

ERIC SALMON & PARTNERS INSIGHTS REPORT:

Built to Last?

The Evolution of Sustainability Leadership in Real Estate



SUMMARY

Introduction

“We shape our buildings and, afterwards, our buildings shape us.” Winston Churchill

Arguably no other sector impacts community in the way that the real estate sector does: its societal impact casts a long shadow.

So, too, does its environmental impact. According to the United Nations Environment Programme, the built environment is the largest single contributor to global greenhouse gas (GHG) emissions, at an estimated 30 - 40% of global totals.

Consequently, real estate companies and their leaders' ambitions for, and initiatives towards, sustainable development have significant bearing on global environmental and societal sustainability ambitions.

How companies choose to progress the sustainability agenda is largely driven by leadership: the vision for the organisation, the strategy and plans developed and executed, and culture created.

Report Overview

Keen to understand more, Eric Salmon & Partners has been investigating how sustainability leadership has been evolving within real estate by interviewing leaders across the sector.

- With some focus on understanding the past, our discussions have also looked to the future, seeing what emergent trends are developing within the complex tapestry of real estate's value chain, across property developers, owners, and tenants; asset managers and investors; lenders and advisors.
- We have sought to understand how companies define and engage in sustainability; the impact of the pandemic; enablers and barriers; governance; expectations and emphases over the next 12 – 24 months; and, importantly, these leaders' vision for the built environment over the longer term.

Moreover, we have endeavoured to gain insight beyond corporate manifestos and broadscale communications to understand the composition of real estate's evolving sustainability leadership.

Summary Findings

On the surface, a number of CEOs and Boards within the real estate sector are publicly endorsing and advocating the transition to sustainable development. Based on what we observed, this isn't just lip service. Ambitions of some kind have been put in place by most of those companies we investigated, albeit biased to environmental rather than societal dimensions of Environment, Social and Governance (ESG) development.

This said, in practice, there are a number of challenges that distract from, or are impeding, the rate of change. The diversity of the client portfolio, commercial pressures and technology were some of those limiting dimensions that we observed.

We also witnessed that the complexity of the topic itself created hurdles: the sustainability agenda touches nearly every part of an organisation and, itself, has a dynamism which means no one individual – or organisation – can have all the answers. Collaboration is a vital feature to the new modus operandi.

The interwoven tapestry of players across the real estate value chain requires leaders within it to consider not only their own organisation's impact but beyond. Powerful storytelling and inspiration skills are a must.

Most critically, this new breed of leader is one who can see beyond the here and now, yet understands that, not only sustainable business -- but also our sustained existence--relies on a sense of urgency in thinking, as well as action.

SUSTAINABILITY IN REAL ESTATE

A decade ago, few companies within the sector had considered having a corporate ESG strategy, and only a handful of leaders made pronouncements publicly about sustainability-orientated intentions. Today however, companies can ill-afford to stand on the side-lines. An ESG strategy is not just a 'nice to have' but a necessity.

What does sustainability in real estate mean?

- **Environment:** Investing in, or putting resources towards, assets which are already sustainable (i.e., environmentally friendly, 'green' or future-fit); or investing in or putting resources towards existing assets to upgrade, retrofit or improve functionality to make them environmentally robust, sustainable.
- **Social:** Ensuring that the health and well-being of occupants of buildings, or those inhabiting the space around them, are not negatively impacted and may, indeed, be positively impacted. That the community's interests are actively considered and addressed. Beyond that, broader stakeholder focus including employees, customers, suppliers, local communities, the public, government, the third sector and other entities potentially impacted by an organisation.
- **Governance:** Making decisions based on full knowledge of the entire stakeholder set and their interests and issues. Setting out clear quantitative and qualitative metrics and tracking these goals, consistently and effectively. Reporting accurately and transparently and driving for improvement, challenging the status quo.

But beyond delivering sustainability at a corporate level, the real estate sector is intrinsically connected to a much broader ecosystem. Property owners must work with tenants while developers and investors must reinforce partnerships with communities and local authorities. Lenders also have a critical role to play in fostering change, as do governments and regulatory bodies.

Above all, the sustainability leader's role is to leverage, influence, actively collaborate and alter, where possible, the full value chain to drive systemic change.

THE PANDEMIC AND ITS INFLUENCE ON SUSTAINABILITY IN THE REAL ESTATE SECTOR

COVID-19 has made us acutely aware of how interconnected the world is. It has thrown into focus that if we are to sustain our planet and ourselves, we need to transition towards environmentally friendly and societally engaging approaches. It has also illustrated to business leaders their potential impact both individually and collectively.

