The gathering stranded asset storm in commercial real estate

Andrew Baum, Luke Graham and Jimmy Jia

In the spring 2023 issue of the Property Chronicle, "stranded asset" was playfully cited as real estate's phrase of the year. We tend to agree. Not only is commercial real estate (CRE) facing a once-in-a-generation disruption at the hands of remote and hybrid work, but at the same time, owners are having to deal with increased costs of capital and gradual hikes in environmental performance requirements.

Remote and hybrid work

Commentators have shared their thoughts on remote work ad nauseum, so there is little need to add too much more to this conversation. On one hand, in-person work is seen as a necessity to promote focus, culture, learning, and water cooler-adjacent moments of commercial serendipity. On the other hand, it is argued that knowledge work can be completed from anywhere, and that it can be a force for happy workers and increased productivity. Either way, the very nature of the human-office relationship is being challenged, corresponding with the oft-cited "bifurcation" of offices into those agile enough to adapt to change, and those which aren't. This has prompted research into what amenities and other characteristics are actually valued by occupiers[1]. Although JLL reported a central London office vacancy rate of 8.4%, an arguably more insightful metric is the actual utilisation rate of these spaces. Occupiers might be paying rent for the time being, but how much longer will they tolerate that payment when desks remain empty for most of the week?

Environmental performance

Back in 2021, Pi Labs' own research[2] was published; in it, we cite a 2019 paper by Kevin Muldoon-Smith and Paul Greenhalgh which claims that global stranded asset risk is $16 trillion for residential real estate and $5 trillion for CRE. In the UK, energy-driven stranded asset risk for CRE emerges in the form of energy performance certificate (EPC) requirements to achieve a C-rating by 2027 and B-rating by 2030. The problem? 76% of commercial space in England is rated C or below (Figure 1) representing £1.2 trillion of CRE in the UK. With 2027

[1] See Braesemann, et al, 2022.

[2] Real estate and environmental performance – Bridging the gap with PropTech.

and 2030 fast approaching, industry feedback indicates lenders have largely ceased financing assets rated within the lower EPC tiers.

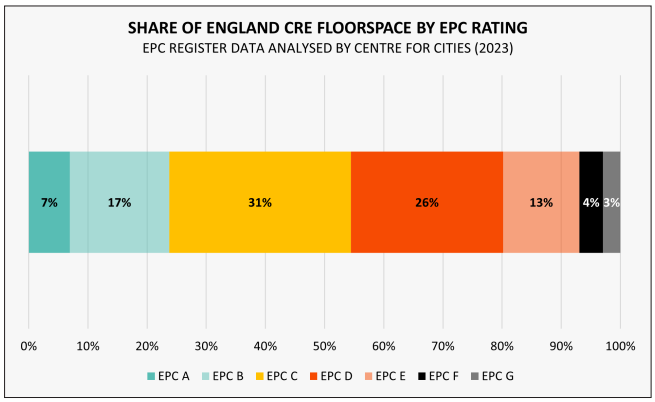

Figure 1

A retrofit revolution?

What exactly does it entail to retrofit the UK's CRE stock? First, according to RICS, "offices, restaurants and shops are among the most challenging buildings to upgrade." What makes it more difficult are accusations of a lack of clarity regarding exactly what alterations precipitate an EPC rating of B or A; different factors affect the UK's diverse building stock in different ways. Finally, a growing chorus questioning the capacity for EPCs to address the root problem of energy performance has grown louder as the screws on CRE tighten. This sentiment is reinforced by annual findings from the Better Buildings Partnership which states "[w]hen looking at the relationship between EPC ratings and operational energy intensity, the data suggests a very weak relationship, if any at all, between how efficiently a building uses energy and its EPC rating… a continuous ratcheting up of design ratings alone will not be adequate to achieve the energy efficiency targets for the UK" (Figure 2).

Are the retrofits worth it?

