Sustainable Finance in CRE with Kelly Souza

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Corey Aber [00:00:00] Sustainability is catching on. And sustainability strategies are becoming much more prevalent.

Luba Kim-Reynolds [00:00:05] But this is still emerging a bit. There are still things to work out and standardize.

Corey Aber [00:00:10] It would be really great if there were someone who sees this from many different perspectives that could help us think about emerging trends and best practices. Hey Luba, do you know anybody?

Luba Kim-Reynolds [00:00:20] I do. And she's our guest today.

Corey Aber [00:00:30] Hello and welcome to this episode of the Freddie Mac Multifamily Podcast. I'm Corey Aber.

Luba Kim-Reynolds [00:00:35] And I'm Luba Kim-Reynolds. Today we are going to look at sustainability strategies in commercial real estate. There's a lot going on here. To help us get a good handle on this, we're joined by Kelly Souza. She's the managing director in the Sustainable Finance & Advisory Group in Wells Fargo's Corporate and Investment Bank. In this role, she delivers thought leadership and financing solutions to help commercial real estate clients achieve their sustainability goals. She is also responsible for developing and advancing client-focused sustainability strategy across environmental and social dimensions. Kelly, thank you so much for being here.

Kelly Souza [00:01:15] Thank you for having me, Luba. Happy to be here.

Luba Kim-Reynolds [00:01:19] Well, great. To start off our conversation, can you tell us a bit more about the Sustainable Finance & Advisory Group and provide us with a better sense of the role you play on the team?

Kelly Souza [00:01:30] I'd be happy to. Wells Fargo is a large financial institution with broad reach across every sector of our economy. Over time, we've developed core banking capabilities in lending, capital markets and advisory that we leverage to help our corporate and investment banking clients achieve their needs. A few years ago, sustainable finance was something that our clients asked for, and that's why we formed the Sustainable Finance & Advisory Group. When asked, the bankers on our team engage with clients about their sustainability strategies and discuss ways to support strategy and capitalization, whether it's an IPO [Initial Public Offering] transaction, M&A [merger & acquisition], bond or loan. We also share industry trends and best practices. My role is to lead our sustainable finance work for the CRE [commercial real estate] business. This includes, first and foremost, client engagement and deployment of sustainable finance, but we also develop content. For example, we released a white paper called, “Navigating an Increasingly Complex Landscape of Sustainable Building Standards”. I also explore new sustainability programs or products to support client needs and curate internal education for our CRE team.

Luba Kim-Reynolds [00:02:45] Well, it sounds like you and your team are really busy. So, what are you hearing from clients relative to developing and advancing their sustainability strategies?

Kelly Souza [00:02:55] I'd say a general sentiment I hear from CRE operators is that the past couple of years have been very challenging. So prioritizing resources is more important than ever. Despite the fact that many are resource constraint, sustainability considerations have risen in importance for CRE operators. Most are in the process of evaluating some type of a strategy, whether they're in the very early ideation stages or further along in implementation. For an example, clients who are further along have done things like completing net zero assessments of their assets, developing multiyear capital expenditure plans, and conducting climate risk diligence for owned assets and new acquisitions. For others that are in the beginning stages, the key is to baseline data such as greenhouse gas emissions, water and waste, so you can set goals and assess progress. Many operators are at this stage and working on data routines, integrating climate risk assessments into property diligence, and completing kind of low-hanging fruit — items like installing LED lights and investing in building management systems that are less capital intensive and have a shorter payback period. I've also been encouraged to hear several operators fundraising for brown-to-green strategies, renewable energy strategies, and affordable and workforce housing strategies.

Corey Aber [00:04:26] Kelly, that's really helpful and gives some really good perspective. One thing I'd like to to sort of lay some groundwork on, though — just for for those who might be less familiar with the sustainable finance market — what are some of the primary types of sustainable finance and and what exists to like create consistency and drive some credibility in all of this?

