BUILD BACK BETTER

Route to resilient and circular real estate management

July, 2020

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Real estate investors and developers have to deal with pressing issues originating from the COVID-19 crisis, while global developments such as climate change, resource scarcity and urbanization need to be dealt with as well. The only way to succeed is by embracing the principles of the circular economy and aim for a low carbon, healthy and regenerative built environment that creates circular shared value[1]. There is not a single solution available to create shared value all at once. There are, however, core principles that can be followed to satisfy the needs of the real estate market in the present and the future. These core principles – distilled from lean management, the Cradle to Cradle philosophy and KPMG's True Value methodology – aim at creating circular shared value in the short and long term and value for shareholders as much as for society. This paper explains why and how to 'build back better' and create long-lasting value through applying these core principles in real estate management.

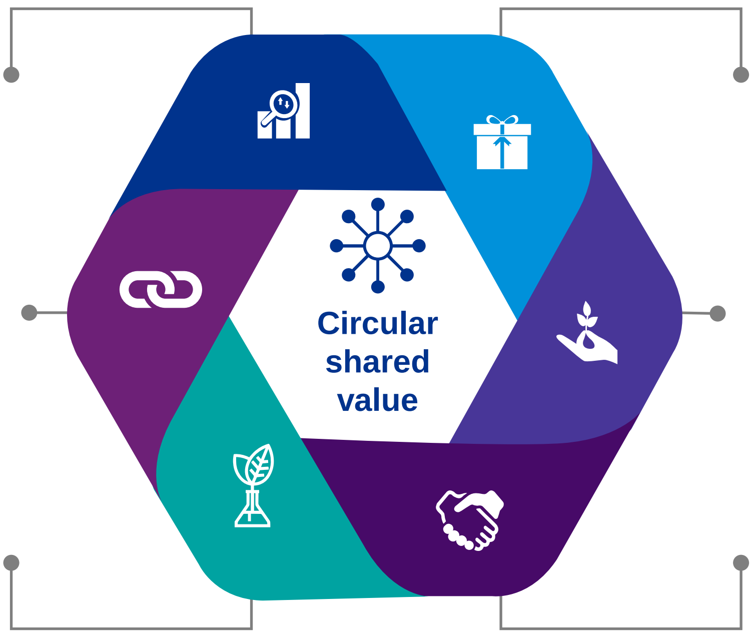

Figure 1: Value map showing examples of circular shared value creation for different stakeholders - values that should be taken into account in order to stay or become successful in the short and long term.

In this paper:

Note: (1) Shared value is a term coined by Michael E. Porter and Michael R. Kramer in 2011 to show businesses need to look further than financial profit to unleash innovation and growth (Porter & Kramer, 2011)).

These are uncertain times for real estate investors, owners and developers

The real estate industry is a significant contributor to global wealth and has a significant impact on the world around us and the way we live our lives. The COVID-19 crisis is affecting the global economy, including the real estate industry. Real estate owners and developers have a complex task ahead of them to deal with the urgent matters as well as developments in the mid and long term that need to be addressed.

COVID-19 consequences

The most urgent matter is to ensure employees and occupants stay healthy and safe. After that, other matters will need to be taken care off. For instance, how to deal with reduced operating income due to a lack of visitors (e.g. in restaurants, malls, lodging), tenants who are struggling to make lease payments and construction delays due to the lack of employees and/or materials. Liquidity will remain one of the main concerns for some time to come, however, financial liquidity and focus on the short-term performance should not be the only focus.

Dealing with social and environmental planetary boundaries

Mid- and long-term developments need to be addressed to stay within the ecological and social limits of our planet (Raworth, 2017). A growing world population combined with average income growth is boosting demand for resources. In addition, climate change demands real estate to adapt to extreme weather patterns on the one hand. While on the other hand the real estate sector can prevent or mitigate carbon emissions through design, business models and choice of materials, ensuring carbon is perpetually cycled or returned back safely to the biosphere to replenish the soil (McDonough, 2016). Furthermore, declining ecosystems and worldwide urbanization ask for a regenerative approach to the built environment and spatial planning in general. Increasing pollution and use of toxic materials are a general concern as well[2]. As a consequence, government regulations are becoming stricter and stricter to make sure national and international sustainable development goals are reached.

