ESG Talks: Opportunities & Challenges in Real Estate Investment Management
Edition #5

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.

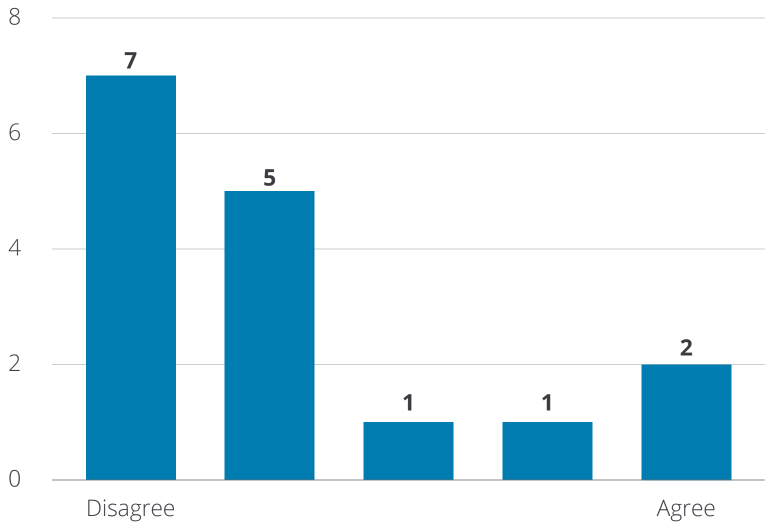
Discussion of Hypothesis #5

"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."

The results of the survey show a general rejection of the hypothesis by the interviewees. Even if the general opinion is that sustainability will cost money, this statement is too one-sided for many participants. After all, in the long term, sustainable investments lead not only to risk minimization, but also to the preservation of stock and the safeguarding of sales prices. Particularly regarding to an investment period of ten or more years, the respondents believe that investments in sustainability will pay off and have a positive effect on the value of the property. In this context, it is important to combine economic and ecological goals to uncover and exploit business opportunities and investment opportunities.

The aspect that sustainability initially means a renunciation of returns is widely shared, but a holistic view must be taken. In this context, the question is also raised as to what it would cost in the long term if nothing is done to combat climate change and climate risks continue to increase. In this context, there is agreement that investments in sustainability or climate neutrality will trigger costs on the one hand but reduce investment risks in the long term on the other hand. For this reason, ecological sustainability is also understood as value sustainability. In addition, a clear trend can be seen among investors across all sectors regarding demand for sustainable investments. Particularly among institutional and professional investors, the concept of sustainability is becoming increasingly important due to the long-term investment horizon. Economic risks at the end of the holding period cannot be neglected and are also comprehensible for the investors. Therefore, they are often willing to forego short-term returns to invest sustainably and pursue climate goals, thus making an overall impact. This is often also driven by the ESG agendas of the investors, who in turn have established clear goals for their investments. Accordingly, some of those surveyed observe a trend on the investor side away from maximizing returns toward optimizing returns, which is why the topic of sustainability – in particular ESG – is increasingly understood as an insurance of returns rather than a renunciation of returns.

Fig. 1 – 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.



"Especially in impact products, there are investors who are willing to give up part of their return in order to have an impact on climate change. We are already seeing this in the Nordics and the Netherlands, and it is increasingly catching on in other countries as well."

Clemens Schäfer, Global Co-Head of Real Estate, APAC & EMEA, DWS Real Estate GmbH

Another point that was addressed in connection with our fifth hypothesis is the issue of the value of real estate in general and existing buildings in particular. The majority of our interviewees expect a decline in the value in the future, especially in case of existing properties that have not yet adopted a sustainability approach. The risk of "stranded assets" is considered to be significant in this context. A sustainable property naturally has a significantly lower risk of becoming a stranded asset or suffering a discount in the sales price at the end of the holding period. For this reason, sustainability is not seen as a risk factor in the long term, but as a value driver.
At its core, ESG does not contain anything new for some of the respondents but is to be treated in a similar way to other topics that are to be included in the pricing of the investment process. For example, a long lease term was mentioned: This leads to a higher factor in purchases and sales, which could also imply a sacrifice of yield. In this case, investors are willing to accept this in favor of cash flow security. The situation is similar in the case of sustainable real estate, since here, too, higher yields are initially foregone in order to secure long-term returns.

Another challenge that emerged from our interviews is that there is currently still an imbalance between market value assessments and ESG requirements. According to some interviewees, necessary ESG investments are currently not or not sufficiently considered in the purchase prices. This proves to be particularly difficult, as the negative value effects of not taking these measures are arduous to estimate. However, it is assumed that prices will adjust downward in the long run, especially for "brown" properties. In the future, the level of a buying and selling factor will depend on how much money and time are needed to transform an existing property into a "green" one.

Conclusion

The fact that sustainable investing means foregoing returns is seen more as a temporary effect. In the long term, it is expected that sustainable investments will prevail and will not result in a loss of return over the entire investment period. In general, there is agreement that while a shift towards sustainable investments will fundamentally increase investment costs in the short to medium term, demand for sustainable properties will increase in the long term. As a result, the initial loss of return is expected to be compensated or even overcompensated by the stability of the property's value over its lifetime. Particularly in the portfolio segment, the implementation of sustainable measures has a significant impact on the fabric of the building and thus on the lifespan of a property.

It also became clear in the discussions that regulation of the market is necessary. Here, it is assumed that the entry into force of the EU taxonomy will contribute to increased price pressure and a change in the value of non-sustainable real estate. Currently, respondents face the challenge of having to make investments that are not yet profitable. At the same time, climate risks are clearly seen as investment risks, so ultimately a sacrifice in return for global investors will lead to a reduction in global investment risk overall. For this reason, it is considered economically profitable for investors to forego returns. In principle, the issue of sustainability must be approached with a view to a sustainable society, regardless of whether a specific sustainability approach is being pursued or not. We need to move all products in this direction.

> "Investments in sustainability will bring a return advantage in the case of long observation periods, as this extends the economic useful life of existing buildings in particular."

Dirk Meißner, Chairman of the Board, Deutsche Investment Kapitalverwaltung AG

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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