All things considered, CRE in the UK finds itself in a quagmire. On the one hand, sub-EPC B assets will be unable to be leased from 2030. On the other hand, it appears that capital expenditures to improve an asset's EPC rating might not actually improve its energy performance or environmental footprint. Let's add another couple of challenges to the mix; the retrofit itself increases the embodied carbon of the asset which might not increase its natural life. Plus, undertaking risks being an absolute waste if the asset stays vacant, or underutilised, after the retrofit because of the ongoing hybrid work revolution. If we could go back in time to the underwriting of each development and add these contingencies, would the project be deemed economically viable? How would the net present value be affected?

The role of technology

This may be an intractable challenge, particularly with interest rates sharply higher, but CRE stakeholders don't need to navigate blindly into this gathering storm. Technology-enabled solutions can serve to attack the problem from multiple angles. Data collection and analysis platforms are becoming increasingly sophisticated in reporting actual environmental footprint (instead of second- or third-order estimates based on expenditure). Increasingly familiar "marketplace platforms" are connecting providers and consumers, creating more opportunities for flexible spaces and "intensification." The world of real estate FinTech may also serve a role in offering green finance for compliant retrofits. At the recent CREtech London 2023 conference, Demand Logic and Qflow were two PropTech companies repeatedly cited for their impact on the sustainability agenda of leading UK-based real estate groups.

We can only hope that wider adoption of such solutions can enable more informed and bespoke decision making from the industry and government alike over the coming years.

Andrew Baum is Emeritus Professor at the University of Oxford, Research & Strategy Partner at Pi Labs, and Chairman at Newcore Capital. Luke Graham is Head of Research at Pi Labs. Jimmy Jia is ESG Venture Partner at Pi Labs and Senior Advisor at Earth Finance

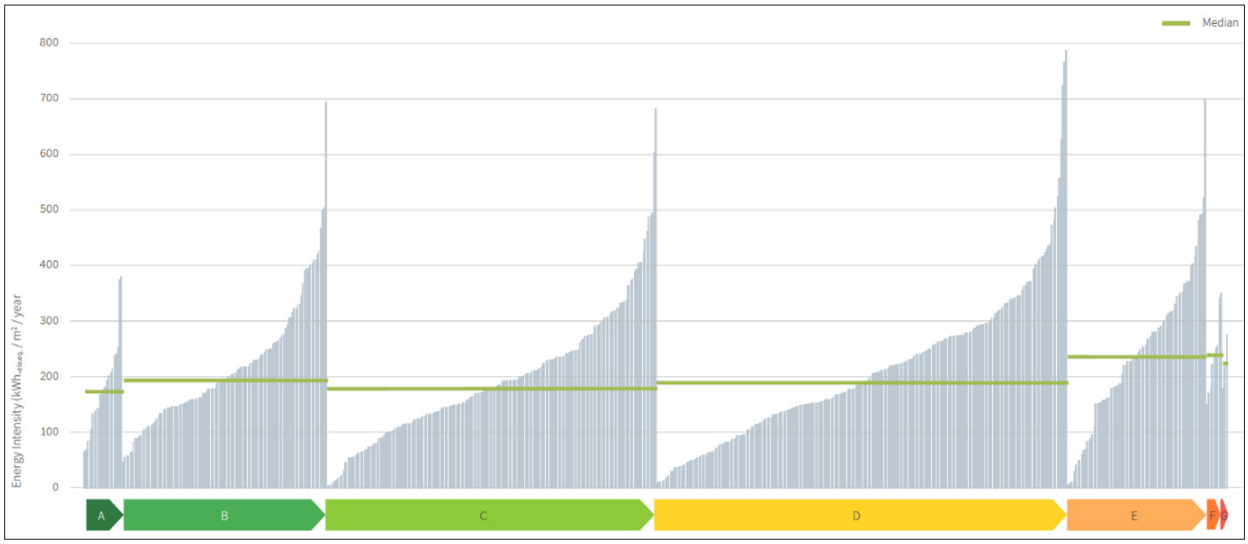

Figure 2: Office Energy Intensity (Electricity Equivalent) by EPC Rating 2019/20 (Better Buildings Partnership, 2021)