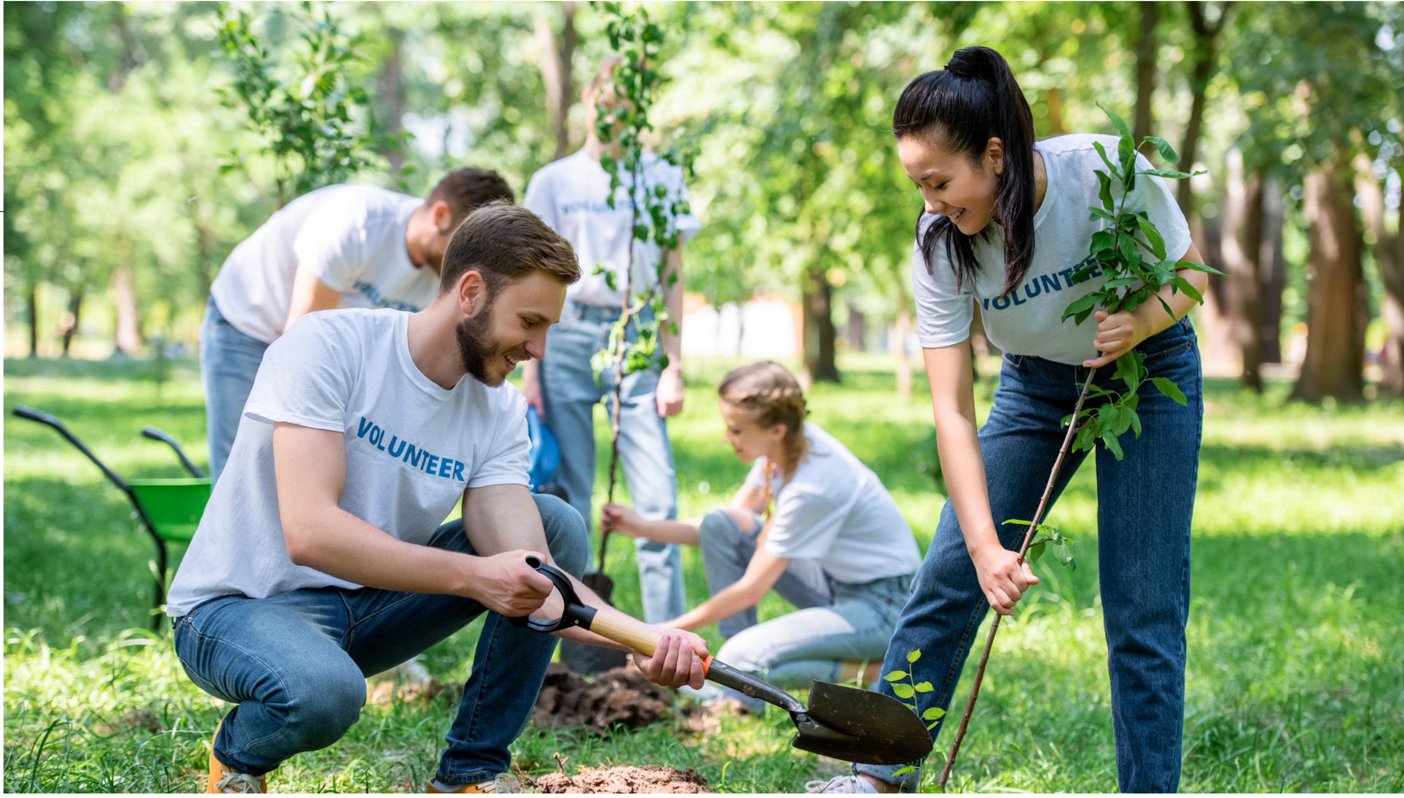
CBRE

The Role of ESG in the Multifamily Property Market

Considerations for The Irish Market

June 2021



Introduction

For some time now, the role of sustainability in the property life cycle has been escalating. Environmental, Social & Governance (ESG) has come to even greater prominence as a result of the Covid-19 pandemic. Health and wellbeing along with environmental considerations have been moving up the priority list for developers, investors, funders, occupiers, Governments and other stakeholders, all of whom are increasingly focussed on environmental impact, energy efficiency and decarbonisation.

"Sustainability will play an increasingly important role in the residential property market over the next decade"

Demand for sustainable energy efficient buildings has long been evident in the commercial property sector with occupiers and investors alike vying for the most sustainable buildings and in many cases willing to pay a premium for same. However, there is reason to believe that sustainability will play an increasingly important role in the residential property market over the next decade. As climate change and sustainability become increasingly topical and the merits of embracing ESG become more evident, we will see more people aspiring to acquire and live in green homes. However, with more people globally opting to rent residential accommodation and institutional multifamily product being developed specifically to cater for this emerging trend, it is timely to consider how ESG will evolve in the multifamily sector of the residential market.

