MSCI ESG THOUGHT LEADERS COUNCIL

FROM MSCI ESG RESEARCH INC.

ESG AND REAL ESTATE | OCTOBER 2015

INTRODUCTION TO THE MSCI ESG THOUGHT LEADER COUNCIL

The goal of the MSCI ESG Research Thought Leaders Council is to maintain our leading edge in research methodology by regularly seeking feedback and opinions from external experts in key industries and relevant ESG issue areas. The MSCI ESG Research Thought Leaders Council consists of a series of about three to four panels annually, with three to seven members on each panel. We aim to assemble international experts with recognized leadership and expertise on the topic area related to the panel.

The seventh council on ESG & Real Estate was held on October 13th, 2015, supplemented by a series of one-on-one discussions with thought leaders who were unable to attend the October 13th panel discussion. Panel members were asked to review MSCI ESG Research's proprietary ESG Ratings methodology, as well as specific industry and company reports before participating in the official panel call with MSCI ESG Research analysts. The following key takeaways and discussion points represent a synopsis/summary of the discussions and do not represent a transcript.

KEY TAKEAWAYS

- There was consensus among panelists that using green building certifications is useful to assess the operational efficiency (water or energy consumption) and the risk of obsolescence ("future-proofing") of properties or of a property portfolio. The analysis of water, energy and carbon performance metrics provides an additional layer of asset differentiation that further complements green certified vs. non-certified buildings assessments.
- Council members recommended that not only quantitative benchmarking should take a prominent place in company analysis, but also that qualitative indicators are equally, if not more, important in some cases for investors to assess if companies are headed in the right direction.
- As a proxy to identify quality tenants, most panelists agreed on the investment relevance of assessing the ESG management of risks and opportunities of a company's main commercial tenants and industries to which the company leases space.
- Council members were in agreement that greenfield and non-urban developments should not be considered automatically as 'unsustainable' or necessarily with a disadvantaged financial profile compared to urban or infill redevelopments. If properties are in development or are already operating in conformity with green certification standards, then it would be fair to assume that such properties are not contributing to 'unsustainable' urban sprawl and, hence, could also enjoy robust financial performance as well.
- Panelists identified affordable real estate for both residential and commercial properties as a long-term investment trend. Council members considered that a key characteristic for affordable real estate should be its green credentials, which could enhance the operational efficiency, the durability and the comfort of using a property. Affordability needs to be sustainable, and sustainability needs to be affordable.

COUNCIL MEMBERS*

Carlos Flores
National Program Manager, National Australian Built Environment Rating System (NABERS)

Jane Henley
former CEO, World Green Building Council, Senior Advisor U.S. Green Building Council

Paul McNamara
OBE, Former Director Head of Research, Prudential Property Investment Managers (PRUPIM)

Scott Muldavin
Executive Director, Green Building Finance Consortium

Nina Reid
Director, Responsible Property Investment, M&G Real Estate

Brian Wilkinson
CEO, Green Building Council South Africa

Additional panelists included **Daniel Cook,** Director of Strategy and Planning, Royal Institution of Chartered Surveyors (RICS)

KEY DISCUSSION POINTS

HARNESSING GREEN OPPORTUNITIES

1. GREEN CAPITAL INVESTMENTS

From an investor perspective, panelists agreed that using green building certifications is useful to assess the operational efficiency (water or energy consumption) and the risk of obsolescence ("future-proofing") of properties or of a property portfolio. Hence, there was an overall agreement on using third party certifications vs. isolated non-certified investments (e.g., HVAC upgrades) as one measure of financial resiliency of real estate investments.

However, there was no clear consensus on how useful it could be for investors to have an assessment of the different certification levels ("shades of green") in a portfolio given that there is no clear equivalence between certification levels of different standards. In this sense, some panelists noted that additional information on this matter would be useful, while others thought that a simplified approach would be preferable, as it could be cumbersome to translate different certification levels of different standards in the same portfolio into a meaningful investment signal and compare it across portfolios. Nevertheless, panelists agreed that analysis of water, energy or carbon performance metrics would provide an additional layer of asset differentiation to complement the assessment of having green certified vs. non-certified buildings.

There was consensus among panelists regarding the limited relevance in assessing isolated green investments to best inform investment decisions. However, some panelists noted that this type of assessment was better than a lack of information. This could be the case, for instance, in markets that are at early stages of adoption of green property investment.

Additionally, council members considered that it was important to make the link explicit between what it is that each green certification or performance level shows about a company's risks (whether these are design or performance certifications or whether they relate to water or energy performance). That is, it is important to explore what the impact of these certifications and performance levels are on net asset cash flow, on rental levels, etc. Some panelists highlighted the importance of benchmarking property types by country, and not only at the aggregated, company level.

2. BEHAVIORAL CHANGES THROUGH GREEN AGREEMENTS

Council members suggested that in some cases qualitative indicators are equally, if not more, important than quantitative benchmarking, and should take a prominent role in company analysis. Panelists considered that by benchmarking tenant engagement policies, the overlap between property management and automation, and programs targeting behavioral changes and towards higher operational efficiency, investors could assess if companies are headed in the right direction.

