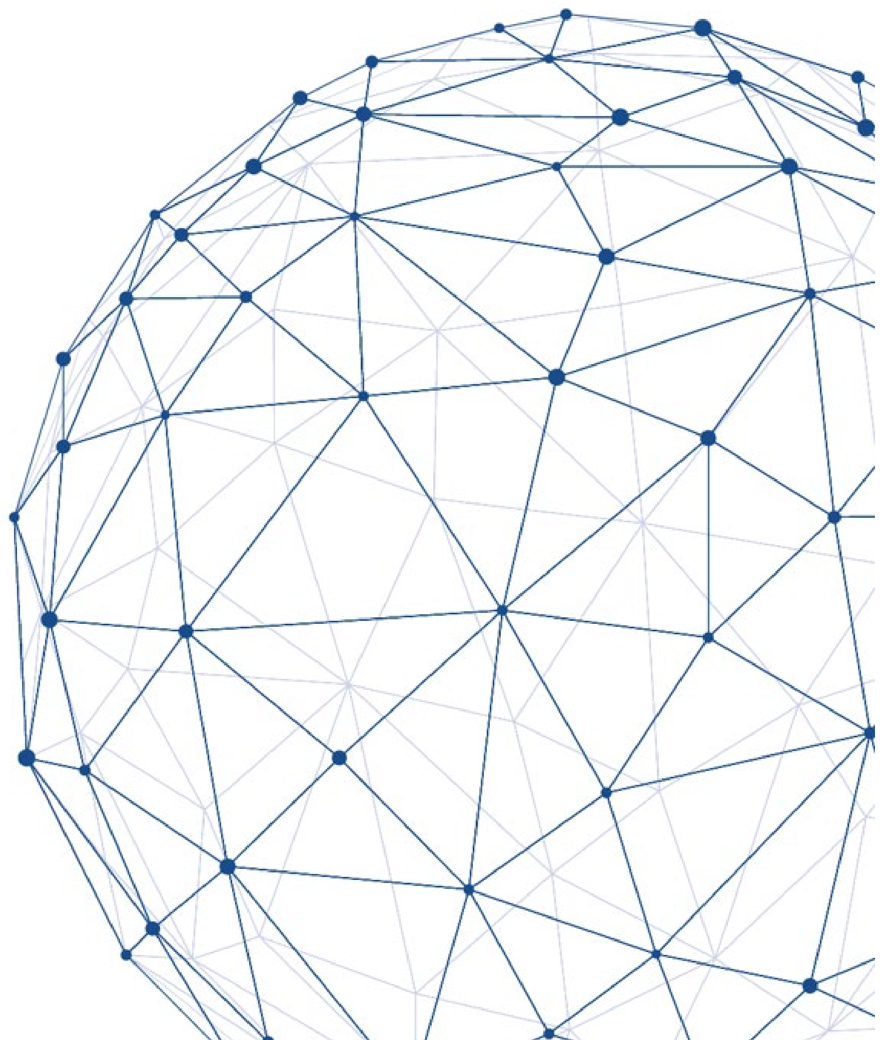
SCOPE Scope Ratings

ESG considerations for the credit ratings of real estate corporates

Europe's real estate sector has a central role in efforts to reduce greenhouse-gas emissions and promote sustainability, with future significant investment required. Exposure to ESG-related credit pressures also involves the challenge of adapting to post-Covid public-health priorities, growing urbanisation and the lack of affordable housing. This document explains the ESG factors we consider relevant to credit ratings.

Scope Ratings GmbH, 23 April 2021



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1. General ESG framework at Scope

Our ESG framework evaluates the extent to which ESG factors are credit-relevant for different industries. We also provide an overview of how ESG factors are integrated into our credit analysis. Our evaluations are not mutually exclusive or collectively exhaustive as these factors overlap and evolve. Reporting standards for these non-financial key performance indicators are undergoing major changes, shedding ever more light on stakeholders' understanding and expectations of ESG. We therefore aim to update the framework on a regular basis.

