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Real Estate Benchmark Survey 2021

ESG – a major transformation in the real estate industry

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Real Estate Benchmark Survey 2021

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A Times of change – an industry begins to transform

Nowadays, it is impossible to imagine discussions without including the topic of sustainability. Market conditions have changed due to a shift in demand and a regulatory requirements increase, forcing the real estate market to reevaluate its strategic position. Early movers have long since integrated the topic, while new providers are penetrating the sustainable investment market, and existing ones are looking to undergo a transformation. To fully appraise the current situation, we conducted a structured survey of the real estate market. The scope predominantly included capital management companies (CMCs). However, other market participants investing in real estate also participated in the survey: Crowd-investing platforms, real estate finance companies, unregulated asset management companies, insurance companies, depositories. The majority of the companies surveyed are domiciled in Germany.

The survey focuses primarily on strategic and product-related issues as well as the impact on organization structures. Regarding the product classes, all real estate-related structures and products are included, the survey is a good indicator of the market average.

B Summary

The companies surveyed have already recognized the strategic relevance of the sustainability topic and are starting to take initial steps toward more sustainability. Increased demand, pressure from investors and mitigating reputational risks are key drivers behind integration of sustainability. However, a large majority of those surveyed see the first step in the transformation at the product level, before subsequently adapting the corresponding processes and structures in the organization. Only around 7.7% of respondents are currently undertaking a comprehensive transformation of their organization and strategy.

On the contrary, regulatory requirements are perceived as an opportunity – even if they entail more effort and expense in terms of implementation. Participants view market standards, approved metrics and assessment methodologies in particular as beneficial for investment processes in order to initiate long-term changes. The positive effect of the EU Sustainable Finance Action Plan on the market for sustainable investments is virtually undisputed.

According to more than 60% of the respondents, environmental, social and governance (ESG) transformation is scheduled to start within six months, which is consistent with PwC's experience: Transformation starts quite early in some areas, whereas considerably more time is needed for transforming the entire organization as well as for implementation.

The performance of sustainable versus conventional products has already been adequately discussed in the past. More than 80% of the market considers the performance of sustainable products to be competitive and sees advantages in terms of their risk profile.

Interestingly, while more and more investors are demanding sustainable products and greater transparency regarding sustainable investments, the respondents believe that they are not willing to accept poorer performance. Therefore, asset management companies are increasingly faced to the communication strategies challenge and presenting their activities as transparently as possible.

Implementation involves the entire organization – this is how respondents see it and it is also part of PwC experience. However, implementation is gradual and iterative – depending on how ambitious the organization is. External service providers are to be enlisted to support implementation, at least on a short-term basis. Sustainability is to become internalized in the long-term, which clearly indicates that companies do not view ESG as a short-term trend. At present, responsibility for putting ESG into practice is located primarily within strategic positions.

Perceptions regarding the impact that the COVID-19 pandemic has had on sustainability are currently mixed. Although the market estimates that social issues have become more important, the topic of the environment and general interest in sustainability have not changed significantly as a result of the pandemic. The decisive factor may be that the industry had already taken its first steps towards more sustainability last year and before the pandemic.

We set out the following assumptions regarding the future of sustainability:

1. **Holistic sustainability strategies will drive C-level decision-making.**
2. **Availability of ESG data will improve over mid-term.**
3. **Demand for sustainable investments will continue to grow.**
4. **Sustainability has many facets – so do sustainable investment strategies.**

1 Background and approach

The questionnaire comprised 31 subject-specific questions on “sustainability in the real estate industry”. To rule out the possibility of inconclusive responses, the questions were structured in such a way that the respondents had to select a preference when answering.

The statements below result from the examination of hypotheses drawn from our project work on sustainability and ESG products, as well as from our dialog with associations in the real estate industry and expert discussions within the PwC network. The results of the survey were used to validate or refute these hypotheses.

C Sustainability and climate protection are key challenges facing our and subsequent generations

The integration of sustainability stopped being a niche topic some time ago. A wide range of industries recently realized that sustainability is not only positive for our environment, but can also be the basis for a profitable business model. The real estate industry in particular is on the verge of a huge transformation. It is clear that the high level of carbon emissions directly and indirectly linked to real estate will require specific action on environmental factors in the years ahead. However, discussions around socially acceptable projects and innovative solutions by a new and far more demanding generation regard to sustainable practices will also present the industry with new challenges.

Investors, fund and asset management companies, portfolio managers and developers are particularly impacted as a result of two interrelated trends:

1. Investors and tenants are demanding sustainable and future-oriented solutions.
2. Regulatory requirements for sustainability are being tightened continually around the world.

Investors in particular have adjusted how the risk/return profiles of their investment decisions are evaluated by including sustainability criteria in their investment decisions, thereby helping to boost the market for sustainable investments.

Changing preferences among a new generation of investors, employees and tenants also play a role in ensuring that new products and property developments meet requirements. For fund products, this means they firstly have to be transparent about whether and to what extent sustainability factors are integrated into investment strategies, investment processes and risk management. Secondly, sustainable and innovative selection criteria are also becoming more and more important at the asset level in order to meet approval requirements when selecting properties, to secure investments and to meet tenants' demands.

Sustainability has also become much more important in legislative procedures around the world. Stricter transparency requirements and the regulation of the advisory process in the EU are also fueling demand for sustainable investment opportunities. The USA, India and China have announced extensive investment programs to improve sustainability, and their economies are on the verge of a huge transformation. In this context, China has set itself an ambitious environmental goal for 2060.

With its comprehensive EU action plan on sustainable finance, the EU has covered the entire value chain of a range of sectors – including the real estate industry – and aims to steer capital flows toward a sustainable economy by means of transparency requirements and organizational integration.

The strong growth in demand for sustainable products as well as additional regulatory requirements increasingly pose new challenges for asset management companies, project developers and investors require them to consider their strategic positions and their own level of ambition – both at company and fund level.

This survey combines the views of leading real estate asset management experts and the experience gained by PwC's Real Estate Consulting Team in its current advisory practice.

> *It is no longer enough for sustainability to be part of a corporate philosophy purely for marketing or image reasons. A sustainability transformation in the real estate market is long overdue. The real estate industry is asking itself how change can be turned into an opportunity and how to optimally combine this change with a strategic reorientation.*
>
> Thomas Veith, Real Asset Leader Germany

D ESG in fund strategy

A company's strategic orientation has always been one of the key factors determining whether or not it will be successful in the market. Therefore, both then and now, it is important for companies to convince their customers that the products and services they provide deliver added value. What happens when there is a fundamental change in how customers perceive the benefits of these products and services?

A study conducted by the German Federal Environment Agency showed that the general public's awareness of the need for environmental and climate protection has grown considerably in the past four years. While 53% of respondents identified environmental and climate protection as a major challenge in 2016, this figure had jumped to 68% by 2019. This increased awareness of the need for environmental and climate protection goes hand in hand with a related effect on consumer behavior. Companies are confronted by the different consumer behavior of a new generation. How can companies respond and adapt when consumer behavior changes?

The answer is clear: Companies have to adapt their products and services to meet their customers' requirements. In addition to well-established decision-making criteria such as what they perceive as value for money, customer loyalty and availability, consumers are attaching greater importance to ESG factors when they are choosing products and services.

However, customers and product consumers are not alone in changing their requirements: Investors' investment expectations have also changed significantly. For example, they expect companies to adhere to sustainability standards in the value chain, that management can identify and track key ESG risks, are compliant with ESG regulations.

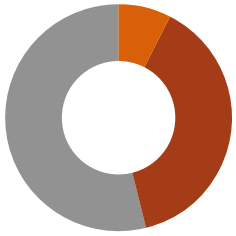
Investors demand high-quality and well-considered commitment, with which the company can showcase its qualitative aspects and management strength.

There are a range of ways to develop successful commitment strategies, such as roadshows, investor forums, events, management consultancies and independent surveys. To increase the efficacy of this commitment from both the company's and the investor's perspective, it is crucial that the company's agenda, as well as the expectations and reactions of investors and other stakeholders like service providers, tenants, employees and regulators are fully understood and taken into account.

1 Strategic positioning for real estate asset management companies

Google offers more than 47,000,000 results when you search for "sustainability" – a buzzword that has permeated today's public debate. But to what extent has this megatrend already been integrated into real estate companies' strategies? In general, it can be seen that against the backdrop of limited natural resources and a marked increase in socioeconomic awareness, the topic of sustainability has evolved into a cross-sectoral social issue in recent years. It is assumed that in five to ten years there will hardly be any public-sector institution left in Germany that is not making sustainable investments. But how can companies succeed in adapting to these new conditions and firmly enshrine carbon neutrality in all of their operations? To what extent is a strategic realignment of real estate companies necessary due to current market developments? And what are ultimately the main factors behind strategic positioning at real estate companies with regard to ESG?

Fig. 1 To what extent (due to ESG) are you planning a strategic realignment as a result of current market developments?



