Sustainable Real Estate Securities – How solid are your foundations?

reo® Research | December 2009

In this report...

- Sustainability risk assessment of 38 companies
- What companies are doing to prepare
- F&C's recommendations for best practice

F&C Investments

Expect excellence

Table of contents

Introduction

Getting through the credit shock

The global credit crisis that nearly brought the world economy to the brink of collapse has its origins in a combination of interlocking failures – but the trigger that brought all these factors to the surface was the bursting of the property bubble, initially in the US. Yet while the residential US property market was the first to be caught out, the dominoes quickly rattled across the global map, sending property values crashing and default rates on securitised mortgage portfolios through the roof. As inter-bank liquidity seized up and the credit crunch took hold, the property industry found itself facing tumbling occupancy and rental rates and evaporating credit lines. At this point, one might reasonably have asked whether many listed property companies had a future at all, let alone one that could be sustained through a sharp global economic downturn and recovery.

The survivors that made it through the storm had to swallow bitter medicine. Following a flurry of rights issues, debt refinancings and other capital-raising exercises to repair balance sheets over the last year, executives of many property companies are now beginning to look to the horizon for fleeting signs of recovery. With lower interest rates across the US and Europe and the credit freeze beginning to thaw, early signs of a turnaround for residential and commercial property developers are beginning to show.

Following such tumultuous times, one might reasonably ask: which companies will emerge from the property rollercoaster? What will they look like? What lessons will have been learned? And what can property companies, and those invested in the listed real estate securities market, do to support a more stable and sustainable future?

What other shocks might the future hold?

Amidst the turmoil of the credit shock, one other fundamental challenge lies ahead for the property industry. Buildings lie at the heart of the climate challenge: on the one hand, they are a major contributor, by accounting for the second-largest contribution of man-made greenhouse gas emissions[1]. On the other hand, they also stand to be one of climate change's greatest victims, through their increasing vulnerability to climate-related damage. A recent report by insurance giant Allianz and environmental advocacy group WWF estimates that the value of assets immediately threatened by rising sea levels due to glacial melt will increase by more than US$28 trillion by 2050[2].

As a result, governments have begun to craft their response: at a macroeconomic level, they have started to introduce a steadily rising cost of carbon through policy instruments such as the European Energy Performance Building Directive and the European Emissions Trading Scheme[3]. This will reset cost structures in the industry, both during the construction phase where energy-hungry materials such as cement and steel will become more costly, and, more importantly, during the buildings' economic life. Ultimately, this will drive a rethink about building materials, systems and even locations for new property developments.

Meanwhile, at national and local level, policymakers and public planning authorities are requiring property developers to meet minimum environmental standards for energy efficiency, property resiliency and local community impacts. Whether by design or happenstance, environmental and financial policymakers are providing mutually-reinforcing signals, in the form of emissions reduction targets and fiscal stimulus funding, to drive environmental efficiencies in the property sector. As of November 2009, US$81.6 billion in worldwide government economic stimulus packages had been targeted at improving the energy efficiency of buildings, in a concerted effort to drive a low-carbon economic recovery following the recession[4].

At the other end of the property chain, owner-occupiers and tenants are increasingly incorporating environmental performance into their criteria for selecting properties for new stores, offices and industrial facilities. Recent studies show that "green-rated" office properties already command differential rental rates relative to standard buildings[5]. Facilities managers also recognise the savings in operating costs that can be achieved by occupying energy-efficient buildings that include efficient technologies, such as better insulation and windows, natural ventilation to reduce reliance on heating and cooling systems, and low-energy or sensor-based lighting systems. However, in many cases the owner will need to make significant upfront investments in order to achieve real efficiencies, while any payback periods may exceed investment time horizons. Therefore, owners will need to evaluate the cost-benefits of such investments, and take a view on the likelihood that value drivers favouring such investment today might evolve at a more rapid rate in the future than they have in the past.

Finally, investors are also beginning to factor property companies' environmental credentials into their valuations and investment decision-making. An increasing number of analysts' notes now cite the proportion of "certified green" buildings as a key indicator of company strategy and competitiveness in building a portfolio of high-quality properties.

[1] Intergovernmental Panel on Climate Change http://www.ipcc.ch/ipccreports/tar/wg3/index.php?idp=91#tab31

[2] This figure reflect the value of assets at risk in 136 global port mega-cities in "Climate change puts world at tipping point" available at https://www.allianz.com/static-resources/en/press/media/documents/tipping_points.pdf

[3] The International Energy Agency has predicted that the cost of CO_2 per tonne will rise from its current €11-14 range to $50 in 2020 and $110 in 2030. Although the ETS only applies to EU countries at the moment, several countries, such as the US, Australia and Canada, are considering similar schemes, while others are exploring other policy options (e.g. a carbon tax in France) aimed at charging for carbon.

[4] "Taking stock of the green stimulus" HSBC Climate Change Global Research, 23 Nov 2009

[5] In a recent study "Doing well by doing good: Green Office Buildings" by Niel Kok, Piet Eichholtz and John Quigley, the authors demonstrated a 3-4% rental premium for green offices.

The future of global property is green

While operational and strategic effectiveness will always be the primary determinants of long-term sustainability for property operators, this is a 'necessary but not sufficient' condition for competitive success. F&C believes that real estate companies that understand the signals outlined above, and respond by incorporating environmental performance into their maintenance and capital investment strategies, will be better positioned both to benefit from changing regulatory demands and to compete for tenants who are keen to keep a lid on energy costs and CO_2 emissions. At the present point in the property cycle, environmental credentials can be a positive differentiator in a market where competition to attract and retain tenants is fierce – rents are under pressure, concessions and rebates are a necessity, and green sweeteners clearly add to a property's appeal. As property markets recover, however, the big question is whether tenants and owner-occupiers will continue to value these qualitative improvements or whether green credentials will get swept aside in the swing of the pricing pendulum. We believe that the broader policy drivers outlined above, combined with a steady cultural shift on the part of users, will result in an irreversible shift in demand in favour of greener, cleaner buildings that are increasingly cheaper to run than their obsolete competitors as energy and carbon costs continue their inexorable climb.

