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There are now a growing litany of LEED-mandating government agencies enacting LEED-compliant regulation and requirements, and not just at the federal level.⁷ While LEED certification is not required, the results are the same. It is below the federal level, however, where variation in the extent of government requirement varies. For example, California was the first state to pursue a comprehensive green building standard. The California Green Building Standards Code (CALGreen) adopted Jan. 1, 2011, requires all new buildings to increase energy efficiency by: demonstrating a 20 percent reduction in water consumption; diversion of 50 percent of construction waste from local landfills; use of low VOC (volatile organic compound) materials; separate water meters to track usage; and mandatory inspection of HVAC and other building energy systems.⁸ At first glance, these seem very aligned with Executive Order 13514, but CALGreen's specific requirements for use of low VOC materials, installment of separate water meters and mandatory inspections go well beyond the federal regulations. These federal and state mandates will all add cost to owners for sustainability actions they otherwise may not have chosen to pursue because they deliver much less accretive value than measures focused on lowering operating cost and boosting efficiency directly. This is a clear illustration of diverging value priority by stakeholders; however, governing bodies always hold the legal trump card, enforcing a common ground, if you will.

In order to forge voluntary common ground between public mandate and private action, economic incentives are offered by governing bodies in order to improve the value proposition for asset owners and sometimes for tenant/users. The incentives are intended to mitigate some of the upfront or ongoing additional cost by providing some other value to the recipient. Green incentives are being used in the areas of energy efficiency, water conservation, use of green materials, reduction of landfill contribution and reduction of greenhouse emissions.⁹

When it comes to owners and users of real estate seeing eye-to-eye on sustainability, there are areas with proven data that illustrate the value enhancement for all. The adoption of LEED certification for buildings has produced a live laboratory to quantify the economic and value benefits of pursuing certain sustainable practices. A 2008 report, "Does Green Pay Off?" by Norm Miller, Jay Spivey and Andy Florance, documented the results of research on the value of LEED certification or ENERGY STAR certification for a building.¹⁰ The study compared

LEED and ENERGY STAR buildings to non-LEED buildings of similar characteristics. Findings showed increased occupancy, increased rents, reduced operating expenses and increased sales per square foot values of up to 15 percent.

LEED and ENERGY STAR vs. Non-LEED Buildings Comparative Performance

Occupancy	2.5% increase ENERGY STAR 5.4% increase LEED
Rents	\$4.73 psf increase ENERGY STAR \$9.06 psf increase LEED
Expenses	\$0.54 psf decrease in energy expense (30%)
Sales Price	15% premium on sale

Source:

University of San Diego Burnham-Moores Center for Real Estate

This data presents a compelling case for pursuing sustainable practices that comprise LEED compliance, especially when one considers that the added cost to achieve basic LEED certification is typically between zero and five percent of the upfront construction cost. These initiatives also provide direct and indirect benefit to tenants through lower occupancy costs and improved workplace environments.

OWNER VERSUS USER

Where do you draw the spending line as an owner when it comes to satisfying tenant sustainability expectations? What should really be tenant expense versus owners—and for what? The answers will depend largely upon who perceives the most value for the action and who receives the economic benefit. There are sustainability initiatives that show up as major parts of corporate environmental responsibility platforms (e.g., recycling efforts, reduction of corporate carbon footprint or lowering greenhouse gas emissions) that may not carry the same importance for the asset owner as for the tenant. The tenant may see more value in such pursuits and in their extent as well.

It is hard to quibble with the ideas of improved efficiency and less waste. We all believe it is possible to do better. But determining at what cost and who should bear the cost is what begins to drive a wedge among owners, users and government agencies. It is obviously easier to avoid

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mistakes and achieve sustainability objectives on the design board than it is to change the operational direction of an existing asset. There will always be the constant tug of interests for an owner between maximizing asset value and spending in the right places and at the right times. The obvious action steps usually address low-hanging fruit and target areas for maximum goal achievement or “biggest bang for your buck” initiatives to help prioritize

Even with varying priorities regarding sustainability initiatives, it is wise to explore future areas for value enhancement for all stakeholders.

focus, but the most successful approaches begin with clearly defining sustainability and its value alongside clear performance measures thereof.

From a tenant/user's perspective, sustainability is most often viewed in the broader context of corporate social responsibility. This is the idea that companies have obligations not only to shareholders, but also to stakeholders, society and the environment. Green initiatives and requirements for the space a company occupies are tied to the larger goals of corporate social responsibility.¹¹

As government regulation and shareholder accountability increase, American corporations are often turning to the International Organization for Standardization (ISO) for guidance with implementing green and corporate responsibility programs. ISO standards provide direction for establishing goals and compliance measurement. The ISO 140001 standard for environmental management systems (EMS) establishes best practices and benchmarks for

green initiatives but it is a compliance monitoring system, not a determiner of sustainable practices to adopt nor does it set performance expectations.¹² For many corporations that use measurement frameworks such as the Dow Jones Sustainability Assessment, sustainability has multiple components including, but not limited to, environmental responsibility.¹³ Statements of corporate social responsibility can be found

on most large corporate Web sites, but the environmental components and how they measure success vary greatly. A list of most commonly addressed environmental sustainability practices are in the following chart along with the relative priority on behalf of tenants versus owners. Summary analysis indicates that areas of expense reduction and improved efficiency for the building show greatest alignment of priority. Practices that are important to users are recognized by owners in the context of enhancing a building's marketability, thus preserving or boosting asset value over the long term.

