PRESIMA Q3 | 2019

Globetrotter

THE SUSTAINABILITY ISSUE

Brown is the new green

Are you getting compensated for your brown discount?

Q3 | 2019

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THE GREEN PREMIUM EROSION

At Presima, we believe that listed real estate without a sustainability orientation deserves a valuation discount.

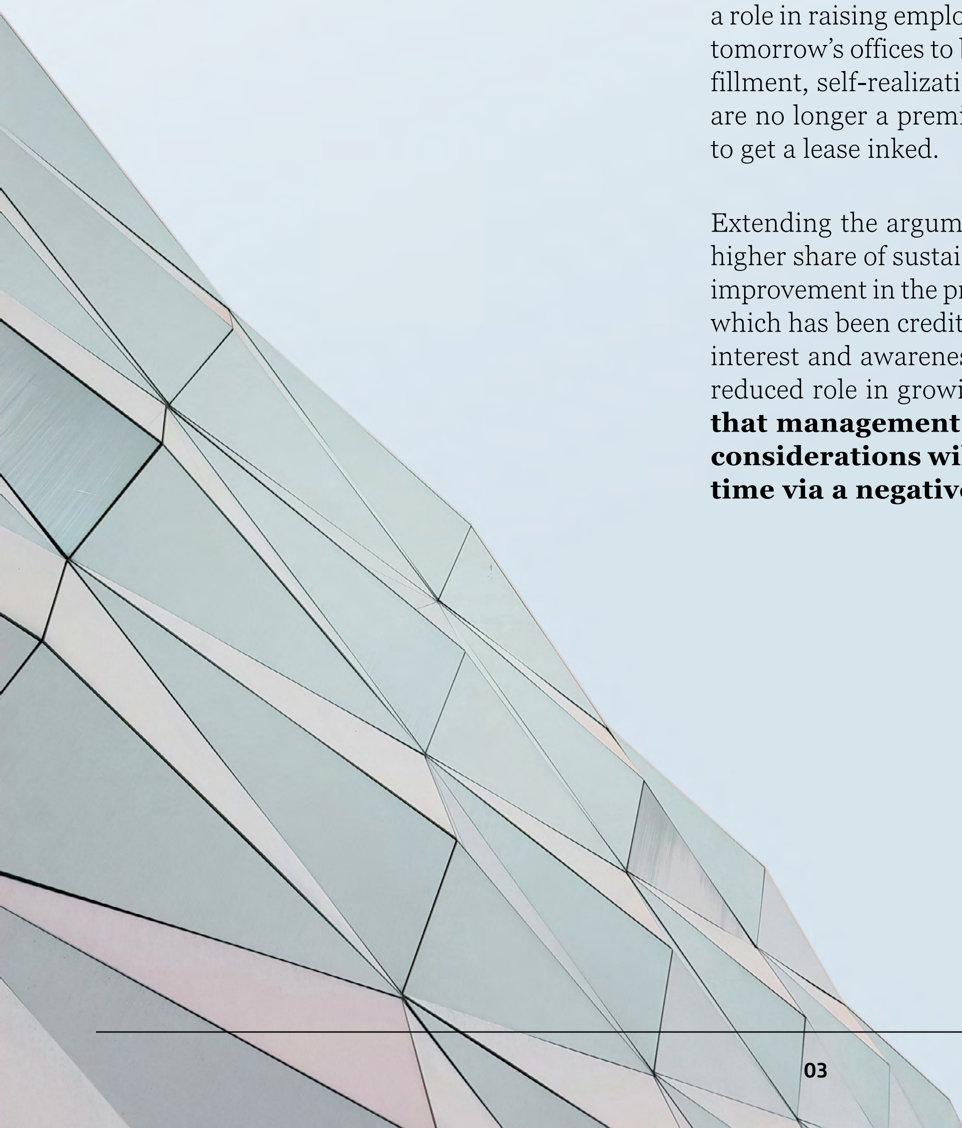
This conviction stems from the future environmental regulations we see as inevitable across the asset class, coupled with the bulging list of social and environmental demands to win – and keep – tenants.

