



ESG Talks: Opportunities & Challenges in Real Estate Investment Management Edition #4

Series Background

ESG (Environmental, Social and Governance) is arguably one of the most discussed topics in the real estate industry, driven by growing public interest in sustainability and new regulatory requirements. Real Estate Investment Managers (REIMs) in particular are strongly affected by this and face various challenges, since ESG requires a broad change of perspective in many business areas. Therefore, as part of this publication series, Deloitte examines the real importance attached to ESG, the

approaches REIMs are taking, where there is room for improvement, and what can be expected from the industry in the future.

The content of this series was collected and analyzed between August and October 2021. In a total of 16 hypothesis-driven interviews, 22 managing directors and department heads of leading European and global REIMs based in Germany and global REIMs based in Germany were surveyed. Thus, the participants represent approximately € 600 billion in real estate assets under

management. The aim of the interviews was to obtain a meaningful picture of the industry on the topic of ESG in order to highlight not only challenges and risks, but also potential solutions and opportunities. The interviews were conducted based on seven hypotheses that participants had to ultimately agree or disagree with in the otherwise free-form conversations. Deloitte now publishes a Point of View at regular intervals as a summary of the interview results for each hypothesis. ➔

Discussion of Hypothesis #4

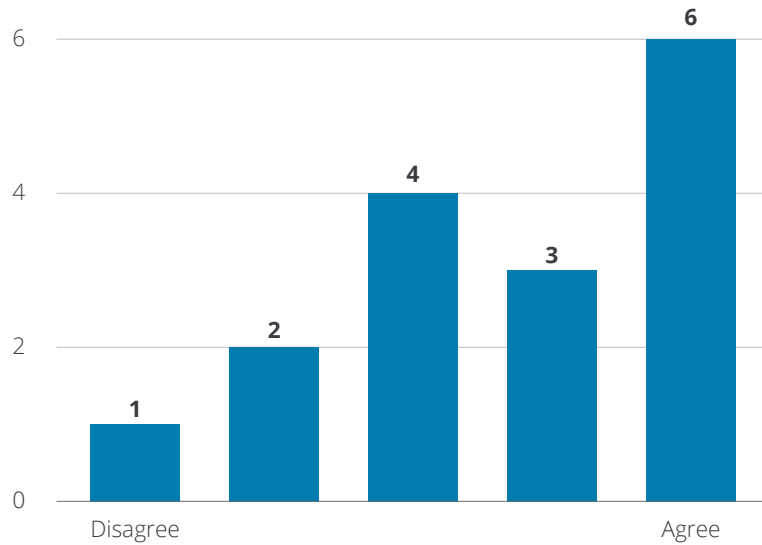
“The most sustainable building is the one that is not built.”

The hypothesis does not seem controversial at first, but in our discussions, it immediately opened up one of the essential current debates about new construction vs. existing buildings. It is evident that the majority of the buildings that will have to contribute to a climate-neutral building stock in 2050 are already standing today. New construction of highly efficient and climate neutral buildings alone will contribute only a fraction to the EU climate targets. Even with “cradle to cradle” approaches, the share of grey energy, i.e., the primary energy required to construct a building, in the total energy demand is extremely high. At the same time, the EU taxonomy (Level 1 & 2) defines strict criteria for the new construction of residential and non-residential buildings, which have been significantly tightened for buildings larger than 5,000 m² for environmental targets 1 and 2 alone.

By way of introduction, it can thus be stated that the discussion of new construction vs. existing buildings makes sense and is correct in focusing on innovation in construction as key issue in the real estate sector. Although the individual decision to renovate existing buildings or demolish/build new ones is always a property- and location-specific one, in both cases a major innovation push is needed in the construction industry.

On the market side, new positions must be found – replacing an existing building with new construction solely from an economic perspective will certainly not meet the sustainability requirements of investors, society, and regulators today or in the future. What is needed much more frequently is a combination of economic, planning, and technical innovation to extend the life cycle of existing buildings through intelligent refurbishment and thus

Fig. 1 – The most sustainable building is the one that is not built.



„Carbon bound in existing buildings should not be released through demolition in order to then release new carbon through new construction production. Where sensible, we should therefore try to preserve as many properties as possible in their structure.“

Bernd Bechheim, Head of Asset Management, Real Estate Global | Member of the Board, Germany, Aberdeen Standard Investments Deutschland AG

reduce significant CO₂ emissions through demolition and new construction. At the same time, not all existing buildings can be subjected to sensible refurbishment. On the way to a Circular Economy, innovation is needed here (among many others) in the deconstruction and new construction process so that the real estate life cycle can manage without the massive addition of CO₂-intensive process steps in this crucial phase.

The discussion was extended when the sector targets of the German government for the building industry were transferred to a CO₂-budget perspective, thus opening up the debate on prioritization of new buildings, between which building permits will have to be weighed up. Thus, as long as the entire construction process cannot be made CO₂ neutral, there will have to be a balancing process in the context of building permits with respect to the federal government's sector goals for existing buildings, which have been missed consecutively in the last two years.¹ Highly energy-intensive new construction/prestige projects will then have to face a comparison with resource-saving projects like existing building renovation.

„The ambitious climate targets will require prioritization of construction measures with regard to the CO₂ budget spent. It is conceivable that the CO₂ consumption of projects will also be examined in the context of building permits and then, for example, residential developments will be prioritized over commercial developments.“

Alexander Dexne, Chief Financial Officer, alstria office REIT-AG

Conclusion

This statement, which at first seems banal, was one of the most discussed hypotheses in our series and should be interpreted as an indicator of what is probably the greatest challenge facing the entire real estate industry. On the way to climate neutrality, the industry will not achieve its goals through new construction measures. Nevertheless, it is precisely in new construction that more innovation is needed, so that not only highly efficient buildings are created, but also the phases of construction and deconstruction are carried out in a way that is as climate- and land-friendly as possible. Assuming such a development, intelligently planned new construction can also achieve spill-over effects for neighborhoods and thus optimally contribute to the "S" component of the ESG definition.

However, the key value driver on the path to a decarbonized real estate industry is to be found in refurbishing the existing building stock. Although not favored by the current regulatory framework, a combination of isolated new construction in conjunction with intelligent renovation of existing buildings can contribute to a neighborhood view in which the contributions of individual properties are considered cumulatively and thus bring about compensatory effects.

Outlook

This point of view is part of a seven-part series that will be published between Q4 2021 and Q1 2022. Each publication presents one of the hypotheses discussed during the interviews.

Hypothesis #1

“ESG is a marketing tool. The industry puts its image and regulatory compliance ahead of delivering real impact.”

Hypothesis #2

“The sum of individual efforts by REIMs is not enough to achieve the ambitious climate targets of the EU Green Deal. Competitive thinking and a lack of trust confront the industry with obstacles when it comes to collaboration among competitors.”

Hypothesis #3

“REIMs cannot implement a ‘manage to green strategy’ on their own. Collaboration with tenants and service providers is essential for this. However, concrete initiatives are still missing.”

Hypothesis #4

“The most sustainable building is the one that is not built.”

Hypothesis #5

“The costs of constructing, refurbishing and operating sustainable buildings will exceed the economic benefits. Sustainable investors will therefore have to forego returns in the future.”

Hypothesis #6

“The integration of ESG along the entire value chain is costly and comes at the expense of profits from management fees. However, the scope for adjustment is moderate. Efficiency pressure on existing business is increasing.”

Hypothesis #7

“An ESG scoring/rating is only as good as its underlying data. The incomplete data basis and the need for extrapolation pose major challenges for REIMs.”

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