REPORT

Sustainability in CRE: Year End Review & 2024 Predictions

Introduction

As 2023 draws to a close, reflections on sustainability in the real estate industry reveal a focused march towards decarbonization, standardized measurement protocols, and sustainable profitability. Building on past momentum and evolving regulations, 2024 is poised to be a significant year. Central to these shifts are the driving forces of regulatory compliance, investor expectations, and technological advancements that enable and accelerate sustainable practices.

Our annual sustainability report looks back at the 2023 predictions from leading professionals in the industry and considers the ongoing effect these predictions will have on sustainability initiatives in 2024.

> “The amount of change we’ve seen in terms of pressure in requirements from an ESG standpoint over the last year has just been really significant. That’s great but also challenging, especially with macro forces within commercial real estate today”
>
> Bryan Bennett, CEO & Founder
> Cortex Sustainability Intelligence

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Prediction 1: The pressure to decarbonize will continue to grow from new and surprising sources

PREDICTION: We anticipated that pressures from investors, regulations, and market dynamics would compel real estate stakeholders to aggressively pursue decarbonization.

OUTCOME: The push for decarbonization intensified, particularly with legislative efforts.

SUMMARY: As 2023 unfolded, the urgency to decarbonize didn't just continue – it intensified. The drivers of this pressure have grown more diverse and surprisingly influential, underscoring the transition from sustainability being a peripheral concern to a central business strategy. Our Sustainability Trends report predicted the escalating pressure. What we witness now is the culmination of various forces – tenant, investor, and regulatory-driven – that have made decarbonization an imperative.

"Whereas, five years ago carbon reduction was a mere consideration; now it must be at the heart of our business strategy. Investors mandate it, and our success hinges on our ability to deliver exceptional returns while minimizing our carbon footprint."

Nick Bienstock, Co-Chairman and Chief Executive Officer
Savanna

Increasing tenant pressure

As the demand for sustainable practices intensifies in commercial real estate, tenants have increasingly become a focal point in the push for decarbonization. This shift is evident in their growing willingness to pay a premium for sustainable spaces. A notable example of this trend is seen in the LEED certification's impact on rental rates. According to a CBRE assessment, in 2022, office buildings with LEED certification commanded rents that were 31% higher than those without the certification. This willingness of tenants to invest more in sustainable leasing solutions signifies a critical change in the market, demonstrating that tenants are ready to put their money where their mouth is when it comes to supporting sustainable practices.

"A more public-facing approach is apparent when buildings are having difficulty either renewing leases or attracting people back to their buildings. They're seeing it as a potential opportunity to increase their marketability and try to close some deals."

Commercial Real Estate ESG Leader

However, this evolving landscape is not without its tensions. Traditional lease structures often create a "split incentive" problem. In this scenario, while building owners are responsible for funding energy-efficient upgrades, the tenants who occupy these spaces enjoy the resulting cost savings. This misalignment of incentives has been a stumbling block on the path to comprehensive sustainability efforts in CRE.

To navigate these challenges and foster a more collaborative approach, innovative strategies are being employed. Green leases and data sharing agreements are at the forefront of these efforts. Additionally, strategies such as tenant fit-outs and behavior change initiatives emphasize the importance of collaboration, urging both tenants and owners to work together toward shared sustainability goals.

The growing readiness of tenants to invest in sustainable leasing solutions, combined with the introduction of innovative collaborative strategies, marks a new era in CRE. This trend is pivotal in overcoming traditional barriers such as the "split incentive" dilemma. As the industry moves forward, it's clear that the path to successful decarbonization requires the collective efforts of both owners and tenants, working hand in hand towards common sustainability goals.

