Carbon Intelligence

IPSX

ESG TRANSPARENCY IN COMMERCIAL REAL ESTATE INVESTING

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ESG Transparency in Commercial Real Estate Investing

Removing the darkness that shrouds investments

The requirement for transparency has ramped up significantly in the past year. Governments, investors, and occupiers are asking for more data to help determine a building's ESG performance. Crucially, this data impacts the valuations of assets, their attractiveness in the market, and their ability to access green loans.

In the first article, 'Net Zero, Why now?', we highlighted the magnitude of real estate investors or asset managers making net zero statements, such as the Net Zero Asset Owner Alliance (NZAOA) $5.7 trillion commitment to 'transition investment portfolio to net zero GHG emissions by 2050' [1]. The Better Building Partnership (BBP) Climate Commitment included 24 signatories representing over £300 billion of AUM, over 11,000 properties[2].

"It is critical that the real estate industry acknowledges the important role it has to play, embraces the challenge, and collaborates. This Framework provides much needed clarity in the way real estate owners should approach the development of net zero carbon pathways, providing collective action and transparency that will help move the industry forward." [3]Nina Reid, Chair of the BBP Net Zero Carbon Pathway Working Group, and Director, Responsible Property Investment at M&G Real Estate

The commitment will mean 11,000 buildings will need to measure their operational emissions 'transparently and accountably.' The transparency will enable real estate owners and investors to better differentiate how net zero could impact valuations in property, as per the following article. In addition, IPSX allows investors to understand the merits of a single-asset investment. IPSX is working in partnership to help develop clear guidelines for all admissions to the exchange on reporting and managing embodied and operational carbon emissions.

What do Environmental, Social and Governance (ESG) metrics tell us about asset quality?

When investing in real estate assets, understanding the underlying quality of the building and how it runs is important. Whilst the ESG data can be challenging to obtain, the insight provided is more granular and valuable than aggregated data at a portfolio or fund level.

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[1] Source: https://www.unepfi.org/net-zero-alliance/
[2] Source: https://www.betterbuildingspartnership.co.uk/node/877
[3]Source: https://www.betterbuildingspartnership.co.uk/bbp-publish-net-zero-carbon-framework

Energy intensity, for example, helps us understand the technical, operational control over the building. High tenant usage or on-site data centers can lead to highly energy-intensive buildings. Energy usage data is helpful in that it can also show how much control the site staff have over the central plant and other aspects of operations. Or equally, it can provide insight into social value impact, for example Federated Hermes worked with Hatch to understand the number of apprenticeships or social benefits generated[4].

The largest asset managers are driving the momentum. On behalf of BlackRock's clients, Larry Fink, in his annual 2021 letter, asked that investors 'publish the proportion of BlackRock's assets under management that are currently aligned to net zero' [5]

IPSX provides a platform to view the credentials of a single-asset investment. We will collaborate and support our partners to improve data transparency. As per article 1, we have provided the six next steps that you can take to approach net zero.

How can transparency on ESG metrics improve property investment?

Transition risks include policy changes, reputational impacts, and market preferences, norms, and technology shifts. Net-zero will have a crucial effect on these risks, as the UK becomes more focused on the legislated target of net-zero by 2050 and inaction could lead to building obsolescence. Increasing the transparency of these risks on individual assets will help investors make clearer decisions on what will maintain or increase in value through that transition.

Between 70-80% of buildings in-use in 2050 have already been built today[6], however, only a handful of buildings that exist are designed to address climate change risks, and fewer still are performing in line with net zero. Therefore, almost all buildings have a high risk of obsolescence in the shift to a zero-carbon economy. We need to focus on how we can transparently report on an asset-by-asset basis because by 2050 all buildings will need to be net zero, and that date is only one to two refurbishment cycles away. Over the next five years, we will have a much better understanding of the quantity of future-proofed buildings or assets likely to be stranded.

These risks are also very dynamic as the UK's legislative framework for the transition to net zero is not yet in place. As a result, the policies our buildings are working within are shifting very quickly. Continuous monitoring of environmental data to improve building performance will help us adapt to the UK Government Whitepaper recommendations. We also anticipate updates concerning Part L building regulations, EPCs, and a new mandatory energy rating requirement.

