SUSTAINABILITY:
IS IT REALLY INFLUENCING INVESTMENT DECISIONS?

CUSHMAN & WAKEFIELD®
Global Real Estate Solutions

CUSHMAN & WAKEFIELD SUSTAINABILITY BRIEFING

SUSTAINABILITY – IS IT REALLY INFLUENCING INVESTMENT DECISIONS?

This report explores the role of sustainability in real estate investment decisions in the UK and continental Europe. The research programme was conducted with the help of Remark – an independent research agency – to establish the views of key European real estate investors on sustainability as a driver for investment decisions and how it impacts on their business strategy.

30 managing directors, fund managers and fund directors from 26 European investment organisations were interviewed:

Allianz
Aviva Investors
AXA
British Land
CBRE Investors
Climate Change Capital
Commerz Real
Cushman & Wakefield Investors
Gazeley
GLL Real Estate Partners
Hammerson
HDG Mansur Investment Services
Heitman
Henderson Global Investors
Hermes
Land Securities
Legal & General
Pramerica Real Estate
Property Alliance Group
PRUPIM
Rockspring
RREEF
Standard Life Investments
Scottish Widows Investment Partnership
The Crown Estate
Westbrook Capital Partners

SUSTAINABILITY IS PLAYING A MORE CENTRAL ROLE IN INVESTMENT DECISION MAKING

Undoubtedly the global economic slowdown has made it difficult to deliver new green buildings and investors are feeling challenged by the state of the market. Sustainability has, however, remained firmly on the corporate agenda. If anything, investors are putting more commitment and resources into their sustainability strategies to gain competitive edge or avoid risk, and they are already anticipating a more central role for sustainability in their decision making processes.

THE INFLUENCE OF SUSTAINABILITY AT FUND LEVEL

Investors recognise the need to drive sustainability from the corporate level through to their funds. Two thirds said they implemented a sustainability policy at fund level and some say that this is driven by their investors who are demanding evidence of sustainability performance.

+ *"Yes we do implement a policy at fund level and will absolutely continue to do that. It is driven in part by the value differential and in part by the fact that sustainability is on our investors' radar. As we are providers of product for them we see sustainability as becoming part of the menu of products that they want to invest in."*

– *"No we don't have one and have no plans to produce one. We don't have a corporate sustainability policy at group level. It is a possibility that we may put one in place in the future, but there hasn't been any focus or substantial discussion of that. It's not top of the agenda at the moment."*

THE VALUE DIFFERENTIAL

A growing body of evidence in the United States claims that a rental premium, if not a value differential per se, does exist in that market and similar results have recently been announced for the UK. Amongst our respondents only 50 per cent believed that a value differential does exist at present, but even so all respondents expect that it will exist in the future.

+ *"Yes. Due to lack of data this is so far not quantifiable. I personally believe that there is a larger rental shortfall risk and a higher exit risk for non-sustainable buildings. The question to that would be how do you define them?"*

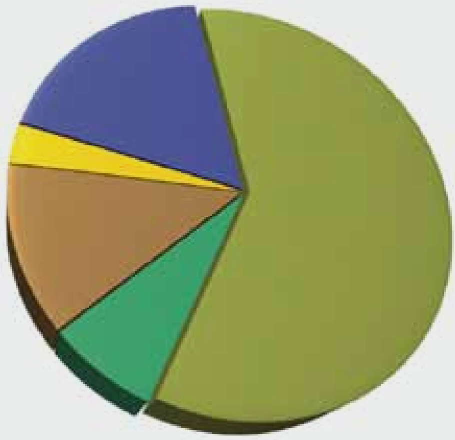
"Yes. In our opinion the more sustainable products will be future proofed. In the long term, sustainable products will be more valuable because low energy buildings, green label buildings will be required by governments and businesses alike and we see that if you don't have that kind of product there will be an obsolescence issue…Most people in the city wouldn't build a building in London without having some green credentials to it. So there is underlying value to it but you don't necessarily note the value in it yet."

