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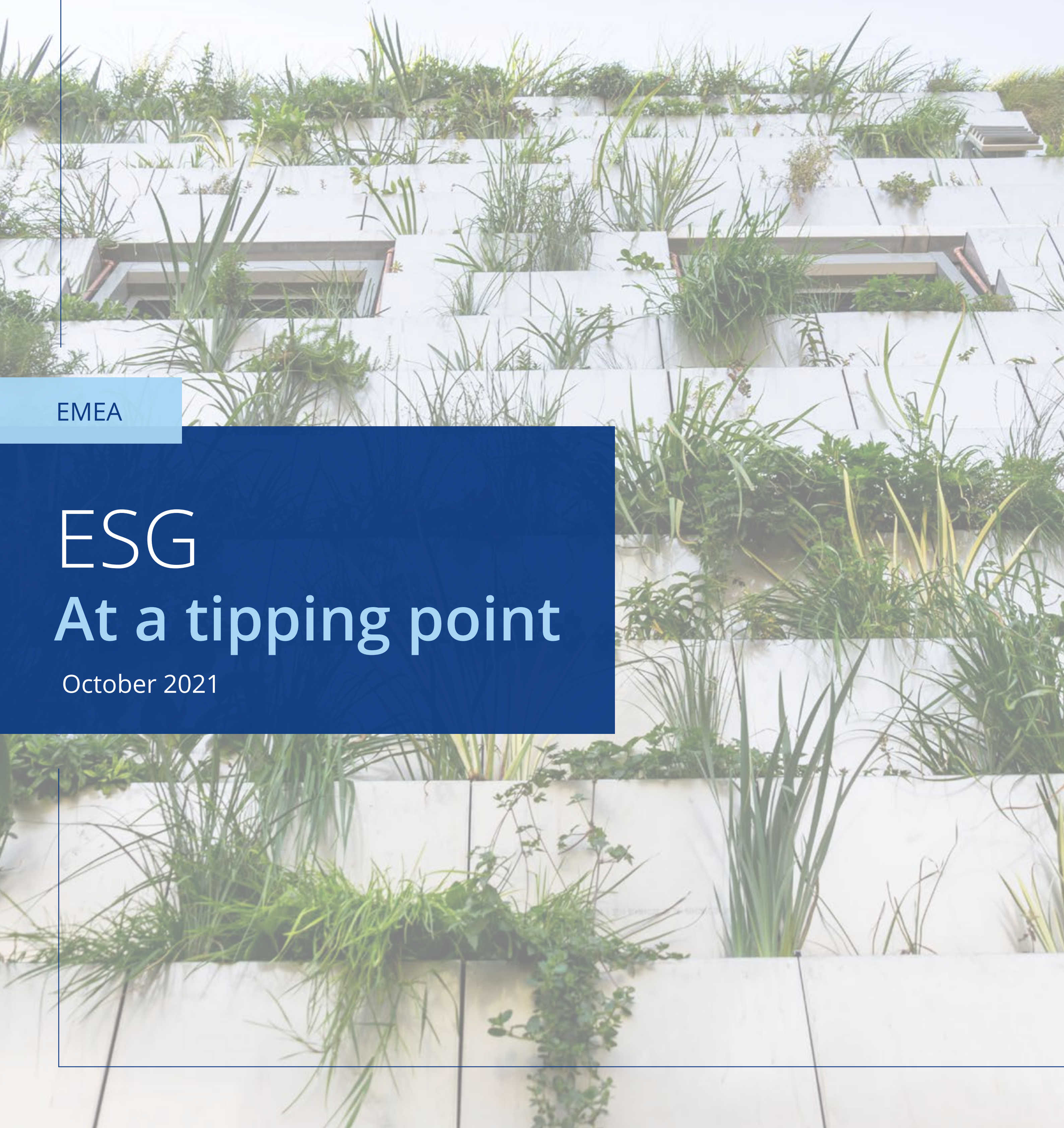
ESG
At a tipping point

October 2021



Executive summary

ESG is no longer an option, it's a 'must have'

The deployment of new regulations in Europe concerning the treatment of environmental, social and governance (ESG) factors in investment and corporate decision-making has reached a tipping point. We have seen investors and major corporates gradually embed a complexity of ESG related guidance, frameworks and benchmarks into their business operations over the last 20 years - particularly the last five. The deployment of EU taxonomy, the Social Financial Reporting Directive (SFDR) and Corporate Sustainability Reporting Directive (CSDR) all mean that ESG is a compulsory part of how businesses must operate in Europe from 2022 onwards.

2021 represents a year of preparation for a significant transition in the way the real estate investment market must operate. The new regulations will act as key drivers of the EU's new 'Green Deal' agenda over the next 10 years and beyond, achieving the environmental objectives laid out in the Paris Agreement and the UN's Sustainable Development Goals.

Transition risk and return

Although ESG has gradually become an embedded part of corporate reporting and disclosure over the last 20 years, the biggest challenge today is the complete lack of consistency around what is reported, versus what needs to be reported and the specific detail of it. One of the key challenges of the new EU regulations is that investors must assess their funds according to whether they have a sustainable investment objective or not. Additionally assets comprising each fund/strategy must be assessed according to their environmental and social characteristics.

However, the technical details, methodologies and measurements to undertake this process will not be available to the market until at least mid-2022. Meanwhile, investors must have undertaken their due diligence to put disclosure reporting in place by January 2023, to be able to market their product.

To say this is going to put a significant squeeze on market resources is an understatement, and it has multiple market implications.

The need for an ESG global framework and reporting methodology / standard

While Europe is very much at the sharp end of the ESG spectrum, the need for a global standard is escalating quickly and new rules are being set across the world. The fact that new EU regulations will require non-EU domiciled investors with assets in the EU to report and disclose in line is a key driver of change.

Additionally, the US Securities and Exchange Commission (SEC) issued a Request for Public Input (RPI) on Climate Change Disclosure in March 2021. The key respondents to the SEC have been clear in support of better regulation of ESG-type information and were unanimous in the need for a specific focus on standardised methodology, not just disclosure. The IFRS have also thrown their hat into the ring.

With China and the UK aligning their reporting to the Task Force on Climate-related Financial Disclosures (TCFD) reporting framework, there is clear need for an international standard to consistently measure and disclose on the critical ESG factors.

What is a realistic target?

