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Real estate lenders

ESG integration and market advances

by Beth Mattson-Teig

The commercial real estate industry is continuing to make impressive strides in advancing environmental, social and governance initiatives. Currently, more than 2,000 real estate entities representing \$7.2 trillion in asset value are reporting their ESG data through GRESB. Progress that has been carried largely on the shoulders of equity owners and investors is now expanding on the debt side of the industry.

Sustainable financing is a growing segment of the commercial real estate (CRE) debt market as capital providers and debt investors look to mitigate risks and align their lending with broader ESG objectives. Although sustainability-linked loans (SLLs) have been slower to take hold in North America compared with other regions, there is growing momentum behind efforts to improve ESG attributes of the asset and sponsor that could affect loan performance.

A big driver behind the increased focus on analyzing and monitoring ESG factors for new and existing loans is risks that could jeopardize the performance of the loan and overall value of the asset. In particular, the cost of climate-related physical risk to property is significant — and rising. According to Aon, natural disasters caused \$380 billion in global economic loss in 2023, with insured losses accounting for less than one-third at 31 percent.

Transition risk also is putting more pressure on lender ESG requirements. “There are many greenhouse gas emission-related laws that have been enacted in various jurisdictions around the U.S., with more passing regularly, and we expect that trend to continue for the next several years,” says Jim Landau, LEED AP, MAI, head of environmental, social & governance, real estate and agricultural finance, at MetLife Investment

Overview of 2023 GRESB Real Estate Benchmark



Source: GRESB

Management (MIM). “We expect that many jurisdictions, places where we have loans as well as equity assets, will enact one of these BPS — building performance standards — laws,” he says.

Existing and future BPS laws create risk to the future value of an asset, as well as the ability to refinance a loan. “We recognize that ESG risks are a factor in financial risk. How to underwrite them isn’t so easy. We don’t have operational control. And in most cases, we don’t even have the energy or the emissions data. So it is difficult to forecast what that risk might be,” says Landau.

At MetLife Investment Management, ESG has been part of the lending process for more than five years. “We incorporate ESG risks into our overall analysis of the risks of any loan that we process,” says Jennifer Jaclin, director, real estate, at MIM. “One of the things that we have found is that as a debt investor rather than an equity investor, you don’t have direct control over the asset, and you don’t have direct information. You don’t necessarily know everything that is going on at the asset.” However, MetLife and other lenders are working toward a sharper lens into ESG factors related to the borrower and the asset.

Developing standard ESG questionnaires

Lenders that have developed their own internal ESG questionnaires are rallying around efforts to adopt an industry-standard set of questions. The ESG Integrated Disclosure Project (ESG IDP) is an industry initiative bringing together leading lenders in the private credit and syndicated loan markets to improve transparency and accountability. The goal is to promote greater harmonization and consistency of disclosure

of key ESG indicators by borrowers in private credit and syndicated loan transactions by using a standard template of questions to solicit a global baseline of information.

GRESB recently announced a collaboration with IDP to create a “real estate module” that develops a standardized method for private credit firms to assess real estate borrowers in a way that aligns metrics and measures in the IDP framework. During the first part of 2024, GRESB members and IDP members will collaborate to improve on the existing module, such as by identifying overlap and missing elements between the two frameworks. The module serves as a standardized ESG due diligence questionnaire that can be used by private credit lenders globally.

“Until recently, there hasn’t been an industry North Star for ESG questionnaires or scorecards in the credit space,” says Lee Hodgkinson, head of ESG at Avrio Real Estate Credit. Avrio Real Estate Credit leverages the IDP template in its questionnaire. “We’ve layered in our expertise as a real estate owner and operator to understand what data we think is valuable to make lending investment decisions in addition to this framework that exists,” he adds.

