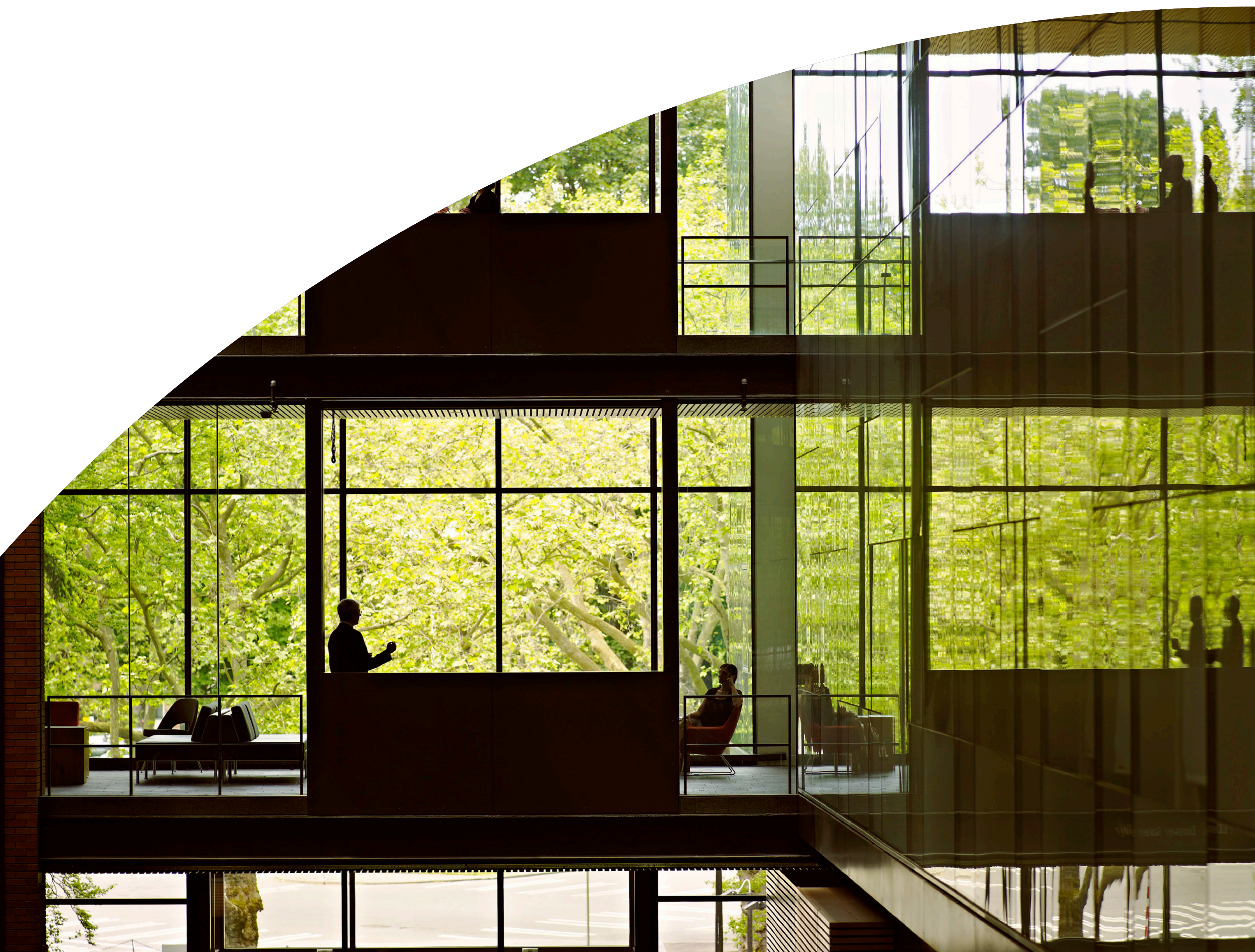
ESG is a business imperative

Current events and the impact on real estate



Last year was marked by social unrest, a pandemic and environmental disasters spanning continents, which unwittingly raised public awareness around the burgeoning field of environmental, social and corporate governance (ESG) practices. In fact, during the 2020 American Institute of Certified Public Accountants Conference on Current SEC and Public Company Accounting Oversight Board Developments last December, Julie Bell Lindsay, executive director of the Center for Audit Quality, said that we are now experiencing a "watershed moment" with the increased investment in public companies with strong ESG practices.

"ESG is no longer a nice-to-have, but it has become a business imperative. With the changing political tide, increased consumer pressure and focus around employee wellness, we see each environmental, social and governance issue be top of mind of our CEOs, CFOs and audit committee chairs. With growing internal and external momentum, the focus on ESG in North America has never been more promising," said Angela Jhanji, strategy director at Grant Thornton.

In short, ESG has evolved into a major driver in the global capital markets.

A recent Chartered Financial Analyst (CFA) Institute report indicated that in 2020, 85% of its more than 7,000 members considered ESG factors in making their investment decisions. CFA institute members include 3,525 retail investors with minimum assets of $100,000 and 921 institutional investors with funds of $50 million assets or more under management, showing that ESG is not a focus of niche investment groups and has a broad impact on capital markets.

