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JONES LANG LASALLE®

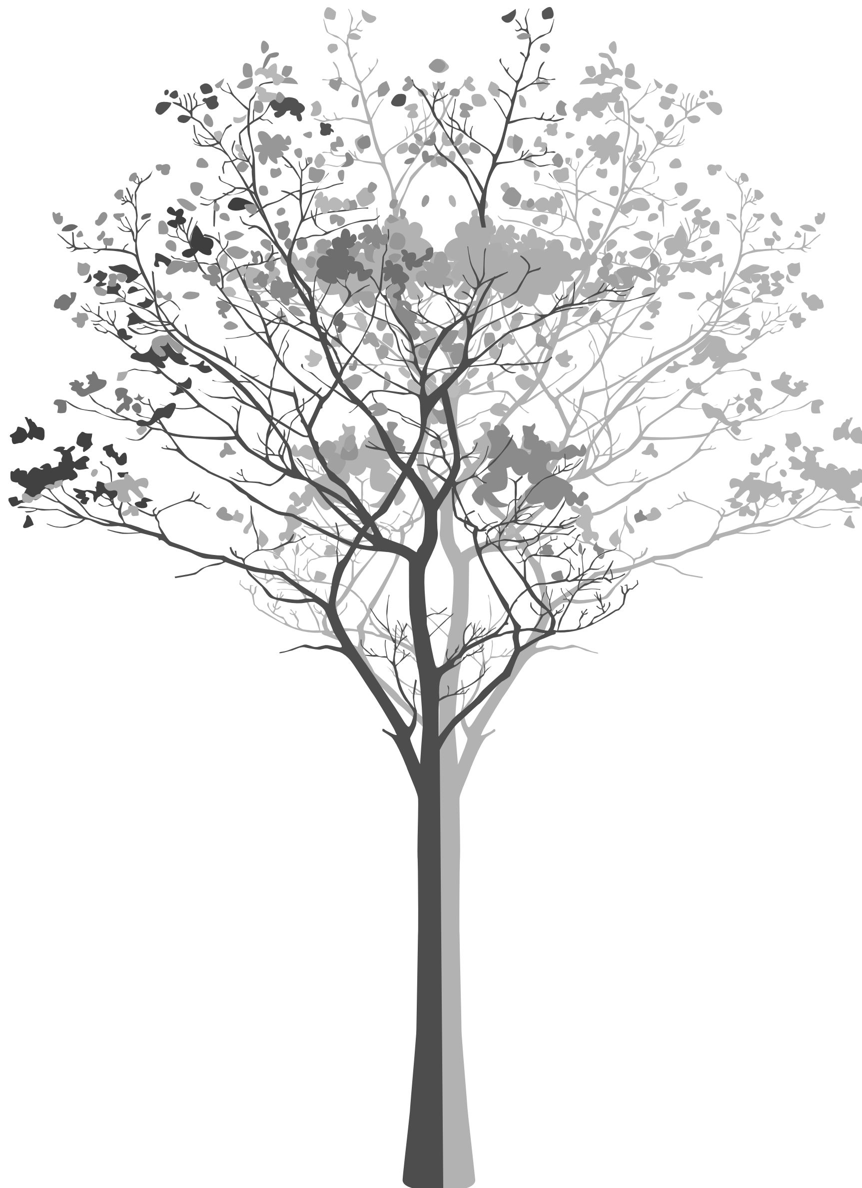
Real value in a changing world

Sustaining Value, May 2008

Sustainability is a new dimension to property risk and therefore price and performance

Occupiers beginning to factor into procurement policies matters of sustainability

Increased rate of obsolescence is threat to property performance and value

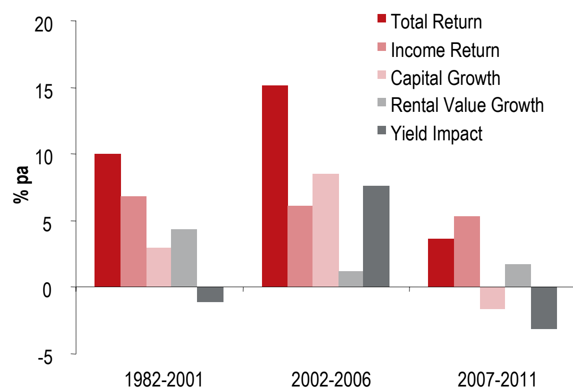


Sustaining Value

At a time of market correction when falling yields will no longer deliver performance, it is worthwhile considering how investment value is to be sustained. Jones Lang LaSalle's recent acquisition of Upstream, the UK's leading sustainability consultancy in the property sector, provides a fresh opportunity to do this. In their work, the true meaning of sustainability is taken to mean not only social and environmental sustainability but also economic sustainability. Additionally, sustainability as a whole, and climate change in particular, are now increasingly recognised as adding a new dimension to risk and therefore to both price and performance.