Questionnaires are intentionally trying to gather information across E, S and G factors for the asset and the borrower. Governance, for example, speaks to a sponsor’s ability to achieve certain outcomes and objectives. Similarly, if a project doesn’t have community buy-in or is not addressing a community need, it could damage the long-term viability of an asset. “At the end of the day, we’re not really in it for one loan. We’re in it for the long run, and so goodwill with the



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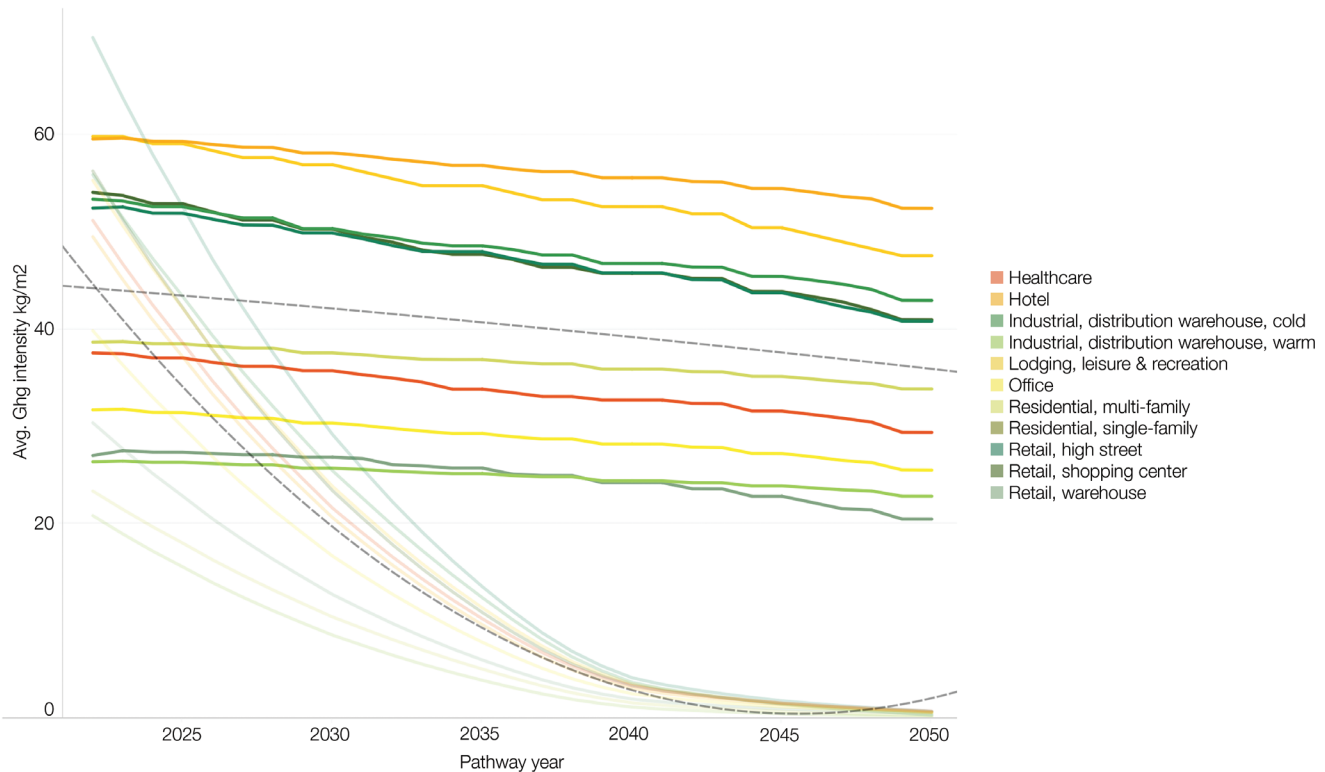
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ESG refers to "Environmental, Social and Governance" factors, and to the consideration of these factors when making investment decisions. ESG related diligence screens does not assure compliance with the UN-sponsored "Principles for Responsible Investment." No strategy, formula or approach can guarantee gains or avoid losses. GRESB is an independent fee-based real estate sustainability benchmark that offers validated ESG performance data and portfolio analysis tools to investment managers and other institutional clients. GRESB dated scores reflect the review of the prior calendar year. PREA ESG Awards recognizes PREA members who are at the forefront of ESG within real estate investing. Recipients submitted for the ESG award and winners were chosen by a panel of anonymous voters. The award was received in March 2023 for calendar year 2022. Fitwel is a certification system administered by the Center for Active Design ("CfAD") that promotes health and wellness for occupants of real estate assets; applicants pay a fee in order to receive a certification, but the certification is based on property-related criteria established by CfAD. Except as noted above, Harrison Street did not pay a fee to participate in the mentioned awards processes. This is not an offer to sell or the solicitation of an offer to purchase securities.

