ESG 2.0:
The evolution of ESG trends and metrics

Environmental, social, and governance (ESG) factors have become a critically important topic for the commercial real estate industry. Since the onset of the pandemic, much has changed regarding how investors and asset managers view ESG, including how these factors impact risk and returns. Today, investors expect ESG to be considered throughout a manager's decision-making process.

Principal Real Estate Investors recently hosted a panel of industry experts to discuss the evolution of ESG in real estate, including current trends, the drivers of these changes, and the resulting landscape of reporting, scores, and metrics. Following is a summary of the key points from the discussion.

JENNIFER McCONKEY
Senior Director of Operations and Sustainability
Principal Real Estate Investors

DEBORAH CLOUTIER
President and Founder
RE Tech Advisors

BILLY GRAYSON
Executive Director
Urban Land Institute

Drivers of ESG trends

Deborah Cloutier, President and Founder of RE Tech Advisors, spoke about the drivers of ESG trends for commercial real estate. She noted that the landscape is evolving quickly, and there are multiple mega trends occurring across all geographies. These include the changing expectations of tenants and residents regarding health and wellness, the massive wealth transfer between baby boomers and millennials, and the fast-paced disruption of technologies that are impacting all aspects of our lives.

Climate change is a good way to understand how ESG intersects with the real estate industry. Looking at the physical and transitional risks of climate change from the property and casualty losses of the insurance industry, we can clearly see the financial impact. In 2020, there were 22 weather and climate disasters with losses exceeding a billion dollars each, totaling approximately $95 billion in property losses and damages. Globally the national natural catastrophe losses covered by insurance is totaling $40 billion as of the second quarter of 2021. We're seeing insurers invest significantly in building state of the art climate models to better understand global warming impacts and rebalance their premiums and pricing strategies. The near-term effect is the rise of global commercial insurance prices by 15% in the second quarter of this year, the 15th consecutive quarter of rate increases.

The largest pension funds are analyzing financial risk as well. CalPERS is reporting that 20% of its $180 billion equity portfolio faces financial risk due to climate change issues. And financial analysts are projecting by 2030 more than 15% of the current S&P National Municipal Bond index will be issued by cities suffering likely yearly economic losses of up to 1% of their GDP if significant climate action is not taken. Perhaps the most visible example of the drivers of ESG is the flow of capital into ESG funds. In 2020, $51 billion flowed into ESG funds, an annual record for net flows for the fifth calendar year in a row. For those investors caught off guard by climate risk, these changes are going to be painful. Those who are prepared will have an opportunity to outperform their peers.

The "E" evolution

Billy Grayson, Executive Director of the Urban Land Institute, talked about the evolution of environmental concerns in real estate. New carbon disclosure and reporting requirements in the European Union, Hong Kong, Switzerland, and over a dozen major cities came out in 2020, and soon there will be new regulations in the United Kingdom, China, and possibly even the United States. Along with these new regulations is a significant increase in government funding to drive climate mitigation and a path to zero. Last year China, Canada, and Germany created new stimulus opportunities for green buildings and Singapore issued a $100 billion plan. More recently, the U.S. infrastructure bill included more than $50 billion toward climate mitigation activities. However, the amount of private capital commitments to drive us on a path to net zero carbon is around $15 trillion.

There is a proliferation of funds looking to invest green capital in real estate, as well as a proliferation of green bonds. Significantly more developers and investors are taking a close look at the climate risk of their current portfolio and building climate risk analysis into their development and acquisition strategy. As extreme weather events increase in frequency and magnitude, it's even more important to not just assess these risks but to also start pricing them into deals. Virtually all major investors are now working with a software provider or consultant to map their physical risk.

Prioritizing social considerations

The "S" in ESG has gone through a radical transformation in the wake of the pandemic. Grayson said that owners and tenants have become more aware of the link between health and the built environment. Buildings can make you happier, sleep better, and aid creativity and productivity. Light nourishment, fitness, and effective ventilation are other design strategies that are helping generate value and achieve some meaningful social goals. COVID-19 accelerated this trend with the refined focus on being healthy from airborne diseases. The focus turned almost exclusively to ventilation sanitation and spacing and we're just now getting back to a more holistic view of what healthy buildings really mean.

The pandemic environment also rewarded developers in cities that are flexible and adaptive with space, including outdoor space. This allowed those that were able to provide onsite health care services to build a connection with their communities. This was not only a good community development and community building social strategy, but it also led to an activation of retail and hospitality services at the properties. The last year has been a reminder of the persistent issues we face around inequality, racism, and social justice. This has impacted corporate ESG strategies as companies, including in real estate, have enhanced and refined diversity programs. New approaches to community engagement and development have emerged, including community center design, urban planning projects, and reconnecting neighborhoods.

The importance of "G"

Good governance continues to be the foundation of ESG. Cloutier talked about the importance of governance being demonstrable and increasingly moving toward new standards and more consistent measurement of performance. The top asset managers already have strong governance in place, so the question is really how governance is evolving from an environmental and social perspective. Governance is becoming the framework by which to evaluate an organization's commitment and the way in which the "E" and "S" commitments and performance are being tracked and communicated to investors and other stakeholders. In the absence of regulation, there is a growing body of standards focused on greater transparency. The most well aligned frameworks for real estate standards (e.g., GRESB and Principles for Responsible Investment or PRI) can be used to benchmark and communicate performance.