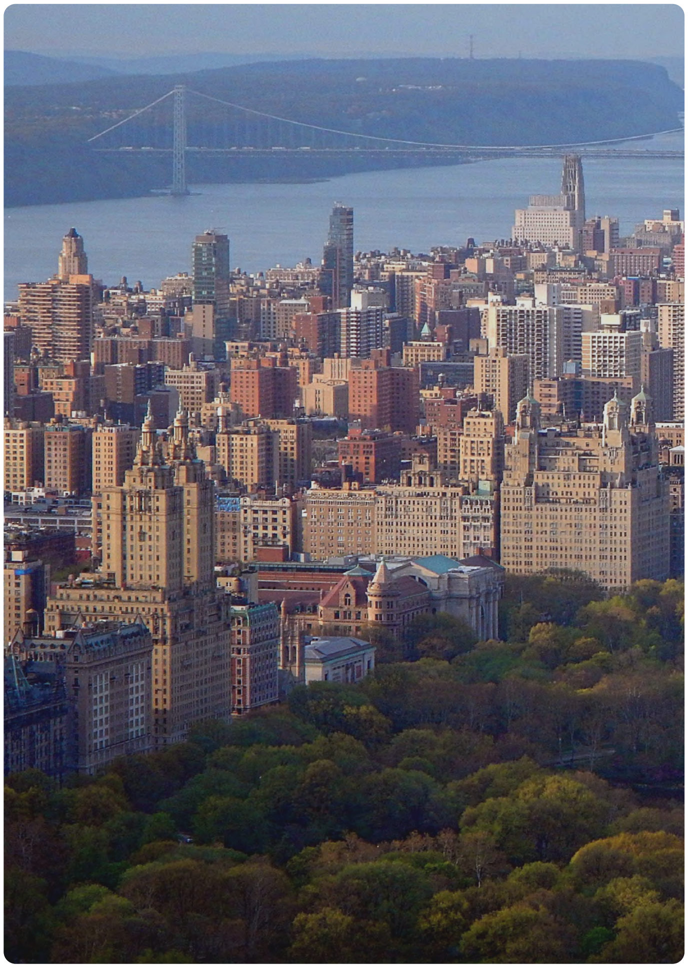
"To achieve whole building reductions in carbon emissions, property owners and tenants must work together—sometimes in new and creative ways."

Kara Kokernak, Senior Director
Urban Land Institute
2023 BOMA International Conference

Continuing investor pressure

Today's businesses face heightened scrutiny from investors demanding transparency in current and anticipated sustainability performance. A staggering 51% of corporate boards exert significant influence on sustainability investments, marking a sharp transition from sustainability being a peripheral concern to a core strategic pillar in the last decade. A remarkable 28% consider sustainability metrics on par with financial metrics. Such transformations show that operational longevity and market competitiveness are increasingly tied to integrating financial performance with responsible environmental and social stewardship. This change signifies a strategic reorientation towards sustainability and guarantees that it is integrated into every operational decision, marking a critical evolution in corporate governance.

Penalty-driven regulatory pressure



In 2023, there was a marked rise in the amount of legislative action taken to promote sustainability in the United States. It's clear that policy makers across the board are taking stronger measures to confront climate change.

While it's not new for states and cities to encourage energy efficiency upgrades in existing buildings, the past few years saw jurisdictions put teeth behind attempts to mitigate greenhouse gas emissions in the form of Building Performance Standards (BPS). Why? At the current pace, it'll take over 50 years to complete whole-building retrofits on commercial buildings, well short of what's needed to meet net zero by 2050.

Today, forty plus jurisdictions have enacted or are considering BPS legislation, including - Colorado, Maryland, and Washington - and many localities ranging in size from Reno, Nevada to New York City. The first wave of BPS comes into effect in New York City, NY in 2024, in Boston, MA in 2025, and in the state of Washington in 2026.

Depending on regulations under the BPS, the financial cost of not complying can be significant. A study by the Real Estate Board of New York projected landlords would be hit by $200M in LL97 fines in 2024 and cumulative fines of $900M by 2030. New York has since waived fines for landlords who make 'good faith efforts' to reduce emissions.

