assigning value to green buildings

Establishing a way to let investors and lenders quantify the value of green buildings should spur development of green mortgage-backed securities

Facility executives justifying investments in green facilities may soon have another weapon in their arsenal — at least if Michael Italiano has his way. Italiano, president/CEO of the Institute for Market Transformation to Sustainability (MTS) and co-founder of the U.S. Green Building Council, has been advocating the development of green mortgage-backed securities (MBS) for several years. Now, as development begins on a methodology to enable the financial community to accurately value green buildings, his goal is moving closer to being realized.

Put simply, a mortgage-backed security is a bond for which the value is derived from hundreds of mortgages that are securitized together and then rated and sold to investors. A "green" MBS would package mortgages on buildings that meet specific energy-use and environmental benchmarks. According to proponents of the idea, green MBS should be rated higher and worth more as a result of the operational-efficiency, marketability and occupant-satisfaction benefits of green buildings. The result: better and cheaper access to capital for borrowers and owners who want to invest in green buildings.

"If you can rate an MBS higher because it's primarily green buildings, you can make more money for everybody involved," says Italiano. Appropriately valuing green and energy efficient buildings, he says, could provide cheaper cost of capital, higher appraised value and higher credit ratings.

The green MBS concept has support not only from environmentally minded proponents like Italiano, but increasingly from lenders, investors and financial experts who say that incorporating environmental and energy-use issues into the valuation and financing processes for commercial real estate only makes sense.

Green Building Finance Consortium

A key step to developing green MBS is the "Green and Energy Star Building Finance Summit," which was scheduled to take place Dec. 5. The event's sponsors included corporations, financial institutions and government agencies. The goal was to bring together real estate, financial and environmental experts to help initiate the Green Building Finance Consortium's efforts to develop a valuation methodology that can translate green design features into financial terms.

"We're trying to develop a tool and an analytic model that will make both the benefits and the costs of green buildings more transparent," says Scott Muldavin. A seasoned real-estate finance expert who developed the initial commercial MBS (CMBS) risk-rating system for Standard & Poor's, Muldavin is president of The Muldavin Co., which pulled together real estate finance and

Report prepared on behalf of the Institute for Market Transformation to Sustainability

investment companies and trade groups representing lenders, investors and corporations to form the consortium. With input from consortium members, The Muldavin Co. will lead development of the value measurement methodology.

Once finalized, the value measurement methodology will function as an overlay to the underwriting decision systems used by rating agencies, financial institutions and investment advisers to evaluate real estate transactions. While green commercial MBS are not the focus of the value measurement methodology effort, Muldavin hopes that it will prove to be one of the important applications of a system that could also be used, for instance, to qualify building owners for future tax breaks or other green incentive programs. The value measurement methodology's development, however, is a critical first step to the introduction of green MBS.

"We need to communicate the impact of green and energy-efficient measures in a structured fashion to people who will then be able to build these elements into their underwriting and value them in the marketplace when pursuing commercial financing and acquisition transactions," says Dan Winters, a real estate finance expert, managing principal with Evolution Partners and a green MBS advocate.

"It's clear that numerous elements of high-performance green design have significant value, and this value isn't always clear to the finance community, given the way deals are historically underwritten," says Winters. "The goal is a straightforward system that allows the market to appropriately recognize these features."

Achieving this will be no small task. As the first step, the development of the valuation methodology will require the culling and analysis of years' worth of performance data demonstrating the bottom-line impacts — positive and negative — of all kinds of green and energy-efficient measures in a range of buildings and locations. This information will provide a basis for comparing green buildings' operating costs, leasability and other characteristics to those of standard facilities.

Much of the groundwork for this process has already been laid by the U.S. Green Buildings Council's LEED (Leadership in Energy and Environmental Design) green building rating program and the ENERGY STAR program. Criteria from those programs will be built into the valuation tool.

"The development of a valuation methodology such as green mortgage-backed securities will help speed the market's adoption of LEED and green building," says Rick Fedrizzi, president and CEO of the U.S. Green Building Council.

Green MBS should be rated higher and worth more because of the benefits of green buildings: OPERATIONAL EFFICIENCY, MARKETABILITY AND OCCUPANT SATISFACTION

Gaining Buy-In

Once the methodology is completed, implementing a green MBS will require the buy-in of the appraising and underwriting industries, and of the ratings agencies — specifically Standards & Poor's, Fitch, Moody, and Duff & Phelps — that rate MBS bonds.

The process promises challenges, but proponents are emboldened by past victories. A committee led by Italiano successfully advocated for creation of Phase I ESA-MBS — mortgage-backed securities for facilities completing Phase I environmental site assessments (ESAs). Today, virtually all MBS are Phase 1 ESA-MBS.

In addition, champions of the green MBS concept point to momentum and increasing interest from owners and developers seeking favorable financing terms, real estate professionals eyeing a new market niche, and lenders and investors looking to reduce their risk exposure.

