ESG AND INVESTMENT STRATEGY: A VIRTUOUS RELATIONSHIP

Environmental, social and governance (ESG) is a high priority for real estate investors, but there is no agreed industry position on what ESG means in practice for investment strategy. Affording significant weight to ESG within investment decisions is prudent regardless of whether an investor has altruistic or financial motivations given that ESG-based strategies generally deliver superior long-term capital protection, creation and growth. ESG and financial performance are inherently interlinked. In light of this ESG considerations should permeate every facet of investment strategy from macro-sector allocations though asset selection and management to occupier profile.

As set out in this paper, we believe that ESG strategies should be inclusive at all levels including business and sectoral inclusion. In our view and in accordance with the guidance in the UN Principles for Responsible Investment (UNPRI), it is not the role of real estate investors to deprive any business or sector with access to the modern, well-specified floorspace they require to operate efficiently and fulfil their customer and employee need. Indeed, doing so may deliver poorer ESG outcomes. Nevertheless we advocate particular investment strategy approaches towards allocation, assets and occupiers for those investors seeking to maximise the potential for their capital to achieve greater tangible ESG impact.

Figure 1: Principles for maximum ESG impact in investment strategy

	Sectors	Assets	Occupiers
Environment	• All sectors/segments are investable • Overweight living/mixed-use/logistics & light industrial/energy infrastructure	• Prioritise value-added strategies • Enact improvement works early • Acquire & create dense & adaptable assets • Reuse > refurbishment, refurbishment > redevelopment • Construction priority towards brownfield land & sustainable materials • Deploy smart technological solutions • Use sustainable finance	• Influence rather than exclude • Use green leases
Social	• All sectors/segments are investable • Overweight living/mixed-use	• Ensure assets are inclusive or cater specifically to niche users • Consider social value in deal screening & portfolio reviews • Prioritise value-added strategies & mixed-use development • Deploy technological solutions • Survey occupiers/users, track use patterns	• Incorporate occupiers who cannot pay market rent • Adopt new approaches to utilise short or long-term vacancy • Support temporary/meanwhile uses
Governance	• Create & adhere to a transparent allocation process which meets ESG commitments	• Actively pursue partnerships • Collaborate with other parties in the micro/macro location • Apply & adhere to in house assurance	• Engage/partner with occupiers

Source: Cromwell Property Group

INTRODUCTION: THE NEED FOR AN ESG-BASED MINDSET

ESG issues are centre stage for real estate investors. Rightly so, given this topic has historically been overlooked and underappreciated. Given that successful real estate is about people – customers, workers, occupiers – and requires physical land and materials, it has a direct and tangible impact on achieving ESG objectives incomparable to other investable sectors such as equities or bonds.

Whilst almost all investors are aware of ESG objectives, what this means in reality differs markedly. There are currently few agreed standards or metrics within the real estate industry to assess value. There is also a lack of clarity on what ESG means in practice for asset targeting, acquiring and management.

In this paper the Cromwell Research, Strategy and Product team sets out our views on how ESG should influence investment strategy. We are not seeking to comment on the practical application of ESG methodologies nor to comment on climate change risk/resilience. Rather, we are narrowly focussed on how the desire to achieve positive ESG impacts can be applied within investment strategy to influence investment, management and divestment decisions.

DEFINITIONS

We consider the main ESG components of direct relevance to real estate investment strategy to be as follows:

Environmental	Energy consumption, resource management, greenhouse gas emissions, biodiversity impacts, waste, water
Social	Human rights, community & supply chain relations, diversity and inclusion, occupier satisfaction, worker wellbeing
Governance	Management structures and practices, assurance & compliance, regulations

Source: Cromwell Property Group

The UNPRI defines ESG integration as *"the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions"*[1]. This definition does not seek to elevate ESG above over investment metrics, but rather to encourage its consideration alongside them. The UNPRI guidance is clear that accounting for ESG is not about prohibiting investment in sectors, countries or companies. It is not about disregarding financial factors or sacrificing performance in order to elevate the importance of ESG. It is about viewing them all in parallel.

That being said, investments which maximise positive ESG outcomes also maximise long-term performance given their contribution towards ensuring stable, well-functioning and well-governed social, environmental and economic systems[2]. There is no trade-off between ESG and financial return – they go hand-in-hand. That is why it is prudent that investors seeking to protect, create and grow long-term performance ensure that ESG is central to investment strategy decisions.

