KEYNOTE INTERVIEW

The green premium becomes a reality

Sustainability is now firmly entrenched as a key driver of value for real estate portfolios, says Partners Group's Peter Holden

As the world strives to deliver the emissions reductions necessary to avoid catastrophic climate change, ever-increasing regulatory pressure will be brought to bear to ensure compliance with decarbonization targets. That means managers of property portfolios must commit themselves to staying ahead of the net-zero carbon curve if they are to maintain and increase the value of their assets, or risk their holdings being left behind in the wake of progress, argues Peter Holden, managing director and co-head of private real estate asset management at Partners Group.

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Q What are the legislative drivers for property owners to decarbonize?

Real estate is of course a major contributor to greenhouses gases – 40 percent of emissions are generated by built assets, of which 28 percent is from operations.

As a responsible investor that is committed to achieving positive stakeholder impact, we must do the right thing and participate in the decarbonization and energy reduction objectives that global leaders have committed us to in the Paris Agreement and reconfirmed at COP26 in Glasgow.

The legislative impetus to do so is increasing country by country. But much of the legislation that we will need to comply with, to deliver the goal of net-zero carbon by 2050, has not yet been written. Some regions are much further ahead than others, with Europe at the forefront, so there is a differentiated landscape of targets and legislation that will create an uneven playing field.

There is no point in just making our buildings compliant, however, because that will not be enough. The leveling factor will be pressure from investors to see sustainability strategies implemented, and pricing will drive behavior. Legislation is pushing and the market is pulling. That provides impetus for our industry. If a manager gets several calls a week from investors who want to talk about ESG, and occupiers will not take their building if it has not got the right energy performance certificate, then that will force them to upgrade their assets. Those market dynamics are driving the behavior of managers in their attempts to move their assets closer to net zero.

Q How important is sustainability to capturing occupier demand?

The market is moving more quickly than legislators. Assets that are energy efficient, as evidenced by BREEAM or LEED certificates, are achieving higher prices in capital markets when they trade. That is because occupiers, many of which have signed up to emissions reduction targets, are selecting buildings that meet with their corporate ESG goals when they relocate. Reducing cost is no longer their main priority.

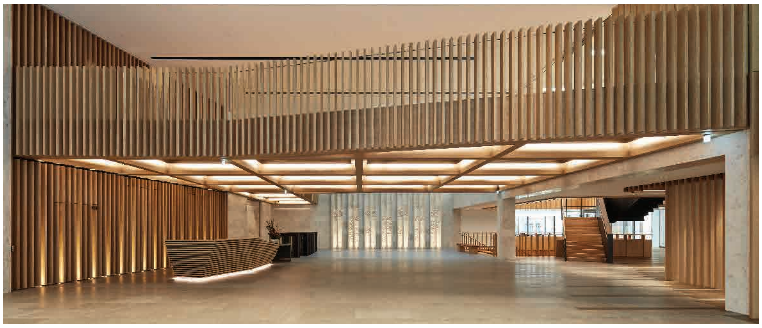
Choosing a green building that aligns with those objectives is a quick and easy way for tenants to demonstrate their commitment to sustainability. If a landlord is targeting the most well-advised and informed cohort of occupiers, then they need to be aware that this group may only look at the best buildings with the highest grades of certification.

If your product does not meet that requirement, it is probably filtered out of the process, and won't get shortlisted. That has implications for rents because there is demand pressure from occupiers who want sustainable buildings, which leads to rental premiums being paid.

Q How much do an asset's green credentials affect its pricing in capital markets?

Last year marked the first time in my career that I saw credible published evidence of a premium for green buildings. In November, CBRE published a report showing a 21 percent rental premium for certified buildings in key European cities. Previously, occupiers would have taken a green building and not paid any more rent for it.

