VALUING SUSTAINABILITY

ESG AND THE BELFAST OFFICE MARKET

The valuer's toolkit has evolved to respond to significant events that have shifted the Northern Ireland property market dynamics. These events include, The Troubles, The Global Financial Crisis, Brexit and COVID-19. Having weathered these storms, ESG is fast becoming the priority.

ESG, which stands for "**Environmental**", "**Social**" and "**Governance**", is a broad acronym which encompasses a variety of factors which can largely be interpreted as follows:

Environmental	Social	Governance
This limb incorporates (amongst others) climate mitigation and adaptation, natural resources, pollution, recycling and waste. In the real estate sector, a lot of focus has been put on the energy efficiency and carbon emissions of buildings, which are assessed by Energy Performance Certificates (EPCs) or more sophisticated operational net zero certifications such as NABERS.	This limb incorporates human capital and social opportunities. Again, in real estate terms, this focusses on a building's impact on society, for example, the health and wellbeing of tenants and the local community, and how this is driving demand for larger green spaces, frictionless (no contact) building access and support for local enterprises such as cafés and shops.	This limb incorporates processes, procedures and management, from policy-making to the distribution of rights and responsibilities amongst different participants in corporations, including the board of directors, managers, shareholders, and stakeholders. Data and reporting on governance allows for more transparency on the purpose of a corporation, the role and makeup of its board of directors, as well as other structural factors.

Whilst the 'E' (Environmental) has historically been the more dominant factor, Social and Governance have more recently taken centre stage. The UK's non domestic property stock accounts for 23% of overall operational carbon emissions in the built environment and is now statutorily required to meet net zero emissions by 2050. However, the COVID-19 pandemic has left an indelible mark on the real estate sector, pushing the 'social' and 'governance' limbs to the fore and driving demand for assets which are able to demonstrate compliance with all three of the environmental, social and governance limbs.

This paper examines the 3 limbs of ESG and their impact on the Belfast office market dynamics and values in Northern Ireland.

ENVIRONMENTAL

Minimum Energy Efficiency Standards (MEES)

MEES are regulations which require a minimum energy efficiency standard to be met before properties in England and Wales can be let or sold. The aim of MEES Regulations for commercial property is to help meet the UK government's target to reduce carbon emissions to net zero by 2050.

2023

On 1st April 2023, the next phase of the Minimum Energy Efficiency Standards (MEES) came into force.

From then, the prohibition on letting a commercial property with an EPC rating below E applied to continuing / existing leases as well as new leases. As a result, both new and existing leases are caught by the requirement of an EPC rating of E (unless a valid exemption has been registered).

2030

Going forward, commercial property owners in the UK who wish to let their property will be expected to achieve a **minimum Energy Performance Certificate rating of B by 1st April 2030** (a significant increase on the current requirement for an E rating).

2027

There will be a phased implementation of the EPC B by 2030 requirement, with **EPC C by 2027 set as an interim milestone.**

