A mountain to climb? The European Green Deal and alternative real estate investment

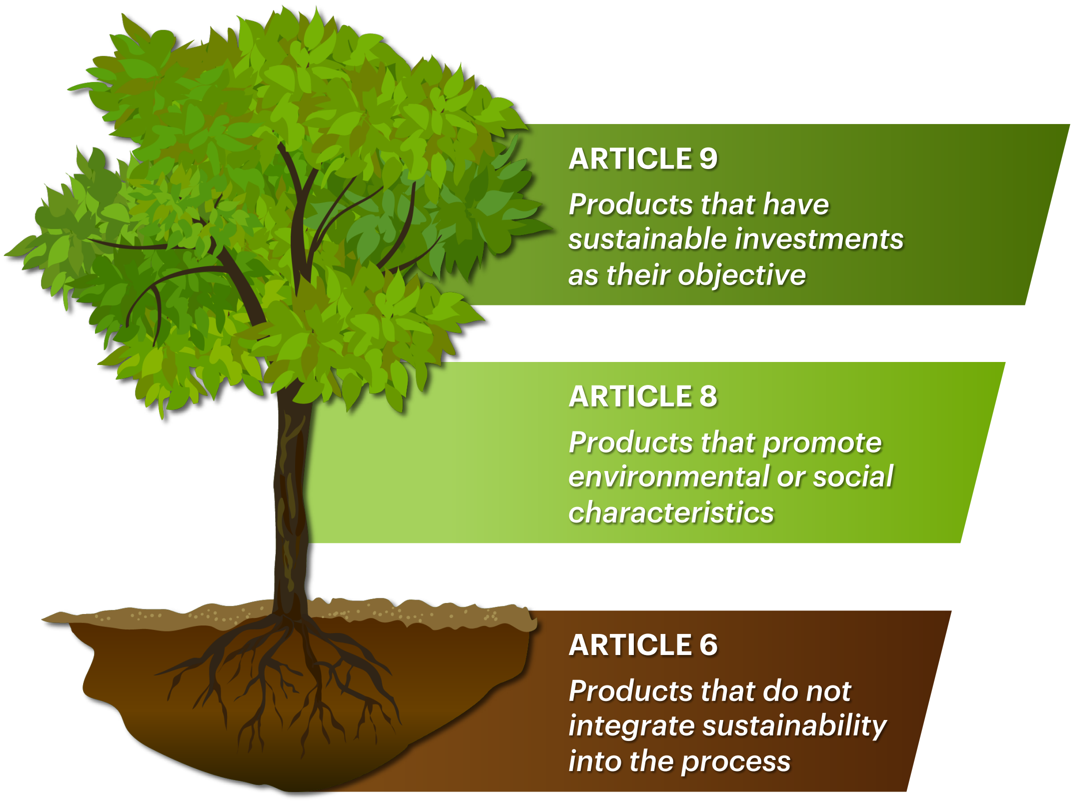
In the summer of 2021, Europe experienced a series of extreme-weather emergencies bringing the reality of climate risk to the continent's doorstep. Previously, for many Europeans, the impact of climate change had shown up mostly in news items from far-off places, such as rising sea-levels threatening low-lying nations, or wildfires in Australia and America. In 2021, climate risks came home with great force. Heavy rains caused floods in Germany, Austria, Belgium and Italy, while forest fires swept through Greece, Turkey and Spain. Flash floods killed more than 200 people in Germany and Belgium, and thousands became homeless or lost access to water or electricity in North Rhine-Westphalia and Rhineland-Palatinate, two of the most economically advanced states in Germany. Coming just weeks before federal elections, the floods raised urgent questions about the adequacy of Germany's disaster response systems and the extent of under-investment in climate-mitigation infrastructure.

Similar crises are only expected to grow in frequency in coming years. Across the EU, climate-related economic losses averaged €12 billion per year before 2021. Conservative estimates suggest that global warming of 3°C above pre-industrial levels would cause annual losses 15 times greater, or 1.4% of the EU's annual output. Today, only 35% of climate-related economic losses are insured; in some parts of Europe, this figure is less than 5%. Distributional impact is also uneven. Coastal areas, which produce 40% of EU GDP and are home to 40% of the population, would be among the hardest-hit in future emergencies.

