Sustainable Value

A common approach to the commercial benefits of sustainability in UK CRE

AREF
The Association of Real Estate Funds

Contents

Executive Summary Page 1

Introduction Page 2

Establishing wider market certainty on sustainability in asset values Page 3

The role of the valuer in the context of sustainability Page 4

Different ways of determining sustainability Page 6

Climate risks outweigh other ESG risks for funds Page 8

Social Value and Impact Page 10

Capex costs relating to ESG risks Page 11

The effect on value from ESG related Capex Page 12

Green Leases help manage Capex risk Page 13

Recommended Sustainability Aspects in Valuations Page 14

Energy Performance Certificates Page 16

Green Building Certificates and Ratings Page 19

Localised physical risks Page 20

Conclusion Page 21

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Executive Summary

In the summer 2022, the AREF ESG and Impact Investing Committee established the Sustainability Valuations Working Group to consider common approaches to sustainability in commercial property. The aim was to draw together sustainability and ESG related features which may be considered in how value is established across the AREF membership of fund managers within the UK market.

While we may not reflect more ambitious sustainability objectives which address long term risks to value, we believe this approach will provide more consistency and clarity across the commercial property market today and provide the basis for further evolution in standard practices in the future. We agreed a baseline of standard accepted practices was important, and these are reflected in our recommendations.

In this report:

- We provide a framework for recognizing how sustainability oriented features may impact value, discuss the current state of the market against this framework, which then informs our recommendations.

- We consider some of today's most material factors, but establish that climate risk currently outweigh others in how we consider sustainability in asset values.

- A key focus is on how asset owners and valuers should adopt common approaches to capital expenditure (Capex) on sustainability matters, noting that sustainability related capex should be treated within rather than alongside other forms of asset investment.

- We consider specific sustainability aspects which should be considered as standard within asset valuations. These recommendations include:

    - Energy Performance Certificates, due to being established across the UK market and the basis of current and expected regulations in the UK and Europe.

    - Green Building Certificates such as BREEAM, Well or LEED, which help demonstrate the investment in sustainability features within an asset to assist market transactions.

- Localised physical risks, highlighting that flood risk is the most notable in the UK.

- That valuers should recognize the above in the comparable market evidence as well as the asset being valued.

The ways that sustainability and Environmental, Social and Governance (ESG) factors impact commercial property investment are evolving quickly. This is true of the practices of sustainability and the regulations which oversee it. This report reflects the market today with the expectation that these practices will evolve in the short term, which could supersede our recommendations. That said, we believe this report to be a practical baseline which should be used to establish more common practices, improve certainty and consistency in how we invest in buildings to align with the UK's transition to net zero.

Introduction

Following December 2021 publication of the RICS Guidance Note Sustainability and ESG in Valuations and Strategic Advice [1]. AREF have convened a working group to determine how the guidance should be implemented for fund managers within the UK market. This document is the output from the working group meetings held between September and December 2022.

The working group was assembled to support questions from the AREF Board, namely:

- What asset owners should be requesting of valuers;
- What data valuers should request of funds and assets and how that can be standardised;
- How fund managers should interpret information provided by valuers on ESG (environmental, social and governance) when assessing fund performance.

This document seeks to develop guidance to support a common set of fund engagement requirements covering key ESG/sustainability issues when undertaking routine valuations of commercial property. As such, this document has been developed as an initial "version 1", consolidating the current market practices, recognizing that the guidance and requirements will quickly evolve and valuer approaches will need to be adjusted to meet requirements of specialist sectors. This report maintains a focus on sustainability and ESG as it specifically relates to its impact on Market Value.

Establishing wider market certainty on sustainability in asset values

The UK Government recently published an independent review into the UK's net zero ambitions, conducted by Chris Skidmore MP [2], which analysed independent feedback from over 1800 sources from across the UK. The review concluded that net zero was the "economic opportunity of the 21st century" but highlighted the need for "clarity, certainty, consistency and continuity".