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[4] Source: https://www.betterbuildingspartnership.co.uk/hermes-generates-social-value-and-economic-benefits-through-placemaking
[5] Source: https://www.minterellison.com/articles/summary-blackrock-larry-fink-annual-letter-2021

[6] Source: https://www.jll.co.uk/en/views/net-zero-carbon-and-the-circular-economy-impact-on-value

On March 10th, 2021, the EU Sustainable Finance Disclosure Regulation (SFDR) came into force. SFDR set out a new set of rules across the European Union that the UK government may adopt. The regulation requires real estate investors domiciled in Europe to provide greater transparency across their portfolios. Example data requirements include scope 1, 2, and 3 emissions, energy procured from renewable sources, and the energy performance certificate. Crucially the reporting also sets out definitions such as is the building a 'nearly zero-energy building'? Or what is 'the primary energy demand'? Greater transparency will help investors identify the best performers in the market and drive a more significant brown discount.

An increasing number of green loans are being made available that result in lower finance costs where sustainable KPIs are achieved, giving a lower cost of debt and enhancing returns.[7] A margin reduction of up to 10 basis points is available subject to transparent reporting delivering specific targets assessed annually. Achieving this will be subject to CLS providing transparent reporting and demonstrating the performance improvement that they have made.

The Mailbox REIT plc

The Mailbox is the first asset to float on IPSX, has already implemented the energy management standard ISO 50001 and addressed low-hanging fruit through strong data management. There are other opportunities identified to drive their net zero pathway forward. Indicative examples include the following:

1. Occupier engagement: The Mailbox could collaborate on decarbonisation projects with their retail tenants and FRI occupiers, including blue chip firms with their own ambitious targets. This engagement can be facilitated by sharing data, insight, and case studies.
2. Smart building/ or sub-meter data capture across high consuming equipment; the real-time data could help the Mailbox further optimise their energy performance.
3. Track data to maximise refurbishments/ plant replacement cycles to ensure equipment and building fabric is future-proofed.

Real estate investors have also started to consider offering basis point reductions on rent to tenants who can demonstrate strong ESG performance, particularly under a single-let arrangement. IPSX has a unique role within the context of net zero, as the assets traded on IPSX can provide clearer market signals as buildings transition. Assets with transparent ESG metrics and a plan for managing physical and transition risks can attract and retain investment through the transition to net zero, aligning investment performance with environmental performance.

[7] Source: https://www.jll.co.uk/en/views/valuing-net-zero-esg-for-offices

Actual asset performance is what really matters

Historically the most marketable feature of a green building has been its building rating, such as a BREEAM rating, or an EPC. However, with modern smart metering, recovering data on actual performance has become easier.

Within the London Plan, the Greater London Authority (GLA) has launched the 'be seen' initiative and will require new developments to track energy consumption and publish it publicly for the first seven years of a building's life. This kind of transparency is important for several reasons:

1. The data management process needs to be considered at earliest stages in a development's cycle. This will likely improve upon Part L's (a building regulation that concerns energy efficiency in new construction projects) metering requirements as it will require meters to measure something specific and make that data available for others to see. It will be sufficiently costed within the project, as opposed to an afterthought when the project is complete.
2. Live data can be used for research into energy performance in buildings, improving real world benchmarks. This will help address the real world performance gap in buildings.
3. The requirements for transparency in operational consumption will provide incentives to improve energy performance.
4. Access to data has long been an issue between developers, landlord and tenants, which will be solved by a universal requirement to disclose.

This is not to say that the "be seen" programme will be easy to implement but when as a requirement for planning within the GLA jurisdiction, even if uptake is inconsistent, it will become a major step forward for increasing transparency in how buildings are operated in the UK.

Elsewhere, Australia adopted a national initiative called the National Australian Built Environment Rating System (NABERS). The NABERS energy rating for buildings has helped 78% of Australian office space better understand actual energy performance. This improved insight into the building's performance has led to 7 million tonnes of CO2 and over a $1 billion AUS saved. NABERS has proven so successful; the UK recently launched NABERS UK. In addition, the United States have their rating platform called Energy Star.

