

THE HIGH PERFORMANCE PORTFOLIO: ENERGY EFFICIENCY AND APPRAISALS



BETTERBRICKS
Bottom line thinking on energy.

SUMMARY:

Investments in energy efficiency often have a positive impact on the bottom-line. However, to fully realize the value of a high performance building, developers, owners, and managers need to engage with appraisers, documenting and demonstrating the financial benefits and risks of energy management strategies.

IN DEPTH:

Appraisal professionals serve as independent experts, providing lenders, investors, and developers with documented evidence of market preferences and estimates of building value. As such, appraisers - or as they are more globally known, "valuers" - play a pivotal role in lending decisions with capital sources, investors, and financial institutions. Their assessments of properties, projects, market conditions, etc. provide a third-party view, with their appraisals serving as a qualifying mechanism upon which a lender decides to approve or deny a loan.

Appraisers play a pivotal role with capital sources, and thus are critical in capitalizing on the rewards of energy efficiency.

Energy should be examined as a separate line item within the operational budget of a specific building, and energy usage should be compared with that of other properties in the "subject" building's marketplace. Energy costs incurred or projected for the subject are compared with its demonstrated performance and the performance of its peers.

In general, documented historical data is preferred, but this type of information may not always be available or relevant. For example, if a building has no operational history (is new), then a valuer would rely on costs seen in similar buildings, or on data collected and published by recognized market sources. The BOMA (Building Owners and Managers Association) Experience Exchange Report or IREM (Institute of Real Estate Management) Income/Expense Analysis Reports are two such examples.



Energy models, commissioning reports, energy audits, energy benchmarking scores, and other indicators of building performance and costs should be brought to the appraiser's attention.

Property owners, developers, and investors should educate the appraiser on additional data sources that can inform the analysis. Energy models, commissioning reports, energy audits, energy benchmarking scores, and other indicators of building performance and costs should be brought to the appraiser's attention. Reports certified and vetted by third parties are especially valuable in this regard, as is information on potential utility or governmental incentives.

Data provided on life-cycle costs, versus simple "first costs" might also assist the appraiser. Life-cycle cost assessment has not historically been applied in the valuation of investment properties, but will likely become more relevant as innovations and new best practices enter the mainstream.

A key challenge in assessing the value implications of energy management strategies is gauging the market's acceptance of those strategies. This factor, coupled with the knowledge that the appraisal community relies heavily upon empirical data, means new or unorthodox approaches to building construction and operations will require a greater burden of proof to support performance projections. Examples may include innovations such as:

- Incorporating new and/or unproven systems and technologies
- Introducing new concepts – such as integrated design, daylighting, etc.,
- Implementing new practices – such as commissioning or life cycle analysis

These approaches may very well reduce energy consumption, but their impact on asset value will also be heavily dependent upon the market's recognition of their value, and the associated risks and rewards.

An appraiser relies heavily on market evidence to estimate value. The benefits of energy efficient practices need to be concrete and logically understood to be included in the analysis. Examples of such benefits include:

- Reduced utility expenses through more efficient components or systems often result in increased net operating income, which can result in an increase in asset value
- Reductions in capital reserves and maintenance costs resulting from:
 - The use of longer-lived components (Mechanical, Electrical and Plumbing (MEP) systems,)
 - Systems integration and efficiencies gained through "right-sizing."

Perhaps even more important, the role of implied risk assumed by the valuer directly impacts both discount and capitalization rates. Increased risk translates to higher discount and cap rates, driving down values. Conversely, a reduction in implied risk results in more favorable rates and higher estimates of value.

For instance, risk will factor heavily into the analysis of the following situations – and may positively or negatively affect value:

- Utilization of new or unproven systems or components
- Expertise (or the lack thereof) of the developer, manager, or engineer
- Experience level of the contractor with new or different systems
- Effect of energy efficiency technologies on the tenant improvement cycle

The appraiser must consider: is there a possibility of failure or underperformance from unproven systems? Or is there a risk of early obsolescence if more sophisticated and energy-efficient components are not used? Is there increased regulatory risk of not being able to comply with changing energy regulations or codes? Will future tenant fit-out costs be higher because efficiency was “value-engineered” out of the design when the building was initially constructed?

In any case, the appraised value of a property is impacted just as much by considerations of associated risk as it is by its financial performance. Investment in energy efficiency could present a compelling business argument for reduced costs, and may offer tangible benefits for managing risks as well. But increased value will only be realized when the market perceives these features as more valuable and higher prices are paid for buildings with these features.

Thus, investors, developers, and owners will be better served by engaging more directly with lenders and appraisers, detailing how your approaches to energy management present a more compelling investment opportunity. A clear explanation of key strategies, innovative or non-traditional techniques - and the reason for their incorporation - will facilitate a better assessment, increasing the potential for increased assessed value.

Owners will be better served by engaging more directly with lenders and appraisers, detailing how your approaches to energy management present a more compelling investment opportunity.



THE BOTTOM LINE:

- Industry momentum is shifting to recognize and value high-performance buildings.
- The appraisal community, like the rest of the real estate industry, is working to better understand the potential costs, risks, and benefits associated with these properties.
- Many emerging energy management technologies and practices have little precedent in the market.
- The burden of proof often falls to the owner or manager.
- Owners can improve asset value when all aspects of energy efficiency are adequately analyzed.

USEFUL LINKS:

The High Performance Portfolio Framework
www.betterbricks.com/office/framework

The Appraisal Institute
www.appraisalinstitute.org

Green Building Finance Consortium
www.greenbuildingfc.com

Vancouver Valuation Accord
www.vancouveraccord.com



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