This issue has particular resonance for countries such as Ireland where multifamily development is at such an embryonic stage. Arguably, with lots of new purpose-built rental stock being developed, there is an opportunity to embrace ESG from the outset of the development process and in doing so future-proof these buildings.

While trends are still evolving, this report aims to explore the role that ESG may play in multifamily developments in the future and the trends that we might expect to see emerging over the coming decade both from an asset and market perspective.

The report considers the various E, S and G initiatives that can be explored in order to achieve more sustainable multifamily developments. It also explores the extent to which investment in sustainability measures will impact on cost, viability and deliverability of rental product as well as considering longer-term value implications for multifamily portfolios.

More fundamentally, it questions the extent to which end users, i.e. those renting multifamily housing, want or expect sustainable accommodation and if renters are willing, or indeed in a position to sustain higher rental costs in exchange for environmental credentials.

Why is Sustainability Important?

As sustainability has become increasingly topical over recent years, demand for energy efficient and sustainable buildings has increased substantially - a trend that has become even more evident since the onset of Covid-19. Indeed, two thirds of key investors in CBRE's EMEA Investor Intentions Survey in 2021 said that they have already adopted ESG criteria into their investment practices and processes. An ever-increasing number of organisations are aiming to become net zero carbon businesses and reduce greenhouse gas emissions in in their buildings.

Meanwhile, many new sustainable impact funds have been established to target investment opportunities in this sector. Interest in sustainability is emanating from a myriad of stakeholders including those developing and investing in real estate but increasingly from those occupying buildings also.

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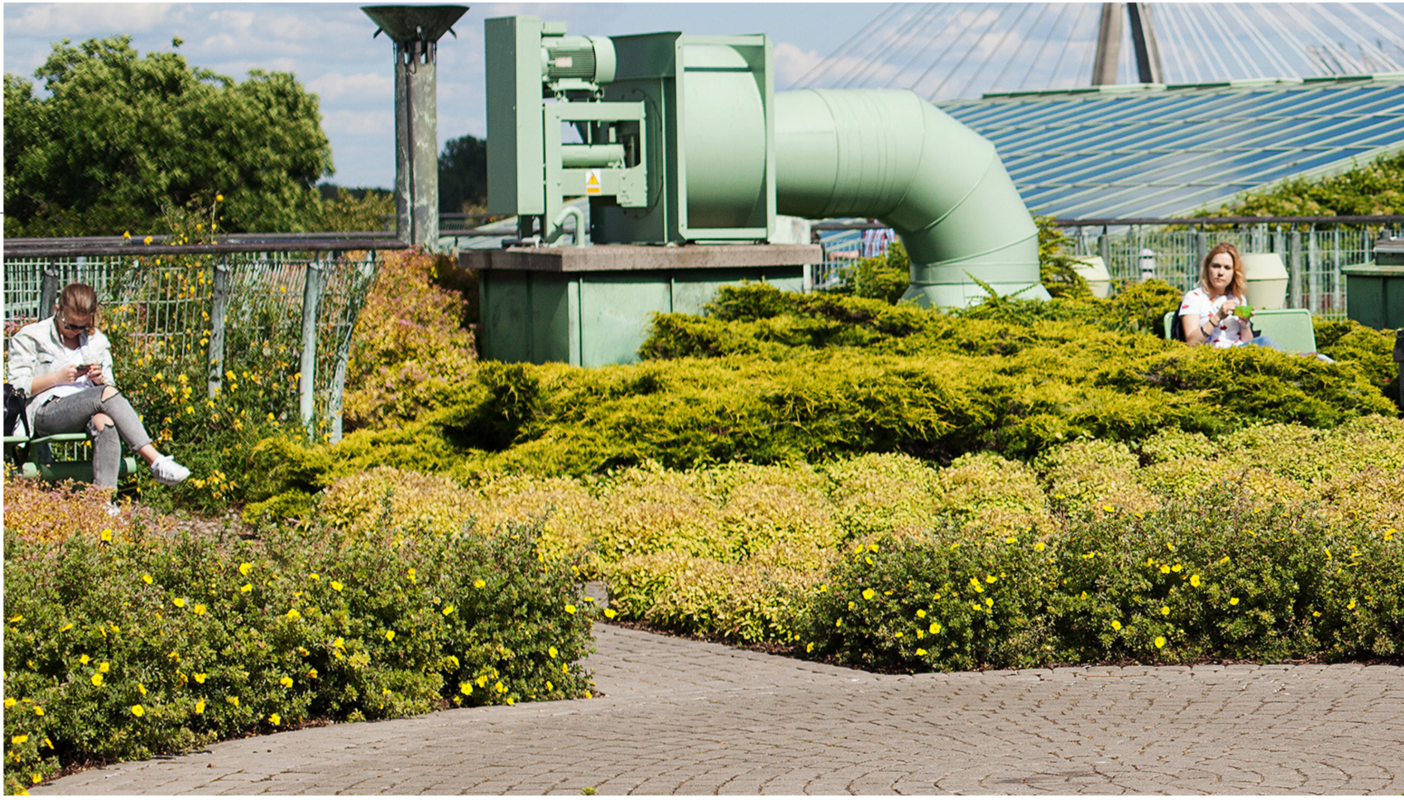
ESG is no longer about limiting environmental impact but has a much wider remit. Companies and individuals

