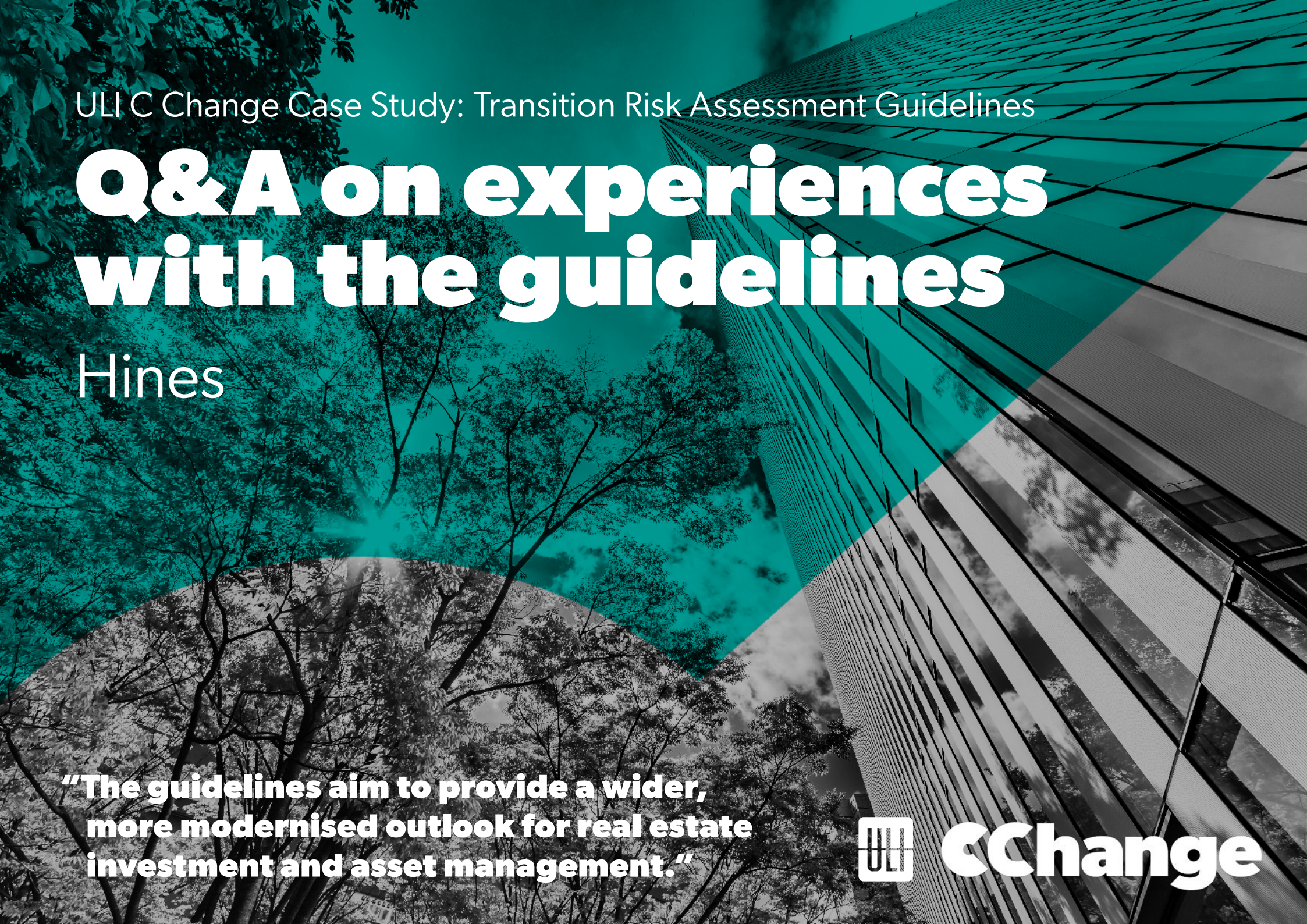


ULI C Change Case Study: Transition Risk Assessment Guidelines

Q&A on experiences with the guidelines

Hines

"The guidelines aim to provide a wider, more modernised outlook for real estate investment and asset management."

