

# MAP REAL ESTATE MARKET INSIGHT

Frankfurt, June 2023

## THE MEANING OF THE S IN ESG. SOCIAL IMPACT INVESTING IN REAL ESTATE

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### Introduction

ESG criteria have long since found their way into the real estate industry. The recognition that engagement in this area offers many opportunities is now firmly established. Many companies have installed departments with specialists dedicated to ESG. However, the concept of ESG is still mainly reduced to environmental and sustainability aspects. While corporate governance has been an issue for some time, it is above all the social dimension which is given far less consideration.

We are currently economically and operationally challenged with the fulfilment of the current and future CO<sub>2</sub> reduction that we might dare to assume that we can "postpone" the "S" requirements. The foreseeable problem resulting from this, however, could be that we have to expect higher vacancy rates if the now proven, dramatically dropped utilization of e.g. the rented office space to now approx. 40%<sup>1</sup> also very soon leads to strongly increasing vacancy rates. This could presumably derive from e.g. the effects of the Corona crisis in particular, the effects of the current sharp rise in financing costs and possibly the effects of the forthcoming refinancing round. The reduced demand for office space in particular is already becoming apparent and is now a reality.

We at MAP Real Estate have even experienced that some institutional investors are sending their portfolio managers down to the asset management level in order to discuss to what extent vacancy rates can actually be absorbed by the market (with more or less moderate effort) on the property level. We do not believe that merely improving the E-criteria will fully optimize the competitiveness of the property, but we also need the implementation of the S-criteria in order to achieve the best possible competitive situation for the product. The prerequisite for this is, of course, that the product with its mobility concept and the previous property qualities, such as space efficiency, ensures a sound basis for this upgrading.

The aim of this implementation of the S-criteria e.g. in the office market is to design workspaces so attractively that employees return back into the office space again, in order to reduce vacancies, achieve a faster leasing success, achieve sustainable rents, optimize the overall return on investment and make the product more resilient to the challenges of the market.

In order to shed some light on the subject and raise awareness of its significance, in this Market Insight we finally take a deeper look at the S-criterion.

We introduce what is meant by the S-criterion and report on current research findings on the relevance of the S in the German real estate market, which will certainly increase in the future. Finally, we show the difficulties of measuring the social impact of a property and clarify whether green building standards offer a way out.

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<sup>1</sup> Thomeczek, H., 2023: Die Büroauslastung ist dramatisch gesunken. In: Immobilienzeitung, 06/26/2023. <https://www.iz.de/maerkte/news/-die-bueroauslastung-ist-dramatisch-gesunken-2000017468>

## The meaning of the S

So far, there is no exact and generally accepted definition of what exactly the S in ESG includes. In 2020, the EU adopted a classification system which lists environmentally sustainable economic activities (EU taxonomy). The aim of the taxonomy is to direct investments towards sustainable projects and activities, and it has so far focused mainly on environmental goals.<sup>2</sup> A social taxonomy is in preparation. To date, recommendations from a group of experts have been published by the EU. They contain three overarching goals:

1. decent work (including for value-chain-workers),
2. adequate living standards and wellbeing for end-users,
3. inclusive and sustainable communities and societies.<sup>3</sup>

In real estate, the social aspects of a property need to be considered well beyond the building itself. A comprehensive study with the aim of establishing a measurement concept for the social impact of a building or project distinguishes 40 indicators in 5 clusters (urban mix, infrastructure, identity, built environment, connectivity).<sup>4</sup> Another study, the PMRE Monitor 2023, distinguishes twelve categories of S-criteria (see Figure 1).

Figure 1: Categories of S-criteria according to the PMRE Monitor 2023



Source: Hochschule für Technik und Wirtschaft Berlin and CCTM Consulting Real Estate & Infrastructure Capital, 2023: PMRE Monitor 2023. Process Management Real Estate Monitor.

The compilation shows that features of the property as well as characteristics of the neighborhood are of importance. The former determine the user experience of the residents of the building or of the employees of an office in their everyday life inside the building. The latter also influence the user experience via structural features and the quality of life in the neighborhood. At the same time, the building's presence and design have an impact on its

<sup>2</sup> The Taxonomy Regulation establishes six environmental objectives: climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, the protection and restoration of biodiversity and ecosystems. Cf. European Commission, 2023: EU taxonomy for sustainable activities. [https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities\\_en](https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en)

<sup>3</sup> Platform On Sustainable Finance, 2022: Final Report on Social Taxonomy. February 2022.

