REAL ESTATE INVESTING

HOW TO INTEGRATE CLIMATE CHANGE AND RACIAL EQUITY

EBS Universität

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CSP Center for Sustainable Finance & Private Wealth

REAL ESTATE INVESTING:
HOW TO INTEGRATE CLIMATE CHANGE AND RACIAL EQUITY

Global residential and commercial real estate are one of the biggest asset classes in the world. Knowing this, real estate investors are at the heart of enabling a positive impact through investing. The big question is: how to create sustained impact in the sector.

BACKGROUND

The field of sustainable finance attracts substantial interest by investors. In capitalism, this can be a key mechanism to achieve sustainable development.

Private high net worth investors play a vital role herein. This is due to (a) the substantial amount of capital that is controlled by families following decades of wealth concentration – 0.7% of the global population control about USD 140 trillion, ca. 50% of global wealth – and (b) the unconstrained, conviction-driven, and innovative way these families can deploy their capital.

Important barriers remain, however, to turn more of this interest into action. Surveys show that 60% of high net worth individuals are interested in sustainable finance, but less than 10% deploy their capital accordingly. Thus, substantial capital that could advance sustainable development remains untapped.

In Spring 2021, we brought groups of EBS students together with three real-world private impact investors and one fund to help them overcome four specific such barriers. The results were summarized in four student white papers, in collaboration with the Center for Sustainable Finance and Private Wealth (CSP) at University of Zurich. The reports cover the four topics of

- Life Science Impact Investing,
- Voting and Engagement in Public Equities,
- Measuring the impact of investments on the U.N. Sustainable Development Goals (SDGs),
- and the topic of this white paper, namely: Integrating climate change and racial equity into real estate investments

Climate change and racial equity are two of the most pressing themes of our time. Real estate as an outstandingly large asset class and with substantial interactions with both the climate and racial equity is a critical topic for any investor interested in impact and long-term financial stability. I am glad that with this short student report we can bring more clarity to this important topic.

Towards impact,

Prof. Dr. Falko Paetzold
Assistant Professor in Social Finance, EBS Universität für Wirtschaft und Recht
Founder and Managing Director, Center for Sustainable Finance and Private Wealth (CSP), University of Zurich

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SUSTAINABLE AND IMPACTFUL REAL ESTATE INVESTMENTS: CASE INTRODUCTION

The study was conducted for an American ultra-high-net-worth individual who aims to create a sustainable impact as a passive real estate investor:

I am part of a family office which owns multiple real estate assets. My family is interested in exploring possibilities to invest in real estate and creating long-term sustainable impact through these investments. Deeply engaged and committed to the topics of sustainability and racial equity, I am driven to know how other large investors address the topics in their portfolios. Questions I am confronted with in in my work are:

- *How is racial equity and climate change addressed in large portfolios?*
- *How are the topics addressed in the real estate sector?*
- *What are the advantages and disadvantages of the various approaches?*
- *How is impact measured in each approach and in the sector?*
- *What pitfalls should be avoided when seeking impact through real estate investments and ownership?*

In order to narrow down the questions, I wish to focus on the investment and real estate context of the United States. In terms of the asset type, I am most keen on learning about the commercial real estate sector, but am interested in opportunities that can be modified and applied to residential real estate as well. As most of the climate impact of the sector comes from sustainable construction, long-term impact demands creativity and a solution-oriented approach from a passive investor. This is an underlying challenge I am also looking answers for.

My question to the EBS students was the following: How can an investor have a positive impact on climate change and racial equity through real estate?

METHODOLOGY

The student group interviewed various real estate investment firms, impact investors and family offices to derive an initial understanding of the real estate industry, its current status and its progress in terms of sustainability and impact creation. The group conducted approximately 15 interviews, including discussions with the heads of impact management, managing directors of real estate investment companies, and experienced impact investors, in order to establish an accurate picture of the industry. Additionally, the group analyzed standards, certifications, and tools providing guidance for impact measurement and documentation approaches.

The data gathered as part of the research project enabled the group to evaluate existing impact analysis and measurement tools and to derive insights regarding best-in-class approaches in impact generation. Combining the industry's practical experience with best-in-class and theoretical investment methods allowed for illustrating ways to adapt impact creating approaches to traditional forms of investing in the real estate sector.

