PITCH

Property Income Trust For Charities

Net Zero Carbon: The Real Estate Response, Challenge and Outlook

MAYFAIR CAPITAL

Member of Swiss Life Asset Managers

Net Zero Carbon: The Real Estate Response, Challenge and Outlook

Contents

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Introduction

This paper aims to provide an update on the current real estate response to net zero carbon, encourage discussion of the practical challenges and provide insight into Mayfair Capital's current position and progress with partciular reference to the Property Income Trust for Charities (PITCH). We hope that this paper encourages discourse within the industry, and initiates collaboration and collective solutions that support the advancement of the sector towards net zero carbon.

Executive Summary

We have seen a seismic shift in the understanding of Environmental, Social and Governance (ESG) issues and its importance for the real estate industry as a whole. One of the most critical issues - climate change - is no longer seen as only a challenge for future generations; the impacts of climate change are evident today. The real estate sector has a significant environmental impact, but as a result can also play a pivotal role in mitigating climate change.

Increasingly stringent legislation and industry-led initiatives are transforming the real estate market. There has been immense industry focus on net zero carbon, brought about through increased public pressure for meaningful climate action as well as through the UK government's commitment to net zero carbon by 2050. Organisations around the world are following suit, defining their corporate pathways to net zero and communicating these commitments publicly. As organisations and the government start to grapple with implementation, it is evident that there are industry challenges to transitioning a real estate portfolio to net zero, with careful consideration required for data availability, timing, resource use and cost benefit, all whilst trying to maintain sustainable returns.

We recognise the critical role that ESG plays in protecting value, building resilience and ensuring stable long-term returns. As a result, building climate resilience and developing a clear pathway to net zero carbon is a primary focus for our parent company, Swiss Life Asset Managers and for Mayfair Capital. Swiss Life Asset Managers is currently undertaking a project to define its pathway to net zero carbon, with Mayfair Capital and its portfolio a key part of this project. By having a clear understanding of our pathway to net zero, we will be able to prioritise effectively and make informed decisions at the appropriate time.

We recognise the critical role that ESG plays in protecting value, building resilience and ensuring stable long-term returns.

At Mayfair Capital, our investment philosophy and approach to responsible investment are integral in shaping our approach to net zero. Leveraging our intimate and detailed knowledge of our portfolios, we believe that we can use these insights to methodically and practically transition our portfolios to net zero carbon through strategic bottom-up considerations.

The scale of the challenge of decarbonising the built environment is significant, however we acknowledge that as a real estate investment management company, we have an important role to play in the transition. In recognition of this, our Chief Investment Officer, Tim Munn and newly appointed Head of ESG, UK Christi Vosloo are prioritising planning and implementation of key next steps towards net zero carbon for the UK business.

The Backdrop

The impacts of climate change are evident, with the real estate industry playing a pivotal role in mitigation.

The latest Intergovernmental Panel on Climate Change (IPCC) report (AR6) provides new estimates of the likelihood of exceeding 1.5°C degrees of warming in the next decade, and finds that unless there are immediate, rapid and large-scale reductions in greenhouse gas emissions, limiting warming to close to 1.5°C or even 2°C will not be possible[1].

[1] IPCC 2021: https://www.ipcc.ch/2021/08/09/ar6-wg1-20210809-pr/

"This report is a reality check, we now have a much clearer picture of the past, present and future climate, which is essential for understanding where we are headed, what can be done, and how we can prepare."[2]

IPCC Working Group I Co-Chair Valérie Masson-Delmotte

The real estate sector has a significant environmental impact, with building and construction activities accounting for 39% of global carbon emissions[3] and 40% of the UK's total carbon footprint[4]. These contributions towards climate change increase the likelihood of climate-related risk, to which the real estate sector is particularly exposed through the nature of long-term investment and location-based factors. In the UK, an extended period of extreme winter rainfall is now seven times more likely due to human induced climate change, according to the Met Office[5]. Recent research found that 35% of real estate investment trust (REIT) properties globally are geographically exposed to climate hazards, including inland flooding (17%), typhoons, hurricanes (12%), coastal flooding and sea-level rise (6%)[6].

In the UK, 80% of properties that will exist in 2050 have already been built and thus decarbonisation efforts need to be focused on existing stock[7]. In England, two thirds of non-domestic Energy Performance Certificates (EPCs) lodged in Q1 2020 were given a C or D rating[8], with only 15% achieving EPC B or higher. Evidently, there is much progress and investment required to bring existing stock up to standard; with ever increasing pressure from government, investors, shareholders and clients for demonstrable and meaningful change.

