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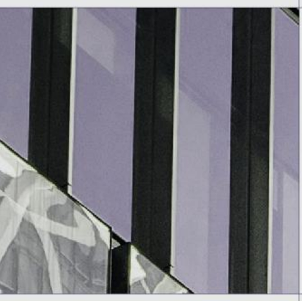
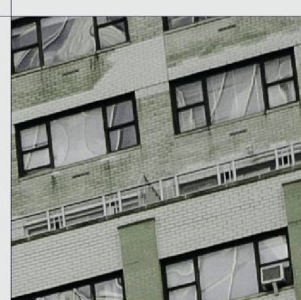
Gina Ding,
Senior Public Affairs
Europe, RICS

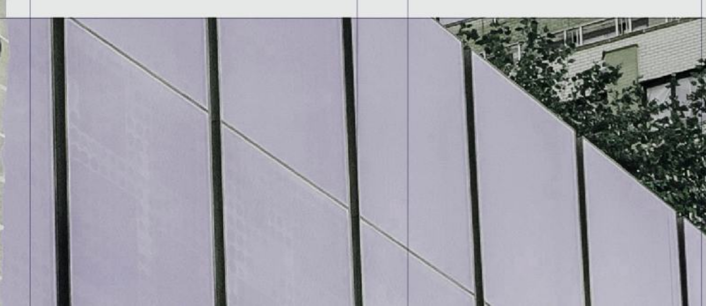
RICS

Reducing Risk and Driving Sustainability by incorporating ESG considerations into Property Valuation

Today, environmental, social and governance (ESG) considerations play a larger role in property valuation than ever before. This is the result of intensifying regulatory mandates, shifting stakeholder expectations and the imperative for robust risk mitigation. Stringent regulations foster elevated sustainability benchmarks, while heightened stakeholder consciousness increases the demand for environmentally-friendly properties, potentially elevating market worth. Integrating ESG dimensions into assessments enables valuers to pinpoint potential risks and deliver more precise valuations. Certain factors already exert a direct influence on valuation, while others may exert influence in the future.







The Role of Professional Standards in ESG Property Valuation

The Royal Institution of Chartered Surveyors (RICS)

sets and maintains professional valuation standards that apply to RICS members and regulated firms globally. These include RICS Valuation Global Standards ('Red Book Global Standards'), as well as and supporting guidance and insight. Along with RICS' own requirements, ***Red Book Global Standards*** incorporates the common, global concepts defined *in the International Valuation Standards* (developed by the IVSC) and provides an effective, regulatable framework for valuation professional and firms to adhere to..

Red Book Global Standards reflects the growing importance of successfully combining professional, technical and performance standards to deliver high-quality valuation advice that meets the expectations and requirements of a range of stakeholders: clients, governments, regulatory bodies and other standard-setters and the public. Mandatory rules ensure benchmarking and compliance with the latest regulations. Red Book-compliant valuations support financial reporting for accounting, secure lending and taxation purposes. Taken together, these rules, standards and guidance support best practice and provide assurance on the consistency and transparent handling of information, helping to reduce risks for valuers and their clients.

In Europe, notable instances of recognition of Red Book Global Standards include:

- In Spain, it is recognized by the CNMV (Spanish Stock Exchange Regulator). It is required by law under the CNMV to carry out valuations for IPOs (Initial Public Offerings) and for financial purposes.

- The Italian Banking Association (ABI) guidelines were updated in 2022. They include references to the latest edition of Red Book Global Standards and 'Sustainability and ESG in commercial property valuation and strategic advice', RICS professional standard.

- There are references to Red Book Global Standards in several reports and guideline documents from EU institutions, such as the European Banking Authority guidelines on loan origination and monitoring.

- Red Book Global Standards is also referenced in INREV's Property Valuation guidelines.

According to Red Book Global Standards,

'the relevance and significance of sustainability and ESG matters should form an integral part of the valuation approach' (VPS 3, 2.2, I). The relevant ESG factors can then be implemented in the entire valuation process, starting with the terms of engagement, as required by Red Book Global Standards. The terms of engagement and assumptions are supposed to be tailored to the purpose of the valuation, taking into consideration potential factors not yet reflected in the market value. While valuers should reflect markets, not lead them, they should be aware of sustainability features and the implications these could have on property values in the short, medium and longer term.

