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SUSTAINABILITY SHIFTS FROM NICE-TO-HAVE TO MUST-HAVE

BY ELIZABETH BLOSFIELD

A portfolio-wide sustainability strategy is no longer an advantage, but a necessity, as institutional investors increasingly demand energy-efficient assets in the wake of more robust data about their financial performance.

"Sustainability on the investor side is really just starting to gain momentum—not many people were asking for it in the past, and it wasn't a big decision factor when deciding whether to invest," says Tony Liou, principal engineer and president at Partner Energy, an energy efficiency consulting firm. "Today, we're hearing more [investors] say it is a factor. Institutional investors are asking for sustainability, and fund managers have to have a plan to address this need."

When fundraising in the past, fund managers would tout their experience, the type of assets in which they invest, where they invest, levels of risk and anticipated financial returns, he explains. Today, sustainability is an equally imperative component.

"What [a sustainability strategy] does for managers is it gives them a road map to market their fund's performance," he adds. "From the institutional investor side, it allows them transparency into the portfolios in which they're investing so they can rate the performance of the fund."

One increasingly apparent challenge, however, is a lack of consistency in sustainability benchmarking. Too many competing standards may be leading to confusion among fund managers as to how best to pursue an energy-efficient approach, Liou says. "Right now, there may be too many competing standards, so the drive toward sustainability loses its strength, and managers lose their motivation when they are confused," he explains. "If the industry adopts a certain standard for sustainability, then everyone will be working toward one thing."

Many market players are touting GRESB, a global real estate sustainability benchmarking system created by the Carbon War Room in 2009, as a needed solution. The benchmark, which has just begun to ramp up among industry players, takes into account the entire portfolio rather than individual assets.

"What they've managed to do is create a reporting system that is consistent globally for all building owners to report sustainability activities," says Clare Broderick, director of facilities engineering at Partner Engineering and Science, an environmental and energy consulting firm. "It's a huge thing because it's a consistent measuring stick, as opposed to individual asset certifications like ENERGY STAR and LEED—it's one consistent measure across an entire portfolio."

The Empire State Building: A sustainable retrofit has yielded huge savings on energy costs

While it's not the first sustainability benchmark to rate an entire portfolio, GRESB is the first to be embraced on a large scale, Liou says. "We hear people that have 1,000 buildings talking about this and people with 30 buildings talking about this," he states.

Clarion Partners originally became involved with GRESB in 2011 with its open-ended fund. "We didn't know what we would get out of it, but we thought it would be valuable," says Bohdy Hedgcock, senior v.p. "Since then, we really ramped up our activity around it, and now we're reporting for three of our open-ended funds and using additional consulting assistance to help pull the information together. This expansion reflects [our] larger commitment to sustainability as a whole."

This year, the $32bn real estate asset manager won GRESB's sector leader award for the top performing fund in its class and two green stars for outstanding sustainability performance, according to reports.

"In our opinion, GRESB is really solidifying itself as the go-to benchmark at the portfolio level," Hedgcock says. "It's the one that we pay the most attention to, and the one we believe others will pay the most attention to going forward. There are other ways to address [sustainability] at the individual property level through building certifications, but at the fund level, GRESB will likely establish itself as a leader going forward."

This comes at a good time, as there is a much bigger emphasis on portfolio-wide sustainability within the commercial real estate fund industry while more investors see the financial benefits of energy-efficient buildings and success stories like Clarion's become increasingly common.

"Many major office tenants, like government agencies and big corporations, have made it clear that they will only consider buildings with some element of green certification," Hedgcock said. "That helps justify the cost [of sustainability] if tenants are demanding it."

With this in mind, Liou is advocating that managers look at sustainability through the lens of their entire portfolio, rather than pursuing it on an asset-by-asset basis. "Worldwide standards for sustainability have historically taken into account single assets for building certification," Liou explains. "We saw this as a trend for a little bit, where portfolio owners would do one or two buildings that were LEED certified, and that would be their sustainability practice for their whole portfolio - one or two buildings out of 500 that they own. However, if you want a clear indicator of how your portfolio is performing, you can't just do one or two assets and consider that your entire sustainability strategy anymore."

