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# Frontier Line

Thought leadership and insights from Frontier Advisors

Issue 140 August 2018

## ESG in Property “Best Practice”

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*Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than \$320B in assets across the superannuation, charity, public sector and higher education sectors.*

*Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.*

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Benjamin Woolley joined Frontier in 2012 and currently holds the role of Associate. Benjamin provides client consulting support and undertakes manager and investment research, with a focus on property and infrastructure. Benjamin also holds responsibility for the firm's global infrastructure and property research database, RADIAS.

Prior to joining Frontier, Benjamin gained experience as a Project Coordinator with Quanco, a boutique business consultancy based in Los Angeles, USA. Benjamin has completed a Bachelor of Commerce (Finance and Management) from the University of Melbourne and a Diploma of Superannuation from the Australian Institute of Superannuation Trustees. He is also currently undertaking a Masters of Applied Finance at Macquarie University.

# ESG in property—“best practice”

*The long-term and tangible nature of real assets necessitates prudent environmental, social and governance (ESG) management to ensure optimal investment outcomes are achieved.*

Given the high visibility and deep community connectivity of property, the need for robust ESG practices is heightened. Positively, most of the institutional funds management community Frontier interact with incorporate ESG into their investment processes.

However, just as manager investment skill varies, so too does the sophistication and strength of each managers’ approach to ESG integration. While ESG has historically been viewed from a risk perspective, Frontier is increasingly observing ESG being used as a value - creation tool.

## Frontier ESG survey

*While global ESG benchmarking resources provide a platform for relative performance assessment, quantitative methods of measuring complex and nuanced data are inherently constrained in the richness of information conveyed.*

Equally, quantitative ratings do not always properly reward innovative practices. To gain a deeper understanding of the various ESG approaches employed by managers in the property space, Frontier surveyed ten client-invested fund managers with coverage of twenty property funds across the globe.

Survey respondents included retail, office and diversified funds spanning Australian, US and pan-European geographies.

*In this paper, we will dissect the qualitative survey responses and provide insight into the ESG frameworks and programs currently deployed, highlighting a selection of market leading practices.*



# ESG strategy and implementation

## Strategy

An ESG strategy creates the foundational framework that supports the monitoring, management and mitigation of ESG risk.

Although all surveyed managers employed a strategy, the level of sophistication varied significantly. Some managers operate relatively simplistic ESG strategies, setting objectives and expectations at the firm-level. These frameworks typically pursue a narrow scope of ESG outcomes and have broad performance targets.

Conversely, the best approaches construct a clear vision, tailored to the specific characteristics of the individual fund. Customisation is important as variations arise between products, sectors and geographies.

Differences may arise due to idiosyncratic operational control structures, tenant/landlord relationships, regional rating tools, investor expectations and progress achieved to date. Strong ESG strategies typically include detailed ambitions, defined objectives, methods of performance measurement and a clear framework to monitor progress.

Such strategies also consider elements beyond the standard (such as energy efficiency, health and safety) to consider tertiary issues (such as supply chain, resilience and biodiversity).

In addition, market leading strategies incorporate ambitions of best-in-class performance and will often seek to develop community knowledge and awareness of sustainability. This might be achieved through university partnerships, industry relationships or tenant engagement, as examples.

## Objectives

Best practice will establish ESG objectives that are clearly defined, regularly monitored and externally communicated. More simplistic approaches set qualitative targets over undefined periods.

Noting that some sustainability outcomes necessitate qualitative measurement, top tier managers quantify ESG ambitions by setting goals focused on both near-term and longer-term strategic metrics.

## Resourcing

Prudent ESG management is increasingly viewed as both a fiduciary duty and a value lever by property managers. As the depth, breadth and overall complexity of ESG investing continues to expand, so too does the expertise required to properly implement an ESG strategy. As such, many funds employ specialists to construct and deploy their ESG programs. Alternatively, some offshore managers outsource this function to third-party providers.

Care needs to be taken when adopting either a specialist or outsourced approach to ensure that ESG efforts are not “siloe” and that the firm’s ESG philosophy is properly integrated throughout the organisation. To achieve this, some managers insert ESG “champions” across business functions, while others undertake regular training and/or establish formal ESG working groups.

