

# CORRELATING ESG & PROPERTY VALUATION

Presented by

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# CONTENT

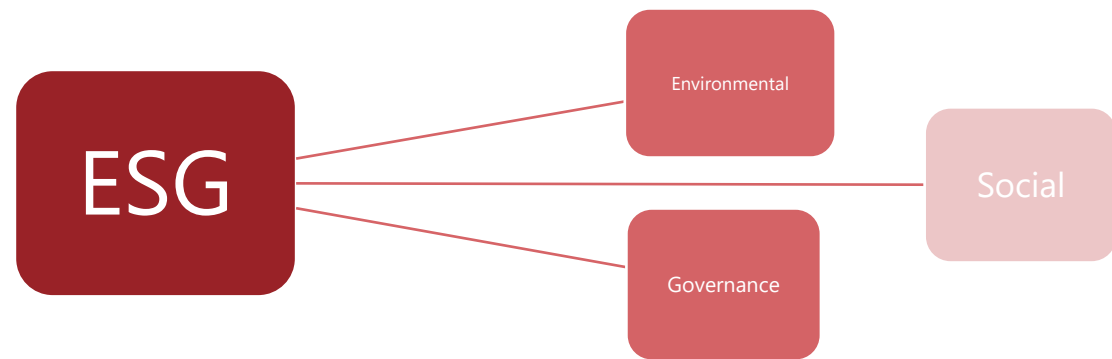
- 1. OVERVIEW**
- 2. ESG & VALUATION OF ASSETS**
- 3. ESG & IVS**
- 4. GLOBAL AND AUSTRALIAN PERSPECTIVE**
- 5. THE VALUATION METHODS RELATED TO ESG**
- 6. DCF INPUTS & ESG**
- 7. INFLATION & ESG**
- 8. HOW VALUERS CAN ADOPT AN ESG PERSPECTIVE**
- 9. OUR VISION OF ESG**
- 10. SUMMARY**



## OVERVIEW

Environmental, Social, and Governance (ESG) are criteria increasingly used to assess the impact of the environmental, social and **ethical practices of companies on their operations, financial performance and attractiveness to investors.**

## WHAT WE USED TO SAY



## INFLUENCE

Criteria should also be considered from a tangible asset's perspective as the **ESG principles affect not only the behavior of owners and operators of assets**, but also other matters related to **the physical properties themselves**, such as energy efficiency

## CORPORATE DECISIONS

**Capital flows will be increasingly channeled into sustainable economic activities** in the future meaning ESG will play an important role in corporate decisions



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# ESG & VALUATION ASSETS

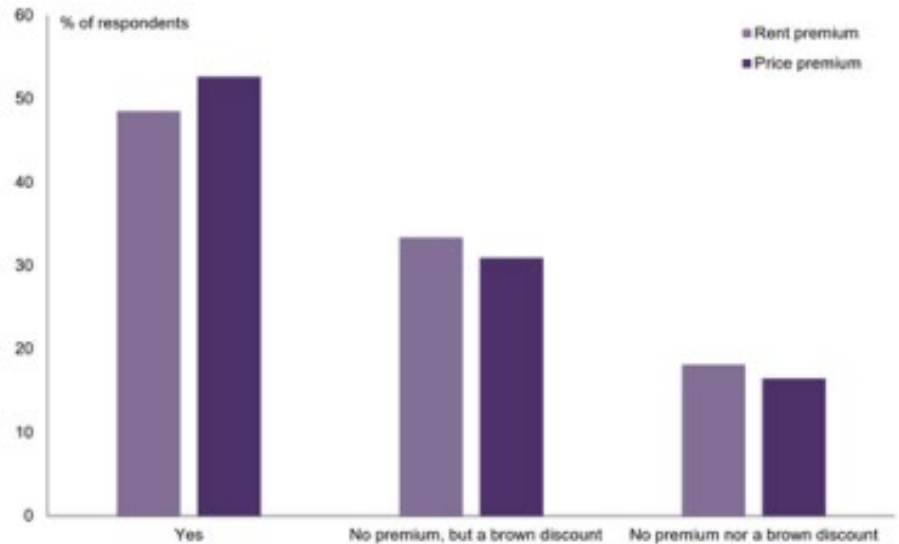


Figure 4 Rent and price premium for green buildings

Source: RICS

RICS World Built Environment Forum Sustainability Report Q2 2021

## RICS SUSTAINABILITY REPORT Q2 2021 (DIAGRAM)

The diagram above that **“Globally, around half of respondents believe that green/sustainable buildings achieve a rent and a price premium over comparable non-green/sustainable buildings”**

