EII CAPITAL MANAGEMENT

Sustainable Investing in "REITLand": Making real progress

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IN BRIEF

- Despite lingering concerns, among some investors, that opting for sustainable investments means sacrificing financial performance, we have seen investor interest in sustainability investing rise at an impressive rate.
- The real estate sector has lagged other corporate sectors in embracing sustainable, but good progress is being made towards a substantial universe of companies that are committed to sustainability.
- The good news for investors is that the current universe for sustainable global real estate securities displays a risk/return profile that is commensurate with that of the broader global real estate securities investment alternative.
- Despite having fewer constituents than the broader global universe, dispersion among stock returns is very similar, suggesting that the opportunity for an active manager to deliver excess returns using the sustainable universe is not significantly diminished.

Investor interest in sustainability is growing

For many, the chief obstacle to sustainability investing (see sidebar, "Defining Sustainability") is an appropriate skepticism of whether environmental, social and governance (ESG practices) can deliver differentiated[1] financial and investment performance. In a 2015 survey, 47% of advisors indicated that a lack of best-in-class investment strategies or funds played a role in preventing them from recommending sustainable investing to their clients[2]. In a second survey, 54% of the active individual investors surveyed believed there is a trade-off between investing in sustainability and financial gains[3].

However, as highlighted in the survey results to the right, individual investors and corporates acknowledge that sustainability strategies are, or will be, important to financial performance; and investors are expressing elevated interest in sustainable investing[4].

In the public pension plan world, sponsors may be constrained by the perception that sustainable investing conflicts with their fiduciary responsibility if it involves accepting lower investment performance. However, the Department of Labor issued new guidance in late 2015 outlining the point at which it would be acceptable for public plan sponsors to invest in economically targeted investments (ETIs) or sustainable and responsible investment (SRI) funds. The guidance clearly was given with the intent of supporting investments in ETIs, but did offer the caveat "that environmental, social, and governance considerations may be used as 'tie-breakers' where 'the ETI has an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics.'"[5]

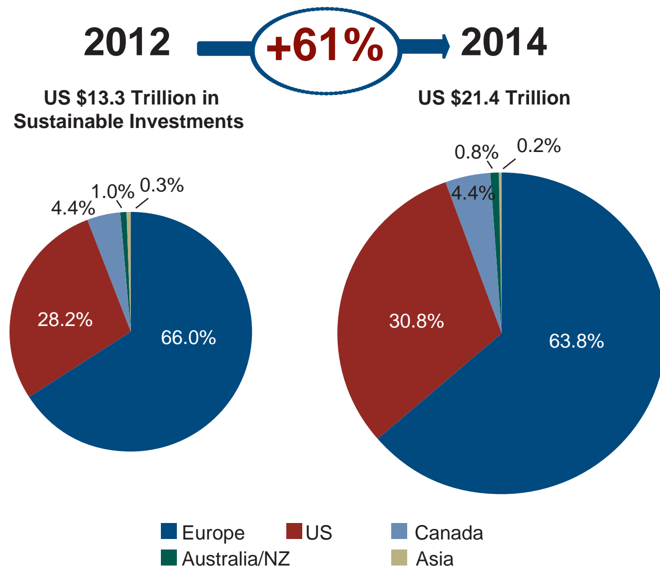
76% *of affluent investors indicated that they would like their investments to promote positive social and environmental outcomes, while delivering competitive returns.[1]*

71% *of respondents expressed an interest in sustainable investing, and 65% expected it to become more prevalent in the next five years.[2]*

90% *of corporate managers believe a sustainability strategy is essential to remaining competitive. 75% of investors cited improved revenue performance and operational efficiency from sustainability as strong reasons to invest.[3]*

This elevated interest has driven growth in the capital invested in sustainable strategies (Exhibit 1): The Global Sustainable Investment Alliance (GSIA), an umbrella group for membership-based sustainable investment organizations across the world, reported that the global sustainable investment market expanded by 61% from 2012 to 2014 (assets rose from $13.3 trillion to $21.4 trillion over the same period)[6]. The proportion of assets is largest in Europe and the US, but all other regions showed growth. While this analysis uses an inclusive definition of "sustainable investments," we believe the growth rate is indicative of the level of interest consistently shown in surveys.

