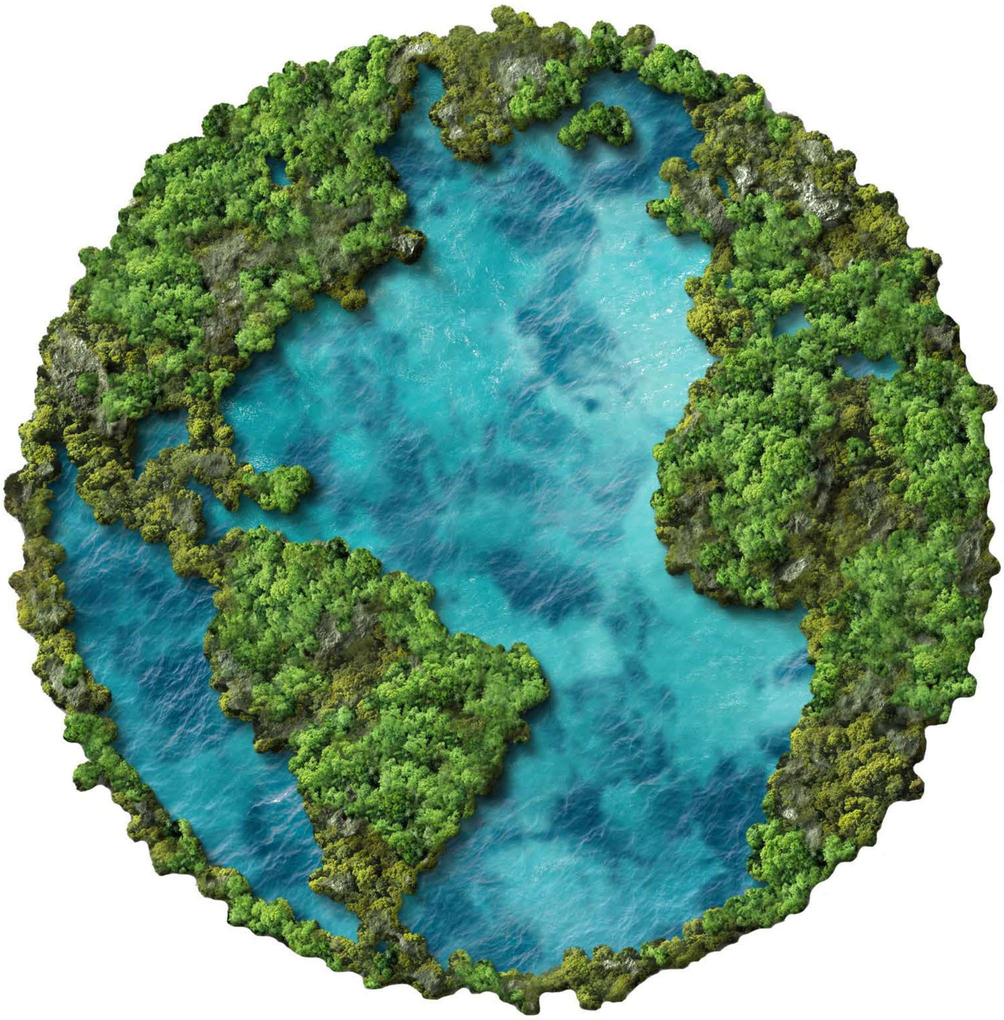


ESG Talks: Opportunities & Challenges in Real Estate Investment Management
Edition #6

Series Background

ESG (Environmental, Social and Governance) is arguably one of the most discussed topics in the real estate industry, driven by growing public interest in sustainability and new regulatory requirements. Real Estate Investment Managers (REIMs) in particular are strongly affected by this and face various challenges, since ESG requires a broad change of perspective in many business areas. Therefore, as part of this publication series, Deloitte examines the real importance attached to ESG, the approaches REIMs are taking, where there is room for improvement, and what can be expected from the industry in the future.

The content of this series was collected and analyzed between August and October 2021. In a total of 16 hypothesis-driven interviews, 22 managing directors and department heads of leading European and global REIMs based in Germany were surveyed. Thus, the participants represent approximately € 600 billion in real estate assets under management. The aim of the interviews was to obtain a meaningful picture of the industry on the topic of ESG in order to highlight not only challenges and risks, but also potential solutions and opportunities. The interviews were conducted based on seven hypotheses that participants had to ultimately agree or disagree with in the otherwise free-form conversations. Deloitte now publishes a Point of View at regular intervals as a summary of the interview results for each hypothesis.

Discussion of Hypothesis #6

"The integration of ESG along the entire value chain is costly and comes at the expense of profits from management fees. However, the scope for adjustment is moderate. Efficiency pressure on existing business is increasing."

The results of our interviews conducted in the course of hypothesis 6 show that there are many different opinions among the experts on the topic of integrating ESG along the value chain and on the resulting consequences.