ULI cChange

Hines, a global real estate investment manager, used the *ULI C Change Transition Risk Assessment Guidelines* to assess an office building in Amsterdam. This asset belongs to one of Hines' European funds which aims to grow the income profile during the holding period through sustainability-linked initiatives and active asset management. The building chosen for the assessment was constructed in 1981 and is due to be subject to a complete refurbishment programme. We spoke with Daniel Chang, European Head of ESG and Arjun Sahota, ESG Associate at Hines, about their experience of using the guidelines.

What is your current approach to assessing transition risks?

Hines aims to achieve net zero scope 1 and 2 emissions by 2030, and net zero scope 3 emissions by 2040. To ensure progress towards this goal, the fund's operational energy intensity and carbon intensity targets are benchmarked against the CRREM pathway for the entire portfolio, asset by asset.

Such analysis allows the fund managers to understand the trajectory at which they should seek to improve the operational performance of the assets by identifying and applying decarbonisation measures. This approach helps to mitigate the transition risk, while ensuring that assets remain liquid and competitive within the market.

What do you see as the benefits from having an industry-wide approach to assessing transition risks?

With the market leveraging a consistent framework, we can be more effective at building a collective understanding and consensus around how the industry can collaborate to mitigate transition risks. In addition, with industry alignment, risks can be more clearly communicated and can begin to have material impacts in the marketplace. For example, if we seek to sell an asset with high levels of transition risk, and the purchaser also makes the same assessment, there can be a constructive negotiation during the transaction to reflect the risk's impact on the purchase price. If a buyer and seller have a completely different view of the market in this regard, then no such negotiations can take place, or will be imbalanced at best. Therefore, there is a strong argument to align the understanding of risks, and the measures required to mitigate them.

CRREM is a good example of a tool that helps the industry to identify these risks. When we buy or sell an asset, we understand that both buyer and seller are likely to undertake CRREM assessments of the property. Hines has begun negotiating purchase prices depending on estimated capex to decarbonise properties, leveraging the CRREM framework. As this framework is widely adopted, such negotiations could become clearer and more straightforward.

Industry-wide adoption of ULI's *Transition Risk Assessment Guidelines* will provide a consistent approach to quantifying decarbonisation risks and opportunities, bringing the sector closer to creating the link between carbon performance and financial implications.

Why did you choose to test the guidelines through a case study?
We wanted to understand how the guidelines would impact our existing cash flow modelling, and what the value implications would be for a specific example. This allowed us to probe assumptions and challenge some of the guidelines, to get comfortable with them.

We also had the benefit of testing the guidelines in a collaborative way with one of our peers, Catella, and felt that this was very helpful in enabling us to understand how the guidelines could be interpreted in different ways, highlighting the importance of having a consistent and clear approach.

How would you describe the stranding risk for the building you assessed?
We knew that there was an elevated stranding risk for this asset, compared to the fund's target, and decarbonisation measures have been planned accordingly, taking into consideration alignment with scheduled asset management events. For this reason, it was a very useful exercise to pilot the guidelines on this example – to dive deeper into the details of decarbonisation and to explore its broader impacts in the context of discussions with occupiers, the budget and cashflow.

Would this risk have an impact on your portfolio?
As this asset is a long-term hold, constitutes a relatively substantial proportion of the portfolio in terms of the size and value, and is landlord controlled, we prioritised mitigating any risk that could impact the building's stranding date and the underlying liquidity of the investment. We are targeting capex measures at this asset to reduce the stranding risk of the property and intend to prioritise it ahead of other assets in the fund that are also long-term holds, but with a later stranding date.

We also believe that offices carry a higher risk of vacancy in the current market, therefore upgrading to the highest ESG standards is an effective measure to ensure lettability, maintain a high level of occupancy, and potentially preserve or even uplift rent levels. So, indeed, the risk could impact our portfolio if no actions are considered.

