



VAN LANSCHOT
KEMPEN

Building for the future

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INVESTMENT MANAGEMENT

A data-driven approach to measuring, analysing and monitoring sustainability risks and opportunities in Real Assets.

From houses to highways, investing in Real Assets – comprising of Listed and Non-listed Real Estate and Listed Infrastructure – is about much more than attractive and predictable cashflows. The building and operation of Real Estate and Infrastructure forms the backbone of the economies, societies and communities in which people will live and work, now and in the future.

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1 Managing ESG risks

Real Assets are set to benefit from secular growth driven by digitalisation, demographic changes and, last but not least, the energy transition. In fact, the sector plays a key role in facilitating the global move towards a lower carbon economy. Recent US data show that 27% of CO₂ emissions are from Utilities, and a further 12% from Real Estate.¹ EU statistics up to 2017 tell a similar story, with the energy producing industries responsible for the largest share (29%) of total GHG emissions across the bloc.² The opportunity for more sustainable pathways in this area is demonstrably clear.

Most recently, the Covid-19 global crisis has in many ways been a boon to public Infrastructure programmes. A determination to 'build back better' has seen Europe's fiscal stimulus promise to direct significant capital towards rebuilding after the pandemic, while the US House of Representatives passed in July 2020 a package of public works improvements worth US\$1.5 trillion. Against this backdrop, Real Assets that take ESG factors into account offer investors a source of long term returns, often tied to inflation and so offering real returns from Real Assets.

This paper will seek to help the reader understand what questions we ask at Van Lanschot Kempen Investment Management (VLK Investment Management) to consider whether Real Assets are effectively managing ESG risks, capturing opportunities, what we can learn from the answers, and why we put ESG data at the heart of our investment decision-making.

Across this paper we will primarily explore examples of using data on the 'E' for environmental, rather than the full spectrum of ESG, which includes social and governance elements. The breadth and quality of climate-related data led by key players such as non-profit CDP (Carbon Disclosure Project) is in a much stronger position and has led to serious momentum in environmental and governance-focused investment. As of 2020, the same breadth and quality is lacking for the social dimension.

¹ <https://www.epa.gov/ghgemissions/sources-greenhouse-gas-emissions>

² <https://ec.europa.eu/eurostat/cache/infographs/energy/bloc-4a.html#:~:text=In%202017%2C%20the%20energy%20producing,1990%20to%2023.8%20%25%20in%202017.>



In future papers, we look forward to presenting our data for social and governance factors too. Last year, shocks such as the pandemic and social movements such as Black Lives Matter have brought the need to pay closer attention to these factors to the fore, and we forecast that there will be stronger data to back it up in the future.

2 Measuring portfolio sustainability: easier said than done

Active investors are driven by the search for alpha. Among Real Asset portfolios the aim of our investments are to generate sustainable returns. ESG considerations move us towards that goal, by helping to better capture the true opportunities and costs of doing business. This means giving weight to ESG factors alongside other factors that impact a company's earnings potential over a multi-year time horizon, such as the quality of management or the quality of the assets. Integrating ESG factors into every stock selection decision, ensures consistency of process.

Thus at VLK Investment Management we believe that a robust assessment of a company's willingness, commitment and ability to participate in the energy transition, or to mitigate against physical asset risks, is crucial to determining the sustainability of the investment.

The risk of over simplification

Before we delve deeper into a progressive investment approach, it is important to understand certain challenges of measuring sustainability. Let's use a snapshot at portfolio level.

One objective of a portfolio of sustainable investments should be to reduce global CO₂ emissions. Increasingly among regulators and peers, the overall CO₂ footprint of a portfolio is viewed as a proxy for sustainability.

Admittedly, it is a quick and easy measurement to screen across several funds. All you need to do is to look for the lowest CO₂ footprint. However, what this one-size-fits-all methodology offers in simplicity, it lacks in signal.

The overall goal of the energy transition is that the CO₂ footprint of the planet is reduced and this should supersede other goals, such as an individual company, or those portfolios' CO₂ footprints falling. It could be argued that a falling CO₂ footprint for a portfolio does not mean reduced CO₂ emissions globally. And vice versa, a portfolio with a rising CO₂ footprint does not individually raise global CO₂ emissions.

Some of these shortcomings are best expressed through examples:

- a) Buying a Utility company, which aims to cease reliance on a coal-fired power plant and force its closure in the near term.
 - This would raise the portfolios CO₂ footprint today, but lower the planet's CO₂ in the long term
- b) Third party CO₂ footprint – investing in a company selling gas to a country, which is replacing coal power with gas (to halve its CO₂ footprint). The more the company sells, the higher its CO₂ footprint.
 - The portfolio's CO₂ footprint would rise, but lower the planet's CO₂ in the long term
- c) The change in portfolio industry exposure – selling the best-in-class from a higher CO₂ industry, to buying the worst-in-class in a lower CO₂ industry.
 - The portfolio's CO₂ footprint would fall, but with no change to the planet's CO₂, and the unintended consequence of rewarding the worst in class with fresh capital
- d) The change in a company's CO₂ emissions, when it simply sells heavily-emitting assets to other operators, who continue running those assets
 - The portfolio's CO₂ footprint would fall, but no change to the planet's CO₂

In these examples, it is clear that a novel approach is needed which both aligns with regulatory mechanisms aimed at reducing global emissions, but which also has a measurable impact.

