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VALUATIONS AND EU TAXONOMY

SCSI SUSTAINABILITY CPD SERIES

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- EU Taxonomy is a classification system that defines **‘environmentally sustainable’** or **‘green’** economic activities
- It is designed to help investors identify and invest in sustainable business
- Economic activities for which Taxonomy technical screening criteria have been detailed include

  1. Acquisition and Ownership of Buildings
  2. Construction of new buildings
  3. Renovation of existing buildings

- So Taxonomy clearly impacts the real estate sector and property valuation

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- Sets out clear and consistent criteria for determining if an activity is
  - Sustainable and
  - Contributes to / doesn't harm one or more of the specified environmental objectives

1. **Climate Change Mitigation** – *stabilize greenhouse gas emissions – renewable energy / energy efficient building*
2. **Climate Change Adaptation** – *Renovation of existing buildings reduction / prevention of adverse impact on current / future climate – flood resistant infrastructure*
3. **Sustainable use and protection of water and marine resources** – *water harvesting / use of grey water for toilet flushing / possibly landscaping if treated*

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4. **Transition to a Circular Economy** – *recycling*
5. **Pollution Prevention** – *avoiding use of materials and products that cause pollution*
6. **Protection and Restoration of biodiversity and ecosystems** – *protect and maintain natural ecosystems – bug hotels, green roofs*

- To qualify as an environmentally sustainable activity under EU Taxonomy the activity should
  - Substantially contribute to one of the above
  - Do no significant harm to the other five
  - Comply with minimum safeguards – e.g. UN Guiding Principles on Business and Human Rights

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- In terms of valuations and the obligations on valuers carrying out Red Book Valuations while Taxonomy itself isn't specifically referred to it would very definitely be caught under the global umbrella of ESG which is very much a key factor to be considered in terms of value.
- ESG is referenced throughout the Red Book, starting with the definition below in the Glossary -

Environmental, social and governance (ESG)	'The criteria that together establish the framework for assessing the impact of the sustainability and ethical practices of a company on its financial performance and operations. ESG comprises three pillars: environmental, social and governance, all of which collectively contribute to effective performance, with positive benefits for the wider markets, society and world as a whole.' **IVS 2020 Agenda Consultation** (p14). Although ESG principally refers to companies and investors, ESG-related factors are also used to describe the characteristics and, where relevant, operation of individual assets. It is used throughout these standards in this context.

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- **There are then further references to the obligations on valuers carrying out Red Book Valuations throughout the Red Book itself**
  - **in Global valuation technical and performance standards (VPS) – which are mandatory**
  - **and also in RICS valuation practice guidance notes (VPGA) - which are advisory.**

- **VPS 2** – Inspections, investigations and records
  - 1.5 *'VPGA 8 provides detailed commentary on matters evident or to be considered during inspection of real estate, including those matters that fall within the general heading of "sustainability and ESG matters". Such factors are commonly important in terms of market and societal perception and influence, and valuers should have proper regard to their relevance and significance in relation to individual valuation assignments.'*
  - 2.3 *'The valuer must also consider any sustainability and ESG factors that could affect the valuation.'*

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- **VPGA 2** – Valuation of interests for secured lending
    - 6.1 *‘”Sustainability and ESG factors can be a significant market influence and valuations for secured lending should always have appropriate regard to their relevance to the particular assignment.”*

- **VPGA 8** – Valuation of real property interests

    ‘Particular care should be taken when assessing or commenting on ESG factors, as valuers may not have the specialist knowledge and experience required.’

