The Performance of Green Offices at a Time of Price Correction

Do green premiums hold up in a downturn?

IN A NUTSHELL

- ESG-certified offices have been shown to let at premium rents and sell at relatively high capital values. Whether these premiums hold up in a time of price correction is now being tested.
- Initial evidence suggests that London offices with a high level of certification have seen growth in sales premiums since the onset of the Ukraine war. Premiums are also holding up for the top two levels of certification for German offices, with offices with a mediocre level of certification failing to achieve any premium.
- Evidence from Paris is more mixed. This may be because existing sales premiums were higher before the current crisis, or because a greater number of accredited offices are situated in higher vacancy submarkets.
- Existing regulation requires high energy performance from new office buildings and minimum energy performance standards are only going up. The likely result is an accentuation of green building premiums and a widening of existing discounts for less efficient buildings.

The outperformance of ESG-certified buildings[1] has been well documented. We distilled the findings of this literature in our 'Office Green Premium Review' paper last year, which found an average rent premium ranging between 4% and 8% and a sales premium ranging between 8% and 22% for ESG-certified offices. Since then, other studies have been published that support these findings. CBRE estimated a 6% rental premium for certified office buildings in Europe[2], and JLL found a near 12% rental and 20% capital value premium based on investment deals in central London during 2017 and 2021.[3]

Now that we are in a period of price correction, we ask in this paper, how resilient are these office buildings during a downturn? Will the rental and capital value premiums evaporate when both investors and occupiers are more price sensitive? Or will they continue to hold their worth?

Are accredited offices holding their value for investors?

In the years (2007-10) around the Global Financial Crisis, analysis of certified offices in the United States showed that green premiums

[1] In this paper 'ESG accredited/certified', 'green' or 'sustainable' refers to offices which have a BREEAM, LEED, HQE or DGNB rating. The scope does not encompass other ratings such as WELL or Fitwell as these certifications are limited in focus. Other certifications which are prevalent elsewhere in the world have also been excluded, being less common in Europe.
[2] CBRE, November 2022
[3] JLL, January 2023

are counter-cyclical as rental premiums widened during downturns[4].

Fast forward to 2023, and the real estate market is in another downturn, this time precipitated by rising financing costs. There is not yet a large volume of transactional data available since the yield expansion only began in the second half of 2022 and capital markets have been subdued since then. However, conversations with market participants have suggested that both occupiers and investors still value ESG accreditation, often to a greater extent than pre-crisis:

"Despite the small volume of transactions over the past half year, we see office buildings with some form of ESG accreditation trade more easily. Investors increasingly have their own ESG requirements for the buildings they acquire and so the pool of potential buyers for buildings without some form of certification, or without the potential to achieve it, is getting smaller".
Cameron Ramsey, JLL, Director, Capital Markets, EMEA & UK Research & Strategy

"In the German markets, to be classed as a prime building you need to have some ESG angle to your building. Otherwise, there will be some kind of discount. Properties with poor energy performance are likely to have lower rental income and limited marketability."
Jan Linsin, CBRE, Head of Research Germany

This story is supported by the albeit limited number of transactions from the last four quarters of investment in Europe. Volumes for offices with a high level of ESG certification have held up better than office volumes overall. Even offices which have achieved a low level of certification remain more liquid than their uncertified counterparts.

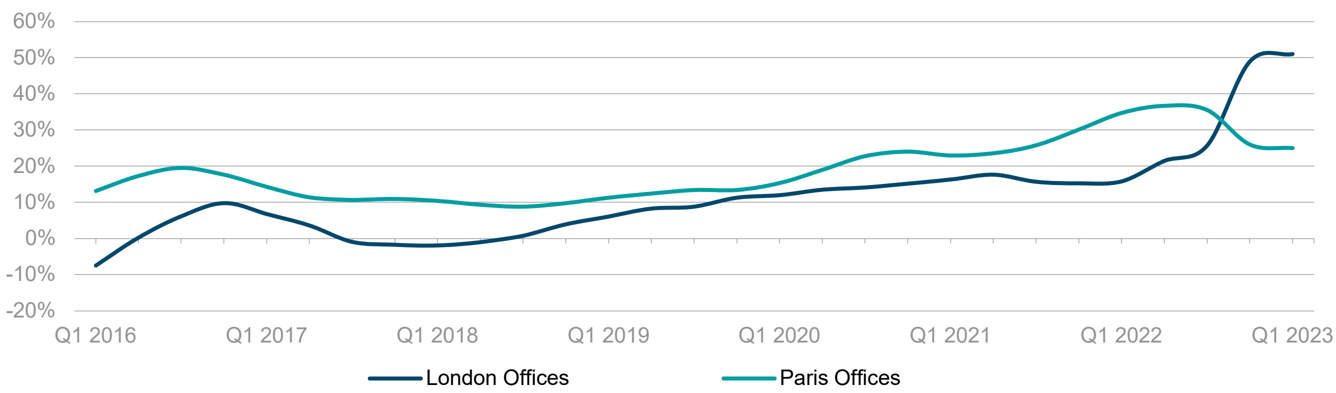
Y-o-Y % change in investment volumes over the last 4Q of European office investment

