SUSTAINABILITY SERIES

Knight Frank

ESG Property Investor Survey

Q3 2023

A unique research survey providing valuable insight into how ESG trends are shaping property investment decisions

knightfrank.com/research

Regulation, disclosures and commitments driving change

ESG has become a critical factor for investment decisions. To understand how ESG is influencing capital markets specifically, we surveyed 45 investors representing nearly £300 billion of assets under management

REGULATED

Environment, Social and Governance (ESG) is in the spotlight across all asset classes and property is no exception. It is well-established that the built environment is responsible for around 40% of global carbon emissions and therefore is a firm target for regulation aimed at driving down both embodied and operational carbon.

In England, Minimum Energy Efficiency Standards (MEES) for non-residential buildings require a minimum Energy Performance Certificate (EPC) rating of E to be lettable from 1 April 2023, with proposals for this to rise to a minimum of C by 2027 and B by 2030. By analysing EPC data, we estimate that currently 70% of all commercial space falls short of the minimum B rating, the office sector being the most exposed with 79% of floor space currently below EPC B. If these standards are implemented, energy efficiency measures will be required on the majority of commercial stock if to comply.

Across the EU there are similar regulations coming into force. The European Performance of Buildings Directive has staggered targets, with a minimum EPC of D by 2030 and all buildings to be net zero emissions by 2050. However, stringency and adaption varies from country to country. For example, in the Netherlands, all office buildings are required to have a minimum EPC rating of C since 1 January 2023. Latest available data shows that 10% of offices fall short, rated EPC D or below, and 30% have no energy label but will need to comply or risk facing a fine.

DISCLOSED

Besides the regulatory requirements for energy efficiency, there are also legal and voluntary disclosures, the need to manage stranded asset risk and risk of ability to secure funding to consider. For example, since April 2022 in the UK any entity over 500 employees and £500 million in

FIVE KEY TAKEAWAYS

100% of our investor sample stated they employ green leases with 36% linking remuneration to ESG targets.

77% of our investor sample have minimum environmental certification criteria for new acquisitions. Of those respondents targeting EPCs, over 50% require a minimum B rating.

74% of our investor sample currently use CRREM analysis to analyse their existing portfolio and more than half require CRREM analysis as part of acquisition due diligence.

58% of our investor sample are actively looking to acquire poor ESG-performing assets to improve/upgrade and reposition.

44% of our investor sample own or are developing a NABERS-rated building.

turnover has been required to report metrics aligned to the Task Force for Climate-related Financial Disclosures (TCFD).

COMMITTED

Being able to lease buildings is critical and the appetite of occupiers has shifted towards more sustainable and healthier buildings. This can be attributed to occupiers' own ESG requirements and commitments, as well as the need to attract and retain talent. Our latest *(Y)OUR SPACE* report of more than 300 global occupiers found that almost all respondents said ESG strategies and commitments will influence real estate decisions over the next three years.

£300bn

of assets under management represented by our survey respondents

About the survey

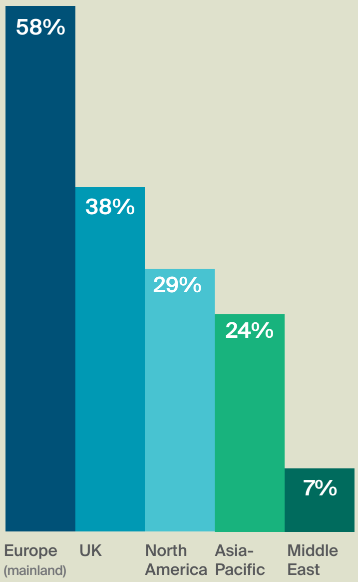
In June 2023, we surveyed 45 investors about ESG and their property investments focusing on the UK and Europe.

The survey participants represent nearly £300 billion of assets under management. Of those surveyed:

- The investor mix was 64% investment managers, 16% listed property companies and 13% funds; the remainder included private investors, private equity groups, private property companies and local authorities.
- Three quarters of those surveyed considered 'Core Plus' investments, 56% targeted 'Core' and 51% had 'Value-add' business plans.
- 60% stated their primary sector of focus was offices.
- Some 62% invest across Europe with only a fifth focusing solely on the UK.
- The capital surveyed represents a global investor base. When asked what nationalities their capital represented, 58% stated that their funds included capital from mainland Europe, 38% represent UK capital, 29% represent North American and 24% cited Asian-Pacific capital.
- 40% of surveyed investors had £10 billion or more in AUM.

