Property Valuation

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

"ESG - Factors [that] collectively describe the transparency and robustness of governance processes and the impact on a company and/or assets, which may impact its financial performance, operations and the external environment."

IVS, 2023

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Property Valuation

Market Value and ESG (Sustainability)

The future is not some place we are going, but one we are creating

John Schaar, Legitimacy in the Modern State (1981)

ESG is a mix of market choice of stakeholders and market intervention by governments (eg MEES in UK)

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Agenda – Valuation: ESG, Sustainability & Climate Change

- **STOP PRESS - RICS UPDATES (General and ESG)**
  - Minimum Energy Efficiency Standards (MEES) and Energy Performance Certificates (EPCs)
  - RICS Valuation - Global Standards and UK National Supplement (together known colloquially as the Red Book).
  - Changes to the UK Supplement came into effect on the 1st May 2024
  - A new edition of RICS Valuation - Global Standards - 31st January 2025.
- **The Importance of ESG on Valuation**
- **ESG Valuation Methods and Models**
  - The valuation model is the choice of the valuer - "mark to market"
  - Market Approach - Comparable Method
  - Income Approach – Investment Method and Residual Method
- **Conclusions**

Publications and Readings

- RICS Sustainability and ESG in commercial property valuation and strategic advice, 3rd Edition
  1. *https://www.rics.org/profession-standards/rics-standards-and-guidance/sector-standards/valuation-standards/sustainability-and-commercial-property-valuation*
- IVSC Perspectives Paper – ESG and Real Asset Valuation
  2. *https://www.ivsc.org/esg-perspectives/*
- Whole life carbon assessment for the built environment, 1st UK edition (2023)
- MEES: Impact on UK property management and valuation (2018)

Value & Sustainability

- Do green buildings command higher rents and higher capital values?
- Government Climate Change (mitigation) Targets
- MEES legislation in the UK: what will be the impact on rent/capital property values?
- All let properties to be B rated by 2030 (current expectation)

Please note - All talks on Sustainability and ESG MUST have a picture of a stranded polar bear – It is the LAW!

Impact on Commercial Property

- What is Market Value in a post MEES legislative world?
- What will be the impact of MEES 2030 proposal?
- New Valuation Methods?
- Valuation Reports – due diligence – onus on valuer to comment upon ESG in reporting to the client
- Values will be affected not just for those with C/D/E now, but over time, as more detail is made available about 2030 targets and the calibration of EPCs become more stringent, it will affect all let property

RICS Valuation Standards (Red Book)

Global Standards and UK National Supplement

Changes to the UK Supplement came into effect on the 1st May 24

A new edition of RICS Valuation - Global Standards will come into effect on the 31st January 2025.

General changes and changes incorporating ESG

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RICS Valuation Global Standards:

UK national supplement

- The UK supplement supports the Global Red Book for UK valuations but does not replace the Global Standards BOTH BOOKS APPLY TO ALL UK VALUATIONS
- ESG has been incorporated into the UK Supplement
- UK commercial property for secured lending purposes may include the valuation impact of MEES, EPCs, sustainability-related property certification, ‘green’ leases and flood risk

RICS UK Supplement

Sustainability, Resilience and ESG

- "Sustainability – the consideration of matters such as (but not restricted to) environment and climate change, health and wellbeing, and personal and corporate responsibility that can or do impact on the valuation of an asset"
- "In some jurisdictions, the term 'resilience' is being adopted to replace the term 'sustainability' when related to property assets"
- "Sustainability may also be a factor in environmental, social and governance (ESG) considerations"

In simple terms – is the valuation being affected by changes in demand in the market?

Property Valuation

The difference between Market Value & Worth

- **Market Valuation**
  The process of determining market value. An estimation of the price of exchange for a property in the market place using market information and expectations
- **Calculation of Worth (Investment Value)**
  The process of determining the worth of a property asset to the owner/purchaser based on specified forecasts of the future that may differ from market expectations

IVSC/RICS – MARKET VALUE

MARKET VALUE (MV)

Market Value is the estimated amount for which an asset or liability should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

Market Misunderstandings

- "People don't know how to value and recognise the benefits of green buildings".
- "Chartered Surveyors need to properly value sustainability elements rather than undervaluing such elements in buildings"
- "Valuers must make the first move to change the value of MEES affected properties so that the market prices these investments correctly"

All the above are wrong – laudable but WRONG

Market Truths

- Remember that Market Valuations are estimates of Price in the market NOT WORTH
- "Reflect the market, not make the market"
- *If, at the date of valuation, the market does not differentiate "sustainable" and "non-sustainable", there will be no impact on value*
- The role of the valuer is to "mark to market" so if the market doesn't yet "price sustainability", the valuer would be wrong to increase the value

The Market is in transition

- So that is the default setting – reflect the market, don’t correct the market – although there isn’t one market. Prime, secondary and tertiary markets are all different
- In the prime and new build markets for offices, retail and industrial/logistics, there is increasing evidence that values are beginning to respond to MEES by the discounting non-compliant buildings
- Investment bids in those markets are now lower to reflect the “MEES related liability of ownership

Drivers affecting change

- Banks - Lending policies are geared towards lending on MEES compliant buildings with lower rates applying according to EPC rating
- Market evidence of ‘brown discount’ stronger than ‘green premium’: this is likely to become accentuated
- In secondary and tertiary markets, there may be a move towards owner occupation to avoid MEES legislation – a two-tier market?