<sup>4</sup> Institut für Corporate Governance in der deutschen Immobilienwirtschaft, 2021: Social Impact Investing. Wissenschaftliche Analyse von Projektbeispielen zur Anwendung der Messung des Social Impacts. In Kooperation mit EBS REMI.

surroundings. Under the criterion of building quality, the compilation in Figure 1 also includes environmental aspects such as resource consumption and CO<sub>2</sub> emissions. The close links between the different areas of the ESG concept are evident here.

It is easy to find examples of the above factors, which influence the social impact of a building or a project. Moving from the outer environment to the building and entering it, the following qualities could contribute to an improvement of the social impact:

- A wide range of environmentally friendly mobility concepts in the building and of the area,
- screens for timely information about mobility options (public transport and availability of shared bikes or cars),
- a good infrastructure in the micro location of the building,
- a green facade and a green roof to improve the microclimate,
- a thoroughly planned concept for parking spaces with and without e-loading capacities,
- an entry with interlocking function to support the adaptation to temperature differences between inside and outside,
- an air purification system inside the building, e.g., with the help of sophisticated air quality measurement and management and the placement of plants,
- a discreet, healthy, allergy-free room fragrance system to create a feel-good atmosphere
- an appealing design of the staircases to invite people to forego the elevators (e.g., with screens, art or color design on the walls),
- an elevator design which helps prevent claustrophobia e.g. by glass and mirror,
- the creation of spaces that invite people to meet and communicate,
- green roof terraces for relaxation and for the organization of events,
- a concept for lighting that particularly addresses health aspects of artificial and natural lighting.

This list does not claim to be complete and is only intended to illustrate how broad the concept of the social impact of a property is. In addition, there is a second level at which ESG-compliant behavior is expressed with reference to the S-criterion, namely the acting company itself. This can be a positive, appreciative corporate culture, social benefits for employees or public welfare-oriented sponsoring, and much more. In the effort to attract young talent, these aspects are already important today and will become even more so in the future. However, these challenges apply equally to all companies in all sectors. In the following, we want to focus on the topics that are particularly relevant for real estate.

### **The relevance of the S in today's real estate industry**

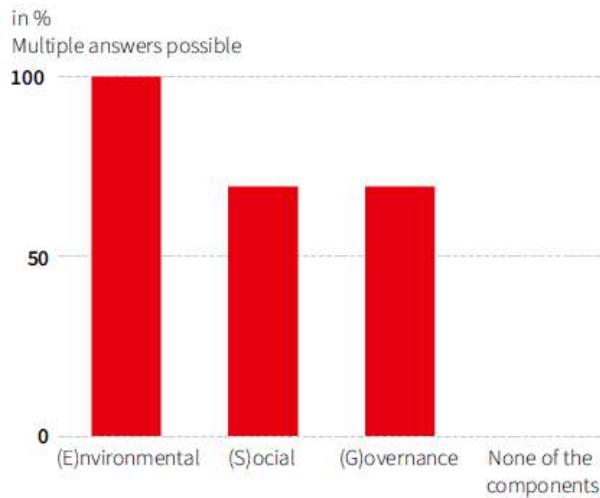
As mentioned in the introduction, it is fair to say that when most people in the real estate industry hear the word ESG, they think first of reducing energy consumption and limiting CO<sub>2</sub> emissions. This can also be seen from a JLL survey of decision-makers who together have invested over €61 billion in real estate acquisitions in Germany over the last 10 years.<sup>5</sup> When asked how relevant the ESG issue is today for their company, 70% of the respondents answered that it is high or very high. Figure 2 shows that the social and governance

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<sup>5</sup> JLL, 2021: *Green building certification as a value driver? Empirical assessment and scenario analysis of the effect on the value of office buildings.*

components of ESG are predominantly (70% each) seen as important or very important for their companies, but significantly less so than environmental issues (100%).

Figure 2: Which ESG components are important or very important for your company?



