RICS PROFESSIONAL STANDARD

Sustainability and ESG in commercial property valuation and strategic advice

Basis for Conclusions

December 2021

RICS

Purpose

This document has been prepared to support the publication of *Sustainability and ESG in commercial property valuation and strategic advice,* 3rd edition, RICS professional standard, effective from 31 January 2022.

It is emphasised that this document has been produced purely to assist the reader and does not form part of the standard.

RICS Standards and Professional Development

December 2021

Overview

The reasons for developing the RICS professional standard *Sustainability and ESG in commercial property valuation and strategic advice* are:

- to provide a comprehensive update of the 2013 guidance note
- to give a practical framework for delivering RICS Red Book Global Standards sustainability and ESG standards
- to consider a substantial recent increase in interest and regulation relating to this issue globally.

There were 22 written responses to the online consultation, which proposed changes to the professional standard, and included detailed technical comments, commentary and suggestions for amendments. Responses were received from stakeholders across the globe, with particular concentration from the UK, Europe and APAC regions. Though some respondents were anonymous, those who stated their firm were from a range of company sizes and business purposes, including valuers, lenders, investors, asset managers and sustainability consultants. A range of firm sizes from SMEs to multidisciplinary international firms responded. There were also responses from national and multinational trade bodies and professional organisations.

Commentary is set out below referencing those sections commented on by respondents. It is not possible to provide an individual response to all comments, though the commentary below endeavours to be reflective of the consultation responses as a whole. Respondents, where referred to, have been anonymised, though in some cases their sector and geographic reach are referenced for clarity. Material changes agreed from the draft version to reflect responses have also been detailed below. Where a suggested change is not considered appropriate, a response and alternative next steps are provided. Changes have been referred to the lead author and expert working group and approved by the RICS Standards and Regulation Board following a full public consultation. RICS thanks all contributors to the consultation.

General

In addition to the commentary on individual aspects covered below, two respondents (a valuation advisory firm and an investor organisation) made comments looking at the overall structure. These comments made suggestions around the overall length and scope of coverage and also requested adding more graphical elements. We have sought to add clarity, where possible, to the standard through addressing issues raised in the consultation responses, highlighted below. The standard is entirely text based in its present form and it was concluded that this was necessary for a professional standard of this nature. However, it is recognised that RICS will need to produce communications, articles and insight to support the standard that can be more targeted (in terms of geography and scope), graphical and concise.

An update to Red Book Global Standards was published 30 November 2021 and all cross references to this have been updated to correspond with the new version accordingly.

Glossary

One respondent suggested that the professional standard should include further definitions of additional sustainability-related terms, such as 'physical risk' and 'transition risk'. Upon reflection, the glossary has been expanded to include additional key terms. However, it is recognised that there are not agreed or definitive definitions of some terms – and a statement to this effect has been added to the glossary.

A further respondent wanted the capital expenditure definition to reference International Financial Reporting Standards (IFRS). Where possible glossary terms have been sourced from a recognised standard definition. In some cases, the exact definition may depend on the context of the valuation purpose. Revised commentary has been added to section 4 *Valuation instructions and terms of engagement* to consider this.

Introduction

One respondent suggested that transactions and associated finance should be reflected in the scope. Given the substantial reference to real estate transactions and lending during our global insight gathering for the standard, the suggested omission in the draft is accepted and a change has been made.

A number of respondents sought further clarification of the scope of the standard, including around non-financial disclosures, net-zero carbon strategies and carbon off-setting. It has now been clarified within the document that these elements are not specifically covered by this standard, which is focused on valuation. However, RICS is committed to undertaking further work in this area. Content can be found on the sustainability section of our website, with more coming in 2022. In addition to the subject professional standard, RICS has also recently published other significant pieces of work covering sustainability and ESG, such as the global Responsible Business Framework and ICMS 3 cost and carbon management standard.

To enhance the global scope of the standard and its range of reference a respondent suggested adding 'heat' to the locational examples in addition to 'flooding and severe storms'. This was seen as a good suggestion and has been adopted.

One respondent thought it might be useful to reference other RICS standard, information and workstreams related to sustainability and ESG in the introduction. We have looked to reference these in the standard where they are global and relate to ESG in valuation, however we have not included references to all RICS' work in this area. In some cases, RICS content may not have the same status as a professional standard (for example the RICS Responsible Business Framework), and there might be confusion as to its application if referenced. Other RICS sustainability content has been referenced and promoted on the web page hosting the subject professional standard.

A substantial number of respondents thought the TCFD (Taskforce for Climate-Related Financial Disclosures) reference should be expanded to give details of the framework and how it might relate to real estate valuation. Some stakeholders thought the standard should actually set out steps for alignment with TCFD. TCFD looks at sustainability at a corporate level and is a system for appropriate measurement and governance related to climate risks. It is not a tool designed specifically for application in respect of individual real estate asset valuations – although it is accepted that there is relevance to valuation (particularly for the purpose of financial reporting). To address the comments made in respect of TCFD we have expanded the description at Appendix A and highlighted in section 4 that requirements to align with specific schemes beyond valuation standards and practice information should be agreed in instructions. RICS will produce further content around TCFD alignment and ESG financial disclosures in 2022.

Role of the valuer

It was suggested by one respondent that 'responsibilities' be added to the heading for this section. Looking at the balance of responses and having reviewed the content in this section it was agreed that this was implicit within the text.