(VPGA8, 2.6 (c), iii).

In addition, Sustainability and ESG in commercial property valuation and strategic advice, professional standard, provide a practical framework for delivering on sustainability and ESG investigation and reporting requirements in professional valuation advice. It looks into the alignment of ESG and sustainability considerations with the core mechanics of valuation (purpose, basis, approach). Red Book Global Standards are currently being updated in 2024, while 'Sustainability and ESG in commercial property valuation and strategic advice' is scheduled to be updated over 2025 and 2026.

ESG Drivers of Value in Property Valuation

Of course, ESG factors ensure the real estate sector remains both ethical and societally beneficial. But they are also necessary to comply with regulatory requirements and to keep up with market demand. The three pillars of ESG collectively contribute to the overall performance and value of a property. For valuers to evaluate the influence of all ESG factors and integrate them into their valuation assessments accurately, well-defined guidelines are essential.

As illustrated in the RICS publication 'The future of real estate valuations: the impact of ESG', there are a few drivers that can affect a property's performance and risk profile in relation to ESG and property market value:

Value drivers

Factors that can directly impact the property's market value, such as energy efficiency, sustainable design and green certifications. Properties with strong ESG credentials may command higher rents and have lower vacancy rates, increasing their market value and influencing their risk profile. For example, investments in sustainable design not only enhance the property's appeal to environmentally-conscious investors but also mitigate environmental risks, thereby bolstering its long-term value. Also, properties with recognized green certifications tend to command premium pricing in the market, reflecting reduced risk exposure and increased desirability.

Risk drivers

Factors that elevate the property's risk profile, including environmental hazards, social conflict and poor governance among market participants in general. For example, environmental hazards such as proximity to flood zones or geological instability pose tangible risks to property investments, potentially leading to financial losses or regulatory liabilities. Similarly, poor regulatory compliance with building codes and environmental regulations can exacerbate risks associated with property transactions and ownership. Collectively, these risk drivers contribute to the property's elevated risk profile, necessitating thorough risk assessment and mitigation strategies to safeguard investment interests and ensure sustainable value creation in the real estate market.

Cash flow drivers

Factors that influence a property's generated cash flow, such as tenant demand, operating costs and financing costs. Properties with strong ESG credentials may benefit from lower operating costs, higher tenant retention rates and access to lower-cost financing. In turn, this results in higher cash flows, enhanced investment returns and risk mitigation associated with property ownership.

RICS Europe Leaders' Forum ‘The future of real estate valuations: the impact of ESG’

On 12 October 2022, RICS established a Leaders’ Forum consisting of the major European valuation service providers, the financial industry (banks and investors) and likeminded relevant associations and organizations.
The aim of the Leaders’ Forum is to set the conditions for a consistent and transparent approach to embedding ESG requirements into valuations and the valuation process.

Alignment between key stakeholders, transparency and expectation management are key in driving the ESG agenda forward in a collective manner. Collaboration and information exchange between valuers, investors and other stakeholders are the key activities of the Forum. This will enable the various stakeholders to adopt a holistic approach to incorporating ESG factors into valuation analysis, enabling stakeholders to better assess risk, identify opportunities for value creation and promote sustainable outcomes in the real estate market.

One of the most impactful outputs of the Leaders’ Forum is the ESG and valuation data list, which was published in February 2024. It focuses on the real estate asset level, both existing assets and those under development or redevelopment. The geographical scope of the data list is the EU, and references are made to EU regulatory requirements and supervisory expectations for each indicator. However, we encourage uptake of this data list in other jurisdictions as well.

The data list document consists of a core data list and a future potential indicators list. The core data list consists of 12 ESG indicators we believe are important when assessing ESG performance. This data list is for valuers to present to their financial clients and encourage inclusion of the indicators in the terms of reference, valuation reports and ultimately in the market value. Data availability is not assumed, and focus should be placed on those indicators where the information is readily available and where it can reasonably be expected to have an impact on the valuation. If data is not available, the required information is not shared with the valuer if a certain indicator is not relevant for the client or the property in question, the 'comply or explain' approach applies. The future potential indicators list refers to ESG requirements that are likely to become relevant in the near future. Valuers and financial clients should therefore be aware of and reflect on them.

