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Sustainable Investing

December 2025/January 2026 • perenews.com

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KEYNOTE INTERVIEW

Turning sustainability into value

From stronger tenant demand to better financing conditions and higher exit values, the rewards for sustainable assets are tangible, argues PIMCO Prime's Annette Kroeger

The path to decarbonization is not one-size-fits-all; timing and strategy make all the difference. Annette Kroeger, chief executive officer, Europe for investment management firm PIMCO Prime Real Estate, says that combining smart operational upgrades, tenant engagement and targeted refurbishments can future-proof assets and capture the value premium of a sustainable approach.

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Q Sustainability is increasingly seen not just as a regulatory requirement but as a lever for value creation. How does this play out for investors in practice?

Of course, investors want to comply with regulatory requirements. But equally important is the focus on what actually creates value for investors. A sustainable, stabilized asset can generate more value going forward, because in the end, it comes back to the tenant. What drives value is tenant satisfaction and meeting their targets.

Corporate occupiers, especially larger ones, have their own sustainability agendas. So, when selecting assets, they already have in mind how the property can help them meet their targets and how they can meet reporting requirements with it. There is also the operating cost element. When those costs are lower, when the building is more energy-efficient, that will benefit the tenant and make the asset more attractive.

Especially after covid, tenants are much more sensitive not only to sustainability but also to the wellbeing offered by a physical space. So, having an attractive and efficient asset in terms of cost, employee health and alignment with sustainability goals makes tenants commit longer term. That commitment results in more resilient income, whether through tenants staying longer, signing longer leases or shorter downtime if there is turnover. This, in turn, drives portfolio returns and overall portfolio value because of that higher resilience.

Q How does sustainability translate into long-term returns, whether through operational savings, tenant demand or capital appreciation?

It is really a combination of all three.

Going back to operational savings, generally the landlord spends the money upfront and the tenants benefit from lower operating expenses over time. So, if you take measures to reduce energy consumption and make buildings more efficient, that benefit goes to the tenant. But the landlord also sees advantages in attracting tenants or driving rents.

In terms of tenant demand, there is a debate about whether there is an immediate impact on rental value because you have a sustainable asset, but there are studies that prove that. What we see is tenants now often have specific ESG requirements when selecting assets. If your asset does not meet those, you are not even considered in the selection process. So, sustainability measures help you get on tenants' lists, especially in a competitive leasing market.

When it comes to capital appreciation, you need to consider how much to invest. Some measures cost little but make a big difference, while larger upgrades can only be done during major refurbishments. Even then, the extra cost of adding sustainability measures is usually a small part of the overall budget when you reposition an asset. So, it is about being smart and assessing what individual assets need at a given time to continue driving sustainability.

Then as you exit, there are two main benefits. One is higher rents or an increased sales price, so that is your capital appreciation. The other is stronger market demand for sustainable assets. While the market may debate whether that value comes from a green premium or simply avoiding a brown discount, there is clearly a value benefit to owning a sustainable asset.

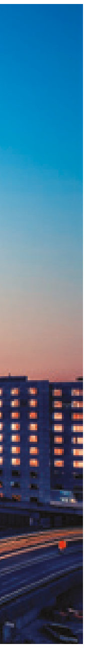
"When the building is more energy-efficient, that will benefit the tenant and makes the asset more attractive"

Q What kinds of upgrades are proving most effective in translating sustainability gains into measurable income growth for investors?

It is very hard to generalize that. Some measures are reasonably low cost. When you start putting in place smart-building systems that steer your building based on tenant usage or weather forecasts or by leveraging AI, that can significantly impact your CO_2 emissions and energy consumption. You go back to reduced operating expenses and more tenant demand, and that drives your value.

For example, through sensors that measure occupancy, temperature and energy emissions, you can much more actively make adjustments in real time and optimize the operation of your building. These are lower-cost measures and therefore the ones that often make sense in any case.

Beyond that, it depends very much on the individual building what makes the most sense in terms of physical upgrades. The key is timing those measures within the life cycle of your asset. When doing a deeper upgrade, make sure you go as far as possible. If your heating is no longer functional and needs replacement as part of the maintenance cycle, replace it with a sustainable option. That way, you achieve the lowest possible cost at that point in time while aligning with the asset's life cycle to continuously improve its quality.



Q How important is tenant engagement to drive value as part of active management?

That remains a key component of what you can implement relatively easily. In addition to physical measures, which you need to take over time to improve the credentials of your asset, you can build a relationship with your tenant around sustainability and deepen that tenant-landlord relationship.

For example, in France, tenants need to do a certain level of reporting, which can be cumbersome. What we have done is have conversations with them about implementing those sensors and by sharing the data, we can better steer the building and the tenant can complete its mandatory reporting. By offering additional services and engaging with tenants around sustainability, you also strengthen tenant retention.

We have seen engagement evolve over time. About 10 years ago, one of our first large corporate tenants suggested regular ESG discussions. At the time, it was still new for us, but we engaged. Now, the approach has shifted: we proactively reach out to tenants to discuss ways to improve sustainability in the asset and how that benefits them. Today, it is a mutual, positive conversation – sustainability is on the tenants' agenda, and they appreciate that we prioritize it as well.

"There is clearly a value benefit to owning a sustainable asset"

Of course, we look at this on a portfolio level as well. It is not about one "lighthouse" project with perfect ESG credentials you can point to, but instead about managing a large portfolio to get on the right track over time – improving sustainability credentials, future-proofing the assets and protecting long-term value. That is why it is important to be very conscious about when to take which measures to optimize the portfolio.

Q Are low-cost efficiency measures sufficient today or are deeper, full-building refurbishments unavoidable to future-proof portfolios?

These no-regrets, first-step measures like LED lights or low-flow fixtures are a good way to get going and are very beneficial. But if we look at the long-term targets that we all want to achieve, owners will need to do more and take additional steps. It really is about the right timing of measures for each individual asset. You can always apply some of the smart measures I mentioned, but at a certain point, you will need to go deeper and carry out a refurbishment, replace technical systems or whatever is required.

It always comes down to understanding the life cycle and specific features of your asset. We recently did a deep refurbishment in Milan on a former Allianz building that had become outdated. We reused materials to reduce embedded carbon and implemented geothermal energy to make the building more sustainable, producing about 70-75 percent of its energy onsite. We also created a campus-style environment with amenities that tenants really value.

It is that entire package we need to put together, taking significant physical measures at the right time for each building, with smaller steps in between to stay on the decarbonization path.

Q Are sustainable assets already being rewarded with better financing terms or higher exit values?

I think that continues to be the case. Sustainable assets – and more broadly, those that meet today's tenant requirements – continue to be in high demand, even for offices. We see a clear bifurcation in the market, including on the financing side, with strong lender appetite for assets that meet, or will meet, these prime ESG criteria.

Another way to look at the issue is that it is becoming increasingly difficult to secure financing for assets without these credentials. You can debate how much of a margin improvement there is between one level of sustainability and another, but it is certainly harder to get financing for brown assets that lack a clear path to green-building improvement.

This is certainly true from a sales perspective. In Paris, we have several projects underway involving well-located assets that are physically outdated.

We provide a significant upgrade to those spaces, which allows us to achieve a strong uplift on the rental side, and then that is reflected in the exit value. Day to day, we see how creating that full package – sustainability, amenities, quality and modern space concepts – drives the best pricing in the market, both on rents and on cap rates. That is where we see proof of concept on a daily basis. ■