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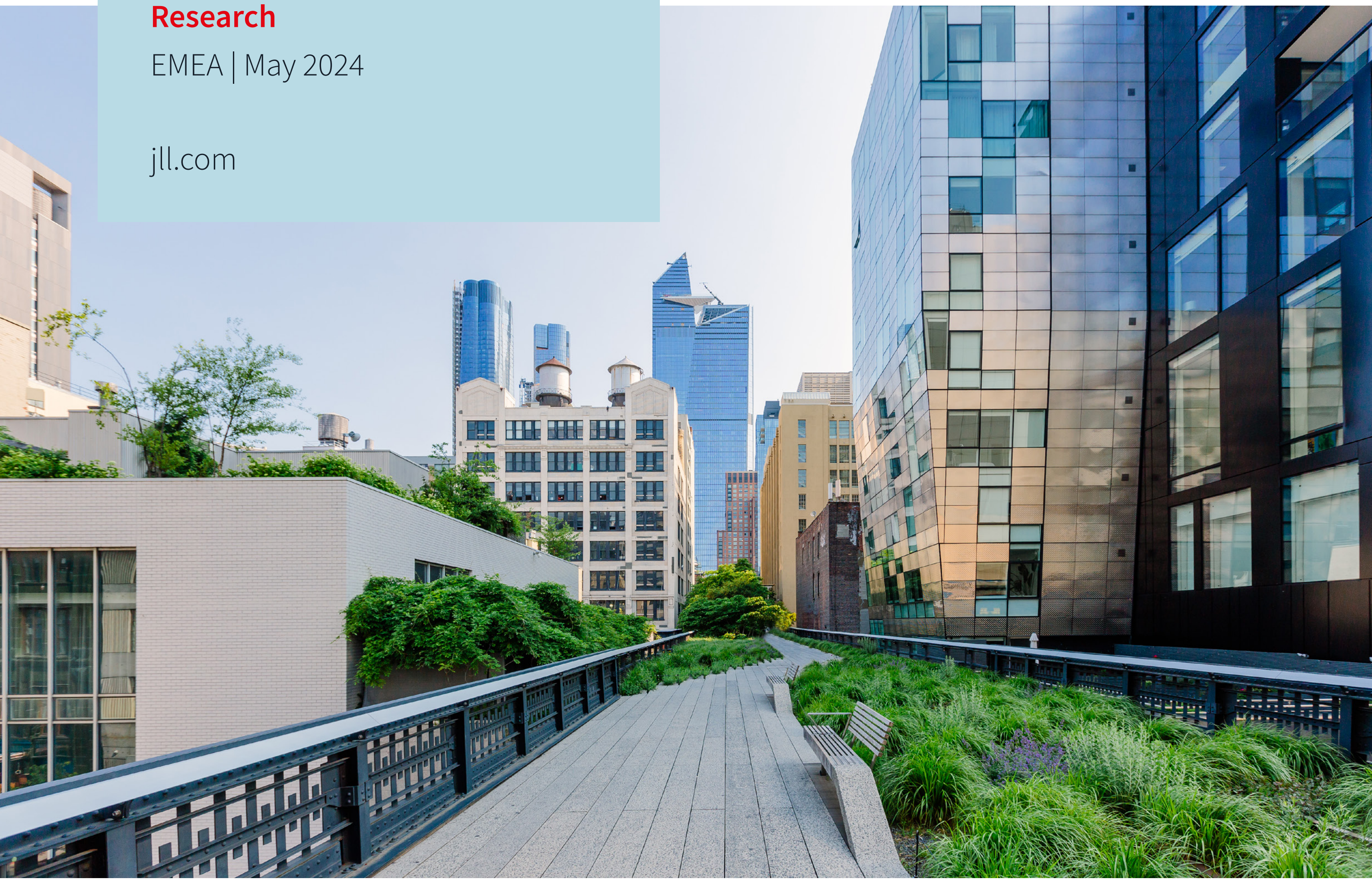

