From trend to norm

Real estate investment and sustainability | White paper

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As lawmakers, investors and tenants continue to raise the bar in terms of their expectations, integrated sustainability strategies have become an essential part of real estate investment management and a key to maintaining the value of these investments.

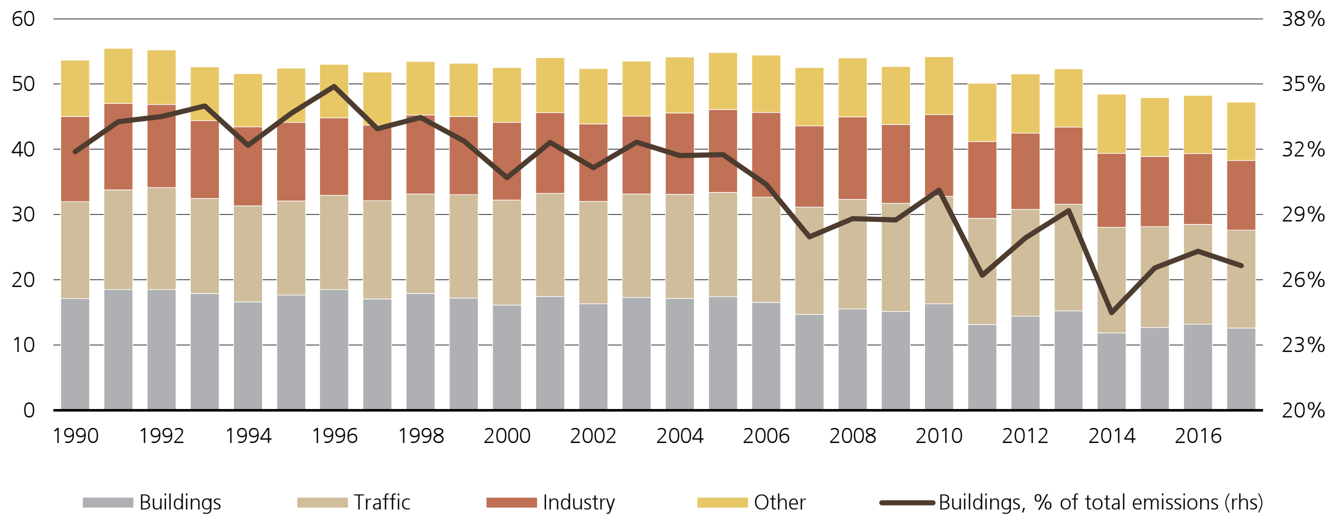
Sustainability – a trend that's here to stay

Sustainability as a concept is now firmly rooted in the minds of both the general public and institutions. In our view, this is just the start of a major change that will set new standards for real estate investment.

Growing awareness of the need for sustainability
If there was one issue that united public opinion in Switzerland and abroad last year, it was climate change. According to *The Guardian* it brought around six million protesters onto the world's streets in September in one of the biggest demonstrations ever seen in favor of environmental protection. The Swiss reacted too with a major demonstration, especially in the capital city Bern. But the movement against climate change is just one symptom of a more general awareness, reflected in public opinion, of increasing environmental and social problems. Sustainability as a concept is therefore growing in importance to extend well beyond just the environment, with ESG (environment, social, governance) one of the keys to this holistic approach for investors.

Focus on real estate
Real estate is one of the drivers on this path to a more sustainable future. Although the trend has been falling since the start of this century, the Swiss building stock was responsible for generating 12.6 million tonnes of CO_2 (27% of all the country's greenhouse gas emissions) in 2017 (Figure 1). From the global viewpoint, the figure was slightly higher – over one third of all CO_2 emissions according to the World Green Building Council. Real estate also provides the spaces where people live, work, shop and meet, giving it great social importance. And big real estate and area development projects impact the structure and functionality of the urban environment. As comprehensive sustainability standards become more deeply rooted, the real estate industry must come to grips with new and more complex requirements

Figure 1: Swiss real estate is a major emitter of greenhouse gases
Greenhouse gas emissions in Switzerland by sector (millions of tonnes of CO_2 equivalent)



Source: Federal Office for the Environment BAFU; UBS Asset Management, Real Estate & Private Markets, Research & Strategy.

