EVORA

EXCLUSIVE CONTENT

Unlocking Value in Short-Term Real Estate Investments Through Sustainability.

By **Ed Gabbitas**
Founder, Head of North America
EVORA Global

evoraglobal.com

EVORA Global has read with interest commentary that commercial real estate strategies offering higher yields, at a higher risk, will likely move first and fastest as the real estate market seeks to deploy built up capital. This trend is being driven by investors demanding higher returns in a challenged market.

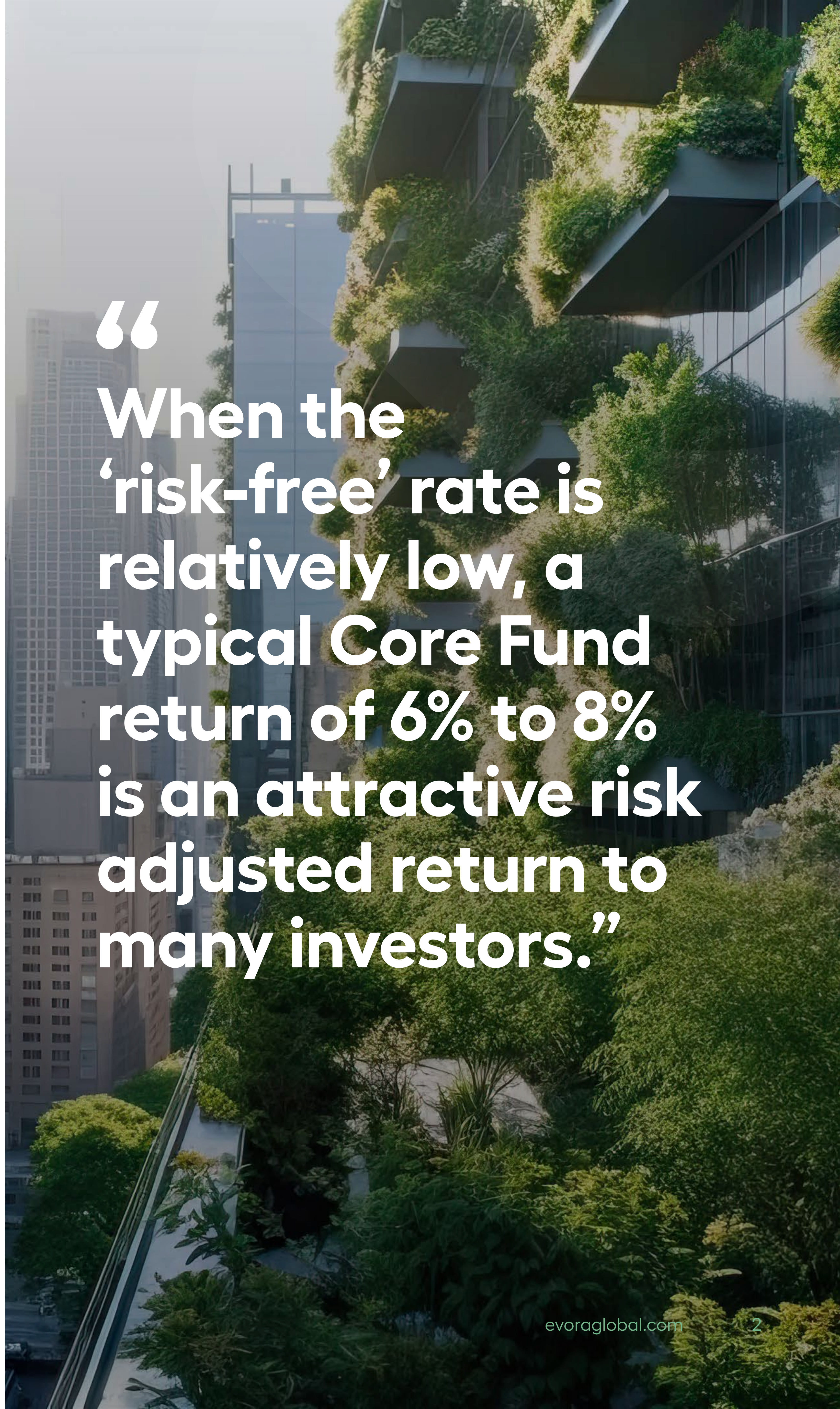
When the 'risk-free' rate (represented by the yield of a 10-year U.S. Govt Bond) is relatively low, (e.g. 1%to 2%), a typical Core Fund return of 6% to 8% is an attractive risk adjusted return to many investors. However, when the risk-free rate rises, the dynamics change. The risk premium of an asset is the additional return investors expect to earn for taking on additional risk beyond a risk-free investment. When the risk-free rate is 4.5%, the premium for Core real estate investments returning 6% to 8% shrinks to just 1.5% to 3.5%. This smaller premium is considered insufficient to compensate investors for the risks associated with typical real estate investments.

