THE GREEN TRIFECTA[1]

Assessing Value Potential in Green Development

The Broader Green Perspective

Informed commercial real estate investors, developers and owners are increasingly 'placing their bets' on green/sustainable strategies. Whether considering new construction, much diminished by the current economic environment, or retrofitting existing buildings, a growing practice in cities ranging across the U.S., the adoption of 'green' as an investment strategy is gaining momentum across all real estate sectors.

As any real estate market participant will confirm, one of the most challenging aspects of 'going green' is how to prioritize the decisions that must be made to successfully achieve long term goals. Relative to real estate, this challenge takes many forms, based most specifically on the individual goals of various market participants. However, at the basis of all these decisions, no matter how disparate, is the concept of 'value'.

Though the perception of value may vary widely, the definition:

> *"…..the worth, desirability, or utility of a thing, or the qualities on which these depend."* [2]

is fairly consistent. The differences of opinion arise from individual assessments of what exactly is *most* valuable about green development. Which benefits, or qualities, are most valuable and upon which set of values are you basing your assessment? John Elkington introduced us to the concept of valuing real estate on the basis of a "Triple Bottom Line" in his book, Cannibals with Forks. [3] The notion that real estate value should incorporate not only the economic/bottom line benefits afforded the owner or investor, but also the environmental and social benefits generated for the community, has been adopted by a multitude of investors, developers, owners and other real estate market participants world wide.

The United Nations' Principles of Responsible Investing have been signed by investment managers, pension funds, banks, government groups and major corporations around the world. Not only do these principles include the concepts contained within the triple bottom line, but they also incorporate workforce and security considerations as well. In other words, major organizations worldwide are viewing the "value" of real estate from a much more expanded perspective than just bottom line, economic results – and investment decisions are being made globally using this broader perspective.

As a result, the prioritization of the various factors incorporated into 'value' rests with the individual investors/owners and this approach allows them to choose the "trifecta" which provides them with the most profitable outcome, based on the values they attribute to their own goals.

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[1] Trifecta: "A form of betting in which the first three places in a race must be predicted in correct order." The Australian Concise Oxford Dictionary, Oxford University Press, pg. 1242.
[2] The Australian Concise Oxford Dictionary, Oxford University Press, pg. 1290.
[3] Cannibals with Forks, John Elkington, Capstone, Oxford, 1998, 402 pp.

The Basics

In the formal valuation of commercial real estate, the valuation process itself is decidedly formulaic; however, many of the embodied concepts are quite qualitative. In its most basic form, the valuation "trifecta" reflects some combination of the following:

$$\frac{I}{R} = V \quad \text{or} \quad \frac{I}{V} = R \quad \text{or} \quad V \times R = I$$ [4]

The "winning" order is based upon which factor the particular owner or investor considers the most important. Due diligence for investment properties includes extensive analyses to assess income potential, return on investment and ultimate property value – and the decision as to which of these is most important to individual investors or funds is driven by the investment parameters of the various groups. Whether the investor's appetite is primarily for upside in the cash flows (I), the highest possible return on their investment (R), or long-term asset appreciation (V) often drives the type and level of investment in a particular real estate opportunity.

Why is this important for green/sustainable development? Because these principles and considerations are going to be applied by investors, underwriters and valuers regardless of whether a project is energy efficient, possibly certified, truly green (moving toward sustainability), or not. The concept that 'going green' gets you a pass on any of the considerations above is simply wrong. To achieve a greener building environment and get private sector buy-in of high performance buildings, a meeting of formulaic, qualitative, creative and fundamental real estate principles must occur.

The Green Building Value Trifecta

If you choose to 'bet' on high performance buildings, how do you identify the essential elements and prioritize them to achieve optimal results? Based on the understanding that integrated strategies provide the greatest success, whether you are seeking economic, environmental or social goals, remember that they are all as interrelated as the IRV valuation formula. Beginning with a thorough market analysis of supply and demand factors for the sector you are considering – and integrating these findings into every aspect of design and delivery – will ensure the best possible results. A thorough cost benefit analysis that incorporates considerations of both market and building factors will provide the basis for optimal returns, whether your goals are based on economic, environmental or social considerations.