Principal's ESG commitment

Jennifer McConkey, Senior Director of Operations and Sustainability at Principal Real Estate Investors, spoke about the firm's longstanding commitment to ESG. In 2013, Principal Real Estate Investors launched an initiative called the Pillars of Responsible Property Investing (PRPI), an investment platform to deliver positive financial and ESG outcomes through outstanding asset management fiduciary governance by creating positive environments for our tenants and our residents. We created portfolio-wide environmental targets, including a greenhouse gas and reduction target of 10%, which we were able to surpass. We have been working on enhancing our ESG platform to include additional topics and trends and align with new key performance indicators to track and monitor our ESG progress. We are constantly assessing how to mitigate climate risk, which has been informing the development of new environmental targets.

Principal Financial Group recently announced four ambitious ESG commitments—two of which are a 40% greenhouse gas emission reduction by 2035 and net zero by 2050 and alignment with seven United Nations Sustainable Development Goals (UN SDGs). Our enhanced platform may help Principal stay ahead of the market and evolving expectations and requirements.

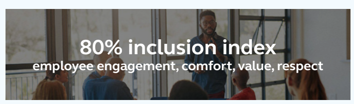
Exhibit 1: Principal carbon targets

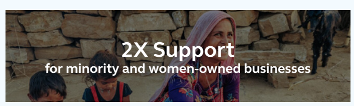
PRINCIPAL REAL ESTATE 2020 TARGETS

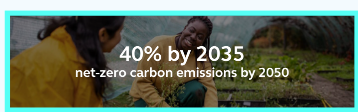
- **Energy:** 20% reduction
- **GHG:** 10% reduction
- **Water:** 10% reduction
- **Waste:** 10% diversion

Baselines are individually set and vary depending on the date properties were purchased and when the first 12 months of reliable utility data is available.

PRINCIPAL FINANCIAL GROUP TARGETS







https://www.principal.com/sustainability

ENHANCED PRINCIPAL REAL ESTATE TARGETS

- Energy
- GHG
- Water
- Waste
- Data coverage
- Renewable energy
- Building certifications

One of our key initiatives this year was implementing a climate risk and resiliency process as part of our new property acquisition and development due diligence. Using third-party software and several public databases, our acquisitions and asset management teams review both physical and transition risk and work with the Principal engineers and property condition consultants to understand any potential property impacts. From there, we incorporate any necessary changes into our underwriting. We then work with the property's asset and property managers on mitigating any identified risks.

Additionally, we plan to monitor and track the social and community impact across our properties. This includes things like walk, bike, and transit scores, tenant and resident satisfaction, and job creation, as well as number of affordable and workforce housing units. We are focused on health and wellness in our buildings, too. In 2020, we became a Fitwel champion with four Fitwel-certified buildings and are in the process of certifying 17 more.

In addition to health and wellness, diversity is also a top priority. Specific to real estate, to help attract, retain, and advance women in the organization in 2016, Principal Real Estate Investors established an internal Women in Real Estate group (WIRE) with a mission of creating development and networking opportunities, promoting an inclusion and diverse organizational culture, and cultivating leadership in the global real estate investment management industry. Principal Real Estate Investors also supports the Iowa Chapter of Commercial Real Estate Women (CREW). Lastly, to support students from underrepresented populations, Principal Real Estate Investors has established a scholarship program that offers up to $7,500 per student per year for four years.

Exhibit 2: Principal's external reporting and disclosure frameworks

EXTERNAL REPORTING

PRI Direct Property Assessment
A+ band ranking[1]
fourth consecutive year, 2020
*highest possible rating

GRESB
4-Star rating[2]
sixth consecutive year, 2021
*represents top 40% wordwide performance

CDP
Eight-time CDP S&P 500 Climate Performance Leader, 2020

DISCLOSURE FRAMEWORKS

Principal FInancial Group aligns with:

[1] Performance band score of "A+" by earning 50 out of 51 maximum points in the PRI 2020 assessment.
[2] 2021 Global Real Estate Sustainability Benchmark (GRESB) assessment, data as of 31 December 2020.
[3] 2020 CDP Climate Change Response, data as of 31 December 2019.

Corporate governance is a foundational element of our PRPI initiatives, so managing that risk and meeting investor objectives is done through a commitment to the highest ethical standards and integrity. These are concepts that are deeply rooted in our overall culture. We have a number of protocols in place to help strengthen internal and external accountability, transparency, and operational control. We use a system of checks and balances to help prevent conflicts of interest and preserve the integrity of our overall investment processes. We have also implemented standardized internal and external policies and procedures as well as oversight measures to help ensure compliance. Finally, we participate in industry reporting where we monitor and disclose key financial and environmental metrics to provide transparency to our stakeholders. These efforts have earned us recognition, including an A+ rating from the PRI Direct Property Assessment for four consecutive years.

Beyond these current initiatives, Principal Real Estate Investors remains focused on ESG and sustainable practices. We continue to build upon our ESG legacy to help ensure that as a firm we are doing everything we can to be responsible within the communities we serve.

Risk considerations

Investing involves risk, including possible loss of principal. 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. Past performance does not guarantee future results.

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MM12598 | 12/2021 | 1947121-120121