In the survey we conducted, more than 50% of the companies questioned stated that they were planning product-related, strategic realignments in response to current market developments. More than a third of those surveyed also stated that they intended to adjust their organizational structure and processes – ESG criteria also playing a relevant role in this study. None of the companies surveyed are not planning a strategic realignment, which clearly underscores the relevance of sustainability in the current market environment.

In response to the question on how they rate their strategic positioning in terms of sustainability relative to the market, over 84% of the companies surveyed identified themselves as early movers. This clearly shows that sustainability has become a management level priority, and the respondents believe that their competitors have room for improvement. No company currently views itself as a "laggard", which may be an indication that they are already dealing with the issue more intensively.

In this context, the question on the drivers behind ESG is very interesting: The participants rated six drivers behind their own company's strategic positioning based on the school grading system. "Increased demand for ESG products", the intrinsic motivation of stakeholders and regulatory requirements were cited as the most important drivers here.

> *Aligning products with sustainability at an early stage is above all necessary to respond to shifts in investor demand profiles. This is why, in our projects, we increasingly see asset management companies adapting their investment processes and converting existing products into ESG products while also developing and launching new ESG products.*
>
> Martin Weirich, ESG Asset & Wealth Management Leader Germany

Fig. 2 **How do you rate your strategic positioning in terms of sustainability relative to the market?**

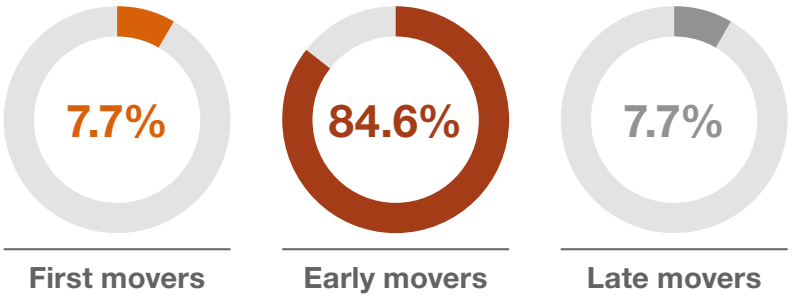
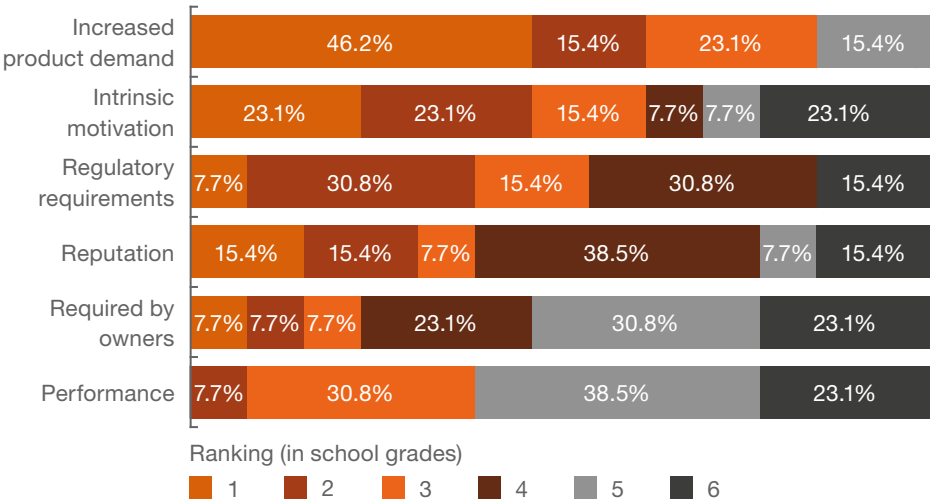


Fig. 3 **In your opinion, which of the following is a key driver behind your company's strategic positioning with regard to ESG?**



2 Strategy at product level

A strategic realignment is perfectly linked with a shift in the product portfolio. We are seeing this in the ESG environment as well. The first ESG-compliant products claiming to be ecologically sustainable and socially responsible as well as subject to strong governance are already on the market.

In the survey, 43% of the companies questioned stated that they were transforming their existing products in line with ESG criteria. 55% revealed that they were aligning new products with the ESG criteria currently in place. Here, too, it is clear that ESG has now emerged from its infancy on the product side, and that the market for new ESG-compliant products can be expected to grow in the months ahead.

Another reason to take ESG criteria into account, aside from enhanced performance, could be to avoid stranded assets.

3 The ESG regulatory framework – blessing or curse?

Sustainability development is gaining new momentum as the European Commission establishes a regulatory framework for sustainable investments and financing. The political goal here is ambitious: It involves commissioning the entire financial industry to achieve environmental and social sustainability objectives – with combating climate change foremost among them.

The distinctive characteristic of sustainable finance regulation is that it applies to the financial sector as a whole. Whereas EU regulation has thus far targeted specific parts of the financial industry, the set of measures under the EU Action Plan for Sustainable Finance affects all elements of the financial and asset value chain. This presents the entire industry with enormous challenges in implementing the ambitious requirements on an individual basis.

Europe is known worldwide for its solid regulatory and legislative framework, which also extends to ESG. The current momentum behind ESG is highly conducive for market growth and has driven its development from an idea to sustainable investment standards managed by EU regulatory authorities.

These EU regulatory authorities are increasingly aware of the role played by financial services in mitigating sustainability risks and have taken an increasingly rigorous approach to implementing the relevant legal provisions. Both EU Action Plan and Sustainable Financial Disclosure Regulation (SFDR) constitute a landmark change in the real estate industry that will transform sustainable finance from an option to a focal point for the European fund industry. Additional regulations will continue to standardize the way in which ESG products are handled in the future.

For example, starting in 2021, a number of fundamentally new regulations are being introduced along with amendments of existing regulations to ensure they comply with new sustainability standards. This creates a whole new set of non-financial standards for investors and other market participants.

We are already seeing a change in the status quo and real estate industry need to adapt. Within this new environment, sustainable investment is no longer an option, but a requirement if companies are to remain competitive in the medium- to long-term.

What does the Sustainable Finance Regulation entail exactly?

The European Commission is firmly committed to being a global leader in the effort to combat climate change. This means: Europe must become the first climate-neutral continent by 2050. To achieve this goal, EU is also seeking to oblige the financial industry to take appropriate action. The significance of the financial industry with regard to sustainability is also underlined in the European Green Deal, which the European Commission presented in December 2019 and forms the basis for its growth strategy aimed at achieving a climate-neutral Europe.

The magnitude of this task is huge: In order to meet the two-degree target set by the Paris Agreement, between 180 and 270 billion euros must be invested every year in sustainable growth on the European Union. The European Commission intends to accomplish this level of investment via an unprecedented rerouting of capital flows. The EU intends to define a regulatory framework for this purpose. This is why sustainability will be the main focus of European financial market regulation through the next year. At the same time, EU wants that agencies to take sustainability risks into account as key risk drivers going forward.

> *Transformation is becoming more and more urgent simply because of increasing regulatory requirements. The real estate industry is faced with the challenge of moving closer to the transparency levels of liquid markets. The proposed regulatory framework will facilitate standards in a highly fragmented market.*
>
> Thomas Veith, Real Asset Leader Germany

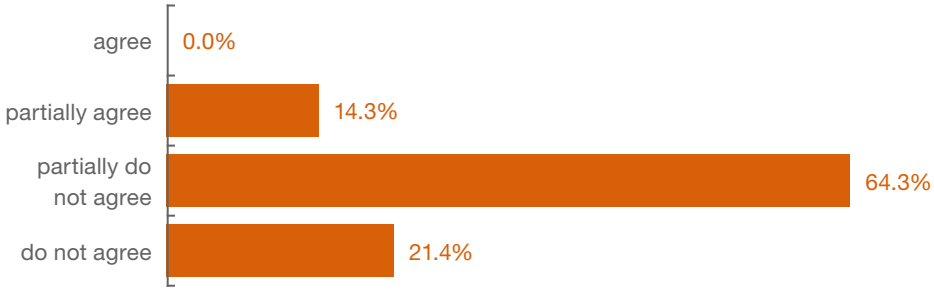
With its Action Plan for Financing Sustainable Growth, the European Commission already put together a set of regulatory tools in March 2018. These measures are now being systematically set up. The first implementation packages have been in force across the EU since the start of 2021 – and more of them will follow before the end of the year.

While increasing requirements resulting from the regulatory framework may be very extensive and entail additional effort and expense at first, market participants largely see advantages in such a regulatory framework. This may be due, in part, to the fact that the regulatory framework represents a market standard, thus providing certainty in the planned implementations. The planned regulatory requirements will also boost demand for sustainable products, since private investors will be consulted on their sustainability preferences during the sales process.

Most market participants do not see the regulatory framework as a threat to their company either. This could be an indicator that they have already addressed this issue and are anticipating future requirements.

Fig. 4 You see the regulatory framework as an opportunity for your company.

Fig. 5 You see the regulatory framework as a threat to your company.