A forward-looking approach: the carbon trajectory

At VLK Investment Management, we believe the answer to this dilemma lies in our use of deeper explanations and forward-looking data wherever possible.

This is an approach in line with the way regulatory headwinds are blowing. For example, governments across the world have been looking at making climate-related risk reporting mandatory. In September 2020, New Zealand became the first country to introduce requirements to report on this risk and in November 2020 the UK said it would make TCFD reporting (Task Force on Climate-related Financial Disclosure) mandatory on a 'comply or explain' basis. In the coming years, as this measurement is reported on a comply-or-explain basis, we believe the explanation side will become more relevant.

Our approach means that there is continued reporting on a portfolio's CO₂ footprint, but what will become more critical is an explanation of the carbon trajectory of those same companies. In other words, when capital is allocated to a company which is a heavy CO₂ emitter (such as a Utility), the forward-looking trajectory of its emissions need to be assessed in addition to its current emissions, and studied alongside its willingness and capability to align with the goals of the Paris agreement.

This forward-looking approach is explained in greater detail later in this report and the Xcel Energy case study provides a crisp example of it in action. US electricity provider Xcel is a good example of a company that raises the CO₂ footprint of our portfolio in the near term, but offers a net positive contribution to reducing overall global emissions based on its transition pathway.

Case study: Xcel Energy

Driving real change, despite a heavy footprint today

Xcel Energy is a major US electricity provider. Data from CDP shows its current (scope 1 and 2) emissions are approximately 47 million tons of CO₂ per year. That is as much CO₂ as is produced by 10 million cars.

We cannot consider Xcel sustainable today, nor would the EU taxonomy definitions, as too much of its electricity is still generated by coal. However, we do not rule out Xcel Energy as an investment and remain invested in this company as of November 2020.

Why?

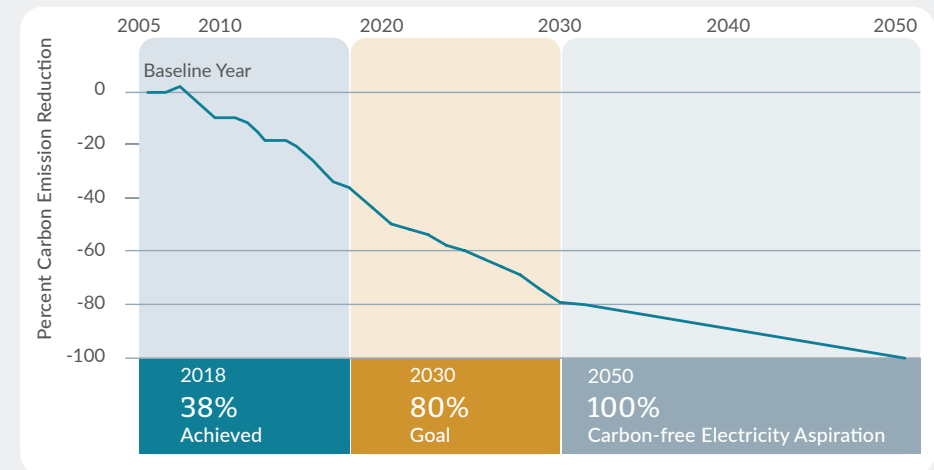
It's because rather than deploying a standard ESG snapshot approach, our strategy looks forward to what this company plans to become. Here we find a clear roadmap for transition on which we have engaged with this company in person.

Xcel has set an ambitious path planning for an 80% reduction in CO₂ emissions by 2030 (beyond the 50% goal of Paris), and 100% by 2060. Credibility is added to this trajectory from:

- a) reductions in CO₂ already shown in recent times;
- b) the inclusion of CO₂ reduction into the management's Long Term Incentive Plan; and
- c) transparency on the moving parts to achieve this transition.

The investment approach of focusing on how a company or its situation is changing, is also brought into our sustainability analysis in order to build more sustainable alpha.

Figure 1 Xcel Energy Carbon Reduction Trajectory



Source: Xcel's investor presentation, June 2020

3

Defining Real Assets

Real Assets can be divided into subsectors within the asset class. Each of these may focus on a different aspects of ESG factors that are most relevant to the asset (for example, focusing on exiting coal is an issue more relevant to Utilities than for Offices). The opportunity to contribute to the UN Sustainable Development Goals is greatest for SDG 13: Climate Action. Within Real Assets, Listed Infrastructure also contributes to SDG 7: Clean Energy and SDG 9: Industry, Innovation & Infrastructure. Real Estate also contributes to SDG 11: Sustainable Cities & Communities.

