By Michael Moran and Charles Paumelle

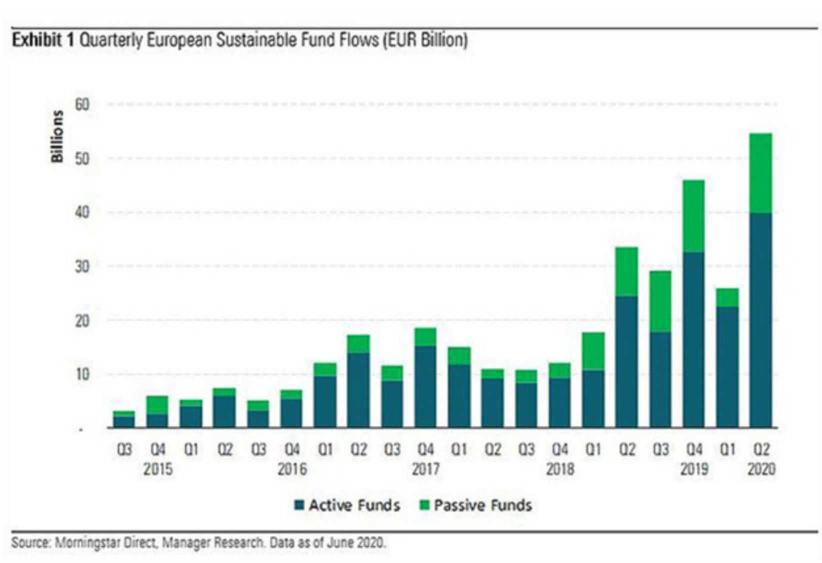
Executive Summary: On March 10, the most sweeping regulation of green finance and sustainability practice ever promulgated the European Union will take effect, raising burdensome new demands on asset managers, ETFs, mutual funds and other financial players, with important implications for owners and operators of large real estate portfolios. In an echo of its precedent setting 2018 data privacy regulation, which forced global corporates to comply even if they were domiciled outside the EU, the upcoming Sustainable Finance Disclosure Regulation (SFDR) will have sweeping impact that belies its mundane name. The cost of complying across economic sectors will be significant and risks exist with regard to subjectivity of some so-called (Environment | Social | Government) ESG metrics that underlay the new regulation. For Commercial Real Estate (CRE) and corporate portfolios, this will mean new scrutiny at the operational level, new expectations from investors with regard to carbon footprint, safety, staff diversity and wellness and a host of metrics on occupant wellness, all of which could pose significant financial and reputational risk if not met. But technology, in particular Smart Building data feeds fed by Internet of Things (IoT) sensors, offer a significant opportunity to mitigate these costs and risks for the CRE sector.

Introduction

True to its tendency to favor proof over puff – the European Union in March will move beyond the “name and shame” approach to sustainability regulation and begin requiring that financial services firms – banks, brokers, insurance and financial advisors, asset and fund managers, private equity groups and others – make detailed disclosures on any activities or investments they claim are advancing the cause of sustainability.

Beginning on March 10, all financial management companies, Real Estate Investment Trusts (REITs) and other investment vehicles will be required to provide information on their websites about their policies on the integration of sustainability risks into the investment decision-making process. Under the new law, firms must produce an annual report on up to 50 metrics that make up the principal adverse impacts (PAI) of the firms in their portfolio, potentially bringing significant pressure on firms whose metrics are flagging to improve their practices or face disinvestment.

“In practice, this will require portfolio management teams and risk teams within management companies to assess how sustainability risks are integrated into the investment decision-making process applicable to each fund under management and to update due diligence policies accordingly,” says an analysis from Dillon Eustace,[i] one of Ireland’s leading law firms.



Flows into European ESG funds continue to set records in 2020

Track record of setting the standard

"What does the EU have to do with me?" some of you may be asking. After all, if you're domiciled in the US or doing little or no business within the EU, why should you care?

In a word, "extraterritoriality." As demonstrated in 2018 when the EU's propagated new regulations on data privacy, the General Data Privacy Regulation (GDPR), the world's largest trading bloc has the power to force the rest of the world, even exceptional Americans, to jump through its regulatory hoops.

Also like GDPR, the new Sustainable Finance Disclosure Regulation (SFDR) coming into effect March 10 is given teeth by the potentially crushing fines that can be levied for any firm violating them. And like it's data privacy predecessor, the new green finance regulation is consciously designed to leverage the EU's size and extraterritorial reach, forcing corporations with only nominal interests within the EU to step up to the new standards. Google didn't move quickly enough to comply with GDPR in 2018, and in early 2019 was fined $57 million by the EU.[ii] The company has lost several appeals since, and has also spent millions to comply.