[1] Royal Institute of Chartered Surveyors (RICS), "Sustainability and ESG in Valuations and Strategic Advice, 3rd Edition", December 2021.
[2) Department for Business, Energy & Industrial Strategy, "Mission Zero: Independent Review of Net Zero – final report", January 13th, 2023.

This report has been developed with the ambition of establishing greater certainty and consistency across the UK commercial property market. Many of our members have ambitious, market leading sustainability programmes. Others across commercial property have not yet established extensive programmes for sustainability. Valuers must reflect fair market value across a market, reflecting the decisions of both or either party.

For that reason, the recommendations in this report may be more pragmatic than ambitious. This is deliberate, as we are seeking to provide consistency and certainty so that the market may move collectively forward in recognising standard practices in how sustainability may or may not reflect in asset valuations.

The role of the valuer in the context of sustainability

When valuers carry out valuations, they are independently assessing the value of an asset, or a collection of assets at a given point of time. To make this assessment, many factors are considered, including the location, asset quality, configuration and features, relative obsolescence, the tenant(s) covenant, lease, and so forth.

Historically, in common with other property features, sustainability and ESG risks associated with the asset have been reflected implicitly within the valuation. This has been done through the use of 'comparables' (comparing the given asset with other assets of a comparative quality and characteristics) to assess the value at a specific moment in time. A more explicit approach has been difficult to date, as the basis for comparison of sustainable features has not been standardized, and the market is not explicit about the value attributed to individual sustainability and ESG risks and attributes in any given transaction.

To understand the ways sustainability and ESG affect value, valuers need to understand the market for an asset in a given location, including the most likely buyer and what they would be seeking. Ultimately, value is determined through what constitutes the market, and how market players are transacting. So unless the valuer understands how green features have impacted

the purchase price in a given transaction, these may not be sufficiently recognized. This is specifically important when considering capital expenditure or 'Capex', and how evidence from market comparables with or without similar green features should be applied.

It must be stressed that the valuer's role is to reflect the market value at the point in time of the valuation. As we comment below, ESG and sustainability are concerned with long term risks. These risks may not be present or considered within transactions which reflect the market value at that time. As fund managers carry out their fund strategy they will likely consider long term ESG risks not currently reflected in the assessment of today's valuations.

The RICS Red Book and "Sustainability in Valuations Guidance Note"

The RICS states in VPGA 8 section 2.6 (c), Valuation of real property interests, valuers should have a working knowledge of the various ways that sustainability and ESG can impact value:

'While valuers should reflect markets, not lead them, they should be aware of sustainability features and the implications these could have on property values in the short, medium and longer term.'

The RICS has produced guidance in the form of the Guidance Note referenced above which supports RICS Red Book Global Standards VPGA 8 Section 2.6 (c) (vii)[3] on commentary on sustainability and ESG matters:

- Assess the extent to which the subject property currently meets sustainability and ESG criteria
- Provide a description of the sustainability-related property characteristics
- Opinion on the relationship between sustainability factors and the resultant valuation
- Opinion on the potential impact of these benefits and/or risks to relative property values over time.

These requirements and guidance have been formed for a global audience, and can be applied across markets. So valuers must interpret how these requirements apply to a local market.

3 The RICS consultation on a revised Red Book UK Supplement includes "UK VPGA 1.5 Reflecting ESG and climate-related matters in valuation and financial reporting" which is aligned with the points raised in this paper, and highlights the consolidation of ESG and sustainability reporting standards under the International Sustainability Standards Board (ISSB).

These factors should be recognised by valuers and reflected in valuations in accordance with the relevant market at the time of the valuation. However, the challenge remains, how to explicitly reflect the impacts of sustainability on value when these impacts have historically been implicit in purchase prices or not factored?

There is a lack of shared adopted standards for assessing sustainability and ESG criteria across the market. The terms ESG and sustainability cover a wide range of activities, which could include social impact, addressing climate change or managing the waste generated from an asset. The RICS Guidance Note also refers to ESG and sustainability related criteria, characteristics, factors and impacts, but as it is intended for a global audience, further UK market definition will support coherent approach to valuations.

