Creating Resilience

European Green Deal and its Implications for Commercial Real Estate

VIEWPOINT

Transition to zero-carbon is much more than underwriting and investments into green assets. To achieve zero-carbon, substantial financing will be needed to help carbon intensive assets transition to green.

CBRE RESEARCH
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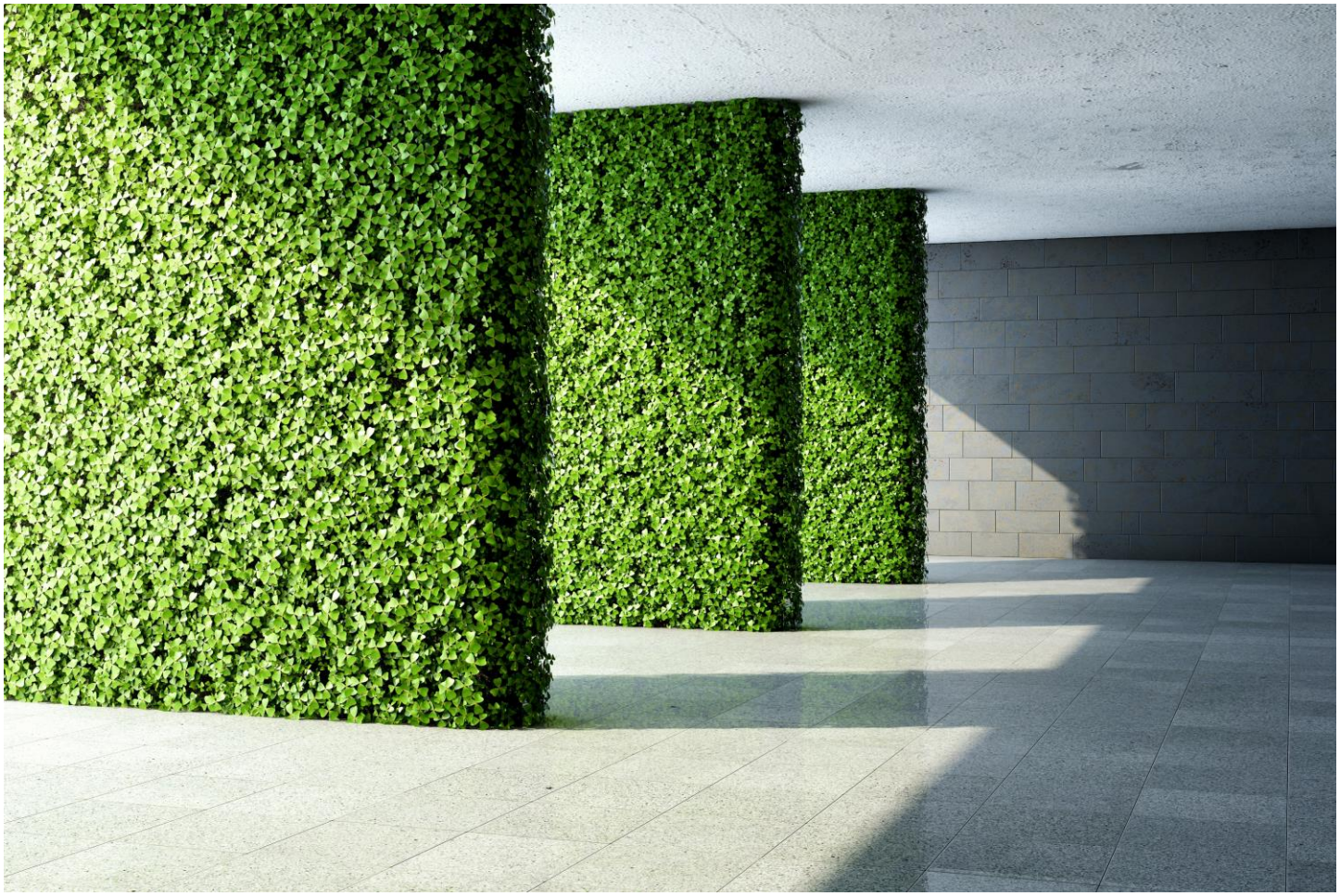

Summary

01 The European Green Deal is an ambitious set of policy initiatives aimed at making Europe climate neutral by 2050.

02 For the building sector, refurbishment is a crucial element of the decarbonisation efforts. The overwhelming majority of buildings will still be standing in 2050.

03 The decarbonisation pathway is not solely a technical challenge – substantial funds will be needed.

04 To reduce emissions sufficiently to meet EU targets, superficial improvements are not enough.

05 Given the scale of the challenge, financial innovation and policy guidance is required.

The European Green Deal is an ambitious set of policy initiatives aimed at making Europe climate neutral by 2050. To succeed, nearly all major aspects of the European economy will need to be remodelled – from transport, food production and energy consumption, to manufacturing and construction.

The European Commission has proposed in the Climate Target Plan 2030 to cut net greenhouse gas emissions (GHG) in the EU by at least 55% by 2030 compared to 1990. The Fit for 55 Package encompasses a suite of legislative initiatives across various sectors, including energy, transport and buildings. An essential component for action is energy efficiency, with the building sector being identified as one of the areas requiring efforts to be ramped up.