While there is undoubtedly still plenty of room for improvement, there is little question that financial institutions speak the language of green more fluently now than they did just a few years ago.

"When we approached bankers on the 4 Times Square project in 1999 and started talking about wanting to incorporate fuel cells and photovoltaic panels, they looked at us like they didn't know what the heck we were talking about," says Jody Durst, co-president of Durst Development. "But it's clear the concept has been truly embraced since then."

Durst's current large project — the Bank of America headquarters at One Bryant Park in New York City — has been able to secure more favorable financing in part because of the green measures intended to qualify the new building for LEED platinum certification.

"You're going to have a facility that's cheaper to operate and that's easier to lease because it's a more pleasant workplace," says John Saclarides, Bank of America senior vice president in charge of headquarters corporate real estate. "That combination enhances the net operating income. If you're a lender, your environmental commitment is not even the issue — it's just common sense."

The Impact of Energy Costs

The growing open-mindedness in the financial industry will make for somewhat smoother sailing when the time comes to sell the green MBS concept to appraisers, underwriters and ratings agencies. The task will likely be further simplified by concerns about the impact of rising energy costs on real estate investments. Because the buildings included in the securities would be more energy-efficient than comparable non-green facilities, their financial performance would be less affected by an oil crunch.

"Energy costs are predicted to go up significantly over the long term, and we have all witnessed a significant short-term increase in the past couple of months," says Italiano. "It is a financial risk for people not to address it."

Winston Hickox agrees. The special adviser to the California Public Employees' Retirement System's (CALPERS) environmental initiative and former secretary of the California EPA, Hickox shares Italiano's grim assessment of the future of energy prices, and he takes the risk this presents to CALPERS' $15 billion in real estate investments very seriously.

"It is my contention that it's our fiduciary responsibility to better understand this risk and to mitigate it and account for it in making decisions about investments," he says.

However, oil prices aren't the only factor that's making real estate lenders and investors nervous. Hickox notes that climate change — with its threats of volatile weather and increasingly violent storms — will soon give many investors considerably more pause.

"It's not on everybody's radar screen yet," says Hickox, "but insurance companies — especially re-insurers — have been an early indicator of concern about climate change and what it's going to mean for the risk exposure of facilities in what have traditionally been very desirable locations."

Italiano says that the incentives provided by green MBS could increase market penetration for green buildings from less than 5 percent to 70 percent within five years. That, he explains, would have a significant impact not only on the wallets of those whose properties or investments are directly affected, but on the course of climate change and its impact on the planet.

It's an idea, says Hickox, that savvy investors should consider backing.

"Green MBS is something that we may be very interested in pursuing

'It's our fiduciary responsibility to UNDERSTAND THE RISK OF RISING ENERGY PRICES AND ACCOUNT FOR IT in making decisions about investments in buildings'

once we see a proposal that fleshes out how it would work," says Hickox. "Ideas like this are very much needed in the marketplace right now. I don't know that I've ever seen a more appropriate application of the concept that necessity is the mother of invention."

Lenders, too, are watching with interest as the green MBS concept moves forward.

"We are definitely talking about and considering green commercial mortgage-backed securities," says Stephanie Rico, communications consultant with Wells Fargo, one of the sponsors of the December summit. "In fact, we have already originated several LEED construction loans and are actively seeking to include more green permanent loans in our CMBS pools."

Change on the Horizon

Proponents of green MBS say that the booming growth in mortgage-backed securities, which have come to penetrate 25 to 30 percent of the mortgage market over the past decade or so, make them an ideal instrument for maximizing green market penetration. Those who have watched the development of green MBS are cautiously optimistic that the idea will take flight within the year following the December summit. Others note hurdles remain: Potential investors will want diversity, with the securitized pool encompassing various facility types and geographies, and the current stock of green buildings may be inadequate to support green MBS.

*Lenders are already becoming **MORE OPEN-MINDED** about the value of green design*

"I think it's a good idea," says Jacques Khouri, CEO, Vancity Enterprises. "You have to have scale before CMBS make any sense, though, so making sure there are enough green projects out there may be one challenge."

The green MBS concept may also find opposition from owners of older or non-green facilities, which may compare unfavorably with the buildings that qualify for inclusion in a green MBS.

Whether MBS are the vehicle that ultimately makes it happen or not, however, experts say the emergence of financing instruments that recognize the benefits of green buildings is inevitable.

"It's going to happen," says Muldavin. "The only issue is the speed of penetration into the private finance sector and how broad that penetration is. Getting a green CMBS is one possible outcome of this process, but the goal is much broader than that. The real goal is for any member of the finance community — whether it's a lender doing a regular mortgage, a lender doing a CMBS, or an investor wanting to buy a building — to have a way to appropriately value green or energy efficiency factors when making decisions about financing."