

# ESG - Financial Risks and Opportunities for Real Estate Portfolios

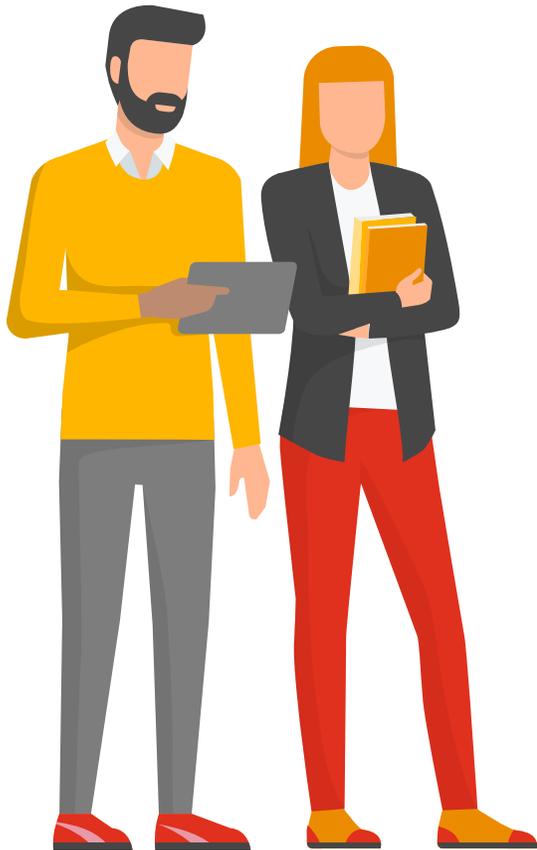
BFW Experten-Forum

15 June 2022

Strictly private and confidential



# Agenda



## Outline and Requirements of EU Taxonomy

- The EU taxonomy aims to redirect capital flows into sustainable investments to enable integrated sustainable development
- Financial as well as non-financial reports will have to include the reporting obligations defined by the taxonomy



## Impacts on Real Estate

- Besides conforming to the requirements of the taxonomy, being ESG compliant also has a positive effect on real estate performance



## PwC discussion paper

- A proposal to integrate ESG into real estate valuation using capital markets analysis and rating models



## Summary

- Our conclusions at a glance

# Today with you



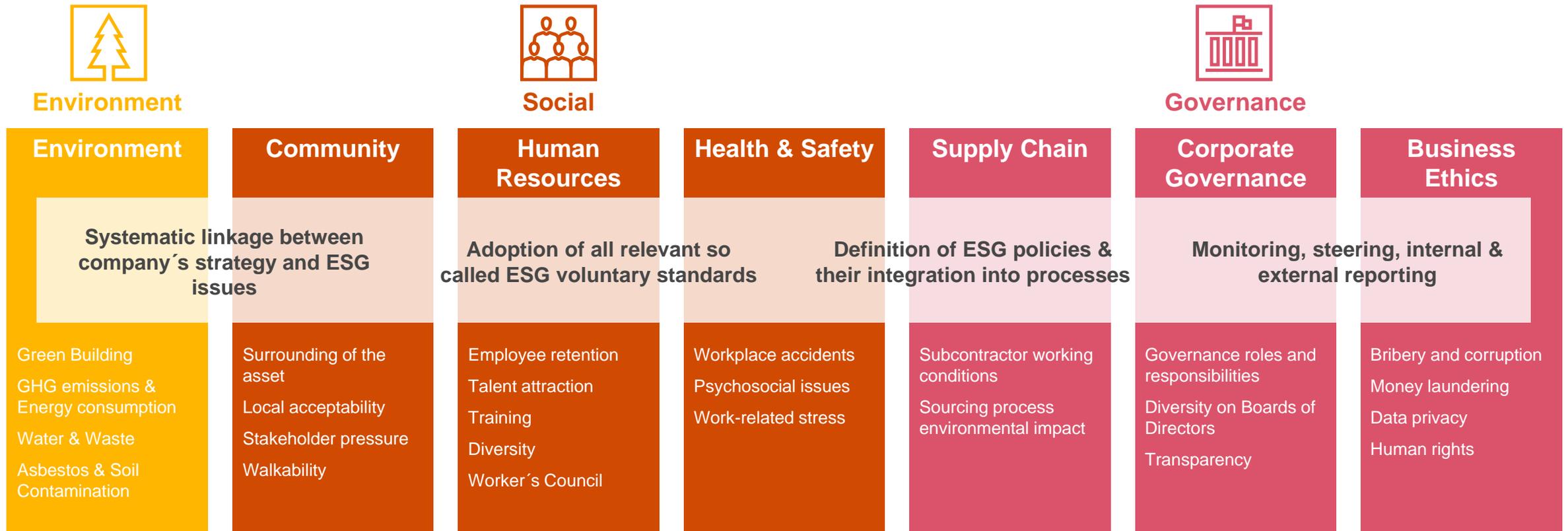
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### Curriculum Vitae

