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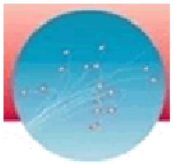

Responsible Property Investing in Canada

Factoring both Environmental and Social Impacts in the Canadian Real Estate Market

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+Shareholder Association for Research and Education (SHARE)

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Abstract: Institutional investors and corporations alike increasingly recognize that extra-financial determinants of business performance can both create value and uncover significant risks within a business or investment portfolio. For companies that invest in, develop, own, or operate commercial real estate assets, this awareness of extra-financial impacts has led to a significant interest in what has been called "responsible property investment (RPI)". Within the field of responsible property investment, green real estate—real estate investment and management that seeks to reduce the environmental impacts of building construction and operations—has begun to receive attention. On the social side of the equation, affordable and workforce housing, urban revitalization, brownfield redevelopment, and other opportunities to integrate environmental, social and governance (ESG) issues into investment decision-making have also received increased attention over the past decade. Labour and workplace considerations are also key components of responsible property investing, yet to date they have not received as much attention in RPI.

This paper explores responsible real estate investment in Canada by taking an integrated approach in examining both environmental and social factors and their potential impact on such investments. We conduct a series of semi-structured interviews with key stakeholders in Canada to gain insight into how using environmental and social factors may influence long-term risk and financial returns in real estate investment in Canada with particular emphasis on institutional investors engaged in these practices. We use data to analyze the impact that ESG considerations have on financial performance of these assets. We use Jantzi Research Inc. ESG ratings and the stock price changes of fourteen real estate companies and REITs to interrogate this question.

Keywords: responsible property investment (RPI), responsible investment, real estate, ESG standards, green buildings

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Introduction

Institutional investors and corporations alike, increasingly recognize that extra-financial determinants of business performance can both create value and uncover significant risks within a business or investment portfolio. For example, institutional investors including pension funds are realizing that the long-term nature of their portfolio holdings leaves them vulnerable to risk over time. In response, they are integrating responsible investment practices into their investment approach.

Responsible investors consider environmental, social and governance (ESG) factors and incorporate them into the investment decision-making process. ESG factors have been dubbed 'extra-financial,' and in the past have not played a significant role in investors' and analysts' decisions. But there is increasing evidence that these three factors can play a significant role in both reputation risk and share value over time. The growing awareness of the importance of responsible investing is evident in the numbers of signatories to the UN Principles for Responsible Investing (UNPRI, 2006) representing $13 trillion of assets under management. As a result, corporate responsibility and responsible investment issues have gained increasing public attention, prompting leading companies and investors to more closely examine the wider societal and ecological impacts of their business and investment decisions.

For companies that develop, own or operate commercial real estate assets, this awareness of extra-financial impacts has led to a significant interest in what has been called 'responsible property investment.' Investment in the property sector is closely tied to key regulatory, consumer, and demographic issues, and the physical nature of the built environment encourages investors to adopt longer time frames in their investment strategies – the materiality of ESG issues is more deeply felt over longer term horizons.

Within the field of responsible property investment, green real estate – real estate investment and management that seeks to reduce the environmental impacts of building construction and operations – has received special attention. Anticipating increased regulatory attention to

greenhouse gas emissions, or seeking operational savings from energy efficiency or reduction of water use, for instance, have become standard tools in the real estate investment toolkit. Companies can benefit from these improvements as a result of increased tenant satisfaction, energy cost savings, and growing market demand for green real estate (Kok, 2008). Increasingly institutional investors in commercial real estate are seeking investment in LEED certified buildings.[i] Utilizing such a standard allows these investors to capture both the positive financial impacts that come from high environmental standards and the reputational gains that following such standards bestow.

Similarly, on the social side of the equation, affordable and workforce housing, urban revitalization, brownfield redevelopment, and other opportunities to integrate ESG issues into investment decision-making have also received increased attention over the past decade (Hebb 2005, 2007; Hagerman et al., 2007; Sass Rubin, 2007). Many US pension funds, banks and insurance companies have deliberately targeted a portion of their real estate investments in urban centers traditionally underserved by investors and developers. They have had considerable impact through their investments on urban revitalization while generating above benchmark financial returns.

Labour and workplace considerations are also a key component of responsible property investing, although they have received relatively little explicit attention within the Canadian commercial property industry. Given that construction and maintenance of commercial properties are vital components of the property supply chain, and that labour comprises a significant cost in developing and maintaining properties, labour and human capital issues are key aspects of responsible property ownership and management, and may carry material risks and opportunities for property investors.

This paper explores the impact of responsible property investment in Canada from the perspective of investors, real estate developers and property managers. This paper investigates the financial implications of factoring environmental, social and governance (ESG) considerations in real estate investment decision-making in Canada. This can be thought of as consideration of both the "footprint" (environmental impacts) and "the handprint" (labour and social considerations) in responsible property investment. While this question has been asked in

other jurisdictions such as the US, this is the first time this question has been asked about such investment in Canada. Additionally, while previous research has addressed environmental issues in property development and management, there has been limited academic work on social factors of ESG consideration in real estate.

