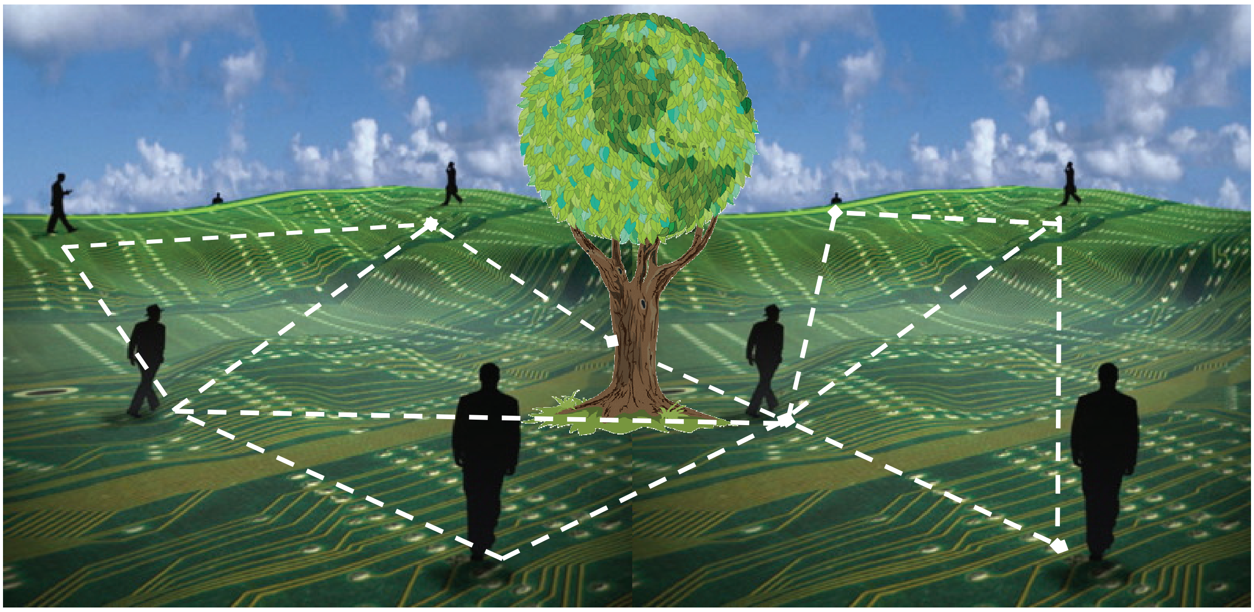
2009

Pulling Together or Pulling Apart?

The Sustainable Debate



Pierre Ricord, Consultant & Valuation Analyst

Tim Smith, MRICS, Director

With the support of:

George Martin, Head of Sustainable Development, Willmott Dixon Construction

HVS – LONDON OFFICE
7-10 Chandos Street
London, W1G 9DQ
+44 20 7878 7700
+44 20 7878 7799 (Fax)

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Pulling Together or Pulling Apart – The Sustainable Debate

Are sustainable developments and other green initiatives the result of sound strategic decisions or just a transitory humanist trend?

The early adopters of the green philosophy were considered to be pessimists at best. After consecutive years of fast and intensive international growth, the green movement has endorsed a more complete scope, also defined as the triple bottom-line concept; considering that economic, social and environmental performances should be considered when evaluating a business or asset performance. Hotels, restaurants, and leisure facilities are complex micro-societies where customers are expecting to do what they normally do at home, both the challenges and benefits of contributing to the green movement and overall sustainability could be significant. We focus on Sustainable Development and not the complex issue of climate change, a different but connected issue which could have just as significant an impact on the hotel industry. Here we challenge the thinking rather than focus on issues in depth. It is no longer acceptable to live passively in this world, we need to challenge the way we have been living to make sure there is a bright future for generations to come: René Descartes gave us the philosophy of '**I think therefore I am**'[1], today's observer has updated it to '**I doubt therefore I will be**'.

Given the current state of economies, the financial turmoil and related ethical issues, we may wonder to what extent the profile of green investments in the hospitality sector has changed. The goal of this article is to clarify the notion of sustainable development and identify the challenges and responsibilities of the parties involved at present and for the foreseeable future. Although this paper focuses on the hospitality business we consider that sustainable development will not flourish unless it prompts an overall behavioural change.

