

Unlocking future value in commercial real estate

The drive towards a sustainable, low-carbon economy presents both risks and opportunities for commercial real estate investors. Here, we consider the potential impacts on rental income, capital value and future investment returns.

The global credit crunch, volatile commodity prices and macro economic uncertainty have created a very challenging investment environment. As institutional investors seek to mitigate risk, more assets are flowing into alternative asset classes. Watson Wyatt's *Global alternatives survey* found a 40 per cent increase in alternative assets under management on behalf of pension funds between 2007 and 2008, within which, real estate accounts for 62 per cent¹. As is the case with many other asset classes, current conditions have led to falling returns from commercial real estate². However, challenging investment environments can lead to greater focus on investment risks, including those from sustainability. Investment returns from commercial real estate are a function of rental income and capital value and, in our view, both could be influenced by regulatory drivers and changes in occupier demand related to sustainability.

A key message from a recent RICS³ conference was that "unsustainable construction, investment and management practices will lead to accelerated building obsolescence and losses with regard to asset value and financial performance"⁴.

We believe that environmentally sustainable buildings could prove to be more competitive, trade at a rental premium to the market, have shorter vacant periods, experience reduced obsolescence and slower depreciation and ultimately command higher capital values.

Long-term investors and their managers should assess how resilient their real estate assets are to new regulations and changing occupier demand. Where economically feasible, asset managers should mitigate risks to future returns by incorporating sustainability considerations into decisions about acquisition, management and sale of real estate assets.



What is sustainable real estate?

Building design, construction, management and use which integrates environmental, social and economic objectives.

Whilst unique to each building, typical issues to consider might include:

Energy

Energy consumption during construction and use, energy efficiency measures, use of renewable energy.

Materials

Environmental sustainability of building materials, for example, timber, steel, cement.

Water

Consumption of potable water, water efficiency and recycling measures.

Waste

Waste management and recycling facilities.

Transport

Access to public transport and cycling facilities.

Pollution

Atmospheric emissions, waste water discharges and surface water run-off.

Local environment

Land use, local ecology, visual impact, contextual fit and community relations.

Internal environment

Occupant health, safety and well-being, building design, climate control.

Adaptation

Scope for building to adapt to changing climatic conditions or occupant needs.

Impact on real estate investment returns

To date, the forecast sustainability performance of a building has not been explicitly priced-in by the market, in part because there has been no formal means to attach financial values to sustainability characteristics. Although information gaps still exist, there is emerging agreement that sustainability will influence future real estate returns, but there is little clarity around the scale and timing of this. Here, we explore some of the ways investment returns could be impacted.

Regulatory drivers

International efforts to cut carbon emissions are translated into regional and national targets, enforceable through regulation and market-based instruments. In 2007, the European Union agreed to cut greenhouse gas emissions by 20 per cent by 2020, or 30 per cent if international agreement is reached⁵. Through the Climate Change Bill, the UK has set a binding target of 60 per cent reduction in carbon dioxide emissions by 2050 and at least 26 per cent by 2020, against a 1990 baseline⁶. A range of measures will be taken to achieve these targets, including market-based emissions trading schemes, investment in low carbon technologies and promotion of energy efficiency.

The real estate sector is an obvious target for energy regulation because, on average, buildings in Europe account for 36 per cent of total energy use. Residential buildings are responsible for a major part of this, around 27 per cent, however, consumption by commercial buildings such as offices, retail, educational and healthcare facilities is also significant at almost 9 per cent of the total⁷. Energy efficiency measures

are central to achieving carbon reduction targets, as typically around 80 per cent of the energy consumed by buildings occurs during operation (rather than construction) for lighting, heating, cooling and powering appliances. A landmark piece of legislation in this area is the EU Energy Performance of Buildings Directive which introduces Energy Performance Certificates (EPCs) for commercial real estate.

These indicate, via an A to G rating, the intrinsic energy performance of a building and must be provided at the time of construction, sale and letting to give prospective tenants and investors information on the energy efficiency and carbon emissions of a building. These are required for all commercial buildings in the UK from October 2008.

Another regulatory development in the UK is the proposed Carbon Reduction Commitment (CRC) which would introduce a mandatory cap-and-trade scheme applicable to around 500 large non-energy intensive businesses and public sector bodies. It would apply to organisations whose electricity use is more than 6,000MWh/year and who are not covered by existing emissions trading schemes. The sectors affected would include large retail organisations, banks, large offices, universities and hospitals, local government and central government departments. The aim of the CRC is to stimulate energy efficiency and cut carbon emissions by 1.1 million tonnes per year by 2020⁸. If enacted, the CRC would focus occupiers' minds on the energy performance of their premises and is likely to influence real estate decisions.

Demand changes

Research suggests that tenants are becoming more interested in the sustainability of the buildings

they occupy; possibly because they value operational efficiency, cost control and alignment with their organisation's own sustainability objectives. The Property Industry Alliance and CoreNet Global UK commissioned the UK Occupier Satisfaction Index, to measure and track occupier satisfaction across the UK commercial real estate industry. The 2007 and 2008 indices identified sustainability as one of the six key challenges that occupiers would like addressed and concluded that "sustainability is top of mind with many occupiers and an area where occupiers want to see the industry take more action". Specifically, respondents wanted to see environmental solutions for older building stock and highlighted energy consumption, waste management and sustainable development as priority issues⁹. Industry professionals increasingly recognise the importance of sustainability for commercial real estate. Research by Jones Lang La Salle in 2007 sought the views of 400 industry professionals and found that around half believe sustainability is already critical to corporate real estate and nearly 80 per cent felt it would be critical within two years. The research also found that over half of the respondents would be willing to pay up to 5 per cent more for a sustainable building and a further 25 per cent said they would be willing to pay an additional 5 to 10 per cent¹⁰. Furthermore, research by GVA Grimley also suggests demand for 'greener' offices is increasing with 79 per cent of surveyed occupiers in the finance and business service sector willing to pay more for a 'green' building¹¹.