The Response

Increasingly stringent legislation and industry-led initiatives are transforming the real estate market.

Government Response

Legislation will play a pivotal role in decarbonisation, with the UK government committed to a 78% reduction in carbon emissions by 2035[9], ahead of net zero carbon by 2050[10]. Initiatives like the EU Action Plan for Sustainable Finance and UK Green Industrial Revolution intend to redirect capital flows towards a more sustainable economy. The EU regulation on Sustainable Finance Disclosures (SFDR) came into effect in March 2021 with the purpose of enhancing transparency regarding ESG objectives and the integration of ESG into investment decisions. Whilst SFDR does not directly apply to Mayfair Capital's UK funds, we recognise the importance of increasing the level of transparency in our ESG reporting and aligning to best practice disclosure across all our portfolios.

Industry Response

In 2015, The Financial Stability Board (FSB) established the Task Force on Climate-related Financial Disclosures (TCFD) to develop recommendations for more effective climate-related disclosures to promote more informed investment decisions and enhance transparency on climate-related risk. The UK government has since announced that it will be adopting and implementing the recommendations of TCFD across the economy by 2025[11].

TCFD sets out detailed recommended disclosures covering Governance, Strategy, Risk Management and Metrics & Targets to create consistent reporting on the physical and transition risks associated with climate change. The HM Treasury's Interim Report sets out the roadmap for planned reporting, with mandatory reporting for large pension schemes, premium listed companies and banks, building societies and insurance companies from 2021. The next phase applies to the largest UK-authorised asset managers by AuM (expected to be in excess of £50bn) from 2022 and the remaining UK-authorised asset managers are required to disclose from 2023[12].

Mayfair Capital is a signatory to the United Nations Principles for Responsible Investment (PRI)[13] and our PITCH Fund submits to

[2] IPCC 2021: IPCC report: 'Code red' for human driven global heating, warns UN chief | | UN News

[3] WGBC 2017: Global Status Report 2017 | World Green Building Council (worldgbc.org)

[4] UKGBC: https://www.ukgbc.org/climate-change/

[5] Met Office 2020: UK extreme events - Heavy rainfall and floods - Met Office

[6] Four Twenty Seven 2018: Climate Risk, Real Estate, and the Bottom Line - Four Twenty Seven (427mt.com)

[7] UKGBC: https://www.ukgbc.org/climate-change/

[8] Ministry of Housing, Communities and Local Government 2020: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/882412/EPB_Cert_Statistics_Release_Q1_2020.pdf

[9] UK Government 2021: https://www.gov.uk/government/news/uk-enshrines-new-target-in-law-to-slash-emissions-by-78-by-2035

[10] UK Government 2019: UK becomes first major economy to pass net zero emissions law - GOV.UK (www.gov.uk)

[11] UK Government 2020: https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services

[12] HM Treasury 2020: FINAL_TCFD_REPORT.pdf (publishing.service.gov.uk)

[13] PRI is a UN-supported international network of investors that developed six principles for incorporating ESG into investment practices. Signatories commit to adopt and implement them where consistent with their fiduciary responsibilities.

GRESB[14] annually, which reflects the continual commitment and progress in the asset and portfolio-level strategies of Mayfair Capital. Both GRESB and UN PRI are strongly aligned with the TCFD recommendations and stand us in good stead for future disclosures.

Mayfair Capital has recently been accepted as a signatory of the UK Stewardship Code which is recognition of Mayfair Capital's holistic approach to stewardship. The code has an 'apply and explain' approach for its 12 principles with Principle 7 focussed on ESG and climate change, requiring that *'Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.'*

GRESB is the leading sustainability benchmark for the global real estate sector. It is a clear benchmark for investors indicating a fund's sustainability performance relative to its peers. GRESB has a strong influence on how the market collates and reports ESG information, and the key issues prioritised and included within the assessment. In recognition of the importance of comprehensive environmental data to accurately understand performance, GRESB's scoring is weighted favourably towards data availability. As ESG reporting becomes more comprehensive and detailed, industry standards such as GRESB are paving the way for a global common language for investors.

The Challenge for Real Estate

A Balancing Act

The costs of net zero are uncertain, with a balancing act between transitioning a portfolio to net zero and careful consideration of timing, resource use and cost benefit, all whilst trying to maintain sustainable returns.