The current system of creating value in the real estate sector is not sufficient anymore and the sector – responsible for approximately 40% of material use, 40% of energy consumption and 30% of global GHG emissions – has to take its responsibility and address these global issues (KPMG, 2011). Value creation should not be seen purely in financial terms, it has major social and environmental implications as well (KPMG, 2014). When looking at the reasons for value increases or losses in the real estate market, the focus is primarily on short-term losses, but the real estate paradox lies in the fact that value retention and creation is a long-term job, with global implications affecting a myriad of stakeholders. Future proof real estate industry needs to be urgently revisited.

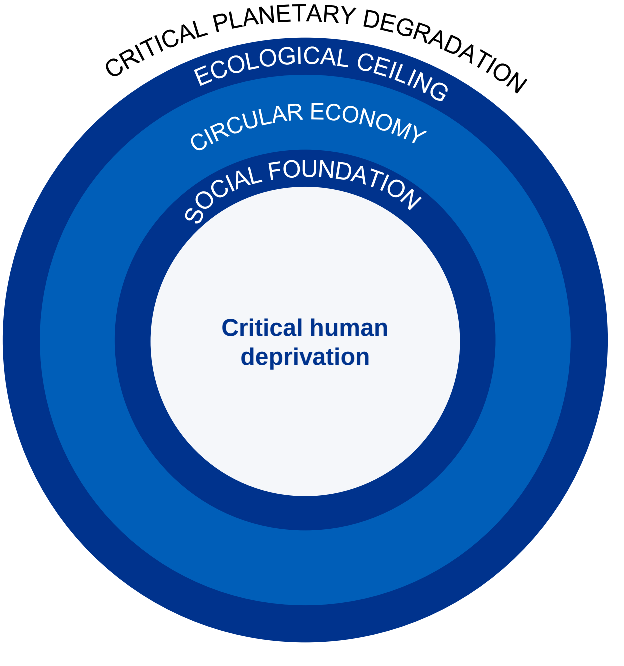

Figure 2: Our planetary boundaries illustrated as a doughnut, clearly showing the need to stay above the social foundation and below the ecological ceiling to have a liveable planet for generations to come. Image designed by Christian Guthier for the book Doughnut Economics (Raworth, 2017, p. 11).

Note: (2) Current research even suggests that high levels of air pollution may be one of the most important contributors to deaths from COVID-19 (Carrington, 2020).

There are barriers to be overcome

Creating circular shared value and looking for social, ecological and financial return on investment is a complex task as there can be many challenges on the road (R2Pi, 2018; Bianchini, Rossi, & Pellegrini, 2019). The six main barriers to creating circular shared value can be found in the following areas: planetary boundaries, technical feasibility, business implementation gap, legislation & governance, readiness to innovate and (cross-)sector collaboration.

1. **Planetary boundaries**: Circular shared value creation should preferably result in regenerating ecosystems and improving health and well-being of those affected. The difficulty lies in satisfying all stakeholders and optimizing social, environmental and financial value creation. Total cost of ownership approaches and lifecycle analysis can help in making the right decisions for the short and long term.
2. **Technical feasibility:** Is it possible to deliver the same real estate quality while using alternative materials, construction processes or locations? And are we technologically or chemically advanced enough to positively deal with the assets that became obsolete? Cross-sector knowledge sharing and funding for dedicated education can mitigate these limiting factors. And as other barriers lower, particularly regulation, there will be new incentives that will spur innovation in both technology and business models.
3. **Business implementation gap:** On the one hand markets are not always ready for innovative and/or more costly products. On the other hand, a gap exists between corporate strategy and availability of internal resources to advance the creation of circular shared value. What is more, measuring non-financial value to convince stakeholders can be challenging. Initial public financial support for innovation can improve the business case for circular shared value and increase uptake in the long run. In addition, reporting initiatives to quantify ecological, social and long-term business benefits also help in building the business case for innovative circular solutions.
4. **Legislation & governance:** Current legislation does not always support creating circular shared value. Waste regulations can limit reuse, public procurement does not always contain social or ecological requirements and in general negative ecological impact is not taxed. However, all across the world we do see a changing regulatory environment that stimulates sustainable public procurement, taxes activities with negative impacts and fosters collaboration through international green deals[3].
5. **Readiness to innovate**: The high durability and heterogeneous nature of real estate assets as well as the relatively high cost of experimentation, have always presented a barrier for innovation. In the real estate industry this is true for not only the way to retain and create value, but also the way to address real estate – ultimate – valuing. The real estate industry is slowly opening up to innovation because in this digital era it has become a necessity to provide better offline environments due to online competition and create a futureproof business model. This can be accelerated through creating an open, curious and execution-oriented culture that focuses on optimizing circular shared value (KPMG, 2019).
6. **(Cross-)sector collaboration**: (Cross-)sector collaboration is mentioned separately, although the lack of collaboration is also a result of the other five barriers. The main other challenge lies in the willingness and ability of organizations to share knowledge within or outside the value chain. Collaboration can be facilitated by specific funding as well as setting up dedicated networks and pilot sites.