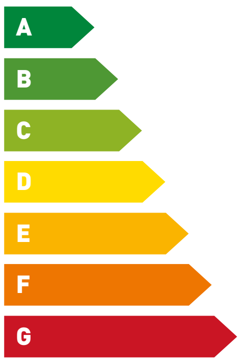
2050

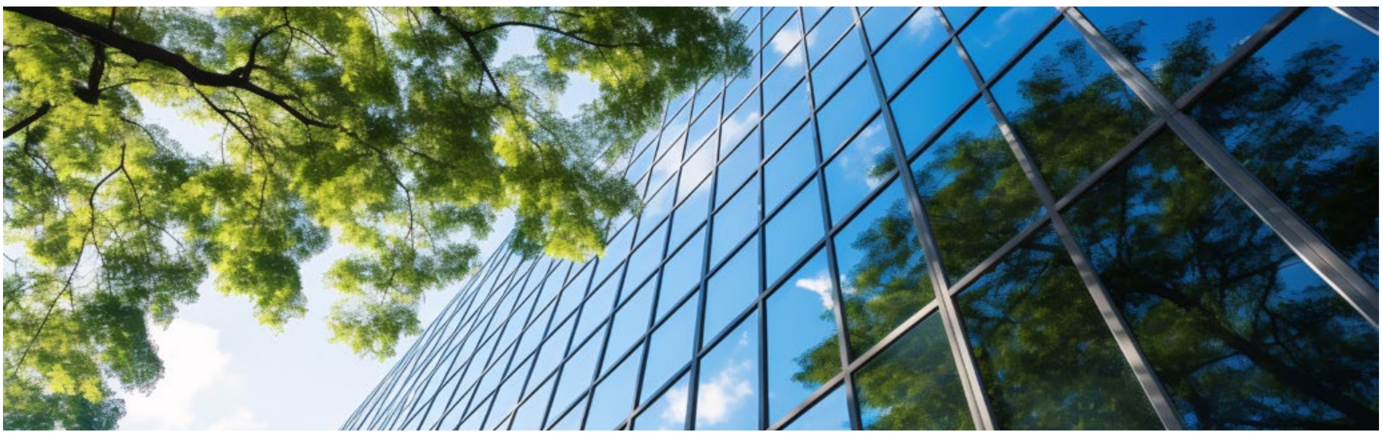
The government's

NET ZERO TARGET

The position is different in Northern Ireland. To date, there is no regulatory requirement for landlords in Northern Ireland to comply with MEES legislation applicable in England and Wales. However, it is difficult to see how Northern Ireland can continue without a version of its own in the next few years. Property owners should therefore be aware of and plan for the likely escalation of regulatory reform leading to tightening minimum standards of compliance in Northern Ireland.

The impact of MEES in England and Wales means that landlords are required to undertake energy efficiency improvements to their properties if their EPC rating falls below the minimum standard. Failure to comply can result in hefty fines and a prohibition from letting the property until the necessary improvements have been made. If these standards were to become effective in Northern Ireland, commercial landlords in the region would likely experience a significant impact on the investment value of their less energy efficient properties.





ENVIRONMENTAL

Stranded Assets

High capex requirements dilute returns for building owners and investors in Northern Ireland, therefore the cost of green buildings may prove daunting, considering the expense of creating a more ESG-centric building.

However, landlords of older stock need to be putting plans in place now to improve the energy efficiency and lower the carbon footprint of their buildings, otherwise they will end up with a property that they cannot let and therefore its Market Value will be detrimentally impacted. Otherwise known as a 'stranded' asset, these properties will be exposed to the risk of early obsolescence because they will not meet the likely future regulatory efficiency standards or market expectations driven by concern with climate change and other environmental matters. In Northern Ireland, this is likely to affect the office market most (where there is a significant volume of older secondary stock).

Refurbishment and retrofitting of these poorer quality buildings will require careful analysis as such actions are capital intensive with a return on the expenditure only occurring over several years in the future. Consequently, owners considering such capital expenditure must be forward looking and consider evolving regulatory requirements and forecast future rental incomes based on amenities that could be offered to occupiers.

COMPLIANCE

MEES

No statutory requirement to adhere to MEES in NI but an evolving market aligning with UK and European requirements.

LOCAL REGULATORY REFORM

Property owners should plan for the escalation of regulatory reform leading to tightening minimum standards of compliance in NI.

COST

ENERGY EFFICIENCY

Landlords of older stock will need to improve energy efficiency and lower carbon footprint of their buildings.

REFURBISHMENT AND RETROFITTING

Requires careful analysis and is capital intensive with long-term ROI. Consider evolving regulatory requirements.

IMPACT ON OFFICE MARKET

STRANDED ASSETS

Risk of early obsolescence as older buildings won't meet future regulatory efficiency standards.

BEST AND THE REST

The gap between the best and the rest will invariably widen.

