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Real Estate Practice

Proposed climate rule signals new era for real estate

The SEC's draft regulation would require all public companies to disclose emissions and risks related to their real estate. Here's why the real-estate industry should move preemptively.

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June 2022

On March 21, 2022, the US Securities and Exchange Commission (SEC) proposed a rule to enhance and standardize climate-related disclosure for investors.[1] If carried through as written, the rule would require public issuers to disclose material climate risks, greenhouse-gas (GHG) emissions, and, as applicable, emissions reduction targets and transition plans.

The proposed SEC rule would affect the real-estate world in two key ways. First, it would apply directly to publicly traded real-estate companies and real-estate investment trusts that are registered with the SEC.[2]

Second, it would indirectly apply to the vast majority of large real-estate owners. A significant number of corporate tenants, real-estate lenders, and real-estate investors are public entities that would be covered by the SEC rule, and therefore would have to make disclosures about their real-estate holdings. Given that real estate accounts for a significant component of scopes 1 and 2 GHG emissions[3] for players in most industries, meeting the SEC's reporting requirements is impossible without understanding the emissions that come from real-estate footprints. If enacted, the SEC's rule would mean both public and private real-estate companies must provide this insight to their tenants, investors, lenders, and other stakeholders.

While the rule may be challenged, the proposal is likely to have a significant impact on the real-estate industry. Over the past several years, some real-estate players have developed a growing awareness of the need to incorporate both climate-related risks and emissions into their valuation, decision making, operations, reporting, and pricing.[4] Others have moved more slowly. The proposed rule introduces the idea that climate disclosures are fundamental to running any real-estate business.

Real-estate firms will likely soon be receiving calls from their tenants and investors looking for emissions figures, risk disclosures, and emission-reductions plans. Tenants and investors may be concerned with meeting the requirements of the proposed SEC rule or doing the same for other regulations that could emerge. They will likely want to work with companies that can provide reporting of current emissions and risks, ongoing assessments as the climate changes, and options for reducing emissions.

For publicly held tenants and investors, the requirement to disclose real estate climate risks and emissions provides another reason to reduce emissions and help their stakeholders and customers do so. A benefit may be that those who do it well and early have a competitive edge.

For the real-estate industry, the lingering question around climate change has always been, what will be the catalyst for decisive, collective action? The SEC's proposed rule provides an answer: the time to act is now.

Real-estate companies have an opportunity to respond to the SEC's proposal preemptively

Publicly traded companies in all sectors are preparing for the potential implications of the SEC's proposed disclosure rule (exhibit). Real-estate companies would be wise to prepare for the climate-risk questions tenants, investors, lenders, and other stakeholders will have. They can use these insights to revalue and reassess their real-estate portfolios, and ultimately differentiate themselves in the marketplace by offering the most comprehensive and effective emissions reduction solutions.

[1] "SEC proposes rules to enhance and standardize climate-related disclosures for investors," US Securities and Exchange Commission, March 21, 2022.
[2] Patrick J. Kiger, "What SEC's proposed climate disclosure rule could mean for real estate companies," *Urban Land*, April 15, 2022.
[3] *2019 Global status report for buildings and construction: Towards a zero-emissions, efficient and resilient buildings and construction sector*, Global Alliance for Buildings and Construction, 2019.
[4] Jameelah D. Robinson, "Real estate investors want to know what cities are doing about climate risks," Bloomberg, November 3, 2020.

Exhibit

The SEC's climate-related disclosure rule would require companies to disclose material climate risks, including emissions data and transition plans.

What companies would have to disclose[1]

Material impacts

How climate can impact companies' bottom lines—in the short, medium, and long term—and what governance, strategy, and risk-management processes will address these impacts.

Greenhouse-gas emissions

Audited scopes 1 and 2 emissions and scope 3 emissions, if material (or if the entity has a scope 3 target), as well as safe harbor for liability from scope 3 emissions.

