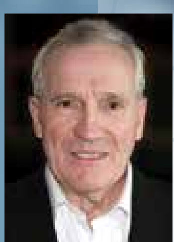
The 'G' element in 'ESG' for commercial real estate



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The environmental, social, and governance (ESG) factors of a company's sustainability and ethical impact is a multi-faceted concept which can be difficult to fully understand without a comprehensive analysis.

For several years, real estate professionals have recognized sustainability in valuing green and high-performance buildings because their unique features may result in lower energy and water costs, differing operating costs, and improved marketability. There may also be special tax advantages or incentives that offset the gross cost of these features. Sustainability, as such, has proven challenging to valuers as the market's reaction to green features may not be supported in the sales comparison approach with limited sales in each market. Generally, the income capitalization and cost approaches are considered to provide more credible value conclusions in this realm.[1]

This article will explore our rapidly evolving understanding of ESG factors related to commercial real estate, and its challenges to market acceptance in either investment analysis or valuation. Finally, it looks briefly at responses to ESG by professional valuers' associations in a still uncertain environment.

So, what is ESG?

The International Valuation Standards Council (IVSC) says that ESG are criteria increasingly used to assess the impact of the environmental, social, and ethical practices of companies on their operations, financial performance, and attractiveness to investors. IVSC's perspective paper goes on to say that ESG factors should also be considered from a tangible asset's perspective, as the ESG principles affect not only the behaviour of owners and operators of assets, but also other matters related to the physical properties themselves. In its 2023 Exposure Draft, IVSC's *IVS 104* introduces ESG definitions and examples for consideration.[2]

While environmental factors are generally addressed in appraisal practice for 'green buildings,' social and governance factors present greater challenges. As IVSC notes in a perspectives paper, the meaning of social value is often clouded in uncertainty, with many definitions, and by the lack of an internationally recognized measurement framework and standards of practice.[3] Social values are influenced by and perceived differently across cultures and geopolitics. That is, social factors tend to have a regional context and, therefore, do not readily lend themselves to analysis and quantification in the valuation process. Without some rationalization for 'normalizing' these differences across cultures, comparisons and quantifications may not be meaningful. Efforts at assigning a monetary value to social impact may be subject to misinterpretation.[4,5]

For commercial real estate, governance has less to do with individual assets or even portfolios, and more to do with how a business is structured and led, and how decisions are made. For example, an executive compensation structure tied to ESG benchmarks and a board-level ESG committee are signs that the real estate company is fully integrating ESG issues into its enterprise risk management system and long-term planning.[6]

Basic questions to consider ESG risks related to governance might include:[7]

- Are executive compensation packages tied to ESG strategy[8] benchmarks for the property and/or portfolio?
- Do the key stakeholders have ESG and net-zero strategies with specific targets and action plans? (i.e., increasingly important to investors and tenants)
- What business ethics do the key stakeholders subscribe to? How transparent is the data provided to stakeholders? What kind of reporting practices are in place? (e.g., are data governance and reporting principles and practices in line with *ESG Principles of Reporting for Private Real Estate*, NCREIF PREA Reporting Standards URL: *https://reportingstandardsinfo.files.wordpress.com/2021/10/rs-handbook-vol-ii-research-esg-principles.pdf.*
- How do the principal players (e.g., investors, owners, managers, tenants, lenders, etc.) reflect and report on diversity and inclusion?

Good governance practices directly impact an organization's ability to build investor, tenant, and community trust. Corporate governance structures that adopt ESG frameworks are better equipped to identify and respond to changing conditions that contribute to obsolescence, regulatory non-compliance, litigation, and reputational risk.

Commercial real estate governance may be influenced by multiple stakeholder perspectives beyond owners – across lenders, investors, and occupiers. Upon clarifying the purpose of the valuation, multiple stakeholder perspectives may need to be considered in a decision matrix weighing the expectations of each, considered in terms of relative contributions of material non-financial (social and governance) factors that impact financial feasibility. Consider, for example, the valuation of a social housing complex with a restrictive covenant that constrains the site's highest and best use.[9]

Do ESG factors receive market recognition, including previously recognized 'green value'[10] relating primarily to energy?

The UN's Sustainable Real Estate Investment initiative states that the people who manage global real estate assets – valued at around US$50 trillion – are one of the most important decision-making groups to address climate change and responses to the COVID-19 pandemic.

The buildings sector has one of the highest carbon footprints – currently contributing 30% of global annual greenhouse gas (GHG) emissions and consuming around 40% of the world's energy. Following through on the 2015 commitments made in Paris to limit global warming means avoiding 77% in total CO2 emissions in the buildings sector by 2050 compared to today's levels.

"Globally, around half of respondents believe that green/sustainable buildings achieve a rent and a price premium over comparable non-green/unsustainable buildings. More than one-third believe that the rent and price premium stands at up to 10%; around 15% judge it to be higher still. Furthermore, over 30% of respondents suggest that, even if there is no rent or price premium, buildings not classed as green or sustainable are subject to a brown discount."