Navigating the sustainability maze

The struggle of ESG for hotel valuers

JLL SEE A BRIGHTER WAY

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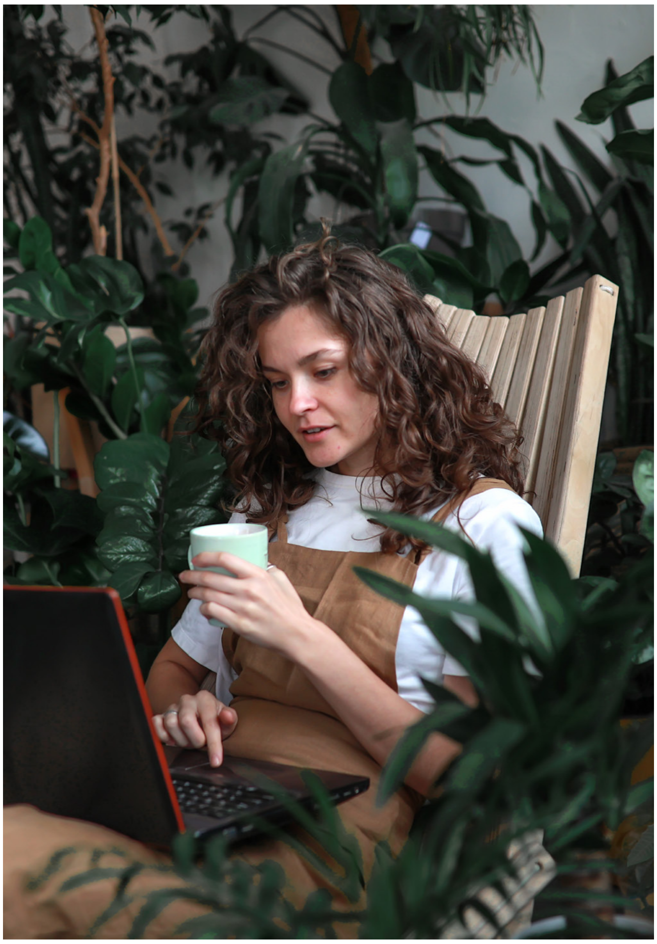
Introduction

> ESG is a huge value preservation opportunity. It focuses the attention of the investor on ensuring value retention and value creation. The valuation of the asset is absolutely critical in that mix
>
> **Ufi Ibrahim**
> *Chief Executive Officer*
> *Energy & Environment Alliance*

As the world continues to prioritise sustainability and combat climate change, the hospitality sector has a crucial role to play in achieving a net zero carbon (NZC) future. The tourism sector is responsible for c. 8% of the world's carbon emissions, with the hospitality sector constituting a significant part of this. Since our last report, Valuing Hotels in a Net Zero Carbon World in 2021, progress has been made in several areas, while in others, challenges remain.

In this report, we outline the key themes identified in our previous research and delve into the improvements made and obstacles hindering the sector's sustainability goals. Supporting our research, we spoke with leading industry experts who shared on the ground insights on how the sector has fared, and what pressing challenges remain.



We have witnessed growing momentum around regulatory frameworks, such as the EU's Corporate Sustainability Reporting Directive (CSRD) and The International Sustainability Standards Board (ISSB) inaugural standards, IFRS S1 and IFRS S2, which aim to align reporting standards for ESG matters. Caroline Tivéus, Director of Sustainable Business at Pandox, highlights the shift that the implementation of the CSRD has created for the industry: *"… it's about transparency and having a road map aligned with the Paris agreement including KPIs"*.

In terms of valuation recommendations, in February 2024, the International Valuation Standards Council (IVSC) published updated guidance, adding a section on incorporating ESG into the valuation process, while the Royal Institution of Chartered Surveyors (RICS) released recommendations on specific ESG-related data which should be included in regulated valuations. These ESG directives are showing increasing alignment on the subtopics for which data should be collected in valuation processes, with IVSC, RICS, and Better Building Partnership (BPP) guidance covering similar areas.