Combining Listed Infrastructure and Listed and Non-listed Real Estate enlarges the investment opportunity set, allowing investors to construct a bottom-up portfolio by selecting assets that offer the risk/return characteristics most in line with their goals. While across the asset class, investment involves the ownership of physical buildings or infrastructure projects, the short-term investment dynamics across each category tend to differ. However, in the long run, their behaviour with regards ESG measurement is relatively similar across the asset class.

This section provides some definitions of the subsectors of the asset class and discusses how these divergences are addressed in the ESG integration process.

Listed Infrastructure

Companies in this sector are focused on the ownership, development and operation of assets which are critical to the economic function of society. These include, but are not limited to, regulated utilities and energy infrastructure, communications and transportation. They offer stable comparative cash flows in an industry defined by long-term contracts, regulation, high barriers to entry, and monopolistic characteristics.

The need for Infrastructure investment is ongoing and is consistently an engine for growth in most economies. According to GLIO, “the total market capitalisation of the global Listed Infrastructure companies has grown considerably since 1999 (CAGR +10.4%). The current market capitalisation of the asset class is approximately \$2.5 trillion. In terms of free float, on average at least 85% of shares are freely traded which means that investors can build exposure to core Infrastructure relatively easily.”³

In many ways, “Listed Infrastructure companies offer liquid access to illiquid assets.”⁴ This liquidity means that investors are able to adjust their portfolios according to various factors including climate-related criteria. Whereby non-Listed Infrastructure tend to lag behind current market conditions, Listed Infrastructure valuations are subject to daily pricing and are thus more volatile. Aside from these short-term differences, the GLIO research highlights that, “over the long term, Listed Infrastructure offers the very similar performance as non-Listed Infrastructure and vice-versa.”⁵

Listed and Non-listed Real Estate

There are three ways of investing in Real Estate:

1. Direct purchase of assets;
2. Listed vehicles purchased on a stock exchange;
3. Non-listed or unlisted vehicles which do not feature on any stock exchange.

Each provides some access to a wide range of opportunities which can bring in returns from different sources.

³ <https://www.glio.org/gli101>

⁴ Sources: GLIO.

⁵ Sources: GLIO.

As with Infrastructure investments, Real Estate offers an important contribution to the global economy. Alongside Infrastructure and housing, building works account for a significant amount of all capital investment in the EU. Five years ago in 2015, commercial property brought in €329 billion to the EU economy – significantly larger than the automotive manufacturing or telecommunications sectors. This amounts to around 2.5% of the total European economy.^{6,7}

From an investment perspective there are some significant divergences but there remain a great number of similarities when assessing and reporting ESG criteria, as will be explained later in this report. For a detailed analysis of the key differences between Listed and Non-listed Real Estate [please read our whitepaper](#).

Figure 2 Comparison of listed and non-listed indirect real estate

| | Listed real estate | Non-listed indirect real estate |
|---------------------------|--|--|
| Returns | Correlation to underlying real estate in medium term but to equities in short term | Higher correlation to direct real estate markets |
| Volatility | Higher | Lower |
| Liquidity | Higher, daily | Lower |
| Transparency | Higher (public mandatory company disclosure, analyst coverage) | Lower but improving. Information not widely available (little analyst coverage, limited public mandatory disclosure) |
| Governance | Strong by law, board of directors directly responsible | Weak, mostly as a result of fund structure. External management |
| Investor influence | Limited impact on management and strategy | Higher impact on management and strategy |
| Leverage | Lower | Lower for core funds |
| Cost levels | Cost levels easy to compare between listed real estate companies | Cost levels easy to compare between non-listed real estate funds |
| Diversification | Easy to achieve starting from any initial investment | Difficult to achieve due to high AuM needed to construct a well-diversified portfolio |

Source: VLK Investment Management

6 [epra.com/media/INREV_EPRA_Real_Estate_Real_Economy_2016_Report_1466582653897.pdf](https://www.epra.com/media/INREV_EPRA_Real_Estate_Real_Economy_2016_Report_1466582653897.pdf)

7 [epra.com/application/files/6215/0592/3119/EPRA_Total_Markets_Table_-_June_2017.pdf](https://www.epra.com/application/files/6215/0592/3119/EPRA_Total_Markets_Table_-_June_2017.pdf)

4 Our strategic approach

The following section outlines three key elements at the heart of VLK Investment Management's strategic approach to sustainable Real Assets investment:

1. Understanding climate risk
2. Putting data, including forward-looking data, at the heart of our approach
3. Using engagement to enhance our analysis and improve outcomes.

