Real estate taxonomy disclosures: Mind the gap

The real estate sector finds itself in a competitive position when it comes to both alignment levels and eligibility for Turnover, CapEx and OpEx compared to most other sectors. But narrowing the gap between the two isn't going to be entirely straightforward – and this may prove to be just one of a few challenges the sector could be facing

According to research by Greenomy, the real estate sector is by far the sector with the highest share of EU Taxonomy eligibility

A brief overview

The EU Taxonomy took effect in 2020 as part of the EU's Green Deal to reach climate neutrality by 2050. The EU Taxonomy Regulation introduced a detailed classification system to define environmentally sustainable economic activities with the aim of channelling private and public investments into these activities. Its aim is also to standardise economic activities that can be considered environmentally sustainable and improve transparency for companies, investors, and policymakers.

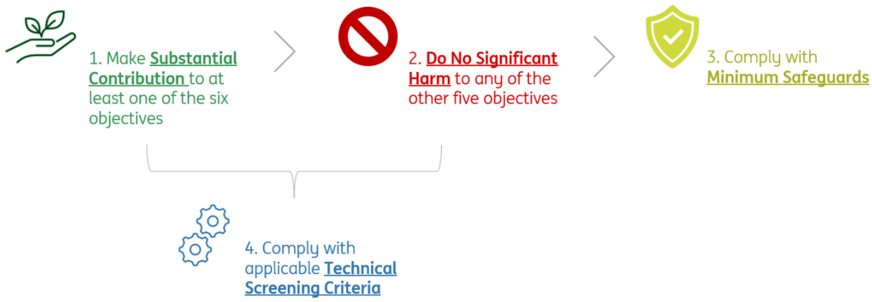
The regulation requires non-financial companies to disclose one or more of the following:

- EU Taxonomy-aligned share of **turnover.**
- Capital expenditure (**CapEx**) aligned with the taxonomy.
- Operating Expenses (**OpEx**) aligned with the taxonomy.

There are six Taxonomy objectives, including (1) climate change mitigation, (2) climate change adaptation, (3) sustainable use and protection of water and marine resources, (4) transition to a circular economy, (5) pollution prevention and control, and (6) protection and restoration of biodiversity and ecosystems. As part of the Taxonomy classification system, an economic activity needs to fulfil the following criteria to be aligned with the Taxonomy:

- Contributes substantially to **at least one of the six** above mentioned objectives.
- **Does not significantly harm (DNSH)** any of the other environmental objectives.
- Complies with several **minimum social and governance safeguards.**
- Complies with quantitative/qualitative **Technical Screening Criteria.**

As part of the Taxonomy classification system, certain economic activity needs to be fulfilled



Source: ING

With the introduction of Article 8 Regulation, companies in scope are required to report on Taxonomy alignment. For companies already required to include non-financial statements in their management report under the Non-Financial Reporting Directive (NFRD), Article 8 therefore complements the NFRD by providing a common reference point for taxonomy-related reporting requirements.

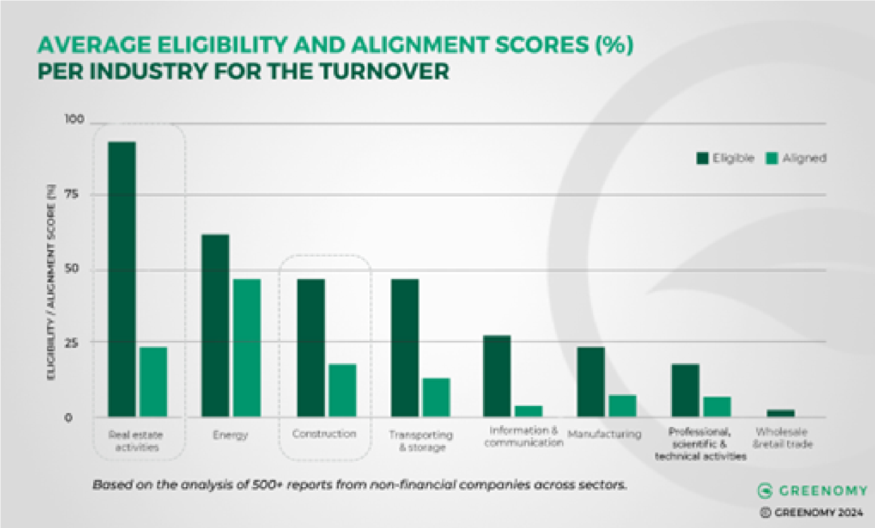
Large non-financial undertakings have been disclosing data on taxonomy-eligible activities since 2021 and taxonomy-aligned activities since 2022. This means that we have now had two years of both eligibility and alignment disclosures for environmental objectives from large public-interest companies, including real estate companies which are in scope.

