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Building Back Better?

Real Estate in the wake of Covid-19 and the European Green Deal

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It has long been known that a significant majority of Europe's buildings are not fit for purpose in a world of accelerating climate change. Accounting for approximately 40% of the European Union's total energy consumption and for 36% of its CO2 emissions, the sector has been slow to respond, but is going to be at the forefront of rapid change as Europe targets climate neutrality by 2050 as its political priority, and uses the European Green Deal as its growth strategy. With the sector grappling with the dramatic short-term consequences of the Covid-19 pandemic, EU policy-makers are now targeting massive investment in a 'Renovation Wave' as well as an ambitious legislative programme on buildings and construction, including on ESG and sustainability issues, that will immediately and directly impact the real estate industry. How prepared is it for the challenges and opportunities ahead?

The need to renovate

For well over a decade, and since its first combined package of climate and energy policies, the EU has seen the need to improve the quality of Europe's built environment, given the amount of CO2 emissions that come from buildings and construction.

However, the policy landscape has recently picked up the pace, driven by the climate crisis and the urgent need for change. The EU, representing the world's largest single market, enacted the first European 'Climate Law' in March 2020, collectively committing the EU and its 27 Member States to being climate neutral by 2050. It's a significant challenge. More directly, the EU announced its Renovation Wave strategy on 14th October, an ambitious policy framework that could result in the renovation of around 35 million buildings by 2030 and create up to 160,000 construction jobs in the process (Source: EUobserver, 2020). Why? Because 35% of its buildings are over fifty years old and almost 75% of its building stock is energy inefficient (Source: European Commission, 2020).

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Europe is full of rich contrast and diversity, but united in inefficiency in energy terms. Over two thirds of Europeans now live in towns and cities, scattered across a multitude of different countries. From the frozen north to the sunny shores of the Mediterranean, from coastline to hinterland, it is full of historic buildings, many of which are rather charming, but which are not helping the fight against global warming. From the materials used to build them, the cement, steel and aluminium, to the way they are heated or air conditioned, they collectively represent Europe's single biggest source of CO_2 emissions. A systemic change is needed in the way we build, invest and manage the buildings in which we live, work and play if Europe is to address the climate emergency and deliver its ambitious targets.

Many within the real estate sector will recognize and be sympathetic to the need for a greener built environment. Many will support its objectives and aspirations. The principle of building more environmentally friendly buildings has been around for a while. However, policy, regulations and financial incentives up until now have not driven a sufficient change, so a sizeable majority of what still gets built or renovated every year will not be as energy efficient as it needs to be. The current annual energy renovation rate of around 1% (Source: European Commission, 2020), is not enough to get to where it needs to be which the European Commission estimates to be at least 3% per annum.

As long as land prices remain high, tax regimes are unsupportive and with materials and improvements costing more than the market value of a newly renovated property, we will not see the rate of change needed to meet the EU's objectives. It presents a commercial conundrum – one that the European Green Deal and the EU's response to Covid-19 aims to change.

Building back better - The EU's plan for a green and digital transition

The European Union (EU) is taking a lead on driving a more sustainable future. With the appointment of Commission President Ursula von der Leyen and the new Commission in November last year, green is now Europe's favourite colour. Winding back the clock to the pre-COVID world in late 2019, she presented her European Green Deal referring to it as "Europe's man on the moon moment". It is the EU's flagship programme; an ambitious roadmap which sets out key initiatives towards reaching climate neutrality by 2050, in line with its commitment to global climate action under the Paris Agreement. Europe is the world's first continent to commit to climate neutrality, committed to achieving a more circular economy. The real estate sector is central to this agenda.

Fast forward to present times, and despite its severe social and economic impact, the coronavirus pandemic has turbo charged European ambitions as it seeks to build back better. Perhaps reflecting Winston Churchill's sentiment to "never let a good crisis go to waste", it has been a catalyst within the European institutions to drive more ambitious targets and to anchor the proposed €750 billion recovery fund to building a more resilient economy. For example, the Commission has proposed raising EU climate ambitions to reduce CO_2 emissions by at least 55% by 2030. The European Parliament wants to go further, voting in favour of a 60% reduction. It is now up to the European Council, representing the governments of the 27 Member States, to wrap up negotiations by the end of this year. All of this will be complemented by a significant amount of new policy and regulation, sustainable finance and ESG measures, all designed to drive investment towards these goals.

The Renovation Wave – a new policy landscape

What does all this mean for the real estate sector? The Renovation Wave is a formal communication setting out a number of commitments to be carried forward as draft legislation in the next few years. One of its priorities is improving the energy performance of buildings across the EU by doubling the renovation rate over the next decade.

The Commission is hoping to drive a systemic change affecting every building across every sector in every Member State: commercial, retail, industrial and residential. It is a holistic approach where the emphasis is shifting towards more accountability for the buildings we live in, we operate in, we build, invest in and manage. A property company or investment fund's performance will be measured on the environmental impact of its entire portfolio, rather than on selective and piecemeal commitments to help support the sustainability agenda. Greenwashing has become a dirty word.

