FUTURE-PROOFING LISTED REAL ESTATE: SUSTAINABLE REAL ESTATE SECURITIES

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It is widely acknowledged that “sustainable investment” is one of the fastest-growing investment approaches in the world. (Sustainable investment is defined here as an investment discipline where environmental, social, and governance (ESG) factors are considered alongside more traditional financial metrics in selecting securities and building portfolios. The objective is to combine strong financial returns with positive environmental and social impacts). One proxy for this rapid growth is the remarkable expansion of the Principles for Responsible Investment (PRI), a coalition of asset owners who have committed publicly to implement sustainable investment practices in their portfolios. In the space of only 10 years, the volume of managed assets committed to the PRI has mushroomed more than tenfold from $6 trillion to over $70 trillion.

Initially, sustainability considerations were largely confined to equity portfolios. More recently, however, some of the largest and most sophisticated asset owners in the world (Japan’s GPIF, the U.S. funds CalPERS and CALSTRS, Sweden’s AP4 and APG, and PGGM in the Netherlands, to name just six) are intensifying their efforts to spread the integration of ESG analysis beyond equities to their other asset classes. In no asset class is sustainability a more compelling factor driving competitiveness and profitability than in the listed real estate sector. We would argue that the best way to “future-proof” a real estate portfolio is to make ESG an integral part of the analysis of every company being considered for inclusion.

A New Competitive Environment: Global Megatrends

One reason for this is the profound impact, which a number of secular, global megatrends are beginning to have on the real estate sector. Among the megatrends with particular relevance and importance for the sector are the following:

- **Urbanization**: fuelled by both overall population growth and internal migration. The UN projects a global urban population of 5 billion by 2030, with 90% of the growth coming from Asia and Africa;[1]
- **A shift in the economic centre of gravity and dynamism:** from the developed markets of the OECD countries to the exploding economies of China, India, and the rest of Asia; by 2050, six of the largest seven economies in the world will be found in emerging markets;[2]
- **Ageing societies:** with particular needs for housing, health care, transportation, recreation, and social services;[3]
- **Technological innovation:** in construction methods and materials, smart cities, smart buildings, distributed energy production and use, and so on;
- **Closer collaboration with governments:** whether in their capacity as regulators and policy-makers, or as key financial players in public/private partnerships;
- **The globalization and intensification of real estate competition:** The larger real estate companies are both expanding their property portfolios and extending their activities to entirely new countries and regions;
- **Growing concerns about sustainability:** concerns about issues such as climate change and eco-efficiency, have now expanded beyond government and civil society, and have now become a central preoccupation for institutional investors. The

[1] *UN Department of Economics and Social Affairs.*
[2] *PWC (2017) Shift of Global Economic Power;*
[3] *United Nations (2017) World Population Prospects: the 2017 Revisions;*

Institutional Investors Group on Climate Change, for example, brings together asset owners and managers with $20 *trillion* under management.

Taken together, these structural changes are literally reshaping the global competitive environment within which real estate developers and managers must operate. Collectively, they place a new premium on a number of skill sets and operating approaches which real estate companies may or may not possess: adaptability, responsiveness, horizon-scanning, and innovation. Without those attributes, their ability to thrive and even survive amidst 21st century hyper-competition will remain very much in doubt. For that reason, those qualities feature prominently in Inflection Point Capital Management's (IPCM's) proprietary 5-Factor model, along with the more traditional E,S, and G elements. We believe that a sophisticated analysis of companies' performance and strategic positioning on sustainability issues provides an excellent prism through which to assess those capabilities.

The Investment Thesis

The investment thesis underpinning the introduction of ESG factors into the analysis of listed real estate companies is actually quite straightforward: the challenges posed in the sector by the imperatives of sustainability are sufficiently complex, difficult, and rapidly changing that they provide a robust test of and leading indicator for the *overall* strategic management quality of the leadership of both real estate investment trusts (REITs) and real estate operating companies (REOCs). The companies' performance (or non-performance) on ESG issues can reveal important insights about that management quality, at both strategic and operational/implementation levels. Real estate companies demonstrating sustainability leadership tend to be more forward-looking, agile, adaptable, innovative, and sensitive to changes in the marketplace than their peers.