are now looking to maximise what they can do from an ESG perspective and aspire to making a difference. Most real estate providers now realise that if they do the right thing from an ESG perspective that this will ultimately improve the marketability and liquidity of their assets and generate higher returns in the long-run while also improving operational efficiencies and running costs.

Investors and financiers in turn are favouring the greenest and most sustainable buildings with evidence of a green premium or brown discount becoming increasing evident from a valuation perspective. To date, much of the focus has been on commercial real estate. While individual householders have been leading the move towards sustainability in the residential sector, we are now beginning to see increased focus on ESG in terms of multifamily development.

With this form of tenure at such an early stage of development and adoption in markets such as Ireland, there is huge opportunity to fully embrace sustainability and develop multifamily stock that is best in class from an ESG perspective. Much of the multifamily stock that is being developed is purpose-built and therefore



adheres to current regulatory requirements such as Near Zero Energy Buildings (NZEB) and Building Energy Rating (BER) certifications so is already well on its way to demonstrating favourable sustainability characteristics.

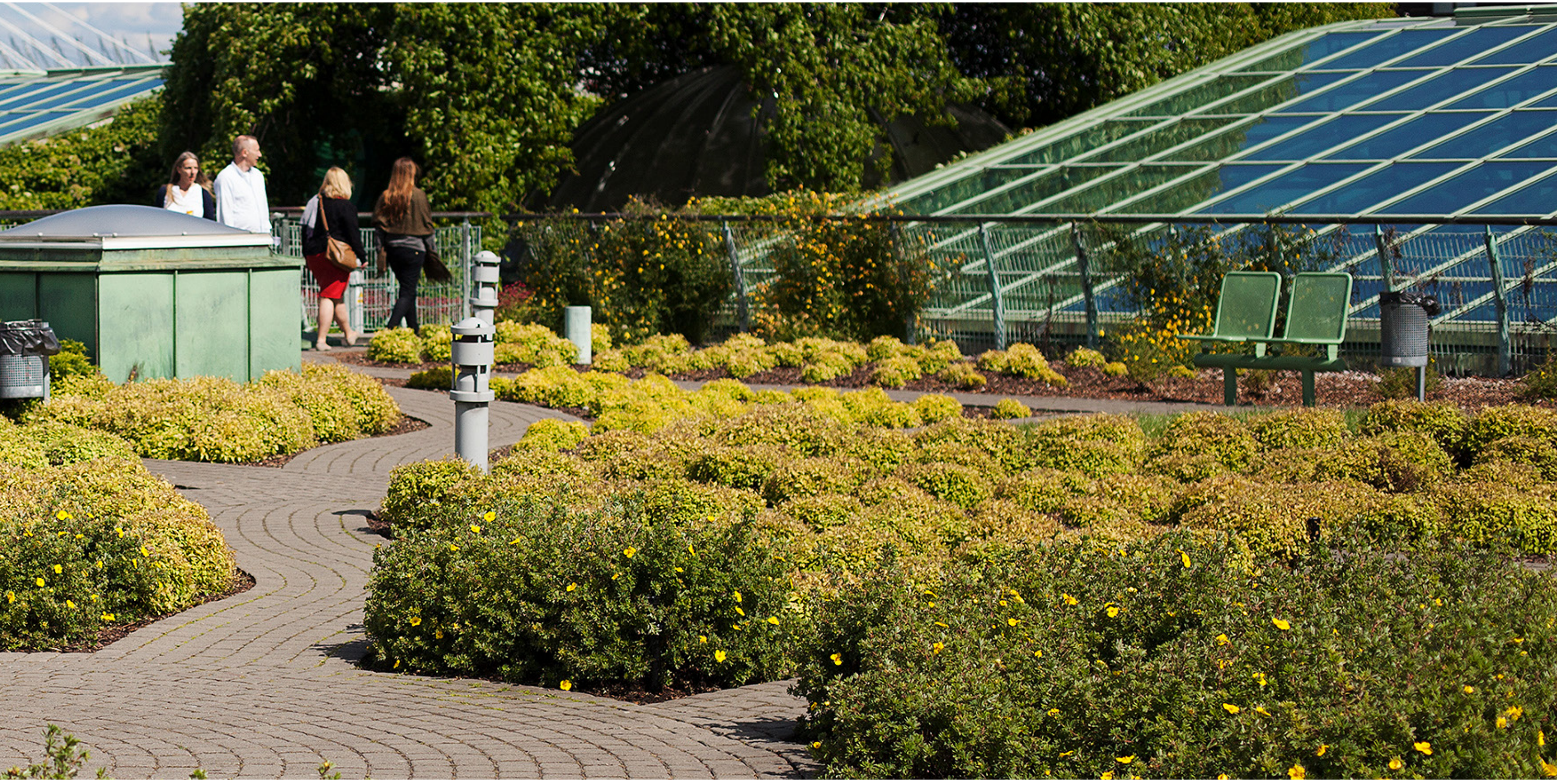
However, the focus is now moving away from regulation and design elements and focusing on other construction and operational aspects that also have a part to play in improving overall ESG credentials within a development.