- *"Not explicitly, no. There is no evidence to suggest anything like that. What it boils down to are individual factors within a building. If a building has a more sustainable profile for the longer term, that is likely to be based on where it is located, its construction and various other factors and that is going to feed into voids and rental growth, but the market is not specifically marking out sustainability on its own."*

"No. I would hope that there would be going forward, but there doesn't seem to be any investment premium for buying a building with a good BREEAM rating. I would assume that tenants moving towards a more sustainable building would generate that, but there certainly doesn't seem to be one at the moment."

Those that thought there was a differential were asked to quantify it.

INVESTORS PERCEPTION OF A VALUE DIFFERENTIAL IN PERCENTAGE TERMS

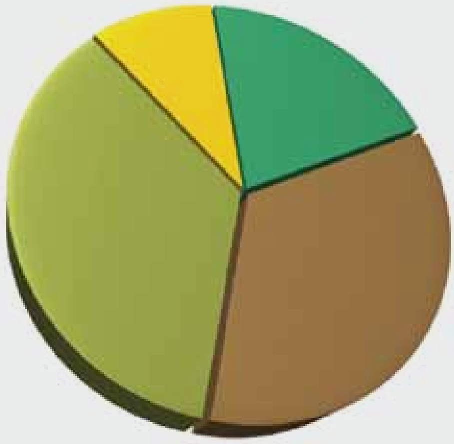


- Up to 20%
- Up to 10%
- 5% to 10%
- <5%
- Unquantifiable right now

HOW A VALUE DIFFERENTIAL WOULD TRANSLATE

There is diverse opinion in how a value differential would be most likely to manifest itself. However investors' expectation is leaning towards a brown discount, that is, failure to achieve expected rents/values, rather than achieving a green premium, albeit that many recognised that, in reality, it is likely to be a combination of a green premium and a brown discount.

INVESTORS EXPECTATION OF HOW A VALUE DIFFERENTIAL WILL BE MANIFESTED



Green Premium
Brown Discount
Combination of Green Premium & Brown Discount
Discount Other

"A lot of larger corporate tenants will want to go to green. That may or may not have a rental differential but it certainly will have consequences like reducing letting voids on the buildings that comply compared with others that don't comply."

"It will be an obsolescence value as opposed to getting more rent. If you've got a building that doesn't have sustainable credentials attached to it, you won't let it as quickly."

"It will be both. I believe it won't be driven by the valuation market it will be driven by the occupation market by demand for more cost efficient stock in terms of total cost of occupation".

YIELD ADJUSTMENT

Given the diverse opinions regarding value differential, unsurprisingly less than a quarter of respondents said that they are currently applying adjustment factors to yields.

