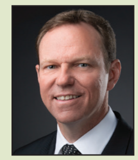
Principal Real Estate Investors

ESG and real estate — Evolving drivers of value

Recently, **Chase McWhorter,** Institutional Real Estate, Inc.'s managing director, Americas, spoke with members of the leadership team at Principal Real Estate Investors — **John Berg,** senior managing director, head of private equity portfolio management; **Russ Beecher,** managing director, acquisitions/dispositions; and **Jennifer McConkey,** senior director, operations and sustainability — about how the firm is applying ESG principles. An excerpt of their roundtable conversation follows.

CONTRIBUTORS

John Berg
Senior Managing Director, Head of Private Equity Portfolio Management



Russ Beecher
Managing Director, Acquisitions/ Dispositions

Jennifer McConkey
Senior Director, Operations & Sustainability

Sustainable real estate is a hot topic, even though it has been around a long time. Principal has been a leader in "green" real estate, but how have you seen it evolve over the past several years?

John Berg: The real estate industry has evolved from a green, environmental focus on energy and cost reductions to a much more robust environmental, social and governance program embedded into the entire real estate lifecycle. Investors used to ask if you had an ESG policy. Now they want to know, "What is your ESG policy? How is it implemented? Who is responsible for the strategy, and how do you measure results and progress?" We benefit today from an abundant amount of evidence that responsible property investments can achieve both positive environmental and financial outcomes.

Russ Beecher: According to the RE Tech Advisors ESG Sentiment Survey (January 2019), between 2007 and 2019, socially responsible real estate funds achieved gross returns of 5.62 percent, compared with 5.08 percent for non–socially responsible funds, a 54-basis-point difference. Additionally, green-certified buildings generally have positive sale and rental premiums compared with non-green buildings, as well as 9 percent to 14 percent lower operating costs, and 9 percent higher occupancy rates. There is also an expansion of the universe of tenants and buyers requiring high-performing, energy-efficient buildings that foster healthy working and living environments.

Jennifer McConkey: The other evolution we are seeing is investor demand for transparency, data collection and reporting. More investors are participating in industry reporting and benchmarking programs. For example, investor members in GRESB [the global ESG benchmark for real assets] increased by about 22 percent in 2020, and it now accounts for more than $30 trillion in assets under management. The signatories to PRI [Principles for Responsible Investment] also have increased from 100 in 2006 to more than 3,000 in 2020, now representing about $100 trillion in AUM. In the United States, there are more than 36 active benchmarking regulations, and 19 others that really go beyond benchmarking, such as auditing, retro-commissioning and performance requirements. In Europe, there is the E.U. Taxonomy, the Sustainable Finance Disclosure Regulation and the Non-Financial Reporting Directive.

What trends or developments are you seeing in the industry in response to this evolution of the ESG landscape?

McConkey: The key trends right now are carbon neutrality, climate risk, health and wellness, social action and the expansion of niche property type investment. The trend toward carbon neutrality in utility consumption is shifting from energy savings to carbon neutrality, and although saving energy is still important, the focus on decarbonization is key, especially as regulations regarding carbon emissions become more prevalent. There has been five-fol growth in carbon targets between 2016 and 2020, with nearly 30 percent of Fortune 500 companies announcing some type of goal. At Principal, several of our funds are currently evaluating carbon-neutrality goals and approaches. And recently, Principal Financial Group committed to a 40 percent reduction in carbon by 2025 and net-zero carbon by 2050.

The second development is climate risk. As the likelihood of extreme weather events has increased, climate risk potentially impacts our investment decisions, how we operate buildings and how we address risk mitigation strategies. In 2020, we saw 22 $1 billion weather and climate disaster events in the United States, and it was the sixth consecutive year with 10 or more $1 billion weather and climate disaster events. As part of our property-acquisition process, our acquisitions and portfolio-management teams review both physical and transition risk, and appropriately incorporate changes into our underwriting. Then, upon closing, we work with the asset managers and property managers on those risks and provide climate prescriptions, outlining risk-mitigation strategies for each identified risk on an ongoing basis. So we have a comprehensive strategy in our acquisition process to proactively address climate risk in our underwriting and specific measures for the ongoing operations of the building.

The third trend is health and wellness. Although this trend started prior to COVID-19, the pandemic accelerated the focus on health and wellness. Tenants and occupiers are recognizing the impact of the built environment on human health and selecting buildings with strong health-and-wellness offerings. The World Green Building Council reported a 69 percent increase in tenant satisfaction and engagement due to healthy-building features. This is encouraging property owners to proactively implement healthy-building strategies. Long before COVID-19, we developed a health-and-wellness policy our internal staff and property teams have used for the foundation of their health-and-wellness programs. Principal further solidified that commitment by becoming a Fitwel

Champion in 2021. As vaccination rates rise and more people start returning to the office, we are seeing an increased green-building premium compared with non-certified counterparts.

