SPECIAL REPORT
ENVIRONMENTAL, SOCIAL, & GOVERNANCE

IPA INSTITUTIONAL PROPERTY ADVISORS
A DIVISION OF MARCUS & MILLICHAP, BROKERAGE

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ESG Growing in Prominence as an Investment Requirement

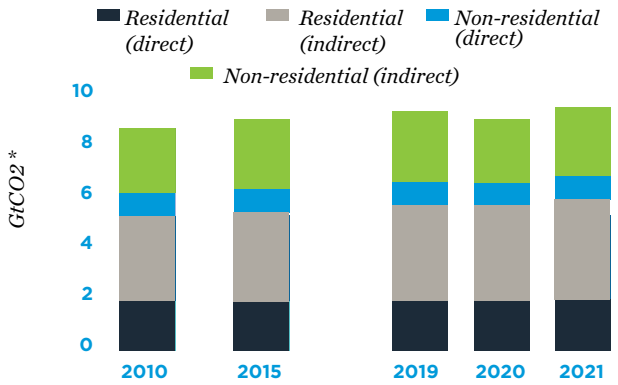
ESG sets framework for future investment. Environmental, social, and governance refers to a set of standards a company attempts to follow in order to attract socially-conscious investors, tenants and employees. Environmental criteria considers how a company safeguards climate initiatives, social criteria examines how corporations manage relationships with its stakeholders, and governance deals with a firm's leadership structure. Recently, this framework has gained attention as people become more aware of the impact companies have on the world around them, and a desire to invest in vehicles that are well-positioned for long-term sustainability. While not all aspects impact the commercial real estate industry, many investors, developers and market participants are beginning to heavily favour properties and organizations that prioritize the environmental factor of ESG.

Government's incentivizing decarbonization. There are a number of laws and regulations in Canada that apply to commercial real estate and address ESG issues, including energy efficiency regulations, green building certifications, climate change mitigation policies, and corporate reporting requirements. These initiatives reflect Canada's commitment to promote sustainable development and attain net-zero emissions by 2050. This commitment was recently highlighted in the Federal government's new budget, as it announced a $55 billion green economy initiative program that will provide tax credits for industries looking to reduce emissions and invest in clean electricity. This new initiative is also accompanied by existing federal and provincial programs, such as tax reductions, subsidies and low-interest loans. One example is CMHC's MLI Select multi-unit mortgage loan, which provides more favourable loan terms based off climate compatibility.

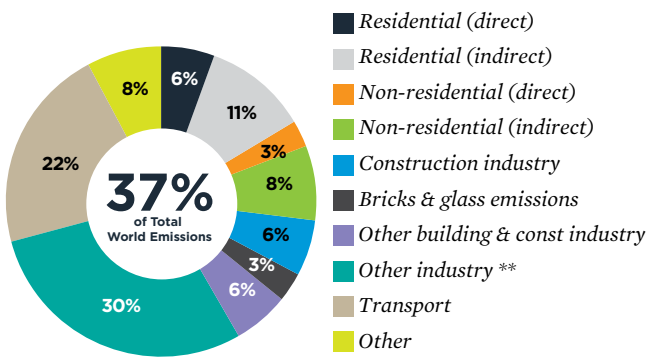
ESG becoming prominent investment criterion. While these incentive programs will help transition buildings to green energy, recently proposed legislation in Toronto and Vancouver requires all new buildings to be constructed and designed to meet zero emissions standards by 2040. As a result, it is becoming of greater importance to capitalize on government programs and prioritize initiatives to help transition toward green energy. Incorporating ESG measures and substituting natural gas for electricity will almost certainly become a requirement in order to attract future investment and potential tenants. This is critical to remain competitive with newer buildings, which is especially true in the emerging environment of flight-to-quality and the growing importance of long-term sustainability.

