

Does sustainability pay?

How is the Gulf integrating
global best practice?

TOP
OF
THE
TREE



Perspectives on sustainability

Architects, planners and regulators alike all favour sustainable buildings, each with good reason: to design, shape and order new developments that will benefit the planet and improve the environment. The upcoming COP28 Conference in Dubai,¹ and the prioritisation of carbon emission reductions through the circular economy as an integral part of 2023 as the Year of Sustainability,² is evidence that policymakers in the UAE are placing a high value on sustainability overall.

Real estate can and must play a central role in the achievement of sustainability in the UAE. It is therefore welcome news that evidence from Cavendish Maxwell, both from recent regional valuations including Sharjah's BEEAH development,³ and from project financing cost data, shows that the real estate industry in the Gulf is moving solidly in the direction of green sustainability, as both financially and environmentally desirable.

It is developers and investors in the region, however, who must enact the dream. The problem is that valuation data on its own is currently insufficient for them to know whether to adopt particular aspects of sustainability in the buildings they construct and buy. Why? For several reasons.

1 Markets are not perfect: just because green buildings may achieve higher rents, higher levels of occupancy or generally be more expensive⁴, doesn't necessarily make it more or less financially desirable to build or buy them, any more than capital cities are better or worse value-for-money than secondary cities. From a developer or investor perspective, the real answer for them depends on the comparative overall performance of individual projects – including lifecycle costing – best initially judged through projected Internal Rates of Return (IRRs).

2 That being said, base case IRRs themselves are not perfect as, in isolation, they fail to take into account risks.⁵ These include largely unanticipated energy price and regulatory changes, which complicate the task of forecasting the components of returns – principally rents, costs and sales prices – and demand risk analysis.

3 Conversely, both developers and investors may be able to take advantage of lower financing costs for green buildings (in turn improving their IRRs),⁶ the case for which is reinforced by the Cavendish Maxwell project financing cost data tracking.

4 Finally, publicly available data on green buildings is somewhat limited, including whether buildings are actually green certified. This can lead to the differences between the very sustainability aspects and choices that developers and investors must make being unclear. This includes energy and water efficiency, site location, indoor environment quality and materials, and waste management.⁷ With this in mind, the increasing transparency of Gulf real estate markets in relation to sustainability criteria, including through the Dubai REST platform,⁸ is very much welcome.



Global Evidence on Sustainability Returns

Developers and investors will therefore want to look to the past to see what the returns to sustainability have actually been. Research presents a solidly favourable set of results, but a much more mixed picture of their usefulness. Not least because, as recent European research has suggested, market inefficiencies still favour green buildings, with only about 70% of projected energy cost savings included in subsequent transaction prices.⁹

Fortunately, even academics awash in construction cost and price data are now coming to recognise that returns measured by IRR are more important than pricing or rental data in isolation.^{10,11} Methodologies for tracking comparative achieved IRRs for energy-efficient buildings do however exist. In four early US studies, conducted at a time when sustainable buildings were very few and so comparing individual comparable properties was the only possible research method, increased rents and occupancy rates for LEED and ENERGY-STAR buildings were accompanied by raised construction costs. The IRR of the sustainability decision itself, however, was spectacular, averaging 90% and 109% respectively.¹² However, modelling around the same time suggested far lower returns, around 12%¹³, and so, even if achieved, these benefits almost certainly represented gains to initial adopters, hence no longer available. A similar comparative analysis between adopting LEED 2009 and the later LEED v4 in Thailand, for example, concluded in favour of LEED 2009.¹⁴

More recently, however, evidence from the returns of Green Building investments has now begun to emerge.

In the UK, for example, researchers found that although green buildings cost on average 6.5% more to develop, they rented for between 13.3-36.5 per cent more,¹⁵

clearly pointing to higher IRRs. Recent studies on returns in developing countries, although largely focused on whether IRRs have been greater than corporate cost of capital in Brazil or in India, or theoretically justified in Jordan,¹⁸ are also pointing in the direction of favourable assessments of green building development.

Developers and investors, however, face opportunity costs and alternatives, and this information, whilst no doubt welcome, is again insufficient for decision-making purposes. My own research indicates that developers are searching for more accurate metrics, but do not have access to them yet, even in mature markets such as the UK, USA and Australia, as only analysis at the level of individual developments can produce a clear-cut answer.

It was ever thus: investments in Class B and C offices in the past frequently generated higher returns than their more opulent Class A brethren. It was only when markets turned that the risks of investing in inferior real estate became evident, a ratio that has been tracked by Cavendish Maxwell in its commercial valuations. Much the same can be expected of today's highly rated commercial buildings: they will really only prove their worth in a crisis.



Is the Gulf different?

Yes, it is. And in a good way. Buildings are generally younger in the Gulf, which means that graded sustainability (AL SAFAT in Dubai,¹⁹ ESTIDAMA in Abu Dhabi,²⁰ and others) has been built into a much larger percentage of them than anywhere else in the world. This has been done in significant measure as a result of progressive Government initiatives,²¹ but also because of increasing demand from multinational organisations for reporting on the quality and efficiency of buildings.

At the city-building level, Cavendish Maxwell has already been involved in green city planning across the region, where studies have focused on how employment opportunities can be successfully integrated into the housing and transport developments of environmentally sustainable new cities.

As a result of all these initiatives, data capture in the region is greater and more granular, whilst at the same time sustainability features are less likely to be overshadowed by factors such as location or age. Measurements can therefore be expected to be more accurate.

So far, publicly available research for the region has been based on modelling expenditure, and returns have used the reference building comparative method to analyse the comparative IRRs of different green building certification methods in the Gulf.²² At the time, the lower requirements of the Trakhees rating system appeared to be the best approach for developers and investors to adopt. The expectation, however, is that this will increasingly favour buildings with higher green ratings in future.

There has also been use of surveys to try to ascertain the willingness to pay for green property attributes by residential buyers.^{23 24} Whilst this latter approach has considerable merit, surveys can only go so far to determine answers, and they cannot easily be repeated in order to generate data over time. By comparison, Cavendish Maxwell's approach is to use the proprietary data of Property Monitor, coupled with evidence from valuation and favourable financing arrangements, to value the different sustainability components of property sustainability separately.

This modelling approach has the potential to generate a more favourable evaluation of more recent green rating systems, such as AL SAFAT and ESTIDAMA, especially if future taxation structures generate further incentives both to construct and rent highly rated buildings, as the evidence from Europe strongly suggests that it will.²⁴

Furthermore, the group will also be exploring qualitative and quantitative research initiatives over the coming months, including conducting client surveys on sustainability, ESG and various other topics.

Conclusion

Higher prices for sustainable real estate do not tell the whole story. Comparative IRRs are much better tools with which to judge whether sustainability is financially viable. Continued global evidence has always suggested that it is.

In the Gulf, past evidence suggests that the availability of inexpensive fossil energy, coupled with the limited number of high sustainability demanding tenants, has tended to reduce sustainability premia, both in residential and commercial property.

In the past few years, however, both those constraints have begun to fall away. As a result, the Gulf has seen a rapid change in relative return projections, and sustainability is now increasingly expected to pay. But there is far from carte blanche to succeed, as there are now many more factors involved in the comparative financial performance of real estate than there were in the past.

In order to outperform competitors moving forward, developers and investors will need to employ the impressive data resources that are now available from sources such as Property Monitor in a systematic way. This will facilitate an understanding of the value implications of each of the aspects of sustainability as it applies to each particular development, and integrate the results of that analysis into their overall planning before proceeding.

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