As a result, multiple industry outlooks expect to see a shift away from Core and Core+ strategies, towards higher yielding strategies of Value-Add and Opportunistic funds.

EVORA has extensive experience working with a number of Value-Add funds, providing sustainability advice across capital raising, capital deployment and management, and ultimately in achieving exit goals. A common misconception among many clients is that sustainability, decarbonization and / or ESG are not applicable due to the short hold periods. However, there are multiple instances that back up why Value-Add funds are perfectly positioned to capitalize on sustainability initiatives.

The fundamentals of a Value-Add strategy are to enhance a property's value by improving its income, decreasing expenses, or both. Four common approaches to achieve this are set out in the following pages.

Ed Gabbitas
Founder, Head of North America
EVORA Global



1 **Physical improvements** – major renovations and upgrades to building equipment, lighting and central machinery is a common strategy for Value-Add funds. However, undertaking improvements to achieve the bare minimum on energy efficiency, or only progressing initiatives that have a short ROI is often a missed opportunity.

How sustainability can add value

Thinking beyond a typical Return on Investment (ROI) of say 3 to 5 years or taking a like-for-like approach on capital works, can be extremely rewarding for value-add funds, particularly where actions enable meaningful decarbonization. However, that doesn't mean an asset needs to be fully net zero carbon (NZC) within the hold period. This is a common misconception we hear, which is understandable as the science behind net zero is complicated. A simple way to look at it, is imaging all buildings have a carbon budget, measured by tonnes of carbon per square feet or meter, and that budget needs to trend downwards from present day to 2050 (or the date at which NZC goal has been set). Buildings can position themselves anywhere along that line, depending on how ambitious a building upgrade is on Energy Use and Carbon Use Intensity (CUI). Being on, or below, the trend line will be viewed positively by a future buyer at the point of sale. The lower the CUI, the further this risk is pushed out (in years).

Considering the target exit market for Value-Add is typically Core funds, we recommend to our Value-Add clients that they identify how far along the decarbonization curve an asset should position itself to de-risk excessive future CapEx costs, which may be a concern for future buyers. This will likely mean considering enhancements that deliver energy, carbon and likely operational cost, savings compared to existing equipment. This action may involve additional upfront capex, however, it is important to compare the incremental costs from the base case / like-for-like replacement versus the enhancement. The delta is the true cost of decarbonization. This may seem at odds to a short hold Value-Add strategy, but it supports better net operating income (NOI) for the next owner, improves liquidity, and de-risks price chipping if the buyer has to undertake significant upgrades in their hold period because the building is carrying a high carbon load. In simple terms, doing more upfront, can deliver benefits of improved liquidity, higher capital values, and reduced bid-ask spreads – especially when targeting exit to Core funds with their own Net Zero Carbon strategies.

Takeaway

Progressing decarbonization is valuable because:

- It reduces future CapEx requirements for prospective Core fund buyers.
- It aligns building performance to corporate tenant's decarbonization goals, which can help shorten lease up periods.
- The risk, and cost, of non-compliance with Building Performance Standards penalties and taxes is reduced, and it;
- Ultimately supports liquidity on exit.

2 **Market positioning** – Green Building Certification can enhance brand image, reduce lease up, and appeal to tenants across a number of asset classes.

How sustainability can add value

In conjunction with undertaking building upgrades, green building certifications (GBCs) such as LEED, BOMA and BREEAM are excellent tools for demonstrating the quality of assets to tenants, and future buyers. In certain markets, attaining high quality (high scoring) GBCs is a contributory factor for out-performance in rental income. They are no silver bullet, but multiple studies provide a correlation of rental premiums to GBC. For example, a 2022 CBRE study across 20,000 US office offices found an average rent of LEED certified buildings to be 31% higher than those without LEED. When accounting for other fundamental rent drivers, such as location, building age etc, the premium was still determined to by 4%. A similar study by C&W identified that LEED certified buildings attracted rental premiums of 3.1% (multifamily) and 25% (Class A office) versus non-certified equivalents. Linkages to capital value premiums, over and above increases to total building costs, are also noted in a number of studies.

The flight to quality is not limited to office tenants. Modern logistics assets are forecast to lead on rent growth by sector, with an average of 4.3% for 2024-2028. In addition to building features like clear height column spacing, sustainability features such as roof load (to support PV), electric vehicle charging, and enhanced tenant amenities (such as gyms and showers) are all seen as driving value through enhanced market positioning as these assets can capture the top end of the market. Each of these measures typically feature within GBCs such as LEED.