How does the EU Taxonomy affect real estate?

According to the European Commission, buildings are the single largest emitter of greenhouse gases in Europe, accounting for around 36% of emissions in 2021. As such, buildings and real estate are a very important piece of the puzzle for the EU in its push to reach net zero by 2050, which is why there is such a strong legislative focus on the sector.

What's more is that the real estate sector is by far the sector with the highest share of EU Taxonomy eligibility, according to research by Greenomy. As shown in the chart below, the average turnover eligibility is a significant 87% for real estate activities, compared to an overall average of just 27% for all other sectors. Turnover alignment is also relatively high at 19%, which is the second highest after energy (48%). However, what this also tells us that the **gap between the eligibility and alignment scores (68%) is by far the largest of all sectors.**

Average eligibility and alignment per sector (turnover)



Source: Greenomy

Similarly, CapEx and OpEx eligibility at 89% and 82% are also the highest of all sectors. The sector discloses a 24% and 14% alignment for CapEx and OpEx respectively which – while still being the second highest across all sectors – points to a **large gap between eligible vs aligned CapEx and OpEx.**

When looking at taxonomy-eligible and aligned activities, the key activities for real estate and construction include 'construction and renovation of buildings'.

Banks and financial institutions have also started reporting on their Taxonomy alignment and banks use clients' disclosures for this, including for disclosure requirements such as the Green Asset Ratio. This likely means that lending will increasingly be directed to sectors, companies and activities which have a higher alignment or where alignment is improving. This is somewhat favourable for real estate companies, as current alignment levels are relatively high.

However, the fact that eligibility is much higher suggests that the gap can only be closed if the sustainability of activities improves strongly to generate higher levels of alignment. This will require significant focus in the real estate sector in order to increase levels of Taxonomy aligned Turnover, CapEx and OpEx. At the same time, the sector is currently facing challenges such as higher interest rates and weaker demand for property. In turn, this adds further pressure on property from a financial perspective in the drive to improve the sustainability and energy efficiency of buildings.

The sample of companies with published Taxonomy disclosures

Large, listed corporates have been reporting their taxonomy disclosures since 2021, and there is now a substantial number of real estate companies reporting on taxonomy KPIs. In addition, real estate companies were up until recently only able to report on activities with a substantial contribution towards climate change mitigation (CCM) and climate change adaptation (CCA). This was due to a delay in publication in the delegated act of the four other objectives.

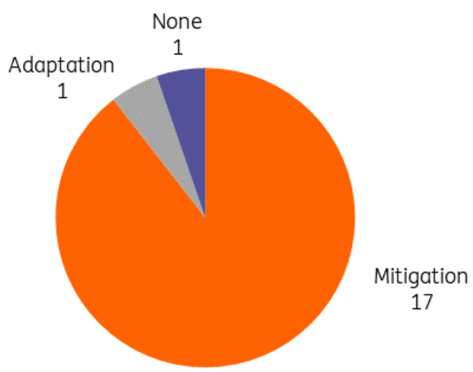
However, since this reporting year, companies can also report on these four new objectives: the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems. Of these four, the transition to a circular economy is the only objective which includes real estate-related activities. This includes the construction of new buildings and renovation of existing buildings, with a focus on areas such as improved utilisation, space sharing models and transitioning from carbon-intensive materials like steel to lower carbon alternatives like timber.

We found a total of **19 companies** in the real estate sector which report on both eligible and aligned activities across the three KPIs (Turnover, CapEx, OpEx). We have excluded companies which only report on eligibility to ensure consistency across results – this only excludes one company in the sector that we could find.

Sample results indicate that most companies report on activities which are related to the objective of CCM. In our sample, 82% of aligned KPI disclosures are related to CCM, with a further 11% of companies reporting aligned KPI disclosures related to CCA. None of the companies reported aligned KPI figures related to the circular economy (CE) yet – although this unsurprising given that it only becomes mandatory from next year onwards, and current disclosures would be on a voluntary basis.

This breakdown is shown below for turnover by environmental objective. Out of the 19 companies, 17 disclose turnover from aligned activities related to CCM, with one company disclosing on CCA. Furthermore, one company doesn't provide a breakdown of aligned turnover.

