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INVESTMENT MANAGEMENT

# Sustainable Logistics and Decarbonizing Real Estate Efforts Across the Globe

**MORGAN STANLEY'S SUSTAINABLE FINANCE SUMMIT | KEY TAKEAWAYS** | August 2023

Laurel Durkay shares her insights on environmental, social, and governance (ESG) factors across real estate sectors and geographies during the Sustainable Logistics & Decarbonizing Real Estate panel at Morgan Stanley's Sustainable Finance Summit.


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### Climate Change Impact on Real Estate

Climate change is an important factor to consider for the real estate sector, as building operations and construction account for approximately 40% of global energy-related $CO_2$ emissions. Existing buildings face chronic and acute physical risks, including intensifying hurricanes, floods, and wildfires, as well as economic, social and regulatory changes necessary for decarbonization. Publicly traded real estate companies hold a significant share of the building stock globally. As such, they are in a unique position to play an important role in achieving global sustainability targets. For public market investors, understanding how companies can influence and achieve net-zero targets is important, as is assessing the financial implications and, importantly, the capital expenditures required to reach such targets.

### Managing Sustainability Risks and Opportunity

Real estate owners and operators are under pressure to understand and manage the risks and opportunities related to sustainability from parties such as investors, regulators, and tenants. As the effects of climate change intensify around the globe, the regulatory landscape is evolving to address and mitigate the worst impacts, with a number of real estate-specific local laws and regulations being adopted in the U.S. and Europe. For example, Local Law 97 in New York City aims to increase the sustainability of New York City's buildings by reducing building emissions, while Energy Performance Certificates are a rating scheme to summarize the energy efficiency of buildings in many European countries. These types of regulations, along with increased demand for green buildings, energy metering and the prioritization of health, safety and wellness by tenants are expected to lead to a new capital expenditure cycle for commercial real estate. We believe that property owners that have already made significant investments in these areas will be best positioned to navigate the increasing costs. In fact, there is evidence that rent premiums are being associated with green buildings across many sectors.

### Understanding Scope 3 Emissions[1]

Scope 3 emissions are important for the real estate sector and can account for up to 90% of some companies' total carbon emissions. As a result, it is essential for companies to better understand and manage their Scope 3 emissions in a transparent and prudent manner. Scope 3 emissions occur along the entire real estate value chain and disclosure varies within individual sectors. While self-storage facilities, industrial facilities, and data centers may each have different approaches for estimating Scope 3 emissions, all real estate companies must act as partners with investors and provide transparency to help the market understand how these emissions are defined and managed in a responsible manner.

### Controlling Emissions and Improving Outcomes

There are many ways to analyze Scope 3 emissions, from the absolute level of emissions, to the amount of financed emissions, or the degree to which a company has reduced emissions over time. Real estate companies must focus on their ability to control emissions and improve outcomes. For example, new technologies and innovations such as electronic metering can help companies better understand energy consumption trends and emissions. In triple net lease real estate, a landlord essentially has a 10- to 30-year lease with the tenant and that lease is essentially a form of financing. This lease structure passes the costs of structural maintenance and repairs to the tenant in addition to rent, property taxes, and insurance premiums. Unfortunately due to this structure, triple net lease real estate landlords lag in understanding Scope 3 emissions and are generally unable to report on total energy usage. To help mitigate this structural issue, leases with underlying tenants can and should be structured to ensure tenants provide emissions disclosure and ESG data, such that triple net lease landlords can better understand energy usage in their properties and potentially implement solutions in partnership with tenants to reduce and effectively manage emissions.

### The Importance of ESG Oversight

Corporate Governance and Board oversight of ESG is of utmost importance, and increasingly incorporated into company charters and board mandates, in particular in Europe, the U.S. and Australia. Appropriate Board and executive oversight of ESG matters signals to investors and the market that a company is trying to understand and manage ESG risks and opportunities, an analysis of which should be incorporated into performance and compensation metrics for executive officers. ESG risks and opportunities will have a growing impact on valuations, cash flow projections and total returns and are increasingly important considerations for real estate companies and investors. Just as a company must focus on maximizing occupancy levels and managing rents, it must also understand and effectively manage sustainability.

For MSIM's GLRA team, the identification and assessment of risks and opportunities related to sustainability—specifically ESG integration—is a core element of our research process, comparable to our focus on other factors[2] such as building quality, tenancy, occupancy, strategic business plans, etc. We strive to stay ahead of ESG and other trends in seeking to provide clients with exposure to real estate securities with the best expected total returns.

[1] Greenhouse Gas emissions are categorized by the type of emission. Scope 3 emissions are the result of activities from assets not owned or controlled by the reporting organization, but that the organization indirectly affects in its value chain.

[2] Individual funds and client accounts operating within the strategy may have specific ESG related goals and restrictions that affects ESG integration. Please refer to governing documents of individual vehicles to understand their binding ESG criteria.

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