EVORA

Is Sustainability Dead?

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Introduction

You may be expecting a treatise on the retrenchment on sustainability commitments around the world, due to a combination of geopolitics, ESG backlash and greenhushing due to fear of reputational risk. Not so, however.

Instead, in this paper we will discuss how sustainability's role within the real asset investment market is changing rapidly and needs to continue to evolve if it is to be integrated successfully into the next round of investment models. We apologise that we have blown through our own 3-page limit but there is much to discuss, it seems.

Here, we highlight some of our observations on what is driving this change:

1. The next iteration of sustainability means going back to investment school, now that it has become more professionalised. In the capital-constrained cycle we are in, sustainability measures need to visibly add value, reduce costs, or mitigate known risks at a time when the cost of doing nothing is no longer zero.
2. As a result of this professionalisation, the industry requires a new set of accounts and internal reporting structures to be built.
3. Much of sustainability now feels like tax – it requires a complex range of technical knowledge and is often under-appreciated; if done well it can pass unnoticed, if done badly it can wipe out the IRR of a deal. The simplicity, however, remains that we are striving for a better planet and bottom line by protecting asset values.
4. Artificial Intelligence (AI) will fundamentally change data integration and analytics, but are we ready for it?
5. Tenants are changing along with societal shifts, although they often come last on the list and not first. We need to move from a "build it and they will come" model to a "build them what they want" model.
6. If sustainability professionals are obsolete, what is their role in the new world of integrated finance?

The next iteration of sustainability requires going back to investment and accounting class

In many markets driven by European and sustainability-focused investors, there is now a tangible value creation & retention element to sustainable buildings, as well as a value erosion factor for unsustainable assets. If only we could agree on what un/sustainable means.

It is no longer viable to keep sustainability data - with all its historical assumptions, subjective gap-filling and inaccuracies, in a separate spreadsheet. In addition, **are we even sure that those historical assumptions are still valid? We are seeing climate risks which were not underwritten in current models now translating into tangible financial risks.**

We also need to remember that any modelling assumptions that have been used historically will not be fit for the future, given the exponential effects of both transition and physical risk.

In the US, the move to open access data via ENERGY STAR and the 'big green button' is driving transparency. But what about the rest of the world?

In order to be able to track the known metrics and begin the trend analysis on the unknown unknowns, the industry needs to move towards a robust new accounting system which can deliver:

- Reliable fundamental data on which to build disclosure and analytic.
- Realistic projections and analysis to enable decision-making at scale across sectors, regions and hold periods.
- Decision-ready outputs (not the same outputs that sustainability has typically used in the past).
- Relevant and meaningful metrics which combine climate and investment.
- Consistent reporting standards.

A new set of accounts and internal reporting structures

As integrated reporting looms on the horizon for all (listed companies need to be ready sooner) all of this will require a new set of accounting standards and metrics which can be applied across both internal and external reporting structures. The finance industry has had centuries (some would argue millennia) to work out what their metrics are and how to standardise them. We do not have this luxury for the sustainability metrics, and need to move much, much faster.

Meanwhile, the data conundrum persists. We continue to discuss the right ways to measure in/efficient buildings but we still haven't even agreed on how to measure a square metre across real estate, so perhaps we should move on from worrying about finding the perfect tools and agree on an imperfect version so that we can all move on to the actions. All credit to the IIGCC for coordination an industry approach to this through its ARESI working group.

As we begin to integrate the two accounting systems, sustainability will be forced to grow up. This is a GOOD thing.

- All assumptions and exclusions will have to be clearly explained and verifiable.
- The notes to the sustainability accounting entries will become as long, and as important to read, as those of the financial statements.
- IFRS and ISSB will probably write the Chart of Accounts on which all of this is built (do hurry up please, we need clarity asap). In order to make this possible, compromises and practicality will have to be enshrined so that the global market can begin to align and move forward. It will be far from perfect, but it will at least be consistent. "Let not perfect be the enemy of good".

Much of Sustainability now feels like tax

Very complex, rather under-appreciated and often goes unnoticed if done well; if done badly it can wipe out the IRR of an investment deal, fund or even company, not to mention the reputational risk. But it still needs an experienced hand at the rudder to make sure the ship doesn't hit the rocks – this is where the strategic expertise comes into play, especially as markets and associated capital flows into various sectors continue to shift.

What role will AI play in this new world where integrated data is critical to make informed decisions?

How much Artificial Intelligence (AI) versus Human Intervention (HI) is needed for real assets? If investment decisions are being made on a pyramid of gap-filled, AI-generated assumptions, how safe are they?

IT IS NOT SIMPLE MATHS: the models might be, but the underlying assumptions and exclusions are very difficult to set and do need HI, in our opinion. It feels like there is still a long way to go before we can trust the outcome of AI. In most cases we feel the provenance of data and quality controls are not yet part of a robust-enough approach. However, increasing public disclosure requirements will enable AI engines to link new trends and analyse the relationships between sustainability risks and values. AI is already being applied to investment analysis in other markets, so while we are lagging behind as usual, it will surely come – and quickly.