The paper is laid out in the following manner. The second section provides a detailed literature review, assessing early research in this field. It examines academic, industry and government publications to provide an overview on previous findings. The third section of the paper draws on a set of semi-structured interviews with real estate industry practitioners, pension funds, investment managers and key stakeholders to provide qualitative analysis from the perspective of investors, property developers and property managers to assess the impact of factoring ESG considerations in real estate investment. The fourth section of the paper examines the ESG ratings of a number of Canadian property developers and management companies. Using Jantzi Research Inc. data on ESG standards of these firms, we construct a high ESG performance portfolio and a low ESG performance portfolio and analyze the financial performance of each. The last section of the paper provides a discussion of findings from the research. This section addresses the implications drawn from the research for investors, property developers and property managers as well as any public policy implications that arise. It looks at the role of metrics in the integration of ESG factors in responsible property investment in Canada. We close the paper with some final thoughts and suggestions for future research.

The Footprint and Handprint of Responsible Property Investment

While responsible property investment (RPI) is beginning to establish a more solid footing in the US (as indicated by the growing number of reports, academic literature and conferences on the topic), the extension of responsible investing to the property sector is still in its infancy in Canada. This may soon change, as an increasing number of academics, policy makers and real estate owners, managers and investors in Canada are beginning to acknowledge the significant impact commercial property has on the human and natural environment (NRTEE, 2009).

The Footprint of RPI

Buildings that have less impact on the environment, in comparison with conventional buildings, are often referred to as 'green buildings'. Recent efforts to apply environmental considerations to the property sector have been motivated by recognition of the impact that buildings have on the environment. Buildings contribute to 35% of Canada's greenhouse gas emissions and represent 33% of Canada's energy consumption, 50% of natural resources extracted, and 25% of waste going to landfill (Pembina Institute, 2004).

To date, most of the literature focused on encouraging investors and building owners to finance properties that promote favorable environmental conditions has focused on the business case for such investment. This literature attempts to document the relationship between characteristics of green buildings (e.g., the incorporation of environmental considerations in design, location, materials and operation) with the reduced economic costs and value-added that derive from environmental considerations (e.g., an increase in worker productivity and tenancy occupation rates, economic savings from water, energy and waste reduction, and price and rental premiums).

Cost containment is more commonly addressed in the business case literature, since methods for calculating it are more advanced and widely accepted than methods for assessing the value-added aspects of green buildings. Matthisessen et al. (2007) find no significant difference in average costs for green buildings compared to non-green buildings, whereas Kats (2003) and Miller et al. (2007) find that LEED certified buildings tend to cost 2 - 3% more to construct than conventional buildings of the same design. While some studies find higher cost premiums for the construction of green buildings, "on average, [green buildings] result in life cycle savings of 20% of total construction costs- more than ten times the initial investment" (Kats, 2003). Seppanen and Fisk (2006) Watson, (2008) Rawlinson and Langdon (2007) and Kats (2003), among several others, have estimated these life-cycle savings associated with green buildings, through reduced energy, water, operating and maintenance costs.

In addition to reduced costs associated with green buildings, some aspects of value-added are also beginning to be subjected to empirical analysis. For example, Fuerst and McAllister (2009) find a rent and transaction price premium of 6% and 35% respectively for LEED rated

buildings.[ii] Kok (2008) shows similar results in a study of US office buildings, finding that buildings with a green label command rents that are on average 2% higher (6% for buildings adjusted for occupancy levels) and selling prices that are 16% higher than non-labeled buildings. Another recent study finds rent premiums of $11.33/sq ft in comparison with non-LEED buildings (Costar, 2008). In addition to premiums, this study also finds that occupancy rates of LEED buildings increase 4.1% (Costar, 2008). Benefits associated with marketing of green buildings have also been identified. "A green building tipping point is at hand; 40% of corporate leaders in the US believe that ignoring green building will result in public relations problems" (Bernstein, 2007).

Literature reviewed thus far has been focused on the business case (e.g., reduced cost and value-added) for green buildings from the perspective of property owners, developers and tenants, and has largely ignored the investor perspective. "While systematic attempts have been made to present the business case for more responsible buildings, almost no studies have examined the relationship between investment returns and responsibility in the property sector" (Pivo, 2008). This is despite the fact that "68% of leading US executives, whose companies are involved in green buildings, report superior ROIs in green buildings compared to conventional ones" (Kats, 2007).

Of the few studies that do examine that relationship between RPI and financial returns, the literature is exploratory. For example, the UNEP FI's Property Working Group paper (2009) provides investors with practical knowledge related to the differences between socially responsible investing (SRI) in equity assets and property, as does the Institute for Responsible Investment's *Handbook on Responsible Investment* (2007). Some recent academic literature, which applies empirical analysis to the relationship between RPI and financial returns is also beginning to surface. Pivo (2008) uses a time series regression analysis to demonstrate that investors can earn returns on a portfolio consisting exclusively of US RPI office properties, which are equivalent or superior to a portfolio without these criteria. Another study attempts to identify a set of parameters for measuring the impact of a building's functional performance on rental growth and depreciation, finding that green building features can be linked to the potential positive impact on investment appraisal variables (Ellison et al, 2007).