Exhibit 1: Investor interest is translating into growth in invested capital for sustainable strategies



Source: EII Capital Management Inc., Global Sustainable Investment Alliance. As of December 31, 2014 (most recent data available). This data was provided in the 2014 Global Sustainable Investment Review and was based on the aggregation of all SRI strategies reported in the 2014 European SRI Study 2014. Figures are USD. The totals encompass various activities and strategies related to sustainability.

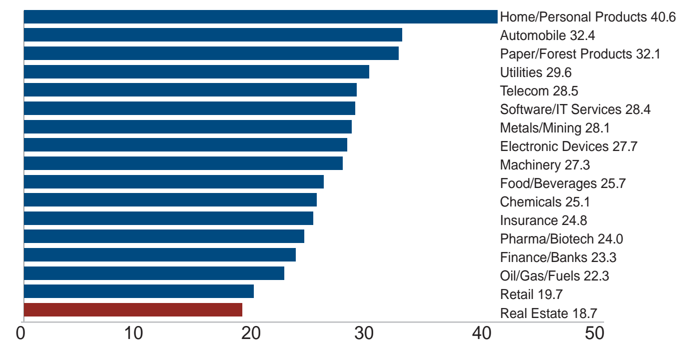
Defining sustainability – ensuring we know what we're talking about

The initial challenge for anyone acquainting themselves with the opportunity for sustainable investing is to understand the concept in its fullest sense. At the heart is the philosophy of ESG – environmental, social and governance – and the fundamental belief that companies (or direct investments) will deliver sustainable and differentiated performance if they are committed to practices that impact the people, the planet and profit in a positive and measurable way. A core assumption of the ESG movement is that a commitment to sustainability requires no compromise in terms of financial performance or investment return potential; and, in fact, should result in outperformance by those companies and direct investments that execute successfully on the ESG front. To add to the confusion, investment strategies that make the ESG philosophy instrumental in the selection of specific opportunities, whether through public or private equity, will label themselves in multiple ways: sustainable investing, socially responsible investing, or sustainable and responsible investing (SRI), responsible investing (RI), and economically targeted investing (ETI). In the end, their objectives are the same.

The "REITLand" opportunity for sustainable investing

Publicly traded real estate companies have lagged other sectors in implementing sustainability strategies for their businesses. Exhibit 2 shows comparative ESG scores from oekom research (see sidebar "Introduction to oekom") for various corporate sectors. Most corporations, no matter the sector, face similar governance challenges, and have similar opportunities to implement programs that benefit their employees and communities. However, one of the perhaps unique challenges for real estate companies is that the "E" (environment) is an unusually visceral part of their sustainability strategy (thus, score) since their business is almost solely about hard assets (property portfolios). And, as noted by oekom, "real estate is responsible for about 40% of the energy consumption in industrialized nations, and consequently, for the largest share of energy-related greenhouse emissions."[7]

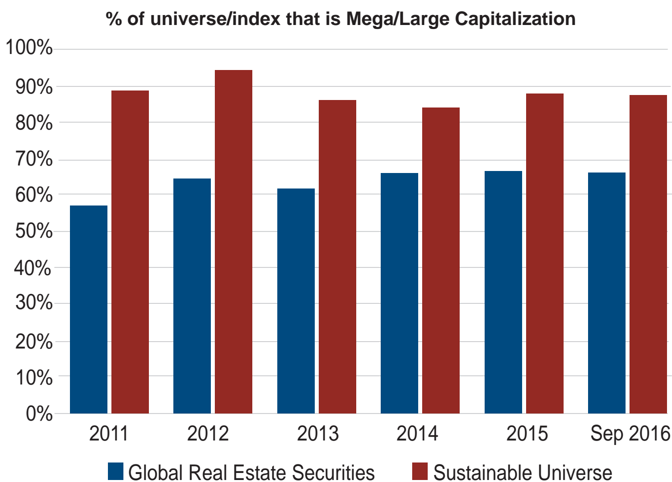
Exhibit 2: The real estate sector has lagged other industries in embracing sustainability



Source: EII Capital Management Inc., oekom research. As of August 31, 2016. oekom computes an average overall sustainability score for companies in select industries. This score ranges from 0 to 100 (best), and is aggregated from company specific oekom Performance Scores (OPS).

