

Top 10 Real
INSIGHTS
ESG Trend Report

ISSUE 69

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1

INSIGHTS FROM INDUSTRY LEADERS ON ESG TRENDS

THE ESG ALPHABET SOUP

Ask any three real estate professionals what “ESG” is and you’ll likely get three different – and possibly confusing – answers. It wasn’t always so.

2

WHAT IS ESG?

ESG criteria brings people and the planet into investment decision-making alongside pecuniary benefit.

3

LEED – NO LONGER LEADING

Although the name “LEED” implies certified buildings are energy efficient, mounting research and media reports have built up over the years challenging that assumption.

7

THE “S” IN ESG

In addition to the “E”, social factors can also be key considerations in ESG integration, especially in retail and multi-family investments.

6

ESG INTEGRATION

Investors must drive ESG factors into investment process, starting with the acquisition phase and carrying right through the asset management cycle.

5

PROPERTY’S ENERGY ADDICTION

Unfortunately, GRESB participants represent only a small percentage of global real estate owners, and they are a virtuous few fighting the world-wide trend of rising property-related emissions.

4

G3 ESG

Fortunately, real estate is stepping up to the competitive challenge with next-generation ESG reporting.

8

ESG DECISIONS ARE INVESTMENT DECISIONS

ESG factors must be consistent with, and supportive of, sound investment decision-making by investment organizations that are required to act as fiduciaries.

9

GREENWASHING

‘Greenwashing’ is becoming a major concern for institutional investors.

10

ESG IS NOT A FAD

ESG in real estate is here to stay because it has a meaningful role in investment decision-making that will only grow in importance as climate change and other issues escalate in importance.

For further details on these top trends please visit the Real Estate Forums portal at realestateforums.com

1. THE ESG ALPHABET SOUP

Ask any three real estate professionals what “ESG” is and you’ll likely get three different – and possibly confusing – answers. It wasn’t always so.

In the late 2000s, most professionals would have answered in unison if asked about “greening” real estate. Topics that fall under today’s Environmental, Social and Governance (ESG) criteria, such as building certification and resource-saving building upgrades, were gaining momentum. Back in the day, this put real estate’s ESG leadership far ahead of stocks, bonds and other asset classes.

But widespread investor focus on ESG today has attracted more than \$100 trillion globally and, along with it, too many competing interests. This has produced an “alphabet soup” of acronyms, jargon, targets and competing reporting standards. In turn, this has produced widespread confusion.

The flip side of this is that competition between standard-setters benefits ESG by raising the bar on investor expectations.

However, it has not benefited real estate. In the midst of increased expectations, investors are questioning real estate’s tangible accomplishments after more than a decade of effort. Have building certifications had an “impact” and have improvements in energy saving been significant? In the face of weak answers, real estate’s credibility as an ESG leader has been lost.




Going forward, real estate must have better responses to questions about tangible ESG accomplishments to rebuild relevance and investor trust.

2. WHAT IS ESG?

ESG criteria brings people and the planet into investment decision-making alongside pecuniary benefit.

An example of this, *Figure 1*, shows a list of 28 individual ESG issues that the UN-supported Principles for Responsible Investment (PRI) recommends for consideration in real estate investing.

Figure 1: 28 Real Estate ESG Factors

 ENVIRONMENTAL	 SOCIAL	 GOVERNANCE
<ul style="list-style-type: none"> ■ Biodiversity and habitat ■ Climate change ■ Land contamination ■ Energy consumption ■ Greenhouse gas emissions ■ Indoor environmental quality ■ Location and transportation ■ Materials ■ Pollution ■ Resilience to catastrophe/ disaster ■ Renewable energy ■ Sustainable procurement ■ Waste management ■ Water consumption 	<ul style="list-style-type: none"> ■ Community development ■ Health and safety ■ Human rights ■ Inclusion and diversity ■ Labour standards and working conditions ■ Social enterprise partnering ■ Stakeholder relations ■ Occupier amenities – showers, changing rooms, ■ Controversial tenants 	<ul style="list-style-type: none"> ■ Anti-bribery and money laundering ■ Cybersecurity ■ Data protection and privacy ■ Legal and regulatory fines ■ ESG clauses in existing leases

Source: *Principles for Responsible Investment*

In addition to PRI, there are numerous other standard-setting bodies who created ESG frameworks, reporting tools, and measurement indicators. Many real estate operators are familiar with LEED (*Leadership in Energy and Environmental Design*), created by the U.S. Green Building Council, and *Energy Star*. Examples of some other leading standards in real estate are the *Sustainability Accounting Standards Board (SASB)*, the *Task force on Climate-related Financial Disclosures (TCFD)*, and the *UN Sustainable Development Goals (SDGs)*.

