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The Uncertainty New Normal

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Sustainable real estate - Increasing pressures for hotel investors

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What are the implications of the march towards carbon neutrality for the hospitality industry? This article explains how consumer and investor behaviors are changing and discusses the challenges and opportunities for hotel operators and investors in the coming years.

WHY SUSTAINABILITY MATTERS FOR THE HOSPITALITY INDUSTRY

Sustainability and ESG have emerged from niche topics to now being high on everyone's agenda. Following up on the Paris Agreement on climate change to minimize global warming, the European Union's Green Deal targets climate-neutrality for the continent long term. By 2030, the EU and the US seek to cut greenhouse gas emissions by more than 50%. The next years will be defined by the evolution of regulatory frameworks to ensure these ambitions are achieved through concrete actions.

The stakes for the hospitality industry are high. Buildings, including hotels, are the biggest source of greenhouse gases after transportation. In fact, hotel operations consume more energy than any other type of building, accounting for an estimated 1% of global carbon emissions. The long-term commitment to becoming carbon-neutral by most major hotel chains is thus an important goal, also to raise awareness for people who stay and enjoy amenities at the hotels.

However, net-zero operations are just one side of the story. Embodied carbon in the construction and renovation of buildings contributes to at least 21% of global emissions. Given the worldwide share of hotel real estate and the sector's ongoing growth, up to 10% of embodied carbon emissions may be attributable to hotels. By this estimate, hotel construction accounts for another 2% of global carbon emissions, bringing the total footprint of the hospitality industry to 3%.

THE ROLE OF REPORTING SYSTEMS

Investors and business leaders should aim to anticipate where the puck is going, not where it has been. In light of the recent developments, it is not surprising that sustainability was also the key topic during the 2022 International Hospitality Investor Forum (IHIF) in Berlin.

Hospitality businesses should institutionalize competency by creating dedicated teams within head offices to implement suitable measuring and reporting systems. A consensus that emerged from the IHIF meeting is that the key performance indicator (KPI) to monitor sustainability is a hotel's energy consumption. Reporting is not only an upcoming CSRD requirement. An objective review of the current situation is also the basis for triggering a change in the right direction.

TRAVELERS PREFER SUSTAINABLE HOTELS – ARE THEY ALSO WILLING TO PAY UP?

71% of global travelers want to travel more sustainably, according to Booking's most recent sustainable travel report. This statistic represents a 10% increase compared to last year. Half of the respondents attribute the rising importance of sustainable travel choices to recent news about climate change. The consequences of this trend for hotel owners and operators are significant. 70% say they would be more likely to select a sustainable hotel option, whether or not they were explicitly looking for one.

But are customers also willing to pay more? The academic research indicates a change in consumer behavior. While in 2014, hotel guests required a room price discount to accept common sustainability practices by hotels, more recent studies document that customers are finally willing to pay up. Green hotels benefit from a room rate premium of 6.5% without reducing occupancy, mainly due to better indoor environmental quality.

During times of uncertainty, investors tend to become more risk-averse. Given the evolving regulatory environment, it is thus not surprising that equity investors as well as financiers tend to take the less risky route by investing in more sustainable hotels already today.

On the financing side, it became evident at the IHIF meeting that some banks have already stopped providing loans for unsustainable hotels. The hesitance to lend to unsustainable hotels is understandable, given that lenders too may soon be required to report on how sustainable their loan portfolios are. We may also see a higher demand for green bonds as a debt-financing instrument. The so-called 'green premium' for sustainable bonds leads to cheaper interest rates for the borrower.

On the equity investor side, we may also see a valuation premium for sustainable hotels. From a financial perspective, it seems rational to expect that sustainable hotels should trade at a price premium relative to unsustainable ones: First, sustainable hotels may achieve higher revenues if customers are willing to pay up. Second, sustainable hotels may benefit from higher cash flows through energy consumption and sustainability-related cost savings. Third, sustainable hotels may also benefit from lower interest rates on their bank loans. Consistent with these advantages, investors expect average transaction price premiums of 3-9% for hotels with the highest ESG certifications, according to a recent survey by Cushman & Wakefield. Some funds are already limiting their buying to only Breeam or Leed sustainability-certified buildings.

In the future, the green premium for sustainable hotels may increase even further. Or put differently, the discount for unsustainable hotels may become more significant. In a recent report, the Urban Land Institute warns that real estate investors in Europe risk major asset value writedowns if they fail to reduce the carbon emissions of their property portfolios. Therefore, the critical question for investors is, what is a sustainable hotel's fair price premium?

