EVORA

Whitepaper

SCENARIOS FOR STRATEGY PLANNING

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Why are scenarios becoming more important for sustainability strategy?

Sustainability and ESG data used for performance monitoring, reporting and disclosure has traditionally been focused on past performance. This means that a lot of sustainability professionals have been distracted with the time-consuming task of getting access to that data and looking to the past. As sustainability becomes more embedded across a business there is a new need to integrate this into forward planning.

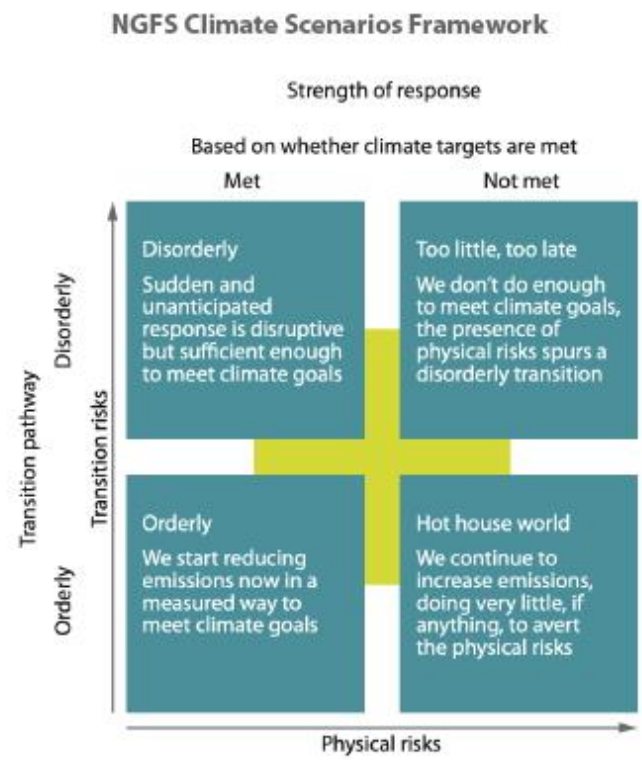
Over the past decade, we've seen significant progress made in climate change science and our understanding of how a changed climate will impact our world. We now know that climate change and the destruction of biodiversity has created an environment of non-stop Volatility, Uncertainty, Complexity and Ambiguity (known to military planners as a VUCA world). To cope with a VUCA world and as a result of new recommendations from the TCFD, the popularity of Net Zero Carbon and science-based targets, and the increasing amount of legislation with future commitments to ESG targets, there is a need for companies to be *forward-looking* when it comes to incorporating ESG risks into company strategy and business planning.

It is clear from market research on ESG disclosure, particularly related to climate change and TCFD, that companies are struggling to integrate these risks effectively into their core business strategy. The articulation of how a company will continue to create value in this changing environment is a skill requiring development. To frame these strategic conversations, the use of scenarios is a popular tool. Since the 1970s, the use of scenarios has become an important tool in strategic planning and adaptive leadership of major corporations. Inspired by a US military planner, Herman Kahn, Pierre Wack introduced this approach to Shell. His insightful realisation was described in the HBR:

"I have found that getting to that management "Aha!" is the real challenge…. It does not simply leap at you when you've presented all the alternatives, no matter how eloquent your expression or how beautifully drawn your charts. It happens when your message reaches the microcosm [mental models] of decision markers, obliges them to question their assumptions about how their business world works, and leads them to change and reorganize their inner models of reality."

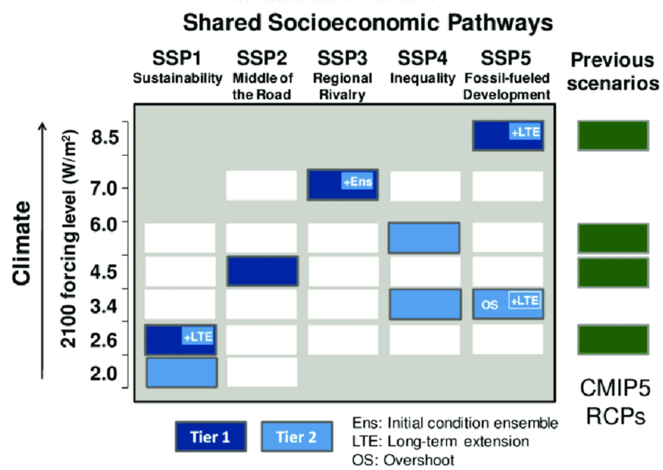
A number of scenarios have been published to challenge the status quo. Each of them bring a new perspective. The World Economic Forum (WEF) is a good source of a broad range of sector-specific scenarios.

