ESG - A driving force behind investor intentions

Environmental, social, and governance (ESG) factors have gradually assumed a central role in shaping investors' intentions over the past few years, notably on what is 'shared value' and correct, sustainable, investment practices. This leads, through a correlated effect, to fund promoters shaping their asset management strategies, risk appetites and underwriting assumptions. Understanding how ESG has shaped investors' intentions is a proxy toward future expectations and understanding challenges deriving from a fluctuating market.

Investors' increased focus in generating positive social and/or environmental impacts alongside financial returns can be traced back to the launch of the United Nations Sustainable Development Goals and the United Nation's Climate Change Conference, COP21, both held in Paris in 2015, during which major commitments to reduce greenhouse gas emissions were made. Responding to their investees' expectations, many institutional investors, among which pension funds are well represented, have shown a commitment to incorporating ESG considerations into their investment decisions by becoming signatories to initiatives like the United Nations' Principles for Responsible Investment.

Since then, investors in the real estate market have increasingly reshaped their investment strategies and pushed for environmentally sustainable buildings that meet sustainability standards, resulting in the 'green building' trend. On top of the environmental impact, investments in such properties have proven to be a significant driver of returns as office life and urban habits changed accordingly. Not only limited to adapting buildings to a lower carbon imprint, but investors also look at affordability, inclusivity, and safety of the real estate assets in which they invest.

Asset managers have responded to this new demand from investors by developing innovative strategies aimed at meeting their investors' ESG considerations. These strategies range from the adoption of new rules, frameworks, and guidelines, to the employment of data and technology in setting key indicators and specific goals. Many investment funds have embraced comprehensive ESG integration into their investment structures and processes, incorporating ESG screening, in-depth ESG research, and active engagement with investees' on ESG topics.

Investors welcomed and actively relayed the European Union (EU) Action Plan on Financing Sustainable Growth, as it implied numerous regulatory adaptations including the EU taxonomy for sustainable activities and the implementation of the Sustainable Finance Disclosure Regulation (SFDR). Regulations welcomed and formalized the trend making it mandatory for funds to disclose their consideration of ESG factors in a more transparent manner, further exposing their potential impacts. However, if the SFDR has been designed to contribute to this objective by providing transparency to investors about the sustainability risks and the adverse impacts that such investments have on the environment and society, it seems that the market is expecting an improvement of the outcome of the SFDR classification and is willing to go beyond the pure labelling which is a good indicator of the involvement of the real estate industry in ESG matters.[1]

With the complement offered by the Corporate Sustainability Reporting Directive that ensures the transparency of the undertaking on their efforts to comply with the EU taxonomy and the upcoming Corporate Sustainability Due Diligence Directive that imposes companies to provide data and information on risks within their supply chain that are linked to human rights or environmental impacts, investors should have relevant information to assess their ESG risks, to develop their ESG investments and to verify whether their investments are aligned with their ESG strategy.

But we have only witnessed the beginning—reinforced by the new ESG regulatory framework, it can be expected that investors will go deeper in the monitoring of the impact investments, the ESG-risk management and compliance and will ask for an improved governance leading to more sustainable investment structures.

Looking ahead, with the combined effect of investors' appetite for ESG and sustainability performance, and the increase of the ESG regulatory framework, real estate market participants have a lot to gain from monitoring their exposure to changing regulations and keeping on adapting their ESG strategies and diligence programs.

Contacts

Francisco da Cunha
Partner, Real Estate Tax Leader
Deloitte Luxembourg
fdacunha@deloitte.lu

Anne-Sophie Le Bris
Senior Manager, Tax M&A
Deloitte Luxembourg
alebris@deloitte.lu

Endnote

1. Implementation of the sustainable finance disclosures regulation. European Commission. 2023.