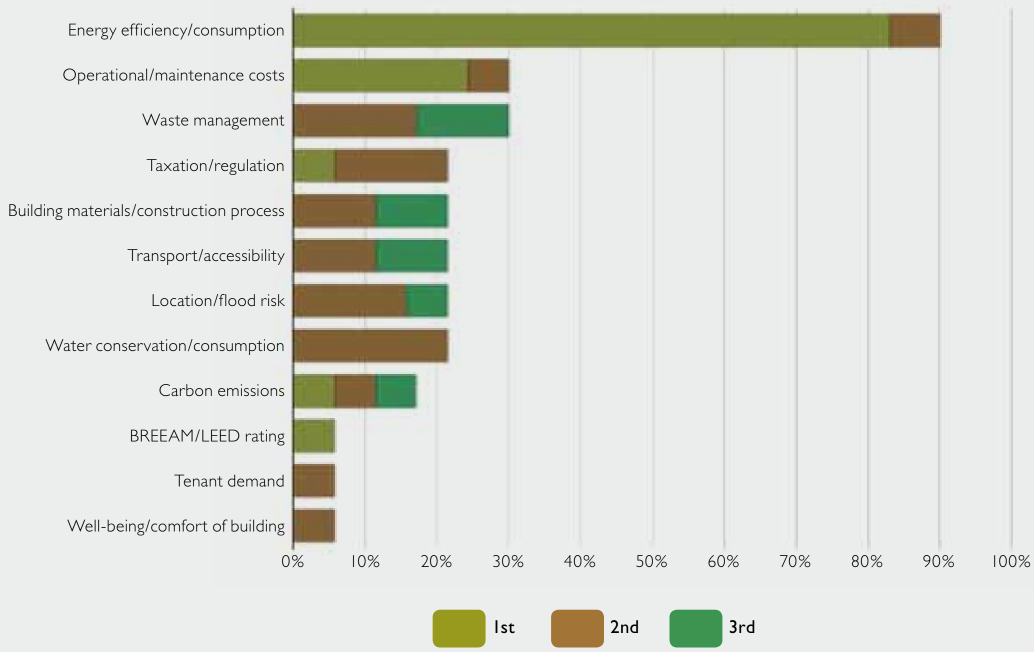
"We have an internal evaluation model and within this model we try to reflect sustainability, but this is just a best guess and it suits our purpose to show within the investment community that there is a differentiation between a sustainable and non-sustainable investment, but we also make it very clear that the amount we have is just a best guess based on our experience and it's not very reliable."

"The trouble is that to calculate that you need a sizeable benchmark and we don't have that. We are working with Kingston University and Euro Real Estate on a project called S-I-R-E to investigate values and linked values."

SUSTAINABILITY FACTORS AFFECTING VALUE

Respondents were asked to list (in order of importance) those sustainability factors that they felt would have the greatest impact on the value of a specific property.

MOST IMPORTANT SUSTAINABILITY FACTORS AFFECTING VALUE



Recognising that sustainability means different things to different people we asked respondents what specific factors will be the main drivers for value and are therefore the areas where capital expenditure will be focused.

Energy performance and utility consumption is, perhaps expectedly, seen as the primary driver for value. More surprisingly, green credentials such as the BREEAM and LEED rating of a building were not seen as strong drivers for value and neither was exposure to flood risk. The latter will no doubt change if the insurance industry were to start pricing this risk differently.

"We start looking at the environmental performance of the building and energy efficiency is the first factor. Then we look at water usage, then waste production and finally we look at property related travel. We are now starting to look at the 'well-being' factor of a building, but this is very hard to measure and quantify because it is very subjective."

"The obvious one is the costs of heating and energy consumption. Other factors such as waste, flooding, environmental pollution, transport etc all link back. They are the major factors."

EVALUATION OF ACQUISITIONS IN TERMS OF SUSTAINABILITY

Eighty percent of respondents evaluate a potential new acquisition in terms of its sustainability and all but five claim to use a consistent methodology to evaluate an acquisition for its sustainability but there is a data challenge.

"We look at it as part of our valuation of an asset, it's not a science; it's more of an art. If there was more legislation or a little more corporate action in this regard then I think we would be a bit more scientific in our approach."

Other organisations have adopted a more rigorous approach:

"Yes, we do look at the efficiency and costs of running the buildings we acquire."

"We joined the Green Rating Alliance. An alliance of European real estate investors. We joined this alliance because they developed a method to assess sustainability performance, at least across Europe, in a very standardised way and a very effective way."

When asked how consistency of methodology might change in the future, improved data and tax efficiency are seen to be important factors.

"I think in time it will just evolve to a greater understanding as to why an occupier would take one building for £10 a foot and another building for £5 a foot. For example, at the moment we know the value of an air-conditioned building over one that has no air-conditioning."

"I don't think energy labelling for buildings has yet been established adequately in the UK and that is the way that it will evolve."

SETTING MINIMUM SUSTAINABILITY STANDARDS FOR PROPERTIES UNDER MANAGEMENT

The majority (70 per cent) do not set a minimum sustainability performance standard for the properties that they have under management. Just seven respondents indicate that they set, or sometimes set, minimum standards for certain properties.