Source: RCA, May 2023.

A closer look at the most liquid markets in Europe, London and Paris, gives further insight. In London, office buildings with an ESG accreditation have achieved meaningful capital value premiums compared with similar, non-accredited buildings. For example, a recent study from MSCI found this gap quickly widened over the course of 2022 from 15% at the start of the year to over 50% in Q1 2023. [5]

[4] Das et al., 2011
[5] MSCI, November 2022

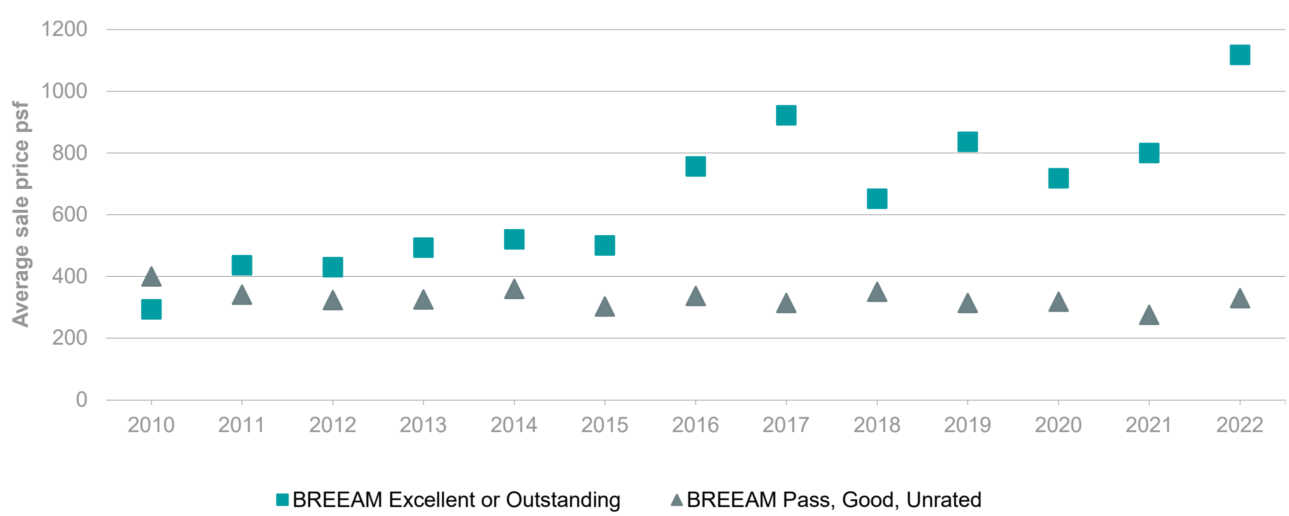
Sales Price Gap – Offices with and without ESG certification



Source: MSCI, May 2023.

CoStar analysis provided further support, comparing sale prices for buildings which had BREEAM 'Excellent' or 'Outstanding' certifications with unrated or BREEAM 'Pass' or 'Good' offices,[6] and showed a clear increase in green sales premium in 2016-2021 compared to 2011-2015, and a further increase in 2022. And while the true green sales price premium might be lower when controlled for variables such as building age, size, tenant(s), submarket and micro location, the direction of travel was visibly evident.