What is Sustainable Development?

Sustainable development is perhaps the most over used and misunderstood concept of the past decade. It can be taken to different levels of commitment, by a variable scope of participants and in various areas of business life. On a practical level, sustainable development ranges from using energy efficient light bulbs to designing entire facilities and operational processes of a business in line with enhanced efficiency, sustainability of resources, and respect of local communities' well-being. The participants of this 'ecolution' must be aware that sustainable development cannot be limited to Corporate Social Responsibility (CSR) any more as a way to ease conscience. Knowledge has spread and this change is even more obvious when we compare the two following definitions; the first one was developed more than 20 years ago in the Bruntland report, while the second is the 2008 update proposed by the advisory group, 'Forum of the Future':

'Development that meets the needs of the present without compromising the ability of future generations to meet their own needs' – Brundtland report, 1987[2]

'Sustainable development is a dynamic process which enables all people to realise their potential and to improve their quality of life in ways which simultaneously protect the Earth's life support systems' – Forum of the Future[3], 2008

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[1] R. Descartes, 'Discourse on Method', 1637

[2] The Report of the Brundtland Commission, *'Our Common Future'*, Oxford University Press, 1987, report published following the 1983 United Nations' commission suggesting processes that should be put in place from an environmental perspective for the year 2000 and beyond.

[3] Forum for the Future: UK-based charity committed to researching, educating, and training private and public organisations on sustainable development.

While the Brundtland definition sounds more like what we now call CSR, the second definition offers a more global vision of the sustainability issue. Also, the use of the term 'quality of life' over 'needs' refocuses on the essence of sustainability, which is to live within environmental limits and avoid the subjectivity of the word 'needs' when brought to the business world. The lesson to the business world here is: '*do not simply adapt your current practices, but face the world's reality and rethink the paradigm*', or what has been defined in the past as '*constructive destruction*'.

Certifications, labels and processes have emerged that provide guidance for sustainable initiatives. They vary greatly in scope and impact starting from sustainable building certifications (LEED[4] and BREEAM[5]), to recurrent processes reviews (ISO[6]) and tourism labels (11 national eco-label programs across Asia, Europe and America). This approach formalises the process and is informative for customers. However, the proliferation of these labels has damaged their credibility resulting in reduced visibility both for hoteliers and for their customers. According to industry professionals, while labels and certifications are useful starting points, there is no ideal and universal solution as yet. A successful sustainability strategy will require open minds, long-term thinking, transversal communication gathering all parties involved in the life cycle of the building (development, use, maintenance, disposal), creativity and a strong organisational culture that can only be achieved if everyone takes ownership of this issue in every aspect of their lives. We must create an environment for a whole lifestyle change. In this regard it would be beneficial to share the experience of others – both successes and failures – and put into practice the guidelines provided by individual initiatives such as Natural Step, One Planet Living, SA 8000 and AA 1000.

The Circle of Blame and Past Deadlock

For years sustainable development has been at the discussion table of the property sector without having really being taken seriously. Why is that? In 2008 the Royal Institution of Chartered Surveyors[7] reintroduced the concept of the 'the Circle of Blame', presented eight years ago by Sir Martin Laing and Professor David Cadman. Besides the creation of advisory groups and efforts towards public awareness this concept still sounds very current. Table 1 illustrates this concept, which shows the conflicting interests of building developers and those who are going to invest in or occupy them. Throughout this article we will review the different market drivers that push stakeholders to appreciate their benefits while understanding other parties' needs, and consequently turn the 'Vicious Circle of Blame' into the 'Virtuous Circle of Sustainability'.