Climate change, growing recognition of social inequity, and the pandemic are contributing to more robust approaches to sustainability-related risks. The three ESG factors are increasingly recognized as critical drivers of long-term value. In its *2022 Sustainability Report,* RICS reported rising investor demand for sustainable buildings.

Not so fast –
Does everyone accept ESG as a driver of long-term value?

ESG shifts corporate economic performance from its singular long-term focus on profit for *shareholders* to include *stakeholders'* perspectives, with the aim of encouraging more socially responsible (or perhaps less socially irresponsible) behaviour.[11] While investors and valuers have previously considered environmental issues (e.g., energy), their risk perspectives are expanding to consider governance and social impacts.

Owners, tenants, investors, and other stakeholders are increasingly using ESG performance as a predictor of long-term financial and economic performance.[12] The increasing emphasis on ESG drives a need for more clarity on its commercial real estate impacts. We need to know: Do ESG factors impact real estate markets? And how can we measure ESG impacts in real estate valuations?

For the valuer, expanding the traditional profit perspective to include ESG factors is key to analyzing governance and social factors. These are increasingly important to understanding the backstory of comparable transactions – for example, in capitalization rate analysis.

The functional definition of material ESG factors can vary across geopolitical, cultural, and legislative differences.

Adding to the complexity of ESG is the confusion of multiple ESG frameworks[13,14,15] that real estate professionals are invited to consider. Consistent global standards are not yet available. Caution should be exercised in selecting and implementing standards to avoid claims of greenwashing and other reputational risks. More widely recognized ESG frameworks and standards for commercial real estate include: the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), and the Task Force on Climate-related Financial Disclosures (TCFD). In Australia, NABERS (the National Australian Built Environment Rating System) provides reliable and comparable environmental measurement across building sectors, including hotels, shopping centres, apartments, offices, and data centres. Such frameworks target financial disclosure, climate risk, and GHG emissions with varying relevance to real estate in Europe, North America, and Asia. Existing standards attempt to integrate ESG criteria and certifications across a patchwork of jurisdictional regulation and legislation, hindered by lack of common taxonomy. On a regional basis, the EU Taxonomy is one strategy that defines what actually constitutes sustainable activities across the European Union. It uses minimum compliance criteria for economic activities that are environmentally sustainable.

A *Harvard Business Review* article sums the issue: "*... two conversations have been going on .... One is about its financial performance .... The other is about sustainability performance ... a conversation between the company's sustainability function and the sustainability and stewardship function in the investor. These two conversations are already starting to converge and must become one. Finance and sustainability people at both companies and investors must become bilingual.*"[16]

What are other challenges to market acceptance of ESG?

To help inform their clients' investment and whole-life asset (valuation) decisions, real estate professionals need to evaluate material ESG factors that are likely to affect commercial real estate. To do so, real estate professionals need to know which ESG factors are relevant and have an impact on the risks and value of the specific property or portfolio being considered. Borrowing from business and finance, *material* ESG issues may be defined as those governance, sustainability, or societal factors likely to affect the financial condition or operating performance of specific properties within each asset class.

Sustainability and the sustained use of a building can be determined by certification. Some of the most well-known international certification systems are LEED, BOMA Best, BREEAM and DGNB.[17]

Building Owners and Managers Association International (BOMA), in its recently released *BOMA Best 4.0*, presents an example of continually improving certification programs. *BOMA Best 4.0* is a streamlined version of the sustainable certification standard for existing commercial and multi-family real estate buildings that was launched April 2023. It offers a simplified questionnaire for each asset class, with an emphasis on carbon emissions. These simplified questionnaires can also contribute to improved data governance.[18]

ESG analysis is integral to generally accepted appraisal practice. For example, in the direct comparison approach, the appraiser identifies and evaluates the importance of various elements of comparison *in the market* to judge the relative weight a particular sale should have in comparative analysis.

Likewise, real estate professionals need to identify and evaluate those elements of ESG that are material to *highest and best use (HBU) analysis*, and that are *relevant* to the investors' or clients' needs.

There are four tests in HBU analysis. ESG factors influence the first three HBU tests (physically possible, legally permissible, and financially feasible). But identifying and analyzing the social and governance factors may be better considered as part of the fourth HBU test – that is, evaluating each alternative to determine the option to achieve maximal productivity over the long-term. Rating and weighing these factors in a decision matrix needs to reflect the preferred criteria and scope of work defined by the investor, lender, or other stakeholders typical to the given asset market.

The analyst is challenged to identify relevant ESG factors and evaluate their impact on value with limited market evidence. Transactional evidence, authoritative surveys, and benchmarks may help provide an understanding of how real estate investors, lenders, tenants, and owners weigh ESG factors in evidence-based real estate decisions. Criteria rating and weighting factors in a decision matrix that meets the ESG perspectives of stakeholders means reviewing property characteristics, market risks, societal and governance considerations, and investment criteria.