1. Understanding climate risk

We expect environmental considerations, especially those related to climate change to become increasingly material. Using definitions provided by the Taskforce on Climate-related Financial Disclosures (TCFD) among others we believe climate risk for Real Assets is best understood in two ways:

- **Energy transition risk:** Understanding how a company or asset is positioned once we measure the gap between its CO₂ emissions, versus what is required by the multi-decade goals of the Paris Climate Agreement. Is it an asset able to evolve or does it risk becoming a stranded asset?
- **Physical asset risks:** Understanding the different physical impacts of climate change from flooding to extreme weather and the effect those changes may have on the economic potential of the geographical location. As with the energy transition, there is risk that these could become stranded assets too.

For both types of climate risk we seek to measure, analyse, monitor and generate alpha and/or reduce risk within our Real Assets investments.

Energy transition risk

Measurement

In Real Assets, CO₂ intensity should be measured at company portfolio level over a set time horizon. Across Infrastructure assets, it is advised to take Scope 1 (all direct), Scope 2 (indirect) and Scope 3 (all other indirect)

emissions.⁸ However, at VLK Investment Management we do not take Scope 3 emissions into account for Real Estate clients since these emissions are not usually as integral to the physical asset as they are for Infrastructure.

For Non-listed Real Estate, annual CO₂ emissions data is gained from GRESB and applied at portfolio level. In the near future this should move to reporting at asset level. The measurement of CO₂ goes before target setting, and measurement is one of the key engagements. As disclosures vary, the reported emissions become harder to compare across portfolios. Differences in CO₂ emissions can also be a function of the use tenant composition of the building; for example some tenants may require 24/7 air conditioning or lighting.

Data at this stage is also used to highlight laggards within a peer group for further engagement, which is covered in some detail later in the report. Intensity measures are included in the metric of emissions per unit of income.

Analyse

The large amount of raw data received needs to be optimally weighted within the investment process, to capture signal and minimise noise. Portfolio Managers should decide the optimal weight for the relevant peer group, based on the teams' experience.

Within Real Estate portfolios at VLK Investment Management, a property's CO₂ emission level and trajectory are referenced against the Paris goals. To draw an example, consider a situation where a decarbonisation pathway required under the Paris Agreement is something that a company is unable to achieve, if the timing is too tight or the scale of CO₂ reductions are too great to overcome. It will be left with assets that do not fit the transition and thus

⁸ Scope 1 emissions are all direct emissions from the activities of an organisation, or emissions under their direct control. Scope 2 emissions are indirect emissions, from electricity purchased by the organisation for example. Scope 3 emissions are all other indirect emissions occurring from sources which they do not own or control. They include waste, water, procurement and other third party issues.

become stranded. For instance, from 2023 office buildings in the Netherlands are required to meet a certain energy efficiency requirement.⁹ If a Real Estate company has assets which do not or cannot meet Energy Label C or higher by the deadline, those buildings will no longer be allowed to operate and thus become stranded.

The greater the misalignment, the larger the capex requirement assumed by our Portfolio Managers, in order to address this stranded asset risk. Larger capex means a lower ascribed value to the Real Estate portfolio. If a company successfully invests the necessary capex and prepares the Real Estate portfolio for future sustainable demands, long-term rental growth assumptions are increased, mitigating the financial impact of the capex.

For Listed Infrastructure, this forms one input into the ESG analysis and determines one third of the qualitative score of a company. This third is equally weighted with Management Quality and Infrastructure Quality. The higher the qualitative score, the more capital that may be allocated to a position, resulting in a positive allocation towards companies with improving ESG trajectories.

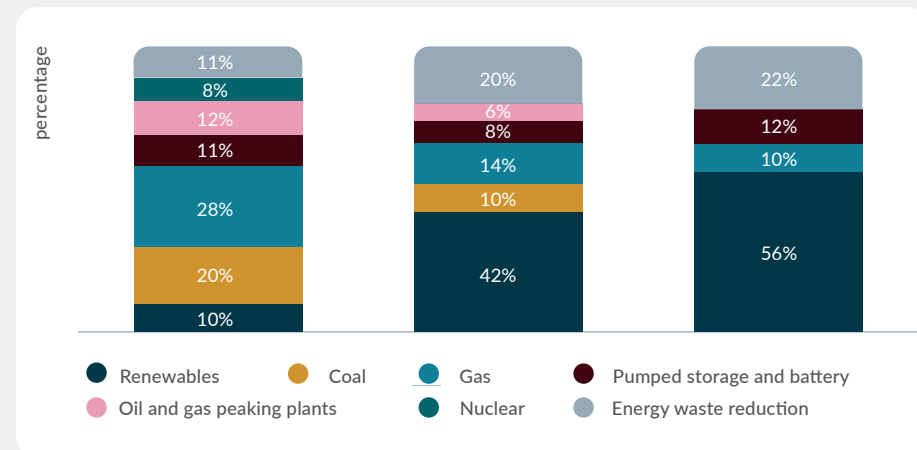
⁹ <https://www.gtlaw-amsterdamlawblog.com/2018/11/energy-label-c-obligation-for-all-office-buildings-in-the-netherlands-in-2023-with-few-exceptions/>

Case study: CMS Energy Corporation

Engaging to help gain insights and catalyse positive change

CMS Energy Corporation is a US energy company with a market capitalisation of over \$17.4 billion providing electricity and natural gas to its customers. CMS Energy also invests in and operates non-utility power generation plants in the United States and abroad.

