Theme 4) ESG strategies: developing vs redeveloping

Net zero is going to be the main priority next year and in the coming years for real estate stakeholders. Our industry is responsible for about 40% of the world's carbon emissions, so it is no surprise that there is an urgency to act. Investment managers and investors are setting ambitious targets for the reduction of their emissions over the coming years across the entire lifecycle of their real estate assets. Decarbonisation of real estate portfolios needs to accelerate under the threat of a warming climate and the pressure of new regulations. In order to achieve this investors and asset managers need to measure the energy footprint of their existing portfolios and to assess future climate adaptation risks of newly acquired assets.

In this context we expect to see more investment into climate tech and retrofitting, in an effort to address climate risks and improve the energy performance of the buildings. With regards to new acquisitions, initially investors are likely to focus on newly built assets with high energy performance credentials and future developments. Over the past 10 years, the share of forward funding deals across sectors went from for 3.7% to 16.4%. During the same time, the share of acquisitions of development land went from 6.1% to 8.9%. Most of these forward funding and land development deals involved logistics and residential projects; two sectors currently in a strong supply and demand imbalance situation. The weight of capital and competition for the best assets is likely to lead to some further prime yield compression. We project prime achievable yields to compress by up to 5bps for offices, 10-5bps for logistics and 5-10bps for living sectors on average across Europe. Retail yields should gradually stabilise or correct further in some markets.

The need for energy efficiency is also driven by major corporate tenants from a variety of sectors. Major companies, such as Microsoft, Amazon and Google have stated significant carbon reduction commitments for the future decades, meaning that they will require corporate space that meets these prerequisites.

Tenant demand for green buildings has led to an increase in office development activity with the development pipeline in 2021 having increased by 24% yoy. However, new construction is responsible for significant amounts of carbon emissions, which are commonly referred to as embodied carbon. It is argued that renovation and reuse projects typically save between 50% and 75% of the embodied carbon emissions compared to constructing a new building. Regulations and planning are likely to force the shift from new construction to renovations and repurposing of assets in the coming years. The polarisation of occupier and investor demand is expected to lead the repricing of secondary assets, which will make their redevelopment financially viable.

The yield gap between prime and secondary office assets tends to narrow in periods of high investment turnover and to widen in periods of uncertainty. Post GFC the gap peaked at 90bps in 2014 and started moving in until 2017 at 59bps. This year it is closing at 77bps, with secondary yields moving out in some of the markets, where new environmental regulations are being introduced (UK, Netherlands). We expect this trend to spread across most markets in Europe offering value-add opportunities to investors with higher risk tolerance.

Building decarbonization is being pushed by more property owners, real estate investors, and corporations not simply to help cool a warming planet, but also because their own success depends on it.