A large consulting organization, for example, may have just one or at most, a handful of large headquarter buildings that they can monitor for emissions, energy use, etc. and then take documentable action to improve or convert those assets to an environmentally friendly condition. Real estate companies, on the other hand, can have portfolios that encompass hundreds of properties across multiple jurisdictions. With larger and more dispersed portfolios, the challenges of collecting data and implementing improvements grow exponentially in terms of scope and complexity. Moreover, for sectors like triple net or for-rent apartments, where the tenant – not the owner – is responsible for paying property-related expenses, the real estate owner may not even have access to the data required to identify inefficiencies.

Exhibit 3: The global real estate sustainable universe is heavily weighted to large-capitalization companies



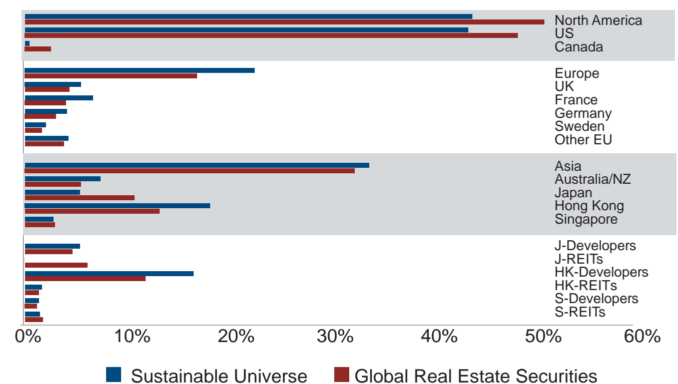
Source: EII Capital Management Inc., Factset, FTSE EPRA/NAREIT, oekom research. As of September 30, 2016, for the period covering the last five calendar years and 2016 year-to-date. For the global real estate securities sustainable universe we use the year-end oekom universe of real estate securities with a sustainable grade of D or greater for each period shown. Similarly, we use the year-end constituents of the FTSE EPRA/NAREIT Developed Index for the broader global real estate securities opportunity set. Note, we eliminate any companies from the sustainable universe that are not included in the FTSE EPRA/NAREIT Developed Index to make as comparable as possible. Equity market capitalization data at year-end is used for each period, in USD. Using a cut-off of $5-$14.9 billion for large-cap and >$15 billion for Mega-cap, we calculated the percentage of the total equity market capitalization for each universe that falls into each category and then sum those percentages to show the total for Mega- and Large-cap.

Introduction to oekom research

oekom research AG is one of the world's leading rating agencies in the field of sustainable investment. Since 1993 the agency has been analyzing companies and countries with regard to their environmental and social performance. oekom research has extensive experience as a partner to institutional investors and financial service providers, identifying issuers of securities and bonds which are distinguished by their responsible management of social and environmental issues. More than 140 asset managers and asset owners routinely draw on the rating agency's research in their investment decision making. oekom research's analyses therefore currently influences the management of assets valued at over €600 billion.

We saw in Exhibit 2 that the global real estate securities universe has not scored well on the sustainability front. This also means that the size of the global real estate securities investable universe – those that achieve an acceptable ESG score on oekom's rating system[8] – will be a subset of those indices not filtered for corporate commitment to sustainability. As an example, as of September 30, 2016, the sustainable universe[9] consisted of 133 companies and $1.2 trillion equity market capitalization (compared to 333 and $1.5 trillion for the FTSE EPRA/NAREIT Developed Index, a global real estate securities index that holds only property companies listed in developed economies). The large difference in the number of constituents though with a less stark delta in equity market capitalization is explained by the fact that the sustainable universe is more heavily weighted to mega and large-capitalization stocks. This characteristic has been consistent over time for both the sustainable universe and the highlighted broader index (Exhibit 3). Intuitively, this makes sense as larger companies may, as a result of elevated investor scrutiny, be more sensitive to increasing investor interest in ESG. Additionally, and perhaps more critically, they may also have the wherewithal to respond with the more-detailed disclosure and reporting required for a "passing" grade.

