

# An Introduction to Responsible Property Investing (RPI) and Kennedy Associates

August 13, 2008

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Similar to Socially Responsible Investing (“SRI”) which is used within the securities industry to manage investments according to social, environmental, and other criteria to match investor preferences, Responsible Property Investing (“RPI”) is a holistic approach specific to real estate investment management. RPI looks to create financial, social, and environmental value through the incorporation of collection and analysis of environmental, social, and governance data as part of the investment process. RPI includes many metrics organized in 10 general areas including:

- Energy conservation
- Environmental protection
- Social equity and community development
- Urban revitalization and;
- Worker well-being

Defined first in the United Kingdom as a distinct approach to property investing, RPI has been embraced by certain segments of the investment management community in the United States. Kennedy Associates Real Estate Counsel, LP (“Kennedy”), among other institutional advisors and owners, has helped lead a growing movement to incorporate RPI principles into real estate investment management for its clients. Included is the \$7.2 billion Multi-Employer Property Trust (“MEPT”), as well as major public and corporate retirement funds and university endowments. Although RPI has evolved over the last several years, Kennedy has been practicing many of its principles for over 30 years. RPI is organized at Kennedy into three key areas including:

- Supporting economic fairness and worker health
- Developing sustainable “green” buildings
- Promoting high performance property operations and maintenance

RPI provides the framework by which Kennedy evaluates all development opportunities as well as directs how it approaches the management of its growing \$9.6 billion portfolio. RPI feasibility and performance are continually assessed. Kennedy’s long-standing, exclusive commitment to the use of contractors and development companies that honor fair labor laws and foster positive work environments (“Responsible Contracting”), transit-oriented urban development, and environmentally acclaimed projects represent examples where Kennedy’s investment philosophies dovetail with RPI objectives. The application of these philosophies has been successfully balanced with the fiduciary responsibilities of obtaining the highest possible risk-adjusted returns for Kennedy’s clients.

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RPI is a meaningful investment strategy because it is holistic. RPI allows investors to consider the environmental and social profiles of property investments as integral to their ability to generate financial returns, while also simultaneously creating value for society as a whole. As a member of the United States Green Building Council (“USGBC”), Kennedy recognizes that Leadership in Energy and Environmental Design (“LEED”) is the most widely adopted third-party rating system for sustainable development. Kennedy views the LEED framework as an important measure of the environmental profile of real estate investments. However, LEED is limited in its ability to certify the economic and social impacts of real estate. RPI not only incorporates many key components of LEED, it goes further by providing economic and social metrics.

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RPI is also an attractive investment approach because it reflects a growing global movement highlighting issue areas less frequently addressed in US real estate circles. The global focus on RPI is reflected through the United Nations (UN) Principles of Responsible Investing (PRI) and the United Nations Environment Programme (UNEP) Finance Initiative (FI). Kennedy (along with several other prominent US property owners) has become a signatory to the UN PRI because its goals both reflect and reinforce the RPI commitment Kennedy has made as an investment advisor.

Kennedy’s commitment to RPI also reflects the simple fact that the built environment has significant social and environmental impacts. Take for instance, the increasingly prominent issue of climate change. According to the USGBC, buildings account for 71% of electricity consumption, 39% of energy use, and approximately 39% of greenhouse gas emissions. The environmental impact of buildings on climate (among other things) prompted Kennedy to focus on replicating sustainable development practices, by targeting LEED Silver certification for all new construction regardless of property type. LEED

currently provides four escalating levels of certification that correspond to scale of LEED points achieved for a given LEED standard (i.e., New Construction, Core and Shell etc.). Current LEED certification levels include (from low to high): Certified, Silver, Gold and Platinum. With close to \$2.0 billion in LEED certified projects completed or in development/pre-development, Kennedy’s commitment to green building is substantial.

Although LEED has been most frequently applied to new construction, there are very few certified LEED Existing Buildings (EB). The lack of LEED EB adoption offers a distinct opportunity for building owners interested in improving the energy performance of existing buildings. As a select participant in the LEED EB Portfolio/Volume Pilot program, Kennedy will seek LEED EB certification for close to eight million sf of office space. LEED EB certification will help Kennedy standardize sustainable policies and operational procedures across a diverse portfolio with varied service providers. One important tool Kennedy proactively uses to improve the energy efficiency of its existing portfolio is ENERGY STAR benchmarking. Kennedy currently benchmarks over 22 million sf of office and industrial space quarterly and has received ENERGY STAR building labels for over \$1.3 billion of its portfolio for exemplary performance.

Although an owner can work to improve a given building’s operations, Kennedy understands the relative permanence of real estate in light of the significant amount of capital investment with any new development. Consequently, Kennedy understands the importance of designing and building assets that are environmentally sound and enhance, rather than detract, from their communities. Owners of inefficient, poorly designed real estate are saddled with undesirable assets that suffer from diminished values and eroded returns. Ultimately, these assets fail to realize their highest and best use and must be sold, redeveloped or repositioned.

