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The NEW Industrial Revolution — The Value of Green

The decision to ignore the growing trend toward "green" development could have a greater impact on a company's bottom line than just the actual physical expense.

By Theddi Wright Chappell, Managing Director of Advisory Services, Pacific Security Capital, and CEO, Sustainable Values, Inc.

This is not an article about the esoteric and holistic benefits of sustainable development, though those topics are indeed timely. This is an article about the bottom line; i.e., about making business decisions regarding the incorporation of sustainable practices, principles, and products and whether or not the long-term benefits outweigh the costs. It is about whether or not you should even consider this form of development as a viable alternative to traditional construction.

So why is this consideration relevant to the industrial market? The industrial/manufacturing sector is one of the most significant employers in the United States, and in fact the world. The sector comprises billions of square feet of developed space that are analyzed regularly on the basis of their efficiency and marketability. In addition, both workplace safety and worker productivity factor heavily into the success — or failure — of individual companies and the sector overall. Having the best equipment and most efficient systems only provides optimum results when housed in a facility that maximizes functional design and worker comfort.

The Framework for Evaluating Facilities

The foregoing noted, the very basis upon which industrial facilities are evaluated and valued is changing — and changing fast. The framework that establishes value is being modified, changed to include factors that are not only economic, but social and environmental as well. The institutional investors who serve as significant capital sources for industrial development are increasingly balancing longer-term environmental and social costs against solely bottom-line results. More and more business cases and real estate analyses are weighing up the use of products and practices that either deplete or destroy environmental resources against savings from reduced water and energy consumption, and the potential for a healthier work environment and increased worker productivity.

Discussions in C-suites across corporate America are moving from simply "the bottom line" to the "triple bottom line." Greater emphasis is being placed upon identifying not only the first costs of development, but also the much broader concepts of the social and environmental impacts of location choice and development methodology. This analysis is coupled with a growing focus on accurately assessing the longer-term benefits of sustainable or "green" development. Considerations go beyond the recognition of increasing bottom line results through reduced water and energy consumption and meeting fiscal requirements to more complex issues of risk assessment and the potential to positively influence the marketability of a particular building/product or company via association with environmental responsibility.

Recent Events

What are the factors driving these changes? A number of events in recent years have prompted institutional, corporate, and individual investors to reassess not only the manner in which they

select properties for their portfolios, but also the values upon which they make their investment decisions. These events include:

- The creation of green building standards and green building councils in 17 countries worldwide, including the LEED (Leadership in Energy and Environmental Design) and Green Globes rating systems in the United States and Canada;
- The creation of a worldwide initiative, the United Nations Environment Programme, to monitor the environmental impact of the building and construction industries and provide global guidelines to the sector on environmental issues, products, and practices;
- The mandate by the General Services Administration that all new construction undertaken on their behalf will meet LEED standards;
- The May 6, 2006 resolution by the U.S. Conference of Mayors that all city buildings will be carbon-neutral by 2030;
- The September 2006 announcement by San Francisco Mayor Gavin Newsom that all new and renovated buildings qualifying for LEED Gold, or equivalent, will be granted an expedited permitting process — effectively reducing a typical permitting period of six months to approximately 30 days;
- The provision of energy tax credits by a growing number of states, including New York, Oregon, and California, for the use of energy-efficient practices and systems, particularly related to the EnergyStar program and its guidelines; and
- The creation of the first recognized fully "green" investment fund, the Hines CalPERS Green Development Fund that, once formed, closed in roughly 60 days with more than $120 million worth of commitments for up to $500 million of investment.

Benefits vs. Costs

It is apparent that the proponents of green development are increasing and the practices associated with this type of development are gaining acceptance and momentum. So how do the actual costs — generally referred to as "first costs" by the architectural, construction, and valuation communities — compare to the perceived benefits?

There have been numerous studies done to estimate the cost "premium" attributed to the green components of a building. In a major study undertaken in 2003 by California's Sustainable Building Task Force, principal author Greg Kats concluded an average cost premium for green development of approximately 2 percent. Another independent study undertaken in 2004 by Davis Langdon, nationally recognized cost estimators, found little or no cost differentials between green and traditionally constructed buildings; premiums reflected in the buildings they researched were primarily attributed to programmatic differences — not green elements.

Numerous interviews conducted with both architects and construction specialists have revealed three consistent points of agreement:

1. A zero to 2 percent premium is effectively no premium at all.
2. Groups who effectively implement systems integration and quality construction practices should not experience any cost premium on construction up to a LEED Gold standard.
3. LEED projects receive much closer scrutiny than traditional construction projects, evidenced by the large number of traditional projects that reflect variances as great as 10 percent from budget without penalty or prejudice.

