ESG themes in Real Estate Finance

Reflecting on the last roundtable in July 2020 (note produced from that meeting available here) the following developments and themes were recently discussed by attendees from the industry body, Commercial Real Estate Finance Council (CREFC) and CMS.

ESG is embedded in the decision-making process for large organisations

- For a variety of reasons, but especially given the focus by investors, ESG matters are now considered in far more depth at credit and investor committees than they were only two years ago. Real estate lenders are concentrating on the impact of climate and transition risk in their underwriting process alongside certain lenders having their own net-zero targets to manage. Sponsors are focusing on de-carbonising buildings in anticipation of future regulatory pressures including a rush to 'get the gas out and the solar panels in'.
- Pay packages and bonus criteria in larger organisations are increasingly being measured against ESG achievements and that is further entrenching this topic in the decision-making process. However, measuring a clear link between reaching sustainability targets and realising economic returns is challenging and until such time as the market clearly demonstrates the outperformance of a zero carbon asset or portfolio, traction in this area may remain patchy.

Despite changing macro-economic challenges, ESG remains a key concern

- Whilst macro-economic concerns have moved on from the global pandemic to high inflation, interest rates, weakening growth and the current conflict in Ukraine, ESG remains in the 'top three' of factors that participants consider when analysing deals.
- However, categorising topics is not straightforward and indeed there could be good arguments to treat social issues triggered by the aftermath of Covid or the current war in Ukraine as falling under the 'S' umbrella of ESG. As ever, terminology in this area remains a challenge with the lack of a common approach.

Green mortgages and leases

- On the residential side the use of green mortgages is rising considerably (at least for new builds), with banks and building societies launching green mortgage products at an ever increasing rate.
- However, whilst the green lease product is available they have yet to become popular in the market with continuing debate around information covenants and a lack of a consistent framework between landlords and tenants. Furthermore rising inflation and energy price hikes have made such leases difficult to sell to commercial tenants who are focused on minimising liabilities and the perceived costs associated with a 'fully green' lease.

Regulation and ratings

- The Minimum Energy Efficiency Standards (MEES) regulations that will extend to existing tenancies from 1 April 2023 and restrict a landlord's ability to continue to let properties with a F or G Energy Performance Certificate (EPC) rating is clearly driving behaviours in this space

- It is less clear whether the government will enact legislation to raise the bar to EPC B by 2030 (as proposed in an early 2021 consultation). Some noted how that could cut across the UK government's levelling up agenda, and the objective to provide financing throughout the country. Watch this space.
- In addition to MEES and the Building Research Establishment Environmental Assessment Method (BREEAM), other voluntary rating systems may play a role. For example, in the office sector, the National Australian Built Environment Rating System (NABERS) allows landlords to identify areas for savings and improvements and NABERS UK has been launched to bring that approach to the office market here. However, there is a risk that multiple rating systems may further confuse an already complicated area.
- The consensus seems to be that we could end up with a three or four speed market when it comes to implementing ESG regulation. Higher value assets and more liquid property sectors will naturally have higher engagement with ESG matters than secondary and tertiary assets in which achieving impressive ESG certification is simply not the priority.
- Flexibility will be essential and whilst regulation may provide the floor for the market there is a call to let common sense prevail and not be too prescriptive.

Measuring the G in ESG

- Continuing the theme from two years ago, there are now over 700 B corporations certified in the UK with the constitutional aim of positively impacting all stakeholders – workers, communities, customers and our planet – and that number is likely to grow, albeit the certification process is challenging for those companies that do apply.
- Mainstream corporates obviously appreciate the importance of good governance particularly when it comes to ESG and the importance of avoiding the reputational risk associated with greenwashing (noting the recent dawn raids at certain property fund managers). But what does good governance look like and how can one effectively measure that with KPIs?
- Some commented this could be viewed as pricing in the risk of a company not delivering on its ESG strategy by analysing its track record and experience of delivering on projects. Others noted that board diversity metrics or employee engagement and investment into staff development and education are measurable factors that could be tested.

Interest rate adjustments

- Margin ratchet provisions in loan agreements are viewed favourably as helping to move the market in the right direction when it comes to positively recognising ESG factors. This approach is more popular than the alternative of lenders insisting on the stick of event of default provisions in credit agreements.
- Some lenders are reportedly requesting very specific criteria for margin ratchets which are not linked to the asset and so are of questionable value, and in any event these margin variations are minimal (5 or 10 basis points at most – which may at least offset additional costs incurred by the borrower if additional third party certification is required).
- Sponsors look forward to more of an open dialogue around each particular asset that will then enable the lender (or sustainability coordinator if one is appointed) to agree KPIs that clearly link to enhancements to the value of the building and may accordingly allow for larger interest rate ratchets.

What's around the corner?

- If regulation continues at the current pace (see above) then there will be an increasing rush into the space of retrofitting buildings over the next couple of years, so they are compliant. To assist with that transition, public bodies such as the UK Infrastructure Bank may start to play a role (there are similar conversations about the potential role of public sector bodies at EU level in the context of the EEFIG working group on Energy Efficiency First, for example).

— Whilst the plethora of acronyms and rating tools in the ESG space can be frustrating, there is an expectation (or should that be hope?) that there will be a move towards commonality of approach.

— The use of technology in this space will be important. More and more lenders are using ESG apps for their real estate borrowers to provide retrofit-related advice (CPF probably being the preeminent example). If the resulting data is pooled, that may facilitate the emergence of more standardised products, especially those aimed at SMEs, which are likely to have the greatest impact on carbon usage.

— Some in the wider market argue the 'ESG movement' has gone too far and recent investigations into greenwashing are raising many challenging questions. The clear consensus in this group was that, notwithstanding these developments, market interest and the expectation of further regulation mean that ESG will remain a key focus in the real estate industry for both investors and lenders for the foreseeable future.

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We attach some links provided by these respective organisations with more details about their ESG policies and related matters:

1. https://www.cheynecapital.com/esg-responsible-investment/ (Cheyne Capital)
2. https://www.deka.de/deka-group/our-responsibility/how-we-practice-sustainability (Deka Bank)
3. https://eqtgroup.com/sustainability (EQT Partners)
4. https://www.greenfinanceinstitute.co.uk/ (Green Finance Institute)
5. https://www.ing.com/Sustainability.htm (ING)
6. https://www.lloydsbank.com/business/sustainability.html (Lloyds Bank)
7. https://tokorocapital.com/kokoro/ (Tokoro Capital)
8. https://cms.law/en/gbr/insight/sustainability (CMS)
9. https://www.crefceurope.org (CREFC Europe)

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