European Commercial - December 2022

SPOTLIGHT
Savills Research

European Office Obsolescence

Challenges and Opportunities

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• Stranded assets • Value-add opportunity • Capital expenditure

The challenge

Key points:

- **Significant proportion of office stock at risk.**
- **Green financing will help to bridge the undersupply of EPC compliant office space.**
- **72% of investors are willing to undertake a 'manage to ESG' investment strategy.**
- **Landlords are increasing retrofitting of existing space to reduce net carbon emissions.**
- **Value-add investors with cash on their balance sheets will seek to redevelop secondary assets into prime.**

According to the International Energy Agency, the built environment produces approximately 40% of annual global carbon dioxide emissions, with 27% accounted for by building operations. Across the UK and EU, increasing focus is being placed on the role the real estate sector has to play in reducing greenhouse gas emissions (GHG) and achieving wider European climate targets. With approximately two thirds of global building stock that will exist in 2040 already built today, a widespread decarbonisation strategy is needed as refurbishment and circular economy principles gain steady momentum.

The sustainability agenda in the real estate sector is being driven by a rapidly advancing EU regulatory framework. The European Green Deal is the main growth strategy to transition the EU economy to a sustainable model and move towards net zero by 2050. The Green Deal is strategically relevant for real estate companies – it will impact business models, market demand and financing conditions. Under this framework, a revision of the Energy Performance of Buildings Directive (EPBD) in December 2021 proposed new EU-wide Minimum Energy Performance Standards (MEPS), which state that public and non-residential buildings will need to be improved to at least energy performance certificate (EPC) level 'F' by 2027 and 'E' by 2030 on an EU revised A-G scale of EPCs. The recast EPBD aims to accelerate energy-efficient renovations in the worst 15% of EU buildings.

While some markets are implementing legislation that is more restrictive and going above the minimum standards, others are yet to act. In September 2022, the European Commission has lodged severe complaints with Belgium, Austria and Germany for failing to transpose the 2018 Energy Performance of Buildings Directive (EPBD) into national law.

Tightening legislation and mandatory disclosures are increasing the risk associated with stranded assets within real estate portfolios. A 'stranded asset' is a property that will fail to meet future energy efficiency regulations or market expectations, and as a result face obsolescence. We expect to see investors become more ESG conscious and avoid assets at risk of stranding or incurring penalties by failing to comply with legislation. The value of an asset is likely to be impacted if it does not meet occupational, investor and legislative standards. Despite this, the UN estimates that only 1% of the EU building stock is renovated each year.

The EU Taxonomy is a classification system created to establish which economic activities are environmentally 'sustainable', aiming to inform investors and minimise 'greenwashing'. Companies in scope of the Corporate Sustainability Reporting Directive (CSRD) will be required to report on the proportion of their activities that align with the Taxonomy.

Under the Taxonomy regulation, EPCs are receiving further attention and a more thorough screening process. For the acquisition or ownership of commercial buildings, the Act states that any property constructed before the end of 2020 will need an EPC class 'A' or higher or fall within the top 15% of the national building stock to comply. This is set to further speed up the transition to energy efficient-buildings.

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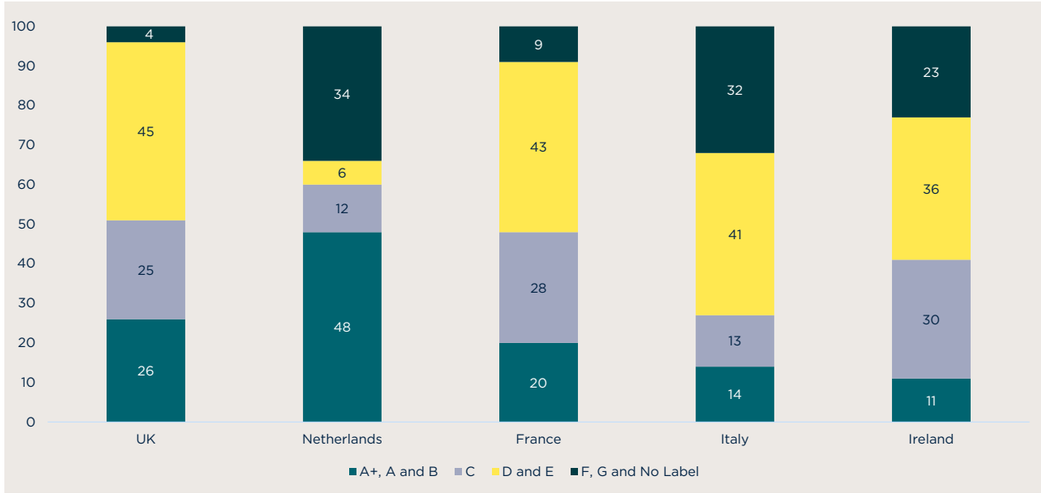
EPC analysis - the regulatory cliff-edge