Data alignment across the industry

	Carbon emissions	Physical risk	Health and wellbeing	Biodiversity	Waste management	Community impact/ relations	Voluntary certifications
Data	✓	✓	✓	✓	✓	✓	✓
IVSC	✓	✓	✓	✓	✓	✓	✓
RICS	✓	✓	✓	✓	✓	✓	✓
BBP	✓	✓	✓	✓	✓	✓	✓

There is **strong alignment** with major industry bodies on **ESG data** to be included in the valuation process.
This list is **not exhaustive.**

Source: JLL Research

Recent guidance and standards particularly highlight the importance of data for the reflection of ESG factors in valuations. While the hotel sector is gaining some confidence around data collection, considering technological advancements, the complexity of hotel operations makes easy access to good quality data challenging for many operators. As a result, and combined with an opaque transaction market that is fully reflecting the impact of ESG credentials, hotel valuers find it particularly challenging to reflect the risk of assets becoming stranded. While some particularly larger companies have introduced wide ranging initiatives to capture and act on ESG data, others are yet to start the process and risk falling behind the curve.

Ufi Ibrahim Reinforces the challenge smaller hospitality businesses face: *"Nine out of 10 hospitality business employ fewer than 10 people. While larger companies are starting to think about ESG, the real question is how do we effectively engage the SMEs in this transition."*

Adrian Flueck, Director of Hotel Investment Management at Invesco Real Estate agrees, adding: *"The small to medium enterprises are the ones which need education and support because they're increasingly overwhelmed with the speed of the ESG regulation and ESG demands from stakeholders."*

01

Guest behaviour remains key in determining the payback period of investment into NZC measures.

In our last report, we highlighted how Gen Z prefer to spend their money on brands they consider to be on a sustainable path and are willing to pay up to 10% more for these products. We also outlined how investment into NZC measures may have a positive impact on average rates or occupancy due to a hotel's elevated appeal to guests, however also noted that transparency would be key for changes in consumer behaviour.

Challenges remain, however. Booking.com Sustainable Travel Reports are a frequently cited source, showing the positive response of guests to investment into ESG areas with 75% of travellers intending to travel more sustainably, as cited in the April 2024 report. However, when it relates to reflecting ESG investment in hotel valuations, there are several hurdles that make it difficult for valuers to project a positive impact on top-line performance:

Intention-Behaviour Gap

While consumers may claim they are willing to spend more on stays at ESG-aligned hotels, there is a long way to go between stating good intentions on a survey and actual spending behaviour.

"Despite extremely high sentiment, consumers currently do not seem to be willing to forgo any part of their experience or to pay a higher price for more sustainable products" Ufi Ibrahim notes.

This seems particularly applicable to cases where guests might have already booked a flight to a destination and in a classic example of the sunken cost fallacy might not care much about the incremental carbon emission caused by a hotel stay. Sentiment is highlighted by 28% of surveyed travellers telling Booking.com that time spent travelling is too precious to put sustainability at the top of their decision-making list.

Transparency/Greenwashing

The translation of ESG investment into improved top line performance assumes the visibility of these measures to guests and their trust into the claims made by the hotel owners. There is an abundance of third-party hotel sustainability certifications, many meaning very little to the hotel guest seeing them on a booking platform. Additionally, some certifications are largely operationally focused, often neglecting the real estate side of the hotel and as such show a reduced correlation to actual Co_2 emission savings.

Caroline Tivéus illustrates: *"You can skip the smaller initiatives like the plastic straws - it won't push the needle, focus on finding your hotel's biggest emissions and launch initiatives that make a real difference instead."*

The lack of transparency around these certifications may lead to greenwashing or a general lack of trust from consumers towards them, counteracting a positive impact on top line trading. If the hotel sector itself is struggling to devise industry-wide certifications, how are consumers expected to understand them?

Notably, companies are increasingly implementing corporate travel policies and tend to have a better visibility and understanding of green certifications in hotels. Hotels with a high share of corporate travel, particularly when relying on larger, publicly listed companies will likely be pushed towards implementing ESG measures to stay competitive as many corporations have no choice but to choose more sustainable travel options as part of their own governance commitment to hit NZC. In due course, this means that hotels will need to demonstrate their NZC measures to corporates.