Marketing teams, too, need to pay heed: SDFR also aims to stop "greenwashing," the practice of claiming to be sustainable and humane even as you flatten a rainforest, operate energy inefficient buildings or leak waste into waterways. In short, the time when paying lip service to ESG (Environment, Social and Governance) issues is ending.

"The main rationale for providing transparency about the underlying ESG approaches is to prevent misleading the investor and, therefore, also reduce the prevalence of "greenwashing," said a December report from Ernst & Young.[iii] Now, fund managers, financial advisors and others will be required to sign off on marketing claims, making them personally liable for false claims and potentially putting their licenses at risk.

Green contagion

"What does this have to do with commercial real estate?" you may ask. It's a valid question. On the surface, the new EU regulation does not specifically target the real estate sector with specific requirements for operational changes. But, as Woodward and Bernstein were told during the Watergate investigation, just follow the money.

Large institutions of various kinds – banks, insurance companies, pension funds, hedge funds, REITs, investment advisors, endowments, and mutual funds – control over 70 percent of the share value of US and European stock exchanges, led by giants like Vanguard, BlackRock and State Street. Institutional investors already have been leading the adoption of ESG standards in their investment decisions, with ESG and other "green" funds proliferating.

Around the world, regulations mandating disclosures and setting targets for various ESG performance metrics are on the rise. In New York City, one of the most valuable Commercial Real Estate markets in the world, Local Law 97[iv] mandates that buildings begin posting energy usage information in public spaces this year and, by 2024, will begin fining buildings that lag on energy efficiency based on their age and square-footage. Similar laws have passed or are pending in local jurisdictions across Europe, China and North America, including Seattle, Berlin, Boston, Stockholm and London.

Regulation, though, is not driving this trend. Most "green building codes" to date are confined to standards promulgated by independent bodies or industry groups that certify rather than require action with the force of law.[v] By and large, ESG's momentum has been driven by the force of large investment funds and individual activist investors who have harvested public sentiment on behalf of sustainability.

With research indicating that the Millennial generation is putting far more emphasis on these questions than their aging Boomer parents, assets under management from so-called sustainable investment funds have exploded. Between 2018 and 2020, total U.S.-domiciled sustainably invested assets under management, both institutional and retail, grew 42%, to $17.1 trillion, up from $12 trillion.[vi] Put another way, that $17.1 trillion represents 33% of the $51.4 trillion in total U.S. assets under professional management.

And that was before the EU's regulation took effect. Indeed, the US is a laggard. In the EU (including the United Kingdom for our purposes), over 45% of funds under professional investment were using sustainability metrics as a key component of investment decisions in 2020.[vii]

And so, back to the question: What does this have to do with the operation of corporate or commercial real estate? The answer is in the power of markets: Every single company in the Top 20 global owners of commercial real estate[viii] is publicly traded, and if you think that the financial and reputational risks associated with being rated poorly on sustainability don't matter these days, just take a look at what happened to the market cap of global oil companies in the past four years.[ix]

Lessons for 'the Built World'

Complying with the new data regulation will be burdensome for financial firms directly targeted and they will be powerfully incentivized to push that pain downstream. Within the portfolios of giant asset managers, mutual funds and others, well performing commercial real estate holdings will quickly go from assets to liabilities in the new environment. ESG goals will be set, sustainability claims scrutinized, and in some cases, divestment will follow.

So how should CRE professionals prepare? Gathering the data required to meeting the new due diligence that investment funds will demand will be no walk in the park. Traditionally, large firms have well-paid ESG, Sustainability or Compliance teams which spend the vast majority of their time collecting data on things like energy usage, gender and racial diversity, financial transparency, the physical safety and comfort of the workforce, or the environmental and labor practices that exist within their supply chain. For a global company with complex supply chains and a trans-continental footprint this can be exorbitantly expensive, and damned near impossible to do perfectly.