In seeking to understand how it is that the value of commercial property can be sustained over time, the first factor to explore is the relationship between income and yields as drivers of performance. As the following diagram shows, if we look at the IPD data for All Property, from 1981 to end-2001 we can see that the impact of the movement of yields over this period of twenty years was neutral to negative. Total returns were driven by income and rental growth. By contrast, and not surprisingly, in the period end-2001 to end-2006 performance was driven by a significant compression of yields.

Investment Performance 1982 - 2011



Source: Jones Lang LaSalle

However, as the diagram also shows, now that a correction in yields is underway, Jones Lang LaSalle's forecasts to end-2011 suggest that once more, and to a marked degree, we will return to a period in which performance will be driven by income.

This being so, the sustenance of investment value requires that we now turn our attention to the vagaries of income to see if we can discern what it is that will differentiate good from poor performance, as performance will no longer be delivered by the general "gift" of falling yields.

Traditionally, the variables that have been taken into account in assessing the likely income performance of different property types include factors such as voids and changes in rental value. In a recent Jones Lang LaSalle paper, *The Search for Value – Where Next for UK Yields,* attention was drawn to the historic ten-year differences in income performance by property type. This analysis suggested that whilst all property types had shown real income growth over the period, it was retail that had shown the best performance, followed by offices and then industrial, which, as it happens, had not kept place with inflation.

The traditional differentiators of income performance focus upon matters such as void rates and rental growth. However, we suggest that there are some new factors that may differentiate future income performance. Indeed, it can be argued that the property sector is now likely to suffer not simply a market correction but a structural shift – a move from an old to a new economy. The Old Economy and therefore the Old Market – the economy and the market with which we are familiar – was founded on three factors:

1. Cheap energy
2. High levels of mobility
3. The apparent isolation of markets from the society and environment upon which they actually depended.

By contrast, the New Economy and therefore the New Market could well be characterised by:

1. Costly and insecure energy
2. Costly and constrained mobility
3. Economies and markets that have to be evaluated within a social and environmental context.

The consequence of this shift is that there will be new factors that impact on income performance. Indeed, a fundamental shift of balance in the economy towards the shortage of, and hence the rising cost of, natural resources may mean that the drivers of performance will have to be entirely reconsidered. It is even possible that the Holy Grail of "unending growth" will come into question, and that – at least in the West – we will have to get use to a much more stable economy where change takes place within the confines of real resource limitation. If this were to happen the matter of income would become even more important.

If, therefore, in seeking to understand the link between sustainability and value, we focus upon income, there would appear to be three possible areas for investigation and evaluation: building fabric/location, the costs/quality of management and occupier demand. Underneath each of these are a number of factors that need to be considered. They include those that are simply regulatory or physical as well as those that are more complex and are of a socio-economic nature.

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Building fabric/location

The factors encompassed by building fabric/location include the following:

- The age and construction profile of the building and the extent to which it allows for a restricted or flexible usage.
- The extent to which the building is vulnerable to the most pressing aspects of climate, such as heavy rain and consequent flooding.
- The strength or weakness of demand for the building and the extent of competing supply, including shifting occupier requirements.

Costs/quality of management

Management costs and the quality of the management regime determine the difference between gross and net income and encompass the following factors and issues:

- Increased costs of oil, gas and other natural resources accentuated by the possibility of a rising demand for energy during hotter summers.
- Increased costs of dealing with waste, due to rising costs of sending waste to landfill and the increasing need to manage waste to reduce the amounts sent to landfill.
- The consequences of complying with the EU Energy Directive as owners seek to upgrade their energy performance.
- Increased insurance costs in respect of flood risk.
- Higher and more frequent maintenance costs resulting from increased weathering and storm damage.

Occupier demand

The strength and character of occupier demand affects income performance in its impact upon rental growth and income security, voids and the time taken for lease renewals. It is therefore necessary to understand how occupier preferences may be changing. Experience suggests that occupiers are already beginning to factor into their procurement policies matters of sustainability, in part to manage the costs of occupation, in part to meet the requirements of their staff and in part to demonstrate their corporate commitment to sustainability and corporate responsibility.

Recent global survey work undertaken by Jones Lang LaSalle and Corenet sought to understand the sentiment of occupiers towards sustainable buildings and, with 61% now viewing sustainability as a critical issue, the overall results indicated a high level of both awareness of and willingness to occupy responsibly. As stated above, the survey bore out that it is energy costs and management, Corporate Social Responsibility and employee/brand management that were amongst the most important drivers.