Berg: Other key trends are the increased focus on social action and its importance in an overall ESG strategy, as well as expanded investor interest in niche property sectors, including life science, medical office, single-family rental and manufactured housing.

You've touched on this a bit, but how is Principal responding to the changing ESG dynamics?

McConkey: Principal has a longstanding commitment to environmental excellence and efficiency through our Pillars of Responsible Property Investing (PRPI) initiative, which is our ESG platform. This platform guides our investment management practices and is used by both Principal and our property-management partners. There are three pillars that make up this platform. The first is property performance, which involves improving each building's competitive stature — reducing costs and delivering enhanced value and environmental performance, mainly through a reduction of energy, carbon, water and waste consumption, as well as the implementation of operational best practices. The second pillar is market resilience, which is our social pillar, and it is about reinforcing the social and economic vitality in markets where we do business, to help strengthen the local economies, foster a healthy and productive environment for our tenants, and reinforce the ESG performance of our properties. The third pillar is around corporate governance, and it involves managing risk and meeting investor objectives through a commitment to the highest ethical standards and integrity. These concepts are deeply rooted in our overall culture at Principal.

How do you measure success in ESG?

McConkey: Data is paramount. It is the foundation of everything that we do and helps drive our decision making. Our PRPI platform is built upon data collection and the importance of benchmarking ESG data, including, but not limited to, utility consumption, which starts at the property level. We use the data we collect to monitor that progress toward environmental and reduction targets. This helps us identify properties that need additional assistance and determine which property management partners are performing well, as well as inform the capital improvements and efficienc projects we may need to implement. Tracking this data and using this granular approach enables us to understand, not only how each asset is performing, but how each fund is performing and the portfolio as a whole.

Beecher: The consistent portfolio-wide implementation of our PRPI platform has really helped us achieve strong results from its implementation in 2013 through to the fourth quarter of 2020. The PRPI program has led us to more than $51 million in cumulative energy savings and a 21.2 percent reduction in GHG emissions, surpassing our 10 percent GHG emissions reduction goal by 2020. Furthermore, as of the first quarter of 2021, 77 percent of our office square footage is green certified. Additionally, industry benchmarks and frameworks help us monitor our progress and communicate our success to stakeholders, which increases our transparency. This is the fourth consecutive year we have ranked A+ for PRI, the fourth consecutive year we have received four stars on GRESB awarded to the top 40 percent worldwide, and the seventh consecutive year we have been awarded the GRESB green star, awarded to entities that earn more than 50 percent of points in the development, management and performance components.

Where are you seeing opportunity to create value for investors?

Berg: In this highly competitive market for existing assets — especially industrial and multifamily properties — we are leveraging our value-add and development capabilities and leaning on a strong foundation of the PRPI program for our operational assets. Given the growth drivers supporting industrial and multifamily, we continue to view value-add and new development of these property types as offering some of the best relative value available in the marketplace today. New development represents a unique opportunity, as we can develop an ESG strategy for the entire lifecycle of a property. This process starts early with design and construction, providing recommendations for developing the sustainability strategy, site selection, evaluating the site for renewable energy, low-impact design and materials, pursuing building certifications, and creating positive impact on the community. Development has significant economic, cultural, social and environmental implications for communities and can act as a catalyst for growth and renewal.

How do you accomplish ESG goals in industrial and multifamily, considering these property types are usually tenant controlled?

Beecher: For operational assets, a strong property-management and tenant-engagement program is key for the successful integration of ESG strategies — and that is essential for multifamily and industrial product types. Over the last year, we have added more than 100 industrial and multifamily assets into the PRPI initiative, and this provides property managers and tenants access to our library of education resources and engagement tools for building initiatives and sustainability measures that can reduce environmental impact, cut operating costs and improve the occupant experience. We have also developed standard lease language that fosters collaboration between the landlord and tenants or residents. These engagement strategies help develop strong tenant/landlord partnerships. We realize our property management teams are critical to the success of the PRPI initiative — each property manager, building engineer, and service and product provider has an important role in contributing to the overall success of our real estate investments and providing value to our tenants, residents, shoppers and guests. Our PRPI initiative is central to the everyday work of our asset management team and operations team in working with our property management team, and ultimately our tenants and residents, to focus on this ESG component and create a better environment at the asset level. The expectations around ESG are very clear, and they are part of the contractual agreement with our property managers. ESG is part of their responsibilities, just like leasing and operating the building.

COMPANY OVERVIEW

Principal Real Estate Investors is a top-10 global real estate manager with more than 60 years of commercial real estate experience and expertise that spans the spectrum of public and private equity and debt. Our specialized market knowledge, dedicated and experienced teams, and extensive connections across all four real estate quadrants allow us to maximize opportunities and find the best relative value on behalf of our clients. Visit our website at www.principalrealestateinvestors.com

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