LEGAL BRIEFING – Real Estate

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Sustainability – A green premium or a brown discount?

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Is it the next big thing? Is it already here? Is it worth the hype? Let’s see.

Fact: Stakeholders across all sectors of the economy are showing a growing interest in sustainable development of their businesses. The real estate industry, which accounts for 39% of energy-related CO_2 emissions globally, is no stranger to this trend. Over the last couple of decades sustainability-minded features have been promoted from niche products to essential ingredients of a successful investment in real estate.

Sustainability in real estate basically consists in properties that emit minimal greenhouse gases and produce less waste at all phases of their life cycle, thus preventing climate change and preserving the environment for future generations. The concept is present in all phases of real estate: from construction, through the use of responsibly sourced and recycled building materials (in both new buildings and when retrofitting existing structures)[1], to operation, which aims at a minimal environmental footprint through the adoption of energy-efficient and renewable energy technologies (such as improved insulation, rooftop solar panels, LED lighting and drain water heat recovery, as well as the implementation of eco-friendly waste management systems), and all the way through to the refurbishment or dismantling of a structure at the end of its life (rather than it simply being demolished and replaced by freshly extracted materials).

So, where does the market stand?

[1] A sustainable trend is the modular construction, a building method where a building’s components are manufactured off site; certain progressive hoteliers take pride in it being their established practice.

Fact: The general perception is that sustainable buildings call for higher initial costs. This might explain why a number of developers are discouraged from "going green". The dozens of different green building certification systems existing worldwide have not been of much help in developing a clear formula to measure the market value of sustainability features.

But, also fact: The actual cost of green buildings is "dramatically overestimated"[2]. Plus, sustainable investment in real estate is generally associated with longer amortization periods, as it is expected to pay off in the medium and long run, while it may also benefit the potential tenants and operators through energy and operations savings more than the investors themselves.

Fact(s): Empirical evidence proves that sustainable buildings exhibit increased market values compared to traditional properties and that sustainability is bound to become a significant value driver in the future.

- Since energy-efficient modifications result in **reduced running costs**, they represent extremely attractive opportunities for tenants, occupiers and hotel managers, and are thus capable of bringing an important premium in rental income.
- The **branding advantages** of owning and/or operating sustainable real estate are rather obvious, as, in the near future, the majority of stakeholders in the industry (from investors and hotel managers to tenants and customers) will likely be coming from environmentally-conscious generations and will be genuinely seeking eco-friendly qualities in their business and leisure activities[3] .
- Commercial and financial practices around sustainable real estate investment have gained notable momentum in recent years. Firstly, **ESG[4] due diligence** has clearly become an international trend; more and more real estate investors, already familiar with the practice of measuring the most intricate forms of economic, market and credit risk, are now carefully gauging social and climate risks when purchasing real estate assets or appraising the policies of potential managers. Secondly, many major corporations have realized the benefits of green buildings

[2] https://www.usgbc.org/articles/green-building-costs-and-savings: The public believed, on average, that green features added 17% to the cost of a building, whereas a study of 146 green buildings found an actual average marginal cost of less than 2%. https://thesustainabilist.ae/is-it-affordable-to-build-green/: The data shows that more than 60% of people believe that the cost of green building practices and processes is considerably higher than conventional building. A study conducted by the World Business Council for Sustainable Development (WBCSD) indicates that the cost of installing green building features and technologies is significantly overestimated, as the research participants perceived that the upfront cost of a green building is, on average, 17% higher than the original cost of a similar traditional building. While according to the U.S. Green building Council (USGBC), the initial cost of a green building is only 2%-3% higher than its non-green counterpart.

[3] A challenge in this sector for the hospitality industry is that implementing carbon reduction initiatives can be seen to be at odds with providing a luxury service to guests. Often, guests at luxury hotels expect bedsheets changed and new towels provided daily and are not willing to go without air conditioning in hot climates. However, a 2019 survey by Booking.com revealed that this is already the case not only with millennials, as 74% of global travelers aged 46-55 strongly believe that people should start making sustainable travel choices:

https://globalnews.booking.com/bookingcom-reveals-key-findings-from-its-2019-sustainable-travel-report/

[4] ESG stands for "Environmental, Social and Governance". I had to google it a couple of years back and was embarrassed to confirm it was totally unrelated to the EKG.

and are now demanding that sustainability provisions be included in their lease agreements ("**green leases**"). Conversely, owners of obsolete properties are most likely to resort to "brown discounts" in a questionable attempt to remain competitive. Thirdly, the "**green bond**" market has been growing at an exponential rate, with issuers ranging from financial institutions and non-financial corporates to government-backed entities, local and central governments, offering a more attractive source of finance for environmentally-friendly projects in the real estate and hospitality sector.