KEY FINDINGS

Most sustainability measures applying to the real estate sector have been developed for the construction phase. Due to the nature of the sector, the creation of long-lasting impact is challenging for investors with investment goals– touching on social causes in addition to the environment.
The group quickly realized that the area of racial equity lacked measurements and clear commitments to address the issue as an overarching topic as well as the scarcity of tools to measure progress. The topic of racial equity is potentially featured in some ESG ratings and criteria, yet it is questionable whether the simple featuring of the topic is enough to make a real difference.

1. Climate change and location – Short-term vs. Long-term

The best way to measure impact on the SDGs is to use an external service provider, rather than creating an in-house rating system that may result in data that is difficult to verify and compare across the sector. In fact, an external rating provider offers brand reputation, industry expertise, and comparable metrics. These advantages help fund managers achieve more transparency for their funds' when sharing performance and impact reports with key stakeholders, such as investors and legal authorities.

Providers with a complete range of services are: MSCI ESG, Sustainalytics (owned by Morningstar), ISS-ESG, and Trucost (owned by S&P).

2. Racial injustice in access to the real estate sector

Racial inequity manifests itself in different areas within the real estate sector.
Access to the general housing market is, for example, restricted for people of color, as they are excluded from opportunities to buy or rent houses and apartments in certain (mostly white) neighborhoods or forced to pay a premium – unlike other customers. The history of this injustice is deep, as it is not too long ago that specific guidelines defined how to assess the value of a property based on the ethnic composition of the given neighborhood. Such excluding and racist measures were banned by the Fair Housing Act in 1968, but reality has not followed everywhere.

Another manifestation of racial inequity is seen in the demographics of low-income areas which to this day are mostly inhabited by minorities. These areas are also more likely to be negatively impacted by environmental pollution and these two aspects combined result in the solidification of so-called social blackspots and higher health hazards for marginalized communities.

In order to elaborate: black individuals make up only 12% of the population of the United States, yet 70% of black people live in neighborhoods where at least 20% of the inhabitants are black. More than 40% of black individuals live in neighborhoods where the majority is black. These figures make it clear that opportunities to find housing are related to factors such as skin color.

Setting sustainability criteria and positive impact as a goal in real estate investing goes beyond undertaking actions to reduce racial inequity. Sustainability goals demand setting the needs of the tenants as a priority and creating procedures and guidelines to ensure that environmental and governmental regulations are met.

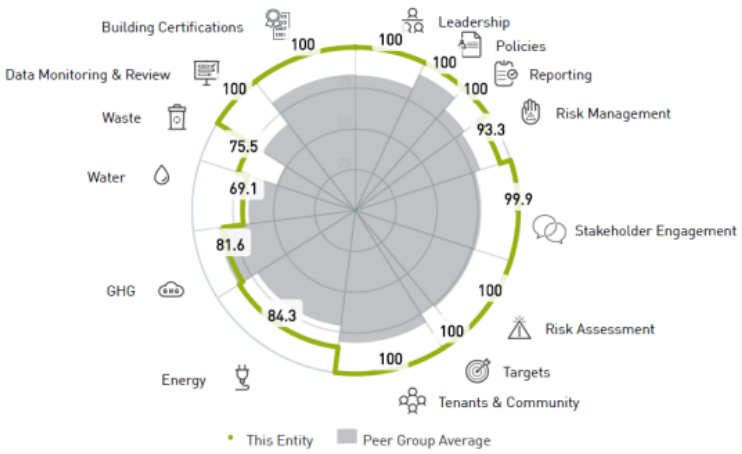
2. Impact Tracking with the help of exemplary measurement tools

Accurate impact tracking is one of the most difficult endeavors in the real estate industry. Besides certifications regarding predefined social and environmental standards of a company or building, the real estate industry lacks a unitary measurement system to consistently track companies' and buildings' social and environmental performance. In order to fill this knowledge gap, we assessed the impact measurement approach of one of the best performing American real estate investment trust known for its impact tool, GRESB.