We readily acknowledge the body of evidence suggesting that strong ESG performance, particularly within the "E" sphere, has led to higher rents and asset values; however, **our view is that this green premium has eroded as sustainability moved mainstream, shifting to a "brown discount" for ESG laggards.**

We assert that a larger proportion of sustainable properties should lead to stable net operating income (NOI), which is supportive of values, but not enough to justify a premium[1]. On the flip side, however, we expect an NOI squeeze for older, less efficient buildings as landlords are forced to slash rents and/or cover a higher proportion of energy costs to attract tenants into suboptimal space. This, in turn, will eat into funds available for distribution to shareholders, leading to an increased risk of dividend cuts for poor ESG performers.

We are not alone in asserting these expectations. Six European REITs recently conducted a series of focus groups with office users to understand expectations for the 2030 workplace[2]. The study revealed that, regardless of region or industry, tenants expect work spaces to be responsive to individual users, to use sustainable building materials and to play a role in raising employees' green awareness. Today's office users expect tomorrow's offices to be professional spaces that promote collective fulfillment, self-realization and well-being. Furthermore, these attributes are no longer a premium niche play, but rather essential prerequisites to get a lease inked.

Extending the argument to market values, research has shown that a higher share of sustainable investments is associated with a significant improvement in the price to net asset value (P/NAV) ratio for US REITs, which has been credited as a reputation effect. With the growth in ESG interest and awareness, we argue that such positive effects will play a reduced role in growing a firm's market value; however, **we believe that management teams who don't embrace sustainability considerations will see their discount to NAV increase over time via a negative reputation effect.**



REGULATION IS COMING

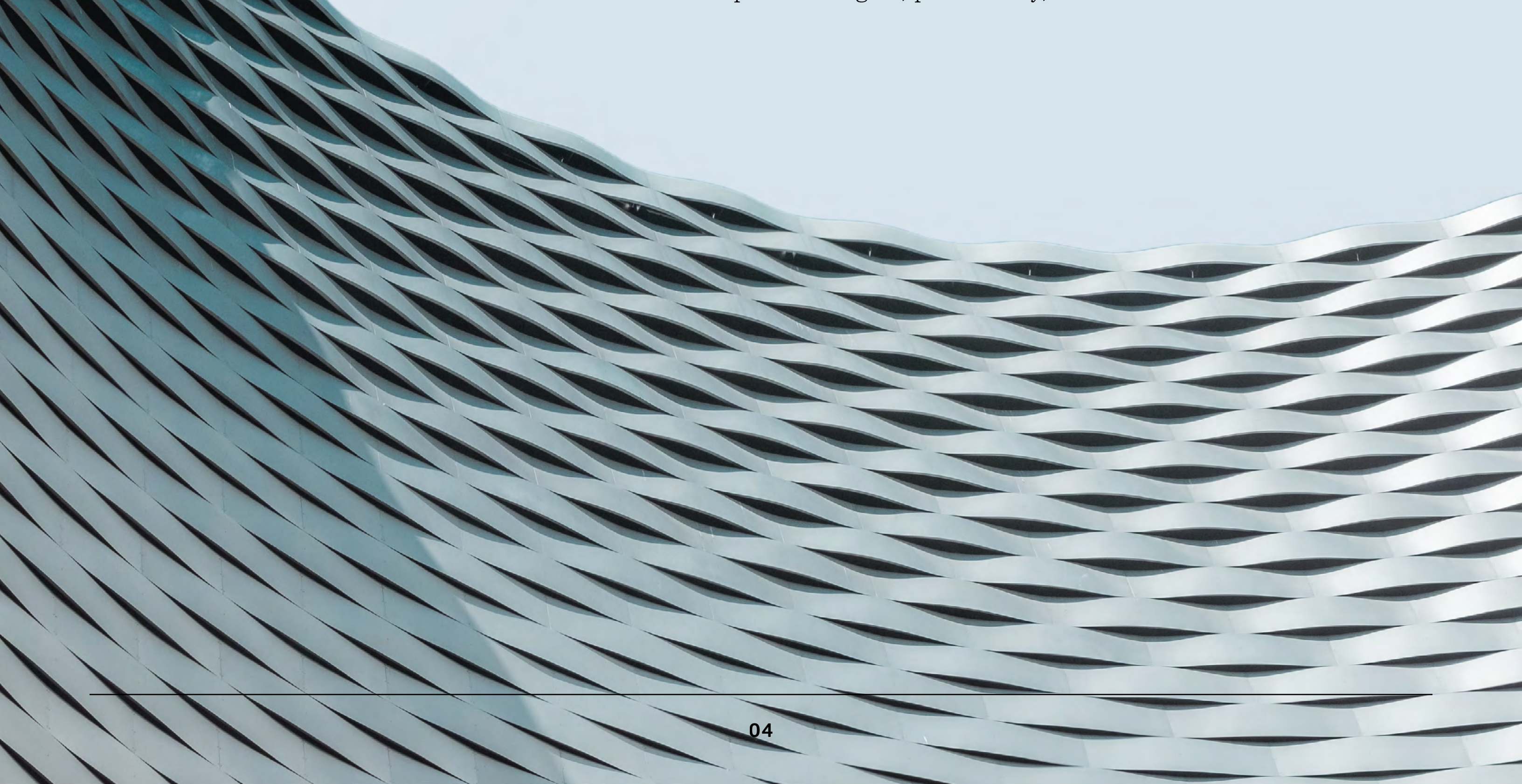
With only a decade of lead time, emissions regulation is no longer a question of "*if*" but "*when, and how severe*".

