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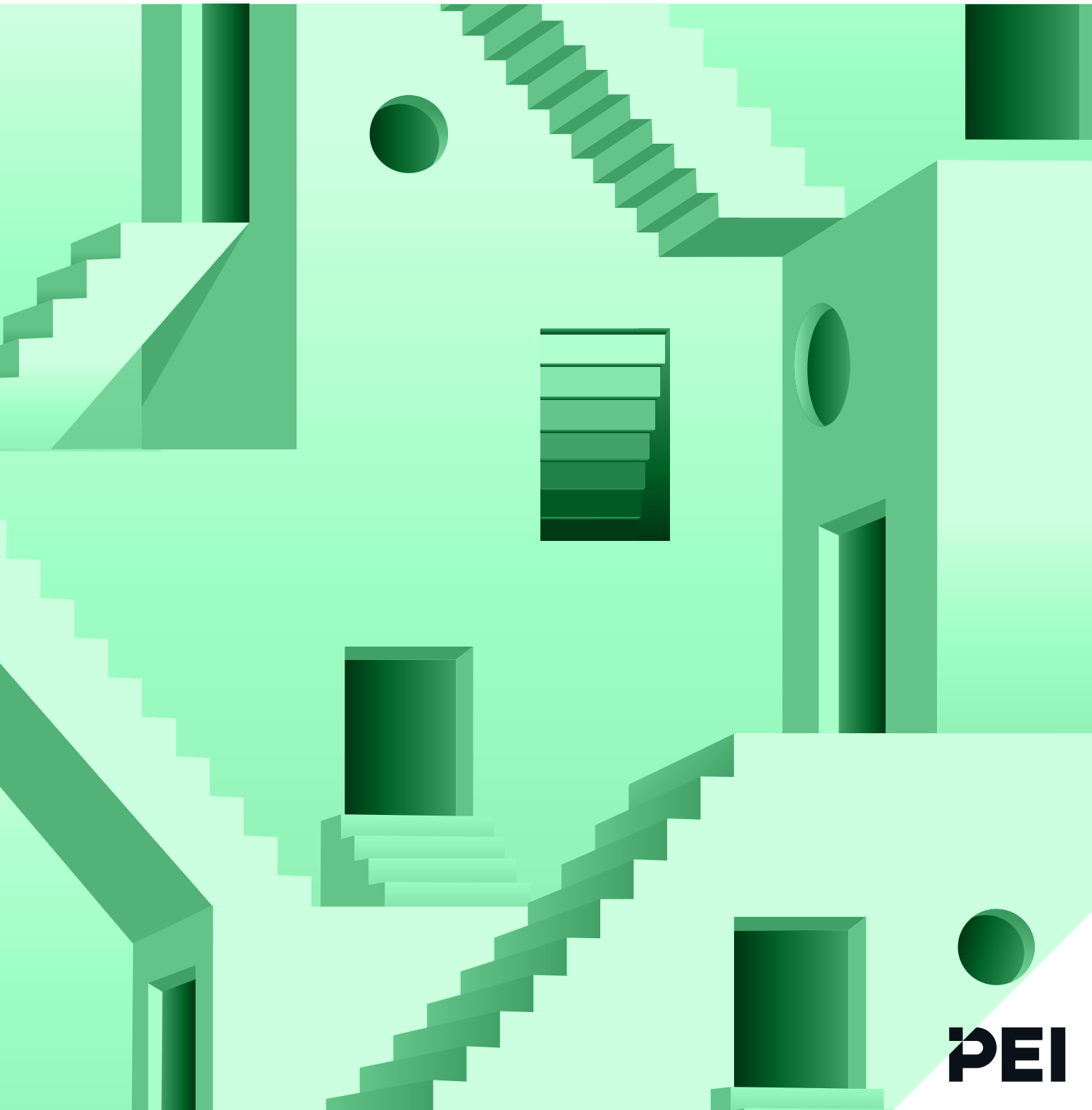

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KEYNOTE INTERVIEW

A 360-degree approach to decarbonization

For LaSalle Investment Management's Ryu Konishi and Julie Manning, decarbonization of the built environment brings significant opportunities for investors – but also risks

The importance of sustainability as part of investment decision-making in the real estate space has been on the rise for quite some time. In fact, the various physical risks associated with climate change, and the regulatory imperative of transitioning to net zero, are now so significant that these factors are gradually filtering through in the form of real-world valuation impacts.