Price per square foot spread between highest and lowest ESG rated London offices

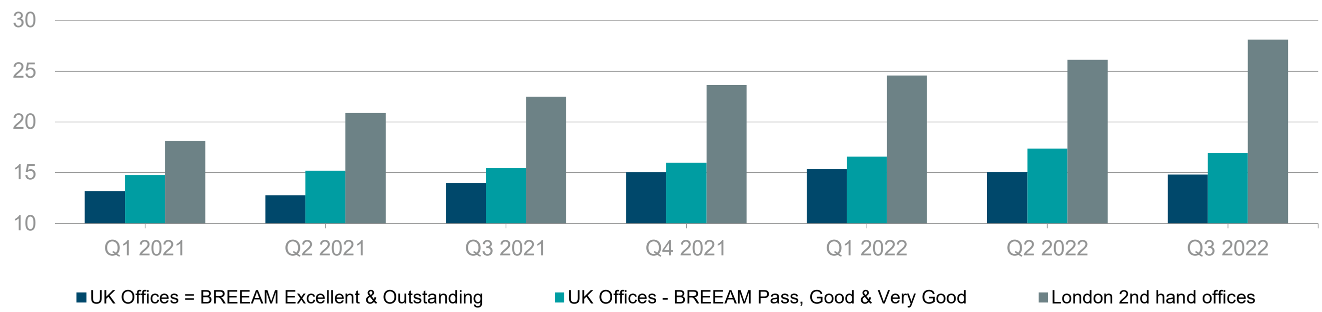


Source: CoStar; November 2022.

According to this analysis, offices with the highest BREEAM certifications also achieve shorter void periods compared to lower BREEAM rated and unrated, second-hand offices. UK offices with a BREEAM 'Excellent' or 'Outstanding' rating are on the market for an average of two months less than offices with a BREEAM 'Pass', 'Good' or 'Very Good' rating. This figure increases to nine months relative to unrated and second-hand offices.

[6] CoStar, Green Street, November 2022

Average void periods by certification



Source: CoStar, November 2022; CBRE, December 2022.

In Paris, we see different dynamics to London:
"We clearly see occupier demand favour 'greener' buildings. Low availability in central Paris means that small surfaces in unaccredited buildings can also attract a tenant but for larger surfaces tenants really look for good environmental credentials."
Virginie Walckenaer, DWS, Head of Real Estate, France and Belux

MSCI's analysis shows that the price gap between accredited and non-accredited buildings in Paris has been above 20% since 2020, rising to over 30% in 2022 before returning to the mid-20s this year. As central Paris has such constrained vacancy, uncertified offices can command competitive rents. At the same time, markets such as La Défense have a large number of certified buildings simultaneously available, pulling down the rents they can individually achieve.

The current sales premium for accredited offices can be explained by several interlinked factors:

1. **Minimum Energy Efficiency Standard (MEES) regulations are tightening**. In the UK in April of this year, commercial buildings with an EPC rating of E or below will no longer be marketable for occupiers or investors. The UK government anticipates MEES to increase to EPC B by 2030, and is currently consulting on proposals to deliver this policy. In Paris, the Décret Tertiaire is requiring energy use intensity in commercial buildings to halve by 2040 compared to benchmark levels, a stretching goal for the office sector.[7]
2. **Occupier demand for accredited buildings is high and growing**. Over the past 6 years, the number of London occupiers signing up to Science Based Targets for lowering their carbon emissions has grown at a rate of 48% annually. [8] The evidence of the strength of demand lies not only in rental premiums of up to 12% for BREEAM 'Outstanding' rated offices but in shorter voids for certified assets as described earlier.[9]
3. **Market expectation is that a prime building will be accredited**. BREEAM 'Excellent' is the now most common level of achievement for office refurbishments, with 36% of office refurbishments reaching BREEAM 'Outstanding'.[10] The City of London Corporation imposes planning conditions requiring offices to receive a minimum rating of BREEAM 'Excellent'.[11]
4. **Institutional investor appetite for accredited buildings in London is strong**. A 2019 survey of global real estate investors found that 93% of investors now include sustainability criteria in investment decision making.[12] This is fuelled by the need of asset managers and other financial markets participants to disclose how ESG factors are integrated into decision making under the Sustainable Finance Disclosure Regulations (SFDR). Acquiring certified offices is a clear way to demonstrate commitment to ESG goals.

[7] JLL, February 2023
[8] JLL, 2022
[9] Knight Frank, September 2021
[10] JLL, February 2023
[11] City of London, April 2020
[12] 'Global ESG Real Estate Investment Survey', United Nations Environment Programme Finance Initiative (UNEP FI), REALPAC and Bentall Kennedy, March 2019

What's happening in debt markets?

Given the change in financing costs is a key driver of the current market dynamics, it is important to consider how lenders are weighing ESG accreditation in their decision-making. While there is little empirical evidence at present, market participants are clear that lenders are employing a highly selective approach in the current environment.