Note: (3) Examples of such green deals are for instance global commitment to reach the Sustainable Development Goals (United Nations, 2019), the European Green Deal (European Commission, 2019) or the Green New Deal that is currently being discussed in the United States (Friedman, 2019).

Strategic decisions are required, not Band-Aids

The current developments in the real estate industry should be an eye-opener to the way business should be done. The chosen measures to deal with urgent matters should not just ensure liquidity in the short term, they should be about creating value in the long term as well. Real estate owners and developers have the choice to either "invest their way out of" or to "save their way out of" it. Organizations that keep investing in innovation and sustainability are most likely to adapt to the challenges caused by the emerging crisis (Ioannou & Flammer, 2019). It will require leadership, ambition and engaging with all public and private actors in the real estate ecosystem, but it should be clear that aiming for anything less than shared value is not meant to last in these times. Like a big vessel manoeuvring in the middle of the bay, vision and stewardship are needed for guidance. Investments made now will determine what real estate will look like for years to come.

Only a systemic approach works

Over the years many tools, methodologies and approaches have been developed that can help organizations in developing futureproof strategies, fact-based decision making and increasing effectiveness of business processes. The core principles laid out below are mainly inspired by the principles of Lean Management (Womack, Jones, & Roos, 1990), the Cradle to Cradle[4] philosophy (McDonough & Braungart, 2009) and KPMG's True Value methodology (KPMG, 2014). These approaches have in common that they provide a holistic view on value creation and aim for continuous improvement. When combined, they translate to five core principles that support the development of resilient organizations that create circular shared value.

Lean management

Maximize value, minimize waste

- Identify value
- Map the value stream
- Create flow
- Establish pull
- Seek perfection

Cradle to cradle

Eco-effectiveness instead of efficiency

- Everything is a resource for something else
- Use clean and renewable energy
- Celebrate diversity

True Value

Connecting corporate and societal value creation

- Asses the company's 'true' earnings
- Understand future earnings at risk
- Create corporate and societal value

5 core principles

1. Have a thorough understanding of circular shared value creation for all stakeholders
2. Create organization-wide insight in core processes and critical functions
3. Measure performance on a regular basis with timely feedback loops
4. Develop an effective prioritization method for improvement possibilities
5. Put safeguards in place for continuous improvement

Figure 3: The five core principles to create circular shared value, distilled from lean management, the Cradle to Cradle philosophy and KPMG's True Value methodology.

Note: (4) Cradle to Cradle is a term coined by Walter R. Stahel in the late 1970s to signify the importance of closing the loops of production processes to optimize the use of materials (The Product-Life Institute, 2017). Around the same time, Michael Braungart was promoting similar ideas and together with Bill McDonough he developed the Cradle to Cradle® design philosophy focused on safety, health and sustainability in the 1990s that resulted in the Cradle to Cradle Certified Product Standard in 2005 (C2C Products Innovation Institute, 2020).

1 Have a thorough understanding of circular shared value creation for all stakeholders

When developing and managing real estate, the main focus used to be on financial profit and growth. Recently, this has changed to a greater emphasis on tenant experience, especially tenant well-being. However, this still only provides a limited view on the value creation (and destruction) of real estate during the asset's use cycle. It is therefore important to look at a wider field of stakeholders and understand what value is required and created with the ultimate goal of satisfying all stakeholders and creating circular shared value. This is about understanding market developments, adapting to changing government requirements, understanding societal paradigm shifts and translating these to how your organization creates value in the short and long term. The goal of developing real estate should be circular shared value, or it won't last.

And why look at the broader picture? Because research is showing time and time again that this is what successful real estate organizations do. For instance, investment funds taking social and ecological value as well as financial value into account outperform investment funds with a traditional approach (MSCI, 2020). In addition, upfront investment in green buildings can increase the asset value with 10% or more, lower maintenance cost by 20%, and lower operational cost by 10% (USGBC, 2020). Furthermore, 46% of healthy building owners mention they are easier to lease, while 28% mentions premium rents can be commanded (WGBC, 2016). And taking future users into account is a profitable strategy as well. The multifunctionality of real estate in the SoHo neighborhood in New York or Amsterdam city centre have proven its worth throughout the decades.