Tougher regulations…

The growing national awareness of sustainability is leaving its mark on the political landscape. In October, Switzerland's Green and Green Liberal parties increased the number of seats they held in the country's *Nationalrat* (lower house) from 7.1% to 13.2% and 4.6% to 7.8%, respectively. The new green block in the Parliament's biggest chamber is therefore likely to push sustainability topics (eg. energy transition and CO_2 reduction) higher up the agenda.

The move towards more regulation of energy efficiency began some time ago in Switzerland. In 2000 the CO_2 Act supplemented the Energy Act by adding provisions on the reduction of greenhouse gas emissions. Following the 2015 Paris Climate Agreement and the decision to abandon nuclear energy, it became necessary to revise Swiss energy policy and emissions targets. The 2050 energy strategy is intended, among other things, to overhaul the entire CO_2 Act, introducing higher taxes on CO_2 and energy regulations applying to properties. One concrete result so far is that the current draft of the new Bill is gradually increasing the tax from CHF 96 to CHF 210 per tonne of CO_2 by the end of this decade. A CO_2 emissions ceiling for existing buildings is also to be introduced and will become stricter over time.

Sustainability regulations are, however, also reaching out beyond just energy efficiency. In addition to the amendment of the federal Spatial Planning Act, which is aimed at a denser urban environment, local regulations require buildings to comply with social standards, with a main focus on comfort and safety in and around the property. As the urban environment densifies, architectural quality, the organization of communal areas and recreation areas will become more important.

… and more demanding stakeholders

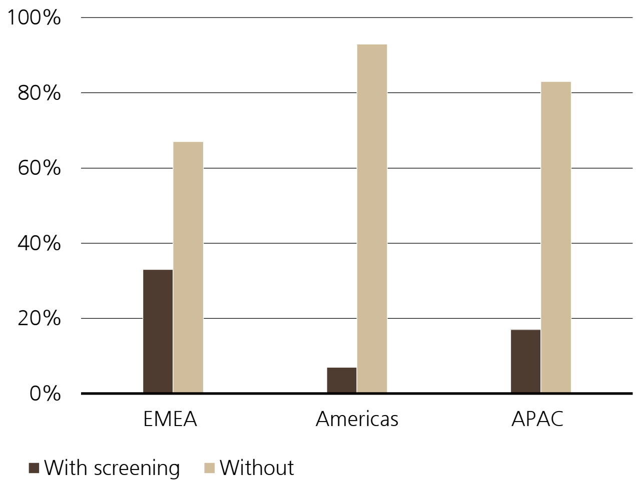
It's not just lawmakers who want the real estate industry to adopt a more integrated approach to sustainability. Investors, (institutional in particular) are increasingly embracing ESG when deciding upon real estate investments and external fund managers. In 2019 PERE (Private Equity Real Estate – a leading publication in the field) ran a global survey of institutional investors in the real estate sector. A total of 60 institutions worldwide took part, with 70% indicating they had integrated ESG policies into their investment decisions. 43% said that they would not invest with a fund manager who did not have an ESG policy.

Negative screening to ensure minimum sustainability requirements are met is becoming ever more popular when selecting real estate products and managers. One third of all EMEA respondents have already built this filter into their investment processes (Figure 2), although the Americas and APAC regions still trail behind the EMEA at just 7% and 17%, respectively.

It is also clear that sustainability is becoming more important to primary beneficiaries of institutional real estate investments; eg. pension fund members are increasingly vocal in demanding greater ESG transparency.

Figure 2: Poor ESG indicators leading to exclusion

% of institutional real estate investors applying a negative ESG-screening when selecting fund managers



Source: PERE ESG Investor Survey 2019, July/August 2019; UBS Asset Management, Real Estate & Private Markets, Research & Strategy.

