Nordic
Credit
Rating

SECTOR COMMENT

16 Mar. 2021

Nordic property managers face green crossroads

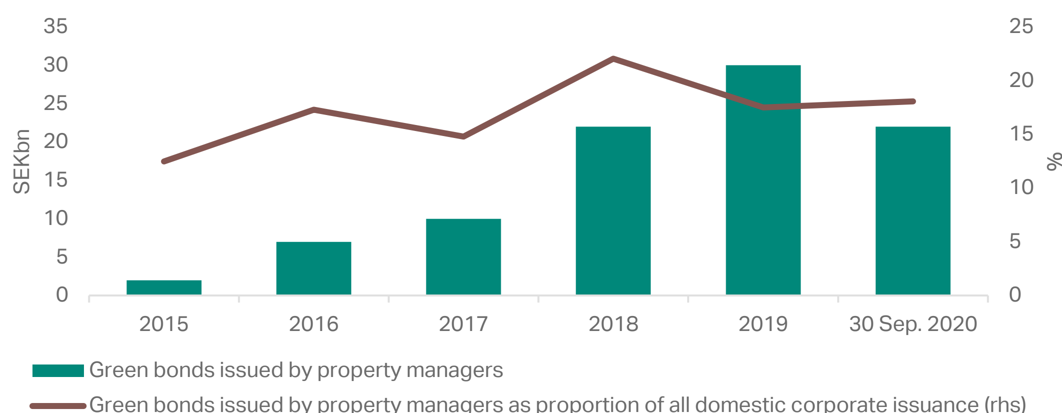
ANALYSTS
Mille O. Fjeldstad
+4799038916
mille.fjeldstad@nordiccreditrating.com

Marcus Gustavsson
+46700442775
marcus.gustavsson@nordiccreditrating.com

The EU Sustainable Finance Taxonomy aims, among other things, to help investors identify sustainable investments. In this regard, it sets out "technical screening criteria" or thresholds on emissions, resource use, and waste management for an activity to be classified as sustainable. Reporting under the taxonomy begins at the end of this year. Simultaneously and separately, Nordic real estate companies have accelerated issuance of green bonds and property certification to increase access to sustainability-driven investors. Given the growing importance of sustainable investment, investor perception of a company's sustainability could affect its access to funding. A key question is whether regional real estate companies embrace the taxonomy-aligned EU Green Bond Standard and adopt the related technical screening criteria or continue to rely on their established means of accessing green funding.

We view the current screening criteria (published for comment in November 2020) as too narrow in defining sustainable activities within the real estate sector, and consequently expect modifications to be made. If the criteria remain too stringent, Nordic real estate issuers and investors could create an alternative rulebook and continue with the certification and second opinion systems that underpin existing green bond issuance, resulting in a separate regional green bond market.

Figure 1. Issuance of green bonds by property managers in Sweden 2015– 30 Sep. 2020



Source: Stamdata and Economic comment by Swedish central bank, 15 Dec. 2020.

Sustainability reporting is no longer a niche activity

If signatories are to reach the goals of the Paris Agreement, a significant shift towards a low-carbon society is needed. Any such shift must be financed, but government funding is unlikely to prove sufficient and institutional and private capital will have to play a part.

Since 2018, large companies in the EU have been required to report non-financial sustainability metrics. However, amid a lack of common standards, the potential for "greenwashing", or cherry-picking favourable metrics, remains. Moreover, an absence of comparable reporting structures could lead to misallocation of earmarked sustainability funds.

In response, the EU Action Plan for Financing Sustainable Growth identified the need for a common ground, a taxonomy. The EU Taxonomy focuses on reporting of consistent sustainability data by financial market participants, such as hedge funds, financial institutions, and companies. The EU Taxonomy Regulation, which enforces the taxonomy, carries legislative weight in the EU and entered into force in July 2020, with plans for eventual implementation in Norway and other European Economic Area (EEA) countries. Financial market participants will be required to disclose according to the taxonomy from end-2021, while large non-financial companies with more than 500 employees will be required to do so a year later. The EU Taxonomy is primarily focused on environmental factors, with complementary consideration given to social and governance issues.

