PUBLICATION

ESG Policies for REITs: Understand the Metrics and Improve Your Rating

Authors: Stephen Nathaniel Gordon
March 25, 2019

Investors are becoming increasingly mindful of the Environmental, Social, and Governance (ESG) policies of public and private companies. ESG is the term used by investors in evaluating whether a company meets certain standards for environmental, social, ethical, and corporate governance practices. ESG practices may include the company's efforts and impact on climate change or carbon emissions, water use or conservation efforts, anti-corruption policies, board member diversity, human rights efforts, and community development.

There has been an increased focus in the REIT industry on establishing and implementing ESG policies for REITs. Nareit, the most prominent REIT industry association, encourages the development and adoption of ESG best practices by REITs and began hosting an ESG Forum in 2018. Nareit's 2019 ESG Forum had record attendance, with 69 of the 130 represented companies being first-time attendees. As the number of socially conscious investors continues to grow, REITs that emphasize the positive role they are playing in society and on the environment can gain an advantage over their competition through higher ESG ratings, which can result in investment appeal to various institutional investors that require companies in which they invest to have comprehensive ESG policies.

The metrics and methods for evaluating ESG practices for REITs are continuously evolving. Glass Lewis and Institutional Shareholder Services (ISS) are two prominent proxy advisory services that recently began rating companies based on their ESG policies. In 2017, an ESG evaluation by Glass Lewis began featuring ESG data and ratings from Sustainalytics. Sustainalytics is a data aggregator and leading provider of ESG research, data, and analytics that provides ESG and corporate governance research and rankings. Relying on data from public company filings and media reports, Sustainalytics measures a company's exposure to and management of material ESG risks, specifically considering three dimensions: preparedness, disclosures, and performance.

In addition, in the fall of 2018, Glass Lewis announced it will begin integrating guidance on material ESG metrics from the Sustainability Accounting Standards Board (SASB) into its Proxy Paper research reports and its vote management application, Viewpoint. SASB's information was incorporated into Glass Lewis's products in advance of the 2019 proxy season. As part of its research, Glass Lewis will perform a holistic review of a company's governance documents to identify which directors or board committees have been charged with oversight of environmental and social issues. Its evaluation will make note of instances where such responsibility and oversight has not been clearly defined in the governance documents. Glass Lewis may recommend voting against directors responsible for oversight of environmental and social issues where companies have not properly managed or mitigated environmental or social risks to the actual or threatened detriment of shareholder value. Similarly, if companies lack explicit board oversight of environmental and social issues, Glass Lewis may recommend voting against members of the audit committee.

Reports generated by ISS also include an ESG component. Introduced in 2018, ISS's Environmental and Social Quality Score (the "E&S Quality Score") is a data driven approach to measure the quality of corporate disclosures on environmental and social issues and identify key disclosure omissions. To determine the E&S Quality Score of a REIT, ISS compares the depth and extent of its ESG-related disclosures to the disclosures which are expected in the REIT industry based on the specific environmental and social risks identified in industry and multi-stakeholder initiatives. These disclosure practices are reflected in standards such as the Global Reporting Initiative (GRI), the SASB standards, and the Task Force on Climate-related Financial Disclosures (TCFD).

The E&S Quality Score indicates whether a company understands its environmental and social risks, and whether it is prepared to face and mitigate them. ISS collects data from company publications including mainstream filings, Sustainability and Corporate Social Responsibility reports, Integrated Reports, publicly available company policies and information on company websites. As part of its report, ISS will also confirm whether a company has participated in or endorsed an authoritative multi-stakeholder initiative on environmental and social issues by collecting data from websites or member lists made available by the relevant initiatives. In addition, ISS includes in its analysis whether a company has been subject to significant controversies, fines, penalties, or litigation associated with environmental or social practices.

Improving Your ESG Rating Through Third-Party Assessment

One way to improve your ESG rating (and avoid a poor ESG rating) is to engage a third party to perform an assessment of your ESG practices and how they are reported to the public. There are a number of reporting frameworks that can provide guidance for companies looking to improve metrics related to ESG reporting, including: (1) voluntary disclosure frameworks like the Carbon Disclosure Project (CDP), the Global Real Estate Sustainability Benchmark (GRESB) and the Dow Jones Sustainability Indices (DJSI); and (2) guidance frameworks like SASB, the Global Reporting Initiative (GRI), and the Task Force on Climate-related Financial Disclosures (TCFD).

These third parties also supply data to shareholder advisory firms like Glass Lewis and ISS. By working with these third-party reporting frameworks, companies can ensure that the data necessary for a high ESG rating is publicly available and will be taken into account by shareholder advisory firms like Glass Lewis and ISS.

Tips for Improving Your ESG Rating

Each of the ESG frameworks discussed above rely on a variety of metrics and methods when evaluating a company's ESG practices. While there are a variety of specific methods and metrics used when evaluating a company's ESG practices, certain key performance indicators show up consistently across most of these frameworks. Focusing on these areas in media reports and disclosures in public documents can result in higher ESG ratings. These areas include:

Environmental Key Performance Indicators

- Climate Change Opportunities and Risk
- Greenhouse Gas Emissions
- Energy
- Environmental Policy
- Environmental Management Systems

Social Key Performance Indicators

- Supply Chain
- Stakeholder Engagement
- Workforce Development/Human Capital
- Health and Safety
- Diversity and Equal Opportunity

Governance Key Performance Indicators

- Compensation Policy
- Governance Policy
- ESG Reporting Standards
- Board Level Oversight
- Governance Risk Assessment

In addition, rather than engaging a third party to assess your company's ESG practices and public disclosures, there are a few actions companies can take to generally improve ESG ratings:

1. Review committee charters, ethics policies, and other governance documents and implement policies that specifically address ESG issues and practices. For example, include specific responsibilities for ESG issues in your committee charters.

2. Include a tab on your company's website devoted to highlighting your ESG practices. This tab may include videos, charts, and blog posts highlighting your ESG related activities.

3. Invest in the production of an annual Sustainability and Corporate Social Responsibility Report to memorialize the company's efforts and progress related to ESG initiatives.

4. Issue press releases highlighting your ESG activities and attendance and endorsement of ESG related events.

Recent growth in third-party aggregation of data by ESG reporting frameworks that score and benchmark ESG-related matters means that all public companies, including REITs, are judged and ranked with respect to ESG matters (regardless of whether or not they want to be). Companies that fail to properly address ESG issues could be subject to poor ratings from firms like Glass Lewis and ISS, which could eventually result in adverse recommendations from the proxy advisory services.

If you have any questions about the ISS or Glass Lewis ESG policies or ESG reporting and disclosure, please reach out to Nathan Gordon or any of the attorneys in Baker Donelson's Corporate Finance and Securities Group.