Penalties add an objective financial cost and serve as a marker for determining necessary capital and operational investments. But, accurately predicting penalties can be difficult when dealing with disparate local rules.

Conclusion

In 2023, businesses have witnessed an undeniable transformation in the way they approach sustainability. As environmental and social imperatives intertwine with operational and financial goals, a clear shift has emerged, pushing organizations to place sustainability at the very heart of their 2024 strategies.

Prediction 2: Refining and standardizing decarbonization measurements

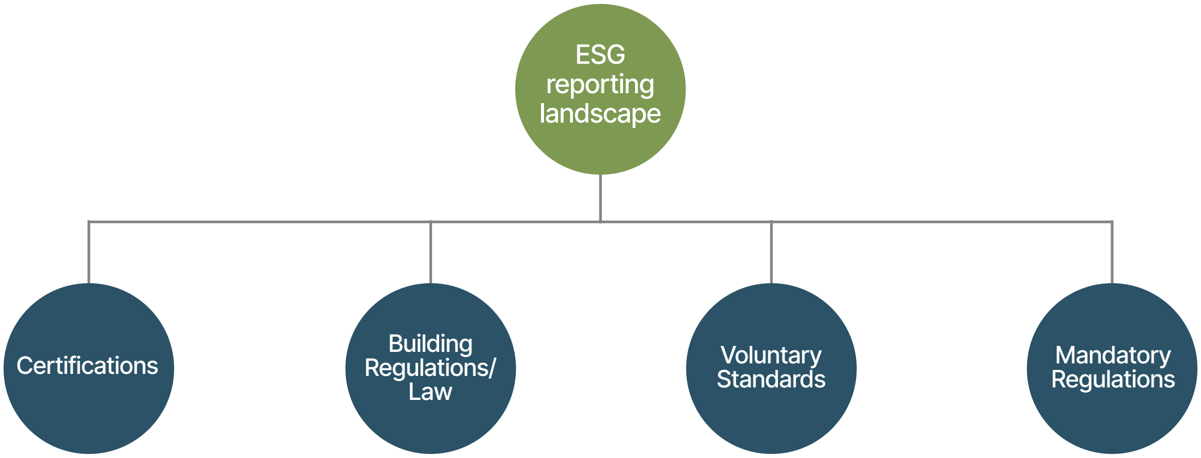
PREDICTION: With the backdrop of the Global ESG Benchmark for Real Assets (GRESB), we foresaw the establishment of clearer measurement standards in 2023.

OUTCOME: While the industry continues to try to harmonize standards, meeting diverse reporting standards and data requirements continues to be a challenge.

SUMMARY: ESG leaders in CRE must present decarbonization data in a clear, compelling manner. Whether to build an investment case for company leaders, create alignment across the organization, meet investor expectations, and comply with regulations, there is a huge data requirement. While efforts are being made, there remains a lack of common language and a standardized approach to measuring and reporting on emissions and ESG performance.

The ESG reporting landscape

ESG reporting has spawned from demand for data to quantify the sustainability of properties and funds.



- **LEED** - Green building certification
- **WELL Building Standard** - occupant health and wellbeing certification

- **Local Law 97** - New York law mandating the reduction of emissions from buildings

- **GRESB** - Real estate benchmark for ESG performance

- **CSRD** - requires large companies to publish regular reports on the social and environmental impacts of their activites

Mandatory disclosure expectations

At an international level, the EU is moving forward with the Corporate Sustainability Reporting Directive (CSRD) to improve how companies report on their sustainability efforts. The first companies will have to apply the new rules in the 2024 financial year. Here in the US, the SEC is mulling a proposed climate disclosure rule to provide investors with consistent, comparable information for making investment decisions. Both emphasize the growing movement to investor-grade data - accurate, timely, and auditable - from ESG teams.