Are owners already behind the curve?

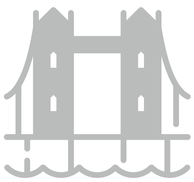
With real estate accounting for nearly a third of global carbon emissions, we view regulation risk as a clear and present danger for our industry. Given its environmental impact, real estate is an essential contributor in achieving ambitious global emission reduction targets and unlikely to be ignored by governments. Estimates from the World Bank indicate that the sector will need to reduce total CO_2 emissions 36% by 2030 to keep global warming below two degrees as mandated by the Paris Agreement[3]. With only a decade of lead time, emissions regulation is no longer a question of "if" but "when, and how severe." **We don't believe that the market is differentiating between proactive and reactive management teams in this regard, leading to mispricing opportunities in the listed real estate space.**

For example, in 2019, the UK government's Committee on Climate Change set a goal of cutting the country's overall carbon emissions to net zero by 2050 and specified that all new buildings will need to be net zero carbon within a decade to achieve that goal. We have seen some UK real estate firms tackle the challenge head on, including Great Portland Estates, which announced aggressive reduction targets for energy and carbon intensity across its portfolio by 2030 and a net zero carbon commitment for new developments after that time.

In a similar push, Australia has committed to reduce carbon emissions by 26% to 28% on 2005 levels by 2030. Australian property group, Mirvac, has one-upped that goal by detailing a plan to achieve and exceed net positive carbon on its investment portfolio by 2030. Aside from creating energy price certainty, the company states that targeting net zero carbon "also has the added benefit of helping us to retain premium tenants and minimise vacancy rates, and with low carbon building policy reforms on the horizon we'll also be ahead of the curve when it comes to compliance"[4]. We argue that real estate companies that aren't taking similar steps today, regardless of where they are located, are putting future development margins, profitability, and asset values at risk.



EXAMPLES OF EMISSIONS REGULATIONS → AND REAL ESTATE COMPANIES' REACTION



UK

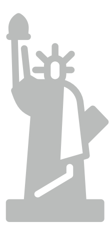
CARBON EMISSIONS
NET ZERO
BY 2050

→ Aggressive reduction targets for energy and carbon intensity across Great Portland Estates' portfolio by 2030 and a net zero carbon commitment for new developments after that time.

AUSTRALIA

REDUCE CARBON EMISSIONS TO 26%–28% ON 2005 LEVELS
BY 2030

→ Mirvac has one-upped that goal by detailing a plan to achieve and exceed net positive carbon on its investment portfolio by 2030.