This paper considers ESG in three allocation dimensions: sectors; assets; and occupiers. We believe the EU and European/UK governments are advanced in progressing climate change and social inclusion objectives. Given that we are not considering climate risk in this paper, our country or geographical allocation strategy recommendations do not vary by geography.

SECTORS: EVERYTHING REMAINS INVESTABLE

The UNPRI is clear that integrating ESG practices into investment strategy is not about prohibiting options. That means that no sectors should be off-limits so long as the investment is truly looking to deliver on ESG ambitions. Whilst it may feel unpalatable for ESG-minded investors to allocate towards sectors or segments that are perceived to be problematic from an ESG perspective, such as the power-hungry data centres or heavily polluting transport infrastructure, the modern economy relies on such real estate and cannot function without it for now.

Given all sectors should remain investable, no options should be off the table if there is an ESG plan in place. However, investment strategy can be used to encourage greater capital allocation towards those sectors and segments which have the greatest potential to create stronger, long-term ESG-positive change.

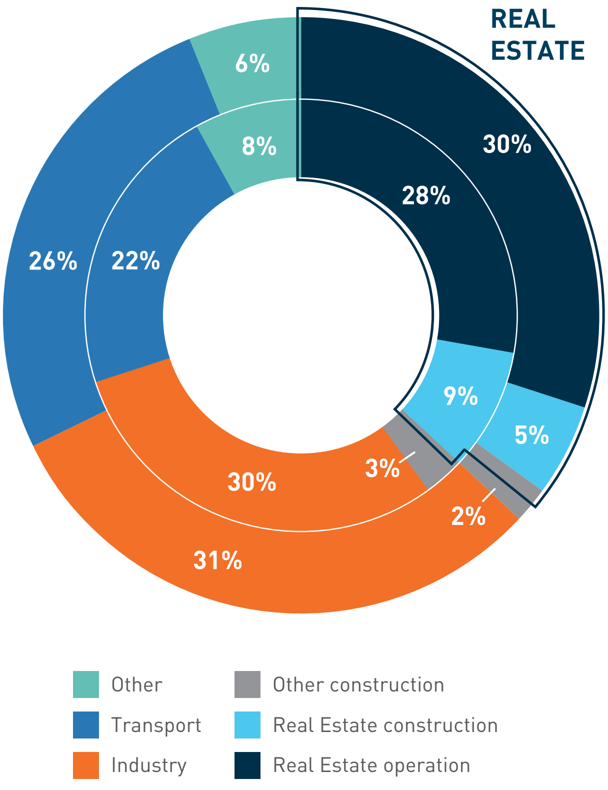
1 UNPRI/CFA Institute, 2018, ESG in equity analysis and credit analysis
2 INREV, 27 October 2021, Global Definitions Database

Environment: Target carbon intensive segments and those which encourage sustainability

In consuming physical land and resources, real estate has a direct impact on the environment. In terms of greenhouse gas emissions, the impact changes annually although it is always significant. The latest data from 2021 estimates that real estate accounted for 35% of global energy consumption and 37% of energy-related carbon emissions through operation and construction (figure 2).

Given that all sectors and segments should remain investable, it is at the asset level that the greatest impacts on reducing emissions, promoting efficient land use and minimising construction-related impacts can be achieved. That being said, greater allocations towards several sectors/segments may deliver greater environmentally positive benefits. In particular living; logistics & light industrial; mixed-use; and energy infrastructure.

Figure 2 Global energy and energy-related carbon emissions by sector, 2021



Source: Global Status Report for Buildings and Construction 2022, Global Alliance for Buildings and Construction

LIVING

Residential uses account for 70% of global energy and 35% of energy-related carbon emissions from real estate[3]. Environmental-minded investors have more opportunity to effect meaningful positive change in lowering energy use and associated carbon emissions by targeting greater capital towards living.

