Real estate: investors seek smarter ESG

Owners of core real estate portfolios seek ESG metrics that enable true impact

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Real estate investors could be forgiven for thinking that ESG is all about energy and emissions reduction.

There are many reasons why the E in ESG, environmental criteria, has dominated in the real estate space. Chief among these is the relative ease of measurement and the worldwide attention given to climate change and its impact. As a result, ESG efforts typically focus on insulation, efficiency and construction materials.

Measuring energy savings and calculating emissions is important, but there is much more to ESG than simply the E. Indeed, investors, owners and tenants expect more action to be taken by fund managers.

Investors increasingly want ESG metrics to encompass the widest-possible range of ESG impacts. They want ESG to be measured in a smart way that takes into account the type of asset and the key impacts of that asset. They want ESG metrics to be embedded in their real estate assets from Day 1 until the day they are divested.

Not least, they want ESG metrics to be a key component of core real estate portfolios, actively participating in the creation of value and the performance, not just in niche or themed portfolios

The value of ESG labels

Let's be clear: mitigating the effects of environmental damage is important, and a good way to introduce ESG into a real estate portfolio. After all, the European real estate industry accounts for approximately 40% of Europe's total energy consumption and around 25% of its greenhouse gas emissions.

The various ESG labels – some of which relate specifically to real estate – are driving focus on the E, encouraging more investors to meet the challenges of climate change. Labels are undoubtedly a force for good. "We are targeting to obtain a certificate for every asset in our portfolio," says Christina Ofschonka, Head of Core Funds and Senior Fund Manager. "It may be an international certificate or the leading certificate of the country where the asset is situated. Either way, meeting recognised standards is important to us and important to our investors."

Key ESG indicators at fund level include a high scoring within the Global Real Estate Sustainability Benchmark (GRESB) and the Articles 8 and 9 of the European Union´s SFDR directive.

GRESB provides validated ESG performance data and peer benchmark. GRESB data shows that over the past three years 75% of real estate investors set climate-related targets. And the proportion making a net-zero commitment has risen from 3.7% in 2019 to 15.1% in 2021.

Meanwhile, an Article 8 fund under SFDR must "promote environmental or

Key takeaways:

- Investors want ESG metrics to be embedded in real estate assets from Day 1. They increasingly demand that ESG credentials are a key component of core real estate portfolios.
- ESG labels are a force for good. The various ESG labels – some of which relate specifically to real estate – are driving change, including encouraging more investors to meet the challenges of climate change.
- To future-proof portfolios, investors need to go beyond labels. AEW's framework, or ESG grid, for its core real estate investments takes into account the nature of each individual asset and enables tangible action to be taken to make improvements.

social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices".

One of the important indicators at the asset level beyond the border of individual countries is for example the Building Research Establishment Environmental Assessment Method (BREEAM). The BREEAM certificate is internationally-recognised and is used by AEW for many of its assets. its , AEW obtained BREEAM excellent for two recently-purchased European core real estate assets: a logistics asset in the Netherlands and a last-mile logistics building in Italy.

A report shows that BREEAM, in tandem with other labels, has a positive impact. The report compared BREEAM-certified A-grade buildings in central London to uncertified buildings. Between 2017 and 2020, the average rental premium of certified buildings was some 8%.

AEW also makes widespread use of gold-standard local labelling. For instance, a

core logistics development in Germany received DNGB Gold certification, while a block of 190 residential serviced apartments in Austria were certified ÖGNI Gold.

Smarter ESG metrics

Labels have their limitations. The chief concern of investors is that labels are based on metrics which are not standardised across sectors and across the globe. This can frustrate attempts to benchmark assets on ESG factors. Another limitation is that labels do not necessarily address the specific ESG impacts of individual asset types.

"We go beyond labels and have a proprietary scoring framework which sits above local and regional labelling," says Ofschonka. AEW's framework takes into account the idiosyncratic characteristics of each asset type. For instance, while residential space or offices require natural light for the wellbeing of office staff and inhabitants, logistics hubs do to a much lower extent.

