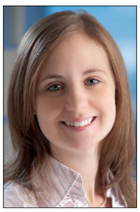
# ESG in the Commercial Real Estate Industry: A Primer on Key Drivers and Impacts on Investment

**David E. Kaye**
Ropes & Gray LLP



**Sally N. Davis**
Ropes & Gray LLP

## Introduction

Over the past several years, environmental, social, and governance, or "ESG," has experienced an exponential increase as a focal point in developing investment strategies and priorities for market participants across all industries.

Distinguishing itself from private equity and other investment markets, the commercial real estate sector is uniquely positioned in its ability to proactively respond to growing ESG interests, due in large part to the tangible and direct impacts that social and environmental factors can have on real estate assets and, in turn, the tangible and direct impacts that real estate assets can have on the environment and surrounding communities.

This article discusses the key drivers of ESG in the commercial real estate space, including the competing interests among market participants and governmental authorities with respect to ESG-related initiatives and the manner in which such interests impact investment and development. We also describe the challenges such market participants face in terms of diligence and monitoring compliance with ESG policies. Finally, we attempt to prognosticate what is on the horizon for ESG in commercial real estate.

## Drivers of ESG

### Market Participants

Within the commercial real estate industry, various interested parties are independently and collectively lending a hand to the focus on ESG initiatives in investment decision-making.

Capital providers (e.g., limited partners in a real estate fund, or the fund itself, if such fund is investing as a capital partner in a joint venture) are at the top of the food chain in terms of driving ESG initiatives, imposing their own internal requirements on, and demanding commitments from, fund sponsors and asset managers regarding climate plans and other ESG-related policies more particularly discussed below.

Fund sponsors are developing their own ESG requirements, in part, because of the demands of their capital partners but also to attract new investors. Fund sponsors are then imposing these requirements on operating partners and managers at the asset level as well as third-party service providers such as property managers, general contractors, and similar consultants that provide asset-specific services.

On the other end of the spectrum, tenants are establishing their own ESG-related criteria that have direct implications on landlords who are reorienting and adapting their spaces to satisfy these needs to attract and maintain desirable tenants.

Finally, a growing number of activist shareholder groups have been putting pressure on boards of public companies to ensure that ESG is a priority in commercial real estate as well as other public markets. The prevalence and scope of such pressures are quickly causing the activist shareholder dynamic to become more mainstream when considering ESG-related policies and priorities.

### Economic, Policy, and Other Considerations

From an economic perspective, an easily quantifiable rationale for expanding ESG mandates is shown through a sustainability premium whereby certain companies with robust ESG mandates outperform their peers that do not place an emphasis on ESG. At the asset level, while ESG-driven requirements may increase the cost of operating facilities, they have also resulted in higher rents and economic efficiencies generated by measures such as LEED certification and tax incentives for green development.

Investors' own internal policies, regulations imposed by governmental and regulatory bodies (as discussed below), and/or more generally, demands organically developing out of changing societal


norms and pressures also inform the market-wide focus on ESG.

On a macro level, climate change and its effects on sea level, flood plains, and other topographical and meteorological matters must directly inform decisions regarding the viability and eligibility of a given project and its location and composition. In turn, these same factors serve as the impetus for real estate developers and investors to invest in and utilize more eco-friendly, sustainable materials and smart technologies in the hopes of mitigating the risks associated with climate change and bettering performance outcomes. Similarly, pressures exerted by local groups voicing concerns regarding a given project's impacts on the surrounding community can lead to delays and conditionality in such a project's ability to obtain necessary permits and approvals. But any given real estate project also has the potential to bring value to the surrounding community through the creation and revitalization of public spaces, the construction of affordable housing, and the connection to development and redevelopment of infrastructure.

## Impact of Regulation and Disclosure Requirements And Other Governmental Incentives

Governmental authorities and regulators are also beginning to place a higher priority on ESG. The most significant impact of governmental regulation relates to an expanding set of disclosure requirements that would obligate market participants not only to disclose key information about the nature and extent of their ESG programs but also to demonstrate ongoing compliance with such disclosures. In August 2021, for example, the SEC approved new rules requiring board diversity and disclosure that, in addition to the disclosure itself, also require an explanation for companies that fail to comply. The SEC is developing mandatory disclosure requirements relating to climate risk and human capital (anticipated to go into effect in early 2022) that would include tracking the progress of companies that have committed to reducing carbon emissions, among other things. Such disclosures were previously voluntary.