In California, Governor Newsom just signed SB253, a new bill that requires California companies with revenue over $1 billion to publicly disclose their Scope 1, 2, and 3 emissions. While most CRE companies won't meet this threshold, many of their tenants will. This means data and emissions reporting has become an essential part of the job for property managers in California.

Voluntary scoring and benchmarking

Within the real estate industry, the Global Real Estate Sustainability Benchmark (GRESB) has emerged as the ESG benchmark and reporting framework. It's particularly valuable as the assessment evolves each year to reflect what investors and the industry consider to be material issues in the sustainability performance of real estate investments.

"Benchmark growth across real estate and infrastructure this year is not just about numbers — it's about the depth, breadth and usefulness of the data. This increasing dedication and awareness of data quality demonstrates the commitment of global real assets to transparency and sustainability on a broader scale."

Sebastien Roussotte, CEO
GRESB

In 2023, Europe and the US saw steady growth in participation in the assessment, indicating maturity and widespread adoption of the benchmark. The US saw the highest number of new participants with 53 entitles in 2023 (from 380 to 433).

This year's changes to the 2023 GRESB Standards enabled us to monitor net-zero progress and track information on net-zero policies, commitments, and targets for the first time.

There are some promising developments towards net zero, but there remains plenty of work to be done. For example, 72% of global real estate participants have a net-zero policy in place, but only 63% of US office sector participants report a net-zero policy. Despite most participants reporting a net-zero policy, only 56% of global participants have made a public net-zero commitment and 50% have established a net-zero target.

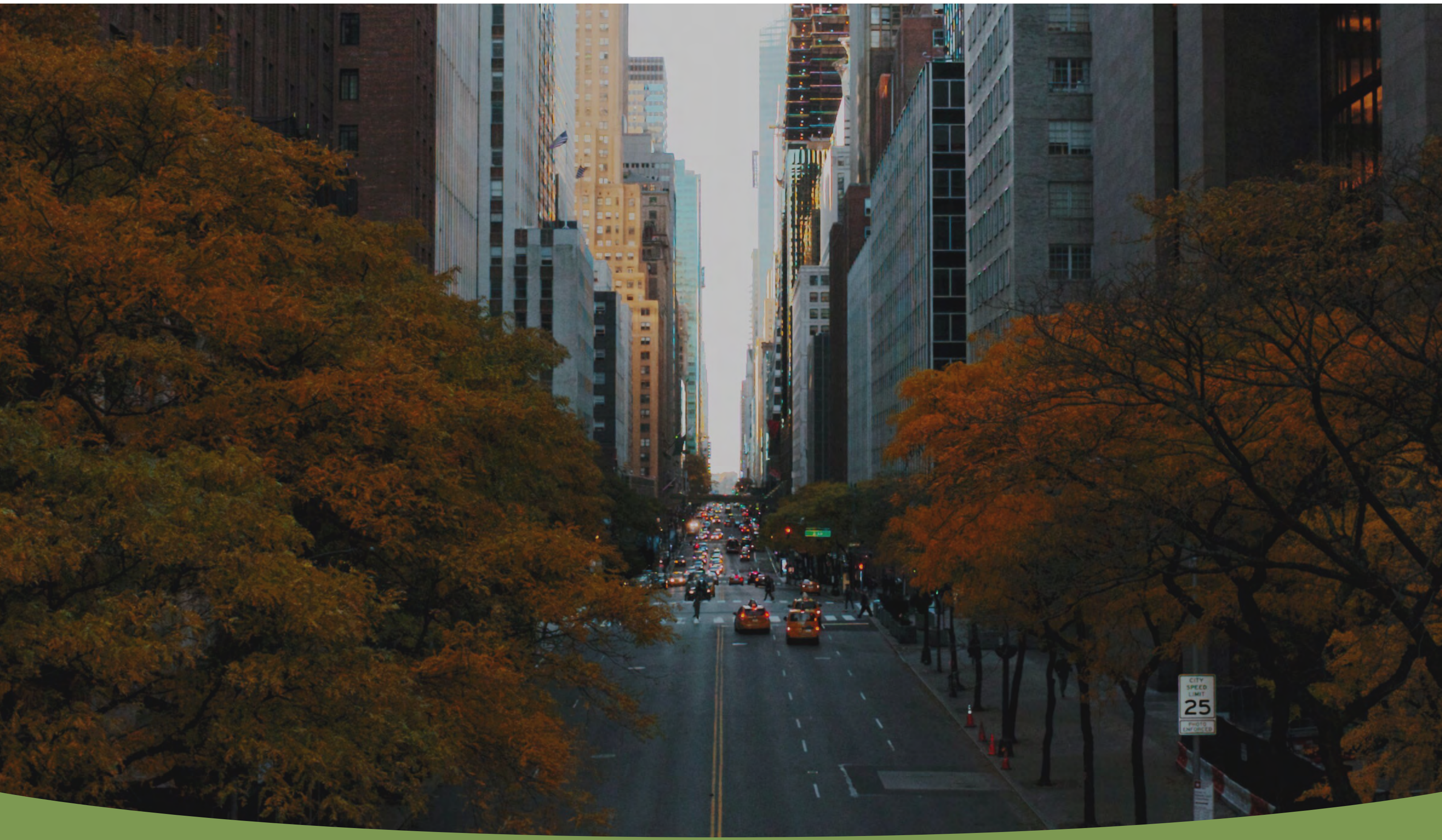
Building-level certifications like LEED are extremely valuable to help meet the expectations of investors, financial institutions, and other stakeholders. In fact, the USGBC released a crosswalk tool in late 2022 to help measure the ESG aspects that LEED can address in GRESB and the UN PRI.

