Morgan Stanley

INVESTMENT MANAGEMENT

Climate Change Is Here… And So Is the Need to Embrace Sustainability in Real Estate

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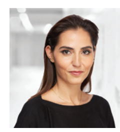

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"It is unequivocal that human influence has warmed the atmosphere, ocean and land." So said the scientists on the United Nations International Panel on Climate Change in their sixth assessment report released in August 2021.[1] Using their strongest phrasing ever to stress that human actions are responsible, this report heightened the sense of urgency to act on climate change.

Not surprisingly, the real estate industry has been under pressure to focus attention on sustainability. After all, building operations and construction account for approximately 40% of global energy-related CO_2 emissions.[2]

Morgan Stanley Investment Management's (MSIM)[3] Global Listed Real Assets (GLRA) team[4] believes environmental, social and governance (ESG) factors and a real estate company's approach to sustainability will significantly influence its future risk and total return prospects. Given this view, we believe it is imperative to focus on analyzing sustainability factors and integrating these risks and opportunities into an assessment of value.

[1] IPCC. "Climate Change 2021: The Physical Science Basis. Contribution of Working Group I to the Sixth Assessment Report of the IPCC", August 2021.

[2] United Nations Environment Programme. "2021 Global Status Report for Buildings and Construction: Towards a Zero-emission, Efficient and Resilient Buildings and Construction Sector", October 2021.

[3] The term MSIM generally includes each registered investment advisor owned by Morgan Stanley. However, unless otherwise noted, references to MSIM do not include Eaton Vance Management, Calvert Research and Management, Atlanta Capital Management Company, or Parametric Portfolio Associates which were acquired by Morgan Stanley on March 1, 2021.

[4] The Global Listed Real Assets team, part of MSIM's Real Assets capability group, invests in publicly traded real estate and infrastructure securities. MSIM Real Assets delivers comprehensive real estate and infrastructure solutions to our partners and clients.

Why Investing Sustainably Matters in Real Estate

Climate change is an important factor to consider for the real estate sector.[5] Existing buildings face chronic and acute physical risks, including intensifying hurricanes, floods and wildfires, as well as economic, social and regulatory changes necessary for decarbonization. To limit the global temperature increase to 1.5°C in this century as required by the Paris Agreement, it has been estimated that real estate's direct carbon emissions will need to be cut in half by 2030, compared to 2020 levels, and reach net-zero by 2050.[6]

Publicly traded real estate companies hold a significant share of the building stock globally. As such, they are in a unique position to play an important role in achieving global sustainability targets. As public market investors, understanding how companies can influence and achieve net-zero targets is important, as is assessing the financial implications and, importantly, the capital expenditures required to reach such targets.

DISPLAY 1

What Is Sustainability?

In the 1987 Brundtland Commission Report, the United Nations defined sustainable development as "meeting the needs of the present without compromising the ability of future generations to meet their own needs".[8] Ultimately, we believe sustainability requires the equilibrium of three core pillars:

ENVIRONMENTAL

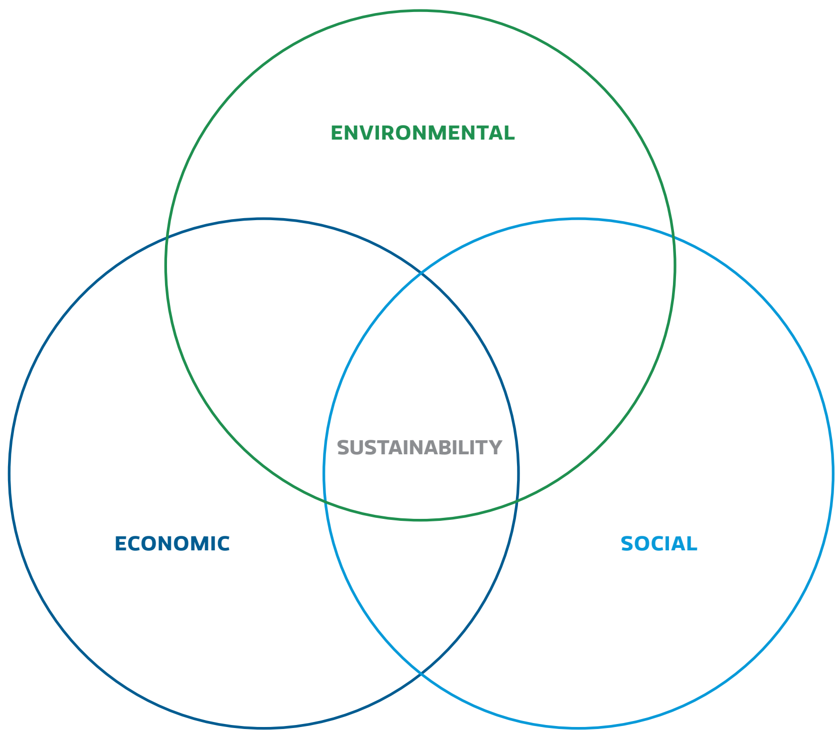
- Managing the consumption of natural resources and reducing environmental impact to preserve the planet