4 Impact on the market environment and provision of green investments

There is consensus within the real estate industry that ESG will become a new market standard in short- to medium-term because of regulation, leading to fundamental changes in the asset management market.

However, the strong demand, similar investment approaches and the valuation of major ESG data providers also harbor risks because increasing amounts of money are being invested in ESG products. This could lead to a significant increase in valuations, especially for stocks with excellent ratings in the sustainability segment. This raises the question of whether the market's understanding of sustainability is still, in part, very limited and whether the high valuation of a small number of stocks is fundamentally justified or merely the result of the considerable inflow of funds.

Investors are leading the green revolution and calling for asset management companies to allocate capital sustainably. Both private clients and institutional investors are showing a fast-growing interest in sustainable investments and are increasingly allocating their capital sustainably. The inflow of sustainable products to Europe was particularly pronounced in 2019. In addition, our analysis shows that annual net inflows to ESG funds as a percentage of assets under management (AuM) have steadily outpaced those to non-ESG funds since 2014. According to Morningstar, ESG funds actually accounted for nearly one-third of all inflows to European funds in the second quarter of 2020.

Fig. 6 In your opinion, the Sustainable Finance Action Plan is changing the market environment for asset management companies.

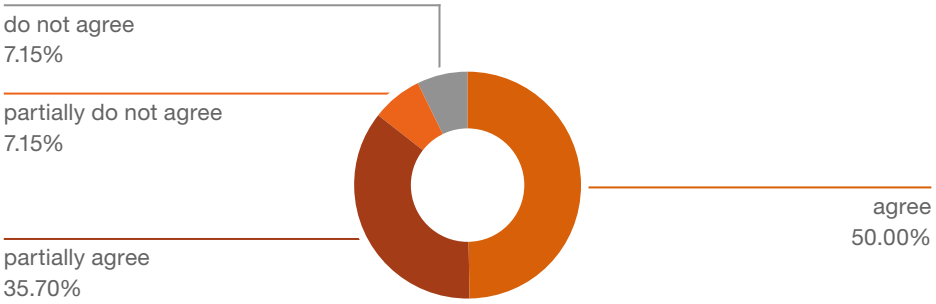
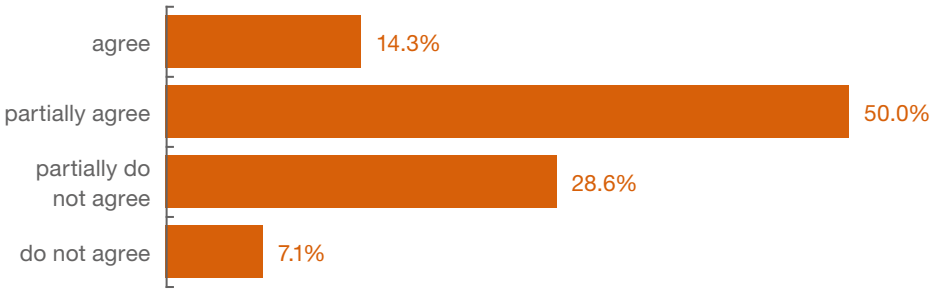


Fig. 7 There is excess demand for green investments.



Demand will be further fueled by the EU Sustainable Finance Action Plan because product providers will have to be more transparent, sales staff will have to actively ask customers about their sustainability preferences, and a range of other measures will improve the exchange of information and data standards between finance and the real economy. This means that more than 85% of the companies surveyed see the EU regulatory framework as a major change in the market environment.

As outlined above, a changing market environment due to the regulatory framework and shifting investment preferences among investors is boosting demand for green or sustainable investments. In fact, the market participants surveyed expect that these factors could lead to excess demand for green investments. Strategically, this would mean that providers could place enough sustainable products in the near future, and that new providers could penetrate the market. Furthermore, it is conceivable that other niche products could emerge from the sustainability segment, such as impact-oriented products, products focused on transforming non-sustainable assets, or themed products.

5 The ESG transformation

It is clear that the transformation toward a holistic ESG strategy will take some time. But have the majority of real estate companies already embarked on this transformation? How long do they think a comprehensive transformation in terms of an ESG strategy will take? Generally, developing an ESG strategy will require the following criteria:

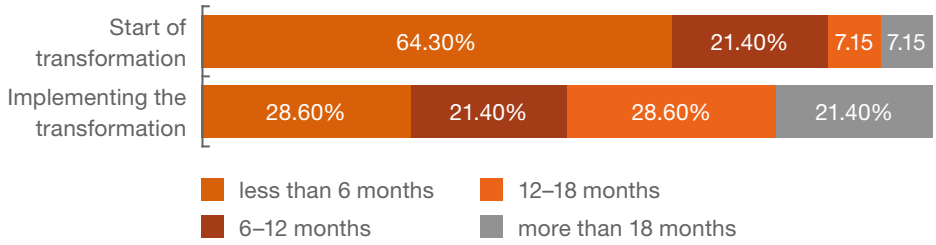
Defining a strategic approach and level of aspiration

- Analyzing market trends and regulatory landscapes
- Forecasting asset owners' expectations with regard to ESG
- Peer reviews and benchmarking
- Identifying the gaps between current and preferred ESG approaches.

The survey shows that the majority of real estate asset management companies plan to initiate their transformations in the next six to 12 months or have already started doing so. However, estimates differ as to the length of time required to implement an ESG transformation: In each case, 20% of respondents estimate that the transformation will take 6 to 12 months or more than 18 months. By contrast, around 30% of respondents think that it will take less than six months or between 12 and 18 months.

The estimates of how long ESG transformations will take illustrate that market participants have different aspirations when it comes to sustainability. They also indicate that different aspiration levels tie in with varying requirements for implementation. We know from our advisory projects that a modular approach can aid the transformation process.

Fig. 8 Planned timeframes for initiating and implementing transformation with regard to individual ESG strategy



E ESG in products and investment

Companies seeking to offer sustainable products have to assess the extent to which their strategic aspirations can be broken down to the product and ultimately to the asset. All the same, individual products allow for initial insights and opportunities to take sustainability factors into account without having to transform the entire platform.

Structuring and offering sustainable products requires integrating ESG criteria into investment decision-making processes. The crucial factor is that investors and, in future, regulators will want transparency regarding this integration so that they can determine whether the level of integration meets the respective investor's ESG objectives. The investment decision-making process should be understood as including both the purchase of assets and maintaining the portfolio over time, including renovation.

Both private and institutional investors are calling for concepts that integrate ESG factors and risks into investment decisions – ideally adopting a holistic approach to the entire strategy. Private investors tend to focus their product selection on impact-related investments, whereas institutional investors tend to attach greater importance to sustainability risk and evaluation in their asset selection.

While in recent years it was mainly institutional investors that drove the development of sustainable investments, private investors are now also following suit and investing heavily in ESG assets.

