Sustainable Commercial Property

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KEY CONCLUSIONS

• Sustainability, particularly environmental sustainability, is increasingly being used as a marker for ‘prime property’.
• This is driven by the concerns of institutional investors and ‘blue-chip’ occupiers and developers
• Benchmarks such as EPCs, BREEAM and GRESB are playing a key role in defining ‘sustainability’ in these contexts.
• However, outside the prime property sector, there is limited interest in environmental sustainability.
• Here tenants and landlords are budget constrained and operate with shorter timescales. They often fail to see the economic case for sustainability investments, as in energy efficiency.
• EPCs are seen primarily as a box-ticking exercise in the non-prime sector with consequences for the potential implementation of Minimum Energy Performance Standards under the Energy Act 2011.

Introduction

This briefing summarises and contrasts the different approaches to sustainability in commercial property between ‘prime’ and ‘non-prime’ properties, examining in particular issues around risk, refurbishment, labelling, leases, Minimum Energy Performance standards, and valuation.

Definitions

Prime property is here understood to comprise A-Grade buildings, built to the highest specification and of interest to institutional investors; **commercial property** is taken to encompass the office and retail sectors. It is estimated that such prime commercial property accounts for about one-third of the sector; the remaining majority of commercial property is typically older and/or smaller.

Key findings

Approaches to sustainability in property sectors

‘Sustainable’ is increasingly being used as a key descriptor for ‘prime’ property. However, the term has little meaning for the sub-prime sector beyond a concern with the longevity of the business and hence beneficial occupation of the premises.

Sustainability and risk in property

Sustainability is of interest to institutional investors because of their desire to reduce risk. A more sustainable property is seen as less likely to experience tenancy voids and obsolescence or require unplanned upgrading.

In the non-prime sector, a high return is sought and higher risks accepted. This acceptance of risk means that pursuing sustainability is less attractive. Voids are reduced through rent-free periods, service charge caps and other negotiated terms.

Sustainability and property refurbishment

Sustainability measures are being incorporated into planned refurbishment of prime properties in order to future-proof them against anticipated regulation and shifts in market demand. This fits with the timescale adopted by such property owners, which can extend to 25 years.

However, investment in measures that might enhance the sustainability of premises is constrained by budgets in the non-prime sector. Energy and other utility costs (which might be reduced by such investments) are not a high priority in budgetary decisions. In addition, the timescale for required payback periods in this sector is a matter of a few years at most.

The perception that a more sustainable building may enhance occupier well-being and productivity – and therefore potentially influence staff recruitment and retention – only has relevance at the prime end of the market.

Sustainability labelling for property

EPCs (Energy Performance Certificates) and BREEAM (Building Research Establishment Environmental Assessment Methodology) have become widely accepted as the main benchmarks for labelling a sustainable property. Both are backed by regulation, either energy efficiency or planning regulation. In addition, institutional investors are readily able to incorporate such labels into their Corporate Social Responsibility reporting.

GRESB (Global Real Estate Sustainability Benchmark) is becoming more widely accepted as a benchmark for investment portfolios. SKA (an environmental assessment method, benchmark and standard for retrofitting) has some limited traction with regard to refurbishment and fitting-out but not at the tertiary end of the market. It may be used as an alternative to BREEAM for some refurbishments.

However, outside the prime property sector, EPCs are largely regarded as a 'box-ticking' exercise. Many tenants, purchasers and some agents do not look at them, much less consider acting on any recommendations they contain. Some agents do advise that a low rating implies higher running costs.

Leases

Landlord-tenant relations are a significant influence but these vary between prime and non-prime sectors. In the prime sector, 15-20 year leases on FRI terms with 5 year RRs are standard, occasionally extending to 25 years, and green leases are increasingly being adopted to overcome the split incentive between landlord and tenant concerning energy efficiency measures.

In the non-prime sector, leases can be 10 years or less, with more frequent RRs and break clauses. There is also a market in lease assignments in the non-prime sector. Green leases do not typically feature here.

BACKGROUND

This note reports on research undertaken by Professor Yvonne Rydin in early 2014 into the commercial property market and sustainability. While this was intended as a pilot project, the results were remarkably consistent across interviewees, suggesting robust

METHODS

The research comprised a comprehensive literature and web-based search together with a series of 17 interviews with property market professionals. The literature review and web-based materials had revealed that attention to sustainability was concentrated in documents addressed to the prime property sector, so a concerted effort was made to interview professionals engaged with all types of commercial property; about half of the interviewees dealt mainly with prime property and the rest with non-prime.

Minimum Energy Performance Standards

The Energy Act 2011 introduced Minimum Energy Performance Standards (MEPS). The potential implications of this are already being taken on board by institutional investors, other fund managers and some large property companies adjusting their DCF (discounted cash flow) financial appraisals of prime property to incorporate measures necessary to comply with MEPS.

In the non-prime sector, there is limited awareness of and little interest in MEPS. A 'wait and see' attitude dominates. In addition, there is some considerable scepticism that MEPS will be vigorously enforced.

Valuation of property

In the prime sector, some instances of 'price-chipping' for properties that might be at risk of not complying with MEPS is being reported. However, in general, it is regarded that sustainability features have already been incorporated in the valuations of prime properties and that no further adjustments of yield are required.

In the non-prime sector, sustainability features play no reported part in determining the value of a commercial property.

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