"No. A number of assets in our portfolio have been acquired a number of years ago. As a result of which a number of them have quite poor EPC ratings and it may be that it's not cost effective for us to change those in the short term. Many of them are fully let. Where it is a managed building, there is no point in setting minimum criteria because one of our objectives is to improve the asset anyway. So if you are already at the bottom of the criteria, to move it up a level is moving it in the right direction."

"Not at this point in time, but it will come in the near future. The lessons we have learnt so far is that the data we have is not very robust. So we have to look first at assessing the current situation and then we can think about setting some thresholds or goals for the future."

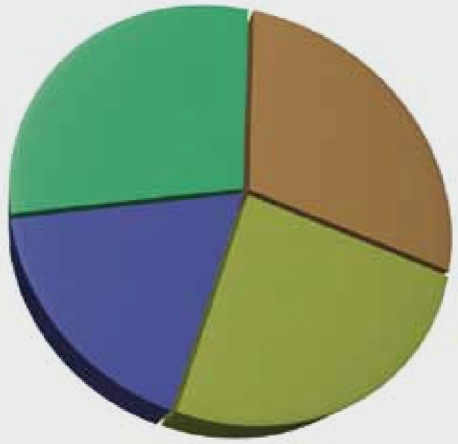
"We think EPC ratings are irrelevant, but we do set management standards at all of our properties. We have a sustainability brief in terms of what we require our managing agents to ensure they're undertaking in the building, but also we set targets around reducing consumption of energy, water and waste."

"Yes we have our own Key Performance Indicators that relate to electricity, gas and water consumption and carbon output, EPCs, DECs, flood risk and transport rating. We have a comprehensive policy."

QUANTIFYING THE SUSTAINABILITY RISK

More than half have not yet considered attempting to quantify the risk to the value of their portfolios from sustainability issues and only half expect to try to do this in the next one to three years.

THE PROPORTION OF INVESTORS ATTEMPTING TO QUANTIFY THE SUSTAINABILITY RISK



"Frankly there is not enough evidence around at the moment to be able to do that."

"We haven't for value because at the moment there is too difficult a link, there's no formula out there for putting value attached to certain sustainability principles. We have a researcher continually looking at the market place to see if there is any development in that. We subscribe to the IPD index, which isn't so far proving terribly useful, but it is a question of getting the data improved."

"Yes we have done this and have done it successfully. It is on-going and we are focusedon reducing operating costs and we think we'll see that going through to value on an on-going basis. We think it will improve as market factors and the economy improve."

"We haven't found a way to do it successfully. Until you get to the end of the time period during which you are investing, it is very difficult to say whether you have done it successfully or not. You can only tell when you exit the property."

SUSTAINABILITY UPGRADE EQUALS OPPORTUNITY

Over 90 per cent see an opportunity in creating value by upgrading non-sustainable space – using opportunistic or value-add funds. The availability of stock ripe for this type opportunistic investment, coupled with the state of the market, may determine whether early movers or late followers will benefit most.

"You hear investors saying 'we will only buy green buildings in the future' so as most of the green buildings we have in Europe have already been sold we see that as an opportunity. We will go for buildings where there is potential to harvest in terms of greening the building or making the building more efficient."

"We'll do anything to enhance value. We'll look at any angle. Sustainability is one of quite a long list of things to add value and sustainability is fairly low down on that list."

"Only if the property initially met our criteria. We wouldn't acquire a building that did not meet our criteria and then upgrade it – no way. There's no point in upgrading something if it's on a flood plain!"

POOR SUSTAINABILITY PERFORMANCE IS A FACTOR IN DISPOSAL

Two thirds would be likely to consider poor sustainability performance or credentials as a contributing factor in a decision to dispose of a specific investment property, though predominantly they look at sustainability within the context of a number of other more significant factors.