DOING WELL BY DOING GOOD? CHALLENGES FOR INVESTORS AND FINANCIERS

The pressing question for hospitality investors today is how to take the sustainability momentum into account in future investment decisions. An existing green premium for sustainable hotels does not automatically have obvious investment implications. There will be a financial trade-off for investors once the green premium is priced efficiently in the hotel investment market. All else equal, higher transaction prices today lead to lower cash flow returns in the future. Thus, investors must understand what is a fair green premium to pay that still allows for sufficient investment returns.

One possible way for investors to make their existing hotel portfolios more sustainable is to invest in retrofitting existing buildings to improve their energy efficiency. Such refurbishments will require significant capital expenditures.

Whether these investments pay off from a financial perspective will ultimately depend on the following three factors: 1) the green premium to be realized when the asset is sold, 2) the extent to which customers are willing to pay up for more sustainable hotel stays, and 3) the magnitude of the realizable energy savings that will affect the hotels' bottom line cash flows. It will be essential to prioritize potential actions and identify which measures will have the most significant impact.

Hotel investors may need to borrow money to finance such retrofitting initiatives. Can investors borrow money at lower interest rates if financiers can classify these loans as sustainable? Financiers themselves may issue sustainability-linked bonds as an efficient refinancing tool to provide capital for such capex programs.

CHANCES FOR OPPORTUNISTIC INVESTORS

The alternative for investors is to sell unsustainable assets and replace them with more sustainable ones, thus leaving the renovation part to other market participants. Here, we may see the emergence of opportunistic funds to buy unsustainable hotels at a discounted price relative to sustainable buildings. These funds could then specialize in CapEx spending programs to make the hotels more sustainable, obtain the green certification and put them back on the market. This investment strategy will require specialist asset manager know-how with a dual competency in ESG/sustainability and project management skills to achieve those goals in a timely and cost-efficient manner.

Finally, global tourism is still a growth industry, despite the Covid-19 shock. Over the following decades, the hospitality industry will continue to build out hotel supply via hotel development projects. New hotel development projects will be approached with a sustainability mindset. Yet the opportunities for redevelopment of existing buildings may be even more important from a sustainability angle. For example, we may see a surge in conversions of vacant office buildings to hotels in the next decade. Office vacancy rates are increasing dramatically due to a paradigm shift in the adoption of home office following the pandemic. These developments may allow hotel investors to gather vacant office buildings in prime locations for attractive prices and convert them to hotels. From a carbon emission viewpoint, "renovating or repurposing an already existing building will almost always be the more sustainable approach."

The sustainability trend raises important questions for all stakeholders. This article discusses the pressing questions hotel operators, investors and financiers face. Most of the answers are still missing. The regulatory environment is evolving. Best practices are yet to be identified. However, the generally open mindset towards sustainability by most market participants will allow everyone to learn faster.

Academic institutions are increasingly integrating sustainability into their courses and programs. The emerging job profile of the sustainability consultant is on the rise. Academic research is increasingly putting the topic on the agenda to contribute to our understanding as we gather more quantifiable evidence. A close collaboration between the industry, regulators, and academia will be necessary to find the answers in due time.

AT A GLANCE

WHERE IS THE PRESSURE COMING FROM FOR HOTEL INVESTORS?

We are in the early stages of an increasing gap between sustainable and unsustainable hotel real estate assets. Hotel guests desire and are willing to pay for sustainable travel options. Sustainable hotels promise cost savings through energy efficient business operations. Financiers are increasingly unwilling to provide loans for unsustainable real estate assets as they also have to demonstrate the sustainability of their loan portfolios. As a result, we observe an increasing valuation premium for sustainable hotels, whereas unsustainable hotels are at risk of becoming stranded assets.

WHAT IS THE LESS DESIRABLE IMPACT OF THE EU NET ZERO BUILDING GOAL ON INVESTORS?

The risk for investors today is that unsustainable properties will be devalued due to the EU's net zero goal for 2050, enhanced by the fact that bank loans are shrinking for non-green investments. Time and money are the main issues here, e.g., a portfolio of 300 buildings that rate low on the sustainability score. To meet the EU objective in 27 years' time means renovating 10 properties per year. What will happen to the properties that have not had the time or money to be renovated? What will they be worth in 2050 if the transformation hasn't been completed? Who will want to buy these unsustainable buildings?

IS THERE A SOLUTION TO THIS PROBLEM?

The sooner we get aligned on certification standards the better. (e.g., USALI is currently creating a reporting framework that integrates hotel sustainability standards for 2023). Once the framework is established, will have a clearer understanding of how much a sustainable renovation will cost and how much it will bring. Investors who can afford the capital expenditure required will then be able to reap the subsequent benefits thanks to a return based on sustainably-driven customer needs. But much of this depends on a) sustainability truly becoming a habit rather than a trend, and b) the banks making green funding as accessible as possible. To ensure the latter, government-backed funding would be extremely helpful to achieve the common goals.

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