Material benefits of environmental engagement in non-listed real estate

Active engagement by real estate asset owners remains critically important, especially as some managers are using the stagflationary economic backdrop and political pushback as a pretext for delaying measures to meet the challenge of climate change.

By *Shaun Stevens*

Material benefits for real assets owners

There's growing evidence that collective engagement helps institutional investors or asset owners to achieve their environmental and sustainability goals and their risk-return objectives. A range of studies show that engagement can bring benefits to real estate asset owners and the UNEP Finance Initiative recommended that they should engage directly or indirectly with managers and support sector wide initiatives. Asset owners should ensure that risk is properly managed and executive interests are aligned with the risk and return of the assets managed.

Nonetheless, many asset managers are not on track to be net zero – 'Paris-Proof' – by 2050. This requires active engagement from asset owners, who need to emphasize to their managers that ambitious net zero targets, science based interim targets and asset level sustainability plans are essential, from an environmental but also a financial perspective. However, climate risk engagement is a resource-consuming effort requiring expertise. As a result, only the largest asset owners can effectively engage themselves, while others expect their external fund managers or their specialists to do the work. Collaboration with an advisor in a specialist area like real estate can help asset owners to make progress that might not be possible if they tried to execute themselves.

Indeed, investors have established coalitions to improve the focus on environmental issues and develop company engagement, with organisations like Climate Action 100+ (CA 100+) and Ceres amongst the most prominent, and The Global Real Estate Engagement Network (GREEN) in the real estate sector. GREEN members encourage real estate funds to improve their sustainability performance and reduce their exposure to financial and non-financial climate risk.

Environmental engagement in practice

GREEN members engage real estate funds to improve across four areas: the implementation of climate change governance structures, including ambitious target setting aiming for 1.5 °C pathways; establishing science-based transition pathways to achieve the Paris goals; the level of disclosure of business plans under different climate scenarios; and promoting the use of certified data, including building certification, across portfolios. An engagement typically runs over a set period. Engagement meetings have a clear data driven agenda to ensure focused conversations with real estate fund managers.

Engagements will establish whether funds are on track to be net zero by 2050, including if there are intermediate science based targets. They also cover implementation pathways, asset level plan usage, assessment of physical risks from climate change and any mitigation measures that have been implemented.

Another area of focus is business plan disclosure and the adoption of standardized green building certifications across portfolios. Twice a year there are progress meetings with non-listed real estate managers. Where necessary GREEN members will encourage

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fund managers to improve if they believe the fund is not on track to be Paris-proof. Eventually, they'll decide whether further engagement is necessary. For example, if a fund is on track, engagement is no longer required and scarce resources can be directed elsewhere. Alternatively, escalation may follow if, for instance, a fund manager refuses to commit to climate risk measures. This could ultimately lead to an end of the engagement, and investors putting the fund involved on the 'sell' list.

Why real estate engagement

While the net zero ambitions of asset owners remain undiminished, recent survey evidence suggests some fund managers, particularly in Asia and the US, have scaled back their ESG ambitions, citing the uncertain macro environment. EU based investors typically remain committed to achieving net zero ambitions, in part because of the tougher regulatory backdrop.

Interestingly, the hesitancy of some managers contrasts with an emerging body of evidence revealing that owning more sustainable real estate can deliver better rental and sales performance. Research by Jones Lang LaSalle in 2022 showed that buildings that don't meet sustainability standards suffered financially from a 'brown discount'. The research confirms that investors need to focus on the long-term benefits from owning green certified properties capable of generating materially significant premiums.

More recently, evidence from the European office market indicates tenants are willing to pay higher rents for newly built, energy-efficient offices than for older, less efficient buildings. Savills found notable divergences between prime and secondary rents in markets like Amsterdam and London, where EPC regulations have been introduced. They expect greater divergence in rental levels across European markets as more countries adopt stricter EPC regulations.

There's also academic evidence illustrating the material benefits of engagement and collaborative engagement about ESG related issues across different sectors, including real estate. A study by Maastricht University observed that repeated, material engagements are linked to improvements in profitability. The research found that collaboration reduces costs and increases the probability of success.

GREEN recently published its 2022 engagement results, gathered from listed and non-listed managers. The initiative is now in its third year and is already showing the value of collective engagement across real estate, as well as the need to increase its scope. In 2022, 36 listed and 19 non-listed funds, investing in all major sectors and regions, were engaged, across 153 different subject areas. On the non-listed side, 75% of funds had a net zero target across scope 1-3, and 40% had intermediate science based targets, but just 30% had credible implementation pathways. These findings show the importance of investigating how managers implement their headline claims around the Paris goals and assessing plans for achieving decarbonisation ambitions.

The value of climate risk engagement

Some real estate managers may be using the challenging global inflation and interest rate backdrop to temper their ESG ambitions. However, the clear message from European and US real estate markets suggests that investors and tenants are beginning to discount unsustainable buildings and that 'green' buildings can add value to investor portfolios. There is also a growing body of evidence that engagement preserves the long term value of investments in assets like real estate. In other words: environmental risk is also a financial risk. Material engagements that are focused and well executed can have a positive impact on companies' sustainability ambitions and can benefit shareholders. Moreover, the emerging resistance against ESG more broadly, particularly in parts of the US, reinforces the need for active ownership around climate risk management.

Engaging with managers about climate risk management has therefore never been as urgent for real asset owners as it is today. ■

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SUMMARY

Evidence from European and US real estate markets suggests investors and tenants are beginning to discount unsustainable buildings.

Collective, material engagements can help asset owners achieve their environmental and sustainability goals.

Engaging with managers about climate risk management has never been as urgent for real asset owners as it is today.

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