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Greener Real Estate Can Create More Green for Investors | June 2014

With May's total return of +2.3%, REITs are now within 0.5% of the 2013 pre-Bernanke 'taper tantrum' peak. The low interest rates of 2014 continue to surprise analysts and investors alike, driving performance of yield-oriented investments. Year to date, the MSCI US REIT Index (RMS) is now up 16.3%, which compares favorably to most of the major US indices. The 10 year US Treasury yield finished the month at 2.5% versus 3.0% at the end of 2013. Though we believe that REIT performance should 'de-couple' from interest rate movements, it seems they are tied at the hip for the time being.

Chilton for Change
Throughout the history of the firm, Chilton has not faltered in its unwavering dedication to recognizing change. By investing in companies that are looking around the corner to solve problems before the industry even realizes there is a problem, Chilton's Growth strategy and REIT strategy have been able to produce returns above their respective benchmarks. Sometimes, the two teams have the ability to corroborate seamlessly on an idea like Cree (NYSE: CREE), a leading producer of LED light bulbs. Chilton portfolio manager / analyst Randall Grace recognized early that the company was improving production cost and effectiveness, which would create an inflection point for industry adoption. The REIT team was able to confirm the adoption from commercial real estate landlords, and the idea became an actionable investment that produced over a 180% return from the time of purchase (12/30/2011) through the end of 2013. Picking the entry point is extremely important because being 'early' and being 'wrong' are often synonymous in the investment business (CREE's 2 year performance prior to 12/30/2011 was -60%!).

The Problem
According to the US Department of Energy, commercial buildings account for 19% of energy usage, 40% of carbon dioxide emissions, and 88% of potable water consumption in the US. Implementing projects to lower consumption of utilities has a measurable effect on the bottom line, but there are other 'green' projects whose financial benefits are more difficult to quantify.

Measurable Solutions
A study by United Technologies (NYSE: UTX) and the Rhodium Group estimated that an investment into making buildings more efficient using current technologies would result in a 30% annual return via expense savings. Figure 1 lists a few ways to save on costs without spending much. For example, reducing the temperature by one degree when it's cold or increasing it by one degree when it's warm will create measurable results without causing much tenant discomfort.

Figure 1: Sample Ideas to Lower Utility Costs

2 degree Fahrenheit adjustment
Restrict lighting in vacant space
Photosensor controls
Preventative HVAC maintenance
LED lights
Variable Frequency Drive on water pumps
Use native or drought-tolerant plants

Simply lowering usage when no one is present can also have a measurable effect on the bottom line. Motion detecting lights have become commonplace, while VFDs (Variable Frequency Drives) on water pumps similarly decreases energy usage when water demand is low.

The payback period on replacing traditional light bulbs with LED has declined significantly in recent years; it's now down to 1-5 years depending on the cost of energy and daily usage. This doesn't even factor in savings on labor for bulb replacement and the lower cooling costs due to the minimal heat produced by LED bulbs.

These are just a few examples of hundreds of projects or tweaks that have a measurable effect on the bottom line of either the owner or the tenant (which one would hope would eventually accrue to the benefit of the owner via higher rent). The 'green' that is achieved through such projects is easily translated to more 'green' on the income statement.

" …an investment into making buildings more efficient using current technologies would result in a 30% annual return via expense savings."

Not So Easily Measurable Solutions
There are other 'green' features with benefits that are more difficult to measure. Adding bike racks, electric car charging stations, showers, diverting waste from landfills, and reducing carbon footprint may sound great, but they have real costs that need to be justified. Though it's near impossible to make a statement that doing one or all of the above will have a quantifiable return, we can look at individual case studies to observe a 'green' project's performance relative to the market. The 'less measurable' benefits would be tenant pride and higher productivity / happiness, which could increase retention, occupancy, and rent.

The Urban Land Institute (ULI) has published results of several case studies on sustainability. A multifamily project opened in 2011 in Fayetteville, Arkansas featuring spray foam insulation, a nonsmoking policy, emphasis on indoor air quality, a community herb and vegetable garden, and a saltwater pool (chemical-free) was able charge rents almost 50% higher than the submarket average. Additionally, the property experienced a turnover rate 1500 basis points lower than the market average.

ULI also described the story of an office park in the Netherlands that opened in 2013 at a 100% leased rate, charging rents 12% over the market average; the owner, Delta Development Group, credits the natural lighting, fitness program, clean air, and community greenhouses for attracting tenants at the higher price point. However, it is impossible to isolate one of the above procedures as a cause of higher rents.