LOGISTICS & LIGHT INDUSTRIAL

Transport and industry are big energy-users and carbon emitters. Investors allocating more capital towards real estate which serves these users and who are motivated to deliver more sustainable assets through improving energy efficiency, lowering transport requirements and encouraging greener transport have significant potential to support high value environmental improvements. For example, supporting light industry assets or logistics hubs close to customers lowers the requirement for road transport. Providing electric vehicle charging infrastructure within logistics and light industrial portfolios increases the viability of electric vehicles. Creating on-site renewable sources increases the access of heavy energy-users to cleaner sources.

MIXED-USE

The '15-minute city' concept, whereby all human needs and desires are met within a short travel radius, is recognised as fostering a more sustainable existence[4]. From an environmental perspective it encourages the effective use of land and minimises transport-related emissions. Mixed-use development is the key to the '15-minute city' concept. Greater capital weighting towards owning, creating and operating mixed-use assets and mixed-use locations will encourage better environment outcomes. In moving away from single-use assets and locations, it also supports greater optionality and allows for more potential to adapt and reuse existing buildings without heavy refurbishment or redevelopment, lowering the need for construction. It will be easier to mitigate vacancy which reduces the requirement for new land and development to meet occupier demand.

ENERGY INFRASTRUCTURE

An emerging niche segment is energy infrastructure which encompasses real estate supporting renewable energy generation, supply and storage. The move to net zero depends on cleaner energy and stronger investor demand for the real estate which facilitates it will hasten the transition. This is a fledgling segment and should be closely monitored for future investable opportunities.

3 Global Status Report for Buildings and Construction 2022, Global Alliance for Buildings and Construction
4 The 15-minute city offers a new framework for sustainability, liveability, and health, March 2022, The Lancet Planetary Health

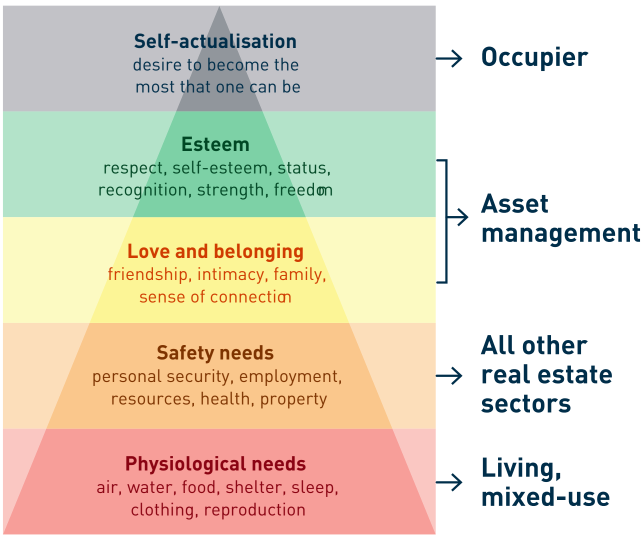
Social: Favour living and mixed-use which fulfil the most basic human physiological needs

Social impacts are maximised when real estate is optimised to meet the full range of all occupier and human end-user need. All sectors and segments impact community outcomes, they all have the potential to effect positive outcomes. As such, any targeted or diversified investment strategy which seeks to own well-specified real estate attuned to end users and communities can support positive social impact. Society relies on all types of real estate being available after all.

Whilst recognising that all sectors and segments deliver social value, the living sector warrants specialist attention for socially minded investors. According to the psychological theory of Maslow's hierarchy of needs, shelter is a physiological human need that must be satisfied before higher order needs such as work, entertainment and leisure are relevant (figure 3). Ensuring that everyone, regardless of their socio-demographic background in terms of health, wealth, age and so on, can access the housing they need is thus an essential base from which all other social benefits flow. Investors weighting capital towards living in all its forms – multi-family, build-to-rent, aged care, sheltered, affordable, social, student, retirement – have the direct ability democratise access to suitable housing across society. It offers the most direct means of maximising social benefits from sector allocations.

Mixed-use development which enables the majority of human needs to be fulfilled within close proximity yields substantial social benefits alongside its positive environmental impacts. It increases access to live, work and play opportunities for all members of society in a mixed-use location. It saves time and supports health and wellbeing by enabling more human-powered transportation. Higher mixed-use allocations can therefore support greater environmental and social benefits as well and should be prioritised for investors motivated to maximise social outcomes.