ECONOMIC

- Using resources efficiently and adopting practices that support long-term economic growth, while also generating operational profit

SOCIAL

- Balancing the needs of individuals in society to maintain community welfare in the long term, including equal opportunities for employment, health and wellbeing



With 80% of the existing building stock expected to still be in place through 2050, retrofitting the current stock is critical to meeting global net-zero targets.[7]

[5] McKinsey. "Climate Risk and the Opportunity for Real Estate", February 2022.

[6] United Nations Environment Programme. "2021 Global Status Report for Buildings and Construction: Towards a Zero-emission, Efficient and Resilient Buildings and Construction Sector", October 2021.

[7] JLL Research. "Return on Sustainability: How the 'Value of Green' Conversation is Growing Up", January 2022.

[8] United Nations Brundtland Commission. "Report of the World Commission on Environment and Development: Our Common Future", April 1987.

Who Is Setting the Priorities for Sustainability?

A confluence of events has led to a rapid increase in the momentum behind sustainability for real estate. This momentum is attributable to three primary constituents: real estate investors, regulators and tenants (see *Display 2*).

REAL ESTATE INVESTORS

The amount of capital directed towards sustainable investing has experienced exponential growth. For example, the UN-convened Net-Zero Asset Owner Alliance (NZAOA), an international group of 74 institutional investors with $10.6 trillion in assets under management, has committed to transition investment portfolios to net-zero greenhouse gas (GHG) emissions by 2050.[9]

Energy-efficient buildings represent the second biggest use of green bond proceeds.[10] Of the $290 billion total green bond global issuance in 2020, $76 billion—more than one quarter—was tagged for green buildings. Banks are also increasing green building construction and mortgage financing.

REGULATORS

As the effects of climate change intensify around the globe, the regulatory landscape is evolving to address and mitigate the worst impacts, with a number of real estate-specific local laws and regulations being adopted in the U.S. and Europe (see *Display 3*).

We are also seeing an even greater global push toward broader ESG regulation, with a particular focus on combating greenwashing.[11]

DISPLAY 2

Three-Pronged Focus on Sustainability

DISPLAY 3

Select Environmental Regulations

U.S. Building Performance Standards (BPS)	The U.S. BPS Coalition is comprised of 37 state and local governments committed to create and implement BPS in their jurisdictions by 2024. BPS are laws that require buildings to achieve minimum levels of energy or climate performance.[12]
New York City (NYC) Local Law 97 (LL97)	Requires most buildings over 25,000 square feet to meet new energy efficiency and greenhouse gas emissions limits by 2024, with stricter limits coming into effect in 2030, or face financial penalties.[13]
California Building Energy Benchmarking	Requires owners of large commercial and multifamily buildings (greater than 50,000 square feet of gross floor area) to annually report whole building energy usage to the California Energy Commission.[14]
French Décret Tertiaire	Requires landlords and tenants of tertiary (i.e., service) sector buildings to reduce energy consumption by 40% by 2030, 50% by 2040 and 60% by 2050 (regulation sets out guidance for defining base year) and to report the energy performance of their buildings annually.[15]
Energy Performance Certificates (EPCs)	Buildings in many European countries are required to hold EPCs, which measure energy efficiency on a scale from A to G. For example, all office buildings greater than 100 square meters in the Netherlands must achieve a minimum EPC rating of C by 2023 and A by 2030.[16]

[9] UN Environment Programme Finance Initiative. "UN-convened Net-Zero Asset Owner Alliance." Updated 28 July 2022.

