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Sustainable Investing

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KEYNOTE INTERVIEW

Prioritizing the green premium

Sustainability is growing in importance, but nothing trumps location, say BCLP's Andrew Auerbach and Kieran Saunders

A recent survey of real estate investors and corporate occupiers conducted by law firm BCLP revealed that 84 percent of US real estate investors see sustainability performance as crucial in making investment decisions, compared with just 68 percent of European investors.

Andrew Auerbach, regional leader covering the firm's real estate practice in the US, and Kieran Saunders, leader of the corporate real estate and funds team in Europe, each partners at the firm, discuss shifting investor views on sustainable real estate and the key factors driving investor decision-making.

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Q What will be the most important factors driving sustainable building investment in the near future?

Kieran Saunders: The principal one is the cost-benefit analysis. Clearly, investors are seeing that occupiers and potential future buyers are interested in sustainability, and that is only going to grow.

They are seeing a bit of a green premium in relation to both rents and sales prices, but they have to weigh that potential benefit against the actual cost of creating or retrofitting these sustainable buildings.

However, we can't think of sustainability in a vacuum. Location is still vital. It is not enough to assume that you will get high rents because a building has great sustainability credentials, because if that building is in the wrong location then you are never going to get the benefits of the green premium.

Andrew Auerbach: Companies don't want to necessarily pay more to be in a sustainable building, but they will choose the building that has better options from a sustainability standpoint over a building that doesn't, so the occupancy rate will increase. Coming out of covid, where office occupancy is down, that is very important from an owner and investor standpoint: to be able to occupy your building and fill the space.

Q To what extent are investors taking environmental standards into account?

AA: From what we are seeing in the US, it is one factor among many. They want to invest in green buildings in order to lower their carbon footprint, which is top of mind considering global warming. The results of our study show an average of 11 percent of investors believe their firm's current real estate investment portfolio is at risk of being unsaleable due to failure to meet certain sustainability criteria. This amounts to an average of $442 million of investments at risk per firm that participated in the study.

So, to that extent, it is definitely a conversation, and the data shows occupancy is higher in sustainable buildings. However, retrofitting a building to add sustainable features is usually more expensive than building a new sustainable building and therefore fund managers have to grapple with the costs and desire to meet sustainability standards while ensuring that their funds are providing the returns that they promised to investors.

KS: It is similar in Europe, where we see that environmental standards are definitely taken into consideration by both occupiers and investors, although always in conjunction with other factors. In relation to the particular standards here in Europe, we see investors requiring that certain criteria are met, a certain level of BREEAM rating, for example. For a development project, investors have a condition that it has to meet a certain level of standard at practical completion for us to be obliged to complete the acquisition.

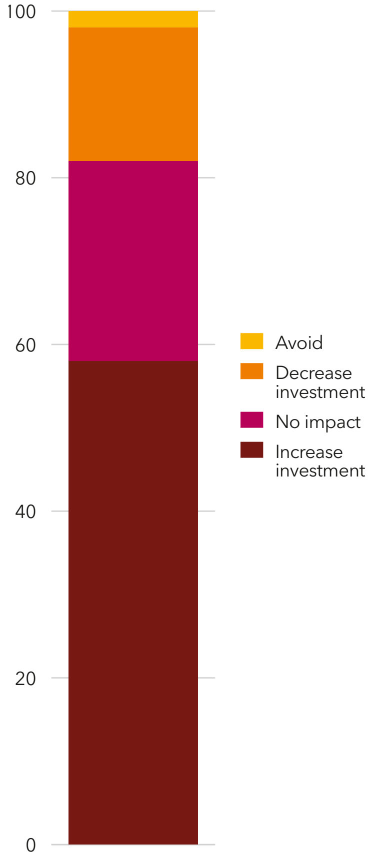
Key findings from BCLP's 'The Sustainability Imperative' research

Top barriers firms face to greater investment in sustainable buildings

1	High cost of inflation and market conditions
2	Lack of agreed sustainable building standards in target markets
3	Lack of global standardized regulation and policies
4	High upfront investment costs

71% Over seven in 10 investors expect a property with strong energy performance standards to have a higher resale value

Impact of governments imposing or increasing minimum energy performance standards for commercial buildings (%)



Source: BCLP

In relation to SFDR, funds are keen to demonstrate ESG credentials by being able to say that they are Article 8 or Article 9 compliant, whereas a few years ago people weren't so concerned. Investors are increasingly focused on ESG criteria and will search out these funds, albeit they are more focused on what the manager is doing in practice rather than simply the badges attached to the fund.