Kelly Souza [00:04:47] Great question. So, there are a couple of sustainable finance formats that real estate operators can consider for loans or bonds. The most common is a proceeds solution. The other option is a sustainability linked solution. So, with the proceeds solution, the use of proceeds must be aligned to an industry-recognized sustainability category and defined in a green or sustainable finance framework. Often, these frameworks leverage third-party tools like green building certification and ENERGY STAR® certified ratings. This option can be incorporated into a bond or a loan. Typically, green bonds and loans don't have an explicit pricing benefit to the issuer, although some lenders do have green loan programs that provide differentiated pricing. Think of this as the in-the-plan option. The other option is based on outcomes with the sustainability linked solution, key performance indicators, or KPIs, related to environmental or social metrics like emissions, energy intensity or biodiversity are incorporated into the loan structure. Sustainability linked structures like this are typically incorporated into corporate- or fund-level credit facilities. In this format, ambitious targets are set over the lifetime of the loan, and there is a pricing benefit if targets are achieved and a pricing penalty if targets are missed. With this option, limited assurance annually is typically a requirement to confirm that key performance indicators are being measured accurately and completely.

Corey Aber [00:06:35] That's that's some really good grounding on this. And you know, there's an interesting aspect of it here where it sounds like there are some advantages to looking at sustainable products, but there's also some, some compliance aspects. So, a little bit of overhead that comes with it too. So why do clients choose to leverage those products versus maybe, maybe doing similar things but not leveraging sustainable finance products?

Kelly Souza [00:07:00] You know, that's a, that's a good question and a fair question in that we need to make sure that the products are credible. And so yes, there is a compliance aspect and in some cases that costs money. So, I would say generally there are three benefits to using sustainable finance. Positive stakeholder signaling would be the first. The second would be increasing and diversifying investors, and the third would be differentiated pricing. So, for example, a company can memorialize its sustainability goals into key performance indicators within the loan structure of a corporate facility, which really allows for broader employee and investor engagement around those goals and the potential to improve cost of

capital if the ambitious targets are met. For bonds or securitizations, labeling a transaction as green or social has the potential to attract a broad set of investors, which increases demand and can result in execution benefits or a greenium. Even green loans present the opportunity to attract and broaden lender interest during loan syndications, which can also have execution benefits.

Corey Aber [00:08:10] Now that makes a lot of sense. So so clearly your clients see some some advantage to this. And what are some of the trends that you're seeing, especially in the commercial real estate space?

Kelly Souza [00:08:22] Well, you know, as it, as it relates to sustainable finance, I really see kind of three main trends. The first is elevated activity. From my perspective, it seems like there's more interest and awareness in sustainable finance. And and that interest has translated into a recent increase in sustainable finance activity. So, if I look at, say, sources like Dealogic in the first quarter of this year, sustainable loan activity is 35% higher than closed sustainable finance transactions in the first quarter of last year. And then if you look at the the data more closely, sustainable finance represents roughly 19.6% of real estate transaction volume in the first quarter, as compared to 13.3% in the first quarter of last year. So, it really does seem like there is elevated activity.

Another potential reason for this activity is that many CRE firms have really made progress in operationalizing their sustainability strategy. So, there's more firms that would potentially be a candidate for using sustainable finance products to support their strategies. For example, when pursuing a green loan or a green bonds, green building certification is one way to meet the green loan or green bond framework criteria. In 2023, that was a record year for LEED, which stands for Leadership in Energy and Environmental Design. LEED added the most LEED-certified gross square footage of green building space in a single year, with more than 6,000 new LEED-certified projects worldwide. Similarly, the number of BREEAM, which is Building Research Establishment Environmental Assessment Methodology — what a mouthful — certified assets across North America grew by 96% in 2023. In fact, the multifamily sector experienced a 438% spike in the number of certifications granted nationwide from 2022 to 2023. So, we've seen tremendous growth, and things like green building certification that really enable borrowers to utilize sustainable finance.

