ESG 101: How ESG is changing Commercial Real Estate

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Presenter

Kyle Bolden

Kyle is currently EY's US East Real Estate, Hospitality, and Construction (EY RHC) Market Segment Leader. In this role, he oversees the Region's four service lines — Assurance, Consulting, Strategy and Transactions, and Tax.

EY work with more than 200,000 clients in 150 countries, from start-ups to multinationals across all sectors, helping them meet their most pressing challenges.

Kyle has a long history of working with national and international entities, including landlords, hotel owner/operators, real estate developers, commercial real estate services firms and flexible office providers.

Kyle is the Environmental, Social and Governance (ESG) leader for EY RHC.

Presenter

Ali Haidar

Ali is a Senior Manager within the in real estate, hospitality and construction sector at EY supporting executives make decisions and solve complex problems relating to their real estate investments/exposure.

While his work is sector agnostic, Ali spends majority of his time with Private Equity, Financial Services, and Public Sector clients. Ali has been involved in multiple roundtable discussions on ESG with a focus on underwriting and impact on lending.

Ali is a big believer in the power of the pen and an advocate for continued education.

"Sustainability is the integration of environmental health, social equity, and economic vitality in order to create thriving, healthy, diverse and resilient communities for this generation and generations to come."

UCLA Sustainability Committee, 2016.

Defining ESG vs. Sustainability - What's the Difference?

ESG

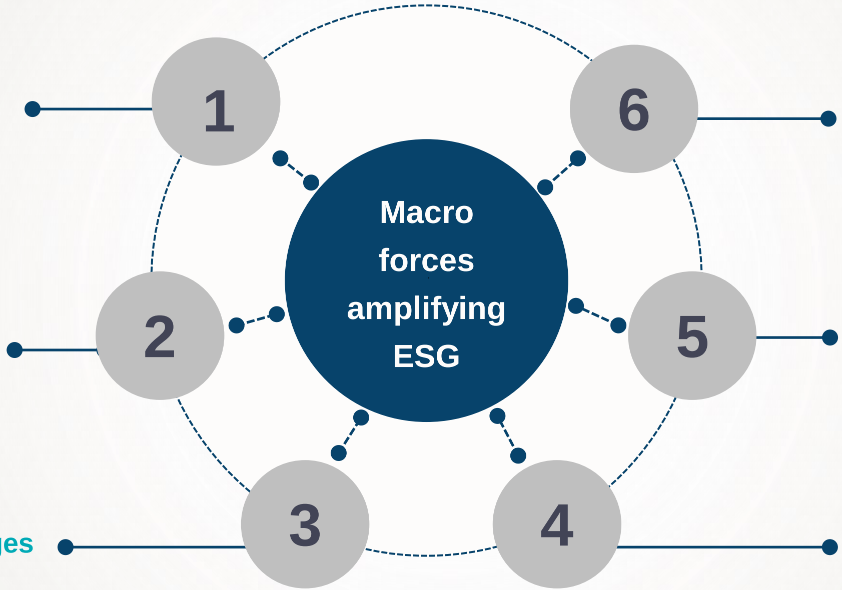
- ✓ ESG is about company stakeholders, identity, and decision-making — the board, CEO, employees, shareholders, and other stakeholders
- ✓ ESG is an investment framework that helps external investors assess company performance and risk
- ✓ ESG is based on standards set by investment and reporting organizations (e.g., PRI, TCFD, MSCI).

Sustainability

- ✓ Sustainability is a framework to make internal capital investments (i.e., installing LED light bulbs or other energy efficiency measures, electrifying a transportation fleet, purchasing sustainability measurement software)
- ✓ Sustainability is about the relationship between a company and the environment
- ✓ Sustainability standards — while also set by standards groups like GHG Protocol — are more science-based and standardized. There are dozens of different frameworks for measuring ESG

- ESG includes sustainability as one of its three pillars, but also incorporates broader social and corporate governance considerations.
- ESG is typically more relevant for large companies who are listed on public investment exchanges or who need to get financing from institutional investors. However, as more banks and financial services firms themselves adopt ESG principles around their business, ESG is also increasingly becoming more material to startups and smaller organizations.

