Green Leasing for Retail Landlord and Tenant Perspectives—Parts 1 and 2

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This overall three-part article is a practitioner's guide to negotiating and drafting "green leases" in commercial property transactions, presented from the separate perspectives of the landlord and the tenant. The three parts discuss incorporating sustainability goals and requirements in the structure of the lease. As used in this article, the term "commercial leasing" includes leases for retail and for mixed use. Part 1addresses the landlord's considerations in developing and marketing green building space. Part 2 addresses the factors that are likely to determine whether a retail tenant decides to seek out space in a green building.

Part 3, to appear in two future RLS issues, will take each of the key lease elements and provide the landlord and the tenant perspectives for each of those elements. This part will also present landlord and tenant "practice tips" to guide them, respectively, in their efforts to negotiate a green lease—including, where appropriate, mutual considerations to help the landlord and tenant reach a resolution of issues.

PART 1: Landlord Considerations

Why Develop and Market Green Building Space?

The factors discussed below may motivate, or in some instances require, a building owner or developer to develop and market a green building.

Designing and Constructing a Green Building/Development

Many factors affect the specific nature and extent of a green building or development. In particular, the type of development and the site-specific conditions will affect the green design of the project. Other factors include:

- Single vs. multi-tenant building/development
- Mixed use vs. retail only
- Horizontal development vs. vertical development
- Indoor public areas vs. open-air design
- New construction vs. renovated building

The design and construction of a green building or green development generally starts with a sustainable design approach:

The use of appropriate materials is critical—for example: recycled and recyclable materials, energy-efficient glass, water-efficient fixtures, energy-efficient mechanical systems and appliances

Passive elements: use of natural light, reflective interior surfaces and low volatile organic compound (VOC) paints

Operational elements: bicycle facilities, cleaning services during normal business hours and dimmable lighting

Construction site conditions: preservation of wetlands, runoff water remediation and recycling construction trash

Third-party sustainability standards are available to help guide green builders, developers and operators. The most common set of standards for sustainable design in the United States is the Leadership in Energy and Environmental Design (LEED) system promulgated by the U.S. Green Building Council (USGBC). LEED provides a specific framework for building developers and operators to implement sustainable design solutions. There are different LEED standards for different building types and uses. Of particular note to the retail industry are the LEED 2009 for Retail rating systems for new construction and for commercial interiors. These LEED rating systems are geared toward retail landlords and tenants and address their specific concerns such as customer parking and interior lighted signage: U.S. Green Building Council, LEED 2009 For Retail: New Construction Fact Sheet, https://www.usgbc.org/ShowFile.aspx?DocumentID=8259 (last visited Dec. 23, 2010).

Regulatory Requirements

There is a statutory framework of regulatory requirements for green development at the local, state and federal levels. Increasingly, jurisdictions are requiring that all new construction be in accordance with specific renewable and sustainable practices. While the statutory framework is highly localized, the requirements are inconsistent at the national level. In addition to statutory requirements that apply to all buildings, green requirements also arise because federal and state agencies that are seeking to lease space may specify the requirements for a qualifying green building.

Costs for Green Construction

Many materials and products that are appropriate for green construction are available at the same, or even lower, cost than standard construction materials. Nevertheless, many construction materials, facilities and systems for green building are significantly expensive. In some instances, while the initial cost of construction or installation is greater for a green building, the costs for operation, maintenance and energy requirements, as well as for the longevity of useful life, will lessen the ultimate long-term cost. Therefore, the question arises: How does the landlord recapture the additional cost of construction of a green building?

Increased Base Rent. The landlord can recapture all or some of the additional cost of constructing a green building by obtaining a higher base rent for the property. Many prospective tenants are attracted to the higher quality of a green building as well as the desire to be located in green developments. Also, the landlord may be able to obtain a higher base rent as an indirect result of the higher caliber of tenants that appeal to a green development. For example, a higher quality of tenant will typically require extensive and greater amounts of tenant improvements and finish work. Often increased tenant improvement costs result in higher tenant improvement allowances, which in turn result in increased base rents.

Increased CAM Charges. If the operation and maintenance costs will be reduced through a higher up-front investment, then it may be possible for the landlord to pass through some of the initial increased up-front costs on an amortized basis as part of the CAM charges. Thus, the landlord may recoup the additional initial investments.

Longer Lease Term. A longer lease term will allow the landlord to recoup costs over a longer period of time on an amortized basis. This will allow a landlord to amortize more costs at a lower cost per month.

Decreased Financing Cost. It is possible that the landlord will have lower financing costs (i.e., lower interest rates) because the green development will attract quality tenants, with better creditworthiness.

