REAL ESTATE

OVERVIEW

- This starter guide provides a quick summary of how to manage environmental, social and governance (ESG) issues for direct and indirect real estate investors.
- It outlines options for how to include ESG issues throughout the investment process and in the relationship between asset owner and investment manager.
- For general information on embedding responsible investment in your organisation, see the first two guides in this series.
- Selected further reading is provided throughout. For more information on anything in this guide, or responsible investment more broadly, please get in touch.

The PRI defines responsible investment as a strategy and practice to incorporate ESG factors in investment decisions and active ownership.

Investing in real estate presents two key ESG considerations when compared to other asset classes. Firstly, it has a long investment horizon, which is important because most ESG issues are more likely to be material when assessed over longer periods. Secondly, many ESG issues play out at a local level, for example extreme weather, water stress and community relations and direct real estate investments are inextricably linked to a specific geographic location. A company can move its operations or choose where it sources materials, but for real estate there is no such flexibility, making the incorporation of ESG issues particularly relevant. In this asset class, a systematic and informed approach to identifying and managing ESG issues across the portfolio will protect, and can significantly enhance, investment value.

This guide will take you through the following typical steps to implement responsible investment across the investment process:

- **DEAL SOURCING**
  - Identifying material ESG issues during screening, due diligence and in the planning of new developments and major renovations

- **INVESTMENT DECISION**
  - Communicating material issues to the investment committee and assessing their impact on valuation

- **OWNERSHIP**
  - Including ESG issues in the management of the asset, use of external property managers and engagement with tenants

- **SALE**
  - Adding value when the asset is sold
SCREENING
When an asset is first identified for potential acquisition, some simple checks can be made to see if there are any serious ESG issues that would rule out the deal immediately, e.g. financial risk related to regulatory fines or uncertain remediation costs related to contaminated land. Some investors also screen new deals for the presence of specific tenants in sectors such as gambling or arms manufacture.

Even at this preliminary stage in the deal process, it is best practice to signal to the vendor that ESG issues are important to your firm.

DUE DILLIGENCE
Once a deal progresses to due diligence, ESG issues can be investigated more thoroughly. This stage is about assessing the potential for improvements, identifying legacy issues and analysing the impact of ESG trends such as changing flooding patterns or energy efficiency standards. For investors that have ESG targets, it is also important to assess how the new asset will impact those. For example, if there is a target to reduce the portfolio’s energy consumption, then acquiring an inefficient building will affect the ability to reach the target.

In practice, ESG due diligence typically starts with a standard list of issues that need to be considered for every deal. As due diligence progresses, some of these issues can be ticked off as satisfactory.

Common ESG issues to investigate during due diligence:

**ENVIRONMENTAL**
- Biodiversity and habitat
- Climate change
- Land contamination
- Energy consumption
- Greenhouse gas emissions
- Indoor environmental quality
- Location and transportation
- Materials
- Pollution
- Resilience to catastrophe/disaster
- Renewable energy
- Sustainable procurement
- Waste management
- Water consumption

**SOCIAL**
- Community development
- Health and safety
- Human rights
- Inclusion and diversity
- Labour standards and working conditions
- Social enterprise partnering
- Stakeholder relations
- Occupier amenities – showers, changing rooms
- Controversial tenants

**GOVERNANCE**
- Anti-bribery and money laundering
- Cybersecurity
- Data protection and privacy
- Legal and regulatory fines
- ESG clauses in existing leases

Based on PRI Reporting Framework questions and GRESB assessment questions.
The output of due diligence work could include a commentary and/or a risk rating for each issue. It could also include a list of improvements with costs and estimated savings.

The information required to assess each issue can come from a variety of sources, including:

- raw data – utility bills, building management system, building logbook, existing environmental management system, engagement with tenants;
- third-party reports – energy audit reports, certification reports, surveyors’ reports;
- independent databases – geospatial databases, flood records.

NEW DEVELOPMENTS AND MAJOR RENOVATIONS

An investor can aim to achieve higher ESG standards during new construction or major renovations than through incremental work done to operational assets. The ESG issues to consider are largely the same as with the management of operational buildings but some issues become more important, e.g. supply chain, health and safety and waste management.

To be effective, ESG factors need to be included as early in the process as possible. During the design phase, the investor can request components that have better ESG performance e.g. high-efficiency insulation. There is also more chance to add optional sustainability features, e.g. rainwater harvesting, renewable energy.