All standard setters have unique criteria, so there is no one universal set of ESG factors in real estate.



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3. LEED — NO LONGER LEADING

Although the name “LEED” implies certified buildings are energy efficient, mounting research and media reports have built up over the years challenging that assumption

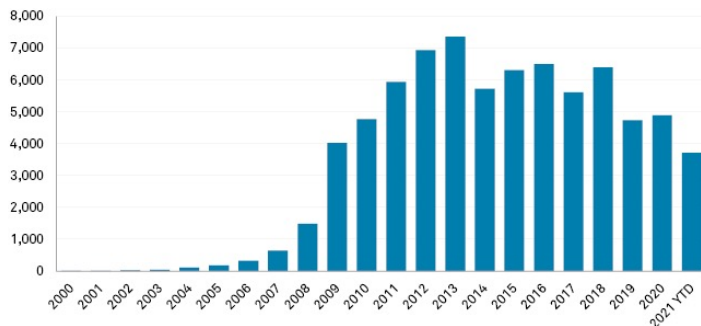
ESG in real estate started with energy efficiency. The earliest North American program – a precursor to *Energy Star* – was launched by the U.S. government in 1991 to promote energy-efficient lighting in commercial buildings. Because lighting retrofits and some other upgrades had a meaningful bottom-line impact, and capital costs could sometimes be shared with tenants, building owners started down the ESG path. In the mid-1990s, *Energy Star* was launched to rate whole building energy efficiency.

By the late 1990s, the *LEED* certification rolled out as a holistic environmental standard to “green” new construction. By 2004, under the auspices of the U.S. Green Building Council and its country affiliates, *LEED* encompassed six standards covering construction and building retrofits.

While energy efficiency efforts were motivated by cost containment, *LEED* certification focused on increasing real estate’s appeal to capital sources and tenants. Research on 10 years of data ending in 2014 showed slight improvements in rental rates, and more marked improvements in occupancy levels, and tenant satisfaction in certified buildings compared to conventional buildings.

However, *LEED* certification has come under fire. *LEED* provides a menu of choices for building inputs with a score attached to each menu option. The points for energy efficiency representing the most expensive points to attain. There are any number of low-cost items that earn points, such as bike racks that may not result in actual energy savings. So, although the name “*LEED*” implies certified buildings are energy efficient, mounting research and media reports have built up over the years challenging that assumption. Recently, an academic review of the literature on building certification showed the energy efficiency of *LEED* buildings is questionable.

Figure 2: Annual LEED Certifications in the U.S. (January 2000-October 2021)

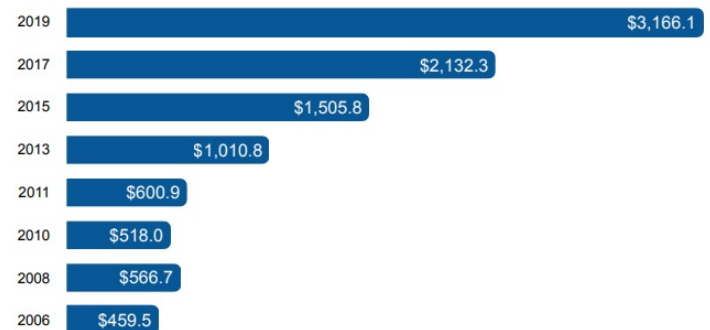


Source: U.S. Green Building Council; LEED data extracted on October 21, 2021

As *Figure 2* highlights, when ESG began to take off in other asset classes around 2013, investor interest in building certification began to wane, possibly as investors focused their ESG efforts elsewhere. This appears to be the point at which real estate’s ESG leadership started its decline.

This decline poses a serious problem as real estate competes with other asset classes for capital. As *Figure 3* shows, of the CAD \$3.16 trillion managed with an ESG focus in 2019, 80% of these assets were Public Equities and Fixed Income. The massive capital flows into public market ESG investments have been driven by their strong return performance.