Our corporate credit rating analysis remains focused on credit quality and credit assessment drivers. We only consider an ESG factor relevant to our credit rating process if it has a ubiquitously discernible and material impact on the rated entity's cash flow profile and, by extension, its overall credit quality. Contrary to ESG ratings, which are largely based on quantitative scores for different rating dimensions, credit-relevant ESG drivers are mostly of a qualitative nature. Hence, identified ESG rating factors are based on an opinion in a relative context.

The importance/relevance of certain ESG factors is specific to each rated entity, industry and region, except for the dimension of governance, which is universally applicable across all industries. For example, the risk of pollution and environmental damage is important in the utilities, chemicals and natural resources industries but less relevant to the retail sector, where governance and social factors are more relevant. The same applies to an assessment of ESG-related factors that might have a significant impact on a company located in western Europe but no effect on an eastern Europe corporate with a similar business model. A good example is the impact of regulatory risks, which may be significantly greater in some jurisdictions.

Governance is an indication of how well a corporation is controlled and directed and the extent to which the interests of different stakeholders are safeguarded, including the payment of all due amounts on time and in full. Governance is thus relevant to all rated entities. In contrast, environmental and social variables capture risks and opportunities that are often specific to the activities of a company and the industry in which it operates. All such factors may have a direct or indirect impact on a rated entity's market position and its financial performance.

ESG-related factors can directly or indirectly affect all the rating elements which make up our assessment of an issuer's business risk profile, financial risk profile and supplementary rating drivers. We provide a list of ESG factors that we normally consider for a given industry, although only some of the factors listed are likely to apply and be relevant to any given company.

ESG rating drivers are part of the rating framework that is outlined in our general rating approach in addition to our specific approach to the sector: see our rating methodology for European real estate corporates.

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2. Important ESG themes in the European real estate industry

Focus on addressing climate change, improving sustainability, and adapting to regulatory shifts

The buildings in which we live, work, shop, socialise and entertain are inevitably at the centre of attempts to create more sustainable economies and improve human wellbeing. Real estate stock accounts for a major part of energy consumption and carbon emissions, which are a driver of climate change. Furthermore, properties – mainly for residential spaces – represent one of the basic human needs.

The three main interlinked challenges we have identified that relate to the environmental, governance and social impacts and risks for any real estate company and the broader industry are:

1. Addressing climate change
2. Improving sustainability
3. Adapting to regulatory change

2.1. Climate change: balancing emissions reduction and capital expenditure

The European Union (EU) intends to cut emissions on buildings, transport, electricity and heating to reduce carbon dioxide emissions as part of its contribution to limiting the global increase in temperature to well below 2°C, aligned with the Paris Agreement. Reaching net-zero emissions or climate neutrality by 2050 depends on a coordinated effort by many different actors.

The real estate industry is the largest energy-consuming sector in Europe, accounting for around 40% of total energy consumption and one-third of carbon dioxide emissions. The Carbon Risk Real Estate Monitor (CRREM), an EU research project, found that emissions from commercial building stock alone would need to fall by 78% over the next 30 years to keep the increase in global temperature below 2°C.

Carbon taxes[1], subsidies and the decarbonisation of the economy can lead to incremental emissions reductions to meet these targets. The EU's evolving CO2 policy framework is potentially a step forward, as similar initiatives have worked in other countries like the United Kingdom and Sweden, the latter of which was the first country to implement a carbon tax (1991).

However, the investment required to upgrade stock to minimise greenhouse gas emissions mostly exceeds not just the penalties for not doing so but also the benefits of related government subsidies and savings in running costs in the short to medium term. This limits any prospect of a favourable outcome for the profitability of landlords and at least a neutral outcome on costs for tenants.

Tenant costs are a particularly important factor in the management of real estate companies' second-tier portfolios, where rents tend to be lower and tenants more sensitive to any steep increase in rents triggered by landlords' efforts to cover the cost of environment-related investment. Climate-related investments in the real estate sector appear a moral-ethical concern rather than an economically incentivised one – at least in the short to medium term.

Addressing climate change also requires property owners to literally weatherproof their portfolios to deal with rising temperatures and other natural hazards to ensure the health and safety of building occupants as well as minimise insurance premiums.

We believe policy frameworks to deal with climate change will be introduced across the EU, forcing all market participants to address these risks.

