

The future of commercial real estate is written in green: Debt financing the transition

Written by



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In brief

- ▶ Industry experts estimate that approximately €300bn of debt finance could be required to fund the capex needed to bring commercial real estate assets across Europe in line with environmental standards
- ▶ Demand for credit will create significant lending opportunities for both Banks and Non-Bank Lenders
- ▶ The increasing prominence of Sustainability is changing attitudes towards commercial real estate
- ▶ The issue of “stranded assets”, created by climate change and the transition to a low-carbon economy, has escalated considerably on the international and national agenda in recent years
- ▶ The real estate industry is seeing signs that buildings which aren't sustainable are facing a ‘brown discount’ on rental returns and sales value
- ▶ Operators are modifying business models to include refurbishment projects to futureproof income streams and attractiveness to potential tenants

Ensuring that new buildings are sustainable and energy-efficient is key to global efforts to tackle climate change. Sustainability in modern offices takes many forms but has been predominantly introduced at design stage, rather than through renovations - what does this mean for older, less sustainable, buildings? Will older buildings become obsolete as they will not be up to spec from an environmental standards point of view?

With awareness of climate change and sustainability at an all-time high and Ireland's ambitious Climate Act actively pushing to Net Zero emissions - it is no longer enough for organisations to set ambitious net zero carbon targets without a clear pathway for how to achieve them. The real estate choices that an investor or occupier makes will either enable their net zero carbon journey or obstruct it.

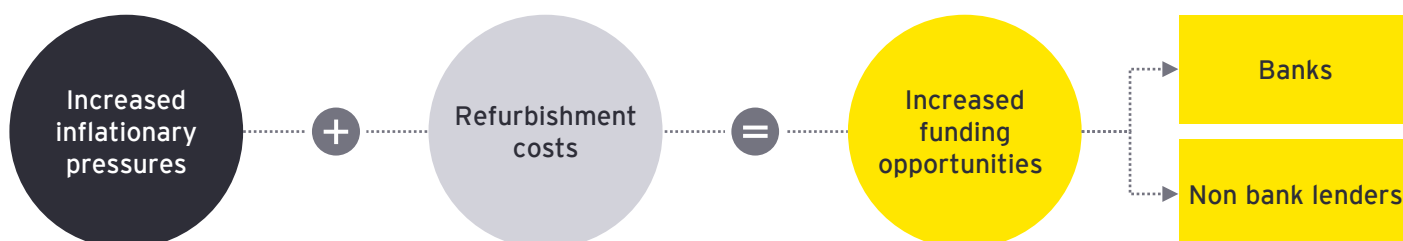
This is manifesting itself in green building policies, the leasing of workspaces with green building accreditations, and investment in solutions to improve energy efficiency. Sustainability is impacting real estate valuations, with valuers placing greater emphasis on energy rating certificates. Buildings which are not sufficiently energy efficient are being marked down and could, in time, become *stranded assets*, leading to direct and indirect impacts on investment strategies and liabilities.

What are Stranded Assets?

When you hear "stranded assets" you may think of oil and gas reserves left in the ground as the market increasingly swings towards renewable energy. However, as climate change and ESG requirements are shifting the landscape and expectations of the real estate industry, the phrase is also being used to refer to older commercial real estate assets whose value could be adversely impacted with the shift towards greener buildings.

Retrofit: from Brown to Green

Older buildings will require substantial capital expenditure to meet market expectations and/or future regulatory standards. This will result in not only the need for refurbishment but for vast structural changes - creating opportunities for investors that are prepared to take on development risk to enhance investment returns and lenders willing to finance the works.



Given the risk associated with substantial capex refurbishment projects, non-bank lenders will be better positioned to underwrite this type of project. Banks will also play a critical role providing the post-refurbishment take-out financing, which is more suited to their core property approach.

Despite the recent exit of Ulster Bank and KBC, the Irish debt market remains well serviced by both national and international capital providers. The non-bank lender sector in particular has experienced significant growth over the past 5 years, with EY Debt Advisory having relationships with 60 active lenders.

Embodied Carbon – Another Consideration

With the ESG Agenda at the forefront of business strategies, the impact of embodied carbon on the carbon footprint of a building should also be taken into consideration.

Put simply, embodied carbon is the carbon footprint of a building or infrastructure project before it becomes operational. It also refers to the CO₂ produced maintaining the building and eventually demolishing it, transporting the waste, and recycling it.

Over 80% of buildings that will exist in 2050 have already been built, meaning that retrofitting will be pivotal in achieving net zero targets. Refurbishing a building creates far fewer emissions than constructing a new one. Older buildings refurbished to include modern and sustainable technologies are set to be the real sustainable buildings.

