LOOKING BEYOND THE WALLS: THE TRUE MEANING OF SUSTAINABLE REAL ESTATE INVESTING

Green is good, but when you're looking for investments in commercial real estate, green alone is not enough. We talked to Doug Kinney, Executive Vice President, Client Relations and Product Development, Bentall Kennedy, based in Chicago, about the need for a broader definition of sustainable real estate investing.

Building certifications in North America such as LEED and Energy Star are becoming table stakes in commercial real estate. Why are these certifications important?

We've always believed that obtaining green building certifications have lower operating costs due to their efficiencies, which is great for tenants and great for the environment. We felt that prioritising sustainability resulted in a superior experience for tenants and created value for investors. But, we also knew there was a bigger impact to investors and that's why we commissioned independent academic research in 2014 that involved the study of nearly 300 office properties across North America, and the findings were significant.

The research, conducted by Dr. Nils Kok of Maastricht University in The Netherlands and Avis Devine of the University of Guelph in Canada, found that properties with green building certification generated higher rents, had higher tenant satisfaction scores, had higher renewal rates with fewer rent concessions – and not surprisingly used less energy.

These findings demonstrate the potential for enhanced net operating income and an overall improved valuation for green certified buildings relative to their non-certified counterparts. From an investor standpoint, that's a significant upside.

The real driver is that companies want to attract and retain the best employees – and employees, especially the millennial cohort, are demanding high-quality, green environments aligning with their values in which to work.

This is especially important in the high-growth technology and innovation sectors, where talent attraction and productivity are top corporate priorities. In the end, you have happier more productive employees and employers want to stay. We've seen it firsthand – when you provide a quality product that meets surging demand, good things happen to the income generation and capital appreciation of these real estate assets.

Have global real estate markets caught on to the importance of sustainability?

It's actually the US that's lagging – we're the ones playing catch-up to Europe and other parts of the world. In many countries, pension plan guidelines require that sustainability scores be factored in to the investment process. The Netherlands is a great example of this – they're true leaders in the area and sustainability is a driving force in their investment planning. Managers that prioritise sustainability are proving to be a pathway for such pension plans to find high value investments in the US where previously they were unable.

Our firm's advantage is that we're ahead of the curve in the US. We've been ranked among the top firms in the world for the past six years by the Global Real Estate Sustainability Benchmark (GRESB). And for the seventh year in a row, we earned the US Environmental Protection Agency's (EPA) ENERGY STAR Partner of the Year – Sustained Excellence Award.

As investors outside of our country look to invest in the US market, they stand to benefit from Bentall Kennedy's commitment to sustainability.

Commercial real estate investors often equate sustainability with the building itself. How does it extend beyond those four walls?

First, we place a high priority on tenant engagement, and actively involve them in both sustainability initiatives and in the building improvement process. When it's done well, it creates a stronger loyalty to the building and the workplace – and enhances overall employee job satisfaction. This supports corporate tenant goals of reducing absenteeism and increasing employee productivity. And for our investors, this leads to greater occupant satisfaction and higher net income due to lower turnover and higher occupancy rates.

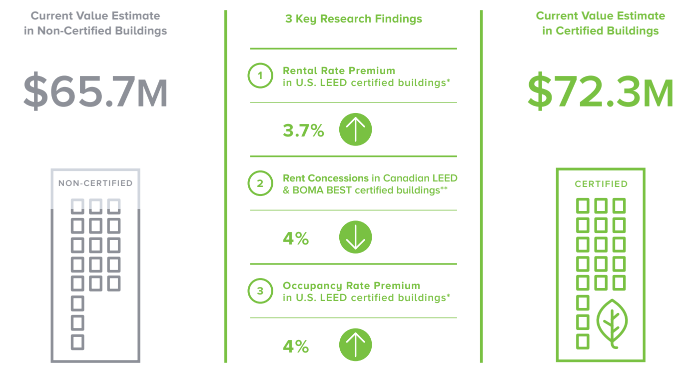
A good example is right here in Chicago, where McDonald's recently announced that it's moving its headquarters from the suburbs to downtown. If you want to compete for the best and the brightest, you need to be where the talent wants to be.

Given the policy uncertainty with the recent change in government, do you expect any change to this sustainable investing strategy?

The short answer is no. The move to these sustainable urban nodes is cultural, and policy shifts won't impact the cultural aspect of what's defining this movement. Potential tenants will always desire to work, live and play in areas or within buildings that are consistent with their values and their well-being, irrespective of policy set by government.

GROUNDBREAKING FINDINGS

An illustration of the value impact from three key research findings suggests an 8–10% higher asset value for green buildings.



The illustration above shows the hypothetical change in value of a hypothetical property using a Bentall Kennedy valuation model that is based on a discounted cash flow approach. This is a hypothetical illustration for the purpose of estimating a possible value impact of the changes in rental rates, rent concessions, and occupancy rates correlated to green building certification in the study. It does not present actual increases in value or potential future increases in value of actual investments. The increase of value shown is at a point in time based on changes to assumptions in the valuation model, and does not represent a rate of return. Bentall Kennedy believes that the assumptions about market conditions that factor into the model are reasonable for an office property located in North America, but market conditions vary by geographic area and could differ significantly from these assumptions. There can be no assurance that an investment in green certification would have a similar impact on an actual building. The model further does not reflect fees, transaction costs and other expenses that would decrease the return on an actual investment.

*In Canada, LEED data less robust
**In U.S., BOMA BEST not available

ASSUMPTIONS

Year one market rent assumption: $30 psf

Tenant Improvements: $30 psf (new tenants)/ $15 psf (renewals) calculated on a 75% retention ratio

General Vacancy: 7%

COMMON ASSUMPTIONS

Lag Time: 8 months

Commissions: $5 psf (new deals) / $2.50 psf (renewals)

100,000 sf office building; 10 tenants renting 10,000 sf each; Lease expiries and renewals spread evenly over 10-year investment time horizon; reversion of NOI in year 11

Discount rate of 6% applied to future income

Terminal capitalization rate: 5%

MODIFIED ASSUMPTIONS

Year one market rent assumption: $31.11 psf

Tenant Improvements: $28.80 psf (new tenants) / $14.40 psf (renewals) calculated on a 80.6% retention ratio

General Vacancy: 3.28%

Second, we factor in the ability of the broader urban neighborhood to sustain growth through mixed-use development that aligns with green goals. At a regional level, we want cities that have the appropriate infrastructure, policies and planning in place – such as public transit, smart growth and environmental health – to attract people and businesses. We're investing for the long term, so we want to invest in cities that proactively address sustainability issues.

At a community level, we focus on communities that offer a range of amenities – entertainment, recreation, and residential options at different price points, and that emphasise green credentials and health-oriented facilities. Good transit is also critical, but with a focus on active transportation such as walking and cycling.

And from an economic perspective, we invest in areas that contain high-growth, innovative job sectors, such as technology, health care, digital entertainment, e-commerce and higher education, because those are the growth areas of our economy.

What's driving the growth in these areas is a generational lifestyle shift, led by the millennials. They're no longer willing to be sent across the country to large corporate campuses. Instead, employers are moving to where the talent is, and these are typically innovation, technology and higher-education centers with live/work/play features.

As the millennial generation ages, some will undoubtedly choose to move outside of these urban cores, but the younger generation following is as large or larger and they'll be creating additional demand. That's why we believe that areas with growing millennial demographics, innovation industries, and revitalisation initiatives that create live/work/play communities lie at the centre of future growth and demand.

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