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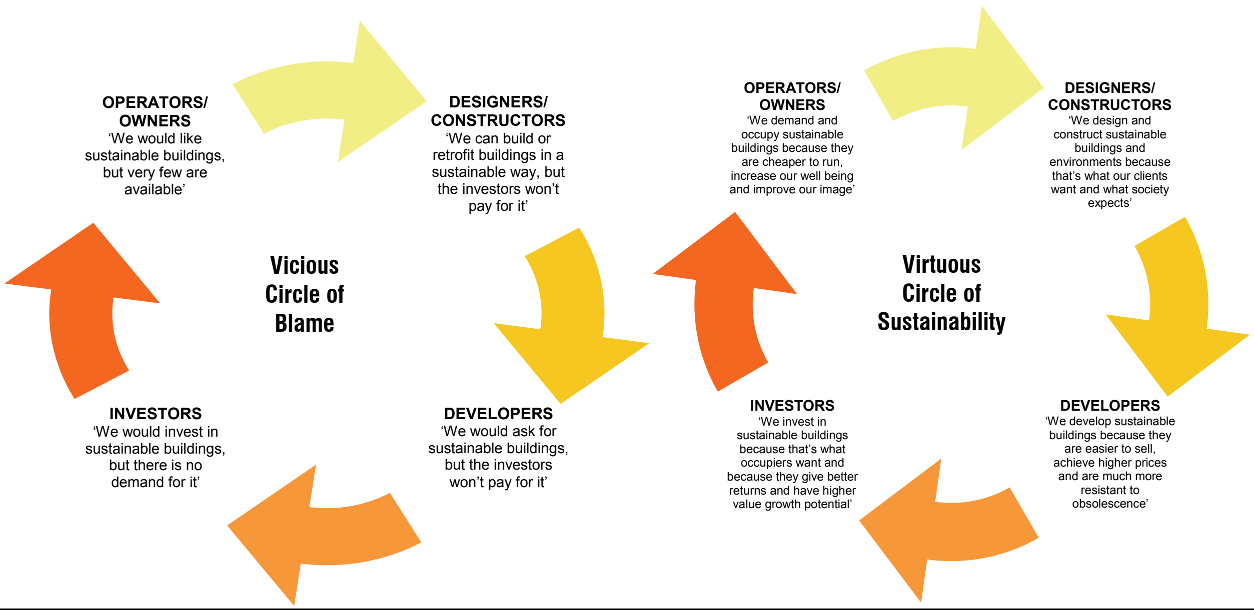
[4] LEED: Leadership in Energy and Environmental Design provides a suite of standards and grading system for environmentally sustainable construction developed in 1998 by the US Green Building Council.

[5] BREEAM: Building Research Establishment Environmental Assessment Method was launched in the UK in 1990, and provides building techniques, recommendations and assessment tools to help property professionals mitigate the environmental impacts of the developments they design, build and manage.

[6] ISO: International Organization for Standardization is the world's largest developer and publisher of International Standards that forms a bridge between the public and private sectors.

[7] RICS Research, 'Breaking the vicious circle of blame – Making the business case for sustainable buildings', June 2008

Table 1 The Circles of Blame and Sustainability



Sustainability Cash Flows Impact

For the purposes of a hotel valuation, a significant factor is the asset's ability to generate cash flows and enhance the return on the initial development cost or purchase price. In this matter sustainability has successfully improved these cash flows, be it by maintaining revenue streams, reducing operational costs, or mitigating financial costs. We summarise the upsides brought by sustainability and its different approaches in Table 2.

