Retail Opportunities Investment Corporation (ROIC)

engagement commentary

Federated Hermes SDG Engagement Equity Fund

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Federated Hermes Limited

www.hermes-investment.com

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ENGAGEMENT COMMENTARY:

Retail Opportunities Investment Corporation (ROIC)

In a nutshell

ROIC is the largest publicly-traded, grocery-anchored shopping centre real estate investment trust (REIT)[1] focused exclusively on the west coast of the US.

Equity market capitalisation:
$2bn
(as at July 2022)

Size: owns
10m sq ft
across 89 shopping centres

Employees:
68
(FY21) of which 68% are female

Headline progress

The company has moved markedly over the past few years. From zero sustainability reporting and limited internal initiatives in 2018, the company has since established inaugural policies, published inaugural reports and set out measurable, time-bound targets for reducing its environmental impact.

- 13% cumulative reduction in same-centre greenhouse gas emissions (2021 vs. 2019 base year)
- 20% cumulative reduction in same-centre energy consumption (2021 vs. 2019 base year)
- But also an 18% year-on-year increase in same-centre water consumption (2021 vs. 2020)

Theory of change

The construction and operation of buildings contribute around 40% of worldwide greenhouse gas emission[2]. In the United States, the Department of Energy estimates that commercial buildings account for c18%[3] of energy usage and account for 40% of carbon dioxide (CO_2) emissions, and 88% of potable water consumption[4].

Western US states, such as California, have been experiencing a worsening water crisis with more frequent and severe droughts. Indeed, the American west has spent the last two decades in what scientists are now saying is the most extreme megadrought in at least 1,200 years[5], and 2021 was the second driest year on record[6]. However, water use intensity per capita in the western states tends to be higher than the US average[7].

The need for action is therefore clear. In most countries, the buildings that will principally constitute the urban environment in 2030 already exist. Therefore, improving the energy efficiency of these buildings is one of the most cost-effective and fastest ways to reduce electricity demand, while indirectly slashing carbon emissions as well as improving local air quality and public health.

The Global Alliance for Buildings and Construction (GlobalABC) however, notes that in its 2021 Global Status Report[8], investment in the energy efficiency of buildings continues to climb and reached more than US$180bn in 2020, up from $129bn (in 2020 dollars) in 2015. However, most of this increase has arisen in just a small number of European countries. Without broader investment, this level is unlikely to be sufficient to tackle efficiency improvements among the existing global building stock. Furthermore, the International Energy Agency (IEA) notes that buildings remain off-track to achieve carbon neutrality by 2050. To meet this target, all new buildings and 20% of the existing building stock would need to be zero-carbon-ready as soon as 2030[9].

Commercial building operators can contribute to reducing carbon emissions by switching to cleaner energy sources and reducing energy consumption via energy efficiency measures.

[1] A real estate investment trust (REIT) is a company that owns, operates, or finances income-generating real estate. REITs pool the capital of numerous investors. This makes it possible for individual investors to earn dividends from real estate investments – without having to buy, manage, or finance any properties themselves.
[2] Comprehensive Carbon Footprinting in Real Estate | GRESB
[3] EIA.gov.uk
[4] Use of energy in commercial buildings in depth - U.S. Energy Information Administration (EIA)
[5] US west 'megadrought' is worst in at least 1,200 years, new study says | Drought | The Guardian
[6] Current drought conditions (ca.gov)
[7] A guide to California's water crisis — and why it's so hard to fix - Vox
[8] 2021 Global Status Report for Buildings and Construction | Globalabc
[9] Buildings – Topics - IEA

Furthermore, operators such as Retail Opportunities Investment Corp (ROIC) can contribute to water use savings by adopting a series of water upgrade measures.

Finally, with increasing demand for 'green' buildings from larger building tenants and with utility costs impacting commercial real estate profits, it makes business sense to adopt greener building practices. Doing so ultimately presents a win-win possibility of attracting stickier tenants and maximising rental income and asset values while reducing environmental impacts.

Practice of change

We have been invested in ROIC for many years, including since inception of the SDG Engagement Equity strategy at the start of 2018. During that time we have had approximately 20 interactions which have included meetings and calls with the senior management team, most commonly the CEO, as well as with the chairman and others.