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CRREM pathways in the Americas region by property type



Source: GRESB

community and understanding and addressing the community needs is very important from a financial perspective and a business operations perspective,” says Hodgkinson.

Developing ESG scorecards

The next step for lenders is how to best utilize the information they are gathering from borrowers. With every new loan origination, MIM now puts together a scorecard that combines information received from the questionnaires with other publicly available information. The “E” has always been easier to address with quantifiable data around things like green building certifications. “We are working with other industry participants and organizations like GRESB to obtain more energy consumption and emissions data. Now we’re layering other information on top that we feel adds to the sustainability of an asset,” says Jaclin. As an example, MIM is bringing in additional information on social elements, governance and DEI policies to complete that scorecard. “Right now, our goal is to gain a better understanding of our portfolio and where different loans fit within the ESG realm,” she says.

Avrio also uses information gathered by its questionnaire to create an ESG scorecard for a prospective loan. “We’re transparent with our borrowers on those ESG scorecards because we

want them to understand best practices,” says Hodgkinson. “We recognize that not every borrower is going to come from the same ESG walk of life. Some are going to have very advanced programs, and some are going to be relatively new to sustainability. So we use the scorecards as an opportunity to educate our borrowers and be transparent with them around things like what elements of their assets are risky and which ones have opportunities that they’re not identifying.” Avrio incorporates the “score” into the actual loan and decision approval process and follows up with its borrowers on a quarterly basis to get updated information to monitor their track record and outcomes.

“Once we identify a risk, we bring it to the borrower and say, what are you doing to mitigate this risk?” says Hodgkinson. “If they are not aware of that risk, or not planning to mitigate that risk, that’s where the engagement part can kick in.”

In addition to risks, ESG questionnaires and information uncovered during due diligence can help to identify opportunities. For example, a borrower may not recognize the value creation of putting solar photovoltaics on the roof of a building. Avrio is able to leverage experience and knowledge in solar that the borrower might not have. In its experience with some of its investments, Avrio has seen investment in solar projects create attractive returns. “So that’s an opportunity



