Property Debentures – Environmental Engagement Project 2023

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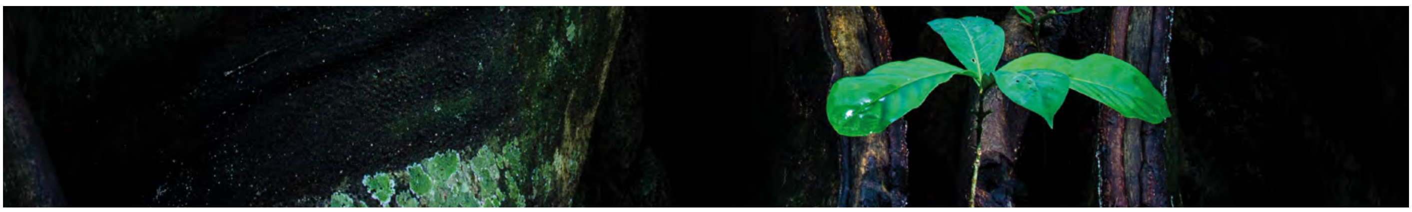
Executive summary

- Commercial real estate is a prime example of how any perceived distinction between credit analysis and ESG analysis is becoming increasingly invalid
- We conducted an environmental engagement project to understand the net zero transition impact on secured property debentures issuers. Although our typical Sterling Credit portfolios do not target a specific ESG or climate outcome, and different portfolios will have differing bond weightings to reflect their investment objectives, such bespoke ESG analysis allows us to enhance our risk identification and evaluation - with the greater understanding of issuers' credentials informing our assessment of cash flows and collateral values
- We are pleased with the attention placed by our borrowers on sustainability and net zero more specifically, with the companies that more materially depend on strong environmental credentials taking the strongest actions
- We obtained a clearer picture of where each of our borrowers stand on the journey to net zero, as well as the quality of the assets that we are secured upon, enabling us to integrate transition preparedness into the evaluation of balance sheet sustainability
- We will continue working with the laggards, pushing them to improve their practices and better align to the expectations we have on material issues

Table 1. Company profiles

	Company A	Company B	Company C	Company D	Company E
Portfolio Size	→ £5bn	→ £5bn	→ £5bn	← £1.5bn	← £0.5bn
Property Types	Offices, Retail	Offices, Residential, Retail	Offices	Industrial, Offices, Retail	Industrial, Offices, Retail
Portfolio Location	Across UK	London	London	Across UK	Across UK

Source: Royal London Asset Management as at 31 December 2023



Introduction

The commercial real estate sector is seeing strong momentum towards better climate practices.

This is being driven by several factors which are having a direct impact on the underlying market for property, including regulation and the growing demand for properties with leading environmental credentials. This is particularly the case for commercial office space, with more tenants looking for greener buildings that align to their sustainability ambitions. The implication is that property values and income streams are becoming increasingly linked to environmental credentials and a performance gap is arising between landlords with newer and greener properties and those owning buildings with lagging ESG characteristics. To the extent these forces have a direct impact on the sustainability of borrowers' balance sheets and their ability to service debt, commercial real estate is a prime example of how any perceived distinction between credit analysis and ESG analysis is becoming increasingly invalid.

Royal London Asset Management invests in a range of secured property debentures, as a subset of property bonds, and we undertook an engagement project in 2023 in order to understand further the net zero transition impact on these issuers. Generally, these companies have lower public profiles than more conventional issuers of unsecured corporate bonds and a number of the bonds are unrated. This means that not only do we potentially have additional influence as lenders, helping to shape transition planning and reporting, but we also have an enhanced opportunity for enhanced understanding. Furthermore, given the perception of these bonds being less liquid, and more 'buy and hold' in nature, a longer-term understanding of sustainability feels even more appropriate.