"Lenders are employing a very selective approach in the current environment. ESG certification is often required to show lenders there is lower risk of obsolescence and higher liquidity at exit."
Nicolas Deyon, DWS, Head of Real Estate Debt Transactions

In this risk-off climate, certified buildings have real advantage, being perceived lower risk from a regulatory, occupier, and liquidity perspective. Therefore, the pool of willing lenders for non-accredited buildings has narrowed in significantly recent months, sometimes resulting in failure to attract financing altogether because of poor ESG performance. At the same time, certified offices appeal to a growing pool of capital focused specifically on green buildings.

As financing becomes more challenging to secure, we are seeing ESG loans becoming more common in commercial real estate. These provide an opportunity for borrowers to negotiate ESG-linked margin ratchets into their lending agreements to secure lower financing costs upon achieving certain ESG-linked KPIs. ING's development of a $33m Green Incentive Loan with a view to incentivizing pursuing green certification is a key example.[13]

What next?

Current and future regulation will enforce an improvement in the performance of all office stock. The main piece of regulation in the pipeline is the 2023 update to the Energy Performance of Buildings Directive (EPBD), which states that more harmonised Minimum Energy Performance Standards (MEES) will be set at EU level and proposes that non-residential buildings must be brought up to at least EPC class F by 2027 and at least class E by 2030.[14] What we have observed in the UK and Netherlands, where MEES are already in place, is a marked shift in take-up towards higher rated buildings leaving a trail of vacant obsolete stock. Both markets have seen an increase in office conversions.

In future, value premiums are likely to be derived from actual energy consumption, not from theoretical energy performance. While most EPCs in Europe measure theoretical energy use, there is little correlation between EPC ratings and actual energy performance.[15] EPC ratings therefore risk guiding investors towards hitting regulatory EPC targets but missing the point of the legislation: to reduce carbon emissions. The UK government is now proposing to move the current EPC system to one based on the Australian NABERS rating scheme, which is much more linked to energy performance, and we may see similar moves on the Continent. CRREM, an EU-funded tool developed to indicate when assets will fall short of required energy efficiency standards to allow the EU to decarbonize the building sector by 2050, is moving in a similar direction. These shifts should help align regulation and the tools for enforcing it with actual carbon emission reduction targets.

Conclusion

The strong relative performance of accredited offices in the London and Paris office markets indicates that rental and capital value green premiums could be resilient through the current property downcycle. Regulatory, occupier, and investor-related pressures will most probably continue to work together to maintain the premiums for certified offices we observe today. However, over time, green premiums may erode as new standards become more widespread, resulting in a brown discount. Hence, now is a critical juncture for brown to green conversions.

[13] ESG Today, June 2021
[14] Energy Performance of Buildings Directive, March 2023
[15] UK Government, March 2021

Real Estate Research Team

Office Locations

Chicago
222 South Riverside Plaza
34th Floor
Chicago
IL 60606-1901
United States
Tel: +1 312 537 7000

Frankfurt
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: +49 69 71909 0

London
Winchester House
1 Great Winchester Street
London EC2N 2DB
United Kingdom
Tel: +44 20 754 58000

New York
875 Third Avenue
26th Floor
New York
NY 10022-6225
United States
Tel: +1 212 454 3414

San Francisco
101 California Street
24th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
One Raffles Quay
South Tower
20th Floor
Singapore 048583
Tel: +65 6538 7011

Tokyo
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
18th Floor
Tokyo
Japan
Tel: +81 3 5156 6000

Teams

Global

Kevin White, CFA
Global Co-Head of Real Estate Research

Simon Wallace
Global Co-Head of Real Estate Research

Americas

Brooks Wells
Head of Research, Americas

Liliana Diaconu, CFA
Office Research

Ross Adams
Industrial Research

Sharim Sohail
Property Market Research

Europe

Ruben Bos, CFA
Head of Real Estate Investment Strategy, Europe

Tom Francis
Property Market Research

Siena Golan
Property Market Research

Rosie Hunt
Property Market Research

Carsten Lieser
Property Market Research

Martin Lippmann
Head of Real Estate Research, Europe

Asia Pacific

Koichiro Obu
Head of Real Estate Research, Asia Pacific

Natasha Lee
Property Market Research

Hyunwoo Kim
Property Market Research

Seng-Hong Teng
Property Market Research

AUTHORS

Ruben Bos, CFA
Head of Real Estate Investment Strategy, Europe

Siena Golan
Property Market Research

Important information