



COVER SHEET

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Valuing the Changes - Will Investment in Sustainable Features be Recognised in Market Value?

(1) Introduction

Sustainability has rapidly evolved as a key issue within the development and use of the urban, built environment. Due to its emergence over such a short period of time, most efforts have been directed at exploring and offering suggestions on **physical** issues such as energy usage, design and operational solutions. The suppliers of new product into the market – developers, architects, builders, building product suppliers, etc can be justifiably proud of the achievements to date.

However, more research and development is needed within all areas of production that will refine the products further and we need better ways to refurbish existing stocks. Nevertheless, the built environment sector has demonstrably achieved more in addressing the issues of sustainability compared to manufacturing, mining, primary production or the services sector in general. Sustainability is now a mainstream “pressure point” for all of those sectors, none more so than the built environment given that, for example, they are responsible for 40% of all energy consumption and 40% of all atmospheric emissions (AGO 1999).

Without denigrating past achievements, it is reasonable to observe that our efforts and focus has been largely “supply” oriented. We are experiencing a dramatic situation that is emerging with global change in its various forms and we continue to translate that into adaptable, flexible and sustainable products particularly in long term, high value products such as redeveloped property. But we know – and if we don’t our banks will tell us – that a supply side approach particularly in such complex economic environments, is fundamentally flawed and incomplete. Unless the market identifies the values and demands of a particular product (or generic principle such as sustainability) we will never achieve the level of certainty and predictability that stable markets require.

On that premise, this paper makes some observations on these demand parameters and how they may change and develop into the future. They are observations of not simply about the individuals in the market place but more importantly the approach taken by financiers (and their professional advisors such as valuers) who provide the financial underpinning for that demand.

(2) The Current State of Play

The current sustainability debate in the residential sector or anywhere else is in disorder and certainly confusing for producers and consumers alike.

That is not a criticism but a statement of fact and reflects the relatively early developmental stage of the whole debate. It seems that everyone knows enough about sustainability to be concerned about it and its related issues but nobody seems to have a sound and “sustainable” response to it. This is not made easier by current, shallow political point-scoring and numerous “one size fits all, simple” solutions that have emerged. These are complex problems that are going to take comprehensive and innovative solutions to resolve.

The current situation with the sustainability debate is perhaps not dissimilar to the introduction of ICT and Internet systems in the mid 1990s. Typical of any radical enabling technologies or changes, many first viewed it as a threat and inconvenience to be avoided. However, it rapidly moved to mainstream when sound policy settings by government leaders were put in place, businesses realised they can increase profits or lower their risk from its use and the wider community were willing to change their existing consumption habits and patterns.

Unfortunately, we still have some time to go on that journey and the nature of the residential market currently does not assist the situation.

The market is segmented with varying levels of price sensitivity and unfortunately, detailed market knowledge on sustainability remains disappointingly low. This is not simply the case for consumers but also for property professionals. There are examples of cases where valuers have been critical where high value residential properties have not provided for ducted air conditioning even though innovative, passive design features have been incorporated to make such expenditures unnecessary!

Overlaying all of that has been the remarkably resilient, if now increasingly patchy, residential property boom where high levels of confidence and supply shortages have currently overwhelmed and hidden other emerging trends such as sustainability. It would be extremely naïve to believe that such market conditions will continue at their current rate and the astute will use this time to position themselves and their products for quieter and more discerning markets ahead.

(3) Valuation Principles and Their Application to the Sustainability Agenda

In order to understand the demand parameters of the residential market, it is worthwhile to consider the approach that professionals adopt to interpret such information.

Valuers provide the “eyes and ears” and basic risk management for the financiers who underpin investment in the property market. Their task is both remarkably simple (given that it is based on the evidence provided by sales of comparable property) and extremely difficult (given the inherent issues in dealing with the unique characteristics of each individual property). Not only do they have to read the general trends within the market but at a

microeconomic level, put themselves in the position of the “hypothetical purchaser standing before the property and wishing but not being forced to purchase it”. Much of the case law surrounding valuation practice focuses on the likely “reasonable” reaction of that hypothetical purchaser.

Some counter-intuitive observations emerge here. Valuers are often asked to undertake very complex tasks particularly in commercial and development sectors. These tasks are very analytical and with proper research are reasonably predictable through anticipated returns on investment, internal rate of return and so forth. Analysing these sales will normally show high levels of consistency. By comparison, in the residential sector the basis unit of production – be it a residential house or apartment - is physically and financially much simpler and yet the market is much more individualistic and less rational in a financial sense at least.

An underlying reason is that our “prudent purchaser” in the residential market is often ill-prepared for the task. Most undertake this activity only a few times in their lives and unlike their commercial counterparts, see the acquisition in a much more holistic, personal and emotive way. Whilst in most cases they are acutely aware of the financial aspects of the sale, this often relates to their ability to repay debt rather than the comparative value and long-term cost effectiveness of the particular product. They very much consider “the whole offer” that the individual property presents to them.

This will, in the case of the residential buyer, include a large range of issues that “rush at them” during the typically short period that they are in the market place. It includes their own tastes and preferences, individual/family needs, their overall level of confidence to make such a significant purchase, the style and lifestyle image presented by the property (normally enhanced by the “sales pitch”) and a range of other physical property features, of which sustainability and building efficiencies are only one.

This is not to imply that residential purchasers are ignorant or naïve. It simply reflects that the parameters and drivers of residential markets are different and unique. Consequently, we should not presume the strategies that facilitate sustainable design, construction and operations elsewhere will have the same acceptance levels in residential sectors.