Multinational capital

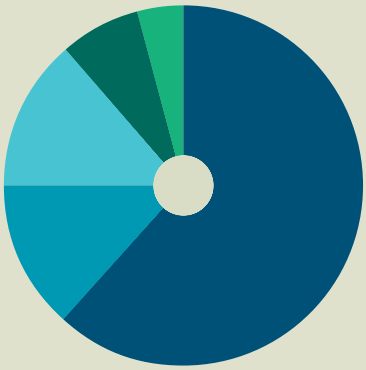
Q. What nationalities are predominantly represented by your capital?



Source: Knight Frank Research

Offices dominant

Q. What is your main sector focus?

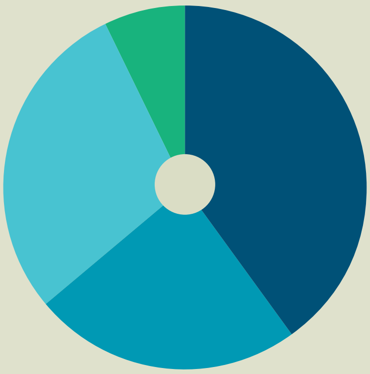


Office	60%
Logistics	13%
Multi-sector	13%
Living Sectors (Residential, BTR, Student Accommodation)	7%
Retail	4%

Source: Knight Frank Research

Firepower

Q. What is the approximate total value of your assets under management across Europe including the UK?



£10BN +	40%
£5BN to £10BN	24%
£500M to £5BN	29%
Up to £500M	7%

Source: Knight Frank Research

To note: Stated statistics within the survey represent the proportion of respondents who selected each answer in relation to those which answered each question, not all respondents answered all questions. Some figures may not add up to 100% due to rounding and 'other' options.

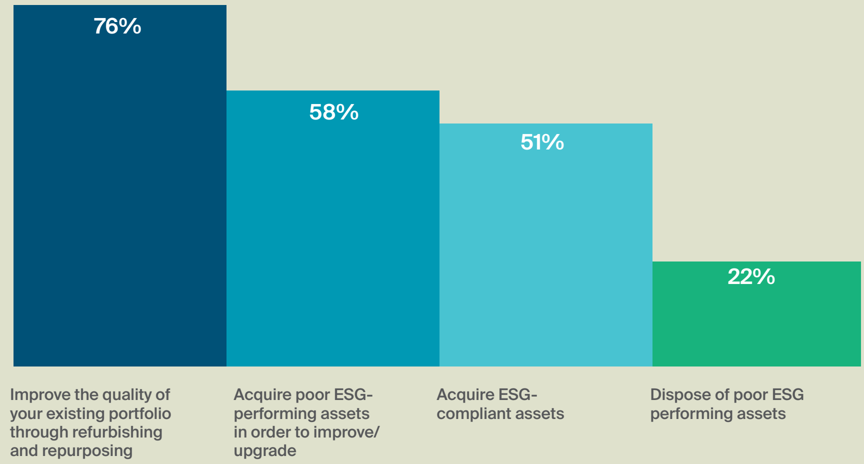
Upgrading Expectations

Improving property performance is the top focus...

Three-quarters of surveyed investors say they want to improve the quality of their existing portfolios by refurbishing and repurposing. In addition, 58% are looking to acquire poor ESG-performing assets with the aim to improve and upgrade. Several investors have launched 'impact funds' to achieve exactly this. Knight Frank's capital markets teams are regularly working with investors to actively target the acquisition of such assets, often from asset owners who do not have the appetite, capability or funds to improve the ESG characteristics. Of those investors surveyed, fewer than a quarter are looking to dispose of poor-performing assets in favour of higher performing ESG assets – however among Core investors this rises to 40%.