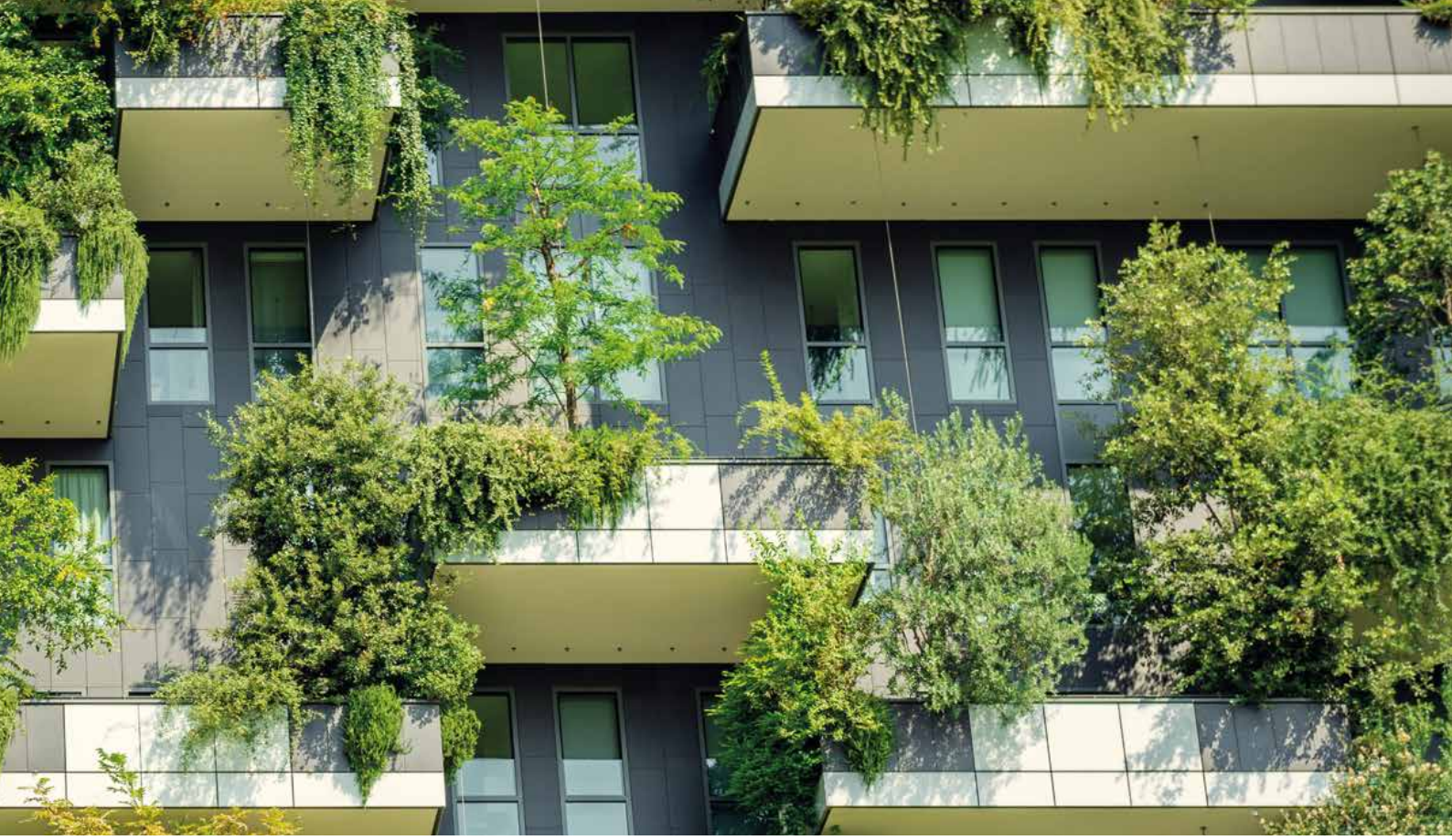
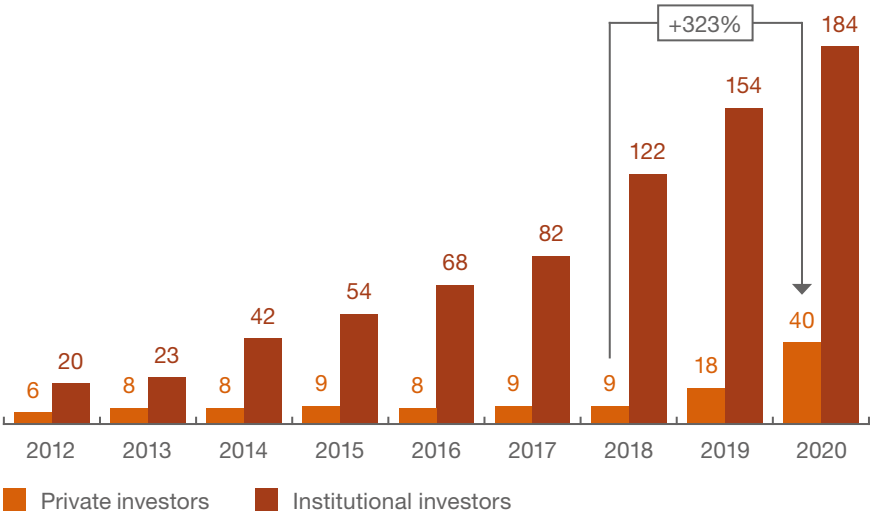


Fig. 9 Market developments in ESG investments in the capital market paint a positive picture

ESG investments by institutional investors are already on the rise
ESG investments in Germany according to investor profile (in EUR bn.)



- Institutional investors are looking for sustainable investment opportunities – private investors are following suit
- The volume of ESG investments is far from the volumes required by the EU

Financing requirements have to be covered by the private sector

€270 billion p.a.
… required in addition to meet targets for energy, transport, water and waste overall[1]

€160.1 billion[1]
By comparison: the entire EU 2018 budget only covers approx. 60%

[1] Information provided by European Commission Representation in Germany

Source: FNG Market Report Sustainable Investments 2021 (authors' own graphs).

1 Assessing sustainable products

Sustainable yes – but only if returns are good. Is this really what investors believe? One often reads about misconceptions that returns and sustainability are mutually exclusive. In general, sustainability still plays the least prominent role compared to the conventional investment criteria, i.e. security, availability and return. However, a shift can already be seen. Sustainability will no longer remain a secondary concern, rather it will become a quality criterion for investment decisions. Real estate asset management companies can already see today that sustainable products are competitive and, in terms of performance, on a par with comparable traditional products. This will also attract investors in the future.

Likewise, asset managers estimate the risk of sustainable investments to be lower, which also explains why pension funds and insurance companies are increasingly investing in sustainable products. Even risk-averse investors are increasingly being won over by sustainable investments, as can also be seen in the case of liquid investments with an ESG classification.

However, the majority of asset management companies estimate that investors are unlikely to accept lower returns on ESG products. ESG criteria are important for investments, but it seems that altruism alone does not convince investors to invest.

Consequently, asset management companies should align their products to enable ESG criteria to be integrated. The current perception in the market is that sustainable products have the same competitive risk-return profiles as comparable conventional products. Nevertheless, investors still demand a positive return on their investment, even if it is expected to have a positive environmental and social impact.

Fig. 10 In terms of performance, sustainable products can compete with "conventional" products (assumption: comparable product).

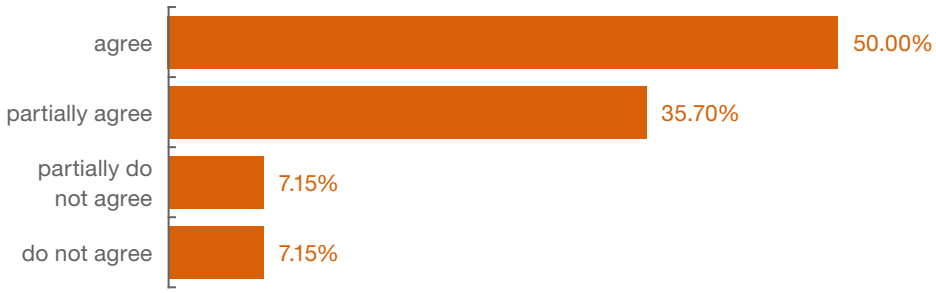


Fig. 11 The risks inherent in sustainable products are lower than those inherent in "conventional" products (assumption: comparable product).

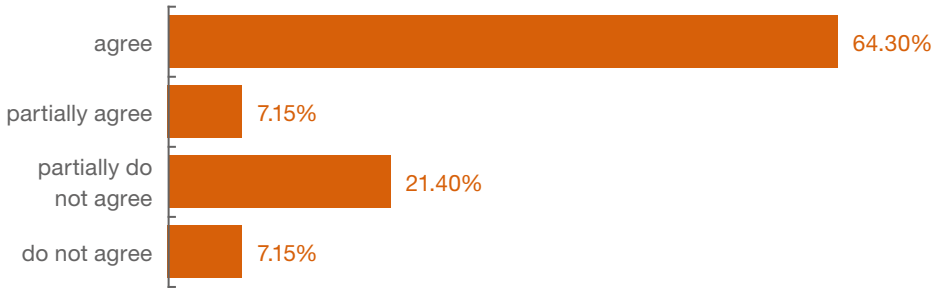
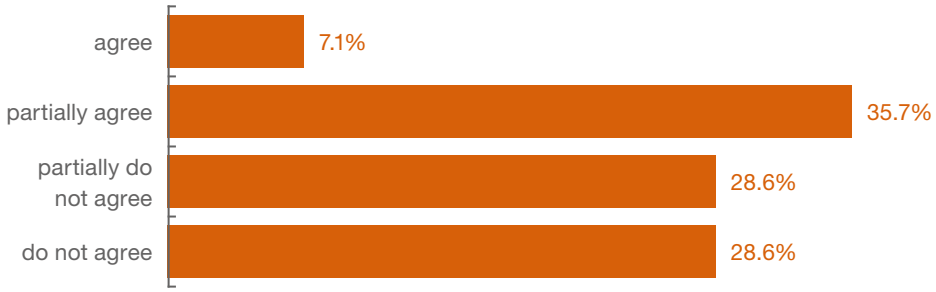


Fig. 12 In your view, investors will accept poorer performance in order to meet ESG criteria.



2 The role played by ESG criteria in investment decisions

Investors are demanding ever greater transparency from financial market participants and their products. Therefore, it is no longer enough to offer a sustainable product. Asset management companies are also expected to provide transparent information on how ESG factors are integrated into the processes of their organization or of the respective fund. As a result, an increasing number of proprietary initiatives and scoring models can be seen on the market, which allow asset management companies to integrate sustainability criteria in a structured way alongside the more familiar economic and legal factors.

In this context, risk criteria and positive criteria have become established on the market. When taking sustainability criteria into account, the purchased assets and the asset portfolio are assessed with regard to sustainability risks. Broadly speaking, sustainability risks can be divided into the following categories:

- Transitory risks
- Physical risks
- Reputational risks

Transitory risks are incurred by the asset management company or the asset as a result of the transformation to a low-carbon economy. The Paris Agreement targets are often used as reference values. Risks stem from technical innovations in the market (e.g. new building materials and substances, networked data collection), regulatory requirements (price of CO_2, energy efficiency requirements, minimum energy performance values), customer requirements and investor demand.

