



VAN LANSCHOT
KEMPEN

INVESTMENT MANAGEMENT

Investing with a Social purpose

Real Estate Social
Framework

FOR PROFESSIONAL INVESTORS ONLY

What does S in ESG really mean?

An important, but overlooked task

At Van Lanschot Kempen Investment Management we aim to create and preserve wealth for our clients and society. It is our strong belief that ESG is an essential part of the ever-evolving set of tools in selecting the most resilient and strongest risk adjusted investments in the long-term. ESG is made up of three distinct concepts, and although they all depend on each other, they do have differences. There has been a general lack of clarity, structure and direction on evaluating the Social policies of companies as a factor of future return generation and engagement within the investment management industry.

When we mention and analyse “ESG” within an investment environment, we believe strongly that it is wrong to ignore the “S”, the Social component as it has long term financial materiality. In this short paper we explore this important and often overlooked task in detail. S is an integral part of the “ESG” acronym. Within the three components of ESG, it is fair to say that, whilst environmental and governance aspects are progressively well covered, the S-social still largely remains in the background, from a global standpoint. The inclusion of the S component is very important due to its financial materiality, but is also very challenging, as it attempts to incorporate market practices into what traditionally has been considered a more political area.

What we mean by Social

It is important to take a step back and shed some clarity on what Social really is. Social can be defined as the company’s strengths and weaknesses in dealing with social trends, labor and politics. It looks at the way a company interacts with its workforce, suppliers, consumers and the communities it operates in.

Within the universe of our investment companies, we see many examples of companies highlighting very few and specific Social initiatives and believing that their work is done or that this check-box is ticked. The lack of a streamlined approach to analyse Social factors can in many ways remove the urgency on taking action and for change to occur. Important factors for a resilient investment can be missed out in the cloud of ambiguity.

What we do not mean by Social

As we have spoken about what Social is, it is also important to define what it is not. It is not linked to a political system like “socialism” and it does not simply link to social housing (although it can). It really is a lot broader than that as we will showcase throughout this paper.

Why is the Social factor material in investing?

Social as an investment valuation factor

From an investment theory standpoint, we treat the Social factor as one of several performance factor variables that we can analyse and eventually exploit for mispricing in an active management environment. If we use the Real Estate investment process as an example, there are four high level factors to generate risk adjusted outperformance or “alpha”. A proprietary data model to feed fundamental bottom-up real estate models is utilised to gain an edge on location and building quality. This we refer to as the valuation of the investment and is the first return investment factor. Additionally, the team analyses each company’s management team acumen, the balance sheet and the ESG performance of a company which are the three remaining investment risk factors. These latter factors are referred to as the risk of the investment. It is in this latter context that the Social factor enters the Real Estate team’s investment process quantitatively.

All else equal, we are willing to pay a higher price for a company with stronger Social policies than one with weaker ones. This goes for all the other factors that we listed which constitute the risk of the investment. In short, lower risk warrants a higher price. Further colour on our investment process can be found on the website of Van Lanschot Kempen.

Social factors as an engagement tool for change

Next to ESG integration into valuation, continuous engagement for change is just as important in active investment. The social framework allows us to have precise tools to implement positive change. Having designed a quantitative score which builds up from many moving numerical parts, we can zoom-in on the precise points of attention of social practices that we would need to see changed. We can also showcase precisely how the valuation of the investment would change based on our valuation models, and ultimately the size of the potential increase in investment value that we would potentially make should the companies make the changes.

Figure 1: VLK Real Assets Factors of company mis-pricings



Source: Van Lanschot Kempen Investment Management, September, 2023

Our Social framework

Van Lanschot Kempen's Social Investment Framework

We have developed a forward looking Social investment framework to help us streamline each potential investment's willingness, ability and commitment to Social resilience. We are currently able to fully score the companies we cover in the real estate space and compare them against each other, but also to compare them to an overarching standard in certain cases. Whilst investment processes differ per strategy, the high level thought process of this framework can be used by other investment teams at Van Lanschot Kempen.

Before we dive into the precise categories of social improvement we need to establish who and what this framework affects. Ultimately the Social aspect is all about people. In line with the forthcoming European Sustainability Reporting Standards, we have tailored our framework to have as wide of an impact as possible. Mainly, the focus categories cover a company's own workforce, the workers in the value chain, the affected communities (of paramount importance in real estate) and the end consumers (or tenants). These we define as the Social Value Chain.