Sustainable urban developent is now a key focus for Governments, not least in Ireland where between 20% and 50% of schemes in some local authority areas can be potentially ring-fenced for the provision of social and affordable housing. Investors are increasingly focusing on the interplay between schemes and the surrounding area on the basis that it has a bearing on the future 'attractiveness' of a location, with the '15 minute city' concept top of mind.

Do Renters Want or Expect Sustainable Buildings & Are They Willing to Pay for ESG Credentials?

One can understand why those purchasing or building their own homes are increasingly looking to live in green homes. Therefore, it stands to reason that those renting accommodation should be equally mindful of ESG criteria when choosing where and how to live. If given a choice, those renting residential accommodation would surely also opt for energy efficient sustainable buildings over the alternative. The millennial generation, who generally make up the biggest cohort of renters within multifamily schemes, have grown up with a heightened awareness of climate change and sustainability and understand its importance. We can therefore conclude that renters both want and expect sustainable accommodation options.

However, developing sustainable buildings can be costly and what is yet unproven is whether renters are prepared to pay extra for a more sustainable offering, especially in markets such as Ireland where supply is so constrained, and rents are already expensive. Developers want to be ethical and develop the best quality residential product but there is a cost associated with doing so and in markets where rent affordability is already an issue, the end user is not going to want to, or indeed be in a position to, pay extra for sustainable features despite expecting them to be in place.



In the multifamily sector, occupiers are primarily focussed on key attributes of schemes such as accessibility; the quality of fit-out, design and amenity; digital connectivity and to a lesser degree sustainability and environmental issues but the reality is that the cost of rent is the primary determinant in their choice of where to live. It must also be remembered that 'sustainable' is a very broad term and means very different things to different stakeholders.

