

REITs and Energy Management

The real estate investment trust (REIT) property management structure provides significant incentives for investments in energy-efficiency.

**BY GRETCHEN PARKER AND
MARK CHAO**

Real estate investment trusts (REITs) are corporations that buy, sell, manage, and develop real estate of various types (see Fig. 1). REITs currently own a large and growing share of the \$1.3 trillion institutionally-owned commercial real estate in the U.S.

Ownership is particularly large in sectors such as retail malls (28%) and hotels (18%)¹, and is predicted to grow to 30% of total commercial property ownership in the next three decades². At present there are over 300 REITs, the majority of which are publicly traded, with a total market capitalization of over \$200 billion.

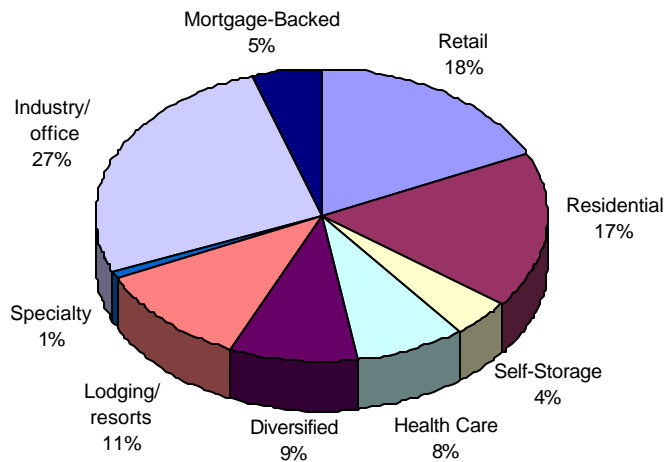


Figure 1: Types of REITs¹

Like savvy traditional building owners and property managers, a growing number of REITs are recognizing that energy savings raise net building income. Many are also starting to realize that energy-efficient retrofits — to the

extent that they may help to improve occupant comfort and productivity — could help in the retention of existing tenants, the justification of rent hikes, and the attraction of new tenants. For retail REITs, the non-energy benefits of energy-efficient installations and services could even help draw customers and increase sales.

While REITs have many features in common with conventional property ownership, we believe that their economic and managerial structures present distinct advantages for investment in energy-efficient technologies and services. This article discusses the economic incentives, contractual procedures, and reporting methods that may make energy efficiency especially attractive to this industry.

To what degree do REIT property managers already address energy-efficiency opportunities in their buildings? How and why does the REIT structure lend itself so well to long-term energy management strategies?

Measures of Performance

REITs are measured by the same performance indices as other industrial stocks — including net income, net assets, and dividend payout ratios. However, they also closely track funds from operations (FFO).

FFO represents the company's net income, not including the effects of depreciation, nor the cash gains and losses associated with the sale of

properties. FFO is the most widely-accepted measure of financial and management success in REITs, and investors pay close attention to it as an index of the company's investment value³.

In trying to increase FFO, REITs have a variety of means at their disposal, including acquisition and development of new properties ("external growth"), and increased returns from existing properties ("internal growth"). Since external growth is often difficult due to the limits of obtaining new capital (REITs are required by law to distribute at least 95% of total income to shareholders), internal growth is a very important factor affecting FFO. REITs pursue various internal-growth strategies, including refurbishments and retrofits of their existing buildings. In terms of energy-related investments, lighting and HVAC improvements are the primary choices among REIT decision-makers.

Incentives, Approaches, and Success Stories

Many REITs will tell you that energy costs are one of their largest operating expenses, at about 20 to 40% of total operating costs. Those responsible for monitoring operating expenses of the portfolio and making necessary investments are the property managers, who are either retained internally as REIT employees, or externally, with a contracted professional management company. With both internal and external property management, REITs apply various methods for contracting and budget planning. These arrangements create varying levels of incentives for pursuit of energy efficiency.

With internal property management, incentives may take the form of property managers' compensation programs that tie their pay to company profits, giving them a personal stake in the REIT's performance. Under one external

property management arrangement, specific budget goals and objectives must be met in order for the company to be paid.

For example, in the contract agreement between Corporate Office Properties Trust and their consultant property managers, Corporate Realty Management (CRM), the operation and maintenance budget doesn't set targets for specific line items, but rather only for total cost. Such an arrangement gives the management company strong incentives to pursue the least-cost opportunities to improve net operating income (NOI) because they're able to keep as profit any savings achieved from reducing expenses at the various properties.

In this example, the property management company begins each calendar year with a budget based on historical operation costs of all the buildings, normalized for degree days — expenses are then reviewed for individual buildings on a monthly basis.

CRM reports that energy is their highest cost, and is therefore the category they focus on most. They look at the payback features of various energy-efficient technologies, and implement energy management systems with both short and long-term targets. For example, they look at the energy efficiency of equipment in the buildings, then offer recommendations to the REIT as to the timing and type of retrofits.