Through the taxonomy, financial market participants must disclose the level of their taxonomy-aligned investments. Non-financial companies' reporting must include the proportion of capital expenditure, operating expenditure and turnover related to sustainable economic activity. The reporting requirements imposed by the taxonomy are expected to increase market transparency by providing comparable and relevant data to help investors make educated decisions on sustainable investments.

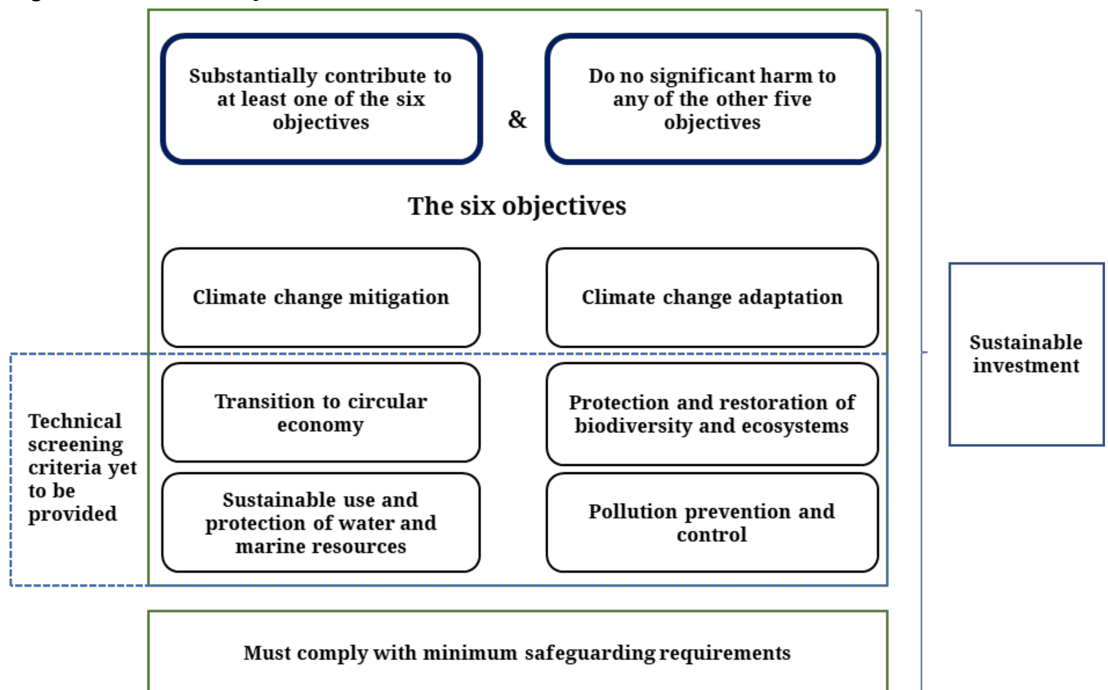
Screening criteria define level of sustainability

Data reported under the taxonomy will be used to assess the sustainability of economic activities through the screening criteria. The criteria will determine if an activity contributes substantially to one of six objectives, while doing no significant harm to any of the other five. Activities must meet minimum safeguarding requirements in compliance with the OECD's Guidelines on Multinational Enterprises and the UN's Guiding Principles on Business and Human Rights. The criteria are still under development.

Climate change mitigation and adaptation

The EU Technical Expert Group on Sustainable Finance has identified 70 activities under the first objective, climate change mitigation, and a further 68 under the second, climate change adaptation, and is likely to identify more as the taxonomy evolves (see Figure 2). Work has yet to commence on the remaining four objectives. Climate change mitigation refers to activities that produce low greenhouse gas emissions, support transition towards low emissions, or enable other activities designed to promote low emissions. Climate change adaptation refers to activities that enable significant adaptation to climate change or enable other activities to do so. Each activity within a company covered by the taxonomy will be reviewed on the basis of the criteria. The proportion of revenue, capital spending and operating expenses aligned with the taxonomy will be considered in determining whether or not a company is sustainable.