Panelists noted that it was important to identify the specific financial indicators that the aforementioned metrics could affect. In addition, panelists considered that details on, for instance, green lease types, were desirable in some use cases, as company engagement. However, from the investor perspective keeping the analysis simple would be better, as adding too much information could render the research useless.

3. URBAN-SITE INVESTMENT CRITERIA

Council members were in agreement that greenfield and non-urban developments should not be considered automatically as 'unsustainable' or necessarily with a disadvantaged financial profile compared to urban or infill redevelopments. If properties are in development or are already operating in conformity with green certification standards, then it would be fair to assume that such properties are not contributing to 'unsustainable' urban sprawl. Consequently, such properties could have a robust financial performance as well. Design-based green certifications do take into consideration indicators to gauge the resiliency of properties, including proximity to transportation hubs and services, and avoidance or minimization of environmental degradation from the property construction and operation.

MANAGING SOCIAL, GOVERNANCE, AND TENANT RELATED RISKS

4. CORRUPTION

According to Transparency International, the real estate development industry is perceived as the second most corrupt in the world, yet, panelists considered that companies that operate primarily in the real estate management industry should also be assessed on their risk mitigation capabilities for corruption and business ethics. Council members considered that it was particularly important to evaluate companies on issues related to business ethics, as non-ethical practices are more likely to happen in a business-to-business fashion rather than in business-to-government fashion, particularly in the cases of companies managing buildings on behalf of property owners. While members of the Thought Leader Council pointed to some regional differences in the incidence of unethical business practices, there was a consensus that scandals relating to ethical practices could destroy brands overnight and that this is a reality across both developed and emerging markets.

Finally, with respect to the quality of residential development, Council members noted that the issue is dependent on codes and local regulations. From an investor perspective, an element that could be relevant to assess is the age of the company as a proxy for how firms manage this type of liability, as younger companies might not have well developed policies to mitigate these risks.

5. TENANT RELATED RISKS

As a proxy to identify quality tenants, most panelists agreed on the importance of assessing the ESG management of risks and opportunities of a company's main commercial tenants and industries to which the company leases space. Some council members considered this approach a powerful vehicle to identify those companies whose lease-cash flows at risk stemming from tenants that are not mitigating ESG related risks. However, other Council members noted that in the case of highly diversified portfolios, such a signal might not be useful of a differentiator between companies.

6. LABOR: HEALTH & SAFETY, HUMAN CAPITAL MANAGEMENT

Council members considered analysis related to these two topics to be relevant for investors, as long as it is coupled with regulatory violations (such as those flagged by the US Occupational Safety and Health Administration) and employee lawsuits, given that these infrequent events are what generally damage a company the most. For human capital management, in particular, some panelists suggested analyzing the availability of qualified labor in a particular location, together with how desirable (affordability, quality of public services, cultural offering, etc.) a location is to attract and retain talented employees could be relevant factors to complement the analysis.

Panelists considered that while analyzing performance is critical, analyzing whether companies are actively managing labor-related risks is also an important element to consider. Together, these two pieces of information are relevant to investors to assess whether companies' performance is due to random factors. In terms of training, Council members pointed to adding technology proficiency as a specific training category, given that more complex buildings need more qualified people to manage them.

7. AFFORDABLE REAL ESTATE

The members of this Though Leader Council identified affordable real estate, for both residential and commercial properties – the latter catered to Small, Medium Enterprises (SMEs)-, as a long-term investment trend given that urbanization trends globally will only increase population in cities and will heighten the importance of affordability.

Panelists recognized, however, that the existence of affordable real estate, particularly for housing, depends in some cases on policies that allow for development or leasing of properties at lower costs than the existing market ones. In this sense, some Council members considered the merit for investing in affordable real estate from two angles. First, from the risk point of view, as a hedge to potential rent caps.

Second, from a first mover advantage perspective, as companies that are providing affordable spaces now are gaining experience and will be better positioned to monetize on the social resiliency they are contributing to establish.

Council members considered that a key characteristic for an affordable property should be its green credentials. Affordable properties should be green, durable, flexible, i.e., they should be future proof; built to operate efficiently and with high indoor-environmental quality; cost-effective to maintain; and, sited in socially and environmentally sustainable locations. Affordability needs to be sustainable, and sustainability needs to be affordable.

Some panelists highlighted the interest from impact investors in affordable real estate, as population in an increasing number of income brackets are priced out of property options that could contribute to their economic prosperity. Therefore, panelists consider that there is potential for a product to come to market that poses social benefits given that there seems to be an unmet demand.

FINAL THOUGHTS

In the real estate industry, changes do not happen as fast as in other industries. Hence, it would be interesting to explore how to measure innovation in the industry, across its value chain, and whether that innovation provides resiliency to the business models of property companies.