Incentives for innovation can be very significant in such cases where external property management companies operate under specific contracted objectives with regard to the operations budget, yet have a large degree of discretion about how to reduce costs and increase net income.

Like Corporate Office Properties Trust, Arden Realty is also a large office REIT trying to differentiate itself with energy-saving success stories. Their stated internal growth strategy is to achieve economies-of-scale benefits through portfolio-wide installation of lighting retrofits, computer-driven energy management systems, and replacement of HVAC equipment.

Other aggressively-managed REITs have developed energy management plans on either a portfolio-wide or building-by-building basis. In cases where buildings are deemed too old or otherwise unworthy of new investment, some REITs restrict operating hours to achieve their energy-cost saving goals.

A few REITs have gone a step further in addressing the link between energy efficiency and increasing FFO, and have conducted energy analyses of all their facilities. Equity Office Properties Trust has established itself as a leader in energy conservation, having launched an aggressive program including routine energy audits, wholesale lighting retrofits, and installation of energy management systems. Their efforts were rewarded with \$1.7 million in savings after installing lighting retrofits in 28 buildings.

Untapped Opportunities

While the energy-cost saving benefits and FFO-raising potential of improved building performance are well established and well rewarded for some REITs, investment opportunities in energy-saving measures and services appear largely untapped industry-wide. In fact, only three of 26 randomly-chosen annual reports even listed utility costs in the financial statements, indicating that most REIT property managers may give energy costs relatively low priority.

This is particularly true, of course, with net lease agreements between REITs and their tenants, where any increased expense incurred with respect to the operation of the facilities is borne by the tenant. Likewise, the tenant reaps any savings achieved, versus the bottom line FFO at the REIT level. The property manager of a medical office REIT with this arrangement recently explained that while he does track energy costs for budget purposes, any energy-efficiency retrofits or commissioning performed is done to maintain tenant satisfaction rather than to reduce operating costs per se.

Other reasons for the general lack of attention to energy efficiency among REIT property managers appear to be their unfamiliarity with the technologies and services (such as commissioning, building tune-ups, comprehensive maintenance), and a perception that the upfront costs of energy-saving equipment and services would be especially prohibitive for REITs.

Contrasts Between REITs and Traditional Ownership

After extensive review of REIT structures and property management practices, we submit that REITs have at least three particular advantages for pursuing energy-efficient products and services.

The first energy-related opportunity inherent to REITs is their ability to achieve economies of scale resulting from owning multiple properties in certain submarkets and maintaining centralized accounting systems. Such economies of scale can be applied to purchasing energy-efficient components and equipment at reduced costs; bulk procurement of electricity in deregulated markets; or to securing commissioning services. (Some traditional owners of multiple properties may

similarly take advantage of economies of scale benefits.) Further, since REITs hold buildings for longer periods of time, on average, than private building owners, the argument for making such investments is multiplied⁴.

REITs are accountable to shareholders and investors in a way that traditional building owners aren't. Like other publicly-traded stocks, REITs are obliged to keep and disclose detailed financial records. Therefore, information on the financial benefits of energy-saving investments in REIT buildings appears to be more rigorous and widely available than with directly owned buildings. Although most REIT annual reports don't contain specific information on energy costs, energy savings will still be reflected directly in bottom-line figures that are reported, such as FFO.

Furthermore, REITs may be able to turn expectations of future energy savings into up-front cash. Since stock prices are linked to investors' judgments on prospects for future FFO, achieving rising FFO can be immediately rewarded in the form of increased share prices when the REIT makes a public stock offering. Increased share prices mean more immediate capital, which REITs can then apply to further growth.

The Payoffs

In sum, pursuit of high performance in buildings is an attractive internal-growth opportunity for REITs, for energy-related and non-energy reasons alike. Though energy savings and non-energy benefits may not appear directly in the financial reports of the trust, these benefits do directly affect FFO and other bottom-line parameters that investors and existing shareholders closely watch.

Thus, not only may energy-efficiency investments yield immediate payoffs in shareholder dividends, but to the extent that they can help maintain steady growth patterns in FFO, energy efficiency may yield longer-term benefits to the firm and its shareholders in the form of rising share price and stable or expanding access to capital.

The basic incentives for efficient energy performance and accompanying non-energy benefits are strong and generally well aligned among all key stakeholders: investors, REIT management, and property managers themselves. And for REITs on the whole, telling the story of successful experience with commissioning and energy management can score points with investors and analysts by providing compelling narrative evidence of a company's aggressiveness, creativity, and commitment to raising FFO.

Gretchen Parker is a research associate and Mark Chao is a program manager with the Institute for Market Transformation (IMT), San Francisco, CA, a non-profit organization that promotes energy efficiency and environmental protection. For more information, visit www.imt.org.

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