According to GRESB, consistency in the measurement of impact requires a coherent and commonly accepted measurement framework supported by a continual tracking process (see Figure 1 and 2). This framework is provided by GRESB's benchmark report addressing the following topics by comparing individual scores with the industry benchmark:

- *Existence of Building Certifications,*
- *Commitment to Leadership Approaches,*
- *Alignment and Consistency in Reporting and Underlying Policies,*
- *Existence of Adequate Risk Management & Assessment and Intensified Stakeholder Engagement,*
- *Treatment of Resources and affected Tenants and Community.*

The report features a helpful and consistent tool summarizing a company's or asset's performance by assessing the underlying impact score with the help of a guiding questionnaire and predefined standards. Moreover, the tool provides stakeholders, buyers and interested parties with a flexible method that can be adjusted according to thematic preferences. Additionally, the questionnaire and guidance report can be expanded by individually elaborated focus themes following a similar scheme.



2020 Kilroy Realty Corporation: Benchmark Report (2020)

	Aspect	Code	Score	Weight Component	Weight Total
Management	Leadership	LE	7	23%	7,0%
	Policies	PO	4,5	15%	4,5%
	Reporting	RP	3,5	12%	3,5%
	Risk Management	RM	5	17%	5,0%
	Stakeholder Engagement	SE	10	33%	10,0%
		Total	30		
Performance	Risk Assessment	RA	9	13%	9,0%
	Targets	T	2	3%	2,0%
	Tenants & Community	TC	11	16%	11,0%
	Energy	EN	14	20%	14,0%
	GHG	GH	7	10%	7,0%
	Water	WT	7	10%	7,0%
	Waste	WS	4	6%	4,0%
	Data Monitoring & Review	MR	5,5	8%	5,5%
	Building Certifications	BC	10,5	15%	10,5%
		Total	70		
	GRESB Score		100		

2020 Kilroy Realty Corporation: Benchmark Report (2020)

KEY RECOMMENDATIONS

Many investors are aware of sustainability issues, yet lack the approaches and tools to address them. Due to the lack of knowledge, awareness building has a significant role to play in enabling impact – by talking about your actions as a sustainable and responsible real estate investor, chances are that other investors will follow your example. The more people participate in the movement, the more effective these actions will be.

1. Location Analysis Framework

Since it is extremely difficult to compare one real estate asset to another one, conscious and diligent investors need a Location Analysis Framework to mitigate potential climate hazards to their properties. A continuously applied location analysis framework can also aid in diversifying the portfolio across various climate zones and mitigating the effect of one specific zone on the performance of the total portfolio.

A sample framework, derived in connection to the high net worth case study that was the main recipient of this report, consists of the following five steps:

- *Negative screening with regard to current and potential climate change risks,*
- *Screening regarding the availability of renewable energy,*
- *Screening of the legal environment,*
- *Screening in regard to transportation and supermarket infrastructure,*
- *Screening in regard to diversity and inclusion potentials.*

2. Social Screening

In the specific case of this report, the group was requested to investigate passive investment approaches where interaction with (potential) tenants would not be necessary. With this in mind, the group recommend investors to work together with governmental programs to address topics like racial inequity. Governmental programs can offer helpful guidelines to get started and enable change due to their work in poverty alleviation and supporting people in need. Communities affected by poverty are often communities consisting of people of color providing clear synergies and shared goals in terms of collaboration. When it comes to the social screening of tenants and the establishment of ESG criteria of real estate investments, the group recommended collaborating with companies specialized in the topic. Assigning the operational tasks related to interacting with tenants to a specialized company ensures that priority topics are addressed, and that resources are allocated efficiently. In terms of ESG criteria, Kilroy Realty Corporation stood above the rest due to their well-established ESG procedures. In addition, it is worthwhile to note that as per the research findings, the more proximity to the community/tenants the company has, the more positive impact appeared to be created.

3. Implement Consistency in Impact Tracking

As long as the industry does not implement a commonly accepted impact tracking system, investors will struggle to comprehensively evaluate a company's or an asset's performance in terms of its social and environmental impact. Nevertheless, a universal solution is not a necessity – using a structured framework that can be flexibly adapted to the needs at hand bears sufficient results too. Accordingly, the group highly recommend GRESB as a tool which supports the investigator in adjusting a predefined framework to her/his own preferences. Using GRESB will enable overall comparability (benchmark) for the evaluated objects following a predefined baseline, paired with the possibility for individualization. Furthermore, engagement with GRESB and Kilroy Realty to establish a consistent and widely accepted impact measurement system was recommended.