Different ways of determining Sustainability

Sustainability and ESG are often used interchangeably within real estate investment. These are slightly different in approach.

ESG relates to the assessment and recognition of environmental, social and governance risks within an investment. These are “input” considerations into an investment.

Sustainability typically refers to practices which promote long term value, output impacts. The assessment of an ESG risk should result in a sustainability activity to manage the outcome.

This is important for valuations as we determine what the risks to value are or additional value generated from overperformance. We can identify a common set of risks to value, and a way of quantifying those risks in accordance with investor pricing, which may then result in impacts on asset value. Setting out common approaches to both ESG risk management and sustainability-focused practices should clarify how they interact with market value.

For this reason, our recommendations are the same across all assets; from prime urban office assets to secondary regional retail assets. This is to define risk and comparability which are predictable, verifiable and can be replicated. In time, this common approach may evolve to consider specific impacts to individual asset types as knowledge and understanding develops, according to the nature of investment in that asset type.

ESG and sustainability related attributes can be categorized into three parts which we comment on, below.

Performance Based

Performance based metrics show how the asset performs in practice, relative to market expectations. These are typically measured against asset benchmarks. Performance is challenging to measure as there must be standard metrics across the market to measure against. The metrics must be independently verifiable and a common basis across the market for recognizing overperformance must be in place.

A challenge with sustainability performance based metrics is the difference between the management of an asset and its physical attributes which are valued. It's possible for good management to out-perform or under perform against the quality of an asset. Underperforming assets may replace management, and improve sustainability performance without altering the quality of the asset and the basis of asset value. Furthermore, the way the sustainability performance of an asset is interpreted may vary across the market, unless regulations enforce a common approach.

The NABERS scheme for offices in Australia is an example of where this is thought to be successful[4] . The NABERS scheme provides a common approach and relatively level playing field across the Australian office market, which arguably has resulted in a stronger relationship with market value. The UK Government has indicated a desire to follow the NABERS approach in the consultation to changes to the Minimum Energy Efficiency Scheme.

Feature Based

Any feature based approach focuses on the attributes and amenities of the asset which enhance value. One example of these include voluntary green certifications (BREEAM or Well Standard), which should make it easier for the market to interpret several qualities and features of the asset. Features can enhance value when market requirements begin to desire these new features. Feature based value is typically driven by higher achievable net rents and liquidity, and results in a value premium.

Specific features (such as solar panels) may be present without a green certification. However, evidence suggests that without a certification, their impact on rent and yields has been slower for the market to reflect.

Regulations Based

The Regulation based approach recognises risks associated with compliance, including asset standards and building regulations. For ESG, fund disclosure regulations (such as the EU's Sustainable Finance Disclosure Regulations, SFDR [5]) may also impact how investors transact. By mandating a feature or performance requirement, the "feature" or "performance" required can become the basis of a regulations based approach.

The value impacts of regulations may not reflect real sustainability outcomes, but the risks in compliance with regulations. Compliance may have a sustainability focus, but as regulations are a blunt instrument there is a risk of split incentives or net negative outcomes.

4. See https://www.cbre.com.au/press-releases/one-million-square-metres-of-premium-or-a-grade-australian-office-space

Climate risks outweigh other ESG risks for funds

Within sustainability and the management of ESG risks, there are a wide range of topics. Some of these may have an impact on asset value, others may affect operations or occupation. Features which promote health and well-being likely have an impact on rental income in markets promoting the return to work post-COVID19, or social value and community engagement may play an important role in placemaking. However, the management of climate risks is the focus of this report as:

