

PERCEIVED RISKS AND BARRIERS TO SUSTAINABLE COMMERCIAL PROPERTY INVESTMENT: AN INVESTOR PERSPECTIVE

J. Bennett¹, D. Halvitigala²

¹The Fletcher Construction Company Limited, Auckland, New Zealand

²Department of Construction, Unitec Institute of Technology, Auckland, New Zealand

dhalvitigala@unitec.ac.nz

ABSTRACT

Sustainability has taken on increased significance in the property industry in recent years. To date, the literature relating to sustainability has placed much of the emphasis on the design and construction of sustainable properties. Relatively limited attention has been given to understanding the impacts of sustainability from a property investment perspective. The New Zealand built environment was introduced to the concept of sustainability with the establishment of Green Building Council in 2005. Even though investors increasingly integrate sustainability into their business platforms, sustainable investment market in New Zealand has been relatively slow to develop and is lagging behind other developed economies. Employing a series of in-depth interviews with the listed property entity sector who has taken a strong leadership role in sustainable investment, this study examines the main barriers and challenges to investment in sustainable properties in New Zealand and how these barriers affect the significance of sustainability in corporate investment strategies.

The study identified that the significance of sustainability in investment strategies had decreased since the global financial crisis and the Christchurch earthquakes. It also identified several market and property specific barriers to sustainable investments such as lack of demand, higher construction costs, limited proof confirming their economic viability, lack of government incentives, limited availability of technology, lack of expertise in building maintenance, higher building obsolescence and lack of market awareness. The research highlights the importance of understanding issues associated with sustainability from investment perspective in order to effectively evaluate sustainability principles.

Keywords: Investment costs and benefits, Property investment, Sustainable property

INTRODUCTION

Construction and property industry has a significant impact on the environment with buildings contributing up to 30% of greenhouse gas emissions, 50% of CO₂ emissions, 40% of energy requirements and 40% of solid landfill waste globally (Atkinson, 2007; Boyd, 2006; Keeping et al., 2007; Reed and Wilkinson, 2007). There is, therefore, a growing pressure on the property industry to mitigate the environmental impact caused by commercial properties. The property industry has responded to these concerns and is at the forefront of movements towards implementing sustainable principles in their property development and investment activities. Particularly, the past decade has experienced a significant increase in both the awareness and implementation of sustainability within the commercial property industry (Harrison and Seiler, 2011).

Although sustainability has taken on increased significance in recent years, it is yet to be fully integrated in overall property investment practices in many countries (Sayce et al., 2007). **Sustainability from the investment perspective is defined as "maximizing the positive effects and minimizing the negative effects of property ownership, management and development on society and the natural environment in a way that is consistent with investor goals and fiduciary responsibilities" (Pivo and McNamara, 2005 as cited in Francesco and Levy, 2008 p73).** Sustainable investment by the private sector has remained limited, particularly in markets where there is lack of strong government commitment towards sustainability (Reed and Wilkinson, 2005). The New Zealand (NZ) property industry was introduced to the concept of sustainability with the establishment of New Zealand Green Building Council (NZGBC) in 2005. Even though investors increasingly integrate sustainability into their business platforms, sustainable investment market in NZ has been relatively slow to develop and is lagging behind other developed economies (Myers et al., 2008). Employing a series of in-depth interviews with the listed property entity sector, this study examines the key barriers, issues and challenges that discouraged or prevented property investors investing in sustainable properties in the NZ office property sector. The NZ listed property entity sector has taken a strong leadership role in terms of implementing best practice in environmental sustainability in their property portfolios. By 2012, approximately 30% of total Green Star rated office buildings in NZ were owned by listed property entities or property funds managed by them. In addition, they owned a number of prime quality properties that were perceived to be sustainable by the market.

The remainder of the paper is in four parts. The following section provides a brief review of the relevant extant literature. The methodology is then presented followed by a summary of the results. The concluding section highlights the key findings of the study.

