HOW AN INCREASED FOCUS ON SUSTAINABILITY IS SHAPING THE REAL ESTATE SECTOR

A CO-AUTHORED OUTLOOK FROM HLB AND MULTILAW

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FOREWORD

We are pleased to present our first co-authored report by HLB and Multilaw, on how sustainability and ESG practices are shaping the real estate sector. We brought together accountants, lawyers and business advisors with a specialism in real estate from both networks to discuss major trends around sustainability for our real estate clients.

We are keenly aware of the significant impact that ESG considerations have on the industry. We are witnessing a global shift towards sustainable practices, with investors, tenants, and governments demanding greater accountability and action on environmental, social, and governance issues. The real estate sector is no exception, with ESG factors now playing a critical role in investment decisions, development projects, and ongoing operations.

However, the economic challenges facing the real estate sector, such as rising construction costs, a stagnating investment climate, and increasing regulations, have made it increasingly difficult for investors and developers to meet these ESG expectations. Nonetheless, we believe that by embracing new technologies and innovative solutions, we can drive sustainable practices while also delivering strong financial returns.

One such opportunity is the emergence of PropTech, which has the potential to transform the way we design, build, and manage our buildings. With the ability to collect and analyse data in real-time, PropTech can help us optimise energy efficiency, reduce waste, and improve the overall sustainability of our assets, among other things.

We hope this report provides valuable insights into the global ESG trends shaping the real estate sector, as well as the opportunities and challenges facing the industry.

We are committed to supporting real estate businesses in navigating these complex issues and developing sustainable strategies that deliver long-term value. If you would like to discuss any of the topics raised in this report, we welcome the opportunity to do so.

Thank you for reading.

Ralph Mitchison & Gerben Bosma

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INTRODUCTION

The real estate sector has always been shaped by global and local macro-trends, forcing business leaders to adjust and to be agile. The need for more environmentally friendly practices in this sector is nothing new. Yet, regulators across the globe are increasingly introducing new legislation around Environment, Social and Governance (ESG) and sustainability measures for real estate. We gathered lawyers, accountants and business advisors with expertise in the real estate sector to discuss how current trends and the need for more sustainability are shaping the industry.

Findings from HLB's Survey of Business Leaders 2023[1] indicate that the top five global real estate concerns for senior executives are inflation (cited by 82% of respondents), economic uncertainty (79%), geopolitical risks (74%), rising resource costs (71%), and rising interest rates (64%). Yet, while current obstacles create issues, they also allow for new trends and opportunities. But while the economic climate is challenging, real estate opportunities are plentiful. From the growing subletting business to the rising importance of PropTech. In the US, billions of dollars are available for sustainable or green infrastructure and buildings under President Biden's Inflation Reduction Act. Meanwhile, the UK market is seeing a significant drop in property valuations, which could lead to potential growth opportunities in the sector.

Reducing energy intake and carbon footprints while ensuring efficient energy management is a high priority, with 55% of real estate business leaders ranking renewable energy as the most important technology for business in the coming 5 years. The use of data in energy efficiency, indoor air quality, and materials were also seen as areas of growth opportunity.

This report explores how the real estate sector is being shaped by a greater focus on sustainability, and the ways in which the industry is rising to meet the requirements of energy efficient buildings.

1. HLB (2023) Leading through a perfect storm - HLB survey of Business Leaders 2023, HLB. Available at: https://www.hlb.global/insights/hlb-survey-of-business-leaders/2023/ (Accessed: 15 May 2023).

HOW ESG IMPACTS THE REAL ESTATE SECTOR

In the last few years, ESG, has emerged as a high priority and essential requirement in the real estate market. ESG is becoming ever more popular, with 60% of the sector rethinking its ESG responsibilities and 55% of the industry believing climate risks will increase in the next five years. Today, stakeholders demand change, and strongly desire to be aligned with real estate projects and developments that focus on ESG practices.

Governments worldwide are setting ESG standards designed to make properties energy efficient. But as ESG reporting standards are still fairly novel, 55% of real estate business leaders are unclear about their reporting obligations. Sustainability requirements are also being raised by investors who want sustainable buildings. Yet pressure from investors is not the only reason to follow the guidance; sustainability, politics, and tenants expecting modern, pleasant workspaces are also factors.

Meanwhile, tenants are facing escalating costs for electricity and gas, and they want sustainability, low cost, and a way to participate in positive environmental change actively. ''It is the high quality, energy efficient buildings that will be the ones that will be fully occupied going forward. And the low-quality energy inefficient buildings will be the ones that will be difficult to let, have high vacancy rates, and will require quite a significant investment,'' says Ralph Mitchison, HLB Global Real Estate Leader.

