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# Sustainable Investing

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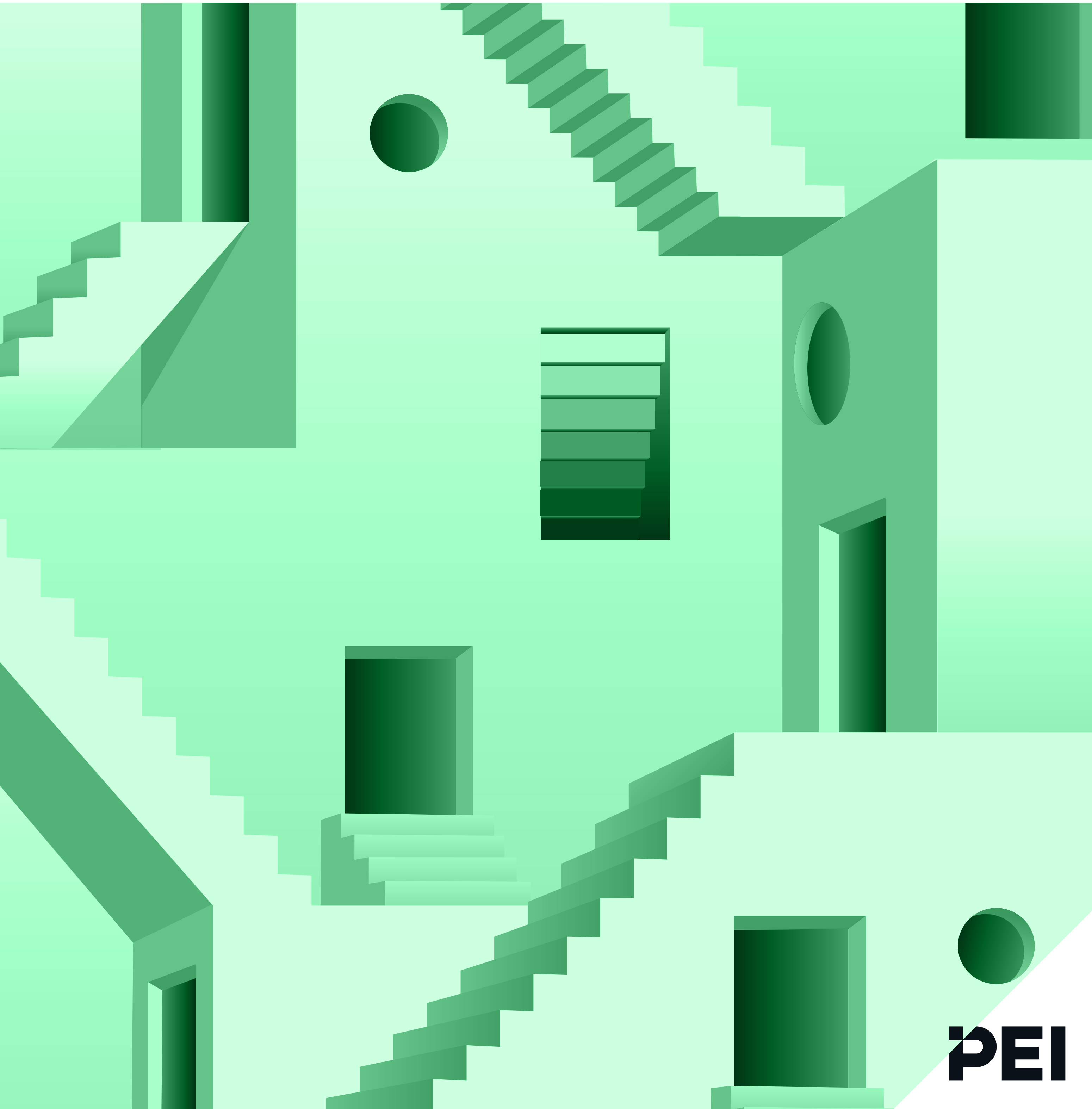

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KEYNOTE INTERVIEW

# From benchmarking to future-proofing

*Efforts to decarbonize real estate assets need to begin with careful benchmarking, says PIMCO Prime Real Estate's Raphael Mertens*

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Ambitious sustainability targets have portfolio and property managers around the world working hard toward decarbonization. As one of the largest contributors to global carbon emissions, the real estate sector is experiencing increased regulatory pressures, investor demands and a growing awareness of sustainability.

However, before decarbonization efforts can get underway, benchmarking is a necessary first step. After all, if buildings are to be put on a carbon diet, benchmarking serves as a 'before' snapshot against which all progress will be measured. In addition to helping identify inefficiencies and ensuring compliance with evolving regulations, the transparency that comes from benchmarking provides investors and stakeholders with quantifiable insights into a building's environmental impact, which will then be reflected in the asset's market value.

Over the past decade, Raphael Mertens, PIMCO Prime Real Estate's chief sustainability officer, has watched as sustainability has gone from a fringe discussion to one of the biggest topics in real estate. He explains that understanding a building's exposure to sustainable considerations is now crucial to delineating an asset's transactional and physical risk.

So, how should sustainability risk management be approached, and ultimately how should it be integrated into real estate decision-making?

**Q Why is it important to benchmark an asset first, before pursuing decarbonization?**

You need to have a starting point. Analyzing the sustainability credentials of an asset with benchmarking defines the starting point. Usually, clients will have a certain ambition for the whole portfolio, whether that is a target around CO2 emissions, energy efficiency or certifications. With benchmarking, you have a starting point that allows you to define or develop your program to get from point A, the starting point, to point B, the target.