Additional opportunities could arise from the application of AI to underperforming assets, particularly where they do not already have sophisticated energy management systems. While we caution the blanket reliance on AI assumptions for real assets, not least as humans have always underestimated the impact of risk, we still see meaningful opportunities for rapid assessments as part of due diligence and action planning.

There is also a potential security risk linked to the dissemination of strategic and highly confidential data sets outside of the original organisation; a risk that could grow exponentially if that data is then combined into an integrated dataset.

Nonetheless, given the speed at which technology adoption is growing, how do we move from the more natural approach of "wait and see" to a forward-looking strategy and subsequent actions that would protect portfolio long term value and provide operational viability?

Tenants are getting more demanding

Why don't they come first and not last? We need to move from a "build it and they will come" model to a "build them what they want" model.

For decades, most occupiers have been passive consumers in the properties they occupy, waiting for the properties to be built and not being involved in the property development process. And other than the newsworthy exceptions, we expect that this will continue along the lines of 'I'd like a net zero building but I don't really understand what that means OR want to contribute to it'. However, we have evidence that thinking about occupiers from the early stages not only leads to a better IRR but also to a more sustainable property. Further, AI data sets will allow tenants to select buildings and/or landlords whose goals align to theirs, providing an opportunity to build longer-term relationships and cost-benefit sharing than the current model, particularly for multi-asset occupiers.

While there is growing consensus that collaboration among investors, owners and occupiers is beneficial to all involved, and a few plans have been deployed to enact this collaboration, the industry is still struggling to scale up any meaningful, whole building decarbonization. In fact, the built environment itself remains the main challenge, not only because any retrofit needs to be planned carefully, which requires time, but also because there is no unanimous nor harmonized application of the method to account for carbon throughout the whole life cycle. Again, it's time to harmonize approaches throughout the whole industry and limit the room for interpretation to any of the steps of the value chain.

So, are sustainability professionals finally obsolete and if not, what is their role in the new world of integrated finance?

They are currently expected to be half accountant (Scope 1, 2,3, carbon reporting anyone?), half Lawyer (SFDR, CSRD, pick an acronym), part Engineer, half planet-saving Enthusiast and all-round Strategist. No, the maths does not add up.

Shouldn't these unwieldly and unrealistic expectations now be dismantled? Perhaps along these lines:

- Internal reporting into FP&A.
- External reporting into Investor Relations and Accounting.
- Asset level actions into investment and Asset Management.
- Leaving sustainability professionals as the subject matter specialists they are and still, hopefully, want to be. Setting long term strategy and risk management tools to uphold fiduciary duty, namely: **to protect the value of assets.**

A New Reality

Only when sustainability becomes systemic and standardised will it be truly Business as Usual and adopted as part of the wider 'licence to operate'. We should celebrate this moment, as it signifies the adoption of standardisation across the market, and the tacit acceptance that climate risk is now financial risk and must be integrated into the entire life cycle as a result. For example, French legislation has set clear decarbonisations targets combined with a 'name and shame' approach for non-compliance. A perfect example of regulation + psychology driving change.

There is no green premium! There, we said it, and most of our clients agree, at least in private. However, the brown discount or, rather, the discount applied to sub-par assets is real and tangible. EVORA's privileged access to most of the world's largest real asset investors allows us to see that sustainability metrics are now being applied to IC memos as standard, ushering in a new era of risk management and appropriately adjusted underwriting. As the market continues to learn how to price this discount more efficiently these metrics will continue to evolve and coalesce.

However, the current green premium is as intangible as the alchemist's formula and was historically based on correlations with certifications largely due to the opaque nature of the market and lack of defined sustainability metrics. In ESG-regulated markets, we fear this will lead to increased mis-pricing and poorer risk management.

Most of the research in support of a green premium is based on the assumption that Green Building Certifications are a means of measuring the sustainability features of a building. However, we would argue that many of the features in those certifications would be applied by investment managers regardless. A building's proximity to a transport hub does drive health, social and financial value but allocating this as a 'green' feature seems to be double counting. Especially in an investment market where professionals implicitly understand that buildings closer to transport hubs generate more rent per sqm. So, while these certifications are a helpful shortcut for market players, providing a means to accredit many invisible factors such as energy efficiency and tenant amenities, correlating this with a specific GREEN premium can be misleading - particularly when then used to drive capex planning for future projects. A better set of metrics, we believe, would be a premium on operationally efficient buildings, using a yield on cost calculation which IS possible on typical interventions deployed at asset level.

The New Reality

So, while we hesitate to recommend the role of the leasing agent to the market, perhaps this is where they really can help us define what a quality building means in addition to the certification. Or is it the Valuation industry that needs to step into the void and place a value on actual efficiency metrics?

Regulation is now enshrining a new set of metrics (think the energy reduction requirements in France, or planning requirements related to energy efficiency). In addition, market dynamics are also redefining what a GOOD building means, including key sustainability metrics as standard. So, while the track record on these new metrics is still too short, it seems clear that a new accounting chart of accounts is emerging.