Building regulations

While the launch of the National Building Performance Standards Coalition signaled a more collaborative approach to building performance standards, disparate approaches and data requirements for each BPS present a unique challenge to portfolio owners operating in multiple cities and states. It's no wonder that 52% of North American real estate managers put responding to sustainability-related regulations as their highest ESG and sustainability initiative from 2024 in a recent Verdantix survey.

Conclusion

The list of challenges CRE faces to ensure their emissions data is accurate, consistent, comparable, and meets the wide range of reporting requirements is endless. Using technology to aggregate the data at scale - we are out beyond the bounds of Excel - will be crucial for transparency, audibility, and ease of use as ESG leaders demonstrate progress on the path to decarbonization.



Prediction #3: Profitable Decarbonization is possible & ESG payback is priority

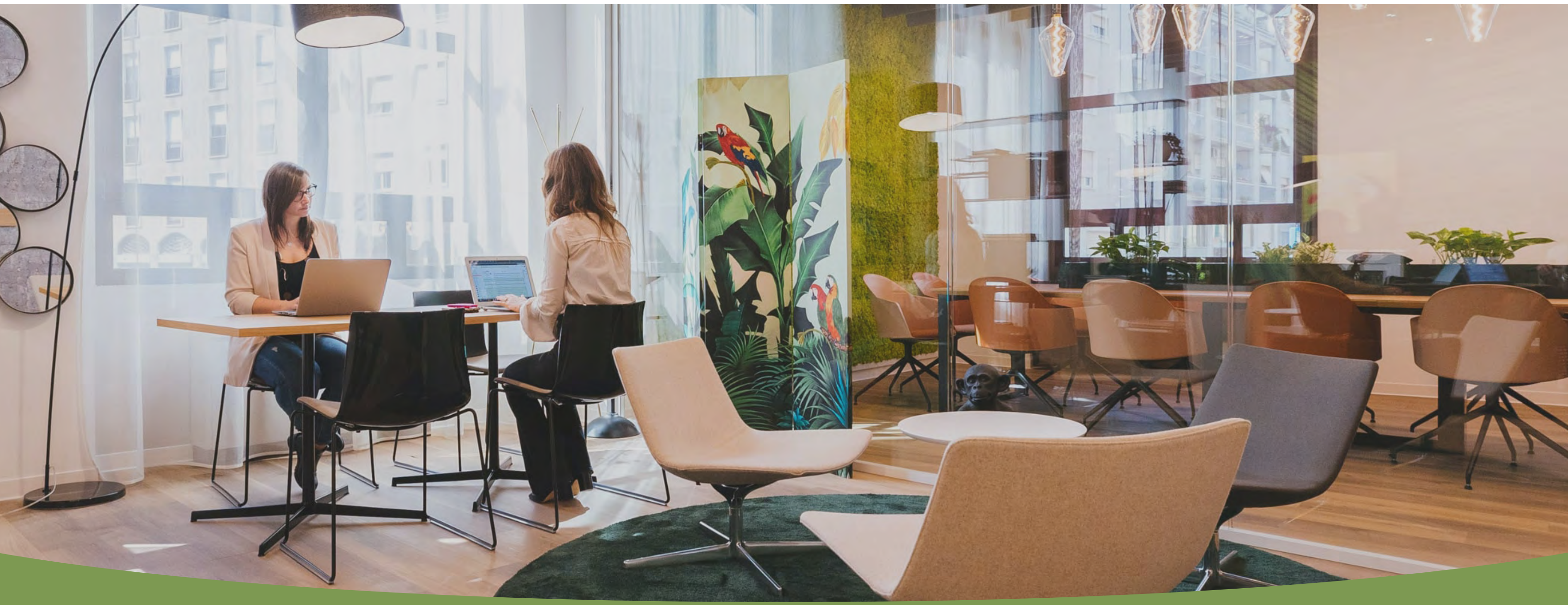
PREDICTION: The nexus between sustainability and profitability would be a primary focus, exploring how real estate can both decarbonize and gain economically.

OUTCOME: With limited capital, there is a shift towards understanding the impact of operational improvements on decarbonization in the shorter term. Even though the significant potential of operational efficiency to drive down carbon emissions, energy use, and cost is often underestimated.

SUMMARY: CRE is currently operating in a landscape of capital scarcity. Deloitte's '2024 Commercial Real Estate Outlook' report underscores a remarkable time for the industry, with an accentuation on cutting costs due to diminishing income projections and considerable worries about the expense of capital and its accessibility. In this situation, capital expenditure investments in sustainable building infrastructure are not seen as attractive or viable options by numerous building owners, but the door remains open for operating expenditures.

"Most of the things you can do to reduce the carbon footprint of your buildings are major capital-intensive decisions. Cortex is an AI-enabled machine learning software solution that we can implement that immediately reduces our carbon footprint. It is probably the cheap, easy, actionable first step that every building owner should use."

Nick Bienstock, Co-Chairman and Chief Executive Officer
Savanna



Driving down carbon emissions and energy costs

Investing in operational improvements, such as digitizing building and power-management systems, replacing fossil-fuel-based heating technologies with electric alternatives, and installing renewables-powered microgrids, can have a huge impact on decreasing the carbon footprint of office buildings. Recent research by Schneider Electric shows that these initiatives can reduce operational carbon emissions by as much as 42%, and another 28% if renewables-powered microgrids are added. This may be a more practical approach than major infrastructure investments.