Additionally, Booking.com has recently removed self-certified Travel Sustainable levels, now only reflecting third-party labels. This is a positive move towards greater transparency in the field and may help gain stronger trust from consumers in the labels. It is, however, clear that survey data alone will not be sufficient to enable hotel valuers to understand and reflect a potential future positive impact within their cash flow projections. One possible solution for this would be for Booking.com to release actual booking data on the link between green certifications and increased hotel bookings.

Overall, it is, however, key to understand that if a hotel has already successfully established itself as particularly sustainable and trades well as a result, valuers will likely also reflect that positive effect within their cash flow projections and resultingly within the value of the asset.

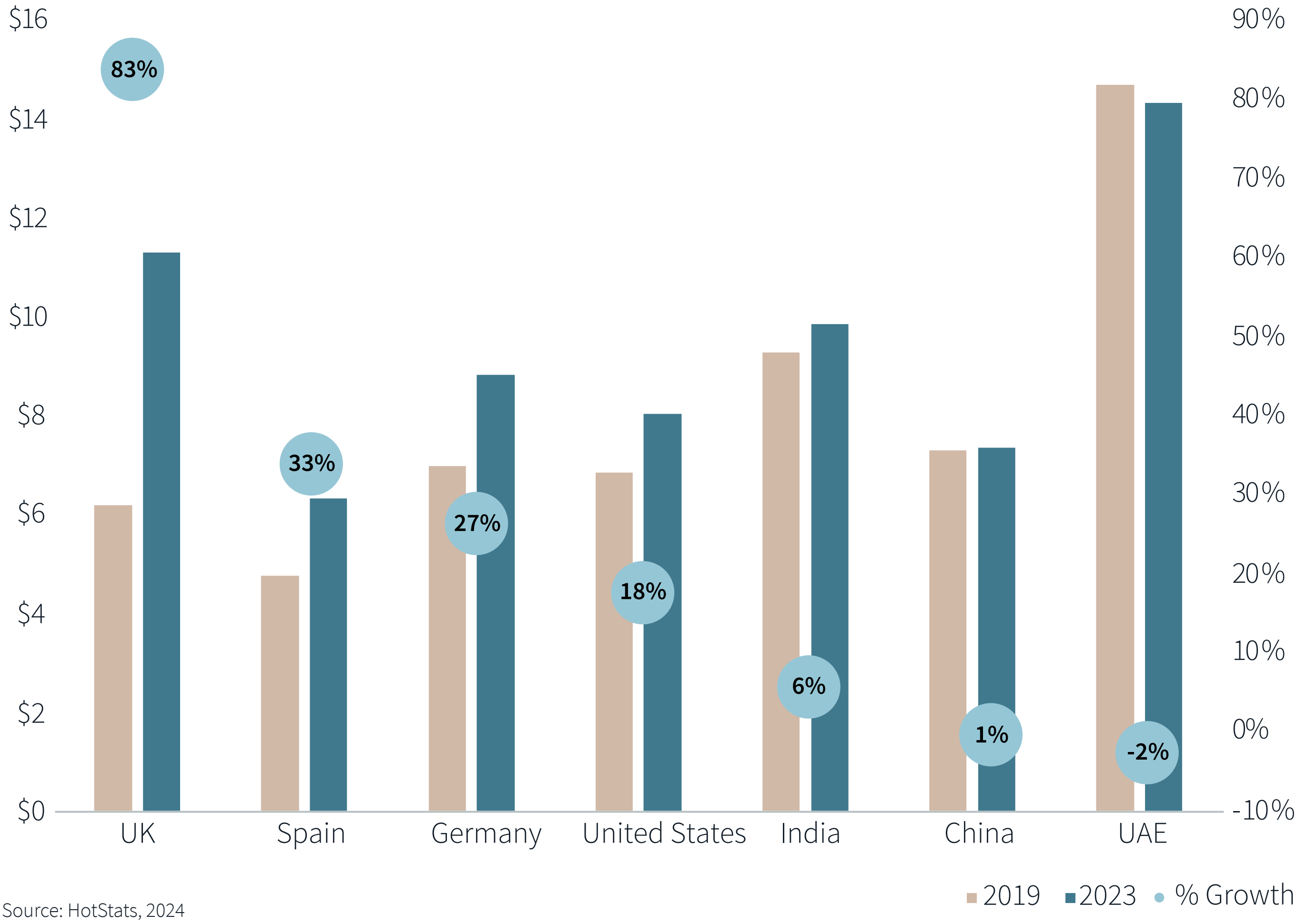
02

All-time high energy prices may have derailed profit margins so now the focus needs to be on improving energy efficiency over the long term.

In our last report we noted that over the long term, a sustainable hotel building will increase profit margins through improved energy efficiency. Energy audits, lighting upgrades, HVAC system optimisation, water conservation, the use of renewable energy and guest engagement are all key to ensure a hotel building is as efficient and sustainable as possible.

This is now even more important than ever, with energy prices reaching all-time highs globally. According to recent analysis from HotStats, total utility costs per available room in the UK have risen a whopping 83% between 2019 and 2023 from $6 to $11 per room, a stark contrast to say the U.S. that have reported a 27% increase from $7 to $9 per room.

