

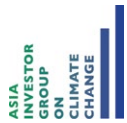
Investor Expectations for listed Real Estate Companies



IIGCC

The Institutional Investors
Group on Climate Change

Produced by the Institutional Investors Group on Climate Change (IIGCC) in November 2019, this report is published on behalf of the four organisations that make up the Global Investor Coalition on Climate Change (GIC).



Asia Investor Group on Climate Change (AIGCC) is an initiative to create awareness among Asia's asset owners and financial institutions about the risks and opportunities associated with climate change and low carbon investing. AIGCC provides capacity for investors to share best practices and to collaborate on investment activity, credit analysis, risk management, engagement, and policy. AIGCC represents the Asian investor perspective in the evolving global discussions on climate change and the transition to a greener economy.

www.aigcc.net



Ceres is a sustainability nonprofit organization working with the most influential investors and companies in North America to build leadership and drive solutions throughout the economy. The Ceres Investor Network on Climate Risk and Sustainability comprises more than 175 institutional investors, collectively managing more than \$25 trillion in assets, advancing leading investment practices, corporate engagement strategies and policy solutions to build an equitable, sustainable global economy and planet.

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The Investor Group on Climate Change (IGCC) is a collaboration of Australian and New Zealand institutional investors and advisors, managing over A\$2 trillion in assets under management and focusing on the impact that climate change has on the financial value of investments. IGCC aims to encourage government policies and investment practices that address the risks and opportunities of climate change.

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The Institutional Investors Group on Climate Change (IIGCC) is the European membership body for investor collaboration on climate change and the voice of investors taking action for a prosperous, low-carbon future. IIGCC has more than 190 members, mainly pension funds and asset managers, across 14 countries, with over €28 trillion in assets under management. Our mission is to mobilise capital for the low-carbon transition and to ensure resilience to the impacts of a changing climate by collaborating with business, policy makers and fellow investors. IIGCC works to support and help define the public policies, investment practices and corporate behaviours that address the long-term risks and opportunities associated with climate change. Members consider it a fiduciary duty to ensure stranded asset risk or other losses from climate change are minimised and that opportunities presented by the transition to a low-carbon economy – such as renewable energy, new technologies and energy efficiency – are maximised.

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1 Introduction

The historic achievement of the Paris Agreement in 2015 was strongly welcomed by institutional investors, in recognition of the significant impact that climate change will have on holdings, portfolios and asset values in the short, medium and long term. The national commitments which underpin the Paris Agreement, as well as the over-arching goal to limit global temperature rises to 1.5°C, imply a need for a low-carbon and climate-resilient transition across all sectors. Investors are acutely aware of the need to understand and manage these transition and physical risks, as well as look to exploit the many opportunities presented by new climate-friendly technologies, business models and markets.

The real estate sector is of particular concern, given its significant contribution to global emissions as well as its representing trillions of dollars of market capitalisation. In parallel, investors also recognise the role of real estate from a social and economic viewpoint, and the unique challenges facing the sector in terms of both mitigating and adapting to climate change. Given that business and capital allocation decisions being made now will determine the future sustainability and profitability of the sector, investors will look to the boards and management of major real estate companies to ensure that these decisions are in the long-term interests of their investors.

This first Investor Expectations Guide for Listed Real Estate Companies therefore aims to underpin investor engagement and voting with the boards and management of real estate companies. It seeks to set out the background information and key questions to allow for constructive engagement, in order for investors to fully understand how companies in this sector are governing and managing the risks and opportunities associated with a 1.5°C trajectory. This guide sets out investor expectations for company climate strategies, drawing from and building on the recommendations of the Financial Stability Board's Taskforce on Climate-Related Financial Disclosures (TCFD)¹

This is one of a number of guides produced by IIGCC members to support productive engagement with investee companies across sectors including oil and gas, automotive, electric utilities, mining, steel, construction materials and investor expectations on corporate lobbying².



