ESG WITHOUT CERTIFICATION

Is it possible? What Does That Look Like?

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THE RISE OF ESG

On February 2, 2016 BlackRock CEO Larry Fink penned an open letter declaring "environmental, social and governance (ESG) issues – ranging from climate change to diversity to board effectiveness – have real and quantifiable financial impacts". He insisted CEOs take this to heart in their operations and strategic planning.[1] The era of ESG as the authoritative measure of "sustainability" or "non-financial" performance had arrived. Its implications are profound and particularly relevant to the commercial real estate sector.

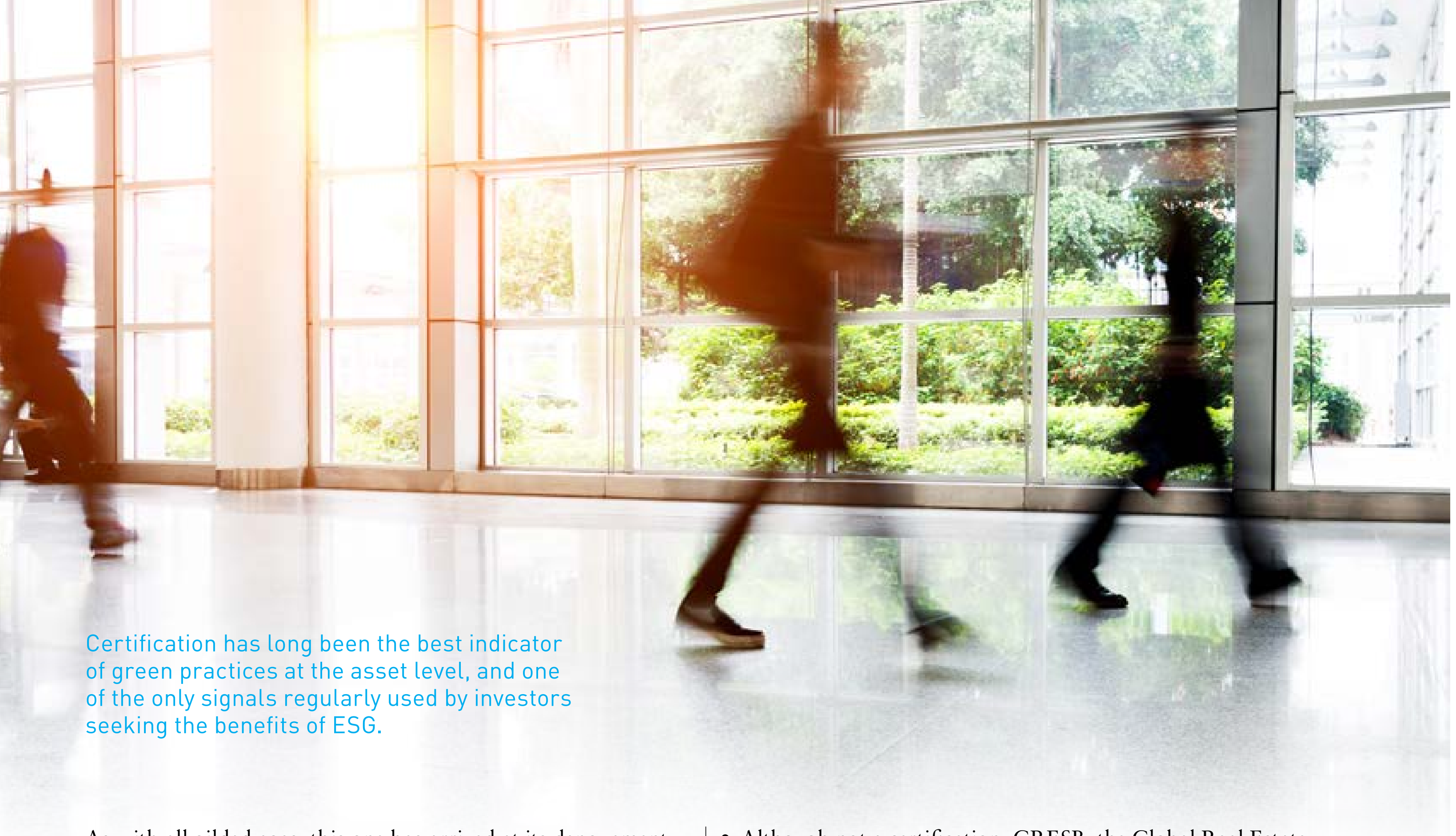
In excess of 80% of electricity, 30% of potable water, and 25% of raw materials are consumed by commercial buildings. People – companies' most valuable asset – spend 90% of their time indoors. The environmental and social impacts of buildings are enormous. This holds equally true for how the institutions that build and operate these assets are governed.