Figure 3 Overview of current and perspective energy generation sources



Source: CMS Energy Corporation 2019 Annual Report

CMS Energy have set ambitious goals to reduce both CO₂ and methane emissions. This holistic approach is in line with VLK Investment Management's thinking around what is required for the energy transition. The inclusion of methane emissions reduction is particularly welcome as it is often overlooked by companies and an important insight that has supported our investment decision making.

The company's goal is to reduce CO₂ emissions by 45% by 2023, which is aligned with the scope of the Paris goal to reduce CO₂ emissions by 50% by 2030. But we're also encouraging the company to go further by tying achievement of its climate goals to long-term incentive planning (LTIP) – so as to embed this goal in company strategy and operations.

We believe a reasonable balance in the LTIP given the other goals at CMS Energy could be in the range of 20% related to greenhouse gas emissions.

In order to enable long-term transformation aligned with the mission of the company, we have also asked for further transparency and the reporting of metrics on the progress for the replacement of old methane pipes with safer and newer pipes. This move would help de-risk CMS Energy operationally, as well as from a climate impact perspective.

We have conveyed to the company that rapid improvement in these areas would increase the company's ESG score and would make it more investible and attractive in the long term.

Monitor

Emissions data is updated annually. However, company ambitions and emissions targets can change during the year, and so these must be monitored continuously for changes that year-end data does not yet capture. The benefit of having monitored emissions data across several years is that there is also signal for companies which are disclosing more (signalling priority is given to investors on climate risk), and also changes in reporting methodology and the exposure of underlying trends that could affect the asset.

Alpha

The greater the misalignment of a company's CO₂ emissions against the goals of the Paris Agreement, the greater residual sustainability risk. As a result, the larger the capex requirements will be to mitigate this risk, and (all else being equal) the lower the valuation. Capital will then flow to better alternatives in the fund.

By applying the data-driven approach of these strategies to ESG factors, the team is able to profit from mispricings that arise from either short termism (climate factors become more material for longer term investors), or from a market that gives too little consideration to ESG factors, or that does not take the right climate risk factor into consideration.

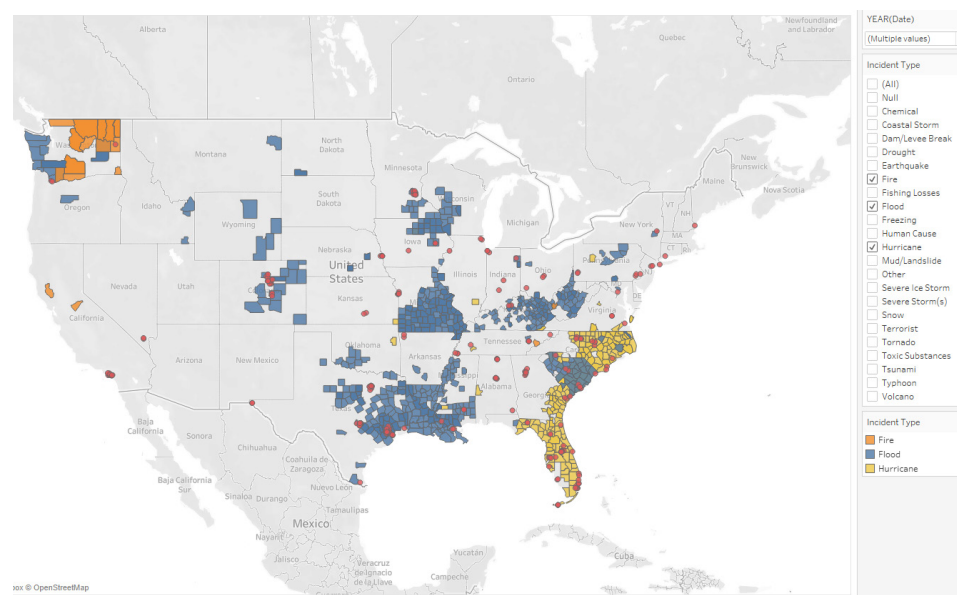
Physical Asset risk

Measurement

Not all climate risks are created equal, nor are they evenly distributed. For insight into which climate disaster types will be most material at each location we need access to relevant and detailed data. At VLK Investment Management for example, we use the Federal Emergency Management Agency data on 22 types of disaster (manmade as well as natural) and their locations across the US, as well as data from Munich Re for better global coverage.

