

Real Estate

Lingering Uncertainty Impedes Investors

Korpacz Real Estate Investor Survey®
Third Quarter 2008



Dear Reader:

At the beginning of the subprime mortgage crisis last year, many Survey participants anticipated a relatively quick recovery and minimal impact on the commercial real estate industry. *"Everything will work itself out in about six months."* *"By the start of the new year, things will be corrected."* Fast forward a year later, and those sentiments couldn't be any further from the reality that has transpired. In our lead story, "Lingering Uncertainty Impedes Investors," read about the difficulties that buyers and sellers continue to confront with regard to acquisitions and dispositions.

This issue also contains our quarterly *Technology News & Trends* and *Economic News* columns. In addition, Dan Winters, the managing principal of Evolution Partners, provides another article, *Underwriting Green Buildings*, which discusses a new underwriting tool that allows investors and lenders to rate a building's "greenness." Given the rising costs of water and energy, the market advancement of green buildings continues to gain speed.

In addition, our semiannual *National Lodging Highlights* is included, as well as information on the four lodging segments. Read these pages to find out how the economic slowdown is impacting each lodging segment now and how they will likely perform in the year ahead.

Lastly, *Emerging Trends in Real Estate® 2009*, jointly published by PricewaterhouseCoopers LLP and the Urban Land Institute, is nearing completion. As always, it will be filled with insightful data and comments from leading investors throughout the country. Survey subscriptions through fourth quarter 2008 receive a complimentary copy. They should be e-mailed in mid-October, so remember to check your inbox!

I hope that you enjoy reading this issue, and I invite your comments, feedback, and suggestions for future topics and markets to cover.

Sincerely,



Susan M. Smith
Editor-in-Chief

Underwriting Green Buildings

By Dan Winters, Managing Principal of Evolution Partners

The market advancement of green buildings continues to gain speed given the significant increase in energy and water costs and fast-emerging tenant sustainability mandates. In many major real estate markets, this dynamic is leading to a bifurcation in the leasing market where LEED-certified green buildings have some degree of competitive advantage over conventional non-green buildings.

Energy- and water-efficient buildings drive down a tenant's overall financial occupancy cost and also help to fulfill sustainability policies and mandates by Fortune 500 companies, with over 50.0% issuing sustainability reports in 2007. Although there has been relatively little recognition of this market dynamic in the real estate finance community to date, this is likely to change over the next 12 to 18 months.

Depending on an asset's overall competitive set, market supply/demand absorption dynamics, and changing tenant sophistication levels, strong operational cost containment coupled with a green market position can have a significant impact on financial performance. Factoring sustainability-related issues into financial underwriting, particularly energy/water efficiency, location, and indoor environmental quality aspects is fast becoming an important set of considerations when making financial-based decisions with five to ten-plus year life spans.

CAPITAL MARKETS PARTNERSHIP

Evolution Partners and the Market Transformation to Sustainability (MTS), through the MTS/Capital Markets Partnership, developed an industry-wide underwriting standard for Wall Street, lenders, capital market investors, and appraisers to use when analyzing both green and conventional buildings. Over the course of 2008, the Capital Markets Partnership (CMP) grew and coalesced around this effort, reinforcing the glaring need to create a standardized system to identify financially tangible green attributes and incorporate them into the underwriting process at all levels of the real estate investment chain.

The CMP is an American National Standards Institute (ANSI) accredited and audited standards developer. This group engaged a large number of real estate capital market participants in the consensus standard process that was developed through ANSI-approved protocols. This rigorous process engendered significant industry participation and input from major capital market participants resulting in a

strong tool for capital market implementation.

CMP is structured as a nonprofit coalition of investors, investment banks, insurers, NGOs (nongovernment organizations), and city, state, and federal governments. Key CMP members include the U.S. Conference of Mayors, JPMorgan Chase, Citi, Bank of America, Wachovia, Jones Lang LaSalle, PNC Bank, Marx Okubo, Allianz, Fireman's Fund, Goldman Sachs, TIAA-CREF, Wells Fargo, U.S. EPA, U.S. Treasury, Federal Home Loan Bank of Boston, Fannie Mae, Destiny USA, and other private market firms along with representatives of the United Kingdom, the states of California, New Jersey, and New York, and numerous major municipalities.