As indicated in this review, while reduced costs associated with operating and maintenance value-added have been more widely assessed in the literature with respect to green buildings, financial returns for investors have received less attention. However, in addition to the literature, which supports the business case for green buildings, recent work which finds premiums in price and rents suggests there is reason for further investigating the possibility of higher investment returns for green buildings. We take up this question in section four of this paper.

The Handprint of RPI

Despite recent developments in the literature on green buildings, there has been relatively little explicit attention to the social impacts of the property industry, such as labour and employment practices, health and safety, urban revitalization, brownfield redevelopments and affordable housing. It is necessary that these factors be incorporated into RPI literature in order to move from the narrow concept of green buildings to a more holistic definition that captures both the social and environmental considerations, and reflect the aims of responsible investing more broadly.

Practitioners in the property industry note that while social factors appear to be absent from the discussions of responsible property investing in Canada, the reality is that some social considerations are included in current literature and corporate practice. One consultant that we interviewed noted that social factors are an *implicit* consideration in the field of green buildings. For example, it is widely recognized that building management systems (air circulation, lighting etc.) have a significant impact on the health and well being of occupants. In fact, the most comprehensive research in the area of social impacts in the property sector to date has focused on the health and productivity effects of green versus traditional buildings.

Romm and Browning (1998), Hagerweegan (2007), Wyon (2007) and Kumar and Fisk (2002) provide case studies and theoretical models linking green buildings with improved organizational performance. Generally, available research has found that tenants in green buildings experience greater employee productivity and reduced salary costs due to lower absenteeism rates and lower health care costs. Lucuik et al. conclude that it is "reasonable to assume a productivity gain of between 2 and 10% when moving from an average building to a green building" (Lucuik, M. et

al 2005, 22). Most of the productivity gain is a result of improved ventilation, higher quality natural light and the ability of users to control their indoor environments, however the authors note that further research is needed to more convincingly articulate productivity gains for building tenants and owners. Persram, Larsson and Lucuik (2007) argue that gains in employee productivity, lower health care costs and reductions in absenteeism rates translates into improved tenant attraction and retention rates, longer leases, and higher rents for building owners and managers.

Other social factors affecting the property industry that have received attention in academic literature include a growing interest in urban revitalization, brownfield redevelopment, provision of affordable housing and attention to transit oriented development. There is evidence in the literature that brownfield redevelopments and urban regeneration projects have the potential for producing positive social and economic returns for the communities in which they are located (NRTEE, 2002, Lamore 2009).

In a series of best practice case studies, Hebb and Hagerman examined the impact of large US public sector pension funds investment in urban revitalization in the US. They found significant positive impacts at the community level including development of mixed use real estate in urban areas previously underserved in the retail market and provision of affordable housing. These impacts while targeted were ancillary to the generation of market rates of return for the pension funds examined (Hebb 2005, 2007, Hagerman et al 2007). In Canada there are fewer examples of this type of targeted investment. Concert Properties with its commitment to 100% union construction and property management with investment from twenty seven BC pension funds (Carmichael, 2002) is a good example of proactive, targeted investment in Canada. Concert Properties has returned above benchmark financial returns while using 100% union contractors (Hebb et al, 2009). Another good example of this type of targeted investment is the Public Service Alliance of Canada staff pension fund's $2 million investment in affordable housing (Harji, 2008).

In terms of return on investment, the NRTEE report (2002) on the economic benefits of brownfield redevelopment considers the use of financial instruments such as tax incentives to encourage investment, yet there is no attempt to estimate direct investment returns. Pivo (2008)

however, does include social aspects (urban revitalization) in a RPI portfolio he constructs to compare with returns of a portfolio without social and environmental criteria. Similarly, urban regeneration projects in the UK have also documented return on investments (Hemphill et al 2006). Results from both studies indicate that investment in these projects can match or outperform national and local benchmarks, and are thus viewed as financially lucrative/attractive for investors.

The benefits of local job creation and economic spin-offs have also been addressed within the responsible property literature as an important social consideration. Many green building standards increasingly favour local hiring and local sourcing of goods and services. For example under the LEED system, proponents receive additional points for sourcing materials locally or regionally (USGBC, 2009). The concept of 'green jobs' has also caught on, as governments try to tie economic stimulus, job creation and recovery programs with long-term environmental goals (Apollo Alliance, 2008; US Gov., 2009).

The area of research that is the least developed currently is the examination of broader supply chain labour considerations. In particular, there is a need to consider issues beyond that of job *creation*, and examine issues of job *quality* and decent work (Hamilton, Hebb and Wood, 2009). Workers in the property service industry are vital stakeholders in the real estate supply chain; they are responsible for delivering high quality building construction and maintenance services – services that form the very foundation of long-term property performance and value. Therefore it is argued that they play an important role in maintaining or enhancing asset value over the long term.