Figure 3: Canadian Responsible Investments Assets (in Billions; 2006-2019)



Source: Responsible Investment Association Canada

4. G3 ESG

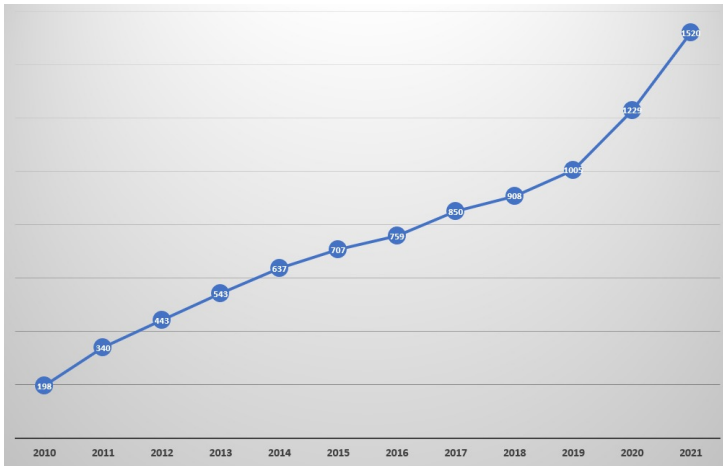
Fortunately, real estate is stepping up to the competitive challenge with next-generation ESG reporting.

If the first generation of ESG in real estate was measuring energy use, and the second generation was building certification based on “greening” buildings, the third generation (G3) of ESG is measuring outcomes. In the case of real estate, that is focused on measuring building performance.

GRESB (formerly the Global Real Estate Sustainability Benchmark) is one of the best examples of G3 reporting in ESG. It requires outcome-focused, quantitative reporting on year-over-year improvement in two critical building performance metrics: energy use and greenhouse gas emissions. As *Figure 4* shows, GRESB reporting has taken off. Consistent with academic evidence in the stock market that ESG is driving return outperformance, there is early evidence that high GRESB scores are associated with above-average returns.

The 2021 GRESB results showed that its 41 Canadian real estate participants saw both their average energy use and emissions drop by more than 8% year-over-year, compared to global GRESB participants’ 7% reduction in energy use, and emissions reduction of 8.25%. The rankings put Canada in the top spot globally.

Figure 4: GRESB Participants (2010-2021)



Source: GRESB

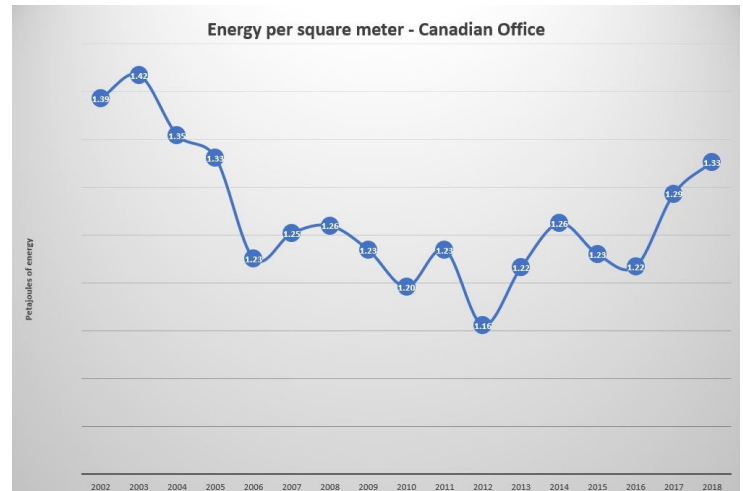
5. PROPERTY’S ENERGY ADDICTION

Unfortunately, GRESB participants represent only a small percentage of global real estate owners, and they are a virtuous few fighting the world-wide trend of rising property-related emissions.

According to the International Energy Agency (IEA), the real estate industry held emissions constant between 2013-2016, but saw them grow again after that. Emissions from property reached a mind-boggling 10 gigatonnes of CO2 in 2019. The IEA blamed a lack of sustainable building construction and investment in energy-efficiency, and said “enormous emissions reduction potential remains untapped.”