    - Make further enquires
    - Obtain specialist advice

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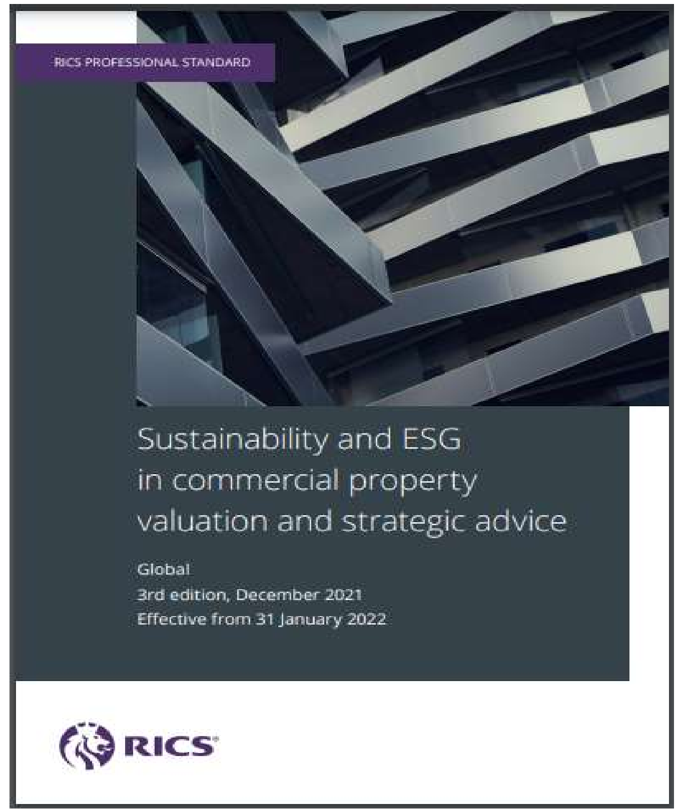
In addition to the Red Book itself the RICS have also published a more detailed guide

- "Sustainability and ESG in commercial property valuation and strategic advice"
- *Guidance Note originally issued in Dec 21, subsequently issued as a Professional Standard in May 23*



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- **S2 – Role of the valuer**
  - *'While valuers should reflect markets, not lead them, they should be aware of sustainability features and the implications these could have on property values in the short, medium and long term.'*
  - *'Valuers should have a working knowledge of the various ways that sustainability and ESG can impact value. These may be physical risks, transition risk related to policy or legislation to achieve ESG and sustainability targets, or simply those reflecting the views and needs of market participants"*

- **S3 – Valuation purpose**
  - Pay particular attention to ESG for valuations for regulated purposes such as
    - Secured lending – may be asked to comment on resilience of a property as security for term of loan
    - Financial reporting – may be particular focus on the evidence supporting the valuer's judgement

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- **S4 – Valuation instructions and terms of engagement**
  - Agree nature and extent of valuer's work, and any limitations
  - Nature and source of information that valuer will rely on

- **S5 – Inspection, investigation and data**
  - Obtain relevant sustainability data from client
  - Some sustainability features obvious at inspection would include access to public transport, bike parking / showers and then tenant facilities such as breakout areas and other tenant engagement initiatives or facilities
  - Also type of business activities carried out by tenant(s) in the building

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- **S7 – Reporting**
  - The valuer should demonstrate how they have considered sustainability and ESG in their approach, calculations and commentary.
  - *'Wherever appropriate the relevance and significance of sustainability and ESG matters should form an integral part of the valuation approach and reasoning supporting the reported figure.'*
  - The valuer should assess the extent to which the property meets the sustainability and ESG criteria typically expected within the subject market / affect this will have on price
  - Describe sustainability related property characteristics
  - State opinion on the relationship between sustainability factors and the resultant valuation

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- **S8 – Comparables and evidence**
  - BER Certs may be a useful starting point to compare relative sustainable performance of comparables
  - Valuers should make efforts to record and reflect ESG and sustainability data from the evidence available

- **S9 – Valuation methods and considerations**
  - Valuer responsible for selection of approach(es) and method(s) to be used
  - Trend towards explicit models (i.e. inputs / assumptions / calculations are presented in more detail) as opposed to implicit models (inputs and assumptions built into smaller number of core calculations)
  - DCF model can be used to reflect say future cap ex, voids, rent levels
  - Security of income is crucial so risk of tenant exercising break clause and any voids will affect value

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- **S10 – Sustainability Characteristics, considerations and risk**
- Decarbonisation / aspiration towards net zero one of the main factors for the property industry. Energy efficiency of a building is key.
- Regulatory, statutory and investment criteria may be more important than operational savings as a result of ESG cap ex.
- Numerous certifications, rating and benchmarks to track ESG characteristics including LEED, BREEAM, GRESB and NABERS

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- Red Book and the Sustainability and ESG in commercial property valuation and strategic advice professional standard clearly show the importance and regard to be had to ESG and sustainability in terms of Red Book valuations.

- The Valuer must
  - Clearly agree / state nature and extent of valuer’s work, and any limitations
  - Reflect markets, not lead them
  - Have general awareness of sustainability and ESG benchmarks, criteria and legislation
  - Aware of trends in both occupier and investor markets
  - Not expected to be an expert

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- In conclusion – EU Taxonomy is one of the many jigsaw pieces that together make up the big ESG / Sustainability picture.

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