Much more needs to be done to integrate the multitude of stakeholders and industries required to give input into establishing the methodology and measurements to drive the necessary standards required. Equally, arbitrary 'climate specific' targets need to be considered by asset type and location around the concept of 'Net Zero.' Net Zero is a very worthy ambition, but it is not immediately achievable for all assets. Ultimately the timeline needed for one property to attain Net Zero will vary significantly to another.

Optimal energy use and reduced emissions is a must, and this should be the target driving the 'E' element of building standards initially. Although building benchmarks have evolved over the last 20 years, the Global Green Building Council estimates that only 1% of stock is genuinely Net Zero. Some of the best designed buildings do not reach this standard. Yet the NABERS building certification system in Australia has achieved market transformation, driving energy use and emissions down considerably.

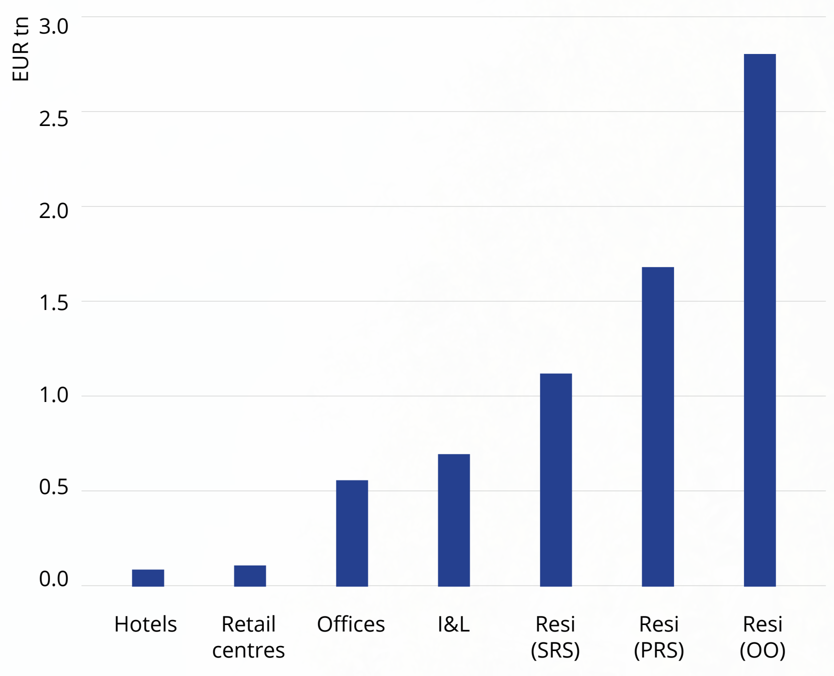
To put it in context, the average office in Melbourne uses three times less energy than the average office in London. It is telling that the NABERS benchmark has now arrived in the UK, raising the bar from an asset benchmarking perspective.

This illustrates that energy levels can be better managed, but this will also come at a cost.

Figure 1:

European retro-fit: estimated CapEx requirement

Elevating the European built environment to meet energy efficiency standards could cost €7 trillion.



Source: Colliers

Re-allocation of capital & skills

The requirement to elevate both the 'E' and 'S' elements of real estate assets, notably the E, is clearly going to come at a cost. In our attempt to estimate the cost of CapEx that may be required to bring European built stock up to higher energy efficiency levels we have made some big assumptions, based on estimated volumes of assets by type (in sqm) in situ across major European cities and commercial regions.

Firstly we have assumed four different levels of existing building standards across asset types, from those requiring no/minimal retrofitting - of which there is a limited amount - to those that require a lot. For the latter we have assumed a low number, with the majority of buildings falling into those needing a modest or a medium level.

In summary, the cost of retrofitting the European built environment will be considerable - on these basic assumptions, we're talking €7 trillion across asset types.

This completely dwarfs the total value of real estate transactions annually in Europe, which is roughly €300 billion. This points to the requirement for some serious dialogue among all stakeholders in this evolution.

Should the investment industry be meeting the bill, when occupiers and society (government) get the benefits of lower operational costs and a better environment? How do we address the skills shortage in the industry that will enable this transition?

Our rough estimates point to the need for thousands more ESG specialists, and for far greater skills and training across industry disciplines including investment and asset management, project management, capital markets, leasing, surveying or valuation. This is in addition to the new skills required in construction, engineering, architecture, design, planning and development.

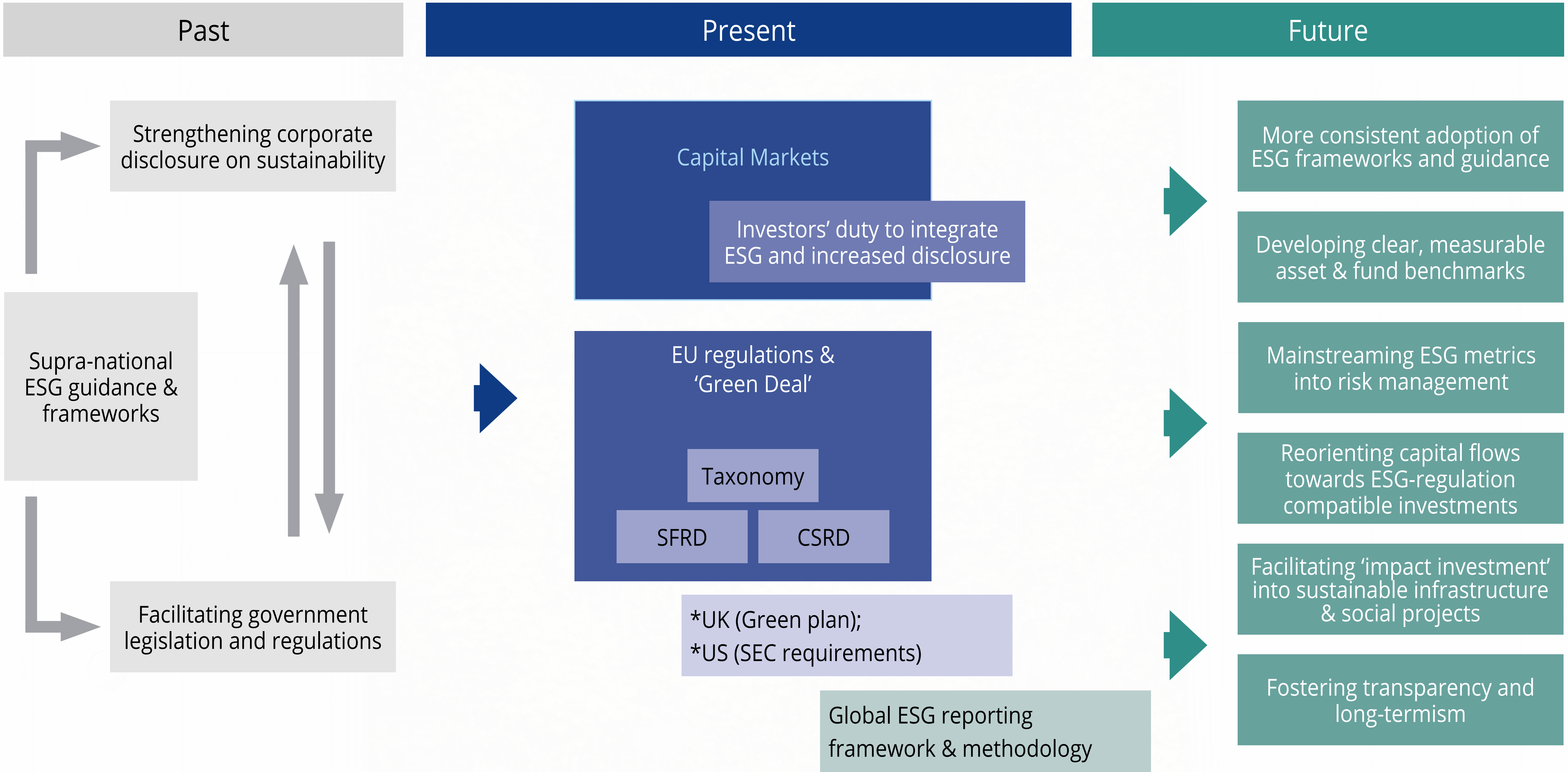
While many large investors seem very well prepared, staffed and funded to manage this intense process, what about the mid-size and smaller investors who have limited resources?

