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Urgent Upgrade

Commercial property value at risk of becoming stranded assets unless upgraded from F and G EPC rating.

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Management Summary

- There is increasing pressure to make buildings in the UK more energy efficient to reduce energy consumption, carbon emissions and costs.
- Recent legislation now demands that commercial buildings must have an EPC (Energy Performance Certificate) rating of at least E to be let – which also applies to existing tenancy agreements.
- This means that the proportion of buildings currently rated F or G are at risk of becoming non-performing assets, seriously undermining capital values for buildings owners, landlords and Real Estate Investment Trusts (REITs).
- This report estimates the commercial property value at risk in the industrial, office and retail sectors, if buildings conversion is deferred.
- The Siemens Financial Services (SFS) model reveals that £93 billion worth of commercial properties in England, Scotland and Wales risk becoming stranded assets, leaving owners without income and the possibility of significant fines and reputational damage.
- For landlords who find it challenging to raise capital budgets for energy efficiency transformation of F- and G-rated buildings, energy performance contracting offers a very attractive upgrade method. These arrangements harness the future savings on energy consumption, and use them to finance today's energy efficiency upgrade. This means that the upgrade is performed at zero-net-cost for the landlord.
- This is the modern perspective for buildings owners, landlords and REITs, recognising the need to access specialist finance to enable energy efficiency transformation, optimising cash flow and transforming former capital expenditure (CAPEX) into operating expenditure (OPEX).

A Missed Opportunity: Buildings Energy Efficiency Potential in the UK

Rented buildings make up 61% of the total non-domestic stock in England and Wales, and account for 37.5% of the total emissions from non-domestic buildings.[1] For this reason higher energy performance standards are considered vital in reducing emissions.

According to the UK government, improving buildings energy efficiency is "one of the most cost-effective ways in which businesses can reduce their energy use and lower the associated bills in the buildings they occupy, improving the productivity of UK businesses and the security of the UK energy supply."[2]

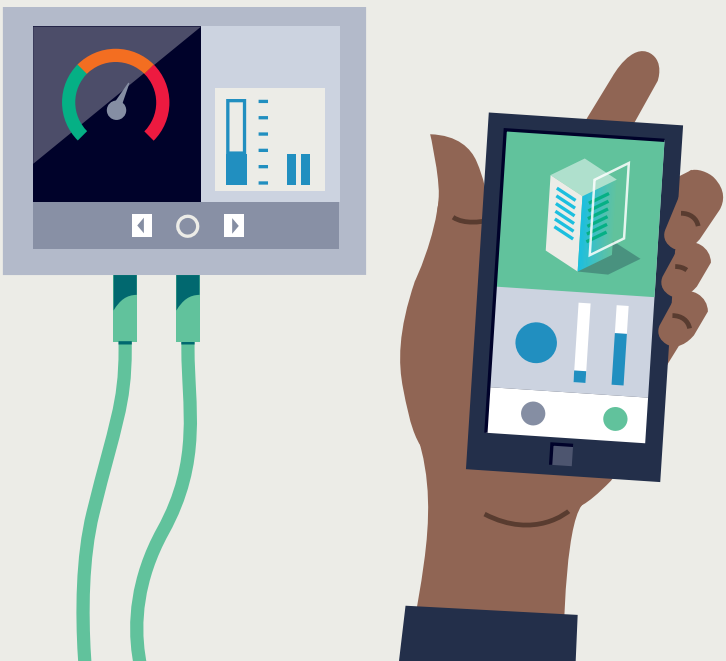
Improving energy efficiency in buildings can also unlock very significant savings for landlords and/or their tenants. Such initiatives have the potential to reduce energy consumption and deliver energy compliance against official targets, such as the government's planned net-zero emissions target by 2040.

In fact, British companies (owners, landlords and tenants) are believed to be missing out on around £1 billion in cost savings achievable through investment in energy efficiency.[3]

Not that the issue is simply one of saving cost. The new breed of finance director is becoming focused on optimising cash flow and working capital management in their organisation. Tying up capital expenditure (CAPEX) in depreciating assets (such as equipment and systems) is increasingly recognised as inefficient.

A growing proportion of corporations are therefore transferring their capital expenditure to third party financiers, using this third party capital to acquire equipment, plant and systems, so that they can maximise the level of working funds they have on hand to implement tactical initiatives.

From the point of view of being a responsible corporate citizen, reducing energy consumption can also help to protect the environment, conserve resources and improve the sustainability of societies and economies.



£1 billion *in cost savings achievable through investment in energy efficiency*

The Urgent Case for Investment: Energy Performance Certificates in the UK

To ensure the timely conversion of its building stock and combat greenwashing, the UK has introduced increasingly stringent environmental, social and governance (ESG) regulations. Immediate pressure comes in the form of the Energy Act 2018, which is designed to prompt landlords to ensure their properties are energy efficient.

Since 1st April 2023, the ensuing legislation – the Minimum Energy Efficiency Standard (MEES) – prohibits landlords from leasing commercial buildings with an EPC rating of 'F' or lower.

The regulations not only prohibit non-domestic landlords from granting new tenancies if the building has an EPC rating below E, but now also apply to existing tenancies as well.[4]

According to the most resent government estimates, around 11.4% of commercial buildings in Great Britain currently fail to meet the new standard.[5]

As a result of these growing sustainability requirements, facilities management and buildings owners must now urgently implement energy efficiency improvements in commercial buildings. It needs to be a top investment priority.

