deepki

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The Deepki European Pension Fund Report: Integrating ESG into commercial real estate investment

Executive summary

Deepki, the ESG data intelligence firm, surveyed 250 European pension fund managers in the UK, Germany, France, Spain and Italy, with a combined AUM of €402 billion.

Headline findings

- 68% of European pension funds expect to increase allocation to commercial real estate over the next three years, with ESG factors a significant motivating factor.
- 79% of European pension funds expect commercial real estate with good environmental, social and governance (ESG) credentials to provide better returns or “green value” over the next five years.
- 64% say that only 21%-30% of their fund’s commercial real estate assets have strong ESG credentials. A further 19% said that this figure was between 11% and 20%.
- 23% expect the majority of their commercial real estate assets to hit net zero in six to ten years and a further 15% expect it to take 11-15 years.
- 80% of European pension funds believe that asset managers are taking a holistic approach to ESG and placing adequate focus on social and governance factors.
- 64% describe their pension fund’s focus on social factors as good or very good while 57% say the same of their environmental focus. 63% of respondents say their fund’s focus on governance is good or very good.
- 62% predict that social factors such as the rehabilitation of public spaces, affordable and social housing and workplace safety will drive the greatest value in the next three years.
- 53% of respondents identify a lack of quality data as the number one obstacle while 47% say the ability to build a strategy based on that data is an issue.
- 37% expect brown discounting to negatively impact assets by 31%-40% and 24% by 21%-30%, severely devaluing poor-performing real estate.

Introduction

More than $5 trillion of investment is needed each year to decarbonize the built environment and ensure the real estate sector can meet its commitment to achieving net zero by 2050.

Pension funds will play a pivotal role as they construct long-term investment strategies that meet their environmental, social and governance (ESG) commitments while returning value to members.

Our research shows that commercial real estate is already a critical asset class for European pension funds, and allocations are set to rise over the next three years as key decision makers recognize that property is inextricably linked to all three pillars of ESG investment.

This is borne out by the majority of pension funds across Europe, who say green real estate will deliver better returns over the next five years.

This being said, allocating to commercial real estate as part of a responsible investment strategy is not without its challenges.

European pension funds admit that most of their real estate allocations have weak ESG credentials with more than one in ten expecting improvements to take 15 years. Further, two-fifths say “brown discounting” is causing their property assets to depreciate.

Respondents also say there is still a lack of suitable data to help inform their real estate investments and there is still a lack of suitable knowledge and experience in the market.

More must be done - and quickly - to make the real estate sector greener, and to provide investors with the metrics that allow them to effectively analyze their ESG credentials, if they are to achieve net zero.

Allocations to commercial real estate

European pension funds have long relied on commercial real estate as a dependable provider of long-term returns, while offering diversification benefits and protection against inflation.

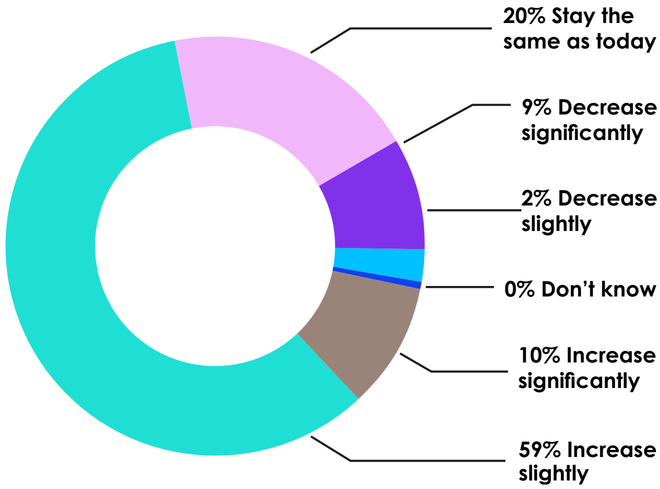
Just under half (46%) of the European pension funds responding to the survey allocate 21%-25% of their fund to domestic commercial real estate. A further 24% allocate 16%-20% to the asset class.

These allocations are set to grow for more than two-thirds (68%) of respondents over the next three years, and while the traditional reasons for allocating to real estate remain key drivers, ESG is also a motivating factor.

