Sustainability and what this means to investors in Real Estate

The sustainability of assets a Real Estate company invests in is a broad subject. It ranges from the efficiency of energy usage to the ability of a building to withstand being flooded. At it's heart though this is about return on investment and the degree to which this will be resilient in the face of a rapidly changing environment be that weather related, legislative or socio economic.

As the third largest insurer in the Real Estate Sector we are fundamentally interested in the resilience of property to all sorts of perils. The management of risk is a key part of what we seek to do and this paper forms a first step for us in outlining our approach to sustainability. We will identify some key risks that sustainability presents along with an assessment of the degree to which these are perceived by investors now. The debate that sits behind this is climate change which is commonly perceived as contentious and unresolved. We are not going to add to that debate but instead we will say that whether real or imagined, it's effect is actual because governments both here and globally are responding to it. This affects the business fundamentals within which an investment is made and constitutes a potential value shock to an investor as commonly no provision would have been made for the associated issues in the initial capital value calculation that nearly all investors use when buying a property.

Understanding the degree of perception and therefore the extent to which sustainability is influencing behaviour both in respect of management of risk and purchase decisions is useful to us in the insurance industry. It helps us develop our proposition in response to need, ultimately through the buying appetite for dedicated risk services.

A number of successive publications will look more closely at weather resilience, modern methods of construction and how we are developing our proposition to respond to these across the Property, Casualty, Engineering, Risk Consultancy and Legal Indemnity lines of business within Zurich Real Estate.

What are the risks?

Legislation and the economic response to it, allied to apparent changing weather patterns is driving the emergence of sustainability risk. The key risk headlines are:-

- Income Risk
- Lease Risk
- Energy Performance Risk
- Flood: Risk to Value & Additional costs of reinstatement
- Capital availability
- Major Renovation

Over the past few years, climate change has become a major issue and legislation has been enacted relating to environmental standards for premises and construction – namely the European Directive for the Energy Performance of Buildings 2003 (EPBD) and Part L (conservation of fuel and power) of the revised Building Regulations October 2010. The Sustainable and Secure Buildings Act 2004 also has powers that could affect new and altered premises.

Provisions of the Energy Act 2011 mean that — as early as April 2015 in Scotland and April 2018 in England and Wales — it could become illegal for owners and occupiers to let commercial buildings that score Energy Performance Certificate (EPC) ratings below a set rating, currently indicated to be an E rating (ratings F or G).

In 2012 Sustainable Investment and Asset Management LLP (SIAM) undertook a study upon a large sample of investment properties and quantified the proportion exposed to sustainability risks, as outlined below:-

- Income Risk – the proportion of total rental value attributable to tenants who have publicly announced a sustainability policy amounts to 57%. At the time of the next relocation opportunity these tenants have, clearly there is a risk that they will migrate to better rated accommodation leading to lower than average tenant retention for poorer property and a consequent reduction in it's value. In their study SIAM found that "business to business" enterprise was the sector most developed here as green supply chains are growing in importance. Separately office occupiers were generally subject to stronger pressure to reduce the carbon intensity of their businesses.

- Lease Risk – Investors cannot usually improve properties whilst they are occupied by tenants, preventing landlords from taking steps to protect value until their existing tenants have gone. Further, whilst most leases allow landlords to pass on the cost of complying with new regulations to their tenants, SIAM reported that 17% of leases leave the landlords with any such liabilities.

- Energy Performance Risk – The proportion of income derived from F- and G-rated EPC properties is as yet uncertain. In SIAM's study this accounted for 13% of all incomes. Not all property will yet have an EPC as these are only mandatory when a property is sold or let and in SIAM's study for instance a third of the sample was uncertified. EPC scoring is linked to Building Regulations which are reviewed on a three yearly cycle. At each cycle the measures are becoming more stringent particularly where a property has air conditioning. It is therefore anticipated that a far higher proportion of property will fall into the F- and G-rated categories over time and of those properties yet to be assessed a significant proportion will sit in these poor performing categories. This means without appropriate energy efficiency improvements they may become more expensive and more difficult to let in 2018.