There are currently no definitive plans in Ireland to regulate or monitor embodied carbon but there are a number of indicators that this is likely to happen over the next five to ten years. Holland and France have already introduced regulations, with Finland set to introduce regulations in 2025 and other countries likely to follow.

In 2006, green building certifications such as LEED and BREEAM were novelties but are now the norm for commercial, residential and many public sector buildings. With the movement towards a greater emphasis on recognising the embedded value of existing buildings, this is likely to become a mainstream consideration in the years ahead.

The Future is Green

In 2021, the Irish Government approved the 'Climate Action and Low Carbon Development Bill' committing to cut carbon emissions by 51% by 2030 and reach net zero carbon by 2050. The introduction of this legislation is part of a global effort to become carbon neutral by 2050, with the EU and UK also committing to this goal. Real estate is fundamental to achieving these objectives, given that it accounts for 40% of all global carbon emissions – RE100, the Global Corporate Renewable Energy Initiative, suggests that new buildings must operate at net zero by 2030 and 100% must operate at this level by 2050 if this target is to be achieved.

Sustainable buildings have the potential to generate a rent premium, however, as sustainable buildings become more of the norm, some assets are being left behind, creating a “brown discount”. Market research suggests that this could be as high as a 30% reduction, leading to significant impacts on the values of real estate portfolios. To remain leasable, these assets will require retrofitting.

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It is critical that we place an appropriate value on the carbon we have already committed to in our built environment. Incurring new construction related carbon will of course be necessary, but it should be the least favoured option. Not only to avoid embedding more carbon, but also to limit our encroachment on natural assets and ecosystems. We need to continue to promote compact building and density such that as well as reducing our carbon footprints, we are also promoting biodiversity and natural asset protection.

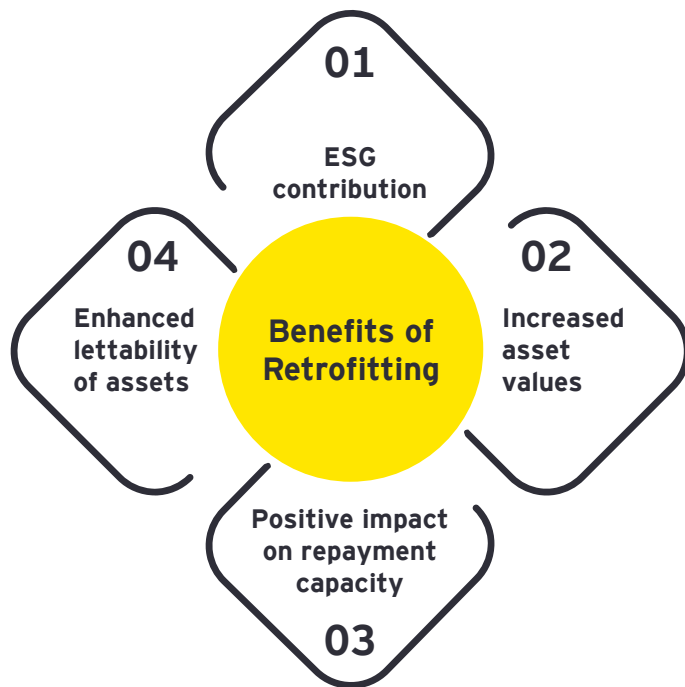
Our goal should be, in so far as possible, to retrofit what we have and further reduce our energy demands through behavioural change and process design.

Building a new shiny building might feel like the most sustainable choice and will be “brand aligned” for many major corporates, but giving that old existing building the attention it needs is likely to be the real sustainable choice.



Stephen Prendiville

EY Ireland Head of Sustainability



Summary

With the requirement for investments to be seen through a green lens, the capital that businesses need to grow is flowing towards sustainable projects. As more companies embed ESG aims and emission reduction targets into their strategies, we can expect capital to continue to be invested in sustainable real estate solutions, the retrofitting of inefficient spaces, and property technologies for measuring and improving buildings' operational carbon footprint.

As occupiers are increasingly demanding green and sustainable space, the divergence between 'green' and 'brown' assets in terms of occupancy, rent levels and capital values is expected to further diverge.

For real estate landlords making assets energy efficient isn't a choice anymore.

Given the complexity and nuances of financing the transition, as well as the undoubted call on debt capital, we recommend talking to your advisors early so as to have a well thought out coherent business plan prepared, and the most appropriate debt funding partners identified.

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