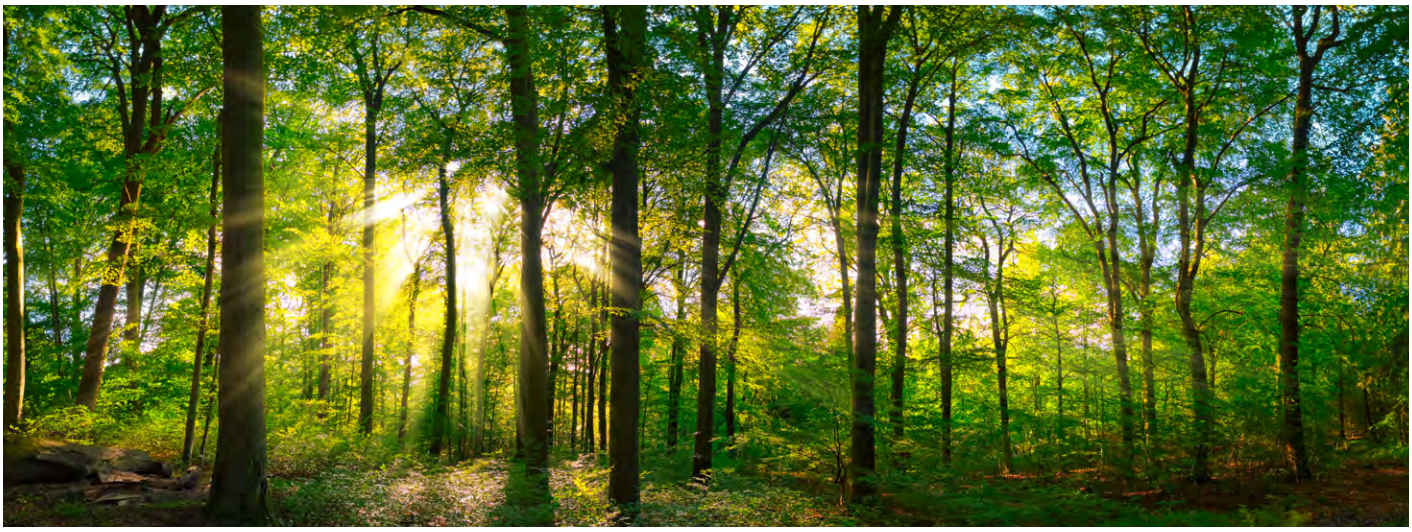
Although certain of the debentures are unrated, these bonds do benefit from security and covenants, which helps to address subordinated creditor control. However, despite the welcome benefit of such protections, which can dampen the credit impact of unforeseen or underestimated ESG risks, we also need to acknowledge their limitations. Most notably, whilst asset and income cover covenants help to maintain the value of collateral against our lending, they do place a reliance on valuers to be prospective in their assessments, as well as having in-built lags due to the covenant compliance cycle. Therefore, supplementing our desktop understanding of asset value with forward looking evaluations of asset life is constructive.

A tailored approach

The topics discussed in our engagements reflect the bespoke approach to climate transition analysis that we have adopted in the Sterling Credit team.

Going beyond the simple review of quantitative metrics or tick-box requirements, we carry out tailored qualitative assessments of issuers — enabling us to produce research that is bespoke to the characteristics of the sector and each company. An example of the practical implication of this approach for the real estate sector is our recognition that Energy Performance Certificates (EPCs) do not fully capture a company's decarbonisation efforts. Our view was shared by the companies we spoke to, with the sector making efforts to move towards the adoption of new ratings e.g. NABERS UK, that more effectively measure the operational performance of buildings.

Our assessments were also aided by the 'climate indicators framework' developed in-house by our Responsible Investment team. The nature of the framework is qualitative and forward-looking, helping us evaluate an issuer's willingness and ability to transition. Bespoke considerations for the sector, combined with the indicators framework, means that our research is additive for our investment decision-making process. This also helps us overcome the lack of comprehensive third-party research on our borrowers. While available in some instances, third-party analysis of real estate companies is often blunt and fails to capture the underlying performance of issuers.



What we learnt

Table 1. Peer benchmarking against expectations on key issues.

Key Issues	Expectations	Company A	Company B	Company C	Company D	Company E
Targets	• Science-based target initiative (SBTi) covering all emission scopes	Leading	Leading	Leading	Lagging	Lagging
Operational Carbon	• Efforts to improve buildings energy efficiency • Engagement with occupiers • Operational efficiency targets for new developments	Leading	Leading	Leading	Lagging	Lagging
Renewable Energy	• Increasing renewable energy, considering off-site renewables	Lagging	Lagging	Lagging	Lagging	Lagging
Embodied Carbon	• Whole-life carbon assessments • Embodied carbon targets for development and refurbishments • Embedding circular economy principles	Leading	Lagging	Lagging	Not applicable*	Not applicable*
Offsetting	• Preference for carbon removal offsets and alignment with best practice offsetting principles	Lagging	Leading	Leading	Lagging	Lagging

● Leading ● Lagging * No material development activities.

