

THE HIGH PERFORMANCE PORTFOLIO:

ENERGY ISSUES IN UNDERWRITING PROPERTIES



BETTERBRICKS
Bottom line thinking on energy.

SUMMARY

Underwriting is the process of lenders investigating and documenting a particular loan to see if it meets their investment and risk criteria. By identifying and analyzing the relevant project characteristics, the bank and its shareholders can better understand and mitigate financial risk. Because energy performance is directly related to a property's financial profile, communicating the operational efficiencies of a high-performance building gives underwriters useful information with which to optimize loan decisions.

IN DEPTH:

Underwriters are tasked with thoroughly reviewing all aspects of a potential real estate loan, identifying the potential risks to the lender, and evaluating the mitigating factors for those risks. Though they are expected to be aware of current market trends, they also rely heavily on the appraisal community as third-party experts to provide independent, objective assessments of market conditions.

FIDUCIARY RESPONSIBILITY

After the Savings & Loan debacle in the 1980's, federal banking regulations became much more stringent, particularly on loans over \$1 million. Bank regulators now frequently verify a lending institution's compliance with federal guidelines. As such, the fiduciary responsibility of lenders is a paramount issue - since, in effect, they are using "other people's money" to make money.

Banks are particularly sensitive to "reputation risk" and carefully monitor disclosure practices, ensuring they and their shareholders are protected from liability associated with questionable or unsound investments. Since many underwriters are remunerated on an incentive basis, they must take particular care that their assessments of loans are unbiased and based on solid market evidence. The possibility of actual or perceived conflict of interest must be avoided.

Risk is the primary basis upon which underwriters make their decisions.



Therefore, lenders depend heavily on external, third-party experts (valuers) for independent, objective assessments. This third-party “sign-off” protects both the lending institution and the borrower from unsound lending practices.

EVALUATING AN INVESTMENT

Risk is the primary basis upon which underwriters make their decisions. In general, the riskier the investment is, the higher the cost of capital.

Various forms of risk - market risk, property risk, and competitive risk - all factor into the two key decisions a lender must make:

- 1) Whether or not to make a loan
- 2) What will be the cost of capital

Critical to the financial success and risk profile of a loan is the “the bottom line” or the net operating income (NOI) of a property. To arrive at this figure, gross revenues are estimated, and then a contingency for vacancy and projected operating costs is deducted to arrive at the net operating income of the property (before debt service).



Additional factors can have a positive or negative impact on NOI, including:

- Quality and quantity of available empirical market evidence
- Track record of developer, investor, or property manager
- Type and quality of construction
- Market conditions – supply and demand
- Location and property specific characteristics

These factors are examined in detail to gauge their possible impact on NOI. Projects with higher NOIs tend to have higher property values. If any of the factors above do not meet underwriting guidelines or market standards, the developments are considered more risky. This in turn can lead to declined loans, higher discount and/or capitalization rates, and potentially lower asset values.

IMPACT OF ENERGY PERFORMANCE ON VALUE AND RISK

When examining a property's NOI, a thorough review of operating expenses is completed. Energy typically accounts for one third of a building's day-to-day costs, directly impacting operating expenses. With recent increases in oil and natural gas prices, a growing awareness of the volatility in utility costs has generated closer scrutiny of energy expenditures.

High-performance buildings may see lower costs of capital (due to lower perceived risk) and higher market values (due to lower operating costs) in numerous ways, including:

- Lower utility consumption yielding lower costs
- Reduced exposure to volatility in energy costs
- Enhanced marketability and quicker absorption
- Lower overall occupancy costs that facilitate higher rents
- Better tenant retention due to lower operating costs and more pleasant tenant environments
- Healthier and more productive tenant spaces

Objective evidence that energy performance levels will meet or exceed projections can decrease the "perceived risk" of the loan...

Of the factors noted above, lower utility consumption is generally viewed as the most direct and measurable influence on operating expenses. However, simply reducing energy costs does not always translate to increased value. Energy-efficiency measures and the resulting costs need to be thoroughly assessed alongside potential long-term benefits. Additionally, given the numerous ways that leases treat utility costs (paid directly by the tenant, by the owner, or a hybrid between the two), a true picture of the role energy plays in NOI must account for the timing and allocation of these expenses.

Given these considerations, and the "risk avoidance" nature of lending decisions, underwriters typically desire validations that actual performance will meet projections. Furthermore, they need to be able to understand cash flows resulting from improvements in efficiency among the lien holder and other parties in order to recognize the impact of energy performance on value.

INFORMATION THAT SHOULD BE PROVIDED TO LENDERS

To ensure the benefits of your high-performance building are reflected in the analysis, provide valuers and lenders with documented evidence that these results can be achieved. Anecdotal claims of improved performance are not sufficient.

A thorough discussion with both the lender and the valuer should include an explanation of overall property goals and objectives. Provide your rationale for energy efficient strategies, information on the systems incorporated, third-party certifications and reports, and data demonstrating performance. Examples of useful information include:

- Utility expense data over time, demonstrating consistency in keeping costs below market averages
- Leasing models detailing allocations of utility costs to owners and tenants
- ENERGY STAR Statement of Energy Performance, approved by a professional engineer
- Energy modeling reports
- History of equipment upgrades to more efficient technologies and systems
- LEED or other green building certifications
- Documented lease negotiations or tenant requests for energy efficient, high performance spaces
- Commissioning reports (for new buildings)

While lenders and appraisers may not be familiar with some of these items, presenting this information will enable a broader dialogue on the impact of rigorous energy management on property financials. Objective evidence of energy performance can decrease the perceived risk of the loan, and increase the likelihood of incorporating expectations of reduced expenses into cash flow analyses. Additionally, the potential of expense savings being lost to the practice of “marking to market” will be reduced.

WHAT IS “MARKING TO MARKET” ?

A common underwriting practice is “marking to market.” When reviewing expenses for an appraisal, the underwriter assesses the expense structure of the property seeking financing (the subject) via a comparison of its expenses to those incurred in similar buildings (the comparables). If the subject’s expenses are significantly lower (for example, through energy efficiency), these savings can be lost in the valuation if the underwriter adjusts them in the analysis, or “marks the expenses to market,” to keep them more in line with the comparables. Giving underwriters proof of high performance may lower the chance of operating expense savings being “marked to market.”

THE BOTTOM LINE:

- Underwriters are responsible for vetting a potential loan against lending and risk criteria.
- The terms of a loan (cost of capital, duration, and debt-coverage ratio) all depend on the perceived risk to the lender of not recouping the investment.
- Lending institutions rely on third-party experts and objective data when factoring energy performance expectations into financial analyses.
- By engaging with lenders and appraisers and providing documentation of energy-efficient strategies, building owners will more likely see the benefits reflected in lending decisions.

USEFUL LINKS:

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



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