2 Climate risks for the property sector

Scientists recommend that in order to avoid dangerous climate change, global greenhouse gas emissions (GHG) must decline rapidly, reaching net zero around 2050, in order to limit global warming to 1.5°C and deliver the goals of the Paris Agreement³.

The real estate sector accounts for nearly 40% of GHG emissions and more than a third of global final energy use, growing by 5% since 2010 as growth in floor area and population has exceeded an 11% improvement in energy efficiency⁴. With the IEA predicting a further 60% growth in floor area by 2040, this trend is likely to continue⁵. However, in order to meet Paris targets, the real estate sector must decrease carbon intensity globally by up to 91% by 2050 compared with 2010⁶. The World Green Building Council⁷ has recommended that all new buildings should be net zero carbon by 2030 and all existing buildings be net zero carbon by 2050. Currently, just 0.01% of all buildings can be considered net zero carbon⁸. However, there remain clear opportunities within the sector e.g. new buildings with wood constructions⁹.

Carbon emissions are released not only during operational life but also during the manufacturing, transportation, construction and end of life phases of all buildings and infrastructure. Embodied carbon has been overlooked historically but contributes around 11% of all global carbon emissions. Carbon emissions released before the building or infrastructure begins to be used, sometimes called upfront carbon, may be responsible for half of the entire carbon footprint of new construction between now and 2050, threatening to consume a large part of our remaining carbon budget¹⁰.

Transition risks

Real estate assets face costs to reduce energy use and improve physical risk resilience, potential obsolescence and depreciation because of changing regulations and preferences from investors and occupiers. For instance, 69% of 192 Nationally Determined Contributions (NDCs), or carbon reduction pledges, submitted by countries during the Paris Agreement's negotiation, explicitly mention property¹¹. In 2017, 38% of building energy use was covered by some sort of policy or regulation, an increase from 28% coverage in 2010¹². Real estate companies could also lose major tenants if they fail to provide sufficiently green buildings and could lose investor confidence leading to lower share price expectations and more expensive capital costs.

Examples of strengthening policies include the UK's minimum energy efficiency standards: as of April 2018, property owners must ensure their buildings have above E rated energy performance certificates with fines of up to £150,000 if tenancies of longer than 6 months are granted or renewed for a non-compliant building¹³. According to a mid-2018 estimate¹⁴, 17% of UK commercial buildings may fail to be aligned with this regulation. Offices in the Netherlands need to have a minimum energy label C by 2023 or they cannot be let¹⁵.

However, wider risks are increasing significantly in the European residential real estate sector, particularly in relation to affordability and pressures on supply. Recent materialisation of these risks can be seen in Germany, where a rental

cap has been introduced for rental homes in the state of Berlin; this has resulted in cuts to capital expenditures related to renovations and efficiency enhancements, as returns do not cover the costs.

In April 2019, New York City introduced an ambitious law to curb GHG emissions from properties larger than 25,000 sq ft, requiring sharp cuts by 2030 and 2050. GHG intensity targets for 2024-2029 and 2030-2034 are set for individual occupancy types with a USD 268/tCO₂ penalty. In Canada, the Alberta government started charging carbon levy¹⁶ on all carbon emissions, at a rate of \$20/tonne in 2017 and \$30/tonne in 2018, this has material impact on Canadian REITs operational income.

The Carbon Risk Real Estate Monitor (CRREM) is developing a property type-specific model for global commercial and residential real estate decarbonisation. CRREM¹⁷ concluded that the sector will need to decarbonize by 91% by 2050 in order to align with the 1.5-degree Scenario. Preliminary analysis of GRESB participants that disclose asset data found that by 2030, nearly 30% of office, retail, hotel and healthcare portfolios could be stranded, which could rise to 74% by 2050¹⁸.

