ESG AND ITS SIGNIFICANCE IN THE REAL ESTATE SECTOR

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Introduction to ESG

'ESG' or 'Environmental, Social, Governance' is a term which has recently been adopted as a measure of progressive practice for organisations in both public and private sectors across the world.

The three categories of ESG broadly relate to an organisation's impact on the planet (environmental), impact on society (social), and internal organisation and leadership (governance).

ESG can be seen to have developed in response to significant global milestones, such as the Paris Agreement 2015, COP26, and the general rise in strategic climate litigation across the globe.

The real estate industry has seen increasing expectations from investors and lenders for real estate investments and portfolios to show an adoption of and demonstrable adherence to ESG practices and principles.

Relevant Legislation and Policies

As awareness of ESG has become more widespread, so have ESG-focused legislation and policies. In the real estate sector, the following pieces of legislation and policies have likely acted as catalysts for ESG practices.

Minimum Energy Efficiency Standards ('MEES'):

MEES came into force in England on 1 April 2018. MEES applies to both private rented residential and non-domestic property and are a key component in the UK government strategy to reduce carbon emissions. Landlords and lenders have become more aware of the impact of an EPC rating on the valuation of a property. Many investors are looking at their real estate letting portfolios and weighing up the costs of making properties compliant with MEES, versus the impact of the market value if they sell them on prior to rendering the properties MEES-compliant. Meanwhile lenders are concerned with the risks associated with the loans they make.

The swift introduction and integration of MEES into real estate, shows how standardised methods of measuring energy efficiency can drive more action and awareness of environmental impacts of the sector.

Climate-related Disclosures:

The Taskforce on Climate-related Financial Disclosures (TCFD) was set up in 2015 by the Financial Stability Board (FSB) to create a set of voluntary, consistent disclosure recommendations for companies to use when providing information about their climate-related financial risks. TCFD is now disbanded and in 2024, the International Sustainability Standards Board (ISSB) will take over from TCFD. As the ISSB assumes responsibility over climate-related financial disclosures, it is envisaged that steps will be taken to establish the interoperability of ISSB standards across diverse jurisdictions.

For real estate investors and landlords with diverse real estate portfolios, metrics and data can vary dramatically in each locality.

A selection of TCFD metric categories for building-related reporting include:

(1) Building energy intensity

(2) GHG emissions intensity from buildings and from new construction and redevelopment

(3) Area of properties located in flood hazard areas.

(4) Percentage of properties certified as sustainable.

Whilst climate-related disclosures remain largely voluntary in nature, the increase in the engagement of market actors and the general pressure to attain CO2 reduction targets would suggest that the world is heading towards mandatory climate-related disclosure in the future.

Global Real Estate Sustainability Benchmark (GRESB)

GRESB is an independent organisation which was established and is driven by investors with the aim of providing transparent, and validated ESG data to financial markets. It serves real estate funds, REITs, property companies, real estate developers, infrastructure fund managers and asset operators to assess their performance within the three limbs of ESG. According to GRESB, 98% of investors use ESG data in their investment process, showing the industry's increasing focus on ESG.

Corporate Sustainable Reporting Directive (CSRD)

In the EU, on 5 January 2023, the CSRD came into force. Companies subject to the CSRD will be required to report according to European Sustainability Reporting Standards (ESRS). The ESRS will require reports on a range of information relating to ESG. As with other forms of climate-related disclosure, it aims to help investors, civil society, consumers and stakeholders evaluate the sustainability performance of companies.

For the real estate sector, which already has GRESB and defined metrics relating to buildings as set out by TCFD, it remains to be seen to what extent the ESRS for the sector will vary from those already established and commonly used in the sector.

Real Estate Investment Strategies

For the real estate sector, which encountered significant challenges during the Covid-19 pandemic, it can be seen to have responded remarkably in its increasing adoption and implementation of ESG practices and compliance. Whilst legislation like MEES have invariably forced change, the role of real estate investors in evoking change in the sector cannot be understated.

There are approximately 600 green certification systems worldwide, including BREEAM and LEED. Investors are increasingly taking into account potential long-term operational costs, higher rents and occupancy rates as additional incentives for complying with green ratings systems.

In the rental sector, investors can prompt change in a swift and simple manner. Investors can promote green leases where tenants agree to have for example, energy-efficient lighting and high-efficiency air conditioners.

For the building and construction industries, using green construction materials like sustainable timber are becoming more common and commercially viable for investors. For example, the use of sustainable timber can reduce construction times, compared to concrete and steel.

The 'Social' limb of ESG can also be embedded into the wider business case for real estate. Real estate is in a unique position in that real estate is an integral part of communities and their localities. In addition to measuring social impact through its environmental initiatives, real estate can also play a significant role in the economic wellbeing of a region.

Corporate social responsibility (CSR) forms a significant part of the 'Governance' pillar. Strong operational processes, diversity, inclusion and transparency are deemed key to the resilience of businesses. At all levels, real estate investment companies and

organisations can look to strengthen their processes and future-proof their businesses, enabling them to be well-equipped to deal with a multitude of socio-economic and environmental challenges.

Looking Ahead

The real estate sector has shown that it can be vulnerable to external shocks such as pandemics and conflict. Climate change is no exception. The cost of utilities and insurance for properties has increased in several regions around the world in response to climate-related risks such as wildfires, flooding, and higher energy production, with extreme heat for example, increasing the demand for air conditioning.

For real estate actors navigating this landscape, participating in climate-related disclosure, enables not just governments and private entities to have a better measure of sectoral impact, but also increases the awareness and focus of real estate investors on their role and influence on society, as well as areas of their portfolios which may be at greater risk as a result of climate change.

The term 'ESG', whilst often open to different interpretations, can be seen as a universal approach which can prompt organisations to be managed and adapted to robustly contend with present and future global challenges.