Valuation Checklist[1]
Nick French – November 2024

The practical impact of Environmental, Social, and Governance (ESG) on the valuation of commercial properties in the UK

"If, at the date of valuation, the market does not differentiate 'sustainable' and 'non-sustainable', there will be no impact on Value." **(RICS, 2009)**

Background
The goal of this briefing is to provide an insight into how the new energy efficiency legislation in the UK is impacting upon the valuation of commercial properties. This paper looks at how to adapt implicit valuation models to reflect the new risks of the impact of Minimum Energy Efficiency Standards (MEES) legislation. In a free market, sustainability will only have an impact if the occupiers of properties consider that the "sustainable elements" make a contribution (perceived or real) to the bottom line. Occupiers will only pay for specifications that impact positively upon their businesses. That said, legislation will have an impact if it restricts occupation.

As of the 1st November 2024, the property profession is still waiting for confirmation that the UK government that it will continue with the white paper proposal (2021) for MEES on commercial investment buildings (in England and Wales) for all lettings. There current proposal is that for commercial (non-domestic[2]) property, only properties with a C (or above) EPC rating can be let from 1st April 2027 and this will rise to a minimum rating of B from 1st April 2030[3]. There are exemptions available but the degree on which that these can be relied is less broad than previously.

Practical Application
The role of the valuer in practice is to observe market sentiment and to reflect the impact of the proposed new targets, if implemented, on the value of the subject property and choose the correct model for the valuation when undertaking as Red Book[4] valuation.

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[1] This checklist is a personal view of Nick French and is not endorsed by any professional body including the Royal Institution of Chartered Surveyors. Its intent is to provide a framework for a valuer to undertake the valuation of commercial property with relation to the current ESG liabilities as proposed in the UK (as of Nov 2024). No liability will be accepted for the use of this checklist but it is hoped that it provides guidance to help the valuer produce estimates of market value.

[2] The new Labour Government (The Department for Energy and Net Zero) have already announced (Sept 2024) that all let residential properties must have a minimum of C EPC rating by 2030

[3] It is possible that these dates will be pushed out but we are awaiting an announcement on non-domestic property; an announcement is due in spring 2025.

[4] The Royal Institution of Chartered Surveyors (RICS) - Report from January 2025 will be prepared in accordance with the requirements of the RICS Valuation – Global Standards 2025 (which incorporate the International Valuation Standards 2025) and the UK national supplement 2024. This is colloquially known as the Red Book.

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Valuations under the RICS Red Book

The role of a valuer in providing a valuation under the Red Book is multi-faceted but condenses down into two main requirements with regards to the impact of ESG provisions and legislation. Firstly, the valuer is to provide the Market Value (MV) of the subject property (an estimate of the price on the date of the valuation) but they must also place that value in context as part of the due diligence of the valuation and the commentary that accompanies the MV figure. In terms of valuation practice, MEES has become embedded in the due diligence process. Even if there is no clear evidence of market value change, within their due diligence/commentary the valuer must comment upon any (future) risks posed by MEES and other ESG issues that may affect the property.

Due Diligence Checklist

1. **MEES and EPCs: they are a source of risk and should be checked for validity and accuracy.**
2. **When reporting, 'wherever appropriate, the relevance and significance of sustainability and ESG matters should form an integral part of the valuation approach and reasoning supporting the reported figure'.**
3. **Valuers should assess the level of risk posed by MEES and the extent to which the market rent/yield will be affected based on market evidence and/or sentiment - Until comparables adjust the yield, valuers need to "value" any observed change in market sentiment.**
4. **VALUERS MUST REFER TO THE RELEVANT SECTIONS AND HEADINGS WITHIN THE RICS RED BOOK TO IDENTIFY THE IMPACT OF ESG ON THE PROPERTY BOTH NOW (in assessing MV) and IN THE FUTURE (for placing the value in an economic/market context)**

Valuation Checklist (in addition to normal checks and balances)

5. **Valuers must only operate within their skills and competence – DO NOT GUESSTIMATE THE COST OF RETROFITTING – EPC assessors and/or construction cost consultants should provide any costs for works required when the valuer has chosen to use a residual method of valuation.**
6. **Check the MEES regulations at the date of the valuation**
7. **Collate and check all EPC certificates as they relate to the building.**
8. **Ensure that the EPC covers the whole area of the building and not just part.**
9. **Check on the currency and veracity of certificates as provided. Check the EPC Register to determine the history of EPCs for the subject property.**
10. **Choose the appropriate valuation method/model for the subject property – this will be dependent upon the sector or sub-sector of the property and the prime, secondary or tertiary classification.**
11. **Undertake the valuation looking at all other (non-ESG) factors that might impact upon the value of the subject property**
12. **MEES compliance and other ESG drivers are just additional elements (specifications) that impact upon value.**

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Valuation Method/Model Choice