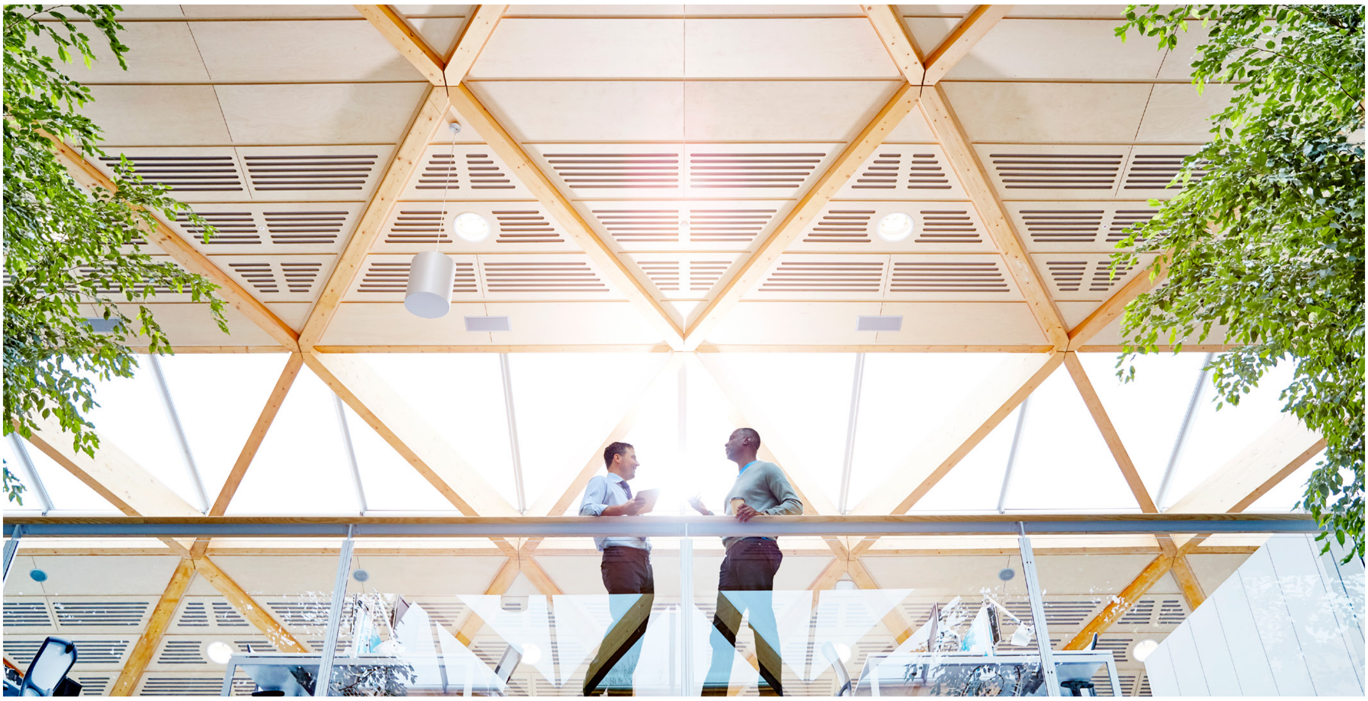
Total utility costs per available room



Source: HotStats, 2024

So, what impact does energy efficiency have on hotel values? Efficiencies in utility costs due to investment into plant and machinery for example, will likely be reflected within a valuer's cash flow projection for an asset. Communication on the exact investment undertaken and any independent expert advice on anticipated savings will be key for the hotel valuer to reflect decreased utility costs. This decline in cost, will, all other factors being equal, likely result in an improved profit margin and in turn translate to a higher asset value.

In some ways, this could be considered the 'green premium' of the hotel asset, with cash flow improvements arguably preserving its value for the future.



03

Changes in design and improvement works are contributing to ESG targets and potential reductions in operational costs.

We continue to see improvements in the way buildings are constructed or reconstructed, where changes in the design itself could result in alternative solutions, allowing hotel buildings to become more economically and environmentally viable.

Since our last report, for existing hotel buildings, improvements are being incorporated into planned maintenance and refurbishment works, with each solution being assessed to consider CAPEX, contribution towards ESG targets and potential reduction to operational costs.

The decision to replace existing plant and equipment depends on factors such as current condition, estimated remaining service life, plus the hotel owner's sustainability objectives and target dates for achieving them.

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80% of the hotels that will exist in 2050 have already been built. How we transition those hotels towards net zero emissions is the fundamental challenge we face as an industry.

Ufi Ibrahim
Chief Executive Officer
Energy & Environment Alliance

The works typically focus around:

Thermal insulation upgrades
Replacing existing windows, upgrading insulation on existing external walls, and adding new or replacing existing roof insulation to enhance thermal performance.

A fully integrated building management system (BMS)
to improve energy efficiency of the whole building.