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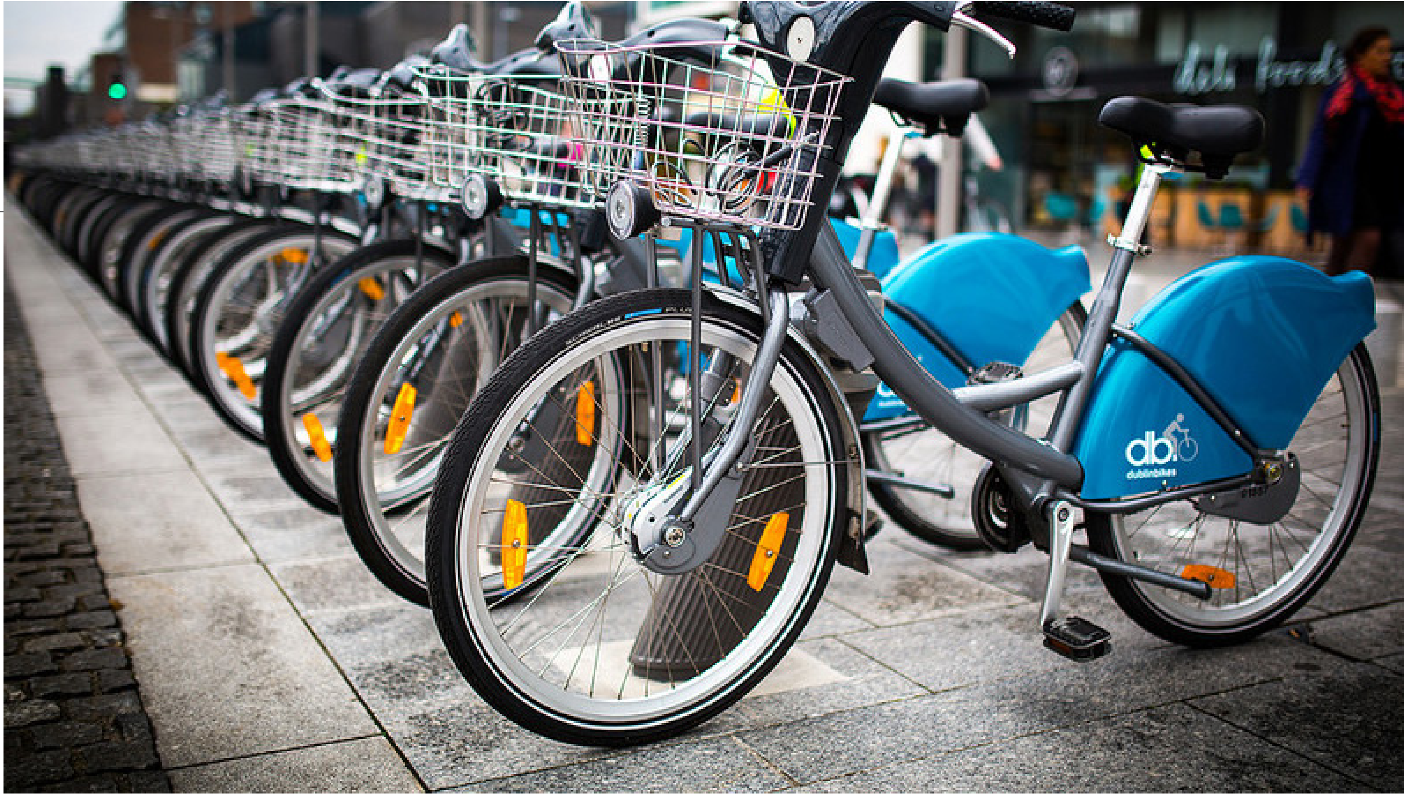
While all renters will opt for the most sustainable option if offered the choice, they will be less inclined to pay extra for the privilege of living in a sustainable scheme unless perhaps it can be demonstrated that significant cost savings can be generated from reduced utility bills as a direct result.

If Renters Are Unwilling to Pay Extra for Sustainable Features, Why Would Multifamily Developers Incorporate Anything Other Than What is Required Legally?

Although less of an issue in the current market in Ireland, where rental supply is so tight, environmental credentials can have significant marketing benefits where developers can demonstrate the tangible sustainability measures that occupiers in their scheme will benefit from in comparison to competing schemes. In locations where supply and demand are in broad equilibrium, sustainable multifamily developments should generate higher rents and demonstrate higher occupancy than competing schemes that don't have equivalent ESG credentials.

Developers should be mindful of this and look to incorporate sustainable features into their developments to improve liquidity and future-proof their multifamily developments.

This doesn't mean incorporating every single element of the E, the S and the G, which would clearly render development unviable, but rather incorporate



elements that are sensible for that particular scheme or location which in time will preserve the value of their investment.

Are Sustainability Certifications & Accreditations Necessary?

While industry certifications such as BREEAM, GRESB, WELL, LEED and others are well established and are recognised brands in the commercial property market, they have been somewhat less visible in the residential sector although this is now starting to change. The expectation is that we will see more streamlining over the coming decade with these and other accreditations becoming increasingly popular in the multifamily sector as developers and investors seek to future-proof and improve marketability of their schemes.

In the Irish market, none of these accreditations are mandatory at present and the expectation is that if developers opt to apply for these accreditations in time, it will be in an effort to set their schemes apart from competitors and improve marketability albeit they are unlikely to be hugely meaningful to end users, who are likely to be more influenced by local regulatory badges such as NZEB and BER ratings.

BER NZEB

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Another accreditation that is likely to become more prevalent in the Irish market is the Home Performance Index, which has been developed by the Irish Green Building Council as the first sustainability certification for new Irish homes.

This accreditation goes beyond BER to address all environmental impacts of new home construction such as the production of building materials, impacts on ecology, pollution, water consumption and flood risk and also encourages home builders to improve the health of new homes by improving daylighting and acoustics and minimising the use of chemicals.

