

# Green values

Scope

27<sup>th</sup> March 2008



Creating order from Confusion

# Background

## Leading the way

Increasingly, large companies around the world have adopted formal statements of corporate values, and senior executives now routinely identify ethical behaviour and social concerns as top of their agendas.

Concern for the environment is seen both as a social issue and an opportunity to add commercial value. Institutional investors are pressing companies to report the total amount of carbon dioxide that they and their suppliers emit – their carbon footprint - and to define their risk exposure to regulations that limit emissions.

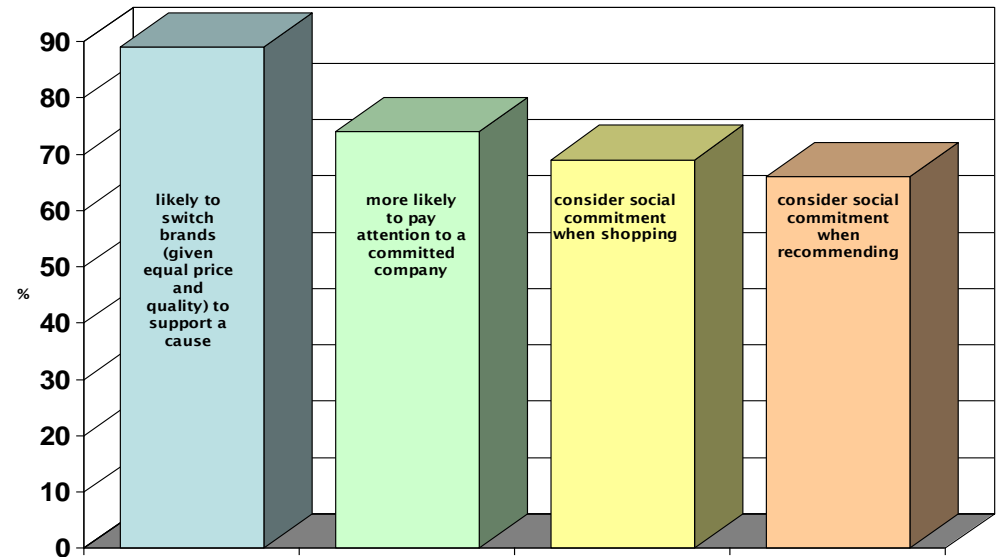
For companies, buildings are a visible public demonstration of their values. According to the EU, 40% of carbon dioxide emissions come from creating or using buildings and the context is changing fast:

- Customers are beginning to demand higher standards of governance. A survey conducted for Business Week at the end of 2006 amongst 13-25 year olds found that great prominence was given to social commitment when purchasing and recommending.
- The UK Government has a stated target to cut 60% of carbon dioxide emissions by 2050 and has pledged that all new homes will be have zero net emissions of carbon dioxide from all energy use by 2016: Clear statements of political intent.
- From April 2008 the construction, sale or rent of commercial buildings over 10,000 square metres in the EU will require an Energy Performance Certificate (EPC). By October all buildings must comply.

All these things continue to raise the profile of the environment. It is safe to assume that green issues will become ever more important to customers of any company and that they will be looking to that company to lead the way in the reduction of carbon output from buildings.

Far sighted companies are already leading the way. For the time being this still represents an opportunity to gain competitive advantage. Over the next five years failure to be green will be a significant threat to profitability and even survival. Going green is not a bleeding heart issue - it needs to be a substantive, unemotional business decision.

Customer responses: 13-25 year olds



For some time now, UK planners have been imposing environmental standards on new development, usually through a BREEAM “Very Good “or “Excellent” rating as a minimum.

A new development is an opportunity to set up a beacon of best practice in the development and occupation of low carbon buildings and much of the emphasis of the green lobby has been placed upon new buildings. There is no doubt that the biggest carbon savings can be made this way but this benefit comes at a higher construction cost.

For the vast majority of companies however, development of new buildings is not an option. Although the absolute benefits are smaller, there are still green strategies that can be adopted that will reduce the carbon footprint of an existing building significantly. These, when combined with attitudinal and cultural changes can make a substantial contribution to the corporate carbon footprint. Vivaly, from a property perspective, these changes add value to a building.

# Valuation – owners/investors

The first question here is value to whom? From the landlords perspective there appears to be little incentive to invest in green changes to the fabric of a building if the majority of the benefit will be realised by its subsequent occupant. That is, of course, unless the occupier is prepared to pay a premium to fund those investments.

From the occupiers perspective there is little point in paying extra for a green building when security of tenure would be relatively short-term and, although operating costs would be lower, there might not be the opportunity to offset the additional rental cost.

This, an accurate depiction of much of the current leasing market, is unsustainable.

From the occupiers perspective the situation is clearer if the building is purchased, since lower operating costs would offset any price premium.

