Principal Real Estate

Principal Asset Management℠

Understanding carbon neutrality and its impact on European core real estate

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Real estate's environmental impact is significant. In the European Union, buildings are responsible for 40% of overall energy consumption and 36% of greenhouse gas (GHG) emissions, much of which is generated from the construction and operation of properties.[1]

At the same time, three out of four EU buildings are considered energy inefficient.[1]

Core real estate investors have demonstrated a desire to change these dynamics and continue to make environmental, social, and governance (ESG) factors a top priority.

Achieving carbon neutrality has become paramount as organisations are increasingly committing to reducing their carbon footprint. This goal has already altered the capital markets landscape and is only set to become more predominant among businesses, governments, and investors. The number of real estate companies and investment funds focused on carbon neutrality continues to increase at a rapid pace, accelerated by the European Commission's adoption of regulations aimed at achieving net zero carbon by 2050.[2]

But not all approaches to carbon neutrality are equal. Business leaders are often quick to agree to long-term carbon reduction goals without a full understanding of implementation at the individual property level.

To understand exactly how a company or fund plans to meet their stated carbon reduction goals, investors should be prepared to ask several important questions when evaluating initiatives and measuring results.

Definitions matter

One of the biggest obstacles to understanding a carbon reduction programme's impact is a lack of a uniform definition and consistent approach to carbon neutrality. The path by which funds achieve carbon neutrality can vary greatly depending on what activities are pursued, such as emissions reduction via operational improvements versus purchasing environmental attribute certificates (EACs) and carbon offsets.

Carbon neutrality: Five key questions for core fund due diligence:

1. What emission sources are included?
2. How is the fund's carbon footprint measured?
3. What types of emissions reductions count toward a target?
4. Are tenants actively engaged and included in the target?
5. What processes are in place to identify energy efficiency and renewable energy? Opportunities?

While the term "carbon neutrality" can be loosely applied to a wide array of practices, it's essentially a commitment to balancing GHG emissions through a combination of emissions-reductions activities and the purchase of EACs and carbon offsets.

There are, however, many more considerations to take into account when trying to understand how a firm or fund is moving toward this goal. You'll find them below.

Emission criteria: What's included?

Often, sustainability reports will include carbon neutral claims front and center—but with scant details around how exactly carbon neutrality will be achieved.

An investor should also understand which emissions are included to accurately assess the quality of a carbon neutrality goal.

There are two main categories of emissions: direct and indirect (see Exhibit 1). Direct GHG emissions (Scope 1) are from company-owned sources, such as heating fuel, gas in company vehicles, or leakage from refrigerants. Indirect GHG emissions (Scopes 2 and 3) can come from the consumption of purchased electricity or a company's activities outside of its control, such as employee travel or tenant emissions.

Understanding which of these emissions are counted can be critical to assess a company's true carbon footprint and reduction goals.