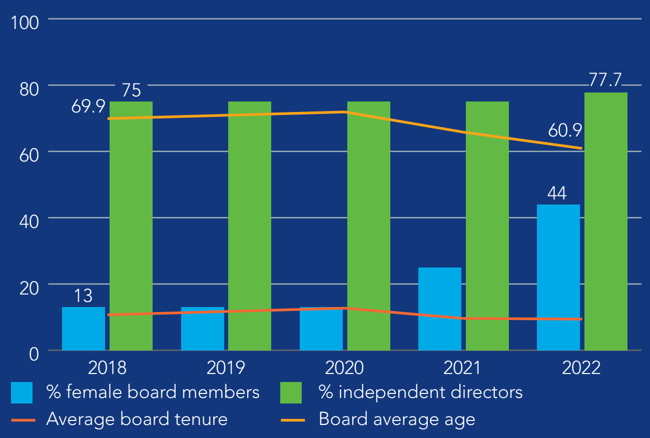
Many real estate companies are now including ESG information as part of their investor and public reporting and include numerous key performance indicators, including energy usage, greenhouse gas emissions, waste management, number of sutainability certified assets among other metrics. This level of disclosure remains patchier in some markets such as North America than for Europe, however, there is progress.

When we first began engaging with ROIC on sustainability matters the company was notably lagging, although in a market as per above with lower levels of ESG disclosure than elsewhere. After multiple, predominantly positive and constructive conversations with the ROIC management team over a sustained period, we have been pleased at the progress the company has made to date. Indeed, management noted that our dialogues were the catalyst for them to accelerate their practices and investment around this agenda.

- 2019 – The company established an internal ESG committee.
- 2020 – ROIC adopted ESG metrics as part of its long-term incentive plan – well ahead of many of its peers.
- 2021 – The group formally set out its inaugural ESG plans policies at the beginning of the year and later published its first ESG report. These included data and forward looking, measurable and time-bound reduction targets for energy, water, waste, and greenhouse gas emissions.
- 2022 – ROIC was selected as a 2022 Green Lease Leader by the US Department of Energy's Better Buildings Alliance and the Institute for Market Transformation. Specifically, ROIC was awarded 'Gold' level designation in recognition of its continued success in collaborating with tenants on energy efficiency, decarbonisation, air quality and other environmental and social issues.

Beyond the 'E', the company has made large strides on governance with much improving levels of diversity – spanning age, gender and ethnicity.

Figure 9: Board composition – a rise in diversity and refreshment



Source: ROIC.

In 2018 and 2019 we voted against the chair of the governance committee (Edward Meyer) due to ongoing lack of board diversity and the ongoing restriction on shareholders ability to amend the company's bylaws – in addition to the fact that the board member was well into his 90s. We were also concerned that the board was exhibiting a worrying tendency of ignoring the will of its minority shareholders.

At the 2019 AGM, non-executive director Lee Neibart received a majority of cast votes against his re-election and in 2020, the aforementioned Ed Meyer similarly received two-thirds opposition. In both cases the individuals offered their resignation. In both cases too, the board voted in response to decline the resignations.

In Q1 2021 however, the company announced that Edward Meyer would not stand for re-election at the 2021 AGM. Alongside Ed Meyer's retirement, Angela Ho joined the board bringing increased diversity. Furthermore, it was later confirmed that Zabrina Jenkins and Adrienne Banks Pitts were to join the board as independent directors with director Charles Persico not standing for re-election at the 2022 AGM. These changes were accompanied by welcome amendments to the company's bylaws. As a result, as of July 2022 the company now operates a refreshed and diverse board and has for a couple of years afforded a material weighting (25%) towards ESG metrics within the performance-share element of the long-term incentive plan granted to management.

Next steps

While the rate of progress has been laudable, there remains scope for more to be achieved. We continue to speak with the company around its installation of energy efficient lighting and solar arrays, as well as its installation of EV charging units and its support for more efficient waste management.