PRI resources:

- Sustainable real estate investment
- Responding to megatrends: Investment institutions trend index
INVESTMENT DECISIONS

INVESTMENT COMMITTEE

The ESG findings identified during due diligence can be included in the investment memorandum to ensure they are incorporated into the decision-making process and understood by the investment committee. Even if no risks are identified, including this in the memo can be useful to highlight that ESG factors were considered during due diligence. If serious issues have been identified, then it could be useful for a responsible investment staff member to attend the committee meeting to answer questions.

IMPACT ON VALUATION

There are many ways that ESG issues can affect the valuation, including:

- discount due to additional capital expenditure e.g. upgrade equipment to improve energy performance;
- discount due to future income uncertainty e.g. buildings that do not meet minimum energy performance standards set by legislation;
- discount due to obsolescence risk e.g. low-quality buildings have a shorter life;
- deal abandonment due to unacceptable risks identified during due diligence e.g. inadequate fire protection, high likelihood of natural disaster, land contamination.

PRI resources:

Sustainable real estate investment
MANAGEMENT OF THE ASSET

Examples of approaches to creating value through responsible investment:

<table>
<thead>
<tr>
<th>Reducing costs and liabilities</th>
<th>Increasing revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating costs - installing more energy-efficient equipment reduces costs</td>
<td>Less incentives – tenants prefer buildings with higher ESG performance which reduces the need for incentives</td>
</tr>
<tr>
<td>Liabilities - better knowledge of a building’s environmental condition reduces the chance of unforeseen litigation</td>
<td>Reduced voids – more satisfied tenants are more likely to renew their lease</td>
</tr>
<tr>
<td>Obsolescence - staying ahead of regulatory requirements reduces risk of falling foul of more stringent regulations</td>
<td>Higher rents – higher rents can be charged for properties with green certifications</td>
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Research conducted prior to acquisition will give a starting point for which issues to focus on, but new issues will emerge during the holding period. It is important to have appropriate systems in place to manage issues on an ongoing basis. Some of the key processes to include are:

- targets – provide motivation and a way to measure success (typically about energy/water use, greenhouse gas emissions, waste management or tenant engagement);
- monitoring and reporting – a way to collect data on the asset’s ESG performance and report this to stakeholders;
- identifying ways to improve ESG performance – often accomplished by writing an action plan for each asset, which is reviewed and revised at set intervals.

CERTIFICATIONS

Certifications are used widely in the real estate industry. They can be used at each stage in the investment process. A certification is a signal that ESG has been considered in the building’s design and/or operation and is an objective indicator of what constitutes a green building. The reports produced when the certification is granted contain useful due diligence information. Certifications are also useful for attracting tenants and buyers. Some investors set targets (up to 100%) for the number of certified properties in their portfolio. For others, whether to pursue certifications is decided on a case-by-case basis.

A list of certifications is included in the property module of the PRI Reporting Framework.
EXTERNAL PROPERTY MANAGERS

As day-to-day management of the asset is often outsourced to an external property manager, the successful management of ESG issues will rest on selecting a good external property manager and understanding how to work with them effectively. This process can be broken down into three stages.

**Selection** (assessing the external property manager’s track record and expertise) – this could include legislative compliance, ability to collect data, history of engaging tenants, internal training programmes, sustainable procurement practices. Some investors build the different assessment criteria into a score.

**Appointment** (the legal agreement between the external property manager and the investor) – this could include a basic commitment to improving ESG performance or specific actions like energy reduction targets. Some investors also make the bonus paid to the external property manager contingent on hitting ESG targets or performance levels.

**Working with the external property manager** (creating systems to check the external property manager’s performance and working with them to improve it) – this could include:

- web-based portals to collect information – aggregate information can be used to benchmark the different companies;
- annual scorecards;
- site visits;
- awards and recognition for outstanding performance;
- newsletters;
- sustainability committee;
- manuals/guides on best practice;
- workshops.

TENANTS

**Engagement**

Building a relationship with tenants is vital to managing ESG issues, as their behaviour affects areas such as energy use and recycling. Such engagement might be outsourced to an external property manager.

