



Boardroom Briefings. Navigating the ESG landscape in real estate investment

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Sustainable strategies and the future of green governance

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| ESG – flash in the pan, or here to stay?

You'd be hard pressed to find a boardroom in the real estate sector that hasn't played host to long, complex and, at times, daunting discussions around environmental, social and governance (ESG) issues and their impact on assets and business plan underwritings.

Having been long since accepted by industry as much more than the latest in-vogue acronym (from a sector that does love an acronym), sustainability and its many considerations are now central to almost every element of decision making in the real estate investment space. ESG is here to stay and, as many fund managers, investors and landlords are finding, there's no hiding from it.

Those unwilling, or perhaps unable, to accept the tide of change in reducing carbon footprints and join the journey to becoming net zero face a new stream of risks asset obsolescence, debt raising option scarcity, tenant demand for sustainable and premium space, and what has now been coined as the "brown discount" - the idea that unsustainable and inefficient buildings achieve lower estimated rental values and are, ultimately, being valued lower by the market. These are all very real risks fund managers and boards alike are attempting to manage.

Has the sector taken its foot off the gas (excuse the pun)?

Despite Rishi Sunak's decision in 2023 to renege on a series of ESG related climate policies and targets - which, based on current predictions, appear to now leave the UK susceptible to falling short of its Paris Agreement pledge to cut emissions to below 1990 levels by 2030 - fund managers, investors and landlords appear to be continuing to place ESG and decarbonising at the top of their agendas.

In fact, certain industry based studies are even suggesting that ESG concerns in real estate currently rank ahead of market liquidity and refinancing concerns, in the context of 2024 investment projections. From our position as board members across a variety of property holding vehicles, Ogier's real estate directors are yet to see signs of intentional watering down of ESG commitments by managers and investors, as initially feared by some following the Prime Minister's U-turn.

The sector appears to be taking ESG seriously, and for good reason too. According to a [2022 report commissioned by the House of Commons Environmental Audit Committee](#), the UK build environment is responsible for approximately 25% of the UK's total greenhouse gas emissions – a staggering amount, but perhaps unsurprising to some. Developers and investors are being encouraged by policy makers to challenge the way they source materials, construct, operate and demolish real estate – as part of their commitment to improving the whole-life cycle of a building.

In doing so, fund managers and boards are beginning to better understand the operational carbon emissions (the emissions from the energy used to run/operate a building) and embodied carbon emissions (the emissions baked into the materials, construction and demolition) produced by their assets and, importantly, how they can be improved. But measuring emissions is complex – particularly embodied emissions – and although the introduction of the Energy Performance Certificate (**EPC**) and the Building Research Establishment Environmental Assessment Method (**BREEAM**) have gone some way towards assessing, accrediting and categorising sustainability, emission disclosure remains largely unregulated and voluntary.

Interestingly, the implications of ESG in the real estate sector are being felt beyond the asset level "bricks and mortar". Fund managers themselves are under increasing pressure to participate (and rank highly) under, among others, the Global Real Estate Sustainability Benchmark (**GRESB**) – one of the leading global ESG benchmarking appraisers. With the list of GRESB 5-star rated managers ever-growing, fund managers appear acutely aware of their need to remain competitive in this space in order to attract (and retain) investor capital.

ESG crystal ball gazing

Diverging, momentarily, away from the "environmental" limb of the ESG acronym, real estate fund managers, landlords and tenants alike continue to grapple with the long-term social fallout from the global pandemic. Regional, sectoral and industry variance in approaches to hybrid working and, significantly, the subsequent effects on office space demand have been, and continue to be, important discussions around the boardroom and at investment committee meetings.

Tenant organisations in certain sectors find themselves caught, unenviably, between a rock and a hard place when considering future space requirements. Boards are being asked to make difficult decisions around whether to prioritise maximum occupancy utilisation through the withdrawal of remote working policies, while simultaneously acknowledging they may well be sacrificing their most effective talent recruitment and retention tool in the process.

With the US and Europe reportedly trailing behind the APAC region in return to pre-pandemic office utilisation levels, it is perhaps unsurprising that transactional volumes in the commercial office sector remain heavily suppressed. But, with subletting volumes reportedly on the rise in the US and Europe, the expectation that interest rates may drop quicker than previously anticipated, and wider optimism in the credit market for H2 2024, there are signs of positivity in the real estate space.

It's not all doom and gloom for an industry already feeling the pinch from prolonged interest rate hikes, weakened investor sentiment towards the asset class, inflationary effects on construction costs, and the macroeconomic implications of conflicts and instability in Eastern Europe and the Middle East. For landlords holding EPC A+ and BREEAM "Outstanding" and "Excellent" rated assets, estimated rental values are expected to remain strong, to match tenant demand and scarcity of supply - the "green premium" versus the "brown discount".

Conversely, for those landlords holding assets with poor ESG credentials, the tenant flight to quality will remain a significant challenge. Risk of asset obsolescence being accelerated by the ESG demands of key stakeholders is a real concern for many, and is prompting interesting conversations in the industry around alternative uses and the re-purposing of assets (the challenges of which are explored by Tom Stevenson in our [previous Boardroom Briefing article](#)).

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Meet the Author



[James Philpott](#)

Associate Director

[Jersey](#)

E: james.philpott@ogier.com

T: [+44 1534 514423](tel:+441534514423)

Key Contacts



Lawrie Cunningham

Director

Jersey

E: lawrie.cunningham@ogier.com

T: +44 1534 514473

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