Figure 3: Maslow's hierarchy of needs: A framework for directing social impact allocations



Source: Cromwell Property Group

Table 1: Sector allocation summary

	Environment	Social
Retail	No change	No change
Offices	No change	No change
Logistics & light industrial	Increase	No change
Living	Increase	Increase
Alternatives	Increase	Increase
Tourist accommodation	No change	No change
Leisure	No change	No change
Self-storage	No change	No change
Data centres	No change	No change
Mixed-use	Increase	Increase
Energy infrastructure	Increase	No change

Increase No change

Source: Cromwell Property Group

ASSETS: TARGET VALUE-ADDED, ENACT IMPROVEMENTS AND INGRAIN FLEXIBILITY/ADAPTABILITY

Assets are the point at which real estate serves it users and fulfils its purpose – be that to accommodate households, workers or businesses, store data or physical goods or enable goods or services to be exchanged. As a real asset, it is at the asset level where ESG outcomes manifest. Thus it is at the asset level that ESG minded strategies yield their impact in maximising beneficial outcomes and minimising externalities.

Because ESG creates sustainable long-term value, there is no comprise between maximising positive ESG impacts and delivering financial performance. Therefore these considerations should be imperative both to investors prioritising financial returns and also those who are seeking to maximise or at least increase positive ESG impacts. ESG is of universal value to all investor profiles.

Environment: Consciously improve weaker assets to generate meaningful impact

Real estate is a major greenhouse gas emitter. Most emissions are derived from building operations although construction-related embodied carbon is also a significant pollutant source. In light of this, it is at an asset level that environmental gains are realised.

Operations: Prioritise environmentally weak assets with the most improvement potential

Operationally, environment outcomes are increased when assets maximise resource efficiency and utilise sustainable energy whilst minimising waste and fossil fuel powered transport-requirements. This does not mean that investors seeking to support the strongest environmental impacts targeting only modern buildings which are the most efficient. Quite the opposite. It is the least operationally efficient and most wasteful assets today which offer the greatest improvement potential tomorrow and the best ability to deliver meaningfully better environmental outcomes. Thus all assets should be investable, especially the environmentally weakest.

For investment strategy purposes, the environmental impetus is on understanding and then improving upon operational efficiency alongside encouraging more sustainable use. In appraising new investments, determining portfolio management strategies and identifying divestments it is prudent to:

1. **Measure –** you cannot manage what you cannot quantify, therefore it is essential to ensure full transparency of the energy, water and waste utilisation of each asset. This may require capital expenditure and will need technical solutions to be integrated but it is the foundational component of improving asset-level environmental outcome. Strong governance practices are also essential.
2. **Test –** as a real asset, every single property is unique. That means there will never be a one-size fits all model for all assets of a certain type. Rather individual attention, hands-on application and trial and error will be necessary to determine the optimum solution for each asset. Asset management will become more active. Over time commonalities, best practices and rules of thumb will emerge which can then be holistically applied to inform investment decisions.
3. **Document –** transparent reporting of asset-level environmental performance is needed which requires strong governance. Improving operational performance requires collaboration between occupiers who will want to minimise disruption and cost and may be less motivated by sustainability objectives and the investor seeking to improve environmental outcomes and enhance returns. Transparent reporting educates all stakeholders about the environmental impacts of the asset. It helps to engender trust and can validate resource and operational cost savings achievable through improvement works and expose the tangible benefits that will result. Data transparency will support more accurate underwriting assumptions on capital expenditure and asset management liabilities and strengthen asset liquidity too.
4. **Innovate –** the real estate industry has only just begun its decarbonisation journey. Investors that lead change, adopt environmental strategies early and initiate innovation will stimulate faster industry-wide change. In conjunction, they will benefit from the financial performance sooner and for longer from the higher rents, lower yields and greater investor capital likely to emerge for environmentally friendlier buildings.

Investment strategy must be realistic about the greater capital expenditure and asset management intensity involved in elevating the importance of environmental factors. This is particularly pertinent for older secondary assets which will face the most challenges but by virtue of that will deliver the most meaningful improvements. This will impact underwriting assumptions and management costs but, given the performance benefits of sustainable real estate, this should be counter-balanced against stronger returns.

Underwriting assumptions and management programs should be predicated on proactivity rather than reactivity. This means actioning achievable environmental efficiency improvements, technological deployment and renewable energy installations at the earliest feasible opportunity, rather than including these as a future option should the occupier, investor or legalisation require it.