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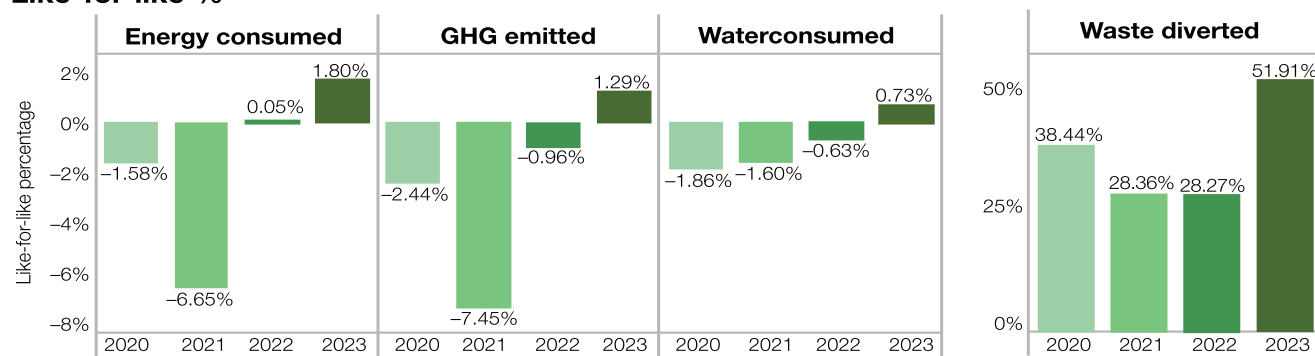
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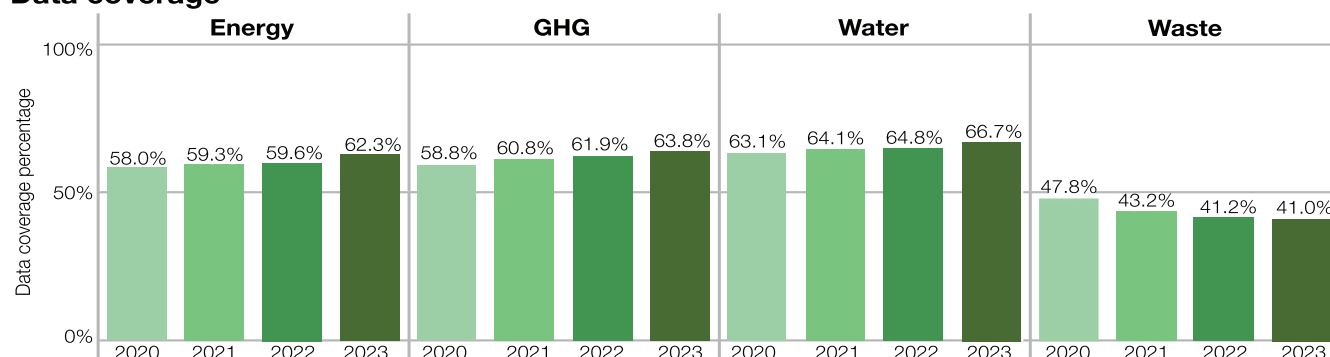
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Asset consumption metrics in the GRESB Real Estate Benchmark for the Americas region

Like-for-like %



Data coverage



Source: GRESB

that we might say, “If you do this, maybe you can save money on another part of your building and still receive the same outcome and potentially create new revenue streams,” says Hodgkinson.

The scorecards generally have different weightings on questions that result in scores ranging from zero to 100. For most lenders, a subpar score does not mean they will not do a loan. It’s more of a data collection process to help understand potential value creation and mitigate potential risks. Lenders are collecting data and learning from outcomes, which they can then apply to decisions on future loans. “Obviously, we operate in a competitive lending environment. So, whenever you can have a higher level of certainty on a risk premium or a higher level of certainty on a value-add opportunity, then you can price yourself better,” adds Hodgkinson.

Overcoming obstacles to SLLs

Globally, sustainability-linked loans have grown in popularity among both lenders and borrowers in the real estate and infrastructure sectors over the past few years as a mechanism for responsible financing. With them, borrowers can incentivize their sustainability performance, increase access to capital and potentially reduce costs, while lenders can better manage risk and demonstrate sustainability-related commitments

to regulators and investors. GRESB is increasingly becoming a cornerstone of these loans, with scores and benchmark standings being used both to set and manage Sustainability Performance Targets and to support reporting and verification of the loan.

Although European banks have helped move the market on sustainable finance programs, adoption has been more gradual in North America. One reason it has been slower to take hold is likely a lack of financial and tax incentives that benefit sponsors/issuers, notes Kathy Thurston, executive director, director of sustainable finance at PGIM Real Estate: “Until the passage of key tax benefits, borrowers may not see the economic benefit of doing good. Similarly, investors have been unwilling to sacrifice return for advancement of sustainability objectives,” she says.