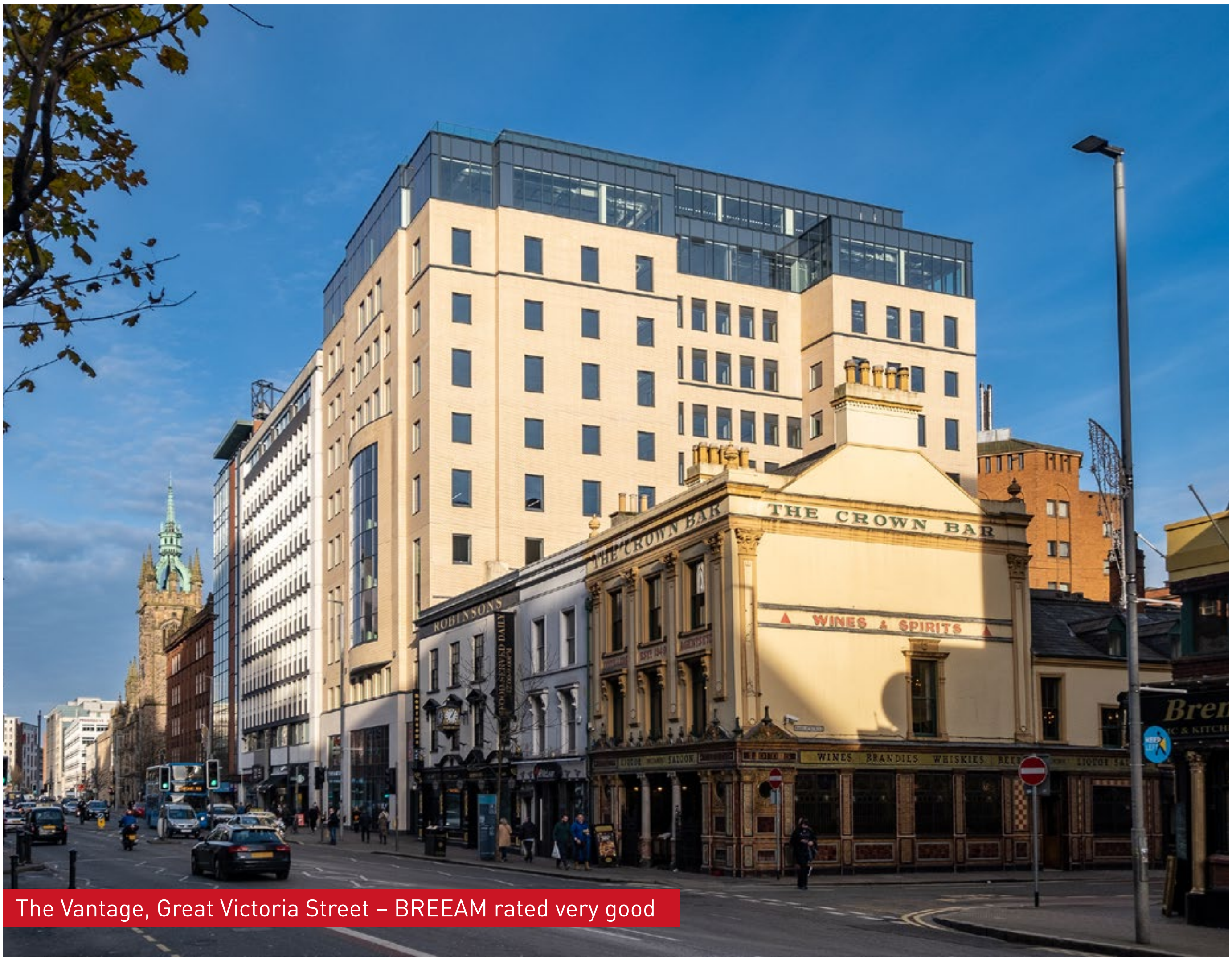
The Green Premium

Whilst older stock risks becoming 'stranded', upgrading less efficient buildings could result in long-term cost savings and increased demand for energy-efficient properties.

New and refurbished commercial properties in Belfast such as the City Quays buildings, The Vantage and The Ewart have been constructed/refurbished with ESG credentials as a priority, which makes them very attractive to prospective tenants. In particular, these properties all come with recognised Green certificates. These are dominated by BREEAM and LEED, and have been historically important for bundling sustainable features into a marketable badge which can then attract additional rent or capital value, the so-called 'Green Premium'.

The added value of ESG or sustainability criteria can be reflected in two dimensions. On the one hand, in the property quality itself – the material used, the location, the design, resilience and flexibility. This can translate into good usability, low operating costs and a long remaining useful life, thus increasing the value of the property, regardless of a rating or certification. On the other hand, the transparency that a certificate or rating provides to market participants also influences market value. In a market of low supply, the influence of sustainability may initially result in a high price premium, which could decrease as the number of demonstrably sustainable properties on the market increases, and ultimately lead to further value discount for non-sustainable properties. A good ESG rating in combination with recognised proof would have become the standard at this point.

While many valuations of real estate assets are performed before consideration of financing, there are an increasing number of green loans available in Northern Ireland where lower finance costs are offered to buildings where sustainability Key Performance Indicators are achieved. This results in lower costs of debt and in the case of investment properties, enhanced equity returns to the property owner - contributing toward a 'green premium' for such assets.



The Vantage, Great Victoria Street – BREEAM rated very good

SOCIAL

City Quays Gardens, Belfast Harbour, Belfast

Unlike the "E" in ESG, measuring the "S" can mistakenly be considered as difficult to do, however there are now a number of ways available to capture social value both at portfolio and asset level.