Physical risks concern assets and portfolios primarily through acute and/or chronic risks. Weather events such as storms, droughts and floods are acute physical risks, while rising sea levels and global warming are chronic physical risks.

Reputational risks arise primarily from non-compliance with social and societal norms as well as from neglecting the property's impact on tenants' and users' living and working environments. In so doing, criteria such as taking social housing, innovative real estate concepts and the use of building materials into account are applied across the market.

The extension of the broader definition of risk to include sustainability is reflected both in the purchasing process and in ongoing monitoring during the portfolio stage.

Positive criteria and the inclusion of ESG valuation criteria are also taken into account, whereby a particular focus is placed on the purchase and initial due diligence of properties. Asset management companies mainly draw on market standards and common key performance indicators (KPIs) for their valuation criteria. From an environmental perspective, KPIs covering factors such as energy efficiency, electricity and water consumption as well waste disposal are evaluated. Along with consumption, the sustainable purchase of energy (via centralized purchasing management) and the generation of sustainable energy (using solar panels, for example) are also included in the analyses.

Socioeconomic standards such as compatibility with social housing, proximity to social amenities and public transport, focusing on residents' and workers' health and well-being, and new types of use concepts are also increasingly being factored into asset management companies' investment decisions.

In most cases, the criteria are integrated by broadening the scope of technical due diligence. However, the company's own scoring models and sustainability due diligence approach are also used in the structured analysis of acquisitions. Audits, regular or automated reporting, and the structure of green leases are used in management during the portfolio phase. By incorporating ESG into contracts, tenants and service providers are also subject to a company's sustainability goals.

The increasing transparency in investment processes is being reinforced by greater demand for sustainable products. On the one hand, legislation in the form of the EU Sustainable Finance Disclosure Regulation (SFDR) increasingly requires disclosure regarding the manner in which ESG is integrated into products and processes; on the other hand, more and more investors are calling for transparency regarding the scope of sustainability activities. The intention behind the legislation is to provide investors with consistent disclosures regarding the integration of sustainability products. On top of this, investors are no longer satisfied with general statements, but instead require specific approaches and methods of integrating sustainability.

Asset management companies have recognized investors' widening transparency requirements.

They currently take a variety of approaches to integrating sustainability criteria and risks, with the result that the intensity of integration also varies. In addition, sustainability activities can be related to individual funds rather than to the company overall.

Asset management companies' estimates of what percentage of investors currently base their investment decisions on ESG criteria differ widely: 14.3% of the companies surveyed estimate the proportion to be under 5%. A share of 6% to 10% or 11% to 20% is estimated by around 21.4%, while the share of investors with a clear ESG preference is estimated to be between 21% and 50% by 35.7% of the companies surveyed. Only about 7.2% of the companies believe that the figure is between 51% and 70%.

Even if the companies' have differing estimates of the share of investors, it is apparent that most companies have already recognized that sustainability is becoming more and more important for investors and that relevant products are offered.

Based on the above assessment of customers with clear ESG preferences, the assessment of the target allocation in asset management companies' current portfolios is balanced: About half of the portfolio plays either a major or a minor role in the target allocation.

Does not consider the subject to be irrelevant to the portfolio. However, sustainable criteria do not yet seem to play a significant role in the target allocation in portfolios, especially in the case of existing funds.

Since real estate investments tend to be long-term, not only the current status should be considered, but also the near and distant future. The vast majority of asset management companies will be taking ESG criteria into account when making their next investments.

Fig. 13 In your opinion, investors demand greater transparency with regard to the additional costs and revenues attributable to ESG integration.

Fig. 14 How many of your clients make investment decisions based on ESG criteria?

Share of customers in %

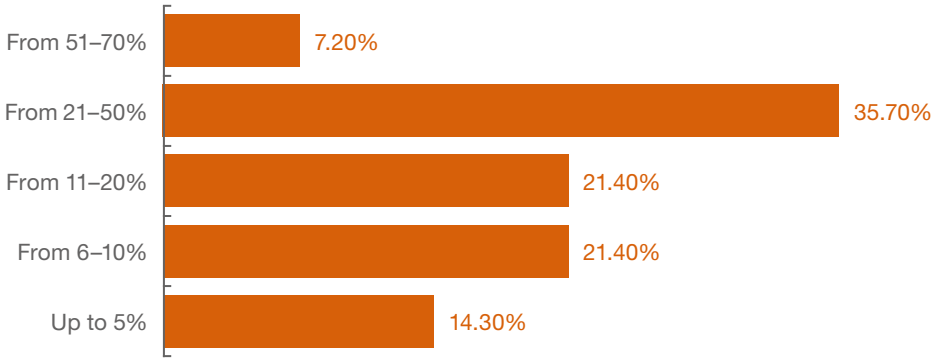


Fig. 15 What role do ESG criteria currently play in your target allocation for the overall portfolio?

Fig. 16 Taking ESG criteria into account will play a significant role when deciding on future investments.

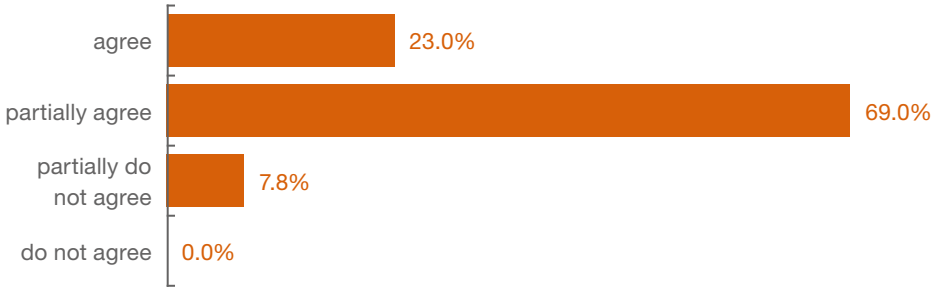
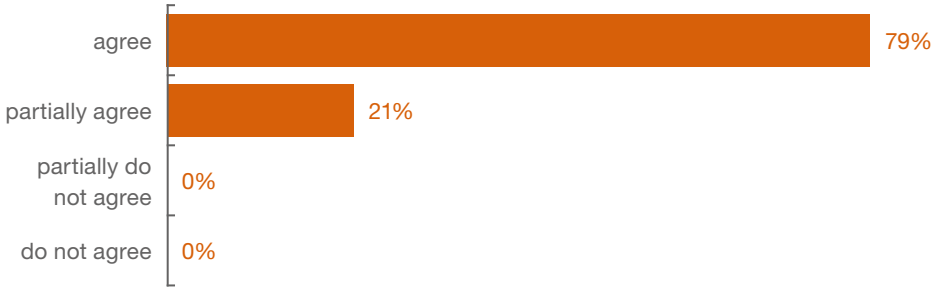


Fig. 17 Taking ESG criteria into account in investment decisions will become increasingly important.



Here, too, it is obvious that the market recognizes the importance. The moderate degree of certainty with regard to ESG preferences for future investments can be largely explained by the fact that existing products have defined existing investment targets and the relevant investors have not explicitly required sustainable investment at this stage.

Asset management companies are nevertheless aware that sustainability will play an ever more important role in investment decisions. For example, most asset management companies (79%) fully agree with this statement and 21% partially agree.

Likewise, companies estimate that the inclusion of ESG criteria will become standard corporate practice in the medium- to long-term.

For this reason, asset management companies will mainly invest in assets that have a specific minimum ESG rating. These include market standards such as GRESB (Global Real Estate Sustainability Benchmark) or the ECORE initiative in Germany, or internationally recognized building certifications such as BREEAM (Building Research Establishment Environmental Assessment Methodology), LEED (Leadership in Energy and Environmental Design) and DGNB (German Sustainable Building Council).

The results show that the asset management companies surveyed are currently adapting to anticipated ESG preferences and adjusting their portfolios accordingly.

The asset management companies surveyed have already recognized that ESG is changing the investment environment. Nevertheless, portfolios cannot be converted swiftly at this stage, with the result that asset management companies will be increasingly integrating ESG into their investment decisions going forward. It remains to be seen to what extent ESG criteria will only be applied to existing assets or if developers will also include ESG criteria in their conceptual plans. It also remains to be seen if the market will feature investment strategies that predominantly transform non-sustainable properties. This type of investment would also be in the interests of law makers since it reduces the risk of stranded assets. Therefore, it is crucial that not only the current situation is considered, but also that a specific development or goal is pursued.

Fig. 18 In the medium- to long-term, the inclusion of ESG criteria in investment decisions will become standard practice for your company.

