How BREEAM certifications impact prime Central London office rents

The Sustainability Series

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Sustainability is an increasingly important consideration for London as a major global office market. A combination of top-level investor pressure, risk mitigation, regulatory changes and the search for alpha is driving the demand for sustainable real estate in the capital.

However, while sustainability is more and more demanded at the prime end in both the occupier and investor markets, the actual monetary benefit that investors, landlords and developers can reap from green-rated buildings has been challenging to quantify. This is due to the difficulties in both being able to measure what makes a building green, but also the large and varied amount of data that is needed to then run the analysis. When it comes to the question of, for example, rental premiums, are they down to green ratings? Newness? Location? Something else?

In trying to answer this, London is an ideal petri dish, having one of the largest pools of green buildings of any city globally. London further benefits from one of the world’s most well-known green ratings, BREEAM, having been first established in Watford, just to the north of the capital in 1990, meaning the city also has one of the longest histories of green-rated buildings.

In our comprehensive research, we have collaborated with BRE, the creators of BREEAM, to quantify the impact of BREEAM ratings on prime Central London office rents. To do this, we have used a hedonic regression model, which controls for an extensive set of property, time and locational characteristics. By quantifying the impact these other factors have on rental levels, we can identify, with confidence, the impact of green ratings on rents. This is made possible by combining BREEAM ratings with proprietary Knight Frank data, which covers transaction activity over the last decade for more than 2,700 Central London office buildings.

In summary, we found a positive and significant effect of Very Good, Excellent and Outstanding BREEAM ratings on prime Central London office rents – ranging from 3.7% to 12.3% premiums, while controlling for other property characteristics. This is significant for occupiers, investors and developers alike to understand the impact green ratings have on income, a key contributor to a building’s value.

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WHAT IS BREEAM?

BREEAM is the world’s leading sustainability assessment method for master-planning projects, infrastructure and buildings. It recognises and reflects the value in higher performing assets across the built environment lifecycle, from new construction to in-use and refurbishment.

Investors know that BREEAM:
- Significantly reduces building services running costs
- Ensures that their building is more durable and resilient
- Tackles building performance gap issues with reduced risk of underperforming
- Improves staff attendance and productivity
- Meets Climate Crisis and CSR responsibilities
- Payback is typically within 2-5 years through utility cost savings alone

The BREEAM rating benchmark levels enable a client or other stakeholder to compare an individual building’s performance with other BREEAM rated buildings and the typical sustainability performance with examples below for new non-domestic buildings in the UK.

| Each BREEAM rating level broadly represents performance equivalent to: |
|-------------------|-------------------|-------------------|
| **Outstanding**   | Less than top 1%  | ≥ 85% of score    |
| **Excellent**     | Top 10% (best practice) | ≥ 70% of score    |
| **Very Good**     | Top 25% (advanced good practice) | ≥ 65% of score    |
| **Good**          | Top 50% (intermediate good practice) | ≥ 45% of score    |
| **Pass**          | Top 75% (standard good practice) | ≥ 30% of score    |

SHAMIR GHUMRA
HEAD OF BUILDING PERFORMANCE SERVICES BRE
THE FINDINGS IN DETAIL:

BREEAM CERTIFICATIONS INCREASE PRIME CENTRAL LONDON OFFICE RENTS BY UP TO 12.3%

We analysed a proprietary Knight Frank data sample of rental observations for 2,701 properties over the time span Q1 2010 – Q1 2021 using a hedonic regression model.

The average impact of BREEAM certifications prime Central London office rents

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<tr>
<th>BREEAM Very GOOD certifications result in a</th>
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<th>BREEAM Outstanding certifications result in a</th>
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<td>3.7% premium</td>
<td>4.7% premium</td>
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Understanding the methodology

In order to accurately understand the relationship between rent and BREEAM certifications – independent of the building’s other characteristics (such as age, grade and location) – we actively investigated the impacts of these characteristics via hedonic regression analysis. Hedonic modelling helps to represent the price of a commodity as a sum of its attributes and is a go-to method for eco-certification premia analysis in academic literature.

