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Greening Leases: The Landlord and Tenant Relationship as a Driver for Sustainability



Summary report

June 2009

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This programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high quality analysis on a structured basis. It will enable the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

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GREENING LEASES: THE LANDLORD AND TENANT RELATIONSHIP AS A DRIVER FOR SUSTAINABILITY

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1.0 INTRODUCTION: OVERVIEW AND AIMS OF THE PROJECT

1.1 Aim

This study aims to provide the investment community with an analysis of UK landlords' and tenants' views on green leases and their possible use to promote the embedding of sustainability principles within property management practice. The research explores the extent to which the landlord and tenant relationship has been affected by the sustainability agenda and questions whether the relationship, as supported by current leasing practice, provides an appropriate framework to assist the achievement of sustainability goals. It also provides recommendations for actions by stakeholders.

1.2 The rise of the sustainability agenda and commercial property

Sustainability may have found a place within the agenda of many organisations but it has proved both difficult and challenging to implement these principles within the operational practices of property investors. For this research the issue was whether sustainability principles are hindered or assisted by current leasing practice.

1.3 Towards sustainable property and asset management

It is possible to identify a number of barriers to achieving sustainable asset management (SAM). The term SAM refers within this research to the pursuit of environmental and social risk reduction measures to protect future economic performance; progress towards government environment and social targets and the drive towards delivering services effectively and efficiently. A lack of robust analytical tools and data sets has meant it has been difficult to evaluate building performance. Furthermore, the perceived additional cost of incorporating sustainable specifications has been a barrier to ongoing investment into sustainable measures.

The growing importance of Corporate Social Responsibility (CSR) and the present and future cost implications of not being sustainable are central to the idea that the market for sustainable property will grow. As the commercial lease is the mechanism through which investors and occupiers interact, it has become the focus for many as a vehicle for promoting change in landlord and tenant behaviour. It is therefore useful to understand whether or not the commercial lease is currently in a form that acts as a barrier to more sustainable asset management practices and if change is required.

1.0 INTRODUCTION: OVERVIEW AND AIMS OF THE PROJECT

1.4 The Research Objectives

The specific objectives of this research were to assess how the landlord and tenant relationship is:

- Affected by the sustainability agenda;
- Used by landlords to reduce sustainability related risks and achieve CSR objectives;
- Used by tenants to support CSR objectives; and
- Acting as a driver for more sustainable property management as lease terms modernise.

1.5 The commercial lease: perceptions of the need for a green lease

1.5.1 Developments within commercial lease practice

The nature of commercial leases within the UK has evolved over many decades. The so-called 'institutional lease', was the prevalent interface between the mid-1970s and the 1990s. This type of lease resulted in a landlord and tenant relationship was characterised by long periods of silence interspersed with high levels of disputes. The structure lacked any incentive on the part of either landlord or tenant to invest in the building.

The property recession of the early 1990s provided the stimulus for change in UK lease patterns. Market conditions and the introduction of a code of practice strongly supported by industry has led to shorter leases but there has been little observed change to the established covenants relating to rent reviews, repairs and improvements, yet these items are of major importance in terms of achieving sustainable occupation and sustainable asset management.

1.5 Incentives for improved sustainability performance

Investor focus on sustainable property is supported by the commonly held view that buildings with good environmental performance are likely to be 'future-proofed' over time and less susceptible to value depreciation. For tenants, sustainable buildings offer revenue savings through reduced running costs and provide better working environments which may enhance staff productivity. Possible future legislative changes may place direct obligations on landlord and tenant organisations to conform to higher building standards over time. These factors combine to create a case for investing in environmental improvement and may be used to support changes in leasing practice.

2.0 METHODOLOGY

The findings presented in this report are based on 26 interviews undertaken between February and October 2008 supported by a review of literature both from within the UK and internationally. The interviews sought the views of investors holding substantial property portfolios (landlord representatives) and of large corporate and public occupiers (tenant representatives). In addition two focus groups were held with delegates from the landlord and tenant groups as well as property agents and lawyers. It is acknowledged that since the interviews were conducted the property market has undergone a period of turbulence which could impact on views. Conclusions have been developed to reflect this.

3.0 THE NATURE OF A GREEN LEASE

3.1 What is a green lease?

The concept of a green lease was first realised in Australia as being either a lease of a 'green building' or of a building to be refurbished to 'green' standards. It was thus as much about the actual building as the covenants within the lease and over time a template has been developed which now provides a set of obligations to be contained within leases. Most commonly, a green lease as practiced in Australia, will relate to tenant behaviour around the issues of energy efficiency and water and waste management.