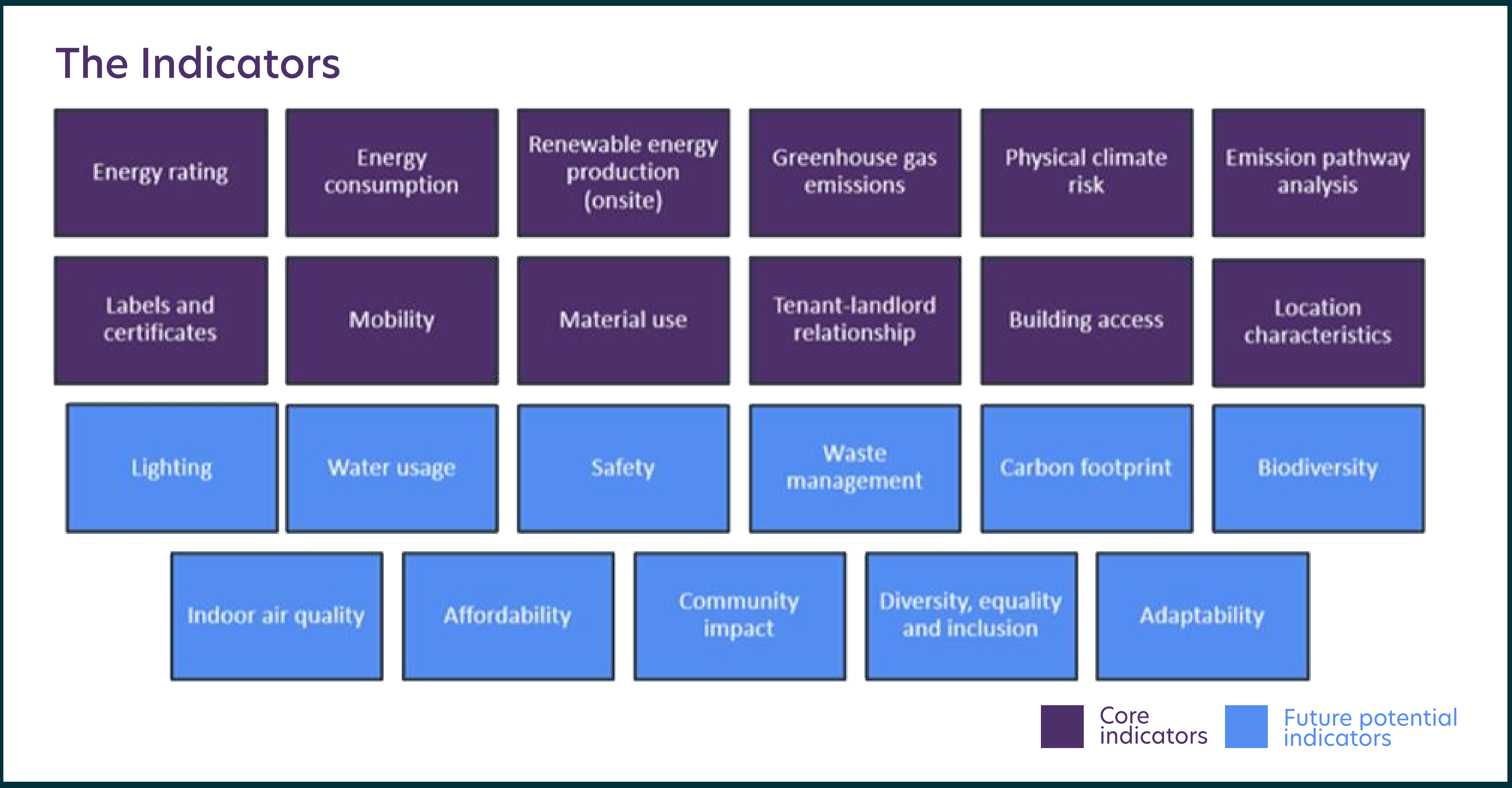


Figure 1: Indicators from the RICS ESG data list for real estate valuations (2024)

Not all markets are equally evolved, and ultimately it is up to the valuation service providers and their clients to determine how to best factor local market and regulatory requirements into the data list. However, to ensure market consistency and transparency when including ESG factors in valuations, using the data list as a reference point is strongly recommended and could serve as a useful tool to structure the dialogue.