An example in Real Estate (figure 4) shows the hotel locations (red dots) of REITs (Real Estate investment trusts) in our investment universe and their potential exposure to three disaster types: wildfires (orange), flooding (blue), and hurricanes (yellow). Data like this can be interpreted to understand the risks for these physical assets.

Figure 4 hotel locations for three disaster types



Source: FEMA data base, and Company data

Analyse

Good data is only a starting point. We need to identify which risk is most relevant in combination with the asset's location and identification, all the way down to US county level. The outlook for each risk at each location becomes more relevant when forecast 10+ years into the future. This analysis, as with the transition risk, impacts asset quality and feeds directly into the ESG score. In Real Estate it feeds our assumptions for Real Estate building

down-time and capital expenditure requirements for re-build. This directly impacts our estimate of the valuation of the Real Estate buildings in scope. Therefore, our valuation of buildings is forward-looking as opposed to traditional external appraisal values that are backward-looking.

We are slowly seeing more data points on the magnitude of the physical asset risks. Failing to identify and mitigate this risk at company level or in analysis exposes investors to stranded asset risk. We can draw an example from Japanese developers no longer being able to insure against certain natural disasters. In this case we are now able to proactively screen for this stranded asset risk using our data infrastructure.

Approaching from a different angle, given the unfortunate lack of progress towards the 1.5°C pathway laid out in the Paris Agreement the likelihood of stronger negative impacts from climate change is increasing. These climate risks are expected to have serious impacts on society and physical assets (and therefore their earning power too).

Consider the impact of an extreme weather event on Real Estate, such as the case of Hurricane vs. Hotel example suffered by Diamond Rock Hospitality in 2017 with Hurricane Irma, and subsequently Dorian in 2019.¹⁰ As these kinds of disasters become more intense, the ability to insure these assets falls and the cost of operating these businesses increases. The direction of travel is therefore towards having stranded assets.

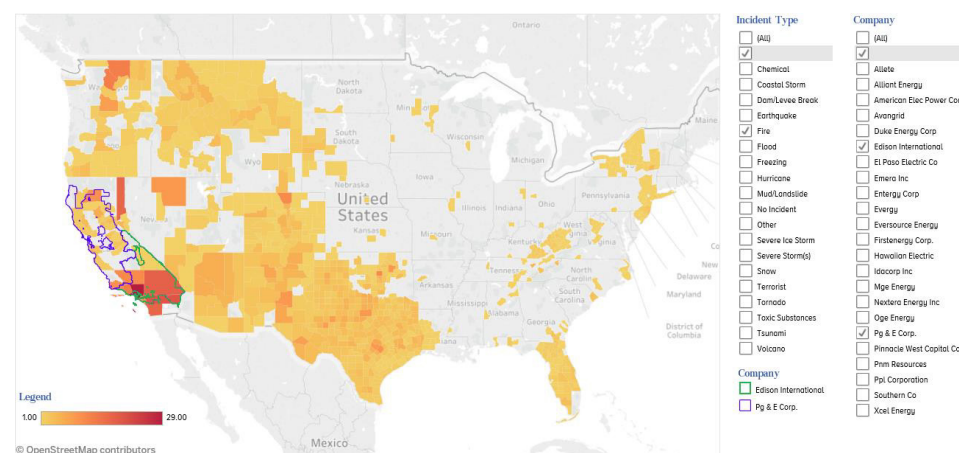
Though we cannot predict exactly where and when the next disaster will hit, we can make preparations in our investment work through data analysis. Knowing who is most exposed – that is, using data to overlay geo-coordinates of company assets with the most likely disaster type – allows us to analyse their preparedness, address relevant mitigation steps with management, and include datapoints to score the companies.

¹⁰ <https://www.prnewswire.com/news-releases/diamondrock-provides-update-on-impact-of-hurricane-dorian-300914603.html>

Monitor

One caveat is that national disaster databases are only updated annually. During the year, the location of an ongoing disaster can be mapped against the specific location of a property (these are already in our data infrastructure down to postal code level). As an example below (figure 5) we overlay disaster type: Fire, with the asset locations for two companies. This helps inform discussions on whether the right risk is being mitigated and to what extent.

Figure 5 Climate risk: Example of 22 types of disasters vs. Infrastructure asset location



Source: SNL, Federal Emergency Management Agency , VLK Investment Management

Though the US data is most readily available, as global investors we need to extend our reach. VLK Investment Management recently partnered with Munich Re to benefit from its global database and core expertise on forecasting climate risk. Their data set was deliberately selected against other sources from NGOs or data sets from academia for its detail.

Alpha

Given the insights generated on which climate risk impacts which asset, we are better able to assess the appropriate physical asset risk by location per company and the impact on valuation and more specifically target our engagement with a company.

