



ARTICLE | Intelligent Investment

Sustainability Index

By: Aidan Reynolds, Executive Director & Head of Valuations at CBRE Ireland

Three years ago, CBRE set out to establish a Sustainability Index, meticulously tracking the value of over 1,100 UK assets (approx £20bn) with varying levels of energy efficiency, across the main commercial property sectors. With the scrutiny of CSRD, SFDR, etc intensifying, the insights offered by the index are an essential read, and it will be an important tool for those aiming to direct capital deployment to upgrades across the commercial property sectors, and extract maximum value.

Introduction

In Q4 2023, the first edition of the CBRE UK Sustainability Index was launched. The Index has been tracking investment performance of property assets with varying levels of energy efficiency since Q1 2021. Although the index is UK based, and does not include assets in Ireland, the UK market shares significant similarities to the Irish commercial property market, especially in the main sectors (Office, Retail, Industrial), and the research has highlighted some interesting market dynamics.

Existing research in the area of sustainable assets often provides snapshots of the market without reflecting trends over time or maintaining a consistent sample. This limitation makes these studies less useful for decision making purposes. In addition, much commentary is heavily focused on office properties.

The CBRE Sustainability Index takes a different approach by tracking the relationship between energy efficiency and investment performance over time and across the three main sectors – retail, industrial, and office properties, allowing for an examination of trends over a market cycle. The index tracks the correlation between energy efficiency and value, and will be a useful tool to understand and discuss the relationship between energy efficiency, sustainability and value.

Number of assets in index sample

Figure 1 above shows the index sample. The capital value of the sample as at Q4 2023 was £20.3 billion, and comprised 1,101 assets. Dark green bars represent the EPC's of the sample, whereas the light green bars indicate all EPC's issued in England and Wales, so the graph illustrates that the sample is broadly representative.

EPC's (Energy Performance Certificates) are the UK equivalent of the Irish BER (Building Energy Rating) Certs. The methodology of the UK EPC's and Irish BER's are considered to be reasonably closely aligned.

CBRE Sample (Q4 2023)

