The increasing role of ESG factors on capital allocation and performance measurement.

IPF Project with Professor Graeme Newell, UWS, and Professor Anupam Nanda, University of Reading

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Key Points

- ESG has taken on increased importance in the real estate investment decision-making space in recent years and will continue to increase in importance going forward

- <u>However</u> there is a lot of confusion about which benchmarks to use, how to use them, and the jargon/acronyms involved.

- We have recently undertaken a project, sponsored by the IPF, with University of Western Sydney and Reading University, interviewing 60 global participants about their use of benchmarks

- They included REITs, Unlisted Funds, Asset Managers, Pension Funds , Index Providers, Sell Side and Buy Side Analysts

- Participants were from US, Canada, Australia, UAE, Europe, UK

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Objective

Our purpose was to identify the following:

- Which ESG benchmarks and groups do real estate participants use, and why ? What are their differences ?
- How do they use them – just to comply with regulation/peer group pressure or to help run their business and asset allocation policy
- The different approaches and attitudes geographically
- The different approaches between participants e.g. Pension Funds and Fund Managers, Listed REITs and Unlisted Funds/Private companies, Developers/Investors
- What is included within ESG – more than just Sustainability i.e. the S in the E
- What are the trends which will impact the pricing and transaction of

Global real estate going forward

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Which external benchmarks are relevant to the real estate industry – A small sample

- BREEAM: Building Research Establishment Environmental Assessment Scheme; green building rating scheme.
- CDP: Carbon Disclosure Project; global reporting framework for an organisation's carbon footprint.
- GRESB: Global Real Estate Sustainability Benchmark; benchmark established for assessing ESG in real estate investment.
- GRI: Global Reporting Initiative; the global framework for reporting ESG.

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Which external benchmarks are relevant to the real estate industry 2

- LEED: Leadership in Energy and Environmental Design; green building rating scheme.
- NABERS: National Australian Built Environment Rating Scheme; green building rating scheme.
- EPRA and INREV Sustainability BPRs
- Third party Index providers e.g. FTSE 4Good, GPR Sustainability Index

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What are their differences

- Three separate categories which cover Asset/Portfolio level to Corporate level

1. Benchmarks companies/Funds contribute to via Questionnaires for performance measurement e.g. GRESB

2. Guidelines for Best practice from their industry association e.g. EPRA, INREV, NAREIT

3. Equity market Indices that screen for ESG compliance e.g. FTSE 4 Good

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How are Benchmarks used?

- External benchmarks tend to be used for the benefit of investors (i.e. attracting capital) whilst internal benchmarks were used to run the business – Examples of internal benchmarks are as follows:

- One fund manager launched a survey to determine the optimal internal benchmark but found that reducing answers to a simple numerical score did not produce a useful tool as it requires a far more holistic approach
- One fund manager used energy efficiency to sort assets and funds into relative performance quartiles and determine those in most need of improvement
- Some of the larger pension funds are developing proprietary composite benchmarks using their own data to measure physical impact as well as the volume of their impact investments. Physical data is being built on models they are developing with investment managers and a number of universities.

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Different approaches

- In terms of difference in approach to ESG benchmarks between different types of participant and geography we observed the following:

- The first fundamental difference in approach, and amount of importance placed on ESG factors lay in the investment time horizon, and the requirement to allocate or raise capital.

- The second fundamental difference lay in the size of the participant, and its ability to devote human and financial resource to an area that in the short term is not income-producing.

- The third fundamental difference lay in property type, with developers of new CBD offices being most aware of current trends and developments in the Sustainability area, as this is the area of great concern for their new customers (tenants seeking pre-lets) whilst owners of multi-tenanted , mature, industrial estates were least affected.

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Different approaches

- By definition, the participants who have thought most about integrating all the ESG issues into an holistic framework for evaluating performance are the(particularly Dutch) pension funds.

- They are looking to service/match a long term liability stream with sustainable income. The extent to which the income streams they invest in (via direct ownership of assets, JVs, Funds or REITs) is likely to suffer from identifiable ESG issues over the time is of paramount importance.

- Therefore they allocate to areas where they are confident that the relevant ESG factors are being considered, and do not allocate capital where they are not. This last point is extremely important, because this form of capital rationing is likely to have a very positive impact upon the willingness of funds/REITs/asset owners to ensure that their ESG performance is of the very highest level, otherwise they will not be able to attract capital.

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Different approaches

- In terms of geographic bias it is clear that the Dutch are the most advanced and keen proponents of a rigorous ESG policy.

- There was a significant difference between perpetual and finite life capital participants, and that size has historically been a factor but is now less so. The largest listed companies have historically been at the forefront of best ESG practice but is noticeable how this has now permeated across to companies of all sizes, who regard <u>best ESG practice as a sign of management capability and therefore better equity valuation long term and greater ability to raise capital.</u>

- The role of EPRA and others in encouraging best practice and ensuring wider participation in this area and continued attention and development via their BPR guidelines and awards is very noticeable and this positive peer group pressure impact is likely to continue.

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What is included within ESG

- Climate change risk mitigation, zero carbon policies, social impact, wellness, corporate governance

- The emphasis within ESG is changing significantly. Initially the G element was key. This has now moved towards the Sustainability part of the E. Both are capable of measurement.

- The Social element is now taking a more prominent role, but is much harder to measure, is not equally applicable, and is often referred to as Impact investing.

- There are a wide variety of definitions for ESG, and the most important factors. These depend, inter alia, upon the participants role.

- Some participants see the terms as broadly regulatory, and market compliance issues, whilst others integrate the principles into their operations and have integrated the into their operations,

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Trends impacting capital allocation and pricing 1

- Number 1 by a long way and mentioned by all 60 participants is climate change risk mitigation – how is this building/portfolio/company going to be affected , and what are you, the owner, doing about it…..

- All companies/funds and operations requiring long term capital are expected to have a coherent ESG policy , which originates from the senior management and is understood throughout the institution

- Most institutions now have a dedicated team to ESG and produce annual 100+ reports, so this is no longer exceptional

- A clear understanding of how ESG affects <u>the sustainability of the business is regarded by investors as crucial.</u>

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Trends impacting capital allocation and pricing 2

- At the corporate level the Holy Grail of linking good ESG performance with good share price or fundamental performance is no longer key…..as without good ESG performance the corporate will not attract capital.

- At the property level the attempts to link good energy efficiency to good rental levels is similarly clouded by the modernity of prime buildings, but many are still trying to prove it…..

- As yet there does not appear to be a link between say a good BREEAM rating and the yield/ability to sell, but again this may be due to a vintage effect

- There is a strong industry wide desire to improve the transparency of GRESB and move towards a watertight definition of carbon-neutral

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