A real issue for valuers lies in the fact that they can only interpret the market as exhibited by sales evidence. As well as the difficulties in actually **identifying** sustainable features in buildings, immediate issues for valuing sustainability aspects include:

- too few sales of identifiable sustainable product in the market to recognise long-term preference and therefore demonstrable added value,
- various degrees of sustainability, each with their own cost implications and value impacts. (This “prudent purchaser” typically sees the product as a holistic offer and trying to extricate the

components that can be identified as “the sustainability bits” and then attempting to allocate marginal increases in value because of those, is a fairly theoretical and abstract exercise), and

- in a practical sense, residential valuers for financial institutions may be inspecting six or eight properties a day, sometimes more and they are simply unable to investigate such components in depth on individual properties as they might with a commercial property where the profiling of research costs is an important component of financial analyses.

A number of generic issues arise when considering the impact and value of a suitable development approach. For example, quite different strategies will need to be applied to the growing proportion of the market represented by multiple dwellings. Here the role of Body Corporate may increase over time to facilitate such activities.

New issues will also emerge with the 30% of the market that is rented through the public or private sectors. Here the operational practices of tenants may have little regard to the savings in resources for which they have no direct financial responsibility of and where changes in residential tenancy legislation may well prove difficult.

All of these issues should be seen in the context of the evolutionary nature of the sustainability debate. In the wider urban context, there is no doubt that issues related to sustainability are already having dramatic effects. Foremost amongst these are the location preferences now evident, strongly favouring proximity to workplaces and services and areas with good public transport and/or limited commute times.

A further significant advance is in the recognition of use and various ratings schemes, either at land development and building design, construction or operation levels. This provides a good opportunity as a point of difference in identification. Such rating schemes clearly demonstrates to the market (and therefore to the valuer) that a particular standard has been achieved and the long term benefits and savings can be recognised and accepted without further detailed investigation by that valuer.

(4) Affordability, Sustainability and the Market

It is impossible to assume the valuation considerations and demand parameters for residential sustainability without also considering affordability.

Affordability and price are critically important in recognising the demand for sustainable design and practices in the residential sector. However, the underlying situation may be substantially different from that portrayed through anecdotal observations and media reports.

For a proportion of the population particularly first home buyers or those who would aspire to home ownership, there is indeed an affordability crisis in

Australia. Despite relatively low mortgage interest rates, affordability is the worst point that it has been in Australia for over 20 years (Powall and Withers 2006). Under these circumstances, those facing the significant challenges of acquiring a first home are hardly likely to be over prescriptive in their demands for sustainable features. Features that are inbuilt, passive and that add little or no cost are one thing, anything that is seen as “an addition” even demonstrably cost effective components are more difficult to accept by the buyers. Here the stark choice may be between such sound features or the provision of carpets, curtains or other essentials. Under these circumstances, the obvious financial logic does not always win out.

Affordability however, has different connotations here and for the two-thirds of the market who have already paid off their homes or are advanced in doing so, there is no affordability crisis and quite the reverse there is considerable support for maintaining the status quo. It is to this group that the financial logic of incorporating sustainable features or when changing houses is much more likely to be accepted.

Considerable research work has already been done in these areas by AHURI (2004) and by the Institute for Sustainable Futures at UTS (2003).

The AHURI Report recognises that the normal sustainability indicators such as triple bottom line (TBL) work comparatively well in a neighbourhood or master plan community but their necessary scales of measurement are difficult to pare down to finer grained research, say for example individual housing. They observe the potential that lies in addressing affordability through the construction of higher density and smaller houses with emphasis given to innovation in construction and operational activities and costs that can both address affordability and sustainability issues at the same time. Through this, it can be hoped that affordability could be assisted rather than adversely affected by the incorporation of sustainable features.

(5) Micro-economic Analysis – Macro Issues

Traditionally, the valuer’s role has been one that is based on micro-economic analysis, which is comparative studies of the market’s consensus view in the value of a property to a number of sales of reasonably similar properties that happen to have occurred at the same time.

When a new or significant trend such as environmental/physical, economic and social/community sustainability emerges, lags in knowledge will occur until sufficient verified sales evidence is uncovered to reflect that change. Whilst the problem is not of the valuer’s making, an understanding of the broader parameters and future prospects for the market must be taken into account.

The sustainability component of the built environment is clearly a matter of importance to this prudent purchaser. The willingness of households to reduce residential water consumption in Brisbane by 44% over the past two years is testimony to community and individual involvement in such issues.

Whilst the impact on value of sustainable residential design might still be open to interpretation, there is no doubt that the overall influences of the sustainability agenda has had dramatic effects, most notably on strong geographical preferences for residential areas that minimise commute times and that are well located to workplaces and services. As urban development and infrastructure and servicing costs increase, these trends will advance over time.

(6) Summary and Conclusions

This paper will suggest that we should accept the evolving nature of the sustainability debate and at this stage at least, look for overall trends rather than definitive evidence. In saying that, we also need to be cognisant of the fairly conservative approach in the opinions of financiers and their advisors.

The residential market and customers within it are influenced by quite different demand parameters compared to other property market sectors and a holistic and often subjective approach tends to prevail over more analytical component-based analysis. On that basis, it will always be difficult to identify cause or relationships between say, the marginal investment in sustainable design and the marginal impact on value. Nevertheless, further research in these areas should be able to provide better guidance particularly as they become more mainstream. In other market parameters such as location preferences, sustainability issues are now well entrenched and has considerable impact on the market.

The increased use and recognition of rating schemes, improved consumer education and the upgrading of valuers' skills to better identify sustainable features will also assist in the recognition and acceptance of such components.

Finally, for the developer and builder there are the opportunities for increased point of difference in product recognition and potentially, threats in falling behind the market if such recognition is not taken. The key issue as always, will be balancing innovative design and inbuilt features with price point marketing. Surely, the obvious market trends must lead one to believe that investment in such components will be increasingly rewarded over time.

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