That said, some skepticism still exists involving the financial burden of energy-efficient building upgrades, which typically cost more to owners up front, leading to some hesitation, says James Gray-Donald, v.p. of sustainability at Bentall Kennedy.

"What is common in the industry is for a building owner to try to continue running the building's mechanical systems beyond their natural lifetime until a major failure occurs, and then replace it with what is cheap and what is available," he says. "By being proactive about replacing major components and doing so intelligently, you can actually save a substantial amount of money."

Indeed, Bentall Kennedy's own research shows that although it costs upfront, returns on energy efficiency are typically strong, and the payback period averages between three and five years or even less.

"Through our research based on our own portfolio, we've seen that even in newer, well-built and well-managed office buildings, you can find savings," he says. "Often, there are a number of projects where owners will pay the energy reduction costs up front, but those costs will be offset against savings in the first one to two years of tenant operations."

A complete study of the financial performance of Bentall Kennedy's managed office portfolio published this fall in the *Journal of Portfolio Management* found that buildings with sustainable certification consistently outperformed similar non-green buildings in terms of rental rates, occupancy levels, tenant satisfaction scores and lease renewals. The study began in 2005 and analyzed a decade of financial performance data throughout Bentall Kennedy's office portfolio, which totals 58 million square feet of buildings in the U.S. and Canada. The survey takes into account nearly 300 North American office properties and serves as the most in-depth analysis to date of the link between responsible property investment practices and financial returns, says Gary Whitelaw, CEO for Bentall Kennedy Group, in a company press release.

"[Our research] confirms what we've intuitively believed for the past 10 years—that green certified buildings have higher rents and better occupancy," Gray-Donald states. "We felt that way about it for a while, but there was always some doubt about the comprehensiveness of the research. It was great to be able to confirm it with our own portfolio data over a much longer time period than in other studies and throughout multiple real estate cycles."

Bentall Kennedy's research found that net effective rents averaged 3.7% higher in LEED certified U.S. office properties than in similar non-certified buildings, and occupancy rates were 9.5% higher in U.S. office buildings with ENERGY STAR certification than in buildings without certification.

"[With better data], we're able to respond that having green buildings is a worthwhile investment and not just an environmental benefit – there are also financial benefits," he says. "That's a strong message to send to the marketplace, especially because a number of the larger funds factor risk into their decision matrix more heavily, so they're seeing green building as a way to mitigate long-term risks. Investors who are more focused on financial performance and less on risk are also coming on board with pushing for green buildings in portfolios as well."

To capitalize on this trend, Gray-Donald encourages building owners to work with utility providers and expects more partnerships between both parties to occur going forward. "Engineering and consulting companies have built out their skill sets on this in the last 10 years as sustainability has been gaining capacity in most regions," he says. "Now, there are very skilled engineering firms that know how to do this, and it makes it easier for building owners to find people to do this work."

Utility providers can not only help to measure performance indicators, such as water use, energy consumption, greenhouse gas and waste year-over-year to track portfolio performance from a holistic perspective, but many will work directly with owners to offer incentives as well.

"If you're ever doing any type of investing in an asset, you should talk to the utilities that are responsible for getting power and gas to your doors," Gray-Donald says. "Here in New York, for example, our infrastructure is aging. From a utilities perspective, it is cheaper to reduce energy demand and consumption as opposed to building new power plants and infrastructure, which is really expensive to maintain. A lot of utility providers have always been motivated to reduce energy consumption, and there is demand to incentivize parts of their services or to work directly with building owners to bring in the utility to offset labor."

As more building owners, utility companies and service providers work together, and the commercial real estate industry moves toward consistent portfolio benchmarking standards, market players agree that sustainability is set to see a big shift going forward.

"We're in an exciting time in the industry, and we're hoping to see a confluence of investors with building owners and occupants, and that's what we really need," Broderick says. "Sustainability is much deeper and wider now than it has been in the past," Gray-Donald adds. "The need for energy efficiency isn't going anywhere, so this increased awareness is just filling a need that has always existed."