The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) has published a set of eight climate scenarios (2019), which provides a common set for analysing climate risks to the economy and financial system. The illustration on the right shows that they have framed these scenarios against two axis: an orderly to disorderly transition risk pathway; and an increasing exposure to and magnitude of physical risks, depending on whether we meet climate targets or not.



Source: NGFS (2019a).

Other sets of scenarios have also been published, including corporate reports. The Scenario Model Intercomparison Project (ScenarioMIP) for CMIP6 is a significant academic project which has selected a set of Shared Socioeconomic Pathways (SSPs) to inform the UN's Climate Modelling and next Assessment Report 6, which will be published in 2021.

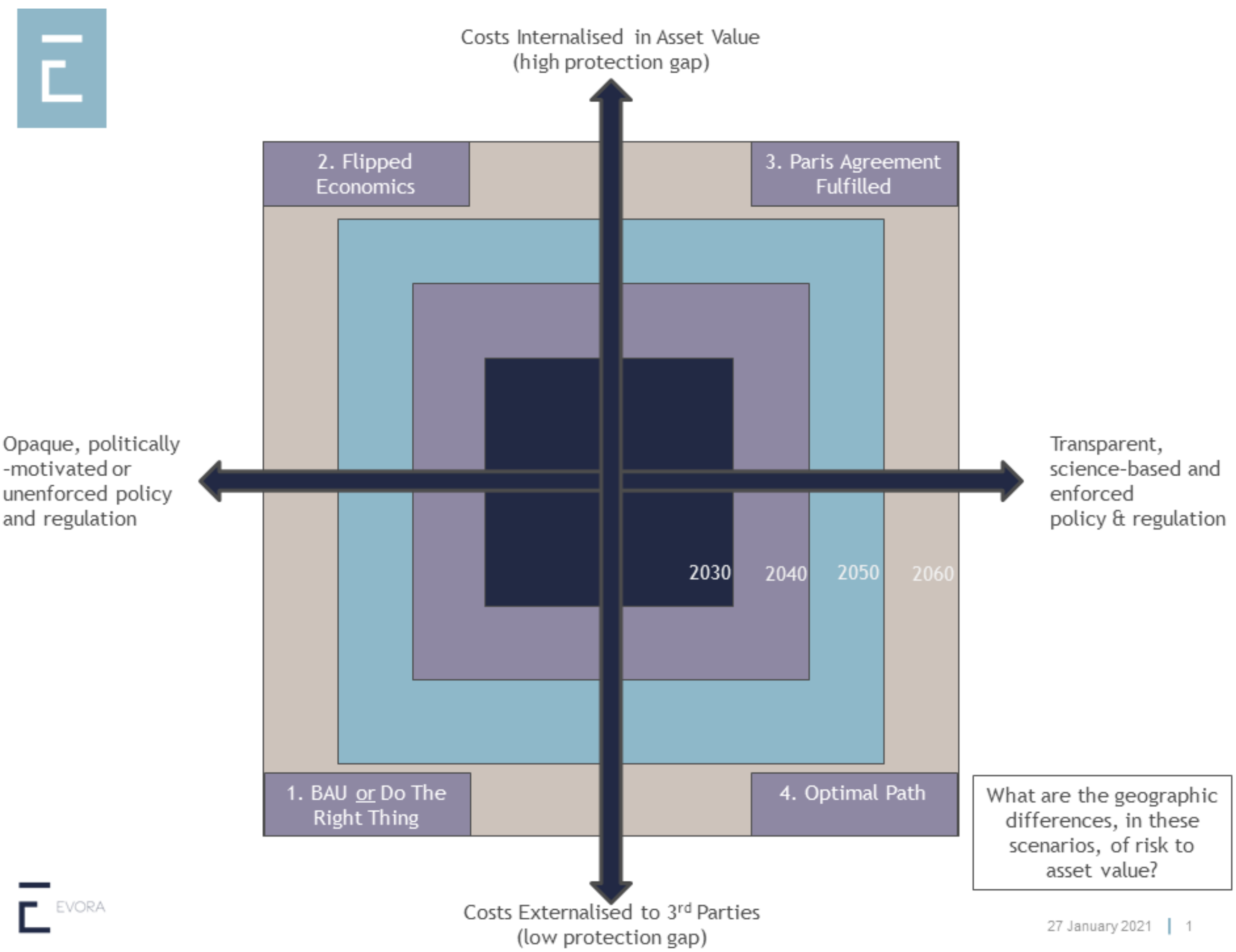


Each of the SSPs make different assumptions about the extent of global actions taken to tackle climate change, for example Sustainability vs. Fossil-fueled Development. These scenarios provide a useful reference for EVORA and our clients about how we are progressing to a more sustainable future, although the level of detail and the way in which these scenarios are framed may not be a perfect fit to frame strategic conversations about real assets, their value and the related financial decisions.

