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Capital markets lag behind green buildings by Dan Winters - 4.29.07

The growth of the green building industry accelerated in 2006 with a number of major developers and high-profile tenants embracing the benefits inherent to the design, construction and operation of high performance buildings. Fundamentally, the benefits from green building fall into two categories: value enhancement and risk reduction.

While the development and tenant markets have seized on these attributes and are moving forward, capital markets have been slow to recognize the positive attributes of green building and, as a result, are lagging behind the curve. Of note are the major risk-rating agencies — Moody's (NYSE: MCO), Standard & Poors and Fitch — which serve their customers by accurately assessing investment risk features, including tangible and intangible financial benefits and risks that materially affect the underlying collateral.

Under the U.S. Securities Exchange Commission criteria, rating agencies have a legal duty to their investor fiduciary clients and capital markets to incorporate various risks and risk reduction measures — for existing equity and debt financial instruments as well as new issuances — into their overall ratings.

With the passage of the Sarbanes-Oxley Act, credit rating agencies received intense scrutiny due to the importance of credit ratings in the investor decision-making process. A credit agency rating impacts a stock or bond issuer's access to and resultant cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to make particular investments.

The rating agencies hold themselves to a very high standard. While numerous elements of high-performance green developments have significant real estate financial value, the value isn't always clear to the finance community given the way deals are historically underwritten. Communicating the impact of critical green building features in a structured fashion can enable investors to incorporate these elements into their underwriting, a critical component to assessing asset value and performing fiduciary duties.

It has become clear that a number of key risks pertaining to investor assessment of current and future cash flow, risk exposure and default potential can be reduced by adherence to green design and construction principles.

Foremost among the risks are:

1. Reduced current energy consumption, costs and future price volatility
2. Operational risk reduction derived through the building-commissioning processes
3. Indoor air quality, occupant health and associated potential liability
4. Mold prevention and defense to legal liability



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5. Future regulation risk on climate change
6. Lower asset operating costs affecting default risk thresholds
7. Superior asset quality leading to higher probability of occupancy and associated rental revenue.

Measuring these risks falls into the following general categories:

- Increased collateral value and/or reduced obsolescence risk
- Reduced liability risk exposure and/or large dollar capital outlays
- Reduced default risk from no or diminished insurance coverage
- Reduced future regulation risk

These value enhancement and risk reduction factors create a compelling business case to incorporate green features into asset underwriting criteria, and opens the door for the rating agencies to address these issues within their rating systems. Recently, the signatories of the Vancouver Valuation Accord took an important step forward in agreeing to develop guidelines and processes that embed sustainability within real estate valuation practices.

Of significance are two reports that highlight the importance of this issue. A September 2006 Goldman Sachs presentation to the Clinton Global Initiative focused on why investors are concerned about their fiduciary responsibilities under environmental, social and governance issues (ESG) and are cognizant of these investment opportunities and risks.

Second, an October 2005 report released by the United Nations Environment Programme Finance Initiative outlines a framework for incorporating ESG issues into institutional investment decision processes. The report, written by the law firm Freshfields Bruckhaus Deringer, asserts that under U.S. common law, a fiduciary's responsibility is "to exercise reasonable care, skill and caution in pursuing an overall investment strategy that incorporates risk and return objectives reasonably suitable to the trust."

Essentially, a fiduciary must follow the "correct process" in reaching investment decisions, and conforming requires regard to all considerations relevant to the investment decision, including those that impact value and/or reduce risk.

This effectively creates the requirement to integrate pertinent risk reduction measures into fund management processes, particularly where there is the potential for material financial impact. Given the demonstrated risk reduction exhibited by green buildings and the value inherent within these assets, it is clear the industry should be a significant area of focus and investment opportunity.

To do so requires the rating agencies and Wall Street to both accurately articulate and appropriately rate these risks within the securities they sell. Implementing measures on this front is a proper response to the rapidly evolving needs of the global capital markets and the fiduciaries that drive investment decisions.

Ultimately, it is up to the financial industry to lead the way in addressing issues such as carbon dioxide emissions, energy cost price volatility exposure and climate change. Recognizing the sweeping changes undertaken by leaders in the building industry and incorporating these into evolving underwriting standards is a solid step forward.

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