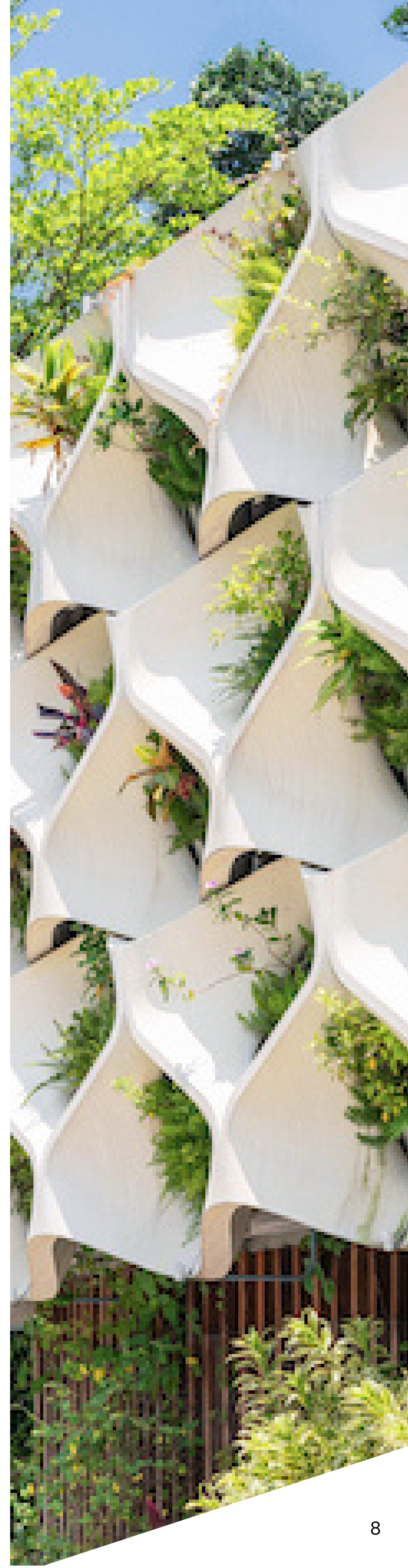
- **This topic contains the more immediate threat to asset value;**
- **There are several performance, feature and regulation based value considerations that can be used to understand how sustainability and ESG risks affect asset values.**

This report will use the environmental risks associated with climate and energy efficiency as its focus, but AREF recognise these are only a part of how ESG and sustainability may impact asset values.

TCFD: Connecting physical and transition risks to value

The 2017 recommendations of the Taskforce on Climate-related Financial Disclosure (TCFD)[6] relate to how the financial impacts of climate risks should be disclosed by organisations. TCFD[7] categorises climate risks into physical and transition risks:

- Physical climate risks include notable potential changes in precipitation, water and heat stress, coastal and fluvial flooding, and the recommendations request disclosure is made on the future impact of these events when modelled against investments.



- Transition risks are more market based, and typically include the market requiring greater action on climate, or impact of regulations on an organization. TCFD also recognize there are opportunities related to the transition, which may be found with early action, for example capturing a market as regulations change.

AREF believe that these terms should be associated with how we talk about the longer term risks associated with asset valuations, and there should be alignment with wider TCFD related strategic considerations. In this case the recognition of longer term risks may fall outside of RICS governed asset valuations, as they are considering the scale and probability of these risks to future asset value. Instead they be considered as strategic advice which relate to the valuations. Valuers may be made aware of these risks, but they may not be reflected in current market values at the time of valuation.

Biodiversity and Nature

Aligned with climate, risks to biodiversity and nature are becoming a key ESG theme. Currently, there are several initiatives which seek to mitigate the devastation of habitats and biodiversity, for example:

- Biodiversity Net Gain which requires 10% additional biodiversity expansion in new developments [8].
- Task-force for Nature-related Financial Disclosure (TNFD) which seeks to address biodiversity issues in a similar format to how TCFD addresses climate disclosure [9].

As these develop, the results may have an impact on property values, as the aims of these initiatives seek to share the same space with commercial property. Landlords should consider biodiversity aspects of the real estate in order to manage the upcoming risks to value.

Alongside this, there is a strong crossover between biodiversity and the wellbeing agenda, as biophilia and access to green space are thought to promote productivity and enhance rental and capital values, though the market evidence of this has yet to be determined.