Target and transition plans

If available, climate-related targets or goals, accompanied by detailed transition plans, scenario analysis methods, internal carbon pricing, and how it is set, and the use of offsets and renewable-energy certificates.

[1]This chart is a summary for general information only and does not constitute legal or regulatory advice. Advice of appropriate counsel must be sought prior to any consideration of the issues raised herein.
Source: US Securities and Exchange Commission (SEC) enhancement and standardization of climate-related disclosures, March 2022

Tenants will soon be calling

Tenants that lease commercial real estate for business unrelated to real estate may be contemplating for the first time that the physical spaces they occupy contribute to emissions and expose them to climate risks. They will need answers from their real-estate partners.

The most straightforward questions will involve emissions, including the following:

— What are my emissions today?

— How can I reduce those emissions? Can I do so in my current buildings?

— What will these reductions cost? What value could they create?

— As the climate or regulation changes, or as operations change, will our real-estate partner be able to provide updated emissions readings?

More complex questions will emerge from disclosure requirements regarding materiality impacts and specific risks to organizations' physical footprints, including the following:

— Which offices are at risk and to what extent?

— Which manufacturing facilities, distribution centers, data centers, or hospitals will be affected by climate risks?

— How will the above risks affect operational continuity?

— How probable are these impacts, and how severe?

Answering these questions requires understanding the details of the physical hazards in a specific location and the extent to which these hazards could affect the operation of a building (such as if a flood could disable the building's mechanical systems or whether those systems are located on the roof).

Investors will have a new set of needs as the 'Great Repricing' accelerates

Real-estate investors may be familiar with green building concepts but should get used to the idea that their entire portfolios will likely need to be reexamined through a climate lens.

We have argued in prior work on climate risk and the opportunity for real estate[5] that emissions and climate impacts will soon be significant drivers of the value and performance of real-estate assets. These impacts can manifest in both positive and negative ways for the value of a given real-estate asset.

On the positive side, real estate can help companies meet their emissions reduction targets and tenants will likely make greater investment in climate-ready real-estate assets because of the long-term savings that stem from mitigating climate and regulatory risk. Insurance costs, utility costs, and other costs (such as for repairs and maintenance) could decrease in such buildings due to better physical resilience. In turn, the value of these assets could be higher because of more attractive income and operating-cost profiles. As a corollary to these direct impacts on property net operating income (NOI), as investors look to decarbonize and reduce the climate risks in their portfolios, the attractiveness of assets will vary based on their emissions and risks, and capitalization rates will reflect this.

Conversely, buildings at risk from growing physical hazards or with higher emissions profiles will decrease in value over time, as industry players comprehend, account for, and report on climate-related risks. Insurance costs, utility costs, and other operating costs may be higher in these properties.

Until now, the impact of climate on the performance and valuation of real-estate assets has been felt primarily by select pockets of the most obviously exposed real-estate.[6] However, as thousands of companies begin to comprehend the emissions and risks that emanate from their real-estate choices, this information will become clearer and more widely distributed.

It is easy to imagine this awareness creating tenant demand for lower-emissions building performance from their landlords and for lower-risk locations or buildings. As tenants migrate, it follows that lenders and investors would do the same. The result is a phenomenon we call the "Great Repricing," a re-sorting of value in which some assets would be devalued, some would be stranded, and some would become more attractive. Still others could be significantly refurbished and repositioned in light of these changes.

We believe growing climate awareness that ultimately results in the Great Repricing will happen whether the SEC's proposed rule becomes reality sooner, later, or not at all. However, by focusing the attention of all public companies on the climate risks and emissions profiles in their real-estate footprints, we think that the proposal will accelerate the process.

Real-estate players with climate intelligence and capabilities will stand out

As the Great Repricing unfolds, opportunities will arise for real-estate players that understand how climate factors affect their portfolios and asset values and can respond in ways valued by tenants, lenders, and investors.