Occupiers are also accepting that it may cost more to develop sustainable buildings, with only 20% expecting development to be comparable to non-sustainable buildings. Indeed, although we are yet to witness it within the market, 65% of respondents were willing to pay more for a sustainable solution and one of their key barriers is lack of supply.

From an occupational perspective, if overall property procurement, waste/water/energy management and supplier management schemes are to be effective a real need exists for management teams to be both aware of, and in a position to procure from, suitable sources and innovative technology as appropriate. This will include working closely with investors and developers throughout the life-cycle of the building, reducing consumption levels and being aware of regulatory carrots as well as sticks.

To tackle and evaluate these possible market changes and the risks associated with them, we have been working over the last two years with a syndicate of institutional investors to add a new dimension of investment analysis that they have called The Third Dimension – adding to the two standard dimensions of investment value (risk and return) a third dimension represented by a “sustainability score”. Although the detailed findings of this analysis are confidential to the Upstream syndicate, it can be said that the analysis reveals the difference between likely short and medium term risks and returns, with the sustainability score adding a new dimension to the assessment of risk.

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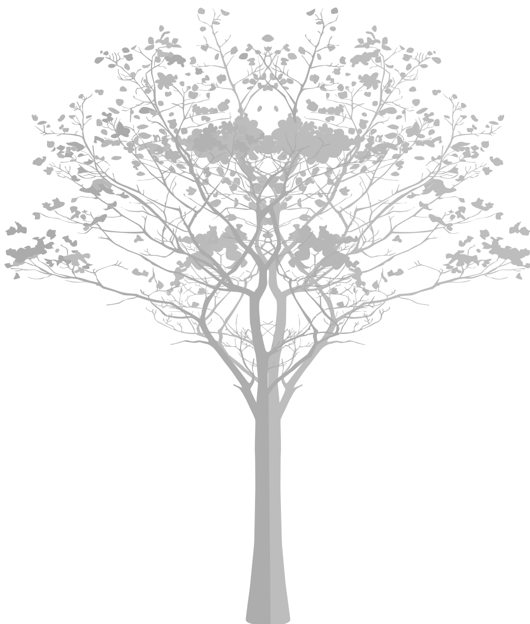
Impact on Value

Most important in this analysis is the creation of a significant Property Database of the relevant analysis. So far, the sustainability scores by property type have been arrived at by a "top down" set of informed but "given" relative scores – for example, by asking questions such as: is this property type typically likely to use average, above average or below average levels of energy per square metre or generate average, above average or below average levels of waste?

By using the new database, we are able to replace this "top down" approach with a "bottom up" approach based upon the examination and scoring of more than one thousand individual "live" properties. Not only will this new data strengthen the analysis of typical scores by property type, it will also enable fund managers to interrogate, understand and then manage the performance of individual buildings against identified risks. The analysis of future risks and returns will be strengthened and the future performance of individual buildings will be capable of more detailed analysis.



It is important to note that there is as yet little evidence for premium rents being applied to sustainable buildings in the UK. This is because market valuations are intended to replicate transactions in the marketplace and it has been difficult to prove that an occupier has paid a higher rent for a sustainable building. However, looking forward, if occupiers are committed to sustainability or to climate change proofing, this may be reflected in rents, especially if demand is greater than supply. In addition, it is more than likely that it will be the lettability of a building that will be affected. There is evidence already in Australia that there is a two tier market for rental values, reflecting the impact of the Australian Building Greenhouse Ratings (ABGR) which are applied to commercial properties. Australia has also seen the development of the Green Lease in which the landlord and tenant relationship fulfil mutual green and sustainable covenants and goals.

With regards to the investment market, and, until recently, in a time of intense investor activity, there has been no evidence of premium yields being paid for sustainable buildings. However, our Third Dimension work shows the commitment of a significant number of UK institutional investors and, in the future, the concern may well be the increased obsolescence brought about by a failure to meet the requirements associated with sustainable buildings, with increased costs and future voids if there is a lack of tenant demand. In addition, property investors, in particular institutional funds seeking to manage risk, may be encouraged to invest only in sustainable product and therefore the price of buildings that do not fulfil their criteria will be discounted.

As indicated, the pace of change in the UK property market that relates to sustainability has accelerated during the past 18 months. Going forward, it is difficult to suppose that this will not impact on markets and therefore on values. The real question is how and by how much. It is to this question that we are now turning our attention, working with both occupiers and investors and bringing to the task our long-established understanding of markets and our more recently acquired understanding of sustainability and climate change.

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