Table 2 Sustainable Development – Improving Cash Flows

Profit and Loss Item	Stakeholders	Drivers	Expected Impact	Cash Flow Impact
Revenues	**Customers** **Government**	Corporate policies Government agencies example Dedicated on-line distribution channel Additional benefit for loyalty programmes	Customer retention	= ↗
Payroll	**Employees**	Higher motivation, involvement Enhance employer attraction Reduced turnover costs Higher operational performance	Reduced turnover costs Higher operational performance	↘
Amenities, Supplies	**Suppliers**	Increased demand from hoteliers Inreased Purchase and bargaining power of operators Increased availability of eco-alternatives	Cost reduction or match with regular products, no premium	= ↘
Operational Margin				↗
Administrative & General	**Employees**	Reduced staff turnover Reduced need for recruitment	Reduced recruitment and HR costs	↘
Sales & Marketing	**Customers**	Targeted channels, specialised press, free PR Increased proportion of on-line marketing	Improved customer reach Reduced costs	↘
Utilities	**Suppliers**	Increased energy prices Increased expertise in energy efficient buildings Cost decrease of energy and waste management systems Savings traceability Customers and staff involvement	Energy cost reduction	↘
Maintenance	**Suppliers**	Improved durability of materials	Reduced need for maintenance	↘
Gross Operating Profit				↗
Insurance		Better compliance with building norms and certifications Decreased risk	Decreased premium	↘
Rent	**Owner**	Increasing demand for green buildings Improved well being of occupiers Improved maintenance costs and reliability	Potential for lease premium	= ↗
EBITDA				↗
Incentive Fee	**Operator/Owner**	Questioning – Refocus of operator on operations	Potential reduction in % cost, or refocus on other criteria – Triple bottom line – social performance criteria	= ↘
Debt Interest	**Lenders**	Increased reliability of building Improved marketability Decrease of risk Improved cash flows Reduced risk of default Stronger negotiating position	Improved lending terms Eased access to debt financing Increased tax shelter	= ↘
Tax	**Government**	Government support in green initiative (location correlated)	Tax deductions	= ↘
Net Operating Income				↗
Reserve for Replacement	**Operator/Owner**	Improved durability of materials	Reduced cost of RR Extension of four-year capital expenditure cycle	↘
Debt Principal Repayment	**Lenders**	See Debt Interest	Potentially higher loan to value ratio	= ↗
Equity Cash Flows	**Owner**	Lower tax interest Improved operational performance Reduction of fixed costs Lower maintenace investment (capital expenditure)	Increased cash flows	↗
Return on Equity	**Owner**	Access to debt financing Quality of cash flows	Higher loan to value ratio, improved cash flows	↗

Green Leases Premiums – In markets where more green buildings are available and tenants have a choice of green or non-green, there is now evidence of rental and purchase premiums being paid for green. The Green Building Council of Australia reported[8] that green buildings commanded 5% to 10% higher rents and have higher relative investment returns (minimum 14% ROI) and asset values (10%). Obviously the level of premium and/or additional rent should vary in line with the various levels of certification of the building which should be demonstrated through energy efficiency, for example. In 2008, a US survey of over 1,300 LEED-accredited buildings[9] revealed: '*LEED buildings command rent premiums of $11.24 per square foot over their non-LEED peers and have 3.8% higher occupancy*'. By inducing higher rents sustainable buildings should have higher market values.

What About Value?

In September this year, Times online published an interview with Zac Goldsmith[10], former editor of The Ecologist, during which he hit upon one aspect of our problem: '*Once you can write or price the value of the environment in the market, I think the market then will deliver the kind of changes that we need. Marrying the market with the environment is the defining challenge of our day.*' If the cash flows are enhanced then what else is needed to break the deadlock?

'Behavioural Finance' – A recent paper by David Leece[11], suggested the use of behavioural finance as a basis for research into property markets and urban sustainability. Behavioural finance suggests there is a 'behavioural space' within which so called 'irrational traders' can influence asset prices as well as the behaviour of 'rational traders': '*by creating their own space traders' 'irrational' opinions […] have a collective impact on markets*'. This behaviour affects stock prices, which in turn impact upon corporate decision making and it might be a feature of other markets. It is particularly applicable to markets where there are limits to arbitrage and evident risk aversion, such as the property market.

<u>Picture</u>: *The first green '1' property is scheduled to open in Seattle in 2009. It will have private residences, a residential hotel, spa, athletics club, restaurant and organic grocer.*

Research conducted by Eurosif[12] has found Europe's richest individuals may be securing eight per cent of their total assets in green investments. On top of providing a growing source of financing for hotel developers, this group of wealthy individuals plays the role of irrational traders cited above. The repetition of investment decisions based on sustainable criteria will support the consolidation of performance data over time and prove the business case to more conservative investors. The feedback of these pioneers is expected to encourage brands and investors to follow suit and integrate sustainability as one of their prime investment criteria.