Exhibit 4: Weightings for the Sustainable Universe may differ compared to the broader global REIT universe



Source: EII Capital Management Inc., Factset, FTSE EPRA/NAREIT, oekom research. As of September 30, 2016, for the period covering the last five calendar years and 2016 year-to-date. For the global real estate securities sustainable universe we use the oekom universe of real estate securities with a sustainable grade of D or greater. We use the constituents of the FTSE EPRA/NAREIT Developed Index for the broader global real estate securities opportunity set. Note, we eliminate any companies from the sustainable universe that are not included in the FTSE EPRA/NAREIT Developed Index to make as comparable as possible. We then compute country, region and REIT versus Non-REIT (only in Asia) weightings using equity market capitalization data in USD. The country assignments and REIT versus Non-REIT assignments are provided by FTSE.

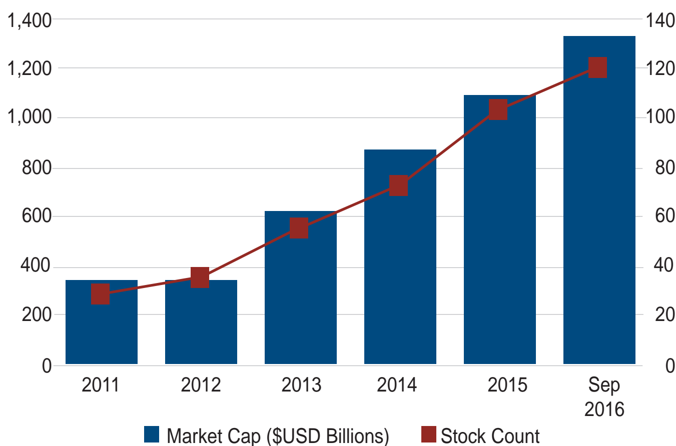
Investors should also be aware that country and regional weights may differ given the filtering of constituents. As we saw in Exhibit 1, some global regions are ahead of others in terms of sustainability investing, so we may see lower representation of corporations by country and/or region. For Exhibit 4, we took the sustainable universe from oekom and eliminated any companies that were not constituents of the FTSE EPRA/NAREIT Developed Index. Scanning the chart for regions or countries where the delta is greater than 2% (either way) reveals several noteworthy differences: North America is under-represented in the sustainable universe, with the differential exceeding 2% in both the US and Canada; Europe is over-represented, and this makes sense given the interest in sustainability investing reported by GSIA (Exhibit 1); Japan is under-represented in the sustainable universe driven by the absence of any JREITs constituents, while Hong Kong is over-represented given a higher weighting for the developers (or real estate operating companies).

The good news: The real estate industry is making significant progress

The good news is that significant progress has been made on rectifying the differentials in weightings, and there are trends suggesting that this trajectory will continue.

As shown in Exhibit 5, the sustainable universe[9] has expanded significantly over the last five years, with its stock count and equity market capitalization both quadrupling since 2011. On a more qualitative basis, the average ESG score for oekom's real estate sustainable universe has also increased steadily, a sign that real estate companies are either improving their sustainable practice or improving disclosure or both. On a more qualitative basis, the average score for ESG reporting for oekom's real estate universe has also increased steadily, a sign that real estate companies are improving their disclosure of ESG practices, a key first step in achieving higher overall ESG scores. That average grade improved from 1.56 (1-4 scale with 4 being best) or an average D+ letter grade to 1.76 in August 2016, an average of C-.