Commercial Real Estate Taxonomy
To address the challenge of clarifying for investors, landlords, and tenants if a building owner or company has made an effort for sustainability, hundreds of different 'classifications' have been created. Among REITs, the most commonly used certifications are EnergyStar, LEED, and GRESB.

EnergyStar
The EnergyStar program was created by the Environmental Protection Agency (EPA) in 1992 in order to "…identify and promote energy-efficient products and buildings in order to reduce energy consumption, improve energy security, and reduce pollution through voluntary labeling of or other forms of communication about products and buildings that meet the highest energy efficiency standards." For a building to become EnergyStar certified, it must be in the top quartile for energy efficiency relative to other buildings in the area. As of year end 2012, over 300,000 buildings were reporting metrics to EnergyStar, comprising 30 billion sqft, or approximately 40% of the total US commercial real estate market.

EnergyStar is the most widely adopted program domestically, but has its downfalls. Though the benchmarking tool has the capacity to compare water consumption and greenhouse gas emissions, it is much less ubiquitous than energy usage reporting. Furthermore, comparing only to other buildings in the area that have chosen to report, makes it difficult to compare portfolios across geographies.

LEED
LEED, or Leadership in Energy and Environmental Design, has become a popular measuring stick for office buildings and is gaining traction among other property types. Created by the US Green Building Council (USGBC) in 2000 to "promote sustainability in the building and construction industry", the LEED certification applied to 2.8 billion sqft as of January 1, 2014. LEED uses a point system that labels the project anywhere from 'certified' to 'platinum' depending on the number of boxes checked.

LEED has the following categories for which a project can apply: New Construction, Core & Shell, Retail: New Construction and Major Renovations, Healthcare, Commercial Interiors, Retail: Commercial Interiors, and Operations & Maintenance. LEED certified buildings are very green by most standards: LEED projects have diverted over 80 million tons of waste thus far, have an average EnergyStar rating of 89 (75 is the minimum to be EnergyStar certified), and LEED government agency buildings have reported water usage 15% below their comparable non-certified buildings.

However, costs for the owner to get certified range from $55,000 to $130,000, including a fee to USGBC of $15,000 to $30,000. Especially for existing building certifications, there are significant costs with monitoring and reporting. Lastly, the LEED certification has barely scratched the surface in any property types other than office. As of September 30, 2012, approximately 27% of office REIT portfolios were either EnergyStar or LEED certified, but less than 2% of non-office REIT portfolios had either (see Figure 2). Furthermore, like EnergyStar, LEED ignores policies at the corporate level.

GRESB

The Global Real Estate Sustainability Benchmark (GRESB) is a survey-based initiative with the object to assess sustainability performance of real estate portfolios around the world. Each participant in the survey is given a score from 0-100 based on management and policy, and implementation and measuring. In 2013, 543 companies and fund managers who owned over 49,000 properties participated. Given that it is at the entity level, comparison between REIT participants is simple. However, not all REITs are participants. Filling out the survey and tracking the relevant data requires full time staff. Additionally, a large weighting is given to the policy portion, and less to the actual property impact (24% to performance indicators, and 10.5% to building certification and benchmarking for the 2013 survey).

Figure 2: Portfolio Percentage Either LEED or EnergyStar Certified

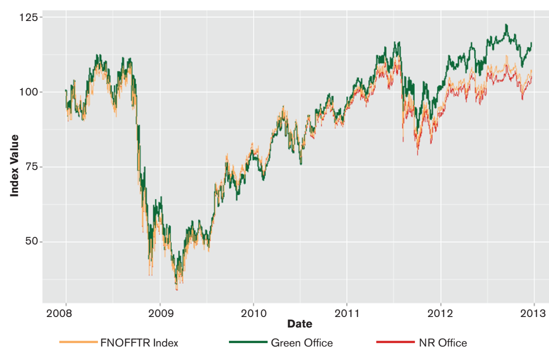
Property Type	Market Cap	'Green' Market Cap	'Green' Percentage
Apartments	71,261	428	0.6%
Diversified	22,870	4,895	21.4%
Free Standing	11,096	10	0.1%
Health Care	67,878	383	0.6%
Industrial	21,301	74	0.3%
Lodging	25,915	2,520	9.7%
Mixed Office/Industrial	10,134	687	6.8%
Office	54,649	14,605	26.7%
Regional Malls	84,469	1,080	1.3%
Shopping Centers	43,146	643	1.5%
Grand Total	**412,719**	**25,325**	**6.1%**

Source: FTSE, as of 9/30/2012. SNL, USGBC.