- As one leading investor commented, *“the pandemic has activated a sense of purpose that was unseen in our senior leadership before the crisis. There’s been a calling to ensure that we’re seen as and act as a “responsible businesses”.*
- Some have used the pandemic to get their houses in order, setting a more ‘responsible’ approach. Others have leapfrogged into action. *“The pace really picked up with full engagement from the Board. We’ve now not only set high level ambitions for 2040 but more immediate goals. This year, for the first time, our annual performance appraisals will include a sustainability metric. The pandemic’s biggest influence was our realisation that we can move quickly as a business if we set our mind to something.”*

Others mentioned the wake-up call triggered by COVID-19. As Richard Branson said, *“Doing good is good for business.”* A CEO remarked *“doing the right thing for our people, the environment and our communities, leads to better results for all stakeholders [including, but not limited to, investors].”*

THE ROAD TO SUSTAINABILITY

Whilst the pandemic acted as accelerator, Eric Salmon & Partners observed an already growing sustainability movement, pre-COVID-19.

A steady increase in regulatory demands has prompted a response in approach and reporting. Investor expectations have also evolved considerably over recent years, although requirements have often varied according to geography. Pressure is also growing from the public.

This has spawned a flurry of sustainability activity across the real estate and finance sector:

- Global investors and private equity players with integrated real estate platforms have already been mobilising efforts to define and implement ESG strategies. Meanwhile we observed some smaller investors and asset managers having to rapidly catch up to upskill their teams to incorporate the necessary frameworks and processes.
- Property companies and real estate operators have also been deploying ambitious policies, while the construction and development industry have been at the forefront in designing and building new generation SMART buildings.
- Given the emphasis on post-pandemic recovery and future economic growth with ‘green’ thinking, there has been an emergence and subsequent surge of ESG themed real estate funds, socially responsible investing, impact funds and green loans. According to Moody’s, a record \$491 billion was issued for green bonds in 2020, with expectations it could rise to as much as \$650 billion in 2021.
- There has been a significant increase in the number of sustainability-led nominations across the sector. Creation of new Sustainability lead roles (“Head”, “Officer”, etc) have been combined with the reinforcement of existing teams. Beyond this, functions such as investment, asset and fund management, development, finance, compliance/risk and human resources have begun to incorporate ESG dimensions.

Only a few years ago, detractors might have branded this as ‘greenwashing’. However, today, few can deny there has been a fundamental paradigm shift. As one leader remarked: *“even the most reluctant have been forced into action.”*

‘WALKING THE TALK’ – A VIEW OF THE TOP

According to the Energy and Climate Intelligence Unit (ECIU) and Oxford Net Zero approximately 20% of the world’s largest 2,000 publicly listed companies have set net-zero targets. Amongst those noticeably represented, are real estate actors. The pandemic also laid bare societal issues, with a developing recalibration from ‘shareholder’ to ‘stakeholder’ language within the broader real estate value chain.

At least on the surface, a number of those companies surveyed have CEOs and Boards actively supporting the advancement on sustainability-led development.

Nevertheless, we observed a varying degree of commitment, from individual CEOs, Executive Committees, and Boards. In other words, we noted a broad spectrum from those extremely proactive in charting paths ahead while others were largely reacting to the wave of change, rather than genuinely ‘walking the talk’.

Inciting Change

Companies whose CEOs have actively embraced the topic -- spurred on by personal beliefs or a view that their business would be advantaged by ‘early adopter’ status -- have unsurprisingly made most significant inroads.

- One leader commented: *“We’ve had the view [for some years] that being in real estate, we can make an impact that is very tangible. It’s now just part of our m.o. It’s part of who we are.”* Sustainability is threaded into the organisation, *“part of the DNA.”*
- *“It’s not just the right thing”* but a chance to *“positively impact the well-being of staff, tenants and communities”* highlighted a CEO.

These organisations have considered the benefits, embraced the topic, and taken it upon themselves to harness the ambition and inculcate sustainability into the thinking and execution of their work.

We also noted younger generations have proved to be enablers of sustainable development, generating enthusiasm at grass roots level, while also catalysing business leaders to follow through on promises.

- *“Pace really picked up with full engagement from the CEO and CFO, but also because ‘grass roots’, and junior staff expect us to be good citizens. If we don’t deliver for them, we’re failing them,”* remarked one participant.

Just as the investor and finance community is putting pressure on real estate leaders so, too, are clients. Real estate actors are forced to, by way of the knock on, raise the bar on sustainability transition. This has positive effects but also challenges. It has created momentum or traction – often at much greater speed than would otherwise be the case – while also prompting opportunities for collaboration.