Since it is widely accepted in investment circles that superior management quality will generally translate into superior competitiveness and profitability, any insights into those capabilities must, almost by definition, be of value. And this is particularly true in the case of listed real estate companies; from an ESG perspective they are badly under-researched by financial (and even ESG) analysts, so high quality, proprietary research on companies' performance and strategic positioning can provide a powerful information advantage for investors.

"Greener" or more sustainable real estate can offer a number of tangible commercial and competitive benefits to its corporate owners[4], including:

- Operating costs which may be 20% lower, partly due to superior energy efficiency
- Rents which provide a 20% premium on average
- Occupancy rates which are 10% higher
- Greater tenant satisfaction and productivity, by an average of 16%
- Lower tenant turnover and attendant costs
- Higher resale values

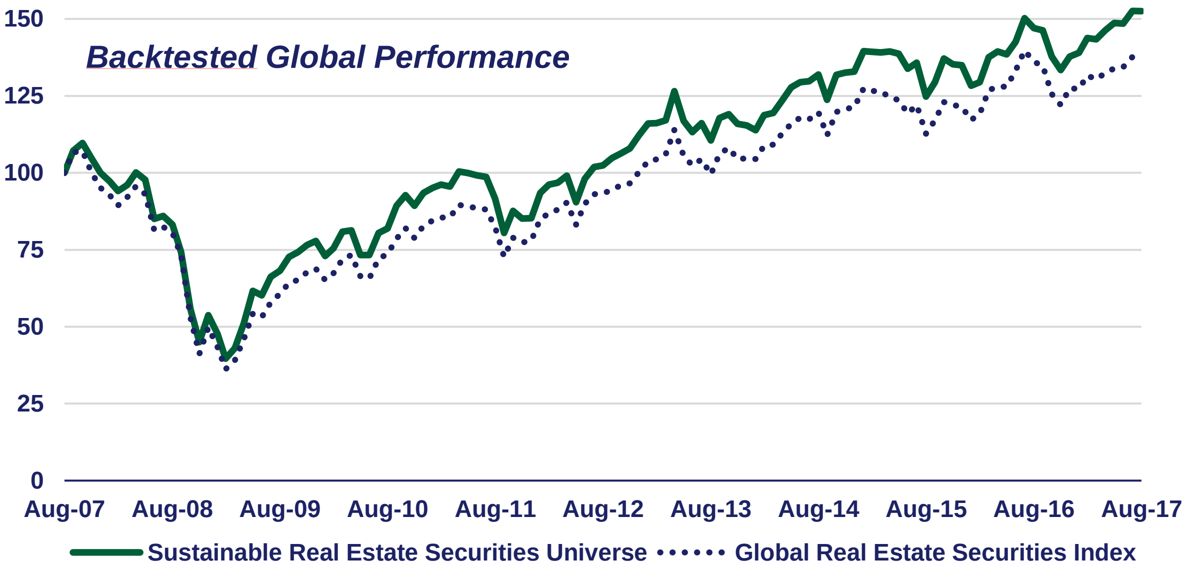
[4] *Sources: World Green Building Council, U.S. Green Building Council, Building Research Establishment, and " The Financial Rewards of Sustainability: a Global Performance Study of Real Estate Investment Trusts ". Franz Fuerst, University of Cambridge, June 2015)*

It follows logically, therefore, that if proprietary, in-depth research on a given investment universe can identify REITs and REOCs that are superior to their peers on ESG issues, those companies have a high probability of out-performing their peers, on both accounting measures and share price performance.

There are at least two practical ways in which these sustainability-driven investment insights can be harnessed and leveraged by investors:

- As an aid to individual security selection when constructing and managing an active investment portfolio
- As a basis for tilting a passive benchmark or "smart beta" portfolio whose initial composition was driven by more conventional factors such as market capitalization or accounting-driven financial fundamentals

An example of the potential financial benefits of the latter is provided by a recent backtest conducted by the financial engineering team at our partner, La Française. Over a 10-year period, a portfolio tilted towards more sustainable real estate securities[5] out-performed its conventional benchmark[6] by 110 basis points (1.1%) per annum.