The legislative and voluntary reporting frameworks and guidance standards, coupled with public pressure, has led to immense industry focus on net zero carbon. Organisations around the world are following suit, defining their corporate pathways to net zero and communicating these commitments publicly.

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As technology and the market advances, we expect to see the cost of net zero carbon measures and technologies become increasingly competitive, however, at present, the costs of net zero are uncertain. There are evident industry challenges of transitioning a real estate portfolio to net zero, with careful consideration required for data availability, timing, resource use and cost benefit, all whilst trying to maintain sustainable returns.

The Devil's in the Detail

A "bottom-up" approach to net zero provides a clear picture of Mayfair Capital's climate transition risk[15].

Understanding a portfolio's exposure to inefficient and poorly performing assets allows an investment manager to determine whether this exposure is within the risk tolerance threshold. We believe this bottom-up planning across our investment process provides us with a clear understanding of our exposure to transition risk informing our next steps in our pathway to net zero carbon. Our acquisition process includes risk screening of net zero carbon transition risk, all refurbishment projects follow our Sustainable Development & Refurbishment Guide to enhance efficiency, and for standing investments we routinely conduct technical assessments to identify practical carbon reduction strategies. Over time this builds a comprehensive picture of our portfolio supporting our pathway to net zero and most importantly, ensuring our products are appropriately futureproofed.

The industry is focussed on ensuring that the appropriate ESG considerations are integrated effectively into the investment process and are supported by the latest climate science. Specialist tools can be utilised, such as the Carbon Risk Real Estate Monitor (CRREM), which has been used by Mayfair Capital in addition to engaging with specialist ESG software and support. These tools, coupled with in-depth asset management and technical engineering expertise are critical to ensuring ESG risks are understood, managed and effective decisions are made at the right time.

[14] GRESB is a global assessment to capture and benchmark information on ESG performance and sustainability best practices for real estate and infrastructure companies, funds and assets.

[15] "Transition risks" risks are associated with the transition to a lower-carbon global economy, the most common of which relate to policy and legal actions, technology changes, market responses, and reputational considerations.

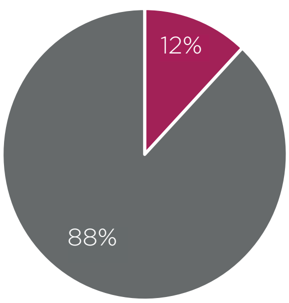
Data Acquisition

Energy data is crucial for climate transition risk analysis, but far from readily available.

One of the most pressing ESG challenges in the industry at present is data acquisition. Energy data is fundamentally important in understanding carbon performance and as a result transitional risk. Accessible, accurate and automated data is the goal, but this is seldom achieved at scale across a real estate portfolio, particularly where funds comprise a high percentage of FRI lease[16] assets, where procurement of utilities is the responsibility of the occupier. Without regulatory or contractual support, landlords can be limited in accessing data from their tenants. Mayfair Capital's PITCH Fund, deliberately structured as a leaner portfolio, allows for a more intimate engagement with its occupiers. PITCH has built, and continues to build, strong relationships with its tenants which we believe is crucial to accessing this data and jointly working towards our climate goals. We are also leveraging technology to support automation, benefiting both parties, including the roll out of a data management system and innovative data extraction tools.

The first of the following charts illustrates where our PITCH Fund has contractual access to whole building energy data versus where there is no contractual agreement in place with tenants who procure their own energy.

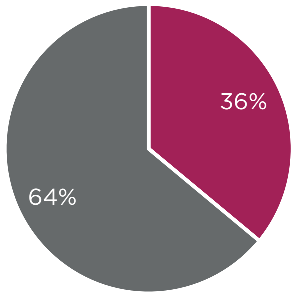
Contractual access to whole building energy data across PITCH portfolio



■ Contractual access to whole building data
■ No contractual access to whole building data

The second chart illustrates the progress we have made in obtaining this data to understand actual carbon performance of our portfolio, with the remainder estimated using best practice industry estimation methodology.

Visibility of actual vs estimated carbon performance across PITCH portfolio



■ Actual carbon performance
■ Estimated carbon performance

The Outlook

With a thematic approach to investing, we believe it is critical to position our PITCH Fund, in line with the following three ESG trends that will define the next decade:

- Climate-related disruption;
- Increasing ESG policy and regulation;
- Rising internal costs of ESG mitigation and adaptation.

Mayfair Capital has developed an ESG strategy to manage each of these ESG trends throughout the investment lifecycle.

Climate-related Disruption

Effective integration of an ESG strategy at the asset level is essential in mitigating climate-related disruption.