What is clear is that it will create a raft of opportunities across global markets as investors re-calibrate their funds and assets.

The risk is adverse growth in the number of undesirable 'stranded assets.' However, this could also provide the opportunity for significant growth in impact investing.

All things considered, it will be some time before the benchmarks and measurement tools are in place to accurately discern asset values – probably not until at least mid-2023. This could create something of a slow-down in investment volumes during this period, as the market makes significant adjustments to a new norm.

ESG regulatory impact on capital markets: timeline



Sources: Colliers, UKSIF

The evolution of ESG: at a tipping point?

The timing of COP26 on the very near horizon aligns with an important juncture in the evolution of ESG and its impact on government legislation, energy policy, corporate activity and investment decision-making.

Since the turn of the century huge steps have been made with regard to putting the planet on a path to Net Zero, in the face of significant global warming, and in addressing global inequality. Yet much more needs to be done, and COP26 comes at a crucial tipping point in reshaping how we live, work and play in order to transition to a more carbon-neutral world and global economy.

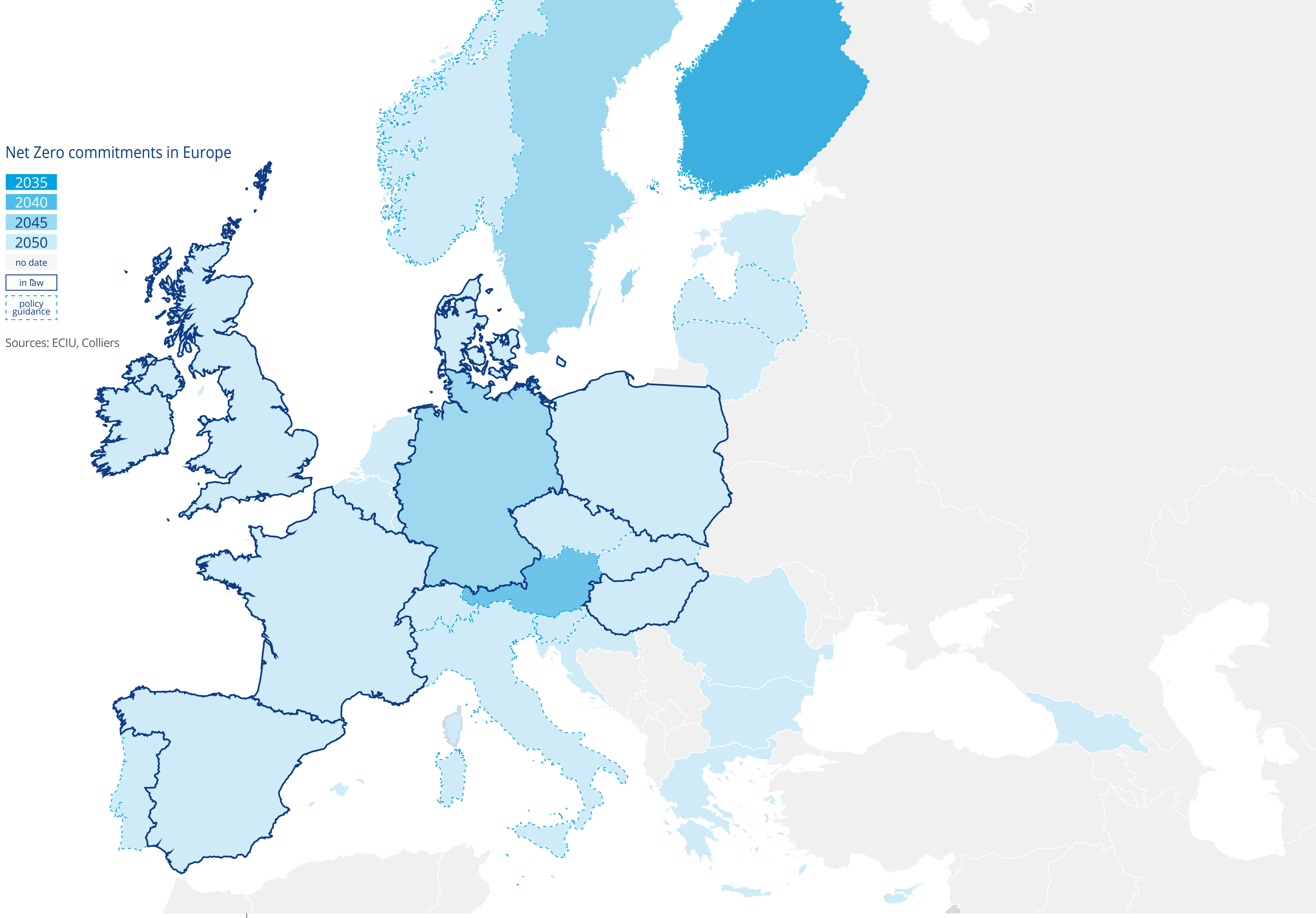
Policy and guidance evolution

Almost twenty years ago the UN Global Compact Study set the tone for change. This was enhanced in 2011 by the UN Guiding Principles on Business and Human Rights. Concurrently, the OECD Guidelines for multi-national enterprises (MNEs) and ISO 26000 were established, to provide voluntary guidance addressing a range of social and environmental challenges.

