INVESTMENT INSIGHTS

Q&A: Making ESG Work for Real Estate Investors

January 2021

Lisa Davis
Portfolio Manager,
Impact Investing
Lisa.Davis@pgim.com

Environmental, social and governance (ESG) investing has evolved considerably over time from its origins more than 100 years ago, when many charitable organizations started to establish simple exclusionary rules. Still, there is no single one-size-fits-all approach to implementing ESG investing across asset classes — or even within a single asset class — because investors have diverse goals and varied individual requirements for their ESG-oriented portfolios. To demystify the application of ESG principles and practices to investment solutions, Lisa Davis, portfolio manager, U.S. Impact Value Partners (IVP), discusses PGIM Real Estate's approach to constructing and managing ESG-oriented portfolios.

How does PGIM Real Estate capture ESG principles when building its portfolios?

ESG has long been a way we believe we can achieve the outcomes our investors are looking for. Certainly, the environmental aspect is usually what we lead with. Buildings account for about 40% of greenhouse gas emissions in the United States, and so, improving the energy efficiency and carbon footprints of those buildings is critical to dealing with climate change. It also increases a building's net operating income because it reduces energy usage and water usage and deals more efficiently with waste. We've had a sustainability program at PGIM Real Estate for a long time, and in many ways, the sustainability aspects of real estate development have become beta with regard to energy efficiency. So, what we're looking at now is not just ESG but also R, which stands for resiliency — the ability to withstand any kind of shock in the market. Even though that often involves addressing *climate change* shocks, in the current moment we also see that resiliency is about addressing *social* needs and, in the United States specifically, about addressing inequality.

How does this emphasis on ESG and resiliency translate into the creation of actual investments?

One of our relatively new investment strategies at PGIM Real Estate — Impact Value Partners, which I lead — has a dual mandate to (1) create competitive returns for our investors and (2) have positive social and environmental impacts. For impact investing, which in some ways is one step further than ESG, we're not only screening investments and enhancing our risk management by looking at ESG factors; we're also seeking to proactively have a positive impact on social outcomes and the environment. Therefore, impact investing is truly leading the charge at our firm. Finally, there's the governance aspect, which is about risk management and due diligence processes. ESG has become a distinct advantage in a crisis situation like the COVID-19 pandemic we're experiencing now. So, the transparency and rigorous investment processes associated with ESG have major impacts on investment performance and our positioning in the market.

How do you incorporate ESG principles and practices into your investment process?

We embed ESG practices throughout our investment management, asset management, risk management and talent management processes. What's interesting about the field of real estate with respect to ESG is that we can have a much more direct impact on the trajectory of an investment than we would otherwise have if we were just *investing* in companies or in public securities. Because we are *owners* and *operators* of real estate, we're able to change the trajectory of any individual asset. For example, we can add renewable energy to a project or increase energy efficiency or provide affordable housing during our ownership. That's why, for us, ESG isn't just about selecting the right assets. We can apply ESG very directly during the time we own a particular asset, which is what sets us apart in the market and makes real estate such an important component of an ESG-oriented portfolio. It's those direct impacts.

What impact have the COVID-19 pandemic and the resulting lockdowns had on ESG in general and on real estate impact investing in particular?

The global pandemic has forced us to see the connections between the health of the economy and social factors, specifically when it comes to addressing inequality and racial justice. One of the terrible outcomes of the pandemic around the world is that it has had a much severer impact on marginalized and vulnerable communities with regard to both deaths and transmission rates. To be clear, that severe impact is not because of any inherent differences in the people in marginalized communities but, rather, because of the conditions under which the people live, work and receive their health care. In the United States, that impact manifests itself by way of much higher death rates and transmission rates in communities of color.

At PGIM Real Estate, we attempt to address those inequalities through impact investing. We invest in affordable housing and in transformative real estate development, and both of those types of investments target helping people of modest means gain access to stable, affordable housing and thereby live in communities that have access to the things required for healthy lifestyles such as healthy fresh foods, nice parks and open space. And what we've seen during the pandemic is that in many ways, that affordable housing segment of the real estate market — specifically, affordable workforce housing — has been the best-performing segment. It's outperformed Class A and luxury housing, and it's certainly outperformed retail in this cycle. That's consistent with a pattern of resiliency of financial performance by affordable housing across market cycles, which was true during the global financial crisis and which is proving to be true now. There are a lot of reasons for that, but one of them is that when an investment fulfills an essential human need, the returns from and the general financial performance by that investment tend to be more resilient over time.

What do you tell people who assume that applying ESG principles to a fund or other investment solution will drag down performance?

We would say it's a false dichotomy. We believe it's possible to make investments that achieve ESG outcomes and also achieve good financial performance. And in fact, we're seeing that with regard to investment performance over the market cycle, ESG investments are going to do better. In addition, in the area of impact investing, wherein investors are proactively trying to have positive social and environmental outcomes, not every ESG-oriented investment will necessarily enhance financial performance. While there are ESG-oriented investments where the linkage to financial performance is less clear, there is a way to select investments, particularly real estate assets, where the dual mandate is evident. Our experience over the years has proven to us that focusing on socially and environmentally positive outcomes can drive positive investment performance.

Within ESG, what will investors be focusing on in the months and years ahead?

There will be a lot of attention to social inequality in the postpandemic world. Those of us in ESG circles used to believe that climate change was the great systemic risk to financial markets that we needed to find a way to account for. And the challenge was to connect individual investments we were making to address climate risk at a systemic level. Today inequality around the globe is an equally important systemic risk — one that, interestingly, also is often connected to climate risk. So, finding ways to address the risks presented by social inequality is going to be very much on the minds of investors in the years ahead. I'm certainly very interested in addressing those risks in the portfolios I help manage.

PGIM REAL ESTATE