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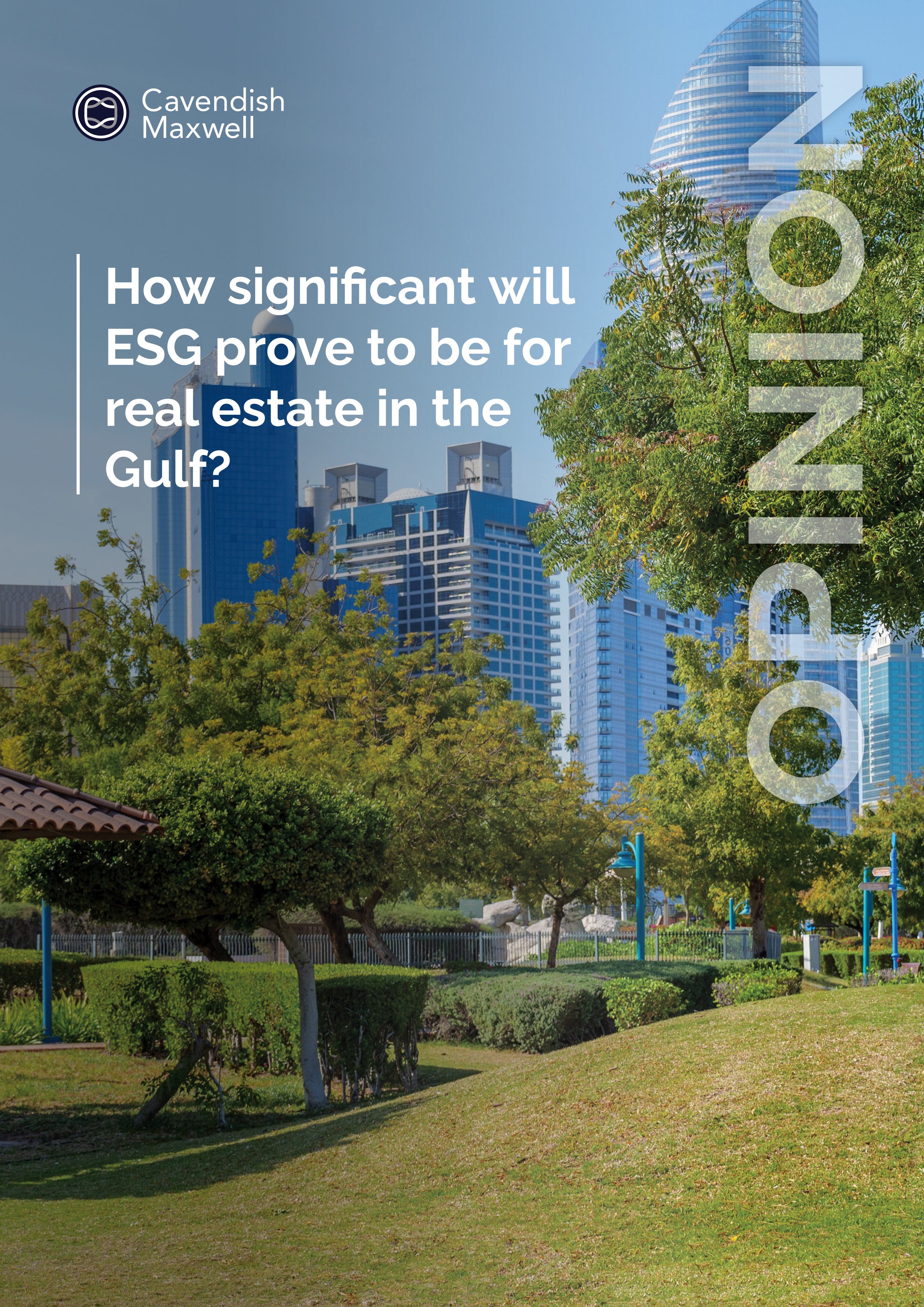
OPINION

How significant will ESG prove to be for real estate in the Gulf?



The rise of ESG

From its beginnings with the UN Report 'Who Cares Wins' back in 2005,[1] ESG has emerged as one of the most important trends in international investment.[2] With more than a quarter of the world's investments now deployed through funds and corporation that embrace it – Bloomberg thinks it will reach a third by 2025[3] - investment managers warned that failure to take ESG into account could be a breach of fidiciary duty,[4] mandatory reporting now being demanded by jurisdictions such as the European Union, notably with the Sustainable Finance Disclosure Regulation (SFDR), and participation by leading Stock Exchanges in the Sustainable Stock Exchanges initiative, including in the region Abu Dhabi, Dubai and Saudi Arabia,[5] ESG seems very likely to be here to stay. The crucial change from the previous world of Corporate Social Responsibility that is upon us is this: commercial organisations must now deliver their performance not only in purely financial terms, but in the three extra dimensions imposed by ESG.