But good governance and stakeholder relations are also key value drivers

In addition to sustainable environmental performance, global property markets will also need to be underpinned by strong corporate governance practices, marked by financial discipline, an engaged and enlightened board, and robust internal controls for ensuring effective operational risk management. In addition, constructive working relationships with local communities and city planners will be key to securing and expanding landbanks in prime locations, and developing projects on time and on budget.

Undertaking a sustainable real estate risk assessment

Against this backdrop of both top-down and bottom-up "green" property drivers, we carried out an in-depth research exercise to evaluate a representative basket of property companies held in our F&C REIT portfolios[6] against a series of environmental, social and corporate governance (ESG) indicators. The purpose of this exercise was three-fold:

- To identify hidden ESG risks in our property portfolios and to spot opportunities that may have been unrecognised by the market;
- To establish a benchmark for good practice that would reflect the variety and global nature of the indirect real estate sector; and
- To encourage underperforming companies to improve their performance in order to generate sustainable returns.

F&C methodology

In March 2009, F&C convened an in-house team consisting of indirect real estate fund managers and equity analysts, direct property portfolio managers and ESG experts who worked together to identify which ESG issues were most material to the sector. Based on this assessment, we developed a short 10-question survey focusing on the most significant ESG risks facing the property sector. At the same time, we also developed a set of 17 further ESG indicators based on publicly-available information against which all companies could be evaluated.

Following the establishment of this framework, we identified 38 global property companies where F&C clients had a significant financial investment. We contacted the CEO or another suitable executive at each company and asked them to participate in the survey, which was distributed electronically. At the same time, all companies were evaluated against our ESG indicators in order to establish an index of ESG practices. In order to reflect the diversity of the sector, F&C selected companies for our sample set in all major geographies and across the property value chain as demonstrated in Table 1 below.

[6] This included property companies held in funds managed directly by F&C, as well as those held by F&C's ***reo***® advisory clients, which total 20 institutions with assets worth £37 billion as of 30 June 2009. These institutions have appointed F&C to research and engage with companies held in their funds on significant ESG issues that could present risks to their investments performance. These institutions are identified in our quarterly ***reo***® report at www.fandc.com/reopublicreport.

[7] A full copy of the survey is available in Appendix C

Table 1: ESG sample set and survey respondents

Company	Region	Country	Real Estate Sub-sector[8]
AvalonBay	Americas	USA	Residential
Babis Vovos	Europe	Greece	Holding and development
Boston Properties	Americas	USA	Industrial and office
British Land	Europe	UK	Retail
Capitaland	APAC	Singapore	Holding and development
Castellum	Europe	Sweden	Holding and development
Citycon	Europe	Finland	Holding and development
Corio	Europe	Netherlands	Retail
Corporate Office Properties	Americas	USA	Industrial and office
Derwent London	Europe	UK	Industrial and office
Essex Property	Americas	USA	Residential
Eurocommercial Property	Europe	Netherlands	Retail
Fabege	Europe	Sweden	Holding and development
Gecina	Europe	France	Industrial and office
Globe Trade Centre	Europe	Poland	Holding and development
Great Portland Estates	Europe	UK	Industrial and office
Hammerson	Europe	UK	Retail
Hufvudstaden	Europe	Sweden	Holding and development
Icade	Europe	France	Industrial and office
Kimco Realty	Americas	USA	Retail
Klépierre	Europe	France	Retail
Klovern Ab	Europe	Sweden	Holding and development
Land Securities	Europe	UK	Industrial and office
Liberty International	Europe	UK	Retail
Mercialys	Europe	France	Retail
Mitsubishi Estate	Asia Pacific	Japan	Holding and development
Nippon Building Fund	Asia Pacific	Japan	Industrial and office
Prologis	Americas	USA	Industrial and office
Regency Centers	Americas	USA	Retail
Shaftsbury	Europe	UK	Retail
Simon Property	Americas	USA	Retail
Stockland	Asia Pacific	Australia	Residential
Sun Hung Kai	Asia Pacific	Hong Kong	Holding and development
Taubman Centers	Americas	USA	Retail
Unibail-Rodamco	Europe	France	Retail

[8] Real estate sub-sector classifications are based on the Industry Classification Benchmark used by FTSE.

Once we had collected the ESG data from our sample set, we scored each company individually based on the public information available against a total possible score of 25. Companies were then given an absolute ESG performance rating as follows:

- Excellent: 20-25
- Good: 15-20
- Adequate: 10-15
- Inadequate: Below 10

Companies were also assessed for relative performance versus peers.

We also reviewed and scored responses to the surveys separately, so as to distinguish company practice that was not publicly disclosed from that available to the market more broadly. Here, companies were given a rating geared to reflect their preparedness to respond to ESG risks and opportunities. Possible ratings, and their definitions, were as follows:

- **Managing:** Identified ESG risks and opportunities and were actively responding
- **Monitoring:** Identified ESG issues and were monitoring them but had yet to actively respond
- **Aware:** Aware of ESG issues but not routinely monitoring or managing them
- **Unprepared:** Limited or no indication of ESG preparedness

What we found: Current practice in global property markets

Overall findings

Property companies around the world show significant variation in managing environmental, social and governance issues relevant to their business. Overall, our key findings based on ESG data collected from our sample set were as follows:

- Of the 38 companies reviewed, 13 received a rating of ***Excellent*** or ***Good***, representing barely a third of the sample set.
- No company received a perfect score, although four companies received a rating of Excellent.
- In contrast, fully half of the sample set – 19 companies – scored in the bottom performance category of ***Inadequate***, with one company scoring 0.

The divergence in results indicates that there is plenty of room for differentiation and improvement. Investors looking to invest in companies with strong corporate governance and sustainable operating practices have sufficient information and opportunity to do so. However, investors with a commitment to active ownership also have a strong opportunity to encourage poorly-performing companies to improve their behaviour as a means of generating additional value.

Furthermore, companies that were willing to engage by responding to our survey revealed a wealth of information and good practice that was either not obvious to investors or not publicly disclosed. Key findings based on survey responses were as follows:

- 19 companies – exactly 50% – responded to our survey
- Of these, all but two were rated as ***Managing*** or ***Monitoring*** significant ESG issues
- Three company, **Great Portland Estates**, **Stockland**, and **Klépierre**, achieved perfect scores.