2 Create organization-wide insight in core processes and critical functions

Dealing with unexpected events as well longer-term developments asks a company to focus on what matters most: how are we delivering value to our direct and indirect customers? Usually an organization is part of a complex value ecosystem that stretches from the internal organization to third tier suppliers of even further. Mapping this ecosystem and understanding how each step creates or destructs value gives a good basis for decision making. The classical lean approach where each step in the process is classified as value adding, indispensable for business and non-value adding is to be done at least annually. Especially when taking into account value creation for a broader range of stakeholders that were previously neglected.

3 Measure performance on a regular basis with timely feedback-loops

Usually, basic business performance is measured and discussed at least quarterly at management level. But is there a true understanding of performance against customer requirements? And how are core processes and critical functions performing? The aim should not be to measure as much as possible, but to ensure performance measurement provides feedback on the effectiveness of the chosen strategy and related activities. Governance should be in place so that evaluation of measurement data leads to actual improvement of processes and performance. How to exactly measure performance depends on local situations as well, but the following topics should be included in circular shared value performance measurement: customer satisfaction, employee satisfaction, return on investments, cash generation, gross margin, carbon management, material health, material cycling, water stewardship, social fairness and critical to quality requirements. Understanding where value is wasted (either through negative impact or a missed opportunity to create positive impact) should be one of the core drivers of performance management.

4 Develop an effective prioritization method for improvement possibilities

It is obvious that COVID-19 measures currently have the highest priority. However the longer-term impacts of these measures should be included in decision-making as well. Are the decisions aligned with occupants needs and wishes in the coming years? Does it fit with expected future regulations? Is this how we can best contribute to society? And what are possible rebound effects of these measures? These are all questions that need an answer before implementation. The only proper way to prioritize is by looking at all aspects of the value created through the measures during the full use cycle. When combined with the required efforts, prioritization is now made based on a much completer picture than when just looking at cost reduction or margin growth.

5 Put safeguards in place for continuous improvement

The final principle relates to creating resilience within the organization to become futureproof. Continuous improvement requires engaging customers and employees to understand their needs and to educate them on creating circular shared value. It is a continuous cycle of plan, do, check and act. How well is our organization performing, are we still meeting customer requirements and did we create solutions that deal with the root-cause or did we only cure the symptoms? Ensure systems are in place to capture this information and feed it back to the relevant departments within the organization. It only works if the full organization can contribute to creating circular shared value; facilitating regular feedback moments for product and process optimization are another essential ingredient for continuous improvement and becoming a resilient organization.

Find inspiration, seek partnerships and get started

It is not going to be easy to apply these principles all at once and as thorough as hoped for. Luckily, many real estate organizations have already started to invest, manage and develop real estate with a broader mindset than just financial gains. Organizations such as Dexus, Mirvac, Stockland, Bouwinvest or Unibail-Rodamco-Westfield are a great source of inspiration and learning. And they've shown to be successful in the market.

Also knowledge institutes like the World Green Business Council and the WELL Building Institute or benchmarks such as GRESB or DJSI are great sources for further steps.

It is time to start applying the five core principles and create shared value through resilient real estate management. If you would like to discuss the content of this paper, or if you have any questions, please contact the authors of this paper.

1. Have a thorough understanding of circular shared value creation for all stakeholders		— Increased customer satisfaction — Facilitates employee attraction and retention — Higher quality and sustainability of overall real estate portfolio
2. Create organization wide insight in core processes and critical functions		— Increased productivity — Better customer focus — Prepared for unexpected events
3. Measure performance on a regular basis with timely feedback loops		— Improved strategic decision making — In control of effectiveness of activities — Enables a fact-based dialogue with stakeholders
4. Develop an effective prioritization method for improvement possibilities		— Improved occupancy rates — Improved impact on society — Better (long-term) financial performance
5. Put safeguards in place for continuous improvement		— Agile organization — Become leading and innovative in sector — Better competitive position towards clients

Figure 4: Examples of shared value creation in real estate through application of the five principles

Time to invest in a futureproof strategy

KPMG and EIG have set up a Lean2Cradle® True Value toolkit built on the principles outlined in this paper. The toolkit enables real estate organizations to make fact-based decisions and develop futureproof business strategies aimed at organizational resilience and shared value creation.

There are no silver bullets to tackle all the challenges that our generation is facing, but there's one statement that can't be overlooked – expect the unexpected. This precautionary principle is the corner stone of the Cradle to Cradle vision. Our Lean2Cradle® True Value toolkit will make sure you are prepared for unexpected (and expected) events in the short and long term and reap the business benefits that come with it.

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KPMG on social media

KPMG app