Two valuer respondents felt that at the current stage of global awareness related to this issue in technical terms, limitations on the valuer's role should be explicitly listed in this section. There is difficulty with this approach in that it depends on the nature, purpose and basis of the valuation – however amends have been made throughout the standard to clarify expectations around the valuer's role in different scenarios, and the role of other valuation parties. This is most prominent in the need to clarify expectations in terms of engagement.

Valuation purpose

Valuations for a regulated purpose are prominently highlighted in this section – however, one respondent thought it should be made clear that ESG and sustainability are a consideration whatever the valuation purpose. This was agreed and a statement has been added to that effect.

Valuation instructions and terms of engagement

Given the frequent comments by respondents throughout the draft, querying the expectations of the valuer and their subsequent investigation and reporting it was felt that a cross reference to Red Book Global Standards covering this would be a useful addition to this section, explicitly covering the nature and extent of the valuer's work, nature and source of information and any assumptions or special assumptions.

A clarification was also added to this section further to the queries around TCFD and other financial disclosure mechanisms highlighted above. The addition highlights that these may need to be agreed as part of terms of engagement or as separate instructions where alignment is required.

Two respondents felt that a specific heading for strategic advice should be included, and a number of others thought the commentary on strategic advice should be more clearly separated. A heading has been added in the revised draft and a section added around the need for strategic advice to either be separately instructed or clearly delineated in reporting.

Investigations data

A significant number of respondents wanted more detail around the sources of data and whose responsibility it was to identify and investigate these. Amendments have been made to reflect that data may come from the client, public sources and third-party data as well as the valuer's own investigations. The reference to property metrics has been amended to specifically refer to the rating and benchmark schemes included at Appendix A.

Reporting

Similar to the TCFD alignment requests referred to above, a number of respondents, mainly from client side suggested there should be more explicit reference and required alignment with financial reporting systems and requirements such as the EU Taxonomy and Sustainable Finance Disclosure Recommendations (SFDR). There was also significant commentary from respondents from all sectors requesting specific reference to current and pending UK Minimum Energy Efficiency Standards (MEES) and Energy Performance Certificates (EPCs). This is a global professional standard and does not go into detail about world regional or national regulation, however it is recognised that RICS has a role to play supporting valuers on these issues going forward. RICS is committed to undertaking further work around world regional and national ESG and sustainability requirements in future workstreams. An example of this is a proposed update of the 2018 Minimum Energy Efficiency Standards: Impact on UK property management insight report.

A respondent representing European investors and lenders suggested that explicit reporting requirements should be included to cover:

a. A separate line for ESG capex vs 'normal' Capex.
b. Explanation of the effect of the asset ESG 'quality'/rating vs the prime yield.
c. ESG rating per asset.

It was felt that this could not be assumed to be in scope for all commercial property valuation globally and was subject to the purpose and basis of value as well as specific instructions. Notwithstanding this, it is recognised that there is a need among some end users of valuations to have the level of detail explicitly reported as above. RICS will undertake further investigations around how end users' ESG and sustainability needs can be met – including areas that might be beyond a typical valuation instruction. Details of these workstreams will be published on our website sustainability page.

Comparables and evidence

Similar commentary to above was made by a number of respondents in respect of the need to reference local and international regulatory performance schemes in analysis of comparables. UK EPCs were the most frequently referenced. Although the subject standard does not cover national level requirements, a change has been made clarifying the need to consider statutory schemes when analysing comparables in relevant circumstances.

Valuation methods and considerations

Two valuer respondents thought that the comparison between DCF and income capitalisation could better be framed as a comparison between explicit and implicit valuation techniques, pointing out that modern valuation software was capable of making traditional income capitalisation techniques more explicit – such as including cost analysis. We agree that there is some validity to these suggestions and have made a number of changes to this section to reflect this insight.

Carbon emissions, net zero and energy efficiency

Further to the suggestion of two respondents, a small change has been made to this section to clarify the details a valuer may need to reflect on here. A change has been made adding: 'it is advised that, where available, valuers obtain relevant carbon assessment and energy efficiency information relevant to the asset being valued from their client and, for example, third-party data and publicly available sources.'.

Environmental, physical (and transition) risks

Two respondents felt that the different types of risk were clearly identified and commented upon in this section. On reflection this was agreed, with transition risk being added to the heading (and glossary) as well as the section being reorganised to cover three distinct types of risk. In terms of the capability of the valuer to assess transition risk, the following has been added: 'A valuation undertaken on the basis of market value or fair value reflects the evidence available to the valuer and information known at the valuation date and any commentary around environmental, physical and transition risk will be reflective of this.'.

Secondary property (property quality and market participants)

Two respondents thought that the term 'secondary property' would not be understood globally, and one suggested an alternative heading 'Property quality and market participants', which has been adopted.

Governance

Two respondents queried why the 'g' in ESG wasn't covered and to reflect this a short paragraph/section covering governance has been added. This mainly references the need-to-follow standards.

Appendix A – International sustainability/ESG rating, benchmarking and measurement schemes

One respondent asked that CREMM be referred to additionally and this was agreed and has now been added. The TCFD reference has been expanded as per the suggestion above.

Appendix B – Property observation checklist for identifying potential environmental issues (commercial and industrial)

Commentary on this section suggested that its use was not clear without the context of the environmental risks professional standard and that it also did not address some contemporary valuation issues around environmental risks, nor delineate, e.g. transition risk. This appendix has therefore been removed.