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The Sustainability Edge in Real Estate Investing

Commercial real estate can have a significant impact on the environment and an increasing number of real estate industry professionals are incorporating sustainability practices into corporate strategy and building management. Kimberly Ryan, Portfolio Manager for the Wells Fargo Social Impact Investing (SII) Real Estate Investment Trust (REIT) strategies offers her thoughts on the benefits of integrating sustainability and Environmental, Social and Governance (ESG) analysis into the REIT investment process.

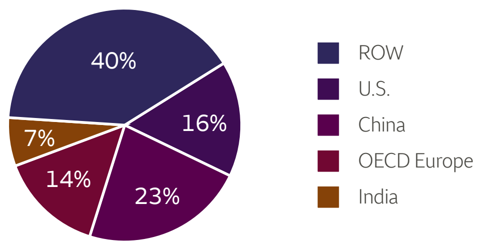
Why is sustainability important for real estate management teams to address?

U.S. buildings account for 41% of primary energy consumption and 74% of all electricity consumed domestically.[2] They account for more annual energy use than the U.S. transportation sector and produce more greenhouse gases than any other country in the world except China. Through 2030, greenhouse gas emissions from U.S. buildings are expected to grow faster than any other sector.[3]

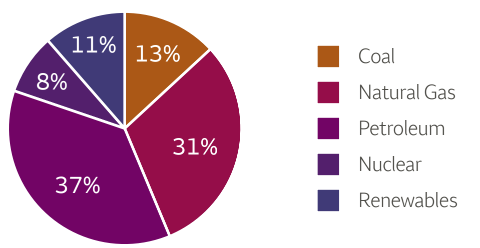
Beyond energy use, the risks of climate change loom large for real estate operators. According to a recent report from GeoPhy and 427, five percent of REITs properties globally are currently exposed to climate hazards. Of these, seventeen percent of properties are exposed to inland flood risk, six percent to sea level rise and coastal floods, and twelve percent to hurricanes or typhoons.[4] The potential risks of climate change should be addressed by management teams with respect to their existing operations and development pipelines.

In some U.S. states, regulators are proactively setting targets that could affect the cost of doing business. The California Energy Commission has set a goal of having all buildings reach zero net energy—that is, consuming only as much energy as can be generated on-site by renewable sources—by 2030.[5] We see this as a huge economic opportunity for real estate management teams to better position assets for a low carbon economy through retrofits, upgrades and redesign.

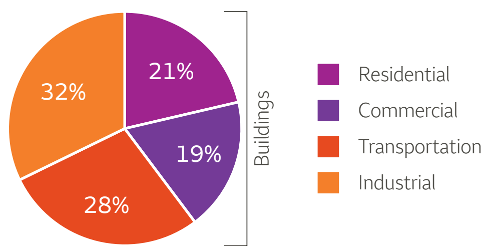
World Energy Demand
(Quadrillion BTU)



U.S. Energy Consumption by Source
(Trillion BTU)



U.S. Energy Consumption by Sector
(Trillion BTU)



Source: U.S. Energy Information Administration. 2018 data.[1]

[1] https://www.eia.gov/totalenergy/data/annual/index.php; https://www.eia.gov/totalenergy/data/monthly/pdf/flow/css_2018_energy.pdf

[2] https://www.eia.gov/tools/faqs/faq.php?id=86&t=1

[3] Buildings and Climate Change, US Green Building Council., http://www.eesi.org/files/climate.pdf

[4] Climate Risk, Real Estate, and the Bottom Line, October 2018. http://427mt.com/wp-content/uploads/2018/10/ClimateRiskRealEstateBottomLine_427GeoPhy_Oct2018-4.pdf

[5] California Energy Commission, Background on the 2019 Building Energy Efficiency Standards. https://www.energy.ca.gov/programs-and-topics/programs/building-energy-efficiency-standards/2019-building-energy-efficiency

Are there financial benefits that accrue to companies and management teams that prioritize sustainability?

Improvements in building efficiency can provide real cost savings to landlords and tenants. Some of the more impactful initiatives include the installation of more efficient LED lighting; upgrades to heating, ventilation and air conditioning (HVAC); smart metering; reductions in water consumption; and waste management.

Above and beyond any cost savings, however, sustainably-managed structures typically command higher rents, and experience lower vacancy and higher tenant satisfaction.[6] This positively impacts property valuations and may also play a role in portfolio strategy as management teams evaluate whether to dispose, renovate or acquire properties as a way to generate higher returns on investment.

As an investor, how do you evaluate the sustainability performance of a real estate operating company?

We take a broad view of sustainability, focusing not just on the environment, but also on broader social and governance issues. Some examples include:

Environmental	Social	Governance
• Energy management • Water management • Waste management • Climate change adaptation	• Tenant satisfaction • Tenant health and wellbeing • Human capital management • Community relations	• Director independence • Executive pay for performance • Diversity • Shareholder rights

We evaluate performance by reviewing a company's environmental disclosures and talking with management about its specific goals for energy, water and waste management. We examine current progress toward these goals as well as future opportunities. Building certifications and the use of 'green leases' can serve as an additional avenue into management's thinking on sustainability.

We pay attention to tenant health and well-being. This is an emerging area of interest, supported by industry leaders that are innovating to create healthier environments for tenants (i.e. employees and residents). Initiatives may include green cleaning, improved air quality, thermal comfort, and exposure to natural light and access to healthy food.

How does your process account for different types of real estate that a company may own and operate?