In addition to these global foundations, multiple third-party organisations and not-for-profit groups have been established, setting out frameworks, benchmarks and guidance to support corporate reporting and disclosure. The Global Reporting Initiative (GRI) and Greenhouse Gas (GHG) Protocol set the directives for emissions management, notably Scope 1, 2 and 3 targets for corporate and public/governmental entities. GRI has established many other environmental and social accounting frameworks, embodying this methodology.

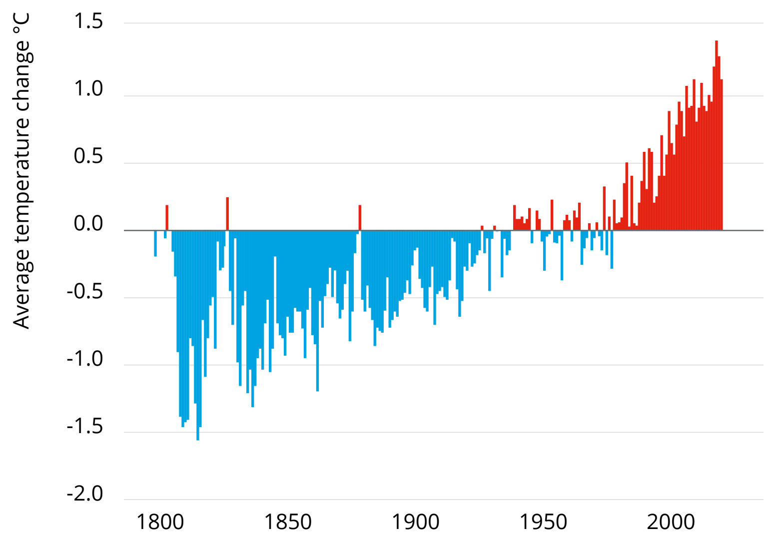
Other third-party groups and benchmarks have since been established to enrich and diversify the range of metrics companies can utilise to better manage, measure and benchmark their performance when it comes to the reporting and disclosure of a broad range of 'E&S' factors. To date, Sustainability and Accountancy Standards Board (SASB) established in 2011 and the Task force on Climate-related Financial Disclosures (TCFD) established in 2017 – both of which have since been upgraded – account for the main global standards alongside GRI, to which much of the corporate world now adheres.

Net Zero commitments in Europe



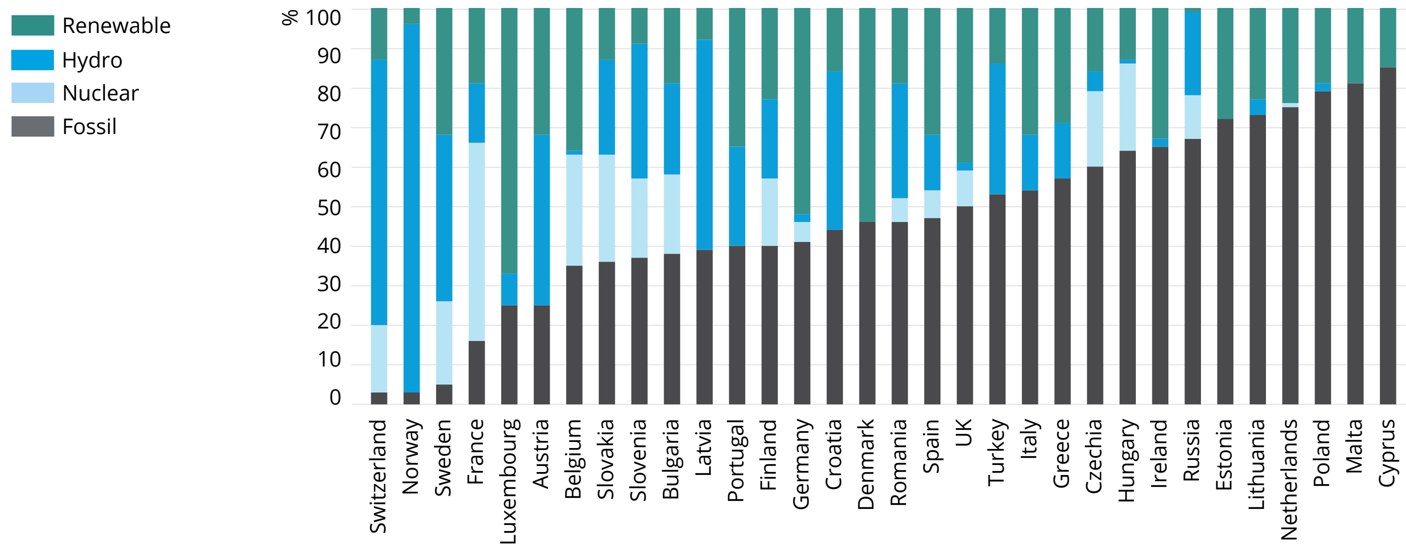
Sources: ECIU, Colliers

Figure 2:
The rate of global warming - annual mean around the 1951-80 average (°C)



Sources: University of California Berkeley, BBC, Colliers

Figure 3:
National fuel source for electricity generation, by country



Sources: CIA World Factbook, Colliers

Key global ESG benchmarks

Top 3 benchmarks

Duff & Phelps - a leader in governance, risk and transparency solutions - in association with the International Valuation Standards Council (IVSC) conducted a survey of 150 valuation professionals to find out how many different ESG platforms were in use and which were the preferred ones. According to their report published earlier in 2021, the survey identified 14 different combinations of frameworks in use, but found GRI, SASB and TCFD combined represented 90% of all survey responses.

Both the GRI and SASB standards are very prescriptive and leave little room for misinterpretation, going into significant levels of detail at a company and asset specific level to address both scope 1 and 2 level points of reference. SASB and GRI differ in that while SASB takes an industry focus in its standard setting and a broader view covering 'social' impacts, GRI is more topic focused.