Sustainable real estate investments can transform communities, while enhancing income returns and market valuations. One example of such sustainable real estate is Kennedy's Brewery Block II project on behalf of the Multi-Employer Property Trust ("MEPT") with local developer Gerding Edlen Development ("GED") in Portland, OR. Brewery Block II offers a blend of sustainable design, mixed uses, and historic preservation. The LEED Gold certified project received was a key catalyst in the transformation of Portland's *Pearl District*, and has been successful in both attracting high credit tenants, and commanding above market rents.



As noted, and as the example of Brewery blocks suggests, RPI addresses social and economic as well as environmental issues. Real estate development and property management create substantial opportunities to improve the well-being for workers associated with a given project, from conception to completion and later providing ongoing maintenance services, to those designing and installing lighting retrofits aimed at improving energy efficiency. RPI offers a framework to measure and manage these social and environmental benefits, and ideally to capture the specific investor interest and financial value associated with them.

For 26 years, Kennedy as founder and advisor to MEPT has consistently created economic opportunity for its clients by using Responsible Contractors. In order to fully understand the economic impacts of the use of Responsible Contractors, Kennedy used

ECONorthwest, a third party economic research firm to quantify the economic impact of development, tenant improvement and renovation activity within MEPT. ECONorthwest analyzed 218 projects acquired, built or committed to by MEPT between 1982 and 2005 and estimated the economic impacts of new construction projects and second-generation tenant improvements. Released in August 2006, the study found that MEPT:

- Created 84,330 jobs and \$4.1 billion in income and benefits
- Generated 52.7 million job hours for building trades' members
- Spurred over \$9.9 billion in economic activity nationwide and;
- Produced \$199.5 million in state personal income taxes and \$127.6 million in state sales taxes

Studies like these offer institutional owners, evidence that market-rate investments specifically create jobs and economic development even as they generate competitive returns.

Kennedy's commitment to RPI reflects a fundamental conviction that buildings with RPI characteristics are sound investments. The financial argument for RPI is relatively straight forward. Buildings developed with sustainable standards, and managed using operational best practices have been proven to reduce operating expenses while increasing Net Operating Income (NOI). Each budget cycle, Kennedy's asset managers work to implement key systems reviews, retrofitting, and upgrades to improve energy efficiency in an effort to reduce operating expenses.

According to the USGBC, LEED certified buildings are significantly more efficient than buildings constructed to basic standards. LEED structures typically use 25-30% less energy, 30-50% less water and generate 70% less solid waste than non-LEED structures. This figure is supported by the New Buildings Institute (NBI) which surveyed 121 stabilized LEED certified office buildings, and concluded that they used energy less intensively and had higher ENERGY STAR scores than non-LEED buildings. The Environmental Protection Agency ("EPA") also notes that ENERGY STAR labeled buildings typically use 35% less energy. In an environment of scarce resources and rising energy prices, cost effective efforts to reduce energy and water use contribute directly to the bottom line.

Another study of ENERGY STAR labeled buildings by the CoStar Group not only confirms the presence of lower energy costs, but also higher occupancy levels and rental rates. USGBC data also suggests that LEED certified buildings carry a rent premium. Kennedy LEED certified assets have historically leased up more quickly than competitive product and at higher rental rates. Although Kennedy has not fully determined if the existing rent premium stems exclusively from the asset's LEED certification, Kennedy is confident that as additional LEED registered buildings are delivered to market and lease up, data will support the LEED value proposition.

A crucial part of the value proposition for sustainable development is that LEED certification can be achieved cost effectively. The assumption that LEED construction is cost prohibitive has largely been proven incorrect through research by the international research firm Davis Langdon among others. Davis Langdon has studied the costs of LEED development releasing in depth studies in 2004 and more recently in 2007. Davis Langdon also provides comprehensive construction cost planning and management services to owners, architects, government agencies and institutions. Kennedy's own experience with multiple LEED projects suggests that additional LEED related project costs (i.e., hard and soft) are often no more than 1-2%. Part of Kennedy's success minimizing LEED related costs results from motivated development partners and general contractors, thoughtful designers, and experienced LEED consultants. Predictably, initiating the LEED process early is critical.

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Sustainable, LEED certified projects with RPI characteristics will act as a buffer to the cyclical nature of real estate; offering a means to mitigate functional obsolescence. Going forward, LEED certified buildings will likely have a competitive advantage resulting in quicker lease-up and lower tenant turnover. There is growing evidence suggesting tenant demand for LEED certified space is increasing, driven by corporate policy and employee preference. In two LEED pre-certified buildings within the Kennedy portfolio, credit tenants have made it clear they will only lease space

in LEED certified buildings. Kennedy is convinced this market transformation will expand as additional data further quantifies the correlation between improved indoor environmental quality in LEED buildings and employee productivity, absenteeism and overall health. There seems little doubt that tomorrow's tenants will place a high priority on RPI characteristics.

