Knight Frank

THE ESG IMPERATIVE

The View from The Middle East

GREEN IS THE NEW BLACK

As sustainability issues take centre stage globally, environmental, social and governance (ESG) considerations are growing in importance. With 40% of global greenhouse gas emissions traced to the buildings we occupy, the imperative to go green has never been stronger. Furthermore, ESG factors can have a significant impact on the attractiveness of commercial assets to occupiers, as well as investors. Our research shows clear evidence of rental premia for ESG rated assets, which are now being highly sought after, especially by international blue-chip businesses.

THE GRADE A RACE

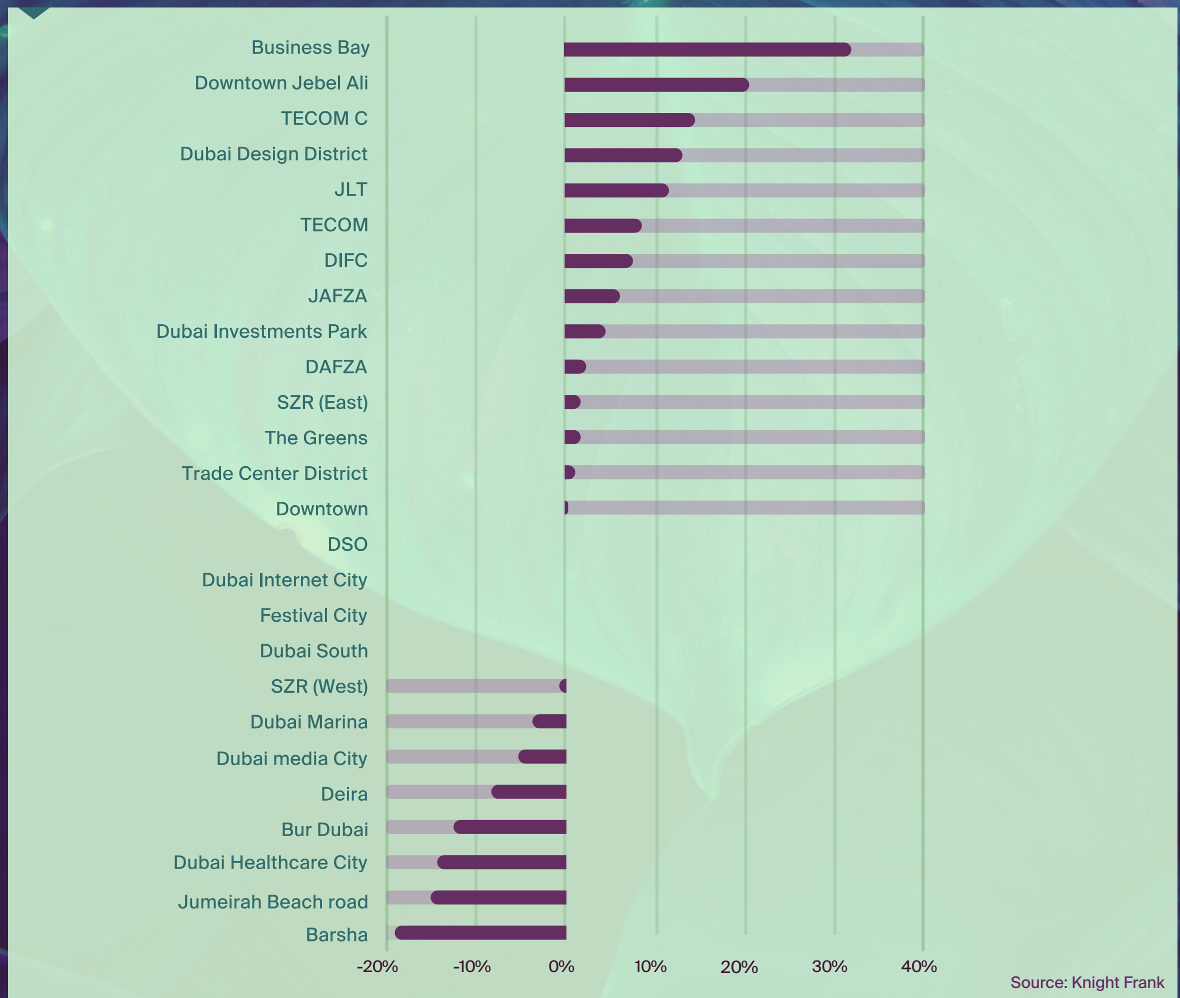
Most businesses, particularly those of an international variety are actively seeking prime Grade A space, with a strong preference for green rated buildings. Many have a global mandate to occupy green buildings, as seen to be actively responding to the climate emergency plays a significant role in attracting and retaining talent. This occurs through offering world-class work environments that embrace ESG considerations.