Source: Royal London Asset Management as at 31 December 2023. Past performance is not a guide to future performance.

Targets
The first point of discussion was the emission reduction targets that have been set by our borrowers. This is an area where there is the most alignment across the companies we spoke to, with best practice consisting of 1.5°C-aligned targets that cover all emission scopes – including scope 3 emissions associated with the tenants' use of the properties. Among the companies we spoke to, **companies D and E** have not set a target addressing tenants' emissions, as they remain in the process of mapping the full carbon footprint of their assets.

We are looking for ambitious targets and expect our borrowers to outline actions being taken to address emissions.

When it comes to operational emissions i.e. emissions associated with the energy used by landlords for communal areas and by tenants for their units, what we learnt from our conversations is that along with improving the energy efficiency of properties, the focus is on increasing reliance on renewable power – with electrification of the grid seen as the key driver for the sector's decarbonisation. For the time being, the companies we spoke to tend to rely on Renewable Energy Guarantees of Origin, known as REGO-backed tariffs for the electricity that they procure directly, with the aim of eventually generating greater on-site renewable power to achieve further emissions reductions. Investments in offsite renewables are also being looked at, with **Company B** planning to build an offsite solar farm that will produce enough power to meet 50% of its electricity needs. We also noted how a couple of our borrowers, **companies A and B**, are making plans to move away from gas through the installation of heat pump systems.

Operational carbon
A greater challenge that remains is that of tackling emissions associated with tenants' use of the properties – which tend to represent a large portion of the operational carbon footprint of the companies we spoke to. We noted some encouraging feedback from borrowers in this area, with a general recognition of the importance of tenant engagement in helping occupiers better understand their energy usage.

Company B in particular told us how they hold regular one-to-one meetings with tenants to discuss energy use, while also holding green forums that bring all occupiers together to discuss a building's net zero plan. Another borrower, **Company A**, has conducted net zero audits for its buildings and produced net zero carbon pathways tailored to its assets, which it uses in discussions with tenants.

Company C plans to step up its tenant engagement efforts to address the unavailability of energy usage data from occupiers. This is a particular issue that is common across the industry. The company told us that less than half of the data they have available is actual energy usage data and outlined their intention to increase this share through a smart meter rollout, in addition to more engagement with tenants. The challenge around data was also noted by **Company D**, explaining how they currently get only minimal data from tenants on energy usage – and how this is partly due to their tenants being smaller companies. To address this, they are working on enhancing a data sharing tool that will be used by tenants to obtain information on the energy efficiency of the buildings as well as to upload data on their energy use.

Company A noted how the issue of data availability was greater in their retail parks rather than their office buildings. Including green clauses in leases that require tenants to share data can be a solution, with such clauses having become common across all the companies we spoke to. However, these clauses address the issue only for new tenants and for leases coming up for renewal – rather than for all occupiers.

Embodied Carbon

As we look for our borrowers to take a whole-life approach to carbon, we expect to see efforts to address operational emissions and action to tackle embodied carbon i.e. emissions associated with materials and the construction process. These are the emissions that are most difficult to address, given the carbon intensity of materials used in construction. One valid approach to addressing embodied carbon starts by getting the balance right between redevelopment and refurbishment and we were keen to get our borrowers' thoughts on this important issue for the industry. While **Company C** told us that they have a retrofit-first approach, the general view is that all options should be considered when deciding between redeveloping and refurbishing and that refurbishment may not necessarily be the best option in all instances. For example, **Company A** noted how the existing structure of a site may not be suitable for the end uses planned, and redeveloping the site is therefore necessary. While doing so will result in higher embodied carbon, this solution also has benefits in the form of lower operational emissions throughout the life of the building.

Key to addressing embodied carbon is to conduct asset-by-asset measurements, avoiding a reliance on benchmarks. **Company B** explained how embodied carbon is measured multiple times during a project, including by the construction company, who can provide information on the exact materials used. Another company explained how whole-life carbon assessments, including third-party verification, are undertaken for all projects. We also welcome the embodied carbon targets set by each of the three companies we engaged with material development activities (companies A, B, and C).