There are many actions that can be taken to engage with tenants:

- tenant handbook – a written guide that explains the importance of managing ESG issues and contains ideas for how to improve performance;
- regular meetings – schedule a regular meeting with the tenant to discuss initiatives;
- sharing data – establish a system for the tenant to provide their ESG data to the investor and for the investor to share data about the whole building;
- newsletters – send a newsletter to all tenants with the latest information on ESG initiatives;
- ESG committee – a formal or informal group which guides the direction of ESG work and has representatives drawn from various stakeholders;
- campaigns – one-off educational campaigns designed to change tenant behaviour;
- tenant satisfaction surveys – to identify issues that might relate to ESG performance and where improvements might be made;
- training - hold training workshops prior to tenants moving in on how to get the most out of the building and its sustainability features – usually for larger tenants.

Where the lease terms mean that the tenant has operational control and is responsible for insurance, repair, maintenance and other variable costs, the investor can still play a role. They can offer to share knowledge and expertise, provide finance for projects and include the tenant in some of the items listed above.

**ESG clauses in lease agreement**

A lease for a property can, within its terms or through an attached schedule, include provisions that encourage the investor, tenant or both to carry out their roles in a sustainable way. The details of the provisions and the means of encouraging sustainable behaviour are negotiated between the parties, but typically relate to:

- an intention to cooperate and minimise negative ESG issues and maximise positive issues;
- responsibility for capital expenditure on ESG projects and sharing of cost savings;
- sharing data and installation of energy and water sub-metering;
- commitment that ESG factors will be considered when using contractors e.g. cleaners.

The use of ESG clauses in lease agreements varies widely according to geography and investor preferences. Some investors offer them to all tenants, others only use them for buildings over a certain size. An investor that wants ESG clauses will often give the legal team a set of guidelines on which ESG considerations could go into a lease.

**PRI resources:**

"Sustainable real estate investment"
Managing ESG issues and improving performance during the ownership phase can reduce risk and enhance value, which is realised on the asset's sale. Other benefits that a responsible investment approach can yield on sale include:

- identifying and managing material ESG issues – avoids a buyer raising unforeseen risks to negotiate a lower price;
- setting KPIs at the beginning of the holding period – provides evidence to support claims that ESG issues are well managed;
- demonstrating a professional approach to managing ESG issues – can signify that the asset has been well managed.
INVESTING IN A FUND

<table>
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<th>SELECTION</th>
<th>APPOINTMENT</th>
<th>MONITORING</th>
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<td><strong>Investment manager</strong> - showcasing responsible investment approach in the fundraising/marketing material</td>
<td><strong>Embedding the most important responsible investment issues in the legal agreement between asset owner and investment manager</strong></td>
<td><strong>Investment manager</strong> - proactively reporting relevant information to the asset owner</td>
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<tr>
<td><strong>Asset owner</strong> - conducting due diligence to assess the quality of the investment manager</td>
<td></td>
<td><strong>Asset owner</strong> - monitoring that responsible investment commitments are being put into practice</td>
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When an investor chooses to invest in a fund managed by an external investment manager, a different approach to responsible investment is required. The investor cannot make, or materially influence, specific investment decisions, but it can still influence a decision-making process. In fulfilling its fiduciary duties and where applicable, its ESG policy, an indirect investor should monitor and, where necessary, engage an investment manager about the policies, systems and resources used to incorporate ESG factors into investment decisions, management and stewardship.

This can fall into the three main areas:

**SELECTION**

Investment managers can include references to responsible investment in the documentation used to advertise the fund and attract potential investors. This can be a starting point for asset owners to enquire about the investment manager’s responsible investment approach. Investors can also use a due diligence questionnaire (DDQ) to prompt dialogue.

**APPOINTMENT**

Including responsible investment in the legal agreement reinforces the investment manager’s commitment to managing ESG issues and encourages the adoption of related business practices across the organisation.

**MONITORING**

Regular communication on responsible investment throughout the fund’s life cycle will help to strengthen the relationship, signal good management and manage reputational risks. This might include a mix of quantitative and qualitative information in client reports or as part of annual meetings. Approaches will differ depending on the fund structure (segregated portfolio or pooled vehicle).

**PRI resources:**

- Responsible investment DDQ for real estate investors
- Asset owner manager selection guide

**FURTHER READING**

For a list of resources on responsible investment in real estate from other organisations, visit the PRI website.
CREDITS

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