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Insights

GREENING REAL ESTATE - UNDERSTANDING THE GREEN PREMIUM IN CORPORATE REAL ESTATE M&A

ENERGY EFFICIENCY SERIES – PART 2

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SUMMARY

In the first part of our series on Energy Efficiency, we looked at the backdrop and the various factors at play in relation to the target of achieving net-zero by 2050. In this article, we will explore how that backdrop is creating M&A and other transactional activities in the real estate sector, with a particular look at the green premium and how it can present opportunities for investors. We also explore how asset owners can leverage on environmental, technological and energy solutions to harness this green premium.

THE GREEN PREMIUM

The green premium is described as the higher price that sustainability-focused companies pay when renting or buying buildings with certified sustainability credentials that align with their values.[1]There are market research and academic studies that show the presence of the green premium in various real estate markets around the world. A snapshot of some of green premium reported are:

- Knight Frank has found that in prime central London, offices with a BREEAM Excellent rating and BREEAM Very Good rating enjoy 10.5% and 10.1% sales premium respectively compared to equivalent unrated buildings;[2]
- JLL has reported rental premiums for green certified Grade A offices across 11 cities in Asia.[3]By way of example, in Hong Kong SAR, lease premium ranges from 7% to 28% (the bottom of the range being the base level certification and the top of the range being the highest level certification);
- in London, in respect of development schemes completed between 2013 and 2017, those that have a BREEAM Outstanding/Excellent rating tended to show a higher pace of leasing and have lower vacancy rates (of 7% compared to 20% for those rated very good) 24 months after completion;[4]
- a higher level of certification generates a higher premium (but the relation is not linear); [5]and
- a study reviewing empirical research carried out between 2013 and 2018 shows that buildings with green certification benefit from rental premium (up to 23%), increased occupancy (up to 17%) and sale price (up to 43%).[6]

WHAT MAKES UP THE PREMIUM?

Statistical analysis showing the evidence of the green premium does not identify the source of the premium or to what extent energy efficiency is important relative to other factors contributing to the premium. The studies compare the price of assets with certification standards rather than purely measuring the carbon dioxide emissions and what makes up the premium is complex and is likely to involve:

- energy cost savings (there is evidence that a 10% decrease in energy consumption leads to an increase in value of about 1% over and above the rent and value premium of a building); [7]
- building quality (buildings with higher standards are generally more modern/better equipped and attract a premium beyond the strict environmental impact);
- the owner/tenant taking into account occupation of a building with better environmental performance; and
- carbon price/offset impact (offset costs whether actual expenses or used in internal decision making by the investors).[8]

Better understanding of what makes up the green premium in the future would also allow investors to cater to their approach and strategies.

As ESG measures become standard practice for the best assets, investors are becoming more inclined to consider the “brown discount” non-ESG compliant assets suffer, rather than the ‘green premium’ for better assets.[9]

BUYING GREEN OR TURNING GREEN

With apparent financial rewards presented by the green premium in addition to pursuing their own environmental and sustainability goals and net zero targets, investors will focus on acquiring assets/buildings that already have some form of high sustainability rating and improving the sustainability performance of buildings already owned. RICS sustainability report 2022 states that the demand for green buildings is rising globally and demand in Europe is outpacing the other regions.[10]The demand is likely to be greater than the pace of supply and therefore there will be competition for sustainable assets/buildings.[11]

Over the next decade, it will be harder for the developers to justify demolition and new construction both in terms of ESG commitments and through new planning policy in the near future.[12]The debates on and public enquiry into Marks & Spencer's proposal to overhaul its flagship store in Marble Arch, London is a recent example illustrating the tensions between rebuilding and refurbishing. Creating more sustainable real estate through refurbishment and development will continue to be the higher risk and higher return area of the property market.[13]

Examples of steps that can be taken to increase the energy efficiency of a building and improve its green credentials are use of renewable energy, metering, installing LED lighting, optimisation of building management systems (BMS), insulation to improve building thermodynamics, upgrades to heating and ventilation systems, window glazing and shading and reflective surfacing and measuring output in close collaboration between tenant, property manager, owner and investor.[14]

Beyond such premiums and discounts, stricter regulation will adversely affect the older less energy efficient buildings. In the United Kingdom, by April 2023, every commercial property that is leased is required to have an EPC certificate of E or above and there are plans to increase such minimum requirement to C by 2027 and B by 2030. Buildings that do not meet such minimum requirements will not be lettable.