The second trend I would say is just more ambitious structure. When I joined Sustainable Finance & Advisory team, much of the initial sustainable finance activity in CRE was really related to incorporating sustainability linked structure into revolving credit facilities for REITs [real estate investment trusts]. At that time, it was really market standard to only include one key performance indicator, or KPI, in exchange for a modest pricing benefit. In many cases, since data routines were not well established, the KPI was related to an external third-party score like a company's GRESB, which is the Global Real Estate Sustainability Benchmark Rating. The market standard has changed, meaningfully, over the past two years. Today, a typical loan structure includes one to three KPIs that are often specific to a company's public target for greenhouse gas emissions, maybe water or even waste reduction. In some cases, these targets are even aligned with the science-based target initiative. Limited assurance of data is now required and depending on actual performance, there is either a pricing benefit or conversely, a pricing penalty. The bar has risen with green finance frameworks as well. So, a couple of years ago it was common in green bond frameworks to allow for LEED Silver Green Building Certification. Today, industry best practice is to require a minimum of LEED Gold.

And so, the third and final trend that I'm seeing as it relates to sustainable finance would be really this broad, flexible green or sustainable framework development. With the rate volatility that's been experienced over the past year, execution flexibility has proven to be extremely important. Historically, when a company has chosen to issue in a green or sustainable format, they would develop a bespoke framework for each transaction. This process could take, say, anywhere from two to four weeks, depending on the complexity, and an individual second-party opinion would be required for each transaction. Over the past year, I've observed larger firms that utilize different types of products like asset-

backed securities, commercial mortgage-backed securities (CMBS) and bonds to memorialize their green or sustainable activity within a much broader green or sustainable framework. This requires one second-party opinion, even for multiple bonds or loans, and allows for more agility and execution timing with fewer resources expended. I think this is a really interesting development that will really enable quite a bit more sustainable finance activity.

Luba Kim-Reynolds [00:13:34] Well, thank you, Kelly. These trends honestly are really encouraging. I especially love that statistic you mentioned at the beginning: 19.6% of commercial real estate are kind of taking advantage of the sustainable finance. So, this is really encouraging. And something we like to ask our guests is usually when we're discussing sustainability or green or anything climate-related is to give us some examples of maybe major transactions you've done recently or something that really stood out to you. And give us a little bit more detail. What was so meaningful there?

Kelly Souza [00:14:13] I would be happy to. I guess the first comment I would say, Luba, is that from my perspective, every transaction is a meaningful transaction because it advances the sustainability of the built environment. But, there are some some examples I would love to share. So earlier this year, Wells Fargo's Debt Capital Markets team assisted a client in the development of a novel green bond framework. This framework leveraged the home efficiency rating system, or HERS rating, and allowed for funds utilized to develop a portfolio of new homes that had achieved certain HERS criteria to be allocated to a green bond. Ultimately, when this transaction went to market, it was oversubscribed, upsized and priced inside fair value, showcasing execution momentum for the grain format. What I think is notable about this particular transaction is that it illustrates a framework solution for the homebuilder and single-family rental market, where we really don't see much sustainable finance activity because green building certification — which we've touched on already — is really quite a bit less prevalent in single-family residential. Yet single-family residential represents an outsized share of building emissions in the U.S.

Maybe another example I would touch on is recently the team had the opportunity to work on the first private label sustainable CMBS transaction in the United States, secured by a multifamily property in New York. The Debt Capital Markets team helped develop a sustainable finance framework leveraged in the transaction. The sustainable designation was warranted given the combination of the LEED Platinum Green Building Certification and the fact that a portion of the units were designated for middle-income residents based on the area median income restrictions and aligned to a New York affordable housing program. In this particular case, the sustainable designation raised investor focus and led to positive investor demand. And you know, I've mentioned this example because it represents a first-of-its-kind secured private placement and really illustrates how the market is growing and evolving, and provides an example of how commercial real estate operators are leveraging sustainable finance to support business strategy.