Our overall conclusion is that many companies are doing a lot more to manage ESG risks and capture opportunities than may be clear to the market, which is encouraging. On the one hand, much of the information in the survey responses was not published in company annual reports or securities filings. Where the information was available, either directly from the companies or from third-party sources, the link to business performance was often not articulated, making it difficult for investors to incorporate it into investment analysis. Companies that improve transparency on ESG strategy and management, such as those rated ***Excellent*** in our ESG performance assessment, can reassure investors that they are maximising operating efficiencies, preparing for regulatory change, and actively evaluating strategic opportunities that will contribute to long-term sustainable returns.

Relative performance on ES&G

Overall, in both the our ESG research and survey information, companies tended to score best on questions regarding environmental management systems and worst on those related to stakeholder relations and other social issues. Given the environmental opportunities outlined above, high environmental scores overall were encouraging but not surprising. We believe lower social scores may reflect variances in the legal and cultural norms underpinning companies' operating environment. For instance, some companies seemed to feel that publishing a health and safety policy or reporting on their processes for consulting with local communities was unnecessary as all developed markets have strict laws and planning requirements addressing these issues. However, numerous case studies demonstrate that legal requirements are not always known or complied with. Companies that embed legal standards and best practice in their operating policies, train employees on them, and monitor and report on compliance stand to generate better performance. Such systems may also serve as an early warning system to spot concerns and avoid legal penalties, industrial action, lawsuits and most of all, construction delays. From an investor perspective, improved transparency on such issues will also provide investors with valuable additional insight into key operational performance indicators, which are an important signal of management effectiveness.

In the final area of corporate governance, we identified poor governance as a stronger negative impact on valuations from poor governance than a positive one from good governance. We found some relatively simple opportunities for companies to improve governance and boost the share price, such as eliminating anti-takeover devices and strengthening shareholder rights through pre-emption. The higher-hanging fruit would consist of recruiting qualified board members that can contribute to corporate strategy and overall board effectiveness. The companies in our sample were listed in markets with strong and generally well-enforced corporate law and listing standards as reflected in the chart above. This ensured a basic level of good governance, making aberrations from the norm stand out as stronger indicators of risk. Indeed, a recent report by UBS investment research highlighted significant underperformance for European real estate companies with poor governance practices relative to better-governed peers, with leading companies showing a share price premium versus Net Asset Value.[9]

Spreads between leading and lagging companies also indicate that there is substantial differentiation across the sector and ample room for improvement. We hope this study will lead to improvements in ESG management across the board and a greater concentration of companies moving into the ***Excellent*** and ***Good*** performance categories in future.

F&C indicators of best practice for sustainable real estate

Based on our review and analysis of current ESG practices in the real estate sector, we identified the following as best practice indicators in identifying sustainable real estate companies:

Environment:

- Adopt an environmental management system for portfolio properties based on a recognised standard, such as BREEAM or LEED. Effective systems will address the full lifecycle impacts of a building including: 1) material selection, 2) building construction and ongoing capital improvement, 3) building use and maintenance, 4) demolition, and 5) indirect impacts such as those associated with transport to and from the property.
- Identify and measure key environmental impacts and set targets for improvement. At a minimum, we would expect this to include emissions from energy used during a property's operational life, given that this accounts for approximately 80% of total emissions from buildings. Good practice companies will also measure and reduce water use, and waste collected and recycled.
- Work with tenants to identify opportunities to reduce their environmental impacts in order to minimise operating costs and their environmental footprint.
- Evaluate and reduce environmental impacts in the supply and construction chain. This should include an evaluation of the environmental impacts of building materials, operational systems and other high-impact components of buildings, given that materials, construction and demolition account for roughly 20% of lifecycle emissions.
- Review and prepare for the probable impacts of climate change as they specifically apply to portfolio properties.

Social:

- Establish and disclose on site clear workplace policies covering the key labour standards issues, including health and safety, working hours and freedom of association. This policy should apply to companies' own employees as well as to contractors employed in property development and management. For companies using labour agents in the building of new properties, this policy should be incorporated into contracts and included in the selection of construction companies.
- Develop and implement community consultation and stakeholder feedback systems. These should be available to the community at large. These systems should also include an environmental or social impact assessment to identify major community impacts prior to commencing new building or major renovation projects.
- Publish a code of ethics and supporting hotline. The code should clearly communicate the company's standards to employees, contractors and the public. A reporting system should also be available through which ethical concerns or violations can be reported.

Governance:

- As part of its review of business strategy and performance, the board, or a relevant board committee, should identify which ESG issues have the most significant impact on the company and ensure that the business strategy reflects these.
- In its review of internal controls and risk management systems, the audit or risk committee of the board should satisfy itself that all major ESG risks are being managed appropriately and that steps are taken to mitigate any new risks.
- The remuneration committee should set and disclose clear performance targets linked to executive incentive plans. Sustainability targets should also be set and disclosed, and incorporated into executive remuneration plans.

[9] UBS Investment Research, European Real Estate, Real Estate Corporate Governance Report, 1 September 2009.

Digging deeper: Companies responses to ES&G impacts

Environmental management takes top marks

Overall, most companies stated a clear commitment to managing their environmental impacts, with a focus on environmental design and energy efficiency. Key environmental findings were as follows:

- 76% of companies in our sample published an environment policy and details of an environmental management system.
- In reviewing survey responses, all but one company had established an environmental standard for evaluating the environmental footprint of their properties.
- Over 60% of survey respondents also published environmental performance data demonstrating that policies were embedded and environmental management systems were delivering results.

Designing for the environment and a low-carbon future

While these overall findings were in line with expectations, digging into the detail revealed varying levels of responsiveness to specific environmental issues. For instance, environmental certification standards for properties typically reflected national green building standards, although there was an overarching shift towards the UK's BREEAM[10] standard, as it was considered to enjoy international recognition and greater relevance for multinational property companies. As noted above, investors increasingly cite environmental certifications as their key indicator in evaluating property companies' strategic positioning to capture growing demand for 'green' buildings.