An energy efficient building powered by renewables is not necessarily sustainable if it is in a city characterised by urban sprawl and high transport emissions. A real estate investor supported report found that cities with good density are associated with higher returns, capital values, and commercial real estate investment levels¹⁹. The investors committed to support and champion a greater understanding compact, well connected, smart urban development²⁰.

A variety of voluntary and mandatory disclosure requirements exist for buildings around the world. A growing number of cities, states and regions are setting ambitions for net zero buildings, indicating that policies, targets and potential penalties will continue to strengthen over the next several years.

Physical risks

Real estate is also a sector that is highly exposed to physical climate risks. One estimate is that 35% of Real Estate Investment Trust (REIT) properties globally are exposed to climate risks, including inland flooding (17%), typhoons or hurricanes (12%), and coastal flooding and sea-level rise (6%). The most exposed REITs were concentrated in Asia. In Japan, 27% of the REIT-owned real estate market is exposed to flood risk and 15% exposed to sea level rise by 2040. Thirty-seven Japanese REITs have their entire portfolio exposed to the highest risk for typhoon globally²¹.

To advance the TCFD on physical climate risks, the European Bank for Reconstruction and Development (EBRD) and the Global Center on Adaptation convened a group of financial institutions to recommend how corporations should disclose physical climate risks and business opportunities. One of the recommendations is for companies to aim to apply insurance sector metrics such as 1 in 100 year value at risk from disruption to operations, suppliers, customers, increasing insurance cost and markets²².

3 Investor expectations and questions for companies

In order to ensure robust, responsive and resilient business strategies, and encourage a smooth transition to lower carbon economy, this section of the report sets out expectations and guiding questions for investors to raise in their discussions with the board and management of listed real estate companies.



a Governance

Expectation:

Establish a strong and complete governance framework and process to support board's oversight and accountability of climate change strategy. The board should be in position to ensure that climate-related risks (physical and transition) impacting property assets and portfolios are properly managed and that the strategy, and to monitor the implementation of effective planning so the company is transitioning to a low-carbon economy.

Questions for board members:

- 1 Does the company undertake analyses of its exposure to short-, mid- and long-term climate risk? If so, what are the outputs?
- 2 How is the board involved in the overseeing of the company's climate risk policy? Has the board nominated a member or committee with explicit responsibility for oversight of the climate change and/or ESG strategy?
- 3 How is the remuneration committee ensuring that incentives are aligned with the company's climate risk strategy?

Questions for sustainability professionals:

- 4 What knowledge, experience and expertise do board members have to oversee the climate and sustainability strategy of the company?
- 5 How would climate targets deploy across the company, specially targeting portfolio and property managers?
- 6 To what extent is climate change incorporated into your in-house and external training and education programmes?

b Strategy and scenario planning

Expectation:

Take action to reduce greenhouse gas emissions and make business operations consistent with the Paris agreement targets – notably via a net zero emissions commitment – and to undertake physical risk assessments. Companies are expected to implement their strategic decisions based on scientific climate scenarios.

Questions for board members:

- 1 Did you conduct a climate scenario analysis, describing the implications for the business of various scenarios?
- 2 According to your climate scenario, how will transition and physical risks impact your business strategy and the resilience of your property assets?

Questions for sustainability professionals:

- 3 How do the carbon intensity trends from your climate scenario differ from other climate scenarios (e.g. International Energy Agency)?
- 4 What are the key assumptions in your climate scenario with respect to:
 - Policy changes (regional, national and local level)
 - Energy and carbon prices
 - Tenant retention and occupancy rates
 - Technology changes
 - Physical risks
- 5 Do you have Asset-level Sustainability Action Plans in place to integrate ESG ambitions and concrete actions in the portfolio?
- 6 When modelling your strategy with regard to climate-related risks and opportunities, how do the outcomes of climate scenarios translate into business decisions?
 - Research and development, operating and capital expenditure, mergers and acquisitions, debt?
 - Higher share of green buildings in the portfolio?
 - Energy efficiency improvements?
 - Due diligence on acquisition and procurement decisions for new assets?
 - Active asset management strategy to sell or upgrade high energy consuming assets?
 - How is ESG integrated into long-term maintenance plans per asset?

c Risk management

Expectation:

Integrate climate related risks (including physical, regulatory/technology and changes in market preferences/behaviour) into overall risk management, aiming to monitor and control how these risks affect the company operations and the value of its property portfolios.