Energy performance and carbon emissions

Stronger data relating to energy performance will result in significant long-term energy avoided costs for a building or portfolio. In 2016 Carbon Intelligence started a smart building programme with Aviva Investors, which has saved over £2 million to date. Strong energy performance also typically leads to improved maintenance, reduced life-cycle costs, and lower service charges. Long-term, all these benefits will lead to improved IRR. A review of a portfolio with ~£2 billion AUM,

highlighted that they would save £15 million a year if they aligned their energy performance with the UK-GBC net-zero pathway.

Another challenge facing the nation is that the amount of green energy is limited; for this reason, transparent performance needs to show both figures, typically energy intensity, so it can be compared against other similar buildings, and absolute carbon emissions. This will show the environmental impact of energy used by the building.

The government plans to introduce a national performance-based policy framework for assessing energy use and carbon emissions in commercial and industrial buildings above 1,000m^2 in England and Wales, with annual ratings and mandatory disclosure.[8] Owners and single tenants of buildings above 1,000m^2 will be required to obtain a rating for their building on an annual basis, and have that rating disclosed publicly online.

For investors, the Global Real Estate Sustainability Benchmark (GRESB) has played an essential role in improving the transparency of ESG reporting. The challenge is that the GRESB scorecards do not display asset ESG performance. GRESB and other European partners produced the Carbon Risk Real Estate Monitor (CRREM); CRREM helps track the carbon intensity of specific assets and track an indicative stranding date, though it is only as valuable as the data you obtain and input. As discussed earlier, other reporting, such as SFDR, will mean companies domiciled in the European Union will have to report against ESG metrics. We believe that investors will increasingly want to drill down into the asset data. We will provide a guidance document to support IPSX issuers and investors understand how to improve building performance in the future.

"Boards' responsibility regarding ESG disclosures goes beyond the company's own reporting" A guide to ESG Transparency LGIM October 2020.[9]

Climate resilience and physical risks

While our carbon emissions show the impacts of the asset on the environment, investors are becoming increasingly aware of the impacts of a changing climate on the assets themselves. This is a relatively new area of analysis, stemming from the Taskforce for Climate Related Financial Disclosure (TCFD) recommendations in 2017. This will likely grow in sophistication and is currently tracked at an organisation or portfolio level. The TCFD recommendations are worth being aware of for future compliance requirements. BlackRock requested that investors follow the TCDF recommendations and increase the transparency of their public reporting.

[8] Source: https://www.gov.uk/government/consultations/introducing-a-performance-based-policy-framework-in-large-commercial-and-industrial-buildings

[9] Source: https://www.lgim.com/landg-assets/lgim/_document-library/capabilities/cc64082020-a-guide-to-esg-transparency.pdf

In real estate there are clear physical risks associated with climate change, such as (but not limited to) overheating, extreme weather, and flood risks. Understanding if an asset is on a floodplain has been a part of asset due diligence for some time, but these risks have not necessarily been reported to investors in the context of climate change. As our weather evolves under climate change, these risks are becoming more dynamic, and the associated analysis will become more sophisticated. The TCFD provides a framework for scenario modelling to describe the financial risks of these events.

Another aspect of TCFD that is important to real estate are the transition risks. These are more abstract than the physical risks. They describe the risks to the asset or portfolio as we transition to a zero-carbon world. These can include tenant preferences, exposure to legislation, and potential devaluation if the asset is not aligned with the transition.

Premium Office Case Study:

As a simplified example: an energy intense, premium office building next to a river which has a tenant who has set an aggressive decarbonisation target has several headline risks. The risks of flooding are clearer than the risk that the tenant will leave the asset because the energy performance of the building does not fit within the tenant's long-term emissions targets. The relative energy intensity may require large amounts of additional investment in the building to achieve future legislation as the UK aims to achieve net zero by 2050. What looked like a strong investment may have transition risks which fundamentally undermine the long-term value within the asset.

Transparency on Scope 3 emissions

Scope 3 emissions are all the other emissions that happen indirectly from a company's activities and typically account for over 85% of a real estate company's entire footprint. Regulation such as SFDR will request that reporting includes emissions from tenants, supply chains, purchased goods and services, waste, water, and business travel.

We typically estimate Scope 3 data first based on financial data; however, more transparent reporting will be undertaken once the most material emissions are identified. Benefits of understanding and reducing a building or portfolios scope 3 emissions include the following:

1. Tenants: Through engagement with tenants, the landlord can future-proof the asset through collaborating on decarbonisation projects. The landlord may wish to forward fund projects, which in turn can support leases discussions. Tenants are setting their own net zero targets and will want more transparent reporting from their landlords.
2. Supply chain: The company can instigate training and a code of practice with their suppliers to ensure market best practice is followed.

