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The New Norm: ESG as a Material Risk and Opportunity for Real Estate

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ESG was listed as the #10 issue in the 2020-21 Top Ten Issues Affecting Real Estate® by The Counselors of Real Estate®.

Environmental, Social and Governance (ESG) is no longer an emerging trend, but a critical component of real estate investment integrated into investment decision-making. COVID-19 has further cemented this new “norm" as risk management, resiliency, transparency and social engagement—key outputs of ESG—take center stage.

While COVID-19 has underscored the importance of ESG issues, this new “norm” is a result of trends already underway including dramatically changing acceptance of the risks of climate change, innovations in the measurement and tracking of ESG performance, new innovative ESG investment alternatives, the growing influence of millennial investors, and ultimately the rapidly expanding business acceptance.

DRAMATIC CHANGES IN ACCEPTANCE OF CLIMATE CHANGE

Perhaps most explicitly, issues of climate change and the associated risks to investors has snapped into focus within the ESG lens. In recent years there has been a shift in American, Australian, EU, and Asian perspective on ESG and climate change. A recent poll found a majority of Americans said dealing with climate change should be a top priority for the government, a 14% rise from four years ago. Nearly two-thirds of Americans ranked protecting the environment as a policy priority, echoing similar sentiments from Australians.[1, 2] Almost one-half of Europeans and nearly three-quarters of Chinese people consider climate change a major threat.[3]

Where are these changes in public opinion coming from? Some can point to heightened awareness of climate risks as weather-related events increase. The year 2019 was unquestionably notable, with America tallying

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14 weather disasters that cost $1 billion or more.[4] Additionally, Australia noted the warmest and driest year on record , and the World Economic Forum's annual long-term risk survey showed environmental and climate change factors represented all five of the top risks for the first time ever.[5,6]

Accelerating frequency of weather-related events has increased property insurance rates, which is further supporting people's acceptance of the importance of climate change. Rates in the U.S. have been increasing for 10 consecutive quarters since the fourth quarter of 2017, following hurricanes Harvey, Irma, and Maria. The numbers are going up because catastrophic losses are becoming more frequent and more intense, and because properties themselves are increasing in value.[7] TREPP released research that shows green buildings carry 34% less default risk due to a more favorable loan-to-value ratio, where risk is lowered by a green price premium, furthering the business case for ESG.[8]

INNOVATION IN MEASURING AND TRACKING ESG

Greater transparency and stakeholder engagement provide the foundation of any ESG initiative, most notably demonstrated through the collection and reporting on ESG data. Voluntary reporting continues to grow in popularity and scope as it expands across the globe. One of those reporting methods, GRESB, represents over $4 trillion in real asset value.[9] The UN Principles for Responsible Investment, another reporting methodology, has more than 1,100 signatories and $70 trillion in assets under management.[10]

The EU Taxonomy, a new set of screening criteria developed by the European Commission, is designed to help companies, investors, and other stakeholders evaluate the environmental impact of financial products as the EU transitions to a low-carbon, resilient and resource-efficient economy.[11] According to *Bloomberg*, the aim of the EU Taxonomy "is to provide clarity to both corporate and investment firms on how environmentally friendly different activities are, and to drive more capital to fund greener economic activities." For companies and firms that sell to the EU this means reporting and disclosing economic activities and products that either have sustainable investment as their objective or which promote environmental characteristics.[12] This mandatory regulation goes into effect in 2021.[13]

Recent market forces and industry initiatives such as the Task Force on Climate-related Financial Disclosures (TCFD) are encouraging property owners to assess and publicly disclose climate risks to investors and other stakeholders. TCFD is a set of voluntary recommendations on climate-related financial risk disclosures that companies can use to report to investors and other stakeholders. Though not a formal policy, TCFD is a framework that many organizations are looking to in order to properly track climate-related risk in their portfolios.

EU Taxonomy Environmental Objectives:

- Climate change mitigation
- Climate change adaptation
- Sustainable use and protection of water and marine resources
- Transition to a circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

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NEW ESG INVESTMENT ALTERNATIVES

Sustainability has always been at the core of ESG, often with the most direct financial linkages to real estate performance. Now, efforts are expanding beyond the property line, moving from focus areas such as energy efficiency and recycling programs, to greater neighborhood and regional-scale environmental strategies – such as renewable energy and building electrification.