Turnover - alignment disclosure across EUT objectives



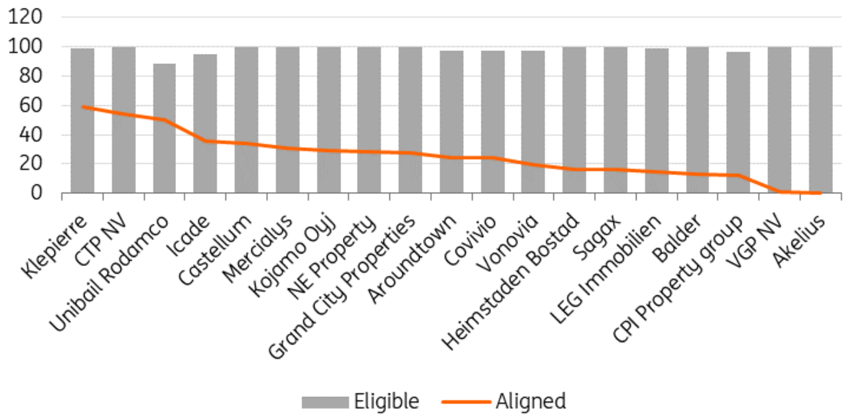
Note: shows the total number of companies reporting level of alignment greater than 0% Source: Company reports, ING

It's a similar picture for OpEx, while slightly different for CapEx. For OpEx, 13 companies have reported alignment with the CCM objective, and one with the CCA objective. However, it is interesting to note that there are four companies reporting aligned CapEx related to the CCA objective, suggesting that CapEx (i.e., longer-term investment) is focused on the adaptation of new and existing properties in response to climate change and its effects, including extreme weather. This is also in line with UN estimates that spending on climate adaptation is likely to double by 2030.

2023 disclosures – taking a closer look

For turnover, we included data from the 19 companies in our sample. As the chart below demonstrates, the level of eligible turnover is very high, averaging 98%, with the lowest reported figure of 88% from Unibail-Rodamco-Westfield suggesting limited variability. For Unibail, this “lower” figure doesn’t suggest much, as the percentage of aligned turnover is the third highest (50%). Overall, the average percentage of aligned turnover for the sample is quite high at 26%, which is also higher than the 19% findings from Greenomy for the real estate sector. The average gap between eligible and aligned turnover is 72%.

Turnover - eligible vs aligned (%)

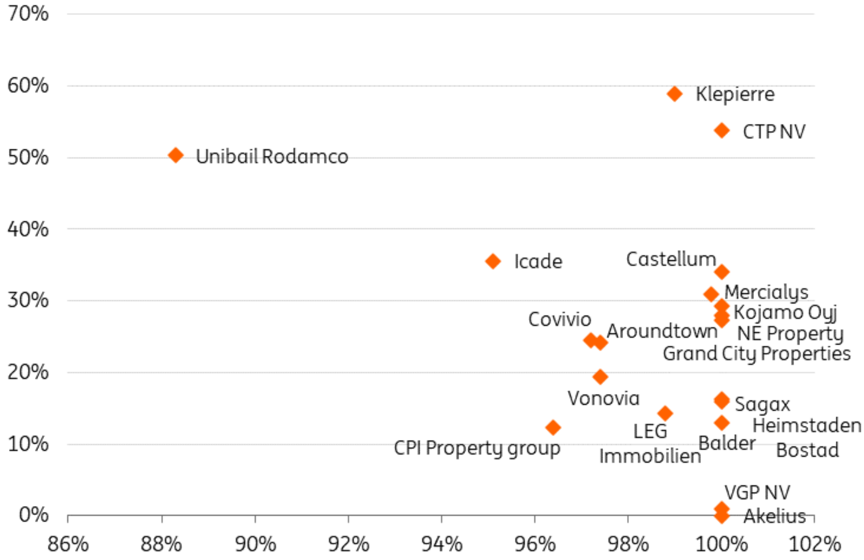


Source: Company reports, ING

Furthermore, the correlation between the level of eligible vs aligned turnover disclosed does not seem to be strong, as shown below. This may partly be explained by the fact that there is not a great level of variability between the level of eligible turnover (between 88-100%).