Improvement first

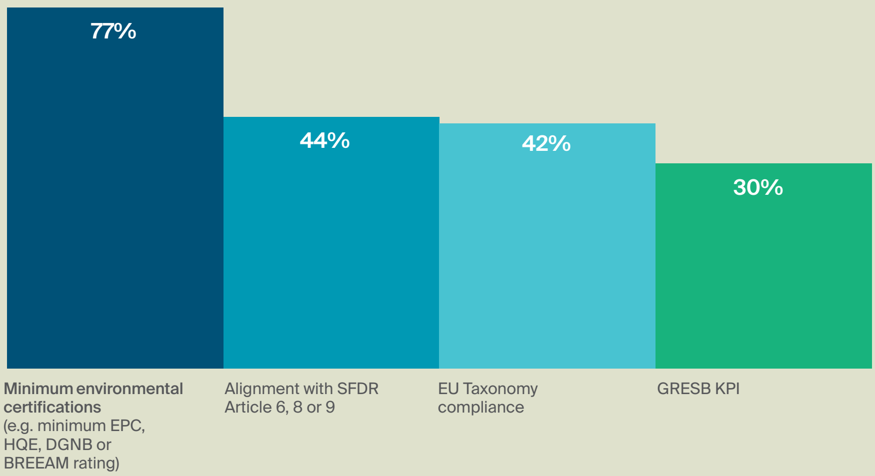
Q. What is your focus on ESG in relation to property (Please select all that apply)



Source: Knight Frank Research

Certifications key

Q. Please select the key metrics by which you assess the ESG criteria of an asset under review for new acquisitions



Source: Knight Frank Research

... with 2030 the most common goal for net zero

Of the investors who stated their company's net zero target, one has already reached this goal, 41% are committed to 2030, 15% look towards 2040, and the remainder are targeting 2050. We believe such aggressive short-term goals will only exacerbate the premium for the most sustainable Core assets. Those seeking 2030 are ahead of most nations where three-quarters of the world's countries have a pledge, proposal or law requiring net zero be reached by 2050, the UK and EU included. Real estate will play a pivotal role for organisations on their net zero journey which is evident in our survey findings.

Minimum environmental certification a key ESG metric for new acquisitions...

77% of surveyed investors have minimum environmental certification criteria. Of those targeting EPCs, more than 50% require a minimum B rating, the proposed minimum energy efficiency rating in the UK from 2030. Similarly, 47% require BREEAM 'Excellent' or 'Outstanding' ratings. This illustrates the continued bifurcation of property, which is particularly acute for offices, and the level of sustainability required to attract institutional investors.

Our previous research found that central London offices command a *rental* and *sales premia* for BREEAM-certified buildings. For those in our sample rated 'Excellent', the sales premium was 10.5%, when compared to the equivalent unrated building, with a rental premium of 4.7%. However, the rental premium was far higher at 12.3% for 'Outstanding' rated buildings.

44%

of surveyed investors said they either own or are developing a NABERS-rated building

… and 44% of surveyed investors require alignment to Sustainable Finance Disclosure Regulation (SFDR) for new acquisitions, and 42% require EU Taxonomy compliance

ESG reports which can cover EU Taxonomy compliance, CRREM (Carbon Risk Real Estate Monitor) analysis and an EPC Pathway report, are becoming as important as a Building Survey as part of the due diligence process for investors acquiring assets. This is highlighted by the prevalence of investors already requiring alignment to SFDR or EU Taxonomy compliance.

Four in ten surveyed investors own or are developing a NABERS-rated building…

NABERS UK is a relatively new system rating the energy efficiency of office buildings across the UK, yet given the prevalence already among investors we expect it to become widespread over the coming years. 44% of surveyed investors said they either own or are developing a NABERS-rated building, with three-quarters of those who are solely UK focussed doing so. NABERS, originally developed in Australia, measures the energy efficiency of a building over 12 months and awards a rating from one to six stars (six being the best) by comparing energy consumption to averages across the sector.

The ability to demonstrate actual energy efficiency has the potential to add value. Our previous research found that prime office buildings in Melbourne and Sydney with a NABERS rating of five stars of more command a *17.9% premium on sales price* compared to equivalent unrated buildings. In the UK, there are currently 25 NABERS-rated buildings, according to data from GreenBookLive, with 22 of them holding the NABERS UK Design for Performance rating for energy-efficient new buildings and the remaining three having the NABERS UK Energy for Offices rating for existing buildings.