[5]Sustainable Finance Disclosure Regulations
[6] See https://www.fsb-tcfd.org/
[7] Task Force on Climate-Related Financial Disclosure, "Recommendations of the Task Force on Climate-related Financial Disclosures", June 2017
[8} Natural England, "Biodiversity Net Gain, An introduction to the benefits", April 2022
[9] Task Force on Nature-related Financial Disclosures website: https://tnfd.global/

Social Value and Impact

This report focuses on environmental aspects of the ESG agenda, as these have become notably pressing across the real estate market, with the rise of occupier and investor focus, combined with increasing regulations. The social impacts of real estate are also very important, but lack the specific and universal focus of climate.

Social value is the product of an asset which is well positioned in the community that it serves. This requires more specific context for assessment, and a more specific process for assessing value. It may become a focus for future consideration.

Capex costs related to ESG risks

The real estate market is incorporating climate risks, specifically transition risks, at a rapid rate. This is reflecting a combination of occupier and investor requirements and increasing regulation. The speed that real estate is adjusting to incorporate these complex considerations requires an explicit focus on how Capex costs are recognised in valuations.

These costs are a material risk to value and valuers must consider this Capex and the impact on asset valuations.

ESG related Capex will vary significantly across assets making this a sophisticated challenge for asset owners and valuers to consider and reflect. Most assets will be impacted significantly and the uncertainty over these costs is high. This is because case studies of successfully transitioned assets are not commonplace, and many asset owners and valuers are recognising these costs for the first time. This uncertainty will perpetuate for the short term, as the market properly incorporates these factors into asset plans and valuations.

The working group has been clear that while these costs require specialist input, as Capex costs, they are no different from other costs requiring consideration to align an asset to regulations and market conditions. Fund and asset managers and valuers should resist focusing them as ESG costs. For clarity in this report, we have called them Capex related to ESG risks to be specific about what we are considering, but in valuations these are considered as any other costs are.

As always, fund and asset managers should have an understanding of capex costs, including those relating to ESG risks. The valuer should be provided with any planned works for the asset, or any capex proposals. These costs should reflect the investment strategy of the asset and the needs of the most likely buyer and tenant to maintain market value.

Poor positioning, in general, can result in accelerated depreciation as market requirements evolve. Positioning to mitigate ESG risks, especially regulations but also occupier or investor needs, are a notable example of this. Capex costs prepared by asset owners should reference ESG requirements.

The RICS Guidance Note[10] states:

"It is accepted that in certain circumstances, and subject to their experience and competence, valuers may need to make professional judgements around capital expenditure cost estimates. This will depend on the nature of the asset, the purpose and basis of valuation and the details of the specific instruction."

While it may be beyond RICS requirements, we recommend valuers have an approximate understanding of whether the costs provided are realistic. Where Capex is not provided, the valuer should consider ESG related Capex risks to the asset in line with market expectations and the urgency of these improvements for the specific asset. Once again, this is beyond RICS general requirements, but we see valuers' contribution to these capex considerations and potential risks as important strategic advice.

The valuer should not be considered as a reasonable source for either carrying out or reviewing cost assessments, as they do not have specialist skills required to assess Capex and it is not within the scope of a Red Book valuation to be able to undertake this level of analysis. However, they must work with the fund manager and appointed specialists to reflect risks identified, their costs and any resultant impact on valuations

The effect on value from ESG related Capex

Historically, sustainability in the built environment has focused on creating additional value through best practices and additional sustainable amenities. These add features, certification processes and additional costs, which increase rental and capital values, result in the so-called "Green Premium" [11].

The UK has committed to be Net Zero by 2050[12], which means the UK commercial real estate market must become net zero within 30 years. As the UK's net zero commitment has been made law through the Climate Change Act[13] , it follows that policy and regulation will continue to develop which will place greater requirement on real estate to align with this objective.

These additional requirements on real estate will distinguish assets that are aligned, and those that require the Capex to meet these objectives. We can expect occupiers and investors to increasingly require real estate that meets these objectives, which will accelerate the depreciation of those assets that do not. This results in the "Brown Discount", which will likely be guided by the Capex required to align the asset to regulations and market positioning.