Taking these inferences into account, it would appear that the cost aspects of green development should be manageable, providing a qualified team is employed. However, for those unable to self-fund their investments, their challenge becomes obtaining financing from an industry characterized by conservatism, burdened by excessive regulation, and steeped in unwillingness to change. Without the right appraisal methodology, one that properly identifies the costs and objectively assesses the benefits, the ability to get a green project accurately and successfully underwritten will continue to be extremely difficult.

Additional Benefits

The "low-hanging fruit" in this analogy are the energy savings. One of the primary areas of emphasis for almost any green development or re-development is a focus on energy efficiency. Reduction in utility consumption (both energy and water) can reasonably be expected to flow directly to the bottom line, resulting in a higher net operating income and the potential for a higher value. But this factor alone is not enough to make a commitment to this form of development. Proponents suggest it is reasonable to anticipate a number of additional benefits with even farther reaching impacts from implementing this development methodology, including the following:

- The provision of healthier working environments will result in greater worker productivity and, hence, significant corporate benefit.
- The utilization of higher performance building systems will increase energy efficiency, thereby minimizing energy consumption, maximizing control over unpredictable energy costs, and stabilizing cash flows.
- The factors above indicate a green building will be a less risky investment.
- All of the foregoing would also suggest there is a greater chance that a non-green building will become obsolete more quickly, and hence be a riskier investment going forward.

Because the standards by which buildings can be certified "green" are so new in comparison to the data available for analyzing traditional construction, the current challenge of valuers and underwriters is to gather sufficient market data to prove (or disprove) any of the aforementioned potential benefits. There is ample anecdotal information to do so, but the valuation and lending communities are reluctant to rely on such data.

However, there are a few potential benefits that have been recognized by the investment community. The potential of reduced risk — one of the most significant and critical considerations in the investment assessment and valuation of any property — was acknowledged by Fireman's Fund Insurance recently when they guaranteed a premium reduction of 5 percent for any commercial property achieving either a LEED or Green Globes certification. Similarly, the mandate to meet LEED requirements by a growing number of municipalities is viewed as support for the premise that these properties will be less susceptible to obsolescence created via planning, zoning, or code changes.

Thus, it appears at this point in time that the physical costs associated with green development are much more easily quantified than the potential benefits. However, there is sufficient data on the identified and potential benefits to indicate that green development should at least be strongly considered when assessing the possibilities of acquiring, developing, or re-developing a facility.

Market Acceptance

The more compelling consideration may be the "cost" of market acceptance if an owner/developer does not at least consider this form of development. In a time of contentious corporate governance issues and an international focus on corporate responsibility, to dismiss a healthier, more efficient building methodology outright could be much more expensive strategically. With pension funds having the stature of CalPERS and CalSTRS and institutional investment advisors like Kennedy Associates embracing green development as a responsible alternative for their investors, the decision to ignore this growing trend could have greater impacts on the bottom line than the actual physical expense.

This probability is discussed in-depth in the book The Ecology of Commerce by Paul Hawken, an entrepreneur, journalist, and environmentalist whose works have appeared in The Wall Street Journal, Harvard Business Review, and The Washington Post. In this widely acclaimed work, Hawken suggests 20th century industry should internalize some of the environmental costs its production methodologies have created, and if it refuses, it should be taxed accordingly. It is further explored in Ray Anderson's book, Mid-Course Correction. Anderson is the founder, chairman, and CEO of Interface, one of the most successful providers of interior furnishings on a global basis with annual revenues of over $1 billion. He is also an environmentalist committed to being an agent of change for the business and industrial communities worldwide. The following quote from his book epitomizes the growing attitude toward both corporate and environmental responsibility:

"There is not an industrial company on earth, and — I feel pretty safe in saying — not a company or institution of any kind...that is sustainable, in the sense of meeting its current needs without, in some measure, depriving future generations of the means of meeting their needs. When earth runs out of finite, exhaustible resources and ecosystems collapse, our descendants will be left holding the empty bag. Someday, people like me may be put in jail. But maybe, just maybe, the changes that accompany the new industrial revolution can keep my kind out of jail. I hope so, most assuredly."

So perhaps the appropriate question to ask yourself, your board, and your shareholders when deciding whether or not to consider green development and what its value might be to you or your organization is not if you can afford to — but if you can afford not to.

About The Author

Theddi Wright Chappell is managing director of Advisory Services at Pacific Security Capital and CEO of Sustainable Values, Inc. She holds the CRE, MAI, FRICS, and AAPI designations and is a LEED Accredited Professional. Chappell has extensive experience in both national and international investment analysis, valuation, and consulting services. Her practice focuses on objectively assessing both the business case for, and cost benefit analyses of, sustainable development and redevelopment and how to optimize investment returns for corporations, investors, developers, and owners.

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