

Will greener buildings bring bigger profits?

EXECUTIVE SUMMARY

- Questions about a building's sustainability are now entering the decision-making process.
- There has been a reluctance among investors to address the environmental impacts of property holdings.
- Not only will less sustainable properties command lower rents, they will take longer to re-let at the end of a lease.

Debate continues about the economics of developing environmentally friendly offices, shops and factories but investors can best understand the impact of sustainability on returns through focusing more on the sustainability of their existing buildings, argues Paul McNamara, ASIP

BY: PAUL MCNAMARA, ASIP

Even the casual observer knows that, in common with the other main asset markets, commercial real estate has had a torrid time over the past year. After an extended run of spectacular performance, the market has corrected violently with UK capital values falling by about 20% from their peak in the middle of 2007. Similar corrections are now underway in many other markets around the world.

However, obscured by this cyclical

turbulence, a more long-term, secular trend has been developing, namely a steady and growing appreciation that the issues of climate change and sustainability are changing the context within which property investment and occupational decisions are made. Questions about sustainability are entering the decision-making processes underlying which properties should be occupied and bought, and how those properties should then be operated and managed.

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PROFILE – FACT BOX



Paul McNamara, ASIP

Career highlights:

Paul McNamara, ASIP is head of property research and a board director at PRUPIM. He has a first class honours degree from the University of St Andrews and a PhD from the University of Edinburgh, both in Geography. He was chairman of the Investment Property Forum (IPF) between 2005-2006, and is a fellow and former chairman and president of the UK Society of Property Researchers. He is also a visiting professor in the Department of Real Estate Management at Oxford Brookes University.

In 2003, McNamara was awarded an OBE for services to the property industry. He currently chairs the Institutional Investors Group on Climate Change and is co-chair of the UNEP FI Property Working Group.

Through its development, use and ultimate demolition, commercial and domestic real estate is believed to be linked to approximately 50% of all carbon-dioxide emissions in developed economies. As such, it is an obvious focus for both policymakers and activists concerned about sustainability and global warming. Policy development in this area is rapid at European, national and local government level and embraces a wide range of issues to do with, among other things, lowering carbon-dioxide emissions, the efficient use of energy, water and other natural resources, and reducing waste generation.

Most significantly in Europe, we have recently seen the introduction of Energy Performance Certificates which, like the scheme used for refrigerators and cookers in our shops, grade and inform prospective purchasers and tenants about the energy efficiency of commercial buildings and what can be done to improve them. They allow tenants and investors, whether acting through their own volition or under pressure from activist shareholders and more demanding social values, to make more informed choices about the assets they rent and buy.

The effects of these policy and attitude changes have been most evident in the new development and construction sector, where the property industry has shown the greatest innovation and where industry-led labelling schemes are being used increasingly to rate the environmental credentials of new buildings. Here, financial debate has tended to revolve around the scale of any potential additional costs of ‘responsible’

construction and the extent to which these are subsequently offset by lower running costs through the life of the building.

FOCUS ON EXISTING STOCK

However, the real-estate industry is increasingly aware that to focus solely on new buildings when considering how to react to the burgeoning sustainability debate would be to miss the point – both from an environmental and an investment perspective. Developers deliver about 2% new stock each year over a cycle. So, even if all new stock was as sustainable as possible, it would still form only a small part of the built environment and investment portfolios for some time to come.

Yet, until recently, based on the perception that to do so would undermine investment performance, there has been a general reluctance among investors to address materially the environmental impacts of existing property holdings. This was not wholly irrational, given precious little evidence to show tenants paying higher rents for more sustainable accommodation. Clearly, expending capital to retro-fit buildings to reduce their environmental impacts without recompense through higher rents or improved asset valuations will harm investment returns and, like fund managers everywhere, those in property are highly focused on short- and medium-term performance.

However, this is changing rapidly now and property fund managers are wrestling with how to account for these new concerns in their investment decisions and strategies, and what financially viable actions they can take.