These preferences mean that sustainable buildings could be more attractive to prospective occupiers,

and consequently may let faster and retain tenants for longer. This is potentially good for investment returns as it reduces the length of vacant periods when the building is not earning rental income and the owner has to pay an empty rates liability.

To understand how these preferences translate into practice, the Investment Property Forum (IPF) has commissioned Oxford Brookes University to examine acquisitions of office space over an 18 month period and, working with the parties involved, assess the extent to which sustainability was a factor in their decision-making. From this work, the IPF aim to identify barriers and opportunities in the supply of sustainable real estate to commercial occupiers.

Rental values

In addition to traditional factors such as location, building and tenant quality, we believe that in future the sustainability credentials of a building will play a more important part in determining rental value and growth. To date it has not been possible to test whether sustainable buildings command premium rents due to the lack of common measurement tools and centralised data. However, there are a number of initiatives which are likely to change this. For example, the UK Green Building Council's Campaign for Real Data encourages more measurement and reporting using standardised comparable data. In a similar vein, the Investment Property Databank (IPD) launched the Environment Code in February 2008 which provides a global standard for measuring the environmental performance of commercial buildings. The IPD Code provides common definitions, metrics and a framework to gather information across a portfolio of

varied building types. To consolidate the effects of sustainability on the built environment and to monitor the investment impacts, the IPF and IPD are developing a sustainable property index which will track the investment performance of sustainable buildings.

Capital expenditure

Buildings that are allowed to become obsolete may experience lower rents and deliver a less attractive return on investment as the property ages. Capital expenditure is required to maintain, refurbish or remodel commercial buildings to ensure they remain competitive. As sustainability plays a more important role in occupiers property choice, capital expenditure may be required to upgrade buildings to make them more sustainable, for example by introducing more energy efficient plant and equipment to upgrade the EPC rating. When evaluating real estate investment opportunities investors should consider the potential financial impact of future capital expenditure needed for sustainability improvements.

Capital value

The capital value of commercial property takes into account the building's income stream, vacancy and collection losses, operating expenses and capital expenditure. In future, buildings that are more sustainable than comparable peers could benefit from premium rents, lower vacancy losses and lower capital expenditure and therefore could potentially command higher capital values. Sustainability has, arguably, not been explicitly reflected in valuations to date. The Sustainable Property Appraisal Project, led by Kingston University, sought to address this and noted that "with no means to measure sustainability within commercial

property stock or identify potential impact on property worth, the market has been unable to discern a clear business case to generate demand for property with positive sustainability characteristics¹². The project identified seven quantifiable sustainability indicators and investigated the potential impact on property worth. As more information becomes available about the sustainability characteristics of buildings, valuations could evolve to reflect these more explicitly. RICS states that it "has the potential to champion these issues through the education and training of property professionals to include sustainable issues in the valuation process"¹³. We believe investors should be mindful of this when assessing real estate investments and consider the possible risks to future capital value from poor sustainability performance.

What can investors do?

A considerable amount of activity is already occurring in the sector to understand and measure the potential impacts of sustainability on real estate returns. At an international level, the United Nations Environment Programme is bringing industry participants together to explore and encourage real estate investment that incorporates sustainability considerations. In the UK, the Green Property Alliance unites bodies such as the British Council for Offices, the British Property Federation, IPF and RICS, to share information, identify common areas of work and act as a collective voice regarding sustainability issues within the built environment.

We welcome progress by some of the UK's larger real estate investment managers that are starting to assess and manage sustainability risks within their real

estate portfolios/funds. However, we note that this is generally at an early stage and is not common practice across the industry. With the aim of managing risk and enhancing long-term investment returns, we encourage real estate asset managers to:

- Assess real estate portfolios to identify buildings whose financial performance may suffer due to poor sustainability performance, or may breach current or future legal requirements. Periodically re-assess performance to monitor progress.
- Identify actions to upgrade the sustainability performance of buildings and conduct cost-benefit analysis to prioritise low-cost opportunities. Set objectives, targets and timescales to implement actions as part of ongoing maintenance and refurbishment programmes where economically feasible.
- Incorporate sustainability considerations into real estate acquisition, development, management and disposal decision-making.
- Work with tenants and other relevant stakeholders to achieve mutually beneficial sustainability objectives and targets.

Conclusion

New regulation and changing occupier demand is likely to raise further the profile of sustainability issues within the commercial real estate industry. We believe sustainability will have more influence on investment returns in future through impacts on rental values, vacancy periods, capital expenditure and capital values. We therefore encourage long-term investors, or their agents, to assess the sustainability performance of real estate portfolios in order

to identify risks to future returns and incorporate sustainability considerations into decisions about acquisition, management and sale of real estate assets.

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Further information

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