- *“We’ve had real discussions with our clients, in a way we’ve never had before [beyond the transactional]”* cited one CEO of a property REIT.

Nearly every leader referenced three further enablers of change: regulatory requirements and scrutiny, the prospect of litigation and the possibility of obsolescence or ‘stranded assets’. Critical to the financial robustness, viability and overarching sustainability of a firm, they are very real motivators for transition.

Companies shared they were also starting to see sustainability as an engine for innovation.

- The use of artificial intelligence and digitalisation en route to SMART city development— the urban environment of the future—was given as one such example. Reinforcing this, was a comment made by the CEO of a global investment manager: *“No one wants to work in a chicken factory any longer”*. The pandemic has been a game changer in thinking about offices. Designing greener, healthier buildings and surrounds for communities is now an expectation, and innovation which leverages sustainability principles is at the heart of that design.
- Nevertheless, a sense of urgency around sustainability has promoted the need for greater agility. To keep up, digest and act has required a new pace of change. *“Sustainability has prompted new ways of working, across the business,”* remarked another CEO.
- With sustainability commitments tracked by visible metrics, *“one is forced to put cards on the table. It may create some discomfort for the leadership team at first. But transparency can breed trust which opens dialogues necessary in order to bring about long term [systemic] change,”* said a sustainability leader who has been partnering with companies never previously considered for collaboration, including business competitors.

Challenges

Even amongst the most committed Boards, CEOs and leadership teams, there are immense challenges ahead to ensure a seamless and swift transition.

All leaders also acknowledged hurdles, including customer pressures, financial imperatives, technology and the breadth of the agenda. This was combined with the need to enhance both hard and soft leadership skills to grapple with the complexity of the ESG agenda.

- One asset manager reflected *“we have a highly diverse client base of tenants, and each organisation with which we do business has its own frameworks. Most of these clients are not keen to answer to us or share data... they want to be in control.”* This was echoed by another participant who stated, *“our occupiers [clients] have their own behaviours, and we can try to influence, but ultimately they behave as they want”*.
- Others interviewed remarked that clients are sometimes *“not really willing to pay”* for products and services which are ESG-centric. This is particularly true for older assets, as they are markedly more difficult (and costly) to bring up to standard than new builds. While, philosophically, these businesses may wish to ‘walk away’ from these clients, in practical commercial terms, they see that they often cannot. This reflects one of the significant tensions cited across nearly all those surveyed: striking the delicate balance between sustainability and commercial interests.
- Having the necessary tools and technology is paramount for measuring and reporting. It is fair to say that, only over the last year, have most businesses surveyed reached a stage where they can properly track and measure. Commented a participant: *“It’s only now that we’re able to see if we are really fulfilling our promises.”*
- While positively impacting change, the race is on to increase certifications. *“Environmental credentialing has been around in the property sector for a number of years and forced us to raise the bar on environmental dimensions related to ESG,”* said a Managing Director.
- Less easy to articulate is the social dimension of sustainability. *“Health and well-being of our staff, our tenants and surrounding community is something we can think about. But how do we measure it and hold ourselves accountable?”* commented a participant.

- Another leader reflected a common theme from nearly all those surveyed firms: *“there are a number of “traditional” leaders in the business who haven’t the knowledge [about sustainability] and may or may not have the interest and ability to adapt and change.”*

While sustainability training is typically a part of any company’s ESG approach, embedding and mobilising a culture which, as one participant reflected *“sees sustainability not just as a nice to have but an integral part of activity”* takes more than just training. *“It is a mindset shift”,* reinforced a CEO, and takes time and heavy lifting to make it happen.

ORGANISATIONAL STRUCTURE

Although there was a noted desire to ensure sustainability was not ‘owned’ by one Sustainability titled leader but was woven into the business, many companies have nonetheless set up a Sustainability function to secure action and ownership of the agenda, by all.

- A number of large institutional investors have structured Sustainability into their Research and Strategy functions.
- Asset Managers and Technical Directors have additionally taken ownership of the function.
- The large property companies and developers -- more often than not – had created Chief Sustainability Officer leads who are part of Corporate Affairs, Corporate Communications, Strategy or Innovation departments.
- In a few instances, a functional lead carried the banner of Sustainability as an adjunct to his/her ‘day job,’ but this was seen as a way to demonstrate the seniority of the role and, with it, the importance to the company.