Beyond the calls from TCFD and others for more disclosure on climate risk, we can drill down to the most relevant risk, and hence a more efficient engagement.

2. Putting forward-looking data at the centre of our approach

This section shows which data points are being tracked, and which tools and resources are used by the Real Assets team at VLK Investment Management. Similar methodologies are used across the asset class, though there is a different weighting depending on whether the asset is in Listed or Non-Listed Infrastructure or Real Estate.

Tracking data

The table below provides information on the data points, their vendors, plus relevant comments on data points, are shown in the in the following table.

| Data point | data vendor | other comments |
|---|--|--|
| CO ₂ emissions, scope 1 and 2, company level | ISS Southpole | Asset level data available |
| GRESB rating | GRESB | Specifically relevant sub-components of score and raw data are used. |
| MSCI ESG rating | MSCI ESG | Specifically relevant sub-components of score used. |
| Governance metrics | MSCI Governance Metrics | Specifically selected governance sub-components of score are used. |
| ESG Management scores | GRESB | Scores used to assess ESG Policy, Tools, and Resources in place. |
| US Disaster database | FEMA (US Federal Emergency Management Agency) | Most relevant disaster type by location, used to assess risk, valuation and to target engagement. |
| Global Disaster database | Munich Re / VLK Investment Management Joint Venture | Most relevant disaster type globally. Core expertise is to forecast risk, hence rejected NGO/Academic data sets. |
| Environmental Controversies | Greenpeace | 10 year + ongoing contact on different sustainability issues. |
| Global Sustainability Issues | University of Cambridge, Department of Sustainability. | Team includes graduate from Business Sustainability Management, University of Cambridge, and also uses alumni network / lecturers. |
| Prof. Andreas Hoepner | EU Technical Expert Group on Sustainable Finance | Advisor to VLK Investment Management |

Looking forward

Figure 6 Sustainability pathways framework for Real Assets companies.



Source: VLK Investment Management

As investors, we have a healthy obsession with what a business can become in future, not just what it is today. The diagram above provides a framework for how companies in the Real Assets universe are aligned with Paris goals.

On a stock level, our first step is to determine how far along the path a company is towards becoming sustainable. We assess this using two tools: the first is from reported or estimated carbon emissions data, which gives the point in time snapshot of where the company is; the second is the ambition level set by the company (CO₂ reduction goal, and target date).

Some companies will have CO₂ emission levels showing much of its journey is still ahead (e.g. the firms in the box on the left). Other companies may have an elevated CO₂ footprint today, but credible targets, such as clear and realistic milestones linked into management's long term incentive plans, which show they are on the sustainability pathway but more needs to be done to align to Paris. Finally, there are companies that have goals aligned to Paris and which contribute significantly to decarbonisation.

There are some divergences among Real Estate investments. For Non-listed Real Estate, there are differences in the level of transparency among companies. For example, it may be the case that not 100% of the portfolio

can have its CO₂ footprint measured, meaning that disclosures can be less comparable. However, through the interpretation of GRESB data, we can investigate why a company may or may not have a low score and engage directly to encourage portfolio adaptation.

3. Using engagement to improve outcomes

We also use the insights from our stewardship and engagement activities to add to our forward-looking analysis.

The engagement pathways we propose rely on a fundamental understanding of the companies we invest in, the challenges they face (whether environmental, social, or governance), the materiality (or reputational risk) of the issue, and the companies' options across an appropriate time horizon.

Identification of laggards is rules-based at a minimum (e.g. Single B rating or below on MSCI ESG, or Orange or Red MSCI Controversy score). Above and beyond this minimum standard, laggards are also identified by our Portfolio Managers. Sometimes an ESG data vendor may not have flagged an issue, but our own analysis does.

At VLK Investment Management, our engagement has three distinct pathways:

- **Engagement for change:** where company actions need to be improved (from aligning remuneration to addressing societal risks)
- **Engagement for transparency:** where company disclosure needs to be improved
- **Engagement for public policy or collaboration:** where general ESG performance of markets or sectors need to be addressed

With this in mind, engagement with ESG laggards is a key part of the brief. Where we see a company underperforming on a key ESG issue, we actively engage, beginning with private one-on-one engagements with management teams. The degree of engagement can be subtle to start with, with a request for information, general disclosure, greater transparency or overall change. This applies across the elements in the asset class, but as with the non-listed

space, we can also exert a degree of influence in investments via engagements for change. This can take the form of individually or collaboratively pushing for a different sustainability strategy.

In the spirit of SDG 17 'Partnership for Goals', our fund relies on multi-stakeholder partnerships to inform sustainability decisions. Our sustainability network consists of different stakeholders with whom we have frequent discussions: ESG data providers - ISS (carbon emission score), Sustainalytics (ESG Criteria score), MSCI ESG (ESG Criteria score), Academia - University of Cambridge, Institute for Sustainability (Sustainability challenges), and NGO Greenpeace (Environmental issues).