LITERATURE REVIEW

Academic studies evaluating the impact of sustainability on building design, construction, and investment represent a relatively new, but rapidly expanding subfield of the property discipline. To date, the literature relating to sustainability has placed much of the emphasis on the design and construction of sustainable properties; however relatively limited attention has been given to understanding the impacts of sustainability from an investment perspective (Reed and Wilkinson, 2005). Sustainable investments are defined as the investments that 'give joint consideration to the economic, social and the natural environments that effectively utilise resources for current and future generations' (Francesco and Levy, 2008, p73). Drivers for sustainable commercial property have been both top-down drivers via government environmental legislation and regulations regarding sustainability, and bottom-up market drivers such as potentially enhanced returns and reduced downside investment risks (Newell, 2008).

The review of the extant literature highlights a dearth of research into understanding the benefits of sustainable properties to property investors. These include enhanced returns and property value, utility cost savings, maintenance cost reductions, brand differentiation, improved marketability, faster lease-up periods, higher tenant retention, reduced risk, increased occupier productivity and improved reputation (Cajias et al., 2012; Ellison et al., 2007; Keeping et al., 2007; King, 2007; Lutzkendorf and Lorenz, 2007; Sayce et al., 2007; Yudelson, 2010). Despite these advantages, there are many barriers to investing in sustainable buildings. Higher construction costs, lack of concrete evidence on their economic viability, split incentives between landlords and tenants, lack of incentives, and lack of knowledge and experienced workforce have been identified as the main barriers (Bond, 2010; Boyd, 2006; Choi, 2009; Lorenz et al., 2007; Yudelson, 2010). Most of the benefits of green buildings are only evident over the long term (Choi, 2009). Even though literature provides evidence of the positive intrinsic value of sustainable properties (Eichholtz et al., 2010; Fuerst and MaAllister, 2011), markets are yet to shed light on the financial viability of sustainable buildings and identify the links with market value (Myers et al., 2008).

These studies have been conducted in other developed economies where sustainable building practice has been used for several years, particularly the US, UK and Australia. However, there is lack of research in NZ to understand the perceptions, behaviours and experience of investors when investing in sustainable buildings. A study of the NZ property sector by Myers et al. (2008, p 298) found that "even though targeted measures have been taken by the NZ Green Building Council and government, there is considerable hesitation and scepticism existing in the property market from both an investor's and building owner's perspective'. Given the fact

that NZ investors are somewhat sceptical of the viability of sustainable buildings (Bond and Perrett, 2012; Myers et al., 2008), it is important to understand the issues and barriers that discourage or prevent them investing in sustainable properties.

METHODOLOGY

The focus of this study is to explore and gain an in-depth understanding of property investor perceptions and experiences of issues and challenges associated with sustainable property investments. Qualitative methodology using in-depth key informant interviews with **10 senior property portfolio managers** of all listed property entities that have actively invested in office properties were utilised as the most effective data collection method. A qualitative approach was well suited for the objectives of this study since it provided a deeper understanding of participants' live experiences of the phenomenon being studied (Marshall and Rossman, 1999). The interviewed portfolio managers between them were responsible for the management of approximately 1 million m² of commercial space worth in excess of NZ\$6.3 billion. The property entities represented in the interviews made up more than 75% of the total asset value of all assets held by the NZ listed property sector. **All property portfolio managers interviewed held the ultimate responsibility for key property related investment and management decisions for their entire property entity.**

A number of topics were covered in the interview including; significance of sustainability in their current corporate strategies, implications of sustainability on property returns, risks and barriers to sustainable investment, and changes or improvements that would further encourage them to invest in sustainable properties. The interview transcripts were analysed using a thematic analysis which enabled to develop categories, themes or patterns about the phenomenon (Miles and Huberman, 1994).

KEY FINDINGS

Significance of sustainability in current investment strategies

Firstly, the research attempted to determine whether the NZ listed property entity sector considered environmental sustainability to be a significant factor when investing in office property and how significant it was in their current investment strategies. All listed property entities indicated that sustainability was one of the primary considerations in their investment decisions. Sustainability was introduced to their mainstream property investments in the last six years; however the priority of sustainable buildings as an investment vehicle varied among the property entities. The size of the property entity tended to affect their strategy towards sustainability practices, with larger property entities with more

resources tended to incorporate sustainability into their portfolios more actively than relatively smaller listed property entities.