## 2015 PARIS CLIMATE AGREEMENT

ENVIRONMENTAL SOCIAL GOVERNANCE (ESG) CRITERIA FOR INVESTMENT AND THE NUMBER OF ESG FUNDS, ‘DOING NOTHING’ MEANS THE VALUE OF YOUR ASSET – NO MATTER WHERE IT IS OR WHAT TYPE – WILL LIKELY BE IMPACTED BY LONG-TERM SUSTAINABILITY CHALLENGES

## ESG AND IVS

Within IVS 105 50.36 through 50.4, the adjustments for additional risks within the cash flow projection require detailed consideration and this will include ESG elements

# GLOBAL AND AUSTRALIAN PERSPECTIVE

- From a real estate perspective, Environmental issues are especially important as the built environment contributes approximately 39% of the world's carbon dioxide emissions and 40% of the energy consumption
- Australia's National Australian Built Environment Rating System (NABERS), which provides comparable sustainability measurements across building sectors (e.g. hotels, shopping centers, apartments, offices, data centers)

# THE VALUATION METHODS RELATED TO ESG

“When it comes to valuing real estate, the impact of ESG is not to be found in any white paper or think tank study; **it is to be measured from the market and is to reflect the actions of market participants, buyers, sellers, tenants and landlords, developers and lenders.** The impact of ESG will evolve over time as both it becomes increasingly more evident in a world-built market and is better understood by those active in the market.” – (Source: IVSC)



## COST APPROACH

**Accrued depreciation and obsolescence** and adds in the estimated value of the land

Physical obsolescence

-

Functional obsolescence

-

Economic obsolescence



## SALES COMPARISON APPROACH

Considers prices achieved for transactions of similar properties. At this early stage of **market recognition and adoption of ESG practices, there is not yet full transparency regarding ESG characteristics for buildings** making it very challenging to find comparable market transactions reflecting full ESG adoption



## INCOME APPROACH

ESG & Market rent

-

ESG & Outgoings

-

ESG & Capitalisation Rates

-

ESG & Discount Rates

# DCF INPUTS & ESG

## Income capitalization analysis

Discounted cash flow analysis is very well suited to quantifying ESG factors within a real estate valuation because a DCF can explicitly reflect specific assumptions which relate to income, expense, capital expenditure and exit yields and vacancies over a period of years

## DCF ANALYSIS

When using a DCF analysis, the forecasted cash flow is discounted back to the valuation date, resulting in a present value

- (a) Rental Cash Flow Forecast
- (b) Outgoings Forecast
- (c) Terminal Capital & Value Forecast
- (d) Capital Forecast

## DCF INPUTS

**It is believed that the impact of ESG will be observable in sales and lease transactions. Like NABERS and Green Star ratings ESG will feature in transaction analysis**



# DCF INPUTS & ESG



## NON-RECOVERABLE CAP EX -

New buildings versus established assets needing retro fitting and capital expenditure to achieve higher environmental and efficiency ratings

## CAPITALISATION RATE

The capitalisation rate reflects the risk-return profile of the underlying property, and numerous aspects must be taken into account (location, type of use, occupancy rate, year of construction, tenant-mix, etc.) including the most probable buyer.