Many market and societal forces have heightened the importance of ESG



Rising global threats and associated opportunities from climate change

The seriousness and scale of the risks posed by climate change highlight the need to accelerate change through business innovation.

Shift to stakeholder capitalism

Stakeholders' demands are forcing executives and decision-makers to rethink their organizations' goals beyond maximizing shareholder value.

Biden administration's bold climate agenda and SEC changes

The Biden administration has a bold climate agenda and is focused on building a modern, sustainable infrastructure and clean energy future.

The fight for racial equity and social justice

Working to achieve racial diversity, equity and inclusion is a renewed priority for companies looking to drive sustainability and overall performance.

Talent and customer attraction

Employees and customers are demanding that organizations stand for something beyond profit.

Sustainable investing from niche to mass market

Sustainable investing continues to expand into a major market segment, fueled by investors and firms demanding corporate disclosures.

Stakeholder expectations have been the main market driver for ESG so far

Investors

98% of investors in EY survey **evaluate ESG** performance based on corporate disclosures.

Sustainably invested assets represent **$1 in every $3 US assets** under professional management.

Employees

Millennials are **three times more likely** to seek employment with a company because of its stance on social and/or environmental issues.

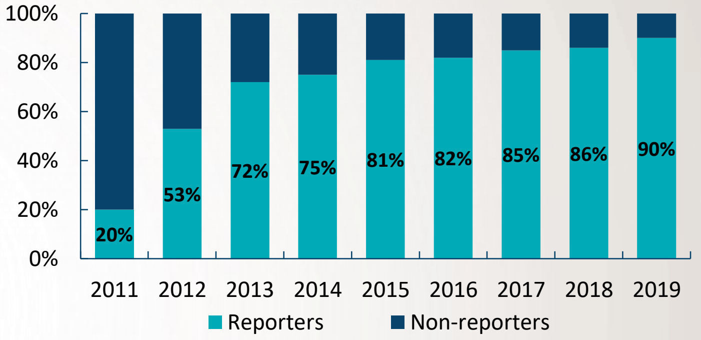
Customers

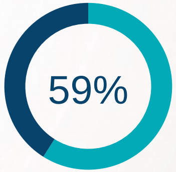
More than **150 members** with $4 trillion of purchasing power are using the **Carbon Disclosure Project (CDP)** supply chain program to request ESG information from **15,000 suppliers** worldwide.

Consumers

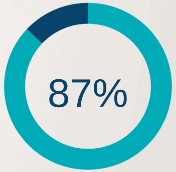
57% of consumers are willing to change their purchasing habits to help reduce negative environmental impact.

S&P500 companies publishing sustainability reports[1]





of investors are concerned with environmental issues/ climate change[2]



of respondents agree that stakeholders, not shareholders, are most important to long-term company success[3]

[1] "Trends on the sustainability reporting practices of S&P 500 index companies," Governance and Accountability Institute, Inc., 2020

[2] "2020 proxy season preview: What investors expect from the 2020 proxy season," *EY website*, February 5, 2021.

[3] "Edelman Trust Barometer 2020," *Edelman website*, 2020 Edelman Trust Barometer Global Report_LIVE.pdf, accessed February 9, 2021.

Stakeholder value creation chain: how do ESG strategies/metrics and the stakeholder model align?

Environmental, Social and Governance (ESG) Strategy

Intermediate outcomes

Employees
- Engagement
- Innovation
- Productivity
- Retention
- Diverse workforce

Community
- Public Image
- License to operate
- Community Partnership

Suppliers
- Reputation
- Interdependency and trust

Customers
- Loyalty
- Brand premium
- “word of mouth” marketing

Shareholders
- Focus on performance
- Attractive for long-term investors
- More attractive for ESG investors
- Mitigates governance risk

