ASSET OWNERS
NETWORK

EMBEDDING ESG FACTORS INTO REAL ESTATE INVESTMENTS

A summary guide for pension trustees

Investing in real estate can generate attractive long-term absolute returns, with different levels of protection against inflation. Rental income typically makes up a significant part of the expected return for 'core' real estate portfolios, while capital appreciation is available for more speculative development projects. By carefully using leverage - borrowing to fund real estate investments - pension schemes can also enhance expected returns and income.

There is a lot of variety in this asset class, so investors can build a portfolio to meet a broad range of risk, return and yield requirements across geographies and sectors. Pension scheme investors hold real estate to:

- Provide a diversified stream of returns that is less dependent on equity and bond markets.
- Deliver long-term contractual cash flows that can be used to meet liabilities.

Relevance of ESG considerations in achieving these objectives

The planning and construction process associated with new real estate can expose pension investors to ESG-related risks. Such risks can come from bribery and corruption; low quality, irresponsibly sourced building materials; and poor human rights and labour standards. Over the long term, buildings can be exposed to physical risks such as flooding and fire damage – many of which are exacerbated by climate change.

How buildings are used can also expose pension schemes to ESG risk. For example, if schemes invest either in properties that house social tenants in unsafe conditions, or in care homes where abuse scandals occur. These risks can be especially challenging because real estate investments are illiquid. Investors should also consider financial and reputational climate risks, as the global construction industry is responsible for approximately 40% of all greenhouse gas emissions contributing to climate change.[1] Schemes that are targeting net zero real estate investments will also need to plan to offset carbon emissions.

Real estate holdings can offer significant ESG-related opportunities for pension investors. Buildings built to high environmental standards can help pension schemes to meet climate commitments while increasing scheme values. Schemes can also invest in buildings that are used to produce social benefits: good quality social housing or real estate for companies that contribute to local communities. Focusing on health and wellbeing in real estate has also been linked to higher tenant satisfaction and shorter void periods[2] – particularly relevant in the current pandemic.

1 Global Alliance for Buildings and Construction – 2019 Global Status Report for Buildings and Construction
2 Health & Well-being in Real Estate - Green Health Partnership & GRESB (2019)

ESG maturity map

The A4S ESG maturity map, part of ESG Toolkit for Pension Chairs and Trustees, sets out example behaviours for integrating ESG into real estate investment decision making. At the beginning of a pension scheme's journey, trustees might consider the opportunity to achieve positive social and environmental impact by investing in sustainable real estate; whereas at the leading edge of this journey, trustees may be actively and publicly talking about the challenges and opportunities of ESG investing in real estate investments.

	Level 1 Understanding	Level 2 Adopting	Level 3 Deepening	Level 4 Leading
Example behaviours	The Board: • can confidently discuss the relationship between ESG factors and real estate risks and returns • has considered the ESG capabilities of the property developers and real estate funds the scheme invests in • can confidently discuss the types and level of availability of ESG data for real estate investments, and how this can be used in investment decision making • has considered and documented its appetite to integrate ESG into real estate investment decisions and risk management practices • has considered the opportunity to achieve positive social and environmental impact by investing in sustainable real estate	The Board: • is developing a framework for integrating ESG factors into real estate investments (including direct developments and real estate funds) • has identified the material issues their investments are exposed to and have defined expectations of what its fund managers should be doing to manage and mitigate these • has carried out climate scenario planning to assess the potential for standing assets to be exposed to long-term physical risks • has identified sources of ESG information and ways to generate ESG data for real estate investments	The Board: • has implemented a framework for integrating ESG factors into real estate investments, covering both direct and / or fund-level investing by external managers • has a process for continual assessment of external real estate managers' ESG investment capabilities through regular reporting against a clearly defined set of metrics • has a process for engaging with real estate companies or funds to embed ESG into their investment processes	The Board: • actively and publicly talks about the challenges and opportunities of ESG investing in real estate investments • is active in promoting better standards and disclosures around ESG investing in real estate

Practical actions that trustees can take

Area	Action
Education	• Arrange for all trustees to be educated about the ESG risks and opportunities associated with investing in real estate, including: – The potential to be exposed to bribery and corruption scandals during the planning and construction phase; – The risks and opportunities associated with real estate construction, such as upskilling workers or being exposed to health and safety and labour rights abuses; – The long-term environmental impacts of buildings (including significant greenhouse gas emissions at the construction phase) – The role of carbon offsetting in achieving net zero real estate investments; – The use of buildings from a social perspective (in terms whether tenants are treated fairly, or whether space is earmarked for social tenants / socially focused businesses).
External manager expectations	• Build a system for assessing the fund managers' capabilities around ESG investing which covers: – Approach to investing in sustainable buildings; – Responsible investment policies covering recognized international guidelines on bribery, corruption and human rights; – Climate stress testing; – Global Real Estate Sustainability Benchmark (GRESB) participation and score; – Integration of sustainability criteria in manager fee structure. • Instil a requirement for transparent reporting on ESG performance to enhance data availability and insights.
ESG framework – direct real estate development	• Oversee the development of an in-house framework for integrating ESG analysis and data in the real estate investment process. • Carry out climate scenario planning to assess the potential for standing assets to be exposed to long-term physical risks such as flooding and overheating. This may require partnering with a specialist third party. • When investing directly, assess developers' track records in sustainable building based on robust ESG policies and procedures. • Ask developers about the safeguards for managing their supply chains in a responsible way, including through questionnaires, audit and supply chain commitments. • Establish a means of improving the energy efficiency of real estate holdings, especially where regulations are changing (such as restrictions on the leasing of inefficient buildings which increase stranded asset risk).
Measurement and reporting	• Actively explore ways for the scheme to generate ESG metrics from the real estate portfolio, such as: – Social metrics – people employed through construction, social tenants housed and social businesses provided with commercial / office space; – Environmental metrics – including carbon emissions, trees plated and water recycled.

This summary guide for pension trustees is part of an ESG Toolkit for Pension Chairs and Trustees by The Prince's Accounting for Sustainability Project.