Given that four-fifths of the lifecycle impacts of a building occur during its use, rather than during construction or demolition, the greatest focus should be on building performance. Energy efficiency emerged as the issue resonating most clearly with property developers and managers. This is unsurprising given the regulatory trend across Europe and North America towards minimum energy efficiency standards, and an increasing tendency to include energy efficiency in the property procurement process, especially for government-occupied properties. The focus on energy efficiency was also predictable given it is usually the primary contributor to any property company's carbon footprint. Government targets to reduce their national greenhouse gas emissions as part of their climate change strategy means property companies will be expected to contribute to this goal. Of the companies in our sample set, just over half had participated in the carbon disclosure project (CDP)[11], indicating a basic commitment to evaluating how climate change will impact their business. 14 companies in the sample disclosed their group greenhouse gas emissions, but of these, only 10 set clear targets to reduce emissions or measurably improve energy efficiency.

Climate-proofing for better resilience

On the other side of the climate change equation are the physical impacts of climate change on property companies themselves. As greenhouse gas levels and average temperatures rise, climate change is already triggering more severe localised weather events that have an immediate impact on the built environment. While the physical impacts of climate change will vary by region, properties that are designed with enhanced resiliency features will be able to withstand those impacts, bringing direct benefit to occupiers, owners and investors alike. We therefore asked companies to tell us more about how the physical impacts of climate change would impact their property portfolios. Key findings were as follows:

- Nearly two-thirds of survey respondents had evaluated the physical impacts climate change would have on their portfolios.
- Of those that had evaluated the impacts, only two had put in place a strategy to respond.
- Of the remaining companies, four simply had not evaluated the impacts climate change might bring to their properties and a further three stated they did not believe climate change would have significant impacts on their properties.

Reducing water use

Water management also emerged as an environmental issue rising up the priority list. Water shortages are already surfacing as a primary manifestation of global warming in some key markets such as Australia and China, and are expected to affect other markets in due course as weather patterns become more erratic and aquifers are depleted. Therefore, companies taking action now to reduce water use will likely see the benefits as water becomes more costly. Our research revealed clear evidence of growing attention to water consumption, as, after energy, water came in as the second environmental issue most in focus for global property companies. Many reported programmes to reduce water use, and/or capture or reclaim water for re-use in other functions.

[10] BREEAM stands for the Building Research Establishment's Environmental Assessment Method. The standard was developed in 1990 in the UK to measure the environmental performance of buildings including homes, offices, retail space, industrial sites, and civic buildings such as hospitals and courts. Buildings are certified as achieving a BREEAM standard of Outstanding through to Pass based on a series of environmental indicators. For more information see www.breeam.org

[11] For more information on the Carbon Disclosure Project go to www.cdproject.net.

Leading the pack in climate adaptation

Klépierre in France and **Stockland** in Australia were the only companies that clearly outlined how the impacts of climate change presented significant threats to their strategy and operating performance. Commercial property developer **Klépierre** has introduced a plan for the prevention of natural and technological risks, and, in particular, a flood prevention plan. A prevention assessment is conducted for every project at the pre-design stage, where, for instance, drainage systems are designed to cope with more intense and localised rain or snowfall that is likely to result from global warming. Meanwhile, **Stockland** identified rising temperatures as putting extreme stress on the built environment, leading to increased operating costs due to greater reliance on cooling systems and contributing to a risk of energy shortages or power outages. As one company that has already experienced the direct increases in operating costs of global warming, we hope others will head this warning and take steps to adapt before they are forced to shoulder higher costs as well.

Environmental impacts throughout the value stream

The environmental impacts of suppliers also surfaced as an area of potential environmental savings. Indeed, if property owners are to reduce their environmental footprint and improve energy efficiency, they will need to begin with the materials used in construction. Building materials contribute significantly to the overall energy intensity of the sector, with the cement and steel sectors being among the highest carbon emitters in the world, and approximately 15% of a building's full life carbon emissions arising during the building phase. Building materials also provide enormous opportunity to reduce emission for instance through the use of better insulation, energy efficient glass and even cutting-edge technologies such as built-in solar photovoltaic (BIPV) which is beginning to allow companies to reap the rewards driven by mandated renewable energy targets as well. Our research revealed that while most companies had developed an environmental policy governing their own operations, fewer had articulated programmes to reduce their indirect impacts through their supply chains. Key finding were as follows:

- 68% of survey respondents had introduced initiatives to reduce the environmental impacts through their suppliers.

Leading companies also looked up the value chain to their tenants to identify further environmental savings, working with tenants to facilitate awareness raising and drive behavioural change among employees and occupiers. The traditional adversarial nature of landlord-tenant relations is changing and a spirit of dialogue and engagement is seen as progressive as both parties look to liaise and establish common aspirations and actions. Developing good relations with tenants should promote loyalty and commitment to each other and the building – securing the rental income that drives value.

Overall companies seem to have got the message that the future of global real estate is green. Across our global sample set, companies are taking pro-active steps to capture operating efficiencies through reduced resource use, with leading companies going further and encouraging reductions by suppliers and tenants. However, property companies need to incorporate environmental risk better into their property resiliency and adaptation plans if they are to weather the storms that climate change will surely bring.

But the social record is much less clear

While property companies seem to have a reasonable awareness of environmental matters, when it comes to managing social risks, their systems for managing impacts on stakeholders including direct and contracted employees, suppliers, and local communities, appear much less well developed. Strong stakeholder management systems will be critical to ensuring compliance with legal standards and to avoid delays in acquisition and development of new properties. Key findings were as follows:

- 55% of companies in our sample set disclosed a labour standards policy covering key issues such as health and safety and right to organise.
- Only 36% published a vendor code of conduct that addressed issues such as labour standards and human rights in the supply chain.

Labour-related risks in property development

A more detailed look at company responses to our survey shed some light on these relatively low statistics. Many companies reported that national employment laws applied to both their own employees and contract labourers, and therefore, company policies addressing such issues were unnecessary. However, anecdotal evidence suggests that legal standards are not always understood or enforced, particularly by labour agents and among contract employees hired. Even though major markets in Europe have strict employment laws, EU enlargement has led to inconsistencies in enforcement across the region and increased the risks of non-compliance. By clearly disclosing employment policies, workplace safety standards and mechanisms for reporting concerns, companies can reduce the risk of non-compliance with local labour laws, while still reaping the benefits of open borders. These will be most effective if they are on-site and published in the native language(s) of workers. Furthermore, by undertaking regular reviews or audits of performance against these standards, or including related performance targets in site managers' appraisals, companies should be able to improve overall workforce performance and avoid costs associated with lost-time injuries and other health and safety breaches.