- Flood: With 2012 being the second wettest year on record sentiment is worsening towards property that has any degree of exposure to flooding. Uncertainty characterises property of this type and uncertainty in investment terms is not positive. Uncertainty of continued access to insurance, changing weather patterns with more intense and localised events and higher than anticipated reinstatement costs to meet specifications now required in flood risk areas all build to a growing negative perception and is expected to cause a downgrading of values.

- Capital availability – a key issue since the valuation crash of 2007 has been the difficulty of raising capital from banks and other institutional investors. As we will see perception is king and in general terms the larger the organisation the more cautious an approach towards any asset that exhibits any potential sustainability issues. Banks are at the forefront of the cautious here with the implications of the 2011 Energy Act and flood area problems becoming increasingly significant when raising capital with which invest. This not only applies to an individual property but could further impact upon an investor's broader operations as these at risk assets would be deemed to negatively affect a portfolio of investments.

- Major Renovation Whenever a building undergoes major renovation or replacement of building parts or systems (boilers, air conditioning, windows etc), the building's energy performance must be upgraded to meet higher standards. Major renovation is a refurbishment of more than 25% of the building's surface, or where the total costs of the renovation are higher than 20% of the building's value — as defined by the European Parliament.

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Trends in perception

PWC and the Urban Land Institute's "Emerging Trends in Real Estate Europe 2013" sampled a wide cross section of market opinion and found that "sustainability is still rising up the corporate agenda."…"be they REITs, residential developers, banks, or investors, (their interviewees) say environmental concerns are now intrinsic to their due diligence. In the consumer world, brands are considering how to manage down carbon footprints and how to supply more sustainable products – an agenda which is beginning to influence retail development."

Some of their quotes include:-

"We are looking at asset management initiatives that seek to refurbish good assets with green credentials."

"It's the only thing tenants want to talk about."

"*Sustainable properties are increasingly commanding higher rents and values*."

GVA Grimley Ltd have recently published one of their periodic reviews of how sustainability is perceived by different parts of the Real Estate investor sector. It's their fourth such report, the first being undertaken in 2007. It shows a significant increase in the importance being placed upon the issue by investors. In particular large institutional investors, Fund Managers, REITs and those investing over a long time horizon are reporting that sustainability assessments are becoming the norm in the acquisition process. Aside from new assets 85% of fund managers plan to assess their existing portfolios in light of the risks posed by minimum energy performance standards and occupiers' changing expectations.

The GVA review exposes that although many investors are assessing their properties, 55% of those responding to the research still do not assign specific figures for the costs or benefits of sustainability within their investment appraisals. Only 17% always assign figures, although this level rises to 38% again for those investing over the longer term, in this instance 15 years. As outlined sustainability risks are significant and the risks are to the financial return of the assets invested in.

The implications of the 2011 Energy Act certainly seem to be driving increased perception in the sector. So too are ever rising utility prices and environmental taxes, impacting upon both investors and occupiers. 70% of the respondents to GVA's study report upon the sustainability performance of their portfolios in some shape or form. Again due to increasing regulation, such as the CRC Energy Efficiency Scheme, Mandatory GHG reporting and the anticipated extension of DECs for certain commercial buildings the amount of reporting here is set to increase.

GVA comment that "Some of our clients are already unwilling to purchase properties with poor EPC scores and we expect capital values to be impacted by energy efficiency before 2018. We believe many investors are currently investigating the most cost effective ways to improve EPC ratings across their portfolios"

Ruth Gilbody, Director of 4See Environmental Limited comments;

"A year ago, we started having discussions with Real Estate investors about the implications of the Energy Act and Minimum Energy Efficiency Standards on their property portfolios, we are now seeing them start to take action to assess their portfolio risk and estimate the costs of compliance with this new legislation. Unfortunately in our opinion there has been some 'knee jerk' reaction by the market with some undertaking costly blanket EPC assessments. We are advising a more considered and cost effective risk assessment approach, using their money more wisely."

What you can do

We at Zurich believe that in partnership with our brokers we act jointly as advisors upon risk and, where we are able, in finding solutions to either transfer or mitigate risk. An insurance contract can't address all of the issues highlighted here but what we must be is alive to the implications to our customers' businesses, highlighting the pure financial hazards these present.