1101 Assets 8224 Units

Sector Breakdown





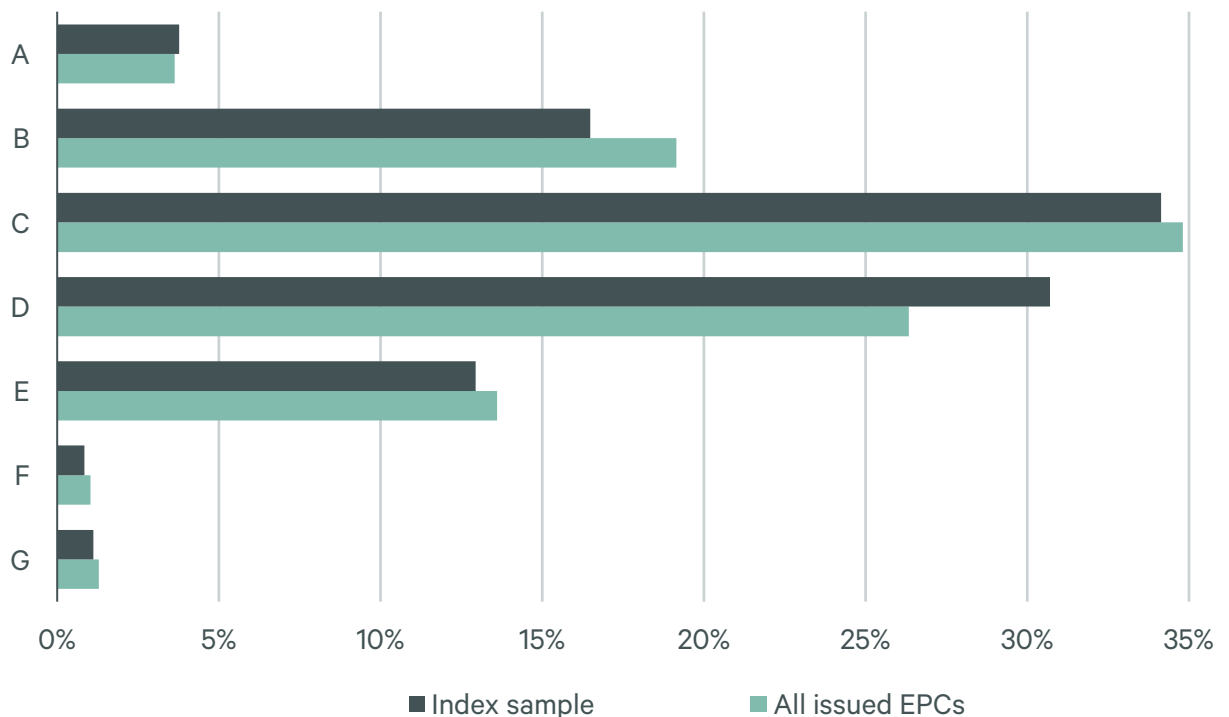
	
24%	31%
Office	Industrial
	
26%	19%
Retail	Other

FIGURE 1: EPC Distribution (unit level)



Source: CBRE Research, Department for Levelling Up, Housing & Communities. As at Q4, 2023

FIGURE 2: Efficient & inefficient assets

Sector	Office		Retail		Industrial	
	Count	Value	Count	Value	Count	Value
Efficient assets	18%	35%	31%	32%	15%	17%
Inefficient assets	82%	64%	69%	68%	85%	83%
Non-compliant assets	7%	2%	1%	0%	0%	0%

Efficient assets Inefficient asset Non-compliant assets
EPC A or B **EPC C or lower** **EPC F or G**





Source: CBRE Research, Department for Levelling Up, Housing & Communities. As at Q4, 2023

CBRE Sample (Q4 2023)

£20.3bn
 Total capital value

£1.5bn
 Total rental value

Sector Breakdown

	
37%	31%
Office	Industrial
	
24%	9%
Retail	Other

Value of assets in index sample

The above Figure 2 indicates the breakdown of the sample by value, compared to the asset count for each of the main sectors that have been considered. The sectors have been categorised into two larger EPC groups rather than by individual EPC ratings, those two groups being;

- 1) Efficient assets - having a weighted average EPC of A or B
- 2) Inefficient assets - having a weighted average of C or lower, and Mees (Minimum Energy Efficient Standard) non-compliant assets – these assets have an energy efficiency of F or G, which are in effect a sub-sector of inefficient assets.

These efficient vs. inefficient definitions are consistent with what is used in European disclosure regulations including the Sustainable Finance Disclosure Regulation (SFDR) for example. On the basis of describing the assets as efficient (A & B) and inefficient (C and below), we can observe that for the office market, the concentration of value for efficient assets is very pronounced. Efficient office assets account for only 18% of the office sample by number of assets, but they account for 35% of the sample by capital value. However, this concentration of value was not as pronounced in the Retail and Industrial Sectors.

From our experience, we would expect a similar pattern to be repeated in the Irish market.

Capital value per sqft

Figure 3 below shows the capital value per square foot across all three sectors at the start of the index. It shows that at the start of the study (Q1 2021) efficient assets had a higher capital value per square foot across all three of these sectors. Clearly it was most pronounced in the office sector, and for retail and industrial, less pronounced, but still evident. We would expect the Irish market to show similar characteristics.

Assets with an EPC of A or B are categorised as efficient.

Assets with an EPC of C or lower are categorised as inefficient.

FIGURE 3: EPC Efficiency



Source: CBRE Sustainability Index, Q2 2021

Rental value per sqft

Figure 4 is a similar graph, but breaks down rental value per square foot for the different sectors at the beginning of the study. And again, we can observe the difference is there and quite pronounced for efficient versus inefficient offices. There's a small difference in industrial, and for retail, there's no difference at all, which is something that surprised us initially.