Climate responsiveness will become a new basis for differentiation across the value chain. Companies that create reporting systems to support tenants, lenders, and investors in meeting their disclosure requirements will be more attractive as partners and landlords. Landlords that help occupiers lower emissions through refurbishment, lower-carbon building systems, and ancillary ways such as solar-energy generation or electric-vehicle charging may gain a competitive edge by offering these value-add services. Individual buildings that are lower carbon and lower risk will be highly differentiated, as will be markets that pose lower risks.

Real-estate players that build climate intelligence and capabilities can separate themselves from the pack. While the race had already begun for some, the SEC has now fired the starting gun for the whole industry.

[5] Brodie Boland, Cindy Levy, Rob Palter, and Daniel Stephens, "Climate risk and the opportunity for real estate," McKinsey, February 4, 2022.
[6] For more information, see *Climate risk and response: Physical hazards and socioeconomic impacts*, McKinsey Global Institute, January 16, 2020.

Now is the time to develop a clear understanding of the impacts of climate on the performance and value of assets.

What can real-estate companies do today?

There are multiple reasons the real-estate industry must make changes to combat climate change and prepare for its effects. First, real-estate assets are vulnerable to long-term climate risk that can be very expensive. Second, real-estate companies have their own commitments to reduce emissions—in some cases in response to demand from investors—and comply with existing regulations. The SEC's proposal can be viewed as a third reason and an accelerant to the above imperatives.

Given the shifts on the real-estate horizon, real estate players should consider several actions:

— *Create an emissions reduction and reporting engine*
  Real-estate companies can effectively understand their baseline emissions, find ways to cost-effectively reduce those emissions, and report on those reductions. This is a good time to take stock of organizational capacity, expertise, and data needs around emissions.

  Companies should determine what people, capabilities, tools, and processes they need to understand each property's emissions. They should determine which insights are required to find the most cost-effective ways to reduce emissions, and what execution capability is required to deliver reductions.

— *Set up an organization and operating model to address emissions*
  It will be important to set up a coordinated governance structure across property operations, asset management, risk, finance, and other functions to ensure this engine is effective.

  Reducing emissions and addressing material impacts will likely require different forms of engagement with a broader set of stakeholders than many real-estate firms are used to. It may also be important to have a single leader responsible for pulling together these threads throughout the business. This leader can develop coalitions that push to reduce emissions in areas not in the landlord's direct control. Partnering with utilities can help in electrification and efficiency efforts; working with banks can unlock lower-cost financing for energy-efficiency retrofits; and working with local municipalities could create development allowances that enable a lower-emissions building or improve the availability of public transport.

— *Build a solid view of material climate impacts*
  Now is the time to develop a clear understanding of the impact of climate on the performance and value of assets. It is important to forecast the impact of changing physical risks such as fires, floods, storms, and heat on the fundamental economics of assets. Equally crucial is an understanding of what a decarbonizing economy means for a company's markets, tenants, asset NOI, and capitalization rates. To make the most of insights into material impacts, knowledge must not remain isolated within the risk function but rather become a capability that cuts across the organization.

— *Translate capabilities into value*
Turning climate-impact insights and emissions reduction into value requires active engagement by real-estate players. For example, if a real-estate company makes changes to a building that lowers energy use—thereby lowering associated emissions—it should also develop a novel leasing structure that acknowledges the building's lower utility costs and "green premium" (the benefit the tenant will derive from occupying such a building). Other innovative approaches could also be pursued, such as financially partnering with tenants, lenders, or equipment providers to conduct retrofits. Changes to assets that create climate resilience can result in an edge not just with tenants but also in capital allocation, investment decisions, and asset management. Many larger players should consider developing an advanced analytics capability to ensure that climate insights effectively inform decisions across the business.

Real estate plays a critical role in ensuring the decarbonization and resilience of our economies and communities. While many of the shifts described in this article are already under way, the SEC announcement will likely accelerate them and create both urgency and opportunity for leading real-estate players to respond.

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