Johannes von Richthofen joined PwC in 2016, previously working for a well-known real estate service firm. He studied industrial engineering (technical specialization: civil engineering) at the Technische Universität of Darmstadt and holds an MBA in International Real Estate Management. Further, he is a professional member of the Royal Institution of Chartered Surveyors (MRICS).

# The three ESG dimensions environment, social and governance have to be incorporated into financial decision making



# Outline and Requirements of EU Taxonomy



## 1 Scope and Goals of EU Taxonomy

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Sustainable finance generally refers to the process of taking due account of environmental, social and governance (ESG) considerations when making investment decisions in the financial sector, leading to increased longer-term investments into sustainable economic activities and projects.

European Commission



# The EU Taxonomy aims to redirect capital flows into sustainable investments to enable integrated sustainable development

## Intention

- A common language for investors, issuers, policymakers, regulators;
- Translate the Paris Agreement and SDGs;
- Put environmental data in economic context;
- Save time and money for investors and issuers;
- Support different investment styles and strategies;
- Avoid reputational risks;
- Deepen the conversation;
- Reward companies.

## Scope of application

The proposed regulation has two mandatory users:

- 1. Financial market participants
- 2. EU Member States

Under the Non-Binding Guidelines for Non-Financial Reporting,

**Companies** are also encouraged to disclose in line with the Taxonomy.

The Taxonomy can be used on a voluntary basis by **credit institutions** and other **issuers**, such as local authorities.

## Goals and screening criteria



Climate Change Mitigation



Climate change adaptation



Sustainable use & protection of water and marine resources



Transition to circular economy



Pollution prevention and control



Protection and restoration of biodiversity and ecosystems

The Taxonomy sets performance thresholds for economic activities which:

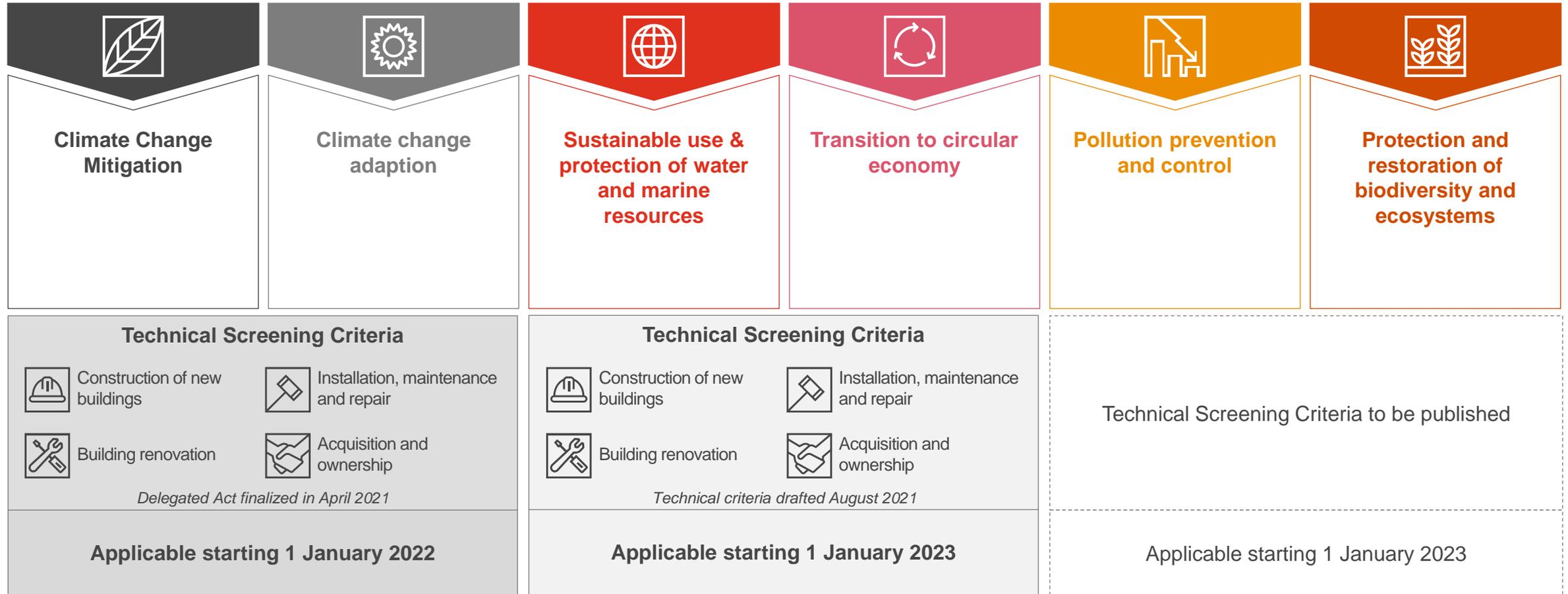
- make a **substantive contribution** to at least one of the six environmental objectives;
- **do no significant harm** (DNSH) to the other five, where relevant;
- **meet minimum safeguards** (e.g., OECD Guidelines and the UN Guiding Principles on Business and Human Rights).

# Impacts on Real Estate



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# The EU Taxonomy lists detailed screening criteria for real estate, which in part have to be incorporated into reporting starting 2022



# Exemplary indicative application of the technical screening criteria for construction and acquisition

### Construction of new buildings



<b>Location</b>	Frankfurt am Main
<b>Construction Year</b>	2023
<b>Rental Area</b>	10.000 m <sup>2</sup>
<b>Certificates</b>	LEED Platinum
<b>PED</b>	KfW 55
<b>Other</b>	n/a

The acquisition is EU Taxonomy not eligible, as the building has **no Energy Performance Certificate Class A.**

The construction project is Taxonomy eligible, as its **PED complies with the outlined requirements** (10% below national PED).

### Acquisition & Ownership



<b>Location</b>	Frankfurt am Main
<b>Construction Year</b>	2012
<b>Rental Area</b>	10.000 m <sup>2</sup>
<b>Certificates</b>	n/a
<b>PED</b>	KfW 150
<b>Other</b>	n/a

# How the impact of the EU Taxonomy could look like

Real Estate Fund A		Real Estate Fund B		Real Estate Fund C	
Type	Closed-end fund	Type	Closed-end fund	Type	Closed-end fund
Targeted environmental goals	Yes [...]	Targeted environmental goals	Yes [...]	Targeted environmental goals	No
Description of the sustainable investment share	Yes [...]	Description of the sustainable investment share	Yes [...]	Description of the sustainable investment share	No
EU Taxonomy compliant activities / investments		EU Taxonomy compliant activities / investments		EU Taxonomy compliant activities / investments	The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.
500+		100+		10+	

Potential investors



# Sustainability topics gain economic relevance along the entire value chain of real estate

## Long-term building value

Our empirical analysis with the Carbon Value Analyser shows: Future regulatory **ESG requirements** could have a **massive impact** on the long-term **building value**. Furthermore, sustainably certified buildings generate **more revenue**<sup>5</sup>.

## Tenant demand

ESG-compliant corporate policies to only rent **sustainable properties** could **increase demand** for these buildings **sharply**<sup>5</sup> and become a strategic imperative for commercial tenants.

## Fund volume

In the last 8 years, the **volume** of investments by institutional investors in the ESG sector has **increased by over 650%**. There is a high future **market potential** for companies offering such funds.



## Reputation

Based on the **overall societal context**, ESG criteria will become the **market standard** in the future and should also be considered for **reputational reasons** as part of **commercial due diligence**.