Our model set-up and our variable selection builds upon previous academic research which analysed the effect of eco-certifications on property values. In application to office rents, our hedonic model accounts for physical attributes (building size and number of floors), quality (grade and age), location (corresponding submarket, walking distance to the nearest transport, proximity to main stations), surroundings (air quality, a proxy for capturing the fact that the building is located in a busy urban area, and proximity to green spaces) and market conditions at the time of the transaction (year dummy variables), along with BREEAM ratings.

By identifying the contributory value of each of the property characteristics, we were able to single out the effect of BREEAM on rent.

Inclusion of a large number of explanatory variables in the model ensures that the identified effect is indeed due to BREEAM, but also requires a large and detailed dataset. In our research, we used Knight Frank proprietary data comprising over 6,400 building-quarter observations (of more than 2,700 buildings), including almost 1,000 observations with a BREEAM rating, covering 17 Central London submarkets and time period Q1 2010 – Q1 2021. Having a substantial amount of observations allowed us to explain the variability in the rental values and to ensure the robustness of our results.
In addition to BREEAM ratings, the following variables were also included in our calculations. Out of multiple variables tested, these were found to have the most statistically significant impact on office rents alongside BREEAM ratings. While the variables are not surprising, they illustrate that a building’s attributes, its location, and its surrounding area influence rents. The variables shown here all have a positive impact on rents. In addition to these shown, London submarket and lease start year were also included in the model.
How significant is this research?

It is really significant. At the moment, there’s a lot of work explaining why ESG is important; we know that sustainable buildings are likely to be protected against future legislation changes, strong mandates are coming down from investors, and occupiers prefer sustainable buildings to match their corporate ethos and to win the war on talent. But there’s not much research that explains how sustainability monetarily adds value – and the market is hungry to understand this. As far as I know, this is the first study in the commercial arena which uses robust econometric methods to quantify the impact of BREEAM rating on commercial office rents.

What is the most interesting finding, in your opinion, from the research?

The most interesting finding, because it is so novel, is the degree of impact that BREEAM ratings have on prime Central London office rents, especially the jump from a 4.7% rise for BREEAM Excellent ratings, to a 12.3% rise in rents for a BREEAM Outstanding ratings. This really indicates that for those investors for whom income is really key, including liability matching institutions, they should be aiming for the best green ratings, rather than simply satisfying.

But the great thing about what has been done here is that this research has also enabled us to identify other ESG related factors that also contribute to rent and can support investor strategies. For example, from this research, we now know that green space within a 900-metre distance contributes to rents and is something that relates to wellness and the ‘S’ of ESG. Similarly, we’ve been able to capture the ‘doughnut effect’ of a positive rental impact on buildings within a 5-10 minute walk to a railway station. Walkability and public transportation are key elements for ESG.

What will this research allow investors and developers to do?

Firstly, it creates that visibility and starts moving the conversation from ‘we know it is a good idea’ to ‘we can quantify the investment’. Secondly, if you think about value, it is a combination of rent and yield. So, if we know that BREEAM rated properties command higher rents, for a building with a given yield, that should translate to a higher value.

This is valuable for developers to understand how targeting BREEAM rated buildings could lift their development value. It is of course, also interesting for investors, because it both identifies the potential to maximise income, but also form a strategy of maximising building value and potentially identify undervalued buildings. More widely, it is important for all sorts of market participants to actually understand the numbers around the benefits of BREEAM ratings.

What impact will these findings have on the London investment market?

“These results are very compelling from a capital markets standpoint. Identifying a clear rental premium for high-end BREEAM ratings is a big factor for investors who are looking to differentiate their buildings from the rest of the market. Occupiers are beginning to demand buildings that better reflect their values and help, not hinder, their own ESG targets. Ultimately, the quality of an occupier and the rent they are prepared to pay for a building directly affects value.”

“As ESG continues to rise quickly up the agenda for both occupiers and investors, we expect to start seeing a ‘green value premium’ for assets strongly aligned with ESG characteristics. Initially, this is likely to materialise through increased liquidity of an asset at sale. We see a clear risk that ‘non-compliant’ buildings will lose value fast as they near obsolescence and eventually become ‘stranded’. Therefore, getting the right help and advice on portfolios and trading strategies now is fundamental for investors.”
In episode 4 of Commercial Conversations webinar series, we discussed how Knight Frank, in collaboration with BREEAM, have used analytical techniques to prove a strong statistical relationship between a building’s environmental credentials and the level of rent achieved.

Register here to watch on-demand