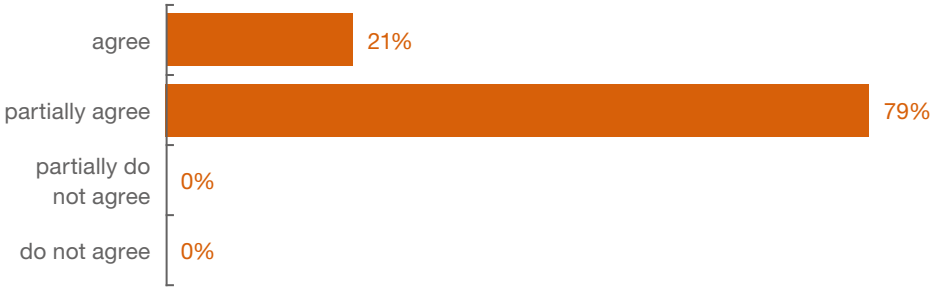


Fig. 19 In the near future, you believe most investments will be in assets with a specific minimum ESG rating.

F ESG in internal organizational structures and processes

The growing demand for ESG poses major challenges towards companies. Integrating ESG into the internal process structure and organization can entail a great deal of effort and expense, but this is necessary to ensure the company's long-term commitment to sustainable goals.

In this context, it is also essential for companies to clarify the extent to which adopting ESG will change operational processes. It is of particular importance to perform an impact analysis for each individual business unit.

Statutory initiatives as well as market standards increasingly require ESG to be integrated into asset management companies' organizational structures and processes. More and more investors are also asking how the integration of ESG will be ultimately rooted in the organization. Analyses performed by PwC some years ago indicated that front office, middle office and back office are affected by the various activities.

Fig. 20 Example of an impact matrix for organizational structures and processes at real estate asset management companies

Indicative estimate – more in-depth analyses required

	Front office			Middle office		Back office	
Services	Identification of ESG services based on new criteria	Demand for ESG services will increase	ESG criteria taken into account for every investment decision	ESG certificates and standards a key factor	Additional risk management requirements		Disclosure requirements for ESG factors/ selection
IT	Extending CRM in respect of ESG preferences	Integration of ESG risk assessment in IT systems (including portfolio management, compliance, reporting systems) and data management					
Products	Segregation of ESG and non-ESG products	ESG expertise required for product release via relevant committees	Need for ESG research (as per EU definition)	ESG applied when acquiring new portfolio assets	Alignment with due diligence at product level (if necessary)	Tax breaks for "green" assets	Disclosure of carbon footprint at fund level
Process	Expanded precontractual disclosure, changes to suitability process	Adjusting the product release process with regard to ESG, defining target markets	Integrating ESG weighting and risk factors	Integrating ESG factors in the DD process	Integrating ESG weighting and risk factors	Additional technical evaluation requirements for ESG products	Expansion in internal/ external reporting
Sales	Requirements adapted to suitability and sales activities	Product information and marketing requirements	New investment advisory requirements in respect of ESG				Active promotion of proESG events to increase demand further
Human resources	Sales training	ESG expertise required for product governance	ESG taxonomy and reporting expertise, aligning ESG strategy with remuneration	Expertise on ESG DD: application and measurement	Ensuring DD expertise, ESG risk management and checks		Ensuring expertise to generate and evaluate reports
Contracts	Precontractual disclosures, restricting contractual terms	Adjustments in product prospectus and other (fundrelated) documents	Amendments to contracts with (ESG) research and rating agencies		Amendments to agreements with external management companies and service providers	Amendments to agreements with service providers (fund admin., depositary)	

low impact mid to high impact

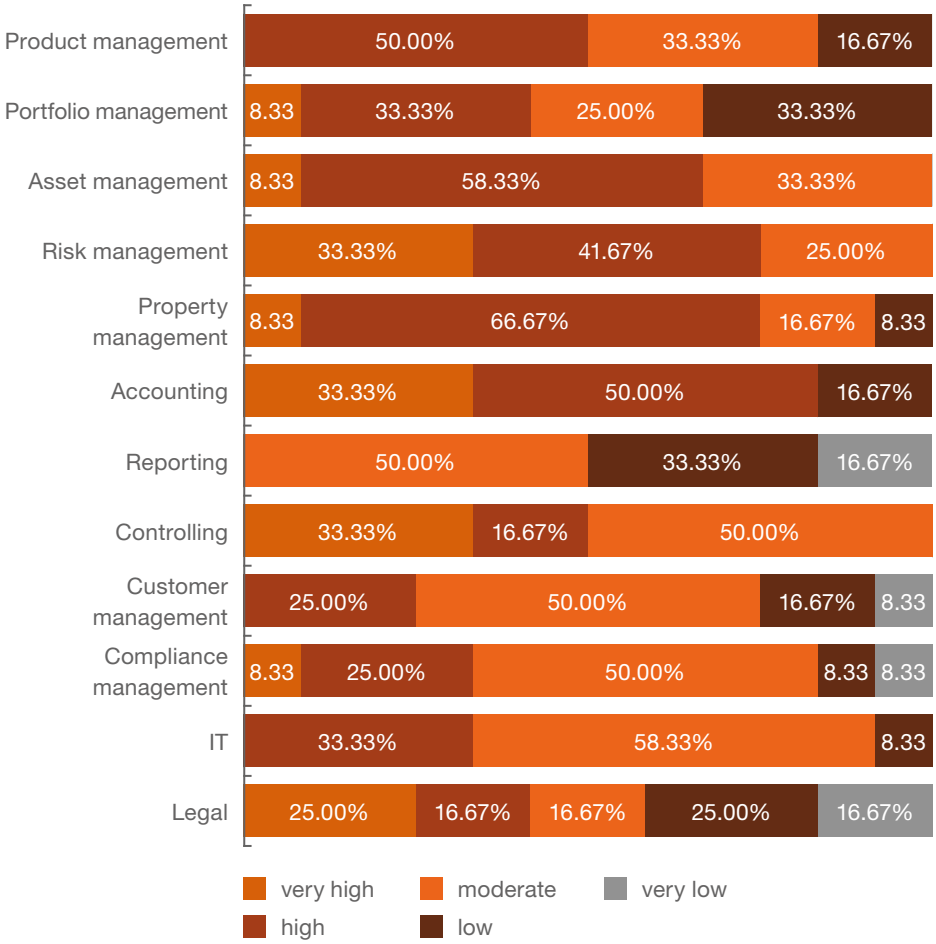
1 ESG in workflows and the structure

ESG compliance requires a high level of knowledge, expertise and analytical work. Outsourcing these competencies can help to maximize ESG potential and enhance organizational processes. Does outsourcing these processes and competencies pay off for companies? For whom is outsourcing particularly attractive and to what extent should it be used?

ESG criteria should be queried as early as the due diligence stage for potential investments. To what extent are ESG criteria currently taken into account in the assessment and what percentage of the questions relate to sustainability?

The majority of the companies surveyed expect risk management and controlling processes in particular to account for most of the effort required at an operational level. However, greater effort is also anticipated in product management as well as in portfolio, asset and property management. The survey indicates that more effort is expected for most internal processes. It is interesting to note that the companies surveyed anticipate less effort in respect of reporting as well as compliance and legal services. This may also be mainly due to the fact that, although content preparation will require greater work, regular operations are more likely to be rooted in the internal processes concerning products and assets.

Fig. 21 In your view, how much effort at an operational level will be required for internal processes to integrate ESG criteria within the organization?



A similar picture emerges when companies are surveyed about the extent of changes in operational processes. The most significant adjustments are expected in the purchasing process, risk management and accounting. Greater adjustments are also anticipated in all portfolio-related processes. With regard to reporting, the companies surveyed expect fewer process adjustments, the reason for which may be that the companies do not need to adapt the processes themselves as much as the content of the reports. The anticipated adjustments within property and asset management, together with accounting and controlling processes, also indicate that asset management companies will be situating data collection and processing in these areas.

Activities can be outsourced to maximize the potential of ESG competencies. For the most part, the companies surveyed have not currently outsourced any sustainability management processes. A comparable percentage of asset management companies have partially outsourced processes while a smaller percentage have outsourced processes on a large scale.

The investment processes mentioned above can primarily be adjusted during due diligence. A large percentage of asset management companies questioned already base more than 20% of their due diligence questions on an ESG context (30.77%). An equally large percentage of the companies surveyed relate 6% to 10% of their due diligence questions to ESG topics. It is clear that sustainability has been taken into account in the technical due diligence process. In this context, sustainability should not be considered in isolation as sustainability criteria are also integrated into technical, economic and legal due diligence. A number of market participants have also carried out stand-alone sustainability due diligence on products with dedicated sustainability and impact strategies.

Fig. 22 How much do you think ESG will change your operational processes?