Capital markets have priced in very little discount to market spread for sustainable bonds/loans — typically as little as 5 basis points of benefit to borrowers willing to abide by the structure and reporting required for sustainable lending products. “Borrowers with sustainability objectives may seek to use these products. However, many are not enticed by the relatively slim benefit,” says Thurston. That being said, the conversation around the capital pricing structures is evolving to include both “carrot” and “stick” approaches for lenders

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Since our founding, The Green Cities Company has recognized the overlay of environmental stewardship, social impact, and fiduciary results. Defined by our proprietary Green Cities Index, our approach includes a holistic focus on Environmental Impact, Climate Change Mitigation, Resilience, Health & Wellbeing, and Equitable Communities.

Through our multifamily equity investments, we have demonstrated the power of ESG to create meaningful – and financially powerful – experiences of sustainability, health, and community for our tenants. Through our Debt originations, Green Cities additionally recognizes that all capital partners can contribute to ESG value drivers, using ESG as an opportunity to negotiate key items into the physical improvements required of the loan as well as act as a mentor to our borrowers throughout their loan period on ESG best practices.

We share with our borrowers the key elements of Green Cities' robust ESG Playbook, advancing current performance and future value through initiatives such as developing detailed Climate Action plans, energy and water management, dedication to air quality, preservation of acoustic and thermal comfort, access to health, use of non-toxic and low-carbon materials, designing with biophilic and inclusivity principles, and a wide variety of other approaches that reduce operational cost, enhance tenant retention, support rent premia, and contribute to greater disposition values.

This approach to underwriting is unique in the credit market: underscoring stronger asset performance with ESG advancement. Traditionally, lenders have not incorporated loan proceeds or supported borrowers for ESG-related capital improvements. However, we believe this strategy is not only responsible but a critical factor in mitigating risk and driving returns.



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and borrowers to align on spread reductions for achievement of sustainability KPIs or penalties for missed targets. And investors who are focused on the space have pushed lenders to ensure the risk/reward equation is in balance and underlying targets met, she adds.

Despite slower adoption in the United States, PGIM Real Estate continues to make directional moves to meet energy transition demands by working with borrowers to find solutions through the type and structure of the capital we offer. This may include working with borrowers to better understand their sustainability goals, or formalizing sustainability monitoring and reporting with regular check-in points to ensure we are aligned during the business plan, adds Thurston.

Ares Management has been very supportive of SLLs across its other business lines outside of real estate, with many examples of SLL deployment. In addition, in 2022, Ares worked with its lenders to introduce sustainability-linked pricing to its corporate revolving credit facility, which includes goals tied to its measurement of GHG emissions, alongside diversity associated with its employees and third-party supplier spend. However, SLLs for real estate assets can be more difficult to structure given the underlying nature of the assets, notes Daren Moss, a principal in the Environmental, Social and Governance Group at Ares. "In real estate debt, one of the challenges is ensuring the sustainability targets are incremental and not business as usual," he says. Given the current market challenges, borrowers could be less comfortable with anything that may increase costs or negatively affect loan pricing and timing, he adds.

Borrower appetite for green financing

North American lenders could be pulled down the path to SLLs by their borrowers. Ivanhoé Cambridge is one firm that is exhibiting a growing appetite for green financing. "Our industry-leading approach to sustainable finance incorporates ESG factors into a number of our transactions," says Rob Simpson, senior director, sustainable investment, and head of climate change strategy at Ivanhoé Cambridge in Toronto. "These innovative tools make it possible to finance our activities in a way that is true to our corporate vision of having a meaningful and sustainable impact on our communities. This approach also allows us to broaden our pool of investors and drive innovation forward within the real estate industry," he adds.