"We 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. This will be a game changer for home-owners, tenants and public authorities"

Kadri Simson, EU Commissioner for Energy, October 2020
(Source: European Commission, 2020)

To reach Europe's targets, the Commission is also seeking a radical transformation in how we build new buildings, whereby they move from largely being energy consumers to be being energy producers, fusing smart technology, energy efficiency and a more sustainable approach to the construction process. In the future we could see buildings connected to the local grid, providing a district or community approach to managing the ever increase rise in electricity demand.

Who pays for it?

According to the European Commission, €275 billion of additional investment in building renovation will be needed every year. To finance this, the Commission will provide direct funding through its Recovery and Resilience Facility as well as public guarantees under its InvestEU programme, which acts as support mechanism to leverage private investments. Regional and local authorities will also receive assistance from the cohesion policy funds and the Just Transition Fund.

In addition, with the Covid-19 recovery plan in part dependent on a revitalised trade policy, the key challenge for the future trade commissioner is to show imagination on how to reinvent EU trade policy wherever it makes sense to do so. The question is whether Valdis Dombrovskis has the vision to make it happen.

"…renovation is going to be one of the issues where we can immediately see results, both for the climate but also for economic growth and jobs…"

Frans Timmermans, EU Executive Vice President of the European Commission, speech to EU Environment Ministers, June 2020
(Source: European Commission, 2012)

Since Covid, more public money may be added to the pot. Europe's economic recovery package tackling the economic impact of the pandemic, known as Next Generation EU, will also prioritise green and digital investments and provide subsidies to help drive the change needed. To access this central funding, each national recovery and resilience plan will have to include a minimum 37% of climate relevant spending as well as committing at least 20% of expenditure on digitalisation.

Beyond public funds, change will increasingly be driven by demand from society, shifting commercial attitudes and business models. People and communities are increasingly paying more attention to the values of the companies they work for, the companies they invest in or the products they choose to buy. Beyond the reputational risk, an increasing number of corporates in multiple sectors are taking a leadership role largely driven by the demands of their investors, employees and their customers, leveraging the significant new business opportunities that it creates. The need for integrated corporate ESG and Sustainability strategies will become increasingly important

How emerging legislation will affect the real estate industry

Real estate development

- Emissions Trading Standards (ETS, 2021): The Commission will assess the extension of ETS to include buildings. Like CBAM, it would bring an additional source of revenue to the EU budget, which will be needed for the repayment of the recovery fund
- Revision of Renewable Energy Directive and the Energy Efficiency Directive (2021): With a focus on decarbonizing heating and cooling, it will target minimum renewable energy requirements in buildings.

Real estate asset managers

- A new directive on sustainable corporate governance (Q1 2021): will require companies to focus on long-term sustainable value creation rather than on short-term benefits, by aligning the interests of companies, their shareholders, managers, stakeholders and society
- A review of the non-financial reporting directive (Q1 2021): will require large companies (more than 500 employees) to disclose non-financial information on their social and environmental impact. Incorporating responsible investing into the investment process will therefore be key, as society will increasingly be able to hold companies accountable for their environmental and social impact.
- The building sector is also mentioned in a recently surfaced unofficial draft of a Delegated Act, which will serve as a basis for the upcoming EU Taxonomy regulation (to enter into force in 2022). Therefore, a technical screening criteria to assess whether investments contribute to climate change mitigation will be laid down for the construction of new buildings, for their renovation, installation of different energy efficiency equipment, on-site renewables, provision of energy services, and for acquisition and ownership of buildings.
- Change will be driven by the increasing role of commercial ESG and Sustainability strategies

Construction and renovation

- Carbon Border Adjustment Mechanism (CBAM, Q2 2021): An initiative that has gained in significance since the outbreak of the pandemic, its aim is to ensure equivalent carbon costs between imports and goods produced in the EU and it will mainly affect sectors like aluminium, iron and steel, in which carbon leakage is high. the Commission has listed the CBAM as one of the repayment options for the recovery fund, which will be repaid between 2028 and 2058.

What should companies be doing?

Never before has the real estate sector been in the spotlight of EU climate legislators. As a regulatory landscape is being created, stakeholders will need to make their voice heard. The European Commission has always been committed to listening closely to industry. However, stakeholders will need to get involved, to ensure a seat at the decision-making table. To have a greater share of voice will require the formation of alliances with like-minded industry players to align on common positions, provide supporting evidence and prioritise concerns and opinions.

It is crucial to be aware of what is on the horizon; stakeholders that anticipate upcoming deadlines will always have a competitive advantage and will better positioned to anticipate the many challenges ahead. It will be just as important to identify the relevant actors involved in each legislative file in the relevant Commission department. It's a train ready to depart: get informed, get engaged and get onboard.

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