A good ESG rating means that, relative to comparable peers, the asset's environmental, social, and governance risks are managed well to preserve (or maximize) long-term value.

Generally, ESG criteria ratings and weightings for corporate real estate are determined by ESG rating agencies and reflect the specific ESG factors *they* determine are most important to the industry. Examples of rating agencies include Global Real Estate Sustainability Benchmark (GRESB),[19] Morgan Stanley Investment Capital (MSCI),[20] Sustainalytics,[21] and Institutional Shareholder Services (ISS).[22] GRESB assesses and benchmarks the ESG performance of real estate *assets* globally, providing standardized and validated data to the capital markets. GRESB, MSCI, and ISS are examples of rating agencies that evaluate real estate *companies* based on ESG criteria such as energy efficiency, water conservation, and indoor air quality, and assign weights to each criterion based on its perceived importance. Engaging a well-recognized commercial real estate rating agency, which recognizes appropriate certification (e.g., GRESB, NABERS, Green Star, BOMA Best) and transparency can help avoid claims of greenwashing[23] and other reputational risks.

ESG ratings and weighting criteria are increasingly used by investors and lenders in their corporate real estate decisions. For example, CBRE notes that real estate investors should at least consider ESG factors such as energy efficiency, water conservation, and indoor air quality when evaluating a property's ESG performance.[24] And Deloitte notes that ESG considerations for real estate include environmental factors such as energy efficiency and carbon emissions, social factors such as tenant health and safety, and governance factors such as board diversity and executive compensation.[25] Investors and lenders consider ESG ratings and weighting criteria to evaluate the sustainability of a property and assess its long-term value.

It can be difficult to evaluate sustainability factors in a given evaluation unless specific sustainability and ESG data, comparables, or benchmarks are available for the subject. With recent emphasis on factors such as carbon emissions, net zero plans, and energy efficiency, it is imperative to seek relevant data for the asset under valuation from key stakeholders as well as from publicly available sources to ensure sustainability decisions are reliably evidence-based. As with other elements of comparison, ESG data requirements for the subject and comparables should align to the asset class and target market, which reflect similar sustainability credentials.

Guidance from professional associations

The body of knowledge around the impact of ESG factors on property valuation is still developing. Here are examples of emerging guidance from professional valuation associations.

The Royal Institute of Chartered Surveyors' (RICS) published a guidance note on sustainability and ESG in commercial property valuation and strategic advice in 2021.[26] The guidance note, complementary to RICS *Red Book Global Standards*, provides direction regarding valuation methods, and sustainability considerations such as risk premiums and obsolescence. The note also provides an overview of issues related to the application of the direct comparison and income (especially discounted cash flow) approaches.

The International Valuations Standards Council (IVSC) states that the obligation to consider ESG within the tangible asset valuation process is implicit in *International Valuation Standards*.[27] IVSC's *Perspectives Paper* says that discounted cash flow analysis (DCF) is well-suited to quantifying ESG factors within a real estate valuation because a DCF can explicitly reflect specific assumptions which relate to income, expense, capital expenditures, exit yields, and vacancies over a period of years. In an IVSC interview, Adrian Nicholls noted the importance of understanding the value of *intangible* assets, whether it be workforce skills, organizational knowledge, or the power of brands.[28]

Today, the blurring of property and business values extends to all property types and industry sectors including hotels and hospitality variations (including timeshares and Airbnb/VRBO), self-storage, manufactured housing and for-rent subdivision communities, REITs with NNN-lease structures for big-box retail stores, e-commerce warehouses, and mixed-use adaptive reuse projects.[29]

DCF valuation methodology and the blurring of property and business enterprise emphasizes the need for clarity in defining the bases of value – distinguishing between market value, investment worth, or synergistic value.[30]

Looking forward

In the current uncertain global real estate market environment, IVSC's advice about ESG may be most appropriate when accounting for ESG factors within the valuation process:

- Monitor the continued evolution of ESG; identifying building aspects that result in higher or lower ESG ratings.
- Evaluate a building in its market, being aware of applicable governmental ESG measures.
- Maintain a keen understanding of green leasing and other market requirements to accurately reflect supply and demand considering ESG.
- Liaise with construction and building cost professionals to understand components that enhance ESG factors and their cost.
- Analyze ESG features of comparables used and determine, through rating criteria, the weight that market participants place on such features.
- Determine the availability and impact of favourable financing on buildings with higher ESG ratings.

Endnotes

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8 An ESG strategy should include a process for tracking metrics and establishing targets (software enabled).

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[23] Avoiding the perception of greenwashing requires ESG disclosures using a reputable, global reporting framework such as Global Reporting Initiative (GRI), Principles for Responsible Investment (PRI), or Sustainability Accounting Standards Board (SASB). ***Such frameworks require presentation of standardized and comparable ESG information.***

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