THE GOLDEN AGE OF CERTIFICATION (IS OVER)...

Green building certification has long been the best indicator of green practices in commercial real estate, and one of the only signals regularly used by investors seeking the benefits of ESG. Perhaps more than any other program, it was LEED that brought about the consensus that "green" pays. LEED brought consistency and credibility to sustainability in commercial real estate. It drove concepts like resource conservation and human experience into the mainstream. LEED, among other leading organizations like BRE, EPA ENERGY STAR, and NABERS, helped establish the ecosystem of sustainability-related products and services we recognize today. These accomplishments are extraordinary and should be lauded.

Today there are over 100 standards for certifying a vast array of green building attributes on a one-time or recurring basis – from energy performance to materials to health and wellbeing.[2] These certification programs range from well-known standards like LEED and BREEAM to upstarts like Fitwel and WELL. When we look back upon the 1990-2020 period, we might reasonably call it the Golden Age of Certification. But voluntary certification regimes that moderate this ecosystem have not kept pace with ESG's growing acceptance as a value driver of real estate investments. They are myriad, complex, expensive, balkanized, and inscrutable to most decision makers. These constraints show up in the limited adoption of certification: in the roughly 30 years since venerable programs like LEED and BREEAM have been available, fewer than 1% of commercial building stock has been certified. Most buildings, particularly those held outside institutional portfolios, will never pursue nor merit certification.

[1] http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2
[2] Exhibit A: Green Building standards recognized by GRESB, the Global Real Estate Sustainability Benchmark.



Certification has long been the best indicator of green practices at the asset level, and one of the only signals regularly used by investors seeking the benefits of ESG.

As with all gilded ages, this one has arrived at its denouement – the rise of ESG coincides with a broad stagnation in voluntary certification.[3] This stagnation is driven by a variety of interrelated factors:

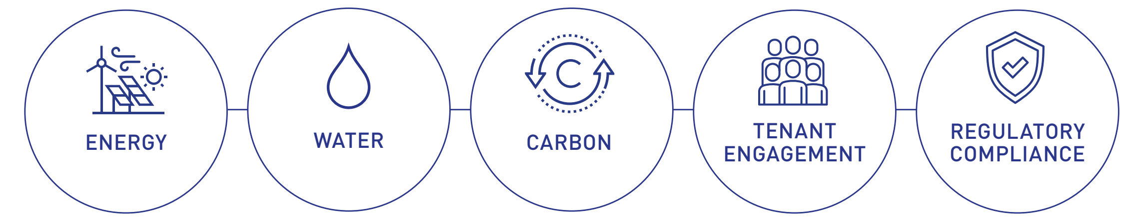
- The spread of regulation across US cities and states made LEED-level building construction the de facto standard, reducing the need to demonstrate green standards through a plaque. European and Australian markets have their analogs. Many jurisdictions are also adopting regulations requiring benchmarking and disclosure of energy usage. Together, these actions erode the rationale for separate certification.
- The proliferation of certification bodies aimed at smaller, lower value existing buildings has begun to run its course, with the arc turning towards consolidation. Most notably USGBC and BRE announced a partnership in November 2018[4], although it is not yet clear whether this will result in consolidation of their competing LEED and BREEAM standards.
- New types of certification have not gained momentum. WELL certification is exemplary here. Aimed at recognizing occupant health and wellbeing, which is a topic of significant interest in industry, WELL has failed to catch on despite unusually large investments by its founding organization Delos. Meanwhile, Fitwel, another health and wellbeing standard developed and tested by CDC and GSA,[5] is competing for what market there is.
- Although not a certification, GRESB, the Global Real Estate Sustainability Benchmark, performs a comparable function at the portfolio level. Its meteoric growth has slowed over the last two years, indicating saturation of the institutional market. Meanwhile, and similar to asset-level certifications, new regimes like the TCFD (Task Force on Climate-Related Financial Disclosures), PRI's Credit Ratings Initiative, and national-level programs like SASB (Sustainability Accounting Standards Board), among other well-resourced standards, pose constant threat and create confusion.