This rationale suggests that investors have better prospects for securing bigger positive environmental contributions if they weight towards value-added strategies which will improve assets rather than core investments, even if the latter are far more sustainable than the former today. The meaningful impact derived from making an asset environmentally better are orders of magnitude larger than acquiring a fully sustainable asset. Deploying capital at scale is advantageous too, yielding exponentially larger environmental benefits from enacting improvements.

Construction: Use a hierarchy-based approach to minimise adverse impacts

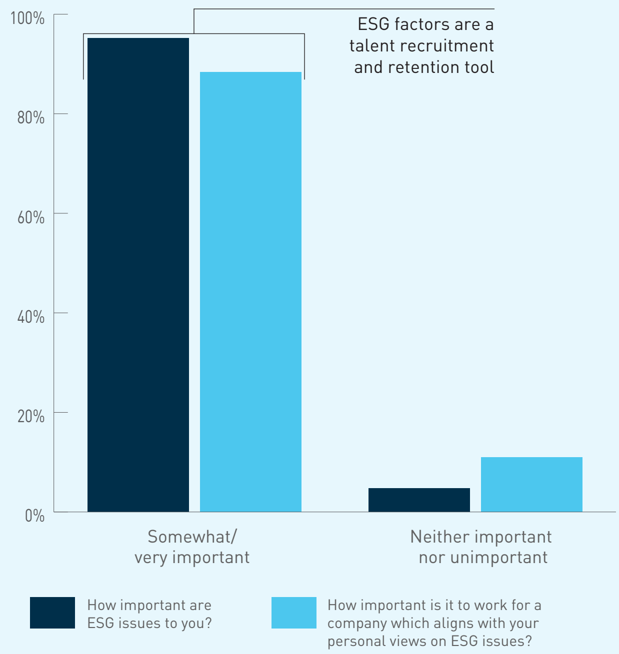
Given embodied carbon savings, reusing existing buildings is the most environmentally sound approach towards accommodating new types of occupier demand. From an asset targeting perspective, this means that investors should seek to acquire and create assets which are flexible and adaptable. This will allow the asset to pivot over time as occupier demand shifts without the need for heavy refurbishment or a comprehensive redevelopment. This is a prudent strategy regardless of the environment benefits given it is likely to become harder to develop in time as carbon impacts are accounted for and more stringent legislative requirements are imposed.

Whilst reuse is best, extensive refurbishment and new construction will still be needed to fulfil changing occupier demand and facilitate growth. Indeed it is estimated that two billion square metres of new building stock will be needed globally every year to 2025 to meet demand[5]. That is almost double the current amount of retail, office and industrial space in Europe according to data provider Real Capital Analytics (RCA).

Environmentally-focused investors should not preclude new development. On the contrary, to make a meaningful impact they should support new development where it is needed using net zero or carbon positive construction processes on brownfield land. Doing so will lower aggregate construction-related emissions and land use requirements which may otherwise have occurred through traditional site acquisition and construction processes.

Strategies which utilise modern construction techniques combined with sustainably sourced materials like timber can remove more carbon from the atmosphere than they create i.e. they are net carbon positive. Construction is quicker which lowers construction cost. Occupier demand for sustainable buildings is rising as corporates seek to demonstrate their environmental credentials through their real estate to align to consumer and shareholder demand. It is also a critical means to attract and retain talent, given the importance of aligning corporate conduct with employee environmental views (figure 4). As a result, timber buildings can command rental premiums and deliver stronger financial performance.

Figure 4: Importance of ESG factors to talent



Source: Cromwell Property Group, Q3 2023.