Source: JLL, 2021: *Green building certification as a value driver? Empirical assessment and scenario analysis of the effect on the value of office buildings.*

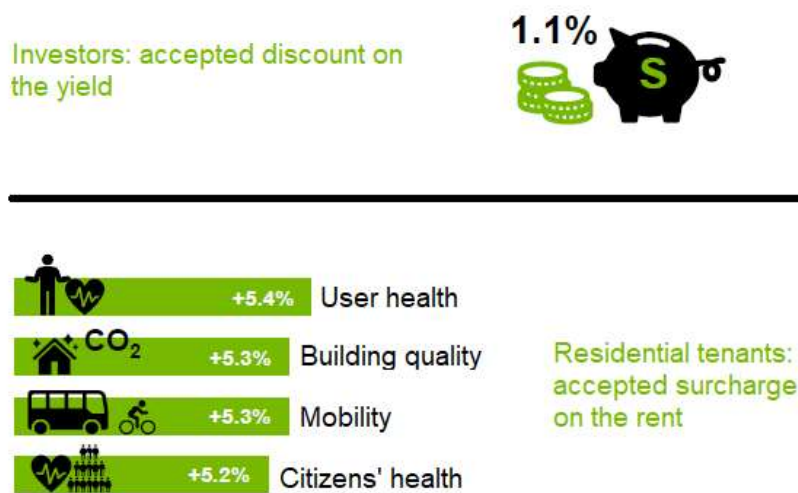
It can be assumed that the social component of the ESG criteria will become more relevant in the future. It is inevitable that at some point all ESG aspects will be equally influential. The adoption of the EU Social Taxonomy will make an important contribution here. Similar to the environmental taxonomy, it will bring about important clarification for all stakeholders. However, it will also entail new reporting obligations for companies. Here, the desire for more information must be balanced with the need to limit the additional effort.<sup>6</sup>

The PMRE Monitor-2023<sup>7</sup>, which is based on a survey of 239 experts in the real estate industry and 209 students of real estate related studies selected as representatives of the young generation Z, shows that this path of increased consideration of the S is worthwhile. One key result is that the investors are prepared to give up 1.1 per cent of the return if a property is 'socially designed' in the sense of its users, the citizens or the society as a whole (see Figure 3). On the other hand, the tenants are also willing to pay a higher rent. The accepted surcharge is on average 4.3 per cent. Figure 3 shows that the criteria user health (5.4 per cent), sustainable building quality (5.3 per cent), mobility (5.3 per cent) and citizens' health (5.2 per cent) are rewarded above average. However, the query of a hypothetical willingness to pay for a socially desired (merit-based) product usually leads to an overestimation. Nevertheless, these results indicate that the consideration of the S-component of ESG already bears significant benefits for investors today.

<sup>6</sup> Platform On Sustainable Finance, 2022: *Final Report on Social Taxonomy. February 2022.*

<sup>7</sup> Hochschule für Technik und Wirtschaft Berlin and CCTM Consulting Real Estate & Infrastructure Capital, 2023: *PMRE Monitor 2023. Process Management Real Estate Monitor*

Figure 3: PMRE Monitor 2023: Key findings from the survey of investors and residential tenants: Attitudes towards properties that particularly meet the S-component of the ESG criteria



Source: Hochschule für Technik und Wirtschaft Berlin and CCTM Consulting Real Estate & Infrastructure Capital, 2023: PMRE Monitor 2023. Process Management Real Estate Monitor

This fundamentally positive assessment of the social aspect of the ESG concept is also reflected in another result of the PMRE Monitor 2023. The participants in the survey rated opportunities (and risks) arising from it on a scale ranging from -100 to +100 (from very risky to very promising). The average rating was +43. Thus, the S criteria and their growing importance are predominantly viewed not only as an additional compulsory exercise. On the contrary, the prevailing assessment is that their integration into projects and corporate culture can be profitable.

Overall, the respondents expect an increase in the importance of the social criteria for the real estate industry in the future. The prospects were specified in more detail by agreeing to various statements on a scale of 0 to 100. The risk of properties becoming stranded assets due to a neglect of social aspects is definitely seen. The average level of agreement here was 59. The danger that companies could suffer reputational damage if too little attention is paid to the S-criteria is rated even higher (63). The fear that this would also make it more difficult to recruit staff also received an approval of around 60.