Source: European Data Warehouse, ING

Turnover - eligible vs aligned correlation

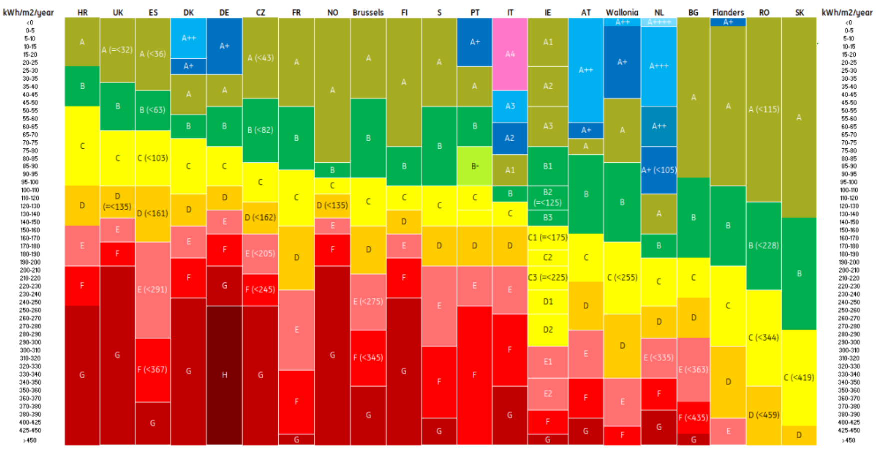


Source: Company reports, ING

However, as the chart above shows, variability within aligned turnover is quite significant, ranging from 0% to 59%. This could be explained by number of factors, including:

- Different EPC rating scores by country (as shown below).
- Diverse types of real estate assets which all must meet the same criteria.
- Differences between countries/regions in terms of certification, market standards and market guidelines.
- Complexities in terms of the KPI disclosure template.

Current EPC labelling discrepancies by countries



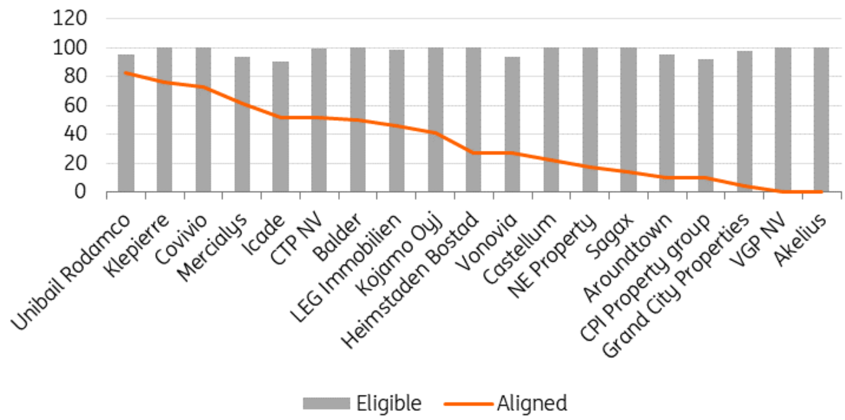
Note: Companies are still in a learning phase

For CapEx and OpEx (shown below), the picture is similar to what we saw with turnover, with a consistently elevated level of taxonomy eligibility but significant variability in terms of alignment.

The average CapEx eligibility is 98%, while the average rate of alignment is 35% – the highest out of the three KPIs. Interestingly, data suggests that French retail and office focused companies report the highest level of alignment.

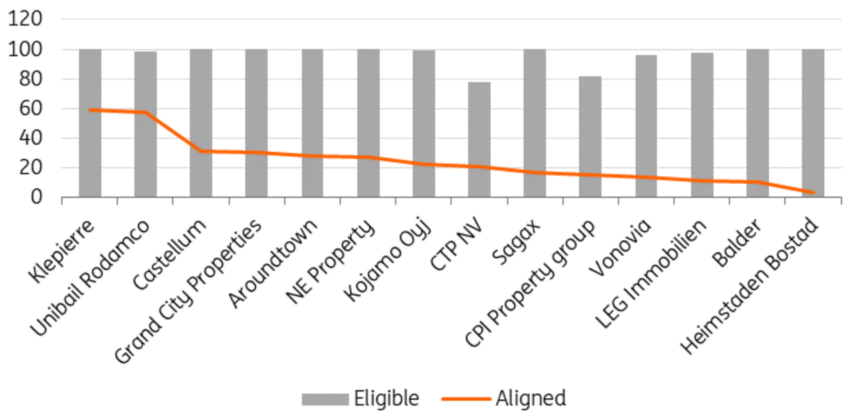
For OpEx, average eligibility and alignment is lower than for the two other KPIs. The average rate of eligibility is 82%, which is still high compared to most other sectors. Average alignment is 18%, with only two companies reporting a rate above 50% (both again French retail companies, Klepierre and Unibail). The lower OpEx eligibility could suggest diverse types of daily expenses which could not be considered eligible or aligned, and that expenses linked to turnover have a significant impact.