Sustainability in REITs Today

In a study by Reichardt et. al titled "Sustainable Building Certification and the Rent Premium: A Panel Data Approach", the authors analyze data for 66,000 office buildings from 2000-2010 concluding that EnergyStar and LEED certified buildings were able to achieve a 2.5% and 2.9% rent premium, respectively. Eichholtz et. al published an articled titled "Portfolio greenness and the financial performance of REITs" in the Journal of International Money and Finance (2012), concluding that REITs with higher percentages of EnergyStar or LEED certified properties in their portfolio had better returns on assets and equity, but certification was not a predictor of stock market returns by using regression analysis. FTSE has conducted extensive research on performance of REITs with more certifications compared to those with less. They found that weighting companies by market capitalization and percent of portfolio either LEED or EnergyStar, the lodging and office subsector 'green' indices outperformed the corresponding non-rated and FTSE/NAREIT subsector indices (see Figure 3 for office subsector results).

Figure 3: Office: Green vs. Non-Rated and FTSE NAREIT Index



Source: SNL, USGBC. FTSE, data as of September 30, 2012.
Map colors based on www.ColorBrewer.org, by Cynthia A. Brewer, Penn State.

Though we respect the research in the above reports, our leasing contacts indicate that their real world experiences don't make the connections as obvious. From such conversations and our own independent research, we believe that green buildings will win more often than not in scenarios where a tenant has the choice between a non-certified and a certified building, leading to higher occupancy and retention rates. Effectively, this will accelerate obsolescence for buildings that fail to adapt to today's tenant demands, which was a theme in our February 2014 REIT Outlook 'Office REITs: Poised for Rental Rate Gains'.

Boston Properties (NYSE: BXP), Cousins (NYSE: CUZ), Vornado (NYSE: VNO), Kilroy (NYSE: KRC), SL Green (NYSE: SLG), Parkway (NYSE: PKY), and Liberty (NYSE: LPT) have been leaders in LEED, EnergyStar, and GRESB among their office peers. However, even in the office sector where LEED is widely accepted, it doesn't make sense for every building to get certified. It is our belief that office REITs with more certifications outperformed their peers because it is one of many things that the company did to 'look around the corner' to stay relevant to investors and tenants. Therefore, the reason other property types have yet to adopt LEED is not because those management teams care less about the environment; it is because the revenue or cost savings have yet to be enough to justify certification. In those sectors, management teams have to find other ways to get credit for their commitment to sustainability.

Regency Centers (NYSE: REG), a shopping center REIT, issued $250 million in 10 year 'green bonds' at 3.75% on May 16 which can only be used on 'eligible green projects', the first such issue by a REIT. Along with Kimco (NYSE: KIM), Regency has been a leader in sustainability in the shopping center REIT sector by using 'green leases', which attempt to resolve owner-tenant conflicts over cost sharing, ensure green tenant build outs (not usually at owner's discretion), and provide access to energy consumption data. NAREIT awards a 'Leader in the Light' award by property type to REITs that demonstrate superior and sustained energy use practices. The winners by property type for 2013 were: Health Care - HCP (NYSE: HCP); Retail – KIM; Industrial - Prologis (NYSE: PLD); Lodging - Hersha Hospitality (NYSE: HT); Residential - AvalonBay (NYSE: AVB); Office – Thomas Properties Group (Since acquired by PKY); Diversified – VNO.

The Problem…Still
There still is no single, universally accepted way to rank REITs by greenness, and it is especially difficult when comparing across property types. Ultimately, management teams that have been skilled at looking around the corner historically should be able to figure out how best to implement green procedures internally, but they may have to take a leap of faith that investors will recognize the efforts externally. Many REITs have now hired a full time employee for sustainability reporting and implementation (more than half of our composite companies have one), and issue a 'sustainability report' annually in accordance with framework from the Global Reporting Initiative (GRI). As a long term investor, we encourage management teams to make decisions that will make earnings more predictable over the long term. If giving up 'green dollars' today will ensure better occupancy during downturns and increase the building's value, then the 'green building' movement is something that all investors need to get behind.

Resources:
https://www.globalreporting.org/Pages/default.aspx
https://www.gresb.com/
http://www.usgbc.org/
https://www.energystar.gov/
http://www.fir-pri-awards.org/wp-content/uploads/Article-Eichhiltz-Kok-Yonder.pdf
http://immobilierdurable.umapresence.com/images/2128_uploads/Fuerst___me_article.pdf
http://www.josre.org/

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RMS: 1526 (5.31.2014) vs. 1312 (12.31.2013) vs. 346 (3.6.2009) and 1330 (2.7.2007)

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton REIT Outlook are available at www.chiltoncapital.com/reit-outlook.html.