“Positive Externality” impact

Desired results

Optimized Stakeholder Value Creation

Enhanced Stakeholder Value

ESG is no longer a marketing tool, but a part of companies’ fiduciary duty

Defining ESG	Environmental	Social	Governance
The term “ESG” is often used interchangeably with the terms “sustainability” and “corporate responsibility.” Priorities vary by company and often include these topics.	• Climate change / carbon • Greenhouse gas emissions • Energy efficiency • Pollution and waste management • Land-use impacts • Water use and conservation • Green building / smart growth	• Diversity and inclusion • Employee safety and wellness • Product quality and safety • Community engagement and impacts Employee wages and benefits	• Board diversity • Business ethics • Management of environmental and social risks • Compensation policies • Data privacy and security • Corporate political contributions

Old World corporate social responsibility (CSR):

- We contribute to society because we are successful.
- We give back.

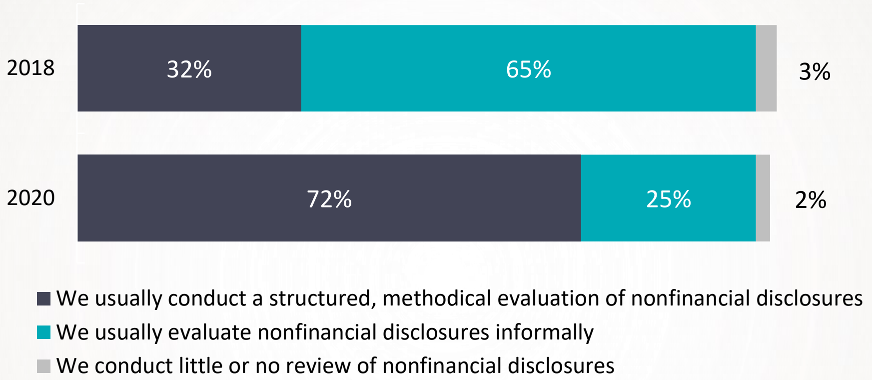
New World sustainability and ESG:

- We are successful because we contribute to society.
- We create shared value.

Adapted from WBSCD.

Investors are driving ESG programs at companies and moving toward more rigorous evaluation of ESG disclosures

The vast majority of investors say that they usually conduct a structured and formal review of ESG disclosures



67%

More than two-thirds of investors say that they make “significant use” of ESG disclosures that are shaped by the Task Force on Climate-related Financial Disclosures (TCFD).

78%

More than three-quarters of those who make significant use of that TCFD information say that it has a significant impact on investment decision-making.[1]

1. Source: "How will your ESG performance shape your future?“ EY website, July 22, 2020.

The ESG regulatory environment is rapidly changing globally

SEC on human capital

Aug 2020 — The SEC adopts amendments requiring human capital disclosures, where material.

SEC Investor Advisory Committee

May 2020 — Recommends the SEC update reporting requirements to include material and decision-useful ESG factors, noting that if the SEC does not take the lead in establishing an ESG disclosure framework, it risks standards developed by other jurisdictions becoming the default for global issuers.

Biden administration makes strong commitment to climate and environmental via executive action

Jan 2021 — New administration says US is rejoining the Paris Agreement and issues EO on tackling the climate crisis and protecting public health and the environment; expects to introduce ESG-related regs.

SEC announces greater ESG and climate focus

Feb 2021 — The SEC says that it will review companies' climate change disclosures.

Mar 3 — SEC announces plans to examine ESG funds for underlying investments' ESG focus.

SEC announces enforcement task force on climate and ESG issues

Mar 4 — Task force to develop initiatives to proactively identify ESG-related misconducts. Initial focus to identify any material gaps or misstatements in issuers' disclosure of climate risks.

March 15 – Public input requested from investors, registrants, and other market participants on climate change disclosures.

2020

2021+

IFAC

Sep 2020 — The International Federation of Accountants (IFAC) calls for the IFRS Foundation to establish sustainability standards board alongside the IASB to set global sustainability/ESG standards.

ESG framework convergence

Sep 2020 — Five of the most important sustainability framework organizations issue
a joint statement of collaboration and potential path forward.

