

Turning Green into Gold

Does It Matter

What the Landlord Thinks About Green? – Part I

by Alan Whitson, RPA



Recently, **CalPERS** – the nation's largest public pension fund made big news when it set a goal to cut energy use in its \$7.9 billion, 144 million sq.ft. real estate portfolio by 20% within five years. The pension fund estimates it will take an investment of roughly \$142 million to retrofit their real estate holdings. The payoff for CalPERS – \$29 million a year in reduced energy costs!

Will other pension funds, REITs, and big real estate owners follow suit? Don't bet on it in the short term. The growing number of A&D professionals touting the benefits of green buildings doesn't want to hear this, but there's the rub. There has been a steady shift in the marketplace from the "Full Service Gross" lease to the "Triple Net" lease. The hyperinflation of the early 70s and the First Oil Embargo started this shift as landlords sought ways to protect their investment and avoid risk they could not control – like a tenant's energy usage.

Under the traditional full service gross lease a tenant's rent includes utilities, maintenance, insurance and taxes. To protect the value of their investment landlords now include some form of rent escalation such as an annual CPI adjustment, a scheduled rent increase, a pass through of any increase in operating expenses (base year or expense stop) in their standard lease document. Today, 42% of office leases are full service gross according to CoStar, national a real estate information company.

A full service gross lease creates an incentive for landlords to manage their buildings well. If a landlord can reduce their operating costs without sacrificing comfort or service, those savings fall to the landlord's bottom line. This increases both net operating income and building value.

Under a triple net lease the tenant pays a base rent plus a separate charge for all operating costs, i.e. utilities, main-

tenance, insurance and taxes. Proponents say this creates a more transparent lease arrangement, and creates an incentive for the tenant to use less energy.

In theory this is good; on the street it doesn't achieve those results. According to the *2003 Experience Exchange Report* produced by the **Building Owners and Managers Association (BOMA)** – the average size for the 2,531 office buildings in the report is 212,563 sq.ft. The average office tenant occupies 12,524 sq.ft. An analysis by the **Corporate Realty, Design and Management Institute** found that energy costs account for 29% of a building's operating costs. Yet energy only represents 0.6% of the office tenant's cost of doing business (people and technology account for 90%). If this average tenant could reduce its energy usage by 40% – the average for EPA Energy Star buildings – the savings would only be \$1.00/day per employee. Sadly, there is insufficient reward for a tenant to justify the time, cost and effort needed to seriously reduce its energy usage.

Want proof? The BOMA report also details energy use in corporate facilities and agency managed office buildings. Compare the energy usage between corporate-managed and agency-managed facilities

| | <u>Utility Cost</u> | <u>Operational Hours</u> | <u>Energy Density</u> |
|------------------|---------------------|--------------------------|-----------------------|
| Corporate | \$2.48/sq.ft./yr. | 124.4 hours/wk | 31.0 kWh/sq.ft./yr. |
| Agency | \$1.87/sq.ft./yr. | 88.6 hours/wk | 23.4 kWh/sq.ft./yr. |

In 58% of U.S. office buildings, energy costs are not included in the tenant's base rent. Even the **U.S. Green Building Council's LEED-Commercial Interiors** rating system gives a credit for this treatment of energy use. Clearly we've placed the carrot in the wrong place. If

we want to promote sustainability, we should encourage a return to full service gross leases with some form of annual expense pass through. This would encourage landlords such as CalPERS to invest money in projects that will save energy, protect the environment and create jobs.

In the next column, we'll take a deeper look at how the marketplace places value on real estate as it has a direct bearing on what designers can get their clients to accept.

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This column is published in conjunction with the Corporate Realty, Design & Management Institute and the Center for Sustainable Real Estate. Click on <http://www.squarefootage.net> for a seminar schedule, books, and white papers on sustainability and high performance buildings. Alan Whitson's latest book, *Standard Tenant Development and Corporate Space Guidelines for a Sustainable & High Performance Workplace* will be released this Spring. ▲

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Does It Matter What the Landlord Thinks About Green? – Part II

B. Alan Whitson, RPA

One of the arguments for green buildings is they're worth more. Which leads to the question of how much more? To arrive at the answer, it's important to understand the appraisal method used to establish the value of a commercial building.

Commercial real estate is typically valued using a method called income capitalization. The building's "net operating income" (NOI) is divided by a "capitalization rate" (Cap Rate). The outcome is the building's economic value. Let's assume a building has a net operating income of \$15.25 per square foot, and using a 7.75% capitalization rate the building would be worth \$196.77 per square foot ($\$15.25/7.75\% = \196.77).

NOI is the building's total annual income minus operating costs for which the landlord is responsible, but not debt service. The cap rate is a market based interest rate that represents a "free and clear return" on the investment. In simple terms, this is the return an investor could expect without the financial leverage of using a mortgage or other types of financing.

The cap rate is market driven. NOI, however, is under the landlord's control. If the landlord can increase the building's NOI, the value will go up. The landlord can accomplish this two ways.

First, increase the building's total income. This can be done by convincing tenants to pay a higher rental rate, which is never easy. It's often easier to find additional income opportunities within the building. These can range from leasing rooftop space to cell phone operators to adding a coffee kiosk in the lobby, or allowing elevator advertising.

Second, reduce the building's operating costs. This goes to another argument for green buildings – they are cheaper to operate. Here's the rub again. The growing popularity of net leases has reduced the operating expenses for which the landlord is responsible. Currently tenants in 58% of the nation's office buildings do not have energy costs included in their base rent – a practice promoted by the USGBC's

LEED Commercial Interiors rating system. Therefore, reducing energy costs in those buildings will not increase the building's NOI.

Landlords that have embraced green buildings often find they are paying a premium of one to two dollars per square foot. Since many of them are using net leases they do not get the financial benefit of reduced operating costs. To compensate for their additional investment landlords have boosted their asking base rent. A logical step since the tenants will benefit from the lower operating costs.

However, tenants and their real estate brokers have learned that under a net lease the landlord has little incentive to aggressively control a building's operating costs. When a landlord tells prospective tenants, "this building's operating costs are lower than other buildings in that market," the tenants aren't buying it.

When tenants and their real estate brokers look for new space, some math and a few assumptions are needed to compare buildings. Since a gross lease includes operating costs this becomes the baseline. For an existing building with a net lease it's the asking base rent plus the current year's operating costs. For a new building with a net lease, it's the asking base rent plus some estimate for operating costs. Typically, a tenant and their real estate broker will take the landlords estimate and compare it to the operating costs of other buildings in the market area – then to be prudent assume it to be at the high end.

How big is the range? For 33 office buildings over 600,000 square feet in downtown Chicago, BOMA reports operating costs from \$13.48 to \$16.12 per square foot. This \$2.64 spread represents the middle 50%; 25% have lower operating costs and 25% have higher operating costs.

Since landlords will not guarantee the operating costs for a building with a net lease and tenants want the lowest total cost of occupancy, this becomes a game of chicken. The tenant is forced



to grind on the landlord's asking base rent. Since this is the only area for negotiation – the base rental rate gets reduced, lowering the landlord's return on investment. Oops, not a good case for investing in green buildings.

Despite these economic obstacles a handful of developers, i.e., Durst, Hines, and Liberty Property Trust, are forging ahead with green buildings. Hines, for one, believes there are a growing number of tenants that will appreciate the value of occupying a green building and market forces will swing in their favor over the long haul. Three things are needed to encourage private sector building owners to embrace green buildings: a lease structure that rewards landlords for their risk, architects who are as well versed in the numbers as in design, and better data on operating and construction costs.

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