Solutions that limit disruption
to occupied properties whilst providing improved performance to include lighting replacement to LED with sensors and dimming capability.

For new developments the sustainability measures, such as the cost and strategies needed to achieve BREEAM Excellent or Outstanding, are typically incorporated into the building design from the outset. Design solutions can include onsite energy generation and water capture, maximising natural light, the incorporation of higher thermal performance materials as well as lower energy use plant and equipment.

04

Appetite for green financing options in the hotel sector strengthens.

One of the key elements for the integration of sustainability aspects into investment decisions is the debt market's focus on ESG. As interest rates rise and access to debt is of the utmost importance, investors are increasingly looking to unlock new sources of capital. Green financing, which refers to the funding of projects with positive environmental benefits, has materialised as an option, with green loans becoming prevalent.

As highlighted in our 2024 Hotel Investment Outlook, over the last decade, $4.4 billion of global impact bonds have been issued, with almost 70% issues in the past three years and the Institute of International Finance expects global ESG-related debt to reach around $7 trillion by 2025.

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> Today we have approximately €200 million in sustainability-linked loans which will double within a couple of months. Banks in the Nordics are pushing to convert existing facilities into green loans – in a couple of years this will be a hygiene factor to get refinancing.
>
> **Caroline Tivéus**
> *Director of Sustainable Business*
> *Pandox*

The hotel industry was slow to participate initially, but adoption has accelerated in recent years, and we expect further growth in this segment during 2024 and beyond. We anticipate Europe to likely lead the way on this front, as considering increasingly stringent regulations, banks are expected to step up initiatives. This includes sustainability-linked loans which typically make performance improvement on several metrics a prerequisite for more favourable debt terms.

