

AXA Investment Managers – Real Assets

Measuring and mitigating physical risk, transitional risk posed by climate change

Recently, **Chase McWhorter**, Institutional Real Estate, Inc.'s managing director, Americas, spoke with **Justin Travlos**, global head of responsible investment at AXA Investment Managers – Real Assets, the real assets arm of AXA IM Alts, about how the firm is figuring out how to measure climate risk and build portfolios that meet ESG thresholds. Following is an excerpt of that conversation.

How does AXA IM – Real Assets look at ESG, and what drivers shape your view?

As investment managers, we cover a breadth of asset classes, from direct real estate to real estate debt to infrastructure — both as equity and debt investors — and, ultimately, right through into forestry and natural capital. It's a very broad spectrum of investments. What is critical for us when it comes to ESG is climate. There are many, many other aspects to ESG, but the greatest drivers reshaping the investment universe at the moment involve climate and climate change, both physically and in terms of regulations. They are driving a change in urgency, in performance of underlying investments, and in demand from investors for more evidence and more stock to be able to prove ESG performance.

What are the firm's overarching sustainability goals and strategies?

We have several major goals applied across our investment platforms. The first is to achieve net-zero carbon emissions for our investment portfolios by 2050 or before. We have a near-term target of reducing operational emissions by 20 percent in our direct real estate investments by 2025, and then by 50 percent by 2030. We have 110 months left to halve global emissions. That is what the science suggests to avoid the worst of climate impacts by the end of the century. We have to act and we have to act now, and these are the levers that we are using to contribute to that global target of being able to contain global warming below 1.5 degrees by the end of the century.

We are trying to match our targets as best we can with global, science-based targets, very mindful that the recent IPCC [Intergovernmental Panel on Climate Change] report is telling us that climate change is accelerating, and the time for us to act more urgently has certainly arrived. While there is a huge amount of variability in the underlying metrics, tools, assumptions and models we use to assess some climate change, the overarching trend is crystal clear, in terms of this transition to a low-carbon economy.

The second goal — and the one that is most difficult to achieve — is our target for 50 percent of our real assets to be aligned with the 2.0-degree or 1.5-degree trajectory by 2025. That means CRREM [Carbon Risk Real Estate Monitor] decarbonization pathways for real estate, and it means using the CBI [Climate Bonds Initiative] taxonomy for infrastructure investments. That is a pretty significant target and a strong directive for the teams in terms of how we achieve that in the next three years. This goal aligns with our overall chief strategy around Decarbonization, Resilience and Building tomorrow. The Decarbonization theme is very much about net-zero emissions; Resilience is focused on understanding and preparing our assets to respond to physical and transitional risk; and

Building tomorrow is about engaging and meeting the needs of our stakeholders, engaging with our tenants to better meet their needs, and finding solutions for our clients to invest into the foundations of tomorrow's world.

How do you see ESG play into the current investment landscape across the breadth of real assets?

It is reshaping the way we consider investments and investment risk. Physical risk is something we measure for all of our assets as we acquire them, and we have looked across our entire global portfolio and mapped it out to understand its current level of physical risk. But probably of greater impact for the investment market is transitional risk. Transitional risk covers the transition to a low-carbon economy and the structural changes that take place through regulation, performance requirements and tax regimes, which change the underlying performance of the asset. We are seeing a significant shift in understanding and action on transitional risk. The simplest way I can describe it is, in Europe, we have energy performance certificates, or EPCs. They are on an alphabetical scale from A being very good to G being very poor. Several years ago, the United Kingdom put a threshold on any assets with a performance worse than E, so F- or G-rated assets are effectively unable to be leased or traded unless they had specific exemption. Today, E.U. regulators are moving toward taking that liquidity threshold and moving it to their rating level of B, which is a very significant shift in demand for performance in the underlying stock. It fundamentally means investors will be prohibited from leasing, trading or selling assets with very poor performance from an energy perspective.

What are the implications of climate change on your different real estate strategies?

The focus on climate will impact different strategies in different ways. Physical risk often comes up because it is a present risk — it is something that could occur today, or in the next couple of years, or in the long distant future. For example, if you evaluate coastal flooding on a particular asset acquisition, the question used to be, how high do you need to build this asset to ensure that it is protected from flood risk? That question now has evolved to, how high do you need to build this asset so that it is capable of withstanding what we expect to be increasing climate shocks. It is playing out in a deeper level of due diligence with a lot more forward-looking expectation in terms of how changing climate might impact particular metrics.