The relatively new TCFD sits alongside these benchmarks providing more in the way of ethical guidelines and recommendations. While this may seem less intrusive, TCFD raises the bar by requiring scenario modeling of the emissions data collected - arguably an important parameter for valuers - while GRI and SASB only use the data for reporting.

TCFD is also backed and funded by the Bank of International Settlements (BIS) and supported by the G20. This gives it significant pedigree on disclosure by setting out the areas that require attention, but leaving the specific detailed reporting preferred by valuers to GRI and SASB.

ESG benchmarking lacks clarity and consistency

Although a blend of these guidelines and benchmarks is enabling companies to report on and disclose their ESG credentials, the biggest problem today is the complete lack of consistency around what is reported, the detail of it and by when. To date, the onus has been on each company to decide what it is they measure, and how they measure it and benchmark against it, and even what they report and disclose.

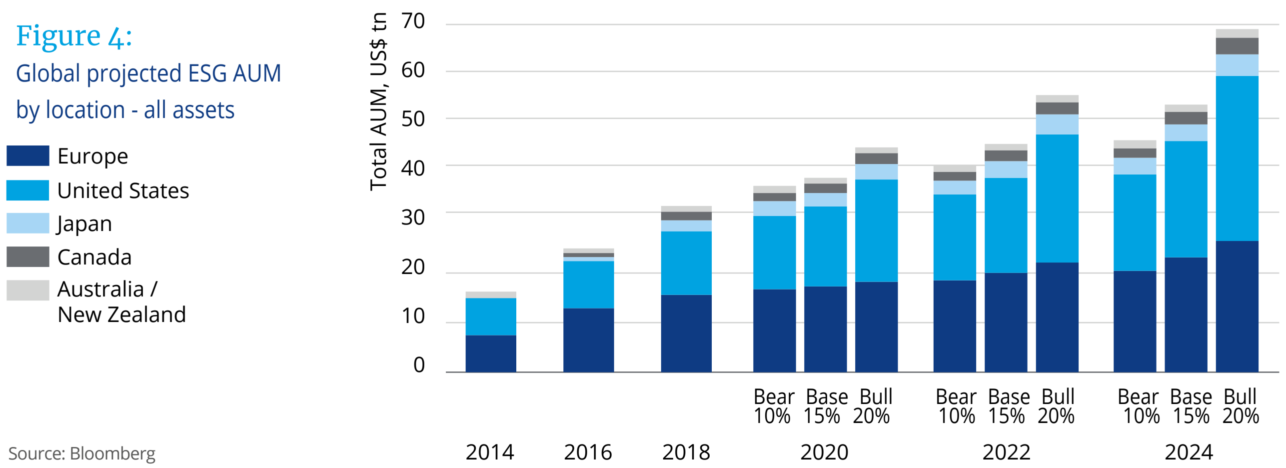
This has a clear market impact when it comes to the raft of new ratings tools and indices that are being provided commercially in order to help benchmark company performance alongside 'E&S' metrics. While ESG benchmarks can provide an indication of companies and their investments which conform to some ESG ratings or standards, there appears to be limited consistency between these indices and the major three disclosure frameworks that have been adopted globally by valuers. The 'black box' approach to disclosure, rating and benchmarking is an issue.

Are ESG assets under management on the rise?

Earlier this year Bloomberg reported that there has been a steep rise in the volume of ESG assets under management globally, which is on track to exceed US$53 trillion by 2025. This would represent more than a third of the US$140.5 trillion in projected total assets under management. This projection assumes ESG assets will grow by 15% per year, half the pace of the past five years. Interestingly, Europe accounts for half of global ESG assets, but the US has the strongest expansion rate in 2020/21 and may dominate the category starting in 2022. The next wave of growth could come from Asia — particularly Japan.

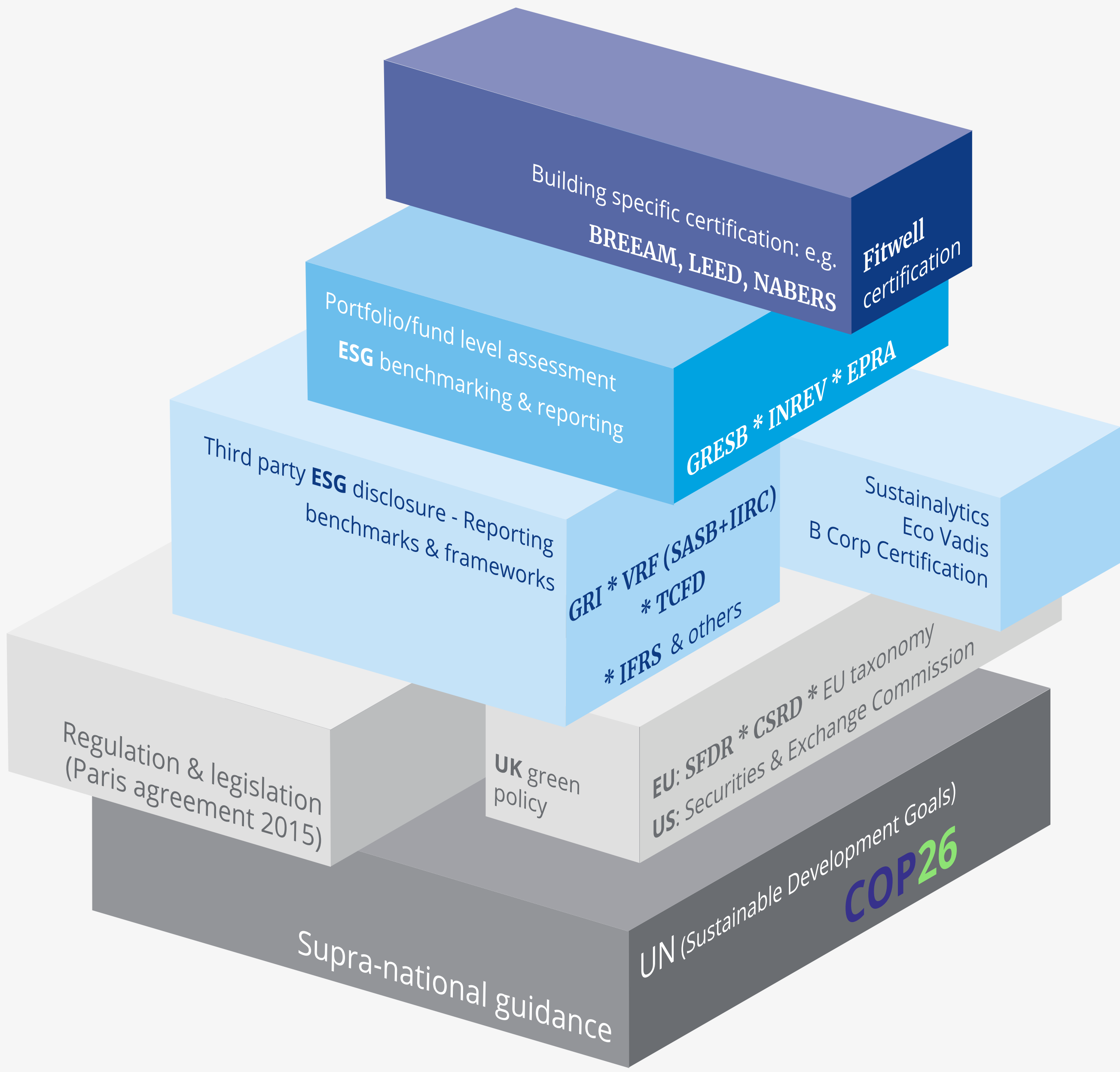
While this is all encouraging, it begs the question – how exactly are these ESG assets and funds being certified as 'ESG compliant'? Bloomberg do not define what ESG assets are. As Tariq Fancy, ex-CIO for sustainable investing at Blackrock, once asked, are they existing assets which comply with the many ESG frameworks or are they new assets?

