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Principal Real Estate

SPECIAL BULLETIN #4 | PRIVATE REAL ESTATE DEBT

ESG INTEGRATION IN COMMERCIAL REAL ESTATE LENDING

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EXECUTIVE SUMMARY:

- The importance of environmental, social, and governance (ESG) factors in commercial real estate lending is accelerating, and the valuation delta between properties with a favorable ESG profile and those ignoring this structural change is positioned to widen.
- By accounting for ESG factors in underwriting and sharing best practices with borrowers, lenders may have the ability to effect change.
- Collecting robust ESG data at the borrower and property level can help identify the connection between ESG attributes and property performance.
- Principal Real Estate has a comprehensive ESG due diligence checklist, created an ESG-centric borrower survey, and is able to leverage ESG experience in private equity to educate borrowers on ESG best practices.

ESG's evolving impact on lending practices

Lenders continue to study how to best incorporate ESG into lending practices. The limited influence and control afforded to a lender relative to a property owner can create challenges but also opportunities. In addition, to date, there are only a handful of lending programs in the industry offering economic incentives to borrowers to make ESG-related changes. However, lenders are more heavily weighting the importance of a building's systems, energy consumption, climate risk factors, and tenant well-being when underwriting loan opportunities and performing due diligence. Lenders are also recognizing broader market trends ascribing valuation premiums or discounts based on a property's ESG profile and a recognition that tenants have increasing leverage in some property sectors to force concessions. In summary, there is good momentum for lenders to expand their influence with regards to facilitating ESG improvements.

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Incorporating ESG into our lending practices

Pillars of Responsible Property Investing (PRPI) ESG platform

Principal Real Estate's proprietary ESG platform - the Pillars of Responsible Property Investing (PRPI) - has evolved since its first publication in 2008. The original platform provided sustainability guidance and education for office properties in Principal Real Estate's private equity real estate funds. In 2013, these guidelines were expanded to office, retail, multifamily, and industrial private equity real estate assets. Private debt investment was formally incorporated throughout the platform in 2021, although the private debt investment process has had ESG procedures in places for many years.

Pillars of Responsible Property Investing (PRPI)

Private Equity and Private Debt[1]

VISION

Through our commitment to responsible property investing and strong governance practices, we seek to invest in and lend on real estate that delivers positive financial and ESG outcomes for all stakeholders while promoting health and wellbeing for tenants and residents, helping to minimize environmental impacts and enhancing the communities where we invest.

PILLARS | The principles that guide our ESG decision making.

Each pillar consists of key performance indicators (KPIs) used to track ESG performance and progress.

Environmental performance

Helping to minimize the environmental impact of energy and water usage, waste production, and greenhouse gas (GHG) emissions

Occupant experience

Enhancing occupant wellbeing by providing healthy, safe, and equitable spaces

Community impact

Connecting with and contributing to the economic and social success of markets where we operate

Climate resilience

Utilizing risk mitigation strategies to help address building safety and preparedness for physical and transitional climate risks

Managerial excellence

Ensuring accountability and oversight of ESG policies, operations, data quality, and regulatory requirements

CORNERSTONES | Our core management approach that drives results at the property level.

The cornerstones represent an iterative, continuous improvement cycle, starting at property acquisition or loan origination and continuing until disposition or loan maturity.

Acquisition / Development / Loan Origination

Management & Operations

Measure performance

Investigate opportunities

Engage stakeholders

Implement best practices

Disposition / Loan Maturity

FOUNDATION | The ESG infrastructure that informs and supports the PRPI ESG platform.

Governance

Governance to strengthen internal and external accountability, transparency, and operational controls

Policies

Policies to set clear ESG expectations

Reporting

Reporting to provide stakeholders with actionable, clear information aligned with industry benchmarks

Research

Research to anticipate and assess industry trends and evolving ESG management needs

[1] Applies to Principal discretionary managed funds. Separate accounts may opt into participation.