"If a building is unsustainable, in time it will become less occupiable[sic] or command a lower rent and that will get factored in to the forecast returns in the disposal decision."

"As part of a range of other factors, it wouldn't be the sole factor. One of the things that might make a building obsolete might be sustainability, though knocking down a building is not very green in itself."

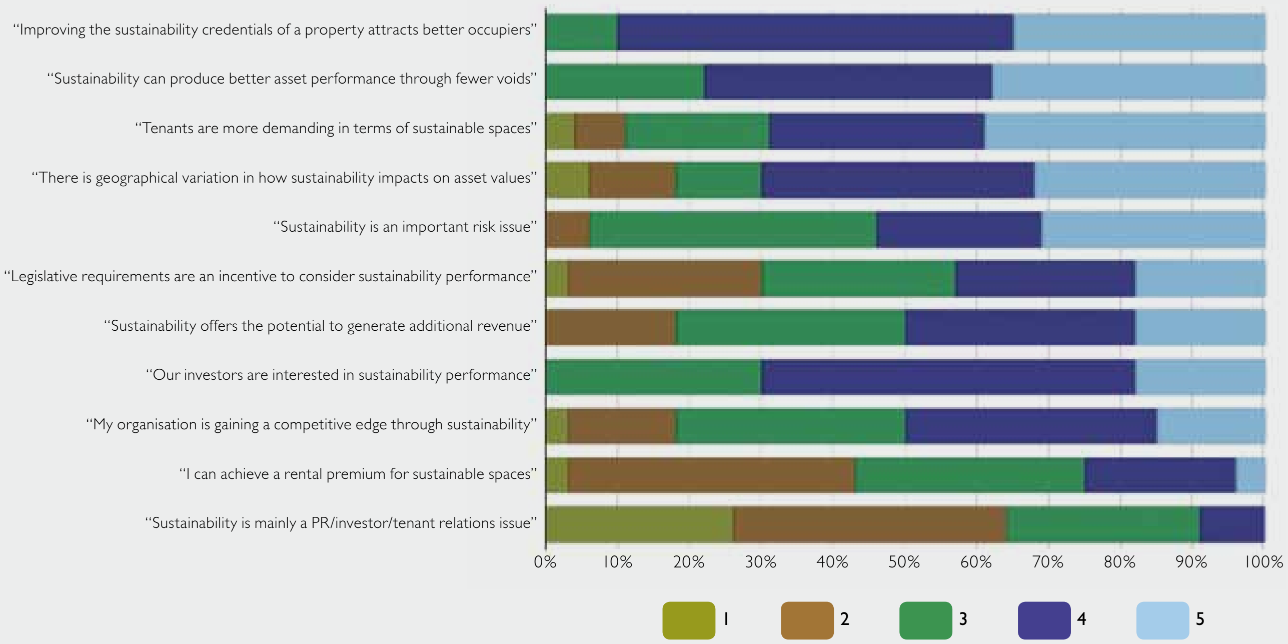
For the other third of the audience, sustainability is not a significant element of a decision to dispose of an asset.

"No, I think there would be bigger reasons for wanting to sell it. It is not the driver. I think once you have realised that it is the driver, you have lost the value anyway. As soon as you tell your valuer 'all of the windows in this building need replacing' then they'll drop the value."

ATTITUDES AND MOTIVATION FACTORS

Those interviewed commented that their investors are taking a much keener interest in the environmental and social responsibility of the investments that they make. It appears that they also see a direct connection with bottom line performance at the fund level through the ability to attract better occupiers, driving down voids and keeping abreast of changing occupier demands, rather than expecting higher rents or additional income.

INVESTORS RATED THE FOLLOWING STATEMENTS ON A SCALE OF 1 TO 5 WHERE 1 = STRONGLY DISAGREE AND 5 = STRONGLY AGREE.



80 per cent of the respondents agreed that improving the sustainability credentials of a property (by, for example achieving a BREEAM or LEED rating or improving an existing rating) could be used to attract better occupiers.

