What does ESG mean for REITS?

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Sustainable investing has developed from a niche to a mainstream market segment as institutional investors are increasingly appreciating the benefits of investing with environmental, social, and governance (‘**ESG**’) aspects in mind. To illustrate, a proxy season study showed that more than 50% of institutional investors surveyed consider effective management of environmental issues and climate change as critical to the strategic success of their portfolio companies[1]. In this article, we discuss ESG from the perspective of Real Estate Investment Trusts (‘**REITs**’) with a view to identifying the key drivers of ESG in this space and the latest trends that asset managers should take into account when looking to apply sustainable practices in their investment decisions, processes, and operations.

ESG definition and components

The National Association of Real Estate Investment Trusts (NAREIT) defines ESG as the environmental stewardship, social responsibility, and good governance practices that, when actively and holistically measured, managed, and disclosed, ensure sustainable business performance and accountability to the industry’s investors, tenants, workforce, and communities.

In the context of REITs, the environmental aspect of ESG is assessed at an asset level and then rolled-up to a portfolio level view. The criteria for evaluation at an asset level include factors such as the energy consumption in the building, the water use metrics, waste generation, GHG emissions, climate risk assessments and third party ratings (e.g. LEED, Energy Star, etc.). Based on the input provided at an asset level, asset managers are then able to compile portfolio level data to include in their disclosures to investors.

As for the social component of ESG, the asset level benchmarks include factors such as the placemaking strategy of the REIT, tenant satisfaction, health and wellbeing and the impact that the asset has on the community. In addition to the foregoing, ESG should be examined at a corporate level. An assessment of the social component, therefor, includes measures relating to whether the employees of the REIT are satisfied and engaged, whether the REIT adopts diversity and inclusion practices, the level of training and developments and such other factors as then-current trends dictate. For example, as a result of the pandemic, asset managers started giving particular attention to resilience measures in their organization.

The governance aspect in ESG revolves around ensuring that there is a clear commitment to institutionalizing good governance policies and practices at the level of the REIT. For this purpose, many REITs in the world have formed interdepartmental ESG committees that include C-suite and board-level representation as well as cross-functional groups comprising employees from different levels of the company. These committees would be entrusted with the responsibilities for developing, overseeing, and deciding on ESG initiatives.

ESG market drivers

There are four key market drivers that are working together to facilitate the development and growth of ESG in the context of REITs.

Institutional investors form the first driver. They are primarily looking to optimize the risk/return profile of their real estate investments and understand that ESG is a key enabler. They are increasingly concerned as well with stakeholder reporting. By way of example, BlackRock Chairman and Chief Executive Larry Fink's annual letter to CEOs has, over the last four years, been consistently focused on ESG. Sustainability management, according to BlackRock, is a business necessity and corporations have a responsibility to demonstrate accountability to their stakeholders.

The second driver are tenants and occupiers. From their perspective, sustainable buildings that are energy efficient can help in reducing their operational costs and environmental footprint. From the perspective of asset managers, green buildings are able to achieve higher rental income by attracting and retaining lucrative tenants. They are associated with higher tenant satisfaction, which in turn lowers tenant incentives and the re-leasing costs on the long run.

The third driver are the regulators who are adopting stricter environmental legislation at a macro level (e.g. introduction of carbon taxes in the United Kingdom and Japan) but also on a micro and asset level with new building codes incorporating sustainability practices such as green certification requirements.

The fourth driver are the real estate associations. These associations such as the Global Real Estate Benchmark for Real Assets (GRESB) and European Public Real Estate (EPRA) are focused on the development of extra-financial reporting standards to inform decision-makers and related standards that incorporate the latest sustainability benchmarks and industry trends and best practices.

Latest trends

We have identified above the components of ESG and the market drivers underpinning it. In this section, we briefly explore the latest trends in ESG as they relate to REITs.

The first and most noticeable trend is about the way in which institutional investors are looking at ESG. Previously, they were looking at ESG from a risk perspective as they were primarily concerned with the liabilities that could be triggered in case of non-compliance with ESG practices. Nowadays, however, institutional investors are approaching ESG from an opportunity perspective as they realize that green assets are more attractive and could generate higher returns in comparison with brown assets. A vast number of studies seem to support this conclusion.

The second trend is about ESG metrics. Now more than ever, asset managers appreciate that it is no longer acceptable to talk about aspirational net-zero goals. REITs that wish do decarbonize their balance sheets must set clear targets and KPIs. They must demonstrate to investors that where the REITs portfolio contains assets that are unable to perform well in a carbon neutral world, appropriate steps are being implemented with a view to improving the asset allocation and generating value. For this purpose, it is imperative that clear quantitative targets be set.

As a third trend, we notice the proliferation of sustainability reporting frameworks. This is largely the result of the increase in international sustainability initiatives such as Paris Climate Agreement, the Task Force on Climate Related Financial Disclosure and the World Green Building Council to name a few. As such, asset managers are finding it increasingly difficult to keep track with reporting requirements. Policy makers should carefully consider this issue and work collaboratively towards a standardization of the reporting requirements.

Concluding remarks

Returns will catch up with REITs that are forward positioned and prepared for a carbon neutral world. Strategically, REITs should adopt a holistic approach to ESG that gives equal weighting to all components of ESG. On a more tactical level, we would expect REITs to enhance the oversight of ESG issues at both asset and portfolio levels, expand efforts to incorporate ESG into business culture and operations, and increase public reporting and disclosures on ESG performance. By so doing, they would be able to tackle the sustainability issues of today and build resilience to proactively navigate the ESG matters of tomorrow.

[1] Harvard Law School Forum on Corporate Governance, Investors' Expectations from the 2020 Proxy Season.

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