Various ways to achieve ESG compliance. As building operations and construction activities contribute to nearly 40 per cent of the world's carbon emissions, the containment of greenhouse gas in the real estate sector has received increasing attention in recent years. Newer buildings may adopt advanced technologies to optimize energy use and waste disposal, which will help control utility costs and increase operation efficiency. However, older buildings usually involve more significant and costly retrofits, which include reconfiguring the entire interior and replacing inefficient heating and cooling systems. While these improvements will increase short-term costs, they will also result in long-term savings, leading to better property performance, an appreciation in property value and an increase in liquidity. Several certification programs, such as ENERGY STAR, LEED, BOMA and GRESB, also exist for building owners to ensure compliance with ESG standards.

Emissions in Buildings 2010-2021



Share of Total Building Emissions



** Billion tonnes of carbon dioxide; ** Other industry refers to the emissions stemming from mining, agriculture and other various sectors impacted by CRE development and operations*

Sources: Marcus & Millichap Research Services; Altus Data Solutions; Bank of Canada; Capital Economics; CoStar Group, Inc.; Ipsos; Sphera; United Nations Environment Programme; Urban Land Institute

Impact on Commercial Real Estate

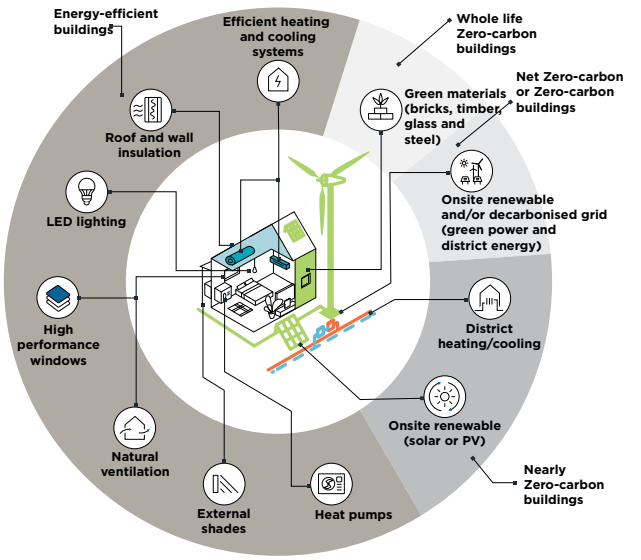
Select assets better for ESG conversion. With office operations being more flexible, coupled with similar technologies used across tenants, these properties are more easily able to comply with ESG standards. Minimizing energy usage, which is the greatest environmental cost, is more straightforward and suited for electricity. Simple modifications like low-flow toilets, implementing waste reduction practices, and installing occupancy sensors to turn off lights and regulate building temperature all work toward sustainability objectives. On the other hand, industrial operations tend to happen around the clock and are dependent on the technologies used by the occupier. Additionally, industrial properties also tend to have higher ceilings, large open spaces and loading/dock doors that enable leakages, which all require more energy from HVAC systems. As a result, it is more difficult for industrial owners to minimize energy output. While older assets are generating less investor enthusiasm already, this may be felt further in the industrial sector as ESG conversion is costly. This may cause a rise in non-core sales and/or redevelopment of older product.

Risk reduction a main driver for implementing ESG measures. While there are many reasons to obtain a good ESG track record, risk reduction remains a key factor. Investors are now putting an increasing emphasis on the minimization of environmental risks, such as climate change and natural disasters. By implementing ESG measures to mitigate these risks, building owners can reduce the potential for property damage and liability, thus lowering long-term costs. Therefore, applying ESG standards will increase property performance through cost savings, while also keeping the asset competitive against newer buildings. Calls for compliance to ESG standards oftentimes come directly from investors. Nearly 70 per cent of Canadians now consider ESG when investing, and company leaders are bound by fiduciary duty to mitigate risks while maximizing returns for those investors.