ESG practices can range from swapping out incandescent bulbs for LED lighting in office buildings, to reducing emissions from manufacturing operations or improving workforce diversity and enhancing labor safety.

This article is the first of periodic content to cover the evolution of ESG practices, frameworks, standards and various guidelines that have emerged and developed through the years. Our goal is to provide a snapshot of the ESG market today, with a focus on the real estate sector. The topics discussed will keep you up to date with ongoing ESG developments and help gauge where your organization stands in comparison to its peers.

ESG through the years

In 2004, United Nations Secretary-General Kofi Annan called for financial institutions to develop guidelines and recommendations on how to better integrate ESG issues in asset management, securities brokerage services and associated research functions. Eighteen financial institutions from nine countries with over $6 trillion in combined assets under management participated in this project. Their recommendations in 2004 have turned into reality today, as shown in the following table.

2004 recommendation	Today
Financial analysts were asked to better incorporate ESG factors in their research where appropriate and to further develop the necessary investment know-how, models and tools in a creative and thoughtful way.	**Financial analysts** currently factor in ESG risks when evaluating investments, and there are third-party agencies that assign institutions an ESG rating, similar to how credit agencies assign credit ratings. A notable example of how ESG risk becomes damaging to investors and stakeholders is the recent cybersecurity breach of Equifax data in 2017, which damaged the company's reputation and significantly impacted its operations. Prior to the cyberbreach, the Equifax ESG rating, according to Morgan Stanley Capital International, dropped to CCC, the lowest possible rating, citing cybersecurity concerns and vulnerability to data theft a year **before** the hacking scandal occurred. This example showcases the relevance of the ESG ratings and the risks they reveal.
Companies are asked to take a leadership role by implementing ESG principles and policies and to provide information and reports on their related performance in a more consistent and standardized format.	About 90% of **companies** listed in the S&P 500 Index and 65% of companies in the Russell 1000® Index published sustainability reports in 2019, a substantial increase from 20% of S&P 500 **companies** in 2011 and 60% of Russell 1000® **companies** in 2018. These statistics published by the Governance & Accountability Institute indicate that stakeholders want to know what **companies** are doing with regard to sustainability and that more and more companies are taking actions on environmental management, whether by reviewing their environmental footprint or by gauging the impact of their operations. Another key takeaway from the sustainability reports is that **companies** believe ESG policies are a long-term strategy over the next several decades, rather than an immediate, short-term initiative.
Investors are urged to explicitly request and reward research that includes ESG components and to reward well-managed companies.	**Investors** now view climate risk as investment risk and believe that sustainability measures will drive investing decisions, according to Larry Fink, chairman and CEO of BlackRock. In his 2020 annual CEO letter, Fink asked each CEO to provide sustainability information in line with the standards issued by the Sustainability Accounting Standards Board. Fink also asked CEOs to evaluate and report climate-related risks, as well as the related governance issues that are essential to managing them, using guidelines released by the Task Force on Climate-Related Financial Disclosures. Then, in his 2020 letter to shareholders, Fink noted that sustainability is the new standard for investing, adding that there will be a focus on "reducing ESG risk" and "increasing action on sustainability" in the future.
Pension fund trustees and their **selection consultants** are encouraged to consider ESG issues in formulating investment mandates and in selecting investment managers, taking into account their fiduciary obligations to participants and beneficiaries.	**Pension funds** and **institutional investors** currently focus on ESG policies as an effective risk-mitigation strategy. The GRESB, a commonly used benchmark for real estate and infrastructure companies, was established in 2009 by a group of large pension funds to provide access to comparable and reliable data on the ESG performance of their investments.

ESG markets

Equity: According to Morningstar, there were 534 index funds focusing on sustainability and overseeing a combined $250 billion as of the end of the second quarter of 2020. In fact, assets in sustainable index funds have quadrupled between 2017 and 2020 in the United States and now comprise 20% of the total investment in index funds.

In a CNBC article published on Sept. 2, 2020, Alex Bryan, Morningstar director of passive strategies research for North America, said that there is "a great realization today that ESG issues are investment issues. They're issues that can affect the bottom line, and that may not always be something that comes to bear immediately." That article reported that inflows into both active and passive ESG-focused funds together hit $71.1 billion during the second quarter of 2020, resulting in global assets under management crossing the $1 trillion mark for the first time.

Investors are also noticing that ESG investments are performing well. According to the Nuveen 5th Annual Responsible Investing survey, 53% of investors cited performance as their main motivation for investing in responsible investments.

Nine of the biggest ESG mutual funds in the United States outperformed the S&P 500 Index last year, and seven of them beat their market benchmarks over the past five years, according to Bloomberg. Karina Funk, a former civil and environmental engineer and currently portfolio manager and chair of sustainable investing at Brown Advisory, said that the No. 1 question investors used to ask is whether investing in ESG would sacrifice returns, which is no longer the case.