Preliminary research on labour and employment issues in the industry has raised concerns about the precarious employment[iii] of property service workers, including workers in the construction, cleaning, maintenance and security industries (Gozan and Moye 2000; Hamilton, Hebb and Wood, 2009). These concerns stem, in part, from the proliferation of innovative employment strategies used by property service firms to meet ever-lower price obligations, which are perpetuated by fierce competition and contract underbidding (Hamilton, Hebb and Wood, 2009). Such strategies include the systemic use of sub-contracted, temporary and part-time labour, and are common practice in property services. For example non-unionized cleaning service firms

often subcontract janitorial work either building to building, or even in some cases, floor by floor, using a combination of franchise and sub-contracting arrangements in order to reduce employment costs.[iv]

In terms of social impact, workers in precarious employment arrangements are highly vulnerable to increased health risks, psychological stress and mental illness (WHO 2008, 72). Social and health burdens on workers can, in turn, have an impact on the quality of work performed, and can lead to greater staff turnover and higher absentee rates. Such human capital management challenges can reverberate up the chain and increase operation and management costs for service providers, property managers and investors (Garland 2007; Hamilton, Hebb and Wood, 2009).

Hamilton, Hebb and Wood (2009) also argue that precarious work can have a cumulative impact on taxpayers and societies over time as service firms continue to hire workers under precarious work arrangements. Under many sub-contracting and franchising schemes, property service companies are able to externalize the cost of providing employment benefits such as Canada Pension Plan/Quebec Pension Plan (CPP/QPP), Employment Insurance (EI), sick leave, extended health benefits and vacation pay. In some cases this can result in a bottom-line cost savings of up to twenty percent, while off-loading responsibilities onto workers and taxpayers. While dispersed and difficult to measure, the externalization of such costs as a result of precarious work arrangements is not negligible in terms of broader societal impact on tax revenues and social benefit systems (OECD 2000, 187).

Practitioners in the green building movement argue that the low cost approach to tendering and contracting, which is deeply ingrained, is adversely affecting the green building industry in general by favouring low-cost services to the detriment of a high-quality approach. Lucuik et al. (2005, 36) point out that the current practice of focusing on minimizing direct costs over a short time-frame (such as during the construction phase) prevents the adoption of a longer-term, life cycle approach that is better aligned with the philosophy and goals of responsible properties, and may lead to cost savings over the life of a building. Similarly, other consultants argue that contrary to current industry perceptions, property managers can design contractor selection processes that provide fair wages and benefits for workers without increasing operation and

management costs. According to industry insiders, "it all comes down to vendor selection and management".

The labour component or the 'handprint' of the property industry is a critical factor in ensuring that properties are designed, financed, built and maintained in a manner that allows them to meet their sustainability performance goals over the entire building life cycle. The net positive benefit of supporting the development of a stable, well-trained and professional property service sector can contribute to improved asset performance and value over time by minimizing human capital management costs and increasing productivity within the building service industry. Other social considerations can also contribute to improved property performance, higher return on investment due to higher rents, and greater tenant satisfaction as a result of improvements in occupant health and productivity. Finally, regional economic spin-offs, local job creation, sustainable transportation and longer-term outlooks can have a significant positive impact on communities and society, both in how people live and work.

Responsible Property Investment: The Canadian Experience

Canadian signatories to the United Nations Principles of Responsible Investment (UN PRI) have applied responsible investment practices to their public equity holdings, using ESG standards in stock selection, proxy voting, and engagement with firms in their equity portfolios. However, as responsible investing matures, these standards are being increasingly applied to other asset classes within Canadian portfolios.[v] There is growing interest in applying ESG standards to institutional investors' real estate holdings, particularly since such factors can have a significant impact on property performance over time.[vi]

Of the Canadian signatories to the UN PRI both the Caisse de Dépôt et placement du Québec (the Caisse) and the British Columbia Investment Management Corporation (BCIMC) have recognized the importance of ESG standards in their real estate portfolios. To date Canadian investors, property developers and property managers have focused primarily on the environmental aspects of Responsible Property Investing with limited attention to the social standards required in real estate portfolios. One reason for this could be that the metrics and

standards used to quantify the impacts of raised environmental standards on real estate investment portfolios are more fully developed. Within this framework it is easier to see the long-term pay-off that comes from factoring environmental concerns into both property development and property management. The physical and tangible nature of real estate also results in a greater sensitivity to the environmental risks and returns associated with this asset class.

We enhance our discussion and analysis in this paper by adding the perspective of industry practitioners, through semi-structured interviews with real estate owners, managers, investors, advisors and consultants. These interviews, conducted over the summer of 2009, contribute to our understanding of the Canadian real estate sector's progress to date, in terms their familiarity with the concept of RPI, and ability to apply it to their business practices. In addition, these interviews contribute to a deeper understanding of the different limitations and opportunities faced by both investors and developers/managers for incorporating ESG considerations into their decision-making, with additional insight from consultants.

The nine interviews are comprised of two real estate developers/managers, two consultants, and five real estate investors/advisors. Most were familiar with the concept of RPI and all interviewees agreed that being a responsible property investor and owner/manager involved the incorporation of ESG factors into their decision-making. However, the extent to which each of these three aspects was included in their definitions varied.