FIGURE 4: EPC Efficiency



Source: CBRE Sustainability Index, Q2 2021



Office Performance Analysis

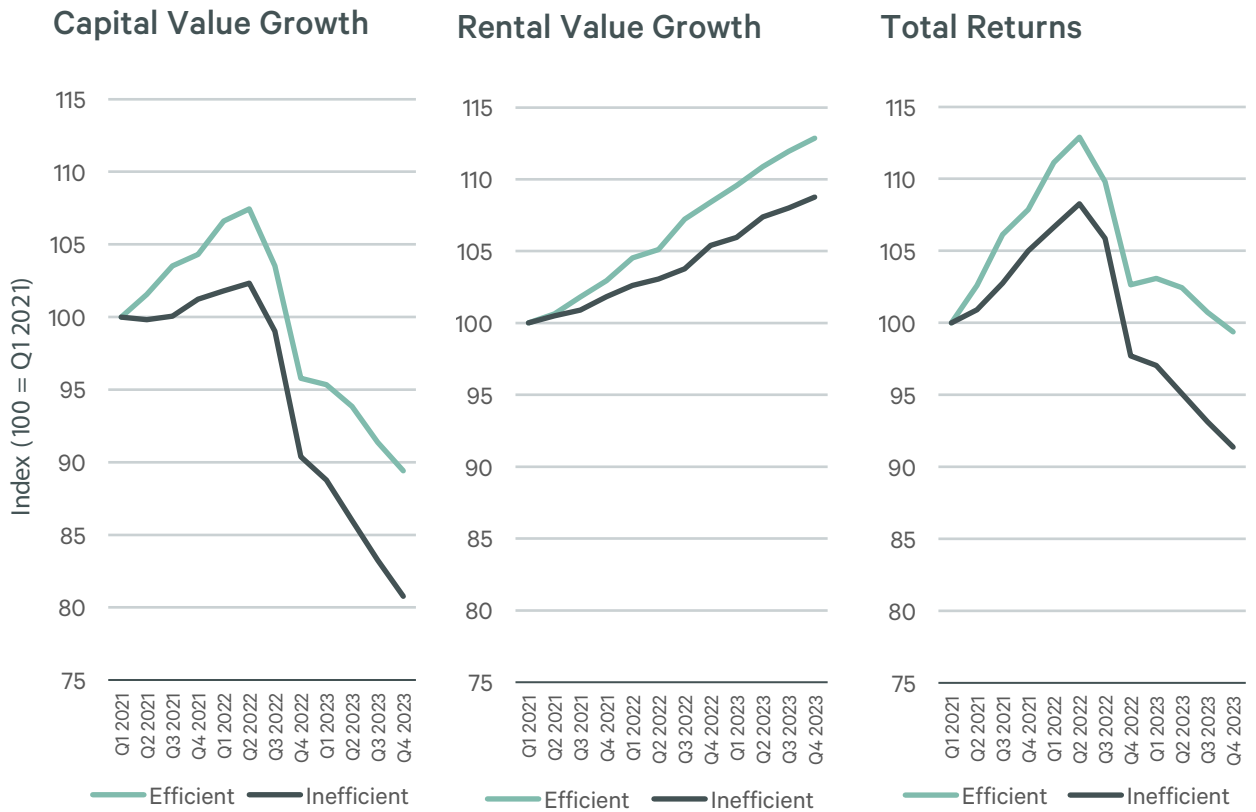
Having considered the sample characteristics, we can then look at the performance over time of these sectors. And this is where the index is interesting, as it allows us to think about the risks and opportunities associated with energy efficiency.

The office sector is where we observed the relationship between efficiency and value to be most pronounced, and we can see (in Figure 5 above) that efficient assets outperform inefficient assets across capital value growth, rental growth, and total returns.