[8] Green Building Council of Australia, 'The Dollars and Sense of Green Buildings', 2006'
[9] CoStar Group, 'CoStar Study Finds Energy Star, LEED buildings outperform peers', March 2008
[10] Times Online, 'The Green Rush: Full transcript of interview with Zac Goldsmith', September 2008
[11] David Leece – RICS Foundation, 'Future Thinking – Behavioural Finance and Urban Sustainability'
[12] Eurosif, 'High Net Worth Individuals & Sustainable Investment', 2008

Construction and Development Costs – There have been arguments that Leadership in Energy and Environmental Design (LEED) is more expensive to implement and that perhaps BREEAM (Building Research Establishment Environmental Assessment Method) is of a higher standard. These arguments may be irrelevant at this stage; perhaps encouraging all initiatives is key until we have secured a lifestyle change. Until recently, the additional development cost of sustainable building was thought to be the main obstacle but the actual cost of constructing a certified sustainable building is often overestimated. In a recent international survey by the Geneva-based World Business Council for Sustainable Development (WBCSD)[13] 1,423 architects, developers, engineers and contractors estimated the average additional cost to be at around 17% (the real additional cost is about 5%). However, in 2006 Davis Langdon's study[14] showed that '*Many project teams are building green buildings with little or no added cost, and with budgets well within the cost range of non-green buildings with similar programs*'. Several other studies have quantified this and demonstrate that sustainable building initiatives increase the cost of development by less than 5% with very short capital cost payback periods. Similarly to the US hotel market, we can expect the European market to consolidate; this will intensify competition, pushing brands to differentiate by their ability to provide an increasingly 'non-hotelier' type of investors' pool with sustainable design and construction guidelines. Scandic is one of the companies that have anticipated this approaching demand, creating the Scandic Environmental Refurbishment Equipment and Construction Standard (SERECS).

Sourcing Equity – As debt financing is shrinking, the investors determined to make their project progress could tap into other sources of financing such as private equity. Eurosif published a ground-breaking report on High Net Worth Individuals (HNWIs) & Sustainable Investment in 2008[15], which highlights a rapidly growing space where investors are seeking returns while considering sustainability issues. It is estimated that sustainable investments represented approximately 8% of European HNWIs' portfolios in 2007 and it is forecast that by 2012 this figure will have increased to 12%, at a value of over €1 trillion. HNWIs have moved from merely philanthropic to increasingly integrating sustainability criteria in their actual investments, reflecting a growing consensus that financial returns are consistent with sustainability issues. Although the Eurosif statement is encouraging, it also means that (at the risk of oversimplifying the picture) the remaining 92% of this investment pool is allocated to literally non-sustainable investments. Hopefully the forecast for sustainable investments will enjoy exponential growth as word spreads in the investment community and existing investments are progressively made greener.

Cost of Debt – According to a recent publication of Cushman & Wakefield[16], some 160 million commercial properties[17] will have to be issued with an Energy Performance Certificate (EPC) by 2009. EPCs are a requirement of the EU Energy Performance of Buildings Directive. The EU directive (2002) has further stimulated the debate on likely future regulatory changes and government initiatives. These changes would call for further investments in a few years, and reduce the ability of investors to repay debt. As a result, the idea of 'future-proofing' buildings against regulatory developments is now being raised within the property industry. This risk when mitigated by investing in sustainable buildings and certifications will reduce the risk of default to the lender, and help investors obtain better lending terms or at least easier access to debt financing. While preferential interest rates would result in larger cash flows, higher loan to value ratios would magnify the return on equity (as shown in Table 2, above).

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[13] Sustainable Building, 'Ignorance the reason for poor building performance', Issue 16, April 2008

[14] Davis Langdon, 'The Cost of Green Revisited: Reexamining the Feasibility and Cost Impact of Sustainability Design in Light of Increased Market Adoption', 2006

[15] Eurosif, 'High Net Worth Individuals & Sustainable Investment', 2008

[16] Cushman & Wakefield, 'Green buildings, a behavioural change, August 2008

[17] Commercial properties over 1,000 m² only.

Role of Appraisers and RICS – Stock market analysts seem to have succeeded in influencing investors with non-financial considerations. According to Harm Meijer[18], a JP Morgan property analyst, listed companies with a strong sustainability agenda experienced a rise in share price by, on average, 6-10% more than others who ignored the matter. He explains this increase as being a direct result of investors understanding that a sustainability policy is a sign that the company is anticipating government policy changes.