Some have suggested that property ‘sustainability’ represents a ‘third dimension’ (additional to risk and return) for investors considering property investments. However, the effects of sustainability can be reviewed in risk-and-return related terms and, in this regard, represent simply a new

addition to the wide range of considerations property investors regularly make judgements on, when evaluating property investments. ‘Sustainability’ should simply be embraced into the appraisal process through an appreciation of how it impacts worth.

UNDERSTANDING THE IMPACTS

A simplified equivalent of the Gordon’s Growth Model offers us a reasonable framework to illustrate how sustainability impacts property value:

$$P = \frac{R}{(Rf + Rp) - G}$$

P = property value

R = Rental income over the forthcoming year

Rf = Risk free rate

Rp = Risk premium

G = net rental growth rate (accounting for asset obsolescence)

If tenants become more concerned about environmental issues (or their corporate image through their corporate responsibility policies), they may increasingly exercise a preference to occupy, ‘sustainable’ properties. (There are various definitions of a sustainable buildings but generally they include energy efficiency, water efficiency, good accessibility by modes of transport other than the car and good waste disposal facilities). This will inevitably lead to a differentiation in rental levels achieved between ‘sustainable’ and ‘non-sustainable’ buildings. The resultant differences represent a form of accelerated depreciation, leading to lower net income growth (G) in less sustainable buildings.

Furthermore, less sustainable buildings are likely to be less energy (or water or waste) efficient. If this increases tenant costs, then less will be available to the landlord for rent. Consequently, rent levels fall for less sustainable properties or, over time, net rental growth (G) is lowered. Not only

will less sustainable properties command lower rents, they will take longer to re-let at lease end. This extended break in cash flow increases risk to an investor for which an increased risk premium (Rp) should be demanded.


Similarly, if investors begin choosing assets more on sustainability grounds, then less sustainable properties will become more illiquid than more sustainable properties. If illiquidity is a form of opportunity cost, investors will naturally demand a higher risk premium (Rp) for these more illiquid, less sustainable assets.

So, using our Gordon’s Growth Model framework, if, going forward, net rental growth (G) is lowered, net rental levels (R) are lowered, and asset risk premia (Rp) are raised for less sustainable assets, then the price (P) for such assets must fall relative to more sustainable comparators. As these effects take hold over a number of years and ‘sustainability’ issues contribute to new equilibrium pricing regimes for real estate, these effects cause less sustainable assets to underperform.

Clearly, when considering the scale of the impact of sustainability on property values, much depends on how much tenants and investors will care about such issues. The more they care, the greater the impact on value. Early impressions suggest they are going to care a lot. So, despite there being limited evidence to date of impact on value, most feel it is inevitable and the search is now on to calibrate and parameterise these effects and seek strategies to best cope with this changing investment context.

INVESTOR RESPONSES

The above shows clearly that it is the fiduciary duty of property fund managers to understand how sustainability impacts differentially on the varied forms of property they hold or might acquire for their portfolios. Smart investors are beginning to look at how to bias their funds towards more sustainable assets. ‘Responsible’ investors are additionally looking for ways to improve the environmental credentials of current assets by all economic means available. Evidence from the UNEP FI Property Working Group suggests that many simple asset-management initiatives help reduce the environmental impact of properties. If these are low or at no cost then, by definition, they cannot threaten managers’ fiduciary responsibilities. Among many other initiatives, my own organisation, PRUPIM, is running an ‘Improver Portfolio’ to explore such solutions on £500 million of existing assets. Clearly, as energy costs rise and technology costs fall, this range of cost-effective actions will grow and property owners should be able to do even more to reduce the impacts of their existing stock.

There are also signs of this area maturing as an investment sub-sector. A number of green real estate funds of various types are now actively being considered or promoted. Socially responsible property investment funds will soon be entering our investable universe. 

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