The following analysis was based on available data in each market, and therefore will be used as a representative sample as not every asset has an EPC label. The UK Minimum Energy Efficiency Standards (MEES) regulation proposes that existing commercial property must achieve a minimum EPC rating of E by April 2023, with plans to increase to C by 2027 and B by 2030. Even tighter regulations are being implemented in the Netherlands where from January 2023, all office buildings will require an energy label of C or higher with penalties for non-compliance. From 2030, the Dutch Government intends to increase this to an A label. Based on these trigger dates, Savills Research has categorised the EPC classes into four quartiles: A+, A & B, C, D & E and F & G. By 2030, under EU-wide MEPS, category F and G will be obsolete. While available data was collected for the five below markets, EPC data is limited across other European markets.

74% of offices are below the required EPC B in the UK in 2030 and 40% do not have the required EPC C in the Netherlands in 2023 (30% have no label, meaning that these properties will need to get an EPC before any lease renewals), presenting a huge risk for capital returns due to the proposed regulatory changes in these countries. There are exemptions from EPCs and not all stock has to have an EPC at present, but regulations are changing. In addition to the UK and the Netherlands having additional EPC regulations, the Décret Tertiaire in France is a binding regulation that sets out the reduction of energy consumption in existing tertiary use buildings, with a target of at least 40% reduction in 2030, 50% in 2040 and 60% in 2050. While only 9% of sampled stock in France is at risk under the EU EPC E by 2030, to achieve a 40% reduction in energy consumption by 2030, improving the energy efficiency of office buildings of a larger portion of the stock will be necessary. 32% and 23% of offices with known EPC ratings in Italy and Ireland respectively are at risk of obsolescence in 2030, providing opportunities for value add investors.

Chart 1: Proportion of office stock relating to each EPC label



Source: Savills Research

* For office stock where EPC ratings are provided on national building registers

**Known no label only applies to the Netherlands, 30% unlabelled

Strong green occupier demand

Demand for best-in-class space intensifies

In addition to more stringent legislation coming into effect across Europe, investors also face pressure from occupiers who are prioritising ESG-compliant buildings and are prepared to pay a premium for the best-in-class space. Maintaining a positive reputation and attracting the best talent are two contributing factors to corporate ESG strategies. Occupier behaviour is driven by the collective push to sustainability and many companies have launched their own targets aimed at achieving net zero. For example, in September 2022, GSK announced the launch of the Sustainable Procurement Programme which will require suppliers to make sustainability commitments in areas including emissions and heat. One environmental goal includes reaching 100% renewable electricity usage and good water stewardship at all GSK sites by 2030. Looking ahead, we can expect rising vacancy rates in dated, non-compliant buildings as corporate strategies seek best-in-class space. Whilst at country level, governments will introduce their own regulation, corporate occupiers will demand a minimum EPC as part of their ESG strategy, which will impact office space in all geographies.

Undoubtedly, the integration of ESG targets into corporate strategies has increased the demand for sustainable and green-certified properties, which in turn is driving prime rents and creating a green premium. Amsterdam saw the highest rental growth y-o-y in Q3 2022 at 16%, despite the overall vacancy rate increasing by 1.2% between Q4 21 and Q3 22, indicative of a two-tier market between prime and secondary stock.

Where the demand intensifies for best-in-class properties, pressure will build to upgrade existing secondary stock to meet the green demand. Research from ESG data intelligence provider, Deepki found that 79% of 250 European pension fund managers surveyed expect commercial real estate with good ESG credentials to provide a green premium over the next five years. One example where a premium has been observed is in Lisbon, where a €23 million office building underwent a €6 million refurbishment, resulting in a marketed price of €40 million that is currently in the BREEAM pre-certification process. Elsewhere, recent analysis from MSCI concluded that there is a 35% capital value premium in Paris and a 25% premium in London for buildings that have a sustainability rating.