Figure 4:
Global projected ESG AUM by location - all assets



Source: Bloomberg

ESG building blocks



Source: Colliers

*Scope 1: **Direct** - The green house gas (GHG) emissions that a company makes directly, such as from real estate and freight that it owns and uses.*

*Scope 2: **Indirect** - The GHG emissions it makes indirectly, such as from the electricity or energy it uses for heating and cooling buildings.*

*Scope 3: **Indirect value-chain** - The GHG emissions associated with a company's entire value chain, including products and services from suppliers and route to market for customers.*

Asset level benchmarks

The World Green Building Council estimates that only up to 1% of office stock is net zero. Bloomberg's own amazing headquarters in London, which received the highest ever BREEAM-in-use accolade at the time of completion, is not a net zero building. Which begs a number of questions:

- Is achieving net zero across all real estate assets an impossible task, set more realistic standards?
- Or, are the benchmarks we are using inadequate at driving better energy efficiency and emissions performance?

In reality, it is a combination of both. In Australia, the NABERS building certification has achieved market transformation, driving emissions down considerably. To put it in context, the average office in Melbourne uses three times less energy than the average office in London. It is telling that NABERS has now arrived in the UK, raising the bar from an asset benchmarking perspective. It also points to the fact that greater international cooperation is required to drive genuine global standards that all owners and occupiers of real estate assets adhere to, and at the higher corporate level.

Change is coming...at all levels of reporting

With so much money flowing into ESG-tagged investments, the US Securities and Exchange Commission has recognised that it needs to set rules. In March 2021, the SEC issued a Request for Public Input (RPI) on Climate Change Disclosures. There were many responses from academia, business and professional bodies but we'll focus on three.

The Chartered Financial Analyst Institute (CFA Institute) core message to the SEC was that it should not re-invent the wheel but instead focus on material ESG and climate data that can be measured and managed by issuers, the inference being that investors will sort out the wheat from the chaff. The CFA Institute also suggested that ESG reporting focused on material financial impacts not environmental data. They also suggested excluding Scope 3 reporting as this was seen as being too vague and distant from the issuer's responsibility. It was also noted that as the factors within ESG were still evolving, regulations and reporting standards relating to them should also be constantly updated.

The Alternative Investment Management Association (AIMA) & Alternative Credit Council (ACC) also encouraged the SEC to introduce a framework for mandatory climate-related disclosure for public companies but also suggested limitation to Scope 1 and 2, and to take on board the recommendations of the TCFD framework.

Interestingly, the Stanford Law School (through its Climate Risk Disclosure Law and Policy Lab) was a bit more forward thinking, urging the SEC to also include standardised methodology for forward looking climate risk scenario analysis and Scope 3 emissions.

Overall, there was clear consensus, on the need to focus on Scope 1 and 2 reporting, with the key respondents all supportive of SEC regulation of ESG type information but noting the focus must be on standardised methodology, not just disclosure. There was also a clear push for greater harmonisation of standards and their application globally.

Thankfully there have been many recent, positive steps towards the standardisation of frameworks and reporting. SASB and IIRC formally merged in 2021 to form the Value Reporting Foundation (VRF). It is also believed that harmonisation with IFRS is underway, to help drive a consistent ESG framework.

ESG progress in Europe: critical path analysis

Earlier this year, the EU established several initiatives impacting companies generally and the real estate and investment market specifically.

Sustainable Financial Disclosure Regulation (SFDR)

The SFDR is initially aimed at the financial services industry, focusing on firms that sell investment products to the public either indirectly via insurance and investment brokers or directly. At present, SFDR is much like the global TCFD, in that it is not technically detailed as to what needs to be reported; more like a test to see if investment managers really understand ESG topics and their obligations to report them. The key milestones for the implementation of the SFDR are: (source S&P Global)

10th March 2021: compliance with high end and principle-based requirements.

30th June 2021: Large firms with over 500 employees (Germany set the level at 3,000) must disclose their due diligence policies for Principal Adverse Impacts (PAIs) on sustainability factors.

January 2022: Periodic reporting on environmental and social characteristics and sustainable investment objectives will begin, as well as relevant alignment with the EU taxonomy on its two climate change mitigation and adaption objectives.

By **30th December 2022**: Firms that consider PAIs must disclose how their products consider these impacts, while others have to explain why they do not.

January 2023: Products that promote environmental and social characteristics and products with sustainable investment as their objective must have periodic and precontractual reporting in place on alignment with the EU Taxonomy's four objectives:

- The sustainable use and protection of water and marine resources;
- The transition to a circular economy;
- Pollution prevention and control; and
- The protection and restoration of biodiversity and ecosystems.

30th June 2023: Firms must disclose the detailed indicators for PAIs for the period from January to December 2022.

For real estate investors, the consequence is that fund strategies have already been categorised in outline, as part of the initial assessment. This has resulted in funds (and their assets) falling into three categories:

Article 6 - Covers funds which do not integrate any sustainability into the investment process and could include assets with limited energy efficiency/emissions standards or social impact. While these will continue to be sold in the EU, provided they are clearly labelled as non-sustainable, they may face considerable marketing and financing difficulties when compared to more sustainable funds.