What stands out is that over the 12 quarters of the index, capital values for efficient office assets fell significantly less than that for inefficient office assets. These results broadly reflect the two-tier state of the office market. Although this is UK based evidence, in our experience this is also the case in the Irish market.

Perhaps the narrative for offices in particular needs to move away from seeing the top line as a premium, to considering resilience, particularly in the current market.

FIGURE 5: Office Growth



Source: CBRE Sustainability Index, Sample at Q4 2023: 70 efficient, 198 inefficient

Industrial Performance Analysis

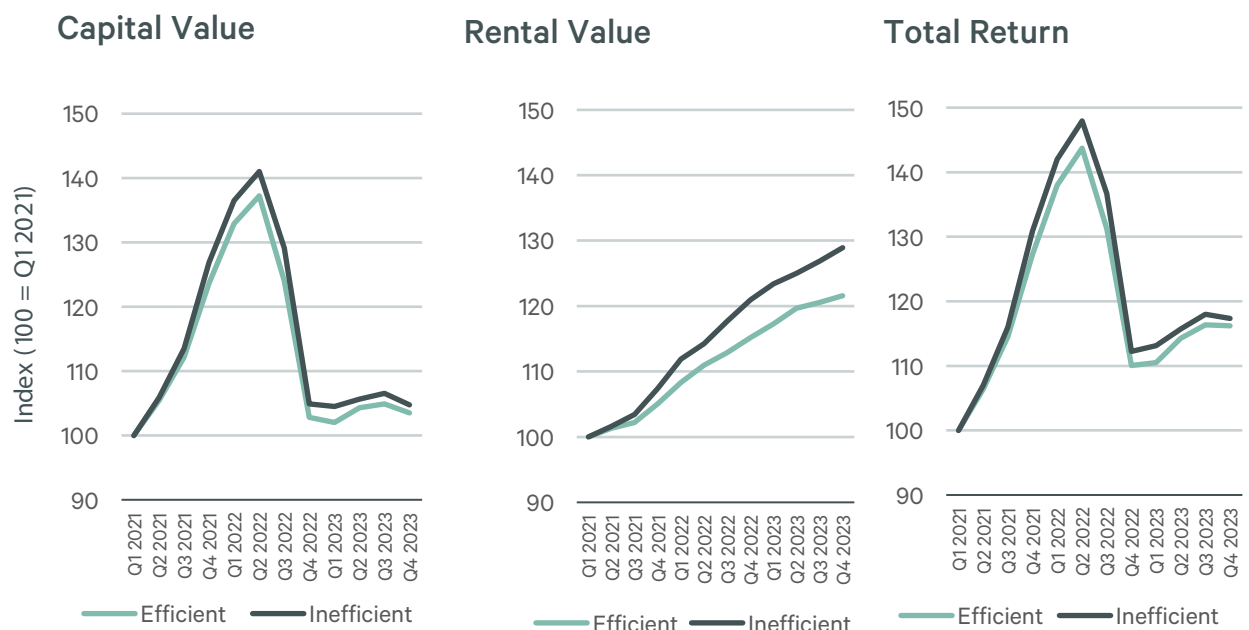
The office relationship is the logical one that you would expect i.e. where more efficient assets have stronger investment performance. But for industrial, that relationship is somewhat reversed. The index indicated efficient assets recording slightly weaker performance across all three of the metrics, being capital value, rental value growth and total returns (see Figure 6 above).

We believe the reason for this may possibly be that there are other stronger market forces than sustainability driving capital and rental values in the industrial sector over the last 12 quarters. Demand across all Industrial categories has been very strong, and supply has been constrained in the UK (which has also been the case in the Irish market). It appears that the competition for industrial space has possibly led to sustainability being a lower ranking for occupiers, who may be prioritizing available space over sustainability. This is potentially the reason behind the lack of correlation between efficient assets and strong investment performance in the Industrial sector. We would expect the Irish market to be in a similar position.