Exhibit 5: The global real estate securities universe has grown by about 4x since 2011



Source: EII Capital Management Inc., Factset, oekom research. As of September 30, 2016, for the period covering the last five calendar years and 2016 year-to-date. For the global real estate securities sustainable universe we use the year-end oekom universe of real estate securities with a sustainable grade of D or greater for each period shown. Year-end equity market capitalization data in USD by constituent is summed for each period shown. The stock count is merely the number of constituents at year-end.

We believe that progress is set to continue. For example, in the US, there is an increasing awareness among the REIT community that sustainability must become a more central part of their business culture. As noted above, one of the challenges has been collecting the data required to address the "E" in ESG. Real estate management teams recognize that this can be overcome by seeking out ways to work with tenants to collect that data (see sidebar, Quantifying Energy Savings in Private Real Estate). At the same time, the Environmental Protection Agency's Energy Start Portfolio Manager software now offers a viable technical solution to the challenge of collecting, collating and analyzing the required data.[10] To facilitate the growing commitment to sustainability, the National Association of Real Estate Investment Trusts (NAREIT), a prominent US REIT industry group, recently assigned a sustainability expert. Finally, in an intriguing development, Fannie Mae has launched a program that offers a lower mortgage rate and potentially a higher loan-to-value (LTV) for apartment and student housing owners that are investing in energy and water conservation projects within their properties or portfolios.[11]

Quantifying Energy Savings in Private Real Estate

One of the challenges associated with quantifying the "E" in ESG has been the difficulty in quantifying energy savings. For example, in multifamily properties, energy & water savings at the apartment unit inures to the tenants – and that data is accessible through tenants' bills.

EII Realty Corp. has been collaborating with its partners to quantify the financial impact of sustainable improvements - for example, working with tenants to review their energy bills before and after energy improvements are implemented and measuring the consumption effects of water sub-metering. The results are impressive - these improvements resulted in monthly savings of approximately $10-25/unit for water improvements and $25-45 in energy savings, or a total of $35-70/month for one renovated property in North Carolina.

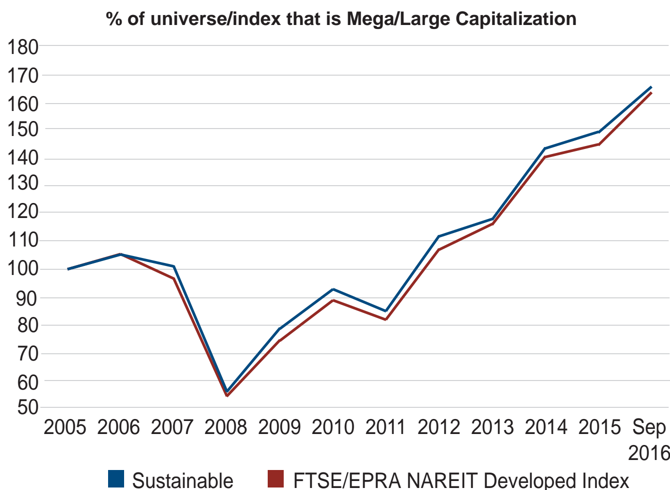
In Japan, another country where the sustainable universe is still meaningfully under-represented, the Financial Services Agency introduced the "Principles for Responsible Institutional Investors" in early 2014. Within six months, 160 institutions, including the Government Pension Investment Fund (GPIF) and the Pension Fund Association for Local Government Officials, had endorsed the guidelines.[12] More broadly, as more sustainable funds are launched in investment markets around the globe, asset managers themselves are playing an active role in expanding the universe by either highlighting these firms providing the scoring services, like oekom research, or engaging with company managements to encourage a level of disclosure that facilitates the scoring progress.