NYC

MAXIMUM EMISSION LEVELS A LARGE OFFICE BUILDING CAN EMIT ANNUALLY WITHOUT BEING FINED
BY 2024

→ "New regulations are probably much more onerous for those who have not been trying to upgrade and redevelop their portfolios and get ahead of this. They may be facing some more significant financial burden over the next 11, 12 years."

Matthew DiLiberto, CFO of SL Green Realty Corp

Earlier this year, the New York City Council passed the Climate Mobilization Act to reduce greenhouse gas emissions and improve energy efficiency for certain buildings in New York City (NYC). The legislation is billed as "the most significant action the city can take to reduce greenhouse gas emissions in NYC"[5] as buildings contribute nearly three-quarters of all citywide emissions. The regulation sets out maximum emission levels that large office buildings (> 25,000 sf) can emit annually without being fined and is tiered with an initial 2024 benchmark that gives way to a more stringent hurdle by 2030. On a 2Q-2019 earnings call, REIT titan Steve Roth, CEO of Vornado Realty Trust, predicted that this regulation will "go universal across the whole country and probably the world as well"[6]. Matthew DiLiberto, CFO of NYC's largest office landlord, SL Green Realty Corp., reassured attendees at Bank of America Merrill Lynch's 2019 Global Real Estate Conference that "we've been ahead of this". He went on to warn that these "new regulations are probably much more onerous for those who have not been trying to upgrade and redevelop their portfolios and get ahead of this. They may be facing some more significant financial burden over the next 11, 12 years."[7]

We believe

We believe the cost of ignoring future environmental regulation is far more than just a capex backlog to retrofit buildings or a hike in insurance costs; we expect the ramifications to run through a company's P&L and spill over to asset values. The reason is simple: tenants will choose landlords that align with their personal values and own climate change commitments. It is our view, therefore, that regulation risk and social considerations are intimately linked when it comes to real estate.

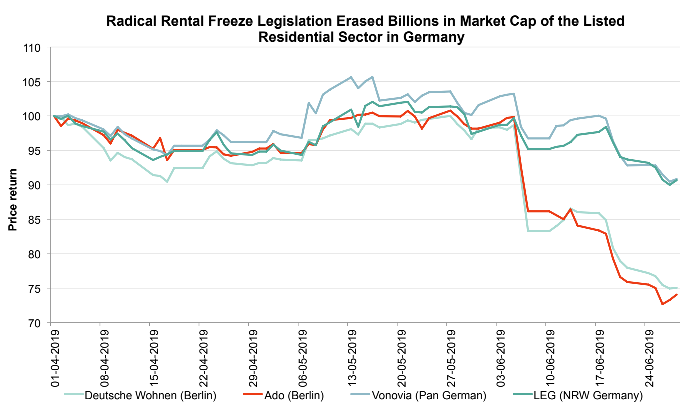
We believe

We believe investors may not be fully appreciating this social risk. The three largest US multi-family landlords (by market cap) are all trading at five-year highs despite an overweight to the US west coast and other "hot" rental markets. The continued strength in share prices relative to their German counterparts suggests that investors are optimistic that subsequent rental regulation in the US – should it materialize – will allow for continued rental growth. We believe, however, that investors might be underestimating the risk of more tenant-friendly US regulation in the future, especially that we calculated a 12-percentage point gap between the average "Social" score of the three largest US multi-family landlords and their German large-cap peers.

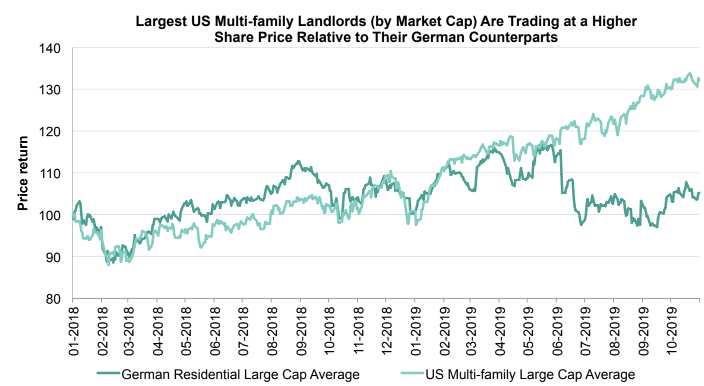
UK real estate heavyweights Landsec and British Land clearly understand how to wield this social power, with both devoting a meaningful portion of recent investor days to explain to capital market participants how their user-centric sustainability strategy drives value. Conversely, German residential landlords have been in the line of fire this year after housing activist Rouzbeh Taheri launched a campaign demanding the nationalization of large housing corporations in Berlin to ensure affordable rents and more democratic tenant treatment. With 85% of Berlin's population estimated to be renters, politicians were quick to acknowledge concerns of their voter base and responded with draft legislation for a radical rental freeze that erased billions in market cap of the listed residential sector in Germany in a matter of days.