IFRS Foundation Trustees

Feb 2021 — Trustees announce plans to produce a definitive proposal (including a road map with timeline) by the end of September 2021, possibly leading to an announcement on establishing a sustainability standards board when the United Nations Climate Change Conference COP26 meets in November 2021.

Sustainable Finance Disclosure Regulation

Mar 10 — Disclosure requirements under the SFDR begin to phase in. Initial requirements focus on sustainability risk and due diligence policies. Requirements are aimed at improving transparency and consistency of disclosures for ESG-focused financial products.

TCFD

By 2022 — The UK Government expects all listed companies and large asset owners to disclose in line with TCFD.

US-focused International

Demand drivers for sustainability are accelerating with the current administration's unprecedented actions

President Biden committed to unprecedented Day 1 executive actions to drive historic climate policy actions, which include the following goals:

Achieve a 100% clean energy economy

Net-zero emissions no later than 2050

These actions, coupled with increasing climate risks and increasing stakeholder pressure for organizations to focus on ESG, make sustainability a global business imperative.

Top 5 priorities

Green jobs and addressing the climate crisis

01

Climate policy

Biden's climate policy goes beyond his initial executive orders of rejoining the Paris Climate Agreement and stopping the Keystone XL Pipeline. Reducing GHG emissions from transportation, requiring public companies to disclose climate risks, and requiring methane pollution limits from oil and gas operations are a few considerations as the his administration moves forward.

02

Energy transformation and job creation

Creating a clean energy economy and net-zero emissions will require major shifts toward renewable energy. Biden has stated that he aims to create 10 million jobs focused on infrastructure and clean energy. This transition will require strong public-private partnerships to ensure a smooth transition at a state and local level.

03

Sustainable supply chain

The pandemic accelerated and magnified issues within global supply chains. The Biden administration policy emphasis is focused on "buy American" and on onshoring products that deliver critical societal needs. Supply chains must now consider sustainability and human equity throughout their architectures; bringing supply chains closer to home can significantly reduce ESG risk.

04

Sustainable finance

Biden's strong focus on racial and gender equity, climate risk and financial inclusion will require a stronger focus on sustainable finance. Financial services will need to play a role in addressing climate change and improving the burden on low-income communities. ESG products and disclosures will continue to strengthen.

05

Social justice and equity

The Biden administration is focused on progressive social justice reform, which will impact the "social" component of ESG, including focusing on racial equity via small businesses, housing and education; advocating for workers' rights and union organizing; and making sweeping reversals of the Trump immigration agenda.

ESG by the Numbers

ESG is a Key Differentiator in Purchasing Decisions

60% of the general public are willing to buy from a company with a high ESG score, whereas only 20% are willing to buy from a company with a low score[1]

ESG score is on average 94% correlated to Reputation[1]

Millennials place 3 times the importance on ESG when making purchases compared to Non-millenials[1]

Sustainable investment product offerings

Assets under management for sustainable funds increased 9x ($113 billion in 2010; $1 trillion in 2020)[2]

Firms offering sustainable investment funds grew from 59 in 2010 to 165 in 2020[2]

9 of 10 of the largest US ESG mutual funds and ETFs outperformed the S&P 500 in the first half of 2020 by an average of 2.1%[2]

Climate-friendly financings

Since 2008, the World Bank has issued nearly $16 billion in green bonds.

Fannie Mae has issued over $97 billion of Multifamily MBS backed by its Green Building Certification program and Green Rewards program.

Sustainable bond issuance (green, social and sustainability) may top $650 billion in 2021, representing a growth of 32% over the previous year.