Improving health and safety on site

Some Asian companies are taking pro-active steps to manage employee-related risks. For instance, Singaporean property developer **Capitaland** is establishing a group health and safety management system based on the international standard OHSAS. This standard will not only apply to Capitaland employees, but will also be applied to vendors and contractors working for the company at Capitaland properties. Such an approach should help the company reduce costs due to lost-time injuries or fatalities and avoid fines linked to non-compliance with labour laws.

Keeping communities on side

Another key social group impacted by the property sector are local communities, who can variously be a great asset or stumbling block to successful property investing. Support from local communities is critical in the commercial property sector, as they will provide employees, customers and possibly tenants. As mixed-use developments become more common, developers will need to balance the interests and demands of various stakeholder groups, including professional tenants, local businesses, residents and the wider public. Failure to secure the support of a wide range of stakeholders can create long and costly development delays by hindering the planning approval process. While most developed markets will have clear procedures for community consultation and public hearings, at times these legal standards may be insufficient to win the support of all local community groups.

When reviewing company practice in managing communities relations, we discovered the following:

- 52% of companies in our sample set published information on their community engagement and feedback programmes.
- When looking in more detail at survey responses, all but one company reported active programmes to review their impacts on local communities and solicit stakeholder feedback.

As in the case of labour policies above, the relatively low proportion of companies reporting on community consultation may reflect local planning requirements for public hearings before a planning application is approved. Nevertheless, companies with a strategic approach to community stakeholder management should be better positioned to avoid serious delays and to respond to objections as and when they do arise. Reporting publicly on these procedures will also give greater insight to investors on how community relations are managed.

Local communities: Future customers or costly nuisance?

Greek real estate developer **Babis Vovos** was halted from building its latest shopping mall in Athens in early 2009 following a dispute with the local community in which 130 residents challenged the project on environmental grounds, leading to the company's shares plunging nearly 30% in May. In contrast, French property developer **Unibail-Rodamco** has incorporated a stakeholder consultation period into its development cycle. Prior to, and during, any major development work, the company liaises with local associations and authorities and holds open public meetings that facilitate discussion and information-sharing.

Relationships with regulators and planners

Closely related to community consent, relations with local regulators are key to enabling companies to secure planning permission and turn landbanks into profit-generating properties. However, highly-regulated markets can also present perverse incentives towards bribery and other corrupt practices that drain company resources and can lead to very costly fines.

We evaluated companies' codes of conduct and business ethics management systems to ascertain what sorts of controls and safeguards were in place to deter unethical business practices or, at a minimum, spot aberrations early. Key findings were as follows:

- 58% of companies in our sample set disclosed a code of conduct covering basic issues including anti-bribery and corruption.

- When pressed on how such codes were implemented, monitored and audited, 13 companies responding to our survey - i.e. approximately a third of the overall sample - reported having a whistleblower system through which concerns could be raised, and/or an ethics training programme to drive good practice.

These results present some serious concerns, since the cost of failing to implement a rigorous business ethics management system is becoming increasingly onerous, as evidenced by the recent £129 million fine on 103 companies in the UK construction sector by the Office of Fair Trade for colluding in the pricing of government contracts. Interestingly, while one might expect better performance of companies bound by strict enforcement of anti-corruption law, such as those required by Sarbanes-Oxley or the US Foreign and Corrupt Practices Act, our research found that geography was not a clear differentiator of good practice.

Keeping an eye on business ethics

Japan's **Mitsubishi Estates** had in place robust business ethics systems. Its whistleblower hotline goes beyond any regulatory requirements and is made available to outside stakeholders, providing an early warning system for potential disputes with local communities or regulators.

With 80% of companies in the total sample showing some systems for managing social risks, the value of pro-actively managing such issues is becoming clear. Nonetheless, we do believe there is room for improvement. While it is difficult to quantify value at risk from weak social management systems, the benefits to having strong employee, community and regulatory relations are clearly to be found in averted costs of project delays or regulatory infringements.

Good governance is foundational for sustainable business practices

While sound environmental and social practices are essential to operational effectiveness, the drive for such operational excellence must come from the top, and be embedded in the company's basic principles of good governance. The board is responsible for driving business strategy, overseeing management's operational performance, and reviewing risk management and internal controls. Therefore, the board, and the governance framework in which it operates, must be robust, balanced, transparent and effective if companies are to manage risks and deliver sustainable returns. Access to capital is also critical to companies, both in the short-term to keep the company afloat during volatile markets, and in the long-term to facilitate acquisitions and grow the business. Companies that respect shareholders rights while raising equity capital, and respect the balance of interests between equity holders and creditors, are more likely to retain investors' loyalty over both the short and long term.

Our research revealed that the state of corporate governance among listed real estate companies varies markedly across the globe. We began by looking at the basic building blocks of good governance, including board balance and independence, remuneration and incentive plans, and shareholder rights. Key findings were as follows:

- Nearly 75% of corporate boards in our sample set has sufficient independence to reflect outside shareholders interests.
- Of our survey respondents, 65% disclosed specific performance targets as part of their remuneration policy. However, this reflects less than one-third of the overall sample set.
- Most companies had taken part in capital-raising exercises in the last year, but the extent to which shareholder rights were protected reflected legal norms based on the country of listing.

Building and incentivising quality boards

The high proportion of independent boards came as a positive sign, as independent directors should be in a position to represent the interests of outside shareholders and hold management accountable for performance. On the other hand, results on remuneration were less encouraging. Few companies in the sample clearly disclosed performance targets, which makes it difficult for investors to determine whether pay is aligned with performance or targets are sufficiently stretching. Many companies argued that in the current economic environment, setting performance targets was too difficult. However, before the recent recession, companies had also resisted disclosing performance targets, arguing that they were commercially sensitive. Setting and disclosing long-term targets informs investors and outside stakeholders of the company's strategy and enables them to hold directors accountable for performance. In the case of annual targets, at a minimum the remuneration committee should explain in its annual report how specific prior year performance indicators triggered annual bonus payments so that investors can review retrospectively how the remuneration policy has been applied in practice.