Investor Relations and Finance were cited as key business allies for Sustainability leaders given the increasing importance of the ratings, reporting, sustainable investing and overall corporate governance. So, too, are those on the front line, in the field: *“In the operational setting one can think of sustainability,”* said one Chief Sustainability Officer, *“as the natural extension of Health, Safety, and Environment (HSE) which has been around for years.”*

Human Resources is a key partner, too, particularly in relation to societal dimensions – human rights, diversity/equity and inclusion as well as health and well-being. These dimensions are typically ‘owned’ by Human Resources rather than dedicated Sustainability executives.

Where companies had clearly appointed a Sustainability leader, the mission of that leader is to drive overall direction/strategy of a group and support the embedding of sustainability into the business. As one sustainability head shared, *“everyone should be involved in the sustainability agenda ... my role is about providing the backbone of the strategy and fostering cultural change. However, it’s for the business, ultimately, to take ownership of sustainability on a daily basis.”*

Reporting Lines

With the exception of those individuals who have (as noted above) Sustainability as an adjunct to their core roles, the Sustainability leaders in the organisations surveyed rarely report into CEOs directly. This is not unusual and is the case in most companies, across sectors.

CORPORATE GOVERNANCE

Decision-making and Performance Management

Those real estate actors more advanced in their journey have already integrated sustainability metrics into their decision-making and performance management processes. However, this generally remains relatively new.

Furthermore, we noted a marked bias currently to the environmental dimensions of ESG rather than the social. This said, nearly all companies noted there is work underway, particularly in partnership with Human Resources departments, on diversity/equity/inclusion aspects.

- Approximately 50% of companies we spoke to started to implement sustainability key performance indicators (KPIs) linked to performance pay or will do so for the first time in 2021 for the top tier in management.
- From our discussions, it is likely that this figure will increase to around 80% of the companies surveyed over the next 18 to 24 months. So, too, it is expected that the KPIs will be incorporated into annual performance objectives for a much larger part or most of the organisation – particularly those functions which can influence sustainability dimensions.

Progressive CEOs heralded the inclusion of such metrics into annual targets. As one global CEO stated, *“it’s a key route for us to assess leadership potential today and in the future.”*

Corporate Boards

Along with the relatively new establishment of ESG and Sustainability committees at executive level, we observed a growing number of organisations instituting such committees at Board level. Sometimes bridging both sustainability and the more historic corporate social responsibility and/or philanthropic aspects of a business, today’s Board committees are delving much more deeply into the overall sustainability agenda.

However, there is no denying there is room for improvement. A recent study by New York University’s Stern Center for Sustainable Business showed that, of the 100 largest US companies, only 6% had environmental experience of any kind. One participant described his Board as bringing some experience lending itself to ‘social’ ESG aspects but there should be more capability: *“We may have ambitions, but we also need a board that can engage the expertise to know what sort of action to take.”*

As with the Executive level, where there has been a gradual upskilling of talent in sustainability, we anticipate a similar impact at Board level.

One company pointed to the fact that there has been a new appointment to their Board, a Chair, with a strong track record of leadership in sustainable companies. As over the last decade with the “digitalisation” and “diversity” of boardrooms, we will increasingly see the composition of Boards incorporating capabilities to ensure comprehensive governance on ESG matters.

CLOSING WORDS

If 2020 has been the tipping point and the first half of 2021 the consolidation period, the next 18 – 24 months are set to be the time of real change and challenge, with companies surveyed upping the ante in both skill and will to pursue more ambitious sustainability agendas. As one leader declared: *“The way the real estate sector has gone about its work hasn’t really changed for hundreds of years --- it’s time to push boundaries.”*

The pandemic has only reinforced how fragile both the planet and humanity are. Real estate sectors’ actors, whose actions impact our lives and our communities, have a critical role both singly and collectively in building a sustainable future.

The foundation for this transition is an evolving leadership which brings systemic thinking coupled with innovation and creativity; powerful communication which inspires; openness and inclusion that engenders collaboration; authenticity that imbues belief; and hearty ambition for one’s own company and others.

This new breed of leader is one who can see beyond here and now, understanding not only sustainable business but also that our sustained existence relies on a sense of urgency as well as bold action.

“Great buildings, like great mountains, are the work of centuries,” Victor Hugo.

Hugo’s words reflect the immense impact the built environment has on all of us, and the endeavours undertaken to achieve their brilliance. His words also imply that -- done right - the outcome of great building is sustainability.

With the real estate sector contributing alongside other industries, government, the third sector and the public, Victor Hugo’s observation will undoubtedly be just as pertinent in 150 years’ time as it was 150 years ago, when he penned it.

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