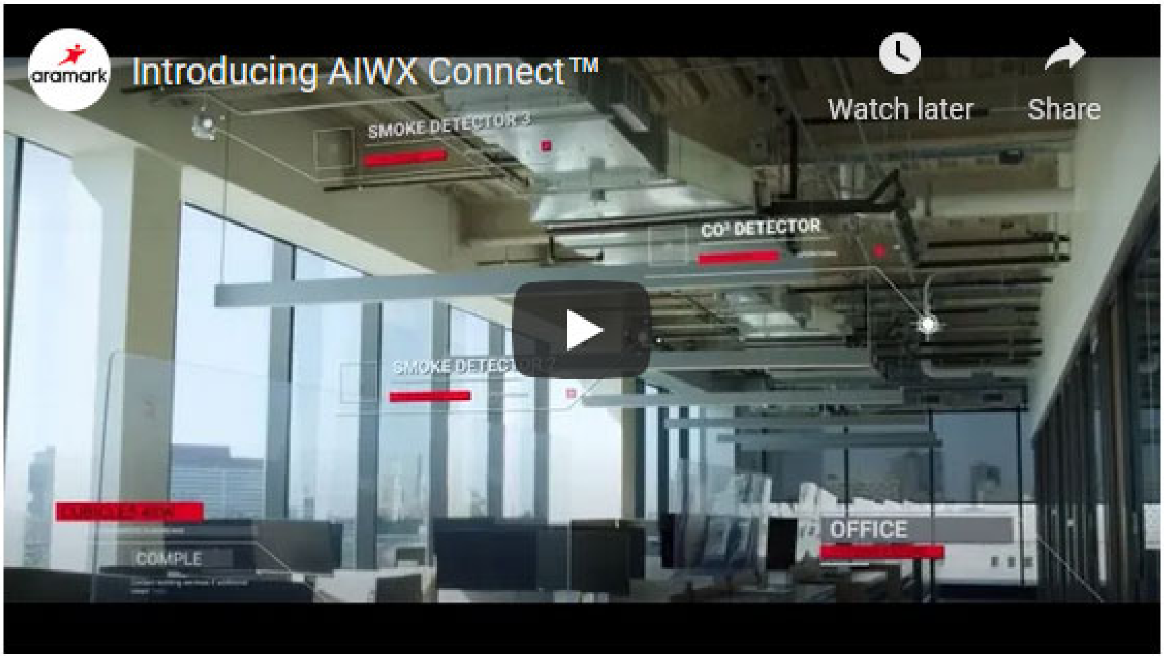
Here real estate has an advantage over manufacturing, mining, or trade-reliant industries. In what is known as “the Built World” in sustainability circles, Smart Building data enabled by Internet of Things (IoT) sensors can fill a good deal of the gap at a small marginal cost, and bring added ROI in the form of efficiencies and preventative intelligence.

Ubiquitous use of technology to monitor buildings has been a topic of digital transformation for a decade at least, and with the lessons of the COVID-19 pandemic in mind, the use of sensors to produce data in real time on a range of ESG relevant metrics is taking root. Most of this involves Internet of Things (IoT) sensors that are easy and relatively inexpensive to deploy, powered by long battery life, standardized low-power wireless networks.

COVID-19 has awakened facilities managers, human resources departments and corporate sustainability officers (not to mention corporate counsels concerned with liability) to the importance of having data on the health and safety of their workforce or other occupants of their real estate. ESG, which before the pandemic largely focused on energy efficiency and gender and racial diversity, has seen the stewardship aspects of the “Social” component grow exponentially.

“What started back in 2010 as simple ‘anchors’ like the focus on the UN Principals for Responsible Investment, followed with 2015 the Paris Climate Accord and currently the carbon pricing or offset markets concept, ” says Michael Scanlon, Senior Managing Director at Silver Leaf Partners in New York and head of its ESG practice. “Now, many of the largest industry analyst and portfolio managers see their clients’ view of ESG as broader, including social issues of diversity, fairness to different demographic groups from seniors and low income earners to health care workers and first responders. These issues have taken on new meaning and value.”

Those who manage indoor space of all kinds, like those responsible for the people inside them, need to provide that information on occupancy, energy usage, asset location, wellness, air quality or cleanliness to reassure the users of these spaces. Real-time information enables a real digital transformation of seemingly non-digital tasks such as janitorial services as demonstrated by the US Facilities Management giant Aramark with their AIWX offering (link to video here). This improves both the feeling of wellness of users as well as improving the bottom line of service providers by right-sizing the service and avoiding waste, in turn contributing to ESG objectives of reducing wasted resources.



This data has an important "double bottom line," too. Whilst the real-time occupancy data helps provide assurance to is an employee seeking a recently cleaned conference room, it's value quickly deteriorates. In effect, new workers care not about whether Meeting Room C was available an hour ago. Yet the accumulated historical data is a gold mine to people who manage the space, who schedule cleaning crews, ventilation, energy use and other services. Besides improved safety and employee engagement metrics, the efficiencies in terms of capital outlays and saved energy are huge.

People, Society, Earth to the fore

While Smart Building technology and the sustainability/ESG movement predate the pandemic, the importance of things that once seemed to be a "nice-to-have" has been tragically underscored as COVID-19 has cut a swath through every nation on Earth. Global CEOs are looking inward and stressing the wellness, safety and environmental efficiency of their own operations, knowing that "return-to-work" will not simply happen on command, but must be accompanied by new steps to assure those returning to their desks, lathes and laboratories.

For evidence of this shift, look no further than the new willingness of corporate leaders to lend their voice – and risk their companies brand – in the service of environmental, social and political issues. This is part of a larger early 21st century story, one that pre-dates the pandemic.

In Europe, for instance, large companies have grown less shy about embracing sustainability or other aspects of the ESG movement. A survey of 40 large European companies published in

November found 77 percent of CEOs wanted their senior managers to take a public stance on issues of concern to society.