With such threats looming, the EU has issued a suite of climate directives since 2018, culminating in the announcement of the "European Green Deal" in July 2021. Its objective is to build a climate-resilient society by 2050, "fully adapted to the unavoidable impacts of climate change". It lays out principles and action points on ten separate fronts, in order to achieve two over-arching targets:

- reducing net greenhouse gas emissions by 55% by 2030 (from 1990 levels)
- achieving climate neutrality by 2050.

The EU climate directives cover a wide range of areas including agriculture, biodiversity, transport, and industrial strategy. From the perspective of real estate investors, two of the most relevant measures are the Sustainable Finance Action Plan and the Strategy on Adaptation to Climate Change. The former aims to redirect capital flows toward a more sustainable economy and to foster a long-term perspective on investment. It details an environmental classification system for economic activities and lays out disclosure rules intended to enhance transparency and minimise greenwashing. The Adaptation Strategy sets out the ground rules to reduce emissions and increase resilience in physical infrastructure and the built environment against adverse climate events.



ARTICLE 9
Products that have sustainable investments as their objective

ARTICLE 8
Products that promote environmental or social characteristics

ARTICLE 6
Products that do not integrate sustainability into the process

The most important tools to achieve these goals are:

- extension of emissions trading to new sectors, mainly buildings and transportation, and tightening of existing trading system
- greater use of renewable energy and emphasis on energy efficiency
- decarbonisation of heating and cooling systems, with continuous gains in renewable energy use
- faster roll-out of low-emission transport modes, supporting infrastructure and fuel systems
- expansion of electrical charging network, expanding smart rechargers to public parking areas
- annual obligation to renovate 3% of all public building stock

In the remainder of this paper, we analyse how these policies will impact European real estate, with a particular focus on the implications for alternative sectors, property types where we see compelling investment opportunities. We explore the likely impact on occupier fundamentals and on investment performance, and aim to identify opportunities and challenges created by these rules.

Several of the above points deserve deeper discussion at the outset. The 55% greenhouse emission reduction target is expected to pose significant challenges to the property sector, and to residential property in particular. Buildings make up 35-40% of all greenhouse gas emissions and energy consumption in Europe, making them an outsized target for reduction. The EC estimates that to reach the overall target of 55%, buildings must reduce emissions by 60% by 2030. How difficult will achieving this goal prove? As a comparison, building emissions fell by just 18% between 2005 and 2017. The burden of reduction will fall most heavily on sectors where the stock is oldest and most energy inefficient. Emissions from housing will need to fall by 65% to meet the 55% target.

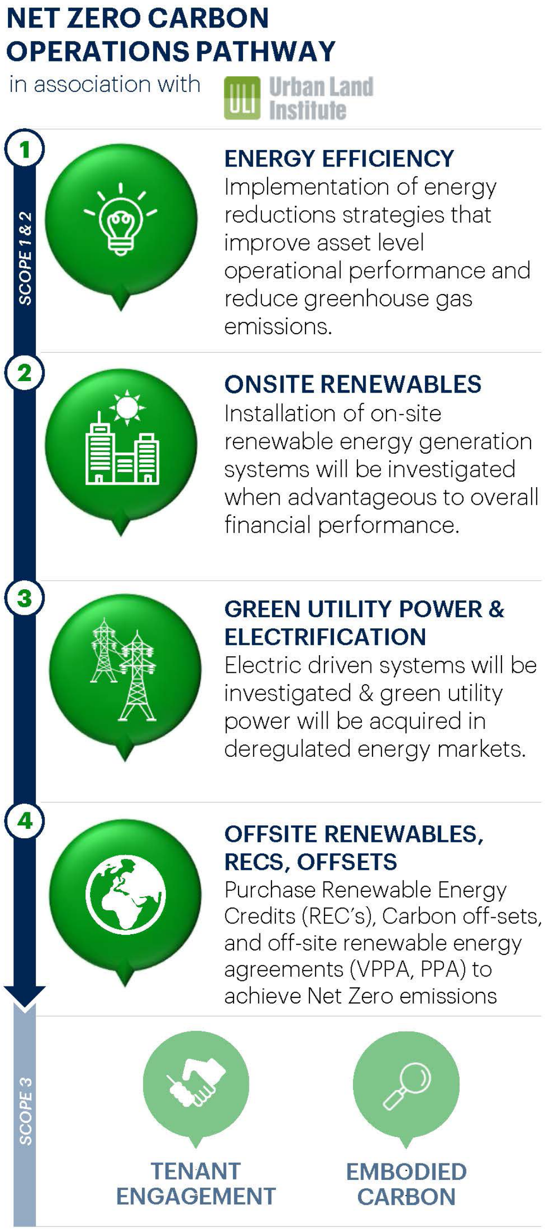
The new cap-and-trade scheme for buildings will also have a significant impact (a cap-and-trade system requires emitters to pay for the right to emit). The cost of emissions allowances will be unevenly distributed, depending on factors such as energy usage patterns, and ownership structure of buildings. In Germany, where 54% of households live in rented dwellings, the effect of higher carbon prices for heating fuels introduced in 2019 fell mainly on tenants, as landlords were able to pass on the higher cost. Other parts of Europe, where coal use is widespread, face even bigger challenges to keep down heating costs. As things stand, 34 million Europeans live in energy poverty (constrained by cost from keeping their home adequately warm or cold). Raising energy bills could spark protests, as demonstrated by the Gilets Jaunes movement in France, which occurred in response to higher fuel costs. To mitigate the impact on vulnerable populations, the EU has proposed a €72 billion Social Climate Fund, providing temporary income support and helping to raise energy performance.