As market drivers tend to align financial interests, today's challenge is more to align vision and communication, to demonstrate value to investors and operators. According to Ursula Hartenberger, RICS EU Public Affairs[19], the key to facilitating more sustainable property markets lies in how we understand and value the built environment. In this respect, valuation professionals and processes should play an important role as mainstream financial professionals are unwilling to include sustainability issues in property investment and financing decisions unless and until sustainable building features and related performance are integrated into property valuations. Appraisers have the role of 'information managers' in a market where the distribution of information is traditionally considered asymmetrical. Although the financial modelling of hotels enabled more accuracy and efficiency in valuing properties, the limited inclusion of considerations other than financial ratios may give an unrealistic and dematerialised perception of the property world. The progressive application of risk premiums could be a first step until consistent data and literature is compiled on cash flow improvement norms by sustainable projects. Therefore current valuation techniques do have the capacity to reflect sustainability issues, but there is a lack of data to empirically support valuers' decisions to provide a 'valuation bonus' for a sustainable building or a 'valuation reduction' for a regular one. Another noticeable obstacle is the heterogeneity of the hotel asset class, under the same category uses may differ greatly between a resort and a city centre high volume conference hotel.

As lenders and investors often refer to experienced appraisers' values, projections and commentary when considering the financing of a project the property professionals must educate and demonstrate to their clients the benefits of sustainable initiatives to their investment both in the short term and longer term. If appraisers succeed in establishing rules in financial modelling to allow positive differentiation for sustainable projects, we can expect lenders to consider more favourably these projects over conventional hotels. Consequently, investors will be incentivised to engage in such investments, thus creating demand for developers, contractors and suppliers.

What is the Financial Crisis Changing About the Green Issue?

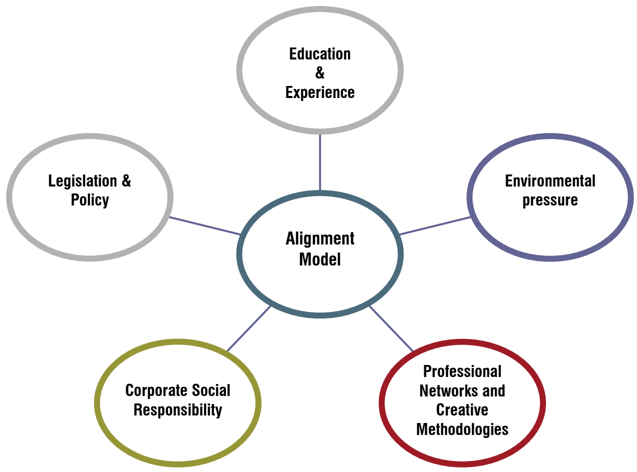
Abyd Karmali, the global head of carbon emissions at Merrill Lynch in London, told the New York Times[20] that financing for a carbon-offsetting project is harder to find than before the credit crunch. But he says, 'The carbon crunch is a multi-generational challenge that will significantly outlast the credit crunch.' As banks have been strongly hit, credit has dried up resulting in higher scrutiny of business plans and project valuation parameters. The underwriting standards are stricter, loan to value ratios decreased, terms shortened, and interest rates gone up.

After the impact of risky investments, and opaque opportunities, lenders are now looking for safer investments and clear business cases. Several factors will influence this confidence in the project: rational and improved cash flows (higher DCR), brand operational experience, limited risk for later

[18] Harm Meijer , JP Morgan property analyst, European Public Real Estate conference Stockholm, 2008
[19] RICS, 'Sustainable Property Investment & Management – Key Issues & Major Challenges', September 2008
[20] Environmental Leader, 'The Executives daily green briefing', October 2008