- **How a company interacts with its direct stakeholders – staff, customers, suppliers, and tenants.**
- **How they contribute to the economic and social success of the communities in which they operate.**

The initial slow start of the adoption of ESG standards may have been built on the erroneous perception that focusing on positive social impact would reduce financial return. It is becoming evident that it is indeed the opposite.

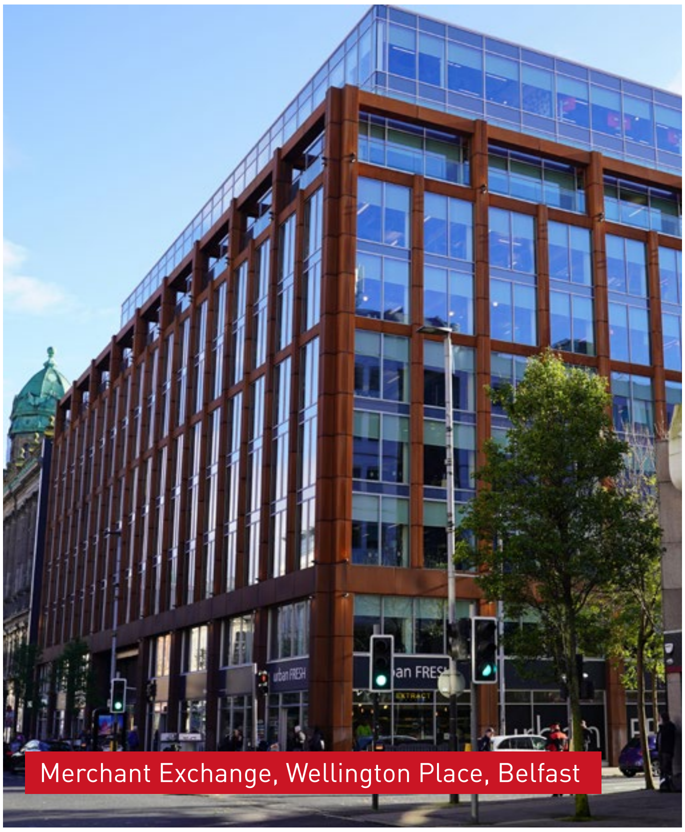
While workplace wellness had already been high on office investors' and landlords' agenda because of its role in attracting tenants, the COVID pandemic has led to increased demand for workplace wellness features by office occupiers. As normality resumes in the post pandemic era, some businesses are seeking to have their employees return to the office, whether it's full time or via hybrid models. In these cases, various property changes and workplace incentives may be necessary to encourage employees to return to the office.

Occupiers now place a greater emphasis on building amenities that enhance employee health and wellness. Properties with sustainability and wellness features, particularly those related to indoor air quality, ventilation systems and other indoor environmental features to improve employee comfort, will attract stronger demand across the short and long term – a trend that could also hasten the development of more FITWEL certified buildings.

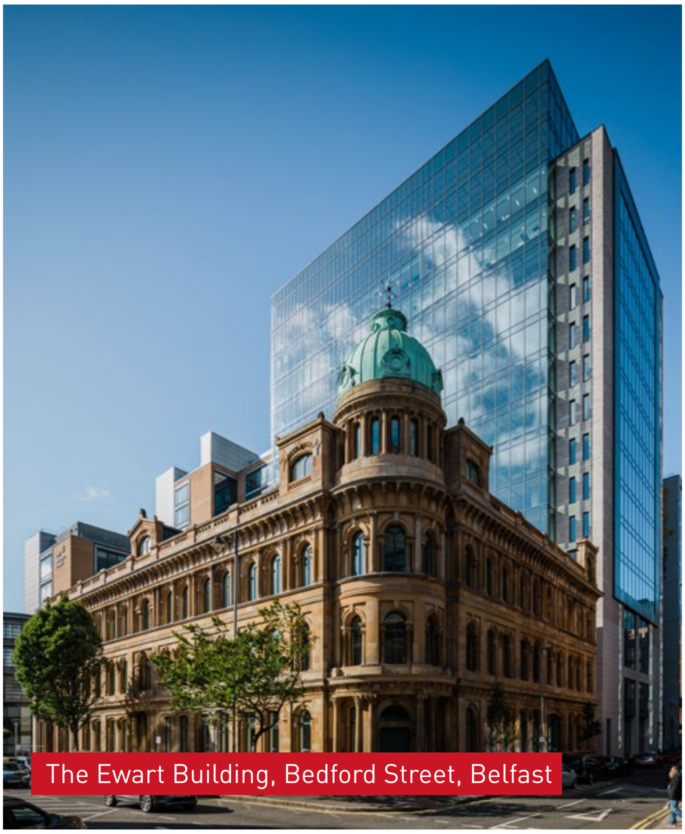
Perhaps one of the most ambitious 'Social' property projects in Northern Ireland is the development of City Quays Gardens by Belfast Harbour Commissioners. This is a multi-million pound investment to create a new two acre public garden adjacent to their City Quays development. It is being developed with wellbeing, sustainability and environmental excellence at its core. It will feature richly planted green spaces, seating, events lawns and outdoor workspace with publicly available 5G WiFi and is on target to be delivered by Q4 2024.