Examples of hospitality green financing options

2019

- BBVA and Pestana Hotel Group issue the first hotel green bond for €60 million.
- Host Hotels & Resorts become first ever hotel REIT to issue a green bond for $650 million.

2020

- Singapore-based Park Hotel Group issues $176 million in green bonds from United Overseas Bank to refinance the Grand Park City Hotel.

2021

- Whitbread issued £300 million of May 2027 and £250 million of May 2031 green bonds in accordance with the company's Green Bond Framework.
- Aareal Bank announces its first ever green loan governed by its Green Finance Framework with the financing of Pro-invest's Holiday Inn Express Macquarie Park in Sydney.
- Accor issues $700 million sustainability bond.

2023

- Host Hotels & Resorts completes $2.5 billion sustainability-linked credit facility refinancing.
- Aareal Bank issues €103 million green loan for Villa Copenhagen Hotel in Denmark.
- FIVE Holdings enter Nasdaq Dubi with $350 million green bond listing.

2024

- Aareal Bank issues largest green loan to date for a 5-hotel portfolio in Asia Pacific, thanks to strategic financing initiative by Pro-Invest.

Source: JLL Research

05

The reflection of ESG in hotel transactions.

Despite the increase and expected continuous focus on sustainability linked loans, there is currently a scarcity of evidence of ESG considerations impacting hotel transaction prices. This is due to a combination of a relative absence of recent transactions, combined with inconsistencies and a lack of visibility on how the market assesses ESG risk.

However, Rekha Toora notes: *"ESG-related due diligence has gained prominence in hotel transactions, specifically regarding climate risk and energy performance which is not necessarily fully measured by the EPCs that the industry has been using as standard."*

Some market participants, as Caroline Tivéus from Pandox tells us, are currently starting to test whether ESG investments into their hotels yields premium prices on exit. As a result, more concrete evidence on the impact of ESG investment on transaction pricing is expected to emerge in the near future.

We believe that increased communication between parties, data collection, and standardisation will be key in avoiding mispricing of assets in the medium to long-term.

Ufi Ibrahim further highlights the risks around mispricing assets, stating: *"if we have enough time, we can price in ESG risks earlier and we can correct prices incrementally, otherwise it's going to be a major shock to the global financial markets."*

> "
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> We have seen few examples of green premiums for hotel transactions because it is difficult to isolate these factors. However, price chips as a result of failing to meet sustainability standards are becoming more common.
>
> **Rekha Toora**
> *Senior Vice President*
> *EMEA Hotels & Hospitality*
> *Capital Markets at JLL*

06

Understanding the impact of investing in NZC measures on hotel cash flows and values.

In our last report, we outlined two hypothetical scenarios within a typical European city centre hotel using Discounted Cash Flow (DCF) methodology. The advantage of a DCF is that it enables hotel valuers to understand and reflect the impact of NZC investments on the cashflow over the holding period and how it could impact the hotel's value today and in the future.

We outline a similar scenario below, with a hotel either benefitting from €2m of NZC focused investment or no NZC investment and highlight which metrics may be affected. In addition to our last report, we also show whether these changes will likely be reflected in a regulated valuation in the current market environment.

The difference between a comprehensive reflection of sustainability-investment changes and a more conservative approach, exemplifies the distinction between risk analysis and regulated valuations. Risk analysis is a forward-looking approach and can be used for internal underwriting, strategy formulation as well as scenario analysis.

In our case, this means that it will likely incorporate more wide-reaching changes to valuation metrics due to expected future market conditions and anticipated sentiment. In contrast, for regulated valuations, the RICS Red Book mandates that valuers should reflect markets, not lead them and as such they will likely base decisions on already existent evidence of any NZC investments on property values.

