The rise of ESG in real estate

Waiting on the sidelines may no longer be an option for real estate investors as our planet and our built environment are at risk.

By Jem Hudson, State Street

In an attempt to spur action-oriented, multi-stakeholder dialogue, the World Economic Forum (WEF) released its Global Risks Report 2019 at its recent annual gathering of global leaders in Davos, Switzerland. For 2019, the report highlights environmental risks as some of the most critical, both in terms of likelihood to occur and their overall global impact.[1]

More specifically, according to WEF, environmental issues represent the top three global risks in terms of likelihood and are three of the top five global risks in terms of impact (Exhibit 1). The greatest environmental risks are linked to extreme weather events, failure of climate-change mitigation and adaptation, and natural disasters.

While climate change is more frequently discussed within the public equity and fixed income spaces, there is no question that environmental risks also present significant challenges, as well as opportunities, in real estate. To that end, we believe environmental factors will become an increasingly important consideration when making real estate investment decisions.

Environmental focus: A business opportunity?

So why should real estate investors increase their focus on environmental factors?

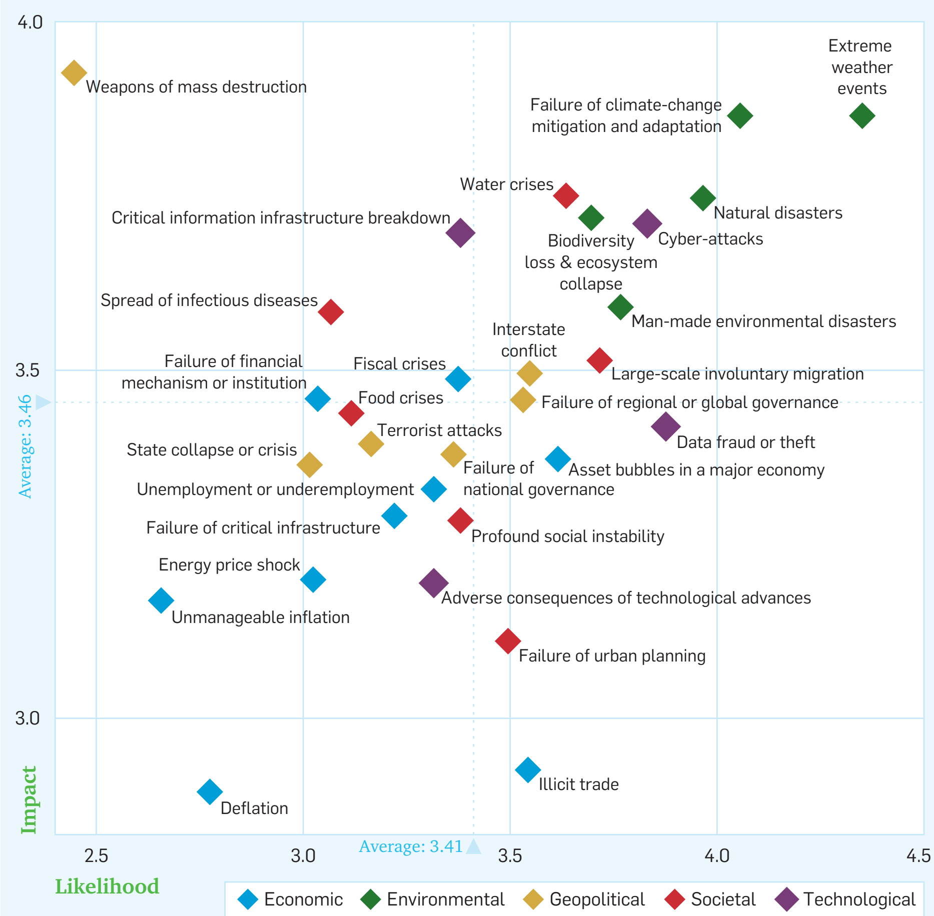
First, institutional investors are increasingly concerned about environmental issues in their asset allocation decisions. According to recent research by the United Nations-backed Principles for Responsible Investment (UN PRI), there has been a steady increase in environmentally focused real asset investments.[2] For example, between 2004–2009 pension fund CalPERS exceeded its energy reduction goal of 20% in its core real estate portfolio, and it continues to focus on further reductions. More recently, as part of a joint investor letter, New York State Common Retirement Fund reiterated its firm commitment to climate action.[3]

Second, cities around the U.S. are starting to pay closer attention to sustainability, with a particular emphasis on reducing the overall environmental impact of their buildings and infrastructure while simultaneously taking smart resiliency measures in anticipation of future risks. According to research by C40, a non-profit

1 World Economic Forum, *The Global Risks Report 2019*.
2 United Nations Principles for Responsible Investment, *How to Invest in the Low-Carbon Economy: An Institutional Investor's Guide*.
3 Investors Call on World Leaders to Address Climate Change 'Ambition Gap'.
4 NewClimate Institute, *Climate Opportunity: More Jobs; Better Health; Liveable Cities*.
5 U.S. Green Building Council, *Why LEED Certification Matters to Your Bottom Line*.