Sustainability: Degrees of Priority – Tenant Versus Owner

Sustainable Practice	Corporate Priority	Landlord Priority
Reduction in energy use	Yes	Yes
Reduction in water use	Yes	Yes
Reduced emissions	Yes	Only those practices mandated for the building
Enhanced lighting	Yes, improves workplace environment	Limited, if it enhances marketability and produces cost savings over time
Improved indoor air quality	Yes, improves workplace environment	Limited, if it enhances marketability
Pollution prevention	Yes	Only those practices mandated for the building
Green products and materials	Yes, improves workplace environment	Yes, provided additional cost is within reason
Waste reduction	Yes, recycling and reduction of landfill contribution	Limited, if cost-effective and enhances marketability
Use of renewable energy	Varies, where appropriate or if part of societal responsibility initiatives of company	Limited, if cost-effective or enhances redundancy
Reduced carbon footprint	Limited, if mandated or if it is perceived to boost societal responsibility initiatives of company	Limited, if enhances marketability
Improved transit patterns	Yes, reduces company impact on environment	Limited, mainly at the time of site selection or to add solution that enhances tenant accessibility, and to address a marketability issue

Source: Johnston Craig LLC

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When corporations operate in an environment of measuring sustainable practices, it can be reasonably expected that they will seek out real estate to occupy that which best helps them achieve their environmental sustainability goals. What are large credit tenants likely to demand in the way of sustainability requirements? How far will they push and in what areas? Where are government mandates also impacting them? What deal breakers are emerging? The answers to these questions reveal the priorities and relative value a tenant/user will ascribe to a sustainable initiative. In a 2010 article for *Commercial Real Estate Investment* magazine, Beth Young, CCIM, LEED AP, shares an anecdotal situation from a Grubb & Ellis broker in South Carolina who lost a 20,000-square-foot tenant to a silver LEED building with rent greater by \$2.12 because the landlord declined to implement a sustainable program at the behest of the tenant. The tenant actually preferred the building and its location but a sustainability program was the deal breaker. This is only one of numerous cases in which a landlord has incorrectly calculated the value ascribed to sustainability initiatives or particular practices by a potential tenant/user. The losing landlord in this instance has now instituted a rolling sustainability program as existing leases roll.¹⁴ Had it not, a building such as this would surely decrease in economic viability over time as it slips in market competitiveness.

FUTURE LANDSCAPE

What will be the likely confluence between government mandates, corporate responsibility initiatives and ownership operational initiatives? While the marketplace is gaining knowledge from data on actual performance improvements with which to gauge the cost/benefit of specific sustainability initiatives, there is ongoing need for vigilance as to what will be the next wave of green practices that may become mandated or could become tenant deal breakers.

What are governments going to mandate?

We can observe trends in sustainable practices that are being integrated into laws, regulations and codes. In this context, they will certainly have an impact on all stakeholders. It is helpful to look at outliers with respect to state and local mandates—who is pushing the envelope? A few examples of outliers include:

- The state of Hawaii mandated solar hot water heaters be installed in all new single-family homes beginning in 2010;¹⁵

- In May 2009, the city of Toronto adopted a green roof mandate of up to 50 percent coverage for multi-unit residential buildings over six stories, schools, non-profit housing, commercial and industrial buildings. Developers opposed the mandate, citing significant additional upfront cost and added maintenance costs which they argue will negatively impact property value.¹⁶

What are tenants and users going to expect?

We should continue to look at corporate responsibility initiatives. Where do tenants and asset owners share common ground on sustainability and green initiatives? What do tenants perceive to be the benefits to them from specific sustainability initiatives? How do tenants measure their own success? Are they expecting a lot more in certain categories than what LEED buildings and government mandated practices are achieving?

How best to preserve and maximize asset value?

For owners, what are the best sustainability initiatives to adopt to maximize long-term asset value? This speaks to the heart of a real estate asset remaining viable in an ever-changing world. It informs where and when to spend and what the measure of success or value should be.

CONCLUSION

Adoption of sustainability initiatives with respect to commercial real estate is a continually evolving process. The extent and rapidity of adoption depends upon what is mandated, what is voluntary and the perceived extent of positive impact on value. While value has differing contexts depending on the stakeholder, there are key areas for thorough assessment that are important for all to consider. Vigilance in monitoring changes in mandates, corporate priorities and proven benefits derived from specific sustainability practices will ensure the ability to maintain market competitiveness, enhance value and prevent potentially fatal missteps or unnecessary expenditures.

Building upon proven areas for achieving valuable improvements in sustainability, stakeholders should consider the potential benefits of adopting new practices as they arise. Even with varying priorities regarding sustainability initiatives, it is wise to explore future areas for value enhancement for all stakeholders. This can be done effectively only in the context of well-defined sustainability goals and measures of benefit and performance. Without this value enhancement framework, an asset is perpetually vulnerable to economic obsolescence. ■

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ENDNOTES

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