3. Purchased goods and services: Limit the use of materials with significant embodied carbon, which can reduce future offset costs.

Transparency across sectors

For real estate investors, it is more straightforward to track the performance of offices and shopping centers through tools or benchmarks such as the Real Estate Environmental Benchmark, Carbon Risk Real Estate Monitor (CRREM), or via research from the British Council for Offices (BCO), and the UK-Green Building Council (UK-GBC).

Restate investors are often more interested in how they can capture data from other asset classes that have significant space under a full repairing and insuring lease ("FRI Lease").

For example, let us take industrial units; despite their strong IRR performance, they are the asset class highlighted, by tools such as MSCi, as having the climate value-at-risk (Climate VaR) due to their location. Moreover, the nature of the leases means that landlords experience tenant data collection challenges, which negatively impacts GRESB scores.

Elsewhere we face similar challenges obtaining data from retail tenants across shopping centers, occupiers in other non-industrial related mega-sheds, residential occupiers, and indirectly managed offices or leisure properties.

The good news is that many of these occupiers are signing up for climate change commitments through forums such as the British Retail Consortium (BRC). The BRC plans to decarbonise every store by 2030, members include IKEA, McDonald's, B&Q, and Argos. Given the short time frame these retailers face, there is an urgency to do whatever is possible to reduce energy usage, meaning they should be open to sharing data if the investor can help them on their journey.

Aside from retail, over the past 12 months, the first magic circle law firm and big four accountancy firm committed to a science-based target. Many insurance firms have signed up to initiatives such as Munich Climate Insurance Initiative (MCII) or the Principles for Sustainable Insurance Initiative (PSI Initiative). These commitments will drive the need to engage with their landlords to share ESG data.

Our partner, Carbon Intelligence has over 45,000 buildings on their technology platform ADAPT. Such a large sample set of data allows investors to use the data to build up proxies where the carbon hot spots will sit across different sectors. By understanding these hot spots, investors can seek to collaborate with occupiers to obtain ESG data.

Summary

As Michael Liebreich, Senior Contributor, BloombergNEF explains: *"This long-term shift of climate risk from fuzzy and voluntary ESG reports to quantified and regulated financial statements will mark a huge inflection point in the history of climate action. As Peter Bakker, president of the WBCSD, noted in 2012, "accountants will save the world"."*[10]

As discussed in article 1 'Net Zero… Why now?', the largest asset managers and asset owners are driving significant momentum in the market. By improving the transparency of how you report your ESG performance, you can move ahead of your peers in demonstrating to investors, occupiers, local governments, or the public that you have a plan. You do not need to try and replicate the market leaders, but it may be worth reviewing the approaches that would work for your company, portfolio, or asset. Even if you decide not to be transparent in your reporting, you will not have a choice, as legislation forces your hand.

The direction of travel highlights the benefits of transparency at an asset level rather than a portfolio. This granularity makes it more possible to improve ESG performance of buildings by utilising operational data. IPSX is unique in providing a proposition that allows investors to understand the merits of single-asset investments. To further support our partners, we will provide a guide on ESG reporting.

The following article will consider the future net zero impact on real estate valuations.

[10] Source: https://about.bnef.com/blog/liebreich-climate-and-finance-lessons-from-a-time-machine/

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IPSX & Carbon Intelligence

IPSX has partnered with Carbon Intelligence to afford all admissions to the exchange clear guidelines for how they should be reporting and managing both embodied and operating carbon emissions.

By taking a proactive approach and drawing on Carbon Intelligence's expertise, assets listed on the International Property Stock Exchange, will have absolute transparency and regular reporting of the carbon emissions of those single assets allowing investors to run more effective ESG-aware portfolios.

carbon.ci

Carbon Intelligence
5th Floor
103-113 Regent Street
London W1B 4HL

T 020 3053 6655
E info@carbon.ci

carbon.ci

IPSX
15 Stratton Street
Mayfair W1J 8LQ

T 020 3931 8800
E sales@ipsx.com
E media@ipsx.com

ipsx.com