[1] The German government, as an example, has committed to a carbon tax from 1 January 2021, under which companies in the transport and heating industries will pay a fee of EUR 25 per tonne of CO2 emissions (to increase to EUR 55 in 2025 and EUR 65 in 2026). This will be implemented through the purchase of pollution rights through greenhouse gas certificates.

Relevance to our rating approach:

When assessing how a real estate company addresses risk related to climate change, we focus on:

i) the resilience of the issuer's property stock to climate change and exposure to natural hazards

ii) the issuer's efforts to comply with targets for keeping the global increase in temperature to well below 2°C (Paris Agreement) by cutting emissions throughout the lifecycle of the property portfolio.

A real estate company that fails to address the CO2 emissions and energy efficiency of its property portfolio and/or its vulnerability to rising temperatures and other natural hazards risks impairing the portfolio's estimated rental value, future cash generation and capitalisation rates. Another risk is extending the maintenance backlog.

2.2. Sustainability: real estate has crucial role in fast-urbanising, post-pandemic world

The real estate industry has a huge contribution to make to more sustainable economic growth in the future by rethinking how buildings are designed, constructed and managed, particularly in light of the Covid-19 pandemic.

The sector is also particularly important in the context of the relentless urbanisation of the world's growing population. Nearly 70% of people will live in cities by 2050, an increase of 25% from 2018, according to United Nations. Designing, constructing and maintaining buildings in more densely populated cities, often spreading into zones more at risk from natural disasters, will require more flexible and efficient use of building space – to help prolong the buildings' life and reduce the need for makeovers and/or new developments.

Real estate assets also have to appreciate in value over time and generate high enough yields to attract the long-term investment the industry requires. Investing in green and more sustainable buildings should be a way to protect asset values, ensure property markets remain liquid, and help reduce ESG-related costs.

Determining what constitutes a sustainable real estate asset remains a challenge. Reliable external assessment using certification schemes is essential for providing clarity and measuring the performance of a building. In theory, certification can help asset managers control operational costs and reduce expenses through documenting buildings' characteristics and setting objectives for improving the quality and sustainability of the building stock. In practice, the wide variety of certification schemes and lack of common standards, particularly for assessing the life-cycle costs of a building, leaves gaps in terms of a comprehensive assessment of sustainability in a real estate context.

The gaps are particularly important when it comes to assessing the full lifecycle of a building. Certification mainly focuses on how a building is used or operated rather than how it is built or refurbished. We see an increasing focus on the complete lifecycle as regulatory scrutiny intensifies on industries that are upstream of real estate – building materials and construction – to ensure that they are reducing greenhouse gas emissions.

An agreement on consolidated and more homogeneous measures of sustainability and integrating them in building certification on an EU-wide basis would be a step forward for the industry, not least because it would facilitate more sustainability-linked financing, which for now is concentrated in the Nordic region, Germany and the UK.

Relevance to our rating approach:

Better and more flexible use of building space will become more important for real estate companies as they contend with more densely populated cities, evolving global supply chains and changing consumer behaviour, all in the context of the aftermath of the Covid-19 pandemic. The sector will also have to pay more attention to public health (such as ensuring high standards of air quality) and sustainability (such as improving water consumption/recycling and waste reduction/recycling) to maintain, if not increase, the value of property portfolios. Such actions will help prolong a building's lifespan and optimise operational and capital expenditure after the initial investment.

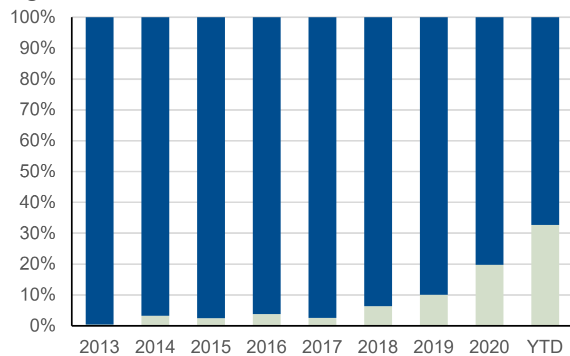
2.3. Regulation: sustainability standards, affordable housing are the main themes

Regulations concerning the sustainability of property stock and the affordability of housing are the two areas most relevant for the real estate industry.