Since 2017, Ivanhoé Cambridge has achieved a number of key milestones. The firm has deployed C\$19 billion (\$14 billion) in sustainable finance, including C\$15 billion (\$11 billion) of sustainability-linked loans where the cost of the



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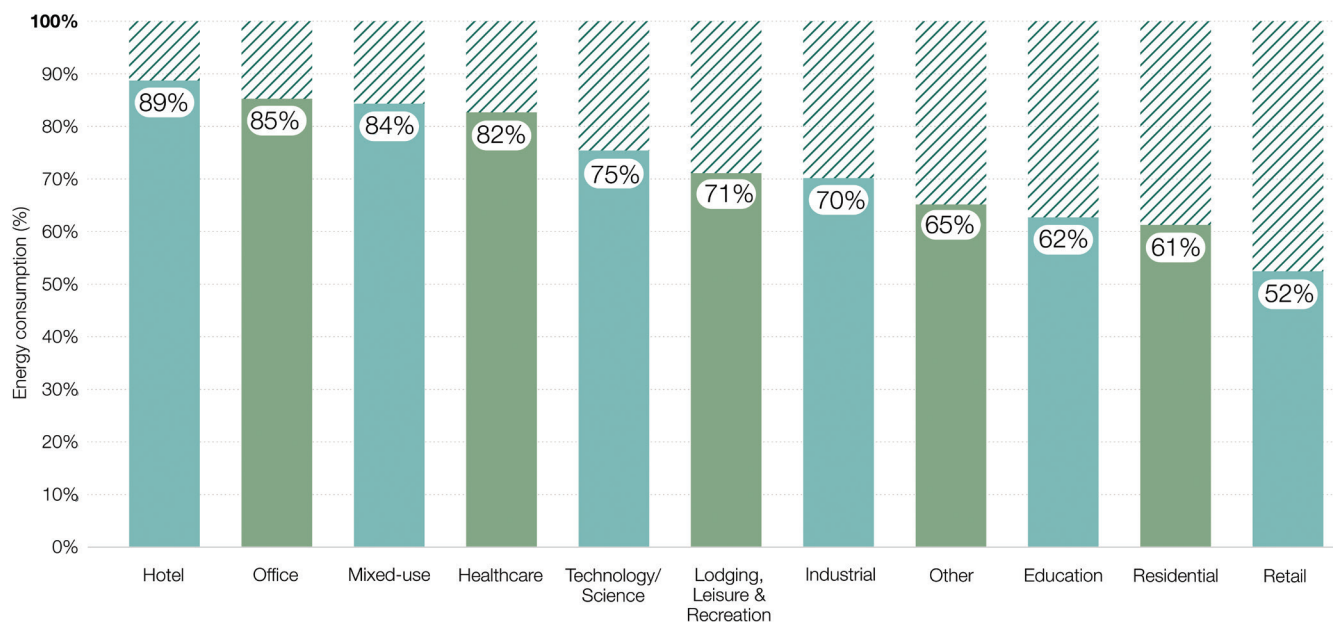
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1. Assets under Management ("AUM") reported in this presentation is calculated as the sum of the gross asset value of the Firm's investment vehicles (debt/equity) & unfunded capital commitments for such vehicles.

2. GRESB 4-star and 5-star responses are in the top 40% and top 20% of all global survey respondents respectively. This rating was provided by GRESB B.V. as of October 2, 2023, for the period covering January 1, 2021, through December 31, 2022. Berkshire compensates GRESB in the form of annual participation fees that do not influence final scores or rankings.

3. Weighted average based on gross asset value, GRESB peer group: United States, Non-listed, Residential Multifamily, Core.

Reported energy consumption data coverage by property type



Source: GRESB

debt is tied to whether the firm has achieved certain targets, such as reduced carbon intensity or amount of low-carbon investments. In May 2023, the company announced that it had issued its first sustainability bond for C\$300 million (\$221 billion), which will help finance green assets that the company owns as well as affordable housing projects. “This bond was placed with 35 investors, the majority of whom considered the sustainable characteristics of this instrument to be a decisive factor in their investment decision,” notes Simpson.