Equally, it is playing out on the sensitivity side of the analysis — if the question is whether we still wish to acquire in this particular area with this level of risk, the other side of the question is, when we look to dispose of the asset at the end of the investment, what constraints might be on institutional capital to be able to acquire assets with that level of risk associated with them? A lot of institutional capital is grappling with: How do we measure this risk? How much risk are we willing to take? What is the time frame we are willing to take that risk in? The science is still very new. A well-understood example

would be earthquake risk, where if the likely annualized loss is above a certain portion of the asset value, then it is not an investment with which to proceed. The level of climate science isn't there yet to provide investors with the same level of clarity for climate risk.

But for every risk, there is probably an opportunity as well. When we look at the stock of existing assets that are performing poorly, to be able to renovate and improve the performance of that stock is one of the key components of being able to reduce global greenhouse-gas emissions for buildings. Having the insight within the business as capable asset managers to be able to convert stock and to be able to identify the value in investments acquisition, development and innovation is becoming quite a refined skill set in the market.

Could you give an example of how you are doing this?

One example is Dolphin Square, a residential estate built between 1935 and 1937 in Pimlico, Central London, and comprising just over 1,200 apartments. When we acquired it a year ago, its energy consumption was almost 300-kilowatt-hours per square meter. It had been run in a similar way for almost 90 years. We have a plan in place that will increase the energy efficiency of the asset by more than 80 percent. It will take its carbon emissions from just under 50 kilograms per square meter down to just over two kilograms per square meter over the course of eight years.

So we are taking an existing asset that has a solid history in a beautiful space — part of the fabric of London — and making it future-fit for the next 50 years by investing in technologies to make the asset much more efficient, reduce its reliance on fossil fuels and breathe new life into an old building. It will probably not be quite as efficient as the most efficient new builds out there, but it avoids the significant cost of embodied energy that it takes to build an entirely new building. We are, like many others, finding our way to the balance between embodied carbon and the impact that we have through construction and operational carbon. These sorts of projects aren't just good for the environment — they also enhance financial returns and minimize risk.

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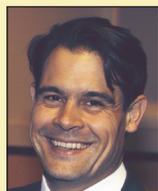
How is the changing regulatory environment shifting investor behavior or demand?

Governments are beginning to put in place frameworks that help provide more transparency to the market. The E.U. Taxonomy, for example, is a classification system that helps industries define assets that are likely to be sustainable in the long term. And it sets up performance criteria for all the economic sectors to meet, to be deemed to be "sustainable." Investors increasingly want to know the proportion of taxonomy-aligned investments in a portfolio. That concern is driving a significant amount of activity and improvement. The thresholds being set by regulation are high relative to the current performance of the market. Putting that in context, a sustainable building in Europe needs to have an energy performance certificate of A; meanwhile, estimates show that only 2 percent of the current building stock in Europe meets this EPC specification at present. The regulatory environment is shifting investor demand quite fundamentally, and the overarching trajectory is crystal clear: there is an absolute demand for performance improvement and a decreasing tolerance for lazy assets.

How are you harnessing data and technology to further your asset performance with regard to sustainability?

The visibility of data within private markets for real estate is probably still quite poor, but it is getting much better. The visibility we have in terms of our landlord-controlled consumption is significantly clearer, and the visibility we have into tenant-level consumption is improving significantly. It allows us to measure performance in the asset so we can manage it better. Proptech's interface at the building level is just the beginning. I think it has a very clear place in the future of real estate and not just in individual assets, but in cities and precincts, where you can start to see synergy between different building topologies to generate greater efficiencies. It is such an exciting time for the market.

CONTRIBUTOR



Justin Travlos
Global Head of Responsible Investment
AXA Investment Managers – Real Assets

Justin Travlos heads AXA IM – Real Assets' Responsible Investment activities. Previously, Travlos was a regional development manager for commercial property in New South Wales, with Stockland, one of Australia's largest diversified listed property companies.

CONTACT INFORMATION

Stephan Ackermann
Head of Client Capital Group
Asia Pacific & United States, Alts
 +44 20 7003 2845
 Stephan.Ackermann@axa-im.com

Jonathan Matson
Senior Sales Manager, Alts
 +1 646 981 1150
 Jonathan.Matson@axa-im.com

CORPORATE OVERVIEW

AXA Investment Managers – Real Assets is the real assets arm of AXA IM Alts, a global leader in alternative investments with €163 billion of assets under management comprising approximately €78 billion of primarily private real estate, approximately €74 billion of private debt and alternative credit, as well as approximately €11 billion in infrastructure, private equity and hedge funds. AXA IM Alts takes a 360-degree approach to real assets (real estate and infrastructure), investing with approximately €110 billion of assets under management in direct opportunities, held indirectly through debt and listed equities and via long-term private-equity investments into operating platforms. ESG is fully integrated into its investment decision-making processes, with its responsible investment approach anchored by the three key pillars of decarbonization, resilience and building tomorrow. AXA IM Alts employs more than 750 people located in 16 offices around the world and serves the needs of more than 400 clients from Europe, North America, Asia Pacific and the Middle East.