ON-SITE GENERATION

Sourcing energy from renewable sources works in tandem with minimising demand and increasing energy efficiency in a building, to reduce the carbon dioxide emissions of the building.[15]In terms of renewable energy sources, on-site generation is considered as the greenest of the available options and on-site solar energy production is the most commonly reported on-site energy production for commercial real estate.[16]

Three common models of on-site solar generation and their characteristics and benefits are set out in the table below:

	Direct Ownership	**Solar Leasing**	**Rooftop Leasing**
Capital expenditure for installation	Upfront cost borne by the property owner	Nil (upfront cost borne by Solar/energy company)	Nil (upfront cost borne by Solar/energy company)
Use of electricity generated	The solar energy generated is for own consumption by the property owner	Property owner pays discounted rates for electricity produced Excess electricity is sold to the grid and the Solar/energy company takes the revenue	Property/property owner uses conventional electricity The electricity generated is sold to the grid and the Solar/energy company takes the revenue
Benefits for property owner	Reduces the overall cost of obtaining electricity from the grid	Discounted rates for purchasing electricity reduces the overall cost of obtaining electricity from the grid	Property owner receives revenue for leasing the rooftop

Direct ownership model requires upfront capital and we will further discuss the financing options in the financing part of this series. Solar leasing and rooftop leasing often involves collaborations between property owners and energy providers. In addition to collaboration on a site-by-site basis, there have also been recent strategic partnerships. For example:

- Engie and Logos have established a Regional Renewable Energy Platform to provide solar generation and renewable energy options for LOGOS' Asia Pacific portfolio. The first project under the partnership has been agreed with the global logistics leader, DHL, who has committed to a circa 5MW solar installation at its Singapore facility at LOGOS estate in Singapore; and
- SP Group is partnering AIMS APAC REIT (AA REIT) to install rooftop solar PV system across six of AA REIT's industrial, logistics and warehouse properties in Singapore by December 2023.

Traditional real estate companies may also establish or purchase energy companies to provide their own solutions for onsite solar.[17]Even if solar panels are not being installed for immediate use, newer developments are being built solar-ready.

OPPORTUNITIES

We have set out below further insight into opportunities presented by the green premium and efforts to meet carbon targets in commercial real estate.

Less saturated markets

In comparison to the established markets, green certificates led to higher rental premium in emerging markets.[18]Data by JLL also shows that the green premium is inversely correlated to the supply of green certified buildings. In Singapore, which has 90% of Grade A office stock green certified, provides a rental premium opportunity of 4% to 9%, whereas Seoul, which has 37% of stock is green certified, the rental premium is between 7% and 22%.[19]Therefore opportunities to benefit from the green premium is greater in markets that have fewer certified buildings overall.

Early mover

There is an early mover advantage as evidence shows that those buildings who adopt the green standards later do not enjoy the same rental and price premium as early movers (evidence shows that when the number of certificated buildings increases, the effect of certification to non-green buildings in the same neighbourhood decreases).[20]

Portfolio effect

The green premium also exists at the portfolio level, which means overall greenness of a portfolio has added benefits. Based on studies conducted on US REITs in 2012, for an increase of 1% of the share of green properties within the portfolio of a REIT, the return on equity increases 7.39% to 7.92% for LEED-certified properties and by 0.66% for Energy Star-certified properties.[21]

Futureproofing

Environmental and sustainability regulations are expected to tighten and what is considered as an advantage today may be the norm a few years down the line. Furthermore, the certifications themselves are also evolving.[22]Accordingly, investors may look to futureproof their asset and portfolios and acquire buildings/portfolios with the highest possible certification.

Other certifications

The studies cited above focus on the building and energy efficiency certification, however additional certifications may also be become important for the green premium in the future.

Following the Covid-19 pandemic, occupiers may focus on and demand health related attributes (including good air quality and ventilation, touch-free access, health amenities such as gyms and open spaces) and end-of-commute facilities such as bicycle parking and showers and there are additional certifications which buildings may opt for beyond energy and sustainability (e.g. certification by the International WELL Building Institute which certifies spaces that advance health and WiredScore which assesses digital connectivity).[23]

Brown discount

For property companies that acquire older stock and carry out asset enhancement initiatives, improving sustainability of the buildings will be one of the key focus areas. The brown discount will provide such companies with acquisition opportunities.

M&A in energy efficiency services

Energy services and property management companies are carrying out bolt-on acquisitions to increase their offering in energy efficiency services. eEnergy plc, a net zero energy services provider, listed on AIM of the London Stock Exchange in January 2020 and has acquired Beond Group Limited, a renewable energy consulting and procurement business in December 2020 and UK energy consultancy Utility Team Trading in October 2021. Johnson Controls has also carried out an array of acquisitions to enhance its net zero service offering.[24]

Consolidation of companies reporting ESG data

Companies today publish reports under multiple reporting frameworks.[25]Due to a lack of standardisation of ESG reporting in the US, the ESG data reporting by companies tend to be inconsistent and thus ESG data and rating providers have played an important role as standard-bearers.[26]Financial rating companies have looked to increase their ESG data capabilities by M&A in recent years.[27]Moody acquired Vigeo Eiris, Four Twenty Seven Inc. and a minority stake in SynTao Green Finance (all in 2019). In 2020, Morningstar acquired Sustainalytics, which itself has acquired two targets in 2015.[28]Further consolidation and acquisition of companies that undertake ESG reporting is expected.

CONCLUSION

This article has looked at the green premium and provided a snapshot of some of the transactional opportunities and activities relating to sustainability in the commercial real estate sector. The underlying factors that have fuelled such activities will continue to exist and increase. This would therefore provide a host of M&A opportunities for actors across the real estate industry in the near future and beyond.

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[28] Responsible Research Pte Ltd and ESG Analytics AG. Sustainalytics also acquired Acquires Property-Level Climate Risk Data Provider Aquantix in 2022

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