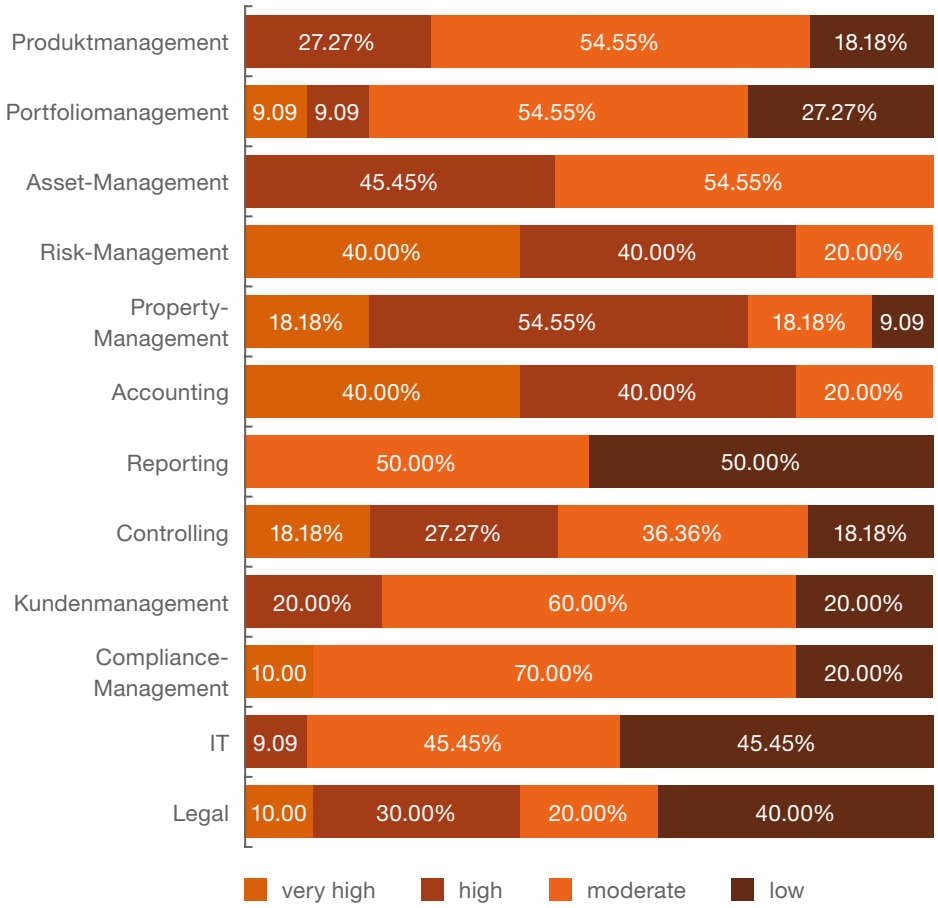
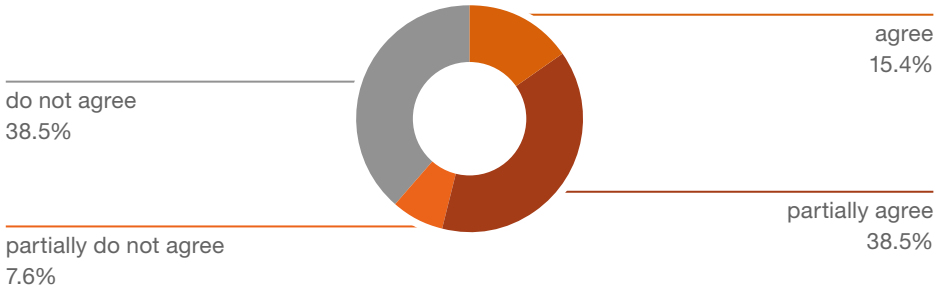


Fig. 23 Processes are being increasingly outsourced to maximize the potential of ESG expertise.



2 ESG in the organizational structure

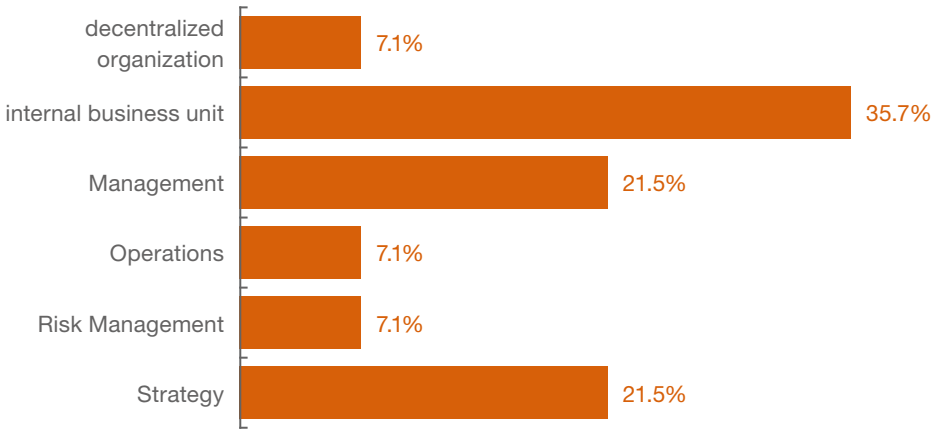
Not every area of a company is equally affected by the adoption of ESG. While some areas are affected very heavily, there may be other departments that are not affected. The consequences should be analyzed at an early stage so that any necessary changes can be made to the process structure in good times.

Due to the growing complexity of the sustainability issue, more and more asset management companies are setting up their own ESG units. This has the advantage to bringing expertise into the organization quickly and implementing sustainability across different units. Among the companies surveyed, a large percentage (around 35%) have organized these responsibilities as a separate unit. 21% have allocated ESG to the management or strategy department. Less frequently, integration is achieved through the risk management department, operations, or a decentralized organization.

Sustainability is a complex topic that is still relatively new for many asset management companies. For this reason, many market participants in the industry opt for cooperation with external service providers. External consultants and experts are involved in particular during the initial design stage. However, it also makes sense for competitors to engage service providers when it comes to operationalization. This involves hiring technical consultants to ensure sustainability measures are in place at the assets, integrate proptech solutions for data mining and utilization, or rating agencies for external assessments of the integration of sustainability in products and organizations. There is a tendency among all providers to currently plan a cooperation in order to implement ESG measures at an operational level rather than to plan a future cooperation. At present, asset management companies prefer to internalize ESG expertise. This underscores the importance that decision-makers attach to the subject of sustainability – especially from a long-term perspective.

The implementation and downstream operationalization of ESG criteria in the organizational structure and processes ensures that sustainability is integrated in a structured manner. The scope and depth of ESG measures are heavily dependent on the level of ambition defined in the strategy. Both investors and the operational complexity demand collaborations and results across functions and competencies. This is why, in some cases, implementation is also carried out on a modular basis in order to ensure the viability of ESG measures in day-to-day business by using flagship projects. While the focus will be on involving external service providers in the short- and medium-term, many providers want to build up ESG expertise in-house by holding extensive training. It is also clear that the companies surveyed consider sustainability to be of extremely high strategic relevance: it is organized either via business units or allocated directly to the management or strategy department.

Fig. 24 Which business unit within your company is ESG most likely to be allocated to for organizational purposes?



G The impact of COVID-19 on sustainability

For many companies, the COVID-19 pandemic has had a significant impact on the manufacturing of goods and the provision of services, as well as their internal organization and activities. In many areas, the pandemic also emphasized the importance of sustainability and underscored the extent to which business models will adapt to include. The market participants surveyed do not seem to share this view entirely: Social aspects in particular appear to have been thrust into the foreground by the COVID-19 crisis. Market participants' assessment of the implementation of environmental and governance issues is moderate and mixed.

Fig. 25 To what extent has the COVID-19 pandemic impacted the implementation of ESG in your organization? – Environment

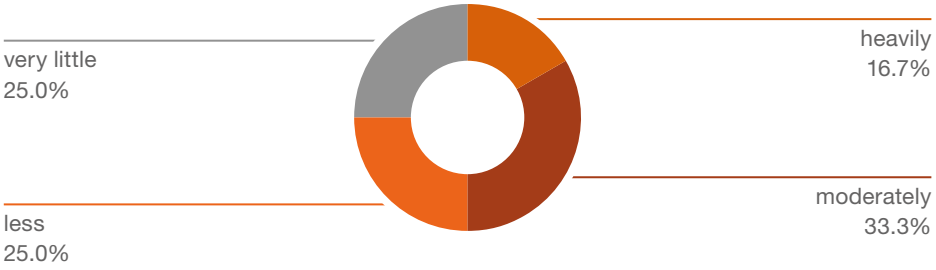
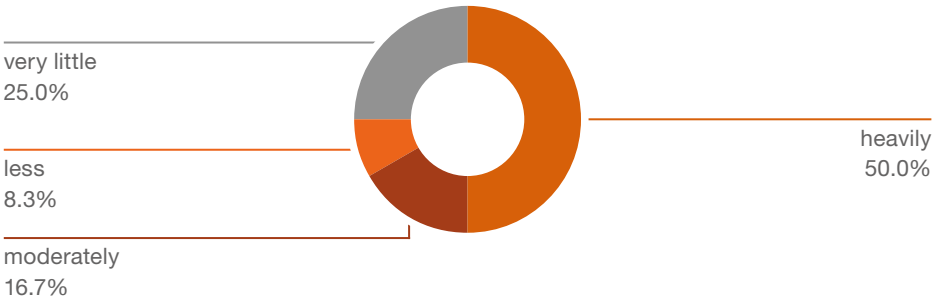


Fig. 26 To what extent has the COVID-19 pandemic impacted the implementation of ESG in your organization? – Social



The “Fridays for Future” movement has fueled debates on sustainability at many institutions and organizations and placed it on decision-makers’ agendas. Given the new conditions brought about by climate change, these issues would also appear to be the most urgent – especially for the real estate industry. However, the COVID-19 pandemic also clearly shows that companies that are not supportive of social cohesion or that prioritize their own business interests over those of the common good will be held publicly accountable by customers and users. In addition, social factors such as the health and well-being of users, as well a innovative use concepts for residential and commercial properties, have also become more important during the pandemic. The market, and therefore also the asset management companies surveyed, will have to carefully monitor the current developments and the effects of the period of working from home and, where necessary, respond to them.

