Sustainability transparency in financial reporting

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Sustainability transparency in financial reporting

Real Estate Investment Trusts Sector Insights
Topics

► What is sustainability (non-financial) reporting
► Real Estate sector trends and drivers
  ► Institutional Investors—raising the sustainability bar
► Beyond reporting – realizing value
  ► Shareholder Value
    ► “Brown discounts” & “Green premiums” reach Earnings Parody-TIAA-CREF’s Report; May-2015
  ► Reduced:
    ► Energy, Water, Waste, Carbon
  ► Improved:
    ► Net Operating Income, Asset Valuation
  ► Leveraging federal, state and utility incentives
► EY – Integration of GRESB, Green Buildings & Incentives
What is non-financial (sustainability) reporting

A sustainability report* describes a company’s non-financial performance with respect to environmental, social and governance topics relevant to internal and external stakeholders.

*Often referred to by companies as a Corporate Social Responsibility Report (CSR) or Citizenship Report
What is non-financial (sustainability) reporting
Reflecting the changing concept of a company’s value

Components of S&P 500 Market Value

<table>
<thead>
<tr>
<th>Year</th>
<th>Intangible Assets</th>
<th>Tangible Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>17%</td>
<td>83%</td>
</tr>
<tr>
<td>1985</td>
<td>32%</td>
<td>68%</td>
</tr>
<tr>
<td>1995</td>
<td>68%</td>
<td>32%</td>
</tr>
<tr>
<td>2005</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>2015</td>
<td>16%</td>
<td>84%</td>
</tr>
</tbody>
</table>

Intangible assets are non-monetary and non-physical such as intellectual or brand capital.

Source: Ocean Tomo LLC
Drivers of sustainability reporting
Shareholder proposals focusing on ESG (environment, social, governance) continue to increase

- Proposals focusing on environmental and social (E+S) topics account for 60% of shareholder proposals submitted as a broad category compared to 45% in 2013.¹

- Three of the top 10 most common shareholder proposal topics in 2014 to date focused on ESG matters: review/report on greenhouse gases No. 2, issue sustainability report No. 4, review/report global labor practices/human rights No. 8.

- A growing number of these proposals are reaching the threshold level of 30% support, the level at which many boards take note.

Support for shareholder E&S proposals by threshold in the past six years

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 30% support</td>
<td>15%</td>
<td>18%</td>
<td>27%</td>
<td>31%</td>
<td>23%</td>
<td>30%</td>
</tr>
<tr>
<td>&gt; 20% support</td>
<td>30%</td>
<td>38%</td>
<td>44%</td>
<td>52%</td>
<td>45%</td>
<td>54%</td>
</tr>
<tr>
<td>&gt; 10% support</td>
<td>40%</td>
<td>48%</td>
<td>52%</td>
<td>59%</td>
<td>62%</td>
<td>65%</td>
</tr>
</tbody>
</table>

Source: Taking flight: Environmental sustainability proposals gain more attention, Ernst & Young LLP, 2013

¹ Other major proposal categories are board-focused, compensation and anti-takeover/strategic proposals.
Reporting risks and benefits
Value of non-financial / sustainability assurance

It’s the cheapest form of *reputational insurance* …

<table>
<thead>
<tr>
<th>Risk management</th>
<th>Cost reduction</th>
<th>Opportunity</th>
</tr>
</thead>
<tbody>
<tr>
<td>▶ Identify inconsistencies in sustainability and compliance reporting</td>
<td>▶ Strengthen and streamline reporting processes and systems</td>
<td>▶ Reporting aligned to the company’s overall organizational purpose and strategic imperatives</td>
</tr>
<tr>
<td>▶ Identify potential errors in reports and public claims</td>
<td>▶ More efficient, and complete data collection and reporting</td>
<td>▶ Greater stakeholder confidence in reported metrics</td>
</tr>
<tr>
<td>▶ Reduce misstatement that could lead to reputation / brand risk</td>
<td>▶ Better data = better decision making</td>
<td>▶ Shows commitment and provides legitimacy in accurate reporting</td>
</tr>
<tr>
<td></td>
<td>▶ Improved management of Environmental, Health and Safety matters</td>
<td>▶ Increase brand / market presence</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Assurance over non-financial metrics is increasingly included in sustainability ratings/rankings</td>
</tr>
</tbody>
</table>

Increased communications and shareholder value
Achieving credible data and reporting

Key elements

Many leading companies follow this sustainability reporting life cycle to produce credible data that truly drives business value.

