THE TIME IS NOW FOR CANADA'S APPRAISERS TO DEVELOP AN ESG VALUATION STRATEGY

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While chatting recently with the owner of several properties occupied by a Canadian grocery company, the topic of ESG came up. The thrust of the conversation was that achieving environmental, social, and governance (ESG) excellence – especially on the environment side – remains a bit of a mystery. Questions were raised such as: How do we become ESG-compliant to meet tenants' corporate policies or potential government regulations? What are the implications if we do not? Are ESG considerations just a fad? What is the value of this property, or its resale value, if it falls behind other competing assets when it comes to ESG factors?

These are increasingly important questions that the broader commercial real estate industry and Professional Appraisers (P. App.) and valuation experts should be tangling with.

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In the near future, ESG will have a greater influence within the property valuation and transaction market across the various asset classes, and it is essential for experts to start figuring out how to establish a solid appraisal process that considers various ESG elements, especially on the sustainability side.

We are already starting to get a sense of what is in store for us based on data that is emerging in Europe, where they are further along in their ESG journey.

In London, we have seen a gap emerge in the last four years between the average purchase prices of buildings with sustainability ratings versus those without, according to research by the MSCI published last year. I wrote recently in *SustainableBiz.ca* that the gap last year had touched 25%, with buyers in London placing a higher value on buildings that had achieved sustainability requirements from organizations like the Building Research Establishment (BREEAM), U.S. Green Building Council (LEED), and GBC Alliance. That same research suggested the value gap had reached 35% in Paris in 2022.

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The North American market is lagging behind Europe on this front. We also face the challenge of not having a clear picture of comparable valuations given that our national CRE transaction market has been slow amid post-pandemic economic challenges and elevated interest rates, and we also have not yet reached a large enough inventory of ESG-ready or certified buildings that are transacting to give us a base of data.

IS ESG JUST A FAD?

Some may be hoping that ESG is just a fad that eventually becomes an issue they do not have to deal with. I am not convinced that is going to happen.

It is likely that some ESG pushback could emerge (most likely along partisan lines), but it will be the reality of the situation our environment, our cities, our communities, and our buildings are facing, that dictates the path and staying power of the ESG movement and sustainability requirements.

Insurance companies, financial institutions, and permitting governments are already adjusting their processes and policies to react to extreme weather events brought by climate change. In the Canadian context, we do not need to search very hard for instances of extreme weather events directly threatening our infrastructure. British Columbia just experienced its most devastating wildfire season on record. For a time this summer, it appeared the entire city of Yellowknife would be lost to wildfire. This comes only two years after the record-setting and fatal Heat Dome in Western Canada, which was followed in the fall of that year by devastating mudslides and floods that overwhelmed communities and destroyed sections of major highways, essentially severing the Lower Mainland from the rest of Canada. These disasters are costing us billions.

Opinions will matter less as real consequences with measurable costs continue to challenge our built environment. Appraisers should be preparing themselves for this movement to properly support clients as they seek to appropriately position their ESG-ready or certified buildings in the market.

"A GOOD STARTING POINT FOR AN ESG-FRIENDLY APPRAISAL STRATEGY IS TO THINK ABOUT RISK."

THINK ABOUT ESG VALUATION STRATEGY IN TERMS OF RISK

A good starting point for an ESG-friendly appraisal strategy is to think about risk. The risk is that, by ignoring the ESG movement, property owners in Canada will start falling behind in the market when aiming to secure large, corporate, global clients. We know, for instance, that 42% of *Fortune Global 500* companies have made public commitments to major climate targets by 2030. Sixty-six per cent of companies have set carbon reduction targets for 2050, according to the Climate Impact Partners Report.

That means there is a larger contingent of companies that will need to find and secure space that achieves net-zero criteria for their own corporate responsibilities. It is possible that that roster of global companies will grow; 2030 is just around the corner.

It is also interesting to take a look at the Net Zero Tracker – a website that tracks

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and publishes information on the net-zero commitments and strategies of companies around the world. The list of companies with targets to eventually achieve net zero carbon or carbon neutrality includes Walmart, Apple, Amazon, Toyota, Volkswagen, and Samsung.

There is not a simple formula to achieve this, but a good starting point is to perceive the risk associated with doing nothing. There is risk in losing ground or value as a property owner, as government ESG regulations expand or increase. There is also the potential to lose out on the carrots or incentives emerging to support the movement in Canada, as policies and grants coalesce around ESG. Another risk is being considered archaic by tenants and being left with an asset that is orphaned or relegated by the market.

START WITH DECARBONIZATION

Carbon neutrality, whether it is with an industrial building or an office building, is the low-hanging fruit that will probably be the first domino to fall. It is already happening. Toronto-based KingSett Capital, for instance, has an asset portfolio of 5.4 milion square feet to decarbonize by 2027. If achieved, it would equate to a 35% drop in carbon emissions from the company's baseline.

In speaking with partners and stakeholders in the national market who are involved in this right now, we are seeing signs in the design-build process that reveal a desire to futureproof buildings, especially on the office and industrial side. The first step tends to be decarbonization efforts.

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ESG is an emerging focus in our built environment and valuation experts must take a nuanced approach, as more clarity emerges in our marketplaces. This clarity will factor in various elements, including the marketability of buildings, financing availability, tenant demand and lease-ability, and adherence to corporate or government policies.

As appraisers, we must accept the challenge of developing a strategy to assess risk and interpret the market as it pertains to a single property at a certain point in time.

"AS APPRAISERS, WE NEED TO ENGAGE WITH THE MOVEMENT AND DEVELOP A STANDARD FOR ESG VALUATION TODAY, SO THAT WE ARE READY FOR TOMORROW."

We are at an interesting inflection point where some major institutional groups are on top of the ESG movement – they are engaging with ESG consultants and updating their corporate stack to futureproof their real estate holdings. On the other hand, some groups appear indifferent and are taking no action.

As appraisers, we need to engage with the movement and develop a standard for ESG valuation today, so that we are ready for tomorrow.