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It's not a question if we will see a valuation effect, it's rather a question when it will happen

Caroline Tivéus
Director of Sustainable Business
Pandox

The impact of NZC investment on valuation metrics

Category	Regulated valuation		Risk analysis*	Explanation
	Base case	Green case	Green case	
CAPEX	€0m	€2m	€2m	
Occupancy	85%	85%	86% ↑	Changes in guest behaviour may be reflected in risk analysis scenarios, but are unlikely to be reflected in regulated valuations at the moment.
Total revenue	€13.3m	€13.3m	€13.5m↑	
Utility costs %	4%	2.5%↓	2.5%	Valuer likely able to reflect impact of NZC CAPEX investment on Utility costs within DCF.
EBITDA (%)	5.15m (39%)	€5.30m↑ (40.5%)	€5.37m↑ (40.5%)	
Exit yield	6.00%	6.00%	5.85%↓	Change in exit yields and discount rates may be reflected in risk analysis scenarios. For regulated valuations, they are currently unlikely to be reflected given lack of evidence.
Discount rate	8.00%	8.00%	7.85%↓	
Gross value	€82m	€85m↑	€88m↑	Depending on payback period of investment, a positive impact of NZC CAPEX may be reflected in both risk analysis and regulated valuations.
Capital value	€82m	€83m↑	€87m↑	

Source: JLL Hotels & Hospitality

*Notes: Exemplary calculation only. Regulated valuations are based on current market evidence, while risk analysis may base its metrics on future sentiment and anticipated future market conditions.

Currently, a potential value increase within a regulated valuation is highly dependent on the return on investment of the specific measure taken, with savings in energy costs the most likely to be reflected in cash flow projections.

Changes in consumer behaviour and capitalisation/discount rate might additionally be factored into a risk advisory/scenario testing exercise, however, they are currently unlikely to play a role in regulated valuations given a lack of transactional evidence. With further market evidence, we would anticipate regulated valuations to gradually move towards the risk analysis green case scenario outlined above.

Overall, we believe that sustainability focused CAPEX schemes that lead to a value uplift in regulated valuations are possible for many hotels, based on payback periods of net zero based investments and a market-standard hold period of 10 years. The highest likelihood for the reflection of such value uplifts is the provision of business cases and sufficient expert advice on the details and payback periods of the specific NZC CAPEX projects.

07

Collaboration remains key in accelerating towards a NZC future.

While there have been positive developments in the hospitality sector over the past three years, such as increased consumer interest in sustainable travel options and the implementation of corporate travel policies, there are still hurdles to overcome. One key challenge for valuers to reflect consumer behaviour changes on this front is the intention-behaviour gap, where consumers may express willingness to support sustainable hotels but might not always follow through in their spending behaviour.

Transparency and trust in sustainability certifications also remain an issue, with many certifications lacking visibility and meaning to hotel guests. However, recent actions, such as the removal of self-certified sustainable travel levels by Booking.com, indicate progress towards greater transparency and consumer trust.

> It's important to choose the right tenants and the right brands which have a strategy that is aligned with yours, that transparently share data and are willing to align targets and work towards common goals.
>
> **Adrian Flueck**
> *Director of Hotel Investment Management*
> *Invesco Real Estate*

Improving energy efficiency is more crucial than ever, especially with soaring energy prices globally. Investments in energy-efficient measures can lead to a decline in utility costs, positively impacting profit margins and capital values. Changes in design and improvement works are also contributing to ESG targets and potential reductions in operational costs, with new developments incorporating sustainability measures from the outset.

The appetite for green financing options is strengthening, potentially offering borrowers wider access to finance, lower costs of capital or more favourable terms. This trend is expected to continue, with Europe leading the way in adopting green financing options in the hotel sector.

Hotel valuers play a key part in the move towards a NZC future for the hotel sector. However, for regulated valuations, they still lack sufficient evidence to reflect a change in yield profile solely as a result of ESG credentials.

While continued and strengthened education and awareness of valuers themselves is certainly crucial in this regard, they are also reliant on continued efforts by the whole sector with regards to data transparency, standardisation, and collaboration to enable an appropriate reflection of the risks and opportunities of NZC for the hotel sector.

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Thank you

We would like to thank Caroline, Ufi and Adrian for their time and insights to support our research on this ever-changing topic.

Research at JLL

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