Corporate social responsibility and good governance were the most commonly understood of the ESG factors considered part of being a good responsible business. For most interviewees these were treated as embedded practice. One interviewee was not familiar with the term RPI, and preferred to talk about corporate responsibility. Environmental aspects received significantly more attention than social factors by all investors and developers/managers interviewed. In contrast, consultants used a broader definition of RPI, referring to both social and environmental aspects. This group extended their definition beyond the traditional one, which "relates to investors being the main stakeholder, and the main goal being their fiduciary duties as investors" to a broader definition that emphasizes responsibility for the community as a whole.

All interviewees claimed to take ESG factors into consideration on some level of their decision-making, although there was variation in this commitment. Real estate managers talked about programs their company supported, which are focused on commitments to reducing environmental impacts of their properties. When probed about social considerations, most respondents were hesitant. One property manager did claim the company would be including labour and contracting considerations in their sustainability program in the near future. Investors referred to mission and value statements and policies, which expressed their commitment to ESG factors. Consistent with real estate developers/managers, investors also had less to say about the social side. "The social piece is harder; it's not on their checklist and is subjective." However all investors and developers/managers did consider Responsible Property Investing to be a part of their Corporate Social Responsibility (CSR).

While interviewees did not have difficulty identifying their commitment to ESG at least on the environmental side, a task that proved more challenging for our respondents was to compare the impact on property where ESG considerations had been taken into account with other properties in their portfolio. The general consensus was that it is too early to draw any conclusions. "There isn't any research and it's hard to quantify these questions." Another respondent commented, "I'm not sure how you would do this comparison. I just don't see a methodology for it." One investor did note however, that "ESG used to be something that was nice to have. Now it is something we need to have." Consultants suggested that RPI plays a large role in their business. For example, one noted that "RPI is becoming increasingly important. Two years ago responsible property was a non-event. It is increasing in importance. It is not a flood, but it is increasing. Everyone wants to talk about it".

To investigate this issue further, respondents were asked to consider more specifically the impacts of incorporating ESG factors on costs, reputation and risk reduction. A common perception amongst most investors and property developers/managers is that there is a cost premium attached to incorporating environmental and social factors into decision making. Consultants on the other hand, argued there is no cost premium for both social and environmental factors and that this is something that needs to be addressed through education. Despite the perception of a premium, all respondents claimed such costs are not preventing them from engaging in these activities. One interviewee suggested that there are also costs associated

with ignoring ESG considerations. "There is also a cost if a company fails to engage its employees. Good employees stay with you when they see these standards." When asked whether they perceived a tradeoff between financial returns, environmental returns, and social returns, one institutional investor replied "a few years ago I would have said yes to tradeoff, but responsible investing shows you can integrate ESG with returns. It is seen as a continuum. That is a sea change over five years ago."

Many engage in RPI to enhance their reputation. All respondents agreed that there is a significant positive impact and view ESG considerations as "part of reputation and risk management". Consistent with previous answers, respondents place greater emphasis on the environmental side of reputation. In regards to risk, RPI can enhance investor relations because "investors are concerned about risks of climate change. Green buildings provide a higher quality brand value and a significant competitive advantage". One consultant also identified the risks associated with the expectation of regulation in Canada. "National regulations on green buildings are not necessarily forthcoming, but regulation will happen provincially/territorially and regionally." For example, Toronto has adopted 'Green Standard Tier One', which requires 25% better energy performance than the model national energy code for buildings (City of Toronto, 2009).

When thinking about costs, reputation and risk, a number of those interviewed raised issues related to tenant satisfaction, retention and rental premiums. Investigating each of these dimensions further, we find that developers/managers and investors are not aware of sufficient empirical evidence to support a strong relationship between any of these. However, most respondents agreed with ease that there would be a positive relationship with respect to tenant satisfaction. Consultants agreed that tenant satisfaction improves with sustainable buildings not only in environmental factors, but also social. "If people working in the building feel cleaners are well paid or fairly paid or that the building is socially responsible, it will increase tenant satisfaction".

Tenant recruitment and retention was not something any interviewees measured with respect to the sustainability of their buildings. Some interviewees did suggest that there may be less turn over in high efficiency buildings. "Buildings that fail to adopt standards will see the greatest risk

of tenant loss." Canadian industry experts suggest "the environmental demand is just starting to gain momentum and it has been a long time coming."

Again, in the opinions of developers/managers and investors we interviewed, there is not enough evidence to directly relate tenancy rent premiums to social and environmental performance. "It is tough to quantify any link between rents and sustainability." However there is some indication that they acknowledge the possibility of a positive relationship. One investor suggested "rents depend on many variables but as markets normalize, tenants are choosy about type of space. They choose sustainable assets. It's a must have." Another interviewee suggested that rent premiums may depend on the type of tenants, particularly with respect to retail and office tenants. "Office tenants may be more willing to pay premiums." The consultants we interviewed believe that there are significant premiums for environmental factors but not yet evidence of the economic value of addressing social factors.

In addition to questions on impacts of responsible property investing and management, we ask interviewees about the measuring systems they use to gauge both the social and environmental performance of their buildings that they invest in, own and manage. We find that most are using LEED or BOMA Best. Also, most are in the initial phases of gathering baseline data for their real estate portfolios. All investors and developers/managers omitted social metrics from their responses.