Figure 2. EU Taxonomy criteria



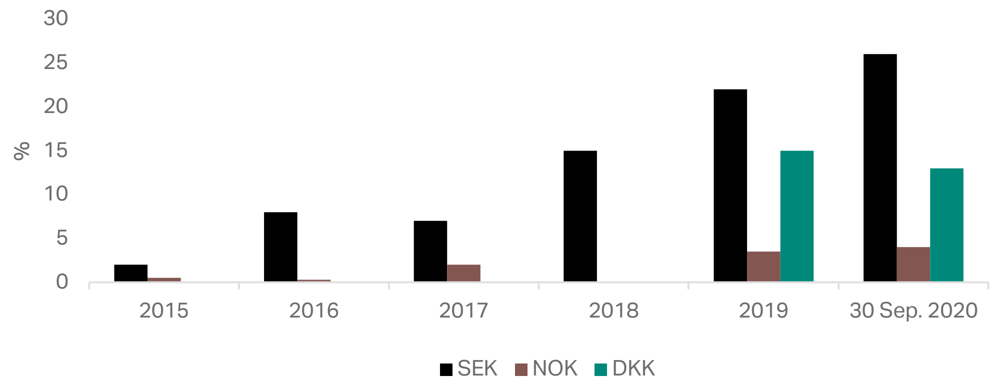
Source: Technical Expert Group on Sustainable Finance: Final report, 2020.

Since November 2020, the European Commission has received more than 45,000 responses to the proposed technical screening criteria governing the first two objectives. In our view, the scale of the feedback represents a degree of pushback that could slow implementation of the taxonomy. We believe that any delay in the EU project could make the Nordic green bond market increasingly attractive to investors, particularly in the real estate sector.

Nordic real estate and the proposed technical screening criteria

The Nordic green bond market has grown significantly in recent years as investors are increasingly drawn to sustainable investment. The market is currently dominated by real estate companies. Green bond issuance generally requires second opinions from third parties such as Norwegian climate research institute CICERO, with the objective of evaluating the 'shade of green', or the environmental sustainability, of the use of the proceeds. Nordic real estate companies generally aim to obtain property certifications, such as BREEAM, LEED or the Swan Label, for new developments and refurbishment work to demonstrate their commitment to sustainability and increase the proportion of their portfolios eligible for green funding.

Figure 3. Issuance of green bonds in selected Nordic currencies, 2015– 30 Sep. 2020



Source: Economic comment by Swedish entral bank, 15 Dec. 2020.

According to the expert group, the property sector is responsible for 40% of energy use and 36% of carbon emissions in the EU. In view of these high levels, real estate activities such as acquisition, construction, renovation and property management have been included in the first part of the screening process presented in November 2020.

To "substantially contribute" to climate change mitigation, energy usage in a property must correspond to defined requirements (see Figure 4). In the case of climate change mitigation, we take the view that most climate-related hazards could be covered by insurance and expect insurance companies to see climate change adaptation as a necessity for proper pricing of insurance. In addition, the "do no significant harm" objective relates to limitation of water usage, preparedness for volatile and extreme weather events, degree of reusage of water and materials, recycling and management of waste and resources as well as limitation of pollution and dangerous substances.

Figure 4. EU requirements for property-related energy use

Activity	Energy requirement
Construction	At least 20% lower primary energy demand than threshold set for Nearly Zero Energy Buildings (NZEBs)
Renovation	At least 30% reduction in primary energy demand
Acquisition and management of properties constructed prior to 31 Dec. 2020	At least Energy Performance Certificate (EPC) class A
Acquisition and management of properties constructed after 31 Dec. 2020	Constructed according to requirement for construction, i.e. at least 20% lower primary energy demand than for NZEBs.

Source: European Commission draft annex to commission-delegated regulation, 20 Nov. 2020.

Lack of international coordination on real estate standards in Europe still exists

What constitutes best practice in terms of sustainability differs within the EU and its neighbours. The EU's Energy Performance of Buildings Directive requires that as of 2021 all new structures must be NZEBs, buildings with very high energy performance and mostly powered from renewable sources.

However, there are no standardised thresholds for NZEBs in the EU, and NZEBs are not yet defined in Norway. Moreover, EPCs are not mandatory in the EU. As the taxonomy aims to align and promote investments in sustainable activities, this lack of international coordination represents an obstacle. If sustainability requirements are too stringent for Nordic property managers, their incentive to comply could be reduced.

In Sweden, new regulations will require new buildings to obtain a climate-compatibility declaration from 1 Jan. 2022. This aim is to increase transparency and comparability, and makes the construction company responsible for emissions and resource use in the building process.

