



# INTRODUCTION

Over the course of four months, from November 2022 to February 2023, EVORA Global hosted a series of client roundtables and conversations in Singapore, New York, London, Berlin and Milan as part of the EVORA Insights program. The companies we spoke to were some of the largest investors, investment managers and investment banks in these financial markets, and globally, and this includes some of the market leaders in sustainable finance and investment.

These conversations were fuelled by the results of our second annual <u>Insights</u> into <u>Real</u> estate <u>Investment Sustainability</u> (IRIS) survey, which tracks how ESG is being integrated into investment decision-making based on responses from over one hundred investors. In addition, and face-to-face, we spoke to more than fifty clients about the survey results.

Despite the different regional and national perspective on sustainable finance, ESG and real assets, there was a common thread. The theme that resonated with so many investors was how can ESG investment decisions be made today based on the likely changes in the future value of a real estate asset, as a result of climate change and other ESG factors.

The EVORA Insights teams decided to delve into this challenge to see how investors and investment managers are quantifying the future returns, costs and risks associated with ESG and climate change so that they can make informed investment decisions today.

We invited our clients to be interviewed and thirty-five of them quickly agreed. They represent a broad section of the real estate investment and credit market from those with less than \$5bn AUM to those with over \$100bn, in both equity and debt markets. The level of interest and the speed of response was evidence that we'd hit upon a topic that mattered to many investors today.

A standard set of questions was used for these structured interviews undertaken by Sonny Masero during March 2023 with the support of Ros Casbard.

We would like to thank everyone who took the time to contribute to these discussions and to this report. A range of investors, investment managers and investment banks took part in these interviews. For compliance reasons we have agreed not to name them so that we could get maximum participation, openness and insight.

In this report we have summarised the main findings from these conversations to explain the challenge that exists in closing the circle of ESG risk and return. Our commentary is supplemented with anonymised quotes from the interviewees to illustrate common points shared by multiple investors. EVORA Global will use this to inform our services and we are sharing this with the wider market so that together we can find solutions that make it easier to allocate capital and invest in sustainable real estate.

We recognise that there is already some collaborative work underway to address this topic in RICS, in ULI and through various trade bodies, including INREV, AREF and NREP, and universities, including IREBS. The intention is to inform and build more momentum behind this body of work.



# **EXECUTIVE SUMMARY**

We have spoken to over eighty real estate investors and investment managers over the last six months and there is a widespread recognition that real estate is mis-priced when you consider ESG risks and opportunities. The *challenge* for all professionals involved in real estate investment and finance is how to factor those concerns into financial decision-making today.

In this report, we summarise the findings from a set of face-to-face interviews with thirty-five investors and investment managers to investigate this specific challenge in detail.

## ESG market leadership is cascading down through the investment value chain

From EVORA Insights research, we have empirical evidence to show that the largest, mainly regulated institutional investors, have been setting the standard for ESG integration into real estate investment. They are cascading this onto their investors managers with the added momentum of sustainable finance regulations filtering through the financial system. What they were doing one year ago is being emulated by smaller investors and investment managers in the market who want to be part of the institutional investment value chain.

Private market participants are having to compete for capital, for assets and for tenants in the same markets, so this ESG agenda is having an indirect, but meaningful impact outside of the regulated institutions.

The leaders today are changing the way that they look at ESG investment value. They recognise that the market is going through a 12-24 month transition period, not just in Europe, but in Asia-Pacific and North America. A transition that will see certain ESG characteristics become the norm, despite the political backlash causing some investors not to use the term 'ESG' with some compatriots.

Some of these investors argue that now is the time to seek alpha in sustainable real estate, when information is imperfect and lacking in transparency. Others are seeking more standardisation in the attribution of costs and measurement of value and a larger evidence base of transaction and valuation data. The majority of investors are seeing sales and leasing deals being impacted today, as well as capital raising.

Either way, some assets are already becoming stranded in institutional, primary and corporate markets because they don't meet minimum ESG credentials. ESG is redefining what is meant by primary, class A properties and this is creating a floor price for ESG basics. In an increasing number of cases, this can be a binary decision by fund managers' transaction teams to consider an asset for acquisition or not, particularly for Core investment strategies. That includes offices in central business districts, but also logistics, warehousing and multi-family asset types outside of primary markets that have been affected.