Aligning pay with performance and strategy

Australia's **Stockland** disclosed both quantitative and qualitative performance targets as part of its remuneration policy. Similarly, the UK's **British Land** and **Derwent London** disclosed specific performance targets underpinning their long-term equity incentive plans. Dutch property developer **Wereldhave** went even further and included the share of sustainable properties in its property portfolio as an objective within its long-term variable income plan. While these examples of strong disclosure in some measure may reflect regulatory requirements for companies to secure shareholder approval for the remuneration report, they nonetheless help inform investors and drive management performance. Little evidence was found that such pro-active disclosure proved to be commercially damaging.

Raising capital while respecting investor interests

Respecting the balance of rights and interests between shareholders and creditors is also a key pillar of good governance, and was seriously tested in 2009. While circumstances varied widely, we attempted to evaluate how capital-raising efforts protected the interests of existing investors, while allowing the company the additional capital and flexibility to restructure the balance sheet and bolster the business going forward. Here again, national securities law and local listing standards tended to be the driving factor in determining whether companies protected pre-emption rights when raising equity capital. Examples include:

- In the UK, companies routinely raised capital through rights issues, allowing existing shareholders the right to buy additional shares before they were offered to the broader public market.
- In Hong Kong and Singapore, companies routinely reserve the right to increase share capital by to 50%, 20% of which can be raised without pre-emption rights, thus diluting existing shareholders.
- In the US, companies routinely raise capital by up to 100% without any pre-emption rights.

These examples highlight different approaches to raising capital, but each will have left existing shareholders more or less protected, and therefore facing differing levels of pricing risk, which in turn will affect the issuers' long-term cost of capital. In the case of the US, shareholders who held on through the downturn would have been rightly angry if their holding was then diluted by 50% or the company issued equity only to avoid a takeover that would otherwise have been value-accretive. While we recognise the board's need to maintain financial flexibility during uncertain markets, it can and should take steps to reduce the negative impact on existing shareholders when raising equity capital.

Sustainability in the boardroom

While governance principles and practices are, in and of themselves, a useful indicator of board oversight, the most effective boards will also be active in overseeing governance of the company's sustainability strategy, including incorporating ESG into the business review and strategic objectives of the company.

In evaluating which companies had established clear oversight for their sustainability management and objectives, we found the following:

- Only 35% of companies in our sample outlined a clear sustainability oversight function.
- Of our 19 survey respondents, over 80% (16) stated that the board held responsibility for evaluating, and developing a strategic response to sustainability-related risks and opportunities.
- Over two thirds (13) of respondents reported that the Board had actually reviewed the company's environmental and social performance as part of its review of internal controls.
- Three companies also reported incorporating sustainability targets into executive incentive plans as part of their overall remuneration.

For sustainability-related risks and opportunities to be effectively managed, companies will need to install appropriate systems for reviewing performance against targets and identifying further areas for improvement. As with any other strategic objective, clear targets and objectives should be set in order to drive strong performance. In many cases, boards may want to consider including such targets in the annual bonus plan.

Overall, our research indicates that good governance systems are established at most listed real estate companies in our sample. However, there is still ample room for improvement, particularly in the area of remuneration and board oversight of ESG issue. Greater transparency and disclosure of performance targets, both in the overall remuneration plan and in driving sustainable performance, will help improve investors' understanding of the company's core business objectives and build their confidence in management's strategy.

Going forward

The third quarter of 2009 has already seen listed real estate companies begin to rebound, particularly in Asia where the property market is booming. Against this backdrop, F&C will continue to encourage listed property companies to develop a sustainable real estate strategy in order to set a course for more stable growth across the sector. Better corporate governance, teamed with a clear and well-embedded commitment to environmental and social management, should help companies in the sector to:

- Manage inherent volatility;
- Position themselves for a further relaxation of credit and mortgage availability, which will drive demand;
- Prepare for forthcoming regulatory and customer demands for high-efficiency, environmentally-friendly properties;
- Develop properties that contribute to local economic development goals; and
- Attract and retain greater loyalty from investors.

For our part, going forward, we will use this report and the underlying data to continue to:

- Evaluate ESG risks in our investment portfolios where we hold equity or debt of listed real estate companies;
- Encourage poorly-performing companies to improve their approach to ESG issues in the interest of long-term value to investors, through our ongoing engagement relationships;
- Evaluate corporate ESG practices when meeting with management of listed property companies;
- Align our proxy voting activities with these assessments, particularly when voting on board directors, remuneration and the annual report.

We will also work with other investors and interested stakeholders, as well as share our assessment of the sector with other companies not covered by this report, in order to continue to support the development of a sustainable global real estate sector.

Appendix A Results of ESG Risk Analysis of Listed Real Estate Securities

Note: We disclosed the names of the best performing companies on a relative basis in order to recognise their leading practice. Other scores were anonymised in the interest of long term engagement in order to encourage ESG improvements. All scores were delivered to companies directly.