In Norway, a new version of the BREEAM-NOR certification is scheduled in 2021, with a draft expected in April. As the EU taxonomy is set to enter Norwegian law under the EEA Area agreement, we expect the updated version of the certification to include the relevant requirements.

Nordic real estate managers and current status

While many Nordic real estate companies have a green bond framework and some level of certified properties, revenues generated from EPC class A properties are low. According to Finance Norway, which represents the county's financial services industry, only 1% of properties in the Nordic countries are EPC class A properties and thereby qualify as sustainable according to the technical screening criteria. Less rigid requirements elsewhere will result in a level of about 16% in the Netherlands and about 10% in Denmark, Portugal and France. According to Sweden's National Board of Housing, Building and Planning (Boverket), properties with EPC class A certification in Sweden represent 2–3% of all certified properties.

Where sustainability meets creditworthiness

NCR aims to provide transparency in its credit ratings on Nordic issuers. Since signing the UN's Principles for Responsible Investment in 2020, we have increased clarity as to how sustainability can impact a credit rating. As the EU Taxonomy and EU Green Bond Standard evolves, we will review the effect on issuers' access to funding. And because the current technical screening criteria exclude a significant amount of real estate funded by green bonds and/or green bank loans, we will follow the Nordic bond market's reaction and adaptation to the screening criteria.

We envisage two possible scenarios:

1. The EU's technical screening criteria will be adapted and adjusted, enabling positive green finance initiatives already seen in Nordic countries to continue; or
2. The Nordic bond market will assess bonds that do not comply with the criteria by a different standard and create an independent green market.

While work continues apace on the EU Taxonomy and Green Bond Standard, we maintain our emphasis on credit-relevant factors associated with environmental, social and governance (ESG) risk. We do not assess whether or not an issuer is sustainable, but rather how ESG factors impact credit drivers, such as access to funding, competitive position, industry risk, and operational efficiency. NCR's role is to assess issuers' creditworthiness, not solely their green credentials. However, we aim to increase transparency as to how ESG factors affect our credit ratings. We have published two articles describing how we assess ESG factors in assigning credit ratings to financial institutions and non-financial corporate entities (see ESG factors in financial institutions ratings and ESG factors in corporate ratings, both published 31 Mar. 2020).

We have identified a number of ESG issues that could impact our ratings on real estate companies (see Figure 5) and raise these topics in our discussions with issuers. We anticipate that as companies and financial institutions increase reporting according to the taxonomy, assessments and comparisons between them will become easier.

NCR assigns outlooks to issuer ratings to indicate where they could move in the near term (normally up to 18 months). A stable outlook indicates that a rating is unlikely to move in the near term. We acknowledge, however, that longer-term shifts in conditions could affect an issuer's access to funding, operating environment, competitive position, or operational efficiency within that period.