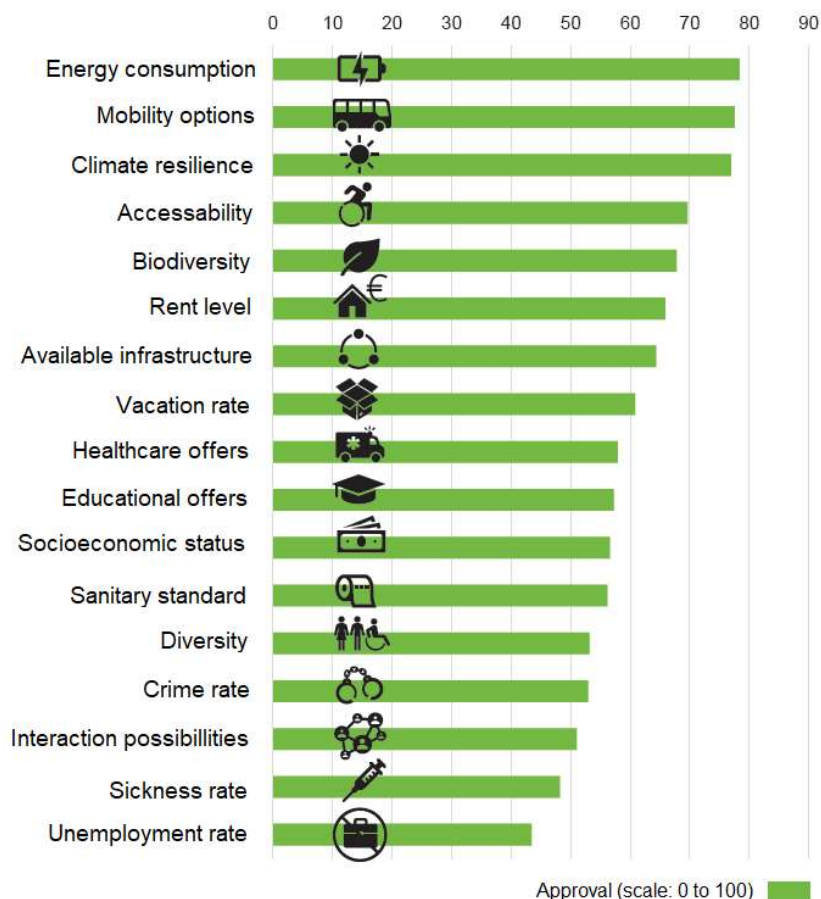
The greatest pressure to change is expected for developers (70). They must integrate the expectations of investors, tenants and other stakeholders into their concepts and plans. But noticeable pressure to adapt is also expected for valuation (65), portfolio management (63) and acquisition (63). According to the respondents, changes are also likely in reporting (62). However, the above-mentioned risk that new regulations such as the upcoming adoption of the EU social taxonomy will lead to extensive additional data requirements is not considered to be particularly high (47). The authors of the PMRE Monitor assume that this reflects the current situation on the market. As ESG reporting has not yet been fully defined, there is a corresponding lack of clarity as to what data is required for reporting.<sup>8</sup>

<sup>8</sup> Hochschule für Technik und Wirtschaft Berlin and CCTM Consulting Real Estate & Infrastructure Capital, 2023: PMRE Monitor 2023. Process Management Real Estate Monitor.

## Challenges of the impact assessment of S criteria

Given the role that the S-criteria already play in the real estate market and the increase in importance that can be expected in the future, an important question arises for decision-makers: How can I improve the position of a project or my company as a whole? Can the degree of target achievement be reliably measured?

Figure 4: Key figures for measuring the social impact of real estate



Source: Hochschule für Technik und Wirtschaft Berlin and CCTM Consulting Real Estate & Infrastructure Capital, 2023: PMRE Monitor 2023. Process Management Real Estate Monitor

It has already become clear from the previous explanations that the number of influencing factors and options is high. In addition, some of these factors cannot be measured objectively, which results in evaluation problems. Figure 4 shows a selection of factors that might be relevant for measuring the social impact of a property and its neighborhood. They are ranked according to the pertinence attributed to them by market participants. The most important aspect is considered to be the energy consumption of the building, which is well documented at the same time. There are also measurement concepts for mobility, which takes second place. Climate resilience, on the other hand, is likely to be more difficult to evaluate but possible. In this case, and for most of the listed criteria, decisions have to be made about the measurement method and, if necessary, the formation of an index, which influences the final evaluation.