The consultants identified strengths and weaknesses of the two most prominent rating systems. "BOMA Best is a self evaluation process. There needs to be real recognition in the marketplace that third party evaluations are far superior to self evaluations". However, LEED also presents opportunities for improvement, particularly on social metrics. "In the LEED systems, there is no explicit concern for social equity, but there are implicit concerns for it. In my opinion, it needs to be explicit and it needs to be broader" commented one consultant.

Although environmental concerns currently top the list in Canadian responsible property development and management, there is an increased recognition that social standards should also be addressed in this framework. The consultants we interviewed suggested that LEED Canada tends to follow trends in the US, and therefore, we may start to see more on the social side in

Canada as LEED US starts to incorporate social metrics. Issues of concern in this area include the impact of fair labour practices on property performance, as well as on reputational risk. For a more detailed examination of social factors in RPI including a number of interviews on this topic specifically see Hamilton, Hebb and Wood, 2009.

Interviews with Canadian investors, property developers and managers and industry consultants indicate that incorporating ESG into real estate portfolios is no longer considered something extra, but rather, embedded in a company's corporate social responsibility. It is clear that environmental factors continue to receive the majority of the attention from property owners and managers, while social factors remain a peripheral and poorly-understood concern in the industry. Interestingly, our interviews demonstrated that there was a significant disconnect between the industry consultants' views on the economic value of RPI, and the views of industry practitioners and investors. Based on these results, there is a need for more research on the impacts of responsible investing practices and management, and more importantly, the need for more effective dissemination of this research to practitioners.

Impact of ESG Standards on Real Estate Investment

Investors' concern with Responsible Property Investment is primarily focused on the long-term share value of investments that factor environmental, social and governance into their decision-making. Here the investment belief is that best practice in ESG both protects corporate reputation (Clark and Hebb 2005) and can contribute to out-performance against industry benchmarks (Kok, 2008). By this logic we would expect to see a link between the long-term share value of real estate developers and managers and high ESG standards.

Increasingly real estate companies and investment trusts in Canada are improving their environmental, social and governance standards. Examining Jantzi Research Inc. ESG ratings on publically traded real estate developers, property managers, and real estate investment trusts from 2004 to 2007 one sees a steady increase in the ESG total scores of these firms and trusts over this period. Jantzi's ESG ratings cover five primary areas of concern. These include community and society issues broadly, governance concerns, environmental considerations, customer considerations, and employee concerns. Each area is scored by Jantzi and an overall

score is given. In 2004 only three real estate companies were rated by Jantzi. These three had total ESG scores ranging from 3.9 to 4.6 with an average score of 4.3. In 2005 Jantzi added eleven real estate investment trusts (REITs) to their ESG rating list. These fourteen firms had a slight increase in the average score to 4.4. By 2007, these companies and trusts received ESG ratings with increased average total scores of 5.1. Clearly over the past five years ESG factors have begun to receive greater attention by the industry as a whole, a conclusion supported by our interviews with real estate practitioners.

Over the four year period 2004-2007, eighteen publically traded real estate companies and REITs were scored by Jantzi Research Inc. The ESG factors receiving the highest scores were corporate governance, customer concerns, and the environment. Average scores for governance through this four-year period were 6.35, making it the highest ranking ESG factor, while customer considerations ranked second at 5.63. Environmental concerns' average among the group score was 5.05. Areas of least concern were communities and employees with average scores of 3.20 and 2.55 respectively. The low score for community and employee considerations speaks to the lack of attention often paid to social concerns detailed in the previous sections of this paper.

This paper asks if Responsible Property Investing provides a business case for investors to choose high ESG rated real estate investments over low ESG real estate investments in terms of long-term share value. Conversely is there are a cost to choosing high ESG real estate investments in terms of share value? Given the cost/benefit implications of high ESG standards detailed earlier in the paper, we suggest that integrating high ESG standards in real estate investment decision-making should have a strong correlation with positive financial returns. We test this theory using the ESG data from Jantzi Research Inc. from 2004 to 2007. With ESG average total scores from fourteen publically held real estate developers, property managers and real estate investment trusts[vii] we established a high ESG portfolio of seven real estate holdings with ESG scores 4.75 and higher. The low ESG portfolio also had seven investments with average scores ranging from 4.60 to 3.90.

We then look at 1, 3 and 5 year cumulative stock price changes (Bloomberg 2009) for each investment[viii]. It must be noted that our study uses December 31st 2008 as the reference date for

1, 3 and 5 year stock price returns.[ix] With the global financial crisis of 2007-2008 all publically listed stocks fell to dramatically low levels during this period. In June 2008 the Canadian stock exchange reached its peak value of just above 15,000 and then fell dramatically along with the rest of the world's stock market to close at 8,987 by December 31st 2008. A similar decline is evident in the sample real estate companies and REITs used in this study with comparable negative impacts on 1, 3 and 5 year returns.

In contrast to 2008 results, by August of 2009 the Canadian real estate sector was being touted as the fastest growing sector of the Canadian stock exchange with many REITS earning over 20% returns through August of 2009.

