

## Other Voices

*Views from beyond the Barron's staff*

# As Green as the Grass Outside

By CHARLES LOCKWOOD

**T**RILLIONS OF DOLLARS OF COMMERCIAL PROPERTY owned by real-estate investment trusts, corporations and other investors around the world will soon become obsolete—and will drop in value.

This looming obsolescence has nothing to do with the housing bubble. It will affect office buildings, shopping malls, warehouses and distribution centers. It threatens real-estate portfolios from Chicago to Shanghai, even as it also opens new profit-making opportunities.

What's going on? A significant real-estate market shift is gathering momentum: Green buildings—which have a less negative impact on the environment, boast lower energy consumption, and offer healthier indoor environments than “standard” buildings—are going mainstream.

The numbers tell the story. The U.S. Green Building Council, an independent nonprofit association of more than 6,000 professionals and organizations dedicated to sustainable building design and construction, offers a rigorous Leadership in Energy and Environmental Design (LEED) certification for buildings seeking to be designated as green. The group's listings go from the most basic, or certified, through silver and gold ratings to its highest ranking, platinum.

As of this month, the council had certified 669 buildings as green. Waiting in the queue for ratings are 4,926 more edifices, an indication of the enormous surge in U.S. market demand and the number of buildings being constructed with green considerations in mind.

### *Thousands of Verdant Venues*

The Green Building Council estimates that 5% of all new U.S. commercial construction will be LEED-certified in 2006, and that thousands more new structures will be built according to sustainable principles: meeting today's economic and social needs without compromising the environment or the ability of future generations to meet their own needs. The McGraw-Hill 2006 Smart Market Report predicts that green U.S. nonresidential construction alone will comprise as much as 10% of all nonresidential construction starts in 2010.

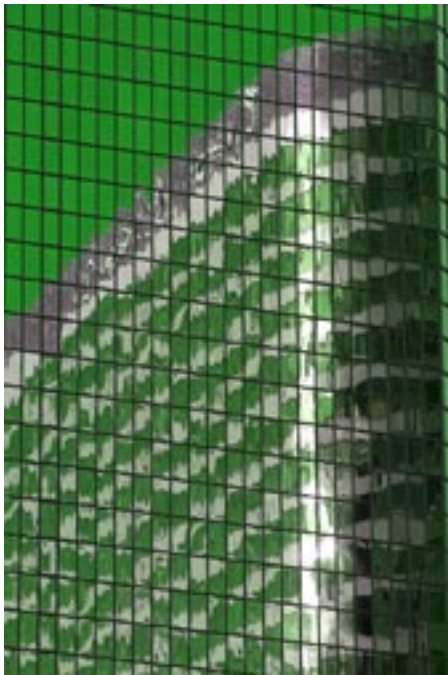
Leading corporations and professional firms are the primary drivers of this green market shift. Genzyme, Goldman Sachs, Hearst, IBM, JPMorgan Chase and Toyota have recently moved into green buildings. Prominent law firms and professional services companies like Deloitte and Accenture are leasing green workplaces. Even U.S. macho-icon Harley-Davidson has constructed a green building for its Product Development Center in Wisconsin.

Recognizing this, speculative developers like Hines, the Durst Organization, Alter Group, East West Partners and Vulcan Real Estate are all constructing green buildings in cities across the U.S., including Atlanta, Chicago, Houston, Los Angeles, New York, San Francisco and Seattle.

### *The Profit Potential in Renovations*

While many real-estate brokers and investors remain unaware of the potential financial gains, some savvy

REITs and other investors are already searching for unrecognized green real-estate investment opportunities. For example, partly empty B, or second-tier, office buildings in A, or top-tier, markets may be renovated to green standards, thus allowing them to bring in premium rents and generate more favorable long-term returns.



Jonathan Rose Companies formed the Rose Smart Growth Investment Fund 1, a \$100 million limited partnership that will acquire buildings in “Smart Growth” locations—compact, transit-oriented, pedestrian-friendly, mixed-use urban and suburban communities—and then carry out green renovations on those properties. Thomas Properties Group is

creating a \$500 million green commercial building fund for both new construction and renovations.

### *What’s so great about green?*

First, these buildings have lower annual operating costs compared to standard structures. Genzyme’s 12-story, 350,000-square-foot corporate headquarters in Cambridge, Mass., for example, uses 42% less energy and 34% less water than a like-sized standard building. Warner Bros.’ renovation of its Building 151 in Burbank, Calif., reduced electricity, gas and water costs by 38%. Overall, green office buildings offer approximately a 10% savings on utility costs each year.