A couple of domestic examples?

Absolutely. In December 2017, the EBRD approved a €21.5 million equity contribution to a joint venture with Dimand S.A., a leading Greek real estate developer and construction services provider, in order to invest in sustainable real estate and hospitality projects (e.g. office buildings, student accomodation, city hotels).

In March 2019, the EBRD approved a €50 million loan in favor of Prodea REIC (then NGB Pangaea), the largest real estate investment company in Greece, in order to support Prodea's sustainable investments.

See, it's happening here, too.

And where does the EU stand?

Major EU policies announced since the signing of the Paris Agreement in 2016 have formed a uniquely favorable backdrop for implementing sustainable real estate investments.

<u>Fact</u>: On 11 December 2019, the Commission presented the European Green Deal, a general roadmap to making the EU climate neutral by 2050.

<u>Even more recent fact</u>: On 14 January 2020 the European Green Deal Investment Plan was introduced, destined to mobilize at least **€1 trillion** of public and private sustainable investments over the next decade. In this context, on 18 March 2021 the EIB signed two agreements **to supply Greece** with a long-term financing of €875 million for the implementation of the *"Electra"* energy efficiency programme for public buildings and the *"Antonis Tritsis"* sustainable urban investment scheme.

In terms of hard law, the Taxonomy Regulation (2020/852) entered into force on 12 July 2020, entrusting the Commission with creating the world's first-ever "green list" – a classification system of environmentally sustainable economic activities, while the first relevant delegated act was published on 21 April 2021, providing the first set of technical criteria to define *"what is green"*. On the same day, the European Parliament and the European Council reached a provisional agreement on the first-ever European Climate Law, as proposed by the Commission, which targets to reduce net greenhouse gas emissions in the EU by 55% by 2030.

But what about the pandemic?

The political and social currents flowing towards a future of sustainable development have remained strong despite the economic obstructions of the COVID-19 pandemic, this being perhaps the most reassuring observation. Not only does the EU's financial plan to mitigate the impact of the COVID-19 crisis (the *"Recovery and Resilience Facility"*) provide that a minimum of **37% of outlay on investments and reforms** in each national plan should support climate objectives, but a coalition of global corporate leaders called *“**Leaders on Purpose**”* (which includes CEOs from Danone, Interface, L’Oréal, Mastercard, Philips and others) have released a historic **open letter** committing towards an inclusive and sustainable economy post-COVID. For its part, the United Nations World Tourism Organization has put emphasis on a *“responsible recovery of the tourism sector”* and on 4 May 2021 the G20 Tourism Ministers welcomed the Organization’s Recommendations for the Transition to a Green Travel and Tourism Economy.

Why should I care?

Because it’s here.

Even if the green premium is still debatable, the brown discount is practically a fact[5]. According to Savills, *“the standards that companies expect from the properties they occupy are getting higher and buildings that do not meet them will be left with fewer tenant options and space that becomes harder to lease”*. And ESG is now part of the due diligence process for all types of real estate assets[6].

Sustainability is the current big thing. It’s now. And it’s worth the hype for more reasons than one. Embrace it, or this might be your Kodak moment.

We’ll leave you with a wise word from T.S. Eliot:

“For last year's words belong to last year's language.
And next year's words await another voice”.

[5] https://www.savills.co.uk/research_articles/229130/313147-0

[6] According to the 2020 EY Climate Change and Sustainability Services (CCaSS) Institutional Investor survey, of the 98% of investors surveyed who assess ESG, 72% carry out a structured review of ESG performance, compared with just 32% in the previous survey conducted two years earlier. Many of those who currently use an informal approach, plan to move to a more rigorous regime (39%). https://www.ey.com/en_gl/assurance/why-esg-performance-is-growing-in-importance-for-investors