The building decarbonisation challenge

To achieve the 55% emission reduction target, by 2030 the EU should reduce buildings' GHG emissions by 60%, their final energy delivered for end consumption by 14% and energy consumption for heating and cooling by 18% (compared to 2015 levels ; European Commission, 2021) . Identifying solutions for making buildings more energy-efficient and less carbon-intensive over their full life cycle becomes therefore an absolute focal point for action.

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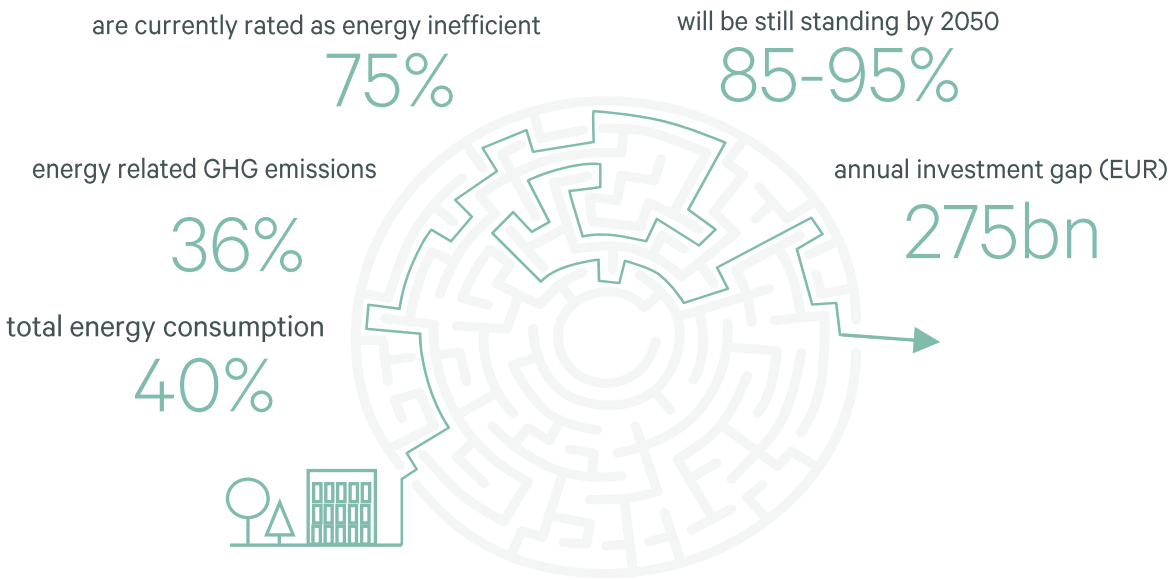
European buildings in numbers



Source: European Commission, 2022

Refurbishment is a crucial element of the response

While the zero-carbon pathway is quite straightforward for new construction, the challenge lies within the renovation of the existing building stock and opens questions of viability of renovation as opposed to demolition and new construction.

The aim of the Renovation Wave initiative is to double Europe's renovation rate in the next ten years. This initiative will propose better ways to measure renovation benefits, minimum energy performance standards, more EU funding and technical assistance, encourage green mortgages, and support more renewables in heating and cooling.

Substantial funds will be needed

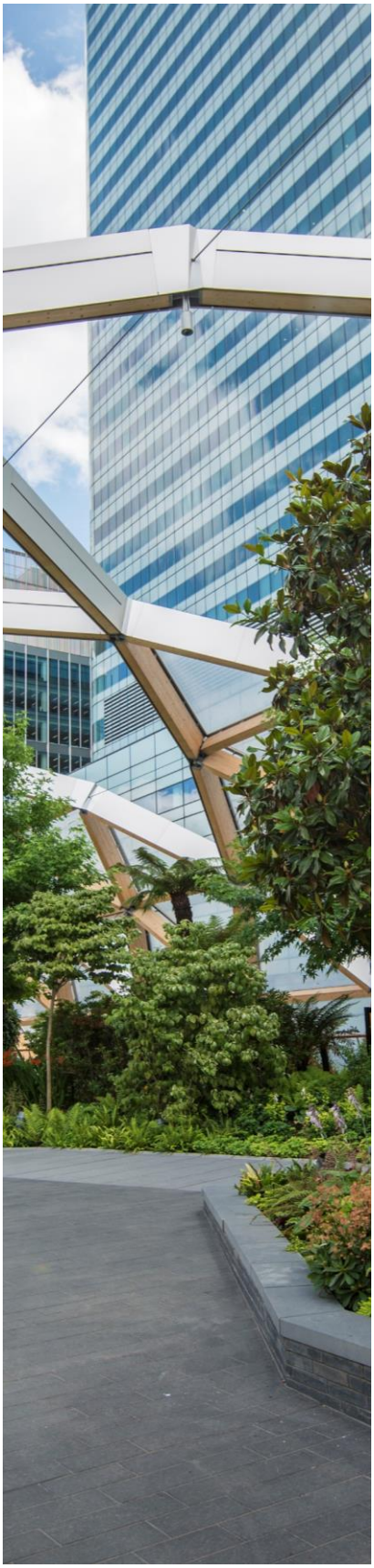
Clearly, the decarbonisation pathway is not solely a technical challenge. The European Commission estimates that to achieve the proposed 55% climate target by 2030, around EUR 275 billion of additional investments are needed per year. Most of this going towards energy efficiency. Beyond requiring the Member States to establish national minimum energy performance requirements for new and renovated buildings, the EU's Energy Performance of Buildings Directive (EPBD) stimulates them to put in place financing schemes and incentives to encourage improvements to the energy performance of their existing buildings.

