Is ESG driving valuation and/or financial decision making in the real estate industry?

CMS has engaged with many of its real estate clients over the course of a series of environment, social and governance (ESG) related meetings. Most recently, we looked at the effects of ESG factors on valuations.

During that conversation, it became clear that there are many, wider causes for concern for businesses considering how to respond to the ESG agenda, whether creating their own ESG principles to guide their business activities or through external agencies such as investors who have their own ESG objectives.

Some of the points discussed and responses shared are set out below.

Preparing an ESG framework for business:

- What was described as the "sustainability" agenda a decade ago has now morphed into a broader ESG theme.
- Often prompted by investor demand, asset owners are increasingly having to develop ESG policies and report on ESG issues.
- Increasingly, not only assets are the subject of analysis by reference to ESG performance but also the asset owning/managing corporate as well.
- Whilst not articulated in the language of ESG (and it was agreed there is confusion over the applicable nomenclature), many established operators already embody ESG principles in their management and development strategies. For some, it is a matter of corralling their activities into an identifiable expression of their commitment to certain standards. For others, it is early days but they are not alone.

Applicable frameworks/guidance:

- In order to better understand and to communicate on ESG matters, some asset owners have opted to use the GRESB ESG in Real Estate framework (https://gresb.com/)
- Others have retained the services of specialised ESG consultants such as EVORA and JLL Upstream.
- The general sentiment is that it would be preferred if the market solved the issue of creating a common ESG standard rather than government intervention; however, it was noted that the "E" component of ESG might need to be legislated for given the need to meet the UK's Paris Agreement obligations.

Impact of ESG on values and strategy for asset ownership/acquisition:

- Valuers are noting that decisions to acquire assets are being affected by the ESG policies of purchasers e.g. avoidance of tenants seen to participate in industries/activities that are not socially responsible. Increased concern may also be raised by perceived exposure of tenants to climate related market shocks e.g. plastics producers. This trickles down to valuations as purchasers reduce in numbers for more challenging assets.
- Valuers are also beginning to consider ESG when assessing the long term ability of an asset to attract quality tenants in the future and re-letting risk.

- Opportunities arise for bold participants that identify assets priced under market due to ESG challenges with a view to re-purposing/modifying for longer term, ESG positive purposes.
- It is currently challenging to integrate the future impact of ESG on valuations within the current Red Book framework. RICS does not adhere to any ESG standard which means that there is inconsistency in application.
- It was also noted that sustainability and strong ESG performance was less likely to be a concern or impact on values in prime real estate locations.

Reporting/data collection:

- Data collection may be an issue for landlords where they need to report on the ESG performance of their assets and/or tenants but don't have the right to obtain this information. Lease terms may evolve to meet these needs.
- Reporting on ESG to investors can also be cumbersome where different frameworks are adopted by different investors. It was considered to be helpful if a recognised industry body could create and promulgate an ESG standard for widespread adoption.

Green benefits?

- Green Projects can often lead to significant cost reductions which then feed back into the value of an asset.
- Green Loans are increasingly being offered by banks but the market is yet to determine the real value of these products.

Rising to the challenge:

The above commentary is illustrative of the issues being discussed in board rooms in the majority of businesses. This may occur at the earliest stages of planning a development, deciding to acquire or to sell an asset or presenting to investors. The demands to be demonstrably managing ESG issues will not diminish. This should not be considered with trepidation but instead seen as an opportunity to preserve or enhance value and ensure that real estate assets and the businesses that own and manage them are fit for the long term.

Contact:

Andrew McLean
Partner - Real Estate Finance
T +44 20 7524 6260
E andrew.mclean@cms-cmno.com

Chinyelu Oranefo
Senior Associate - Real Estate Finance
T +44 20 7524 6932
E chinyelu.oranefo@cms-cmno.com

> It is very good to hear other people's practical issues, as ESG is a subject which is here to stay and growing with importance, which we all have to find a way to deal with. It is in our interests to do so.

Jeremy Gates, Managing Director - Real Estate Capital Investors Limited

Your free online legal information service.

A subscription service for legal articles
on a variety of topics delivered by email.

www.cms-lawnow.com

Your expert legal publications online

In-depth international legal research
and insights that can be personalised.

eguides.cmslegal.com

CMS Legal Services EEIG (CMS EEIG) is a European Economic Interest Grouping that coordinates an organisation of independent law firms. CMS EEIG provides no client services. Such services are solely provided by CMS EEIG's member firms in their respective jurisdictions. CMS EEIG and each of its member firms are separate and legally distinct entities, and no such entity has any authority to bind any other. CMS EEIG and each member firm are liable only for their own acts or omissions and not those of each other. The brand name "CMS" and the term "firm" are used to refer to some or all of the member firms or their offices.

CMS locations:

Aberdeen, Algiers, Amsterdam, Antwerp, Barcelona, Beijing, Belgrade, Berlin, Bogotá, Bratislava, Bristol, Brussels, Bucharest, Budapest, Casablanca, Cologne, Dubai, Dusseldorf, Edinburgh, Frankfurt, Funchal, Geneva, Glasgow, Hamburg, Hong Kong, Istanbul, Kyiv, Leipzig, Lima, Lisbon, Ljubljana, London, Luxembourg, Lyon, Madrid, Manchester, Mexico City, Milan, Monaco, Moscow, Munich, Muscat, Paris, Podgorica, Poznan, Prague, Reading, Rio de Janeiro, Riyadh, Rome, Santiago de Chile, Sarajevo, Seville, Shanghai, Sheffield, Singapore, Skopje, Sofia, Strasbourg, Stuttgart, Tirana, Utrecht, Vienna, Warsaw, Zagreb and Zurich.

The content in this document is for general purposes and guidance only. It does not constitute legal or professional advice and should not be relied on or treated as a substitute for specific advice relevant to particular circumstances. For legal advice, please contact your main contact partner at the relevant CMS member firm.

cms.law