Name	Country	Region	Environmental Policy	Participation in CDP	Disclosure of Group GHG Emissions from Properties	Targets to reduce emissions or improve efficiency score	Labour Standards Policy	Vendor Code of Conduct	Employee Code of Ethics	Policy or Statement on Community Engagement	Board Independence*	Vote Against at last AGM	Sustainability Report or Website	Clear sustainability Management Organisation	Responded to Survey	TOTAL SCORE**	ESG Performance Rating	Relative performance
Corio	NL	Europe	6	1	0	0	2	2	1	2	3	0	2	1	1	21	Excellent	Top quartile
Prologis	USA	Americas	6	1	1	2	2	1	1	2	3	-1	1	1	1	21	Excellent	Top quartile
Land Securities	UK	Europe	6	1	1	2	1	1	1	2	3	0	2	1	0	21	Excellent	Top quartile
British Land	UK	Europe	6	1	1	2	1	1	0	2	3	-1	2	1	1	20	Excellent	Top quartile
Stockland	AU	APAC	3	1	1	2	2	2	0	2	3	0	1	1	1	19	Good	Top quartile
Liberty International	UK	Europe	6	1	1	2	1	1	1	2	0	0	2	1	1	19	Good	Top quartile
Great Portland Estates	UK	Europe	6	1	1	2	0	1	2	1	3	0	1	0	1	19	Good	Top quartile
Unibail-Rodamco	FR	Europe	6	0	0	0	1	1	1	2	3	0	2	1	1	18	Good	Top quartile
Hammerson	UK	Europe	3	1	1	2	1	1	0	2	3	0	2	1	0	17	Good	Top quartile
Company 10		Europe	6	1	1	0	1	1	1	1	3	0	1	0	1	17	Good	2nd quartile
Company 11		Europe	6	1	0	2	2	2	0	0	3	-1	1	0	1	17	Good	2nd quartile
Company 12		APAC	6	1	1	2	1	0	2	1	0	-1	1	1	1	16	Good	2nd quartile
Company 13		Europe	6	1	0	0	1	1	0	2	3	-1	1	1	1	16	Good	2nd quartile
Company 14		Europe	3	0	0	0	2	1	1	1	3	0	1	1	1	14	Adequate	2nd quartile
Company 15		Americas	6	0	0	0	1	0	1	2	3	-1	1	0	1	14	Adequate	2nd quartile
Company 16		Europe	6	1	1	0	1	1	0	1	0	-1	2	0	1	13	Adequate	2nd quartile
Company 17		Americas	6	1	0	0	1	0	1	0	3	-1	1	0	1	13	Adequate	2nd quartile
Company 18		Europe	6	1	1	2	0	0	0	0	3	0	0	0	0	13	Adequate	2nd quartile
Company 19		Europe	3	1	0	0	1	0	1	1	3	-1	1	0	0	10	Adequate	3rd quartile
Company 20		APAC	3	1	1	0	1	0	1	1	0	-1	1	0	1	9	Inadequate	3rd quartile
Company 21		Europe	6	0	0	0	0	0	0	0	0	-1	1	1	1	8	Inadequate	3rd quartile
Company 22		APAC	6	1	0	0	0	0	0	0	0	0	1	0	0	8	Inadequate	3rd quartile
Company 23		Americas	3	0	0	0	0	0	2	0	3	0	0	0	0	8	Inadequate	3rd quartile
Company 24		Europe	3	0	0	0	0	0	0	1	3	0	0	0	1	8	Inadequate	3rd quartile
Company 25		Europe	6	0	0	0	0	0	0	0	3	-1	0	0	0	8	Inadequate	3rd quartile
Company 26		Europe	0	1	1	2	0	0	0	0	3	0	0	0	0.5	7.5	Inadequate	3rd quartile
Company 27		Europe	3	0	0	0	1	0	0	2	0	-1	1	1	0	7	Inadequate	3rd quartile
Company 28		Americas	0	1	1	0	0	0	2	0	3	0	0	0	0	7	Inadequate	3rd quartile
Company 29		Europe	3	0	0	0	1	0	1	1	0	0	0	0	0	6	Inadequate	4th quartile
Company 30		Americas	3	0	0	0	0	0	1	0	3	-1	0	0	0	6	Inadequate	4th quartile
Company 31		Americas	0	0	0	0	1	0	2	0	3	-1	0	0	0	5	Inadequate	4th quartile
Company 32		APAC	3	1	0	0	0	0	0	0	0	-1	1	0	1	5	Inadequate	4th quartile
Company 33		APAC	0	0	0	0	0	0	1	0	3	0	0	0	0	4	Inadequate	4th quartile
Company 34		Europe	0	0	0	0	0	0	0	0	3	0	0	0	1	4	Inadequate	4th quartile
Company 35		Europe	0	0	0	0	0	0	1	0	3	0	0	0	0	4	Inadequate	4th quartile
Company 36		Americas	0	0	0	0	0	0	2	0	3	-1	0	0	0	4	Inadequate	4th quartile
Company 37		Americas	0	0	0	0	0	0	0	0	3	-1	0	0	0	2	Inadequate	4th quartile
Company 38		Americas	0	0	0	0	0	0	1	0	0	-1	0	0	0	0	Inadequate	4th quartile

* Companies with a widely dispersed shareholder base were expected to have a majority independent board. Companies with a controlling shareholder were expected to have boards composed of at least one-third independent directors, since in many cases, controlling shareholders also retain board seats.

** Companies were scored against a total possible score of 25. Most indicators were weighted equally. However, Enivornmental Policy and Board Independence were given a triple weighting while Targets to Reduce Emissions and the publication of a Labour Standards Policy were given a double weighting. Total possible scores for each indicator reflect both absolute disclosure and the quality of information disclosed.

Appendix B Results of Responses to Sustainable Real Estate Securities Survey

Note: We disclosed the names of all companies either managing or monitoring ESG issues in order to recognise their good practice. Other scores were anonymised in the interest of long term engagement in order to encourage ESG improvements. All scores were delivered to companies directly.

Company	Country	E1 - Environmental standard & targets	E2 - Environmental impacts measured and disclosed	E3 - Physical impacts of climate change	E4 - Programme to reduce indirect impacts via suppliers and tenants	S1 - Labour standards policy for own and contract staff	S2 - Review impacts on local communities and solicit stakeholder feedback	S3 - Code of ethics and whistleblowing	G1 - Board responsibility and Overight	G2 - Internal controls for sustainability	G3 - Incentive targets disclosed and linked to sustainability targets	Total Possible Score*	Absolute performance
Great Portland Estates	UK	6	2	2	2	2	2	2	2	2	2	24	Managing
Stockland	AU	6	2	4	2	1	2	2	2	2	1	24	Managing
Klépierre	FR	6	2	4	2	2	2	2	2	2	0	24	Managing
Derwent London plc	UK	6	2	2	2	1	2	2	2	2	1	22	Managing
Capitaland	SG	6	2	2	2	1	1	2	2	2	2	22	Managing
Westfield	AU	6	2	2	0	2	2	2	4	2	0	22	Managing
Liberty International	UK	6	2	2	2	2	2	2	2	0	1	21	Managing
Prologis	US	6	1	2	2	1	2	2	2	2	1	21	Managing
British Land	UK	6	2	2	2	0	2	1	2	2	1	20	Managing
Shaftsbury	UK	3	2	0	2	2	2	2	2	2	1	18	Monitoring
Unibail-Rodamco	FR	6	2	1	2	2	2	1	2	0	0	18	Monitoring
Wereldhave NV	NL	6	1	0	1	1	2	2	2	0	2	17	Monitoring
Mitsubishi Estate	JP	6	2	0	2	1	1	2	0	2	1	17	Monitoring
Corio	NL	3	2	2	2	1	1	2	2	2	0	17	Monitoring
Gecina	FR	6	0	2	2	1	2	0	2	2	0	17	Monitoring
Regency Centers	US	6	0	0	1	1	1	2	2	2	1	16	Monitoring
Icade	FR	6	1	0	0	0	0	1	2	0	1	11	Monitoring
Company 18		3	1	0	0	0	1	0	0	0	0	5	Aware
Company 19		0	1	0	1	0	1	1	0	0	0	4	Unprepared