“Ecological, economic and social issues are identified as the most suitable topics for public comment,” concludes a recent survey. Partisan politics remains something of a third rail, but on broader issues of societal wellbeing and environmental stewardship, it’s a brave new world.[x]

Driven by urgent public (read: customer) concerns about everything from climate change to gender diversity to racial and economic inequality, global firms are embracing activism in the public sphere as never before, pledging greater transparency, lower carbon footprints, and a commitment to “stakeholder capitalism” which seeks to integrate the needs of society into decisions previously driven solely by maximizing profits for investors.

Microshare’s ESG Data Monitoring Suite automates the collection of sustainability metrics for buildings and real estate portfolios.

Making sure it's not easy being green

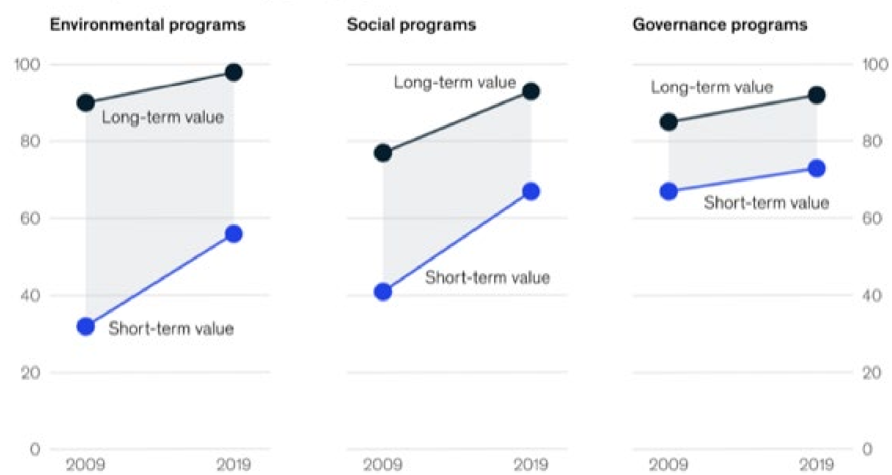
Skeptics rightly point out that talk is cheap, and indeed many of the same firms gushing over their newfound love for humanity can be credibly accused of hypocrisy. The Conference Board, a powerful coalition of multinationals, made a splash in 2019 by declaring that social good should be given at least as much weight as profit in corporate decision making. Yet the group's board includes the CEOs of Dow Chemical, Duke Energy, Bechtel and Raytheon, whose devotion to sustainability, labor rights and other staples of the ESG movement might be most kindly described as "aspirational."

Yet it is important to note that the bottom line still plays a powerful role in fueling the ESG trend. The size of ESG and sustainability funds has grown exponentially in recent years, and here money talks. The "double bottom line" cherished by sustainability activists – the idea that investments in green businesses "do well as they do good," is being proven out in the world of economics, too.

Finally, reports now abound on the performance advantages that companies prioritizing sustainability and scoring high on ESG metrics have over their values-neutral peers. To cite just one, the McKinsey Global Institute studied the performance of 615 large US corporates between 2005 and 2015 and found those with strong environmental, social, and governance norms recorded higher top-line growth, lower costs, fewer legal and regulatory interventions, higher productivity, and optimized investment and asset utilization.[xi]

Among respondents who say ESG programs create value, the share seeing short- and long-term value has grown.

Share of respondents who say given program creates value, %[1]



[1]Question was asked only of respondents who said environmental, social, and governance programs increase shareholder value. Respondents who said "substantially negative," "negative," or "no effect" are not shown; total n = 136 in 2009 and n = 342 in 2019.

McKinsey & Company

As of 2020, sustainability funds are offered by everyone from giants like Morgan Stanley and HSBC to tiny green advisories. As mentioned above, they are exploding in terms of the share of total assets they manage. PwC, the global consultancy, surveyed 300 of the largest investment firms in the world this year and found that more than 75% of them plan to shift all assets from conventional (values neutral) funds to ESG products by 2022.

This certainly reflects reputational concerns among these investment giants. Yet it also reflects demographic shifts, specifically, the rise of the Millennial investor, who on balance will benefit from the greatest transfer of wealth in history when they inherit the estates of their Boomer parents. As any financial advisor will tell you, Millennials care a great deal more than their elders not only how their money is doing, but also *what* it is doing.

"This is a generation that will change jobs if they don't feel that their work has purpose," says Jeffrey Gitterman, co-founder of New York based ESG pioneer Gitterman Wealth Management. "They will spend money differently based on brand and purpose identification." And if you're managing any aspect of a large commercial real estate portfolio, that money, filtered through asset managers, investment banks, REITS, ETFs and many other vehicles, is coming for you.

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