[10) RICS, p. 22
(11) The RICS provides a global overview of how the investment in green features, or lack thereof, may affect values in the 2022 RICS Sustainability Report.
[12] Department for Business, Energy & Industrial Strategy, "Net Zero Strategy: Build Back Greener", October 2021
[13] Climate Change Committee, "A legal duty to act", accessed January 2023

Green Leases help manage Capex risk

Green leases contain specific clauses which seek to promote collaboration and minimum standards across landlord and tenant on green issues. They have historically been challenging to implement due to failures to reach an agreement of terms between parties and have been often limited in their effectiveness. However, as climate regulations develop, so does the need for a formalised approach to managing climate risks which spans landlord and tenant considerations.

The contents of green leases vary depending on the asset type and property characteristics. The Law Society has prepared some guidance[14] in partnership with the RICS, The Better Buildings Partnership (BBP) and Chancery Lane Project, which provides a useful basis for establishing Green Leases. BBP suggests, at a minimum, a green lease should include an agreement on the sharing of data between parties and a collaborative approach to improving the environment performance of the asset[15]. This may include provisions for the management of energy, waste and water, as well as transport and opportunities to improve biodiversity.

Given the sophistication of ESG related Capex risks, Green Leases are a way to establish minimum requirements for how occupiers should operate within their lease, which protects investment in ESG risk mitigation features. They clarify roles and requirements as sustainability and related ESG impacts on valuations evolve. These are beneficial to landlords as they can protect against risks to value from tenant interventions, establish requirements for asset operations in line with sustainability objectives. Green leases should include the sharing of ESG performance data so the landlord can ensure the ESG related Capex has been deployed effectively.

Presence of green leases or lease clauses could be a future consideration for valuers, as it becomes more pressing for landlords to manage risks to climate regulations, investor driven sustainability requirements and decarbonisation programmes.

[14] The Law Society, "Green Leases and Minimum Energy Efficiency Standards", January 2023, accessed March 2023. Which references the Better Buildings Partnership (BBP) Green Lease Toolkit or Chancery Lane Project as examples of green lease clauses.
[15] See BBP Green Lease Toolkit.

Recommended Sustainability Aspects in Valuations

Fund managers should require consideration of the following as a standard within valuations:

CONSIDERATION	TYPE OF RISK [15]
Energy Performance Certificates (Minimum Energy Efficiency Scheme compliance)	Transition of risk
Green Certificates (BREEAM, LEED, NABERS, Well Standard) [16]	Transition of risk
Localised physical risks (typically flood risk in the UK	Physical risk

Each of these will be further developed in the following sections.

[15] Climate risks as defined by the TCFD recommendations.
[16] See Appendix C: Green Certificates as per GRESB for reference to an international, market recognised list of potential certificates within real estate.

Comparables and market evidence

Valuers need to understand and reflect the market, including sustainability features and ESG risks. However, in some cases the evidence to support sustainability impacts on values may not be sufficient to reflect any impact on value. We recommend the sustainability aspects and ESG risks noted below should be set out by all market participants when reporting market evidence. This will provide valuers with more explicit evidence that they can apply reliably in asset valuations. When considering and reporting market comparables to their clients, valuers will then be better able to comment on target buyer priorities for a given asset. In markets where sustainability has an influence on investor or occupier decisions, green buildings are likely a requirement for prime rents and values.

Energy Performance Certificates

Energy Performance Certificates (EPCs) provide a rating which reflects the theoretical, modelled performance of an asset, typically at demise unit level. They do not reflect actual performance achieved and as with any generalized assessment model conducted by independent third parties, may be an inconsistent representation.