Source: La Française. As at 31 August 2017.

Moreover, there are at least three convincing reasons to believe that this "sustainable alpha premium" will only grow larger over time. First, the sustainable universe was constructed purely based on ESG criteria; there was no financial analysis whatsoever during the test. It is, we believe, a reasonable assumption that adding such analysis would only strengthen the selection's performance. Second, the tilted portfolio contained only the top 50% of the rated investable universe; in practice, active asset selection would concentrate on even higher

[5] *The sustainable real estate securities universe measures the performance of the top half of the investment universe as measured by IPCM's ESG criteria*
[6] *Global Real Estate Securities Index = FTSE EPRA/NAREIT Developed TR Index USD (Bloomberg Ticker = RUGL Index). .*

quality, top-quartile or quintile ESG performers. Finally, and perhaps most important of all, the combination of radically changing tenant preferences and requirements on the one hand and tightening regulatory requirements for sustainability on the other can only expand the sustainability premium even further.

These two forces are already reshaping the competitive landscape in the listed real estate sector; the rate of change in both tenant preferences and regulations has been extraordinary. Indeed, this is so much so that the discussion among industry participants has shifted from "what's the payback period for a potential investment in an environmental retrofit?" to "if we don't make this investment, can we even lease the building *at all*?" Sustainability is rapidly becoming the entry ticket for even *playing* in the real estate game.

Key Sustainability Indicators

But, what are the *indicators* of superior sustainability performance and positioning? On the environmental side, we look for superior:

- Energy efficiency
- Carbon efficiency and lower exposure to climate change risk
- Water use efficiency
- Materials use efficiency
- Toxic emissions management
- Ability to identify and capture the *positive* commercial opportunities created by the emerging sustainability imperative
- Environmental risk management systems
- Executive leadership

In assessing the social dimension of corporate sustainability, we examine, among other factors:

- Human capital management and development
- Tenant relations
- Health and safety systems and performance
- External partnerships
- Company policies and practices in the social sphere
- Executive oversight and leadership

Finally, in assessing the corporate governance capabilities of the companies, we assess:

- Board composition and diversity
- Skills and experience balance on the board
- Board development
- Independence

- Transparency
- Executive and board pay levels
- Ethics

Taken together, the components of such an ESG analysis provide a much fuller, more comprehensive picture of the company's risks, opportunities, and management than is ever possible through conventional financial analysis alone. Despite this, for a regrettably long time, conventional "wisdom" in the investment community held that sustainability and financial objectives were mutually exclusive. It was believed that a financial performance penalty would inevitably be imposed on any company --- or investor --- who used ESG criteria in a significant way in their operations.

If this argument were ever true (and it wasn't), those days are now long behind us. Both our own practical experience as investors and a growing volume of credible academic evidence[7] strongly suggest that ESG-enhanced portfolios can *out*perform, and at the very least pay no performance penalty whatsoever. And why should they

Let's use a concrete example to illustrate the kind of ESG attributes which we believe constitute ESG best practice today:

A Case Study: ICADE

French real estate company ICADE is the highest-ranked company on ESG criteria in IPCM's coverage universe of approximately 350 listed real estate companies. One major reason for this is that it is clear that sustainability is genuinely at the heart of both its 3-year strategic plan and its overall corporate culture. The company's ESG strategy is built around three pillars:

- Developing solutions which directly address new lifestyles and living habits, and partnering with local governments and communities to do so
- Contributing to the necessary energy transition and saving resources. ICADE has successfully positioned itself as a leader and pioneer in sustainable development, with buildings whose energy consumption, resource needs, and environmental impact are all progressively reduced over time, and guaranteed by certification requirements
- Paying special attention to its human capital: promoting the development of expertise among the staff, as well as workplace well-being and diversity