Lest it be thought that this fundamental change from add-on to multidimensionality necessarily entails reduced financial performance, however, it is important to recognise that a slew of empirical studies covering now almost a decade of evidence demonstrate quite the opposite result: superior ESG practice by comparison to peers is highly correlated with both lower borrowing costs and relatively better shareholder value,[6] whilst sectorally, analysis of banks has suggested those adopting highly visible and internationally accepted ESG practices score more highly with shareholders as well, including during the Covid-19 crisis.[7] Some caveats remain: correlation is certainly not spread evenly across all three variables[8] and nor is better ESG performance is not always positvely correlated with pure accounting variables such as Return-on-Assets, Return-on-Invested-Capital or Return-on-Equity.[9] But overall, as a result of both awareness of the wider benefits of ESG as well as its connection with superior financial performance, investors, including in the Gulf, are generally now relaxed about the adoption of ESG by investees, even enthusiastic, whilst sovereign wealth funds in the region, themselves large local real estate investors, are moving publicly to integrate ESG throughout their operations.

ESG Reporting – towards a unified framework

The additional reporting responsibilities though are considerable, especially given now almost universal appreciation of how widespread greenwashing has been, so the rise of ESG has been accompanied by a plethora of reporting methodologies and ratings. Currently, these are available from leading international providers of financial and non-financial data, such as Bloomberg, MSCI and Thomson Reuters, from the conventional rating agencies such as S&P, Moodys and Fitch, from the Stock Exchanges and the International Capital Markets Association (ICMA), and also from companies that adhere to specialised ESG reporting frameworks such as Sustainanalytics, now owned by Morningstar, and the Value Reporting Foundation formed by the merger of the IIRC and SASB.[10] So far as real estate is concerned, annual reporting is still the norm and the global market leader remains GRESB, under which $4.8 trillion in real estate was reported in 2020, but it faces competition from GRI, CDP and the DJSI.

In future, however, there is now widespread expectation that reporting will become standardised once IFRS enters the field in strength,[11] as it is now preparing to do with the creation of the proposed International Sustainability Standards Board (ISSB). At that point reporting may also become more frequent. The ISSB[12] holds the key to the next stage of ESG: true globalisation.

ESG and Sharia

Much is held in common between ESG and Sharia real estate investors. Both share a commitment to excluding those engaged in harmful activities from becoming tenants. There are disagreements at the boundaries as to what activities should be regarded in this way, but there is also substantial agreement: both tobacco and gambling companies, for example, would find it difficult to rent premises under either approach. And both involve reporting requirements through independent third parties. Little surprise therefore that the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) already has a set of advisory standards for corporate and social responsibility.[13]

One significant additional contribution to ESG that sharia can make is its interconnected approach to analysing an investment. Whereas ESG has largely concentrated on individual outcomes, sharia boards have always insisted on the requirement for funding as well. Again, there are clear differences, most obviously in the issue of riba and therefore the range of permissible lenders, but also the extent to which gharar extends to the use of certain derivative financial instruments, but there is also common ground, including the need to analyse the organisations that have lent to or invested in a fund, what their lending policies in general have been, and how they have treated their borrowers and investors.

The integration of Sharia into ESG and vice versa may be still in its infancy, but exciting recent research has already indicated that the gain in risk reduction is stronger at high levels of ESG for Sharia-compliant firms, and that therefore a stronger commitment to ESG of Sharia-compliant firms should attract more capital flows.[14] As the research predicts, there is now not only awareness throughout the global fund management industry worldwide of just how close the two sets of principles really are, and the development of integrating principles, but actual funds that aim at combining the two, for example, Maybank's Global Sustainable Equity-i Fund and Schroders' Islamic Global Equity Fund, both launched in 2020. We can expect more convergence between ESG and Sharia in the future.

ESG for developers

Theoretically, developers are profit-maximisers, their sales process complicated only by questions of creditworthiness and timing. In practice, this has never quite been the case, with cultural and ethical factors intersecting with brand development to shape developers' perceptions of the communities they seek to create. Regulation, meanwhile, has proceeded apace, with European countries in the lead of ESG regulation insisting as part of the EU drive to zero carbon by 2050 on the carbon neutrality of all new commercial buildings from this year and requiring the progressive retrofitting of older buildings in the coming decades.[15] Integration of ESG into development is therefore probably easier that it might at first appear.