> "Developing sustainable buildings is a major focus for top architects and designers, who are more likely to take on a large commercial project if it includes sustainability considerations."

Exhibit 1: The global risks landscape 2019



Source: The Global Risks Report 2019, World Economic Forum, 2019.

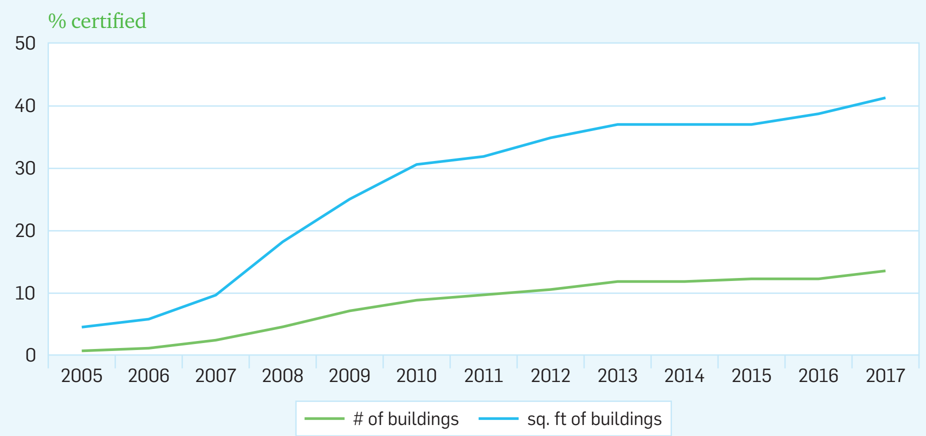
organization that connects the world's major cities in order to galvanize climate action, urban areas account for 73% of global greenhouse gas (GHG) emissions.[4] C40 also finds that efforts to address climate change can, in fact, lead to favorable outcomes for health and prosperity in large cities.

Third, as leading Fortune 500 companies and their peers continue to elevate their commitment to corporate sustainability from the strategic standpoint, there has been growing demand for LEED-certified office spaces. In particular, commercial real estate tenants increasingly view LEED certification as beneficial to their bottom line,[5] in part because it helps attract top talent, including millennials. In its annual *U.S. Green Building Adoption Index* report, CBRE notes that across the 30 largest U.S. office markets, about 4,700 buildings (41% of commercial space) have now been certified as "green" (Exhibit 2).

Fourth, developing sustainable buildings is a major focus for top architects and designers, who are more likely to take on a large commercial project if it includes sustainability considerations. For example, Harvard

[6] Harvard Graduate School of Design, *Harvard Center for Green Buildings and Cities unveils HouseZero.*
[7] State Street, Center for Applied Research, *The Investing Enlightenment: How Principle and Pragmatism Can Create Sustainable Value through ESG.*
[8] United Nations Principles for Responsible Investment, *ESG Engagement for Fixed Income Investors: Managing Risks, Enhancing Returns.*

Exhibit 2: Green Building Adoption Index



Source: U.S. Green Building Adoption Index 2018, CBRE.

University's Graduate School of Design recently announced the completion of its innovative pilot project, HouseZero. According to the press release, it represents a complete retrofitting of its headquarters into a "living-laboratory and an energy-positive prototype for ultra-efficiency."[6] Indeed, sustainability has steadily been making its way into all aspects of the design process.

ESG integration: From theory to practice

In State Street's recent research report *The Investing Enlightenment*, we provide guidance on the effective adoption of ESG integration practices within the broader investment management context.[7] Here we build on this guidance and take into account the unique challenges and opportunities that real estate investors face (Exhibit 3).

First, as is true for investors across all asset classes, it is important to prioritize those environmental, social, and governance (ESG) factors that are most **material** for a given investment. In general, material ESG factors are most likely to be aligned with the underlying business model and have significant top-line as well as bottom-line implications. Intelligent consideration of material ESG factors is often closely linked to critical strategic decisions and long-term strategic planning.

For real estate investors, according to the SASB (Sustainability Accounting Standards Board) materiality map, this means paying particularly close attention to energy management, water management, management of tenant sustainability impacts, and climate change adaptation when evaluating a real estate investment opportunity. Each of these areas includes several sub-topics that should be considered as part of the investment research process (Exhibit 4).