To be classified as a sustainable economic activity making a substantial contribution to the objective of climate mitigation (in accordance with the EU Taxonomy Climate Delegated Act), building renovation needs to either achieve 30% energy savings, comply with minimum energy performance requirements for major renovation or consist of specific individual measures classified as sustainable (European Commission, 2021).

Superficial improvements are not enough

However, the focus of financing schemes should be deep renovations that can deliver nearly zero GHG emissions buildings. If choosing to go with the path of shallow renovations with shorter payback time, undergoing deep renovation at a later point can prove to be more difficult than expected and less cost-effective.

Significant progress can be achieved by replacing old fossil-fuelled heating and cooling systems with higher-efficient ones, or by adding



insulation and/or shading devices. However, to reduce emissions sufficiently to meet EU targets, decarbonisation of the energy supplies and deep renovations to the building envelope are needed. If failed, assets may not be compliant with the regulations that the market requires, therefore becoming stranded.

As a rule of thumb, the cost of the demolition and construction of a new building is higher compared to energy renovation to the same energy performance (La Fleur et al.,2019). Clearly, we cannot disregard the fact that some old buildings may have such severe problems, for example from moisture damage or land subsidence, that demolition is the only feasible option. Also, retrofitting occupied buildings presents practical challenges of upgrading facilities without disrupting business operations, as well as the more complex issue of cost allocation and financial viability (WEF, 2021). However, for most existing buildings, the added value of renovating instead of demolishing and rebuilding has been supported by numerous campaigns, RetroFirst being one of them. But for the renovation wave to be successful, this option needs to be supported by strong policies that can both influence, convince and eventually oblige building owners to choose this road.

Furthermore, renovating a building to reduce its energy consumption makes only sense if the goal is also to minimise embodied GHG emissions when selecting materials, components, and systems to be used for renovations. According to same estimates, the emissions created during the construction and demolition process of a building account for up to 70 percent of the carbon produced during an asset lifetime (ULI, 2022). Currently, the embodied emissions in buildings are only rarely addressed in policy strategies and instruments. However, if embodied carbon is not included in building decarbonisation targets, a failure to meet global decarbonisation targets is highly likely (Rambøll, 2022). The EUT objective Circular economy requires that buildings undertake a life cycle assessment of the entire building in accordance with EN 15978, which is the first time we have seen this in policy. Furthermore, the European Circular Economy Action Plan targets how products are designed, promotes circular economy processes, encourages sustainable consumption, and aims to ensure that waste is prevented and the resources used are kept in the EU economy for as long as possible.

Financial innovation and policy guidance is required

European Green Deal is strategically important for real estate companies, as it will impact market fundamentals, business models, financing conditions.

However, whether retrofitting investment programmes of this scale can be implemented will largely depend on the cost and availability of financial resources. To accelerate this transition, financial institutions require clear guidance to prioritize and finance specific renovation approaches and new construction technologies which will enable the needed long-term structural change of the European building stock (PCAF, 2022). The EU is equally counting on the private sector to fund those objectives, and for that, it needs European companies to increase green bond issues. However, the retrofit wave of capital will not be limited to bond issuance, for example, real estate debt funds will also be critically important and be a significant source of capital being deployed into retrofits.

Ultimately, this opens possibilities for investors that are willing to become the future champions of decarbonisation. Investors prioritise income producing investments and value protection, and stranding assets threaten this, and hence, this is a key driver behind retrofitting. Active management of real estate investment funds and strategic capital investment into the underlying assets will be required to avoid income returns being diluted by stranding assets. The use of the CRREM tool is commonly applied as part of the strategy of managing stranding risk, prioritising and planning cap ex for retrofits.

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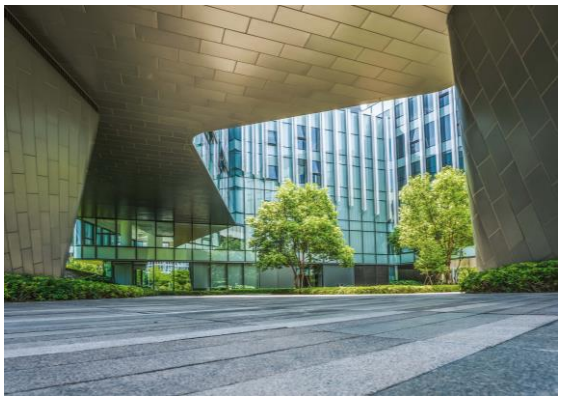

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