Closer to home, we saw Oregon pass the first statewide residential rent control earlier in 2019. The new law caps rent hikes to existing tenants at 7% plus inflation during a 12-month period and bans tenant evictions without cause. Oregon's Governor, Kate Brown, said that the law "will provide immediate relief to Oregonians struggling to keep up with rising rents and a tight rental market."[8] A few months later California followed suit with an even stronger version of rent control called the "Tenant Protection Act" that limits annual rent increases to 5% plus CPI. During the campaign to have the bill passed, its proponents described it as an "anti-rent-gouging" law rather than conventional rent control, clearly insinuating that landlords were falling short on their social responsibility to tenants.

We believe that these types of rent controls are likely to gather steam in other democratic states in the U.S. and echo the sentiments of Christina Livingston, executive director of the Alliance of Californians for Community Empowerment (ACCE). Ms. Livingston believes that the California victory will inspire community and tenant groups around the country, saying that "tenants have been the sleeping giant in American politics. Now they are waking up."[9]



Sources: Bloomberg, L.P.; Presima Inc.



Note: German Residential Large Cap average is composed of the following large cap stocks: Vonovia, Deutsche Wohnen, LEG Immobilien. US Multi-family Large Cap average is composed of the following large cap stocks: AvalonBay Communities, Equity Residential, Essex Property Trust. Sources: Bloomberg, L.P.; Presima Inc.

PRICING THE DISCOUNT: MISSION IMPOSSIBLE?

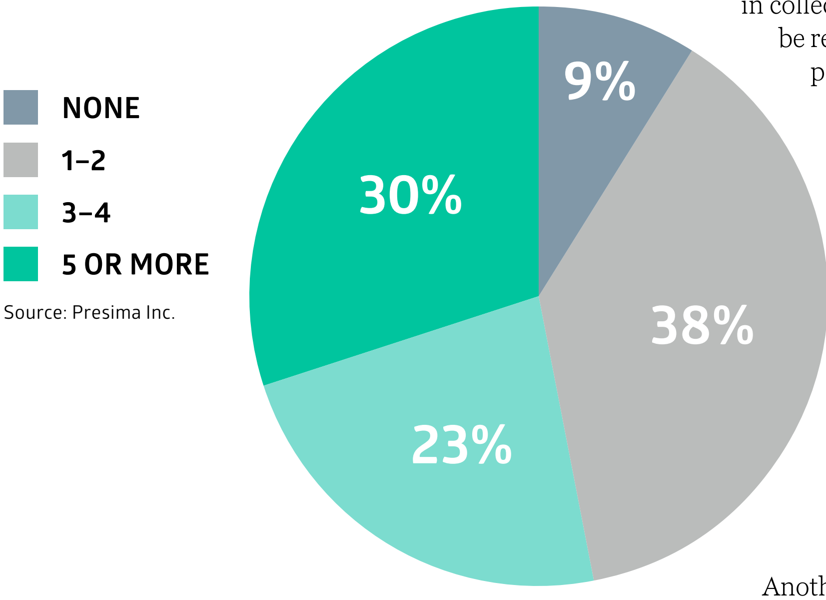
A wide array of competing building certification schemes and confusion around how to capture sustainability momentum make it difficult to ascribe a brown discount.

