Calls for 'greener' buildings that do less damage to the environment have been finding support among institutional investors, who hope that an eco-friendly property investment strategy will not only be good for the planet, but could also make economic sense.

Are 'green' buildings good for your portfolio?

Why sustainable property may promise better returns

Although punishing credit conditions and a swift drop in real estate values have focused institutional interest on other concerns, stricter regulations on energy use, in particular, mean that 'green' issues are not going away. They may drop down the agenda, but there is still global momentum in favour of buildings that meet 'sustainable' standards in terms of energy and water use and waste treatment, among other environmentally-friendly features.

Not long ago, interest in sustainable commercial property was confined to public and local authority pension funds, many of which follow socially responsible investment codes of practice. But the theme has since attracted a wider institutional following. Nearly three quarters of UK pension funds surveyed in June 2008[1] felt that 'strong sustainability credentials' were important when selecting a real estate manager. All but 6 per cent of the 400 funds surveyed were corporate plans.

The key reason for this interest is an emerging consensus within the industry that a green property portfolio could eventually offer better investment returns, as less efficient buildings suffer discounted prices.

In light of this, institutions may want to assess the impact of new sustainability standards, and increasing demand from occupiers who want to help the environment or are themselves obliged to meet new green measures.

Changing values

The business case for sustainable buildings was made by the Royal Institute of Chartered Surveyors (RICS) earlier this year. The key message from a RICS conference was that "unsustainable construction, investment and management practices will lead to accelerated building obsolescence and losses with regard to asset value and financial performance". Other voices have joined in with a similar message.

At a recent UK parliamentary enquiry into 'greening' existing commercial buildings, MPs faced calls from the industry for lower taxes on sustainable properties to promote energy efficiency.

On an international level, EU legislation introduced energy ratings for commercial buildings. In Australia, new buildings must comply with the country's 'Green Star' sustainable performance measures. The UN Environment Programme is actively encouraging industry participants to promote sustainable real estate.

Investors are responding to the trend. For example, some of the largest global pension funds are incorporating environmental concerns in the management of their property portfolios. Green institutional property funds have been launched in the US, and a few large UK real estate managers are starting to assess and manage sustainability risks in their portfolios.

What exactly is sustainable real estate, and can you measure (and price) its benefits over traditional bricks and mortar? Perhaps more importantly, are the benefits worth the potential added costs, particularly in light of strains in the real estate sector?

The core issues are energy and water use, and waste treatment (low usage leading to low emissions and pollutant levels). Ideally a building should also be constructed of environmentally-friendly materials, be sensitive to its surroundings and the needs of its occupants (health, welfare and safety), and close to public transport or cycling routes.

Sustainable buildings may prove to be more competitive, trade at a rental premium to the market, have shorter vacant periods, reduced obsolescence and slower depreciation, ultimately commanding higher capital values. In contrast, buildings that perform comparatively poorly in terms of sustainability goals could see their rents and capital values trade at a discount, resulting in lower investment returns.

So far, however, the words 'could' and 'may' have yet to be replaced by hard numbers. No clear evidence exists that building performance has affected market prices. This is mainly because the lack of commonly-agreed measurement standards and centralised data make it impossible to judge.

What is sustainable real estate?

Building design, construction, management and use which integrates environmental, social and economic objectives. Whilst unique to each building, typical issues to consider include:

Energy
Energy consumption during construction and use, energy efficiency measures, use of renewable energy.

Materials
Environmental sustainability of building materials – for example, timber, steel, cement.

Water
Consumption of potable water, water efficiency and recycling measures.

Waste
Waste management and recycling facilities.

Transport
Access to public transport and cycling facilities.

Pollution
Atmospheric emissions, waste water discharges and surface water run-off.

Local environment
Land use, local ecology, visual impact, contextual fit and community relations.

Internal environment
Occupant health, safety and well-being, building design, climate control.

Adaptation
Scope for building to adapt to changing climatic conditions or occupant needs.

However, the framework for a two-tier market, where sustainable property commands higher values, is well past the design stage and, in many cases, initiatives are already being implemented. The central steps are set out below.

Cutting emissions

Commercial buildings are heavy on energy use and emissions, and so they are an obvious target for energy regulation. The EU pledges to cut carbon emissions by 2020 and has passed a landmark piece of legislation, the EU Energy Performance of Buildings Directive, which introduces Energy Performance Certificates for commercial real estate. These EPCs give an A to G rating for the energy performance of a building and must be provided to prospective tenants and investors.

The proposed Carbon Reduction Commitment (CRC) in the UK, for example, would apply to large retailers, banks, offices, universities, hospitals and government bodies not already covered by existing emissions trading schemes. Its aim is to cut carbon emissions by 1.1 million tonnes a year by 2020. If enacted, the CRC would focus occupiers' minds on the energy performance of their premises and is likely to influence real estate decisions.

What tenants want

This leads to the demand side of the debate about future pricing. It seems that tenants are becoming more interested in the environmental impact of the buildings they occupy, and are willing – in theory, at least – to pay more for a sustainable property.

Occupiers, for example, wish to see environmental solutions for older buildings, and highlighted energy consumption, waste management and sustainable development as priorities.

Industry professionals also recognise the importance of green issues for commercial real estate. About half of 400 UK industry professionals surveyed in 2007[2] said sustainability was critical to corporate real estate, and nearly 80 per cent said it would be critical within two years. More than half of the respondents also said they would pay up to 5 per cent more for a sustainable building, and a further 25 per cent said they would pay 5 to10 per cent more.

Other research[3] found that more than three-quarters of surveyed occupiers in the finance and business service sector were willing to pay more for a green building.

How green is my portfolio?

If green buildings are to command higher capital values and rents, it follows that there must be commonly accepted standards for measuring how eco-friendly they are. In February 2008, the Investment Property Databank (IPD), a research firm, launched its Environment Code, which provides a global standard for measuring

the environmental performance of commercial buildings. The IPD Code sets out common definitions, metrics and a framework to gather information across a portfolio of varied building types.

Global initiatives are being mooted, to address the need for standardised measurement, comparison and benchmarking of sustainable real estate.

What about older buildings? It may be possible to upgrade these (by installing more energy-efficient equipment, for example) to make them competitive. When evaluating their property portfolios, or new investment opportunities, investors should take into account the cost of such improvements, which they may well be required to make in the future. They should also consider the possible future risks of investing in buildings that have low green credentials.

What investors can do

For investors, a good place to start would be to identify buildings that may breach current or future legal requirements, or other green standards. The investors can also look at low-cost ways of making buildings more eco-friendly. They may be able to incorporate these measures into their ongoing maintenance and refurbishment programmes. Last but not least important, investors should be aware of sustainability issues in managing real estate, and deciding whether to buy, sell or develop it.

It would also be a good idea to talk to their tenants and other stakeholders, and possibly agree on actions and goals.

These measures should help investors manage risk and enhance long-term return in commercial property portfolios. Although the business case for sustainable property is far from clear, the signs are pointing to the eventual emergence of a two-tier market.

Over time – and it may be a long time – improved data will show whether new regulations and growing demand are indeed leading to higher prices for greener properties.

[1] Survey conducted by the Pensions Management Institute and asset manager Prupim.
[2] Research conducted by Jones Lang La Salle.
[3] Research conducted by GVA Grimley.