There has been a similar trend in Canada. As shown in Figure 5, Canadian office building data as an example, the biggest sector of commercial real estate, shows energy use per square metre fell by over 18% between 2003 and 2012, was fairly flat between 2013 and 2016, and then increased rapidly into 2018.

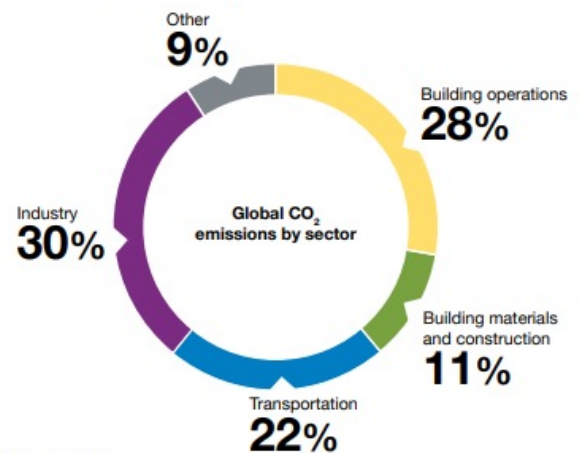
Figure 5: Energy per Square Metre in Canadian Office (2002-2018)



Source: Government of Canada

As Figure 6 shows, building construction and materials, and building operations and are still the biggest source of emissions globally, and represent a combined 39% of total emissions! However, despite almost two decades of investment and efforts to improve energy efficiency, real estate owners have not moved the needle; indeed, real estate is still a very carbon-intensive industry.

Figure 6: Global CO2 Emissions by Sector



Source: Architecture 2030

As such, real estate should expect increasing scrutiny for its contribution to climate change. Due to the escalating climate crisis, investors globally are focusing on this issue, and a recent survey of global investors showed they expect companies that are strong contributors to climate change to provide detailed disclosure on emissions and a clear plan to reduce emissions. In order to maintain investor trust, real estate’s energy performance and disclosure must improve.

Should high levels of carbon emissions from real estate continue, there are potentially serious, negative financial consequences. A key concern for investors will likely be the financial impact of negative publicity and reputational problems at best, and onerous government regulation at worst. The way that investors should factor these risks into today's financial analysis is a process called "ESG integration."

6. ESG INTEGRATION

Investors must drive ESG factors into investment process, starting with the acquisition phase and carrying right through the asset management cycle

ESG integration sounds more daunting than it actually is. What it involves is driving ESG factors into the investment process, starting with the acquisition phase and carrying right through the asset management cycle until selling the asset.

A good process should start with screening potential purchases. There should be some minimum ESG criteria that form part of the quick screen on deals. An example of this could be a minimum level of energy efficiency in a building. If the criteria are important, then there should be a reluctance to continue to pursue an acquisition that fails the initial screen.

Should the potential acquisition pass the initial screen, ESG should be embedded in all steps in the investment process. This can also include identifying and costing a program to improve building performance that can form part of the asset management plan for the property.

As technology is dynamic, including PropTech, to support ESG in asset management, professional investors should be constantly educating themselves and evaluating opportunities to enhance building performance. Greater adoption of materials and processes that support the transition to a low-carbon economy will drive costs down and make the economics increasingly attractive.

7. THE "S" IN ESG

In addition to the "E", social factors can also be key considerations in ESG integration, especially in retail and multi-family investments.

Recently there has been a lot of interest in:

- **Wellness:** tenant health and safety, indoor air quality, toxic materials, occupier amenities
- **Social Factors:** community development; tenant engagement, living conditions
- **Equity:** Affordable housing, diversity and inclusion, labour standards

For instance, improving the sense of belonging in multi-family buildings through management initiatives is a good example of applying social ESG. Especially in buildings with high populations of new immigrants who are visible minorities, improving interaction and positive relations between residents may not only help to integrate newcomers into Canadian society, but may help them to secure or improve their employment.

Meanwhile, the remedy for many struggling enclosed shopping centres may be to add more tenants that are non-profit or social services organizations who support the residents in the trade area. Although this type of tenant cannot pay the rent commanded by prime locations in the centre, community-development organizations as occupiers can eliminate vacancy in low traffic locations and also create new sources of foot traffic that increase the viability of merchandise-oriented tenants.

Affordable housing is a prime "S" factor. However, this serious social issue seems to be beyond the capacity of real estate investors to solve without government subsidies or other financial supports. This is because the economics of affordable housing are currently unworkable in the large cities that need the housing most.