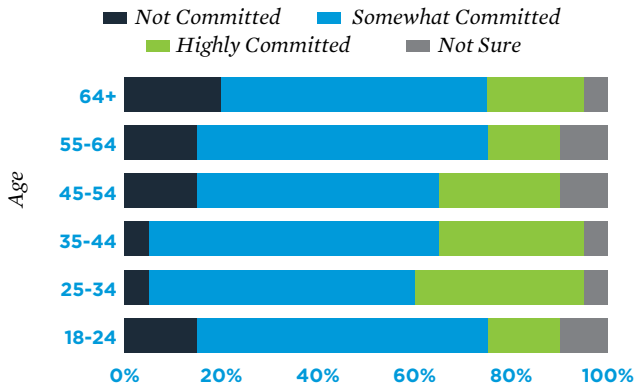
ESG aids tenant attraction and retention. Implementing ESG measures can reduce carbon footprints and appeal to a growing share of the population. Consequently, environmentally friendly buildings will likely attract a more diverse tenant group as occupiers are increasingly looking for buildings that prioritize sustainability. This is driven by a desire to work in buildings that align with their own sustainability goals and to attract and retain employees who value said goals, which is becoming increasingly popular among young professionals. Over the long-term, this increase in tenant demand will allow ESG-compliant properties to charge higher rents, while also saving costs by implementing energy-efficient measures. As a result, incorporating ESG criteria may increase property performance by fueling demand and driving rent growth.

Decarbonization is happening. The market is beginning to see that these newly-developed, top-tier properties with implemented ESG measures are witnessing healthy demand as a flight-to-quality is becoming more apparent. Therefore, properties that prove extremely difficult to decarbonize could see demand slow significantly. This may result in non-core sales and a smaller buyer pool as investor attention will further concentrate toward these higher-quality properties with ESG measures in place. The office market, for example, is already seeing this trend as tenants are vacating older space for newly-delivered, high-tech and environmentally friendly properties. As a result, investor sentiment is still positive for centrally located, class AAA office space. Older product, however, is becoming obsolete, and in some cases repositioned. Nonetheless, the sooner investors address decarbonization and incorporate ESG measures across their portfolios, it will separate both property- and investor-level performance by potentially generating sustainable long-term returns through increased revenue and lower costs.

Different levels of zero-carbon buildings



Commitment to Sustainability



Sources: Marcus & Millichap Research Services; Altus Data Solutions; Bank of Canada; Capital Economics; CoStar Group, Inc.; Ipsos; Sphera; Statistics Canada; United Nations Environment Programme; Urban Land Institute

Strategies to Reduce Carbon Usage

When an owner does an energy-efficiency retrofit on a building, it upgrades the property's energy-consuming systems. It also means including energy efficiency measures in all the renovation and repair activities. A thorough retrofit gives property owners a chance to audit a building's energy performance, reduce operational costs — particularly if it is an older asset — as well as help attract tenants and gain a market edge.

Energy Efficient Upgrades: Install LED lighting, low-flow faucets, variable refrigerant flow HVAC systems, and well-insulated doors and windows.

Building Automation Systems: Optimizes building performance by automatically adjusting lighting, temperature and ventilation, based on current occupancy levels and weather conditions. Adjusting temperature by one degree can result in 3 to 5 per cent energy savings.

Industrial Process Optimization: Improving equipment and optimizing processes can reduce energy usage and lower carbon emissions. Owners can consider on-site energy storage solutions and provide discounts for tenants who retrofit technology with energy-efficient upgrades.

Supply Chain Sustainability: Working with suppliers and customers to reduce transportation emissions and improve energy efficiency can help reduce the carbon footprint of an industrial building.

Renewable Energy Sources: Installing solar panels and/or wind turbines on top of buildings, or on excess land, can generate clean energy and reduce the reliance on fossil fuels. Additionally, designing space to optimize natural light will also benefit sustainability goals.

Case Studies

Office: 777 Bay Street, Toronto, ON

The subject property was built in 1984, and in 2016, the owners began a comprehensive ESG retrofit to improve the building's energy efficiency and sustainability. By completion, the retrofit lowered long-term costs, while driving income growth through increased rent. Property value, as a result, increased once the retrofit was completed.

