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ESG real estate insights

Global perspectives on sustainability and climate

The spectre of stranded assets—risk or opportunity?

With an increasingly recognized and demonstrable connection between ESG credentials and the risk profile of real estate assets, numerous value and performance influencing drivers are now impacting market activity and exposing the risk of stranding.

The impact of climate change on real estate asset resilience—and therefore value and performance potential—is accelerating at pace. Accordingly, it is critical that investors and wider stakeholders develop strategies to identify, quantify and mitigate the "value at risk" of real estate asset portfolios through effective stewardship strategies.

Stranded assets and their causes

The recent International Panel on Climate Change (IPCC) 'Synthesis' report emphasized the increased risk of stranded assets, if near term climate change mitigation and adaptation action is not taken. The term 'stranded assets' typically describes assets that have experienced "unanticipated or premature write-downs, devaluations, or conversion to liabilities."[1] Stranding risks are often associated with climate change impacts and regulatory changes. However, in the context of the real estate market, a wider array of evolving stakeholder expectations needs to also be considered.

The exposure of real estate assets to physical climate change challenges such as heat stress and flooding risks, is driving the development and implementation of adaptation strategies to address asset resilience. This inevitably poses challenges regarding the prioritization and justification of capital investment into assets and long-term asset management decision making. However, the IPCC made it clear that "Deep, rapid and sustained mitigation actions would reduce future adaptation costs and losses and damages, enhance sustainable development co-benefits, avoid locking-in emission sources, and reduce stranded assets and irreversible climate changes."[2]

Whilst adaptation is a key part of managing risk from climate change, the regulatory landscape is also tightening rapidly, such that decarbonisation pathways are now a key component of asset "transition" risk management. Reducing energy use and cutting carbon emissions of assets is critical to mitigating the risk of stranding. Whilst resulting energy efficiency will be of benefit from a "total occupancy cost" perspective, it is the adjustment to risk premia through reduced exposure to transition risk and evolving stakeholder demand that are likely to deliver greater financial impact – optimising occupier appeal and the ability to secure finance in respect of such assets.

Transition risks are a key stranding threat—both where the trajectory of regulatory change is clear, but particularly so where the detail of impending legislative change remains unknown. Minimum Energy Efficiency Standards (MEES) in the UK market is such an example – UK government policy requires all commercial real estate assets to achieve a minimum EPC B rating by 2030; a significant percentage of UK office stock failing to comply with that requirement by that deadline would risk a corresponding percentage of UK office stock becoming unlettable. Similarly, ESG related compliance requirements in the EU are also mounting, with reforms to the Energy Performance of Buildings Directive (EPBD) aiming to drive rapid renovation across underachieving EU building stock. Asset owners and investors need to have strategies in place to both monitor exposure of existing assets to changing regulations as well as address such risks during any acquisition due diligence process.

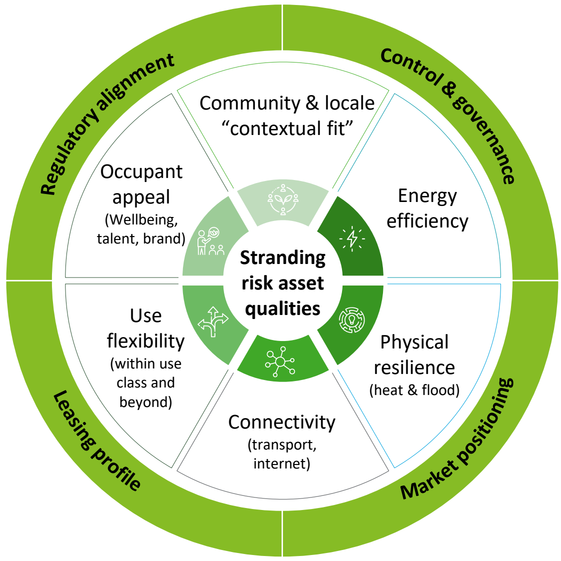
Navigating the regulatory landscape

The Global Real Estate Sustainability Benchmark (GRESB), the Carbon Risk Real Estate Monitor (CRREM) and the Partnership for Carbon Accounting Financials (PCAF) have joined forces to provide investors and banks with technical guidance to measure and report financed emissions from real estate. The aim is to bring a standard methodology (including clear definitions) to the value chain. This technical guidance, which launched in March 2023, aims to help the value chain in the real estate sector effectively monitor, report, and set targets, accelerating the use of forward-looking analytics to manage transition risk and ensure regulatory alignment.

Stranding risks are multifaceted

Evolving stakeholder expectations, flexibility and an asset achieving the right "contextual fit" within the real estate community are factors aligned to the broader ESG agenda that are equally important from a stranding risk perspective. Evolving occupier demands are driving landlords to provide real estate assets with attributes beyond energy efficiency (such as flexibility, wellbeing, and connectivity) as a means to attract/retain the best talent and as an outward demonstration of their brand. The result is that real estate assets that are unable to offer such credentials are exposed to risks such as cash flow interruption, weaker occupier covenants, and reduced liquidity. As noted in Deloitte's London Office [Summer 2023 Crane Survey], mitigation strategies such as retrofitting and refurbishment are gaining momentum as a means to address such risks and take advantage of the polarization in occupational requirements.

Figure 1: Diagram depicts the multifaceted nature of asset stranding



Source: Deloitte

Managing impact and value

The impact of stranding is felt across all asset classes with financial stress (or distress) felt through accelerated value erosion, cash flow loss/disruption, reduced liquidity, and heightened capex needs. Increased management burden, more challenging (and expensive) financing potential and reputational risk are also symptomatic of stranding.

Asset-specific and portfolio-wide diagnostic exercises are now a critical component of the management process to identify stranding risk exposure; followed swiftly by scenario testing to provide an assessment as to the potential scale of impact and the timing over which it could be felt. Adopting such an overt and explicit approach should enable mitigation strategies to be established, and ultimately enable informed decisions to be made which seize the opportunities that inevitably emerge during times of such change.

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Endnotes:

1. Smith School of Enterprise and the Environment, 2014.
2. IPCC, 2023.