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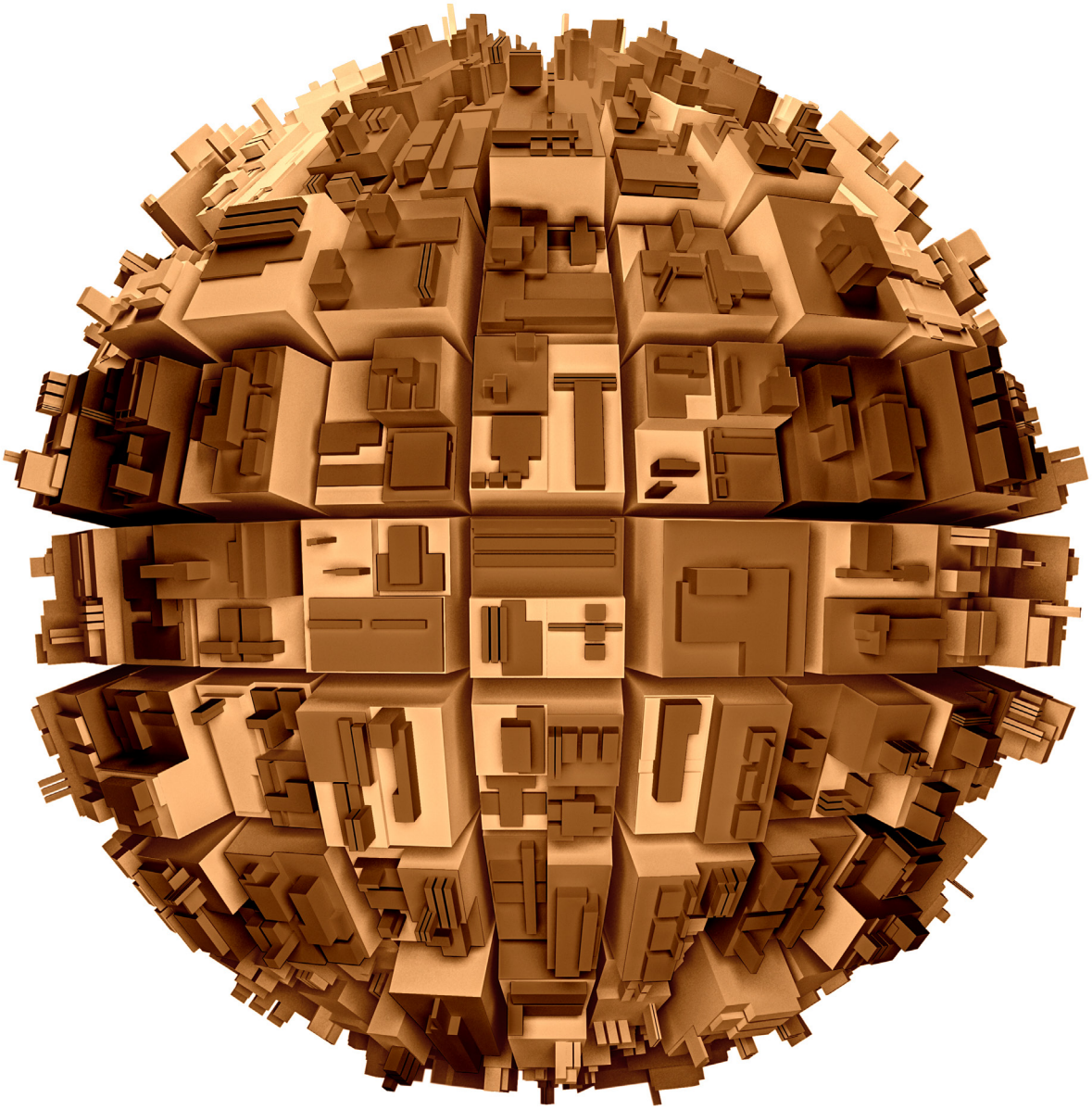

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Real estate in 2020: the year climate change bears down on investment pricing

Nearly 35 years have passed since the publication of *Our Common Future*—otherwise known as the Brundtland Report—and its definition for sustainability: "Development that meets the needs of the present without compromising the ability of future generations to meet their own needs." Roll the clock forward and sustainability—long time anathema to the world of real estate—is now on the verge of impacting sector values in a way that will redefine the market in the form of climate change risk.

The momentum for sustainable change within the real estate sector has been building for some time, setting the stage for both technical capability and market choice evolution. But today, with headlines dominated by such movements as Extinction Rebellion and Greta Thunberg's activism, mindsets are shifting across the general population rather than in niche quarters alone. No longer are climate change-informed investments modeled so that they appeal to so-called "responsible" investors only. Instead, not engaging in sustainable behavior is regarded as a business risk in its own right.

With the built environment contributing between 30% to 40% of all global carbon emissions—and the push to keep average temperatures from rising beyond 1.5 degrees—climate-change risk is of particular relevance to real estate. Most significantly, investors are now considering new and emerging risks as part of real estate pricing.

This adjustment is underscored by increasingly transparent performance benchmarks in the sector, with disclosure now the focus of such climate change groups as the Taskforce on Climate Related Financial Disclosures. The taskforce is now supported by over 1,000 organizations with assets under management well in excess of $100 trillion. But though the taskforce reported in 2019 that transparency in reporting is growing, more is required in light of the United Nation's prediction that climate change risk to business over the next 15 years is in the region of $1.2 trillion.

The response to climate change risk is manifest within the real estate sector, with multiple investors and owners committing to delivering net zero carbon portfolios by 2050 through industry platforms like the Better Buildings Partnership, a UK-based collaboration of commercial property owners focused on improving the sustainability of existing commercial building stock. Others in the sector are challenging themselves with even stiffer timescale ambitions. Delivering on such a commitment is far from straightforward and will undoubtedly require immediate changes in approach.

At a more modest level, yet nonetheless as illustrative of the changes afoot, regulatory valuation standards are sharpening their focus. The new RICS Red Book, effective from the end of January 2020, sees a tightening of requirements placed on valuers with a new mandatory obligation to include comment on assets' sustainability credentials.

With the drive toward ever increasing data and management information transparency, coupled with investor appetite for climate change-resilient assets, climate change risk will inevitably and demonstrably move the value dial. Those assets equipped to address the challenges of climate change should find themselves less exposed to the risks and consequently the specter of premature obsolescence. They should also find themselves better placed to participate in market-led growth and therefore enhanced performance compared to their peers. The corollary is that assets that are more poorly able to address climate change will become increasingly exposed to elevated risks of value erosion.

This value arbitrage may sound similar to the notion of a green premium, that is, sustainable buildings attracting "higher value". But climate change is indiscriminate. It is an issue for all built stock, not just those buildings regarded as “sustainable” or “responsible.”

Markets have a capacity to pay a price; they don’t willingly or knowingly pay “over the odds” but they do discount to accommodate risk – in other words, rather than seeking a “green premium” the real challenge from a value perspective will be to address a so-called “brown discount”.

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