Despite their strong preference to be seen as leading investors in sustainable properties, all property entities stated that their organizations experienced a temporary weakened interest in sustainability following the 2007 global financial crisis (GFC) and the subsequent property market downturn. They described that sustainability has become a 'nice to have' factor, not a 'must have' factor in their current investment decision making. Lack of tenant demand for sustainable properties, property entities' decreased interests in new acquisitions, their focus on safeguarding the existing portfolios to create value, and limited accessibility to finance markets were considered as the main reasons for weakened interest in sustainable investments in difficult economic climate after the GFC.

Furthermore, interviewees confirmed that seismic considerations have taken priority over sustainability in their investment decisions after the Christchurch earthquakes that severely damaged NZ's second largest city causing estimated NZ\$40 billion of rebuilding costs. After the Christchurch earthquakes, office tenants place a strong emphasis on criteria related to seismic specifications when selecting premises. As a result, majority of property entities have been proactive in completing seismic reviews of their portfolios using the NZ Society for Earthquake Engineering (NZSEE) methodology for grading buildings and investing in building strengthening works. Sustainability is at present a factor that is nice to have if costs permit, whereas seismic concerns are essential.

In addition to these temporary factors, interviewees were asked to discuss the key issues and major challenges that discouraged or prevented them investing in sustainable properties. Lack of tenant demand, higher up-front costs versus low perceived rental premiums, lack of evidence in economic viability of green buildings, and knowledge gaps in the market were cited as the most significant reasons.

Lack of tenant demand

All interviewees emphasized that the demand for sustainable properties from both government and corporate tenants had decreased in the negative economic climate at the time. Unlike other developed economies where green rated buildings have become the standard practice, the NZ government imposes little pressure to have sustainable features in property developments. It had previously mandated that all new buildings constructed to house government tenants to have a Green Star rating of at least four; however this mandate was revoked in 2010 and sustainable buildings are not a top priority for the present government. Negative economic climate at the time, lack of awareness in the occupier market of the benefits of green features and capital constraints of tenant companies affecting their location decisions were cited as the main reasons for lack

of tenant demand. All interviewees, however, were hopeful that sustainability will become a more paramount decision making component in the occupier market as economic conditions improve. The importance of market awareness programmes and well documented performance indices for sustainable buildings was cited as a method of increasing tenant demand. Introduction of a performance based rating system to measure buildings' performance, such as NABERS, was identified as the most important thing that can be done to prove operational efficiency of sustainable properties. At the time of the interviews, NZ had not implemented an in-house rating tool; however NABERS NZ was just introduced in June 2013. Furthermore, the necessity of proper mechanism to quantify intangible benefits of sustainable properties such as increased productivity and wellbeing of occupants over conventional buildings was cited in order to increase tenant demand.

Higher upfront costs versus low perceived rental premiums

All respondents stated that there was a significant cost premium for incorporating sustainable features into developments and subsequently obtaining green star certification. From their experience, green buildings would cost 10%-15% more than the cost of a non-green building depending on the scale and green star rating of the building. A significant part of the cost premium was the cost of obtaining Green Star certification and it was seen as a main barrier to the sector's uptake of the formal green star recognition. They were also critical of the Green Star certification system and the time taken by the NZGBC to evaluate green star rating applications. Due to costs and delays in obtaining green star ratings, some property entities had incorporated green elements into their buildings without seeking a formal Green Star recognition.

Despite cost premiums associated with sustainable buildings, all interviewees emphasized that the occupier market was not willing to pay a rental premium for such premises. As the NZ market is gradually embracing the concept of sustainability, many tenants expected sustainable features in office buildings to be the market norm for modern buildings and wouldn't be prepared to pay rental premiums. Current negative market conditions, tenants' lack of interest in the green agenda, lack of faith in effectiveness of green features, lack of proven records on economic viability of green buildings, and unquantifiable nature of some benefits such as employee productivity were identified as the main reasons for tenants' unwillingness to pay a rental premium.