## Financing

The measures of the **EU Action Plan**<sup>1</sup> and the reduced **risk** for ESG products offer improved **financing conditions** on the financial market. In the future, these conditions will be even more strongly influenced by **taxonomy eligibility**<sup>2</sup>.

## Sales and development

The EU's **Renovation Wave**<sup>3</sup> initiative and the **NZEB**<sup>4</sup> standard place new **demands** on project developers and owners. In the future, the fulfilment of **ESG** criteria could increasingly become a key **argument** in purchasing **decisions**<sup>5</sup>.

## Derivation of stakeholder requirements and potential financial implications?

How do I prioritise activities based on their materiality?

How do I consider the interests in the best possible way?

How do I communicate in a targeted manner per stakeholder?

Sources:

\*NZEB (nearly-zero-energy-building);

1) [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance\\_de](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_de);

2) [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en);

3) [https://ec.europa.eu/energy/topics/energy-efficiency/energy-efficient-buildings/nearly-zero-energy-buildings\\_de](https://ec.europa.eu/energy/topics/energy-efficiency/energy-efficient-buildings/nearly-zero-energy-buildings_de);

4) [https://ec.europa.eu/energy/topics/energy-efficiency/energy-efficient-buildings/renovation-wave\\_en](https://ec.europa.eu/energy/topics/energy-efficiency/energy-efficient-buildings/renovation-wave_en);

5) M&G Study: Green buildings-what are the financial benefits for investors?

# PwC discussion paper



# PwC internal analysis of capital market data



## Hypothesis

Companies that align their business and actions more closely with ESG perform better economically



## Approach

- Internal analysis of more than 2,000 companies (all industries)
- The analysis examined globally: is there a measurable relationship or correlation between a company's market capitalization, growth expectation and risk assessment by financial markets and its ESG rating

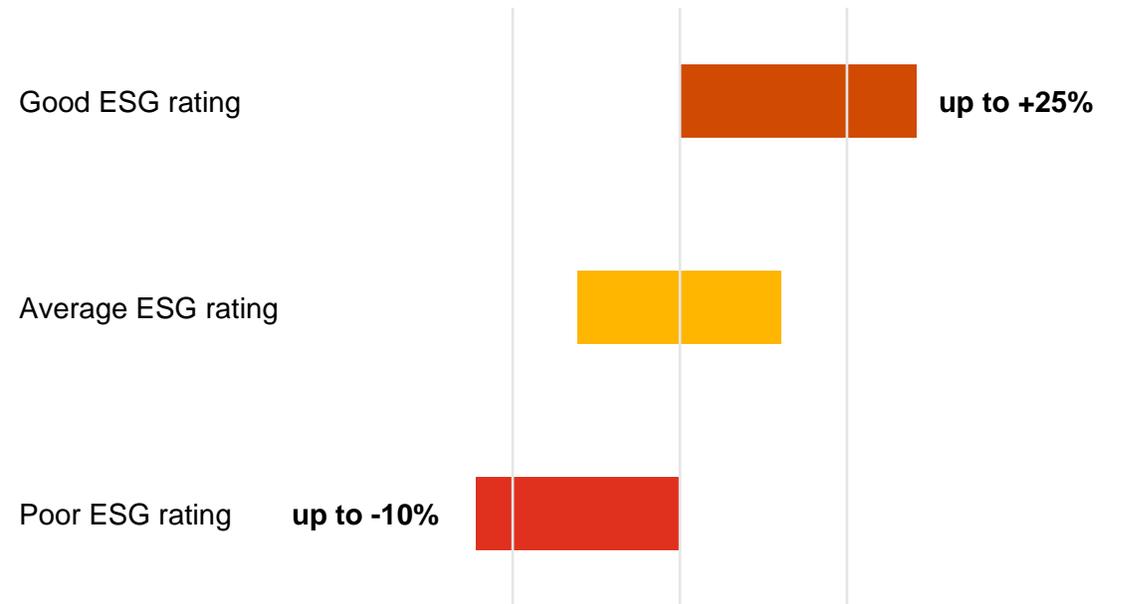


## Results

- Companies with a better ESG rating are generally valued higher, more growth-oriented and less risky by the capital market than companies with a comparatively poorer ESG rating which means valuation discounts were found (compared to an average ESG rating).