The best news: Very little compromise (if any)

The very best news is that the global real estate securities sustainable universe is, even as currently constructed, a viable investment opportunity that offers commensurate return potential, risk characteristics, and potential for alpha generation as the broader non-filtered opportunity set. To test this, we created a market-cap weighted series of calendar year total returns in US dollar for the current constituents (as of September 30, 2016) of the FTSE EPRA/NAREIT Developed Index and the sustainable universe (once again eliminating any companies not included in the FTSE index). We went back 10 calendar years, and also computed the 2016 return as of September 30, 2016. The back-tested indexed returns track each other very

closely, and for this time period, there was a slight outperformance by the sustainable universe, generating an annualized return of 4.1% versus 3.8% for the FTSE index for the same period. We have already shown the market capitalization skew towards large capitalization for the sustainable universe which, all things equal, would suggest similar liquidity characteristics. For two other measures of risk, we found that the market capitalization weighted 1-year beta as compared to the broader FTSE index for the universe came to just under 1.0, in line with the overall index. Finally, leverage, as measured by debt-to-assets, was 39.0% for the sustainable universe compared to 43.0% for the FTSE EPRA/NAREIT Developed Index.

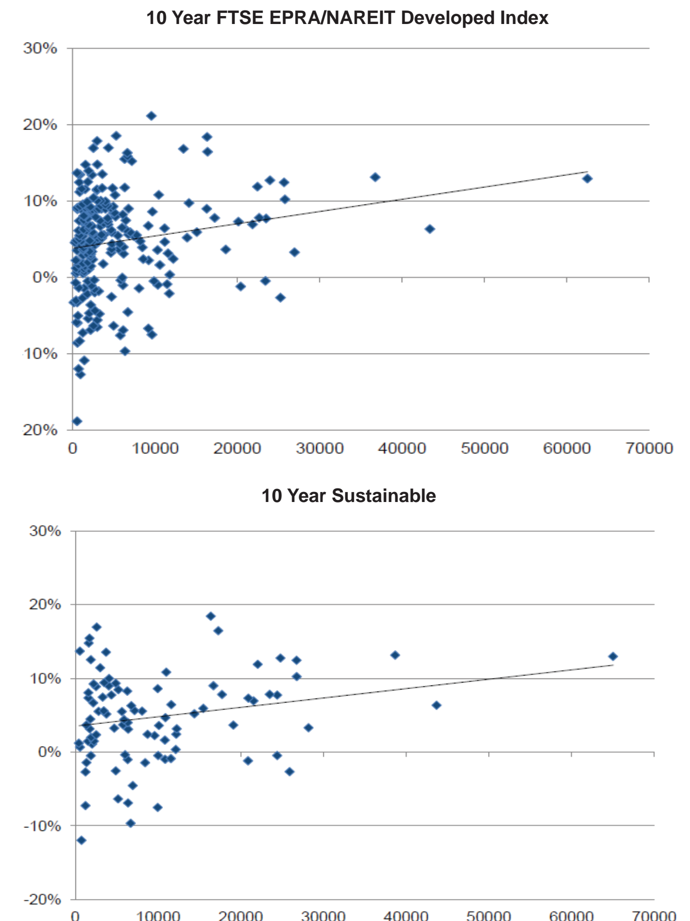
Exhibit 6: The REIT Sustainable Universe has delivered returns in-line with Global REITs



Source: EII Capital Management Inc., Factset, FTSE EPRA/NAREIT, oekom research. As of September 30, 2016. For the global real estate securities sustainable universe we use the current oekom universe of real estate securities with a sustainable grade of D or greater. We use the current constituents of the FTSE EPRA/NAREIT Developed Index for the broader global real estate securities opportunity set. We eliminate any companies from the oekom universe that are not included in the FTSE Index to make this analysis as comparable as possible. Note, that we eliminate any companies with 0 or partial returns in each year for both indices, and we use current holdings in order to backtest the current opportunity set for both universes. We use calendar-year total returns in USD. For each stock, and weight the returns for the index and sustainable universe for each calendar year using the stock-specific equity market capitalization at the beginning of each year. We calculated weighted returns for the past 10 years as well as 2016 year-to-date. We then index those returns starting with 100 at the end of 2005.