REGULATION AT A GLANCE

The **Sustainable Finance Disclosure Regulation (SFDR),** which came into force in 2021 is mandatory for asset managers and financial institutions, outlines ESG disclosure requirements concerning how sustainability risks are considered. SFDR defines financial products as one of three categories:

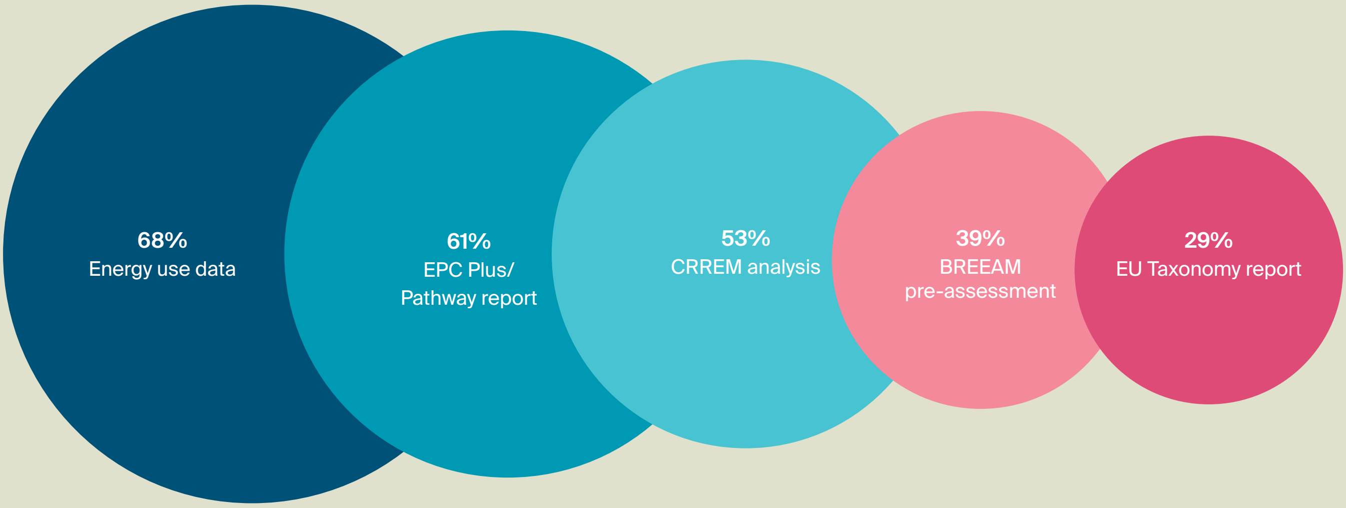
- Article 6 are those which may have ESG considerations but do not go as far as to promote or seek them;
- Article 8 are products which promote social and/or environmental characteristics, but do not have sustainable investing as a core objective; and
- Article 9 are products which have a sustainable investment objective or those with a carbon reduction target.

The **EU Taxonomy**, which came into force in 2022 and relates to any entity with 500 or more employees, is to define what counts as a sustainable economic activity. To be designated as such, the activity must contribute to one of the six environmental objectives within the taxonomy, do no significant harm to any of the five others and comply with minimum social safeguards. There is a defined technical screening criteria to assess this.

The UK are currently consulting on their own Sustainable Disclosure Requirements which follow a similar pattern although the three categories would be Sustainable focus, Sustainable improvers, and Sustainable impact. A consultation on a UK Green Taxonomy is expected later in 2023.

Due dilligence

Q. If you were acquiring a building today which of the following would you require? (Please select all that apply)



Source: Knight Frank Research

THE VARYING PRICE OF CARBON

Just over a quarter of the investors surveyed have implemented an internal/shadow carbon price to assist in the transition to net zero. This acts as a mechanism to incentivise carbon cutting by placing either a theoretical (shadow) or actual cost on emissions. Some developers/ investors commit to using the funds to refurbish buildings, support investment in renewable energy and offset emissions.

The UK carbon price had been between £50 and £60 per tonne (t/CO2) since May 2023, the government's recent reforms to the carbon market have seen the price fall to around £40 at time of writing, the EU's price (via Emission Trading Scheme) is currently between €80 and €90. Our survey respondents cited an even wider range. Of those that disclosed their internal carbon price, the range was from £25 to £150 per tonne, suggesting little industry consensus.

£25-£150

per tonne

…as the importance of energy use data for new acquisitions rises

Almost 70% of the investors surveyed require energy use data before acquiring a building. A wider adoption of NABERS ratings may go some way to enhance the transparency of building performance, yet as an immediate step, investors are looking to verify this themselves by assessing energy use data as part of the due diligence process.

Just over 60% stated they would require an EPC Plus/Pathway report in preparation for forthcoming regulation to understand what measures, if any, will be necessary to reach proposed minimum requirements. These assessments can be used as a tool to understand the level of capital expenditure required to bring the building up to regulatory standards.