Figure 5: Elevating the environment: Adaptive reuse hierarchy

REUSE	• Maximum emission savings • Most resource-efficent
ADAPT REFURBISH	• Retain core • Avoid comprehensive demolition • Reuse and recycle waste • Reuse and recycle existing materials • Sustainably source new materials • Create dense & adaptable space
REDEVELOP EXISTING: BROWNFIELD LAND	• Repurpose previously developed land • Create dense and adaptable space • Reuse and recycle existing materials • Use sustainable materials like timber • Target net carbon negative
REDEVELOP NEW: GREENFIELD LAND	• Last resort • Create dense & adaptable space • Reuse and recycle existing materials • Use sustainable materials like timber • Reinstate natural capital & as a last resort offset land use impacts • Target net carbon negative

Source: Cromwell Property Group

Timber is not the only solution. Innovative research is being conducted into new materials such as low carbon concrete using waste material from other industries and graphene-enhanced concrete which is less dense but more durable. However timber represents the most readily available, proven sustainable material which can be used today. It thus presents the best current option for lowering the carbon emissions associated with refurbishment and redevelopment.

To conserve land, the priority should always be to reuse existing brownfield sites which have already been cleared or developed over new build development on greenfield sites (figure 5). As with buildings, it is likely to become harder to secure planning consent for greenfield site development as local, regional and national governments prioritise environmental objectives. Adopting a brownfield-first strategy therefore also mitigates future planning and development risk alongside promoting the efficient use of land and the reinstatement of natural capital.

Where greenfield development is unavoidable and impacts cannot be mitigated through reinstatement or in-situ enhancements on site, offsets can be sought elsewhere within the portfolio to mitigate environmental impacts. This should be a last resort and may include, for example, greening roofs, planting trees on excess space or enlarging public spaces to support biodiversity. Density should be encouraged to maximise the amount of occupier demand which can be satisfied and lowering the overall requirement for new land and development to meet it elsewhere.

5 Timber Buildings: Truly Sustainable Real Estate, Q2 2022, Cromwell Property Group

Social: Account for all users

Social factors involve considering the views of all stakeholders who are impacted by the asset. This includes the occupier but of greater importance are the human users, whether they are the workers within the asset, the customers served by it or the community in which it is situated.

The occupier: Real estate should be perfectly attuned to demand

The extent to which assets fulfil the needs of occupiers is a key social value metric. It is wise investment strategy to own or create stock that is highly attuned to the needs of modern occupiers given this will maximise rental value and minimise voids. As such at an asset level, occupiers do not need extra attention to account for social value given that robust investment strategy should already target well-located, suitability specified real estate which meets modern occupational need. However, the investors can still build relationships with the occupier to influence better social outcomes. This is considered in the final section of this paper.

It is necessary to communicate with the occupier regularly to assess the extent to which the asset fulfils their needs. Regular surveys or structured meetings to appraise asset operation and identify potential improvements is sensible. Ultimately doing so will be accretive to social, environmental and financial value as building a stronger relationship between occupier and investor will ensure a better functioning asset.

Workers/customers: Tailored to the needs of users

Socially strong assets are those that meet the needs of human users and promote health and wellbeing. Meeting their needs means the asset is fit-for-purpose, inclusive and encourages beneficial behaviour.

Socially strong real estate should thus be well-attuned to its users. If it serves a broad user spectrum, for example a shopping centre or large office, it should be inclusive and ensure all users have equal access. If it serves a particular niche, for example aged care, sheltered housing or childcare, it should specifically respond to the needs of its users in a targeted manner. The extent to which assets are inclusive and fulfilling user need should be assessed through regular surveys and technological tracking solutions.

Health and wellbeing cover a multiple of factors. Some of these are built into the hard infrastructure of the asset in construction, such as the extent of open space or pedestrian access routes. Investors with standing assets may have limited scope to influence these, although minor refurbishing works should be enacted where they can add to health and wellbeing outcomes. Softer aspects are easier to introduce or improve such as incorporating more biophilia, encouraging movement on foot through signage or landscaping or integrating more amenity space. Opportunities to improve social value should form part of investment screening process and asset management strategies.

Technology will have a significant role in delivering socially better assets. Amongst the potential social benefits arising from more investment into, and deployment of, technological solutions are touchless access, enhanced air quality/ventilation, smart security/visitor control and user-controlled building functionality. Technology also provides a means to measure user activity, understand their behaviour and offer options to improve user experience. Investors should actively explore the potential for technology to improve social value.

Community: Prioritise value-added and mixed-use asset strategies

Assets that are well integrated within their micro-location yield stronger community outcomes. Integration can come from being sensitively designed and managed to impact positively on local communities and minimise negative externalities such as traffic movements and noise, which will be largely outside the control of the investor. The most effective approaches to facilitating community integration will come from the occupier, such as by engaging in partnerships to improve local skills and stimulate the local economy. However, investors can ensure that local contractors are offered the chance to tender for new refurbishment or development projects to spread economic opportunity.