Equally, a logistics hub has sizeable, flat roof space to mount solar voltaic panels or install a biodiversity-friendly ecosystem. This is not as easy for office and residential space.

"For each asset, the ESG questions we ask change so that we get only relevant answers," adds Ofschonka.

Investment and ESG metrics are not incompatible

AEW takes a very long term view at its investments and in turn the tenants along with the main question "why" do they opt for one asset and not another. Thinking in generations rather than shortsighted, AEW's framework, or ESG grid, for its core real estate investments is based on the 17 UN Sustainable Development goals. Of these 17, some are more applicable to real estate than others. "The E, S and G are all reflected in our grid, which focuses the goals which are most relevant to the assets we invest in," Ofschonka says.

The grid, developed by AEW's in-house SRI team, allows for eight to ten dimensions of scoring depending on the type of use, with each dimension decomposed into 25 separate criteria – such as transportation, energy, waste and water. The framework is completed during an audit by a technical expert and reviewed by AEW's SRI and Asset Management teams. The scores are highly granular, reflecting an asset's ESG impact with precision and indicate how the impact can be improved. An action plan is then created to which identifies and implements new measures to improve the asset and is reviewed annually. "An asset must be future-proofed against ESG risks when we buy it, but also during our ownership and beyond," says Ofschonka.

A 10-year ESG capex plan feeds into the business plan. This gives control over ESG-related costs and is a transparent process, whereby regular updates to investors report milestones and KPIs relating to ESG. "We roll up our sleeves and work with the asset" says Ofschonka. "When we analyse new acquisitions, we ask ourselves whether the potential returns are sufficient, then we'll do the work, but if there's no way to improve the asset to the required ESG standard, we won't touch it."

To make these kinds of judgments, the SRI and investment capabilities at AEW are integrated and have a team focused-approach. So when an asset is considered for purchase, the acquisition team leading the transaction integrates ESG considerations into their investment process. The comprehensive ESG analysis, which number of criteria can run into the hundreds, are reviewed by the acquisition and SRI teams and this review forms a significant part of the investment committee memo and the final decision whether to buy the asset.

Making a difference

The tangible output of AEW's ESG grid is a score. But the rationale behind the scoring process is to ensure real impact takes place. After all, ratings and labels don't lead to change unless they result in action.

Investors all have their own interpretation of what action means. Some want to know the proportion of assets in their real estate portfolio that have certification. Others have highly idiosyncratic KPIs. "Some of our clients are very sophisticated in this space and use us as a sparring partner. They want to know what is possible and how we can get them to what is possible," says Ofschonka. For example, between 2006 and 2018 AEW worked with a large institutional client, helping it to reduce primary energy use in its core real estate portfolio by 33% and CO2 emissions by 36%. "That project took place long before ESG was mainstream," adds Ofschonka.

Tangible action may equally come through engaging regularly with tenants. Fund managers with strong ESG capabilities can quickly identify issues that improve ESG at tenant companies and can contribute to improved P&L for tenants too.

The strength of a manager's ESG capabilities relies to some extent on having skin in the game. AEW has been a UNPRI signatory since 2009 and has submitted data to the Global Real Estate Sustainability Benchmark (GRESB) since 2014. It introduced an annual ESG audit on its own activities starting in 2011, when it calculated the carbon footprint of its offices. This internal audit galvanised AEW's efforts to develop ESG metrics on client assets and benchmarking against other portfolios globally.

Today, AEW's CEO leads the SRI committee. "This leaves no doubt that ESG is a top priority topic," says Ofschonka.

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Premium on future-proofed assets

Investors' ESG expectations for their core real estate portfolios are changing fast. This is hardly surprising. Future-proof buildings are regarded as higher-quality assets by tenants, and demographics are changing: millennials are hugely focused on sustainability as business owners, tenants and investors.

"It is imperative to stay ahead of ESG trends in core real estate and to employ innovative tools to implement, measure and adapt sustainable practices," says Ofschonka.

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