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REAL ESTATE: GREEN IS THE ANSWER

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ESG – the new mainstream

ESG stands for Environmental, Social and Governance, and refers to three central factors in measuring the sustainability of an investment.

In a nutshell: (i) environmental criteria examine how a business contributes to and performs on environmental challenges, (ii) social criteria envisages to assess how the company treats its own human resources, while (iii) governance criteria determines how a company is governed (e.g. tax practices and strategy, corruption and bribery, and board diversity and structure).

Even though ESG principles have been considered a key factor for companies over the past few years, the pandemic has taught us that sustainability is not just about tackling environmental risks but much more. More than a trend, ESG criteria are currently a critical factor for corporate entities as political and peer pressure increases.

Awareness around these matters is not only a focus for corporate entities as it has driven the European Union to approve the European Green Deal, which sets forth a new growth strategy towards a modern and efficient economy, comprising several actions, including (i) developing environmentally friendly technologies; (ii) decarbonizing its energy production and (iii) increasing the energy efficiency of buildings.

Within this context, real estate, as one of the sectors that most largely contributes for carbon emissions and consumes significant global energy and resources, constitutes one of the greatest potential opportunities to address environmental issues including climate change, while also creating economic opportunity for investors and asset owners.

Market transformation to a more efficient, more sustainable real estate sector will require an astounding amount of capital, and green bonds have emerged as a potential and promising financing source by raising capital to improve the environmental credentials of buildings.

Green Bonds

Bonds are debt securities representing loans made by investors to an issuer, which the issuer must then repay within a certain period (and/or in instalments); the issuer usually also pays interest on borrowed funds: a very standard and plain vanilla instrument in the securities markets.

Nevertheless, to be able to call their bonds *"green"* an issuer needs at least to state that it will use the proceeds obtained from the issuance towards green activities/investments (other requirements may need to be added to ensure marketability, such as certification of the characteristics of the activities/investment by independent third parties and even reporting requirements).

What exactly are green activities/investments, though? Everyone has an opinion but no one really knows because there is no legal framework or uniform taxonomy (yet – the European Comission is exploring the possibility of a legislative initiative for an EU green bond framework for a while now), although market standards are already around.

As company's ESG targets (both mandatory and voluntary) tend to increase, issuers that are able to commit to investing the proceeds of their bond issuances into green projects suddenly have a real possibility to expand their investor base: investors with the need to meet their ESG quotas. This increasing demand may ultimately even mean that these issuers will also able to lower their coupon rate. On the other hand, applying the proceeds of its issuances in green projects may in itself be a way for the issuing company to ensure compliance with its own ESG targets.

Having stressed the major upsides, we cannot ignore the major drawbacks: documenting and reporting the green feature of a bond has a cost, including fees for external bodies performing secondary opinions or third-party certifications, which the issuer will have to bear.

The real estate market is no exception to the green fever, and you theoretically could came up with almost endless ways to get the green label: construction and real estate investment activities including new development projects, land preservation easements, the retrofit of underperforming buildings, and the refinancing of existing high performance buildings, for example.

You can also evolve the plain vanilla bond to fit best the specific purpose and/or target investors. Just a flavour: if the aim is to transfer project risk to the investor, project green bonds (with bond revenues linked to the project revenues) may be the answer; if you want to tranche risk while taking a real estate loan portfolio off the balance sheet, securitised green bonds may be what you are looking for.

The future is here: ELPRE - Long-Term Strategy for the Renovation of Buildings

As mentioned, the real estate sector is well positioned to address long term environmental issues including energy and water consumption, waste management, tenant health and safety, and community impacts.

Directive (EU) 2018/844 of the European Parliament and of the Council of 30 May 2018 (which amended Directive 2010/31/EU), on the energy performance of buildings, established that each Member State shall establish a long-term renovation strategy to support the renovation of the buildings, both public and private, into a highly energy efficient and decarbonised building stock by 2050, facilitating the cost-effective transformation of existing buildings into nearly zero-energy buildings.

The Portuguese Council of Ministers has recently approved the Long-Term Strategy for the Renovation of Buildings (ELPRE) to be implemented until 2050, which forecasts the renovation of 100% of the buildings (existing in 2018) within that timeline.

ELPRE establishes a roadmap for the energy renovation of the existing national stock of residential and non-residential buildings with different milestones to be met in 2030, 2040 and, finally, 2050 and a global estimated investment of approximately EUR 143 billion.

To achieve these main goals, ELPRE's strategy encompasses and focuses on 7 main areas:

(i) Renovation of the existing buildings (enabling funding mechanisms for the energy renovation of the target buildings).

(ii) Development and promotion of smart buildings.

(iii) Reinforcement of the existing legal framework of the energy certification.

(iv) Enhance training and professional qualifications in the field of energy performance of buildings.

(v) Tackle energy poverty, by reducing the energy charges and supporting financially vulnerable households with the process of energy renovation.

(vi) Provide information and awareness on the benefits arising from the renovation of buildings.

(vii) Monitoring the progress of the strategy plan.

Take Aways

It seems undebatable that the real estate sector players would not be able to ignore environmental concerns both in new developments and in the renovation of existing buildings even if they wanted to.

Green bonds may therefore be an interesting route both for (i) asset owners / developers seeking to finance their projects and (ii) investors that take ESG principles on board in their investment decisions. This symbiosis can actually end up to be profitable and a further step to more sustainable businesses (and hopefully a more healthy planet!).