Incentives. Some federal, state and local governmental authorities offer economic incentives to subsidize the cost of green construction: tax credits, tax incentives, density bonuses, property tax relief and tax incremental financing. For instance, New York State has a Brownfield Tax Credit Program, which allows for refundable tax credits to be earned for the rehabilitation of a brownfield site; also, in NYS, a STAR Energy Program allows for credit enhancement of low interest loans and grants for certain costs attributable to energy-efficient components of building construction or renovation: http://www.dec.ny.gov/chemical/8450.html. California's Emerging Renewables Rebate Program provides funding to offset the cost of purchasing and installing new renewable energy systems using emerging renewable technologies: http://www.consumerenergycenter.org/erprebate/index.html. The Portland, OR, Green Investment Fund is a yearly grant supported by the City of Portland and Energy Trust of Oregon, which invests in innovative approaches to waste reduction, water conservation, on-site stormwater management and reuse, energy conservation and on-site renewable energy generation: http://www.consumerenergycenter.org/erprebate/index.html. Additional examples can be found on the USGBC website, which maintains a public policy database of green building programs, including various categories of incentive-based programs, and on the EPA website, which lists numerous sources of funding for green building that are available at the national, state and local levels: http://www.usgbc.org/PublicPolicy/SearchPublicP olicies.aspx?PageID=1776;http://www.pa.gov/greenbuilding/tools/funding.htm#national.

Marketing the Property

Projects that are constructed in accordance with renewable and sustainable practices will undoubtedly be marketed to both retail tenants and the public, with high visibility regarding the attractiveness and the benefits of the green development. This will often be evidenced in the project name, logo, tag line, color scheme and marketing materials.

An owner may be able to charge a premium to a retail tenant for leasing in a green development, depending upon the local market prices and the specific values of the retail tenants. If it can be established that there is tangible value to the tenant (by increased sales) from being part of a green development, then the landlord will be in a position to charge a premium for rentals in the green development (because the higher rent will be offset by higher retail sales).

Many retail developments that are developed as green projects also have higher quality overall construction and tenant mix. In some markets, there is a limited supply of green developments. As the demand by retail tenants to become a part of a green development increases, the landlord may be able to charge a tangible premium for a green project.

PART 2: Tenant Considerations

Why Seek Space in a Green Building?

The factors discussed below may motivate a tenant to seek space in a green building.

Type of Tenant

The type of tenant seeking green space is a threshold consideration for any discussion on green leasing. Big-box tenants have concerns and motivations that can differ significantly from smaller tenants. Where applicable, a distinction will be made in the three parts of this article between the needs and motivations of big-box tenants and other types of tenants.

Corporate Citizenship

Some tenants will seek green space because of their desire to promote environmentally sensitive "corporate citizenship." Such policies dictate environmentally friendly business practices as a form of social responsibility and may strongly motivate tenants to seek green space. Many big-box retailers, such as Gap, Best Buy and Apple, have environmental responsibility policies in place. See http://www.gapinc.com/GapIncSubSites/csr/Goals/Environment/En_Overview.shtml; http://www.bby.com/category/sustainability/; http://www.apple.com/environment/#facilities.

Branding

Branding efforts directed at creating an image of environmental consciousness can result in greater sales for a retail tenant. A recent GfK Roper Green Study indicates that roughly 75 percent of participating consumers consider a company's environmental practices to be important when they decide where to shop and what to buy. See GfK Roper Consulting (2007). 2007 GFK Roper Green Gauge Study, (August 22), http://www.gfkamerica.com.

Increased Worker Productivity
Green space creates a healthier, more modern environment that can translate into a more productive workforce. Green spaces are often perceived as "cutting edge," which may also help attract talented employees.

Reduced Rent/Operating Costs
The prospect of reduced rent and/or operating costs is, and will continue to be, a primary motivator for tenants. If all or a portion of a project is supported by public incentives (whether by grants, tax credits or reduced financing costs), this will have a direct impact on the capital cost of the entire project and presumably the rent payable by the tenants. In addition, some elements of environmentally sensitive construction should be less expensive to operate. Studies indicate that Energy Star buildings use 40 percent less energy than conventional buildings while Gold and Platinum LEED-certified buildings use roughly 50 percent less than conventional buildings. (See Andrew C. Burr, CoStar Study Finds Energy Star, LEED Bldgs. Outperform Peers, CoStar Group, Mar. 26, 2008, http://www.costar.com/News/Article/CoStar-Study-Finds-Energy-Star-LEED-Bldgs-Outperform-Peers/99818.) As energy costs rise, the arguments in favor of green construction become more easily demonstrable, and the rate of return on increased capital costs will be shorter.

Environmental Stewardship
Another strong motivation for a tenant to seek green space is environmental stewardship, or the so-called "feel good" motivation. Before the economic downturn, environmental stewardship was a powerful motivator for many tenants to seek green space, despite any rental premium. Most recently, the economic impact of leasing green space has been of paramount importance; however, as the economy recovers, there will be renewed attention to social concerns.

As mentioned above, Part 3 will discuss the key lease elements to negotiate and offer tips to both landlords and tenants.

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