Sustainability of property stock

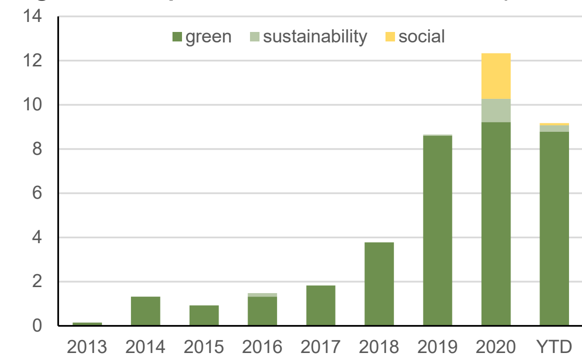
Simplified regulatory requirements on how market players mitigate and adapt to the demands of combatting climate change and improving health and social equity are much needed. For now, administrative and regulatory procedures tend to be complicated and time-consuming and imply heavy investment. They are obstacles to the upgrading of Europe's building stock. Regulatory indifference to risks and rewards is another obstacle, largely for private individuals and smaller companies. As a result, investment flows specifically dedicated to sustainable buildings and/or social factors[2] have represented to date a small, if continuously increasing, fraction of overall investment. Only 20% (+10pp YoY) of European real estate companies' bond issuances in 2020 were labelled as SDG[3] fund-raising. However, in absolute terms, Europe's SDG finance market was resilient in 2020 and should grow more this year, with green, social, sustainability and transition bonds supported by regulatory efforts to establish general applicable frameworks.

Figure 1. Share of SDG bond issuance



Sources: public information[4], Scope Ratings

Figure 2. Composition of SDG bond issuance (EUR bn)



Sources: public information[4], Scope Ratings

The introduction of the EU taxonomy[5] – a classification system which sets out a list of environmentally sustainable economic activities – is relevant to a large group of real estate market participants. The taxonomy will help maximise investment flows towards newly built certified property or renovations to improve the environmental and sustainability profiles of property stock. The taxonomy is designed to help the EU gradually meet net-zero carbon standards by 2050.

The repercussions of the taxonomy will be two-fold for European companies. They will have to review and/or adjust their investment policies to have access to competitively priced financing (debt and equity). Asset market liquidity in Europe will improve as the EU sets the standard for defining what constitutes sustainable economic activity. Thus, sustainability is increasingly embedded in the investment and financial market infrastructure.

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[2] Sustainability/SDG bond frameworks: these distinguish between green and social eligibility criteria and allow the issuer to classify a bond as 'green', 'sustainability' or 'social' depending on the use of proceeds.

[3] SDG = Sustainable Development Goals including Green, Social or Sustainability Bonds

[4] European corporates classified as real estate corporates by amount issued

[5] The classification of activities and assets as sustainable is currently characterised by a high degree of fragmentation. The Taxonomy Regulation aims to eliminate this situation by creating an EU-wide uniform classification system (taxonomy) for sustainable economic activities. The increased transparency should make it easier for investors to select environmentally friendly investments. The regulation defines criteria for determining when an economic activity is ecologically sustainable, i.e. if it promotes one or more of six environmental objectives and does not significantly contradict any of them:

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

All financial market participants that do not describe their financial products as sustainable or green investments are in principle subject to the obligations of the Taxonomy Ordinance. They must inform their customers in advance whether and to what extent they include sustainability risks in investment decisions and, if applicable, regularly inform them about the sustainability impact of the product even after the contract has been concluded. From 2022, the transparency obligations for financial market participants will apply.

Affordable housing: regulation remains blunt tool for addressing supply-demand imbalances

The supply-demand imbalance in Europe's housing markets, notably reflected in rising house prices and rents in metropolitan areas, is drawing increasing regulatory scrutiny as landlords have discovered: take the Berlin 2019 rent freeze, Lisbon's secure rental income programme in 2020, Paris's tightened control of rental caps in 2019, and similar measures in Catalonia[6]. More controls are up for discussion in the European Parliament. Regulatory action is also underway outside Europe. In the United States, the State of New York approved a law in 2019 designed to maintain affordable prices and rental regulation, enabling a more stable rental market and protection for tenants, affecting roughly 65% of rental accommodation.