Figure 5: Standards for Green Building Certification

Green building certification	LEED – Leadership in Energy and Environmental Design	BREEAM – Building Research Establishment Environmental Assessment Method	DGNB – Deutsche Gesellschaft für Nachhaltiges Bauen
<b>General</b>			
Origin	USA	UK	Germany
Established	1998	1990	2007
Familiarity level	International	International	International
<b>Application</b>			
New and existing buildings	✓	✓	✓
Office buildings	✓	✓	✓
Public buildings	✓	✓	✓
Residential buildings	✓	✓	✓
Industrial/retail buildings	✓	✓	✓
Educational facilities	✓	✓	✓
Healthcare and care facilities	✓	✓	✓
<b>Assessment categories</b>			
Management		✓	✓
Sustainable land use	✓	✓	✓
Water efficiency	✓	✓	✓
Energy and atmosphere	✓	✓	✓
Materials and resources	✓	✓	✓
Internal fit-out quality	✓	✓	✓
Innovation and design process	✓	✓	✓
Pollution	✓	✓	✓
Waste		✓	✓
Transport		✓	✓
<b>Evaluation</b>			
	Certified (40-49 points)	Acceptable (>10%)	Bronze (>35%)
	Silver (50-59 points)	Average (>25%)	Silver (>50%)
	Gold (60-79 points)	Good (>40%)	Gold (>65%)
	Platinum (80 -110 points)	Very good (>55%)	Platinum (>80%)
		Excellent (>70%)	
		Outstanding (>85%)	
<b>Assessment method</b>			
	Points awarded for individual criteria with weighted application depending on category		

Source: JLL, 2021: Green building certification as a value driver? Empirical assessment and scenario analysis of the effect on the value of office buildings.

A solution to this is offered by the building standards DGNB (Germany), LEED (USA) and BREEAM (UK). They also include social aspects in their evaluation. Figure 5 compares them in a summary. The standards provide reliable orientation for market participants and can also be used for marketing. However, their usefulness depends on the degree to which they are established. In Germany, the DGNB standard dominates, but LEED and BREEAM are also used.

## Conclusion

We conclude from the findings and study results shown in this report that ESG in practice means more than a sole focus on environmental and sustainability aspects and that this effect will become even more pronounced in the future. The appreciation of S-criteria, which include a wide range of characteristics of a property and its neighborhood, is already paying off. According to the study cited, tenants are already prepared to accept a rent increase of

around 4% in this case.<sup>9</sup> The positive effects of an early implantation of the S-criteria differ depending on the type of use. While asset classes that are more likely to experience devaluations, such as the office sector, it seems sensible, depending on the location and property quality of the product, to implement the overall ESG strategy at an early stage, also with regard to the S criteria, in order to counteract devaluations if necessary. In the co-living and micro-apartment sector, on the other hand, which has so far remained crisis-resistant, realistic value enhancement effects can be assumed if the ESG criteria are implemented holistically – including the S criteria.

If property owners wait until legislation requires them to also implement the S criteria in the EU taxonomy, the following risks could materialize: (i) current tenants will move due to competitive advantages of other properties with implanted S criteria, (ii) vacancies could continue to increase until the time of the statutory requirement to implement the S criteria is in place and (iii) rents could then fall when the USP factor is removed because all properties must then meet the new statutory requirements.

It is therefore important to recognize that the currently tense situation on the German office market should not prevent us from not taking advantage of these opportunities.

However, it remains a challenge to select those measures that are most beneficial in concrete terms. The existing building standards, which take S-criteria into account, can help here.

The S-criteria are also likely to play an increasingly important role for companies in the fight for young talents. It will not only depend on the applicants' assessment of the company policy as a whole, but also the quality of the office space with regard to the social dimension will become increasingly important.

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<sup>9</sup> Cf. Hochschule für Technik und Wirtschaft Berlin and CCTM Consulting Real Estate & Infrastructure Capital, 2023: PMRE Monitor 2023. Process Management Real Estate Monitor



**Note:**

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