4. A decision needs to be made

Combining the goals of racial equity and profit can be a challenge for some investors – yet investors need to make the clear decision to do so and to eliminate pending injustice. Trade-offs that were reported included questions relating to prevailing injustices such as:

- *Should an investor pay the same price for a building in a predominantly black neighborhood as in a predominantly white neighborhood, knowing that the building in a predominantly black neighborhood could be worth less for other, possibly racially biased investors?*
- *Should an investor actively seek people of color as tenants, knowing that this could lead to a devaluation of the property by, again, wrongfully biased other investors?*

Most real estate investors shy away from these highly problematic questions. The group thus recommend applying the do-no-harm approach: the more an investor is personally willing to engage for racial equity by making the required decisions the better, yet the minimum goal is to not make things worse. An ideal approach would enable positive change without compromising returns – which is the outcome to be achieved in an unbiased market.

AVENUES FOR FURTHER RESEARCH

Based on the analysis and related findings, it is evident that questions related to sustainability within the real estate industry are grave and plenty, yet fall short from the attention and weight they deserve. A topic identified as calling for further research includes greenwashing due to its persistence especially among passive investors. Possible avenues for such research include an empirical analysis into the effectiveness and appropriateness of the vast amount of sustainability certifications and their effect on returns.

From an investor perspective, implementing sustainability measures into the investment process offers the possibility of creating a positive impact – regardless of geographical location. As highlighted in this paper, impact can take the shape of actively fighting injustice with regard to access to the real estate market. In terms of racial equity, active ways to promote equality in the properties one owns can already create an impact. In addition as a landlord one can actively encourage an exchange between the ethnic groups that are tenants in a building. Impact approaches can also focus on climate change. In both topics, investors have an opportunity to act as forerunners and pioneers - pathways toward impact are not limited to the ones mentioned in this report.

CONCLUSION

The creation of sustainable, positive impact should be of high priority for individual real estate investors. For passive investors, the creation of impact starts at the very beginning of the investment process as determining the location for a suitable investment. Sustainability and impact are a continuous process, where tweaks can be made at any given time to increase the effectiveness of the chosen approach. This short student report and the findings and recommendations highlighted are a first step in seeking to inspire investors to actively contribute to a better society and healthier planet. Investors also need to include the appropriate set of KPIs on the portfolio level, and to create transparency within their portfolio, as well as an impact tracking system for each individual asset.

ABOUT THE AUTHORS

Christopher Crämer

Christopher Crämer is a M.Sc. in Finance student at the European Business School (EBS) in Oestrich-Winkel, Germany, with majors in Sustainable Finance, Mergers and Acquisitions, and Alternative Investments. Prior to his master studies at EBS, he gained work experience in investment banking and with a real estate private equity firm. He completed his Bachelor studies at the European University Viadrina in Frankfurt (Oder).

Julian Balthasar

Julian Balthasar is a M.Sc. Finance student at the EBS University in Oestrich-Winkel, Germany. His focus during his study was Sustainable Finance, Mergers & Acquisitions and Alternative Investments. Before studying at the EBS he worked in the sales department of an international IT company, during his studies he worked in the digital asset department of a securities trading bank. He did his B.Sc. Economics at the MLU Halle-Wittenberg.

Vincent Schäfer

Vincent Schäfer is a M.Sc. Finance student at the EBS University in Oestrich-Winkel, Germany. During his studies he primarily specialized in Sustainable Finance, Mergers & Acquisitions and Alternative Investments. Prior to his master program at EBS, he graduated from an integrated degree program at the Corporate State University Mannheim in combination with Ernst & Young. Within his dual system program, he gained experience in Advisory Services specializing in information technology and finance.

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CONTACT

Prof. Dr. Falko Paetzold
falko.paetzold@ebs.edu

Vera Schwarzmann
Vera.Schwarzmann@ebs.edu

Christopher Crämer
christopher.craemer@students.ebs.edu

Julian Balthasar
julian.balthasar@students.ebs.edu

Vincent Schäfer
vincent.schaefer@students.ebs.edu

www.ebs.edu

EBS Universität für Wirtschaft und Recht
Rheingaustraße 1
65375 Oestrich-Winkel
GERMANY

Phone +49 611 7102 00
Fax +49 611 7102 1999
info@ebs.edu

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