Lack of evidence in financial viability of sustainability

Previous literature largely suggests that positive rent and value differentials do exist for sustainable property (Fuerst and McAllister, 2011; Jones Lang LaSalle 2006; Miller et al., 2008; Pivo & Fisher, 2010; Wiley et al., 2010). However, participants emphasized that, at the time of the research, the total returns of sustainable properties in their portfolios

were only marginally positive to their conventional counterparts. Also, they were yet to experience significant operating cost savings in their sustainable properties. There was limited knowledge amongst the interviewees of the life cycle cost benefits or payback periods of incorporating sustainable features into their properties. The common view across all property entities was that the sustainable property investment market is still immature in NZ and thus the financial returns are yet to be fully transparent. However, they were optimistic that significant financial benefits of sustainable buildings would be evident over the medium to long term. The need for more reliable tools and indices on the performance, costs and benefits of green buildings in order to minimize market misconceptions and uncertainty about green buildings was frequently discussed.

Lack of government incentives

Interviewees were critical of lack of government initiatives and incentives to induce market decision-making in accommodating and incorporating green attributes in commercial buildings. They stated that the central government should play a more direct role in encouraging sustainable development through government legislation and policy. It was suggested that the government could encourage sustainable investments by introducing government subsidies such as tax breaks, monetary grants for green buildings, reinstating the government green leasing policy and creating green incentive schemes to encourage private developers. The necessity of developing regulatory processes and codes that could help to promote sustainable practices was also discussed.

Interviewees also believed that increasing the availability of funding mechanisms by involving lending institutions in providing preferential lending criteria, low interest loans and preferential guarantee programmes for green projects would increase the delivery of sustainable properties. Further proposed financial incentives include preferential insurance mechanisms and local government property rates concessions to private developers.

Knowledge gaps in the property market

The participants also specified other challenges that were at stake with regard to the management of sustainable properties. The majority interviewees had a perception that the NZ property market was lacking technology, knowledge and skilled personnel to implement the sustainability agenda effectively. It was noted that the use of unproven technologies and lack of experience and knowledge of green building technologies had created additional long term uncertainties in property management. Due to lack of skilled personnel in managing green building technologies, several investors added that they had become heavily reliant on a small pool of specialists for property maintenance. They suggested that there was a risk that the buildings may not realistically be

operated as they were intended since tenants and their employees may not be interested in running their offices sustainably. Several interviewees suggested that green buildings may become obsolete faster due to these operational and management inefficiencies. They stressed that better awareness, training and education of all involved in the occupation and management of sustainable properties were needed.

Other than these most significant factors, several other issues and barriers were identified. These include lack of evidence substantiating the benefits of sustainable property, market immaturity, unavailability of proper valuation methods to estimate the impact of sustainability on property values, lack of availability of standard lease structures to split sustainability benefits between landlords and tenants, and risks and process issues related to sustainable developments. Overall, the results highlight that the property market in NZ is yet to fully embrace sustainability and may not be fully equipped to handle the challenges of sustainability principles. The central government and NZGBC need to play a significant role in educating the public and users around the benefits of sustainability in order for sustainable buildings to be the market norm.

CONCLUSIONS

The results of this study shed light on landlords' perceptions and experiences of key issues and challenges in investing in sustainable properties in the NZ commercial property sector. Even though investor optimism towards sustainable buildings was identified, there was clear evidence that investors experience a temporary weakened interest in sustainability following the GFC and the Christchurch earthquakes. Furthermore, interview results articulated key issues and challenges that discouraged investors investing in green buildings in NZ. Lack of tenant demand, higher up-front costs versus low rental premiums, lack of evidence in the economic viability of green buildings, and knowledge gaps in the market were cited as the most significant reasons. Most of the barriers identified can be attributed to property market and government failures to recognize the value of sustainable properties.

Unlike other developed economies where green buildings have become the norm, the NZ government imposes little pressure to have sustainable features in property developments. Interviewees were critical of lack of government support to encourage sustainability principles and emphasized that central government should play a more direct role by introducing more government initiatives and incentives. It was suggested that NZGBC as the key promoter of sustainable practices, should play a more effective role by providing performance-based rating systems for green buildings, reducing the cost of obtaining green star certification, and by educating the market of the benefits of green buildings. It was also noted that the NZGBC, government and other relevant authorities

should provide sufficient information to demonstrate the business case for green buildings. Investors were optimistic that the recent introduction of NABERS NZ would provide a significant opportunity for green buildings to prove their economic viability and operational efficiency to both investors and tenants. Overall, the study reveals the key issues that need to be addressed in order for sustainable buildings to become a more common practice in NZ.

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