We asked whether they believed that there is a geographical variation in how sustainability impacts on asset values. Most believed there is.

Some referred to the variation within the UK.
"There is a difference in the UK, particularly in the regions where there is higher public sector occupancy."

Some investors commented on geographical variation across Europe.
"Across Europe, the Nordic countries are more up to speed on things, when it comes to energy in particular, while countries as you go south are a year or so behind the north."

"It may be that Eastern/Central European developments catch up with Western Europe in time, but at the moment they are at least five years behind the UK."

More than half of the respondents agreed that sustainability is an important risk issue to their investment portfolio and 75 per cent agree that using sustainability measures to reduce property service charges is likely to translate into better asset performance through fewer voids.

Opinion is clearly divided on whether legislation is a major incentive for considering the sustainability credentials / performance of our respondents' investment properties. For those with property in the UK, the major piece of legislation is the Carbon Reduction Commitment Energy Efficiency Scheme which, because of the government's u-turn on the cap and trade element of the scheme, investors now believe will lose its impact.

"It should be four but I give it two, it gets washed aside by much bigger issues. If an investor wants to buy a building in the West End they will take the first one they can get their hands on and they'll worry about CRC later, or they'll let the managing agent deal with it. The legislation is a mess at the moment because it is being reviewed and it is like a moving target. People don't fully understand what the impact will be. It's about £12 per ton at the moment, but what happens if it goes up to £50 per ton?"

"We have spent £20,000 on trying to understand how it [CRC] works. We're not trying to avoid paying it, but it is an utter, utter shambles. It is fine that it is a tax, just tax us for using energy and we will use less, but the league table aspect is so poorly conceived that if you have a building made out of moon rock and you're not using any energy ever you won't be able to improve it, so you'll sit at the bottom of the league table and people won't understand that it is about relative performance… My hope is that it is totally scrapped or just applied as a taxation. We should all use less energy, but for reasons of common sense rather than statutory bullying."

Investors are split in their view of the potential to generate additional revenue through sustainability (e.g. renewable energy generation).
"I think yes, but it has to be offset against the capital cost of doing it. There are certain situations that you can influence more than others e.g. sticking something on the roof to trap power over the next 25 years, if you are in a serviced building, if that is a large cost you won't be able to get away with it because somebody will complain about the huge service cost in one year, but if it were a relatively small cost in a large building, you could probably justify doing it and get a commercial return on doing it."

71 per cent of respondents said their investors are becoming more interested in the sustainability performance of the properties that they invest in.
"This is a topic that is getting a lot of attention now and is starting to be put into proposals and management agreements."

Over half believe they are gaining competitive edge through their sustainability credentials.
"We are selling investment products to funds who invest in all sorts of things, equities, gilts and some property and often their criterion is 'how can we improve our sustainability position?' The fact that we can provide quite a lot of service in that area means that they will look at our product as opposed to another investors' product."

20 per cent disagreed:
"I can't see any tangible evidence of it either from our perspective or the market's perspective. There are companies who are doing it better than we are, but it's not translating into better performance. It might be translating into better property management, but we can't see that."

"Every customer has their own CSR agenda, which is published, but what we actually see is disconnect between board level and the property guys. At the property level customers want as much as you can possibly give them in terms of sustainable features, but they're not prepared to pay one cent more for them."

An overwhelming majority say they do not achieve a rental premium for more sustainable spaces.
"I don't think the occupier market is factoring it in yet."

"I'm not sure whether you achieve a premium or just avoid the brown discount."

Most investors said they do not regard sustainability as mainly a PR/tenant/investor relations issue.
"It's mainly driven by our investors, it's not really the [tenants] it's the investors. Clients want us to get the best returns possible. Whereas the 'fund of fund managers', if you like, are interrogating us because they have to tick a box somewhere. They have employed people to interrogate other managers about their sustainability. They are driving it more than the tenants are."