We find that the High ESG portfolio on average outperformed the Low ESG portfolio in each of 1, 3 and 5 year periods. This outperformance of the high ESG portfolio occurs in both up and down markets. On average, annual returns for the High ESG portfolio were 8% higher than the low ESG portfolio.[x] There appears to be a positive impact for investors in choosing the high ESG portfolio and certainly no loss of share value by choosing high ESG real estate firms with their attendant positive impacts on reputation, over those with low ESG standards.

Table 1: High and Low ESG Portfolio and Financial Return

High ESG Portfolio	ESG overall average score	Price change - 2008	Price change - 2007	Price change - 2006	Price change - 2005	Price change - 2004	Price change - 2003	Annual Rate of Return 5 years	Annual Rate of Return 3 Years
1	5.33	-43%	8%	95%	15%	3%	18%	7.4%	6.4%
2	4.97	-37%	-13%	10%	28%	16%	23%	-2.2%	-15.7%
3	4.93	-52%	-37%	34%	15%	20%	31%	-10.9%	-26.0%
4	4.87	-42%	-3%	16%	22%	15%		-1.7%	-13.2%
5	4.80	-21%	-9%	17%	12%	17%	23%	1.6%	-6.0%
6	4.80	-63%	-13%	50%	0%	9%	51%	-11.6%	-21.1%
7	4.75	-53%	23%	-2%	11%	88%	129%	3.6%	-17.1%
average price change		**-44%**	**-6%**	**31%**	**15%**	**24%**	**46%**	**-2%**	**-13%**
Low ESG Portfolio									
8	4.60	-22%	-8%	40%	27%	11%	22%	7.2%	0.1%
9	4.53	-64%	-22%	10%	5%	4%	20%	-19.5%	-32.5%
10	4.47	-62%	-18%	16%	10%	20%	19%	-14.1%	-29.0%
11	4.33	-54%	-11%	16%	27%	36%	40%	-3.8%	-21.8%
12	4.33	-2%	-14%	15%	7%	-2%	19%	0.5%	-0.9%
13	4.23	-52%	-19%	-13%	13%	12%		-15.6%	-30.4%
14	3.90	-67%	-33%	4%	11%			-29.1%	-39.0%
Returns		**-46%**	**-18%**	**13%**	**14%**	**14%**	**24%**	**-11%**	**-22%**

Source: Ratings from Jantzi Research Inc., and price data from Bloomberg, Tristat Resources

However, we further tested the data to determine if the ESG score was statistically significant in driving these return differentials. We used the Wilcoxon Rank Sum Test on the data. The Wilcoxon Rank Sum Test was not statistically significantly at $p<0.10$ (z-score of -1.43). It must be noted that the sample size itself was small with 80 values and includes the anomalous year 2008 in the dataset.

Given that we see outperformance of the high ESG portfolio, we recommend that this correlation analysis continue over the next several years. This will enable us to test the hypothesis that real estate development and management firms and REITS with high ESG characteristics outperform those with low ESG ratings by providing us with both additional values in the sample size and providing a more normalized reference point in the financial markets than we find with an end date of Dec. 31st 2008.

Implications and Conclusion

This paper explores the impact of Responsible Property Investment in Canada. We find an increasing awareness of RPI among institutional investors, real estate developers and management firms, and industry consultants. Both in interviews and in the year over year increases in the Jantzi ESG ratings of real estate firms and REITs, it is evident that ESG factors are being taken seriously within the industry itself. Much of this attention is focused on good governance, corporate social responsibility (CSR) and environmental concerns. Increasingly both investors and industry itself point to the positive impacts of 'green buildings' within the real estate portfolio. These positive impacts are measured primarily in increased tenant satisfaction and in positive reputation effects for the company (Kryhul, 2009).

Many of those interviewed were skeptical as to the impact of high ESG standards on the financial bottom-line. They felt that there was not enough empirical evidence to back claims of financial outperformance from high ESG standards. Instead they focused on these standards as reputation enhancing that included their ability to hire and retain top staff in work environments that placed value on ESG attributes of corporate behaviour.

Investors, particularly institutional investors are seeking both reputational and financial impacts from firms that have high ESG standards and see this as part of their Responsible Investing approach in their total portfolio. We tested the business case for RPI investment. We found that the high ESG portfolio of Canadian real estate firms and REITS outperformed on average the low ESG portfolio in 1, 3, and 5 year time periods ending December 31st 2008. Time periods examined included both up and down markets. However, using regression analysis we were not able to find statistical significance between the stock price performance of these firms and their ESG ratings. In other words many other factors in the market influence the stock price changes of these firms to a greater degree than can be claimed by simply having high ESG standards. Such evidence can point to an element of chance that the high ESG portfolio outperformed the low one over the time periods examined. But given the low number of values in the sample and the anomalous year of 2008 in the world's financial markets we would like to see this hypothesis retested in the future against an larger sample size and a more normalized set of years in the financial markets.

Both our interviews and our analysis of the Jantzi ratings showed greater concern for governance and environmental aspects of RPI and less concern from investors or industry representatives with the social factors that form a key aspect of ESG. One challenge is the lack of literature and data on the social factors that impact RPI. It may be that, as social factors are integrated into popular ESG measurement toolkits such as LEED, we will see social concerns receive more attention in the future. Our earlier study of good labour practices in property performance (Hebb et al, 2009) found labour supply chain issues lacked attention among the ESG factors in real estate. We will want to find ways to encourage such social concerns in property development and management going forward.