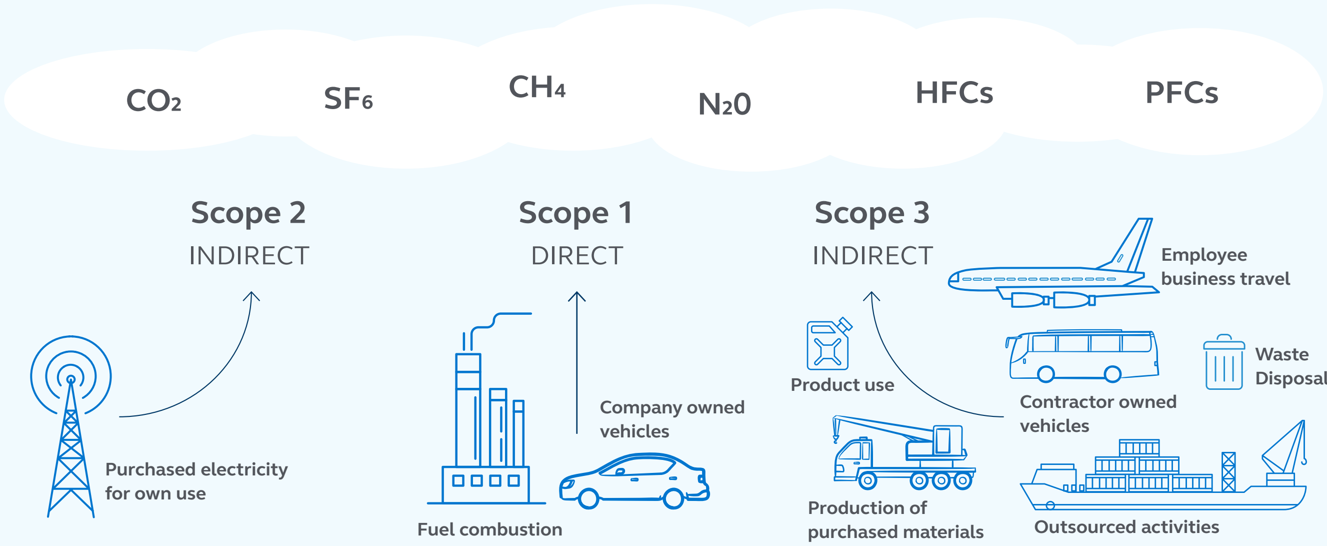
[1] https://ec.europa.eu/info/news/focus-energy-efficiency-buildings-2020-feb-17_en
[2] https://eur-lex.europa.eu/resource.html?uri=cellar:d84ec73c-c773-11eb-a925-01aa75ed71a1.0021.02/DOC_1&format=PDF

For example, a real estate portfolio that excludes tenant energy consumption from its footprint could easily overlook the vast majority of emissions occurring within its properties.

In addition, a business could theoretically measure its emissions and then buy carbon offsets the next day and claim to be carbon neutral without verifying the quality of the offsets or making any attempts to reduce operational emissions.

While technically the business would be carbon neutral—because they are balancing emissions with offsets—this is not nearly as impactful, or defensible to investors, as taking steps to increase energy performance through operational improvements. Therefore, a savvy investor should care not just about which emissions are included in the footprint, but also the source of emissions reductions and how it changes over time.

Exhibit 1: Overview of a company's activities associated emissions, and their scopes, as defined by the Greenhouse Gas Protocol Corporate Standard



Source: The Greenhouse Gas Protocol: A Corporate Accounting and Reporting Standard, March 2004
*Carbon dioxide (CO2), methane (CH4), nitrous oxide (N2O), hydrofluorocarbons (HFCs), perfluorocarbons (PCFs), sulphur hexafluoride (SF6) and nitrogen trifluoride (NF3)

The importance of tenant engagement

On average, the total emission from a property comes mostly from tenant activities. In some instances, such as with warehouses, nearly 100% of emissions are from the tenant.

But a large number of emissions reduction claims from property owners only count certain tenant emissions or not include these emissions at all.

While this might have been acceptable in the past, stakeholders now expect tenant activities to be captured. Some would argue that if a property owner isn't trying to influence tenant emissions, then they are likely not carrying out an effective carbon reduction programme at all.

For any successful carbon reduction strategy, tenants must work openly and in-line with owners for targets to be met.

Engaging tenants early on—whether through a detailed survey on carbon neutrality issues or an assessment to determine what ESG considerations are most important to the tenant—will help ensure an ongoing partnership to meet stated goals for the business and tenant. Ultimately, this type of engagement helps investors and other stakeholders have a better understanding of a property's carbon footprint.

Asset-level data is key

When evaluating the carbon reduction programme for a company or fund, data availability is critical. Identifying data gaps, making estimates where possible, and having a plan to improve coverage over time are all important evaluation tools.

It's one thing to make a broad carbon neutrality claim, but it's another thing entirely to back up that claim with a complete data set.

Access to tenant utility data can be particularly challenging, especially in a triple net lease arrangement where the tenant is paying their own bills. However, getting access to high-quality property-level data—whether through tenant outreach, metering solutions, or working directly with utilities—is necessary to prioritise improvements and track progress.

A complete data set of whole-building energy data also allows businesses to more accurately measure their GHG emissions, set and achieve meaningful carbon reduction targets, and monitor progress over time.

Many core funds in this space have little access to this type of data, even as it is a key foundational element to any successful carbon reduction programme. Investors should be wary of any fund or business without access to a robust and accurate data set.