In some of my previous remarks, I did comment on the fact that several clients have indicated their fundraising for affordable and workforce housing strategies. So, in lieu of an actual example, I thought I would talk more broadly around something that our team is working on. So, we're kind of working on a sustainability linked subscription facility construct for CRE operators that are targeting the acquisition, development and preservation of affordable housing, because this is such an important issue for our country, and to advance this larger goal. Again, this framework concept, the idea would be to have at least one socially oriented key performance indicators and at least one environmental KPI. So, as we're brainstorming this this framework that can be adapted based on a given strategy, the one social option for KPIs could be to set goals around the percentage of investments that meet certain income thresholds, like 60 or 80% of area median income. Another option might be to establish a KPI tied to providing resident services, which can be tailored based on community need. In terms of environmental KPIs, those are opportunities abound. There's a multitude of options, which would include completing property-level assessments, driving improvements in ENERGY STAR scores or site energy use intensity, implementing water and waste reduction initiatives, and and really many more. So, from my perspective, this concept is interesting because it ties both social and what we think of as more traditional environmental key

performance indicators in support of larger affordable housing goal. It also supports the important work many CRE operators are pursuing to address the undersupply of affordable housing in this country.

Corey Aber [00:18:35] So, that's really cool to see, you know, see all that great work kind of going in. And also the creative thinking on the, on the finance side to put put a framework in, in place there. These are all, all things that we care about quite a lot here and we've been focused on, too. You know, as you think about some of these cases, you know, happening, happening in the market, what do you see as some of the greatest needs for building retrofits, for example, or thinking about efficiency or resiliency? You know, what are you seeing out there? And are there some financing solutions that really, you know, help that work pretty well?

Kelly Souza [00:19:11] Housing in general is a large contributor to carbon emissions. I think everyone is aware of that. You know, according to RMI's Financing U.S. Building Decarbonization document, U.S. buildings, commercial in particular, represent 37% of building emissions. And of that 37%, 56% comes from small- and medium-sized buildings. So, most emissions are really attributed to buildings owned by non-institutional owners. Maybe some examples could be like a family office that owns an office building, or a business that owns its manufacturing facility, or a nonprofit that owns affordable housing projects, or a group of doctors that owns a retail property. And to date, much of the sustainable finance activity that's been deployed has really been deployed to larger, more institutional firms. So, I think there's a good indication there that there is a market need that maybe is not being met.

Another area is in the affordable housing sector. You know, in terms of an equitable transition to a low-carbon economy, finding ways to make affordable housing efficient and resilient is extremely important. From a financing perspective, you may have heard the $27 billion Greenhouse Gas Reduction Fund. Allocations were recently announced. It's part of the Inflation Reduction Act. And that could be utilized in large part to improve efficiency of existing affordable housing and enable net zero ready new development by providing long-term subordinate financing for housing. So, not surprising, building retrofits can be quite expensive and require more equity capital, because traditional lenders are often required to stay within pre-set leverage and debt service coverage perimeters. And there really isn't a lot of flexibility or creativity with those parameters. So, the hope is tools like the Greenhouse Gas Reduction Fund will provide a source of subordinate financing to minimize the need for more equity capital to retrofit and develop affordable housing in particular.

So, I wish I had a, a rosier picture. There certainly is lots of need out there. And financial innovation is taking place, but it needs to be brought to scale and this will really require more and better data, increased technical knowledge of all parties, and finding the right mix of flexibility and standardization so that the market can respond favorably.

Corey Aber [00:21:59] Yeah, you know, sometimes it's a really interesting spot to be in when you're seeing — when you're in the midst of a period of innovation in the market, right? It certainly feels like that's where where we are now.

Kelly Souza [00:22:12] I completely agree with you. We are, we are certainly in a place of innovation. And it's happening quickly, which is great to see.

Luba Kim-Reynolds [00:22:21] Well, let's switch gears a little bit. So, your team published their report earlier this year on the Top 10 Sustainability Trends for 2024. So, congratulations by the way. And one of the trends predicted that increasing physical and transitional risk will drive more recognition around sustainability as a value driver. So, from your perspective, have you seen this trend materialize yet?