Questions for board members:

- 1 Does the company have a policy or process to identify and assess climate-related risks and opportunities? Both at portfolio and asset level, using scenarios and forward projections.
- 2 Does the company integrate climate-related risks in the overall risk management function?

Questions for sustainability professionals:

- 3 How energy efficiency standards and regulation for property assets could impact the value of your company's property assets?
- 4 Depending on the property asset types (office/retail, logistics...), and geographic location would there be different climate change risk factors?
- 5 Do you integrate climate risk assessments and short/medium term targets in individual asset business plans to ensure that budget is available to achieve net zero carbon targets?

d Metrics and targets

Expectation:

Develop a framework to track and reduce material emissions (scope 1, 2, 3) and energy use of the whole building. Determine and disclose the property portfolio's opportunities and risks from stronger building energy efficiency policies, technology changes and shifts in tenant preferences for green buildings (climate transition risks). Start to assess, develop, manage and disclose physical climate risk metrics and targets, drawing upon recent guidance that suggests using Value at Risk from future extreme weather events²³.

Questions for board members:

- 1 Has the company set long-term relative or absolute targets for reducing its greenhouse gas emissions? From owner-operated assets? From tenant-operated assets? From development projects? From embodied carbon in materials used in new buildings and project retrofits? Are the targets in line with 1.5 and or 2 degree scenarios, and what methodology at asset level has been used?
- 2 Can you describe the investment decisions to ensure that direct, indirect and tenants' emissions (i.e. scope 1, 2 and 3) are reduced?
- 3 How are you reflecting the risks of climate change (both physical and transition) in your financial statements, including your balance sheet? Do you have adequate comfort that the auditor of your financial statements is incorporating these climate risk factors into its own methodologies?

Questions for sustainability professionals:

- 4 Describe the action to ensure that energy intensity, energy use and carbon emission targets and disclosures cover 100% of assets, including landlord and tenants' spaces.
- 5 Can you describe your approach to measuring, incentivizing, and improving sustainability impacts of tenants?
- 6 Do you have a net zero carbon target for new developments as well as for existing buildings?
- 7 How is your company conducting assessments relating to flood risk, windstorms, overheating and wildfires? Is your company disclosing what share of investment value and share of rental income is allocated to areas with high, medium and low risk?
- 8 What share of assets under management is certified and can you disclose information by rating level (% by value)?

e Public policy

Expectation:

The company's public policy and lobbying positions and that of their trade associations should be aligned with the company's own commitments and implementation of the Paris agreement goals and should have some alignment with IIGCC's views²⁴ on policies to support energy efficiency.

Questions for board members:

- 1 What are your policy and lobbying positions in relation to climate and energy policy and to what extent do these relate to the company's strategy?
- 2 To what extent are you or have you been engaging with regulators, NGOs, public policy makers and others on climate change and renewable energy issues (including the energy performance of buildings, energy efficiency policies and smart urban development policies)?

Questions for sustainability professionals:

- 3 What is your position on specific policy areas relating to improving the energy performance of buildings, including (but not limited to):
 - Adoption and enforcement of advanced building codes for new public and commercial construction;
 - Zero energy standards for new public and commercial buildings;
 - Retrofitting existing public and private buildings (such as policies prohibiting the sale/lease of inefficient buildings beyond a certain date)?;
 - Utility, ratepayer, or public support for energy-efficiency upgrades; and
 - Energy retrofit loan repayment programmes through utility bills or property taxes.



Endnotes

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