The expectation is that this accreditation will in time be one used by multifamily developers in the Irish market albeit international investors may also opt to apply for LEED and BREEAM and other internationally recognised accreditations in order to benchmark the sustainable performance of their multifamily holdings and future-proof the liquidity of their investments. While accreditations are generally valued by developers and investors in schemes and those funding their development, the reality is that accreditations are of less interest to the end users of multifamily schemes, who are more influenced by the cost of rent than other elements. Some developers opt to avoid labels and plaques on the basis that they only measure 'point in time' performance as opposed to ongoing performance and will opt instead to focus on monitoring operational performance over the lifetime of the development on the basis that this is a more meaningful contribution to sustainability efforts.

What E, S and G elements Can Be Incorporated into Multifamily Developments?

ESG in itself is very broad and no scheme can aspire to tick every box, not least because of the cost of providing every aspirational element, which is ideological and would invariably render development unviable. However, those developing multifamily schemes are increasingly looking at all of the options that come under the E, S and G banner and determining which elements they can realistically incorporate into schemes to make them more sustainable and efficient to operate.

"It is arguably the social element of ESG where multifamily developers can make the most fundamental difference to the end user experience"

There are lots of environmental elements that can be incorporated into new build multifamily schemes, some of which are required from a regulatory or Governance perspective in any event. For example, the Near Zero Energy Building (NZEB) regulations, which became mandatory in Ireland in 2019 and the Building Energy Rating (BER) certification, which came into force ten years prior to that, mean that most new build multifamily stock is already built to very high specification from a sustainability perspective.

Therefore, with regulation already enforcing many environmental and governance elements, it is arguably the social element of ESG where multifamily developers can make the most fundamental difference to the end user experience. If multifamily developers and owners are long-term investors (as many of Ireland's multifamily investors claim to be) they should have a vested interest in creating sustainable communities and improving social elements of the schemes they are delivering.

Defining social value can be more challenging than environmental value as social value can change depending on context. According to the UK Green Building Council, social value is created *"when buildings, places and infrastructure support environmental, economic and social wellbeing and in doing so, improve the quality of life of people"*. While most developers already do this, how do you quantify the financial impact of what you give back to a community or the social benefits you provide by improving the public ream and investing in placemaking efforts?

Social value initiatives will be different for different schemes on the basis that they need to be specifically designed and tailored to the needs of the community in which they are situated. There are a number of social value frameworks in use in the UK market, such as the UK GBC Framework for Defining Social Value.

Below is a non-exhaustive list of some of the environment, social and governance initiatives that multifamily providers can consider providing in order to improve the sustainability of schemes they are designing, developing, owning, operating and managing. As outlined previously, it will not be possible to incorporate all of these in any particular scheme and a strategic approach should be taken to balance the cost benefit of any sustainability strategy. While some of these will be obligatory in different jurisdictions, others are optional but desirable.

Environmental

- Demonstrating efforts to mitigate carbon emissions and combat climate change through construction methods, design and use of materials
- Installing technologies & systems to reduce energy consumption such as:
  - High-quality building fabric
  - Using passive design principles
  - Efficient heating and cooling systems
  - Onsite renewable energy sources
  - Smart building technologies to report and manage resource use
- Providing alternatives to private car use such as walking, use of public transport, bikes and improving connections with local amenities
- Monitoring pollution levels and demonstrating efforts to mitigate same
- Demonstrating where renewables can be used in place of alternatives
- Having clear waste management and water consumption procedures in place and encouraging residents to adhere to principles
- Incorporating biodiversity features such as green roofs, beehives, wildflower gardens & sponsorship of biodiversity initiatives in the locality
- Being mindful of the supply chain of materials
- Incorporating electric vehicle charging points within the development
- Incorporating rainwater harvesting systems
- Using biodegradable, recyclable and natural materials and compostable building materials & furniture
- Investigating new construction techniques that reduce the building's carbon footprint such as modular construction
- Introducing incentive schemes for residents to encourage use of technologies and rewarding those who embrace sustainable practices

Social

- Demonstrating efforts to provide homes that are affordable to those on low incomes, including adherence to local regulations regarding ring-fencing particular percentages of schemes for social and affordable purposes
- Listening to and including residents and facilitating communication channels and events to foster a sense of community within developments
- Creating sustainable, lively and inclusive communities which offer easy access to amenities within walking distance
- Carrying out a local needs analysis to identify local issues in order to devise solutions and initiatives that genuinely target the issues that are local to that specific area or development
- Demonstrating efforts to protect residents and keep buildings safe
- Demonstrating efforts to support Human Rights and Inclusion & Diversity with the development
- Demonstrating efforts to promote health and wellbeing of residents
- Ensuring all aspects of the scheme are accessible to all ages and abilities
- Ensuring amenities, public realm and placemaking efforts are available to residents and non-residents alike for the good of the wider community
- Using local businesses in the supply chain and employing locals on site during the construction and operational phases
- Providing employment training for those living in the area and organising educational and cultural programmes for local schools or community groups
- Encouraging residents to eliminate food waste and paper and packaging waste
- Providing grants and sponsorship and volunteering to charities that benefit the local community