But it has to pay. Does it? The environmental aspects of development have been sufficiently widely recognised as to have been the subject of empirical analysis worldwide. In the UAE, the results of initiatives such as the Emirates Green Building Council are perceived to create as yet only a modest valuation effect, with the additional costs of green construction methods consistently identified as the main drag on their adoption.[16 17] The conclusion is clear: jJust as it was government initiatives that originally drove green construction, so it will be investor requirements, ESG reporting standards and further government support that change developer behaviour in the medium term, with improved construction technology only eventually becoming the enabler of more substantial developer alignment with ESG. There therefore now emerges the important task of transforming well-established green building standards, such as those developed by Estidama and Masdar[18] in the UAE,[19] the Green Building Regulation Council in Dubai[20] or the IFC's EDGE (Excellence in Design for Greater Efficiencies),[21] from alignment with LEED and GRESB into integration with the ISSB standards of the future.

This will mean that environmental indicators no longer have the field to themselves. ESG also demands that developers take into consideration wider issues, such as the welfare of the workforce and the success of each development from a community standpoint, including its ability to contribute to wider socio-economic goals such as the improvement of the housing stock for everyone. This increasing demand from investors has a parallel in the requirements that governments worldwide, including in the region, have increasingly placed on developers to set aside a proportion of their residential developments for affordable housing,[22] including where necessary the provision of grants to developers to maintain financial viability.[23] Again therefore, developers will act so long as they are not financially disadvantaged.

Finally, the governance piece entails developers following best practices amongst global firms: independent non-executive directors, board committees, and transparency in financial reporting. The evidence here is much more conclusive overall, as research on real estate developers has been sparse and mainly concentrated on the planning process. As yet, evidence from UAE family businesses is not wholly conclusive, although public family-owned businesses are more successful in generating revenue than private family-owned companies,[24] but developers may be well advised to consider that if governance improves the financial performance of banks,[25] it will probably do so for them as well.

The future developers of the Gulf and their advisers must learn to be fluent in the languages of each dimension of ESG, but developers should certainly not see ESG as simply an extra layer of reporting. The good news for developers is that action along these three dimensions as good for shareholders as it has proved in other industries.

Evidence shows that the most successful developers internationally in terms of Total Shareholder Return are those that have followed active ESG policies across all three dimensions. Developers in the region have already begun to recognise the value creating possibilities of ESG reporting, for example in Saudi Arabia the adoption of GRESB by the Red Sea Development Company (TRSDC).[26]

What is likely to change this decade is that what has been trailblazed by TRSDC and others will be adopted by a much wider range of development companies. Part of the motivation behind this will be that developers with ESG-positive projects will be able to 'reap the greenium' by financing themselves less expensively from banks and investors that are themselves adopting ESG policies. Sustainability loans to real estate developers began last decade: they have now been extended to large organisations such as Capital Land in Singapore and Frasers Property in Australia.[27] In countries such as Rumania, where developer Iulius obtained a syndicated green loan from the IFC for Palas Campus, the evidence for the funding of energy efficient buildings is clear to see: the IFC believes that similar opportunities amount to $24.7 trillion across emerging market cities by 2030.[28] But how much less expensively? The answer depends on two factors. First, whether the ESG requirements imposed by these structured finance deals, such as energy use, are actually met. Evidence from corporate borrowing already suggests that they are, but analysts have as yet insufficient data from developers to be sure that the real estate sector will achieve similar results. Second, the size of the financial incentive, which is an important policy question for governments in the Gulf as elsewhere. This is a goal for which developers will undoubtedly strive, but how quickly will depend on the visibility of both of these factors.

In future, project stakeholders will be concerned with the whole gamut of ESG: the environmental credentials of the project by comparison to its competitors and to previous projects, the future tenant or owner mix and economic benefits of the project, and how the proposed development will be organised, supported by the developer and adminstered for the benefit of its tenants. Developers and their advisers should therefore prepare for much broader presentations to project funders and other stakeholders in years to come.