But it's not just about the environmental element; buildings also have critical social functions. Real estate plays a crucial role in society, with the power to positively impact local communities through communal facilities that help create a positive image which can, for example, attract shoppers and bolster the local economy.

Gerben Bosma, Multilaw Real Estate & Construction Practice Group Leader notes that, ''it is not just about the E in ESG, buildings also have social functions, that is the S in ESG. It is definitely important to ensure that real estate can play a key role in creating positive impacts on the local communities''.

A GLOBAL GLANCE: ADOPTION AND VIEWS ON ESG

While much of Europe is adopting a similar approach to ESG and environmental concerns in particular, adoption of and views on ESG practices vary greatly across the globe.

There is a certain level of bifurcation in the United States between red states and blue states, Democrats and Republicans. While tenants and governments are paying attention in many countries worldwide, the US doesn't appear to be united in its opinions regarding climate change yet. Some of the country's more prominent landlords are still sceptical that higher rates result from sustainability or ESG features, instead viewing their 'newness' as the cause. Many in the US need to pay more attention to the environment, though that's set to change when the Securities Exchange Commission (SEC) finalises its climate disclosure rules.

By contrast, Europe faces stricter energy efficiency requirements as regulators put policies on landlords to improve energy efficiency. Fabrice Rymarz, Partner, Racine Avocats, France explains: ''In France, ESG is more and more present in the legislation. There is more burden on landlords both on the residential and office side. There has been a new law passed recently preventing landlords from renting residential premises if they are not qualifying for a certain level of energy and efficiency. On the office front, there is a strong appetite for tenants in the Paris market for ESG qualifying buildings.''

This is a significant trend in the French market. Offices in the suburbs are less attractive today than in Paris, where the market remains relatively strong. But clearly, there's an appetite for this kind of building. Investors are being offered interest rates based on their capacity to operate transactions on ESG-qualifying buildings.

In the UK, a significant proportion of office spaces are below the minimum standards, and upgrades will be expensive. Moreover, these upgrades are required before 2030, and there is a concern in the market that landlords won't be able to afford these upgrades. The inevitable question is whether they will pass the costs onto tenants and if their leases allow them to do so. Simon Robinson, Partner Shakespeare Martineau, UK explains: ''One factor which could help the focus on ESG carry through, despite it being a trickier economic climate than in recent times in the UK, is the general trend of occupiers re-considering, re-designing and downsizing their space requirements to meet the new working habits. Certainly, the office market will need less space and as overall costs can be reduced by embracing hybrid working and reducing footprint requirements perhaps office occupiers will take on the slightly higher price per square foot required to accommodate ESG elements within real estate.''

Investors and lenders across Europe are increasingly analysing the credentials of their investments through an ESG lens, particularly with sustainability in mind. This is challenging investors and governments as they juggle ESG policy, economic growth, and asset growth. ''In Germany, I think we are seeing very few actual properties on the ground which meet the highest standards of ESG, which also means that they are in compliance with the relevant EU regulations. It causes a challenge as to how are we meant to deal with all the properties, which cannot, for various reasons fulfil those ESG requirements'', Carsten Richter, Partner, Heussen, Germany comments.

Another European example is Denmark, where building regulation codes are also being updated to make the builder responsible for preparing a life cycle assessment calculation. That will be implemented this year, with demands increasing as we move towards 2025. Green bonds are becoming increasingly popular as financing for sustainable building product projects. As a result, there is a significantly increased focus on product solutions. Lars Hammer Wentoft, Partner, Mazanti- Andersen, Denmark says, ''In Denmark we have a lot of old properties constructed in 1800 or early 1900s, so we are facing some difficulties as these properties will not fit the rating system. They need updating to fulfil these ESG requirements. On the other hand, it is not a

sustainable solution to demolish older buildings and build new ones.''

, Latin America and the Caribbean are seeing ESG take precedence, with a slew of sustainability-linked bonds being issued by companies and governments in an effort to create ESG policies with genuine impact. Simultaneously, Africa - which historically has not considered ESG to be a top priority for investors or corporations - are seeing sustainability rise as a megatrend that is forcing change. It does, however, seem likely that the African region will need to craft its own unique approach to the creation of sustainable buildings. While the rest of the world is striving for net-zero initiatives, this may be impractical for a continent with an average GDP per capita that is twenty times less than other countries.