As much as the pandemic slowed down economies and real estate industry activity, the positive side is the wake-up call for investors to prioritise sustainable investment. The short-term profit seeking developer needs to be encouraged to develop something that long-term money wants to own. When people are put front and centre in a building's design and purpose this is when it achieves its greatest value.

GOVERNANCE



Merchant Exchange, Wellington Place, Belfast



The Ewart Building, Bedford Street, Belfast

As occupiers become more socially and environmentally conscious, one element of ESG tends to be forgotten – Governance. Good governance practices directly impact an organisation's ability to build investor, tenant, and community trust.

Corporate occupiers are increasingly thinking about the climate and putting into action their own pathways to becoming net zero. In the UK, this is primarily driven by the UK government's 2050 target, but each corporate can take a different approach. The properties they reside in play a large part in this. As a result, when their leases are up for renewal, they will expect, and look at properties with better climate metrics that will aid them in their commitments to being net zero. Whilst the local and international office markets are in a period of transition, where live requirements exist it is evident that corporate governance is (and has been) driving demand for offices developed with ESG credentials as a priority.

For example:

- **In July 2021, PWC relocated to Merchant Square (taking 225,000 sq ft in total), the first building in Northern Ireland to be awarded 'Excellent' status by BREEAM. This is the largest ever private sector office letting in Northern Ireland.**
- **In April 2022, Deloitte moved to The Ewart (taking 80,000 sq ft). The Ewart is also rated BREAMM excellent. It is understood that other notable corporate occupiers are also intent on relocating from older premises to the Ewart soon.**

Alongside the occupational demand, investors want to put more capital in assets that contribute to positive externalities. This is from a personal standpoint and a regulatory / reputational perspective, particularly in the case of pension schemes and local authorities. As evidence of this, Merchant Square was sold to a Middle Eastern Investor in 2021 for £87,000,000 reflecting a net initial yield of 5.23%, making it the highest ever office sale transaction in Northern Ireland. This demonstrates demand for best in class offices with strong ESG credentials. With both occupiers and investors favouring ESG compliant buildings from a corporate governance perspective, the gap between the best and the rest will invariably widen.

ESG IS HERE TO STAY

Sustained public and political pressure in this area means that the need for the real estate sector in Northern Ireland to engage with ESG issues is imperative. With limited local statutory requirements for buildings to adhere to MEES but an evolving property market aligning with the rest of Europe and the UK, there is a very serious warning right now that we are in the 'gradually' phase but there is going to be a 'suddenly' moment.

Landlords will therefore need to focus on sustainability now, and make sure their portfolios are taking this into account, or face being left with assets that are simply not attractive in the future. Assets that don't tackle excess emissions or generate positive externalities will struggle, as they will be viewed negatively by investors and occupiers. There is currently limited explicit market evidence for valuers to fully reflect the dispersion in sustainability, however it is starting to happen and we expect it to become much more apparent in the not too distant future.

Ultimately, at some point, properties that are unable to demonstrate strong ESG and climate credentials may very well see valuations suffer due to an unsustainability discount. An informed and regular approach to identification and management of ESG impacts should protect investment portfolios, enhancing resilience and guarding against the risk of accelerated obsolescence and value erosion.

ESG & Sustainability at LSH

Our in-house ESG & Sustainability team has developed a unique six-pillar programme that integrates our broad expertise throughout our service offering, including Property Management, Building Consultancy, Valuation, and Planning, Regeneration + Infrastructure.

Our service pillars include:

Net Zero | Resources Use | Social Value | Wellbeing | Biodiversity | Standards

We recognise that each client is at a different stage in their sustainability journey, with unique ambitions and priorities. By working together with our clients to understand what their ambitions and priorities are, we can support them by developing a bespoke ESG strategy.

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