Exhibit 2: Principal Real Estate—Innovation through ESG and sustainability

As fiduciaries for our investors, we understand, quantify, and act upon ESG through our unique Pillars of Responsible Property Investing (PRPI) ESG platform. This platform seeks to deliver positive financial and environmental, social, and governance results by focusing on five pillars throughout the investment life cycle: environmental performance, occupant experience, community impact, climate resilience, and managerial excellence.

IMPACT

Performance: 2020 Targets[3]

14.5% cumulative energy savings

21.2% cumulative GHG reduction

12.8% cumulative water savings

***2035 Targets[4]**

Greenhouse gas emissions:	-40%
Energy use intensity:	-20%
Water use intensity:	-20%
Waste:	20% diversion
Data coverage:	50%
Renewable energy:	20% of energy use
Building certifications[5]:	50% of portfolio

***2050 Target**

Net Zero carbon emissions

*There is no guarantee these targets will be reached.

ACCOMPLISHMENTS

PRI

Signatory to the Principles for Responsible Investment (PRI) since 2010[6]

GRESB 4-Star rating (2022)[7]

U.S. Core strategy, *7th consecutive year*

European Core strategy, *3rd consecutive year*

European Office strategy

The Firm paid GRESB an application fee to be evaluated and use the ranking

GRESB Green Star rating (2022)[8]

Nine strategies (U.S. and Europe)

The Firm paid GRESB an application fee to be evaluated and use the rating

ENERGY STAR
Partner of the Year (2016-2022)[9]

Sustained Excellence 2018-2022

Green Lease Leader Gold Recognition[10]

Second consecutive award, 2017, 2020

Effective programmes are a win for all stakeholders

ESG policies and initiatives, including the implementation of carbon neutrality proposals, will continue to be a top priority for investors, occupiers, and landlords. We believe the transition to a lower carbon economy begins at the individual property level and that prioritising high-impact operational emissions reductions will help create measurable change.

In addition to improving environmental performance, core funds that implement effective carbon neutrality programmes can reduce operating costs, ultimately benefiting investors. Moreover, a rapidly changing regulatory landscape, driven by the exploration of new topics such as embodied carbon, will continue to impact carbon footprints.

As this landscape evolves, we as a firm remain focused on our own sustainable business practices. These include assessing our impact to the climate and adopting responsible investing policies, as stated in our unique Pillars of Responsible Property Investing (PRPI) ESG platform.

Effective carbon reduction programmes will improve the performance and value of properties and ultimately help redefine the relationship between real estate and carbon. We believe that funds with a well-defined programme focused on true property-level emissions reduction will emerge as the beneficiaries in this environment.

[3] Targets ended 12/31/2020, baselines were individually set and generally date back to 2008 (irrespective of potentially earlier acquisition date). [4] Performance relative to a 2019 baseline. [5] 50% of portfolio. [6] Principal Global Investors has been a signatory to UN PRI since 2010. [7] 2016 - 2022 Global Real Estate Sustainability Benchmark (GRESB) assessments for Principal Real Estate's U.S. Core strategy representing data from 31 December 2015 to 31 December 2021; 2020 – 2022 GRESB assessments for Principal Real Estate's European Core strategy representing data from 31 December 2019 to 31 December 2021; 2022 GRESB assessment for Principal Real Estate's European Office strategy representing data from 31 December 2021. 4-star rating reflects top 40% worldwide performance. [8] Awarded to Real Estate entities with a score higher than 50% of the points allocated to the Management and Performance components. Entities with more than 15 points in Management and 35 points in Performance OR 15 points in Management and 35 points in Development will receive the Green Star designation. This rating is based on absolute performance. [9] The U.S. Environmental Protection Agency (EPA) annually honors organizations that have made outstanding contributions to protecting the environment through energy efficiency, April 2022. [10] IMT and the U.S. Department of Energy's Better Building Alliance awards landlords and tenants who incorporate green leasing to drive high-performance and healthy buildings. http//www.greenleaseleaders.com.

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Investing involves risk, including possible loss of principal. Past performance does not guarantee future results. Potential investors should be aware of the risks inherent to owning and investing in real estate, including: value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate.

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