The advent of the green assessment of buildings has sharpened the investors views on this matter considerably. The primary driver for the investor is the value of the asset and its maintenance. To this end there has been a deal of recent impetus towards green leases (see inset). These are likely, assuming a compliant occupier, to ensure that an asset's green values are maintained, but they do not address the central conundrum of value to whom.

In fact, investment in green is likely to deliver significant value to all the stakeholders in a building but it requires some creativity in the expression of that value in order that this can be understood.

## Owners/ Investors

An investor in property will look at an asset and compare it with other classes in which the money could be invested. An expected yield will be identified consisting of a “risk free” return - such as that on a Government bond - plus a premium to reflect the risk profile of the asset. From this will be subtracted the rate of growth (or decline) expected in income over time, plus an allowance for depreciation of the asset.

Anything that affects any of these factors will have an impact, positive or negative, on this expected yield.

If the cost of occupying a building rises, it is rational to expect that the occupier will be less inclined to pay a full rent for a building, particularly if there is an alternative that will cost less to occupy, everything else being equal. This works against the secondhand market since new builds will cost dramatically less to run while refurbishments are likely to deliver significant savings in energy costs particularly (see inset).

From the perspective of the investor this means that depreciation has accelerated and additional investment has to be made in upgrading the brown building or a lower rent has to be accepted. Both these outcomes raise the expected yield and reduce the capital value of the investment.

Once this trend becomes established the value of these “brown” buildings is likely to fall steeply as demand moves away from them and rents decline further.

# Valuation - occupiers

## Occupiers

For the occupier the benefits of green buildings are much more easily defined – lower operational costs. As shown in the side panel savings in energy costs alone from a new green building are genuinely significant and can be added to further by changes in occupational culture.

For those occupiers in brown buildings, it is unlikely that the wholesale changes to building fabric necessary to effect large savings can be countenanced whilst remaining in occupation. Nevertheless, for those starting afresh, substantial savings can be made from simple changes to procurement and culture. Typically these involve relatively small investments and have a short payback period. For some, those changes will represent the extent of their engagement with green issues

However, the dictates of the Corporate Social Responsibility agenda may mean that this is not enough to provide any green competitive edge. Customers and shareholders may well require higher levels of investment that have longer payback periods and might be significantly more disruptive.

## Employees

Experience dictates that employees are often in the vanguard of green implementations but they can also be significant drivers of change. Value to this stakeholder group is expressed slightly differently – in terms of productivity, for example – but can still be described in financial terms.

The links between a contented workforce and increased productivity are well established. Green issues are likely to be an important issue in this group and employers ignore these concerns at their peril. Clearly, the wishes of the workforce have to be placed in a commercial context, but consultation on green issues can defuse these issues before they come to a head.

## Green leases

A Green Lease is a lease which has additional provisions set out within it whereby the Landlord and the Tenant have specific responsibilities and obligations with regards to the sustainable operation of a property.

Clauses are included that relate to all aspects of the supply, maintenance and operational use of the property as well as social and ethical considerations.

Such leases are already commonplace in Australia where the Australian Government has published a suite of Green Lease Schedules designed for particular types of tenancies. These put the onus on tenants to operate efficiently within their premises and to maximise the environmental benefits of the building e.g. through the use of efficient appliances and fittings; low ballast lighting; and efficient thermal control systems.

The schedules set out provisions dealing with the energy rating of a building, the development and implementation of an Energy Management Plan, separate metering of landlord's and tenant's areas, energy rating obligations, stringent energy reporting and remedies for non-compliance.

The development of Green Leases is seen as a way of setting out each party's obligations with regard to the operation of a building sustainably and supporting them with financial incentives or penalties.

The benefits to the occupier of adopting a Green Lease should be a reduction in resource consumption, improved efficiency and reduced costs. However, this has to be balanced against what could become an onerous regime.