1. https://f.hubspotusercontent20.net/hubfs/2963875/ESG%20by%20Numbers.pdf
2. https://etfdb.com/esg-channel/esg-by-the-numbers/
3. https://www.nasdaq.com/articles/green-bonds-on-the-rise-2021-07-02
4. Will green homes perform better in mortgage-backed securities? | Mortgage Professional America (mpamag.com)

How ESG is integrated through the full life cycle of a loan

Lenders are increasingly interested in loans that have a positive environmental, social and corporate governance (ESG) impact

- Underwriting – This process is to determine whether the loan is a good risk for the lender and the main task during the this stage is to avoid as many undue risks as possible.
  - Borrowers with market leading ESG policies and practices could lend further support to an investment thesis as a signal of good risk management and operational excellence.
- Monitoring – During the loan period, the borrower is likely to transition through different credit profiles, for example due to financial management decisions, industry trends, or the economic environment. Effective borrower monitoring is therefore necessary to detect which loans are likely to become stressed, and which loans might default and lead to financial loss.
  - Proactively monitoring loans for developments that may adversely affect an underlying credit can put lenders on the front foot when monitoring its loan portfolio. This practice may inform them of adverse incidents that reach a certain materiality threshold and also provide opportunities to re-engage with borrowers (e.g., identify value-accretive types of ESG initiatives, opportunities to provide credit and pricing terms that incentivize a borrower to achieve specified ESG-related milestones).
- Reporting – Documented requirements in the loan agreement for reviews are not normally differentiated based on financial performance. Whether financial trends are improving, stable, or experiencing some decline, the monitoring requirements can be similar.
  - Mechanism for providing ESG updates (positive or negative) regarding the ESG risks and KPIs, thereby providing a higher level of transparency for stakeholders.

The rise of the "S" in ESG

- Fundamentally, the concept of the "**S**" pillar in the built environment should be about improving the quality of life of people.
- Awareness is growing that real estate can have a significant social impact, e.g., rehabilitation of public spaces (indirectly attributing value to existing real estate), affordable housing, social housing, and care centers, or through an environmental focus investment on new buildings such as green buildings.
- "**Social impact**" is based upon the economic calculation of designing investments to have both a market return and a social benefit which is then more likely to enhance the economic return.
- Commercial real estate development has a large impact on its surrounding community and should be respectful of that community and be a positive addition to that community in the eyes of that community, in that the benefits of development are spread across a wider population.
- It must be **intentional, inclusive, and equitable**; it is community and person focused, and when done correctly, can raise the profile of a commercial real estate project beyond just the square footage, number of units, and tenants.

Social spans employees, tenants and the community

"Long-term thinking has never been more critical than it is today. Companies and investors with a strong sense of purpose and a long-term approach will be better able to navigate this crisis and its aftermath … We've seen sustainable portfolios outperform traditional portfolios [during COVID-19]."

— Larry Fink letter to shareholders (March 29, 2020)

Employee well-being

COVID-19 changed the way employers consider employee well-being. ESG topics at the forefront include:

- Health and safety — from PPE to new work strategies to floorplan redesigns, keeping employees and tenants safe is paramount
- Diversity, equity and inclusion — changing hiring and retention practices to diversify the workforce at all levels
- Employee engagement — listening to employees and understanding concerns around inclusion, safety, and work practices

69% of REITs that responded to NAREIT's Social Responsibility Survey conduct employee satisfaction surveys.[1]

Tenant support

Tenant engagement is critical to creating value for tenants and REITs. Tenants have ESG considerations and are looking for support in addressing health and safety, climate risk, energy management, and water and waste reduction. Locations offering these amenities will likely become more attractive to tenants.

Frameworks like GRESB encourage tenant satisfaction surveys and a joint approach to addressing ESG issues.

Engaging local communities

Companies are responding to stakeholder expectations by using their resources to support communities. Common approaches include:

- Donations to nonprofits
- Student internship programs emphasizing diversity
- Support employee volunteer participation

Focus should be on activities that will drive long-term value in your organization.

