Real estate and ESG: poised to move the needle

Investors of many different types are rapidly joining the ranks of those who support protection of the environment and slowing the rate of climate change. Real estate has been at the center of the broader Environment, Social, and Governance (ESG) movement, which includes social and governance priorities alongside environmental ones. All three criteria are rapidly becoming embedded in the investment processes of real estate managers.

A sound ESG approach is based on the proposition that investors can improve the world for future generations without sacrificing financial returns. In fact, there is evidence that under the right conditions, ESG criteria are consistent with superior investment performance and risk reduction. Real estate is likely to offer many favorable opportunities for investors.

Here are some reasons why:

1. Biggest user of energy.

As countries look to reduce their Greenhouse Gas (GHG) emissions, it makes sense to focus on the energy used to heat and cool real estate. Buildings are the largest user of energy on the planet - consuming 40% of the total through both operations and construction - more than transportation or manufacturing. Furthermore, the World Resources Institute has also identified buildings as "one of the most proven, cost-effective climate mitigation solutions available. Together, regulators may see real estate as a material opportunity to reduce emissions.[1]

2. Manage what is measured.

Energy usage in buildings can be measured carefully, because either the tenant or the landlord must pay for it. Measurement is the first important step toward energy conservation. For context at LaSalle, we collect energy data from nearly 500 properties each year.

3. Alignment with financial performance.

Reducing energy usage in buildings through more efficient cooling, heating, and lighting saves money and attracts tenants who want to align their values with the buildings they occupy while reducing their total cost of occupancy.

4. Regulations are here and increasing.

Nearly 200 countries signed the Paris Climate Agreement at COP21 in 2015. Many local and national governments are using both "carrots and sticks" to reduce GHG as 2025 or 2030 targets approach.[2] The World Bank has identified 60 countries with a carbon tax today and expects 30 more to add one in the next few years. Moreover, 77 countries and 100 cities have pledged to be net zero carbon by 2050.

5. Improving technology.

Real estate investors can contribute to carbon reduction targets several ways. These include low-carbon construction techniques using local or natural materials, generation of electricity from solar panels and other renewable sources, waste recycling, and electric charging stations for tenants' vehicles. Technologies that aid the reduction in energy demand, such as sensors that automatically turn off lights or smart electrochromic glass, also optimise comfort and daylight for occupants. The introduction of any new technology, requires a balancing of cost, risk and reward, and changes cannot compromise tenant safety and security.[3]

6. Avoiding stranded assets.

By virtue of either at risk locations or obsolete systems, some buildings may be destined for future financial losses. This may be because properties are located close to the path of rising seas, are vulnerable to high winds, are too poorly insulated to conserve energy, or have obsolete systems that would be prohibitively expensive to upgrade. The 'stranding of an asset' may be further accentuated by the increased costs to insure – or, more critically, the inability to insure at any cost. Unlike other businesses, which can be moved out of harm's way, real estate is immovable. It can also be very expensive to cure energy-inefficient designs, upgrade obsolete building systems, or protect certain structures from increasing weather volatility. Integration of ESG consideration in investors' due diligence practices and climate-risk assessments can help avoid future financial losses.

7. Increased investor interest.

Perhaps most important of all, institutional and individual investors are demanding that their investments meet ESG criteria. Interest in sustainable investing among the general population of investors jumped from 71% in 2015 to 79% in 2021, and in millennial investors from 84% in 2015 to 99% in 2021, according to Morgan Stanley's Institute for Sustainable Investing. In real estate terms, this is likely to mean that properties with ESG attributes will trade at higher values and lower cap rates, as capital demand for them increases.

Climate Risk

Acute weather events, such as floods, wildfires and hurricanes, as well as chronic increases in extreme temperatures, are forcing buildings and infrastructure to face conditions well outside their historic design parameters. But the potential hazards and value at risk from climate change varies greatly by asset and geographic market. Integrating climate risk data into assessments of existing portfolios and potential acquisitions provides an opportunity to price in future risk and value, and plan for needed capital expenses for mitigation measures in a way that best aligns with the investment lifecycle over the next two decades.

Included in the 2022 edition of our *Investment Strategy Annual* is a Climate Risk Insight Report, which explores the integration of climate risk analysis with investment strategy. We expect to expand this analysis as this variable becomes even more prevalent in the months and years ahead. Those interested in receiving a copy of this segment can email research@lasalle.com.

Beyond Environmental Goals

As the developed world continues to recover and evolve in the aftermath of COVID, the next cycle of growth is likely to emphasise societal values like protecting the environment, assisting the most severely disadvantaged, promoting DEI[4] goals, and contributing to positive social outcomes in terms of health and well-being. Many real estate investments are well-positioned to help achieve Social and Governance goals. However, the routes to "S" and "G" success are not yet as well-marked as the "E" criteria.