Beyond this minimum threshold, we expect that a focus on returns-first will be a key factor in how fast ESG integration progresses. Over the next 12-24 months in the major real estate markets, it is expected that this will drive the adjustments in valuations and investment appraisals required to quantify the costs and accretive value from considering ESG factors.



The main questions that investors are trying to answer for specific assets passing through the investment lifecycle are:

- 1. What are the ESG expectations for a specific real estate market?
  - a. Is there a premium for asset out-performance or just table stakes to avoid discounting?
  - b. How does ESG it affect capital raising?
- 2. What are the investment criteria for the relevant fund?
  - a. Is the asset stabilised?
  - b. Is there capex available for improving the asset?
  - c. What is the hold period?
  - d. Who are the prospective buyers on exit?
- 3. What is the CapEx delta for implementing the Sustainability (decarbonisation) Action Plan compared to Business-as-usual?
- 4. Does this meet the investment hurdle rate for attractive risk-adjusted returns?

### Layers of complexity in integrating sustainability into risk-adjusted returns

Sustainable real estate investment and finance today has many layers of ESG complexity that has to be put in the context of each specific investment thesis and finance rules. There are two professional spheres that are being integrated and that takes time. Investors are having to incorporate the following, and it is not straightforward to connect the dots between the layers:

- 1. Regulatory alignment, at regional, national and local levels covering both sustainable finance disclosure rules and asset-level rules for energy and carbon performance and certification. Financially, these regulations can affect capital raising and the sales or leasing of assets.
- 2. Voluntary disclosure alignment with the requirements of PRI, GRESB, TCFD and segment-specific peer expectations of Net Zero Alliances, in particular, and corporate targets.
- 3. Green building and energy certification and rating requirements, including BREEAM, LEED, EPCs, Energy Star, NABERS and their local equivalent scoring methodologies.
- 4. Decarbonisation pathways capital expenditure aligned with CRREM or other science-based targets, and evidence of action.
- 5. Tenant engagement via Green Leases to improve data acquisition, consider joint investment, avoid poor management and minimise reputational risk.
- 6. Physical climate risk and the costs of adaptation.
- 7. Other ESG factors, such as social value and nature restoration.



The key question is, usually, how can the sustainable asset management plan contribute to addressing all of these layers at the lowest possible additional cost?

When investors talk about sustainable real estate today, the most material aspects for delivering risk-adjusted returns, are two or more of the following, narrower characteristics: regulatory alignment on energy/carbon performance, certification and disclosure; a high-rated energy or green building certificate; energy efficient, low carbon operations; access to renewable energy; and the ability to get to zero carbon emissions, affordably. Assuming that the asset doesn't have a high risk 'red flag' exposure to physical climate risk, particularly flooding, winter storms and wildfire.

The goal is to get the best risk-adjusted financial returns at the lowest cost of action to reduce energy consumption and carbon emissions or to upgrade a certified score, aligned with the appropriate local regulations. This returns-first approach defines the hurdle rate and, consequently, the capex budget available to update the ESG credentials.

Factoring in ESG into discussions about investment value is happening mainly at the deal transaction stage going through the Investment Committee (IC). The leaders are taking an increasingly quantitative approach, bridging the technical language gap between ESG and investment professionals, and pushing the market ahead of a body of transaction evidence and new standardised valuation methods incorporating ESG factors. These new, quantified techniques are being used to underwrite deals and future-proof asset values. It will require time for the education of new methods and a culture shift that is more forward-looking on ESG.