63% of REITs surveyed by NAREIT reported having community outreach policies.[1]

1. *2021 REIT Industry ESG Report*

Incorporation of climate risks into risk appetite

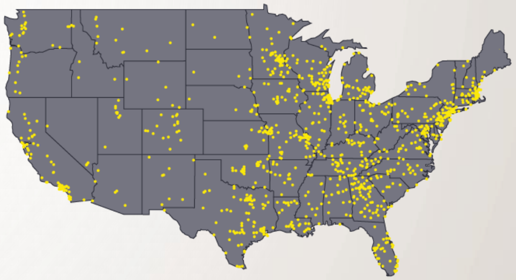
	Climate considerations	
Governance and strategy	Define how it aligns with purpose: • Maintain disciplined strategy for growth, credit ratings and capital • Focus on operational excellence and control, balancing risk and reward • Protect franchise value • Align to investment strategy	Define firm-wide climate change governance and risk strategy, inclusive of public commitments
Risk capacity	Operate within relevant constraints: • Capacity for earnings and capital to absorb losses • Other goals, such as service availability and business resiliency • Investment and trading policies	Determine exposure and assess whether changes are warranted on the buffer between appetite and capacity
Risk appetite	Expressed in common language: • Defined across expected, unexpected and tail events • Focused on core drivers of risk and measured relative to capital, liquidity, earnings or other measures as appropriate	Develop a climate-change risk appetite statement and integrate it into the existing risk appetite framework
Limits and control metrics	Aligned to appetite: • Risk and portfolio metrics • Specific to business units, portfolios, etc. • Calibrated to resources or benchmarks • Focus on control and crisis prevention for unexpected levels of risk	Translate risk appetite into climate-change risk limits and metrics to facilitate monitoring

Commercial and residential real estate

Identify vulnerabilities related to the value of real estate and the value of the land it is built on as this will directly affect real estate prices

Regional exposure to commercial real estate lending[1]

Dots on map represent banks with commercial real estate loans above 300% of total capital



1. *Source: EY*

Governance is the foundation for ESG

- Governance is a broad category of topics that underlays the entire ESG program from ethics to corruption. Trending topics include:
- **Accountability** — define overall accountability structure for sustainability performance, risk management and strategic direction. Create responsibilities for reviewing key sustainability initiatives, policies and practices; sustainability performance; and the company sustainability report
- **Compensation policies** — the rationale, feasibility and effectiveness of including ESG factors in corporate executive pay plans — as well as guiding investors on exercising stewardship
- **Cybersecurity** — recognized as a risk in the World Economic Forum Global Risks Report for several years, with the latest version ranking cybersecurity as one of the top 10 risks that the world will face in the next 10 years.

Board of directors

BOD sustainability-related committee

Sustainability committee

Executive committee subcommittee

Board-level leadership — In recent years, ESG has earned a position as a board-level priority across the REIT industry, with 85% of REITs reporting ESG performance to their board of directors at least annually, and 42% doing so quarterly.[1]

The United Nations-supported PRI is an international network of investors working together to put responsible investment principles into practice.

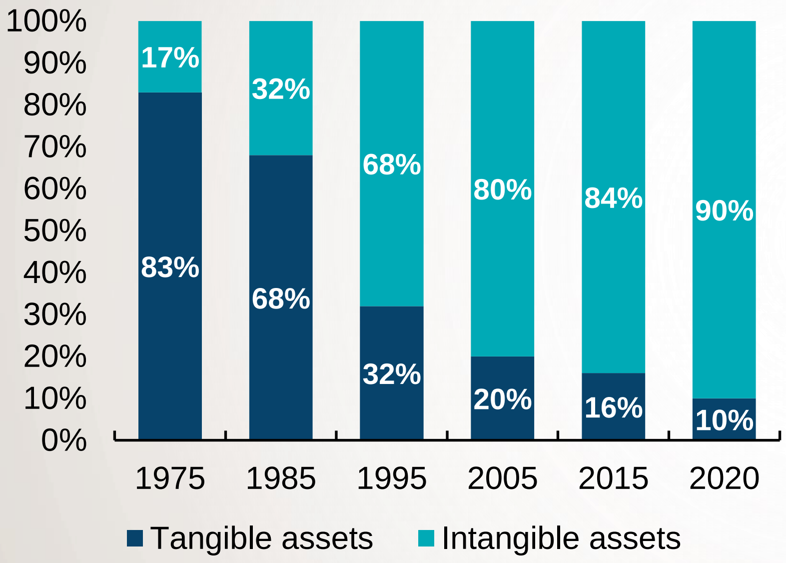
Principles:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the principles.
6. We will each report on our activities and progress towards implementing the principles.