Evaluation of sustainability attributes for new loans

To account for asset-specific ESG benefits and risks, we begin collecting ESG information on new loans before loan approval. This is incorporated into the underwriting process and provides a baseline for comparing annual property performance. ESG-related due diligence completed on each new loan includes but is not limited to:

- Walk, bike, and public transit scores
- Natural hazard risk including seismic risk
- Climate risk considerations such as sea level rise
- Phase 1 Environmental Site Assessment results including health and habitat impacts
- Quality of building energy systems
- Municipality mandates and regulations regarding energy usage and/or carbon emissions
- Socio-economic and development impacts
- Health and wellness amenities
- Accessibility in alignment with ADA requirements
- Evidence of borrower misconduct
- Retrofits and/or capital expenditures needed
- Insurance requirements

In addition, the borrower provides ESG data via a digitized Sustainability Survey. This includes the borrower's organizational ESG efforts, targets, and public disclosures, the property's affordable housing characteristics (for multifamily properties), LEED, ENERGY STAR, and other sustainability certification detail, and if and how the building's utility data is tracked. This information, along with any material due diligence findings, are evaluated by our Investment Committee as part of the assessment of the overall collateral quality and competitive position in the market.

Distribution of annual sustainability survey

The lender can also take steps to promote ESG-related improvements post-closing through borrower education and data monitoring.

To continue to monitor and encourage improvements with respect to the ESG performance of assets, we distribute an annual Sustainability Survey to existing borrowers. The survey requests information on the borrower's organizational sustainability plan, targets, and public disclosures. Annual updates to asset-level information are also requested, including number of affordable or workforce housing units (for multifamily assets), building certifications, and utility data tracking. All responses are tracked and analyzed in a centralized database. Collecting this data helps our capital clients monitor performance and percentage of loans with ESG characteristics.

Members of the real estate private debt team are participating in an industry working group that is seeking to develop a standardized borrower survey. By providing a consistent set of data requests and process questions, it will be easier for borrowers to collect and provide information.

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Utilization of the borrower engagement toolkit

The borrower engagement toolkit, distributed to borrowers post-closing, is an educational resource to encourage borrowers to analyze how ESG initiatives could have a positive impact on building performance and tenant attraction and engagement. It also demonstrates our commitment to ESG and shares best practices based on the success we have had in implementing ESG initiatives within our private equity real estate portfolio.

We recommend a four-step process for implementing ESG initiatives:

MEASURE	INVESTIGATE	IMPLEMENT	ENGAGE
Track and benchwork performance on key metrics	Identify initiatives and resources that may improve performance	Act on identified opportunities	Inform tenants, investors and the broader market on your progress

- **Measure** the asset's environmental impact by benchmarking utility consumption and cost in addition to setting performance goals and targets.
- **Investigate** opportunities for improvement by completing energy, water, and waste audits, researching available incentives, assessing exposure to climate risk and improving resilience.
- **Implement** sustainability best practices to help generate value through no and low-cost operational improvements, such as performing building upgrades, inserting green leasing language, adopting sustainable building standards, rules, and regulations, and applying for ESG-building certifications such as LEED, ENERGY STAR or Fitwel.
- **Engage** building occupants, vendors, and the community to increase participation in and the impact of sustainability initiatives.

Participation in industry initiatives

Principal Real Estate continues to make advances, along with the industry, with respect to integrating ESG into lending, both at origination and during the life of the loan. We are involved with research in partnership with the Mortgage Bankers Association, Urban Land Institute, CREFC Sustainability, DOE Mortgage Energy Factors Working Group, Life Mortgage & Real Estate Officers Council, and the University of California – Berkeley. Key initiatives of these groups include:

- Standardizing and digitizing the borrower sustainability survey
- Measuring historical performance of loans with ESG characteristics
- Collaborating with peers on ESG industry best practices

In conclusion, our Private Debt Real Estate team anticipates that the valuation delta between properties with a favorable ESG profile and those ignoring this structural change is positioned to widen. For example, with the office sector in the early stages of recovery from the negative absorption and higher vacancy caused by the pandemic, tenants will be able to exert pressure on landlords to improve efficiency and resilience, reduce environmental impact, and provide a healthier working environment. The increasing quantity of regulations will mandate owners to disclose energy performance and make building and operational improvements at their properties to meet environmental performance standards. Market and regulatory factors will set the stage for material ESG-related investments over the next five to 10 years and lenders will play a role to spur this trend.

Risk Considerations

Investment involves risk including possible loss of principal. Past performance is no guarantee of future results. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk.

Environmental, social and governance responsible investing (ESG) is qualitative and subjective by nature, and there is no guarantee that the criteria utilized, or judgment exercised, will reflect the beliefs or values of any one particular investor. Information regarding responsible practices is obtained through voluntary or third-party reporting, which may or may not be accurate or complete, and such information is used to evaluate a company's commitment to, or implementation of, responsible practices. Socially responsible norms differ by region.

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