Where investors may offer most community value is by adopting strategies which create more socially positive assets prior to operation. In this regard value-added and mixed-use strategies offer most promise. Value-added strategies involve change and improvement. Acquiring a dated, failing or vacant asset unfit for modern occupiers and repositioning it to create a highly functioning asset will yield significantly positive impacts on the community.

Creating, owning and operating mixed-use assets will offer more communities the ability to live, work and play in a more localised area to commensurate with the '15-minute city' concept. Mixed-use liberalises access to housing, employment, goods and services for all. The impact will be most powerful when these strategies are combined, for example by turning a vacant office or weak shopping centre into a strong, vibrant mixed-use asset. These benefits should also be reflected in financial returns.

Governance: Actively pursue partnerships

Governance is a soft asset-overlay. Fundamentally it is about long-term management and stewardship which protects and enhances the contribution of the asset to society and the occupiers, human users and communities within it. Investors must commit to regularly reporting to all stakeholders who have a vested interest in the asset and to collaborating with other parties to improve its integration within the micro and macro-location. As with every other aspect of ESG, advancing good governance principles will increase long-term financial performance by strengthening links between the asset and the locality and elevating its functions as part of a broader ecosystem. Good governance improves returns.

Occupiers: Influencing behaviour and broad inclusion

For the purposes of this paper, we define occupier-based ESG strategies as fund-level polices towards the occupier base. Funds labelled as 'impact' or 'ethical' funds, for example, may prohibit leasing space to occupiers deemed to be contrary to certain principles such as businesses involved in armament manufacturing, fossil fuel production or alcohol sales. In keeping with the UNPRI definition, we seek to avoid excluding occupiers with a legitimate business and which, as a going concern, perform a function that society needs. Real estate occupation is not the optimal method through which to pressure businesses to undertake transformational structural change. It may even inhibit positive change by raising financial costs and increasing adverse environmental or social impacts resulting from occupying sub-standard real estate. No occupiers should be excluded.

That being said, fund-level approaches can seek to incentivise positive ESG outcomes amongst their occupational base. Green leases, which include specific clauses that oblige occupiers to provide energy consumption data to the landlord, can be incorporated as a standard requirement. They improve environmental performance and prompt joint occupier-investor sustainability initiatives such as installing solar panels or using more renewal energy supply. Occupier engagement initiatives build stronger working relationships and can be used as a method to encourage social inclusion. Examples include hosting site visits for a local school or partnering on volunteer work.

A feasible social initiative is including specific provisions for groups that are unable to pay market rents but which still require space. This diverse group may include community/voluntary organisations, social enterprises, charities, artists/creatives, start-up companies/entrepreneurs, educational groups or new local businesses that lack a sound covenant. In single-let assets providing for such groups may be unrealistic except for during prolonged periods of vacancy, but it is a viable approach for multi-let assets such as industrial parks, shopping centres or mixed-use buildings.

Investors must understand that assets are intrinsically interconnectivity with the local environment. As such, it is important that they are connected through social and governance practices too. Providing space for groups unable to pay market rents strengthens the social and economic fabric of local communities. It fosters goodwill for the asset and, by association, the investor. It can increase asset vibrancy, drive footfall, reactivate vacant or under-used space and cultivate occupier relationships which could become profitable if local businesses succeed and scale. It can be used as a means to test new concepts and asset management initiatives. It may improve the perception of the investor with planning authorities which may prove helpful when negotiating refurbishment or redevelopment permissions.

Flexible approaches can also be used to broaden the occupier base. For example, short-term 'meanwhile' usage or community events can be hosted when an asset is temporarily vacant whilst seeking a new occupier or prior to a redevelopment. Pop-up stalls or markets can be supported within office foyers or outside entrances for a nominal or nil rent to bring in local retailers and caterers. As well as supporting emerging occupiers, it provides additional amenities for occupiers and attracts greater visitation too. Initiating and maintaining conversations with local stakeholders will unlock the social and environmental value of occupier relationships. Once again, the virtuous relationship between ESG and investment strategy is clear.