Kelly Souza [00:22:49] Well, on the surface, 2024 so far has been less eventful from — than 2023. I would say, the insurance markets are a bit calmer, and there has not been a new major building performance legislation since Seattle, which was in the fourth quarter of 2023. So, from my perspective,

that doesn't mean the prediction was inaccurate, but perhaps the timeline is just a little bit different. So, I'll, I'll share a couple of examples. There's a lot of regulation in the pipeline across the United States with the goal of reducing carbon emissions. According to the Institute for Market Transformation, there really are more than two dozen cities, counties or states continuing to take steps to implement further regulation. Granted, we did not see the wave of new regulation anticipated around Earth Day 2024. And, cities like Berkeley[, California] have seen regulation successfully challenged and rolled back.

In addition to kind of the regulation impact, I have heard that tenant preferences are also impacting transition risk. You know, clients have indicated that tenants are exerting their influence on landlords to ensure property greenhouse gas emissions align with their science-based target requirements. Similarly, I've heard from several CRE operators that investor scrutiny around sustainability practices have intensified in the latest round of capital raising. So, transition risk really is continuing to be felt and it is continuing to motivate activity.

Yes, as we think about acute weather events and the impacts on commercial real estate, you know, that continues as well. So according to Deloitte's Center for Financial Services, the average premium for commercial buildings in high-risk U.S. states was around $1,000 per building per month in the year 2000. However, natural hazards over the last five years have pushed premiums on structures in the 10 highest risk states up 108%, and 31% year over year. And looking forward, Deloitte predicts a 10.2% compounded average growth rate for properties located in the greatest extreme weather risk states. And they're predicting a nearly doubling of premium from today's levels by 2030. So, these risks are alive and well, continuing to find themselves into decision making of many CRE owners and investors. And I think this really has resulted in an increase in the activity so far this year in 2024.

Luba Kim-Reynolds [00:25:44] Kelly, so let's pretend you have a crystal ball. What might be different about the status of the CRE's sustainable markets in, let's say, three or four years from now?

Kelly Souza [00:25:56] Oh, gosh. Well, I wish I had a crystal ball. Luba, thanks for the question. Maybe a couple of things. I mean, I think we're seeing — as we've talked about in some of the data — we're seeing potentially an increase in sustainable finance activity. I think, you know, that could be because, CRE operators are more advanced in their strategy. They have data to work with. They're getting their buildings certified. So, I think a couple of things could happen. The first could be that sustainable finance activity just continues to grow and gets bigger and bigger and bigger. I think the other potential option could be that there's no longer a need to really label things as sustainable finance anymore, because potentially we've made so much progress at integrating sustainability into real estate that, you know, there might not be as much need to have the labeling. So, I think the trends, or my hope is that the trends, continue to be positive. I know in my interaction that progress is being made, and I feel very optimistic about that, and I feel optimistic that that's going to continue for many of the reasons we touched on as we think about transition risk. And so, I think, I think things look a lot different. I think progress continues to be made, and and we're in a state, in four or five years from now, where progress is well underway, where there's been more innovation in, in finance and where sustainability is more deeply integrated into all of the things that we do in real estate.

Corey Aber [00:27:40] Well, Kelly, thank you so much. And there's certainly a lot to, a lot to look forward to here, and a lot to keep an eye on as things evolve. Really appreciate you being here with us today to help us understand some of what's going on in the market now and how people are thinking about this.

Kelly Souza [00:27:54] I'm happy to. Appreciate the invite and look forward to bright things in the future.

Luba Kim-Reynolds [00:28:00] Thank you, Kelly.

Corey Aber [00:28:02] Freddie Mac Multifamily podcast is produced and supported by a team of our Freddie Mac colleagues, including our production lead, Jenny Nguyen, and our audio producer, Jackson

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