Landlords of properties with a lower rating must improve the energy efficiency of those buildings or face penalties ranging from £5,000 to £150,000,[6] based on the duration of the breach and a percentage (10% for less than 3 months and 20% for over) of the rateable value of the building.

Alongside financial penalties, buildings owners and investors are also vulnerable to reputational damage through a "name and shame" publication of non-compliant companies on a public register.[7] However, most significant is the possibility of properties becoming unlettable, rendering them stranded assets and threatening commercial value if improvements are not immediately undertaken.

However, this is just the first phase in the government's overall net zero proposal. The long-term trajectory requires that all non-domestic rented buildings will rise to a C rating by 2027 and to a B by 2030. This is a serious matter for buildings owners, landlords and Real Estate Investment Trusts (REITs) alike.

With regulations tightening over the next decade, landlords may be considering an incremental approach to upgrades. However, tenancy cycles (typically 1-5 years) and business sustainability concerns mean today's occupants are already searching for tomorrow's buildings.

The Investment Challenge: Energy Efficiency Conversion for F- & G-rated Buildings

Improving energy performance, however, can be a costly and complicated process. Commercial landlords and investors have expressed concern over the projected costs of converting their properties and real estate portfolios to EPC B ahead of the 2030 deadline.[8]

As Peter Cosmetatos, chief executive of the Commercial Real Estate Finance Council Europe, the trade association for European property lenders, explains "Most owners [...] don't have sustainability teams or net zero plans or quite possibly the capital behind them on the equity side."[9]

Given the urgency of investment, Siemens Financial Services (SFS) has modelled an estimate of the commercial property value at risk, specifically F- and G-rated commercial buildings – across Great Britain and in 3 sectors.

This estimate is designed to give landlords in the commercial buildings sector an idea of the sheer volume of capital value at risk if conversion is deferred.

In each of these segmentations, the commercial property value at risk is considerable but the energy efficiency potential is also significant. As such, this report's estimates should provide landlords, CEOs, CFOs and estates management professionals with a reliable starting point for self-financing smart energy-efficiency projects.

Working with specialist financiers, potential energy savings can be harnessed to effectively subsidise the investment, meaning buildings conversion can often be achieved at zero net cost.

The resulting estimates are as follows:

Commercial property value at risk by sector (F- & G-rated properties in industrial, retail, offices)

(Sector in England, Scotland, Wales)	£ million Total Capital Value
Industrial	**£25,334**
Offices	**£28,588**
Retail	**£31,644**

Commercial property value at risk by region (F- & G-rated properties)

Area	£ million Total Capital Value
Wales	**£3,097**
Scotland	**£9,271**
England	**£81,388**
North East	£2,891
North West	£8,648
Yorkshire and The Humber	£6,637
East Midlands	£5,368
West Midlands	£7,121
East	£7,355
London	£25.788
South East	£10,926
South West	£6,526
Great Britain	**£93,756**

***£93 billion** commercial property value at risk in Great Britain*

Zero-net-cost Solutions: Specialist Financing to Enable Urgent Investment

Given the expected costs of conversion, organisations across the public and private sectors are increasingly looking for financially viable ways to make the energy-efficiency upgrade.

To meet this demand, specialist financiers are now offering financing packages which use future energy savings to finance buildings technology upgrades – covering condensing boilers, solar panels, heating ventilation and air-conditioning (HVAC), insulation, smart buildings controls, and any other technology required to upgrade a building to much higher energy-efficiency levels. These financing schemes allow buildings managers to achieve a strategic upgrade at low- or even zero-net-cost.

In the three areas studied in this report – industrial, retail and offices – little capital is available for such retrofit projects, either because landlords are looking for maximised yield, or because energy costs are usually passed on to the tenant.

However, with F- and G-rated properties no longer lettable, the threat of non-performing assets is providing a compelling new incentive for energy efficiency upgrades.

Pete Colverd, Head of Building Products UK at Siemens, said: "Regulatory and market pressures are creating a need for commercial landlords to act on net-zero. The good news is that much of the technology that can help the sector significantly reduce carbon emissions is already on the market. Whether it's remodelling the physical fabric of buildings, or using hardware and software to glean better insights from your estate – there are a number of things landlords should be considering now to futureproof their assets."

Specialist financing packages allow capital investment to happen without the need to tie up precious cash. In a sense, the building owner is getting a valuable outcome – reduced energy consumption – without having to make an investment.

Typically, a reduction of between 15% and 25% can be made on energy expenditure by retrofitting a building with energy-efficient technologies. Once the financing period is over, and the energy savings have been harnessed to effectively pay for the retrofit, landlords and their tenants then continue over time to reap the full benefit of the energy savings achieved.

Conclusion

Commercial buildings conversion is an urgent priority for owners of F- and G- rated buildings, now unlettable on the UK market. Without immediate investment, these properties are at risk of losing their commercial value.

Similarly, as regulations tighten any building below EPC B could become unlettable if not upgraded before 2030. Therefore, the business case for energy efficient building conversion is a strong one. This is particularly true given future savings can be used to capitalise the transformation.

Alongside the urgent requirement to upgrade buildings – or risk their being stranded assets – improved liquidity and energy cost savings make for a robust business case to invest in sustainability projects.

The potential for these zero-net-cost conversion projects, offered by integrated technology-and-finance providers, remains considerable. The imperative is on buildings management to grasp the opportunity as soon as possible, to ensure buildings compliance and to stop wasted and unnecessary energy consumption and costs.

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