Real estate investors in the Middle East are viewing ESG as a top priority, particularly in light of the upcoming COP 28 summit in November 2023, which this year is being hosted by the UAE. While climate concerns have been a big consideration in the Middle East for several years, the impending climate change summit has spurred an even greater commitment to creating sustainable buildings. Homebuyers are increasingly looking for energy efficient homes, while good air quality and proximity to green space are increasingly swaying purchasing decisions.

Asia, on the other hand, is seeing a marked increase in traction for green leases, which constitute an agreement between tenant and landlord to improve the property's environmental performance through cuts in energy and water usage and reducing waste. Singapore and Hong Kong are considered as leading in the ESG space, while other countries in Asia are far behind due to their developing economies.

STAGNATION IN THE INVESTMENT MARKET

Inflation (81%), rising interest rates (80%) and resource cost (78%) make-up the top three greatest risks to business by real estate leaders, according to HLB's Survey of Business Leaders 2023. Stagnation in the investment market has been seen thanks to rising building costs caused by various economic and geopolitical factors, which pose real challenges in the real estate market. In addition, supply chain issues partly due to the war in Ukraine, all of which add up to towering project costs and many sites coming to a standstill.

We're currently facing high-interest rates, which reduces capital values and decreases returns. At the same time, there is the spectre of a recession looming worldwide. We teeter on the brink and, as a result, sit on the fence. In addition, the recent banking crisis has created uncertainty in the market, which postpones investment due to concerns about gaining tenants or financing for a building.

However, architects, investors, and regulators are currently engaged in lively debate about the possibility of defining a building model for a living building, such as the model office building pro. Such a model would fulfil the minimum requirements for ESG, particularly for energy standards. Properties that do not comply with that standard would then be updated, with new buildings having the ability to fall back on this minimum standard that complies with all the requirements and regulations. So, although this isn't yet in place, it's definitely on the table.

While the investment market is stagnating in some sectors, the equity side is seeing an increase in ESG investing. There's a pause given in light of government policies, public opinion and finding lenders to invest in projects from a debt perspective, yet the equity side of the ledger is still voracious; there's much money still being pumped into that marketplace.

Those investment funds are looking for a home in PropTech or real estate. Specifically, funds are looking to invest in infrastructure with attributes that have some level of carbon capture or reduction in GHG.

In Europe, the EU regulations for ESG drive sustainable practices, but there are still concerns about measuring and comparing sustainability practices. Local issues such as energy costs, transfer tax, and environmental law issues also impact the investment climate in various countries. In The Netherlands, for example, the current energy costs and increasing cost of raw materials can no longer be called an average enterprise risk. While that's true globally, The Netherlands is also facing the planned increase in transfer tax for commercial real estate, which affects investors in particular. This is worrisome as investors are and will remain inventive and creative as long as they see prospects. The strong emphasis on environmental concerns in The Netherlands also leads to a significant challenge on the GHG emissions and deposition on nature reserves. All of this is locking up construction work in crucial places.

However, the UK sees international investment due to the currency market and value for money. We see a lot of investment into the UK from US companies due to the delta in the foreign exchange. So, while the UK has stagnated a bit on, for example, real estate investment, one or two US funds have bought up an enormous amount of four retail parks in the UK. The result is that we are seeing stagnation domestically, but with an awful lot of foreign investment. The UK is fortunate enough to have a domestic investment market built for an international one. And the international one is undoubtedly booming.

Finally, CPACE, a program for lending long-term money for energy reduction goals, is proving to be a better piece of paper than equity capital in the US. CPACE lenders lend and don't get a lien on the property. They get first attachment to the real estate taxes, which they use to pay back the loan. These loans are based on the energy profile of the building. Lenders will lend about 30% of the stabilised value of the project, either on a current or forward basis. In most states, energy codes will get you to the reduction targets you're looking for, and CPACE is competing with construction financing.

THE DEMAND FOR OFFICE SPACE

It is obvious that events in recent years had a significant impact on the real estate sector. Post-pandemic, we find ourselves in a hybrid working world, which has dramatically impacted the demand for and the dynamics of office space. This has led real estate businesses to adapt their sustainability efforts to the changing market conditions. Some ways they are doing this include repurposing office space, offering flexible leasing arrangements and incorporating new technology.

Across all industries, some level of remote working or hybrid working is now the norm. Many office buildings are being re-envisaged as residential properties in the large cities like London and New York. Real estate companies are repurposing unused office space into other types of real estate, such as residential or retail. Marcus Ruhmann, Corporate Lawyer, Schalast, Germany shares an example: ''Most banks have basically cut office space by 50% and if they couldn't get rid of it immediately, because they have long lease leases, they have started to sublet. That's become a huge market in Germany at the moment.'' This reduces the need for new construction and limits the environmental impact of building new properties.