... BUT ESG IS INHERENT IN EVERY BUILDING

Contrasting green building certification, which singles out "the happy few," ESG is inherent in every building and not something that need to be applied for. After all, every building consumes energy, emits carbon, and shelters people to varying degrees. Neither does it require certification any more than traditional financial metrics. We do not, for example, certify an asset for being 90% leased to credit tenants at above market rents. Instead, markets simply internalize these characteristics and reward the asset with a superior purchase price. In other words, ESG is radical because it is so practical.

[3] https://www.reinventinggreenbuilding.com/the-book
[4] https://www.usgbc.org/articles/world%E2%80%99s-leading-green-building-organizations-team-accelerate-progress-advance-green-buildin
[5] See http://grist.org/briefly/trumps-budget-would-get-rid-of-energy-star/

CORE INDICATORS



The post-certification era allows owners to be judged on ESG at the asset level the same way they are leasing income – an objective metric as opposed to "green" or "not green" certification.

By enriching the criteria we use to judge buildings, ESG supports the traditional functions of the industry – from investment to lending, leasing to CapEx, appraisal to insurance – so counterparties can render their opinion in the form of cost of capital, rental rates, and sales prices. As a result, ESG holds the potential for capital markets to find and reward (or punish) any building on its merits, and any portfolio, transaction, or security based upon them. To help us understand this new era we can reflect on the one now coming to a close.

Certification is clearly at a crossroads and measuring specific and individual ESG metrics is ascendant. The question now is whether this is good or bad for the industry? We believe it is good for three reasons:

1. **ESG emphasizes ongoing performance.** We're maturing from idiosyncratic ESG measures taken at a single point in time (aka "certified") to a universal lexicon of data-driven performance measures. Performance is more indicative of asset value than stale, low fidelity snapshots.
2. **ESG is more scalable.** ESG measures are inherent in every building whereas certification is the province of the 1%. The market can therefore use ESG to place any and all assets on a spectrum of performance, which in turn makes it a viable part of any real estate transaction. More transactions across more assets makes markets more efficient.
3. **ESG is democratic.** Taking "green" out of the hands of a relatively small set of arbiters and putting it into the hands of the market will lower costs, reduce complexity, and improve comparability of asset performance.

INTO THE ESG ERA

We routinely talk with the world's largest real estate owners, managers and occupiers – the group that represents virtually all global demand for green certification products. One operator fairly summarized the sentiment of those conversations when they said "there's a disconnect between plaques and performance… Our investors, lenders, and occupier-clients are increasingly sophisticated and want facts, not an opinion".

However, real estate owners are also unsure what a post-certification landscape looks like or how they will operate in it. They need not be.

The post-certification era allows owners to be judged on ESG at the asset level the same way they are leasing income – an objective metric as opposed to the binary "green" or "not green" indicators. What matters, then, is to accurately measure, standardize, and report the data. This is much easier and cheaper than pursuing certification. As little as four core environmental indicators – energy, water, carbon, waste – can be used by most counterparties to improve their assessment of asset efficiency, profitability, likely future performance, and ultimately its value. There room to add "S" and "G" components like indoor air quality and ownership policies. Even this expanded scope results in far fewer than the hundreds of measures found in most typical certifications or surveys, many of which investors don't even deem material. The reliable measurement and reporting of these indicators by all buildings is the place to start. The time is now.

Migrating from landlines to cellular enabled billions to communicate reliably, on demand. Institutional investors have made a similar move from subjective certifications to timely, fact- and performance-based ESG analytics powered by real estate technology platforms. Owners should quickly and happily join them.