## Monitoring and reporting

The structure of reporting lines and oversight of ESG is highly dependent on the characteristics of each individual manager. Nonetheless, monitoring and reporting are essential practices in the attainment of any core organisational objective. As previously mentioned, the better managers establish clearly defined objectives against which performance is regularly measured.

This performance is then reported to sustainability committees, investment committees and/or a subset of the board. Increasingly, key performance indicators for investment personnel include sustainability-linked outcomes. To promote accountability and investor engagement, ESG performance should be communicated to investors and the public through regular external reporting.

# ESG considerations and initiatives

*Invariably, fund managers stated they consider ESG factors throughout investment diligence and in annual asset planning processes.*

Without scrutinising individual investment papers and asset plans, it is difficult to assess the relative strengths of each managers' approach. Instead, Frontier examined the types of ESG issues considered by managers, looking to identify innovative programs and initiatives. Here we highlight our key findings.

## Environmental

Without exception, surveyed managers employed energy efficiency programs. While some were limited to simplistic measures such as installing LED lighting, more advanced approaches employ real time data monitoring hardware and utilise predictive analysis software to identify inefficiencies and issues. Likewise, these approaches commonly provide tenant education on consumption and cost reduction techniques. Similarly, while all funds employed waste reduction programs, the most advanced initiatives turned organic waste into electricity through a process of anaerobic digestion that converts food matter into fertiliser and gas, which is then used as a renewable fuel source. Several managers have also installed (or are investigating) solar panels to meet building energy requirements, providing the dual benefit of reducing cost and limiting carbon footprint.

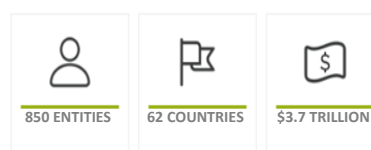
Consideration of climate change revealed disparate approaches. Some respondents noted climate risks are not considered. Others suggested climate change is indirectly

considered through existing environmental initiatives. Alternatively, several funds consider exposure to severe wind, storms, floods and extreme temperatures during the due diligence process, while US funds typically insure against these weather-related risks.

Interestingly, in the Australian market, some funds deploy preventative maintenance processes, such as utilising resilient building materials and constructing landscapes that accommodate climate events, limit flooding, reduce heat absorption and/or prevent erosion. In the event of emergency weather events, one fund has proactively implemented community action plans.

Managers increasingly rely on third-party tools to assess environmental performance (these include LEED, BREEAM, Green Star, NABERS). Each varies in cost, complexity and comparability. While each standard faces challenge, the relatively straightforward and uniform methodology of GRESB has made it a valuable tool for performance benchmarking by both investors and asset managers, leading to broader adoption globally.

### GRESB participation



## Sustainability - QIC Property Fund, Robina Town Centre

- Focused recycling efforts have seen a 200% increase in recycling in the past year.
- First food precinct in Australia to establish an organic waste recycling program – 80,000 litres of organic waste diverted from landfill.
- Oil recycling program reprocesses, and reuses used cooking oil.
- 2,300KL of rainwater captured provides more than 80% of the water needed by the centre for toilets, irrigation and external cleaning.
- A controlled packaging program ensures food retailers are only permitted to use compostable bags and packaging.
- Over 6,000 tableware items washed daily and reused, reducing waste.
- The Kitchens is also home to more than 1 million bees introduced through the establishment of 36 beehives, including an educational show hive on display within the food precinct.



## Social

Awareness of the importance of the built environment for employees, customers and communities, and the resulting impact on the bottom line, is driving managers to explore avenues of socially responsible investment principles. At some level, all surveyed managers recognise this. Basic practices targeting social outcomes typically include providing employee health and wellbeing programs and engaging with local communities (particularly during asset development).

Increasingly, the best managers are looking at creative approaches to engage with key stakeholders and further develop their social license to operate. These initiatives include allowing local charities to operate at discounted rents in underutilised landbanks, providing training in underprivileged communities that can assist with tenant skill shortages, and supplying online toolkits that promote healthy business and tenant practices.

While tracking the success of social initiatives has historically been challenging, the emergence of third-party tools (such as the International WELL Building Institute's WELL Rating and the GRESB's Health & Well-being Module) aim to assist with this. Although these tools are constrained in their ability to track the true financial return of social programs and some certifications can be cost prohibitive, third-party ratings provide a valuable starting point for engaging with key building users.