Ivanhoé Cambridge has made notable advances in its sustainable finance program that include the expansion and diversification of its sustainable finance instruments from green bonds to SLLs, green construction loans and green CMBS to sustainable bonds. Since 2019, sustainable financing has made it possible to align, in some instances, the cost of its loans and credit facilities with its sustainable performance via sustainability-linked loans. “We believe SLLs create a real incentive for the issuer to achieve ESG improvement targets. This is a concrete example of how ESG performance aligns with financial performance through lower cost of debt,” says Simpson. “This creates better alignment of interest on ESG progress, which is very powerful compared to labeling a financing as being green or social-themed, which is also great, but different.”

Both equity owners and lenders are recognizing the positive correlation between sustainable performance and financial performance. “Sustainability and ESG are now core to asset quality, and

we believe they will ultimately be core to asset valuation,” says Simpson. Ivanhoé Cambridge takes the view that real estate will benefit from a green premium in the short term, within the next five years, while risks associated with brown discounts will be a bigger factor over the medium term. Such brown discounts are already emerging in the office sector, where ESG performance is part of the bifurcation and flight to quality.

For this reason, Ivanhoé Cambridge has recently introduced a new metric, the green internal rate of return (green IRR), which integrates the value of carbon across its entire portfolio, enabling it to inform investment and asset management decisions. The green IRR is also an indispensable metric in preventing the obsolescence of its properties, and thereby meeting the growing expectations of tenants, investors and users for low-carbon, sustainable buildings. In certain regions, such as in Europe, financing is simply not available if the asset is not green, adds Simpson. “We firmly believe that over the long term, green capex investments will contribute to future-proofing assets in anticipation of future carbon costs and tenants’ and investors’ expectations,” he says.

Digging for meaningful metrics

Demand for greater ESG data and reporting is coming in part from stakeholders, including investors, borrowers and tenants. “We are seeing more ESG data requests from investors all across the world, including Europe, Asia



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and in the U.S.,” says Shadi Swoish, a managing director at PCCP. “As more groups are doing their own ESG reporting and complying with various frameworks and disclosure obligations, we are being asked to support those efforts.”

Data and measurement of utility and energy consumption are becoming very important as companies are trying to benchmark performance, set targets and meet short- and long-term goals. Desired ESG metrics from borrowers can vary widely depending on the borrower and property type. Some of the metrics and KPIs that are top of mind are green building certificates, minimum energy performance certificates, GHG emissions, energy consumption, water consumption, waste production, the presence of fossil fuels, climate risk exposure, the presence of renewable energy and avoided emissions.

“At the end of the day, we believe that having information on a building’s energy utilization and resource consumption will help us and our borrowers eventually sell assets, as we believe requests for this type of information will become more commonplace in the future,” says Swoish. “Saving energy also saves money to help the bottom line, and knowing how and where to do that starts with having information on how the building is performing today.”

Although lenders are looking broadly at the spectrum of E, S and G factors in their diligence

process, the climate-related risk is at the forefront given the financial risks associated with physical and transition risk. In addition to utilizing a questionnaire, PCCP engages third-party consultants to complete property condition reports to identify physical gaps in the real estate that should proactively be addressed to mitigate potential damage from climate risk, among other factors. The firm recently started conducting a resilience analysis that tracks a property’s exposure to several climate hazards including drought, earthquakes, floods, wind, wildfire and hurricanes.

PCCP also has launched an ESG Partner Program, which it hopes will enable the firm to share best practices with its counterparties. “This partnership program encourages our borrowers and operating partners to create value within the investment through what we believe are achievable steps like signing up for Energy Star Portfolio Manager, incorporating green lease clauses into their form leases and conducting periodic tenant satisfaction surveys,” says Swoish.

More progress ahead

As ESG best practices continue to evolve in respect to real estate financing, lenders are still in the early days of addressing the carbon footprint of loan portfolios. To support those efforts, GRESB has collaborated with PCAF

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(Partnership for Carbon Accounting Financials) and CRREM (Carbon Risk Real Estate Monitor) to develop technical guidance for the financial industry on accounting and reporting of GHG emissions from real estate operations. Released last March, the guidance provides recommendations for accounting procedures for both investors and banks, direct and indirect investments, equity and debt, full ownership and joint partnerships, under a variety of consolidation approaches.