For real estate investors, this raises both risks and opportunities. LaSalle Investment Management is one firm that was early to recognize this, having set up a global sustainability committee back in 2008. More recently, it has worked with the Urban Land Institute to develop a decision-making framework for assessing physical climate risk in relation to its real estate investments.

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According to Julie Manning, global head of climate and carbon, and Ryu Konishi, fund manager of Lp3F (LaSalle's global real estate net-zero strategy), this kind of approach to risk analysis – both broad and deep – is essential. So, where should investors start? And what might a determined decarbonization program in real estate look like?

Q What is making real estate managers focus on the energy transition?

Julie Manning: We are seeing three key drivers of this trend: regulation, tenants and investors.

For one, regulation continues to evolve. There are more and more disclosure requirements, and we are starting to see actual economic impacts on our investments from the risk of fines. A good example is New York City's Local Law 97.

Meanwhile, tenants are driving demand for energy efficiencies and increasingly thinking about their own stakeholders' net-zero goals. As are

Q How can you assess physical climate risk in the built environment?

JM: We spend a lot of time looking at physical climate risk data providers and evaluating the differences between them, and then trying to integrate that data into our decision-making processes, all the way from market evaluation to acquisitions, through to portfolio management and dispositions.

Geospatial resolution is really important. It is one of the questions you should be asking your data providers. Generally speaking, the more granularity the better. But it does still depend on the hazard. Thinking about extreme heat, for instance, you might not need that kind of granularity, because it is pretty pervasive across a larger area. Flood risk, on the other hand, is very specific.

I always advise our teams not to take data at face value. None of the data providers are going to be 100 percent accurate in their forecasts, and we need to use critical thinking. What we have found is that if you look at one building through multiple data providers, you will get different results back. So, I say to them, "Do not underwrite any of the numbers they are giving you. Use them as an indicator only."

end investors. I think all three of those factors are driving us as managers to really pay attention, and to make sure we are not behind the curve – and hopefully, to some degree, ahead of the curve.

Q How does regulation vary geographically?

Ryu Konishi: There are many different mechanisms to be found across different regions. Europe seems to be led by the regulator, with plenty of disclosure obligations of one form or another. The EU taxonomy and the Sustainable Finance Disclosure Regulations are driving several added layers of compliance, requiring real estate funds to report on their decarbonizing activities. We also have building regulations requiring certain minimum energy and carbon emissions standards, as well as increasingly meaningful government targets.

The US and Canada, on the other hand, seem to have more of a combination of carrots and sticks. For instance, there might be a law enacting a carbon intensity or energy use intensity-based fine of some form, which would be a financial hit to property-level operating expenses. But there are also tax incentives, as well as state or local capex cost offset programs, which may incentivize investors to decarbonize.

In Japan, the regulations are different again. For example, the Tokyo metropolitan government has a city-level law enacted where it has a cap-and-trade program for large real estate properties, keeping them to an overall emissions limit.

Q Do you think the regulatory backdrop will change in the US post-election?

JM: I think change on the political side of things will certainly alter some of the carrots and sticks. But even if politicians wobble, the direction of travel is already established, and the world is moving forward on sustainability. That is our north star. And the other two drivers – tenant demand and investor demand – are not going to change.

RK: The key point is that the economics are attractive. In terms of cost, producing renewable energy is on a par with fossil fuels. The risk-adjusted returns make a lot of sense now. We are on the cusp of a seismic shift in how the world economy operates.