We also wanted to consider the relative potential for an active manager using the sustainable universe to generate excess returns (i.e. alpha) over and above the return of the full universe by selecting a subset of stocks for an actively managed portfolio. One way to gauge this potential is to monitor the dispersion of stock specific returns for a given universe. If the share returns for various companies are generally the same, the ability to create value by buying companies that outperform the average is less than in the case where there is greater dispersion between the returns from the various alternatives. We also wanted to make the comparison for the sustainable universe to the broader index. So, for Exhibit 7, we used the same constituents from the analysis shown in Exhibit 6, but charted out the trailing annualized 10-year returns (as of September 30, 2016) on the vertical axis (y-axis) and the corresponding company's current equity market capitalization on the horizontal axis (x-axis). Interestingly, the similarity in dispersion is visibly apparent. An additional note worth making is that the trend lines suggest a slight upwards trend (i.e. positive correlation) in returns compared to the market capitalization for both universes.

Exhibit 7: Dispersion for the sustainable and broader global REIT universe suggest similar potential for generating excess return for either universe



Source: EII Capital Management Inc., Factset, FTSE EPRA/NAREIT, oekom research. As of September 30, 2016. For the global real estate securities sustainable universe we use the current oekom universe of real estate securities with a sustainable grade of D or greater. We use the current constituents of the FTSE EPRA/NAREIT Developed Index for the broader global real estate securities opportunity set. We eliminate any companies from the oekom universe that are not included in the FTSE Index to make this analysis as comparable as possible. Note, that we eliminate any companies with 0 or partial returns in each year for both indices, and we use current holdings in order to backtest the current opportunity set for both universes. We use annualized trailing 10-year total returns in USD for each constituent (stock). We chart those on the vertical axis (y-axis) with the corresponding company's current equity market capitalization on the horizontal axis (x-axis).

Conclusion

The cornerstone of the ESG and sustainable investing movement is the belief that companies (or direct investments) will deliver sustainable and differentiated performance for their stakeholders.

While the evidence that this is, or will be, the case is still developing, investor interest in sustainable investing is growing. The real estate sector has lagged other corporate sectors in embracing sustainability, but good progress is being made. And the good news for investors is that the return and risk profile for a global real estate securities sustainable universe, as it stands now, appears to be commensurate with that of the broader investment alternative. As investor and corporate surveys indicate, the expected upside is that embracing sustainability practices leads to improved financial performance, which should ultimately translate into higher returns to investors relative to non-sustainable investments.

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Footnotes:

1. "Differentiated" signifies relatively better operational/financial performance and/or higher returns to equity compared to "non-sustainable" peers or investments.
2. Second Annual Practice Management Study. "Responsible Investment: Advisor and investor interest is rising. However old myths still exist," TIAA Global Asset Management, 2016.
3. "Sustainable Signals: The Individual Investor Perspective," Morgan Stanley Institute for Sustainable Investing, February 2015.
4. Findings from the 2016 Sustainability Global Executive Study and Research Project: "Investing for a Sustainable Future," The Boston Consulting Group, 2016.
5. Society for Human Resource Management, "DOL Gives an OK to 'Socially Responsible' Funds," Stephen Miller, CEBS, October 28, 2015.
6. 2014 Global Sustainable Investment Review, Global Sustainable Investment Alliance, 2014.
7. oekom Industry Focus Real Estate, oekom research, August 2016.
8. oekom rates each company in its universe (by sector) assigning grades from A to F. Any company with a D or better – A being best – is included in the "investable universe." Note, that oekom can also translate these scores into number scores on a 1-100 or 1-4 scale. Despite a different scale, they are reflective of the same assessment of the company's/sector's demonstrated commitment to sustainability.
9. The sustainable universe is defined using oekom research, but the rule of including only companies with scores of D or better is determined by EII Capital Management, Inc.
10. REIT Magazine, July/August 2016, "Setting the Standards," Charles Keenan, pp. 18-19.
11. https://www.fanniemae.com/multifamily/green-initiative-financing.
12. 2014 Global Sustainable Investment Review, Global Sustainable Investment Alliance, p. 25.

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