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Sustainable Investing

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How is the sector measuring up on ESG?

Spotlight on offices

Expert comment by **Olivier Mege, RQR**

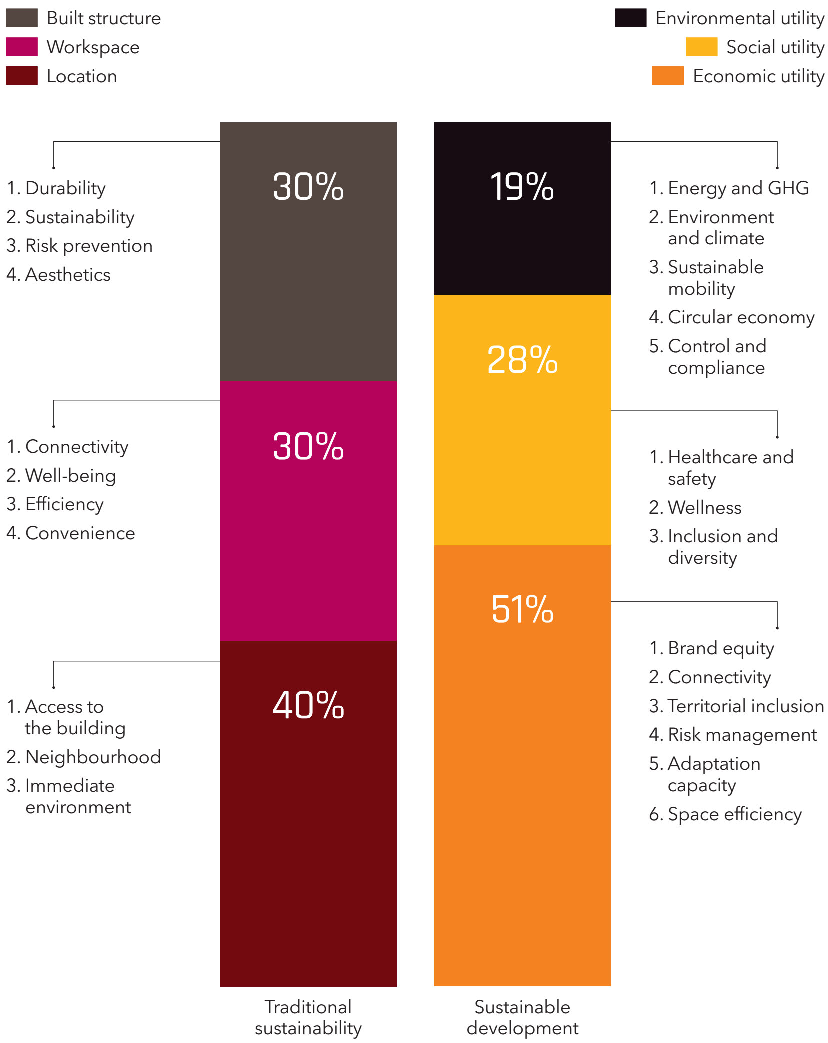
An RQR study offers a revealing insight into how sustainability is factored into the value assessment of assets in the sector

To fully assess the market value and long-term value of any property asset, we must understand the value perception determinants (hereafter ‘preferences’) of all real estate market participants – the investors, tenants, asset managers, occupiers and third-party agents, among others – in terms of the features or criteria they expect a building to possess. To frame it another way: what does an investor expect from an asset before it allocates capital to it? What will convince a tenant to lease floor space?

In recent years, the importance of monitoring these preferences has become even more acute as a result of the fast-changing economic, social and environmental expectations of these stakeholders. The real estate sector now operates in a world where asset obsolescence progresses faster than dilapidation. This means that ethical investment professionals need frameworks and tools to assess properties’ market position and improvement potential to avoid ending up with stranded assets or misallocated capital.

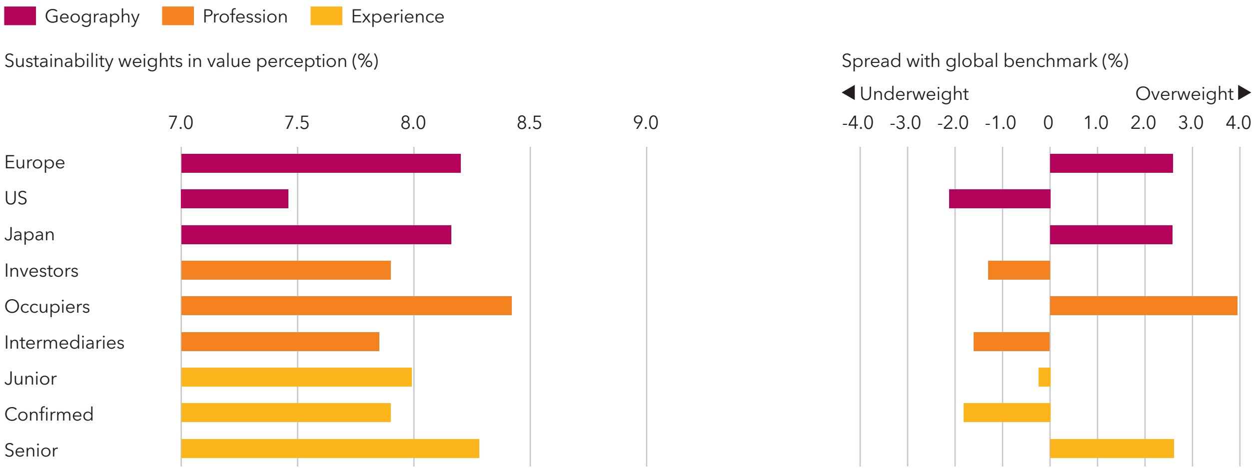
RQR’s 2020 Global Preferences Study reveals some interesting insights into how sustainability is factored into value perceptions of office assets globally, and how perceptions vary by geography and by market participant (for example, whether you are tenant or investor in the office sector).