Another reason may be the perceived amount of Capex that is required to get an industrial asset from an inefficient one, to an efficient one. As a percentage of capital value, our experience to date is that the capex requirement is considerably less for the Industrial sector, than for the Office sector (Source: CBRE Sustainability Team). Investors are apprehensive about the potential capex cost for offices, as it can be a complicated cost, whereas it can be more straightforward and less risky for industrial buildings.

In Offices particularly, that Capex is typically not just a one off spend, but needs to be considered as an ongoing program of asset management works. For an Industrial asset, it is perceived to be a much less sophisticated problem, and thought to be easier to improve the energy rating, and not have any significant spend for a more prolonged period e.g. change to LED lights, upgrade the plant, install solar panels etc.

FIGURE 6: Industrial Growth



Source: CBRE Sustainability Index, Sample at Q4 2023: 62 efficient, 282 inefficient

In simple terms, the whole industrial market over the period of the study has performed quite differently to the other sectors, and one of the fundamentals is that we haven't seen any bifurcation in the industrial market, which we have observed in the office market. However, we believe that as we continue to track the Industrial sector, and as the market changes when supply catches up with demand, the observed pattern to date will most likely change.

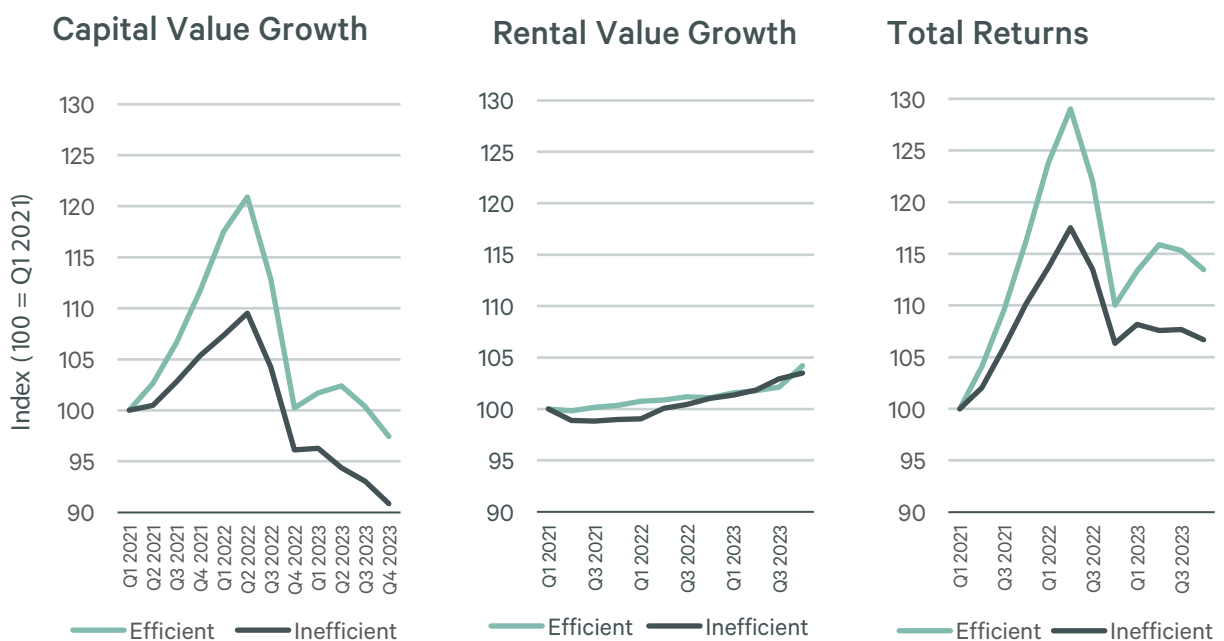
Retail Performance Analysis

In respect of Retail, the overall results are as expected, with efficient assets recording stronger performance, (see Figure 7 above). However, the retail sample is made up of sub-sectors – High Street Shops, Retail Warehouses and Shopping Centres, and those different sub-sectors do report quite different behaviours than those indicated in Figure 7.

