

VALUING NET-ZERO



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With more tenants focusing on environmental targets, the burden to reduce direct emissions places increased pressure on investors, who are at a pivotal moment in ESG strategy.

Sustainability has become a mainstream issue within the commercial real estate sector and will become even more fundamental in the process of delivering office space as it moves up the occupier agenda. Globally, what are the trends in valuing net-zero and ESG strategies for the office sector?

With more tenants focusing on environmental targets, the burden to reduce direct emissions will intensify, placing increased pressure on real estate investors, who are now at a pivotal moment in defining their sustainable investment strategies.

The International Energy Agency's 2019 World Energy Statistics and Balances report shows that the built environment contributes 40% of carbon emissions worldwide. Evolving development legislation urging better sustainability and building practices for new and existing assets coupled with the rapid expansion of ESG criteria for commercial real estate investment will likely significantly impact the value of assets moving forward.

By 2030, many global corporations and ambitious governments aim to achieve their net-zero position. As for the commercial real estate sector, the vision is for all buildings (both new and existing) to be net-zero by 2050.

Investors will need to understand if a building can achieve a net-zero status, how to balance their portfolio, what the costs are to achieve this ambitious goal, and what impact it will have on their valuations. As occupational trends evolve and the future of work transforms, investors will also need to understand if their buildings are able to adapt to meet market demand.

According to a recent JLL survey of investors, sustainability and climate change are deemed to have the greatest impact on real estate performance, with two thirds stating that they would be increasing their allocations to more sustainable properties.¹

HOW TO VALUE SUSTAINABLE STRATEGIES

Valuers adopting Discounted Cash Flow (DCF) methodology can adapt assumptions that relate to income, exit yields, capital expenditures, voids, financing, and discount rates for all building types. Cash flows, which reflect the net income over the hold period, can illustrate how investment in sustainable buildings makes sense both ethically and financially.

INCOME

Rental income will be influenced by a limited supply of appropriately specified buildings and increased demand from tenants with ESG requirements. JLL research indicates that there is already an impact on several office markets, where the most sustainable specifications are resulting in premium rents, or discounts to prime rents are occurring where sustainability credentials are not in line with market expectations. The most significant risks to value exist where older buildings will soon not match up to changing occupier or legislative requirements, resulting in increased obsolescence. Therefore, when using forecasts that principally follow prime rents, there will be under-performing buildings, which will not track forecasted rental growth.

Based on JLL's research in Central London,² there is already a rental premium for BREEAM, a world-renowned sustainability rating scheme to assist the real estate industry to deliver sustainable buildings where the Outstanding- or Excellent-rated buildings tend to perform better than non-rated buildings. In fact, generally all buildings with a BREEAM rating of Very Good or higher achieve higher rents than those Grade-A buildings without a rating. The research shows that over the past three years, the average premium of all rated buildings above non-rated buildings is around eight percent. Similar rental premiums are also coming through internationally from the US and India (for LEED certified buildings) and Australia (for highly rated NABERS and Green Star buildings).

EXHIBIT 1: CENTRAL LONDON BREEAM RATED NEW GRADE A TRANSACTIONS RENTAL PREMIUM COMPARED TO ALL NEW GRADE A ACHIEVED RENTS

Source: JLL

	2011–2013	2014–2016	2017–2019
OUTSTANDING/EXCELLENT (441)	9%	11%	10%
VERY GOOD (303)	9%	5%	6%

It is worth noting that BREEAM and other green ratings are not the sole factor for low vacancy or increased rents. Tenants consider a wide range of factors when seeking new office space, including location, access to transportation, amenities, costs, and floorplates.

CAPITAL EXPENDITURE

When considering refurbishing or retrofitting older buildings, it may be financially advantageous and carbon efficient to upgrade existing buildings, both in terms of specification and plant and machinery, to create a more efficient building.

Investors also need to consider the potential risk of future taxation penalizing excessive carbon emissions or operational inefficiency within a building. In terms of cash flow, the question is whether to commit additional costs at the start of a retrofit project, or to take advantage of the short-term dearth of supply, or lower upfront costs with the anticipation of further significant refurbishments costs within the next ten years, to stay in line with legislation and market demand.

Estimates for additional capital expenditure vary and are dependent upon building type, design, and efficiency. Delivering a more sustainable building will, in most cases, cost more to build than a less sustainable office. However, if this results in higher demand from occupiers, higher rents, lower void rates, and savings in operational expenditures, then the enhanced sustainability of the building should mitigate the initial higher capital investment.

While variations in costs over time and the pace of legislative change are somewhat unknown, delaying action will mean losing out on the short-term supply-and-demand dynamics of the current market.