**As returns are earned in the future, active buyers are forced to be future facing. In some markets investor groups are already targeting ESG conscious buildings** as they see these assets as having lower risks in generating income streams, through a higher market rent and a greater occupancy rate as well as higher prices from a potential sale

# DCF INPUTS & ESG



## DISCOUNT RATE -

As stated in IVS 104 Valuation Approaches and Methods the rate at which the forecast cash flow is discounted should reflect not only the time value of money, but also the risks associated with the type of cash flow and the future operations of the asset. Real estate is frequently valued using discounted cash flows with projections five to ten years or more.

These associated risks could result in a higher discount in pricing to reflect the increased risk of obsolescence where ESG principles are not embraced.

## FINANCE

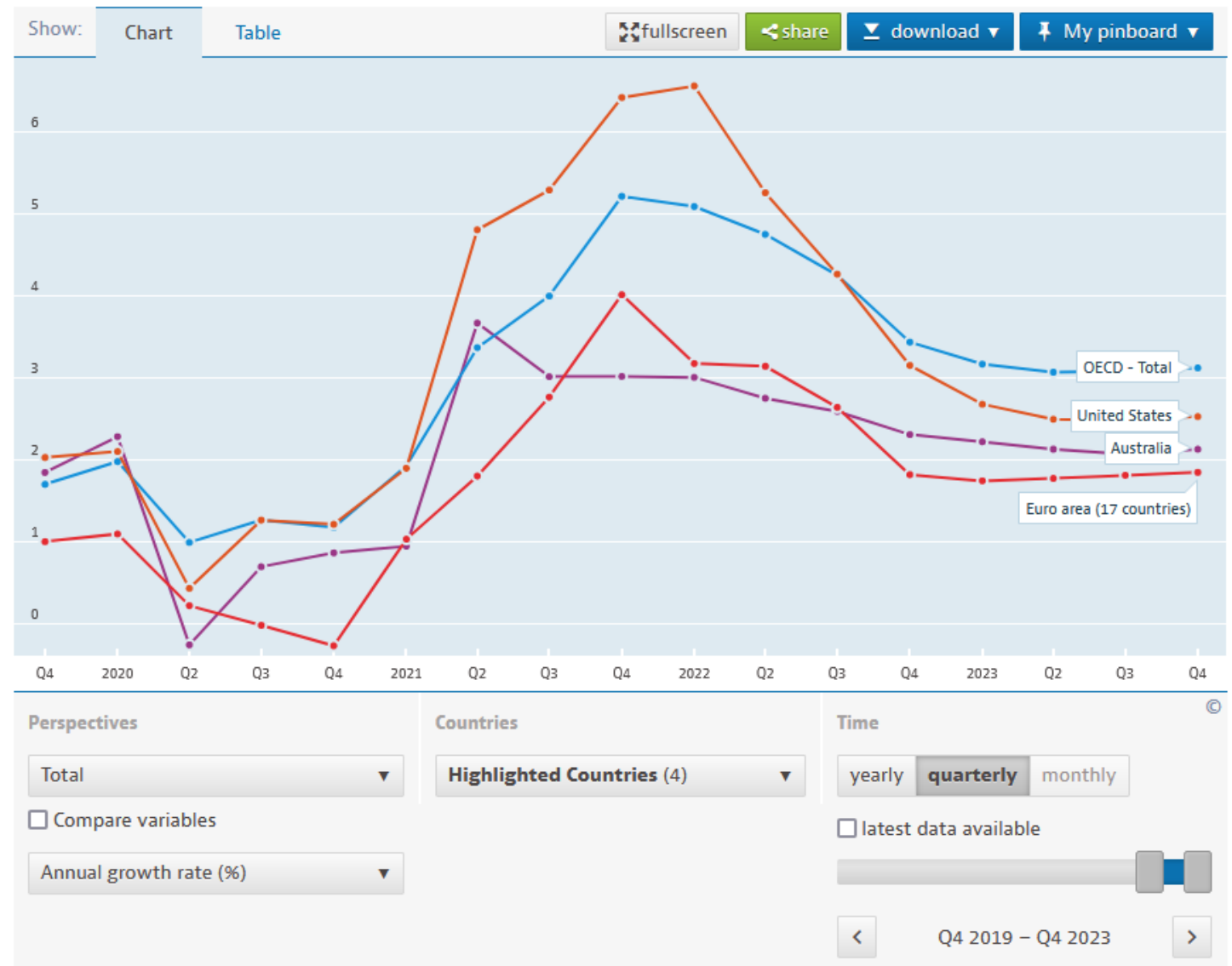
While valuations of real estate assets are performed before consideration of financing, there are an increasing number of green loans available within markets where lower finance costs are offered to buildings where sustainability Key Performance Indicators are achieved. As this logic gathers steam it will undoubtedly impact prices and values.