The efficient sample is weighted more heavily towards Retail Warehouses which we know performed well over the 12 quarter period, and the inefficient sample is weighted towards High Street shops which we know performed weaker over the last 12 quarters.

So actually the divergence observed between efficient and inefficient in our view most likely reflects the divergence in performance between UK Retail Warehouse and High Street shops. Fortunately, having the benefit of a large retail sample size allowed our Research Team to split out and look at UK Retail Warehouse and High Street shops separately;

FIGURE 7: Office Growth



Source: CBRE Sustainability Index, Sample at Q4 2023: 70 efficient, 198 inefficient

Retail Warehouse & High Street Shop Cumulative (Q1 2021 - Q4 2023)

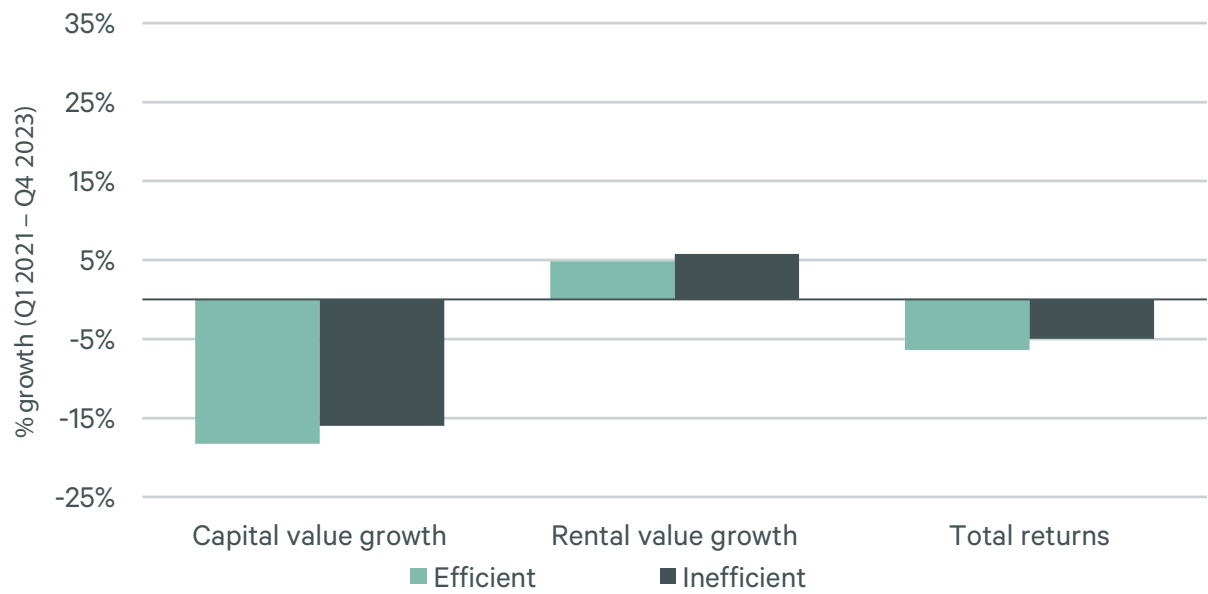
Figure 8 on the next page displays the performance of the three main metrics since the inception of the index. It reveals that efficient assets in the Retail Warehouse sector report lower total returns but higher capital values. This means something unusual appears to be happening with income for Retail Warehouses, and we believe this could be location driven. In respect of High Street shops, efficient assets show weaker performance across all three metrics. We believe this anomaly is attributed to the sample dynamics, particularly a few high-performing, yet energy-inefficient assets in prime central London (e.g. Bond Street), skewing the results.

Even though the UK High Street piece is nuanced, it is useful to observe that the Retail Warehouse stock, where a lot of our fund clients are investing, is benefitting from capital value growth. In addition, the cost of upgrades for Retail Warehouses are likely to be in a similar region to that of Industrial in terms of the simplicity (Source: CBRE Sustainability Team).