Within the UK, there have been calls for the introduction of green leases but there are many different interpretations as to what should be included within a lease in order to classify it as 'green'. In general the term is used to include:

- Leases which place specific obligations on either or both the landlord and the tenant across a range of covenants, including rent review and rent penalty clauses and monitoring and data collection of environmental and social data;
- Leases to which non-enforceable schedules are attached relating to detailed tenant obligations; and
- General guidance issued by landlords to tenants at the commencement of the term which may be anything from a statement of aspiration to a detailed code for using effective building management systems.

Within these categories, the content of leases regarded as 'green' is subject to considerable variation.

3.2 Perceived benefits of green leases

Perceived benefits of green leases relate to:

- Reputational benefits and outward sign of compliance with CSR policies;
- Promotion of building improvements with revenue savings, greater marketability and investment value;
- Improvements of working environment and promotion of well-being;
- 'Future-proofing' against needs to comply with new legislation;
- Enabling a framework where better knowledge of environmental and social performance can be gathered and shared, thus providing a basis from which to improve performance; and
- Encouragement of closer engagement between the landlord and the tenant.

3.3 Perceived disadvantages of green leases

Against the perceived benefits there are perceived disadvantages to green leases:

- They impose clauses on a tenant which could have a detrimental effect on the rental bid and therefore investment value without similar obligations being placed on the landlord;
- Tenants might fear that landlords will seek to 'green-plate' the building at their expense by claiming back the capital cost through services charges in the case of multi-let buildings;
- Concerns by tenants that any revenue savings gained by improvements to the building will be recouped by the landlord in additional rent; and
- Concerns by the tenant that the more onerous terms may reduce their ability to assign their interests should they need so to do.

4.0 KEY FINDINGS

4.1 Drivers for sustainability

Sustainability was confirmed as of major importance to respondents. It was widely accepted that sustainability needs to be considered from strategy through to implementation in leasing. However the drivers towards promoting a more sustainable property portfolio differ between the parties; sustainability is not a single issue but a complex of concerns.

For landlords, the case to improve the portfolio along sustainability lines rests primarily on the need to promote good public relationships and the prospects for future investment returns and risk reduction.

For corporate occupiers, the case rests in the need to respond effectively to stakeholders' requirements and in simple cost reduction. As utility costs increase so revenue savings become of critical importance.

4.2 The sustainability agenda - beyond energy?

The need to manage property for environmental protection and social well-being was widely acknowledged together with the need for metrics to support this. However a very varied picture of current practice emerged. Some landlords and tenants are beginning to collect a wide range of data aimed at benchmarking and managing performance, but others are not. No evidence was found of environmental performance data being systematically shared between landlords and tenants, although views were expressed that data sharing could stimulate better management as well as encourage trust and cooperation between landlords and tenants.

4.3 The landlord and tenant relationship

In response to enquiries as to whether changes in landlord and tenant relationships had improved over recent years, divergent results were found. Many landlords reported an improving picture with short leases mentioned as promoting engagement. Tenants stated that some landlords had made great strides in terms of developing a working relationship, but this was not the dominant picture and a widespread lack of trust still existed. Overall, the majority view was that the lease, *per se*, is not a barrier to more sustainable property management; it is how it is interpreted that matters and the willingness of parties to work together.

4.4 Business Premises Lease Code 2007

Landlords and tenants reported a positive attitude towards the Code; it was widely considered to be the appropriate means of introducing changes in the landlord and tenant relationship, with the caveat that the provisions must be consistent with good commercial sense. Using an extension to the Lease Code to encourage sustainable property management met limited support; the majority view of those engaged with the research was that the industry is 'not there yet' in terms of tightening the Code in respect of sustainability issues.

4.5 The need to introduce a green lease

Respondents' knowledge about green leases varied from those with deep knowledge to those with little or none. Whilst there are some landlords who are promoting green leases, among our respondents there was little appetite for their widespread or systematic introduction; in particular, tenants were sceptical about why a landlord would wish to introduce a green lease and would not welcome any moves that reduced their ability to operate the building as best suited their businesses.

4.0 KEY FINDINGS

4.6 The case for improvements and alterations

The research revealed that it can be difficult to build a financial case for undertaking sustainability improvements to buildings and it can be problematic to find a way of striking the right balance between who bears the cost and who benefits financially from such improvements. Tenants are reluctant to carry out improvements because given short lease commitments, the opportunity for long term savings and benefits are limited. Secondly, tenants, expressed concern that improvement would lead to the possibility of rental increases that would offset revenue savings.