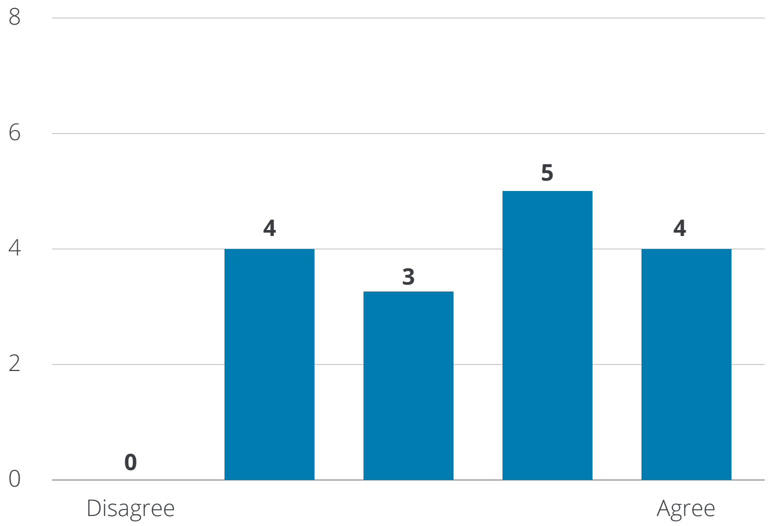
However, there was consensus on one aspect: ESG is here to stay and will join the already existing regulations as a central pillar of regulation, bringing with it specific documentation requirements. Investment managers consequently find themselves in a quandary: on the one hand, they must meet increasing regulatory and investor requirements, while at the same time compensating for the higher costs associated with them.

Meeting regulatory ESG requirements will of course be seen as a minimum requirement by investors in the future. However, many have already defined ambitious targets of their own that once again go beyond the regulatory level, and more will follow. The topic will therefore not lose its relevance and implementation will increasingly become a matter of course.

Based on the statements made in the interviews, we can state that compliance with ESG regulations and the associated additional work for investment managers will be unavoidable. This raises the question of how this additional effort is made up and where costs are incurred. The focus will certainly be on data collection, evaluation, processing and presentation.

However, data management is not only the responsibility of property managers, but also of investment managers, who in turn will have to provide performance-related data to investors. Companies will either need to hire sustainability officers who have the expertise and capacity to address this issue, which will result in increased staffing costs, and/or need consultants to support these issues. Integrating ESG requirements into the business is also subject to a longer implementation process. However, the effort today – if done correctly – will ensure competitiveness tomorrow.

Fig. 1 – The integration of ESG along the entire value chain is costly and comes at the expense of profits from management fees. However, the scope for adjustment is moderate. Efficiency pressure on existing business is increasing.



"The inclusion of ESG is a real selling point to investors. If investment managers position themselves well in this environment, the trend can be an opportunity to grow the business and collect more fees in absolute terms."

Dr. Raphael Mertens, Chief Risk Officer, Global Head of Sustainability, Allianz Real Estate GmbH

Accordingly, in addition to the challenges surrounding ESG compliance, there is also potential for investment managers. This statement can be corroborated by those companies that are already further advanced in this topic area, as a clearly positive "salt effect" can be seen among them. They are convinced that investment managers will have to be ESG-compliant in order to be able to offer the best products in the future and consequently also achieve the highest returns. In addition, some interviewees are convinced that the issue will create market barriers in the future and exclude from competition those participants who have failed to upgrade. But how is it possible that, despite new cost centers, more revenue will result for the company in the end? Our experts identified different scenarios in this regard.

Some participants argued that the additional expense due to ESG integration has to be borne by investors, among others, and that this could also be reflected in practice, for example through increased fund management fees or project management fees. Others point to the possibility of being able to transfer at least part of the ESG costs triggered by property management to the tenant as part of the operating costs.

However, there were also clear counter-opinions to these positive visions for investment managers. Instead of passing on the costs incurred via various fees, these will be reflected in lower profits in the long term. This could subsequently put investment managers under pressure.

In particular, the interviewees who identified a clear market and sales advantage in sustainable investments also pointed out that even if the fees remain the same, the increase in assets under management (AuM) will generate more fees in absolute terms. However, this leverage only really comes into play if the associated processes and data flows have been standardized and automated in such a way that the additional investments are not accompanied by a parallel increase in expenses.

Among all the different points of view, there was finally agreement on one point. Regardless of who ultimately bears the costs, it is essential to think long-term. After all, meeting ESG requirements also ensures the value of the real estate, i.e., the real estate becomes more stable in value. Since the investment manager's fees are based on the value of the property, they are not only secured in the long term, but will also increase.

Conclusion

In summary, investment managers face a major challenge that will also lead to higher costs. Positioning the company and the products in an ESG-compliant manner will be necessary in order to position oneself successfully on the market in the long term. Smaller market participants may be confronted with the challenge of building up appropriate know-how within the company, but at the same time often have the advantage of shorter decision-making paths. Ultimately, good, up-to-date portfolio management will also generate more sales, which in turn will ultimately lead to higher profits for investment managers. In addition, early ESG investments are expected to have a positive effect on the attractiveness of products and property values. In this way, REIMs will remain competitive in the long term and secure margins in the future.

Outlook

This point of view is part of a seven-part series. Each publication presents one of the hypotheses discussed during the interviews.

Hypothesis #1
"ESG is a marketing tool. The industry puts its image and regulatory compliance ahead of delivering real impact."

Hypothesis #2
"The sum of individual efforts by REIMs is not enough to achieve the ambitious climate targets of the EU Green Deal. Competitive thinking and a lack of trust confront the industry with obstacles when it comes to collaboration among competitors."

Hypothesis #3
"REIMs cannot implement a 'manage to green strategy' on their own. Collaboration with tenants and service providers is essential for this. However, concrete initiatives are still missing."

Hypothesis #4
"The most sustainable building is the one that is not built."

Hypothesis #5
"The costs of constructing, refurbishing and operating sustainable buildings will exceed the economic benefits. Sustainable investors will therefore have to forego returns in the future."

Hypothesis #6
"The integration of ESG along the entire value chain is costly and comes at the expense of profits from management fees. However, the scope for adjustment is moderate. Efficiency pressure on existing business is increasing."

Hypothesis #7
"An ESG scoring/rating is only as good as its underlying data. The incomplete data basis and the need for extrapolation pose major challenges for REIMs."

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