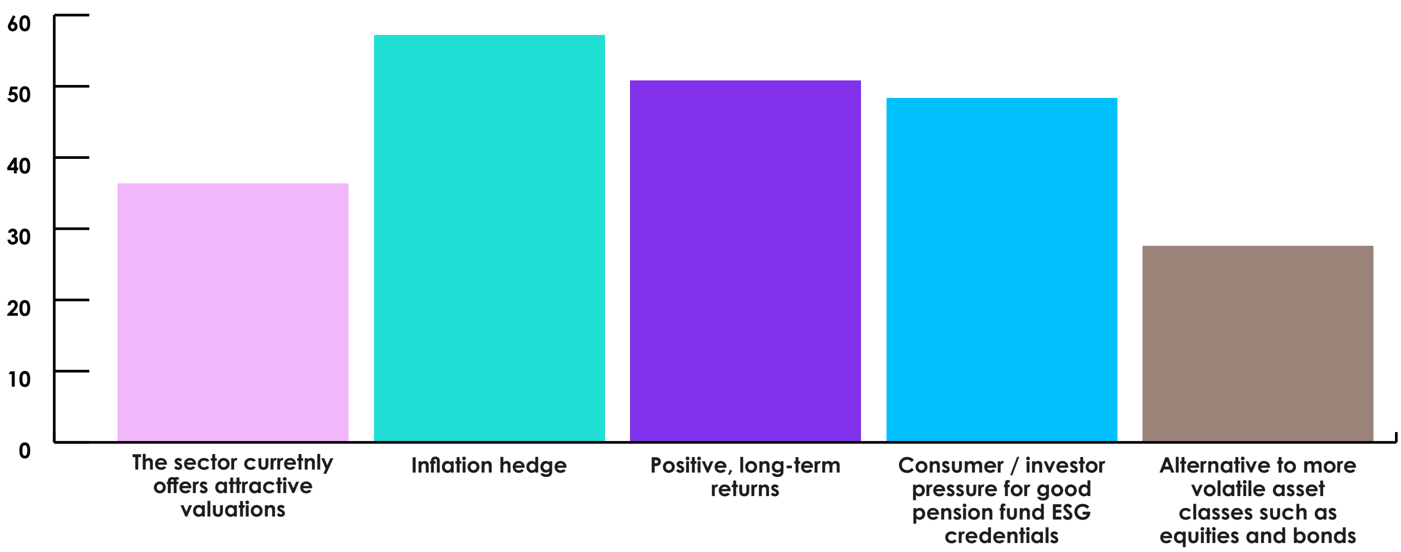
When citing reasons for increasing commercial real estate allocations, 57% say the asset class acts as a hedge against inflation (57%); 52% point to the positive, long-term returns (51%); while 48% mention pressure from investors for good ESG credentials (48%).

However, the research shows that the sector will need to enhance its responsible investment attributes if pension funds are to rely on the asset class as part of an ESG strategy.

How is the allocation to your local/domestic market commercial real estate assets likely tochange over the next three years?

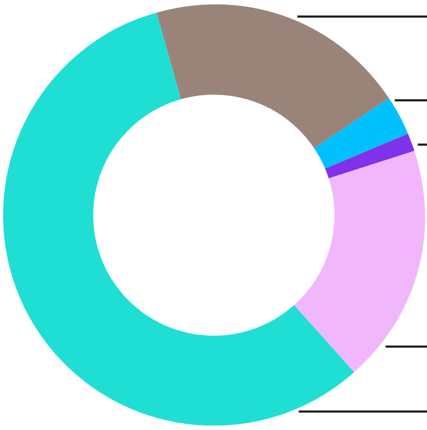


If you are planning to increase your allocation to commercial real estate assets, what are the main reasons?



Just under a fifth (18%) of pension fund managers rated their domestic commercial real estate sector's ESG performance - an evaluation of a firm's collective conscientiousness for environmental, social and governance factors - as "very good", and 57% as "quite good" over the past three years.

How do you rate your local/domestic commercial real estate sector's ESG performance (Environmental, Social, and Corporate Governance is an evaluation of a firm's collective conscientiousness for social and environmental factors) over the past 3 years?



Katie Whipp, head of Deepki UK, says:

"Real estate's role in European pension fund investment strategies will become even more important over the coming years as institutional investors recognize the role the asset class has to play in helping them achieve their ESG targets."

The path to net zero

The built environment is responsible for 40% of the world's carbon emissions, and findings from our research show that there is still a long way to go before property can claim to be carbon neutral.

This means institutional investors will have to play a critical role in helping the sector reach net zero by 2050.