8. ESG DECISIONS ARE INVESTMENT DECISIONS

ESG factors must be consistent with, and supportive of, sound investment decision-making by investment organizations that are required to act as fiduciaries.

This problem with affordable housing highlights one of the most important aspects of ESG in investment: ESG factors must be consistent with, and supportive of, sound investment decision-making by investment organizations that are required to act as fiduciaries.

Fiduciaries are responsible for the sound management of money entrusted to them. In real estate, some of the most important fiduciaries are the boards and management of public companies and pension funds. Using affordable housing as an example, this kind of development cannot be undertaken unless fiduciary organizations can demonstrate that within a reasonable time frame, and without taking on undue risks such as high leverage, an affordable housing project provides a similar return as other multi-family real estate.

Although it is disappointing and even frustrating that affordable housing development is an ESG goal that is inconsistent with the financial requirements of fiduciary organizations, it does highlight the distinction between ESG and Impact Investing. This latter type of investment is undertaken by charities or family foundations in order to provide a social impact, and this is where affordable housing investment belongs.

The good news is that many other ESG goals outside of affordable housing meet the financial criteria of fiduciaries and can be incorporated into sound investment programs. For instance, the earlier example of the shopping centre offering below-market rents to non-profits and social service tenants. The decision is financially sound if the space was likely to remain vacant and the spin-off effects of the increased foot traffic in the centre from these new tenants increased the sales, and percentage rent, of other commercial tenants in the centre.

As we transition to a low-carbon economy, the goal of net-zero is another example of an ESG objective that can be financially viable. As more large corporate occupiers commit to net-zero pledges, they may have to locate in net-zero buildings even if it involves rent premiums. In combination with other factors such as rising carbon taxes, and expected municipal regulations requiring building to decarbonize in future, it becomes easier to financially justify retrofitting to achieve net-zero.

9. GREENWASHING

‘Greenwashing’ is becoming a major concern for institutional investors.

Although there are legal standards and regulation that require the careful financial assessment of ESG decisions, there are few impediments on real estate organization making unfounded ESG claims. As a result, survey after survey shows that ‘greenwashing’ is becoming a major concern for institutional investors.

For instance, the PwC Emerging Trends report says that 73 percent of the European investors it surveyed believe that brand and reputation will become more important to the success of real estate firms in future. Another a recent survey by the proxy-voting firm ISS showed that investors expect companies that are heavy carbon emitters to provide detailed disclosure and a clear plan to reduce emissions.

The lack of progress in decarbonizing real estate operational carbon after more than a decade of “green” announcements and glossy corporate sustainability reports may explain investors’ jaded perspective. To make things even more difficult for real estate, the definition of decarbonizing is expanding as investors increasingly question the heavy carbon footprint of building construction.

It’s clear that both decarbonization and disclosure on the real estate front must improve. Otherwise, the stigma of greenwashing may cause capital to leave real estate and support other assets classes such as infrastructure where the decarbonization outlook is much better.

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10. ESG IS NOT A FAD

ESG in real estate is here to stay because it has a meaningful role in investment decision-making that will only grow in importance as climate change and other issues escalate in importance.

The way that ESG informs financial decisions today is a far cry from the early days of building certification. We now understand that indiscriminately putting “green” features into buildings without a clear rationale doesn’t make investment sense.