Article 8 - Covers funds that promote and include assets with environmental or social characteristics, or a combination of those characteristics.

Article 9 - Known as funds/products targeting sustainable investments, covers those targeting bespoke sustainable investments, but where a fund strategy has sustainable investment as a clear objective and an index has been designated as a reference benchmark.

In real estate investment parlance, Article 8 funds will essentially encompass assets that meet required energy efficiency and emissions standards, alongside social standards. Article 9 funds would comprise 'impact investment funds' where there must be a clear intention in the strategy to create a a broader positive and measurable socio-economic benefit/impact alongside financial returns. This adds a very different dimension to fund categorisation and reporting going forwards.

SFDR regulatory technical standards

The biggest challenge is that while SFRD has introduced the concept of PAIs, it has not defined them in detail nor identified or accredited the processes by which they can be calculated. Are GRI or SASB standards allowed for example? Apparently yes, as long as reference to them is given.

These details will be included n the roll out of Regulatory Technical Standards, which been deferred from 1st January. In the rush to appear to have done something the critical benchmarks have been kicked down the road. While the real estate investment industry is broadly in agreement that Article 8 funds will become the norm, there is a risk that current fund categorisation will change in the coming 18 months while the technical standards are clarified and adopted. The scope for Article 9, ' impact investing' funds is a subject for another time.

The Corporate Sustainability Reporting Directive (CSRD)

CSRD is expected to come into force for the full year 2023 with the second set of sustainability reporting standards coming in 2024. The CSRD applies to all companies operating in the EU, not just to those registered there. SMEs will be required to comply by 2026. A company's ability to fully comply with this value chain risk assessment and disclosure in terms of past, present and future will depend on is's size and maturity. Germany for example has set the initial compliance threshold at 3,000 employees, which might exclude a lot of CRE companies unless they cross the turnover and balance sheet thresholds.

The standard compliance thresholds are:

- *>250 employees,*
- *>€40 million turnover, and*
- *>€20 million total assets*

Any company meeting two out of three of the above thresholds is required to comply with the CSRD.

Table 1:
CSRD: Company threshold metrics 2023/24 - listed real estate companies

Company	Sector	EU Ops	Employees	Turnover EUR mln	Total Assets EUR mln	Subject to CSRD
British Land	Office, resi, retail, leisure	No	634	548	10,384	No
Segro	Logistics	Yes	350	505	14,820	Yes
EPP	Retail	Yes	212	165	2,476	No
Atrium	Retail, resi	Yes	375	195	2,873	Yes
CA Immobilien	Office	Yes	446	297	6,820	Yes
Globalworth	Office, resi	Yes	35	223	3,630	Yes
Hammerson	Retail	Yes	232	115	6,910	Yes

Sources: Colliers, company accounts, various

Nearly all commercial real estate companies will be required to comply with CSRD. Even those without EU operations should expect similar reporting requirements in the UK by 2023.

Because of the move to risk and reporting on value chains, landlords will need to cover what the tenant is doing with the rented space. This could get very interesting for big box units containing confidential data centres or industrial processes.

When it comes to energy use, a lot of landlords have discharged their environmental obligations by simply signing and declaring electricity supply contracts with companies claiming to be 100% RES (renewable energy suppliers). Under value chain due diligence, a landlord is now required to assess the environmental claims of energy providers. The UK's Competition and Markets Authority (CMA) has recently launched an investigation into the claims being made by some of these energy suppliers.

On top of this, there are likely to be challenges for companies that have adopted carbon off-setting on site. Some owners and developers have an additional layer of risk in the embedded carbon in the building itself. Disclosure here is about carbon use but the CSRD also requires forecasting of future emissions which by extension means explaining how these forecasts will be met. The CFA Institute in its response to the SEC picked up on this point.

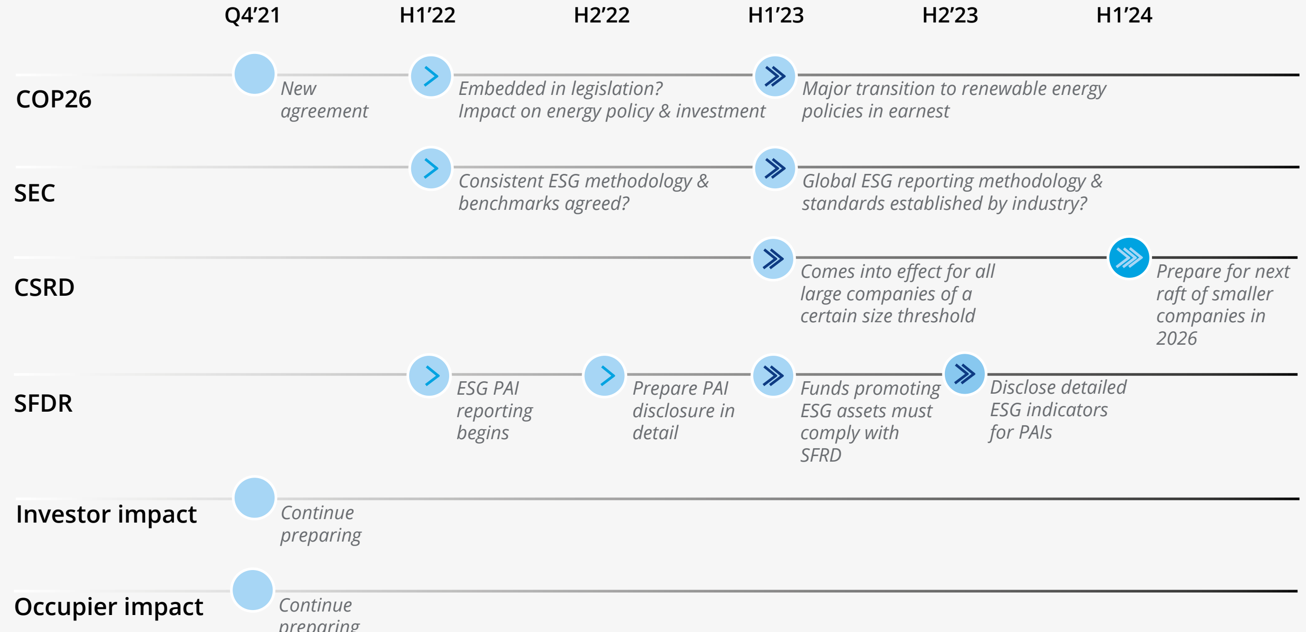
For occupiers, the need to adhere to CSRD standards will require greater transparency concerning lease obligations, how they use space and how their business operates. This is likely to impact consumer choices and shareholder value, so it seems only a matter of time before it impacts product pricing.