ICADE executes these initiatives through a relatively large staff of over 40 persons ensuring the implementation of Corporate Social Responsibility (CSR) actions. On the environmental side, ICADE's efforts began back in 2010; in one major facility, the company managed to reduce energy consumption by 14%, water consumption by 75%, and waste by 36% between 2009 and 2016. Well ahead of regulation, ICADE introduced green lease clauses in its leases, which obligate building operations managers to hit quantitative targets for reducing energy consumption --- by 3% per year on average. Looking forward, the company has set a target of a 40% reduction in CO_2 emissions between 2011 and 2020. In terms of building materials, all new buildings must use certified wood, paints, adhesives, and varnishes to minimize or eliminate the use of volatile organic compounds and other harmful substances. Contracts with

[7] *See, for example Harvard Business School, Khan, Serafeim and Yoon (2016) Corporate Sustainability: First Evidence on Materiality; University of Oxford (2015) From the Stockholder to the Stakeholder; Friede, G et al. (2015) "Aggregated Evidence from Over 2,000 Empirical Studies". Journal of Sustainable Finance and Investment 5:4, pp 210-233.)*

landscape maintenance providers oblige them to use products and techniques which respect biodiversity and the environment.

On the social side, ICADE was a pioneer in raising tenant awareness of both the risks and opportunities created by ESG issues; tenant outreach has since become a differentiator and critical success factor for tenant attraction and retention. Unusually, ICADE also pays special attention to vulnerable workers; it encourages its suppliers to employ individuals from the sheltered work sector, and has set a target of a 50% increase by 2018. Also in the domain of human capital, ICADE revised its compensation policies in 2016, including ESG performance in the criteria for the first time.

ICADE is also a leader in terms of corporate governance; its executive committee is an exemplar of gender diversity; it has five women and four men – the highest percentage of women among the 120 largest listed companies in France. Moreover, each of its board committees is chaired by an independent director, which is in line with international best practice.

In short, both its current performance and its trajectory of continuous improvement combine to make ICADE a real leader in the ESG space among listed real estate companies. And, while one must be cautious about confusing correlation with causation, extrapolating beyond a single company example, and giving an overly simple explanation for what is in fact the multi-factorial nature of share price performance, the fact remains that ICADE's roughly 30% increase in share price coincided almost precisely with the period following its quantum ESG improvement in 2016…….

A Closing Thought ….

While there is clearly no way to "future proof" a real estate portfolio with 100% assurance, adding a layer of sophisticated, returns-oriented sustainability/ESG analysis is arguably the next best thing. The companies comprising the resulting portfolios are likely to be more strategic in identifying emerging trends in the first place, and more resilient and adaptable in responding to them. Combining such ESG analysis with an assessment of more traditional financial factors cannot guarantee a future-proof portfolio, but it can at the very least be an important step in that direction.

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Important Backtest Disclosures

Backtested performance is NOT an indicator of future actual results. The results do NOT represent returns that any investor actually attained. Backtested results are calculated by the retroactive application of a model constructed on the basis of historical data and based on assumptions integral to the model which may or may not be testable and are subject to losses.

General assumptions include: La Française would have been able to purchase the securities recommended by the model and the markets were sufficiently liquid to permit all trading, Changes in these assumptions may have a material impact on the backtested returns presented, Certain assumptions have been made for modelling purposes and are unlikely to be realized, No representations and warranties are made as to the reasonableness of the assumptions, This information is provided for illustrative purposes only.

Backtested performance is developed with the benefit of hindsight and has inherent limitations, Specifically, backtested results do not reflect actual trading or the effect of material economic and market factors on the decision-making process, Since trades have not actually been executed, results may have under or over compensated for the impact, if any, of certain market factors, such as lack of liquidity, and may not reflect the impact that certain economic or market factors may have had on the decision-making process, Further, backtesting allows the security selection methodology to be adjusted until past returns are maximized, Actual performance may differ significantly from backtested performance,

Backtested results are adjusted to reflect the reinvestment of dividends and other income and, except where otherwise indicated, are presented gross-of fees and do not include the effect of backtested transaction costs, management fees, performance fees or expenses, if applicable. In addition, the returns may either increase or decrease as a result of currency fluctuations.

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