EVORA Global Scenarios

For real estate professionals to hold successful strategic conversations about sustainability we need a set of scenarios which frame the issues effectively and engage multiple perspectives. For this purpose, we have focused on asset value and where there could be market dislocations which provide opportunity for out-performance.

To do this effectively, we have selected two axis which will help us explore how different sustainability issues, in particular climate change, could impact on real asset value. The horizontal, x-axis explores how policies and regulations will play out over the coming decades, recognizing that these will be transposed differently in each country. On the left, the policies and regulations will be opaque, politically-motivated or unforced. Meaning that they are likely to be less effective and more disordered in delivering on the science-based commitments made in the Paris Agreement. On the right, there is more alignment with the Paris Agreement with the policy and regulations being transparent, science-based and enforced. This will place more obligations on companies and assets to take action on climate change mitigation and adaptation. Meaning that nations can collectively deliver the commitment to keep global warming to below 2°C.



The vertical, y-axis explores how ESG and climate change costs are internalized within an asset's value. At present, in the majority of cases, climate risks can be externalized to a 3rd party. For instance, most properties can secure affordable insurance against physical climate risks like flooding and storms. There are exceptions, where properties cannot be insured or the cost of insurance is very high and this cost can become internalized in the depreciation of that asset value. In the insurance industry, there is a term called the 'protection gap' and this is the financial gap between the total losses from an insurable event and the cover provided by the insurer. With climate change, real estate owners should expect that the protection gap will increase as we gain a better understanding of the likelihood and magnitude of these risks. For real estate investors to a get deal underwritten, we should expect climate risks to feature more significantly in investment decision-making over the coming decade.

Other risks could be indirect, for instance the increased likelihood of future pandemics which are expected as a result of environmental degradation pushing wildlife into cities and urban areas increasing the likelihood of virus transfer from animals to humans. Severe heat waves, making property unliveable or unworkable, is another indirect example of how value could be affected.
The two-axis together create quadrants which allows for four broad scenarios to be described:

1. In the bottom-left, if costs remain external to the asset value together with weak policy and regulations then we can expect *Business-as-Usual* (BAU). This would mean a continued increase in GHG emissions and the exhausting of our remaining carbon budget. The result being a significant increase in global warming above 3°C resulting in significant, non-linear physical and socio-economic damage including the loss of life and health risks. In this scenario, we will see some companies choose to Do The Right Thing and differentiate their business. Whilst this could deliver outperformance for selected assets, many real estate assets will be exposed to increased climate risks.
2. In the top-left, *Flipped Economics* is a scenario where costs are internalised whilst policy and regulations remain disordered. The investment decision-making is then driven by the change in economics which could be accelerated by new technologies. For instance, wind and solar energy is now the cheapest form of electricity production as the cost of deploying and operating these technologies has fallen rapidly. The same is expected in the coming years for Electric Vehicles as the cost of battery storage falls and solid-state batteries further increase range and efficiency. For real estate, this could mean that the use of smart building technologies are proliferated as this enables health risks and inefficient energy operation to be automatically managed to make offices a desirable destination to go back to work.
3. In the top-right, the ideal scenario where the *Paris Agreement* is fulfilled. The market failures of climate change and environmental degradation are corrected with the costs being internalised at the source of the damage. Policies and regulations are aligned with a science-based 1.5°C-2°C pathway and implemented in all major states. The available clean technologies are deployed efficiently and effectively, and new innovations make these choices a financial no-brainer. In this scenario, real estate investors and asset managers must have a clear plan and

budget for transition, or dispose of these assets to other investors who can fund that transformation. The big question is the pace of this change and how that is managed within investment cycles.

4. In the bottom-right, the *Optimal Path* is probably the most likely scenario. One where policy and regulation is aligned with the Paris Agreement and broader sustainability goals, although it could move at a different pace in each country. Here the internalisation of costs lag behind the requirements to deliver on these goals for public good. The result will be market dislocations, where decisions have to be made on the optimal path to maximise value for each asset and portfolio. An example could be falling energy costs in Europe which makes the business case harder for energy efficiency improvements. Yet, the French Decret Tertiaire and UK MEES regulations require energy efficiency improvements to be made in line with a NZC pathway.

The intention of these scenarios is not to place bets on the most likely outcome and to focus on planning for that outcome. It is to use all four scenarios to stress test the business strategy so that it can be adaptive, because we don't know for certain what's going to happen yet. That's all we know for certain since Paris 2015. If the strategic planning can allow the company to be adaptive in responding to a VUCA world then it is less likely to fail over the long term.

If you would like more information about having strategic ESG conversations in your company, including how EVORA Global can help with your sustainability strategy, please speak to Oliver Pye, EVORA Global Director: opye@evoraglobal.com

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