Assets without those credentials are at risk of discounting, as additional capital expenditure will be required for refurbishments in the future to meet targets. Poorer rated buildings buildings could see rents underperform and diminish the ability to negotiate on price, therefore impacting liquidity and market value. 40% of pension funds surveyed by Deepki said they had seen 21-30% depreciation due to brown discounting. Value-add investors with cash on their balance sheets may see this as a buying opportunity in 2023.

A further issue comes with lower EPC stock in secondary cities with lower achievable headline rents – enough rental growth needs to be captured through asset management to account for the redevelopment costs to make upgrading financially beneficial to the owner. This raises the question as to what will happen to stock unable to meet EPC deadlines, with financial penalties or taxes a probable outcome.

> “Whilst at country level, governments will introduce their own regulation, corporate occupiers will demand a minimum EPC as part of their ESG strategy, which will impact office space in all geographies.”

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The investment perspective

Core opportunity

With tighter regulation in the UK and the Netherlands, we are expecting a larger portion of office stock to comply with the EU 2030 deadline than other markets given the earlier dates of compliance for higher labelled EPCs. As a result, increased activity from core investors will target these markets. Earlier this year, Aviva Investors acquired the FOZ building in Amsterdam with EPC label A as part of the group's Climate Transition strategy and commitment to reaching net zero across the whole of its £47 billion Real Assets portfolio by 2040. Indeed, data from Savills latest EMEA Investor Sentiment survey shows that 24% of investors will seek to acquire only ESG-compliant assets.

German funds are generally most sensitive when buying core assets, with many funds unable to invest in assets with an EPC label lower than a B. According to the Empira Institutional trends 2022 survey of German investors, nearly 90% consider ESG to be very important, which is significantly more than in the previous year (67%). Corporate ESG strategies are restricting investors over what they are able to invest in, with ‘green’ capital chasing those buildings with the highest credentials. Though with fewer projects in the pipeline due to rising construction costs and tighter financing conditions, green loans offering preferable rates will incentive landlords to invest. Whilst the acquisition of sustainable buildings is an important element of net zero strategies, refurbishment and retrofitting will become necessary to help with the undersupply of Grade-A buildings. The US Energy Information Administration estimate that 75% of the carbon emissions in a building’s life cycle come from the construction process, so more landlords are retrofitting existing space to reduce releasing a building’s embodied carbon.

24% of investors will seek to acquire only ESG compliant assets

Value-add opportunity

Value-add investors may look to markets where there is a higher proportion of stock at risk of obsolescence and in need of capex for green improvements in order to generate a higher return. Data from Savills EMEA Investor Sentiment survey shows that 72% of investors are willing to undertake a ‘manage to ESG’ investment strategy.

Although green certifications do not give a holistic view of the ESG performance of an asset, EPCs are often used as proxies for investors as an energy-efficient building is likely compliant in the ‘environmental’ aspect. Therefore, as part of ‘manage to ESG’ strategies, value-add investors may look to geographies where there is a high proportion of non-compliant stock. German Arminius Group, for example, has recently launched a Manage-to-Sustainability Office fund aiming to seek out real estate opportunities with significant value-add potential in all three ESG scopes. So far, Arminius has identified 30 urban areas in Germany for potential investments, including in Hamburg and Cologne.

The regulatory framework in place means without green credentials, assets will be subject to a discount more so than compliant assets will command a premium. For some funds, a pathway to EPC compliance will be written into plans before assets are put on the market in order to secure their value.