In response to such governmental focus on ESG, real estate fund sponsors (as well as private equity fund sponsors and public companies) have been voluntarily including more robust disclosures in their public filings, private placement memorandums, and other marketing materials. These disclosures, which tend to focus on approaches to ESG and the ability to comply with benchmarks and past performance, are likely to be sought after by ESG-sensitive investors, who want to understand what measures are being taken by a fund sponsor or an operator to implement and subsequently monitor ESG protocols to ensure compliance and to confirm that negotiated ESG standards are actually adhered to in the ordinary course of business. In some ways, making such disclosures mandatory could help asset managers establish clear and consistent requirements to placate investors and establish specific benchmarks because there is no binding metric to permit an asset manager to describe its investments as "green" (as discussed below).

State and local authorities are also exerting pressure and beginning to impose their own ESG standards and requirements on investments located within their jurisdictions. Although tax incentives and rebates are currently associated with a developer's providing additional green spaces and/or affordable housing with the government offering a "carrot" to real estate investors, governments are also beginning to follow the SEC with mandatory disclosure requirements, which could be viewed as a "stick." For example, the New York State Department of Financial Services recently announced that it will require certain New York–regulated banking and financial institutions to publish information regarding the gender, racial, and ethnic compositions of their boards and/or governing bodies. While not necessarily applicable to asset managers and developers within the real estate space, these new requirements signal a growing trend to collect this type of information and, in doing so, to promote new best practices with respect to diversity, equity, and inclusion efforts across all industries.

## Challenges and Solutions

As the commercial real estate sector seeks to better define ESG criteria (which, by their nature, are inherently intangible and difficult to quantify), the door has been left open for inconsistency and irregularity, not to mention the potential for greenwashing, whereby a company presents misleading information—intentionally or unintentionally—about itself, its governance, and its products or services in order to make itself appear more environmentally and/or socially conscious than may actually be the case.

To combat greenwashing and to equip investors with more accurate information about ESG performance, several different rating systems for ESG success have been promulgated, including several developed by organizations specifically focusing on the commercial real estate space, such as GRESB (formerly the Global Real Estate Sustainability Benchmark). Complete with their own rules and best practices, these varying systems have created confusion within the market, leaving investors unclear as to which system is most reliable. While certain organizations, such as GRESB, have situated themselves as frontrunners in the race to establish a consistent approach to ESG assessment and monitoring across the real estate and infrastructure industries, these approaches have not yet been truly adopted industry-wide and therefore leave investors and managers without accepted guideposts to set goals and track successes (another reason mandatory SEC reporting may be beneficial to those most likely to resist it).

To avoid greenwashing, fund managers and operators must, among other things, be sensitive in selecting an environmental consultant or engineering firm to advise on such matters and be thoughtful in their approach to verifying the scientific data that inform the decisions and conclusions regarding ESG impacts (not to mention investors may elect to perform their own peer review of the analysis of such consultant or firm).

## What's on the Horizon?

Although the development, application, and tracking of ESG initiatives within the commercial real estate space appears to be a moving target, it seems highly likely—if not inevitable—that these factors will become more ingrained in investment strategy and approach industry-wide in the months and years to come. Looking ahead, we anticipate that climate change will continue to be a key driver in investment eligibility, the use of more eco-friendly materials in construction will become more commonplace, and the pursuit of projects to be repositioned as "ESG-compliant" will become more sought after. We expect more investors to set ESG guidelines for their investments, some of which may come in the form of ESG-concentration limits and/or funds with investment criteria more narrowly focused on ESG-related considerations. From a fund manager's perspective, those jurisdictions trying to be best positioned to address ESG-related matters by offering carrots to developers and fund managers that incorporate social programs, climate change, and/or quality of life into their projects are, in turn, providing a turnkey investment opportunity to enable such fund managers to more easily achieve the benchmarks investors impose.

Out of the various ESG rating systems, a single, standardized approach is likely to take root, which will lend itself, in turn, to more consistency and regularity across the industry, although we expect this to take years to come to fruition. As time goes on, artificial intelligence and similar algorithmic technologies are likely to serve as resources to facilitate ESG-related due diligence and monitor compliance.

Although only time will tell exactly how ESG factors will transform expectations and requirements across the commercial real estate industry, such factors clearly are playing—and are likely to continue to play—key roles in defining and redefining the strategy and approach of investors and fund managers in the real estate space and will continue to remain at the forefront of the conversation in the years to come. ■

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*David E. Kaye is a Partner and Sally N. Davis is an Associate in the Real Estate Investments & Transactions Group of Ropes & Gray LLP.*

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