

# Sustainability Impact Assessments

## Glossary

### Carbon Emissions

Kilograms or tons of CO<sub>2</sub> emitted from buildings through a combination of heating, cooling, lighting etc. This is usually an estimate based on generic data for each type of building as it is rare that detailed assessments have been undertaken on individual buildings. It is rarely possible to discriminate between emissions that relate to the design and construction of the “base” build, and those that relate to the occupiers’ fit-out and daily use of the building.

### Carbon Intensity

Volume of CO<sub>2</sub> emissions per £1m of capital invested, expressed in either Kgs or tons of CO<sub>2</sub> per £ million. The lower the figure, the lower the impact that the property owner’s investment activities are having on the environment.

### Climate Change Scenario

Model used to determine the potential impact of sustainability on the investment performance of property assets. The model assumes that an increasing proportion of tenants of less compliant buildings will move to better buildings at the end of their leases and that it will take longer to re-let empty buildings. The model also assumes that lower rents and shorter leases will be achieved on re-letting.

### Compliance Risk

The degree to which the owner of a building will be exposed to the cost of complying with new legislation. Many leases make tenants responsible for compliance costs in leased areas and some tenants have signed leases which make them responsible for a share of any compliance costs to shared services and common areas managed by the building owners. Some do not. The threat of a shortfall may reduce capital values and will reduce total returns.

### Energy Performance Certificate

Required by law for most buildings before they can be marketed for either sale or lease. The certificate classifies energy performance into seven rankings from A to G (where A is the most efficient). The scheme is designed to allow prospective tenants and purchasers to take account of energy efficiency in pricing bids but has yet to have any demonstrable impact on value. It is expected that retrospective improvements to poorly-ranked buildings will become compulsory at some time before 2020.

### Flood Risk

SIAM’s Flood Risk assessment examines the extent to which the value of assets may be undermined by the risk of coastal or river flooding. Many properties are considered by the Environment Agency to be at risk from flood damage but the impact on value will vary according to a range of different factors, including the probability of a flood incident but also including issues such as demand and supply, lease

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structures, the likely resilience of tenants' businesses to an incident, local and regional economic damage and a number of other factors. SIAM relies on information published by the Environment Agency, regional development agencies, and local government. This is not always accurate when applied to individual buildings but is an adequate guide as to how investors and occupiers are likely to perceive the risk. It is this perception that is most likely to drive any price corrections.

## Flood Risk Classification



SIAM's classifies the extent of the risk to values into four categories, from "Severe" risk to "No Risk". The categories are subdivided between

properties where the risk is expected to deteriorate through climate change and those where the risk is considered to be stable.

All investors should be wary about further investment in the "Severe" and "High" Risk categories and should look to reduce existing exposure over time as part of the normal recycling of capital.

Properties at "moderate" risk will require a more detailed assessment of the physical risk and, where the risk is "worsening" will need to monitor the risk. Subject to asset specific "due diligence" on these properties, however, most funds will continue to invest in this category.

## Flood Zones

All land in the United Kingdom has been assessed by the Environment Agency and the Flood Zone categorisation is now enshrined in the planning system. Properties in Flood Zone 3(b) are situated in a functional flood plain and there is a "high probability" of flooding to properties in Zone 3(a). Significant planning restrictions are in force in Flood Zones 3(a) and (b) and some investors will no longer acquire such investments.

Flood Zone 2 is at "moderate risk" of flooding. Some planning restrictions will apply and many of these areas could be upgraded to Zone 3 as a result of climate change.

## IPD Healthcheck

The Investment Property Databank ("IPD") has designed a system for assessing the overall environment quality of buildings and is intending to benchmark the relative quality of individual properties and entire portfolios. The system relies on self-assessment to arrive at a percentage score which places each property in one of five categories which range from "Very Poor" to "Very Good".

A number of no cost and low cost improvements can be undertaken to improve the relative scores but

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caution needs to be exercised as the Healthcheck scores do not discriminate between items that are within the owners' control and those that have been devolved to the occupiers by lease. In many cases, investors can only make significant improvements to the scores by persuading tenants to make voluntary improvements to the way they use the buildings.

## Leasing Risk

An analysis of the extent to which any threat to current rental and capital value is within the landlord's control. Many of the sustainability issues that may come to affect value are within the exclusive control of the occupier, leaving the building owner limited ability to mitigate against potential loss until the end of the current leases.

## Migration Risk

The risk that current occupiers will migrate to more sustainable buildings at the end of leases or in exercising early break provisions. The degree of risk at each property is assessed according to the nature of the tenant (see definition of Propensity Score below), the availability of suitable, better rated accommodation, length of current leases and the relative cost to the tenant of improving their existing accommodation against the cost of relocation.

## Net Present Value

Used in SIAM's Option Appraisals to compare the impact of different levels of income and expenditure under a range of different scenarios. These almost always include an analysis of the "Status Quo" scenario, which mirrors the property owner's current expectations and the "Climate Change" scenario, with increased tenant migration at the least sustainable buildings, longer voids, shorter leases and lower rental value growth.

This models the extent to which sustainability may undermine existing performance expectations across a portfolio and highlights those properties which are likely to be hardest hit. Other scenarios examine the business case for incurring the costs necessary to protect against any potential loss in value and of meeting investors' Socially Responsible Investment or carbon reduction targets.

## Propensity Score

This measures the degree that sustainability and environmental issues are likely to influence existing tenants' behaviour and how the influence will intensify for some types of occupiers over the next 20 years.

The Propensity Score examines the existing Environmental Policies of tenants and associated companies, the strength of carbon reduction targets and the attitude of various stakeholders, including parent companies, subsidiaries, major shareholders, customers and even staff. The Propensity Score is a key component in assessing the Migration Risk at each investment property, when the tenants'

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Propensity Score at the time of the next relocation opportunity is used to analyse the risk of incurring above-average letting voids etc.

## RAG Rating

“RAG” stands for Red, Amber, Green. Once the overall risk profile has been examined, each property is assigned to one of these three categories.

Properties in the Red category are at significant risk of underperforming against expectation due to issues of sustainability. In many cases, specific actions will be recommended to manage or eliminate the risk. In others, it may be preferable to sell properties before the risks has properly materialised.

Amber properties have a lower risk profile but will require close monitoring as there is a possibility that risks may intensify over time.

At Green properties, there is a low risk of any adverse impact from sustainability. This does not necessarily mean that these properties can be described as sustainable (though most sustainable properties will fall into this category) as, for example, the least sustainable properties may be let on terms that remove any risk to the building owners.

Year on year, property investors should seek to reduce their exposure to Red properties and increase the proportion of capital invested in Green properties. The overall risk profile of a portfolio is an effective measure of overall risk in comparison with other portfolios.

## Resilience

A portfolio is described as resilient if the future performance is unlikely to be prejudiced by climate change and sustainability. Resilience could be achieved by investing only in highly sustainable buildings but can also be achieved by adopting a portfolio-wide approach to the management of risks.

## Status Quo

Net Present Value of a property or all properties in a portfolio, ignoring the potential impacts of climate change, including physical risks, changes to tenant behaviour and differences in investor sentiment.

The Status Quo scenario is the “base case” in SIAM’s Impact Assessment model and is designed to mirror the basis of the current valuation with one main exception: the Status Quo scenario assumes that a proportion of existing tenants generally relocate at the end of the lease and that costs are incurred in preparing empty accommodation for re-marketing.