## Results

### Value range of market capitalization



# Conclusion and outlook



Valuation means comparison. Especially against the background of the currently still insufficient data availability, the quantitative transformation performance and thus transparent consideration of ESG criteria regularly represents the essential challenge in the context of real estate valuation.



# Summary



# Summary



## Overview of Current Developments

- ESG is here to stay: The development, both social and regulatory, is irreversible and is gathering pace.



## Outline and Requirements of EU Taxonomy

- The regulation creates a Europe-wide, uniform framework for the assessment of sustainable economic activities.
- Goal is to redirect capital flows into sustainable investments to enable integrated sustainable development



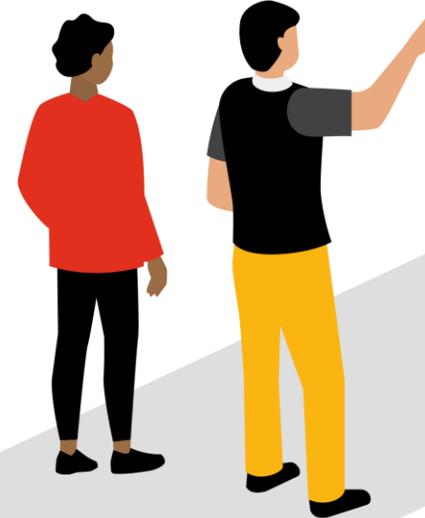
## Impacts on Real Estate Valuation

- For the real estate industry the regulator shows a clear way, which expresses itself in low-energy and sustainable buildings
- Being ESG compliant also has a positive effect on real estate performance
- The market requires adjustments for existing properties to be EU Taxonomy compliant as well as high standards for developments



## PwC discussion paper

- Using the results of an internal global-orientated capital market analysis, we developed an approach to consider ESG within the income approach using the results of a company-owned ESG tool
- Properties with a good ESG rating can carry a lower capitalization rate while properties with a poor ESG rating can carry a higher capitalization rate



# Thought leadership

**Book** (available in English since 14 June 2022)

## “ESG and Real Estate”

Thomas Veith

Christiane Conrads

Florian Hackelberg

<https://shop.haufe.de/prod/esg-in-der-immobilienwirtschaft>

**PwC Discussion Paper**

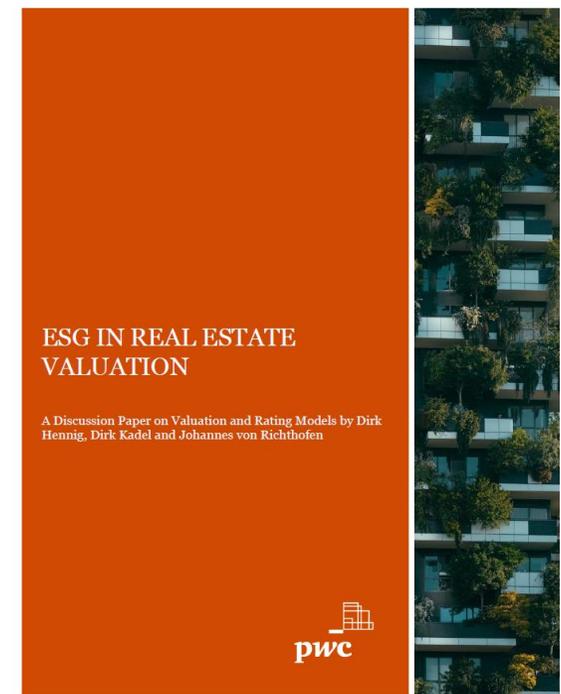
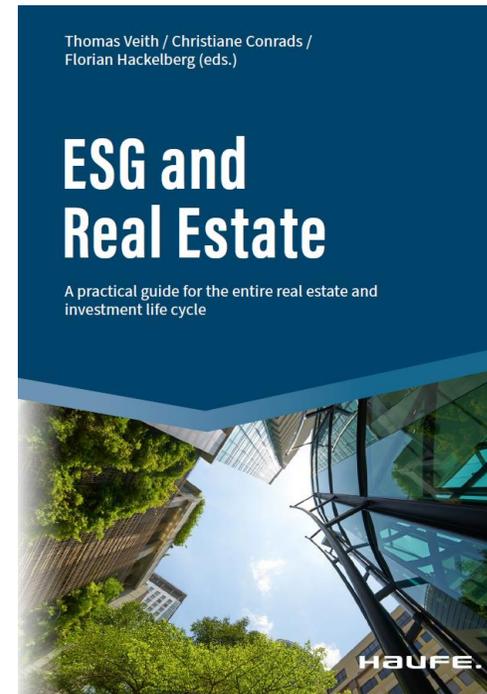
## “ESG in Real Estate Valuation”