DUBAI'S GREEN AWAKENING

While the ESG agenda remains a relatively nascent concept across the Middle East, there is evidence to suggest that the market is already responding to the global green reawakening.

As demand recovers across Dubai, office rents are on the rise and best-in-class space remains in short supply.

Change in office rents since the start of the pandemic (Q1 | 20 v Q3 | 22)



There has been a sharp return to rental growth for locations that have higher concentrations of new, or relatively modern stock. Submarkets such as Business Bay, the DIFC and the Dubai Design District have all seen rents surpass pre-COVID levels, while older parts of the city where there is a higher concentration of older, more secondary stock are still struggling to return pre-pandemic lease rates. This is not necessarily due to a lack of demand in the market, but a lack of demand for older offices.

That said, in a market like the DIFC, where 53% of the precincts total stock of 6 million sqft (excl. / Brookfield Place) was completed before 2010.

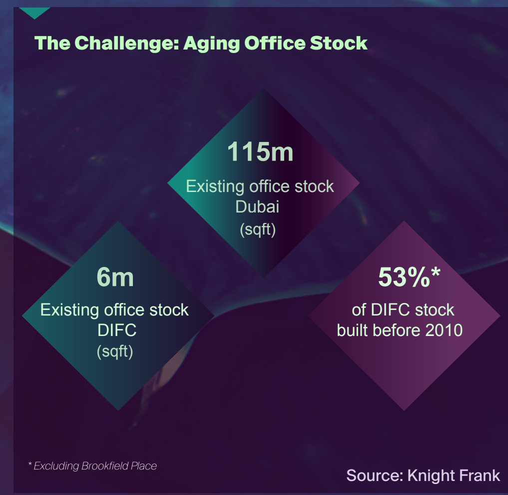
While the DIFC retains its position as Dubai's financial heart and commands the highest office rents in the city, its buildings are rapidly aging. Without extensive refurbishment that is ESG compliant, some buildings may start to see increasing voids and falling rents as occupiers gravitate towards more modern and green buildings.

Elsewhere in the Middle East, similar problems are arising. In the Saudi capital, Riyadh, 50% of office space on King Fahd Road and 84% of office space on Olaya Road is over 5-10 years old. And with King Abdullah Financial District fully committed, the divergence in rents between Grade A and Grade B space is likely to continue widening as occupiers zero in on the best buildings.

THE FUTURE OF OLDER BUILDINGS

Clearly there are options to explore a change of use, or demolish and reconstruct older buildings; however, with green financing increasingly becoming the norm, developers and landlords may face challenges in the future, particularly when the carbon footprint to demolish and rebuild is higher than renovating an existing building.

Average renovation/refurbishment costs for office buildings in Dubai currently ranges from approximately AED 280 psf and can be as high as AED 580 psf.



> **"Most businesses, particularly those of an international variety are actively seeking prime Grade A space, with a strong preference for green rated buildings."**

ESG credential options

LEED
The Leadership in Energy and Environmental Design (LEED) is the world's most well-known green-rating system for buildings. 80,000 buildings globally are LEED certified.

BREEAM
Developed by the Building Research Establishment (BRE) in 1990 in the UK, BREEAM is the world's oldest green building certification system and is currently used in 50 countries and covers over two million buildings.

WiredScore
WiredScore sets the global standard for technology in the built world through education and certification. Over 800 million square feet of commercial and residential space have been committed to certification, impacting over 8 million people across 36 countries.

WELL
A performance-based measure used to assess and promote the health and well-being.

ESG PERCEPTIONS IN THE MIDDLE EAST

Attitudes towards ESG in the Middle East are shifting. The office and residential markets in cities such as Dubai are already feeling the impact of these changes, with a notable shift in sentiment and ESG-linked requirements.

International businesses are looking to their workplaces to revitalise their corporate brand and culture after the pandemic, which we believe will result in the provision of significantly improved amenities and services for staff.

Our second edition of (Y)OUR SPACE draws on responses from almost 400 international businesses with a combined headcount in excess of 10 million, providing unique insight into the workplace strategies and real estate needs of global companies.

As firms begin to emerge from the pandemic they are still assessing their pandemic experiences and investigating the ways in which they can enhance their workplaces, with an emerging focus on employees and their well-being.