Strong use of CRREM among investors

74% of surveyed investors currently use CRREM analysis, to assess the exposure of assets to stranding risks based on energy and emission data and the analysis of regulatory requirements. This will enable investors to design and implement the best strategy to minimise risk and move towards net zero goals. In addition, more than half require CRREM analysis before a new acquisition to understand the asset's impact on overall portfolio performance.

Nine out of ten of those surveyed have social-based targets…

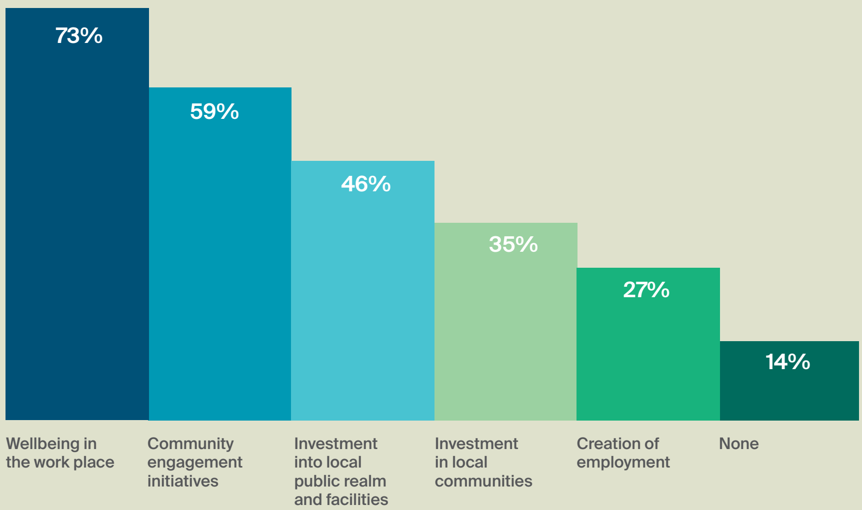
Wellbeing in the workplace is a goal for 73% of the investors surveyed, whilst almost 60% target community engagement initiatives and 46% are pursuing investment into local public realm and facilities. These could include amenities for physical and mental wellbeing, such as cycle facilities and support networks, both are amenities which occupiers expect employees to require according to our latest (Y)OUR SPACE research.

…with the majority aided by in-house expertise

87% of the investors surveyed stated that they have a dedicated in-house ESG team, with 44% saying that the team consists of five or more people. Size matters as all surveyed investors with £10 billion or more in AUM have an in-house ESG team, whereas only 77% of those with £500 million to £5 billion do. This level of expertise is likely to increase ESG due diligence on new acquisitions as well as reporting for disposals.

Wellbeing a top social target

Q. Do you have social-based targets? (Please select all that apply)



Source: Knight Frank Research

87%

have a dedicated in-house ESG team

...and seven in ten surveyed are upskilling/training their staff to realise ESG targets

When considering governance systems to realise ESG targets, 70% are upskilling/training their staff, 59% of investors stated they had landlord/occupier forums for engagement on sustainability initiatives and 38% linked employee remuneration to ESG goals.

100% of surveyed investors stated they use green leases as a way to realise ESG targets

The Better Building Partnership (BBP) defines a green lease as a "standard form lease with additional clauses included which provide for the management and improvement of the Environmental Performance of a building by both owner and occupier(s)."

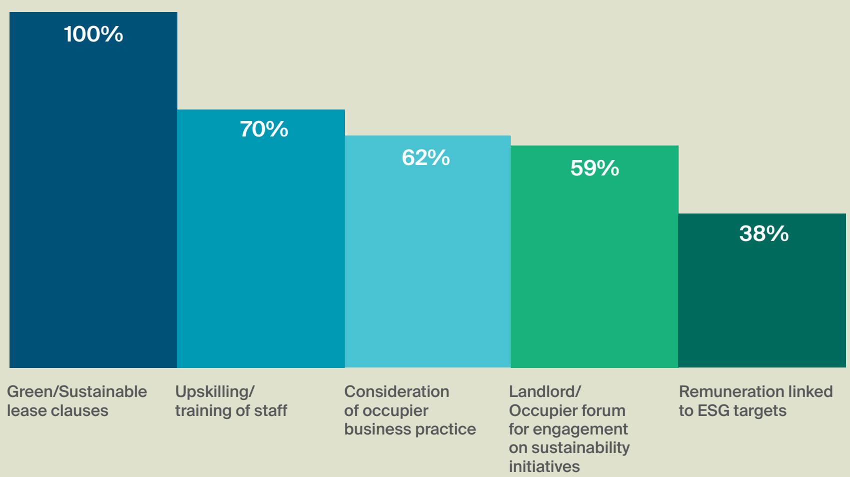
With investors agreeing that green leases are a way to realise ESG goals, these are likely to become even more commonplace and standard across the industry. When asked what provisions they include within these leases, 97% selected energy/water/waste data sharing, which is the minimum recommendation from the BBP. Around seven in ten look to have smart building technology that can aid data collection and maximise efficiency through, for example, monitoring and automated systems for heating, cooling and lighting. Almost two-thirds include restrictions on alterations which may adversely impact energy efficiency ratings.