In addition to brand appeal to tenants, having a GBC in place is a big tick in the box for future buyers who report to benchmark schemes like GRESB.

Takeaway

Enhanced brand and asset appeal though green building certification can be used to demonstrate quality and may lead to:

- Rental premiums versus comparable assets with no certification.
- Appeal from blue chip and government tenants with strong credit worthiness.
- Secure longer leases by aligning building performance with tenant programs on climate and decarbonization.

3 **Operational Improvements** are a key area where sustainability initiatives can help increase NOI through both the reduction of costs and escalation of rents.

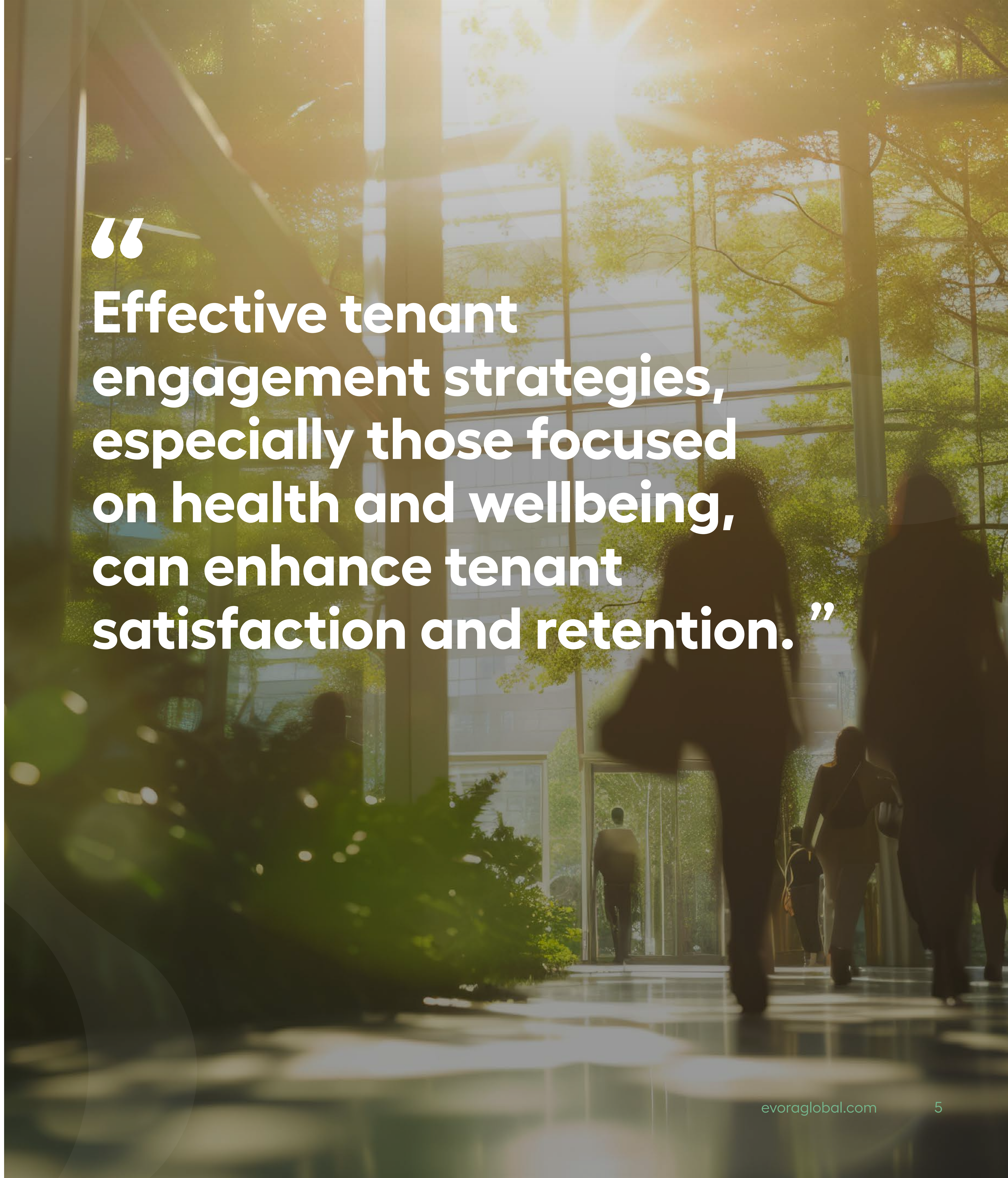
How sustainability can add value

Promoting energy efficiency is a no-brainer in terms of reducing operational expenditure to increase NOI. For Value-Add funds, this means considering the impact of operational energy use and costs at stabilization, which is typically when an asset would move out of a Value-Add fund. As with major upgrades, this likely means installing equipment with an ROI that extends beyond the first year. However, it goes without saying that increasing NOI through reducing expenditure has a direct impact on cap rate compression and therefore increased valuations.