Conclusion & timing

While the 'E' and the 'S' in ESG will influence consumer / investor choice, though not necessarily shareholder choice, it is the 'G' that will bring greater accountability and consistency of disclosure.

The way we benchmark assets and companies needs a clear reset, and this is now very much on the horizon. To say this is a tough ask is an understatement, but disclosure metrics, standards and reporting frameworks, and policy changes are coming to the fore to guide ESG reporting governance, and allow for more consistent and comparable investment decisions.

Figure 5:
Timeline of key trigger events



Sources: Colliers, various

The level of detail required for ESG reporting and compliance will become significantly more granular over the next 12 to 24 months for listed companies and large PIEs (public interest entities), SMEs come under the net from 2026 though the level of reporting required ought to be constrained.

This will create a raft of opportunities across global markets, but pioneers should be wary. It could be some time before the benchmarks and measurement tools are in place to accurately discern price and value – probably not until 2023.

How impact investing evolves alongside this is another matter entirely.

Tactical elements & strategic objectives to adopt

What are the key elements in governance that need to be in place for CSRD and SEC compliance to be met?

Culture: Board level commitment with a permanent place on the board agenda. The point hasn't been made, nor the question asked, but will directors need training in order for them to understand the nuances of environmental risk?

Policy: Probably only a few very large companies will have the competencies to meet these new regulatory challenges and even then they will need to conduct an internal review of the adequacies of dealing with double materiality and value chain risk assessment. Large companies would do well to watch how their larger peers respond and try to adapt best-in-class methodologies to their organisations.

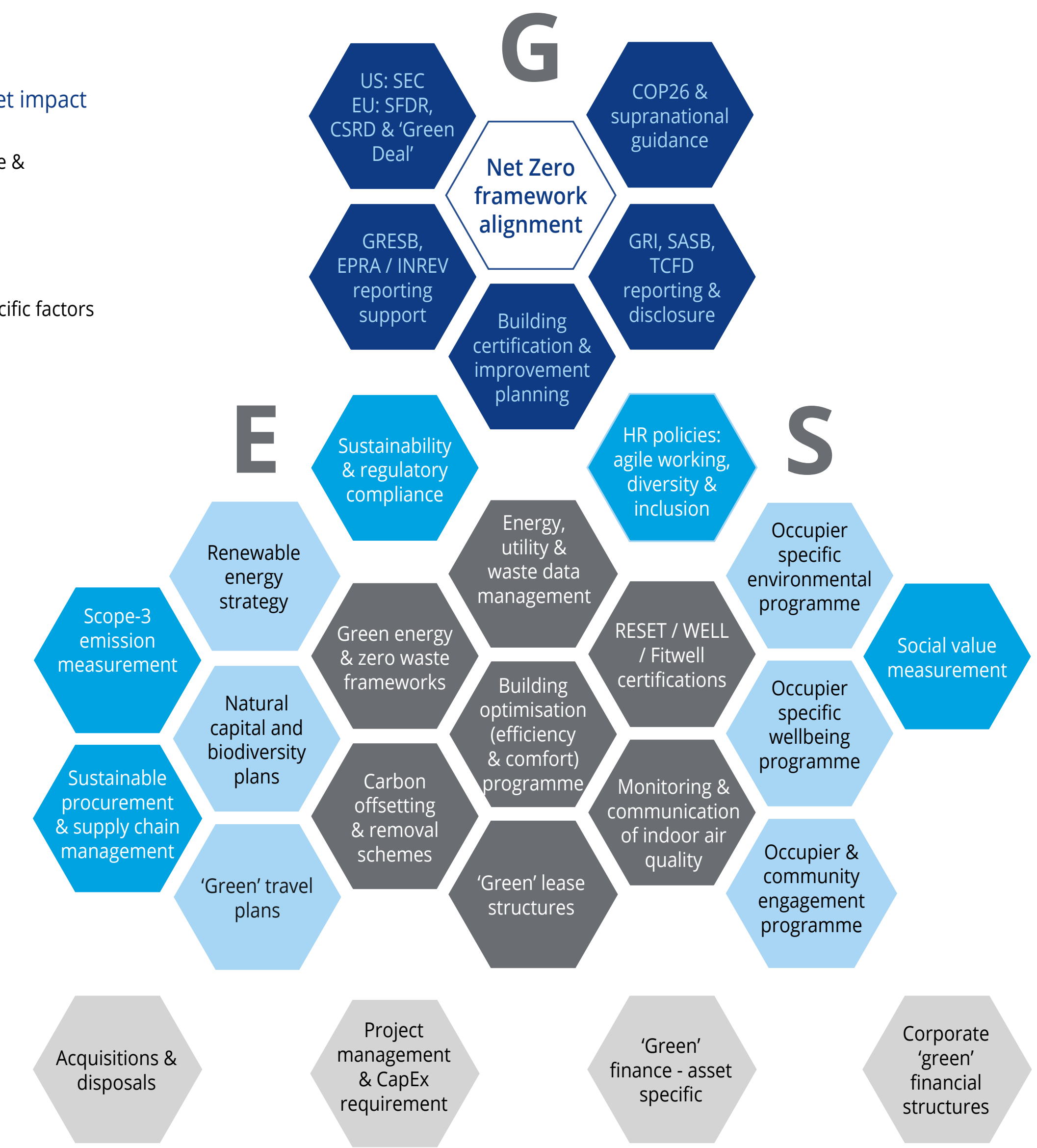
Systems: Are current systems capable of capturing the data needed for value chain risk assessment? Are reporting structures in place for the new disclosure requirements?

Risk: Do you understand the new definition of risk? If not you may need to learn before undertaking an ESG/value chain risk assessment. Identify and remedy areas where data is unavailable, as under SEC rules ignorance is no excuse.

Control: Large companies will already have internal control departments looking at financial and some operational controls to check their effectiveness. ESG will at the very least require the expansion of the internal control/audit department probably with people from outside a conventional finance background.

Figure 6:
Key ESG metrics & market impact

- Corporate governance & benchmarking
- Corporate factors
- Asset & company specific factors
- Asset specific factors
- Market impact



Source: Colliers

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