Second, green offices’ healthier environment helps reduce absenteeism and illness. After Toyota’s customer-services unit moved into a LEED-gold-certified

expansion of the car maker’s North American headquarters in Torrance, Calif., absenteeism fell by 14%.

Third, these structures spawn stronger employee attraction and retention because they’re more comfortable, healthier places to work. Following PNC Financial Services Group’s move into a silver-certified building in Pittsburgh, for example, employee turnover dropped 50% below the typical level experienced at a standard PNC facility.

Finally, and of critical importance to employers, numerous studies and completed buildings demonstrate that green workplaces can raise employee productivity by up to 15% annually. Just a 1% increase in productivity is worth \$3 per square foot to a company annually, or \$600 to \$700 per employee per year, according to the Capital E consulting group.

Many skeptics assume that these benefits are cancelled out by higher construction costs.

Actually, most green buildings now cost no more to construct than standard facilities. Turner Construction’s 2005 Green Building Market Barometer study found that the average estimated cost premium for sustainable building is only 0.8% for a basic LEED certification, which is easily repaid through lower operating costs.

Toyota’s 624,000-square-foot green addition to its Torrance headquarters cost no more to build than a standard low-rise business campus in southern California.

PNC has constructed 27 of its planned 117 LEED-rated bank branches on the East Coast. Each cost \$100,000 less to build than a standard bank branch, uses 40% to 50% less energy, and was ready to go in 45 fewer days.

Of course, a real-estate market shift doesn’t happen unless it’s profitable, and this shift is no exception.

Green buildings generate significant economic benefits. According to the McGraw-Hill 2006 SmartMarket Report, they deliver 3.5% higher occupancy rates, 3% higher rent rates, and an average increase of 7.5% in building values; they also improve return on investment by 6.6%, on average. Some green buildings do much better.

## *Reaping More Green From Green*

Significant sales premiums are also possible. In Chicago, the John Buck Company spent \$270 million constructing 111 South Wacker Drive, a LEED-gold-certified 51-story tower in the Loop district. Completed in late 2005 when the Loop market was struggling with an 18% vacancy rate for Class A office space, the building leased quickly to prestigious tenants. In January 2006, it was sold to a German investment fund for \$386 million, a \$116 million profit.

One South Dearborn Street, a LEED-silver-certified 40-story office tower, has done even better. Upon its completion in mid-2006, One South Dearborn was 93% leased, while the Loop market faced a 14.3% Class A office vacancy rate. The \$200 million green tower also set a new Chicago sales record—besting 111 South Wacker—when developer Hines Interest sold it to Olen Properties Group for \$344 million, a \$144 million profit.

Municipal and state governments are hastening standard buildings' demise. While dozens of U.S. cities, several states, and over a dozen Federal agencies have mandated LEED ratings for new construction and renovation of public buildings, Boston, Pasadena and Washington D.C. passed laws in 2006 requiring LEED ratings for many new private buildings.

As the market shift gathers even greater momentum in coming years, standard buildings will become the real-estate industry's version of the buggy whip.

Rapid and massive obsolescence has challenged the world's commercial real-estate markets before. When earlier innovations were introduced into commercial buildings—like central air conditioning in the 1950s and 1960s—all properties lacking this innovation quickly became outmoded, and their value fell as top tenants headed for the exits. Those owners and investors who renovated their holdings with the new technologies protected and even boosted their property values.

To prevent their properties from becoming passé, today's real-estate owners should undertake renovations now. The pressure will be particularly intense on long-

term investors, like REITs, which own so much commercial real estate, in many nations. When long-term leases expire, those properties will have to be re-leased in a marketplace that increasingly demands the many benefits of green.

Certainly, renovation is a normal expense of commercial real estate. These sorts of upgrades, however, create greater short- and long-term value than a standard renovation. They lower annual operating costs, generate work-force benefits like greater productivity and better employee attraction and retention, and meet the growing demand for green buildings.

A few major corporations have recognized the impact of looming obsolescence.

Citigroup, which owns and leases 13,000-plus properties in more than 100 countries, is already taking action. Citigroup has launched a real-estate portfolio review, so that it can investigate what levels of renovation or operational changes are needed to earn LEED ratings (or equivalents) for everything from Citigroup's office buildings to its data centers. The company has also established a LEED-silver rating as a target for all its new office and operations facilities around the world.

The marketplace shift to green is gathering force. Massive obsolescence is looming. Profits are there for the taking. It's time to act. ■

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