Dirk Hennig

Dirk Kadel

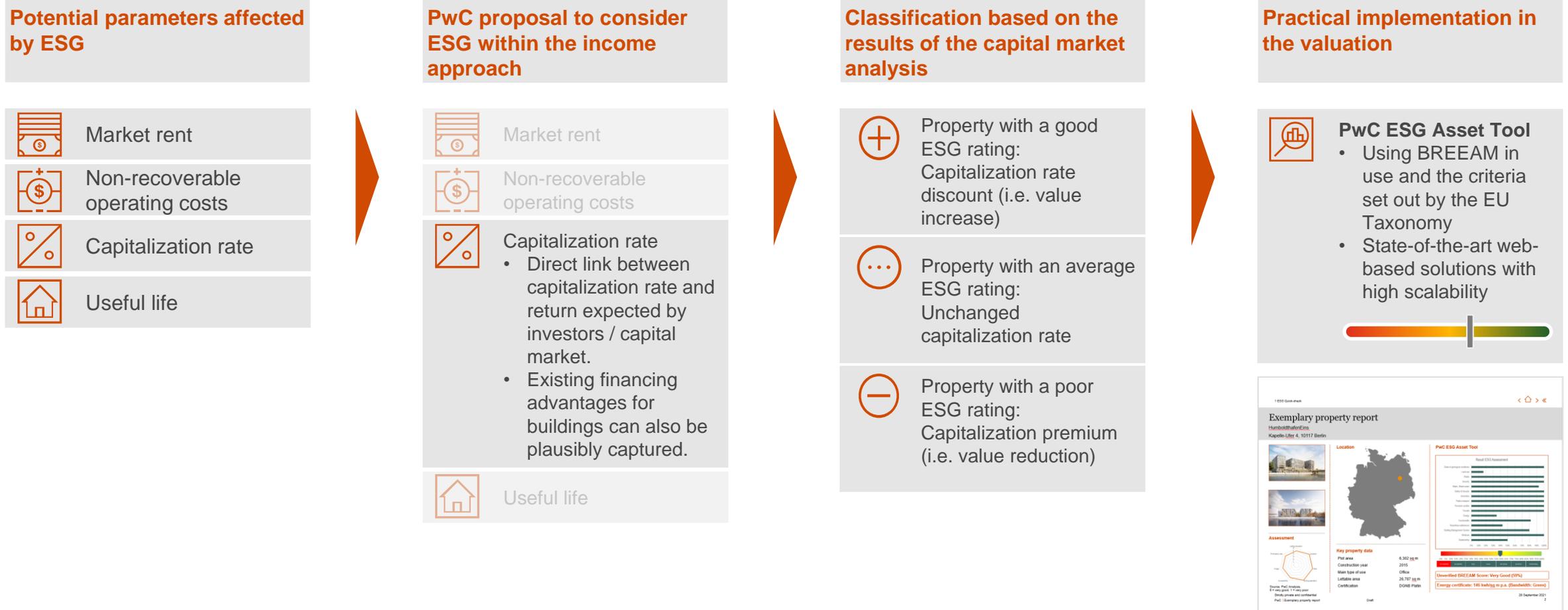
Johannes von Richthofen

<https://www.pwc.de/en/real-estate/esg-in-real-estate-valuation.pdf>



# Appendices

# PwC proposal for incorporating ESG into real estate valuation



# Thank you.