We wonder whether this apparent investor apathy stems from the myriad of challenges to price a company's brown discount. We acknowledge that there is a wide array of competing building certification schemes, with mainly voluntary standards, that differ across real estate asset classes and geographies, netting investors with a frustrating lack of comparability.

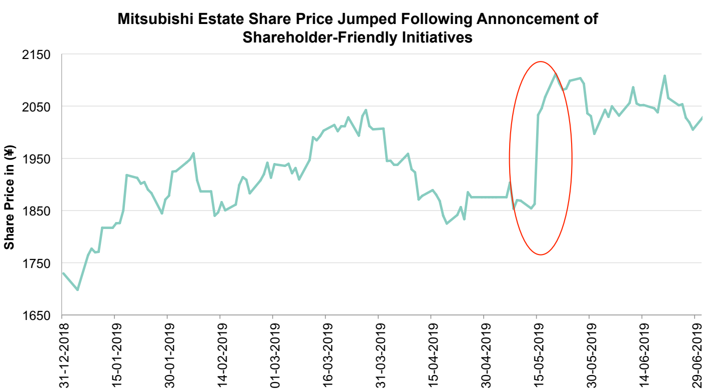
We surveyed

We surveyed a sample of 64 global companies at a recent real estate conference in New York and found that 30% will submit ESG-related data into five or more reporting frameworks over the coming year, while a further 23% will report into at least three. The result is that, despite a rise in real estate companies' disclosure on sustainability performance, investment grade data is not widely available to investors.

OVER THE NEXT 12 MONTHS, HOW MANY CLIMATE-RELATED OR SUSTAINABILITY REPORTING FRAMEWORKS WILL YOU SUBMIT DATA FOR?



Source: Presima Inc.



Source: Bloomberg, L.P.

Even if one can sort through the maze of green certifications, a building label indicates potential, not reality. **Certifications indicate that a building has the capacity to be energy efficient, but actual consumption comes down to human factors and how tenants use the space.** Continuing down the rabbit hole, there are challenges in collecting accurate consumption data because tenants may be responsible for paying energy expenses directly to utility providers, leaving landlords fumbling to pin down the full energy cost of a given asset. It is not surprising, therefore, that less than half of listed real estate companies disclose carbon emissions data for their portfolio and that only one in five is currently able to collect and disclose asset level data for 100% of their holdings.[10]

To add insult to injury, corporates are being asked to submit sustainability-related data to competing disclosure frameworks, translating into a heavy reporting burden for those companies trying to do the right thing and improve sustainability disclosure.

Another aspect that makes calculating an appropriate brown discount difficult is sustainability momentum. For example, Japanese Developers have traded at a perpetual discount to net asset value, which was often attributed, at least in part, to sub-par governance practices. However, it was difficult to know how much sub-par governance was "priced in" until Mitsui Fudosan and Mitsubishi Estate each took big steps to improve their relationship with equity investors.

In May 2018, Mitsui Fudosan announced a package of shareholder-friendly initiatives that saw its share price spike in response. A year later, the rival developer Mitsubishi Estate prepared to release its annual results and we saw a strong likelihood that management would follow its peer by announcing initiatives aimed to close its share discount vis-à-vis private markets. Investors who seized the opportunity to capture this governance momentum were rewarded when shares jumped after the company announced a substantial share buyback and cancelled its poison pill provision.