- Establishing strong governance
  - Involvement of board
  - Performance-based incentives

- Defining what is material
  - Engaging with stakeholders
  - Consider business strategy, risks and opportunities

- Determining the appropriate metrics and goals
  - Defining suitable criteria
  - Leveraging reporting frameworks

- Standardizing data collection
  - Formalizing processes and controls

- Obtaining internal and external assurance

- Improving processes and controls
Real Estate sector trends and drivers
## Sustainability drivers in the Real Estate industry

### Economic returns
- Market leadership
- Improved financial performance and higher returns on assets and equity (ROA and ROE)
- High pressure to remain competitive with peers.
- Higher appraisals, rental premiums, and lower vacancies
- High customer demand for alignment on sustainability
- Onsite power generation
- Renewable energy (cogen, solar PVC, fuel cell)
- Improve operational efficiencies - reduced energy use/costs - across the portfolio
- Reduced Water & Waste
- Leverage Tax incentives
- Leverage Cash Incentives

### Market expectations
- Institutional Investors
- Leaders are influencing sustainability policy and involved in industry benchmarking and standard setting
- 2015 Policy Agenda (RER, NAREIT)
- Performance benchmarking (GRESB)
- Sustainability account standards designed for SEC reporting (SASB)
- Stakeholders
- Manage policies and regulatory risks, such as:
  - The “Sensible Accounting to Value Energy (SAVE)” act for valuing properties
  - “Tenant Star” legislation
  - State/Municipal laws requiring disclosure of energy performance, i.e., energy use labels
  - EPA regulations
  - Coastal Zone Risks

### Cost avoidance

### Risk mitigation

### Sustainability
RE sector sustainability initiatives

- **Began in 1998**
- USGBC’s certification and rating system for sustainable buildings at the property level
- Measures the environmental design and performance of new and existing, commercial, residential and neighborhood developments and properties
- LEED Volume certification measures at a portfolio-level
- Four levels of certification: Certified, Silver, Gold, and Platinum

- **Began in 2005**
- Annual selection program of NAREIT members who show exemplary sustainability practices
- Presented across 8 categories: Diversified, Global, Health Care, Industrial, Lodging/Resorts, Office, Residential, and Retail
- Criteria takes into consideration GRESB scores

- **Began in 2006**
- UN initiative of investors dedicated to bringing the financial materiality of ESG issues into mainstream investment decision making and ownership practices
- Allows signatories to demonstrate their commitment to ESG investment, and implement the PRI’s Six Principles
- Mandatory reporting and assessment for asset owners and investment manager signatories

- **Began in 2009**
- Annual benchmarking survey for property companies and funds to disclose sustainability performance of portfolios to investors
- Participants ranked as Green Starters, Green Talk, Green Walk, or Green Stars
- In 2014, acquired by GBCI, the certification administrator for LEED
- First GRESB debt survey issued in 2015

- **First issued in 2011 (GRI began in 1997)**
- Sector-specific disclosures for the Construction and Real Estate industry designed to be additional to the general GRI G4 Guidelines
- Used in the development of Sustainability Reports to disclose key aspects of sustainability performance

- **Began in 2011**
- Devoted to creating accounting standards for 80 industries in 10 standards to disclose material sustainability information in SEC filings such as the 10-K and 20-F
- Developing disclosure standards for the Infrastructure sector to be released in March 2016
Global Real Estate Sustainability Benchmark (GRESB)--Survey Elements

Used by 50 pension funds representing 5.5 T of institutional capital
637 listed property companies submit GRESB surveys

Timeline:
► April 1: Survey opens
► July 1: Survey closes, validation starts.
► Sept: Survey/scorecard results

Benefits:
► Provides transparency to institutional investors (growing demand).
► Establishes standardized ESG factors for financial analysis.
► Improves portfolio management by helping to navigate uncertainties and opportunities
► Can improve risk adjusted returns.