Q What factors are driving investor interest in new construction versus repurposed buildings?

AA: Buildings that are retrofitted are more expensive to convert, so a lot of investors are waiting to see what tax incentives will be put in place. All over the world, the housing shortage has impacted this, especially in big cities like New York, and you have a lot of new construction for apartments and housing.

With new construction it is more cost-effective to add in sustainability and get different benchmarks put out by LEED and others in the US.

Additionally, with the economy and slowdown in investments over the last year, we are seeing a lot of construction deals go forward with financing because they are not going to come online right away.

There is a lag of eight months to a year before the buildings come online, so a lot of lenders are willing to invest in those markets because the real estate outlook over the next year is positive.

That is a significant contrast with retrofitting, which takes three to four months. Lenders are more concerned with these types of loans because they come online faster and they want to wait and see how the economy turns and what that will mean for real estate.

KS: In Europe, as elsewhere, there is a lack of existing assets that are up to the requisite standards in terms of sustainability caused by a lack of development and low levels of new supply in the pipeline. Therefore, they either need to be retrofitted at great expense or they may suffer in the medium to long term, either for lack of rent or lack of occupation. Inversely, for new assets – and this is true whether we are talking about sustainable buildings or not – there is a lack of space and a lack of availability of space in prime locations.

Retrofitting is extremely difficult and expensive, but there is an element of necessity to it. There is only so much available space in the right locations for you to be able to build new buildings.

That brings retrofitting back into play, because otherwise buildings are not going to be rented out (or at least not at the target rental figures) if they do not meet the standards that occupiers require. London is a good example of that in Europe, with occupiers generally needing less space than was previously the case, but also being willing to pay a bit of a premium for that space to be in the right location with the right amenities and with the right sustainability credentials.

Q How has the lack of universal sustainable building standards affected decisions about investing in retrofits and in new construction?

AA: Not having a set standard is probably slowing down the process. Typically, there is a lot of real estate sustainability talked about in the UK or in the European markets. In the US, it is certainly top of mind and very important to companies and investors, but there is less conversation about it than there is on the other side of the Atlantic.

> *"Eleven percent of investors believe their firm's current real estate investment portfolio is at risk of being unsaleable due to failure to meet certain sustainability criteria"*
>
> **ANDREW AUERBACH**

KS: We work for several major private equity funds and firms that invest globally. If your standards are completely different in different jurisdictions, it just adds another hurdle into the investment decisions they have to make.

If we all had pretty consistent standards, everyone would know what they are talking about whenever they go into a new market or a new jurisdiction. Investors would be able to compare like-for-like and it would make it much easier in terms of your cost-benefit analysis.

Because the legislation and standards are evolving, some people are waiting to see what happens so they don't end up building something to a specific standard only to find out in three years it is out of date.

Here in Europe, one of the big problems is the lack of existing assets that have the right credentials and then the extremely large cost of actually retrofitting them to get them to the requisite level. There is a real eagerness to invest more in sustainable buildings, but the current costs are outweighing the near-term benefits. For a lot of people, it is a case of weighing the long term versus the short term.

Q How do clients weigh costs when making investment decisions on sustainable buildings?

AA: The benefits, like retaining tenants in their location and attracting new tenants to the location, all go into determining what the costs are and whether they are investing in a particular building.

KS: To a degree, people are holding off on retrofitting because that is a very large cost and we are not sure how the standards will evolve over the next few years. Added to the general market uncertainty there has been over the past 12-18 months (particularly in the office sector) with the impact of rising inflation, interest rates and capital expense costs increasing, any decision in respect of incurring significant discretionary costs in the short term has to be carefully weighed up against the longer-term benefits.

Some investors are pausing decisions on where to invest. If they do invest into something new, they are increasingly looking to sustainability so that they can be future-proofing their portfolio.

Certainly here in Europe, one of the big problems is the lack of existing assets that have the right credentials, and then the extremely large cost of actually retrofitting them to get them to the requisite level. There is a real eagerness to invest more in sustainable buildings, but the costs at the moment for some are outweighing the near-term benefits. For a lot of people, it is a case of weighing the long term versus the short term, with the costs at the moment being extremely significant. ■