In Europe, the subletting business is growing, and some offices are being re-envisaged as residential properties in large cities. The private renter sector is also growing, and the development of properties to rent is becoming more popular. From an Eastern European perspective, there is a shift from private equity and real estate funds from the Baltic states to Poland. Ukrainian business is also moving to Poland and further afield. Ukrainian funds are seeking opportunities outside Ukraine, as they want to move their operations further afield to Europe and even the US or Canada. Anna Wyrzykowska, Partner WKB, Poland, says ''in Poland the private rental sector is growing due to rising inflation and other challenges that are not allowing people to buy their own apartments''.

Looking towards North America, the amount of money flowing from the federal government to the states and for programming in the collective space is vast in the US. Under President Biden's Inflation Reduction Act, billions of dollars are available. Carbon sequestration for electric car charger investments, for solar and other renewables from the investment tax credit side, and for infrastructure that reduces greenhouse gas emissions. Over the next three to five years, and particularly in the United States, the number of dollars that will be invested in what we consider sustainable or green infrastructure, buildings and materials will be high in the United States.

''Eventually we will see a trend in the reduction of office space,'' predicts Alex Prew, Partner, Penningtons Manches Cooper, UK. ''When leases gradually expire businesses will take the opportunity to downsize because of their adaptation to hybrid working. We are still waiting to see how the UK economy will react to a possible downturn and with it the employment rate. But one thing that is happening is a slowdown in office development, so it will be interesting to see what impact a lack of stock in quality office space could have as the economy improves in the next couple of years.''

Overall, real estate businesses are adapting their sustainability efforts to the changing market conditions brought on by the pandemic. By implementing energy-efficient technology, using renewable energy sources, adhering to green building standards, and encouraging sustainable transportation, they can continue to reduce their environmental impact while also meeting the evolving needs of their tenants.

55%

OF REAL ESTATE BUSINESS LEADERS SAY RENEWABLE ENERGY WILL BE THE MOST IMPORTANT TECHNOLOGY FOR THEIR BUSINESS IN THE NEXT 5 YEARS

PROPTECH TO DRIVE SUSTAINABLE PRACTICES

New technology innovation is one of the answers to adopting more sustainable practices. Not surprisingly, many investment dollars are being directed at technology to make real estate more environmentally friendly.

One of the major trends in PropTech is the use of smart building technology to monitor and reduce energy consumption. Sensors and IoT devices can now be installed in buildings to track energy usage, water consumption, and other metrics. This data can be analysed to identify areas where energy is being wasted and make changes to reduce usage. For example, lighting and heating can be automatically adjusted based on occupancy, and smart irrigation systems can be used to reduce water usage.

''There's a lot of PropTech being developed that is able to collect and measure data and report about sustainable practices to not only focus on your own sustainable practices, but also of your suppliers too, to develop that whole supply chain that is sustainable,'' says Paul Ashburn, Co-Managing Partner, HLB Thailand.

Another trend in PropTech is the use of sustainable building materials and practices. Buildings can be constructed with materials that are environmentally friendly and energy-efficient, such as recycled or locally-sourced materials. Advanced construction techniques can also be used to reduce waste and minimise the impact on the environment.

Virtual reality and augmented reality are also being used in PropTech to visualise building designs and simulate how they will function in the real world. This can help architects and builders make more informed decisions about building design and materials and identify areas where sustainability can be improved.

In addition, PropTech is driving the adoption of renewable energy sources in real estate. Solar panels and wind turbines can be installed on buildings to generate clean energy, and energy storage systems can be used to store excess energy for later use.

Overall, the trends in PropTech to drive sustainability in real estate are exciting and promising. By leveraging technology to monitor energy usage, use sustainable materials and practices, and adopt renewable energy sources, the real estate industry can make significant progress towards a more sustainable future.

70%

OF REAL ESTATE BUSINESS LEADERS FEEL CONFIDENT IN THEIR ABILITY TO GROW REVENUE IN 2023

LOOKING AHEAD

It is safe to say that an increased focus on sustainability will continue to shape the real estate sector in the years to come. Governments are increasingly holding corporations and landlords accountable for the sustainability of their buildings, inevitably leading to tenants and consumers footing some of the costs where renovation and upgrades are concerned. Yet, the demand from society for more sustainable practices increases too, posing great opportunity for real estate businesses.

Brad Molotsky, Partner, Duane Morris USA, believes that ''...over the next three to five years, and particularly in the United States, the amount of dollars that will be invested in what we would consider to be sustainable or green infrastructure and buildings and materials will be quite high. There's a lot of investment capital being directed to energy efficiency and indoor air quality and renewable energy, on the IAQ front focusing on not only fresh air intake but in cleaning the air indoors as well.''

