Low carbon workplace initiatives open up exciting new investment opportunities

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Socially responsible investment has become an increasingly prominent phenomenon in the investment world, a notable example being moves to reduce the carbon 'footprint' of businesses on the environment. Here in the UK, the government has led the way with legislation creating the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) that initially sought to use tax incentives, but is moving to a penalties regime to persuade businesses and property owners to comply with tougher low carbon standards. What might surprise investors, such as UK pension schemes and other institutional investors, are the lucrative possibilities this development actually opens up.

At present, most existing offices do not satisfy the new CRC regulations, which are expected to fuel a huge rise in demand for carbon-compliant workspace. This coupled with a vast shortage of supply presents a significant, indeed once-in-a-lifetime, investment opportunity.

The UK's commercial building stock accounts for 18% of the country's total CO_2 emissions, so it is no surprise that the government chose to aim legislation at this large, very visible target. But if the argument for a lower carbon work space is so clear, and the benefits that it brings so overwhelming, why have so many in the property industry not implemented many of the energy-saving measures already without legislation?

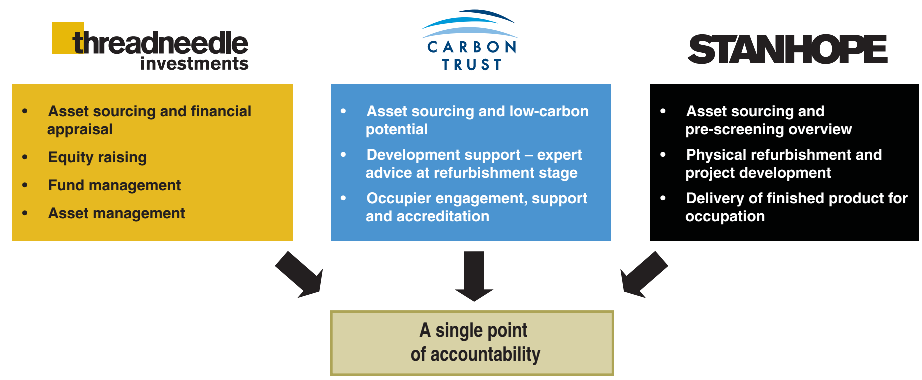
A major factor has been the previous lack of an industry standard, with owners and tenants reluctant to work to a standard that might later be superseded. That barrier was removed late last year when the Carbon Trust, a non-profit company set up by the government, set the industry standard. This is a commercial, workable standard that is provisionally set at 5kg of carbon per person per day.

The Low Carbon Workplace Fund, a partnership set up by investment group Threadneedle Investments, the Carbon Trust and property developer Stanhope, aims to use this new industry standard to significantly increase the availability of high specification low carbon commercial property in the UK. The investment objective will be delivered by the three partners, experts in their respective fields.

Value creation: strength in partnership

Meanwhile, the growing (and largely unsatisfied) occupier demand for low carbon commercial buildings in the UK earlier referred to will almost certainly mount with time. Aside from CRC, demand will be driven by a range of commercial imperatives, including corporate social responsibility and stakeholder sustainability awareness. For office-based businesses, recognition of accommodation as the single biggest contributor to their carbon footprint will place the achievement of a low

Figure 1: Value creation



carbon workplace at the top of corporate responsibility agendas.

What may surprise some is that the government's legislation need not over-burden businesses with costs. Most property professionals agree that the CRC should actually benefit the industry with the creation of a single coherent set of rules to approach the issue. Now, with the introduction of the CRC, energy reduction is in focus and it has elevated the issue from facilities management to top management. CRC employs a cap and trade approach that requires participating organisations to monitor their energy usage and buy allowances for each tonne of CO2 they emit. So there is a direct incentive to reduce energy usage to avoid buying allowances. Nevertheless, the Carbon Trust has calculated that the savings gained should well exceed both the cost of implementing any improvements and participating in the scheme.

The carbon imperative: at the heart of the opportunity

According to Carbon Trust research, latent demand for low carbon work space is around 4.3m square feet. But new development is sluggish and, in its current state, the UK's existing stock (80% of which is more than 10 years old) is unlikely to comply with current or future carbon legislation. Completely replacing it is not a viable option - even in good years, newly built space accounts for only 1% to 2% of total stock.

Under these circumstances, the CRC has brought a welcome focus back onto existing stock. The refurbishment cycle on office properties is typically around 20 years, with a significant proportion of standing properties due for refurbishment in the next 10 years. This presents a key window of opportunity for owners (and investors) to ensure that their office space meets the CRC standard, enabling them to differentiate themselves from properties that will soon become largely obsolete. It is difficult to exaggerate the competitive advantage this will give to those who act to upgrade their properties and hence command significantly higher rents.

The good news is that many city-centre buildings can be made suitably energy efficient very cost-effectively, particularly older office stock. This second lease of life will offer both better security and quality of income, along with a greater likelihood of capital gain, shorter void periods and high levels of pre-let. Tenants will be affected by CRC whether they participate in the scheme directly or not. For progressive landlords, CRC offers the opportunity to attract solid, stable tenants that are more likely to take longer leases. Initially, one of the more attractive pools of potential tenants are likely to be public sector bodies – high quality occupiers who have an added incentive to save money and be environmental exemplars, but other ideal early tenants wishing to buy into this sort of property will be the big corporations as well. The fact that the biggest initial demand is potentially from the public sector makes this an especially valuable long-term investment opportunity. As to potential investors in a portfolio of low carbon compliant properties, UK pension schemes and other institutional investors would seem to be a natural fit because they can combine high return potential with a socially responsible investment.

Another significant consideration associated with CRC for property owners is the issue of depreciation. After 10 to 15 years the physical fabric and components of a building have always needed to be refreshed, requiring a great deal of capital expenditure. Now, insuring that a building meets low carbon standards becomes another element to be factored into accelerated depreciation. Where previously buildings could be functionally or physically obsolete, now they can be environmentally obsolete too; the investment opportunity is in eliminating that part of the equation from an office portfolio.

Looking further ahead, despite the benefits for those investors who move quickly to exploit the rapid advantages to accrue from the CRC that we have outlined above, longer-term benefits will ultimately prove just as appealing – especially for institutional and pension fund investors. Although potential tenants will primarily want to change initially for reasons of reputation and economy, legislation involving carbon reduction is bound to evolve, increasing occupier demand into the future. The principal thing to remember is that this issue is not a short-term one. These high-quality tenants will continue to embrace the need for energy efficiency and consequently will value the expertise that landlords who have mastered the principles associated with the Low Carbon Workplace can offer. This will give them an edge over competitors, because such positive occupier engagement provides the opportunity to build a closer relationship with tenants, thereby increasing the likelihood of leases being renewed down the line. Just to give one example, for local councils facing severe budget cuts, the opportunity to save energy costs by occupying refurbished properties should prove irresistible.

So for investors, far from being a negative development, the advent of CRC provides those interested in benefiting from investment in the property market a completely new avenue to achieving attractive returns over the medium to long-term. The Low Carbon Workplace Fund aims to address this demand, delivering performance through the ability of these uniquely competitive buildings to attract considerable demand from high quality occupiers and secure a long-term income.

Figure 2: The carbon imperative