Our analysis is tailored to the specific type(s) of real estate in a company's portfolio. For example, when assessing a data center REIT, one of the main environmental issues we will consider is the company's management of water and electricity use, as data centers require significant amounts of water and electricity to operate. We will assess how exposed the company is to areas of high water stress, programs to reduce dependence on municipal sources of water, and efforts to improve energy efficiency. In contrast, when analyzing the ESG performance of a single family home rental REIT, we focus on customer satisfaction and service as key factors. We will investigate how well a company is serving its customers, maintaining the quality of the rental property and ensuring terms and conditions are clearly communicated to its tenants.

In all cases, corporate governance is paramount. In assessing a company's corporate governance practices, we hope to identify quality management teams that have a demonstrated track record of success deploying capital and generating shareholder value. We look for directors with industry expertise and a mix of relevant skills and tenures. We seek boards with high levels of independence to help ensure effective oversight of management and diversity (of experience, race, and gender) to help ensure effective decision-making and diversity of thought. We examine executive pay practices to confirm that pay is aligned with performance.

How would you describe the SII team's philosophy when it comes to real estate investing?

In general, we are looking for well-managed firms with good growth prospects, sustainable cash flows, and disciplined capital deployment, trading at reasonable prices. All of our strategies (equity, fixed income, REIT) employ a combination of fundamental, quantitative, and ESG assessment as a part of the investment decision making process. We manage well-diversified portfolios with low turnover and we try to avoid controversy. We look at financial metrics that are specific to real estate as well as more common measures as shown below.

Relative/Absolute Valuation	Price to Funds from Operations (FFO), Adjusted FFO (AFFO), or Net Asset Value (NAV)
Operating	Occupancy, financial leverage, cap rates, dividend growth
Controversy	Estimate dispersion, estimate revisions, short interest

Please see disclosure at the end of the report for definition of terms.

[6] Avis Devine and Nils Kok, "Green Certification and Building Performance: Implications for Tangibles and Intangibles", Journal of Portfolio Management (2015).

Our long-term investment approach aligns well with a focus on sustainability, as the benefits of these initiatives take time to manifest. Just as a homeowner may decide to replace windows with double pane glass or add solar panels to the roof to reduce utility costs, real estate managers also expect to reap the benefits of building efficiency upgrades and tenant amenities over the long term. As investors, we understand it takes time for companies to see their efforts generate and return value to shareholders.

The SII Team launched two REIT strategies in September, 2017. What differentiates the SII strategies from traditional REIT offerings?[7]

The two strategies are similar to other REIT strategies in that they are comprised of publicly traded U.S. equity REITS diversified across property type and geography. Where we feel that we differ is in our investment process. We integrate ESG analysis alongside quantitative and fundamental analyses which helps us identify risks and opportunities that other managers might miss.

What this means, practically speaking, is that a company with a management team that delivers strong financial results yet fails to invest in projects or initiatives to mitigate long-term challenges like the environmental impact of its properties may not qualify for inclusion in our SII strategies. Conversely, those that proactively address environmental impacts could make for better candidates and may warrant higher weights in our strategies.

Closing thoughts

We believe by evaluating a company's intention and analyzing its performance around sustainability, we gain critical insight about its future risks and opportunities. There is evidence to suggest that real estate companies realize tangible financial benefits whether in the form of lower costs, improved cash flows or higher property valuations when management engages in sustainability activities.

Real estate is energy, water and waste intensive. Practices that promote better management of these challenges should be mutually beneficial to companies and investors while spilling over into society in a positive way.

[7] The SII team offers a Sustainable REIT strategy and a Faith Based REIT strategy. The key difference between the two is alignment. Both strategies exclude REITs with exposure to private prisons or casinos. The Faith Based strategy also excludes REITs that serve the healthcare industry since there may be unwanted activities in those facilities.

Glossary of terms:

- **Price-to-FFO Ratio:** Price to FFO ratio is price to Funds from Operations ratio.
- **Price-to-AFFO Ratio:** Price to AFFO ratio is price to Adjusted Funds from Operations ratio.
- **Net Asset Value:** Often presented on a per-share basis, Net Asset Value (NAV) is the value of a company's common equity calculated by applying an updated market value to the company's real estate portfolio & other operating assets and deducting all liabilities, including preferred equity.
- **Occupancy:** A measure, usually in a percentage, of the amount of real estate space currently being rented versus the total amount available for rent, for a given portfolio.
- **Financial leverage:** A measure of a company's use of debt. Broadly defined as Total Liabilities divided by Total Assets.
- **Dividend Growth:** Dividend Growth measures annual growth rate of the split-adjusted indicated dividend per share.
- **Estimate dispersion:** The degree to which the highest earnings estimate differs from the lowest estimate, as a percent of the average ('consensus') earnings estimate at a given point in time.
- **Estimate revisions:** The degree to which, positive or negative, earnings estimates change relative to the average earnings estimate at a given point in time.
- **Short interest:** A ratio, normally in percentage, of the total amount of shares being sold short versus the total available float of common stock.

Risk Considerations

Investing in REITs has special risks, including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Sustainable investing focuses on companies that demonstrate adherence to environmental, social and corporate governance principles, among other values. There is no assurance that social impact investing can be an effective strategy under all market conditions. Different investment styles tend to shift in and out of favor. In addition, a strategy's social policy could cause it to forgo opportunities to gain exposure to certain industries, companies, sectors or regions of the economy which could cause it to underperform similar portfolios that do not have a social policy.

Disclosures

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