1. *2021 REIT Industry ESG Report*

Focus on ESG topics supportive of long-term value creation

Components of S&P 500 market value have significantly shifted from tangibles to intangibles



- There is general consensus that business needs to rebuild trust with society and collectively be seen as part of the solution to the major challenges facing our planet and society
- Increase trust among stakeholders and shareholders through greater transparency from reporting on these topics in a more consistent and comparable ways

Principles of governance	Planet	People	Prosperity
The definition of governance is evolving as organization are increasingly expected to define and embed their purpose at the center of their business. But the principles of agency, accountability and stewardship continue to be vital for truly “good governance”.	An ambition to protect the planet from degradation, including through sustainability consumption and production, sustainable management its natural resources and taking urgent action on clime change so that can support the needs of the present and future generations.	An ambition to end poverty and hunger, in all their forms and dimension, and to ensure that all human beings can fulfill their potentiation in dignity and equality and in a health environment.	An ambition to ensure that all human beings can enjoy prosperous and fulfilling live and that economic, social and technological progress occurs in harmony with nature.

1. *Left Source: Intangible Asset Market Value Study, 2019. Ocean Tomo (https://Oceantomo.com/intangible-asset-market-value-study/)*
2. *Right Source: Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation (World Economic Forum)*

ESG standards and frameworks

Reporting standard setters

Most relevant for developing a separate sustainability report serving the needs of multiple stakeholders

- **Global Reporting Initiative (GRI) — since 1997.** Mission: to empower decisions that create social, environmental and economic benefits for everyone.
- **Sustainability Accounting Standards Board (SASB) — since 2011.** Mission: to develop and disseminate sustainability accounting standards that help companies disclose material, decision-relevant information to investors in a cost-effective way.
- **International <IR> Framework — since 2010.** Mission: help organizations explain to providers of financial capital how they create value over time.
- **WEF/IBC Metrics — since 2020.** Mission: to develop an industry sector-agnostic, core set of metrics to monitor companies' contributions to long-term value creation

International goals and guidance

Principles-based frameworks that provide high-level guidance on global topics and disclosures for multiple stakeholders

- **Sustainable Development Goals (SDGs)**
  - 17 goals supported by 169 targets developed by the United Nations
  - Companies are beginning to set goals in alignment with the SDGs
- **Task Force on Climate-related Financial Disclosures (TCFD)**
  - Established by the Financial Stability Board (FSB) in 2015 to promote more effective climate-related disclosures
  - The TCFD's recommendations (released June 2017) are focused on financial impacts of climate-related risks and opportunities of an organization

ESG rating agencies

Provide scores to companies based on publicly available ESG disclosures, data, surveys or news reports

Example agencies include:

- Vigeo Eiris
- RepRisk
- Refinitiv
- Bloomberg
- RobecoSAM
- Sustainalytics
- MSCI
- ISS-oekom
- FTSE Russell

- The reports developed by these agencies are typically used by investors and industry analysts in their assessment of company performance.

Disclosure-based sustainability scores

Benchmarks or surveys used by investors to integrate sustainability considerations into their portfolio or to assess the financial materiality of sustainability issues

- **Dow Jones Sustainability Index (DJSI)**
  - 2,500 of the largest publicly traded companies are invited to participate
  - The index represents the top 10% of those companies (~300 total)
- **CDP (formerly Carbon Disclosure Project)**
  - Global disclosure system that enables companies, cities, states and regions to measure and manage their environmental impacts. Questionnaires focus on climate change, water scarcity and deforestation. Responses are scored
- **Global Real Estate Sustainability Benchmark (GRESB) — since 2009**
  - The GRESB Real Estate Assessment is an investor-driven global ESG benchmark and reporting framework. Data is self-reported, scored and benchmarked

Contact information and additional resources

If you have any further questions or want to get involved, please don't hesitate to reach out:

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Thank you!

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