There is a distinct mood in the air. Global firms are looking beyond the pandemic and are focused on how their workplaces can enhance corporate culture and re-engage employees in a new age of agile working. Firms want to give employees the best of both worlds, allowing them to work flexibly, but making their offices the best possible experience, which means delivering higher quality and more engaging workplaces.

In the Middle East, our survey results represent the opinions of 8,000 staff and there is an overwhelming sustainability undertone, linked to ESG considerations.

Separately, our 2021 Global Residential Survey showed a similar shift in attitudes amongst home buyers towards ESG issues, with buyers around the region showing a higher interest in air-pollution levels and the energy efficiency of their future homes when compared to their global counterparts.

Commercial real estate

Amenities that are expected to be demanded by staff from their buildings over the next 3 years

1. Gym + F&B facilities
2. Mental wellbeing + Personal parcel facilities
3. Onsite healthcare facilities
4. Concierge + Educational facilities
5. Cycle storage

Benefits of occupying green accredited buildings

1. Cost savings
2. Brand enhancement
3. Supports company ESG strategy

75% of businesses believe their net-zero carbon commitments will change their real estate choices

Source: Knight Frank

Residential real estate

How important is the energy efficiency of your next home purchase?

	Middle East	Global
Very Important	50%	42%
Important	50%	42%
Not Very Important	14%	12%
Irrelevant	5%	3%

Most important energy considerations in your next home purchase

Middle East		Global
24%	None, it has little influence on my purchasing	19%
28%	The prospect of future environmental regulations impacting the value of my home	28%
14%	Cheaper mortage finance for energy efficient homes	22%
31%	I would prefer a greener home and would pay more for it, if required	27%
3%	Other	4%

Source: Knight Frank

Residential real estate

How important will the following factors be for you when choosing where to live ?

Middle East		Global
18%	Proximity to green space	17%
13%	Access to good healthcare	15%
6%	Walking distance to work	9%
14%	Proximity to restaurants, gyms, retail and cultural amenities	11%
19%	Good air quality	17%
8%	Good schools	9%
14%	Good views (ocean, mountain, skyline etc)	13%
9%	Walking distance to a public transport hub	9%

Source: Knight Frank

Refurbishment Cost Estimates by Asset Class (Dubai)

RESIDENTIAL

AED **180 - 510** psf

OFFICES

AED **280 - 580** psf

Figures are based on Knight Frank estimates

Source: Knight Frank

THE GREEN RACE

While the Middle East embraces the importance of sustainability in the urban environment, other parts of the world are slightly ahead of the curve, mainly due to the high concentration of older buildings and lack of new development sites. Still, the region and the UAE, in particular, has surprisingly high concentrations of green-rated buildings.

On a global scale, the UAE has the 14th highest concentration of green-rated buildings. At a city level, London leads the pack with almost 3,000 green buildings (all BREEAM rated), closely followed by New York and Singapore. With 563 green buildings, Dubai is the only city from the region in the world's top 25 cities for the highest number of environmentally accredited buildings, which includes both local and international accreditations.

Therein however lies a challenge. Most of the buildings with local green accreditations are not necessarily always considered by international occupiers and investors, which will likely pose challenges in the future.

Saudi Arabia is ranked 54th with 38 green-rated buildings, while Kuwait and Oman have 12 green-accredited buildings each and rank 69th and 70th, respectively.

The United States leads the world with over 81,000 green buildings.

REGIONAL GREEN BUILDING CONCENTRATIONS

	Global rank	Green buildings
USA	1	81,000
UAE	14	869
QATAR	32	140
SAUDI ARABIA	54	38
KUWAIT	69	12
OMAN	70	12

Source: Knight Frank

A POSTCARD FROM LONDON

London is a leading city for infrastructure and green spaces. In 2019, the city became the world's first National Park City, with approximately eight million trees acting as a carbon sink and 17% of the wider city being covered by public green space. Good public transport helps. There are almost 1.4 billion London Underground journeys per year and the 402km London Underground network is currently being extended. The new Elizabeth line provides a fast link across London and extensions to the Northern and Bakerloo lines are either underway or in the pipeline.

This infrastructure means that there is a wide pool of commercial real estate that offers sustainable credentials from the perspective of travel to and from the buildings. However, commercial real estate investors are often most interested in the green credentials of the buildings themselves. Indeed, our 2020 London Landlord and Investor Survey found that improving the environmental qualities of buildings is one of the top three challenges for the city.