CapEx - eligible vs aligned (%)



Source: Company reports, ING

OpEx - eligible vs aligned (%)



Source: Company reports, ING

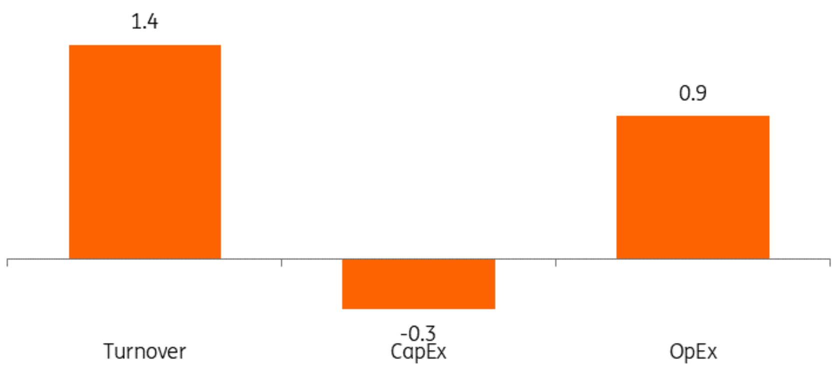
Overall, an interesting observation is the higher CapEx alignment levels than those for both Turnover and OpEx. This is something one may expect given the concerted focus in the real estate sector on investments which improve the sustainability and carbon intensity of properties – as well as where CapEx individually may lead to lower GHG emissions and are output taxonomy aligned, but which are not (yet) aligned in terms of turnover.

Improvement compared to last year

The fiscal year 2023 was the second year that companies were obliged to provide both eligible and alignment activities. Of the 19 companies in our 2023 sample, 17 published the share of eligible KPIs for 2022. However, there were only 13 companies which also reported alignment data for 2022. We therefore had 13 companies where we could assess the year-on-year change.

As shown in the chart below, the level of average eligibility improved marginally related to both Turnover and OpEx, compared to last year. Meanwhile, there was a slight decline for CapEx. Overall, given the remarkably high average eligibility levels, it is not surprising to see limited changes year-on-year.

YoY average eligibility change 2022 to 2023 (%)

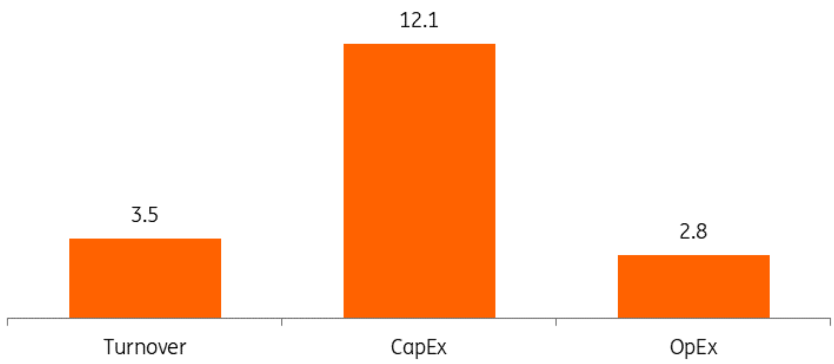


Source: Company reports, ING

For alignment, the annual change seems quite positive – as shown in the chart below, both Turnover and OpEx improved quite a bit year-on-year (3.5% and 2.8% respectively). However, CapEx saw a strong increase since the previous reporting period, increasing 12.1% on average. If this trend continues (with alignment scores increasing faster than eligibility), it could lead to a gradual closing of the gap between the two. This should be favourable to the sector, but could turn into a headwind if the trend does not continue.

The strong improvement in CapEx alignment could partly be explained by the fact that a lot of companies have reduced CapEx and put large renovations and acquisition on hold due to the higher interest rate environment. A significant level of CapEx is related to the activity of acquisition and ownership of buildings, where a lot of focus has been on redevelopment which doesn't exceed "major renovation" thresholds. In other words, CapEx could mainly be directed to smaller scale redevelopments and upgrades to improve sustainability and reduce GHG emissions in the context of higher interest rates and low transaction volumes.