However, EPCs are very common across the UK and Europe, and are the basis of regulations, specifically the Minimum Energy Efficiency Standards (MEES). For that reason, EPCs are primarily considered an indicator of regulatory risk exposure, and can be used as a proxy for asset quality and/or relative operating costs. The benefits for considering EPCs in valuations are their market coverage, driven by regulations. The absence of an EPC may be noteworthy as a risk. Due to their wide coverage and place within regulations, EPCs provide a meaningful basis for comparables and risk assessment.

EPC quality should improve

EPCs are variable in quality, a combination of the use of a generalized building model which covers a range of asset types and uses, alongside historically poor quality control across EPC assessors, use of defaults in calculations over proper measurements, a lack of audit of EPC calculations and lack of any enforcement. Some of these risks will reduce as market participants improve the quality of their EPC instructions due to their growing regulatory emphasis. Also the EPC supplier market is improving tools and quality of outputs, and AREF members are recommended to invest in the assessment and management of EPCs going forward.

The recommendation reports accompanying EPCs are widely considered to be of limited use, but can support an understanding of Capex costs. Sometimes recommendations reports can include unlikely suggestions, but the quality of the recommendations can be used to understand the quality of the EPC assessment. Poor recommendations may reflect a poor quality assessment.

Asset owners should keep EPCs up to date, and share changes to EPCs with valuers. EPCs are required to be updated every 10 years or when there has been a material change to the asset. This material change could be as simple as LED lighting upgrades.

Recommendations

AREF recommends that EPC data is provided at an individual EPC level to valuers by members or their managing agents, including the following information:

- Property address and unit information
- EPC numeric score and expiry dates
- Floor area, especially if not aligned with specific units already in routine valuations
- Material risks identified, either in the EPC Recommendations Report or by the member or managing agents.

Members should note that EPC numeric score for Scottish EPCs, as well as Non-Domestic EPCs and Domestic EPCs in England and Wales operate on different scales and can be in reverse order.

EPC risks should be assessed against the following risk bands:

RISK	DEFINITION	DESCRIPTION
Green	EPC A and B	Efficient demise under SFDR, aligned with UK policy stated in the 2020 Energy White Paper. Includes EPC C for Domestic EPCs where appropriate.
	Documented exemption with immaterial expenditure	Where the demise is exempt and the rationale is evidenced and there will be no requirement for material expenditure on expiry of the exemption.
Amber	EPC C and E	Inefficient demises, compliant with current 2018 version of the Minimum Energy Efficiency Standards (MEES).
	EPC expired or soon to expire	The status of the EPC is either unknown or known to require intervention. The EPC model continues to evolve, and EPC ratings set to expire are unlikely to be of the same rating as when assessed 10 years before.
	Exemption with modest expenditure	Any future EPC expected to be at an A or B rating or a registered exemption where only modest and viable expenditure is estimated on expiry of the exemption.
Red	EPC F and G	Demises considered sub-standard by the Minimum Energy Efficiency Standards regulations, not compliant to be let under the current Minimum Energy Efficiency Standards, or to have a lease after 1st of April, 2023. Requires immediate intervention.
	Exemption with significant expenditure	Registered exemption where material and significant expenditure will be required on expiry of the exemption.
	Missing EPCs	Where EPCs have not been assessed or cannot be provided and there is an unknown regulatory risk exposure.

Where EPCs highlight the need for significant expenditure, a pay-back test can result in exemption. However, this may reflect poorly on the market positioning of the asset.

Green Building Certificates and Ratings

Green Certificates are dominated by BREEAM and LEED, and have been historically important for bundling sustainable features into a marketable badge which can then attract additional rent or capital value, the so-called Green Premium.

Specific green certifications typically dominate a market, depending on the investors and occupiers. In the UK, BREEAM is the most dominant green building certification outside of mandated EPCs. In North America, the LEED is dominant and elsewhere there is a market preferred certification. For example, due to US occupiers playing a major role in the Dublin market, LEED is dominant. Germany (DNGB), France (HQE), Japan (CASBEE) and Australia (Green Star and NABERS) have their own national certifications.

