Covid 19, ESG and Real Estate Securities

April 9th, 2020 by Andrew White, La Francaise Forum Securities

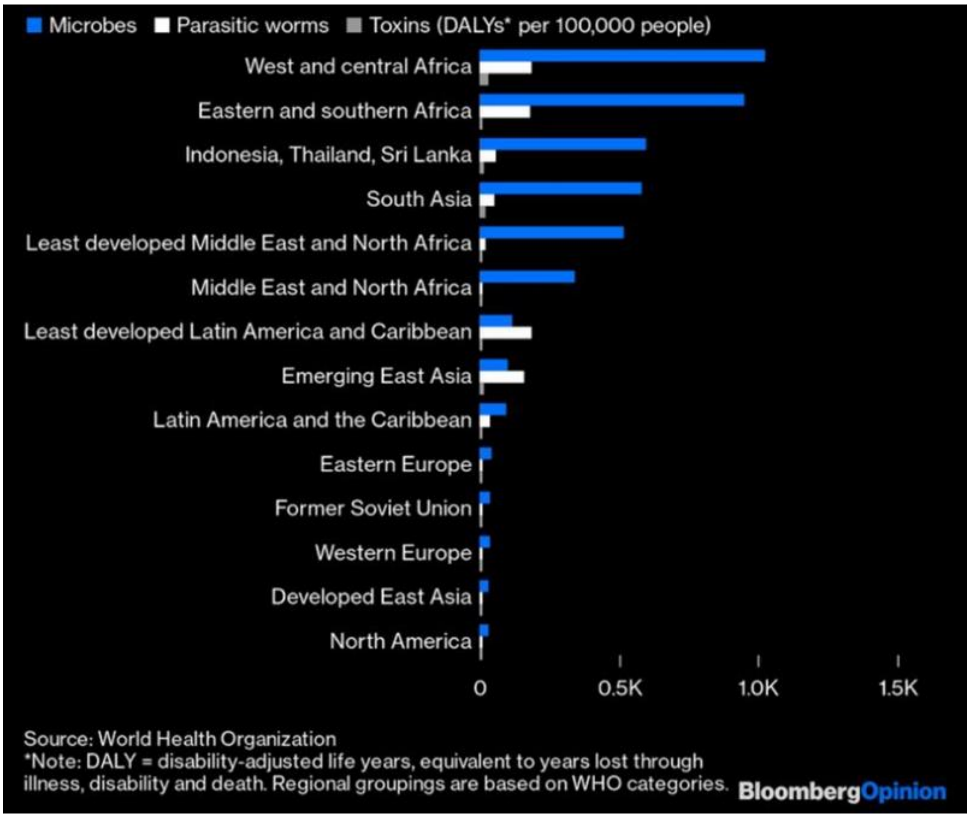
Good environmental, social and governance (ESG) standards are important not just for corporates and investors, but for government administrators and local communities too. In responsible investor circles, we talk about ESG issues being of material financial consequence and vital for the health of people and planet. Over the past thirty years, a raft of reports has attempted to make the business case, usually successfully so. But even as bush fires raged across Australia and North America, most likely due to our changing climate, sceptics have still argued that it is hard to make the link between ESG and environmental and social risk.

But if ever this link can be proven, the evidence is now plain for all to see. Despite some doubt about the precise origins of the corona virus, most likely it can be traced back to wet markets in Asia and more specifically China, but also to the illegal trade in exotic wildlife species. Animals in wet markets are penned or kept in miniscule cages unable to move, and slaughtered or sold live next to stalls selling fruit and vegetables. Places where domestic livestock, foxes, badgers and exotic animals excrete bodily fluids and are killed inhumanely next to fresh food do not sound like a good combination in the promotion of health and safety principles. They are an obvious breeding ground for the virulent novel diseases that cross the species barrier to humans and occasionally become pandemics.

Following the SARS virus in 2003, the Chinese government was criticised for responding slowly to the outbreak and concealing the seriousness of the illness. Standards of hygiene and animal welfare have improved at wet markets, but not enough and are not universal across Asia. ESG standards applied by local government have not been sufficient to prevent yet another corona virus spreading across the globe. It is hard to blame impoverished and perhaps poorly educated communities about animal welfare and health and safety standards, but those with more power and affluence and knowledge could do more. And such viruses now spread at rapid rates, with environmentally damaging airplane travel accelerating the contagion level of pandemics. Local communities in developed markets too have often flouted environmental and social guidelines on how to stay healthy, by still congregating in open spaces.