How real estate participants perceive value in office assets



Note: dimensions are classified according to their importance from top to bottom.
Source: RQR

The importance respondents give to sustainability and the level of overweighting/underweighting of their position against a global benchmark



Global benchmark is the average of the global level of all respondents' value perception.
The difference with the global benchmark is relative and adjusted for significance
Source: RQR

Sustainability in the value hierarchy

The narrow, more traditional, concept of sustainability refers to building performance indicators directly related to general environmental issues – such as energy consumption, carbon emissions and recycling – and has only relatively recently been added to factors such as location, workspace and the built structure (building envelope) as a real estate fundamental that can materially impact the value of office assets.

In the RQR study, this narrow concept of sustainability, as an environmental issue, is ranked overall by respondents as the eighth most important factor in determining the value of office assets. The location of an office building is given the highest weighting (40 percent) within total value perception, followed by the workspace and the structure of the building (respectively 30 percent). Respondents consider the structure of a building to be an important determinant in assessing the market value of an asset and sustainability is the second-most important factor within that category.

Taking into account the Intergovernmental Panel on Climate Change's (IPCC) projections, it is surprising that sustainability does not feature as a higher priority among real estate professionals.

While location is the dimension to which all respondents give the higher weight, it is not as overwhelming as the usual mantra 'location, location, location' suggests. This means that the playing field is wide for value creation-oriented investors.

Although this narrow definition of sustainability still prevails, a much wider concept of sustainability has come into play more recently that defines it by economic and social dimensions as well as environmental. And in the RQR study, economic factors are rated by real estate professionals as almost twice as important than either the social or environmental factors to their perception of the market value of an office asset. This result reminds even the greenest among us that the raison d'être of an office building is primarily a means to support companies in doing business.

Nuances in value perception

Real estate is very much a local business and as such we find there are also local nuances in the way investors, tenants and other market professionals assess the value of office assets.

> Viewpoint
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> *"Sustainability issues are now integral to the underwriting process and therefore valuation. In particular, without a credible, holistic sustainability strategy, funds and companies would struggle to raise long-term equity capital"*
>
> **ALEX MOSS, DIRECTOR**
> **Real Estate Research Centre (formerly Cass)**

RQR's study looked at respondents' geography, professional background, and the generation they belong to, and found clear differences in how they weighted the value of sustainability in its narrow concept. For example, respondents in Europe and Japan tend to place greater importance on the value-add of sustainability to office assets than those in the US, where professionals tend to underweight the importance of location.

Differences between professions are also pronounced. Whereas investors and intermediaries – such as brokers, appraisers and property managers – underweight the importance of sustainability to asset value, occupiers overweight it as a factor. This is probably a reflection of investors' mandates to achieve a specific level of targeted financial performance, which may not be taking into consideration broader value creation factors like sustainability. The result is that many investors avoid spending on areas that are not obvious income generators, relying primarily on market movements to generate returns. By contrast, the pressure on large corporations coming from the general public via the stock and/or the consumption markets seems to be efficient in inducing occupiers to give more weight to social responsibility themes.

Surprisingly, while sustainability is expected to be a greater concern for younger generations than for baby boomers, senior professionals tend to overweight the importance of sustainability while other generations are neutral to underweight its importance. A legitimate question is whether younger cohorts will align their views to their elder colleagues, or whether their preferences today are a good predictor of their future as decision-makers.

Weights changes in value perception over time

↑ Sharp increase ↓ Sharp decrease ↗ Moderate increase ↘ Moderate decrease

	2019	2020
Built structure	↗	↗
Sustainability	↗	↑
Workplace	↑	↗
Location	↓	↘

Source: RQR

"A much wider concept of sustainability has come into play more recently that defines it by economic and social dimensions as well as environmental"

Changing perceptions

Awareness about the relevance of sustainability in real estate has been growing for several years now. And this is confirmed by the analysis of our three-year track record on the European office market: respondents to the RQR study are persistently placing greater value on sustainability over time both in 2019 (over 2018) and in 2020 (over 2019).

Similarly, the importance accorded to the building structure at the expense of location has continuously increased in the period. It even seems to have accelerated in 2020. Although it is too early to draw clear conclusions, it is tempting to relate this evolution to the recent lockdown that has imposed remote operations, which has presumably weakened the geographic anchoring of work.

New themes are also gaining momentum. For example, respondents are acknowledging the ability of buildings to contribute to the local community. Traditionally, investors have viewed buildings merely as a means to draw an economic profit from the local economy and surrounding communities. This is progressively changing, along with the increasing awareness of sustainability in its broader sense. A new breed of investors has emerged, increasingly concerned by the contribution their investments have on society. ■

Olivier Mege is the chief executive of RQR. This article is co-written with Fabrice Larceneux, researcher, Paris Dauphine University, and Chihiro Shimizu, professor, University of Tokyo and Nihon University, and research affiliate at MIT Center for Real Estate. **RQR Global** is a real assets rating agency for quality, risks and impact. The RQR study is supported by Schneider Electric and the University of Tokyo

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