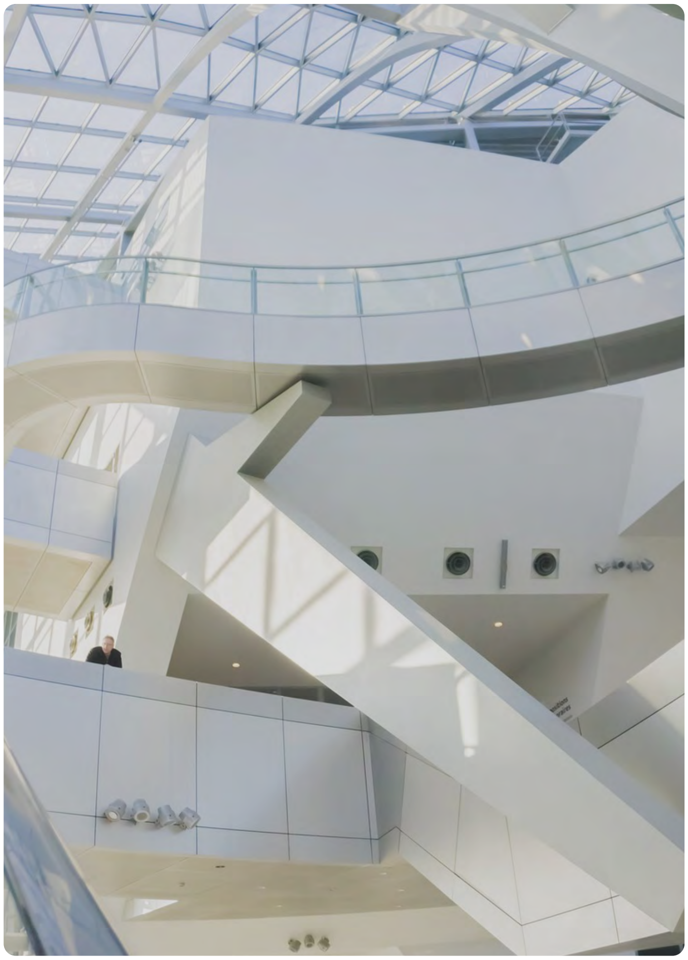
This is further supported by research from the Pacific Northwest National Laboratory (PNNL) that suggests building re-tuning - a systemic, data-driven approach to achieving optimum operations - can net energy savings from 5% to 25% for buildings with building management systems and minimal ReCx/RCx needs.

Enhancing asset value

Improving the operational efficiency of office buildings not only reduces their carbon footprint but also unlocks significant asset value. As the industry approaches a sales cycle in 2024, enhancing a property's Net Operating Income (NOI) becomes increasingly important. Operational reforms that lead to more efficient building operations can substantially improve a property's NOI, making it more attractive to potential buyers or investors. This is particularly relevant in an environment where traditional revenue streams are under pressure, and building owners are seeking ways to increase the value of their assets.

"There just aren't a lot of budget line items that you can look at right now, in an existing building, and make an argument that if you spend this money now, you can make it back in months like you can with software-driven optimization."

Commercial Real Estate ESG Leader



The role of technology

Technology is essential for driving operational excellence. Applying intelligence to Building Management Systems (BMS) is essential to cutting down on carbon emissions and energy consumption. By leveraging technology to optimize building operations, owners can achieve significant improvements in energy efficiency and sustainability, while also enhancing the overall value of the asset. This approach aligns with the industry's increasing focus on technological capabilities and agility, as noted in Deloitte's report, where outsourcing for efficiency and addressing technical debt are emerging trends.

Conclusion

While commercial real estate's financial challenges and a need for sustainability loom large, there's a clear path forward. Operational improvements, supported by technological advancements and efficient management practices, offer a solution to reduce carbon emissions significantly.

How Cortex can help

Cortex's decarbonization platform has helped leaders in the CRE industry with both the asset- and portfolio-level insights to accelerate their decarbonization journey. With 23,000 metric tons of CO2e reduced per year across the 45 million square feet it monitors, Cortex's team is well-versed in identifying the needs of asset and property managers, building engineers, and sustainability executives to meet their ESG goals.

CRE leaders like Empire State Realty Trust, Rockwood Capital, Vornado, SL Green, Moinian, and Savanna are already working with Cortex to enhance operational efficiency, achieve their decarbonization goals, and position themselves for a robust future in the transforming industry.

Interested in learning more about how Cortex can help you achieve your sustainability goals?

Contact us at **sales@cortexintel.com**