1. Market Valuations are estimates of Price in the market NOT WORTH.
2. The valuation model is the choice of the valuer - "mark to market"
3. **There are no NEW valuation models for ESG**
4. The Valuer will adopt the either (or both) the Market Approach (Comparable Method) and the Income Approach (Investment Method (Implicit/Explicit) & Residual Method)
5. In practice, the choice of valuation method is determined by the nature of the property.
   - Large **prime** commercial properties are likely to be valued by allowing for retro-fitting costs (as assessed by an appropriate cost professional) within the Investment Method valuation either within an explicit cash flow model (Shopping Centres/Student housing etc) or an implicit residual model.
   - Smaller **secondary** commercial properties could be valued as above but it is more likely that the risks of ESG/MEES will be captured in observed Net Initial Yields (NIYs) from comparable transactions and applied accordingly with the rent passing. Market rent and an appropriate All-Risks Yield (ARY)
   - **Tertiary** properties may use the same rent/ARY valuation but they may, in many cases, be valued by direct capital comparison (particularly if there is a "work-around" market shift to owner/occupation to circumvent the MEES regulations.

Example 1 - D-Rated Valuation 2024 – ARY 10%

A small office 2 storey property let to one tenant. Let on a 10 year lease in 2017. Thus 3 years to lease end for retrofit. The rent passing is £30,000 (agreed at the 2022 review) with a market rent of £32,000. The ARY of the property if retrofitted (and thus lettable in 2027 at the lease end) is 10%. The cost of cost of retrofitting to conform to a "B" rating is estimated (not by the valuer but by a cost professional) to be £40,000 at the time of the works. Note that the assumption is that the owner will go for a B+ rating to compile with the 2030 MEES requirement and not a C rating which can only be legal for 3 years

1. Market Approach (not illustrated here)

Comparable Method – Heuristic (non-mathematical) model based on a capital value per square unit – direct capital comparison

2. Income Approach (DCF with cost deducted at relevant point - PVed)

Residual Method – This is an explicit model with the costs of retrofitting deducted as any other future cost within the cash flow columns before being discounted by the appropriate target rate for the investment.

3. Income Approach (Implicit Residual)

Residual Method – This is an implicit model with the costs of retrofitting deducted from the value calculated using the ARY and rent of the retrofitted property.

4. Income Approach

Investment Method – This is an implicit model using the ARY of non-retrofitted property. The likely costs of retrofitting are captured in the higher, observed, NIY from the comparables.

Simple examples using Example 1 – for illustration only

Income Approach (DCF with cost deducted at relevant point - PVed)

This is not using Example 1 but is just a hypothetical cash flow investment for illustration. In practice, there are likely to be many more columns/properties/leases than the two illustrated below.

Residual Method – This is an explicit model with the costs of retrofitting deducted as any other future cost within the cash flow columns before being discounted by the appropriate target rate for the investment.

Year	Property A	Property B	Cost of Retrofitting	Total Cash Flow	PV @ 7.75%	PV £
1	£10,000	£8,000		£18,000	0.9281	£16,705
2	£10,000	£8,000		£18,000	0.8613	£15,504
3	£10,000	£10,614	-£50,000	-£29,386	0.7994	-£23,491
4	£14,000	£10,614		£24,614	0.7419	£18,260
5	£14,000	£10,614		£24,614	0.6885	£16,947
6	£14,000	£10,614		£24,614	0.6390	£15,728
7	£14,000	£10,614		£24,614	0.5930	£14,597
8	£14,000	£12,317		£26,317	0.5504	£14,485
9	£14,000	£12,317		£26,317	0.5108	£13,443
10	£324,948	£281,683		£606,631	0.4741	£287,576
				CAPITAL VALUE		£389,753

Income Approach (Implicit Residual)

Residual Method – This is an implicit model with the costs of retrofitting deducted from the value calculated using the ARY and rent of the retrofitted property.

Implicit Term and Reversion with retrofit cost and void *Value as if the property can be re-let at reversion and deduct the (estimated) cost of retrofitting to conform with an "B" (or above) rating*				
Rent Passing		***£30,000***		
YP 3 years @	***10.00%***	***2.49***		***£74,606***
Market Rent		***£32,000***		
YP Perp @	***10.00%***	***10.00***		
PV 3 years @	***10.00%***	***0.75***		***£240,421***
	Capital Value			***£315,026***
Estimated cost of retrofitting				***- £40,000***
	Capital Value			***£275,026***
PV 6 months @	***10.00%***		***0.95***	
	New Capital Value (say)			***£262,000***

5. Income Approach

Investment Method – This is an implicit model using the ARY of non-retrofitted property. The likely costs of retrofitting are captured in the higher, observed, NIY from the comparables.

Implicit Term and Reversion with increased risk *Use a reversionary valuation model and increase the equivalent yield. In this case, a 2% increase has been applied*			
Rent Passing		***£30,000***	
YP 3 years @	***12.00%***	***2.40***	***£72,055***
Market Rent		***£32,000***	
YP Perp @	***12.00%***	***8.33***	
PV 3 years @	***12.00%***	***0.71***	***£189,808***
		Capital Value	***£261,863***
	New Capital Value (say)		***£262,000***