Q So, there are good economic reasons to decarbonize the built environment?

JM: Yes. We are always looking for opportunities to drive value and make our assets future-ready. Our research shows that sustainability performance is becoming increasingly correlated with investment returns. Decarbonizing is an increasingly popular way to help deliver outperformance to investors, and there is a clear and rising likelihood that managers on the lagging end of this process could underperform.

To ensure that a building is operating as efficiently as it can, you must start by sourcing really good quality data and leveraging that to improve decision-making. However, building performance data is still something of a challenge for our industry, typically requiring tenant co-operation.

RK: Once we have that data, we can deploy different operational strategies, from optimizing existing building systems to automating things like lighting and HVAC. There are also

building technology solutions to explore, replacing a gas boiler with an air- or water-sourced heat pump.

But, as Julie says, it is vital to engage with tenants throughout the process. Irrespective of how energy-efficient a landlord can make a building, most of the energy consumption is being done by the tenant. Decarbonization is really about trying to figure out the win-win scenarios between landlords and tenants, and keeping tenants engaged throughout the life of a lease, so that they remain energy-consumption conscious. There are behavioral changes that need to happen, and people need to be conscious of it. Green lease clauses often help with that alignment of incentives.

Q Is it all about operational efficiencies, then?

RK: No, it is also about embodied carbon. Over a building's whole life, say a 50-year timeframe, the carbon liability that's created is equally split: 50 percent embodied, 50 percent operational. However, the embodied carbon liability happens upfront, and the materials and the supply chain involved weigh heavily from the outset of a real estate investment project.

As we have seen with the operational carbon regulations, embodied carbon is on a journey that is advancing at different speeds in different markets. Europe certainly has been very engaged. Look at Paris, London and Amsterdam – each of those markets is focused on earnestly implementing circularity principles.

The prevailing concept is that a building cannot be demolished anymore without taking into account how to reutilize the existing building materials. A building has to be dismantled and reassembled like a Lego set, so that it can be dismantled again 50 or 60 years down the line.

We have also been hearing a lot more about embodied carbon in North American and Asian contexts. However, I think for now the industry has to focus on how to tie embodied carbon into the risk/return equation and exit valuations in order to get investors to buy into the concept.

"The risk-adjusted returns make a lot of sense now"

RYU KONISHI

"Even if politicians wobble, the direction of travel is already established"

JULIE MANNING

Q What of the risk of stranded assets, where buildings cannot be decarbonized?

RK: There are some properties that you could throw all the money in the world at and it will still not be possible to decarbonize them.

You have to audit a building to figure out what can be done to prevent it from becoming stranded. For example, a great deal can be done through the electrification of building systems and greening the grid.

JM: It is our job to identify where we may need to act to protect the value of the assets we already hold for our clients. If we hold an asset in a market that is changing, where demand is changing, we need to be sure that we are ready to deliver what that market requires. That is what we mean by protecting value. There are similar challenges when it comes to physical climate risk.

Q How can managers make assets more resilient against physical climate risk?

RK: Whatever the risk is, the built environment should be prepared to respond to it. There are many architectural design elements that can be incorporated as part of thinking through how to make a building more physically resilient.

JM: I can add to that. Not only are we talking about building resilience, but we are also talking about the economic resilience. And not only are we looking at the physical building itself and the site it is on, but also the area around the building, and the context of usage.

Imagine a tall, glassy tower that is perfectly hardened against a physical risk like flooding. A major flood comes through and the tower is fine. But guess what? You can no longer get in and out of your tower. If that tower is an office building full of legal tenants, that might be fine. All of the lawyers are probably at home doing their work on Zoom, and in a few days they will be able to get back into the building.

But if that building is full of apartments, that is a problem. People need to be able to get in and out of the building. There needs to be access to food, water and emergency services. Operational procedures are just as important as physical hardening measures. That is why you need to take a 360-degree approach to assessing the various risks and opportunities. ■