Building green: EightyFen gets all of its electricity from renewables



Sustainability in the City

Asset case study: 80 Fenchurch Street, London

Completed in September 2020, Partners Group's 80 Fenchurch Street in the City of London secured a BREEAM "Excellent" rating, due to its commitment to sustainable design. During construction of the 250,000-square-foot office building, 96 percent of site waste was diverted from landfill. In operation, all of its electricity supply is produced from renewable sources, including photovoltaic panels installed on the roof, and water consumption is reduced by 40 percent through greywater recycling and efficient sanitary fittings.

Many of the tenants that have signed up so far – including building design and management consultancy Arcadis, mutual insurer Royal London and financial services group Aviva – selected EightyFen as a means of demonstrating their commitment to sustainability and of attracting staff back to the office following the coronavirus pandemic, says Partners Group's Holden. "Developments in solar and wind-sourced power in the UK enabled us to commit to 100 percent green electricity at EightyFen, significantly reducing our carbon footprint in use."

There is also evidence that capital markets are responding. A 2021 Knight Frank report identified an 8 to 18 percent price premium for certified assets, compared with uncertified ones, in London, Melbourne and Sydney. Investors are willing to pay more for the certainty those buildings are free of the risk of becoming "stranded assets" and failing to achieve convergence with the pathway to net zero.

We can see this in our portfolio and also in the debt markets. It is now becoming very clear that when we refinance assets, there is much more demand for those assets that are able to demonstrate the best sustainability credentials, and therefore attract the best tenants.

We are currently in the process of refinancing a sustainable office building in Europe and we have terms on the table from 20 banks. For a less energy-efficient prime asset, we would expect three or four lenders competing. That shows how debt markets are responding to risk around asset longevity. Energy-efficient buildings will continue to attract the right tenants and we know they will still be good assets in 10 or 15 years' time.

Assets that are less able to demonstrate their sustainability credentials will probably have a bigger carbon footprint and be subject to higher carbon taxes when more legislation is introduced. Their longevity as an asset is more questionable.

Q Are energy price increases also encouraging tenants to occupy more efficient property?

We have seen the cost of energy soar over the past six months and how far that will go, none of us can forecast. Consequently, energy efficiency has a far greater effect on determining total occupancy cost. Across our portfolio we are seeing occupiers choosing buildings that are energy efficient – once they add the cost of utilities onto their rent and service charge, the total cost is more affordable.

We see that in our office portfolio, but evidence from the US suggests that this trend is now also having a significant impact on the choices that residential occupiers are making.

Inefficient rented residential property is increasingly expensive to heat and power, so more energy-efficient homes are showing better rental growth, while demand for and absorption of that stock is higher. Consumers can certainly see the value of energy efficiency.

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Q What needs to be done to decarbonize existing assets?

Our industry will need to be really creative to meet that challenge. Of course, time-expired assets reach the end of their life and require renewal and demolition and new builds can deliver highly efficient buildings that are fit for the future, but we must also look at the cost of embedded carbon.

At the same time, the inflationary forces that have emerged in the construction sector over the past year have made development a more challenging investment strategy. Refurbishment and repositioning is therefore increasingly viable, as it saves carbon while retaining the use of much of the existing structure.

In our own portfolio, we take an asset-by-asset approach, applying best principles of sustainable asset management. Each asset has a management plan focused on improving the sustainable credentials of that building. For some older assets, we can make a meaningful change, for newer high-grade assets, the focus is on working with occupiers to help them use the building more sustainably.

Q What is the scale of the challenge if real estate is to achieve a net-zero future?

We are still at the stage where some of the early gains are relatively easy to attain. You can add insulation, replace light bulbs, and put solar panels on the roof as we continue to embrace clean green energy. All that technology has been around for years, it just needs rolling out. The next decarbonizing step is finding renewable sources of energy for heat and weaning off gas, particularly in domestic housing. The bar keeps getting raised as we progress on the pathway to net zero.

Delivering net-zero carbon by 2050 to meet the Paris Accord requires creativity and behavior change, but fundamentally, it aligns with the changing needs of our customers in real estate. ■