Fig. 27 To what extent has the COVID-19 pandemic impacted the implementation of ESG in your organization? – Governance

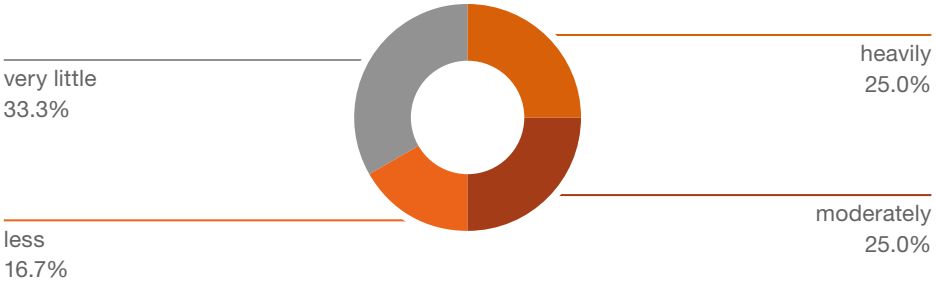
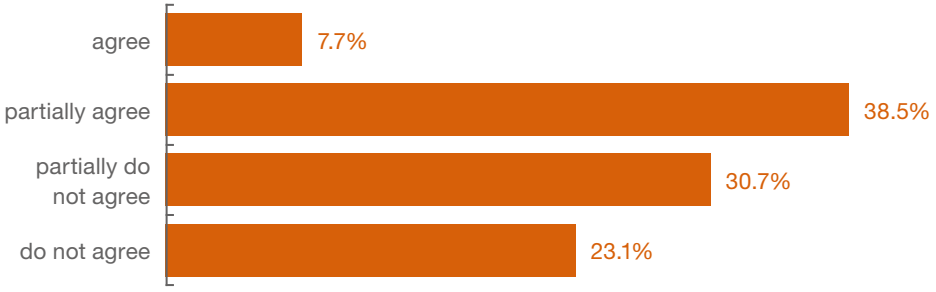


Fig. 28 To what extent do you agree with the following statement: Interest in the topic of ESG has intensified because of the COVID-19 pandemic



Based on the asset management companies’ assessment, the interest in ESG does not seem to have fundamentally changed as a result of the COVID-19 pandemic. Consequently, the asset management companies’ opinion of this statement tends to be moderate and balanced. The percentage of asset management companies that do not agree or partially disagree is also relatively high at 53.8%.

Majority of the industry is already familiar with sustainability from an environmental point of view. The topic of social responsibility is also very prevalent in Germany’s real estate industry, which is why the coronavirus pandemic has not brought about a 180-degree turn in terms of perception or planned ESG integration. This is mainly attributable to the fact that most of the implementation had already started before the pandemic.

By contrast to other sectors, the industry had been dealing with this issue beforehand. Implementation plans on this scale were already in place before the pandemic began.

The impact, on the other hand, is uncertain. Nevertheless, the industry would be well advised to apply and possibly expand proven sustainability concepts in the years ahead.

H Outlook

Comprehensive sustainability strategies will shape the agenda for decision-makers

Surveys and market observations indicate that asset management companies are intensifying and expanding their sustainability activities on a number of levels. Efforts range from financial investments that commit resources, through to the investment of time. As the surveys show, companies are initially adopting modular approaches in order to introduce new solutions to the market or to transform existing products initially. To this end, the initial measures will be mainly implemented at the property level. Aggregation into portfolios is conditional upon structural ESG integration at the product level. Asset management companies and their portfolio managers will increasingly make sustainability an essential part of their investment strategies. In this context, it can be assumed that companies are expanding the more risk-related outlook on investments to include impact-related aspects. The market seems to be moving toward designing individual products as sustainable products initially, since existing products and portfolios are difficult to restructure in the short-term. In addition, legal challenges emerge when products significantly change their strategy. Nevertheless, it is becoming apparent that companies are making sustainability issues a significant part of their overall corporate strategy. The picture that is emerging is one in which companies are specifically pursuing sustainability with individual products and initiatives, while the comprehensive focus of corporate activities is moved downstream to include ESG aspects.

The availability of data will be guaranteed for decision-makers in the medium-term

At present, companies see many challenges in obtaining sufficient data for sustainable investment decisions as well as ex-post reporting. Requirements emerging from the capital market regarding extended sustainability data for the real economy facilitate a broader and more in-depth view at asset level. Some asset management companies have even made the availability and use of data a strategic priority. This, combined with cooperation with new ESG-tech companies and the use of smart metering, can help to greatly improve the availability of data in the medium-term.

Sustainable contracts

The structuring of sustainable contract management focuses on tenants and service providers and ensures that companies can also apply their sustainability agenda to users as well as operators. However, data delivery obligations are also agreed as an essential aspect. In this way, an asset management company can ensure that consumption data can be obtained even in regions and countries with strict data protection.

Smart metering and technological solutions

The survey underlines that, in the short-term, asset management companies are planning to collect data on sustainability performance with the help of external service providers or proptechs. A prerequisite for the availability of data is also a digital link between the assets and the management company. This is increasingly facilitated by automatic interfaces as new properties incorporate digital concepts. Therefore, proptechs and other providers offer solutions. The challenge for decision-makers will be to ensure that these solutions are integrated holistically within the company. At present, many solutions tackle individual challenges, although sustainability should be viewed as a holistic issue.

Demand for sustainable investments will continue to grow

A new generation of investors is emerging, and to adequately cater to their requirements, decision-makers should be prepared for investors to look more critically at how value appreciation and returns are generated. It is worth glancing at other industries that are finding it increasingly difficult to raise fresh funds on the capital market: Private investors are increasingly excluding investments and choosing funds or indices that exclude undesirable investments. Institutional investors are required to meet their fiduciary duties vis-à-vis (private) investors or have also implemented exclusions to mitigate portfolio risks. Lenders only issue credit at an increased cost of capital because they assess the risk as being too high in comparison to sustainable companies.

The real estate industry will not be immune to these developments, which is why decision-makers are already looking at how they can respond to the shift in demand. In the short-term, innovative product solutions in particular will have easier access to capital and generate increased revenues accordingly. Sustainable products are likely to become the standard in the long-term.

There are many sides to sustainability – and just as many investment strategies.

Initially, discussions on sustainability revolved primarily around energy efficiency and environmental protection. As important as the topic is, it is equally fair to assume that asset management companies are now increasingly addressing the issue of environmental sustainability as a matter of course. However, sustainability is multi-dimensional and complex. This gives rise to a variety of investment strategies that can also be applied to the real estate industry. The COVID-19 pandemic has put the spotlight on social sustainability. In future, topics such as innovative use concepts and neighborhood development could also gain importance under the heading of “impact-related investments”. In this regard, decision-makers should allow a certain degree of flexibility and embrace and encourage innovative and creative solutions.

In addition, there is a tendency in the market for asset management companies to integrate properties into their portfolios that are already sustainable when they are acquired. This will automatically lead to shortages and non-performing investments since the supply of such properties is limited. Consequently, investment strategies that apply sustainability not only to new buildings, but also to properties with weak ESG performance will also emerge. In this context, the outlook is not the current status of the asset, but how it can be developed by means of renovation (in the same way as the portfolio). This kind of investing is not new to the real estate industry either. However, the focus will be on sustainability.

Experience has shown that profitability and sustainability are not mutually exclusive. The real estate industry is facing major challenges that also entail a great deal of opportunities. The years ahead will reveal the market participants that possess the necessary flexibility and innovative strength required for a new generation of investments.

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PwC Germany. More than 12,000 dedicated people at 21 locations. €2.3 billion in turnover. The leading auditing and consulting firm in Germany.

To offer Germany's academic community exceptional expertise, PwC has set up a team of university specialists across all cost centers. These specialists have a wealth of knowledge and extensive practical experience (supporting more than 50 universities) in areas such as strategy and organizational development, IT rollouts, and process advisory.

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