Figure 5. ESG issues facing Nordic real estate companies

General	
ESG reporting	Quality reporting is essential to communicate ESG efforts to stakeholders. Preferably, an issuer's reporting would follow international standards such as Task Force on Climate-related Financial Disclosures, while its reporting on CO_2 emissions should outline Scope 1, 2 and 3 emissions. To ensure credibility, ESG targets should be science-based.
Environmental	
Energy and resource management	Property management companies use substantial amounts of energy. Increased use of renewable energy could ensure long-term energy access, reducing risk of increased taxation and regulation of non-renewable energy. Dependence on fossil fuels could pose a risk of lower operating margins and/or increase the need for capital spending. Approximately half of building-related emissions occur during development. Efficient resource management and use of plentiful resources and sustainable materials reduce the risk of increased costs or complete loss or resources through taxation or regulation. As increased taxation and regulation of CO_2 emissions seem likely, these constitute a risk for the sector.
Impact of climate change on operations	The physical impact of climate change could affect properties negatively and lead to loss of revenues or increased capital spending. Furthermore, properties that do not live up to general expectations on energy efficiency or emissions could see decreased demand, reducing occupancy and/or rent.
Viability of tenant industries	Through its tenants, a property management company is indirectly affected by the soundness of the overall economy. Lack of viability in the industries in which tenants operate, could represent a risk as societies and governments adapt to a more sustainable future.
Social	
Employee relations	To retain key personnel, it is preferable that a company offers a sustainable workplace. Equal opportunity is a focus in the sector, as is employee well-being.
Social impact	The property management sector, particularly the residential segment, affects society through development. Lack of upkeep and upgrades can negatively affect local societies.
Regulatory environment	Property management companies can be highly affected by regulation. Taxation, regulation, zoning and other governmental tools can have a direct effect on a property manager's profit and liquidity.
Value chain impact	Through its subcontractors, a property management company can have a material impact on society. Codes of conduct, whistle blowing and other tools could ensure that subcontractors live up to high standards, both upstream and downstream, in the value chain.
Governance	
Conflicts of interest	To reduce the occurrence and impact of conflicts of interests, transparent reporting of transactions with related parties and, if applicable, management/board members' other businesses, is a valuable tool. To ensure effective management, remuneration and incentive programmes should be aligned with risks and ESG ambitions. To ensure an efficient board of directors, it is necessary to have a sufficient number of independent directors. Cross-holdings could create substantial conflicts of interests and represent a key risk.
Loss of credibility	Accounting quality, use of external auditors and external valuations of properties, an appropriate financial policy, and transparent communication with stakeholders can increase credibility in the eyes of stakeholders. Accounting fraud, miscommunication and inflated valuations will increase the risk of loss of confidence on the part of banks, investors, government, tenants, and other stakeholders, significantly affecting access to funding and business.
Processes	To ensure that governance is managed in an appropriate fashion, a company should have an anti-corruption policy, a code of conduct, and a procedure for whistle blowing.

DISCLAIMER

Disclaimer © 2021 Nordic Credit Rating AS (NCR, the agency). All rights reserved. All information and data used by NCR in its analytical activities come from sources the agency considers accurate and reliable. All material relating to NCR's analytical activities is provided on an "as is" basis. The agency does not conduct audits or similar warranty validations of any information used in its analytical activities and related material. NCR advises all users of its services to carry out individual assessments for their own specific use or purpose when using any information or material provided by the agency. Analytical material provided by NCR constitutes only an opinion on relative credit risk and does not address other forms of risk such as volatility or market risk and should not be considered to contain facts of any kind for the purpose of assessing an issuer's or an issue's historical, current or future performance. Analytical material provided by NCR may include certain forward-looking statements relating to the business, financial performance and results of an entity and/or the industry in which it operates. Forward-looking statements concern future circumstances and results and other statements that are not historical facts, sometimes identified by the words "believes", "expects", "predicts", "intends", "projects", "plans", "estimates", "aims", "foresees", "anticipates", "targets", and similar expressions. Forward-looking statements contained in any analytical material provided by NCR, including assumptions, opinions and views either of the agency or cited from third-party sources are solely opinions and forecasts which are subject to risk, uncertainty and other factors that could cause actual events to differ materially from anticipated events. NCR and its personnel and any related third parties provide no assurance that the assumptions underlying any statements in analytical material provided by the agency are free from error, nor are they liable to any party, either directly or indirectly, for any damages, losses or similar, arising from use of NCR's analytical material or the agency's analytical activities. No representation or warranty (express or implied) is made as to, and no reliance should be placed upon, any information, including projections, estimates, targets and opinions, contained in any analytical material provided by NCR, and no liability whatsoever is accepted as to any errors, omissions or misstatements contained in any analytical material provided by the agency. Users of analytical material provided by NCR are solely responsible for making their own assessment of the market and the market position of any relevant entity, conducting their own investigations and analysis, and forming their own view of the future performance of any relevant entity's business and current and future financial situation. NCR is independent of any third party, and any information and/or material resulting from the agency's analytical activities should not be considered as marketing or a recommendation to buy, sell, or hold any financial instruments or similar. Relating to NCR's analytical activities, historical development and past performance does not safeguard or guarantee any future results or outcome. All information herein is the sole property of NCR and is protected by copyright and applicable laws. The information herein, and any other information provided by NCR, may not be reproduced, copied, stored, sold, or distributed without NCR's written permission.

NORDIC CREDIT RATING AS

nordiccreditrating.com

OSLO

Biskop Gunnerus' gate 14A
0185 Oslo
Norway

STOCKHOLM

Norrlandsgatan 10
111 43, Stockholm
Sweden