CONFIDENTIAL – Presentation Briefing

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Re: Real Estate Investment Advisory Council
First Quarter Presentation: **Deciphering the ESG Code**
Hotel InterContinental Buckhead

On Thursday March 16th, The Real Estate Investment Advisory Council gathered at the InterContinental to listen, learn and decipher the fundamentals of ESG.

The REIAC audience was treated to the high-level expertise and experience of:

Holly Neber, CEO of AEI Consultants
Kathy Thurston, Executive Director of Debt ESG, PGIM
Lisa Bozzelli, Senior Director on the Fannie Mae Multifamily Capital Markets Trading Desk
Laura Craft, Senior Vice President and Head of Global ESG Strategy at Heitman, and
Kevin William Fagan, Senior Director and Head of CRE Economic Analysis at Moody's Analytics

<u>First, what does it mean?</u>

The "E" is easy to figure out; it stands for Environment but **could just as easily mean Energy**. Could also mean water usage, healthy building environments, climate resilience and even personal fitness, if you don't mind interchanging words that don't start with E.

The "S" for Social…well, we're still trying to figure that out.

The "G" for Governance could stand in for being a good steward of investment decisions, i.e., responsible due diligence in judging acquisition targets, picking a partner, getting good financing.

The ESG movement has been a standard in European markets for some time, but has slowly bubbled to the surface in the United States, in bits at a time.

The rise of "E" took place during the Great Financial Crisis. Assets couldn't trade, and investment holds became longer. The only way to **juice one's IRR targets and enhance value was through energy savings**. LEED Certified and Energy Star standards made their way into the real estate lexicon. The multifamily lending agencies created loan programs specifically to encourage landlords to institute energy saving practices and capital improvements geared toward the reduction of operating costs: install low-flow toilets and we'll give you a discount on rate, and push loan proceeds a bit.

The rise of" S" came about during COVID, as tenants voiced concern about their landlord's practicing safety standards to maintain healthy building environments. S also came to the forefront as rents began to rise beyond tenants' ability to keep up. Affordability for the typical tenant, and Affordable Housing inventory are major headaches that numerous city governments are addressing, sometimes through onerous legislation.

<ins>Second, how does one quantify it?</ins>

Quantifying ESG is not without its challenges. The biggest issue in the math is the lack of data for such things as energy usage. Utilities are not forthcoming with such data, and going door to door to collect utility bills from tenants is time-consuming.

Or consider this: in wildfire-prone California**, how much fire is too much fire?** There are always fires, but when a prospective investor asks, "how close is the fire risk to your property?" what is a good answer? A few miles? Another mountain range over? Upwind?

On the other hand, landlords can easily detect environmental threats to their properties every time they open their mail from their insurance agents. Skyrocketing premiums bring home the issue straight to the bottom line. Insurance costs are the one topic that puts ESG awareness to the forefront of even the anti-ESG landlords and investors.

<ins>How do they do it across the pond?</ins>

Europe is out front on all things ESG. It is standard operating procedure that **all investments, all lending and all developing complies with strict ESG regulations**. Even in the European capital markets, there is an ESG bond market, in which the underlying collateral is ESG compliant top to bottom.

No such bond market in the US, but interestingly, US-based investment advisors that do even a small bit of business in the European Union have to be fully compliant with European ESG requirements, even when that US advisor is buying a US asset.

This puts the onus on investment advisors to be at the forefront of ESG investing, even when the majority of American property developers resist becoming ESG converts.

So far, the domestic groups that prioritize learning ESG are REITS (given their public disclosure requirements) and lenders that fall under federal government regulation, i.e., the OCC, and of course, quasi-government agencies themselves (Freddie Mac, Fannie, HUD).

<ins>So let's get started on ESG</ins>

From a financial perspective, **let's at least answer the question of "What does it cost, and how do I get there."** To start, identify the risks, and then identify the mitigants. There's a whole lot of information available on risk, and it's out there mostly for free. But mitigation information, not so much.

In the EU, numerous laws and regulations spell out exactly "how do I get there." But in the US, such guidance is limited. The Securities Exchange Commission offers proposals here and there on climate impact transparency, but there's no identifiable written-in-stone methodology.

And that's what's really needed at this junction, **"metrics that matter.**" Some professional groups like the Pension Real Estate Association (PREA) and the National Counsel of Real Estate Investment Fiduciaries (NCREIF) have co-created a system of measures and standards, downloadable as an excel file. The American Society for Testing and Material, now known as ASTM, has a methodology. And the Global Real Estate Sustainable Benchmark, or GRESB for short (rolls right off the tongue, right?) brings together an international set of measures for ESG compliance on a 0 to 5 ranking scale.

It is admittedly an alphabet soup of standards bureaus providing various rankings and benchmarks, and it appears that **no one system is the best**. The industry's advice is "pick the system that closely matches your situation."

Thus, scorecards abound, as every investment advisor likely has their own rankings, their own methodology, their own measures, and their own priorities.

<u>Once I do all that, do I get a bonus?</u>

Are there any "greeniums" for my property? Meaning, any green premiums in pricing, proceeds, etc.

In some areas, yes. Freddie Mac will provide loans with better rates, and these green loans are outside Freddie's yearly volume limits enforced by Congress. It's easy to quantify because Freddie has certain financial goals for green loans which are tallied up at the end of each year.

But for other property types it's difficult to tell. Speakers acknowledge that there is no evidence pointing solely to ESG as a value enhancer. If one property sale is compared to another almost identical property sale but for the ESG compliance, is a sales price premium due to ESG, or some other factor (better financing for one buyer vs. the other buyer, etc.).

Further, energy savings will bring a premium vs. resilience savings. Resilience savings is what the landlord will save, for example, by reinforcing construction to withstand a hurricane. Energy savings can be measured every month in the property's operating statements; but if the property never gets hit by a hurricane, how can you tell if you saved any money?

ESG does bring more liquidity to the market, though. Since ESG is at least a conceptual acquisition target, more investors will be attuned to pursing assets that are ESG compliant, whether or not they will actually pay more for it. And those investors that are playing the long game forecast that while they themselves may not appreciate ESG, the next buyer of that asset ten years from now may well require it.

The Future of ESG

Where does it go from here? ESG proponents point out **that ESG is simply responsible due diligence, repackaged**. ESG requires of a landlord the same level of care and responsibility that the landlord performs in its original due diligence, or ought to be doing.

If the real estate industry cares/worries about increasing environmental risks, rising energy costs, rising insurance costs, available liquidity, **then the industry should embrace ESG**. Just ask Larry Fink.

About REIAC

The Real Estate Investment Advisory Council (REIAC) was established as a nonprofit trade association to provide a forum for the exchange of ideas, concerns and experiences among senior executives who conduct commercial real estate transactions. The Southeast chapter of REIAC was founded in 1994.

REIAC is an exclusive, **principals-only** national fellowship of top real estate executives that offers superior educational events, networking opportunities and community service. REIAC's institutional quality programs are presented in a social environment where members can share experiences and knowledge with their peers. REIAC events encourage members to broaden horizons and develop personal relationships that further their success within the industry.

For further information, please contact:

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