# Valuation - community

## Community

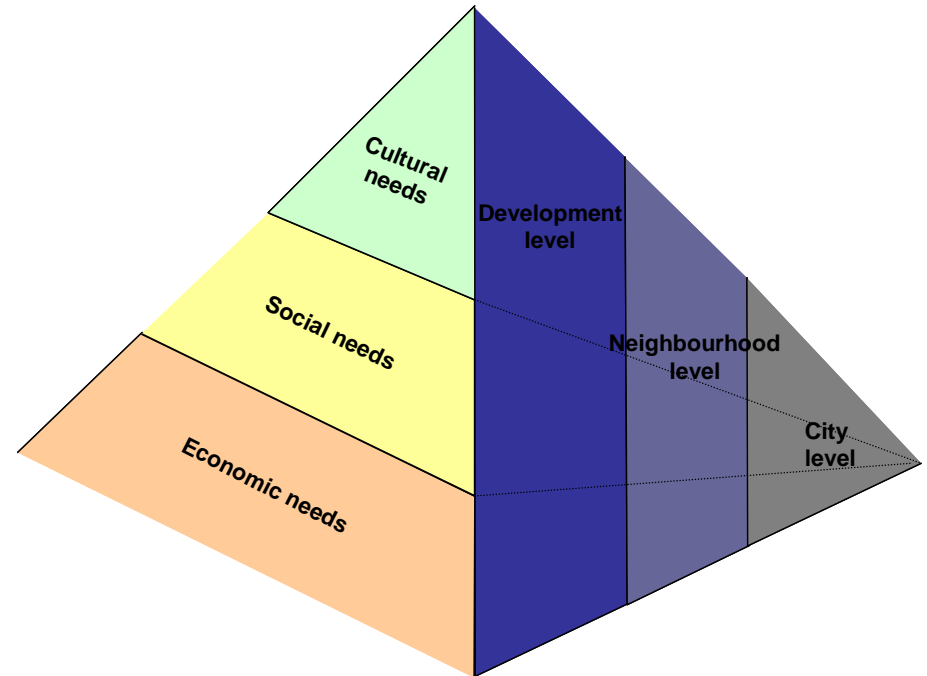
Community value is the most difficult to quantify. Typically the value of a commercial building to a community has been expressed in terms of its employment value - ie the retained wage output of the employed workforce plus any additional secondary employment generated by the occupation of the building.

Offsetting this against any potential damage that the occupation of the building might create has always been a delicate balancing act. For new buildings or significant changes of use, the planning system has been the arbiter in the past and has concentrated upon the potential for direct outputs of pollution of some kind - noise, light, traffic etc - from the premises. The potential for conflict here is obvious - jobs versus pollution - add more green issues into the equation and the situation becomes even more complex.

The growth of independent measurement of the green characteristics of a building such as BREEAM or LEED has allowed planners to set an objective standard that must be met and that the community can buy into, but where they have strayed into areas such as transport policy the results, in the UK at least, have been haphazard and largely dependent upon location.

That communities are concerned with green issues is certain. Local Authorities see themselves as carrying the green torch and anecdotal evidence is that this is one area where the local communities support them wholeheartedly.

For existing buildings there is no real interface between the community and the occupier save that enlightened companies engage regularly with all their stakeholders and that locally-based employees form at least part of that community.



The Liveability spatial model

# Conclusions

Energy is getting ever more expensive. This is not some speculative bubble. As the world economy grows, demand has pushed prices through the roof. We are now a net importer of gas and oil and we have around thirteen days worth of gas needs in storage at any one time.

The vast majority of the commercial stock of buildings, including that built relatively recently, is simply not energy efficient. Yet many occupiers balk at the perceived costs of improving them or, worse, do not see green issues as a core part of their business.

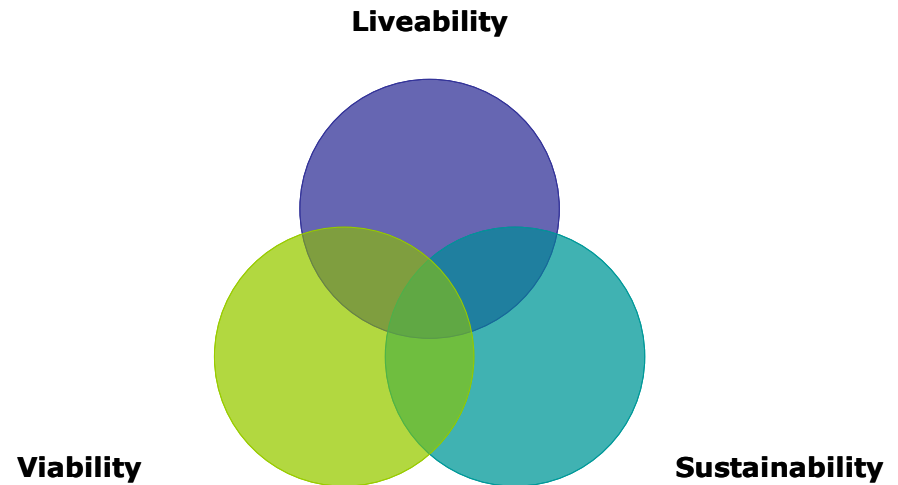
Yet there is evidence here that customers care very much about green issues and are prepared to vote with their feet. Their employees too are in the vanguard of driving green issues forward.

It may well be that green value for occupiers may need the stimulus of a significant penalty for not adopting green processes that a high energy price brings.

If occupiers place value on green investors will surely follow. Currently the forward thinkers are encouraging occupiers with green leases for new, green developments, yet even these leaders have a distinctly brown hue to much of their portfolios that will have to be addressed.

Green value for the community is an altogether more tenuous proposition. Straightforward improvements to energy efficiency tend to become swamped by sideshows like biodiversity and the middle-class hobby of supporting the organic movement.

Nevertheless, improved returns on social capital are valuable to those that see them and liveability is equally as important as viability and sustainability in the developers remit.



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