The enhanced sustainability of the building should mitigate the initial higher capital investment.

VOIDS

At the end of leases, tenants either renew or the space is remarketed. According to JLL research, well-specified spaces fitted out to meet both sustainable and wellness criteria lease up quicker than standard offices.

FINANCE

Geared returns can enhance performance through using debt to either acquire or fund the retrofit of a building. An increasing number of green loans are also being made available, which results in lower finance costs where sustainability-related key performance indicators (KPIs) are achieved, resulting in a lower cost of debt and enhanced returns.

DISCOUNT RATE

The discount rate applied to the cash flow reflects the risks associated with the achievement of a business plan in relation to the building over the hold period. Less sustainable buildings will inherently have a higher discount rate, as well as potential increased capital expenditure over time, taxation, longer voids, lower rents, and higher exit yields.

The associated risks will result in a higher pricing discount. By contrast, more sustainable buildings will prove less risky and bring lower discount rates.

EXIT YIELD

The exit yield adopted in a DCF reflects the quality of the building and the estimated average weighted unexpired term remaining on the lease at the time of the exit, which relates to a hold period normally reflected in the business plan or a standard assumption of either five or ten years. It also reflects the market’s assessment of the long-term net income growth.

If a building does not track the leading market standards, then the exit yield will be higher, resulting in a lower value at the end of the hold period.

LOOKING FORWARD

As more tenants commit to environmental targets, the pressure to engage with the supply chain and reduce direct emissions will intensify, leading to increased pressure on real estate owners. This urgency to build what tenants are increasingly demanding will only accelerate.

Investor- and tenant-driven ESG requirements are expected to increase in all types of buildings, both new and refurbished. Supply and demand imbalances will potentially result in green premiums in the short-term for well-specified buildings, or brown discounts due to increased obsolescence. These fluctuations in supply, demand, cost, and legislation will occur over the next one to two hold periods for investors.

To achieve the best sustainability credentials and net-zero carbon specifications, costs are generally higher than for a standard refurbishment. However, given the speed at which legislation and ESG requirements are advancing, it is projected that within the next ten years, further capital expenditure will be required if net-zero compliance decisions are not made now.

Despite the increase in capital expenditure, the associated rental premiums, reduction in yield, and lower interest expenses should result in a more positive cash flow and an overall increase in returns for greener buildings.

As technology and construction techniques evolve, and as more sustainable buildings become less expensive to deliver, there may be a reduction in capital costs as new construction methods are adopted. Conversely, it is also likely that the costs of maintaining a less sustainable building will rise as fossil fuel prices increase, carbon taxes are introduced, and fines are levied for those not keeping up with legislative requirements.

Further, costs may be mitigated through the principle of the *circular economy*, with much more focus on recycling materials. Demolition costs may be significantly reduced as materials are resold for further use. In addition, building design will result in more flexible buildings so that these assets can be refurbished more economically and adapted to alternative uses.

THE CIRCULAR ECONOMY

“Put simply, the circular economy is an economy where we create more value with fewer resources. A circular economy is based on three principles, as stated by Ellen MacArthur Foundation, the global leader in circular thinking:

- Design out waste and pollution
- Keep products and materials in use
- Regenerate natural systems

As opposed to a linear economy where we extract materials, use them, then dump them, the circular economy seeks to “close the loop” by reusing, repurposing, remanufacturing, or recycling materials.

For instance, it might mean designing a building so it can be easily adapted to different uses, constructing a building in a way that it can be dismantled without damaging the materials, or fitting out a property using repurposed or recycled furniture. It also means maximising the current value of assets by using them to their full capacity, for example, by using empty office space for events outside of business hours.”

Emerging trends indicate that there may also be short-term premiums for net-zero buildings. While the low-carbon premium in rents and capital values may dissipate over time, buildings that have not had meaningful upgrades towards net-zero carbon will experience increased obsolescence.

As sustainability performance becomes clearer and more defined, it is likely that premiums will disappear. Buildings that don’t comply will underperform. Buildings that are not designed to be net-zero carbon will require costly retrofits in the future, which will likely result in the displacement of tenants and lost rent.

ABOUT THE AUTHORS

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NOTES

¹ JLL, “Decarbonizing the Built Environment,” June 20, 2021, <https://www.jll.co.uk/en/trends-and-insights/research/global/responsible-real-estate>.

² JLL, “The Impact of Sustainability on Value,” May 28, 2020, <https://www.jll.co.uk/en/trends-and-insights/research/the-impact-of-sustainability-on-value>.