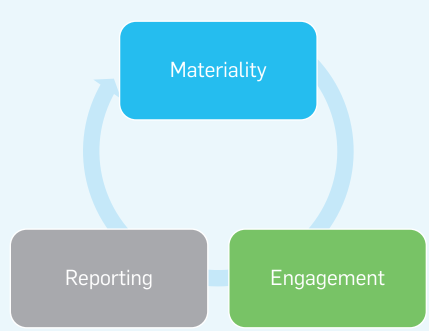
Based on the experience of State Street's direct real estate team, leasing efforts have benefitted from highlighting our properties' positive ESG attributes, including energy efficiency and lifestyle amenities, to today's environmentally savvy commercial and residential tenants. As part of potential acquisitions, State Street's direct real estate team evaluates opportunities to cost-effectively improve ESG factors at the properties.

Second, once an investment is made, it is critical to establish **dialogue** (in the ESG investing space typically referred to as "**engagement**") across all constituents involved in the ownership and operation of a given property to ensure ongoing focus on material ESG factors. While this kind of dialogue is typically seen in public equities, there is growing recognition of its relevance even in asset classes where shareholder vote is not possible (e.g., fixed income).[8]

As part of this multi-stakeholder dialogue, real estate investors and consultants will want to target a range of questions that are strategic in spirit and that aim to understand: (i) how material ESG factors are baked into key management decisions; (ii) what is the linkage between these factors and the given property's financial results; and (iii) how management is thinking about any future risks, such as extreme weather conditions and sea level rises.

For example, State Street's direct real estate team works closely with its buildings' development and operating partners as well as property managers to make responsible and cost-effective decisions about each building's overall

Exhibit 3: ESG integration in real estate investing



Source: State Street Center for Applied Research (CAR).

[9] Task Force on Climate-Related Financial Disclosures, *Implementing the Recommendations of the Task Force on Climate-Related Financial Disclosures.*

Exhibit 4: Real Estate Sustainability Accounting Standard (SASB Materiality Map)

Topic	Accounting metric
Energy management	Energy consumption data coverage as a percentage of total floor area, by property subsector.
	(1) Total energy consumed by portfolio area with data coverage, (2) percentage grid electricity, and (3) percentage renewable, by property subsector.
	Like-for-like percentage change in energy consumption for the portfolio area with data coverage, by property subsector.
	Percentage of eligible portfolio that (1) has an energy rating and (2) is certified to ENERGY STAR, by property subsector.
	Description of how building energy management considerations are integrated into property investment analysis and operational strategy.
Water management	Water withdrawal data coverage as a percentage of (1) total floor area and (2) floor area in regions with High or Extremely High Baseline Water Stress, by property subsector.
	(1) Total water withdrawn by portfolio area with data coverage and (2) percentage in regions with High or Extremely High Baseline Water Stress, by property subsector.
	Like-for-like percentage change in water withdrawn for portfolio area with data coverage, by property subsector.
	Description of water management risks and discussion of strategies and practices to mitigate those risks.
Management of tenant sustainability impacts	(1) Percentage of new leases that contain a cost recovery clause for resource efficiency-related capital improvements and (2) associated leased floor area, by property subsector.
	Percentage of tenants that are separately metered or sub-metered for (1) grid electricity consumption and (2) water withdrawals, by property subsector.
	Discussion of approach to measuring, incentivizing, and improving sustainability impacts of tenants.
Climate change adaptation	Area of properties located in 100-year flood zones, by property subsector.
	Description of climate change risk exposure analysis, degree of systematic portfolio exposure, and strategies for mitigating risks.

Source: Sustainable Accounting Standards, SASB.

sustainability profile and material ESG factors, from the selection of building materials to the operational practices.

Third, effective **measurement and reporting** of relevant ESG-related outcomes enables real estate investors to understand how their consideration of ESG factors drives investment returns while reducing environmental impact. Because real estate investments are tangible and their operating results are measurable, investors can easily track and report their ESG-related outcomes. This type of ESG measurement and reporting then enables closer management of material ESG risks over time.

For guidance on how to think about ESG measurement and reporting, it is useful to consider SASB's aforementioned materiality map. Since all four material ESG factors in the real estate space pertain to environmental considerations, it is also helpful to review reporting guidelines provided by the Task Force on Climate-Related Financial Disclosures, which include general cross-industry guidelines as well as sector-specific guidelines for real estate management and development.[9]

State Street's direct real estate team, for instance, has begun compiling data from its operating partners and property managers to assess the ESG profile of its portfolio. The goal is to identify ESG aspects of individual properties that help drive both improved sustainability and investment returns, and apply those best practices across the portfolio.

Beyond investing: How to protect our planet

Confronted with growing environmental risks, we all need to consider different avenues where we can have the greatest impact.

As we outline above, for real estate investors, this means taking into account material ESG factors in the investment research process, maintaining an active dialogue with key constituents about environmental issues, and reporting on ESG-related outcomes. But it also means reaching out to the broader community of leaders and practitioners regarding this issue.

Climate change mitigation requires close collaboration across a range of key stakeholders, and real estate investors have an important role to play in building critical relationships and catalyzing action.

Waiting on the sidelines may no longer be an option. Our planet and our built environment are at risk. ◆

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