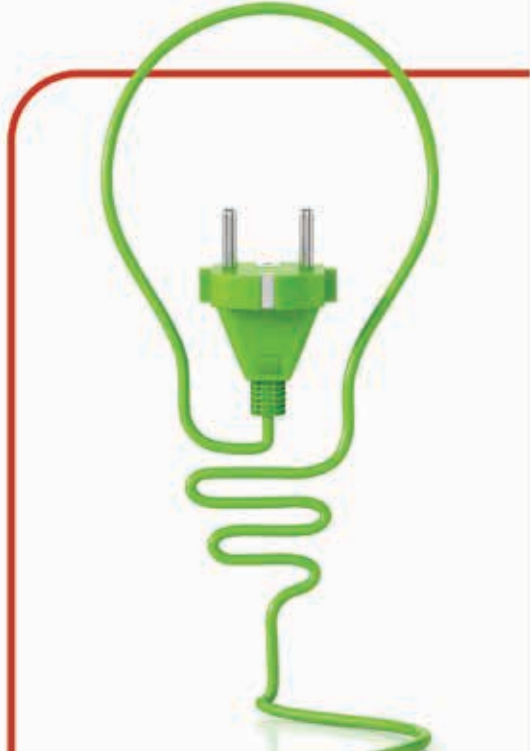
Ares is one firm that has completed what it calls its “first wave” of emissions footprints covering certain investments held by its private equity, direct lending and infrastructure investment teams. “The exercise provided an initial baseline that spans 244 portfolio companies and 14 funds and marked the successful completion of the first round of sustainability targets linked to Ares’ corporate revolving credit facility, further demonstrating our commitment to leading with accountability,” notes Moss. Real estate will be included in the second wave, and the firm intends to publish the real estate carbon footprint (including debt loans) in its 2024 climate reporting.

As the focus on ESG and sustainable financing continues to move forward, real estate capital providers are keeping an eye on the changing landscape and working to

gather more data to inform risk management and decision making. “Having access to actual asset-level consumption data related to energy, water and waste will continue to be a focus for many groups, including ourselves,” says Swoish. “We are being asked by some investors to report on this information, and we ultimately need this data internally to understand current performance and set quantifiable goals and targets to reduce consumption.” This level of data has not historically been reported to lenders but will likely become a more common request from borrowers going forward.

Although lenders are competing for business, there is acknowledgment that collaboration and creating standard practices will allow lenders to better understand and mitigate ESG-related risk. Many borrowers do have their own ESG and carbon goals. However, the process takes time, and change doesn’t happen overnight. “The more lenders ask similar questions, the more likely it is that borrowers will be inclined to share that information,” says Landau. “The question is, how do we get everybody in alignment so that we’re all trying to do better, improve the quality of life and the environment for the occupants of the building?” ♦

Beth Mattson-Teig is a freelance writer based in Minneapolis



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GRESB is a mission-driven and industry-led organization providing standardized, validated, and actionable ESG data and portfolio analyses tools to financial markets. Established in 2009, GRESB has become the leading sustainability benchmark and insights provider for real estate and infrastructure investments across the world, used by 150 institutional and financial investors to inform decision-making.

The independent and not-for-profit GRESB Foundation actively engages with the real assets industry, working closely with investors, financial institutions, managers, and other stakeholders to continually evolve the GRESB Standards, meet industry needs, and offer new insights and solutions that drive tangible improvements. The annual GRESB benchmarks include more than 2,000 real estate portfolios and funds as well as more than 170 infrastructure funds and nearly 700 infrastructure assets, collectively representing \$8.8 trillion in gross asset value.

For more information, visit [GRESB.com](https://www.gresb.com)

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