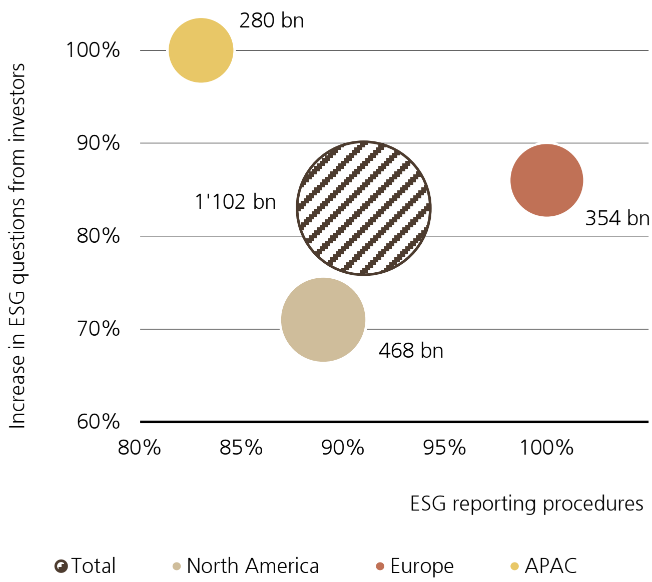
The new ESG preferences of property users is also changing real estate. This is especially true with the commercial sector where – since lessees are disclosing more about their corporate responsibility and the environmental impact of their businesses – sustainability indicators for the property being leased can be a factor in assessments, and thus automatically placing new demands on commercial leases.

These concerns are not yet a major issue for residential property. But growing public awareness of sustainability, more transparent real estate and operating indicators and especially the wider use of new technologies (sensors, rental apps, etc.) mean that a sudden change could be on the cards. New regulations (eg. the planned increase in CO_2 tax) will increasingly impact lessees either directly or indirectly (eg. by raising charges) and will probably push them towards more sustainable homes.

New sustainability requirements from lawmakers, investors and lessees

Real estate asset manager reaction to the new environment
Tougher laws and changing investor and user preferences have led real estate asset managers to gradually adapt to the new sustainability standards. A survey by Bentall Kennedy, Realpac and UNEP Finance Initiative shows that most managers around the world have already built ESG into their decision making. 90% of the investment platforms analyzed, which manage around USD 1,100 billion worldwide, include ESG reporting in their processes (Figure 3). The process is now standard in Europe, where all respondents said they report ESG indicators for their managed portfolios. Respondents also emphasized investors' growing interest in sustainability, with 83% reporting a higher number of questions on the issue in the last fiscal year.

Figure 3: ESG procedures of real estate asset managers
Results of the 2019 global survey, by region and managed assets

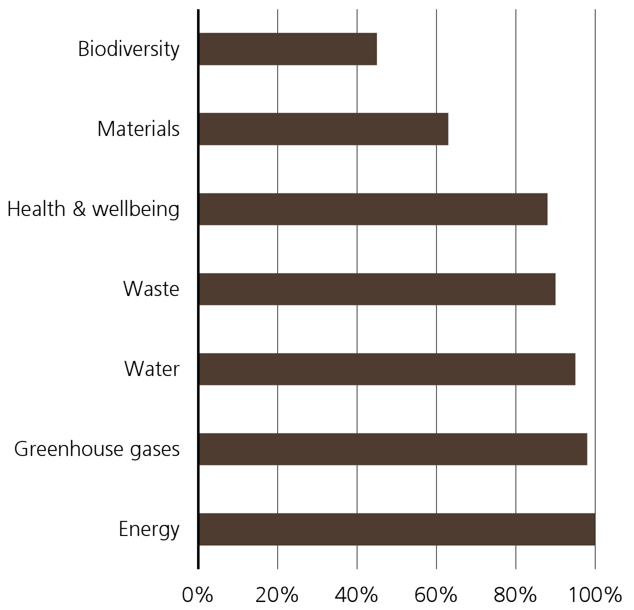


Source: Global ESG Real Estate Investment Survey Results. Bentall Kennedy, Realpac, UNEP Finance Initiative. March 2019; UBS Asset Management, Real Estate & Private Markets, Research & Strategy.

The survey also reveals that asset managers are placing greater emphasis on social responsibility, sustainable corporate management and the circular economy, in addition to just energy-related matters. For example, almost 90% of investment managers responding said that they include health and wellbeing in their ESG processes (Figure 4).