Figure 2: The Social value chain – internal and external¹



Source: Van Lanschot Kempen Investment Management, September, 2023

The Social framework focus categories

After a review of academic literature, data vendors and interviews with our investee companies, we have come up with numerous social areas that we believe require evaluation to measure ultimate progress of a companies' resilience. We settled on the following three overarching focus categories. These are: Security, Inclusion and Resilience. With minor exceptions, these categories can be applied to the full social value chain of own workforce, affected communities etc.

Figure 3: VLK Social Framework categories

Security	Inclusion	Resilience
<ul style="list-style-type: none"> Do no significant harm Physical, financial, mental and technological Cyber security 	<ul style="list-style-type: none"> Addressing inequalities Diversity and inclusion Inclusion and activities with local communities 	<ul style="list-style-type: none"> Well-being Human capital development Affordability and location Pollution and waste

Source: Van Lanschot Kempen Investment Management, September, 2023

Security

Security as an area of focus is a very broad category. It encompasses everything from the physical security of a building or asset and the community it operates in, to the cyber security policies of a company and even the financial security policies offered towards tenants. The better a company does across the value chain to contribute to security, the more likely it will contribute to the resilience of the communities it operates in and equally as importantly, its own competitive place in it, for the long-run.

In this section we evaluate a company's basic compliance with doing no significant harm across the social value chain. Some of the categories we measure are: the social policies and controversies, social risk assessment, United Nations Global Compact status, human rights, labor rights, value chain policies, impact on local communities, occupational health & safety, grievance mechanisms and whistleblower policies, cyber security, physical security and financial support. It is in this category where we would entertain the rare occasion of exclusion whereby an investment has a major red flag (as per MSCi ESG) and has done significant harm.

With respect to yellow flags, this focus area acts as an anchor that can hold back the overall social investment score. This is designed such that a company doesn't end up scoring highly just because it has done many other good social initiatives, but simultaneously has had a major unresolved social controversy.

Should the "do-no-significant-harm" test be passed we move on to the "do-better" categories where companies can really shine and outdo each other. Doing no significant harm is a bare minimum which, if breached, can negate some other positive Social initiatives. For example, if a company has a severe controversy with respect to human rights abuses or insufficient tenant health practices, then it's impossible that this company can still score higher on our Social framework if, for example, it has above average inclusion policies or cyber security initiatives. The ultimate result of course being more capital towards socially resilient initiatives which improve the competitive position of that company within its operating environment, but also improve communities and society at large.

Inclusion

Inclusion and diversity is extremely important in building a future proof business. This category is often as broad or narrow as the societies a company operates in and the clients it serves. We focus on the inclusion and diversity across the whole organization and not only at board level. Although it is difficult to hold a company to a global "best-practice" standard, there are certain bare minimums that should be satisfied for an inclusive and diverse company, in our view. The academic evidence is plentiful and quite precise on the performance enhancing element of a more inclusive company.²

In addition to the bare minimums, ideally a company should be fully supportive and have the policies in place for openness towards inclusivity, as precise targets and prescribed numbers can often be perceived as quick fixes and don't necessarily target the issue head on. Therefore, we place a lot of emphasis on the policies and some emphasis on the final outcome. Inclusion, however, is a broader topic than inclusion and diversity and it extends towards addressing social inequalities in the communities. We evaluate how well a company and its assets contribute towards inclusion activities in their respective local communities.

Resilience

Admittedly, this third category is broad and abstract sounding. However, this is because numerous important themes sit within it. Resilience we define as the wellbeing of the workforce, the human capital development, the affordability and location resilience (e.g. green space, access to healthcare) and the pollution and waste management policies. The American College of Occupational and Environmental medicine found links in long-term relative outperformance of companies with better health and safety programs than peers with less focus on this area.³ These categories, as ever, are measured across the full social value chain. Where possible we evaluate the results of companies with respect to wellbeing of their human capital. In areas where tangible success is difficult to quantitatively capture (such as air pollution) we generally look towards policies in place and measurement initiatives to reward companies that have programs in addressing the more vague and not always easily calculated measures of success.

¹ European Sustainability Reporting Standards "ESRS"

² McKinsey Research, Diversity Matters, February, 2015. ³ 2013 American College of Occupational and Environmental Medicine, The Link Between Workforce Health and Safety and the Health of the Bottom Line.

