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From Materiality to Risk Mitigation: ESG at A Tipping Point for Real Estate

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ESG at a Tipping Point was listed as the #3 issue in the 2021-22 Top Ten Issues Affecting Real Estate® by The Counselors of Real Estate®.

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INTRODUCTION

Environmental, social, and governance (ESG) has reached a tipping point. In a 2019 McKinsey survey, 57% of CEO respondents said they believe ESG programs create long-term value, and 83% say they expect ESG programs to contribute more shareholder value than they do today.[1] But what other signs are forming today in the real estate, finance, and corporate sectors?

For the first time in history, a court ordered a private company, Royal Dutch Shell PLC, to slash its greenhouse gas emissions by 45% by 2030 from 2019 levels.[2] In a record-high vote on an environmentally oriented shareholder proposal that was opposed by management, a whopping 81.2% of investors of DuPont supported a resolution asking the company to report on spills of plastic pellets that are released into the environment—the highest vote ever for a shareholder resolution on environmental issues.[3]

In 2020, ESG funds more than doubled net new money intakes, capturing $51.1 billion.[4] The growth in ESG in recent years is fueled by multiple drivers, including consumer shifts, regulatory requirements, trillions of dollars of wealth transferring to Gen Z and Millennials committed to philanthropic living (not giving), a blurring of work and societal expectations, and a full sprint to attract and retain top talent. PwC's 24th Annual Global CEO Survey found that 30% of CEOs are concerned how climate change will threaten their organization's growth (up from 24% last year)—a growing aspect of the ESG puzzle.[5] Investor and market demand for ESG in real estate spans the globe with the key questions being what is material, where are we

vulnerable, and which strategies will cost-effectively mitigate risks.

Transformative, enterprise-wide ESG programs in all sectors of real estate can be one of the best ways to reduce carbon emissions, accrete value, and demonstrate reputational value. Many Private Equity and real estate firms have set bold ESG commitments, but perhaps one of the most watched organizations is the Blackstone Group. Committing to "reduce carbon emissions by 15% across all new investments where we control energy usage" and "a new target of at least one-third diverse representation on portfolio company boards for new control investments, starting in the U.S. and Europe, and a Career Pathways program designed to create employment opportunities and career mobility for people from underserved communities at Blackstone's portfolio companies," Blackstone is leading the way.[6, 7] Organizations are setting aggressive ESG targets that will need adept implementation and regular reporting on progress. Rating agencies and voluntary reporting frameworks are increasingly providing transparency and serving as watchdogs. GRESB, a leading ESG performance framework for real estate, found: *"Participation in the 2020 Assessment grew by 22% to cover 1,200+ portfolios worth more than USD $4.8 trillion AUM…This increase in participation, coming despite the challenges of the COVID-19 crisis, shows an industry responding decisively to the accelerating investor demand for comparable ESG data…"* [8]

DECARBONIZATION

Unprecedented numbers of companies are conducting greenhouse gas inventories, making commitments to carbon neutrality, emissions reduction goals, or becoming net zero by a set date. There has been a 5x growth in carbon targets between 2016 and 2020, with nearly 30% of Fortune 500 companies possessing a goal. Commercial real estate organizations with carbon reduction frameworks are active in numerous industry frameworks, such as CDP (413 represented), Science Based Targets (72 represented), and TCFD (72 represented). The Net Zero Asset Managers Initiative (87 signatories), and RE 100 (over 300 total organizations) also feature sizeable representation from the industry. Nearly 25% of the Department of Energy's Better Buildings Challenge partners signed onto Better Buildings' Low Carbon Pilot and will use the partnership as an opportunity to make tactical progress towards decarbonizing their portfolio. Driven by stakeholder demand, these commitments present challenges for organizations around funding and implementing the commitments at scale, but also opportunities for collaboration with others and the prospect of lasting change.

CLIMATE RISK AND INSURANCE

Climate change brings with it both physical and financial risk to assets. According to Deloitte:[9]

- *"A majority of U.S. state insurance regulators expect all types of insurance companies' climate change risks to increase over the medium to long term—including physical risks, liability risks, and transition risks.*
- *More than half of the regulators surveyed also indicated that climate change was likely to have a high impact or an extremely high impact on coverage availability and underwriting assumptions."*

With those factors in mind regulators are looking to new processes for due diligence, underwriting, value at risk analysis, and implications for allocations. Though moving at a slower pace than in the U.S., the EU is seeing similar response from banks. Costs are going up for two reasons: catastrophic loss from more frequent and intense storms, water damage, and floods; and the values at risk have grown exponentially in value over time.