YoY average alignment change 2022 to 2023 (%)

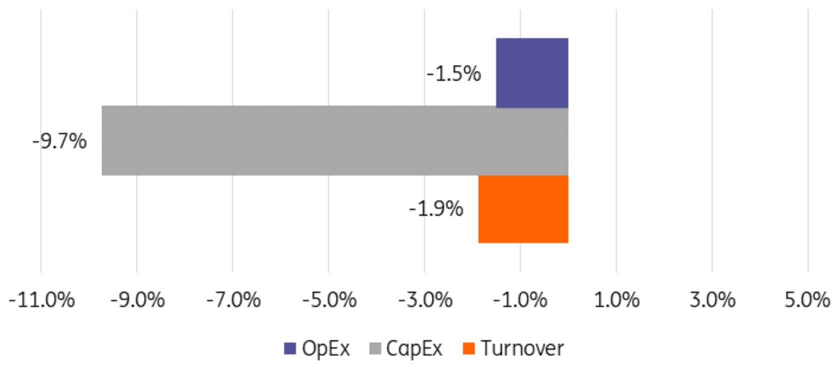


Source: Company reports, ING

Mind the gap

As the data indicates, both eligibility and alignment scores for the KPIs are quite high for the real estate sector, but at the same time, there is a significant gap between the two. This gap has been reduced for all three KPIs in 2023 compared to 2022, which is a welcome development (see chart below). The gap partly exists due to the diverse range of companies in the real estate sector with vastly distinct types of properties and portfolios which may not have certification or certification which is not completely aligned, while subject to the same criteria. A positive note is that the gap is slowly closing.

YoY change in the gap between eligibility and alignment (%)



Source: Company reports, ING

We think that the gap may continue to decline in the coming years as the focus on and understanding of the EU Taxonomy and its implications grows. Making the sector more sustainable and compliant with the Taxonomy is important, and will increasingly be an area of focus for investors and lenders alike in terms of directing capital and funding.

Also, with a growing number of buildings in Europe gaining or improving their EPC, and with EPC harmonisation across Europe alongside harmonisation between Taxonomy and national-level certifications (such as BREEAM in the UK, DGNB in Germany or HQE in France), this could further improve alignment levels. The Energy Performance of Buildings Directive (EPBD) recast in 2025 seeks to address some of these challenges.

However, closing this gap significantly will require a sector-wide and long-term continued effort to tackle the decarbonisation of the real estate sector. Only an increase in the sustainability of activities can improve alignment, while for other sectors there is more scope to improve eligibility and alignment from relatively low levels. The current lead that real estate currently has over other sectors could therefore be reduced in the coming years if not enough is done.

Looking ahead

The EU's introduction of the NFRD and the gradual replacement with the Corporate Sustainability Reporting Directive (CSRD) gradually expands the scope of companies that are required to disclose their Taxonomy eligibility and alignment. Large companies which are not considered in scope for the NFRD but which meet two out of the three CSRD criteria will be required to report on the EU Taxonomy for the fiscal year 2025. This will lead to a larger sample of real estate companies reporting on Taxonomy disclosures, increasing both transparency and comparability.

In addition, the introduction of the Circular Economy Objective from this year further widened the scope of activities that real estate companies can report on. All of this should increase the amount of information available and improve companies' understanding of the complexities of the Taxonomy.

As banks have started reporting on their Green Asset Ratio (GAR) in 2024, and with the introduction of the Bank Book Taxonomy Alignment Ratio (BTAR) in later this year, Taxonomy-related disclosures will increasingly form an important part of financing decisions from banks. With real estate forming such an important and large component of their balance sheets, the high eligibility and alignment disclosures are supportive for future financing.

All in all, real estate displays high eligibility and alignment levels for Turnover, CapEx and OpEx compared to most other sectors. This is a competitive position to be in in terms of financing perspectives for the future. However, the gap between the two is also the widest – and while this improved in 2023 compared to 2022, it will be more difficult to narrow than for many other sectors. This could potentially be a headwind to the sector going forward.

While there are many practical pain points which may prevent part of the gap from being reduced, real estate also has a great opportunity to improve sustainability and decarbonise, as almost all of the sector is considered eligible for the EU Taxonomy. This is a positive given the growing importance of the Taxonomy. At the same time, real estate companies with low alignment levels may face more difficulty in terms of financing or investments in the future if there is limited capacity or willingness to improve these alignment scores.

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