Property sector yet to face its emissions reckoning

First Sentier Investors

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The full scope of the real estate securities sector's contribution to global carbon emissions has not been fully quantified, which could potentially impact the valuation of listed companies not moving towards emissions measurement and disclosure from modernisation programmes.

The mismeasurement and potential mispricing of companies is in part due to the World Business Council for Sustainable Development Greenhouse Gas (GHG) Protocol Definitions not translating well enough.

It's the so called embodied carbon emissions (emissions associated with everything but the operating asset) – rather than the more apparent operational carbon emissions – that could end up surprising investors as more awareness comes to market or regulatory bodies bring in more rigid guidelines.

To get the full picture of the risks and opportunities, investors need to look at how companies are identifying, measuring, addressing, reducing, renewing and supplementing their carbon reduction and renewable energy ambitions, not just how they operate their assets.

We have developed a carbon assessment methodology that allows us to position the strategy appropriately given the structural ESG tailwinds by integrating comprehensive carbon emissions assessment into our investment process so that we can value companies more accurately and mitigate any risks and associated costs of carbon.

This is the first in a series of articles that will draw insights and findings from a methodology we developed in-house to better measure the sector's emissions profile.

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State of the sector

The real estate sector is one of the largest emitters of carbon comparatively, accounting for approximately a third of the world's emissions, according to the World Green Building Council (GBC). Unfortunately, the sector does not have a standardised methodology to account for the full scope of carbon emissions produced from embodied carbon associated with modernisation programmes.

Although some listed property companies are currently demonstrating advanced carbon reporting standards through their annual sustainability reports, a lack of critical carbon disclosures broadly highlights the need for a more collective push as the sector moves towards net zero by 2050.

Embodied carbon disclosures, for example, will be crucial in showcasing the emitting activities of the sector which have previously been too hard to report. Currently, the building sector sends 13% of materials delivered to a construction site straight to landfills without ever being used, the World GBC highlights. Demanding more advanced reporting standards will help rid the industry of such inefficiencies as we continue to build for the future.

Looking at the operational emissions of an asset, a large proportion of an assets operational emissions are derived from heating and cooling systems that in many countries generate power from fossil fuels. To counteract operational emissions, many companies are investing in more efficient plant and equipment and, where the energy is controlled, are looking to procure the required mega-wattage from renewable sources.

At present, progress towards net zero for listed property companies in our investment universe is advancing at a fast rate, with market leaders demonstrating robust reporting standards and a general consensus that doing nothing is no longer an option.

Some progress is being made

The EU's Energy Efficiency Directive and the Energy Performance of Buildings Directive provide a solid framework to achieve these targets; yet for this to happen strong implementation is required.

However, the EU still missed its 2020 operational energy efficiency targets because the European building stock is not being renovated at the rate and depth needed to achieve their targets.

In order to bring their energy emissions back in line with the advancing global net zero ambitions, the European Commission will need to encourage Member States to develop and implement 'nearly zero' energy strategies that go beyond the World GBC directive so all new buildings are net zero carbon by 2030.

The International Energy Agency estimates that direct building CO_2 emissions would need to decrease by 50% and indirect building sector emissions decline through a reduction of 60% in power generation emissions by 2030 to meet 2050 targets. These efforts would need to see building sector emissions fall by around 6% per year from 2020 to 2030. For comparison, the global energy sector CO_2 emissions decreased by 7% during the pandemic.[1]

While much attention is focused on new, state-of-the-art buildings that achieve the highest sustainability certifications, 70% of buildings stock today will still be here in 2050, according to property services company Jones Lang LaSalle.[2] This projected glut of building stock highlights the need to repurpose spaces, retrofit older buildings and refurbish in line with World GBC guidelines. Combined with this, the embodied carbon from building modernisation needs to be measured, target reductions put in place and all resulting emissions fully offset.

Investment opportunity

We believe that ESG alignment, particularly in net zero efforts, will actually improve long-term shareholder returns, giving our clients access to the most attractive risk-adjusted returns within our investment universe. Our proprietary carbon analysis methodology enables accurate assessment of carbon emissions from the following areas: portfolio modernisation (inclusive of development, re-development and capital recycling programmes of companies), renewable energy procurement (purchasing of energy), carbon offset programmes, embodied carbon and on-site renewable energy generation. We will continue to break down aspects of this methodology in future articles in this series.

Already we are starting to see greener assets attract greater levels of tenant demand, which we believe is only the start of a strong structural theme that will last for decades.

The World GBC's recent Beyond the Business Case report found that leasing activity for new, grade-A office buildings in central London with a BREEAM rating of "very good" or higher, achieved on average 10% higher rents than those without a rating. So-called leasing "velocity" also improved, with lower vacancy rates of 7% – compared to 20% – for those rated "very good" 24 months after completion.[3]

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It is becoming increasingly clear that with the rapid expansion of sustainability in real estate investment, the value of your asset – no matter where it is or what type – will be impacted by increased obsolescence or stranding of properties that do not meet occupational, investor and legislative sustainability standards.

We believe that buildings with better efficiency ratings will continue to attract higher rents, will typically have lower running costs and will be more appealing to tenants which we believe will continue to drive performance over the long term.

1. 2020 Global Status Report for Buildings and Construction
2. The 10 Green Building Principles aiming to get real estate to Net Zero – JLL
3. World GBC – Beyond the business case

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