Debt: Issuing debt for projects such as developing a wind farm, retrofitting energy efficiency, reducing emissions or improving workforce diversity are all examples of sustainable debt, a market that doubled in 2019. S&P Global Ratings expects global issuance of debt to surpass $400 billion in 2020, driven by further innovation and growth in "green bonds" (money raised for climate and environmental projects) and other sustainable debt instruments. Green bonds are expected to continue to be the primary source of that projected $400 billion, with investors introducing alternatives to finance socially and environmentally responsible initiatives.

One of the most relevant indicators of the future demand for ESG bonds is the overabundance of subscribers upon issuance. Bloomberg noted that the European Union (EU) offered its first social bond in October 2020, a €17 billion ($20.2 billion) sale that was oversubscribed 14 times over. In other words, the EU could have issued nearly €240 billion in social bonds rather than €17 billion, indicating there are ample opportunities in the ESG bond market due to the high demand by investors.

ESG and real estate

The real estate industry in the United States, just like the overall market, has made significant advances in ESG initiatives and related reporting. The National Association of Real Estate Investment Trusts ESG Dashboard tracks ESG key performance indicators for the U.S. Real Estate Investment Trust (REIT) industry, and these indicators demonstrate that REITs continue to place increasing importance on ESG initiatives.

	2019	2018
REITs reporting ESG publicly	84 [a]	66 [a]
REITs issuing stand-alone sustainability reports	49 [a]	43 [a]
REITs publicly disclosing sustainability goals		
Carbon targets	44% [c]	30% [c]
Sustainability goals	39% [c]	33% [c]
REITs with dedicated ESG staff	36 [b]	31 [b]
REITs with disclosures on social engagement		
Tenant engagement	42% [c]	30% [c]
Community development	72% [c]	62% [c]
REIT board diversity		
Total female board members	202	182
Percentage of board that is female	23% [c]	21% [c]

a Data based on 100 largest REITs by equity market capitalization

b Data by count

c Data based on percentage of equity market capitalization of top 100 REITs

U.S.-based REITs are also taking advantage of the market demand for ESG investments and have been issuing green bonds to fund their environmentally conscious initiatives. The first green bonds among U.S. REITs were the $250 million 10-year green bonds issued by Regency Centers in 2014, according to the September/October 2020 issue of REIT Magazine. In the summer of 2020, Kimco Realty Corp. was planning to issue 10-year green bonds worth $300 million, but ultimately increased the offering to $500 million due to the high demand. “Once they became comfortable with our broader commitment to ESG initiatives and how we planned to allocate the proceeds to green-related projects, it led to strong demand for the bonds,” David Bujnicki, Kimco’s senior vice president of investor relations and strategy, said in the magazine. “As a result, the order book grew very quickly, where it ultimately topped out at $1.8 billion.” Kimco was also able to tighten the pricing to a 2.7% coupon.

Markets were not immune to the disturbance caused by social unrest and the COVID-19 global pandemic in 2020, and green bond issuances “paused for a moment,” said Marilyn Ceci, global head of ESG debt capital markets at J.P. Morgan.

“Coming out of 2020, we see socially and environmentally conscious investments and related disclosures top of mind for clients. Whether that be the amount of options in the ESG space, or from private equity regulation pressures. ESG has often been a niche product, but we see the increasing demand and queries as a sign of its growing commercial presence, no doubt to be propelled by the new administration,” said Grant Thornton’s Angela Jhanji.

ESG and your organization

Real estate owners, investors, building operators, and developers are at the core of our society, deciding how communities will be created, what construction materials and designs will be used, and where and how people will gather. With leadership in Energy and Environmental Design-certified (LEED) buildings becoming the norm for new office buildings, municipalities are demanding sustainable construction and open spaces, while tenants are clamoring for such amenities as open space, nearby restaurants, walkability and a connection to public transportation, to name a few conveniences. As a result, developments and projects must include environmental and socially conscious elements in order to attract and retain customers as well as employees, who are weighing the benefits of added office amenities, development programs, and health and wellness programs.

While the lack of regulations and multiple frameworks to use when reporting ESG matters provides an organization with a lot of flexibility, it can also be a daunting journey for many businesses to embark on. ESG practices are an evolving field, with changes being proposed and introduced frequently. “There are a variety of ways to be engaging with how and what your organization wants to say about and do with regard to ESG. You need to chart your path to success when you get started,” Jhanji said.

Marjorie Whittaker, Grant Thornton’s SEC Regulatory Matters managing director, added: “We are keeping a keen eye on collaboration and consolidation among ESG-reporting standard setters. We know it can be daunting to understand and select from a wide variety of reporting standards and frameworks available, particularly given the potential for convergence in ESG reporting.”

Regardless of where your business is on your ESG journey, it’s smart to have a professional assist you in building your sustainability frameworks and improving your reporting capabilities to better meet the information and disclosure demands by the market and your stakeholders.

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