Kennedy constantly balances the costs and benefits of RPI. In an environment where every vendor, service provider and consultant offers "green" services, Kennedy continuously works to demonstrate or quantify the value of all RPI related initiatives. Like most investment advisors, Kennedy is waiting on additional evidence demonstrating the increased market value LEED certified assets will realize with their sale through green premiums which reduce reversion capitalization rates. However, Kennedy is not waiting for the evidence to pursue LEED. With a rising number of LEED registered and certified buildings, it is reasonable to assume resale data will become available in the near future. If current market trends continue, such as credit tenant LEED space requirements it seems possible that non-LEED certified assets will eventually trade at a discount, with non-sustainable Class A product dropping to Class B and so forth.

Kennedy is also tasked to proactively mitigate risks to assets within our portfolio created by the changing real estate marketplace whether economic, environmental or political. This includes understanding as well as anticipating growing public perception and corresponding public mandates and incentives aimed at spurring additional green building. One example of this trend includes public requirements for LEED development in major markets such as Washington D.C., Boston and Los Angeles. Expanded levels of sustainable development will only enhance these and other market's attractiveness, as additional public incentives are established to encourage green building.

RPI allows Kennedy to effectively respond to demographic and tenant trends currently impacting commercial real estate including: growing urbanization, the impact of traffic congestion and the growing gap between employment and housing. Kennedy specifically targets centrally located urban infill projects with Transit Oriented Design that increase density, while providing key connections to open space, amenities and mixed uses. Projects built

and acquired with these “Smart Growth” characteristics generate positive environmental, economic and social spillover benefits for local communities such as healthy work places, job creation, and reduced carbon emissions. Projects with these characteristics can also help increase community support, secure public incentives such density bonuses, and create a sense of place attractive for single workers as well as empty nesters seeking opportunities to live, work and play.

Kennedy’s commitment to RPI reflects our corporate culture. Headquartered in Seattle, Washington, Kennedy’s company leadership draws upon our history as an institutional real estate advisor as well, and situation in Evergreen state, with its focus on environmental stewardship and proximity to natural resources including Puget Sound and the Cascade Mountains. Kennedy’s dedication to RPI goes farther than public statements; rather, it starts internally through a proactive effort to consider how RPI affects each employee’s role within the company. Kennedy’s commitment to “Walk the Walk” internally has translated into multiple activities including a recent office-wide tree planting of approximately 1,600 trees in one of Seattle’s urban parks to help offset our carbon foot print, annual sponsorship of the Kennedy “Suits on Wheels” bike to work team, and implementation of a sustainable materials purchasing program.

Additionally, Kennedy is making a sizable commitment to RPI by pursuing the LEED certification for its corporate space. Current plans indicate that Kennedy’s remodeled space will use 35% less energy and 40% less water, while creating a more environmentally friendly work environment for its employees. Kennedy has also made substantial pledge to educating its employee base, creating a LEED curriculum to help its employees, (including senior and executive management) achieve LEED professional accreditation. At this time, Kennedy has multiple LEED Accredited Professionals (APs) on staff and expects to have over 10% of its employee base LEED accredited by the middle of 2008.

In an effort to promote the adoption of RPI, Kennedy is currently working to create an appropriate frame work to evaluate assets within its portfolio, benchmarking them against a select subset of the 66 RPI metrics. Kennedy is considering a smaller group of metrics that can be realistically benchmarked, and reflect the

unique challenges presented by benchmarking existing buildings, as well as assets under development. Metrics covering existing buildings include:

- Energy and water reduction goals
- Use of ENERGY STAR benchmarking and building labels
- Recycling and construction waste management
- Sustainable tenant improvements and green leases
- Green cleaning and efforts to improve indoor environmental quality

Development-related RPI metrics include use of:

- LEED certification
- The economic impact of using Responsible Contractors (i.e., job creation, tax revenue)
- Transit Oriented Development (TOD)
- Historic preservation and brownfield redevelopment
- Preservation of open space
- Recycled building materials and
- Provision of tenant amenities like bike racks and showers and mixed uses

Kennedy’s adoption of RPI and sustainable practices, like others in the industry, remains a learning process, refined daily as Kennedy works to successfully juxtapose the costs and benefits of various RPI strategies and metrics against its responsibility as fiduciary and commercial real estate. After surveying almost eight million square feet of its operating office portfolio, it is clear that not every project will meet each RPI metric for numerous reasons. However, Kennedy plans to continue to report on what RPI initiatives make sense going forward as well as what we have learned. Ultimately, Kennedy is committed to leading the charge to promote adoption of RPI principles, staying in the forefront as RPI develops into a mainstream real estate investment strategy.

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