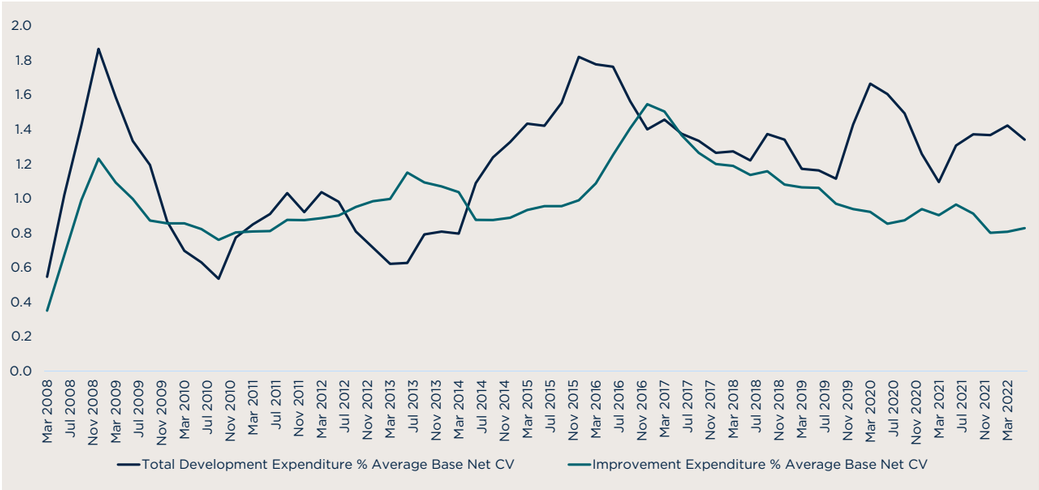
Investors who have a specific brown-to-green strategy are now more common because of increasing regulation. Though for larger-scale refurbishments, it may be difficult to raise capex to manage these assets to core outside of the original management plan.

72% of investors are willing to undertake a 'manage to ESG' strategy

How much will this cost investors?

MSCI data shows that European office improvement expenditure has dropped off to only 0.8% of net capital value, one of the lowest levels since the aftermath of the GFC. This type of expenditure may typically cover replacement lighting and air flow systems, for example, light touch refurbishments that can raise a building's EPC label. Savills Building Project Consultancy (BPC) estimate the average cost of raising an office's EPC rating from D to B is approximately €500 per sq m, although this varies significantly with each asset. With capital value at risk if an asset becomes non-compliant, increasing improvement expenditure presents an opportunity for investors to futureproof the building. Absorbing the cost of this now before hands are forced by tightening regulation allows for early conversations between owners and occupiers over how the cost is negotiated and split. Delaying this means tenants will be more cautious in signing new leases for less energy-efficient buildings closer to 2030.

Chart 2: Development / improvement expenditure as a % of capital value - European offices



Source: MSCI

Green finance

As awareness increases around how the real estate sector impacts the environment, 'green finance' is becoming increasingly important to lenders and borrowers. Finance strategies and the reduced risk associated with investments that consider ESG strategies present an opportunity for more favourable financing conditions such as increased access to green and sustainability-linked loans: sustainability-linked loans have been designed to link borrowing costs to specific company-level sustainability targets. Lenders are becoming increasingly aware of the risk to their loan if borrowers are using capital to invest in non-compliant assets due to the risk of brown discounting. At the point of refinancing a loan, there may be a concern if capital expenditure has not been spent on ensuring the asset is compliant and securing its value.

Elena Rivilla-Lutterkort, Head of Sustainability at Savills France says "both legislative and market drivers for efficient buildings share the requirement to reinvest in existing building stock, the risk of falling behind on the path to 2030, and for legislation to accelerate and move the goalposts in response to known global carbon emission limits should not be underestimated. Mobilising the necessary investment will be challenging as the demand for such investment grows and sustainability-linked financing criteria are strengthened."

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Outlook

Improving the energy efficiency of an office building can bring multiple benefits to investors. Regarding occupier demand, higher occupancy rates can be achieved as tenants seek out more sustainable, greener buildings in a bid to adhere to corporate ESG strategies, attract talent and uphold their corporate reputation. In turn, a higher financial return on the building can be achieved.

As 2030 approaches, decreased rates of depreciation are also an incentive to investors as brown discounting will become more prevalent as assets become closer to the risk of obsolescence. While there is a lack of supply of the most energy-efficient type of asset, those that are compliant are more likely to return a premium while stock is low. The benefit in itself of an energy-efficient building means that landlords with gross leases will see lower utility costs. Where tenants cover energy overheads, green office stock will act as an additional incentive to reduce costs.

At a time of macro-economic instability across Europe, limited financial resources to upgrade buildings to conform to EPC regulations pose issues to developers where construction costs and inflation are high. Where these assets are also located in less desirable locations, they will typically generate a lower rental income which will further complicate the route to EPC compliance.

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Savills Commercial Research

We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.

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