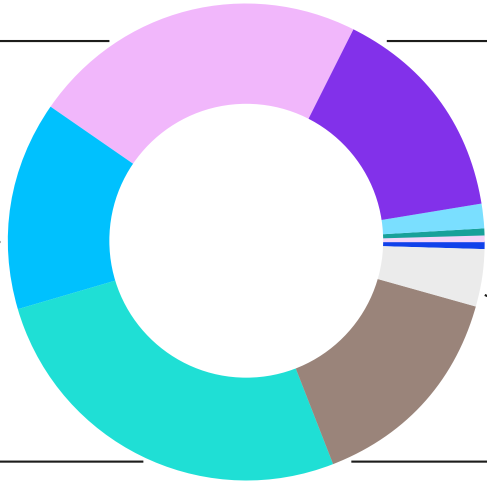
Nearly two thirds (64%) of European pension fund managers say that only 21%-30% of their fund's commercial real estate assets have strong ESG credentials. Just under one-fifth (19%) put this figure at between 11% and 20%.

There is notable pessimism in commercial real estate achieving net zero by 2030. Just under one-quarter (23%) expect the majority of their commercial real estate assets to hit this target in six to ten years and a further 15% expect it to take 11-15 years.

Two fifths (40%) have a more optimistic view, expecting to hit this milestone in two to five years' time, and a further 15% within one to two years.

The slew of European legislation aimed at limiting climate change and encouraging investors to act responsibly – including the EU Green Taxonomy and the Sustainable Finance Disclosure Regulation – has the potential to increase the pace of change.

When do you expect the majority of your local/domestic commercial real estate assets to reach net zero?



Vincent Bryant, Co-founder and CEO of Deepki, says:

"More property companies and real estate trusts are committing to net zero, but our survey shows the complex challenge the sector faces with many buildings falling short when it comes to good ESG performance."

The social dimension

Climate change risk has kept environmental issues at the top of investors' agenda in recent years. However, 80% of respondents to our survey say that asset managers are taking a holistic approach to ESG and are placing adequate focus on social and governance factors, despite the higher profile of climate change and carbon-emissions.

Almost two-thirds (62%) predict social factors such as the rehabilitation of public spaces, affordable and social housing and workplace safety will drive the greatest value in commercial real estate over the next three years.

One quarter (24%) expect environmental factors such as energy efficiency, water use and materials to drive the greatest value and 12% expect governance to be the biggest influence. This includes compliance with regulations, remuneration, diversity and action against corruption.

Social factors also trumped environmental when it came to fund focus. Fifty-seven percent of respondents described their environmental performance as good or very good. Nearly one-fifth (18%) described it as poor. In contrast, 43% described the focus on social factors as very good and 21% as good. Only 12% described it as poor.

Governance factors also scored highly, with 37% of respondents describing their fund's focus as good, and 26% as very good.

Vincent Bryant, Co-founder and CEO of Deepki, adds:

> "The Covid pandemic has shone a spotlight on social factors as businesses have worked hard to ensure work and living spaces provide healthy, safe and secure and environments for occupants."

Risks and challenges

Gathering quality, meaningful data on commercial real estate's ESG credentials remains the biggest challenge to European pension funds when it comes to improving ESG.

More than half (53%) of respondents identify a lack of quality data as the number one obstacle while 47% say the ability to build a strategy based on that data is an issue.

The data gap is further compounded by compliance demands on pension funds to demonstrate they have collected requisite ESG data.

Just over a quarter (29%) say they lack the necessary skills in-house to improve their commercial real estate ESG credentials, suggesting the industry needs to do more to support investors in developing their responsible investment strategies.

What are the greatest challenges to ensuring pension funds' commercial real estate assets can improve their ESG credentials?

Challenges to improving ESG performance of commercial real estate

1.	Collecting quality data	53%
2.	Ability to develop a strategy based on the data	47%
3.	Compliance concerns over data collection	44%
4.	Understanding/analyzing the data	41%
5.	Consistency across different asset managers	40%
6.	Incomplete data	36%
7.	Measurement / benchmarking	34%
8.	Poor In-house expertise	29%
9.	Collaboration with asset managers to improve assets' ESG performance	28%
10.	Trustee knowledge/skills/expertise	22%
11.	Cost of ESG compliance	17%
12.	Balancing short-term performance demands with long-term investments and improving ESG credentials	6%
13.	Regulation	1%

Emmanuel Blanchet, Co-founder and COO of Deepki, says:

“Understanding a real estate asset’s ESG performance has to start with good data, and this represents a real challenge for many pension funds. There is a rapidly-growing demand from funds across Europe with significant commercial property investments because they need expertise and support when it comes to collecting the right data, analyzing it and developing strategies to achieve net zero.”