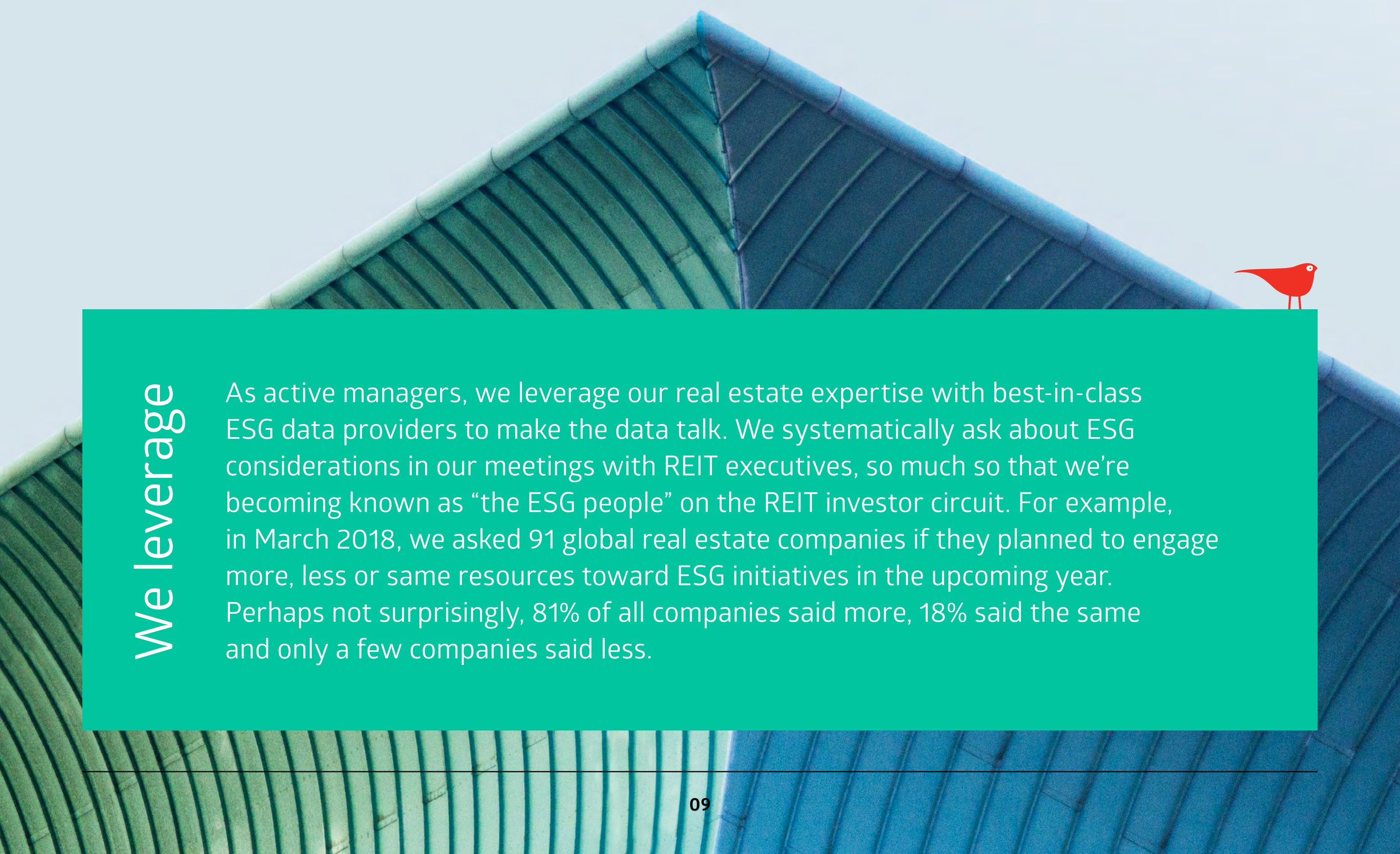
THE MOSAIC THEORY IN PRACTICE

Pricing the elusive brown discount is possible!

While not a perfect science, we have developed an approach to price brown discounts. Our view is that ESG considerations are a measure of risk and should be captured in a firm's cost of capital. As such, we don't employ negative screening, but rather integrate ESG into every valuation model so that we are appropriately compensated in the case of a higher perceived risk. For us, ESG risk makes the connection between material ESG issues affecting real estate and how effective management teams are managing and mitigating these risks. The result is an ESG risk metric that is comparable across our global real estate universe of 300+ securities, with flexibility to zoom into underlying E, S and G performance metrics.

In line with other risk considerations, we leverage ESG risk scores as an adjustment factor in deriving a company's cost of equity. For example, a best-in-class REIT, as measured by a low ESG risk assessment, will receive a nominal adjustment to its cost of equity, while a laggard will be penalized with a meaningful increase.

Our ESG integration process means that we can relative-rank our investment universe according to apples-to-apples ESG risk scores, regardless of sector or geography. We can further drill into these relative rankings to screen for the ESG attributes that we find most (and least) attractive.