[10] United Nations Environment Programme. "2021 Global Status Report for Buildings and Construction: Towards a Zero-emission, Efficient and Resilient Buildings and Construction Sector", October 2021.

[11] Greenwashing refers to misleading representations about the sustainability characteristics of a product.

[12] National BPS Coalition. "About the National BPS Coalition", January 2022.

[13] NYC Sustainable Buildings. "Local Law 97", November 2019.

[14] Kimball, Tirey & St. John LLP. "California Energy Commission's Building Use Benchmarking and Public Disclosure Program – AB 802". Updated June 2018.

[15] Easee. "'Décret Tertiaire' – Tertiary Decree", October 2021.

[16] Greenberg Traurig, LLP. "Energy Label C Obligation for All Office Buildings in the Netherlands in 2023 (With Few Exceptions)", November 2018.

- **European Union (EU) Sustainable Finance Disclosure Regulation (SFDR)** has two underlying policy objectives: preventing greenwashing and directing capital into sustainable economic activities. These are achieved by introducing specific obligations for asset managers at the entity level and investment product, i.e. fund level.[17]
- **EU Taxonomy** is a classification system, establishing a list of environmentally sustainable economic activities. It could play an important role helping the EU scale up sustainable investment and meet the EU's climate and energy targets for 2030.[18]
- **In the U.S., the Securities and Exchange Commission** recently adopted revisions to its fund names rule and has also introduced proposals to enhance disclosures related to ESG investments and alignment with proposed ESG fund categorizations. The new rule and proposal aim to enhance transparency, mitigate greenwashing and provide ESG-related disclosures in the financial industry.

TENANTS

Increasing demand from tenants for sustainable buildings is a natural consequence of the growth in climate target setting by corporations.

Employees returning to the workplace after the COVID pandemic have also brought health and wellbeing into sharper focus. This increasing tenant demand and expectation for green and healthy buildings is leading to rental premiums versus the rest of the market. For example, healthy buildings, as deemed by WELL[22] and Fitwel[23] certifications, command effective rents that are 5% to 8% higher per square foot than comparable non-certified buildings.[24]

How We Integrate ESG into Real Estate Investing

For MSIM's GLRA team, the identification and assessment of risks and opportunities related to sustainability—specifically the Environmental, Social and Governance (ESG) pillars—are a core element of our research process. Our ESG focus is comparable to our focus on other factors such as building quality, tenancy, occupancy, strategic business plans, etc.

Of companies in the Fortune Global 500, 63% have set 2050 emission reduction targets while 42% have set a significant climate milestone—either carbon neutrality, RE100,[19] or a net-zero target—or they have publicly committed to do so by 2030,[20] thus continuing to drive the demand for net-zero carbon buildings.

More than half of FTSE 100 companies have a board-level committee focusing on ESG issues.[21]

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[17] An Article 8 financial product promotes binding environmental and/or social characteristics and investee companies follow good governance practices. An Article 9 financial product has sustainable investment as an objective, does no significant harm to its objective, and investee companies follow good governance practices.

[18] Source: https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en.

[19] RE100 is a global initiative that brings together international businesses committed to 100% renewable electricity. For more info refer to https://www.there100.org/.

[20] Climate Impact Partners. "If Not Now, When?", September 2022.

[21] Bloomberg. "More Than Half of FTSE 100 Companies Now Have ESG Committees", September 2022.

[22] The WELL Building Standard® is a performance-based system for measuring, certifying and monitoring features in buildings and the built environment that impact human health and wellbeing, such as air, water, light and comfort. For more info refer to: https://www.usgbc.org/articles/what-well.

[23] Fitwel is a green building certification system that focuses on improving, enhancing and safeguarding the health and wellbeing of tenants and residents in office buildings, multifamily residential buildings and retail space. For more info refer to https://www.fitwel.org/.

[24] JLL Research. "Return on Sustainability: How the 'Value of Green' Conversation is Growing Up", January 2022.

We undertake a mosaic approach to sustainability research, using both quantitative and qualitative data from multiple sources. The GLRA team's internal research complements and enhances data from company sustainability reports and third-party providers—including MSCI, S&P Global Trucost, ISS, Equileap and the Global Sustainability Real Estate Benchmark (GRESB)—and we focus our sustainability research on the areas shown in *Display 4*.