An ESG strategy is only as effective at mitigating climate-related disruption, as the instruments it uses to engage, monitor and address issues at the asset level. At Mayfair Capital, we place strong emphasis on engaging with our managing agents and our occupiers to ensure environmental and social issues are managed effectively. We have introduced guidance and frameworks for assets that reside within our portfolios and implemented ESG asset logbooks to inform ongoing asset business plans. We believe this level of detail is required to successfully manage climate-related risks and issues.

[16] Full repairing and insuring (FRI) lease is where the tenant is responsible for the cost of all the repairs and upkeep of the property and also the cost of buildings insurance.

Increasing ESG policy and regulation

Staying ahead of tightening policy and legislation is key to a resilient ESG strategy.

Increasingly stringent regulation is expected as we progress further along the path towards carbon emission reduction deadlines. This will become increasingly challenging as the level of ambition will be scaled up. An example is the recent proposed changes to the Minimum Energy Efficiency Standards (MEES) for non-domestic buildings to require energy performance certificates (EPCs) to achieve an EPC of C or better by 2027[17] as an interim milestone with the expectation of increasing to a B by 2030[18].

Staying abreast of all regulatory risks is a key priority and Mayfair Capital believe frequent legal update briefings and continual compliance training is required to ensure the right measures are in place to mitigate risks to the portfolio. In addition to this, Mayfair Capital also carries out annual risk materiality assessments against Global Reporting Initiative standards and industry policies to ensure that our ESG strategy is correctly aligned to rapidly evolving trends.

Rising Internal costs of ESG mitigation

We must begin to forecast environmental performance as we do with financial performance.

Accurately and comprehensively pricing climate risk into investment decisions is still not commonplace in the industry. In time, we expect the cost of mitigation measures to be routinely factored into appraisals and valuations. Opportunistic, higher risk investment strategies targeting stressed assets, will increasingly become riskier as the cost to mitigate ESG risks becomes greater. In the same way, we expect tenants to increasingly prioritise ESG factors in their occupational requirements posing a risk to current income as much as to the capital value of an asset. We believe continuing to build strong relationships and collaborate with tenants to achieve common ESG goals is of vital importance.

Our PITCH Fund has a low-risk style of investing with a high level of scrutiny on the quality of the underlying income and exposure to ESG risks of the assets it acquires and owns. Identifying efficient assets to acquire, coupled with incremental improvements of existing stock, supports a gradual transition of our portfolio. We believe our investment strategy fits well with the underlying investor base of the fund, namely charities, and as our net zero carbon pathway is defined, we will be able to escalate our ambitions appropriately.

A key element of this strategy is understanding 'stranding' risk. 'Stranded assets'[19] are properties that will be exposed to the risk of negative value impacts due to failure to meet future regulatory efficiency standards or market expectations for net zero carbon. As we do with financial performance, we recognise the benefit of using both historical environmental performance in conjunction with forecasted data to assess the resilience of our portfolio. Mayfair Capital has conducted climate resilience assessments using specialist ESG software to identify emission reduction requirements and "transition" risks in various decarbonisation scenarios.

This forward-looking analysis is becoming increasingly important in asset pricing models, and thus, we expect it to become the norm to feature further in the investment decision-making process. The industry has recognised that carbon and ESG risks can no longer be viewed in isolation. Instead, these risks need to be considered holistically, alongside all other business risks and integrated consistently and throughout the investment process. It has become increasingly evident, that environmental action and financial performance are intrinsically linked.

The scale of the challenge of decarbonising the built environment is significant, however we acknowledge that as a real estate investment management company, we have an important role to play in supporting the transition. Over the coming decade, the way in which ESG risks are managed and integrated throughout the real estate sector will be pivotal in determining the future success of funds, investors and the planet.

Mayfair Capital, September 2021

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[17] Department for Business, Energy and Industrial Strategy 2021: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/970192/non-domestic-prs-mees-epc-b-future-trajectory-implementation.pdf

[18] UK Government 2021: https://www.gov.uk/government/consultations/non-domestic-private-rented-sector-minimum-energy-efficiency-standards-epc-b-implementation

[19] Stranded assets are defined as assets that have suffered from unanticipated or premature write-downs, devaluations, or conversion to liabilities. Real estate can be vulnerable to factors such as environmental challenges, changing resource landscapes, technological innovation, changes in regulations and liability and evolving social norms which can result in devaluation or non-performance (GRESB 2017).

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