Of course, there are commercial elements to be considered, and different ways of achieving your targets. But without that starting point and clear targets, it is hard to find the right program. For instance, without benchmarking, you cannot get asset managers to deliver. If you cannot measure it, you cannot claim success. We are data-driven, with a large portfolio. We do not simply work on a case-by-case basis. We need KPIs, data collection and data steering to drive success.

### Q How does benchmarking help with meeting tenants' expectations around sustainability?

Benchmarking should steer you in the right direction. Usually, an asset will need work in order to improve, and that will typically be around things that tenants are asking for from potential landlords anyway. If you cannot achieve the top-level certification or benchmark, they might not be convinced by the building.

We have seen a shift in what tenants are willing to pay for in terms of buildings that are upgraded with added sustainability features. Top tenants often have their own internal sustainability goals. Part of their positioning is in being in a building that is green, and that is a healthy place for their employees to work.

### Q How is the industry currently benchmarking sustainability efforts, and what are the most effective methods for measuring the 'greenness' of an asset?

Various different benchmarks are available. For example, we believe that CRREM (Carbon Risk Real Estate Monitor) is a great benchmark because we have global investors as clients, so we need a global benchmark. CRREM has become the closest there is to an international benchmark for decarbonization efforts. It is global, so it is easy for everyone to understand.

There are also other frameworks to choose from, though. We are strong believers in green certificates, because they tend to look more holistically at sustainability. They do not just look at the environment, but also at the health of the building. That said, the fragmented market means that you have to be selective about which certificate you focus on. Energy performance certificates (EPCs) are not yet standardized, but they can still give you a good idea of energy efficiency.

### Q What are these frameworks and certificates measuring exactly?

CRREM measures the operational carbon of the whole building in the form of greenhouse gases per square meter. EPCs, on the other hand, look at energy use intensity.

With CRREM, you can take greenhouse gas emissions and convert them to energy use intensity, but that figure will likely be a bit theoretical. EPCs are a better way of measuring energy efficiency, because they are generally closer to reality. However, EPCs are difficult to compare across countries.

These frameworks and certificates also have databases that compare the energy use intensity of your building to other assets in the same city or country. For other green certificates, much broader factors and more scoring may be involved.

### Q What role do frameworks like the EU taxonomy and CRREM play in the process of sustainability benchmarking, and which framework is gaining the most traction?

CRREM is an important framework, and if you have a global portfolio of assets, it is becoming critical.

I think both are important, though, as most of our clients need to comply with various international regulations. The EU taxonomy is a good way to go about defining a sustainable building. Many products want to be labeled green, so your underlying efforts will need to comply with that EU taxonomy.

There is some criticism of that approach, though, in that you often need an EPC grade of A to be compliant. From our experience, the most difficult part is getting to EPC A, simply because it is so rare. The practicality of achieving that also varies in different countries. It is far easier in the Netherlands than in Germany, for instance.

**Q Why is the difficulty different?**

The difference is the local building regulations. There are European institutions to contend with, as well as local ones, and national regulations and laws, too. There is not yet an efficient process for translating something decided at the European level into national laws. You can say the same thing about individual states in the US, of course.

The other element is that real estate is a local business, in the sense that you always start with the location of the asset. Many real estate players focus solely on their market or country. We are global, so we see the lack of standardization between different markets, which only comes to light on a pan-European or global basis.

These problems are beginning to spread, too. When talking to teams in Asia, for instance, developers are realizing if they do not do certain things, European buyers will not buy their buildings.

**Q Are decarbonization efforts being held back by the lack of a standardized benchmarking framework?**

Yes, I do think there is a hidden cost to it. If you want to juggle all these different frameworks, in the end, you are spending a lot of extra time and you are inevitably missing some of the targets. They should ideally all point in the same direction. In reality, that is not always the case, which adds a layer of complexity. We need action, not to spend all our time optimizing the frameworks.

**Q How prominent is sustainability in conversations with investors?**

It depends on the client. There are some who care a lot about sustainability. You always discuss commercial aspects, but if they have an ambitious sustainability agenda, it is just as important as the cap rate or rents. Some clients, though, just want to tick the box.

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**Q How can asset managers balance regulatory requirements with client expectations when working toward decarbonization?**

It depends on what the client is asking for. You must customize the strategy to suit their sustainability expectations. From a risk management perspective, you want to avoid physical and transitional risks, so these should always be properly priced into any deal.

Other clients may have clear expectations around whether an investment should be compliant with the EU taxonomy or a particular certification. It simply depends on the client and their strategy.

**Q What is the most important element missing from sustainability conversations around benchmarking?**

I think one element that needs to be added is climate resilience. It comes up more and more often these days. We saw horrible pictures from Florida in October, with the hurricane and so on, and many European and US cities have now experienced extreme weather events. This is probably just the beginning. Models indicate that we are going to see more extreme weather events in the years to come.

That means you need to be asking, 'Is this building resilient enough?' The building will still be there in 30-50 years' time, so you need to understand the future environmental conditions it can be expected to face. There are already markets where you cannot insure buildings. Understanding physical risks and how they can be mitigated is as crucial to institutional investors as business insurance.

In short, as regulatory pressures, investor priorities and climate awareness grow, it all comes back to benchmarking, which offers a measurable way to align assets with certain sustainability goals. Frameworks like CRREM and green certifications help to set global and local standards, guiding asset managers in crafting actionable, compliant programs for decarbonization.

Although a lack of standardization around frameworks poses some challenges, the real estate industry is navigating these complexities by adopting those benchmarks that not only quantify carbon reduction, but also enhance asset marketability. This is all progress in the right direction, which is good to see as climate risk becomes more tangible. ■