On the environmental front, there is a concern that older buildings are excluded from the RPI literature. However, both the increased use of the BOMA Best ratings for buildings in Canada and the adoption of LEED ratings for existing buildings in Canada in 2009, may promote more interest in this area. To further strengthen the business case for RPI we need to encourage empirical data that examines the link between LEED or BOMA building certification and increased tenancy rates and rent. Though there is some work on cost containment and high environmental standards of building management, there is less evidence linking tenant satisfaction, tenancy rates and willingness to pay increased rents to high ESG standards. For some, having these standards is now a necessary part of doing business with corporations increasingly issuing RFPs that demand LEED and BOMA Best standards be present as a minimum condition in order to participate in bidding.

Another significant gap in RPI is metrics. In order to encourage investors to invest in sustainable properties, it is necessary to provide them with the resources to assess the sustainability of property and a consistent method for quantifying that assessment in terms of property worth (Ellison et al, 2007). Pivo (2008) lays the foundation for some metrics through assessing the availability of information in the US for measuring social and environmental performance of real estate portfolios, yet he finds major gaps in the available data. Our interviews suggest that both LEED certification and BOMA Best certification are helping to promote these standards in Canada.

We can expect changes in public policy to drive the trend toward green buildings and ESG factors in Canadian real estate. Increasingly at the provincial/ territorial, regional and municipal level there are regulatory changes that require new and existing buildings to achieve higher standards with respect to energy and waste conservation, and transit orientation. This trend will continue. Real estate development and management firms on the leading edge of this trend will be well positioned to respond to regulatory changes in the future.

Public opinion will also contribute to the demand for green buildings going forward. Whether tenants, employees, or the community at large, on-going concern for environmental standards and corporate responsibility requires increased attention be paid to ESG issues in real estate. "We were looking at our lease maturities, the growth of our business, our strategy for our office personnel … if we were going to have a flagship location, we wanted it to align very strongly with the values of our organization." Said Royal Bank of Canada Vice-President Linda Mantia in a recent interview (Kryhul 2009). The result of not raising these standards will impact reputation, employee productivity and retention, and ultimately tenancy rates. Investors, with a view to long-term share value can protect their real estate investments from both regulatory and reputation risk through the integration of ESG factors in their real estate portfolio. Our research on the impact of the high ESG real estate portfolio on financial returns points to a solid business case for such integration, though correlations in this study were found insignificant, this may be due to the small sample size and anomalous financial returns of 2008.

We suggest that future research in Canadian Responsible Property Investing extend this paper by adding additional years to the sample and as a result increasing the number of values in the analysis in an exploration of the link between long-term shareholder value and ESG standards in Canadian real estate investment.

This paper explores Responsible Property Investment in Canada, an area of research that has not received as much attention as RPI in other countries, most notably the US. We find that ESG standards in Canadian real estate companies and REITs are on the increase. Currently most of that attention is focused on environmental standards and 'green buildings', but increasingly social factors are being integrated in metrics such as LEED and as a result we would expect to see greater consideration of these factors in the future.

While some institutional investors are integrating these standards in their real estate investment portfolios, many are not. Yet our research points to both reputation risk and financial risk in Canadian real estate firms with low ESG standards. We suggest that investors, particularly institutional investors seeking to integrate Responsible Investing in their investment decisions, pay greater attention to ESG factors in their real estate portfolios.

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End Notes

[i] LEED or Leadership in Energy and Environmental Design Standards are a certification standard for new building construction. They range from certified, silver, gold, and platinum levels. For more information on LEED see http://www.cagbc.org/leed/what/index.php.

[ii] It must be noted that this research is based on a static partial equilibrium analysis which allows for the possibility that price differentials vary over time between buildings.

[iii] Precarious employment refers to insecure, low-wage, temporary, contract and part-time work. This form of employment is often driven by the desire for more flexible, mobile workforces, and can lead to significantly higher rates of poverty among workers and their families, limited access to extended health benefits, and increased levels of stress, mental health disorders, addiction and heart disease.

[iv] Personal communication, Jean Van Vliet, Canadian Auto Workers (CAW), Vancouver, October 24, 2008.

[v] Institute for Responsible Investing (IRI) (2007) Handbook on Responsible Investment Across Asset Classes , Center for Corporate Citizenship, Boston College, Boston , http://www.bcccc.net/index.cfm?pageId=1869

vi UN PRI (2008) Building Responsible property portfolios – A review of current practice by UNEP FI and PRI signatories, http://www.unpri.org/property

[vii] Four of the eighteen companies and REITs in the Jantzi ratings no longer were in existence by 2008.

[viii] To maintain proprietary confidentiality we have given each firm a unique identifier in our sample.

[ix] Stock price changes were used in this study rather than total return and does not include dividends paid in each of the time periods.

[x] Statistical work on this paper was verified by Dr. Richard Shillington of Tristat Resources.