ALTERNATIVE FINANCING

The demand for progress towards ESG initiatives is encouraging capital markets and financiers to deploy an increasing diversity of financial products to support these goals. Alternative financing options such as green bonds, energy-as-a-service (EaaS), property-assessed clean energy (PACE), and energy savings performance contracts (ESPCs) are gaining traction in commercial real estate.[10, 11, 12, 13] For example, the commercial PACE market has grown by about 10x since 2015,

and Guidehouse estimates that energy-as-a-service will become a $27.2 billion global market by 2029.[14, 15] Many of these specialized financial products are designed not just to provide access to capital, but to shift the complexity of ESG project implementation from the customer to the service provider. Financiers are offering more streamlined and sophisticated services that can support deployment of ESG projects across large building portfolios—in part, a response to the growing demand for decarbonization at scale.

SOCIAL ISSUES

Workforce development, Diversity, Equity, and Inclusion (DEI) initiatives, and the importance of health and wellness in commercial real estate are setting new expectations for building operations and how to engage stakeholders such as tenants, residents, employees, and the communities in which real estate invests. Now more than ever the spotlight is on commercial real estate and its response to the issues that surfaced in 2020. The Urban Land Institute issued a survey earlier this year, and of those who implemented building health and wellness measures (pre-COVID and during COVID), respondents on average implemented 6 out of the 9 Space Layout measures, 5 out of the 7 Occupancy Control measures, and 3 out of the 10 Equipment measures, with over half stating they will keep the Equipment measures in place permanently such as upgrades to HVAC equipment.

REGULATION, COMPLIANCE, AND POLICIES

But it is the fast-paced changes in the regulatory landscape that will likely drive the most change over the next few years. European Climate Law enshrines the EU's commitment to reaching climate neutrality by 2050 and the intermediate target of reducing net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels.[16] There are several regulatory bodies governing ESG initiatives and reporting in Europe, with two of the largest being SFDR and the EU Taxonomy.[17] SFDR introduced new ESG transparency and disclosure requirements, mandating all financial market participants (FMPs) to evaluate and disclose ESG data at entity, service and product level. The purpose of SFDR is to provide a unified ESG disclosure methodology that maintains transparency, inform investors, and prevent greenwashing in the financial market. Likewise, the EU green taxonomy requires financial participants in scope for SFDR to back up claims on environmental characteristics (e.g., ESG or sustainable funds) associated with their products, and report the percentage of their turnover, capital expenditures, and operational expenditures aligned with the EU taxonomy.

In the U.S., President Biden's decision to re-join the Paris Climate Accord signaled a fundamental shift in the underlying demand from government and capital sources. The Biden White House Executive Order on Climate-Related Financial Risk firmly pushed climate and carbon risks to the forefront of legislative and regulatory agendas. The Executive Order builds on a recent series of regulatory warnings stating "variability and imprecision of industry ESG definitions and terms can create confusion among investors."[18] On April 9, 2021, the United States Securities and Exchange Commission (SEC) issued a risk warning cautioning firms that their ESG statements will be more heavily scrutinized. And, earlier this year, Federal Reserve Governor Lael Brainard cautioned firms that fail to "manage climate-related risks could face outsized losses."

According to the G7 Finance Ministers and Central Bank Governors' Communique, "We support moving towards mandatory climate-related financial disclosures that provide consistent and decision-useful information for market participants and that are based on the Task Force on Climate-related Financial Disclosures (TCFD) framework, in line with domestic regulatory frameworks."[19]

Globally, government stimulus had reached "$15 trillion and counting" by early May, according to Reuters. And the Carbon Brief identified that the stimuli "range from monetary policy, such as central banks lowering base rates or purchasing loans via "quantitative easing" (QE), through to fiscal policy via government spending to pay peoples' wages, investment in specific programs or giving loans to distressed companies."[20, 21, 22, 23] This further confirms that ESG has reached a tipping point, and now

the expertise, creativity, and innovation that the real estate and finance industries are well known for need to be applied to assessing risk and deploying strategies to mitigate those risks while creating value for investors, occupants, and the capital markets that serve them. •

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