Governance

- Committing to transparency through the reporting of ESG performance
- Demonstrating internal ESG leadership and clear responsibilities for performance
- Demonstrating adherence to local regulations
  - A-rated Building Energy Rating (BER) standard
  - Near Zero Energy Building (NZEB)
- Delivering Home Performance Index certifications that result in the delivery of homes that are sustainable and efficient to run
- Putting in place a credible cybersecurity plan
- Demonstrating adherence to data protection, privacy & governance and risk management procedures
- Being able to demonstrate the highest standards of legal and regulatory compliance
- Incorporating ESG clauses in leases
- Demonstrating the highest standards of ethics and compliance and employment of a diverse team
- Demonstrating responsible Procurement & Supply Chain principles
- Ensuring the health and wellbeing of all staff involved in the scheme

Is Incorporating ESG elements Into a Scheme Enough?

The simple answer is no. Developers and owners of multifamily developments can incorporate all manner of ESG elements into a scheme but without engagement from those occupying the units, i.e. the renters, the full impact will not be achieved from an operational perspective. Investing in the right technologies is important in tracking environmental benefits such as the use of renewable energy for example, but occupiers need to know how to use the technology and be encouraged to use it for maximum impact.

Environmental measures such as installing energy management systems, conducting energy audits, installing LED lights etc are all relatively easy to do but developers and owners of multifamily schemes need to be mindful that tenants also generate emissions and need to be encouraged and possibly incentivised to use the technologies at their disposal.

Developers, owners and mangers/ operators of multifamily schemes therefore need to champion the cause of reducing consumption and enable occupiers to use the technologies and systems provided. It is their responsibility to put occupiers on a sustainable journey by letting them see at first hand the cost savings and benefits they are making to the planet by their individual and collective actions.

Will Incorporating ESG into A Multifamily Building Improve its Value?

It has been clearly demonstrated in recent years that investors and in some cases occupiers in the commercial property sector are prepared to pay more for buildings that demonstrate the best sustainability criteria. In time, this trend is expected to become increasingly evident in the multifamily sector also with more investors insisting on minimum ESG criteria in underwriting investment opportunities and some impact funds focussing specifically on sustainable opportunities.

We expect to see a widening delta between core buildings that offer the highest standards in terms of ESG and older secondary buildings that will require considerable retrofitting in order to bring them up to minimum standards. Investing in making a scheme more sustainable will generally cost more upfront but it will benefit in the long term by future-proofing

the investment, generating sustainable long-term income with less obsolescence and lower operational costs. It is no longer a case of considering if you can afford to integrate sustainability elements into a multifamily scheme but rather a question of considering if you can afford not to. However, as stated previously, incorporating ESG can be prohibitively expensive. Multifamily developers therefore need to be mindful of developing sustainably but also sensibly so as not to impact negatively on viability and deliverability of the overall scheme.

Sustainability is a cost that must be considered over the full life cycle of the development and needs to be considered from both an operational and capital expenditure perspective. It will not be possible to incorporate a multitude of E, S and G elements but developers should be aiming to incorporate as many elements as possible. In underwriting investments, one must allow for the fact that sustainability requirements may well become more onerous in time, albeit there may be tax breaks or Government subsidies to help negate the cost of adherence or retrofitting necessary.