The provision of affordable housing, creating local job opportunities, and contributing to the community life of a neighborhood where an asset is located - these are all paths to achieving social and governance goals. Important work still lies ahead to measure the benefits of these "S" initiatives and track their impact over time.

LaSalle's Global Securities group has focused on the "G" as an important driver or destroyer of value for many years now. Their consideration of "G" factors as an important contributor to performance is supported by the academic literature, which has produced dozens of studies that demonstrate the value of diversity and strong governance for listed companies.[5] The real estate industry is just beginning to establish clear frameworks for social and governance goals, tied closely to the United Nation's Sustainability Development Goals.[6]

No single industry is positioned to address a broad array of society's problems - at least on their own. As fiduciaries, asset managers must balance maximising investor returns alongside ESG initiatives. Nevertheless, the ESG approach could improve the contribution of real estate owners to broader societal goals like diversity and social justice, while also meeting or exceeding financial targets.

Moreover, the market forces supporting ESG goals are accelerating in just the last year.

A recent analysis by Jones Lang LaSalle Incorporated (JLL) shows that the number of businesses, companies and local governments pledging to reduce their carbon emissions is increasing rapidly around the world.[7] In time, broader "S&G" goals will likely follow the same pattern of adoption as environmental goals in both the private and public sectors of major economies.

Dynamic Regulatory Environment

ESG activities are undertaken within a regulatory environment that is dynamic at each of the local, state, province, country, and global levels, impacting not only real estate but the asset itself and investment managers. In addition to the regulations listed in this overview, there are securities, emissions, and land use laws in every country and many of the cities in which the real estate industry operates and invests. In addition, there are numerous self-regulatory efforts being undertaken that many global managers, including LaSalle, have signed.

Regulations continue to evolve with more details and guidance to come. Collectively, the industry will need to remain nimble and ready to adapt.

A big governance focus for the real estate industry will be to make sure that practitioners are aware of and comply with the rapidly evolving regulations.

The consequences of failing to comply these run the gamut from reputational risk to criminal sanctions and everything in between.

ESG at LaSalle

Real estate owners and investment managers like LaSalle hold highly visible positions in their local markets and contribute to both national and local public services through property taxes (rates) and transaction taxes (stamp duty).

The real estate investment management industry provides a home for myriad businesses and households, and we are in a good position to improve the quality of life for our tenants and neighbors.

These contributions can provide tangible benefits to surrounding communities while maintaining or improving financial returns. Yet, this can only be accomplished by firms and their employees who are willing to learn how to manage properties for community benefits alongside their own profits.

An ESG approach must be attuned to seeking a balance between achieving strong financial performance and positive results for society at the same time.

In sum, the real estate industry is positioned to help investors achieve their financial and broader ESG goals, but many challenges remain; climate risk, regulations, social issues and enhanced governance all factor into our collective impact. By raising awareness, educating ourselves on the issues and taking action, we can move the needle and make a difference for our investors and the communities we serve.

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LaSalle

FOOTNOTE

1 Source: United Nations Environmental Program https://www.unep.org/news-and-stories/press-release/building-sector-emissions-hit-record-high-low-carbon-pandemic. Buildings are also one of the biggest users of water—representing 25% of total annual usage. https://www.wri.org/news/release-wri-leads-zero-carbon-buildings-all-initiative-launched-un-climate-action-summit

2 Examples include the EU's Sustainable Finance Disclosure Regulation (SFDR), which became elective in March 2021, New York City's Local Law 97 passed in 2019, and the U.K.'s Energy Performance Certificates requirements for commercial buildings which introduced a minimum standard for new leases in 2018 and which will apply to all existing leases from 2023.

3 A good example: The highest-grade HVAC filters and ventilation systems draw more power to purify air and reduce the spread of airborne diseases. Yet, it may be possible to reduce energy usage overall, even if some building systems run at higher levels when airborne pathogens are a threat.

4 Diversity, Equity and Inclusion. Focusing on accessibility, gender, race and marginalised populations.

5 Researchgate.net and Google Scholar list over 30 such studies in the last 20 years in peer-reviewed journals. The literature for listed and unlisted real estate is still accumulating but several landmark studies have been done by NAREIT and the Journal of Property Research. https://www.researchgate.net/publication/329379682_Gender_diversity_and_financial_performance_evidence_from_US_REITs

6 Zooming in on the "S" in ESG: A Road Map for Social Value in Real Estate, ULI-Europe, March 2021. The measurement of the social benefits of moving from temporary to permanent housing is a recent example from the U.K.: House of Commons Library, "Households in temporary accommodation" November 2020.

7 https://www.us.jll.com/en/views/committed-to-net-zero-carbon