Green certifications multifaceted with varying levels and are updated over time. For example,BREEAM offer a certification for “New Construction” and “Major Refurbishment” which reflect the sustainability features of the asset, but also “In Use” which are based on different operational criteria. BREEAM criteria have also changed over time so certifications from different dates are not strictly comparable.

Green certifications typically operate on a scale, depending on the scoring achieved. Certain specific metrics may be required, but other aspects will be elective with more features resulting in a greater achievement on the scale. This means a BREEAM Very Good is a very different building from a BREEAM Outstanding from a sustainability perspective. It also means the credits achieved, and therefore the sustainability specification, can vary a great deal within two comparable BREEAM Very Good assets.

Not all certifications impact value, there must be a notable demand in the market for the certification with a related scarcity of supply of it. A relatively unknown certification, even demonstrating high quality sustainable features, may not impact value any more than the features it represents.

Recommendations

Fund or asset managers should provide details of any certifications stating the date and version of the green certificate. If the certification has not yet been achieved, the status and/or target.

Localised physical risks

Apart from the risk of damage and lost access/operations of the asset, flood risks could affect operating costs through insurance premiums, or become unattractive to investors or occupiers as climate events become more frequent. Physical risks can effect the asset exit strategy, liquidity or carry other long term investment risk[17].

Climate risk reporting under the TCFD recommendations include modelling macro physical risks such as heat or water stress. While important, asset value will reflect the market recognised risks. As noted above in relation to TCFD, long term physical risks which are dependent on future changes in climate may be a consideration for the investment strategy of an asset but not be present in RICS governed market value today.

In the UK, the most material localised climate risk is flood risk and assets lower in elevation and closer to water may be at increasing levels of risk. In other countries, there may be other risks such as wildfires or tornados where risks of higher frequency events may vary across the market.

When assessing flood risk, the granularity of the data is important. Analysis of flood risk should use localised risk maps, such as the Environment Agency Flood Risk maps or comparable, to determine the relative risk within the market.

Asset owners may find such lower resolution, long term flood risk analysis helpful at targeting more flood and physical risk resilient areas to invest, and may have a strategy of avoiding higher risk of flooding locations. The role of the valuer is to reflect the impact on value of the specific risk to the asset in alignment with the market. So localised standard flood risk maps should be considered sufficient to identify that risk within the market the asset is valued within.

Recommendations

Flood risk has historically been considered within valuations. This should not change in considering the following, which should be provided by the client:

- Advice on known flood risk in the area, to include river, coastal, surface and storm, that could impact the property and advice of any evidence that the property has been previously damaged or impacted by flooding.
- Advice on any flood risk defence measures in the area that could mitigate risk and/or property flood resilience measures that have taken place at the property.
- Details of any current or future flood risk that has been identified by any available environmental / flood risk audit.
- Advice on whether insurance is obtainable on standard terms.

[17] United Nations Environment Programme Finance Initiative (UNEP FI) and Henley Business School, "Climate Risk & Commercial Values: A review and analysis of the literature", August 2021,

Conclusion

We see the need for more market alignment on the basis of assessing how sustainability is commercially considered in real estate. This alignment will provide clarity and certainty in how fund managers and asset managers invest in real estate assets. This report seeks to draw together a common-sense baseline of how sustainability risks and features can be articulated in asset valuations, and how to approach Capex considerations.

The valuer has a role to play, but one which is limited to the specific focus governed by Red Book valuations: to reflect market value at the time of the valuations. Due to how the market is interpreting ESG risks, this may not include factors which affect value in the future. Real estate asset owners' strategy for managing these risks will extend beyond what is currently considered in today's valuations.

This report could have a short shelf-life as sustainability and ESG in real estate evolves to meet regulations and market requirements of tenants and investors, and the sophistication of how sustainability is interpreted in asset value further develops. We may find that new metrics and considerations are required to better articulate the commercial view of the value of sustainability features in real estate. This will represent progress which we hope this report, in part, contributes towards.

The Association of Real Estate Funds represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of around £65 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the AREF Property Fund Vision Handbook.

The Association of Real Estate Funds
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