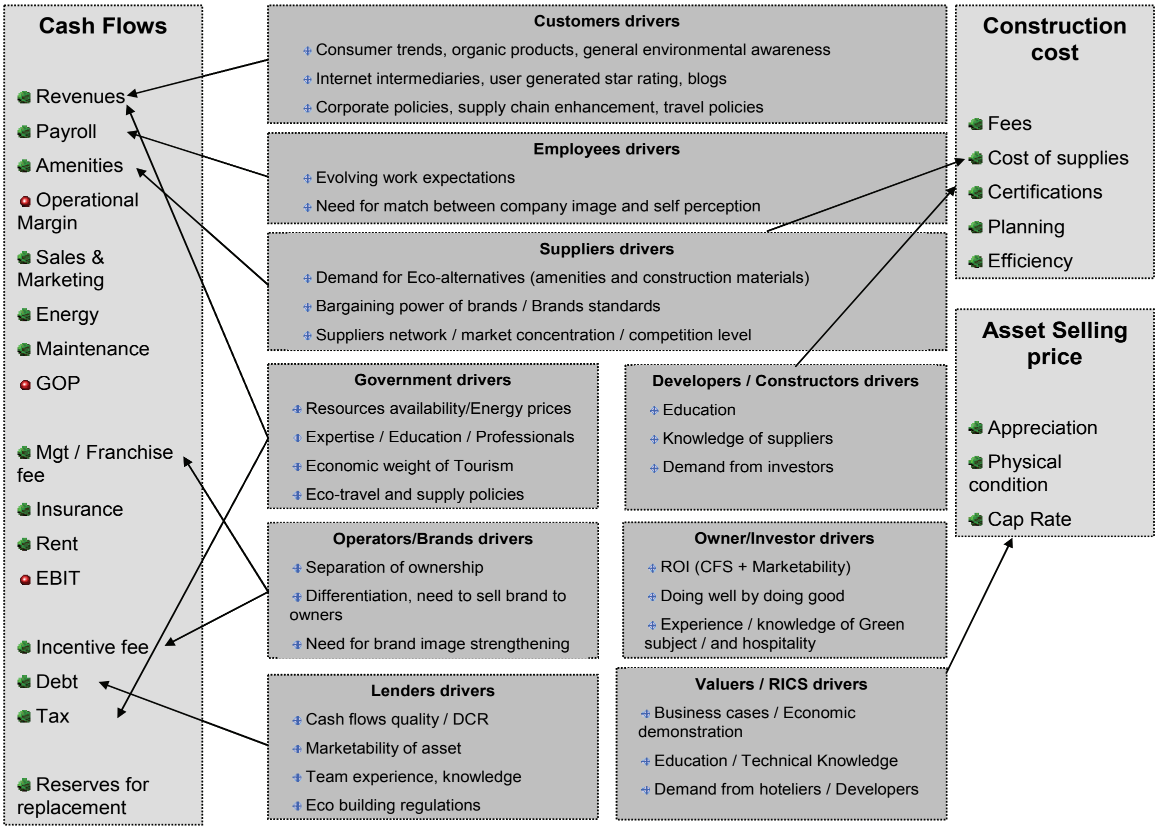
additional unplanned investment (imposed compliance with certification by governments), reduced risk of pollution, environmental damage for which the lender would be responsible for, improved marketability and therefore a reduced exit risk. The financial crisis on top of having changed financing terms has also changed the way lenders and investors are now approaching investments, and the criteria used to evaluate the project performance. The addition of social and environmental factors has certainly enabled us to move to longer term return objectives. The concept of '*doing well by doing good*' is gaining popularity in the world of investors. The endeavour of sustainable supporters towards investors is eased, and as progress is made business cases become increasingly solid and convincing.

Alignment Model: Variations and Limitations



It is important to note that although operators are global, investment is usually locally sourced and is therefore very much influenced by local environmental and regulatory factors. Scarcity of natural resources and public awareness of environmental awareness vary widely around the globe. If the alignment model presented here makes sense for most European and western countries, its relevance may be challenged by the importance or absence of one of these drivers. It is, however, clear that the international expertise of consultancy and appraisal companies will help bring the bigger picture to all parties involved and spread the rationale behind sustainable investment and development. The support of government agencies will be crucial but will also vary widely until international consortia follow some of the initiatives implemented by the EU, for instance. Table 4 summarises the drivers and impacts explained previously.

Table 3 Sustainability Alignment Model: Stakeholders, Drivers and Impacts



Outlook

The misconceptions that emerged with the notion of sustainable development were part of an unavoidable and essential phase. Perhaps we should not say this but we do not think green initiatives represent a niche opportunity. Although this first development stage of the market has passed, early adopters may have benefited from the opacity of this programme. But the opportunity in the foreseeable future will come from the alignment of the main stakeholders' interests that can only be achieved through improved education and increased reliability of documented business cases.