Other market signals, such as the widespread use of energy certificates for new builds and conversions, also show how the real estate industry is embracing sustainability. According to Minergie, Switzerland's biggest energy label, over 39 million sqm of energy-consuming floor area received a provisional certificate between 2010-2018. Furthermore, comprehensive sustainability certification for buildings was introduced a few years ago by the likes of SNBS (Swiss Sustainable Building Standard) and SGNI (Swiss Sustainable Building Council), and this is now consolidating its foothold in the Swiss market.

Figure 4: Trend towards more integrated ESG strategies
% of real estate asset managers considering specific areas of ESG



Source: Global ESG Real Estate Investment Survey Results. Bentall Kennedy, Realpac, UNEP Finance Initiative. March 2019; UBS Asset Management, Real Estate & Private Markets, Research & Strategy.

Analysis of the sustainability profile of the entire real estate portfolio, and not just of individual properties, has recently gained ground. GRESB (Global Real Estate Sustainability Benchmark) is one very well-established comparison indicators. The first GRESB assessment was in 2009 and real estate investments worth over USD 4,000 billion, or over 100,000 individual properties worldwide are nowadays included in the benchmark. GRESB has become well established in Switzerland in the last three years, with many big Swiss real estate investment managers regularly taking part. GRESB does not just assess the energy efficiency of buildings but also looks at their overall sustainability. This places ESG as a whole under the microscope while at the same time continually adjusting and improving the measurement process. In Switzerland we are also working to standardize measurement and comparison. The start of 2020 will for example see the launch of the new Swiss Sustainable Real Estate Index (SSREI) that will examine sustainability at both property and portfolio levels.

ESG procedure development

This is probably just the start of a more integrated approach to sustainability. Many currently peripheral areas will be drawn in to become more important. Figure 4 shows that less than half real estate asset managers include biodiversity in their sustainability strategies. Within the context of the circular economy, construction materials are included at a higher 63% but this does not yet appear to have become an industry standard.

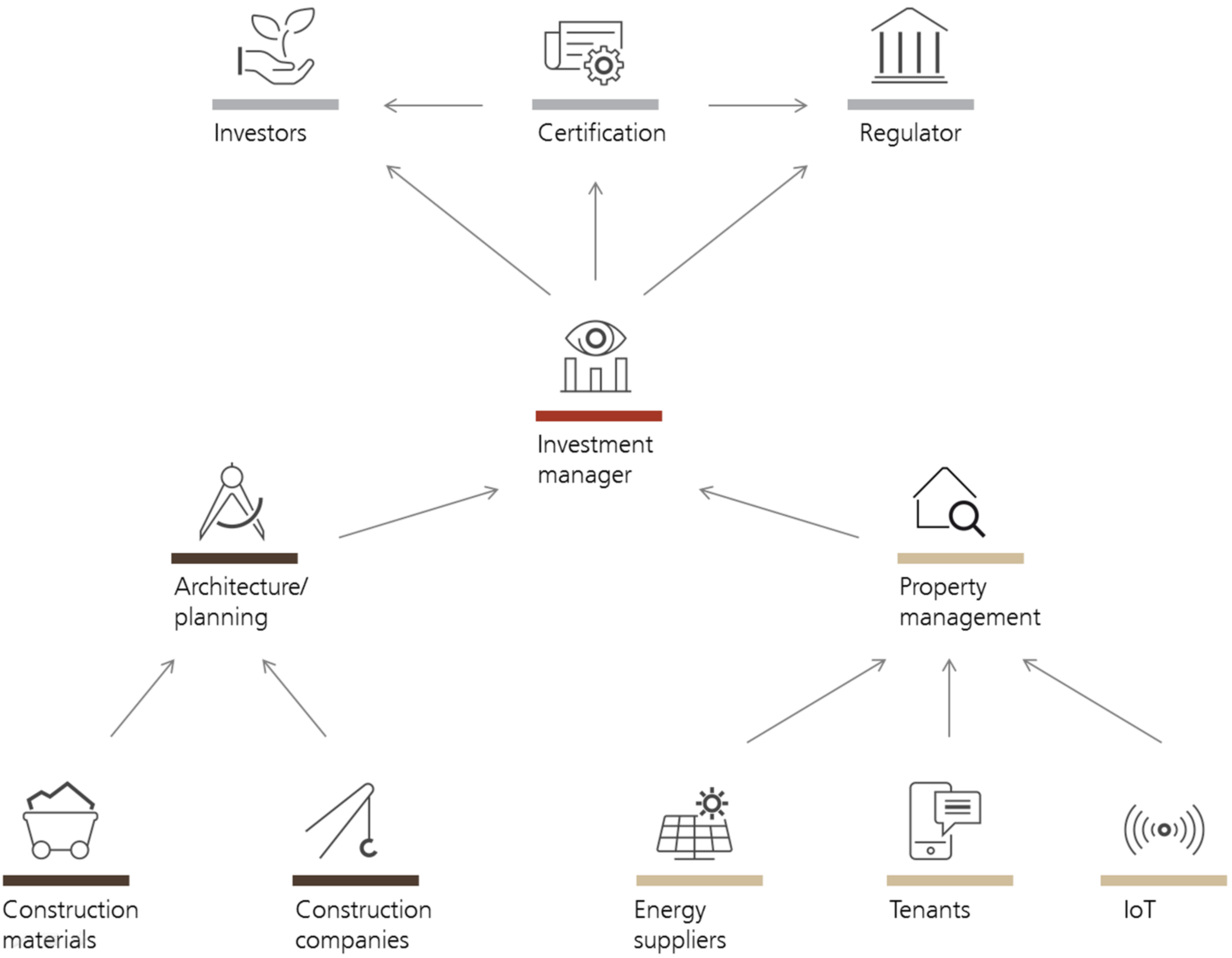
We can also assume that other ESG factors that are at present mostly ignored will very soon become more significant. In the commercial field, the source of lease revenues – and therefore a sustainability assessment of individual lessees – will in future play a bigger role in the ESG assessment of real assets. The ESG quality of revenue streams on a property is critical, in addition to its structural and life cycle characteristics. It is also likely that society will place more emphasis on the architectural quality of real estate developments. This trend could be supported by government policies and guidelines (see page 3). The challenge, however, will be to measure these factors effectively.