An example of an engagement to change behavior (moving a company towards VLK Investment Management's Sustainability Pathway) is CLP Holdings - a Power Generation and Distribution company listed in Hong Kong who cancelled a decision to build two new coal power plants following discussions with VLK Investment Management.

Our investment process allows us to be transparent on how material engagement success can be for a company. We can run a scenario analysis on the ESG score of a company (from engagement success) and have the valuation delta as a result of better ESG behaviour presented to the company. This is used as an engagement tool to encourage a win-win mindset between company management and the portfolio managers.

Where a potential investment is not on the trajectory to align to Paris, and we see an alpha opportunity we will engage for change (sometimes this has happened ahead of the first capital being deployed). However if there is no willingness or intention to change, then we will choose not to invest. We 100% believe in selling the full position of these companies, as opposed to selling back to benchmark position.

You can read more about our engagement activities in our award-winning [Stewardship and Responsible Investment Report](#).

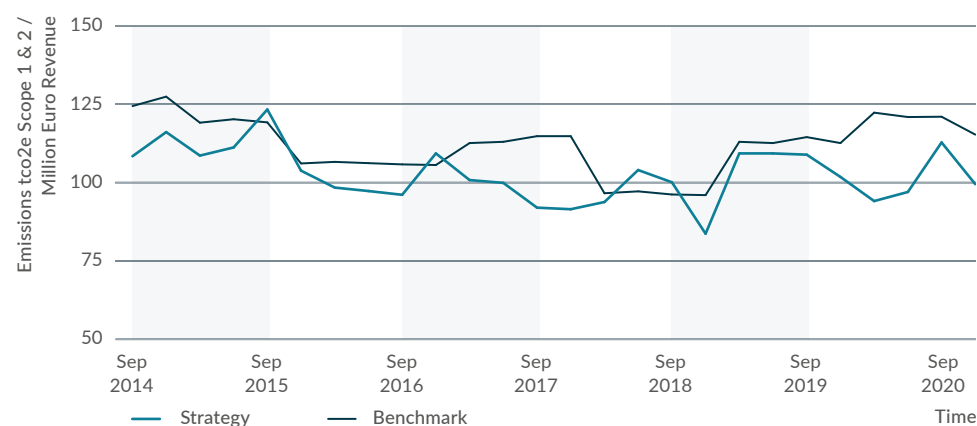
SDG data

We also hope that our forward-looking approach will be enhanced by likely regulation for better data disclosure on SDG exposures. Once good quality data is available, this can be seamlessly integrated into our platform for reporting. Our goal is to be able to report both the positive and negative contributions to each SDG. Future proofing the strategy as far as possible is critical in a world where regulation is becoming more strongly aligned to climate goals.

Currently the Real Estate asset class is more directly exposed to SDG 11: Sustainable Cities & Communities. We recognise there are differences between companies, and as disclosure improves, we expect to be early movers that benefit from this change.

With the Dutch Climate Agreement ('Klimaat Akkoord'), where regulators will require more transparency on fund/strategy level CO₂ emissions, these strategies enjoy a head start. We are encouraged that the CO₂ intensity of the strategies are significantly below the benchmark, as shown in figure 7.

Figure 7 Real Estate holdings as of 30 June 2020, CO₂ data over 2016, measured in tons of CO₂ emission intensity per million US dollar of rental revenue, estimates based on Southpole CO₂ data.



Source: VLK Investment Management

5 Conclusion

This paper sought to present how a forward-thinking, data-driven approach is critical in the Real Asset class. We focused primarily on the environmental criteria in ESG rather than full spectrum, in part due to the availability and depth of high quality data to input into the investment decision making process, and in part because the social and governance elements may deserve closer attention themselves in the coming years.

It is encouraging that many more companies in Real Assets have focused their agenda on closer alignment to the goals laid out in the Paris Agreement in recent years. For investors, this data is invaluable in the decision-making process and it is commendable that tracking and disclosing emissions has become commonplace.

However, our strategic approach is much more forward-looking than simply tracking emissions which have already happened. We propose deploying an investment approach that puts data at the heart of investment decision-making. The data demands clear roadmaps for transition from those companies we invest or might potentially invest in, and investors to strategically engage with companies to guide and where necessary push them to achieve these goals. By making these improvements, these companies increase their ESG scores and make them much more credible, attractive and investible in the long term.

Real Assets are the cornerstone of work that seeks to solve some of the world's greatest challenges, from trade to transport to caring for a growing and ageing population. Understanding how we mobilise capital responsibly will be key, and sustainable investment strategies such as these will necessarily be deployed across all asset classes.

Contact

If you have any questions please contact us or visit vanlanschotkempen.com/investment-management



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