IRR, ROI and Yield on Cost

We have no intention of delving into the detailed definitions here (our Clients are far better placed to do this). However, we would argue that the three are being used almost interchangeably when related to sustainability. Specifically, the issue of IRR (as opposed to Yield on Cost or ROI) on specific interventions is under increased scrutiny at a time when the individual cost-effectiveness of many interventions is not yet clear.

However, there are clear cases where calculation of the Yield on Cost is possible, most obviously where the intervention either generates accretive revenue (think solar panels and renewables) or reduces operating costs (such as MEP upgrades which lower energy consumption & costs). In some cases, there will also avoidance costs on top of the implied cost of doing nothing". In a number of our projects, where this is too opaque to quantify at present, we are discussing using an accelerated discount rate to take this into account.

When it comes to the demand to justify additional features, we suggest this is approached in the way that investment managers have approached their markets for centuries. Since each investment is already scored internally against [Obligatory requirements + additional uplifts] vs risk - adding sustainability features to this list keeps the analysis within the existing process.

IRR, ROI and Yield on Cost

Take the analogy of a new lobby; part of the value-add plan for a major office refurbishment perhaps. Often times, resources and ultimately money, is spent on working out exactly what would be the best new design for this lobby. Many samples are supplied and tried and tested and then once installed, it can even be dismantled and refitted so that it is "just right". The cost for this new lobby is built into the refurbishment capital plan but at no point **does anyone request a yield on cost or IRR specifically and separately for the lobby. Instead, it forms part of the long list of features and amenities provided at the building.**

Instead of isolating sustainability features separately, including items as smart-metering, high energy efficiency, occupier amenities and proximity to transport could be baked into the asset scorecard. In many markets, these are already considered as standard, business as usual (BAU) requirements and part of the complexity that makes up a 'good' building. Depending on the geography and sector, the BAU list will look different and be comprised of the Must Haves (Regulation + House Views) combined with Optional Extras (Add On elements, including certification targets). Put more simply, BAU in more sophisticated markets is the cost of doing business there.

A moment here to remember that a building is not an island (in most cases, at least) but an integral part of the community in which it sits or which it serves. A net positive energy asset in the forest is all good and well, unless the occupiers hate it and can't get to it.

As we (hopefully) enter a new investment cycle, relying on the historical 'green premium' runs the risk of driving a disjointed and mispriced view of sustainability features. One could argue that the correlation between 'good asset features' and 'green features' are almost 1 to 1, in which case any premium associated with green labels should rather be given to 'good buildings'. Put simply, good budlings are also sustainable and efficient buildings. The decisions made by the investment team have always been, and remain, a question of how many of the long list of features do they have to, and want to, put into their good buildings.

From our recent experience, we are also seeing reputational risk featuring highly in Materiality Assessments as the risks of not anticipating market expectations and technological shifts put more focus on the question of timing – in itself, perhaps the most critical factor of all. This fear is also driving increased levels of "green hushing".

IRR, ROI and Yield on Cost

Conversely, the brown discount is alive and well and much of it can now be defined (we're still working on pricing transition risk with some clever industry friends, so watch this space). At EVORA we have seen firsthand the cost of not underwriting efficiency measures adequately in the last investment cycle, leaving assets in sustainability-sensitive markets stranded - not in carbon but in financial terms - where the cost of bringing them up to scratch is now more than the remaining equity portion. These might be exceptions right now but understanding these risk drivers as we enter a new cycle of capital allocation will be critical to effectively manage physical and transition risk over the multiple investment milestones during each hold period. For typical core funds, 2030 is only one hold cycle away and 2050 is no longer in the invisible distance. As cities, in particular, start to implement rigid climate management tools and requirements to safeguard their populations, the real estate industry must also learn to view climate risk through a similar lens. We expect risk profiles to shift beyond even our projections between 2030 and 2050.

So are sustainability professionals now obsolete? Underneath their polished panel performances, many are deeply frustrated. Often seen as the nay-sayers, or the budget busters, and much of their career is now taken up with arbitrating between lawyers' opinions of SFDR and CSRD for real estate, rather than improving the built environment in order to protect the planet and everything that lives on it. We have learned to speak finance so that the investment community will take us seriously, to talk about yield on cost rather than whole life carbon and impact, but most would love to get back to having a tangible impact on the built environment.

Now that value is directly linked to sustainability outcomes, perhaps the time has come to rebrand these roles as Head of Value Preservation and let them get on with what they are passionate about and trained for. It's time for the rest to become rather ordinary and procedural, based on metrics we already have, used intelligently in the next round of underwriting, and built into existing investment decision-making processes.

EVORA is proud to be working with some of the most talented and sophisticated investors in the real asset market; the partnerships we have built with these companies strengthens our ability to drive the industry forward and support the market in transitioning to new methodologies. Together, we can drive sustainable performance as an integrated part of wider investment performance.

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