Since the Green Deal also targets other sectors of the economy just as drastically, there is now little scope to "offload" or trade away the emissions from the building sector to alternative activities such as transport or industry. This means that owners will face renovation requirements, while current occupiers will be charged higher bills. In spite of palliative subsidies, the new targets are expected to affect the finances of millions of families.

The increased obligation to renovate also runs counter to current low rates of renovation and replacement in Europe. The EC estimates that only 1-2% of all building stock is renovated every year, a low figure if the built environment is to achieve carbon neutrality within a reasonable timeframe. The accelerated target of 3% p.a. will apply to all public buildings and the worst-performing private buildings. To the extent this measure reduces available rental units and puts pressure on the rest of the housing stock, it could raise rents further in vulnerable markets. Housing unaffordability is already a dominant theme in European politics. During the past five years, average rents have risen by 4% p.a. in Europe's 20 largest cities, with growth rates in excess of 6% in cities like Dublin and Madrid. The absolute housing gap continues to rise in Western Europe (ranging from a deficit of 350,000 homes in the Netherlands up to 1.2 million in the UK). Energy inefficiency of older buildings is a genuine concern, but stringent "green" measures risk further escalating housing costs unless bottlenecks in supply are addressed. Impediments to housing provision (discussed in earlier IPE papers) range from sclerotic planning to restrictive building codes to rising costs of land and construction.

We now turn to the implications for investors in the alternative sectors (rented-residential, senior, student and self-storage). We do not expect the Green Deal to affect occupier demand. Occupier demand for alternative property types derives from long-term demographic trends and is little affected by economic cycles or environmental regulations. Secular growth in urban households and elderly, and student populations is expected to continue, resulting in a strong demand outlook across Western Europe. The impact of green rules comes primarily through the supply side. Stricter environmental standards will push up the cost of new buildings. The owners of existing assets will need to renovate to bring them into compliance. Some properties will be lost, when the cost to renovate exceeds the potential return. The net result will likely be downward pressure on already low additions to stock. Meanwhile, vacancy rates in large European cities are already in low single digits; any further reduction (or even slowdown) in supply would drive vacancy lower and rents higher. While this creates challenges, it also presents opportunities for proactive managers and operators, i.e., those able to negotiate the maze of evolving regulations and able to extract premium returns through capex programs. When judiciously executed, the higher costs are offset by the ability to charge higher rents. "Green" developers will find opportunities in the residential conversion potential of obsolete commercial stock that no longer meets modern requirements. Institutional partners, whose mandates increasingly emphasize ESG credentials, will reward the most innovative managers and developers with higher capital allocations.

Over the last 50 years, Heitman has played a pioneering role in global real estate investment, through its entry into nascent markets or its championing of previously-unheralded sectors. In 2019, we adopted the ambitious goal of reaching carbon-neutrality across our $46bn global portfolio by 2030 for assets under operational control. As a manager with 25 years of investment history in Europe, we have extensive experience of climate mitigation and adaptation strategies across the lifecycle of assets in a wide range of sub-sectors, aimed to address both physical and transition risks.