ESG for real estate investors

As with markets overall, real estate investors face twin pressures to adopt ESG: regulation, noted above, and performance. The two are interrelated. At the individual building level, studies have suggested that green building Willingness-to-Pay premia range from approximately 3%–8%,[29] although wide variations may exist between jurisdictions and sectors. The combination of higher occupancy rates, lower energy costs and regulatory pressure, however, is likely to push this figure steadily higher. A good idea of what a future ISSB standard may comprise in terms of energy use and environmental compliance can be gleaned by studying today's SASB real estate standard.[30] Investors in the Gulf will therefore likely become as familiar as their counterparts elsewhere in adopting and utilising portfolio software that tracks building data quality, accuracy, target management, regulatory compliance, and physical climate risk, whilst managing data completeness and analysing tenant contributions to ESG performance.[31]

So far as firms are concerned, recent analysis of European real estate databases[32] already indicates that real estate investment firms that are more aware and active in sustainability generate higher returns. Although these results are strongest in respect of social impact performance, they are also statistically significant for other measures: energy usage, greenhouse gasses, energy performance certification and corporate governance. Only in water usage did the analysts find no benefit, and it seems highly likely that in the far more water-aware jurisdictions of the Gulf even this wrinkle will be removed.

As for the social component of real estate ownership, the evolution of standards has been tentative. The SASB standard is silent on the question, whilst GRESB suggests only that the social component of real estate ESG includes 'organisational policies and practices regarding human rights, business ethics, supply chain management, diversity and inclusion, and social impacts resulting from corporate operations.'[33] The Urban Land Institute (ULI), by contrast, has pointed to a series of more precise metrics, including the relationship between landlords, tenants, and local communities, the valuation of location and space, and even how real estate can help tackle social and spatial inequalities. ULI argues that both local data platforms, such as Neighbourlytics, used by over sixty cities worldwide,[34] and indicators, such as the Urban Health Index for London,[35] can help investors with a set of data and indicators to help them understand local needs and market trends.[36] These are trends that Gulf real estate investors will gradually gravitate towards, modifying them to suit local conditions: some transit indicators, for example, are clearly suited only to temperate climates.

Governance is easier territory to identify. High levels of compliance with lawsand codes evidenced by a clean slate in respect of breaches, transparency in asset identification and performance disclosure, HR, the adoption of IFRS, Board and management structure and composition, are all levers available to real estate firms and funds. They can draw the same conclusions about valuations and the cost of finance as by developers. With transparency now frequently identified as a 'short-cut' to ESG or even a proxy for it, real estate fund managers are finding that if they fail to disclose across these measures, investors are assuming the worst. REITs have the in-built advantage of specific regulations, which shows not only in terms of their relatively higher valuations by comparison to their private peers, but. also in the extent that REIT investors in developed markets now price each component of ESG investing differently.[37]

It is therefore no surprise that in terms of funding costs, research has given powerful support to the belief that REITs with higher levels of ESG disclosure across each dimension have lower cost of debt,[38] in the order of 60 b.p. in developed countries, with the cost of equity capital decreasing by 20 b.p. for every percentage of a REIT's buildings that are certified by one percent. Similar benefits have been observed for other measures such as higher ratios for leverage, market-to-book, and Tobin's Q. Moreover, REITs with higher ESG disclosure levels have weathered the Covid-19 crisis better than their less transparent competitors. Evidently, improving ESG disclosure can help REITs to gain better access to the capital markets, as lenders move increasingly towards integrated evaluation of ESG factors into their lending decisions.[39] At the same time, it seems inevitable that real estate funds in the region, notably REITs, will follow Schroders in developing sharia-ESG hybrids, which will have their own special indicators and access to capital. REIT reporting even this decade is therefore likely to feature ESG, and the time for REIT management to prepare for this is evidently now.

Conclusions

If IFRS and Sharia can both be taken as indications of how ESG will evolve, then it has a bright future, guided by a single set of quasi-accounting standards. Real estate reporting in the region is likely to improve, both at fund level and eventually collectively, as has happened with the development of the sBPR database, which even though it is necessarily limited to public real estate, is potentially worth emulating.

The answer to the question posed at the start of this paper is clear: ESG will become increasingly important for real estate, but the process will occur only very gradually. At Cavendish Maxwell we have already seen the movement around the region towards developers seeking social licences to operate gaining pace, migrating from purely a requirement imposed by government to a relationship with all stakeholders, including funders, tenants and future owners that emphasises performance across all four dimensions. Not doubt that IFRS will make the process measurably more straightforward in future. But the steps developers and investors take now to ensure that they lay an auditable trail of success through their existing ESG reporting framework will be crucial in delivering their performance along each dimension in future.

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