

A New Way to Measure Risk

Expect more commercial real estate deals to include energy-performance assessments

By Anthony J. Buonicore

It is standard practice for commercial mortgage lenders to require a building inspection prior to a property sale, but these evaluations have been lacking in one area. A building's energy-use performance is rarely measured before the loan closes and the property sells. That is likely to change.

A task force formed by the American Society for Testing and Materials (ASTM) recently produced a new guide for evaluating a building's energy performance. This should eventually help pave the way for energy assessments to become an automatic part of the due-diligence and loan underwriting processes.

Shifting standards

There are several reasons why energy assessments will likely become standard practice in commercial real estate deals. First, lenders and the government guarantors of commercial mortgages will demand them. Efficient buildings tend to perform better and are less likely to be viewed in the marketplace as obsolete. Energy savings can significantly improve a building's bottom line, thereby increasing its value and the overall income of the property. And lower utility costs also can improve tenant retention rates.

Commercial mortgage-backed securities data suggests that loans backed by energy-efficient buildings may default less frequently. This makes sense since, all else being equal, lower energy costs will increase the borrower's cash flow which, in turn, reduces the repayment risk. Ultimately, a lower-risk, energy-efficient building could result in a lower interest rate for the borrower. On the other hand, energy-inefficient buildings may be more difficult to rent or sell because there's a higher risk that the building will be viewed by the market as obsolete.

Local governments are pushing the commercial real estate industry toward making buildings more energy efficient. An increasing number of local and state governments have mandated that building owners disclose their property's energy performance — a factor that will naturally drive more buyers to conduct energy assessments prior to a sale. As of January 2019, three states, 27 cities and one county had passed legislation or regulations aimed at disclosing the energy performance of a wide variety of commercial properties. Many more governments have expressed interest in following suit. The goal of these legislative initiatives is straightforward: Lawmakers want to reward high-performing buildings and penalize those that underperform.

Commercial mortgage borrowers — your clients — have good reason to do an energy assessment prior to buying a building. Buyers have a real financial



incentive in discovering the relative efficiency of the asset. If a building is underperforming in regard to energy, the probable cost to improve its performance can be viewed as a deficiency in the sales-price negotiations with the seller.

The buyer can use the information to reduce the purchase price or ask the seller to make energy improvements that will close the performance gap. In either case, this helps a new owner avoid a common problem in lease agreements. The owner often has to pay for energy improvements, but the tenants receive the energy-savings benefits without a rent increase. This problem wouldn't exist if the energy-efficiency improvements were paid for by the seller or the new owner obtained a discount on the purchase price. Finally, in areas of the country where energy-disclosure regulations for buildings exist, due-diligence consultants can help the new owner understand and comply with the reporting requirements.

Two-tiered study

These market factors and governmental influence are driving the commercial real estate industry toward mandatory energy assessments and reporting. What has been lacking, however, is a unified process

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for evaluating buildings. In 2017, ASTM formed a task force of more than 200 members to address the need for a standard method to evaluate a building, given the many different green-building standards that have been adopted over the past 20 years as well as an increasing number of state governments that are passing energy-use reporting requirements.

The task force was comprised of engineers, investors, lenders and the government-sponsored enterprises Fannie Mae and Freddie Mac. After two years of work, it has produced a two-tiered system for assessing a building's energy use, similar to the two-phase environmental site studies that are conducted before a property sale. In the first phase, the consultant will determine whether the building's energy performance meets the standard of similar buildings within its classification.

The benchmarking data will come from the U.S. Department of Energy's building-performance database or the Environmental Protection Agency's Energy Star database. In doing the initial study, the building inspector will review a full year of utility bills to evaluate the building's annual electricity and fuel use. This information can then be shared with energy professionals who use the benchmarks to compare the energy use of the subject property to its peers.

If the building performs as well or better than similar buildings, no further work is needed. If the building is using more energy than the norm,

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however, a deeper investigation is conducted to identify potential improvements and a cost estimate to bring the building up to standard. The projected cost of these improvements would be provided to the buyer to use in price negotiations with the seller.

Study expenses

Energy assessments to screen properties prior to closing don't take much time and are affordable. The consultant obtains the utility data from the seller. At least half of these buildings will meet or exceed the performance of peer assets. As for underperforming buildings, the deeper-dive investigation would likely add no more than a day to the process.

The cost of these studies also is minimal, ranging from a few hundred dollars for common midsize property types to about \$1,000 for underperforming buildings that require further assessment and recommendations for high-efficiency upgrades.

The cost, of course, will depend on the building's size and condition.

These relatively low-cost studies make it even more likely that the future buyers and owners of commercial real estate will do them willingly. Energy assessments are likely to become as standard as environmental land studies in property sales. It is important to remember that the standard for Phase I environmental site assessments was first published by the ASTM in 1993. Today, environmental studies are part of virtually every commercial mortgage lender's due-diligence policy.

Commercial real estate owners and investors, as well as mortgage brokers and lenders, can gain valuable insight into the risks associated with a building's energy performance. All of this makes it increasingly likely that they will want their property inspectors to include an energy assessment prior to going forward with a purchase. ■

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