THE GREEN PREMIUM

London already enjoys a stock of over 3,000 BREEAM-rated buildings. However, for investors, being sustainable does not just mean investing in existing green buildings. With 64% of commercial buildings in London completed prior to the year 2000, there is opportunity to enhance value by innovatively greenifying these buildings, particularly if we see an increase in 'brown' building discounts, as the stock of green buildings continue to grow.

Green rental premiums are largely driven by tenant demand for sustainable offices and this links directly to the war for talent.

Our research also shows a clear link between rental premia and green ratings, ranging from 3.7%-12.3% for prime Central London offices.

The average impact of BREEAM certifications on prime Central London office rents

BREEAM Very GOOD certifications result in a **3.7%** premium

BREEAM Excellent certifications result in a **4.7%** premium

BREEAM Outstanding certifications result in a **12.3%** premium

Source: Knight Frank

A GREEN MAGNET FOR INVESTMENT

Not all investors are yet noticing the full extent of demand for green or sustainable investing. However, larger, international institutions are certainly seeing this shift. Globally, assets totalling US$ 120 trillion, including commercial real estate, are now managed by financial firms signed up to voluntary climate change disclosures. This is driving some of the growth in green investor demand, especially as there is an expectation that these standards could become mandatory.

Indeed, green building ratings are already having a notable impact on pricing and we have been able to quantify the uplift in capital values.

Our assessment of green-rated buildings in London, Sydney and Melbourne, combined with other geographic factors has revealed an 8-18% sales price premium for green-rated buildings compared to equivalent buildings without a BREEAM or NABERS rating across these markets, depending on the level of green rating.

This supports our recent research which finds a 3%-12% rental premium, depending on BREAAM rating level for prime Central London office buildings compared to equivalent unrated buildings

With a significant amount of London's office stock now held in international ownership (c.80% in The City), the capital's real estate needs to remain fit for purpose in this environment.

DIGITAL WELLBEING

Digital connectivity is an element of the built environment that isn't necessarily visible, but plays a considerable part in unlocking the true potential of a workspace as well as having a direct impact on the wellbeing of its occupants. This positions connectivity firmly in the 'S' camp of ESG considerations.

WIREDSCORE

WiredScore Certification is a measure of a building's digital infrastructure and overall accessibility. This does not typically feature overtly in the equation for determining rents, or indeed the value of commercial real estate. However, with the technology sector a significant source of office requirements globally and with serviced office space increasing in popularity around the world, digital connectivity looks set to play a bigger role in commercial real estate valuations in the future.

The threat of building obsolescence through poor digital connectivity is real and one that could have a direct impact on the value and saleability of a commercial asset.

With poor digital connectivity, workers' ability to remain productive may be diminished and with it, a business's propensity to renew a lease, or indeed expand in situ may well be compromised.

A CONNECTIVITY PREMIUM?

The answer is: it depends. Research in 2019 by Radius Data Exchange shows that office buildings in London with at least a WiredScore accreditation command a rental premium of 4.7% over similar comparable neighbouring properties.

The research looked at 65 office buildings in Central London, where space had been let in the last five years. In the City Core and West End, the 'digital premiums' stood at just 0.3% and 1.6%, respectively. It was higher elsewhere.

The bottom line is that being connected digitally isn't something that is currently factored in building valuations explicitly, however with a culture of hot-desking becoming increasingly common, it seems inevitable that the digital connectivity rating of a property will start to play a greater role.

Research carried out by YouGov Galaxy in Australia, commissioned by Lendlease, showed that workers who experienced bad digital connectivity had an increase in negative emotions. And since internet outages don't just affect one person in the office, these emotions can become widespread within a business very quickly, thereby impacting overall business productivity.

The vast majority (98%) of respondents to this survey aligned with the idea that digital connectivity enables higher personal productivity at work.

However, in other locations, such as The City Fringe (9.2%) and Southbank (15.2%), there are higher digital connectivity premiums.

We believe, therefore, that high-quality digital infrastructure can be a useful differentiator for landlords, albeit recognising that the benefit will be greatest away from core markets in the centre of London.

From an investment perspective, the benefit, or indeed the appeal of digital connectivity ratings is perhaps less clear. The opportunity we feel lies in upgrading a building's connectivity credentials, which will bring with it a digital connectivity rental premium for the right occupier.

> **"Our recent research finds a 3%-12% rental premium, depending on BREEAM rating level for prime Central London office buildings."**

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