Encouragingly, the targets are aligned to best practice standards in the case of each company. Going forward, we would expect similar targets to also be set for refurbishment activities.

Another best practice is to embed circular economy principles in developments. **Company A** showed a strong approach, addressing re-use, adoption of new lower carbon materials, and mapping all materials going into a new building. This last initiative enables a more efficient re-use of materials during both refurbishing activities as well as the end of life of the building.

Offsets

Although we have generally been sceptical of companies relying on offsets at an early stage in their transition, we also recognise that no real estate net zero strategy is possible without some usage. We were therefore keen to get a better understanding of the extent to which companies are using them. While current best practice guidance allows for a split between avoidance and removal offsets, we welcomed a clear emphasis from our borrowers on removal projects e.g. peatland restoration. **Company B and C** are also looking at self-generated removal offsets.

What's Next: Going Beyond Climate

In addition to this work with the property sector on net zero, our Responsible Investment team has engaged with the UK Property and Housebuilding sector on Biodiversity Net Gain, a new English regulation. With this new regulation coming into force, we were particularly interested in understanding the preparedness of our borrowers to the new requirements. Our findings along with our expectations were published and can be found here.

Investment implications

Our discussions with issuers were an important opportunity to gain insights on the quality of both the companies servicing our bonds but also the specific properties on which our lending is secured, representing a clear enhancement to our risk identification and evaluation. Along with wider insights on sector practices from our in-house property team, these engagements have also informed how we should continue to engage and analyse companies in this sector on an ongoing basis. The insights gained have helped us create a 'best in class' archetype from which to iterate and a future framework for our interactions with the sector.

From our conversations, we were generally pleased with the attention placed by our borrowers on sustainability and net zero more specifically.

We believe all companies we spoke to show a clear recognition of the importance of strong climate credentials, and all are well placed to meet regulatory requirements in the short term. We were also pleased to learn that those companies with businesses that more materially depend on strong environmental credentials are the ones taking the strongest actions. This is an important conclusion given the immediate asset life and cash flow consequences of environmental risks, helping to underpin our current investment in the sector, and is a useful input into both our rating and valuation of the in-scope bonds.

In addition, we now have a clearer picture of where each of our borrowers stand on the journey to net zero, as well as the quality of the assets that we are secured upon, enabling us to integrate transition preparedness into the evaluation of balance sheet sustainability.

Our next steps will be to continue working with the laggards, pushing them to improve their practices and better align to the expectations we have on material issues.

Commercial real estate is a sector that often exhibits heightened volatility given its economic sensitivity and proclivity to leverage when interest rates are low. The combination of security over appropriate assets, dynamic protection from asset and income cover covenants, net zero preparedness and excess spread for the lower profile of the issuers, supports our view that debentures remain an optimal way for us to gain access to property lending.

Terminology

The following table lists key defined terms used throughout the report.

Carbon offsetting	Actions or investments made at a building or organisational level to facilitate another party to reduce or avoid emissions, or absorb atmospheric carbon. Often used as a means of compensation for emissions generated elsewhere.
Embodied carbon	Greenhouse gas emissions associated with building construction, including those arising from extracting, transporting, manufacturing, and installing building materials, in addition to the operational and end-of-life emissions of the materials.
NABERS UK	Green building certification that uses the actual operational performance of a building to assess, rate and certify the sustainability of a building.
Operational carbon	Greenhouse gas emissions associated with the operational stage of a building's lifecycle, mostly attributed to emissions from energy use.
Scope 1 emissions	All direct emissions from sources that an organisation owns or controls directly, such as emissions associated with fuel combustion in boilers.
Scope 2 emissions	Indirect emissions from electricity purchased and used by the organisation
Scope 3 emissions	All other indirect emissions from upstream and downstream activities of the organisation, occurring from sources that they do not directly own or control.
Renewable Energy Guarantees of Origin (REGO) Certificate	A certificate issued by the Office of Gas and Electricity Markets (Ofgem), certifying that the electricity in respect of which the certificate is issued, was electricity produced from renewable energy sources.
Whole life carbon	Greenhouse gas emissions associated with the full lifecycle of a building, from materials and construction through to demolition, combining embodied carbon, operational carbon and any other sources of emissions.

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. Changes in currency exchange rates may affect the value of these investments.

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