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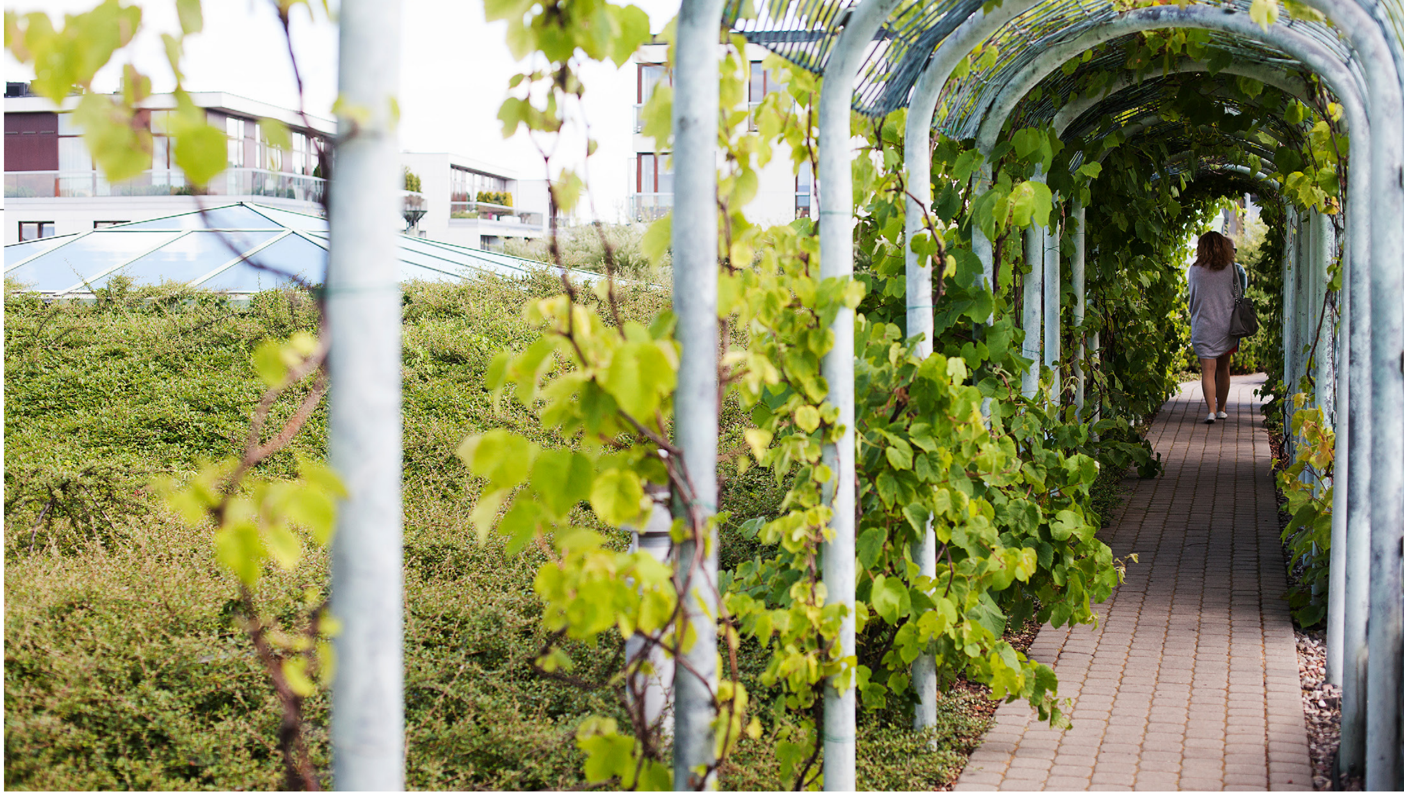
One thing that is clear is that there will be a deeper pool of investors for ESG compliant assets in the future. However, it is important to point out that this will also lead to asset management opportunities for investors who are interested in retrofitting older stock.

Where to From Here?

Developing sustainable multifamily buildings makes financial sense and is clearly 'the right thing to do'. Although there can be a cost associated with it, which is unlikely to be directly recouped from end users, incorporating ESG elements into multifamily developments will have a positive impact, not only on the health and wellbeing of those living within these developments but also on the value and liquidity of the buildings over the longer term.



The key challenge in improving sustainability in the residential sector will be affordability. It would be foolish to let ideology drive the agenda so developers of new multifamily schemes or those retrofitting older schemes will ultimately have to be selective in deciding how to incorporate environmental measures within their schemes so as to ensure viability and ultimately affordability for end users.

"Ireland has the potential to lead the way in terms of the delivery of sustainable multifamily product"

Embracing ESG is clearly not just the responsibility of developers and owners - the end users of schemes and those managing and operating them also have an important role to play if the full benefits of sustainability are to be maximised.

When considering the ESG approach of a residential development, a strategic approach should be taken to balance benefits for residents, community and investors, with the capital cost of incorporating sustainable design elements.

Design and construction should also be flexible to accommodate new technologies and ways of living as they evolve. Incorporating ESG credentials is easiest at the design stage of the development process.

Therefore, considering that Ireland is at a very early stage of multifamily delivery and with a good regulatory regime already in place for new development, Ireland has the potential to lead the way in terms of the delivery of sustainable multifamily product.

Doing so will help achieve sustainable urban development and also aid efforts to create the '15 minute city' that so many cities aspire to.

Considering the age profile of those typically renting accommodation in multifamily schemes, there is significant opportunity to shape the behaviours of a generation and encourage more sustainable living.

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