The proprietary research process ranks the relative strengths and weaknesses of each company in the investment universe on ESG factors. We then adjust our valuations to account for these ESG risks and opportunities, and the impact they may have on a company's net asset value and cash flow forecasts in both the near and intermediate term; ultimately, we seek to identify the real estate securities with the best total expected returns for our clients, inclusive of adjustments for ESG risks and opportunities.

ONGOING ENGAGEMENT AND ADVOCACY

We conduct engagements with select portfolio companies each year and prioritize active dialogues where positions are significant and issues are viewed as material. Our constructive dialogue seeks to drive positive change, improve sustainability and enhance long-term value creation.

Complementing these formal ESG engagements are research touchpoints with companies during which ESG factors are discussed.

DISPLAY 4

ESG Focus Areas for the Global Listed Real Assets Team

ENVIRONMENTAL

- Energy usage and renewables
- Water usage
- GHG emissions
- Waste reduction and diversion
- Supply chain and materials management
- Tenant engagement
- Climate resilience

SOCIAL

- Health and wellness
- Safety
- Diversity, equity and inclusion
- Workforce and labor management
- Community impact

GOVERNANCE

- Governance structure
- Board diversity and refreshment
- Compensation programs
- Government and regulatory risk
- Business ethics
- Sustainability-linked financing
- Management skill

In addition to ongoing research and company engagements, proxy voting is an important piece of ESG integration, with investment team members playing an active role in voting, in line with guidance provided by MSIM's Proxy Voting Policy.

We also leverage our connections in the industry for further collaboration and advocacy. Our involvement includes participation in industry groups and relevant ESG discussions as appropriate including the National Association of Real Estate Investment Managers (NAREIM), National Association of Real Estate Investment Trusts (Nareit), the Real Estate Roundtable and the European Public Real Estate Association (EPRA).

Where We See Sustainability Trends Evolving

- In response to demand from capital allocators and regulators for a rigorous quantitative approach, more ESG data providers will enter the marketplace—creating their own frameworks to rank the ESG profiles of companies using publicly available information.
- Demand will increase for real estate sustainability benchmarks such as GRESB to compare ESG profiles of similar real estate investments.
- Obsolescence risk will increase substantially for "carbon stranded" buildings unable to achieve greenhouse gas emissions (GHGe) reductions necessary to be aligned with a 1.5°C pathway. This will incur a brown discount, ultimately impairing values and potential total returns.

Predictions for Sustainability in Real Estate

Here are our predictions for sustainability in real estate, based on the recognition that assessing ESG risks and opportunities will have a growing impact on valuations, cash flow projections and total returns:

- Increased demand for green buildings, energy metering and prioritizing health, safety and wellness by tenants will lead to a new capital expenditure cycle for commercial real estate. Property owners that have already made significant investments in these areas will be best positioned to navigate the increasing costs.
- While the growing focus on sustainability is a global trend, there will be regional differences due to existing practices and new or expected regulations that mandate energy efficiency; understanding such nuances will be increasingly important for active real estate investors.
- With the evolving regulatory landscape and reporting requirements, ESG data management and disclosure will continue to increase in importance. This should lead to increased transparency and a better understanding of the risks and opportunities related to ESG.
- Responding to ever-expanding tenant demand for green certified buildings, property owners are likely to adopt new technology to achieve sustainability standards. This will pave the way for increased innovation and a growing differentiation between operating platforms, further separating the winners from the losers.

The MSIM GLRA Team seeks to integrate sustainability into certain research and investment processes to stay ahead of these trends, as we seek to provide our clients with exposure to real estate securities with the best expected total returns.

Risk Considerations

The value of investments may increase or decrease in response to economic and financial events (whether real, expected or perceived) in global markets. The value of **equity** securities is sensitive to stock market volatility. **Real Estate Risk**: The risks associated with ownership of real estate and the real estate industry in general include fluctuations in the value of underlying property, defaults by borrowers or tenants, market saturation, decreases in market rents, interest rates, property taxes, increases in operating expenses and political or regulatory occurrences adversely affecting real estate. **Real estate investment trusts (REITs)** are subject to risks similar to those associated with the direct ownership of real estate, and they are sensitive to such factors as management skills and changes in tax laws. **Concentration Risk**: Concentration in a single region may make the portfolio more volatile than one that invests globally. ESG Strategies that incorporate impact investing and/or **Environmental, Social and Governance (ESG) factors** could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

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