SUSTAINABILITY BRINGS FORTH WIDE RANGING VIEWS FROM THE INVESTMENT COMMUNITY

Respondents concluded with a range of views on sustainability as a strategic issue, its importance to their organisation and its likely impact on the investment sector.

"Sustainability is being taken very seriously at fund and investment level. It's very hard to find concrete figures to show the benefits of investing in sustainability. We see the interest in sustainability accelerating rapidly in the next one to three years. As an industry, we are all moving from the talking stage to the walking stage really. Short term interest is going to translate into medium term action. The interest is also translating into benchmark studies and research reports. This is a topic that everyone is now trying to implement. It is only going to be of great interest as we go forward."

"Whilst I agree that investors are increasingly asking for increased sustainability credentials, there is a varying degree of knowledge from the investor community of what sustainability actually is… There is massive difference between what they regard as sustainability. For some it's a BREEAM or an EPC rating, others go into a lot more detail around human rights and labour rights, it's a lot more to them than just energy. Short-termism is a big problem with most companies, so you end up with this problem where you know it's the right thing to do but it's a long term vision so therefore you've got to take some long term decisions which are not always easy to make. One of the big problems we have is definition."

"This is being driven by occupiers; it's not being driven by owners and investors. Occupiers are saying we want, and owners and investors are responding to it accordingly. If occupiers and users were not saying that, then as usual investors and owners would not bother to put the extra time, effort and capital into doing something when there wasn't an obvious return. It is an occupier driven thing. So all the education and information should really be aimed at the occupier. So if someone wants to make this bigger, faster, stronger, better they should target the occupiers."

"I think at the moment the enthusiasm for renewables seems to have worn off and people seem to be looking more realistically at whole building performance, that's why I believe it will come back to energy in the end. It will be about taxation, reputational position in the ranking. As the overhead becomes greater because the taxation will become greater on energy, that's what will drive it through. There's quite a lot of talk about flood as well which is going to potentially blight some areas and make that a more difficult aspect of it all."

"The other area from a risk standpoint is flooding. You may well take assessments of whether you would buy buildings based on its flood risk profile, but otherwise the consideration for sustainability is really more around energy efficiency, how the landlord performs and the systems that are in place. The ability to demonstrate that less energy is consumed in providing services for a building, I think will become more material."

THE FUTURE?

Although conclusive evidence of a value differential between sustainable and non-sustainable space remains elusive in the UK and continental Europe, investment fund managers see sustainability as a bottom line issue that warrants significant investment of time and resources.

The majority are now applying sustainability policies at the fund level, and some are implementing specific measures to reflect sustainability in financial decision making, including applying adjustment factors when calculating yields or income growth potential. The two dominant drivers for these actions are the need to attract funding from investors that now seek evidence of sustainability performance, and the need to attract better occupiers and reduce voids within portfolios.

We find ourselves at the tipping point for sustainability within the investment market and expect to see an increase in the body of evidence for a value differential between sustainable and non-sustainable buildings. Concurrently we are also seeing real progress in creating industry-wide metrics for measuring sustainability performance across building types and geographies, however the challenge of finding a single, agreed methodology perpetuates in a market where new initiatives often compete rather than unite.

TECHNICAL SPECIFICATION

Thirty managing directors, fund directors and fund managers were interviewed by telephone during February and March 2011 and were asked to give their opinions regarding sustainability. The interviews were carried out independently for Cushman & Wakefield by Remark.

For further information contact:

Andries van der Walt
UK Head of Sustainability
andries.vanderwalt@eur.cushwake.com
Tel: +44 20 7152 5269

Natalie Bennett
natalie.bennett@eur.cushwake.com
Tel: +44 20 7152 5589

MIX
Paper from responsible sources
FSC® C000000
www.fsc.org

Printed by an ISO14001 and FSC certified printer using FSC mixed paper and vegetable inks.

CUSHMAN & WAKEFIELD®
Global Real Estate Solutions