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FALL 2024

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Compensation in succession planning

This two-part article delves into the topic of compensation in succession planning. In Part I, NAREIM speaks with *Josh Anbil of Anbil Consulting* on how firms should operate a succession plan, and how identifying and nurturing talent early holds the key to successful leadership. In Part II, NAREIM speaks with *Kristin Renaudin of Stockbridge Capital* and *James Strezewski of Blue Vista Capital Management* on the firms' incentive strategies and compensation tools they have and wield. The feature concludes with *Josh Anbil's* advice on effective compensation strategies.

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Using data to evaluate physical climate risk

Julie Manning, LaSalle Investment Management

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Using data to evaluate physical climate risk

LaSalle and ULI's new report provides an industry-wide framework for commercial real estate that addresses how data can be used in decision-making and supporting investment performance.

By Julie Manning, LaSalle Investment Management

Measuring physical climate risk is of growing importance to institutional real estate managers and their investors, at both the individual property and portfolio levels. Of the \$850 billion of commercial real estate assets tracked by NPI, LaSalle estimates \$285 billion, or 34%, is situated in high and medium-high climate risk zones in the US. Increasingly, being able to accurately assess whether or not assets are at risk, and knowing how to price that risk into management strategies, are essential parts of operating a portfolio.

While data is key to this assessment, understanding how to leverage the right data is even more important. With so much climate risk data available in the market, how can organizations manage and find data that gives them manageable, impactful and usable insights? And more importantly, what should managers do with these insights?

Report overview

This question is at the heart of managing physical climate risk, and what led LaSalle to partner with the Urban Land Institute (ULI) on a report, *How to Choose, Use and Better Understand Climate-Risk Analytics*, to evaluate climate risk data providers and outline how to source and standardize reliable climate risk data. From this initial research, published two years ago, LaSalle found many firms were reporting data to their internal colleagues, and sometimes externally, yet often were still unsure of what a given dataset was saying about an organization's particular climate risks.

To help address this industry-wide issue, LaSalle again partnered with ULI earlier this year on a second report,

“ The first challenge in evaluating physical climate risk is understanding what the data is, and isn't, telling you. ”

which aimed to go deeper in developing an industry-wide framework that addresses how data can be used in business decision-making to ultimately support investment performance. The new report, *Physical Climate Risks and Underwriting Practices in Assets and Portfolios*, builds on the initial paper by highlighting how organizations can properly leverage good data to evaluate the costs of both action and inaction when it comes to investing in resilience.

Report contents

The first section of our latest paper outlines the industry's current status with respect to physical climate-risk analytics, discussing implications of the dichotomy between leading and early-stage firms. We also describe some of the inherent challenges in using emerging approaches to decision-making and shed light on the rapidly evolving regulatory environment.

The second portion of our new paper shifts focus to the process of gathering physical climate-risk data, and the practical application of that data in decision-making processes. It discusses the ways firms are beginning to approach portfolio assessment for managing physical risk at the investment level and examines, at a high level, how leading firms weigh and measure underlying risk factors.

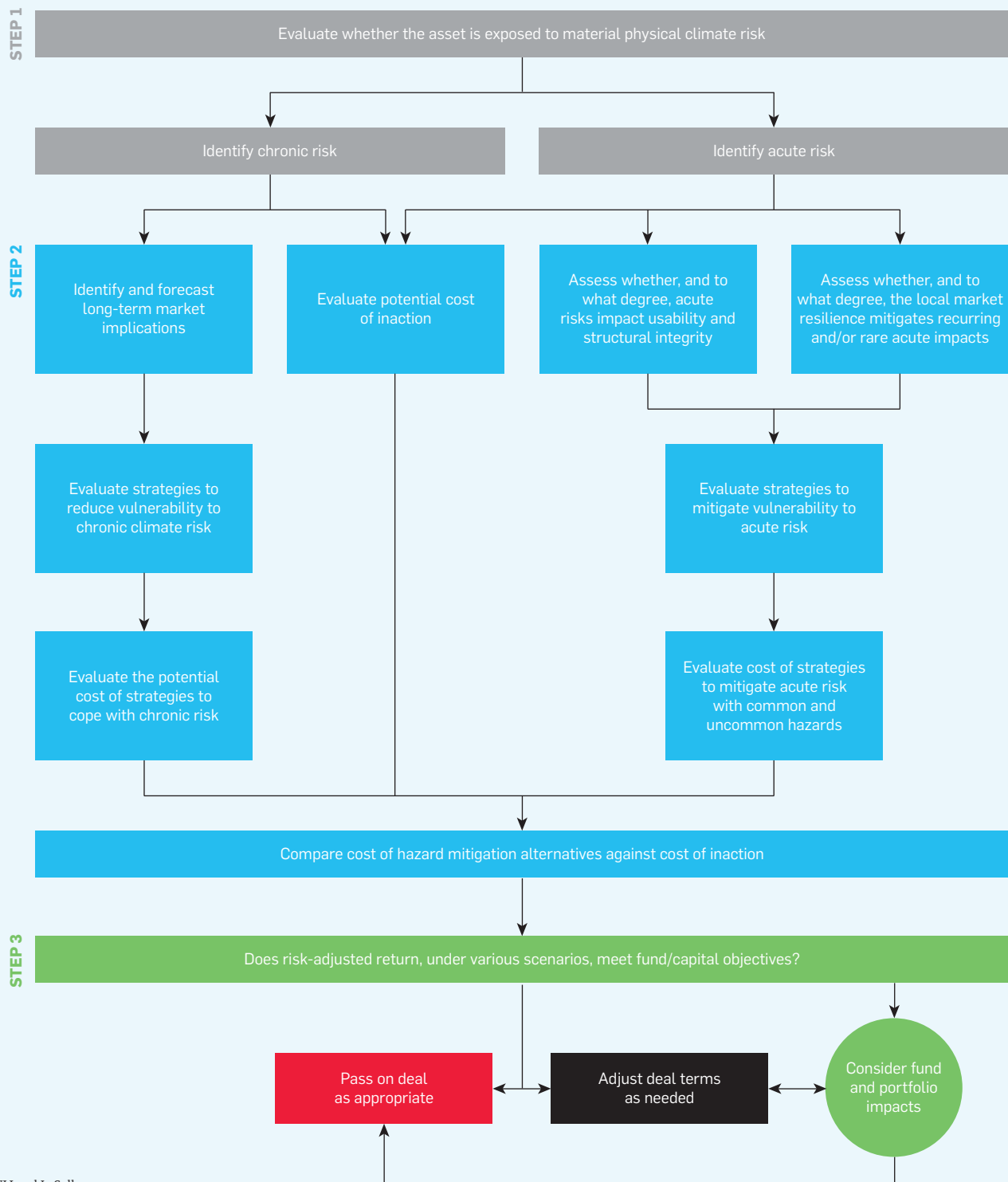
In particular, our research goes into great detail regarding our methodology and the state of monitoring physical