The paradox is that rental caps and/or other limits on the ability of landlords to pass on sustainability-related and other costs to tenants can deter investment in the sector, with a knock-on effect on the construction industry, exacerbating the supply-demand imbalance in the residential sector. Better alignment and interaction between local authorities and investors is important to maintain and improve the quality of the property stock and offer affordable housing for rent.

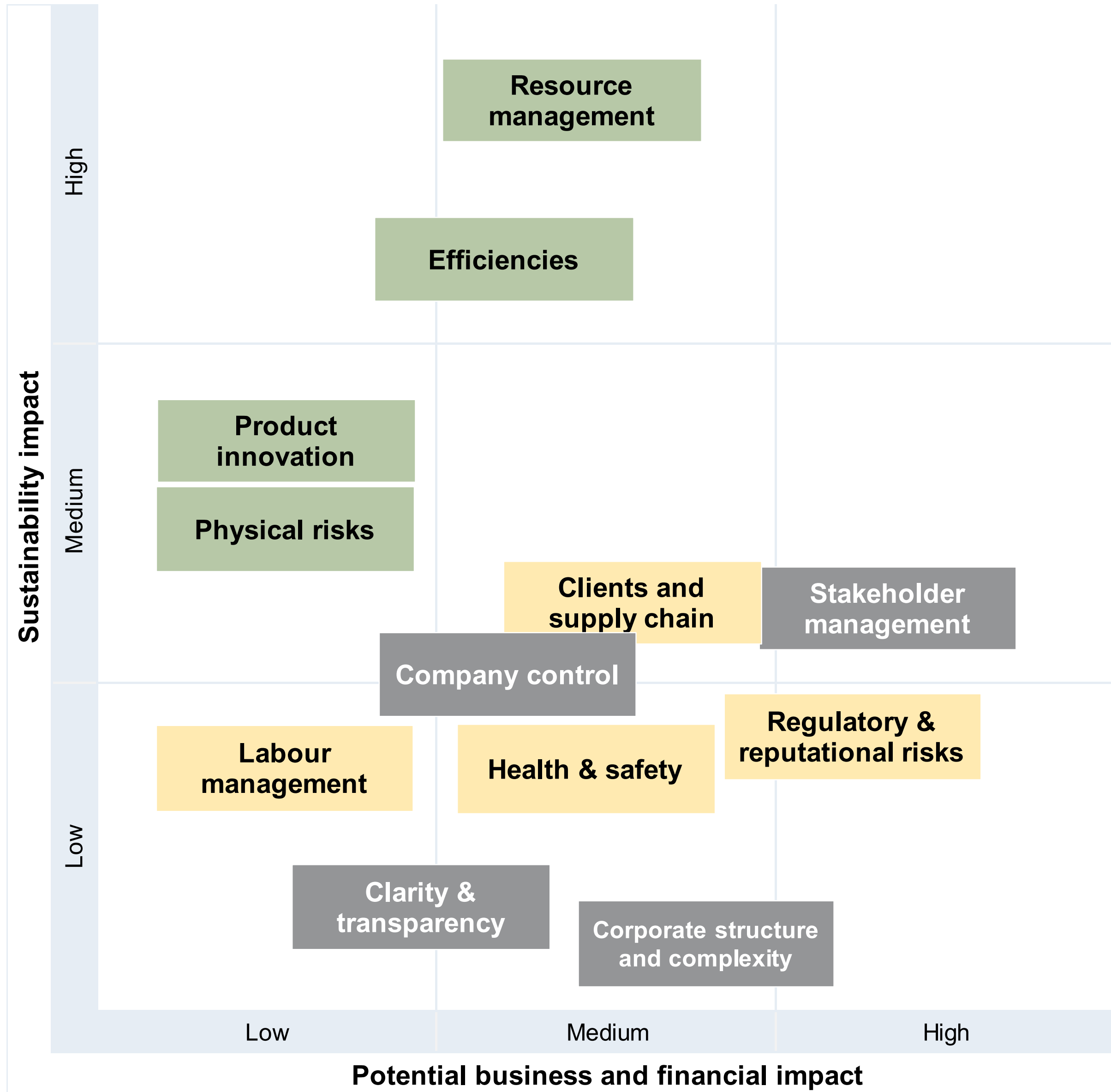
Relevance to our rating approach:

We assess the risk that an issuer is exposed to adverse financial impacts caused by changes in regulation as well as whether it is ready to comply with these changes. Our assessment is based on, but not limited to, the impact of these changes on an issuer's cash generation capability, cost of money and non-discretionary capital expenditure.

