SUSTAINABILITY IMPROVEMENTS DIRECTLY IMPACTS FINANCIAL PERFORMANCE

It seems that everybody is struggling with the same issue: ***What is the financial implication of making assets more sustainable?*** We all know it is necessary to make real estate more sustainable and to reduce carbon emissions, but so far this is mostly reasoned from a risk reduction point of view. In other words, the (danger of) regulation and/or obsolescence is typically the reason for the need of certain sustainable investments. We believe that sustainable buildings are **buildings where the integration of ESG** (Environmental, Social & Governance) **performance is properly monitored and improved over time** and that **this will lead to an improvement of return as well**. This is supported by academic research that has clearly shown that sustainability investments made to obtain an environmental certification has led to a positive financial effect, increasing sales price by approx. 14% on average.

This academic research (see Leskinen et al[1]) has shown that improving the sustainability of buildings in the form of obtaining certification has a **structural positive financial impact**. This financial impact is visible on a number of components, namely operational expenses, rental income, vacancy and the net initial yield and consequently the price is affected. Although not every research is showing a significant improvement and the variation in results is rather wide, the average result is undeniably clear: there is a positive financial impact. Table 1 shows this impact for several financial indicators. It presents the number of academic studies on the specific metric, the range of outcomes of these studies and the median result.

	Number of studies	Range of results	Median
Rental Income	43	0 – 23%	4.6 %
Occupancy	13	0.9 – 17%	4.3 %
Operation Costs	7	-14.3 – 23.8%	-4.9 %
Yield	2	-36 – -55 bps	-46 bps
Sales Price	30	0 – 43%	14.1%

Source: Leskinen et al (2020), modified by BNP Paribas REIM

A quick review on these indicators:

- **RENTAL INCOME** : The impact on rental income has been widely researched and the impact of having an acknowledged certification is slightly below 5% on average. The results vary materially, but the direction is very clear.

- **OCCUPANCY** : Besides the rental premium for sustainable buildings, it is also clear that these buildings are less likely to experience vacancy. On average, these certified buildings have a 5% higher occupancy. Some research also found that the time to relet was also much shorter for these buildings.

- **OPERATION COSTS** : There have not been many papers on the impact on operational costs and the results found are mixed. There seemed to be a stronger effect when considering net leases, as it places the responsibility for the costs with the tenant.

(1) Paper by Leskinen, N., Vimpari, J., & Junnila, S. (2020). A review of the impact of green building certification on the cash flows and values of commercial properties. Sustainability, 12(7), 2729.

- **YIELD :** The two papers analysing the impact on net initial yields have found a significant negative impact of certification of US office buildings. Although the sample is small, much of the yield compression is also covered by the sales price increase.

- **SALES PRICE:** The impact on the most important financial indicator, the sales price, is a net result of all other effects and it has been analysed a lot. It has a strong positive correlation with certification with an average and median increase of around 14% and over 80% of these studies showed a price increase of at least 5%.

- **OTHER BENEFITS** that have been analysed and could have additional, more indirect, financial implications are higher level of tenant satisfaction, decreased tenant rent concessions and lower mortgage rates for certified buildings.

Why are these results important to the real estate investment industry?

Especially in the light of climate change and the latest IPCC report, **change is urgently required**. As properties are responsible for a substantial part of the collective energy usage (EU: 40%[2]) and carbon emissions (EU: 36%), **it is mainly the responsibility of the asset owners and managers to find ways to reduce emissions**. As it is key to construct new properties with a limited amount of emission when being in operation, it becomes more and more important as a second pillar of the strategy to renovate existing buildings instead of replacing existing buildings with new ones. The European Academies' Science Advisory Council calculates that **75%** of all residential buildings alone in the EU (equivalent to approx. 146 million buildings) show a poor energy performance – those assets **are required to be energy efficient according to the Commissions climate neutrality goal, latest by 2050**.
With proofed experiences of BNP Paribas REIM as an early mover but also with the help of academic research, we believe that we are in an era **where sustainability improvements go hand in hand with improvements in return, which is clearly a win-win situation for both environment as well as investors**. Therefore, the industry needs to take its environmental responsibility seriously, as it is in line with the financial responsibility towards the investors, and the academic research has done its work to support the appropriate underwriting.

(2) European Commission: https://ec.europa.eu/info/news/focus-energy-efficiency-buildings-2020-feb-17_en
(3) EASAC: Decarbonisation of buildings: for climate, health and jobs. EASAC policy report 43, June 2021.