Notes:
► First time survey participants are given a “grace period”-results are not disclosed.

Growth numbers: GRESB Respondents

- Total Respondents have increased 221% since 2009
- Total North American Respondents have increased 169% since 2009

Growth numbers: GRESB Asset Value

Global Asset Value has increased 126% since 2011
North American Asset Value has increased 251% since 2011

GRESB Aligned with UNPRI
Principles of Responsible Investment

► Leading network for investors committed to responsible investment principles and the inclusion of ESG factors into their investment decisions and ownership practices

► Institutional investors are asking our real estate clients about their sustainability practices. GRESB helps to communicate this information while helping to build strategy and performance
UN PRI Real Estate Trend Overview

Key Statistics

General Numbers:
1382 Total Global Signatories
236 in the US; 64 in Canada
$59 trillion Total Assets under Management (increase from $4 trillion at 2006 launch)

94% of signatories have instated a responsible investment policy
71% of signatories have asked companies to disclose and integrate ESG indicators into financial reporting

REITs continue to invest in sustainability and realize returns

► Real estate organizations are becoming more focused when it comes to energy management, making smarter investments in energy efficiency projects in order to maximize their returns over the life-cycle of the project or equipment.

► More than half of all investment in 2014 was directed to heating, ventilation and air conditioning (HVAC). Previously, lighting-related projects had attracted the greatest share of investment.

► Respondents are continuing to strategically target investments with the intent of maximizing returns.

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REITs with higher GRESB scores outperform peers

► A higher GRESB ranking of REITs correlates to superior financial performance. Both the returns on assets and returns on equity of REITs with high GRESB scores outperform their peers.

► Adjusted for risk, there is a significant link between portfolio sustainability indicators and REIT stock market performance.

► The study establishes for the first time that investing in sustainability pays off for investors in REITs, enhancing operational performance and lowering risk exposure and volatility.

► Room for improvement - the median score of rated Real Estate companies in 2014 was 58 out of 100.

Real-world example: TIAA-CREFF Social Choice Equity Fund

Here is the table showing the average annual returns vs. Russell 300 Index:

<table>
<thead>
<tr>
<th></th>
<th>3 Month</th>
<th>YTD</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
<th>10 Year</th>
<th>Since Inception</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Choice Equity Fund (Institutional Class)</td>
<td>-0.24</td>
<td>6.91</td>
<td>17.03</td>
<td>22.38</td>
<td>15.28</td>
<td>8.45</td>
<td>4.82</td>
</tr>
<tr>
<td>Russell 300 Index</td>
<td>0.01</td>
<td>6.95</td>
<td>17.76</td>
<td>23.08</td>
<td>15.78</td>
<td>8.44</td>
<td>4.91</td>
</tr>
</tbody>
</table>

(Net of fees, as of Sept. 30, 2014)

- **Takeaway:** pursuit of social/environmental goals in portfolio management does not necessarily mean sacrifice in portfolio performance

Quantitative evidence:

► TIAA-CREF:

“The high winning percentage of the LEED portfolio and the non-LEED portfolio’s low winning percentage are interesting; both are statistically significant. These results validated the LEED portfolio’s tendency to outperform over NCREIF office performance and the non-LEED portfolio’s propensity to underperform.”

Case Study: TIAA-CREF’s Global Real Estate Sustainability Initiative (GRESI)

► TIAA’s GRESI incorporates the pursuit of economic returns, environmental returns, risk mitigation and meeting market expectations

► During 2014, TIAA-CREF’s GRESI benefitted their portfolios:
  ► Over $14 million in energy costs saved
  ► Over 118 million kilowatt-hours of energy consumption avoided
  ► Greenhouse gas emissions reduced by over 47,700 metric tons of carbon dioxide equivalent

► Potentially improving Net Operating Income and Asset Valuation, while meeting shareholder value and stakeholder transparency

EY - Integration of GRESB, Green Buildings and Incentives
A comprehensive approach to corporate social responsibility:

- We focus on continual improvement of business operations covering the ‘triple bottom line’ concept: environmental, social and economical performance factors that include benchmarking, sustainability/carbon reporting, green buildings, alignment of tax and cash incentives, and asset valuation and strategy.