The building's lighting and HVAC systems were upgraded to improve energy efficiency and reduce energy consumption.

Low-flow water fixtures, such as toilets and faucets, were installed to reduce water consumption.

A comprehensive waste management program was implemented to divert waste from landfills.

A green roof was installed to improve thermal performance, reduce storm water runoff and provide a green space for occupants.

Industrial: IKEA Distribution Centre, Richmond, BC

Ikea's distribution centre underwent an ESG retrofit in 2016 to improve the building's energy efficiency and sustainability. These upgrades led to a 30 per cent reduction in the building's energy consumption, and a 40 per cent drop in the property's water usage. The ESG retrofit increased value through long-term cost savings.

The building's lighting and HVAC systems were upgraded to improve energy efficiency and reduce energy consumption.

New building automation systems were implemented to automatically adjust lighting and temperature, based on occupancy levels and weather conditions.

The retrofit included the replacement of the building's roof with a new energy-efficient roofing system that improved insulation and reduced heat transfer.

Sources: Marcus & Millichap Research Services; Altus Data Solutions; Bank of Canada; Capital Economics; CoStar Group, Inc.; Ipsos; Sphera; United Nations Environment Programme; Urban Land Institute

Select Decarbonization Programs

Low Carbon Economy Fund:

The Low Carbon Economy Fund is a Canadian government funding program designed to support projects that reduce greenhouse gas (GHG) emissions. The program challenges applicants to implement specific activities or technologies that have previously demonstrated effectiveness in reducing GHG emissions.

Building owners and developers may be eligible for funding to support energy-efficiency retrofits, such as upgrading lighting, HVAC systems and building envelopes. They may also be eligible for funding to support the installation of renewable energy systems, such as solar panels or geothermal systems.

Funding Amount: Up to 25 per cent of eligible expenses (businesses) or up to 50 per cent of eligible expenses (regional/municipal governments) to a maximum of $25 million per project. Applicants must have a minimum funding ask of $1 million.

Ontario Investment Fund:

Ontario is committing $325 million to the Green Investment Fund for projects that will fight climate change, grow the economy and create jobs. These investments are part of the plan to secure a healthy, clean and prosperous low-carbon future.

Most of Ontario's social housing high-rise apartment towers were built in the 1960s and 1970s, and can use up to 25 per cent more energy per square metre than a house. The province, as a result, is investing in energy retrofits for high-rise social housing towers of 150 units or more. Upgrades include the installation of energy-efficient boilers, insulating outer walls, as well as installing energy-efficient windows, doors and lighting.

The program is also dedicating $74 million to a clean-tech innovation initiative. This will help reduce greenhouse gas pollution by encouraging large industrial plants to adopt leading-edge technologies, while supporting building owners in developing creative sustainability solutions.

Save on Energy Program

The Save on Energy Program is an energy-efficiency program in Ontario designed to help businesses and residents reduce their energy consumption and costs. From a business standpoint, this program will allow compensation of up to 20 per cent of energy use. For industrial-related upgrades and modifications that incorporate sustainability measures, the initiative will cover up to $5 million.

The Save on Energy Program offers a variety of incentives, rebates, and other resources to help businesses and residents implement energy-efficient upgrades and retrofits. This includes funding for the installation of energy-efficient lighting, HVAC systems, building automation systems, and other equipment. The program also provides incentives for building owners who participate in demand response programs, which involve reducing energy usage during peak demand periods.

Net Zero Accelerator Program:

Canada's Net Zero Accelerator Program is a federal initiative designed to accelerate the transition to a net-zero emissions economy, by supporting the development and implementation of innovative clean technologies and infrastructure. The program provides funding to a wide range of organizations — including businesses, municipalities and Indigenous communities — to support projects that reduce greenhouse gas emissions and promote sustainable development.

Building owners and developers may be eligible for funding to support energy efficiency retrofits, such as upgrading lighting, HVAC systems and building envelopes. They may also be eligible for funding to support the installation of renewable energy systems, such as solar panels or geothermal systems.

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