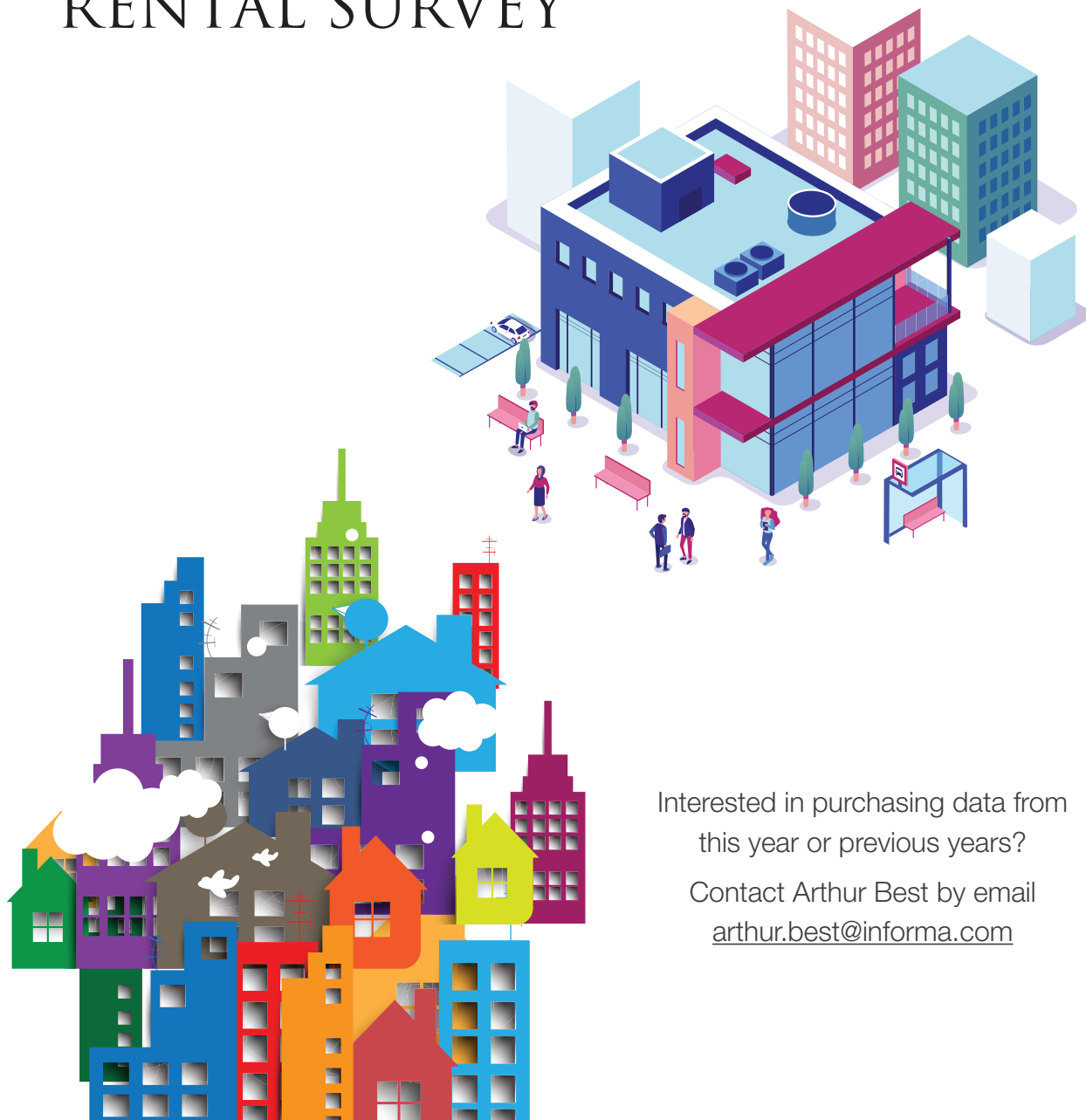
Unfortunately, the industry’s focus on building certification distracted investors from the need for a focus on meaningful energy efficiency to combat buildings’ carbon footprint. Now, with widespread social and business support for the Canadian Government’s target of net zero by 2050, there is less than 30 years for real estate to decarbonize. Most of the focus needs to be on retrofitting existing buildings as this is easier in many cases than abating the carbon intensity of new builds.

The first step for any organization to work toward solutions is to develop an ESG program. Best practice for real estate investors is to begin by assessing the many existing ESG frameworks to find the one most appropriate for them. The benefit of developing a smart program to address ESG issues will likely be significant outperformance over the long run.

The way the pension regulator in the US, the Department of Labor, explained how reducing the climate change risk in investments can lead to outperformance should resonate with real estate investors: “Gradual, yet meaningful shifts in investor preferences toward sustainability and the growing recognition that climate risk is investment risk, may lead to a long-term reallocation of capital that will have a self-fulfilling impact on risk and return.”

In summary, investors must think carefully about developing ESG programs to ensure that targets, measurements, verification and reporting all work together to make “real” progress. Never has there been a more important time for investors, companies, and industry organizations to focus on improving real estate ESG.

CANADIAN MULTI-RES TENANT RENTAL SURVEY



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