What takes first/post position?

Analyze buildings strategies and potential first. For new construction, the process is fairly straight-forward; for existing buildings, which constitute the great majority of opportunities now available, setting design and performance goals that are based on in-depth cost/benefit analyses is critical. Including a knowledgeable market analyst, familiar with the criteria that an investment analyst, underwriter or other funding source needs to make their investment decisions, in the initial design collaborations will ensure there is adequate demand for the green strategies under consideration. The ability to do sensitivity analyses to ascertain whether plans will meet long term risk and investment goals could save hundreds of thousands of dollars; make the difference in whether or not a project is economically feasible or meet underwriting criteria.

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[4] I = Income; V = Value; R = Rate (of return), The Appraisal of Real Estate, 13th Edition, 2008, pg. 500.

Second Place but of Equal Importance

Equally important in maximizing building performance is a qualified building management team. Having identified the strategies for the building that will provide the best long term results for the goals proposed, ensuring the management team can successfully implement the plan and maintain the building at a high level is the second critical element. Their capabilities should include the ability to:

- Identify possibilities for continual upgrade and improvement;
- Suggest, possibly create and assist in the implementation of green lease clauses that are mutually beneficial to tenants and landlords alike;
- Retain a building engineer (or engineers) capable not only of maintaining potentially new types of equipment, but also of identifying new strategies to optimize building performance, and
- Interact with tenants to identify and implement new approaches to maximizing both building performance and tenant satisfaction.

Third Position – but Can't Win Without It

The third critical element in the trifecta of green building value is tenant engagement. This component is the proverbial third leg of the three-legged stool; without tenant involvement, building performance will topple. If tenants are not educated on how to inhabit a green building, they can (and most likely will) inadvertently undermine building performance. Achieving optimal results/returns is commensurate with maximizing building performance, and this cannot be achieved without tenant education and participation.

This concept has been reflected in several studies written in 2009 that attempted to assess the performance of green buildings based solely on physical attributes, but without considering management capabilities or tenant involvement. To do so could only provide skewed results that omit one of the most critical elements in any investment or valuation decision, the element of risk.

The 'Bet' on Green

The element of risk exists in any investment, but is particularly relevant in the real estate sector today. So how much more of a risk is an owner/developer/investor taking if they decide to incorporate green strategies into their building? Though currently limited in number, there are a growing number of examples of high performance buildings in the Northwest that clearly show the value of 'going green'.[5] As more data is gathered and analyzed, it has become increasingly apparent that the right combination of building, skilled management, and informed tenants generates the highest returns for building owners and the most productive workplaces for tenants.

The thoughtful integration of these factors can move 'going green' from the realm of a bet, to that of a sure thing – providing an owner or investor with the greatest probability to win, place and show with their *green building value trifecta*.

[5] High Performance Green Building: What's It Worth?, Cascadia Region Green Building Council; Washington State Department of Ecology and the Real Estate Foundation of British Columbia; 2009.

Theddi Wright Chappell, CRE, MAI, FRICS, AAPI, LEED AP is a Senior Managing Director and National Practice Leader of the Green Building & Sustainability Practice, Valuation & Advisory Services, at Cushman & Wakefield, Inc. She serves as the Ambassador of Sustainable Initiatives for the Appraisal Institute; is a Director of the Green Building Finance Consortium, and was an organizer and presenter at the Vancouver Valuation Accord in Vancouver, BC. She co-authored and teaches the Appraisal Institute's first seminar on valuing green buildings, *An Introduction to Valuing Green Buildings*, and speaks nationally and internationally on the implications of green and sustainable building strategies on asset value.