## Gender diversity: Investa Property Group (IPG)

*IPG is a founding member of the Property Council of Australia's Male Champions of Change program, elevating gender equality as an issue of social and economic importance. Investa has committed to a 40:40:20 gender balance target (40% male, 40% female and 20% balance variable) for all managerial and professional role categories. The organisation's gender balance aspirations are promoted through key performance indicators that link short term incentives with gender equality outcomes.*



## Tenant satisfaction—Invesco Real Estate (IRE)

*Keeping tenants happy and healthy is a key factor in tenant retention. To assess tenant satisfaction, IRE conducts annual third-party tenant surveys. In 2017, IRE found the most sought-after property features included pet friendly apartments, recycling programs, energy efficiency, and access to exercise facilities*

## Governance

While governance frameworks vary considerably between businesses, good governance forms a core element of the fiduciary responsibility of asset management, particularly in the real assets space.

Positively, Frontier's preferred group of managers employ institutional-grade governance practices. In Frontier's recent Property Quarterly (June 2018), we detail best practice investment governance in property funds management.

An emerging area of strong governance focuses on compliance with equitable procurement of services and supply chain management. Initiatives include setting minimum guidelines for the tender of cleaning services and undertaking extensive supply chain risk assessments. Policies in this space set clear ethical, corruption, health and safety, and human rights standards that contractors much adhere to. Stronger approaches regularly review targets and milestones that are contractually agreed with suppliers.

Resilience is also an area of increasing attention. Resilience can include both cyber and physical elements and is typically facilitated by risk management processes and compliance assessments that are reviewed by dedicated teams. The key objective typically focuses on data protection and business continuity. External, independent testing is also pursued in the strongest approaches.

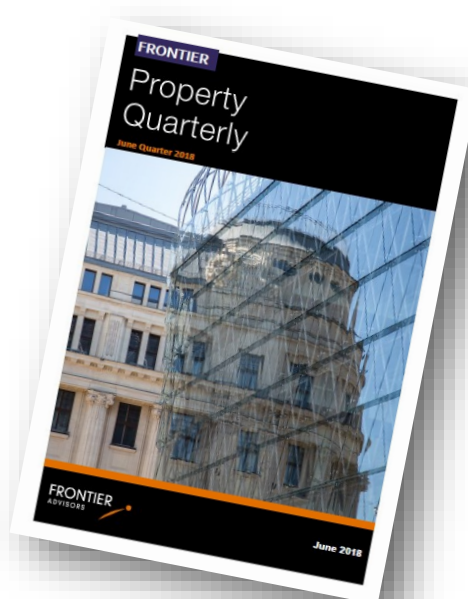
## The final word...

The long-dated asset life, relative illiquidity and social prominence of property investment heightens the need for prudent ESG management. These characteristics, combined with the sector's demonstrable ability to drive tangible efficiency enhancements and risk reduction outcomes through value-accretive ESG initiatives, lead Frontier to closely consider managers' ESG capabilities in our product rating process.

Given the breadth of ESG factors and the nuances surrounding each funds' circumstances, it is not possible to define a single approach as best practice. Instead, this paper highlights the characteristics of the better ESG frameworks and notes some of the novel approaches employed by managers.

## Labour standards: ISPT

*ISPT is a founding member of the Cleaning Accountability Framework (CAF). CAF is an independent, multi-stakeholder initiative that establishes a clear framework for benchmark for labour and cleaning standards in Australia. CAF intends to identify best practice tendering and compliance processes, reducing legal and reputational risks for owners and promoting fair outcomes for workers.*



Positively, early notions of ESG have evolved beyond resource efficiency (which is now viewed as an elementary function of asset management) to include issues such as climate resilience, energy production and supply-chain management. While quantitative assessment tools are not free from challenges, the transparency afforded by sustainability benchmarks has empowered investors to drive many of the successful innovations that are increasingly becoming commonplace.

Awareness and consideration of ESG within the commercial real estate sector continues to expand. While leaders exist within the industry, overall, the selection of managers surveyed by Frontier are progressing their ESG ambitions towards best practice. A continuation of this trend is expected, improving outcomes for investors and key stakeholders alike.



**About Frontier Advisors:** Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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