Respondent landlords said they expect to see sustainable buildings out-perform non-sustainable ones financially over time, but acknowledged that as yet this cannot be backed by robust market evidence. However, overall the results point to landlords being the more appropriate party to take on the responsibility for improving buildings in return for a claim back based on tenants' cost savings.

An important aspect of the impact of improvements on the landlord and tenant relationship concerns the possibility of future legal obligations to upgrade property in respect of environmental standards. Under current leases, normal provision would place the responsibility on tenants but such costs could be significant and disproportionate to tenants' short term leasing commitment. This presents a significant risk and presents for tenants one of the strongest arguments for introducing some form of green lease in the UK.

4.7 Collection of Environmental and Social Data

A pre-requisite to monitoring of environmental performance, which is a key characteristic of a green lease, is the systematic collection and sharing of data. The findings pointed to some data being collected, but this was the exception rather than the rule and there was no evidence of data sharing, though in principle no objections to so doing were raised.

5.0 CONCLUSIONS

5.1 The landlord and tenant relationship – a matter of trust

The most important conclusion is the need for the development of a culture of trust between landlords and tenants. This is a pre-requisite to achieving more sustainable asset management and it would represent a significant change from current practice. It is concluded that two sets of actions would help to achieve this:

- the engagement of tenants on sustainability issues at the stage of agreement of heads of terms; it should not be seen as a ‘bolt-on’ extra after rent and other terms are settled.
- recognition of the critical role played by managing agents, particularly in the case of multi-let buildings and those owned by overseas investors. The education of managing agents in sustainability asset management practices is a pressing need.

5.2 Green leases: a typology not a single entity

Green leases are not yet fully understood within the UK and this provides a ground for scepticism. They are best considered as a typology of leases, from ‘light green’ in which there is little more than a statement of intent by tenants, to a ‘deep green’ lease in which enforceable clauses are embedded within the lease.

It was concluded that it would be beneficial for the industry to develop a deeper understanding of green leases and stimulate discussion and understanding of the management the financial implications of such leases. In driving forward such discussions, it is important that ‘green’ is not purely associated with energy but the full range of environmental and social impacts.

5.3 Green leases: moving practice forward

The standard commercial lease does not, *per se*, act as a barrier to sustainability. What is required is a willingness on the part of both parties to instigate sustainable measures. Whilst some parties are moving towards introducing a ‘light green’ model, it is concluded that moves towards a deep green lease would be widely resisted by tenants. The development of mutual working relationships to encourage sustainable practices which support financial advantage to both sides is the more appropriate way forward. What is required is a negotiation of terms that provide a financial, as well as reputational win for both parties.

5.4 Evolution not revolution: first steps in changing lease practice

The market is currently not ready for the introduction of full-scale green leases. Evolutionary change is more likely to yield positive results. A first step would be the introduction, within both existing leases and at renewal or new lettings, of a Memorandum of Understanding between landlord and tenant to work together to effect change.

5.5 Improving and sharing metrics

The proposition that the development and sharing of data by both landlords and tenants would aid cooperation and assist in the creation of a case for building improvement was widely accepted. It is concluded that data collection and management, at the level of the individual building and collectively, in order to develop benchmarking schemes, would both assist in pin-pointing appropriate improvements and foster stronger working relationships. Collective organizations such as IPF and the British Property Federation have a critical role to play in promoting this.

5.7 Regulation for sustainability

Environmental improvement, identified through, for example, EPCs, is likely to be statutorily mandated in the future and such requirements, if introduced, will present challenges to the industry. It was concluded that, if such measures were combined with incentive schemes which recognise the nature of the landlord and tenant relationship, they could be a driver for improvement to the stock. What is critical is that any regulation is introduced in consultation with key stakeholder groups.

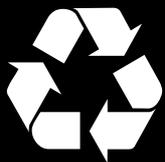
6.0 RECOMMENDATIONS

- Property collective bodies are encouraged to work with landlords and tenants to investigate ways in which a sense of trust can be engendered through enhanced communication
- Landlords and tenants are encouraged to consider introducing Memoranda of Understanding relating to sustainable asset management at lease renewal, or before where the possibility arises.
- An industry-driven initiative to develop a national framework for the collection and ongoing monitoring of sustainability data is needed. It is important that the parties involved agree on the appropriateness and use of such a framework.
- As and when the Lease Code is revised it should include a recommendation and guidance on the introduction of a Memorandum of Understanding on sustainability matters.
- An increased provision of short seminars and education for managing agents on sustainable asset management practices should be encouraged.

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