climate risk across the industry. The framework is summarized in the flowchart depicted in Exhibit 1 overleaf. The process works as follows:

1. Use industry climate data to identify properties susceptible to physical climate risk and whether the nature of the threat is chronic or acute.
2. Evaluate what strategies could be employed to mitigate those risks, the costs of those investments, and what the potential cost of not acting might be. Compare those calculations.
3. Once you've evaluated the costs of any possible mitigation efforts, and weighed those figures against the projected costs of damages that could occur without those upgrades, you can determine whether the risk-adjusted return under these scenarios meets both your fund and capital objectives.
4. Once you've evaluated how these potential mitigation efforts for an asset will affect your broader portfolio in light of its long-term aims, you can decide whether to proceed with a transaction, or whether deal terms need to be adjusted to justify the underlying risk.
5. Once these factors are weighted across an entire portfolio, you'll have a much healthier picture of where your portfolio stands, including considerations like geographic concentration, and whether your portfolio needs additional diversification.

LaSalle has used this framework to make decisions about assets in its own portfolio.

Exhibit 1: Asset risk resilience and underwriting flowchart



Source: ULI and LaSalle.

“ We recommend using data as a warning system, rather than as part of a precise equation. ”

As an example, we can cite a logistics property we own in Osaka, Japan, which is a flat coastal city where buildings are required to be 3 meters above sea level. On top of the height required by local regulations — we determined, based on our analysis of the costs of investing in mitigation measures compared with the potential of what a flooding event might cost in losses, that the coastal flood risk warranted raising the buildings an additional 1.5 meters, and relocating essential building equipment and mechanicals to higher levels of the building.

Report in action

In practice, the first challenge in evaluating physical climate risk is understanding what the data is, and isn't, telling you. Data from a tracking system is not going to reveal all answers; in reality, it is only directionally correct.

Simply put, there are no empirical numbers you can plug into your valuation model or business plan. Managers need to apply a serious dose of judgment, not only in interpreting the data, but also in evaluating how an asset is resilient to the identified risks, both physically as well as operationally.

As a first step, we recommend using data as a warning system, rather than as part of a precise equation. Managers will need to spend time understanding the data, the buildings where it applies and its place in a broader portfolio, and then apply insights gleaned to better inform their portfolio management.

Take, for example, real estate in the city of Amsterdam. Simply looking at sea level and flooding potential, the city would be among the highest risk places to own real estate. However, Amsterdam has been working to mitigate flooding for centuries. They have placed generations' worth of infrastructure, dikes and levees to maintain dry land for building. They have a forward-looking plan in place to address future climate risk. This is a prime example where the data doesn't say everything, but does serve as a warning signal to help identify areas that might be problematic and allow the evaluation of risks at the regional level.

Once portfolio managers have determined that a region is in line with their risk parameters, they should evaluate risk at a property level: look at a given building and its existing resilience measures, including the immediately surrounding area. By coupling this information with an understanding of portfolio goals and tolerance of climate risks, managers can make informed decisions about if and how to invest in resilience strategies at a given property, or, even more fundamentally, whether to purchase or divest an asset.

At a portfolio level, ask: do you need to build in a risk premium or return hurdle into your underwriting to justify the investment?

Even the property class of a given asset can make a difference in a climate risk evaluation. Say you have a large multistory building in a flood-prone

area; even if the individual building's resiliency is maximized, what happens if the surrounding area becomes impassable for a period of time? Is your building an office where most tenants can work from home for a few days? Or is it an apartment building where tenants need access to essential services and basic access? Is it a grocery-anchored retail center that provides food for residents? The structure's intended use becomes a serious point of consideration when pricing in climate risk under our framework.

Conclusion

Knowing where real estate risks are at a portfolio level is essential to being able to properly and transparently demonstrate the state of your investments. Whether or not you decide to make an investment in response to a hazard is an individual firm's decision, but we view being aware of the risks facing our investments as an essential part of our fiduciary responsibilities to our stakeholders.

Looking ahead, the market disruption that climate change is causing, and will continue to cause in the real estate industry, is something that creates not only risk but also potential opportunities. Knowing the risks at hand is critical to properly managing a real estate portfolio, and understanding how to properly interpret and implement data will be critical to successfully managing properties for years to come. ♦

Julie Manning is the Global Head of Climate and Carbon for LaSalle Investment Management.