We leverage

As active managers, we leverage our real estate expertise with best-in-class ESG data providers to make the data talk. We systematically ask about ESG considerations in our meetings with REIT executives, so much so that we're becoming known as "the ESG people" on the REIT investor circuit. For example, in March 2018, we asked 91 global real estate companies if they planned to engage more, less or same resources toward ESG initiatives in the upcoming year. Perhaps not surprisingly, 81% of all companies said more, 18% said the same and only a few companies said less.

HOW WE USE THE BROWN DISCOUNT TO DESIGN CLIENT-CENTRIC SOLUTIONS:

One of our existing clients wanted to reduce its exposure to poor ESG performers that might cause big volatility swings in its portfolio, even if ostensibly being paid for taking on that risk.

We closely collaborated on an investment solution that resulted in identifying a bespoke ESG universe for stock selection that we layered onto the existing investment process.

The result of relative ranking and screening for low ESG risk characteristics left us with c. 200 global securities for stock selection and a client-centric solution in terms of both investment and sustainability objectives.

In September 2018, we identified 17 stocks held across our strategies that received a poor score for "minor to severe concerns regarding the level of gender and/or national diversity on the board". The context being that groupthink is a commonly named culprit of the Global Financial Crisis and we wanted to acknowledge that it may present a risk for these companies. Consequently, our investment professionals set off for global fall due diligence activities armed with relevant and material ESG information with which to engage with companies.

In March 2019, we asked 109 global real estate companies if they had seen any quantifiable income returns from their ESG activities. Eleven companies cited returns from their investment in solar panels (quoted in the range of 10-11%). The resulting energy cost savings can drive margin expansion for the company or be passed on to tenants, thereby allowing landlords to push top-line rental growth. Many companies remarked that they undertake ESG activities to pursue ratings upgrades. This can lead to inclusion in new indexes (e.g. MSCI ESG) and, in turn, give access to a lower cost of financing through green bonds/private placements. Nearly half of respondents could not identify (or quantify) tangible returns on ESG initiatives. In many cases, however, companies countered that leasing would suffer without ESG measures and that this nature of investment was the right thing to do for the long-run, supporting our view that a brown discount is emerging.

Overall, while we acknowledge that there is more than one approach to determine the appropriate brown discount for a company, region, and/or real estate sector, we remain steadfast in our conviction that a brown discount is warranted for sustainability laggards. Non-standardized sustainability frameworks and variable ESG disclosure means it is difficult to see what's priced in, but at Presima, we specialize in identifying mispricing. **ESG mispricing is an extension of our core competency and we think we have an edge.**

NEXT GENERATION DISCOUNTING: LET'S GET PHYSICAL!

We are always scanning the horizon for emerging risks. We believe physical climate risk considerations will be the next wave of inputs in the brown discount equation. When meeting with US lodging companies at a recent real estate conference in New York, executives indicated that insurance costs were up 20-50% year-over-year as a result of increased natural events, such as hurricanes. We have also seen evidence of several major US insurers beginning to exit certain catastrophe-prone markets in the US.

So, is there a stranded asset risk in our sector? Yes and no…a company executive explained that lodging REITs have insurance on their pool of assets, so if one asset were to become uninsurable they would be forced to sell, likely at distressed pricing. It will be up to investors to determine the magnitude of "distress" to apply to portfolio valuations, but we argue that ignoring physical climate risk in a sector of immovable assets is a fool's game.

To conclude, a sustainability orientation is not a nice-to-have, it's necessary for long-time survival in our space. Speaking at the European Public Real Estate Association's annual conference in September 2019, Helen Gordon, CEO of residential landlord Grainger PLC warned property companies that it was no longer acceptable to have a purely asset-focused outlook. **"If you're thinking about a building and not thinking about the environment in which it sits and the town in which it sits, then you're not doing your job,"** she asserted.

At Presima, we are blowing past the data challenges to focus on what matters and we're asking the right questions to ensure we get paid for ESG risks. It's time to ask yourself, are you getting compensated for your brown discount?

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