Property Valuation

The responsibility on the valuer

While valuers should reflect markets, not lead them, they should be aware of sustainability features and the implications these could have on property values in the short, medium and longer term

RICS Valuation - Global Standards VPGA 8 section 2.6 (c)

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Valuation Implications

- 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’
- 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

Due Diligence Implications

- 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, their due diligence, under the Red Book, extends to accounting for any risks posed by MEES
- Valuers are reminded that they must only operate within their skills and competence
- MEES and EPCs: they are a source of risk and should be checked for validity and accuracy

Approaches, Methods and Models

- There are no NEW valuation models for ESG
- The Valuer will adopt the either (or both) the Market Approach and the Income Approach
  - Market Approach – Comparable Method
  - Income Approach – Investment Method (Implicit/Explicit) & Residual Method
- The more complex the property type (Prime properties?), the greater the likelihood that a DCF model will be utilised
- Secondary and tertiary properties will rely upon either capital comparison or ARY (NIY analysis)

Market Approach

Comparable Method

- Although the comparable method (direct capital comparison) isn't regularly used in commercial property, it is the mainstay for residential valuations
- A capital value per square foot/metre can be used as a double check (used more in storage & industrial)
- Obviously, this is a transaction based model where the impact of ESG liabilities will have been reflected in the comparables

Income Approach

Residual Method – Implicit model with costs and using ARY of retrofitted property

- The basis of this model is the same as for any development valuation.
- The CV of retrofitted property minus the costs of the retrofitting
- Example

  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

  Rent passing – £30,000, Market Rent £32,000 ARY 10%.

  The cost of cost of retrofitting to conform with an “B” (or above) rating is estimated to be £40,000 at the time of the works

Income Approach

Residual Method – Implicit model with costs and using ARY of 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***

Income Approach

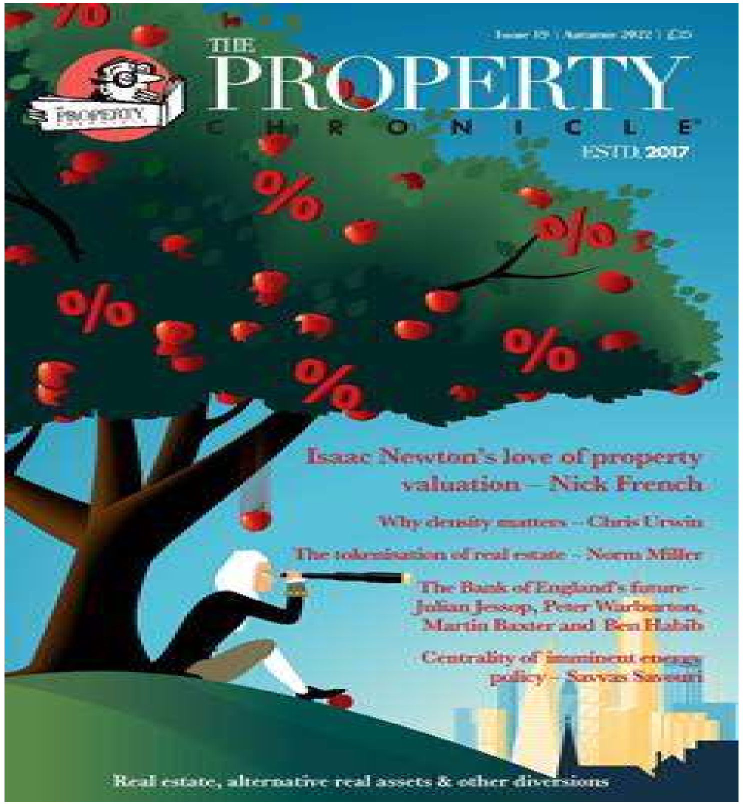
Investment Method – Implicit model using ARY of non-retrofitted property

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***

Conclusions

- Market Value – the valuer seeks to reflect the market
- Not all markets are transitioning at the same time
- Valuer must NOT add value to something for which the market will NOT pay
- Valuers have all the tools to model ESG/MEES impact
- The value of commercial property reflects many factors; sustainability/ESG is just one
- MEES 2030 Minimum Energy Efficiency Standards (MEES): Impact on UK property management and valuation

Further Reading



I have written short articles on all the topics discussed in this presentation.

1. **The Real Estate New Normal: Grappling with the S In ESG**
2. **It's all about MEES, MEES, MEES: The New Rules on Energy Efficiency Will Change Property Forever**

They are published in The Property Chronicle (ESG and others) and are available for free at www.propertychronicle.com/author/nickfrench/ or on the Professional Conferences website.