The work of the RICS Leaders' Forum continues, and the ESG data list is a living document we expect to update each year. The first edition is currently mapped against INREV guidelines and ESG SDDS. Further mapping with other industry guidelines is currently underway.

The Future of ESG in Property Valuation

As time goes on, ESG considerations will become increasingly important in property valuation. These are driven by several key trends and developments, that create challenges as well as opportunities for the property sector.

Regulatory and legislative mandates

Continued evolution of regulatory requirements around ESG reporting and disclosure are driving greater transparency and accountability in the real estate sector. This is prompting investors and valuers to incorporate ESG factors into their decision-making processes. Regulatory requirements will drive greater adoption of ESG integration in property valuation, as compliance becomes a key consideration for asset owners, investors and valuers alike.

To understand the current state of the EU property market, it is important to be aware of the impact of regulation on valuation. In recent years, various regulations and directives have been introduced at both the EU and national levels to address the ESG aspects of real estate. Some legislation targets companies, investors and investment products, rather than individual property assets or portfolios. The valuer will therefore make appropriate judgments around the relevance and impact of the regulations. Those instructing valuations will also need to consider whether the impact on them as an investor or company needs to be considered in the valuation of individual properties or portfolios, and instruct the purpose and resultant basis of value accordingly. The ESG and valuation data list, which links the core indicators with the relevant EU legislation where possible, serves to help structure the dialogue between valuers and their clients.

Alignment of metrics

There are increased calls for, and efforts to, standardize ESG metrics and reporting frameworks, facilitating benchmarking and consistency in assessing the sustainability performance of properties across different markets. Initiatives such as the Leaders' Forum serve to bring key stakeholders from different fields together, to align expectations and needs, agree a reasonable implementation framework and collectively drive the ESG agenda forward.

Stakeholders' expectations

Investors focusing on sustainability and responsible investment practices will drive demand for ESG-aligned properties. Valuers may face pressure from investors to incorporate ESG factors into their valuations to accurately reflect the financial risks and opportunities associated with sustainability. Tenants are increasingly prioritizing ESG considerations when selecting properties, favoring properties with the right kind of green certifications, better energy-efficiency features and amenities that promote health and well-being. Valuers may need to assess the marketability and rental premiums associated with ESG-aligned properties. Ultimately, portfolio assets may change hands within the larger community of investors and asset owners, so it is in everyone's interests to align when it comes to ESG compliance for their properties and future proofing investments.

Knowledge and training

Not all stakeholders fully understand ESG related risks and opportunities, regulatory implications and potential impacts on properties and portfolios. Knowledge and training on ESG will become indispensable for real estate professionals looking to navigate its complexities and drive positive outcomes for both their businesses and the broader real estate industry.

Data and technological advancements

The situation varies geographically, but there are persistent challenges related to the quality, consistency and availability of ESG data for properties. This hinders the ability to conduct comprehensive analysis. However, advanced technologies such as artificial intelligence, machine learning and geospatial analysis are continuously improving ESG integration into property valuation and allowing for more informed decision-making. Advanced data analytics is enabling the processing of large volumes of ESG-related data in order to derive actionable insights and enhance the accuracy of property valuations. Greater data availability would empower valuers to enhance the accuracy, depth and sophistication of their valuation models, thereby improving the reliability and transparency of real estate valuations.

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Summary

ESG integration is essential for improving sustainability, reducing risk and creating long-term value in the real estate industry. Influenced by evolving regulatory standards, stakeholder expectations and risk management needs, ESG-focused properties are increasingly viewed as valuable investments. For investors and asset owners, driving the ESG agenda forward collectively is about future proofing their assets and investments. There is also a clear need for a consistent and transparent approach to embedding ESG requirements into the valuation process.

The nuanced integration of ESG considerations is crucial for optimizing property value and fostering accuracy in valuations. It is important not to reinvent the wheel or create new initiatives that are not linked to what is available currently. It is strongly recommended the industry adopts a collaborative and holistic approach when aligning valuations with sustainability goals and stakeholder expectations.