While there is no denying real estate faces challenges in the current climate, the events of recent years and the rising need for sustainability are forging a bold new path for the sector.

ABOUT THE HLB AND MULTILAW PARTNERSHIP

As we're always seeking the best opportunities for our members and clients, the purpose of our collaboration is to unlock business opportunities for real estate clients working across the globe. We are committed to supporting real estate businesses in navigating complexity and developing sustainable strategies that deliver long-term value. If you would like to discuss any of the topics raised in this report, we welcome the opportunity to do so.

Get in touch with HLB for accounting and advisory services via realestate@hlb.global

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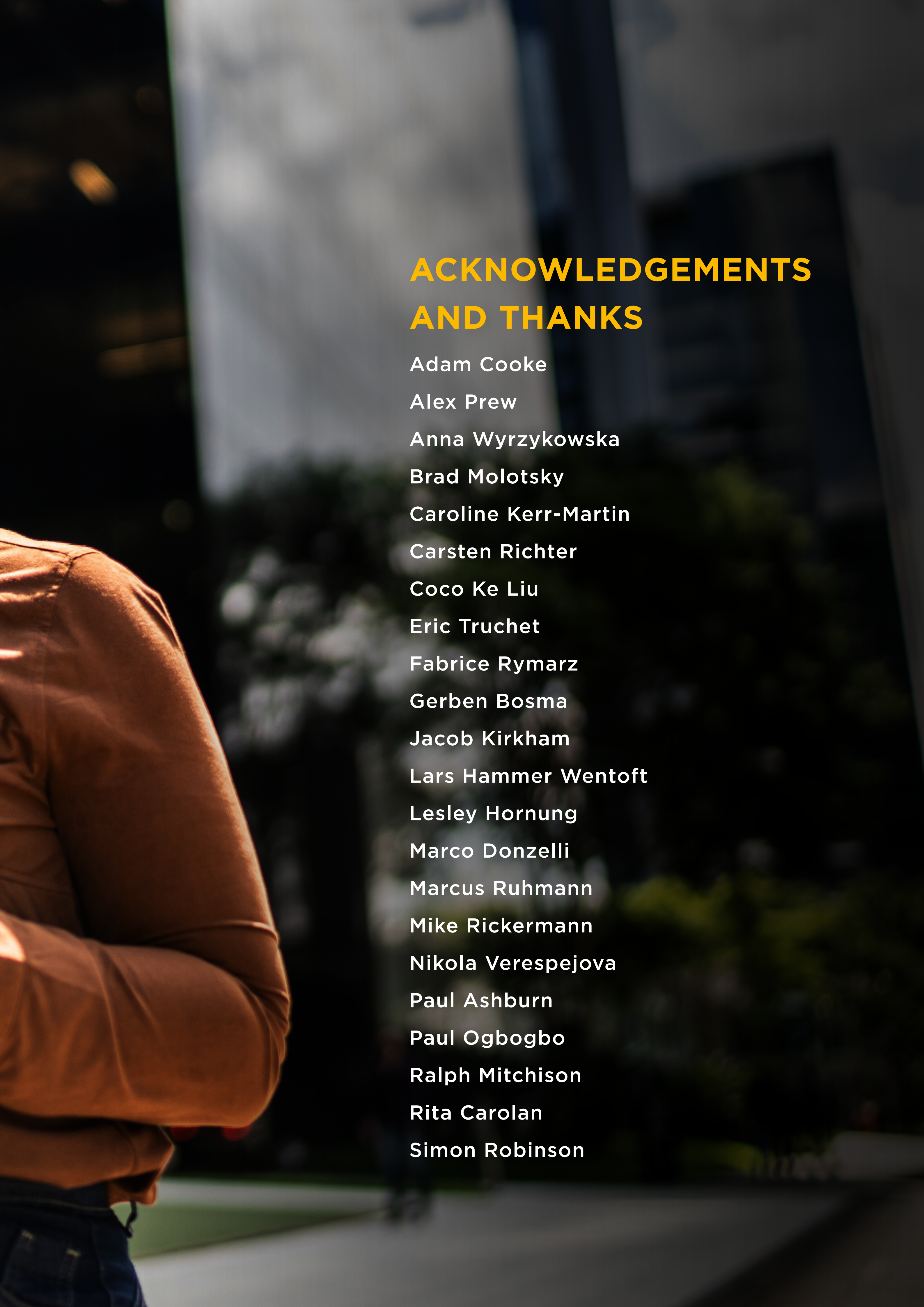

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