Global investment in clean energy infrastructure has risen in recent years, as a study by REBA shows 79 large-scale renewable energy deals in 2019.[14] A total of $240 billion was invested in energy efficiency across the buildings, transport, and industry sectors in 2019.[15] Grid investment in the United States increased by 8% as regulators continue to emphasize grid resilience and reliability. Newer technologies, like smart meters and grid automation equipment, saw investment rise by almost 10% to $35 billion.[16] Smart buildings, which also utilize similar technologies, are expected to grow at a compound annual rate of more than 23% over the period of 2019 – 2024.[17]

Battery storage is integral to an updated power grid as well, as battery storage allows an entity to utilize a system where energy is stored and excess power is consumed on-demand, reducing exposure to the grid when demand is high and use charges are being implemented.[18] Investment in battery storage rose by 45% to a record of over $4 billion in 2018. This was driven by strong increases in both grid-scale and behind-the-meter batteries. Electric vehicle sales growth is having an increasing impact on overall transport efficiency investment, but as battery prices fall, this price gap is narrowing. Global electric passenger car sales reached almost 2 million vehicles in 2018, a nearly 70% increase compared to 2017.[19]

Within real estate investing, ESG requires a more conscious focus on stakeholders and different perspectives – from investors and clients, to tenants, residents, and even staff and contractors. Issues of equity, health and wellness, and diversity all filter into decisions on the form and nature of our real estate. For example, walkable urban areas have successfully captured more affluent and younger people attracted to job access, public transit, entertainment, restaurants, and other advantages. These walkable urban places, over 750 neighborhoods in the 30 largest metro areas in the country, accounted for virtually all new office and rental multi-family construction. Since 2010, sprawling suburban districts around the country's major cities have added no new development, and some even lost occupancy.[20]

EXPANDING INFLUENCE OF MILLENNIAL INVESTORS

The popularity of ESG is further enhanced by the generational transfer of wealth to millennials, who have shown much greater concern about climate change and social issues than their parents. By 2030, millennials will hold five times as much wealth as they do today due to $68 trillion that will be passed down from boomers in the coming decades.[21] More women in the U.S. are leading the shift to sustainable investing as they control $14 trillion in personal wealth, 84% of who expressed interest in sustainable investing, compared to 67% of men.[22] As Millennials have overtaken baby boomers as the largest part of the workforce, they are both generating wealth and putting pressure on employers to reflect their values, affecting both recruiting and retention.

RAPIDLY EXPANDING BUSINESS ACCEPTANCE

Growth in ESG has also permeated the mainstream corporate world. Twenty percent of Fortune Global 500 companies have made a public commitment that they are, or will be by 2030, using 100% renewable power, carbon neutral or positive, or meeting a Science-Based emission reduction target (SBT).[23] According to RE100, 230 U.S. companies have made the commitment to go 100% renewable as of this writing.[24] Growth in ESG is also demonstrated through a rise in job opportunities in the space. Results from GRESB's 2019 reporting found that 73% of reporting firms have a dedicated employee for whom sustainability is the core responsibility, up from 69% in 2018.[25] In a recent survey, respondents working in the real estate sector on ESG issues stated they agreed that their focus on ESG would have a positive impact on their future career trajectory.

Once a topic for niche players, Environmental, Social, and Governance practices have firmly emerged as a strategic imperative for more than 60% of investors and nearly 50% of issuers around the world, driving tangible and material results.[26] According to *Bloomberg*, "nine of the biggest ESG mutual funds in the U.S. outperformed the Standard & Poor's 500 Index last year, and seven of them beat their market benchmarks over the past five years."[27] Stakeholder pressure and concerns over public image are also key drivers, as ESG commitments commonly lead to a more positive reputation.[28]

CONCLUSION

As we navigate these uncertain waters of an unprecedented public health crisis and the amplified deceleration of the global economy, there is an outcry for future COVID-19 economic stimulus to be directed at a green recovery. From the political leaders of the EU, Canada, India and Asia, to the more than 300 business leaders in the U.S., a call to use economic stimulus to address the global climate crisis and stimulate investment in real estate, transportation, and industry.[29, 30, 31, 32, 33, 34]

ESG will continue to be a focus for real estate investors and other stakeholders, so this is the time to make changes to future proof assets to shocks and stressors, enhance resiliency, and reduce climate change-related risk. Putting together plans to increase health and wellness, and safety, is important now as this will no doubt be critical in the future.

The role of resilience and control of operating costs is more important than ever as investors and operators navigate the blow of near-term rental revenue losses, especially for the hospitality, entertainment, and retail sectors. It is the opinion of Counselors of Real Estate that ESG has been established as a prudent risk mitigation strategy that will contribute to long-term value creation that real estate has historically enjoyed. •

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