Are climate change regulations making property investment unsustainable?

As COP29 concludes in Baku, the drive of world leaders to meet the emissions targets set out in the Paris Agreement continues to grow.

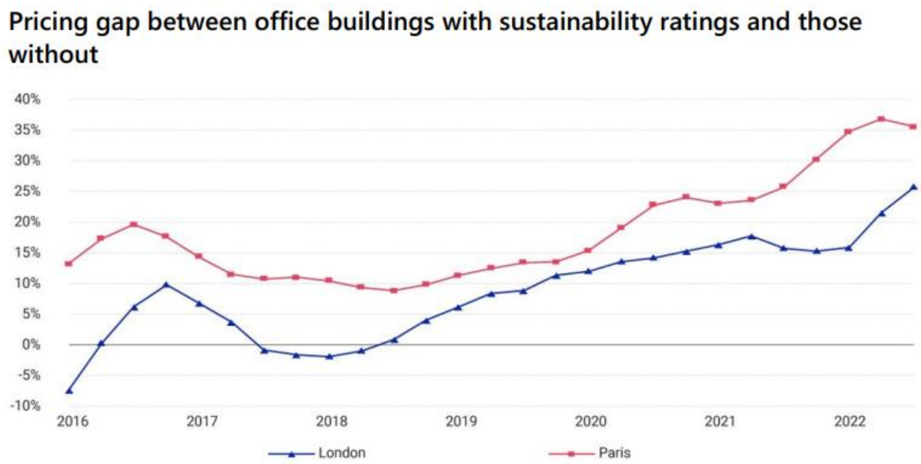
According to Forbes, the global real estate (RE) sector is responsible for nearly 40% of global carbon dioxide emissions, highlighting the need for urgent regulatory intervention. While the Paris Agreement sets the target of achieving net-zero by 2050, the European Union and the UK have set an equally ambitious intermediary goal: a 55% reduction in carbon by 2030. That's just 6 years away!

To ensure the RE sector and the broader European economy achieves these objectives, lawmakers passed the European Climate Law, which established legally binding regulations that aim to achieve climate neutrality by 2050. The UK has similarly published Energy Performance Certificate (EPC) 2030 regulations, which gives each building a specific efficiency rating from A (most efficient) to G (least efficient).

By 2030, EU & UK Energy Performance Regulations will make it illegal to lease office space not complying with minimum energy performance requirements. For the real estate sector to meet these goals, it will require the implementation of several new sustainability practices.

As a result, older buildings that do not meet the minimum criteria will incur penalising carbon taxes due to their inefficiency, and in turn will be required to undergo a costly retrofitting process to improve their energy performance, if they want to remain viable. The cost of the real estate sector's compliance with 2030 regulations, is estimated at a staggering €2.8 trillion. Due to these elevated operating and renovation costs, we expect that outdated buildings will gradually become less desirable to both tenants and owners.

The impact on valuations is clear when looking at the growing pricing gap, as measured on the vertical axis below, between "green" and "brown" buildings in Europe.



Source: MSCI

Death knell or opportunity?

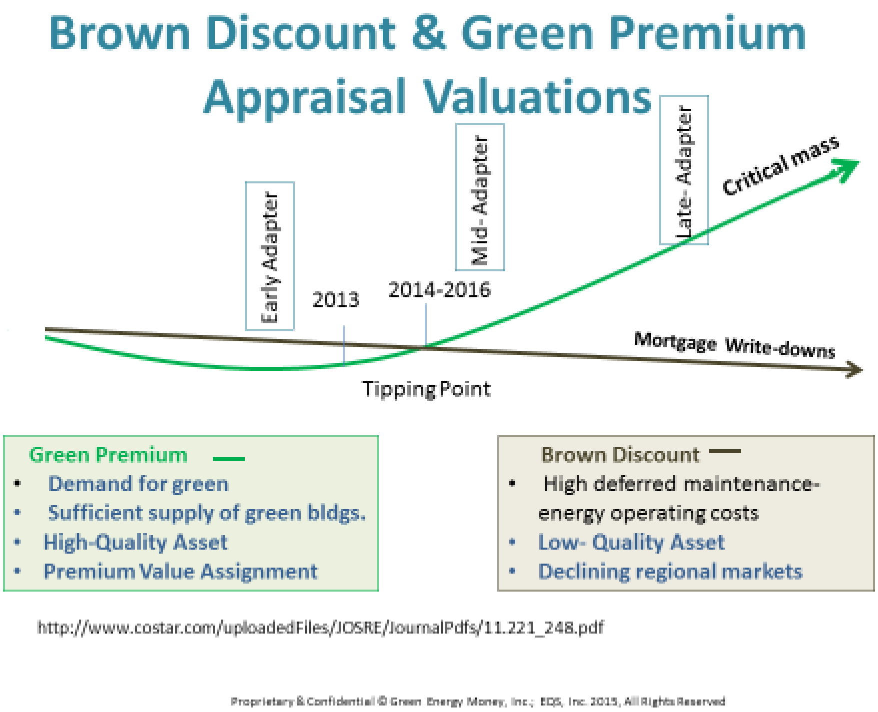
We believe that environmental regulation will be a major return driver for experienced real estate stock pickers.

A recent study conducted by the Bank of England has revealed that high emitting properties saw reductions in value after climate policies were enacted.

Occupiers do not want to lease, and investors do not want to own real estate which does not meet future environmental standards. For example, in London, more than 50% of prospective tenants are demanding green buildings, while less than 15% of London office stock currently complies to the 2030 regulations.

As a result, REITs and property companies who do not consider energy efficient standards in their real estate strategies will experience negative impacts on their returns and asset values as obsolescence rates tick up.

This will force costly investment from all landlords who have not been focussed on gradually improving their buildings. However, landlords who have pro-actively brought their portfolios in line with regulations will benefit from soaring demand for their buildings.



Investment takeaways

Sustainability has been at the forefront of our minds for several years. The Camino Fund scores a 5 out of 5 on Morningstar Sustainalytics' ESG Risk Rating, placing the fund in the top 10% of its peer group. The fund has also earned a Morningstar Low Carbon designation. This is made possible because the manager carefully selects REITs that own properties that score highly on their respective Energy Performance Certificates among other criteria.

In other words, the underlying properties invested in are well equipped to navigate the low-carbon economy transition. In fact, current predictions indicate that during the transition period where demand for sustainability increases, and the supply of net zero carbon buildings remains low, premium returns could be generated.

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As global climate conferences such as COP29 garner ever greater mainstream attention we are reminded of the climate focused targets set for 2050 and even 2030. In response, the real estate sector, a major global carbon dioxide emitter will be forced to undergo a massive transition in the coming years, upending not only how buildings are built and operated, but also how one invests in property. For investors to prosper in this environment we believe it is critical that a climate forward approach is adopted, both for the betterment of the environment and the growth of your investments.

To learn more about how we are positioning our real estate portfolio for the transition to net-zero please reach out to info@globalcap.co.za.

Visit us at www.clearancecaminofund.com.