We at Zurich have sought to enlist third party advisors that can support you in the following ways:-

4see Environmental is a technical environmental consultancy, involved in undertaking thousands of EPCs from the introduction of the EPBD legislation and is offering detailed technical support for organisations addressing their risks associated with the Minimum Energy Performance Standards introduced by the Energy Act 2011. For Zurich they can provide EPC Surveys, desktop and detailed site Energy Audits and a Minimum Energy Performance Standards review.

The 2011 Energy Act is "a very significant consideration indeed for those who occupy, sub-let or own a single commercial property, and a potential time bomb for those who own a portfolio of commercial property," says Ruth Gilbody, Commercial Director.

Ruth is also quick to implore brokers to discuss the issue with any customers who the legislation may apply to.

"As a broker, you have a vital role to play in getting the word out about this, because it's a sophisticated message. Depending on the customer's property-ownership status, the Act will potentially affect them in different ways.

"The Energy Act also offers you the chance to demonstrate to your clients your aptitude as their professional risk adviser and your commitment to keeping an eye on what lies on the risk horizon for them.

Commercial property owners should not assume that all properties with an F or G ratings are likely to be equally affected, but should seek professional help to identify those properties where the impact will be most severe. This includes properties which will not be improved during their natural cycle or which are incapable of improvement at an affordable cost. The costs associated with improving the buildings to the required standard can then be quantified relatively, and a strategy put in place from a position of strength.

SIAM, who's research we have drawn upon for this article work in conjunction with 4see Environmental. They can provide support around the financial impact of sustainability-related issues on investment and operational properties. Services include Portfolio Impact Assessments, Single Asset Stress Tests, Lease quality reviews, Flood risk: impact on value assessments and EPCs: assessments of risk to value.

Zurich, In our standard commercial policies the European Community and Public Authorities clause includes cover for additional costs of complying with European
Community- or UK building regulations, but only to the minimum required level under current legislation. Building upon this Zurich have developed a new cover, much of which we believe is unique in the market; Adaptation. **Zurich's Adaptation clauses** offer cover over and above these stipulations, allowing the policyholder to conform to Energy Performance Certificate assessment recommendations. It's Key benefits are:-

- Low cost solution for clients.
- Buildings may be rebuilt with improved resilience to climate change risks.
- Adaptation assistance from Zurich experts when reinstating damaged property.

Empowering your clients to exceed climate change requirements?

It's as easy as 1, 2, 3…

Clause 1 – Energy Performance and Sustainable Buildings

Available at **no additional cost** for clients' properties that fit acceptable criteria.
Cover is provided for the reasonable additional cost of reinstatement arising from the use of alternative materials or sources of materials in accordance with the principles of the BRE Environmental and Sustainability Standard, or to comply with the recommendations made under an Energy Performance Certificate.
Various limits up to £1m are available, depending on size and composition of portfolio.

Clause 2 – Debris Recycling

Available at **no additional cost** for clients' properties that fit acceptable criteria.
Extends the Debris Recycling clause to also include the additional expenses required to sort, segregate and transport uneconomically recyclable debris to recycling facilities. The clause has a limit on the additional recycling expenses (25% of the costs incurred under the standard Debris Removal definition), and the insured will be responsible for 10% of the additional expenses incurred under the extension. (Note, those materials that are economically recyclable will always be recycled, without limit and without contribution from the Insured).
This clause will be provided only when taken with one or more of the other Adaptation Clauses.

Clause 3 – Resistant design and materials

This is broader cover still, allowing significant improvements to premises that are undergoing repair following a claim; a premium charge therefore applies for this addition. Adaptation Clause 3 helps policyholders achieve efficiencies when buildings are reinstated following a loss, by providing an option for the opportunity to utilise materials and construction methods that improve sustainability in three key areas:

1. Resilience to wet storm and flood water damage through design or use of alternative materials in reinstatement that will perform better in the event of recurrence.
2. Resistance to wet storm and flood water damage through bespoke protective measures or schemes of protective measures designed to protect the property from a recurrence.
3. Superior fire resistance compared with cheaper alternative construction materials or methods.

References-

Emerging Trends in Real Estate Europe 2013 - PwC Legal (UK) and Urban Land Institute. January 2013

Green to Gold Sustainable investment attitudes – GVA Grimley Ltd. Winter 2012/13

Across the Universe, Data Review – Sustainable Investment and Asset Management LLP. June 2012

4see Environmental – www.4SeeEnvironmental.com