# ESG and Inflation

- Valuation Governance Perspective
- Is inflation a long run change or short term COVID & Ukraine induced aberration?
- The OECD inflation forecasts suggest the later.
- Australia faring better that most global peers
- What does inflation mean for ESG principles impacting valuation
- Impact of inflation on interest rates, building costs, rents, outgoings, lease structuring, cap rates, the cost of capital (WACC) and discount rates?

Inflation forecast Total, Annual growth rate (%), Q4 2019 – Q4 2023

Source: OECD Economic Outlook: Statistics and Projections



# HOW CAN VALUERS ADOPT AN ESG PERSPECTIVE

## TRENDS AND RESEARCH

As part of the valuation process the valuer needs to understand trends and developing issues.

## GOVERNMENT INFLUENCE

Responsible valuers need to be aware of steps taken by governments which will affect real estate.

## MONITORING MARKET TRANSACTIONS FOR ESG

Track ESG principles in Lease and Sale transactions

Compare obvious ESG benefitted properties in transactions with those that haven't adopted ESG

# HOW CAN VALUERS ADOPT AN ESG PERSPECTIVE

The most important skill for a valuer is to recognise market changes and to do that, one must be in close touch with their particular market. There is risk in relying on older data and as the pace of change continues to accelerate, a valuer who is aware of ESG changes. To anticipate ESG changes the valuer will need to:-

- Monitor the continued evolution of ESG and what building aspects result in higher or lower ESG ratings.
- When evaluating a building in its market, be aware of applicable governmental ESG measures.
- Maintain a keen understanding of leasing and other market requirements to accurately reflect supply and demand considering ESG.
- Liaise with construction and build cost professionals to understand components that enhance ESG factors and their cost.
- Understand ESG features of comparable used and determine how much emphasis market participants place on such features.
- Understand whether favourable financing is available for buildings with a higher ESG rating.

# HEALTHY BUILDINGS & ESG

## Building rating system

**A HEALTHY building rating system** that certifies buildings on their ability to maintain clean and safe spaces, similar to the current Green Star and NABERS environmental ratings, could help commercial property attract and retain tenants in the post-COVID environment. (Property Funds Association - PFA)

**While there would be capital costs involved in implementation there were benefits on valuations, for both owners and tenants, and for investors**

“Proptech building system innovations including building monitoring systems, smarter air filtration, and ultraviolet light which can disinfect have been developed.”



## FOR ESG FRONT OF MIND IN VALUATION & MANAGEMENT

Develop a plan for implementing ESG thinking

APR  
2021

Implementation of ESG within our 3-year strategic plan and our communications tools

APR  
2022

Training our valuers on how to integrate ESG in our Valuation thinking, templates and valuation math's – track and identify market practices

OCT  
2022

Adoption of a full ESG approach in our Property valuation and property management



## SUMMARY

Valuation necessarily involves comparison. As the impact of ESG is in the early stages of market acceptance transaction data bearing ESG will evolve. Nonetheless valuers need to stay abreast of their markets to accurately consider ESG within the valuation process as this is a rapidly evolving issue. Valuation methodologies have been well developed and tested over years and can begin to reflect market participant attitudes toward ESG factors – if valuers are knowledgeable of what those market participant preferences are.





# ABOUT US

We are a firm of international property consultants and valuers who aspire to be market leaders in the provision of real estate investment and development valuation; asset, property and facilities management; and consultancy services for all classes of real estate and infrastructure; as well as a market leader in the provision of asset valuation for financial reporting (real estate, plant and machinery).

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