NET ZERO CARBON OPERATIONS PATHWAY

in association with Urban Land Institute

ENERGY EFFICIENCY
Implementation of energy reductions strategies that improve asset level operational performance and reduce greenhouse gas emissions.

ONSITE RENEWABLES
Installation of on-site renewable energy generation systems will be investigated when advantageous to overall financial performance.

GREEN UTILITY POWER & ELECTRIFICATION
Electric driven systems will be investigated & green utility power will be acquired in deregulated energy markets.

OFFSITE RENEWABLES, RECS, OFFSETS
Purchase Renewable Energy Credits (REC's), Carbon off-sets, and off-site renewable energy agreements (VPPA, PPA) to achieve Net Zero emissions

TENANT ENGAGEMENT

EMBODIED CARBON

On the latter, common best practices across property types include: deploying smart meters, LED lighting and interactive heat monitoring; switching to renewable providers and using central procurement to achieve best pricing; executing major capex projects such as wall and roof insulation, double glazing, and solar installations. Sector-specific measures can also improve the ESG performance of various alternative sub-types. In storage, green spaces in the form of living walls and green roofs can improve air quality in large facilities. Landscaping can encourage biodiversity and contribute to the streetscape. In general, self-storage is a relatively benign, low-intensity use of urban space, but there are still ways to enhance the social impact, such as deploying free EV charging points to encourage use of electric vehicles.

For more operationally intensive categories, like student and senior housing, the pandemic has highlighted the importance of the S (or "social") pillar of ESG. With residents often isolated and far from family and friends, operators have had to focus on the physical safety and security of buildings and also the mental wellbeing and emotional health of tenants. Means of addressing the latter include circadian lighting, a digital tool to alleviate depression or anxiety, and apps that screen seniors for signs of dementia or loss of autonomy. Responsible operators must also be mindful of the wellbeing of employees. This is especially pressing in care sectors, where the severe shortage of skilled staff (100,000 unfilled positions in the UK) has led to high levels of stress and burnout. Recruitment and retention incentives, alongside pastoral care, can help support staff through an exceptionally challenging time. Many apartment landlords established hardship relief programs during the pandemic, supporting tenants with temporary rent deferrals and flexible payment plans. Germany's largest landlord Deutsche Wohnen cut dividends to shareholders to fund a €30 million relief package for its tenants and business partners. Against the backdrop of intense discussion about rent controls across Europe, such measures demonstrating commitment to tenant welfare by professional operators and investors can help create the conditions for a more balanced debate on the subject.

What about assets that prove beyond fixing under the new rules? Given the prevailing zero-rates regime, the problem of "stranded assets" has so far been limited. Investors continue their hunt for income-generating assets, and property yields have continued to edge downwards in the pandemic, not only in favored categories such as industrial and residential, but also (surprisingly) in most European prime office markets. Climate considerations have yet to impinge on pricing in any material sense. A 2020 study by the EU-funded CRREM project found that there was little correlation between prime CBD office yields in Europe and the intensity of greenhouse emissions in those respective office markets.

However, the renewed urgency shown by the European Green Deal proposals in July 2021, bolstered by the conclusions of the IPCC Climate Report three weeks later, means that investors can no longer ignore difficult questions of regulatory compliance, higher carbon prices, the trade-off between inaction and retrofitting properties, and the timing of future disposition. The choices of individual managers will vary. However, greater transparency with stakeholders and a commitment to data collection and continuous improvement in portfolios can help managers achieve better performance during hold, and position for a successful exit.

Residential properties, a key part of the alternative realm, are operationally intensive and associated with specific challenges. Tenanted by families and individuals, these sectors come with higher levels of political sensitivity than commercial assets, as was evident during the pandemic. Extant stock across Europe is heavily disaggregated and granular, and the aging nature of the stock means that owners and operators face challenges to make their portfolios compliant with supra-national directives such as the European Green Deal. Simultaneously, European Alternatives are going through a sea-change in terms of institutionalisation of ownership and professionalisation of operations. Long-term capital reallocation is lifting investment volumes for alternative assets to record highs and compressing yields. Investment strategies will continue to evolve in response to the regulatory climate, which Heitman will explore in future papers. But it is certain that owners and operators who are best able to negotiate the coming climate challenge will stand to benefit the greatest across multiple measures: customer loyalty and goodwill, deeper liquidity and firmer pricing, and higher returns to and capital allocations from institutional partners.

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