* Companies were scored against a total possible score of 24. Most indicators were weighted equally. However, Environmental Standard and Targets was given a triple weighting while Board Responsibility and Internal Controls were given a double weighting.

Appendix C Sustainable Real Estate Securities Survey

Environment

E1. Has the company adopted an environmental management standard for its properties (eg. LEAD, BREEAM, etc.) or set a target for environmental certification? If so, please explain.

E2. Does the company regularly measure key environmental impacts of its properties (including energy use, water user, waste produced and recycled)? If so, is this information publicly disclosed? (include a link or reference point if relevant)

E3. Has the company evaluated how the impacts of climate change – such as rising sea levels and more frequent and severe storms – might impact property portfolios? If so, please explain.

E4. Has the company introduced any policies or programmes to reduce the environmental impacts of its suppliers or tenants?

Social

S1. Has the company established, and clearly disclosed, minimum labour standards[1] that apply to all employees, including staff employed by labour agents or contractors? If so, please explain. (include a link or reference point if relevant)

S2. When purchasing, developing or renovating properties, does the company systematically review its impact on local communities and solicit stakeholder feedback? This might include undertaking environmental and social impact assessments. If so, please explain.

S3. Has the company established a code of ethics[2] and supporting systems that would discourage employees from ethical misconduct? This might include employee ethics training and a whistleblower hotline though which concerns can be raised. If so, please explain.

Governance

G1. Has the company assigned Board responsibility for evaluating sustainability-related risks such as those outlined above and setting strategies to respond? If so, please explain.

____

____

____

____

____

____

G2. Has the Audit Committee, as part of its remit to review internal controls, or any other board committee evaluated the company's environmental and social performance based on the systems above? If so, please explain.

____

____

____

____

____

____

G3. Has the Remuneration Committee set and disclosed specific targets linked to executive incentive plans (both short and long-term plans)? Do any of these plans include sustainability targets? If so, please explain.

____

____

____

____

____

____

Please feel free to include any additional information we should consider when evaluating your company's ESG performance.

[1] F&C expects companies to meet minimum labour standards based on the International Labour Organisation's (ILO) core conventions which cover: Forced labour, child labour, non-discrimination, health and safety, freedom of association, right to organise and right to collective bargaining. For more information, go to http://www.ilo.org/global/What_we_do/InternationalLabourStandards/Subjects/lang--en/index.htm

[2] At a minimum, a code of ethics will cover anti-bribery and corruption, conflicts of interest and anti-competitive practices. Supporting systems may include ethical hotlines or whistleblower systems, employee training, and regular compliance reviews.

Winning gold with F&C

Delivering highly effective investment strategies is just one part of the service we provide. As principled asset managers, we are determined to lead our industry in all aspects of our business.

In 2009 F&C were voted winners of the 'Gold Standard' in the Fund Management category for the fourth year in succession. Only a few companies have been privileged enough to win a Gold Standard award, and as such, this is an exceptional achievement. The Gold Standard Awards aim to identify financial services companies that excel not just in service but in five key areas important to consumers of financial products and services:

Financial strength
Ability to meet and exceed customer expectations

Capability
Outstanding expertise and aptitude as a fund manager

Service
Ability to maintain and grow an effective post-sales relationship

Fair value
Assessing whether customers receive great value for money

Trust
Ability to instil confidence in consumers

As a result, the Gold Standards are one of the hardest, most sought after awards in the financial market place.

GOLD STANDARD AWARDS WINNER

140 YEARS · TRUSTED FOR CENTURIES · 1868 – 2008

Products

F&C offers a wide range of investment opportunities for pension funds, charities, financial institutions, corporations and other organisations. We offer segregated and pooled portfolio management through a range of onshore and offshore vehicles. These cover developed and emerging markets in equity, bond, cash and property funds.

Please contact us for further details
or visit our website at **www.fandc.com**

For further information on this report please contact:

Karina Litvack
Director, Head of Governance
& Sustainable Investment
karina.litvack@fandc.com
Tel: **+44 (0) 20 7628 8000**

Alexis Krajeski
Associate Director, Governance
& Sustainable Investment
alexis.krajeski@fandc.com
Tel: **+44 (0) 20 7628 8000**

Contact us

Offices

France
Tel: **+33 (0) 1 78 42 40 92**

Germany
Tel: **+49 (0) 69 308 55 098**

Hong Kong
Tel: **+(852) 3965 3160**

Ireland
Tel: **+353 (0) 1 436 4000**

Netherlands
Tel: **+31 (0) 20 582 3000**

Portugal
Tel: **+351 (0) 21 003 3200**

Spain
Tel: **+44 (0) 20 7011 5398**

Sweden
Tel: **+46 (0) 850 901276**

Switzerland
Tel: **+41 (0) 22 747 7714**

United Kingdom
Tel: **+44 (0) 20 7628 8000**

United States
Tel: **+1 (0) 617 426 9050**

Head Office

Institutional Business
Tel: **+44 (0) 20 7011 4444**
Email: **institutional.enquiries@fandc.com**

Global Distribution
Tel: **+44 20 7011 5111**
Email: **mail@fandc.com**

Broker Support
Tel: **0845 799 2299**
Email: **adviser.enquiries@fandc.com**

F&C Investments

Expect excellence