LOOKING AHEAD

The drive for net zero and increasing regulatory and occupational requirements are focusing property investors on the efficiency of buildings. Whilst the majority are seeking improvement of existing properties within their portfolio, the provisions needed for building acquisitions have grown to, often, include energy use data, EPC Plus/Pathway reports and CRREM analysis among other elements. It is likely we will see this requisite grow as net zero targets draw closer, regulation tightens and industry expertise evolves.

Supporting structures

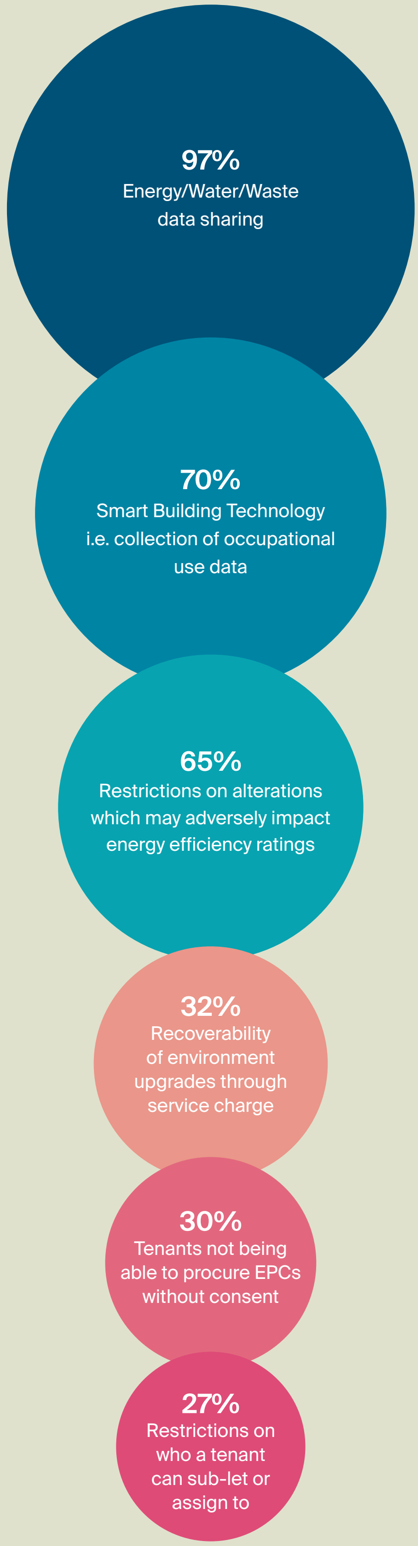
Q. Do you have any of the following structures in place to realise your ESG targets? (Please select all that apply)



Source: Knight Frank Research

Smart sharing

Q. Regarding green/sustainability clauses in leases, which of the following do you include?



Source: Knight Frank Research

Recent Research

Active Capital

Your Space

Sustainability Series (First edition)

Quantifying ESG in Real Estate

Keep up to speed with global property markets with our range of dedicated sector newsletters

SIGN UP ONLINE

Research enquiries

Flora Harley
Head of ESG Research
+44 20 7861 1436
flora.harley@knightfrank.com

Victoria Ormond, CFA
Head of Capital Markets Research
+44 20 7861 5009
victoria ormond@knightfrank.com

Investor enquiries

Kate Horton
Partner, London Capital Markets
+44 20 7861 1334
kate.horton@knightfrank.com

Richard Stewart
Partner, European Capital Markets
+44 20 7861 1217
richard.stewart@knightfrank.com

ESG consultancy enquiries

Jonathan Hale
Head of ESG Consulting
+44 7861 1181
jonathan.hale@knightfrank.com

Harriet Hix
Associate, ESG Consulting
+44 20 7861 5504
harriet.hix@knightfrank.com