[6] Ley de limitación de alquileres

3. Materiality of ESG factors on the real estate industry

Within our ESG framework we look at various broader categories related to E, S and G. We seek to differentiate the sustainability impact of the companies' internalities and externalities, between what is considered sustainable (sustainability impact) and the potential business and financial (credit) impact of ESG factors. Not all ESG factors influence an issuer's creditworthiness to the same extent.



4. Typical ESG factors in real estate

Governance is generic to all industries and is therefore more important in terms of how it is measured. The E and the S are meant to depict a realistic image on the risks and opportunities that a real estate company might face. The list is therefore non-exhaustive and expected to evolve over the next years.

Environment			
	Sub-indicator	**Measurement/Indicator**	**Credit impact**
Resource management	Consumption of natural resources, i.e. water, energy	• Portfolio share of certified buildings(e.g. under BREEAM, DGNB, LEED) • Energy consumption and energy mix (share of renewable energy), both absolute and like-for-like • Water consumption (absolute and like-for-like) • Portfolio share of green leases	• A high share of certified buildings generates more stable cash flow and supports property values that match market- and/or regulation-driven demand from tenants and investors. • Reduced total energy and water consumption lowers service charges, potentially contributing to higher net operating income and cash flow. • Green leases can contribute to the alignment of tenant and landlord interests, ultimately reducing operating expenditure for both.
	Circular economy	• Use of recycled, renewable and eco-label material for all stages of the building lifecycle (development, operation, refurbishment/extensions) • Waste production (e.g. share of waste recycled, amount/treatment of hazardous waste) • Proportion of water that is reused/recycled	• Use of recycled, renewable materials could help lower construction and maintenance costs, thus increasing return on capital invested and/or higher operational cash flow, and supporting stability of property values. • Reduction of waste contributes directly to lower costs for materials, processing and disposal.
	Greenhouse gas emissions	• Greenhouse gas emissions over time (direct: from sources owned or controlled by the reporting company; indirect: from the generation of electricity, heat or steam that is imported and consume; tenants)	• Measuring and disclosing emissions levels can demonstrate leadership in combating climate change, thereby attracting tenants and investors and appeasing regulators. This is ultimately good for operational cash flow and lowering the risk of more onerous regulatory scrutiny.
Efficiencies	Production process	• Use of prefabricated modules for building construction: new units and extensions	• The higher the share of prefabricated modules, the faster construction can be. More efficient use of resources creates economies of scale, lowering development costs.
Product innovation	Real Estate 2.0	• Proportion of self-generated renewable energy • Proportion of highly flexible use of rental space • Technological intensity: smart offices, smart homes	• Self-generated renewable energy reduces the risk posed by disruptions to energy supplies or increases in the energy costs. • Flexible and/or adaptive buildings (weather, temperature, daylight) provide a better living and working environments while saving on energy and other costs.

Environment	Sub-indicator	Measurement/Indicator	Credit impact
Physical risks	Force majeure risks	• Property portfolio exposure that can be negatively affected by extreme weather/natural disasters such as storms, wildfires, flooding	• A high exposure to regions that suffer from extreme weather events or natural disasters leads to higher insurance premiums, greater likelihood of non-performance of assets and increased capex. • Risk of stranded assets/asset impairments