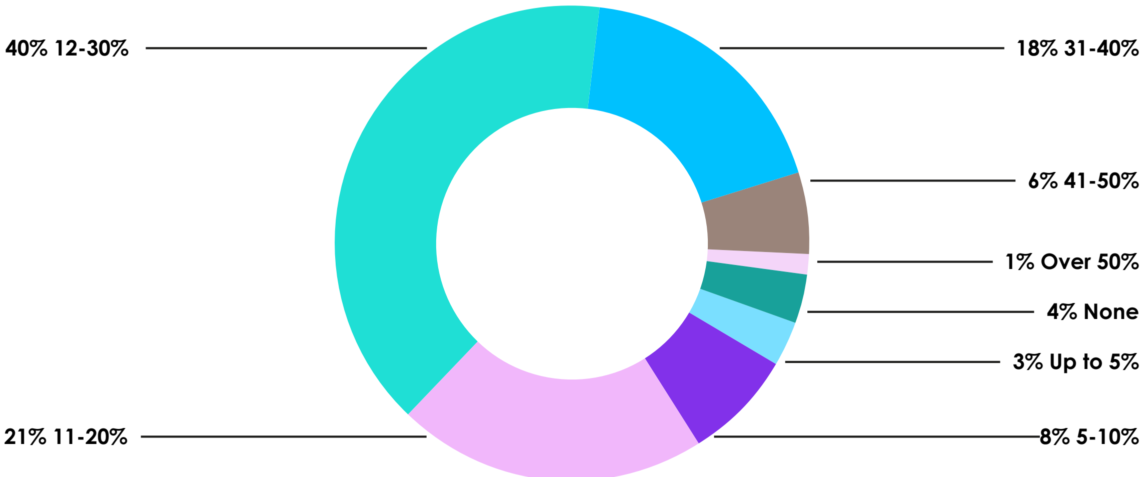
Respondents also identified a growing risk of “brown discounting” for commercial property assets that demonstrate poor ESG compliance and deferred maintenance risk that may require additional capital outlay for improvements.

In the last year, two-fifths of pension funds say brown discounting has led to a depreciation of 21%-30%. A further 21% have seen asset values drop by 11%-20%.

Just under one-fifth (18%) have seen dramatic depreciation of 31%-40%, highlighting the growing focus on climate risk and resilience, carbon emissions and occupant health.

Almost two thirds (62%) of European pension funds expect brown discounting to increase. More than one-third (37%) expect it to negatively impact assets by 31%-40% and 24% by 21%-30%, severely devaluing poor-performing real estate.

What value depreciation are you currently seeing in terms of “brown discounts” for commercial property assets that clearly demonstrate obsolescence or deferred maintenance risk that may require additional capital outlay for improvements compared to 12 months ago?



Emmanuel Blanchet, Co-founder and COO of Deepki, continues:

“The value of commercial real estate with poor ESG performance is being significantly affected by brown discounting and our research suggests that the resulting devaluation is set to become even more pronounced. As a result, we are seeing a sharp increase in demand for our technology as owners and managers take on the net zero challenge to protect their assets.”

Conclusion

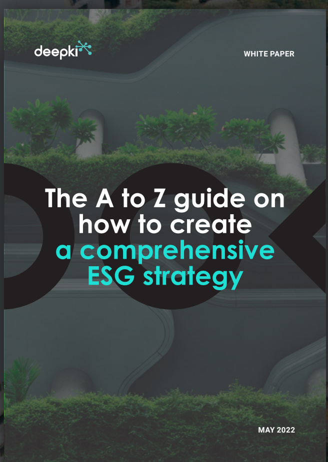
Commercial real estate is making a demonstrably positive impact on investors' portfolios as they strive to build responsible strategies.

There is evidence that social and governance factors are not playing a secondary role to environmental considerations, and that European pension funds are largely positive about commercial real estate's ESG contribution.

Nevertheless, the research also makes clear a number of obstacles to improving ESG.

Importantly, the data gap must be overcome if investors are to make informed decisions and there must be a concerted effort to raise awareness and understanding of the key ESG issues in commercial real estate.

It is incumbent on the entire real estate industry to ensure the sector meets its net zero targets and respects its responsibilities to the individuals and communities it serves.



Get all the insights into building a well-grounded strategy for your portfolio/assets.

Download the white paper