- Our Sustainability Services team is grounded in our core skills in assurance, tax and advisory. We have the regional and global knowledge to help you understand business and regulatory threats and opportunities, explore and execute commercial transactions, link sustainability performance to financial gains and assure public disclosures on progress.
US hotspots: high energy costs or green incentives amplify the opportunities

2014 commercial retail electric prices (average price in cents per kilowatt-hour (kWh))

Source: US EIA August 2014 electric power monthly average commercial retail price/kWh.
The most significant impacts to existing buildings are:

- Cash rebates and tax credits to displace capital expenditures (CAPEX)
- Decreases to operating expense with improved resource efficiency
- Cash and property tax incentives related to green certifications
- Resiliency during weather events (risk mitigation)
- Increases to net operating income (NOI)
- Increases to shareholder value
- Improved access to capital
- Increased asset valuation
- Product differentiation
- Enhanced marketing

*Note: many of these impacts affect one another, e.g., cost reductions improve NOI, which improves asset value*
Example of rebates for energy performance
In addition to tax credits and incentives that may apply

California

- Self-generation incentive program
  - Up to $5 million for customers* who install wind, waste heat to power, combined heat and power, biogas, fuel cells or advanced energy storage

- Non-residential energy efficiency program
  - Up to $2 million in rebates for customers* who install energy efficient mechanical equipment, lighting fixtures, controls, processing & manufacturing equipment and other qualifying equipment

* Retail electric and gas customers of SDG&E, PG&E, SCE or SoCal Gas

New York

- NYSERDA on-site energy program
  - Up to $2.6 million for customers* who install combined heat and power
  - Up to $1 million for customers** who install fuel cells

- NYSERDA energy efficiency program
  - $1M-$5M+ (depending on service territory) for energy-efficiency projects in commercial buildings*
  - Up to $10M for energy efficient data center projects*
  - Up to $75K additional for LEED*

* Customers must pay into the Public Service Commission's Societal Benefits Charge (SBC)
** Customers must pay into the Renewable Portfolio Standard (RPS) Program Surcharge
Incorporating sustainability principles into portfolio properties—its all about the energy

1. Look at low- and no-cost opportunities that can bring meaningful energy savings
2. Identify capital improvement opportunities, as well as financial feasibility
3. Benchmark energy performance
4. Implement sustainable/energy-saving solutions
5. Seek green certification; report on sustainability
Tying it all together
Integration of ESG, Incentives and Transaction Real Estate

Sustainability Incentives
- Assess energy performance against available cash & tax incentives to prioritize short-term opportunities
  - Energy Star rankings
  - Low-cost opportunities
  - High-impact subsidies

Transaction Real Estate
- Integrate sustainability metrics and opportunities in real estate transactions to capture maximum value
  - Update acquisition criteria
  - Hold with improved NOI
  - Translate value on exit

Sustainability Assurance
- ESG metrics further inform risks and opportunities to the broader set of stakeholders, refining key performance indicators
  - ESG strategy & benchmarking
  - Best-practice alignment
  - Reporting and disclosure
ESG questions for our clients

► How are you responding to growing investors and stakeholder requests on sustainability information?
► Are you currently benchmarking against your peers (i.e., GRESB)?
► Do you have a sustainability report? Are you considering assurance of key performance indicators (KPIs)?
► How are you monitoring key industry regulatory/policy issues?
► Do you have a strategy to respond to the emerging regulations on energy use and transparency?
► Are you measuring energy use of tenants?
► Are you considering onsite power generation?
► What is your current data management system for sustainability metrics?
► What types of leases are you currently employing? If triple net, are you using green lease clauses to require sustainable behavior in your tenants?
► Which funds are you prioritizing in terms of sustainability, if any?
► What third party property management (PM) companies are you using, if any? If internal, how are your PMs involved with sustainability efforts?
► Do you have a tenant engagement program in place?
For additional information please contact:

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