Real Estate Investment Case: Inclusion – Communities.

Atrium Ljungberg, a Swedish mixed use real estate landlord with a collection of offices, necessity based retail, and residential properties, has developed its own proprietary City Index. It goes over categories of security, tenant well-being and accessibility, closeness, togetherness and sustainability, ecosystem services and climate adaptation, identity, history and diversity as well as dialogue and participation. Within this framework, Atrium Ljungberg uses a collection of surveys, interviews, financial data and other public data to make sure it improves its score on its own index thus aiming to create resilient locations for the long-term.³ Within this framework, Atrium Ljungberg scores very well on VLK's social framework and particularly in the occupiers' well-being and community involvement categories.

Figure 4: Atrium Ljungberg's proprietary City Index

Security, well-being and accessibility	Closeness, togetherness and flexibility	Ecosystem services and climate adaptation	Identity, history and diversity	Dialogue and participation
<ul style="list-style-type: none"> • Active ground floors • No crime • Balance daytime/night-time population • 24/7 city • Sense of security 	<ul style="list-style-type: none"> • Vaired district • Recreational location • Public space for activation • Sustainable travel behaviour • Easy to find your way around 	<ul style="list-style-type: none"> • Green areas/parks/walkways • Green space factor • Climate adaptation • Good microclimate 	<ul style="list-style-type: none"> • Location identity • Location identity activation • Visitors • Location for everyone 	<ul style="list-style-type: none"> • Dialogue and target groups • Feedback • Cooperation with tenants

Source: Atrium Ljungberg Interim Report January-September 2021

Real Estate Investment Case – Social engagement for impact

Lower rent vs. affordable housing example (Security – Financial)

At the onset of the Covid pandemic, residential landlords had the challenge of managing tenant satisfaction, public image and profitability. Certain companies took the hard approach and sent rental increases to tenants as per contract or because the market allowed it. Admittedly this was an unprecedented situation, but the concept of tenant hardship remained the same. Certain tenants running into difficulties requires a firm-wide approach. As an example, Killam Apartment REIT (an Eastern Canada focused multifamily residential REIT) waived the collection of rental increases on lease renewals beginning with the April 2020 rental payment.⁴ This was a self-imposed regulation to manage turnover, tenant satisfaction, public image as well as predictability of income at the expense of some short term growth. Not all landlords did the same, many stuck by the contract no matter what.

The effect could be that a harder and more inflexible approach of landlord behavior was used as a blueprint for politicians to push through stricter rent restriction legislatures in some Canadian provinces (such as Ontario and British Columbia). Whilst this is a delicate balance to handle, having a proper framework in place to deal with tenant hardships and being ready in advance would, in our view, ultimately make the company more resilient in the long-term. The landlord can save on tenant turnover expenses in the short run (whilst foregoing marking to market higher rent – a clear short term negative in a strong market) but more importantly it can gain better image with the relevant local municipality/council and thus be more likely to gain favorable zoning approvals for future development projects, or it can minimize the likelihood of prohibitive rental restrictions.

Under the investment framework of Van Lanschot Kempfen, Killam Apartment REIT would receive a higher score in the "Security – financial" category for having had this program in place to deal with issues like this before they arise. In practice, this means that the company would receive a higher "S" score than some peers. This would contribute to a better risk score and ultimately, all else equal, would receive a higher valuation due to its more resilient social policies for the long-term.

³ Atrium Ljungberg Interim Report January-September 2021. ⁴ Killam Apartment REIT 2020 Annual Report, MD&A, P25

Conclusion

The active investment management industry has a large say in the development of society. Investors can and should hold corporates accountable not only in the short term, but even more so over the long run. Whilst the rewards may not be immediate, ultimately we strongly believe that the benefit for the shareholders and the communities will be exhibited in the future.

By focusing on security, inclusion and resilience across the workforce, supply chain, customers and communities, we believe we have outlined tangible initiatives that companies can do to improve their own resilience and longevity as well as those of the societies within which they operate. Framing this list in an organised and quantitative way has enabled us to develop a constructive and forward looking social framework.

The outputs have been very tangible and have begun to be integrated into our investment process as we continue to innovate and refine our investment process with more and better quality data. The responsibility as stewards of our clients' capital has made it essential for us to dig as deep as possible in creating sustainable financial returns whilst simultaneously aiding society at large.

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