

April 2009

The Green Phoenix: A flight to quality in challenging times

The investment case for sustainability is still strong despite the economic downturn. Australian investors are re-prioritising in the current market, and while we are seeing the implementation of tighter cost controls, a 'flight to quality' is also being witnessed. Investors are putting their money into maintaining quality assets that are positioned for both short-term survival and long-term viability. Sustainability represents a real opportunity for these investors to cut costs in the short term while increasing attractiveness to tenants and ensuring that assets are 'future-proofed' for the long term.

Key Findings:

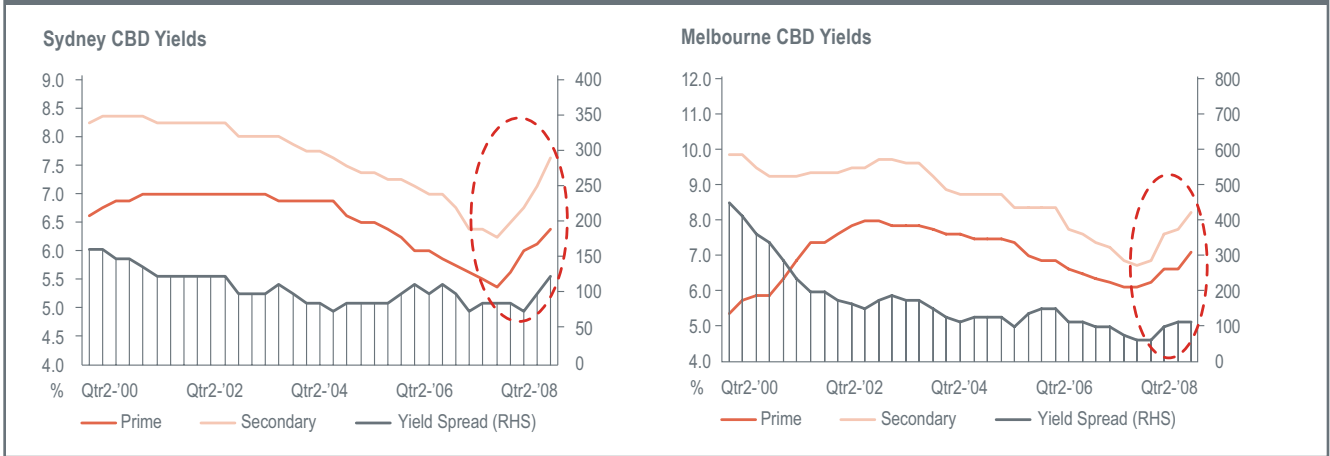
- The current market conditions are driving a continued focus on sustainability, with higher vacancies shifting the focus to tenant attraction and retention.
- Yield decompression is shifting the balance between value and rent, with the market currently rewarding premium-quality assets.
- Tenants are still demanding sustainable space and many are willing to pay for it, or at the very least, see it as a key factor in their decision-making process.
- Investors are increasingly factoring sustainability into their asset strategies to meet demand, maintain the underlying quality of their assets and de-risk their portfolios.
- Opportunities may exist in buying second-grade assets and repositioning them into the market with improved sustainability credentials.

The current market dynamics are driving a flight to quality and a continued focus on sustainability. Over the past ten years, we have seen values rising faster than rents and therefore, a compression in yield profiles between prime and second-grade assets. This provided a temporary boost to investment performance of about 2.5–3% per annum in value uplift. As a result, the focus was on the quantity rather than the quality of assets in portfolios, with many real estate investors acquiring second-grade stock to ride the market boom. With the market rewarding volume and not quality, there was little yield incentive to improve the underlying quality of existing assets. In addition, tenants were readily obtainable, thus tenant attraction and retention were not always the strongest driver in investment decisions.

However, this trend is currently reversing. We are now witnessing yield decompression in markets across the globe. We have already seen prime yields in CBD office markets rise by around 100 basis points through 2008 with another 50 to 75 basis points expected over the next few quarters. Vacancy rates are rising, and sub-leasing is becoming common as CBD tenants downsize or restructure their operations. In this environment, investors are no longer competing for assets; they are now competing for tenants.

Investment performance will now depend on the management and operational factors that make buildings more attractive to tenants. This dynamic is providing the incentive required for investors to improve the underlying quality of their assets. In line with this, tenant demand for sustainability is adding pressure for investors to adopt sustainability into their asset strategies.

Figure 1: Yield Decompression in Sydney and Melbourne



Source: Jones Lang LaSalle

A global survey of occupiers conducted in September 2008 by Jones Lang LaSalle and CoreNet Global found that over 40% of corporate real estate executives will still pay up to 10% more rent to occupy a sustainable building despite the downturn. In addition, sustainability is an increasingly critical issue for tenants, with 67% of respondents saying that it is currently a critical issue, up from 47% in 2007.

In addition, there are regulatory and legislative drivers in Australia. Examples are the potential introduction of a carbon price through the Carbon Pollution Reduction Scheme and the proposed mandatory disclosure of commercial office energy efficiency.

We are seeing this convergence of market dynamics and regulatory and demand drivers being translated into investment decisions.