Social	Sub-indicator	Measurement/Indicator	Credit impact
Labour management	Workforce metrics	• Employee satisfaction, employee retention and turnover • Gender diversity • Gender pay ratio	• The greater the employees' satisfaction, the greater an employer's ability to attract and retain skilled staff, reduce turnover, control staff costs, and enhance productivity (less downtime, lower restructuring and litigation costs). • Staff-diversity reporting beyond the mandatory minimum can limit the risk of future penalties. • Increasing transparency over gender pay ratios can satisfy legislative scrutiny and mandatory reporting covering pay differences, such as those being rolled out across the EU.
Health & safety	Health & safety	• Number of incidents and or illnesses related to quality of building facilities and/or operations, such as equipment malfunction, accidents, personnel issues • Accessibility of property • Absentee rate and number of work-related fatalities	• Well-maintained assets minimise the risk of incidents, lowering insurance premiums. • Easy physical access to properties provides the widest possible tenant base, supporting stability of cash flow. • Attention to health and safety measures should result in fewer occupational injuries and lost days, lowering absenteeism.
Clients and supply chain	Local economic development	• Share of local contractors, inclusion of local retailers and other tenants • Tenant satisfaction • End-customer satisfaction (retail only)	• High proportions of local contractors benefit the company's reputation in the local market. • High tenant satisfaction could lead to higher retention rates, thus lowering operational and capital expenditure incurred through tenant turnover. • Retailing: higher rental cash flow (sales-based) driven by increased attractiveness of shopping malls (footfall, retailer sales)

Social			
	Sub-indicator	**Measurement/Indicator**	**Credit impact**
Regulatory & reputational risk	Regulation	• Adherence and reporting on local regulations	• Anticipating and adapting to changes in local regulation reduce the risk of penalties, expensive late-stage fixes and/or the loss of operating licences.
	Reputation	• Long-term goals	• A focus on sustainable targets, instead of maximising short-term profit, helps establish the company's standing as a reliable long-term partner for all stakeholders.

Governance			
	Sub-indicator	**Measurement/Indicator**	**Credit impact**
Company control	Board structure and effectiveness	• Board independence • Competence and diversity of board members • Effectiveness of oversight, risk management and internal control mechanisms • Sustainability targets at board and executive management levels	• Ineffective board or lack of controls can result in poor decision-making and failure to achieve strategic goals. • Tight controls are vital to minimise fraud, theft and the misuse of company resources.
	Risk management	• Risk management framework and culture • Risk-adjusted return/performance measures	• Risk awareness at all levels of an organisation is crucial for effective strategic, operational and financial risk mitigation.
	Bribery and corruption	• Frequency and magnitude of bribery and corruption incidents.	• Adverse reputational consequences can lead to regulatory reprimands, fines, the loss of assets and/or the loss of operating licences.
Clarity/ transparency	Financial disclosure	• Timeliness and quality (GAAP) of disclosures. • Comprehensiveness of disclosures (e.g. on terms of loan agreements, contingent liabilities, related-party transactions, ownership structure) • Consistency in reporting formats	• Rapid and comprehensive financial reporting instils confidence and signals strong and effective internal controls. • Conversely: slow and incomplete reporting may signal weak controls, incompetence or attempts at concealment ('creative accounting').
	Transparency of communication	• Earnings calls and investor presentations that help stakeholders understand the company's performance drivers and strategic direction • Risk factor (including ESG-related risks) and sensitivity analysis	• Transparency is often associated with strong governance. • Understanding and openness about risk factors allows a company to hedge against risks and prepare mitigation strategies.

Governance	Sub-indicator	Measurement/Indicator	Credit impact
Corporate structure	Complexity	• Complex and transparent ownership structure (nominee holdings hiding true owners) • Complex group structure • Complex debt structure • Significant related-party transactions • Aggressive tax optimisation strategies • History of frequent legal or regulatory infractions	• Opaque company ownership, cross holdings, and significant minority interests may hide conflicts of interest. • Complex debt structures can result in unexpected events of default and cross-acceleration. • Related-party transactions can disguise inappropriate diversion of company assets. • Aggressive tax strategies can backfire and result in unexpected tax penalties, negative publicity, and reputational damage.
Stakeholder management	Stakeholder relations	• Respect and balance of interests of all stakeholders	• Stakeholder disputes may have negative reputational and financial consequences.
	Shareholder distributions	• Financial policy clarity, consistency, credibility and track record • Board level endorsement of financial policy	• A clear and credible financial policy helps management meet strategic targets and manage stakeholder expectations.

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