### Adjustment of investment appraisal financial models

There are a number of techniques being used in investment appraisals and financial models in an attempt to better understand the impact of ESG factors, particularly climate risks:

- 1. Using an income method (i.e. DCF) rather than relying on historic market comparables
- 2. Shifting the business planning time horizon from 5 to 10 years or longer
- 3. Running two comparative discounted cash flow projections to understand the counter-factual
- 4. Taking a view on exit value and exit cap rates based on scenarios including future regulatory requirements and buyer / tenant market expectations, including the next hold period or two
- 5. Redefining what prime is, by equating the measurement of an asset's quality characteristics with minimum ESG credentials, which is essentially setting an ESG floor price. Assuming that certain minimum ESG credentials will be a requirement to transact in specific markets, starting with primary and institutional investment-grade real estate with corporate occupiers
- 6. Adding an ESG capex line item for decarbonisation / NZC / transition mitigation measures
- 7. Adding capex for a green building and/or energy certificate upgrade
- 8. Adding capex for physical climate adaptation costs
- 9. Introducing a carbon price line item, particularly for locally regulated markets with fines
- 10. Increasing insurance premium costs, year-on-year
- 11. Adjusting rental velocity / voids / leasing downtime to reflect the desirability of ESG = quality



- 12. Increasing rental income 'green premiums', or protecting the 'top slice' of rental income and avoiding 'brown' discounts
- 13. Overlaying time factors, including lease events; hold periods; regulatory deadlines; CRREM stranding; and increases in physical climate risk to inform the timing of capex spend
- 14. Starting to think about social value and biodiversity/nature investments as a future prerequisite of investors, tenants and regulators
- 15. Considering how much of the available space may need to be allocated for environmental or social benefits, e.g. green amenity space or affordable space; reducing rentable floor area to secure premium rental income.

There is not yet any market agreement on what the actual numbers should be to adjust these different elements. For some, such as capex spend on decarbonisation measures, these are easier to market test from the bottom-up. It is easier to cost ESG actions, particularly for decarbonisation, than it is to quantify the accretive benefits to investment value. Very few firms are capturing data from transactions in a structured way in terms of how ESG is affecting sales and leasing; often excused by ESG being a factor that is difficult to isolate.

#### Collaboration to move ahead

Whilst there are some investors who are capitalising on the present, imperfect market conditions - the majority recognise that this situation will change with increasing standardisation, better data, clear methods for value attribution, increasing knowledge and awareness, greater choice of sustainable assets, and a reduction in transaction costs.

There is a willingness amongst investors to collaborate where it makes sense. To build on existing initiatives, like ULI's C Change initiative, which has already identified that there is a 'carbon mis-pricing bubble' in real estate, an emerging 'two tier market' and the risk of a 'downward spiral' in the value of secondary and tertiary locations that aren't resilient to climate risks and can't afford to be.

The detail in this report is based on how investors and investment managers are responding to this challenge. It will describe the following activities, which could provide opportunities for collaboration across the market:

- 1. Why there is a desire to quantify ESG in the investment process
- 2. How ESG is being integrated into each step of the investment and finance lifecycle
- 3. What ESG factors are financially most material today
- 4. What is the impact on investment value
- 5. What is being costed into investment appraisals, and left out
- 6. How investors are started to move from a belief system to a financial reality
- 7. What is the expectation for valuers
- 8. Why there is not enough data and evidence



Based on what investors have said, there is a need for more capacity and more capability in the following areas:

- Understanding the CapEx delta for transitioning real estate assets from brown to green, particularly M&E, building fabric and renewable energy costs as well as adaptation to physical climate risks.
- Methods for integrating these costs, and attributing value, in valuations, underwriting and investment appraisals recognising the counter-factual of business-as-usual, and understanding the value-at-risk.
- Better data and evidence from transactions that reveals the price premium and discounts in both sales and leasing.
- Understanding exit scenarios for future-proofing asset values that recognise ESG market dynamics to enable a view to be taken on exit values and exit cap rates.
- Business planning for 5+ years in the context of these scenarios.
- Structuring deals that reflect both orderly and disorderly transitions to 2030, 2040 and 2050.
- Measurement of social value in its disaggregated components of: Diversity, Equality & Inclusion;
  Tenant Wellbeing; Tenant Engagement; Community Impact; and Social Assets (i.e. affordable housing, health, education, etc.).
- A common sales pro forma for disposals, including an energy or carbon passport showing the decarbonisation pathways and capex.

There is an appetite for change, but there is also the reality that this need to quantify ESG could mean that a proportion of real estate is devalued and that's not news that anyone wants to hear in the short term, even if it is inevitable over the long term.

