CBRE Investment Management

Alternative credit is playing a critical role in Europe's ESG transformation

Real estate needs rapidly to reduce its environmental impact to contribute towards the raft of government net-zero target commitments that have been made in recent years. We examine this capital-intensive, expensive process and opportunities for debt investors below. It is likely, as the stock of real estate evolves, a performance spread will emerge between assets with strong and less strong ESG credentials. One concern is that assets that cannot command a minimum level of rent will not meet the economic return threshold for investment, potentially leaving swathes of underperforming areas economically unviable for ESG investment and reinforcing a wealth divide.

Regulation and occupier demand are squeezing real estate owners

The built environment has long been recognised as one of the most significant sources of carbon emissions — it is estimated that buildings account for 40 percent of the EU's total energy consumption — and, therefore, one of the main areas of focus for governments seeking to reduce carbon emissions to net zero. Most European countries have enacted legislation requiring an assessment of energy rating to be carried out when a building is transacted or leased; in most instances, this has not yet led to the legally binding imposition of minimum targets, but in a couple of instances it has: (1) In the United Kingdom, the Energy Performance Certificate (EPC) rates a building's energy efficiency from A to G. As of 2023, it will be illegal to let a building rated F or G, and from 2030 it is proposed that this will also be the case for buildings rated C, D and E, with an interim target of C by 2027 also proposed. And (2) in the Netherlands, legislation has gone further; there, it will be illegal to let a building rated below C from 2023, and again proposals are in place to raise this minimum standard by 2030.

Already, this is resulting in a clear value differential for assets that are future-proofed for the approaching regulatory changes. There is no reason to suppose that the time frame put in place by the United Kingdom and the Netherlands will not be representative of that eventually adopted by the majority of the rest of Europe. Even if not legally mandated via governments, it is highly possible that a de facto minimum EPC standard could come into effect via pressure from occupiers, aware of disclosures they will have to make under Sustainable Financial Disclosure Regulation.

Encouraged via a future carbon tax or "polluter pays principle" regime, larger corporates are already increasingly choosing only to occupy the most energy-efficient stock. Against this we see that only around 1 percent of buildings undergo energy-efficient renovation every year. This would imply that close to 70 percent of the real estate stock would remain energy inefficient by 2030.

Traditional banks are not willing or positioned to fill the need

Retrofitting an asset to comply with a minimum standard is typically not a small undertaking; PMA estimate broadly that the costs of moving an office from an EPC rating of F or G to B or C is on the order of £200 to £300 per square metre (€233 to €350 per square metre). Some investors will be able to afford this themselves, but many will be unable to carry out improvements without external financing.

The scale of the need is immense. Using MSCI's €2.2 trillion nonresidential commercial real estate market estimate (of which roughly 50 percent comprises offices), applying different levels of market loan-to-value (LTV) and then applying an estimate that 60 percent to 75 percent of buildings will need substantial capital expenditure to render them occupiable, results in a figure of €360 billion to €450 billion of office buildings in Europe, with a ratio of capex-to-property value of 20 percent to 25 percent, suggesting a total capex requirement of €160 billion to €200 billion.

The extent to which real estate credit markets can provide this financing is of vital importance to the future of the real estate market. However, traditional bank lending to the commercial real estate sector is decreasing. For example, the years since the GFC have seen significant diversification of the sources of UK real estate credit. Having accounted for more than 70 percent of outstanding real estate credit in the years running up to the GFC, peaking at 72 percent in 2005, UK banks and building societies have seen market share almost halved, to around 38 percent today. At the same time, new origination from insurance companies and other nonbank lenders rose last year to approximately 30 percent of the market.

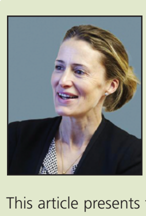
ESG renovation wave cannot succeed without nonbank lenders

With a significant majority of real estate rapidly requiring an energy-efficiency upgrade, and concerns about banks' ability or preparedness to finance projects in sufficient volume, the need for alternative sources of funding is clear. The market requires that nonbank lenders fill the funding gap, and the attractive returns on offer, combined with manageable risk, suggest that there will be an eagerness to do so. Avoiding tail risk will always be the crucial factor in ensuring the performance of a credit portfolio, however. Whereas equity portfolios tend towards a market average — as the performance of assets is roughly normally distributed around a mean, so that the pooling of even a modest number of assets can "buy the market" — credit is much more binary.

A major challenge for nonbank lenders in a world where significant amounts of stock will need to be refurbished in a relatively short time frame, therefore, will be to scrutinise ever more closely the extent to which long-term demand will remain (and the price point at which that will be) for the refurbished assets they choose to underwrite, as well as being confident that assets will not be affected by areas that have suffered mass obsolescence. Given the scale of the opportunity that we believe exists, however, we believe that debt investors with the insight to underwrite active business plans will find the "green renovation wave" to be a very significant opportunity. The constraint is likely to be too much choice rather than too little.

With strong recruitment programmes and the accumulation of expertise in these organisations, we believe this cohort of lenders to be well-placed to meet one of real estate's most pressing challenges, while aligning with investor goals and providing asset resilience and sustainability.

CONTRIBUTOR



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