Were there key differences between the outputs of your baseline discounted cashflow and the risk-adjusted version using the guidelines?
Yes, and these key differences were directly linked to the assumptions taken, such as the level of energy cost savings and to what extent these energy savings were assumed to benefit the landlord, as well as the specific carbon pricing projections.

Were you able to include the quantitative and qualitative shadow costs as part of the discounted cash flow (DCF) model?
We were able to include both in our modelling,

What were the main material transition risks the guidelines helped you identify?

In terms of opportunities, it was very interesting to see how financially material energy savings could be to the asset-level cash flow, and how in this case, they outweighed the anticipated capex spend when capitalised in the cash flow.

In addition, the guidelines helped us to break down and identify the ways in which decarbonisation measures can have varying degrees of impact in terms of financial risks and performance – for example:

- The internal price applied to a tonne of carbon can have an important impact and affect the speed with which action should be taken.
- Some measures, such as onsite renewables, could provide an additional income stream.
- Energy efficiency measures can potentially create savings in operating expenses that increase the Net Operating Income.
- Tenants are focused on total occupancy costs rather than rent only. Reducing operating charges allows to recover the costs sustained through a commensurate increase in rent, while also helping the tenant to achieve their net zero carbon in operation targets.

“This type of assessment provides a more rounded picture beyond capex spend and encourages a holistic approach”

although we focused mostly on the quantifiable risks. The carbon price element was interesting, as we had good data to base this on. That being said, the financial impact was lower than we expected, although we are aware that some carbon pricing standards are more aggressive than the one we applied. Embodied carbon was also modelled, but it was difficult to gather the granularity of information required to accurately reflect the potential implications. For example, we did not have data on the potential embodied carbon emissions associated with asset refurbishment activities.

How might the results of the transition risk assessment influence your investment decision-making for the asset, including long-term operations, maintenance and capex planning?

The results have been certainly helpful in the context of ongoing negotiations with occupiers and considering how improvement works can be tied into the asset management events. They provide intelligence on the cost-benefit analysis of each of the decarbonisation initiatives which can be used to inform our cost tolerance as we look to make improvements – particularly in the context of the business strategy for an asset. Importantly, this type of assessment provides a more rounded picture beyond capex spend and encourages a holistic approach which includes, for example, looking at energy savings and their impact on net operating income.

Have the results of the transition risk assessment changed your view on the business case to decarbonise the asset?

The analysis has provided interesting insights regarding the financial implications of decarbonising, especially in relation to the financial benefits – which help to reconcile the green capex spend. It is important to say that our decarbonisation journey will still need to consider tenant negotiations on the extent to which we can improve the asset. Equally, the live negotiation with occupiers provides the opportunity to actively link improvements with potential rental uplifts. Overall, the assessment has helped us to illustrate the potential for value creation.

"[The guidelines] helped us change the narrative around sustainability and put into focus its financial benefits."

What worked well when using the guidelines? What was more difficult and would be needed to make it easier/more applicable?
The guidelines were clearly structured and straightforward, providing high-level guidance. As a next step, it would be useful to showcase more examples illustrating how the risks could be addressed within cash flows, to avoid varying interpretations by different users.

Which data was easy to collect and include in the DCF model, and which was more difficult?
The more traditional inputs relevant to the main DCF, such as the cost of decarbonisation measures and the related impact on energy costs and potential savings, were relatively easy to obtain.