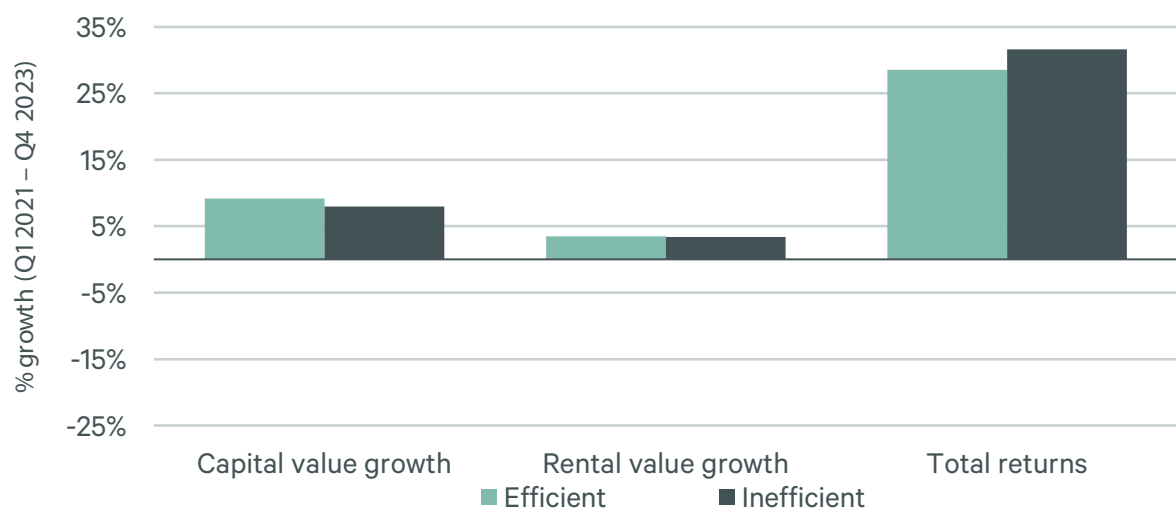
FIGURE 8: Retail Cumulative

High Street Shop



Source: CBRE Sustainability Index, Sample at Q4 2023: 33 efficient, 133 inefficient

Retail Warehouse



Source: CBRE Sustainability Index, Sample at Q4 2023: 56 efficient, 76 inefficient

Takeaways

Office: Office properties showed the most pronounced relationship between energy efficiency and value, with efficient assets outperforming inefficient ones across capital value growth, rental value growth, and total returns.

Industrial: The relationship between energy efficiency and investment performance in the industrial sector was somewhat reversed. Other stronger market forces, such as high demand and supply constraints, were driving capital and rental values in the industrial sector. The competition for industrial space likely resulted in sustainability concerns being lower on the priority list for occupiers.

Retail: More efficient retail assets recorded stronger performance. However, the results were somewhat skewed due to the sample dynamics, across various locations and building types as the efficient sample was weighted more heavily towards Retail Warehouses, which performed well over the 12-quarter period.

Despite the Index not including Irish assets, from our experience the main commercial property sectors in the UK (Retail, Industrial and Office) bear considerable resemblance to the Irish market. The Index has brought to light some interesting market dynamics which could be beneficial for Irish investors and market analysts. Due to the similarities between the UK and Irish market, the index can provide useful warning signals of possible exposures, and highlight potential opportunities to Irish commercial property Stakeholders. At the very least, it facilitates more depth of discussion around sustainability and value.

Looking forward, the aim is to expand the index to track more sustainability metrics, such as physical risks like flooding, heating fuel, and certifications like LEED and BREEAM etc. The index will be updated every 6 months and we also plan to delve deeper into sub-sector analysis, as trends can vary significantly within each sector.

Contacts

Aidan Reynolds
Executive Director
Head of Valuations
Aidan.Reynolds@cbre.com

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