What has been considered so far as philanthropic or financially irrational investment will soon be supported by evidence, and turn into a so-called educated strategy or to some extent business conservatism. The financial crisis combined with the emergence of influential groups such as Sustainable Investments Funds and advisory non-profit organisations will incentivise industry leaders to consider sustainable development as a necessary and integrated phase of business management rather than an additional cost or technical hassle. The good news is that no matter what your commitment to humanity, whether you believe in the strength of society or the individual, understanding the drivers and linkages of this new playground will give you a competitive edge in maximising sustainable value creation, from which we will all inevitably benefit. There are some significant immediate steps to be taken, including the issues of sustainable development on MBA courses would challenge the thinking of future leaders; not waiting for someone else to take the lead (be that your client or your advisor) and finally accepting this whole issue has resulted from a short term approach to development. This generation needs to change that thought process NOW and accept responsibility for the failings of previous generations in an effort to protect future generations. As a short term measure could we be Greeny and Greedy together? Probably not, but it could be a step towards accepting the real way forward, such as Sustainable Wealth Creation.

Author's Notes

Although there are green specific events, the recent emergence of green workshops and discussions to enable owners, operators, developers, suppliers and consultants to interact should prove more efficient. Also the main hospitality investment conferences around the globe (see below) are now bringing sustainable investments to the centre of discussions. Webcasts and forums are complementary platforms for being actively informed and challenged by other industry players.

Main Meetings and Conferences – Hotel Investment Forum Berlin (March), China Hotel Investment Summit (April – Shanghai), Hotel Investment Conference South Asia (April – Mumbai), Arabian Hotel Investment Conference (May – Dubai), Annual New York University International Hospitality Industry Investment Conference (May/June – New York), South American Hotel & Tourism Investment Conference (September), Annual Lodging Conference (September – Phoenix), Russia & CIS Hotel Investment Conference (October – Moscow), Annual International Hotel Conference (October – Venice), American Lodging Investment Summit (January – San Diego), Hotel Investment Conference Asia Pacific (October – Hong Kong)

Useful Readings and Web Links

One Planet Living, www.oneplanetliving.org/

SA 8000, Social Accountability International, www.sa-intl.org/

AA 1000, Account Ability, www.accountability21.net/aa1000series

Forum for the Future, http://www.forumforthefuture.org/

Department for Environment Food and Rural Affairs (DEFRA), www.defra.gov.uk

Greenhotelier, http://www.greenhotelier.org/

Hotelsmag, Green Hotelkeeping, http://www.hotelsmag.com/community/Green+Hotelkeeping/47566.html

International Tourism Partnership, http://www.tourismpartnership.org

The Hospitable Climates Programme, http://www.hospitableclimates.org.uk/

World Business Council for Sustainable Development (WBCSD), http://www.wbcsd.org/

BRE Environmental Assessment Method, http://www.breeam.org/

U.S. Green Building Council, LEED, http://www.usgbc.org

Royal Institution of Chartered Surveyors, http://www.rics.org/

Webcasts

Practical Green Hotelkeeping, http://www.hotelsmag.com/webcasts/green/default.asp?q=webcasts

Green Design, http://www.hotelsmag.com/webcasts/green/default.asp?q=webcasts

About the Authors

Pierre Ricord is a Consultant & Valuation Analyst with HVS's London office, specialising in hotel valuation and consultancy. He joined HVS in 2008 after completing an MBA from IMHI (ESSEC Business School), Paris, France and a diploma in Hotel and Restaurant operations management from the Lycée Hôtelier Savoie-Léman, Thonon-les-Bains, France.

Tim Smith is a Director in the London office of HVS, the leading global specialist hotel valuation, consulting and brokerage firm. Tim graduated from De Montfort University with a degree in Estate Management and has been valuing hotels for 14 years. He is a member of the Royal Institution of Chartered Surveyors, sitting on its UK Education Standards Board. Tim has extensive experience throughout the UK, and also in Ireland, France, Germany, Belgium, Spain, Lithuania, Latvia, Russia and the USA and contributed to various property industry publications and presentations to clients and contacts, including lawyers and bankers.

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Published by:
HVS, 7-10 Chandos Street
Cavendish Square, London W1G 9DQ
Tel:+44 (20) 7878 7700
Fax:+44 (20) 7878 7799

For further information please contact:

Pierre Ricord– pricord@hvs.com

Tim Smith – tsmith@hvs.com

or visit our website at: www.hvs.com

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