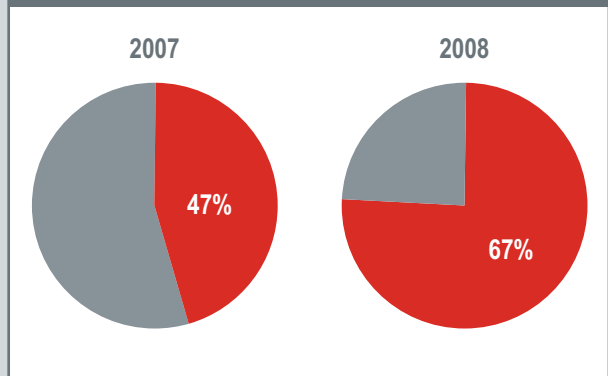
In Jones Lang LaSalle's annual Survey of Investor Sentiment (November 2008), 18% of investors said that they will still pay more for a sustainable building, all other things being equal, compared to 29% in 2007. A further 50% of investors continue to consider sustainability as a 'tie-breaker' factor in investment decisions.

In the current tough operating environment, a sharper drop in the number of investors that are willing to pay more for sustainable buildings may have been expected. However, the survey indicates that sustainability is still firmly on the agenda of Australian investors.

CoreNet-Jones Lang LaSalle Global Sustainability Survey, September 2008

- 42% will pay up to 10% more rent to occupy a sustainable building
- 67% of respondents said that sustainability is currently a critical issue, up from 47% in 2007
- 76% said that energy/sustainability is a major or 'tie breaker' factor in their location decisions
- 82% of respondents consider green building ratings in building selection
- 64% cited limited to no availability of sustainable solutions, up from 48% in 2007

Figure 2: Sustainability as a Critical Business Issue for Occupiers (2007-2008)

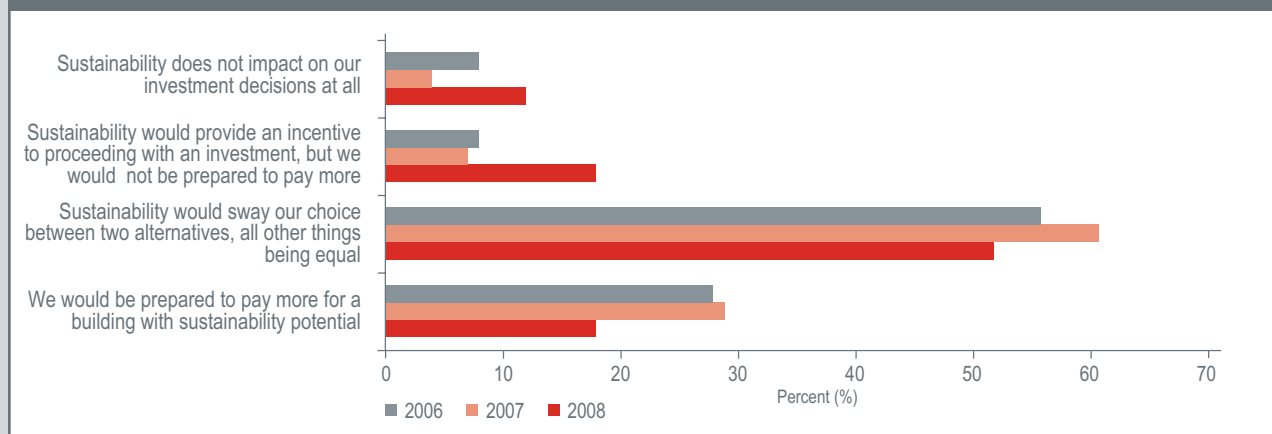


Source: Jones Lang LaSalle / CoreNet Global

Jones Lang LaSalle Survey of Investor Sentiment in Australia, November 2008

- 18% will still pay more for a sustainable building in 2008 compared to 29% in 2007
- Over 50% continue to consider sustainability as a 'tie-breaker' factor in investment decisions
- Tenant expectations are rated the most significant driver by a relatively stable 74% of respondents
- Achieving green ratings increased in importance as a driver from 64% in 2006 to 74% in 2008
- Impact on rentals (51%) and building valuations (49%) remain as strong drivers
- Data measurement and reporting tripled in importance from 8% in 2006 to 29% in 2008

Figure 3: Sustainability as a Critical Business Issue for Occupiers (2006–2008)



Source: Jones Lang LaSalle

Overall, there is reason to believe that sustainability initiatives will survive the current tough economic times despite views from some that these initiatives could be scaled back to save money in the short term. The real money may well be in investing in second-grade assets and repositioning them into the market. Wider yield spreads across grades will offer positive incentives for upgrades as well as retuning and repositioning of assets. Indeed, the current market could well be a breeding ground for innovation and skills and a solid business case that will further drive the uptake of sustainability across the industry.

Jones Lang LaSalle's Energy and Sustainability Services

Jones Lang LaSalle offers services for new, existing or refurbishment projects to optimise expenditure and maximise the results of sustainability initiatives. Our services can be applied at various points of a building's life-cycle and can be engaged to work in harmony with existing design, construction and operational management teams to provide specialist insight into the issues affecting final sustainability outcomes. This enables our clients to make sound commercial decisions that support their sustainability objectives and provide clarity in the reporting of their sustainability performance.

To find out how you can turn green into gold by improving the performance of your real estate, please contact:

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