Effective tenant engagement strategies, especially those focused on health and wellbeing, can enhance tenant satisfaction and retention. Research by The Centre for Active Design and QuadReal on the health and wellbeing certification Fitwel, demonstrated a link between enhanced tenant amenities and a higher net promoter score (NPS). NPS measures the likelihood that building occupants will recommend a property to their peers, with higher scores meaning a greater likelihood. A higher NPS also means greater tenant satisfaction, which is a key factor to tenant retention, and improved amenities can be a key input to rent escalations.

Takeaway

Focusing on operational improvements, such as energy efficiency, can reduce expenditure and increase NOI. Similarly, enhancing tenant amenities and health and wellbeing can drive tenant satisfaction and retention, and potentially rent escalation.



4 **Financial optimization** – Given current market conditions, a key focus for many Value-Add funds relates to refinancing of distressed debt.

How sustainability can add value

Despite the increasing demand for sustainable financing, there is a scarcity of tailored financial instruments and products in the CRE debt market. However, as data accessibility / standardization and risk management techniques develop, lenders and investors will become more apt to seek emerging financial options. Development and implementation of innovative sustainable financing options, such as green and sustainability-linked loans will incentivize the adoption of sustainable practices. These loans, which are tied to sustainability performance targets rather than specific green projects, like green loans, hold great potential for further expansion and adoption. Borrowers can access lower interest rates by achieving predefined sustainability goals that incentivize implementation of sustainable and climate-related considerations over and above "business-as-usual". Such instruments will not only attract sustainability conscious investors but will also continue to push the market towards higher standards of sustainable integration. This capital can be used to support physical improvements referenced earlier in section 1, thereby enhancing brand reputation, mentioned in section 2 and derisking investments thorough improving quality. One challenge that persists, in my opinion, is that margin reductions for green and/or sustainability linked loans remain too low – loan structures need to change to truly incentivize action.

Another important avenue to explore, especially for sectors such as industrial, are feasibility studies for installing rooftop solar as a means of generating additional revenue streams. Funds with these assets, should consider installation of PV, or preparing roof loads to cater for future installations, particularly where policy instruments are favourable.

Takeaway

Green financing can support access to a broader pool of capital, reduce borrowing costs (albeit only slightly right now), deliver outcomes that reduce expenditure, save carbon, and in some instances deliver an additional revenue stream.

Conclusion

Taking a longer-term perspective can, and is, driving performance for many Value-Add funds. Considering the needs of your buyer's buyer i.e. two hold periods, should be undertaken to reduce risk in current business plans and ultimately achieve target exit values.

Savvy investors are identifying risks in due diligence, and any shortfall in performance may lead to a wider bid-ask spread. Intelligent integration of sustainability measure into a business plan is a key means to reduce this risk.

How EVORA can support

Our proven 4D Approach serves as the foundation for creating an appropriate Sustainability Strategy for Value-Add funds. Integrating sustainability risks is no different to integrating standard financial risks into investment decisions; more information should never be harmful to an investment.

Development:

Drivers Initiate your Sustainability Strategy by understanding materiality, key risk and investment drivers. Our outcome is a transparent Roadmap Report that guides your path forward.

Design Establish your Sustainability Strategy Framework and Action Plan to future-proof your real asset investments against sustainability risks and global trends.

Deployment:

Delivery Equipping you with the tools and mechanisms necessary to bring your strategic vision to life and implement your objectives.

Disclosure Helping you meet voluntary and mandatory reporting & disclosure requirements.

Ready to maximize your investment potential?

Contact us today to discover how our comprehensive sustainability strategies can elevate your Value-Add fund's performance, mitigate risks, and unlock new opportunities for growth.

evoraglobal.com/contact-us

Exclusive Webinar Invite

Creating Value Through Sustainability

Perspectives from Value-Add Fund Managers

In the current high interest environment, it is expected that commercial real estate strategies offering higher yields, at a higher risk, will likely move first and fastest, as the real estate market seeks to deploy built up capital. This is being driven by investors demanding higher returns in a challenged market. Value-Add funds are poised to benefit from the current economic environment that has seen decreasing values, and higher operating costs in many markets.

Join us on 11 July 2024.

Highlights of the webinar will include:

- Hear why Value-Add funds are positioned to capitalize on the current CRE cycle.
- Understand how sustainability can be incorporated into common Value-Add strategies.
- Listen to industry leaders talk about how sustainability is adding value to investments. through managing future risks
- Examine the perils of taking a short-term view
- Gain actionable insights to help you stay ahead of the competition.

Register now and **join us on July 11 at 11:00 EST**
evoraglobal.com/events