Digital technology as the catalyst for sustainable change

The integration of ESG factors by the real estate industry is leading to new measurement, reporting and comparability requirements. Comprehensive sustainability strategies require analysis of data on real estate portfolios and lessees, in turn demanding the production and management of significant quantities of data. The use of new technology is essential if a range of sustainability KPIs is to be efficiently and economically reported on. These digital solutions would ideally be applied along the entire value chain of the real estate industry, with investment managers relying on good cooperation with their data generation and management suppliers.

Figure 5 shows the potential structure of efficient data flows between stakeholders in the real estate value chain. At the construction phase of a new property, information on the composition of construction materials and building structure will play a major role. This data can be obtained from construction management companies and planning offices. Blockchain technologies could be particularly useful in ensuring the traceability of construction materials.

Figure 5: Digitizing the real estate industry's value chain



Source: UBS Asset Management, Real Estate & Private Markets, Research & Strategy.

During the operating phase, data flows must be coordinated by the property manager, with ESG information being collected from energy suppliers, tenant characteristics and from IoT equipment and sensors in buildings. The data will then be managed and analyzed by the investment manager to produce a comprehensive sustainability strategy that can be monitored and further developed. The ESG performance of the managed property portfolio should then be made available to investors, legislators and, where possible, the general public. Independent certification and benchmarking institutions could help to ensure that the performance indicators of individual investment managers are produced in a standard, easy to compare format.

Latecomers risk loss of value

Sustainability has become important to the real estate industry. This is more than just a passing trend. It is a concern that has already put down roots and will grow in significance. Developing an integrated approach to sustainability within the real estate investment world is, however, a long and complex process. The physical nature of real estate, its legal aspects and its major social and environmental consequences mean that a wide range of data from different sources must be obtained and analyzed. This in turn means that investment in digital infrastructure, such as IoT sensors and data management systems, is essential, requiring cooperation among all stakeholders along the industry's value chain to improve ESG transparency.

As a result of the great complexity introduced by this change and the investment it will require, real estate investment managers should adopt a proactive approach in this field. Not doing so could cost them dear as increasing regulatory pressure and the swing in the preferences of investors and lessees carry the risk of leading to the gradual obsolescence of their real estate investments and to value loss in the long run.

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