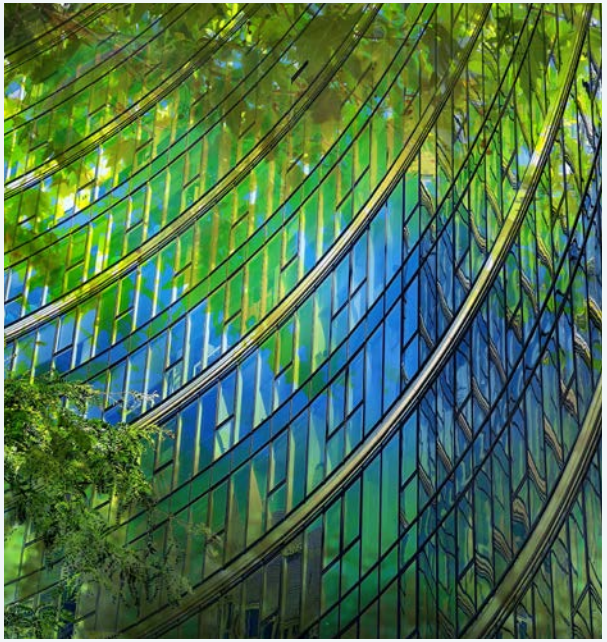
Inputs for the shadow DCF line items were more challenging to determine, e.g. a universal standard for the cost of carbon and relevant embodied carbon data. We needed to identify a plausible external benchmark for the cost of carbon, which took time to research, as there are several standards available that are hugely diverging. We also had no data on the embodied carbon implications of the operational carbon reduction measures, so time had to be spent researching what an appropriate benchmark could be in this regard.

The guidelines address the need to share data to enhance industry progress. Which data is easier to share, and which is more challenging?
Location data or metrics that can make a building easily identifiable can be some of the most sensitive data, as it will reveal the asset more readily. Other than that, we would say that most data sets when anonymised, can be readily shared with limited implications.

Are there elements of the guidance you will integrate into your assessments going forward?
In the immediate term, the core, non-shadow elements of the guidance - such as energy savings - are already being explored for integration into our standard asset-level cash flows. Going forward, we will look to integrate carbon pricing into our processes, once recognised standards become more readily available. ULI's *Universal Principles for Carbon Pricing in the Real Estate Sector* are a step in the right direction.

What was your overall experience of using the guidelines?
It was a very informative and insightful experience. Importantly, it helped us change the narrative around sustainability and put into focus its financial benefits. It challenged the common perception of decarbonisation being just an additional cost, and showed that it brings financial opportunities, as well as mitigates risks.

Would you recommend other companies test the guidelines and provide their feedback?
We would strongly recommend that. The guidelines provide the industry with a more transparent and standardised approach to quantifying transition risks and their impact on asset value – helping us to demonstrate the link between sustainability and financial performance.



About ULI Europe

The Urban Land Institute is a non-profit education and research institute supported by its members. Its mission is to shape the future of the built environment for transformative impact in communities worldwide. Established in 1936, the institute has over 48,000 members worldwide representing all aspects of land use and development disciplines.
In Europe, ULI has almost 5,500 members across 15 National Council country networks.
For more information on ULI, please visit https://europe.uli.org

About C Change

C Change is a ULI-led programme to mobilise the European real estate industry to decarbonise. We're a movement empowering everyone to work together for a sustainable future. We connect the brightest minds from across the value chain. We challenge barriers, share expertise, and champion innovation to move swiftly to accelerate solutions that will transform our industry and protect our planet. C Change means real change.

C Change was formed in late 2021 by a group of leading real estate players that was united in its aim to focus on collaboration to ensure companies large and small have access to practical solutions and education on decarbonisation.

Please visit:
https://europe.uli.org/research/c-change/

About the Transition Risk Assessment Guidelines

The Transition Risk Assessment Guidelines were launched by ULI in 2023 as part of the C Change programme, with the intention of providing a standarised approach to assess and disclose climate-related transition risks as part of property valuations. The guidelines are designed to support owners and managers to assess the impact of 12 transition risks which are material to real estate assets over the time series of an investment; both now and in the future. The adoption of these guidelines in the industry can help remove critical barriers, provide consolidation and enable us to accelerate the transition to a low carbon built environment.

Please visit:
https://europe.uli.org/wp-content/uploads/2023/06/Transition-RIsk-Guidelines-2023.pdf

About Hines

Hines is a leading global real estate investment manager. We own and operate €86.9[1] billion of assets across property types and on behalf of a diverse group of institutional and private wealth clients. Every day, our 5,000 employees in 31 countries draw on our 67-year history investing in, developing, and managing some of the world's best real estate. To learn more, visit www.hines.com and follow @Hines on social media.
[1] Includes both the global Hines organization as well as RIA AUM as of 30 June 2024.

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