CMP received the endorsement of the U.S. Council of Mayors at the 2008 annual meeting through the passage of a resolution led by San Francisco's Mayor Newsome, Chicago's Mayor Daly, San Jose's Mayor Reed, and Miami's Mayor Diaz. This resolution recognizes the urgency of the capital sector to generate investments in high-performance green buildings through the creation of sustainability-based investment criteria and corresponding investment products, such as securities backed by mortgages on green buildings, green building private equity funds, and asset-retrofit equity and debt funds.

The Green Building Underwriting Standard for both commercial and residential application was approved in early September 2008 and will be ready for adoption by the financial real estate community in Fall 2008. It is designed for use by all levels of the capital sector, including direct lending, CMBS underwriting, CMBS purchasing, private equity investing, REIT analysis, and upstream investor reporting.

These national consensus-based standards are an important industry component since they limit risk and uncertainty in investing and are particularly vital to capital market investors and rating agencies. By providing guidance as to an asset's green attributes, including its Energy Star score, LEED rating and specific LEED points achieved, and/or Climate Neutral certification, investment practices will evolve to effectively incorporate a green building's value enhancement.

UNDERWRITING TOOL

The main objective of this straightforward, easy-to-implement tool is to allow lenders, private equity purchasers, and institutional real estate owners the ability to rate an asset's

“greenness” at the time of financing or acquisition. The tool is structured as an underwriting overlay by enhancing current underwriting practices. Upon analysis, an asset is assigned a “CMP Green Score” from 0-100 based on the presence or absence of financially tangible criteria that influence the asset’s financial, operational, and market-risk profile. Once a specific asset’s CMP Green Score is determined, this analysis can expand to the portfolio level through an aggregation of asset-specific scores.

The CMP Green Score takes into account asset features that lead to energy and water efficiency thus reducing current operating costs while also insulating tenants from future energy and water price volatility. The CMP Green Score also incorporates location-based attributes that affect a tenant’s commuting patterns and/or carbon footprint, as well as factors inherent to indoor environmental quality that can affect rents, risk, and liability exposure.

Understanding an asset’s green profile on a relative scale allows greater market transparency across all facets of the investment decision process. The standard addresses critical market pressures that include a rapid rise in conventional energy costs, increased operating costs, tenant preferences swaying in favor of green buildings, and current/future climate-change issues. It also helps tighten loose underwriting standards and increase capital market confidence. Ultimately, the disclosure of the CMP Green Score will better enable investors to fulfill fiduciary responsibilities, improve real estate industry underwriting, and make appropriate risk-adjusted investment decisions.

PROGNOSIS

Assessing risk is a key factor in making superior real estate investment decisions. Asset-based risk comes in many forms – operating cost volatility, vacancy and lease-up time, tenant quality, competitive market profile, rent growth, obsolescence, liability exposure, cap rate on sale, and other relevant issues. Reducing these risks is paramount to an investor’s return expectation and to its fiduciary duties if investing on behalf of third parties.

A key issue addressed is debt underwriting. Projects with energy- and water-efficient features and proven financial metrics tend to be penalized through the application of “greater-than-market-or-actual” on expense-based items and “less-than-market-or-actual” on revenue-based items. A market utility expense figure may be based on appraisal comparables, a lender’s experience, the BOMA Experience and Exchange Report, or some other metric, all of which penalize the asset owner’s investments in efficiencies. Once the

Green Building Underwriting Standard takes hold in the financial arena, efficient buildings and their favorable risk profiles should achieve the recognition they deserve.

On a macro scale, the many benefits of the Green Building Underwriting Standard include:

- Provide an accounting method for green building value within existing underwriting criteria
- Increase the quality of investment underwriting
- Increase the collateral value of the building stock via a third-party certification process
- Stimulate the investment market for green investment products
- Stimulate the asset market to make assets green
- Increase investor security and profitability
- Provide opportunities to adopt clean energy
- Further commercialize green buildings and their many economic and social benefits

Ultimately, real estate asset underwriting requires a focus on both an absolute reduction in total risk exposure, as well as the opportunity to achieve enhanced cash flow from an investment with one set of attributes as compared to an asset without those same attributes. By allowing the finance market to assess building attributes on a relative basis, efficient capital markets will reward developers and investors who invest in tangible green building features and operate their assets at higher efficiency levels over those who do not. It is free-market capitalism at its finest. ♦

Dan Winters is managing principal of Evolution Partners, a real estate investment advisory firm specializing in raising debt/equity capital for high-performance, environmentally responsible LEED/EnergyStar real estate projects. He can be reached at 202-997-3922 or Dan@EvolutionPartners.com