Scientists say the sale of animals in wildlife markets should be strictly prohibited to minimise the risk of future outbreaks. The unusual creature that is the pangolin is likely to be next in line to be eradicated as a scapegoat for society's inability to adopt good ESG policies, encompassing health and safety, animal welfare and exploitation. Pangolins are the most-commonly illegally trafficked mammal, used both as food and in traditional medicine. Two groups of corona viruses related to the virus behind the human pandemic have been identified in Malayan pangolins smuggled into China. Although their role as the intermediate host of the current outbreak remains to be confirmed, experts say sale of these wild animals in wet markets should be strictly prohibited to avoid future zoonotic [animal to human] transmission. Looking at the chart below, however, it seems only a matter of time before we have another such emergency. This chart appeared this week in an article published on Bloomberg. The article heralded the re-opening of wet markets in China as good news, as they are also places where consumers can get fresh, healthy food. But only one such market needs to be contaminated for viruses to germinate and spread.

The article also pointed to the fact that food in developing countries is increasingly sold in supermarkets. This may be a source of some optimism for the retail sector, which elsewhere has taken a hammering and is one which real estate investors are more and more wary of. Shopping malls can offer better levels of hygiene and inspire consumer confidence in the food products they are buying.



In addition to the obvious impacts on human health and restrictions on the way we live and work, the financial impacts of the virus are likely to be catastrophic. News channels report daily on lives lost and new cases of the virus (and thankfully signs that it is being contained, with China having its first virus death free day this week and stock markets rising again as they believe the spread may indeed be on the wane). But on the back pages of newspapers, hard copy and electronic, there are mutterings of a financial crisis that will be worse than that of 1929. One economist at Capital Economics, says PMIs in the US were probably underestimating the scale of the economic fallout. "We are forecasting a 15% fall" in economic output in the period from April to June, he said, "a larger fall in output than in the financial crisis or the Great Depression.

The real estate sector will obviously not be immune in the months ahead. When people lose their jobs, which they are doing in their millions, they default on mortgages and cannot pay the rent. The residential sector will be among the hardest hit, despite some government measures such as mortgage holidays and banning evictions, which can only be short term solutions. Much will depend on how long the crisis lasts and how soon economies can recover, currently no government has an exit strategy for the lock down measures they have imposed.

On the other hand, since citizens are now forced to stay at home – with a quarter of the world's population said to be in confinement – consumer buying and leisure habits have had to rapidly adjust. Online shopping and entertainment represent a lifeline, with a positive impact for logistics firms and data centres. These sectors of the real estate market have high environmental impacts however, being very energy hungry. The flip side is that for the commercial office sector, home working is fast becoming the norm, and it may be hard for both employers and employees to give up their new found teleworking efficiencies and lower cost structures (no expensive premises to rent, light and heat/cool). This could also intensify the need for office and residential space to be far more energy efficient in future, if real estate companies are to make their premises more attractive than the 'home office'.

And finally, what about that old chestnut of the business case for ESG, in the listed real estate sector? Clearly in a period of global economic meltdown ESG ratings cannot offer a safe haven. But they can potentially limit the damage and highlight more resilient sectors and geographies.

A paper published this week by Jana Sehnalova, CEO of La Francaise Forum Securities (LFFS) highlighted a number of recent trends in listed real estate securities, including performance characteristics at the sub-sector and geographic level. Declines in YTD performance were steepest in North America and the United Kingdom, while Hong Kong and Singapore markets showed slightly more resilience, with falls not quite as sharp as elsewhere.

One crumb of comfort from an ESG ratings point of view, is that the ESG scores (out of 10) assigned to listed real estate companies by LFFS for its Sustainable Real Estate Securities (SRES) fund – when aggregated across regions or countries – to some extent indicate that better ESG scores can offer more resilience in times of crisis, and also highlight more vulnerable geographies.

The introduction to this short paper discusses ESG in its broadest sense, and aims to show that in an inter-connected world, issues of planetary stewardship, health and well-being, communications, regulatory controls, animal welfare, crisis responses and so forth are increasingly important. The LFFS SRES fund ESG rating model also places much weight on key performance indicators (KPIs) which are intended to reflect the ability of company management to respond and adapt to broad societal and environmental needs and changing dynamics in their business models.

The table below shows that the poorest performing economies had the weakest ESG scores, according to the LFFS SRES fund rating model, the least bad performers had the best ESG scores. The result for Australia may be anomalous, as it has the fewest companies withing the SRES fund universe. Greater awareness of and preparedness for ESG-related factors has to be the way forward at a holistic level, for corporates and investors, communities and governments. For companies in particular, good performance on ESG can be a strong proxy for superior management quality.

2020 YTD Performance	**% Decline (USD)**	**ESG Average Score**
United States	29	4.8
Canada	34	4.6
United Kingdom	32	5.8
Japan Developers	26	
Japan Reits	24	5.8
Western Europe	26	6.4
Australia	47	6.7
HK Developers	19	
HK Reits	19	6.8
Singapore Developers	30	
Singapore Reits	21	6.9

Note: As of March 31, 2020. Source: La Francaise Forum Securities, Bloomberg.

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