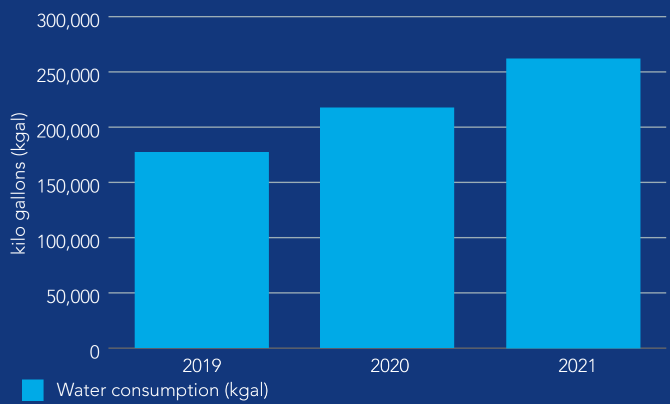
Management have noted that car park lot lighting is a significant drain, commonly comprising 70-80% of total electricity usage. As such they are systematically shifting the lighting of these to LEDs (estimated by the US Department of Energy to be approx.75% more efficient)[10]. At one of its major sites (Fallbrook) the company's switch to LED lighting resulted in a 70% reduction in parking lot lighting consumption. **As of the end of 2021, 10 properties had LED lighting installations, illustrating the scope for progress ahead.**

During an early 2018 call with the company's CEO it was confirmed to us that 'green initiatives' are now a 'very high priority', and to that end, the company was tendering for bids to roll out a series of improvements across all of its sites with all centres to be assessed for installation of electric vehicle charging stations and solar panel installations.

On the installation of solar arrays, as at the end of 2021, the company had **finalised solar agreements for nine of its properties,** representing approximately 19% of its portfolio by gross leasable area.

With respect to electric vehicle (EV) charging units, as at the end of 2021, the company had **installed 51 EV charging stations at five properties**. In addition, anchor tenants have lease rights to add an additional 32 stations across seven properties by the end of 2022.

Figure 10: Although data coverage has improved, water consumption has increased



Source: ROIC as at end 2021.

Finally, we note **50% of the company's assets by square footage are located in extremely water-stressed areas of California.** The company committed to attaining 80% common area water data coverage by 2023 (vs. just 33% data coverage in 2020), something which it comfortably achieved as of the end of 2021. It has also committed to the installation of irrigation controls at 80% of properties by 2023. However, water consumpton has continued to increase in this period. Given the severity of the water stress in many of its locations we continue to encourage the company to prioritise this area.

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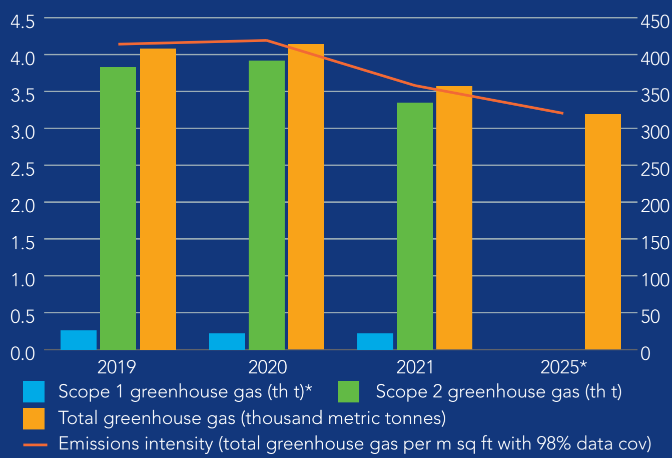
Figure 11: Emissions are projected to continue declining

Emissions targeting a 15% reduction in like-for-like Scope 1 and 2, greenhouse gas emissions vs. 2019 baseline. Achieved to date a 13% reduction from 2019-21[11].



Source: ROIC. * (thousand metric tonnes)

Overall, we continue to engage constructively with ROIC. We are very cognisant of the difficulties in attaining baseline data from tenants and the difficulties this presents in terms of understanding the full environmental footprint and impact of the company's assets. The company has set itself measurable and time-bound targets around emissions generation and energy use, however, these remain relatively modest in our view.

We have highlighted examples of best practice observed elsewhere and are encouraging the company to set itself suitably high ambitions. We continue to press the case for targeting to be net positive for landlord controlled impacts and then subsequently for tenanted areas too.

To date, there has been evident progress but undoubtedly more to achieve too.

In conclusion, we commend the company on the progress it has made to date. We nonetheless hope to see longer-term energy and emissions reduction targets be set, and a real prioritisation and focus on water savings at the company's self-identified water-stressed assets. We are hopeful we will see the positive momuntum maintained during the course of 2022 and beyond.

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[10] LED Lighting | Department of Energy

[11] LFL data comprises six properties for Scope 1 and 85 properties for Scope 2.

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