The 17th Annual International Land Policy Forum

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"Sustainable Real Estate Investment"

Lecture record

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Once again, I am honored to be invited by the Ministry of Land, Infrastructure, Transport and Tourism to address you today on the issue of responsible property investment.

I'm going to focus today on the various forms of responsible property investment and the merits and challenges from those investments from an environmental perspective.

I will look at the different approaches investors can take to responsible property investment and will comment on the rise of various forms of responsible property investment funds that are beginning to emerge in Europe, North America and Australia.

Such a review will allow us to reflect on the environmental investment merits of such funds - not only such funds but also the activities that we might carry on with in our own investment organizations.

I will conclude by raising some questions about the merit of launching 'green property funds' in general.

(Let me start by making it clear that I stand here today as representative of Prudential of the UK, not as that of another company with the same name based in the US. I am required by an agreement between the two different organizations to make it clear that I am not representing the Prudential of the US.)

Let me begin by some introductory remarks. First of all, we should be very clear in this room that real estate is a key part of the problem of climate change.

This slide, taken from the United Nations, identifies property and the built environment as responsible for around 40% of the energy use. It is a major conduit for energy use. It is also a major source (40%) of carbon emissions.

As the slide shows there are many other resources and pollution used by and emanating from real estate. So, real estate is a key part of the problem. But interestingly it would also appear to be a key part of the solution.

This complicated graph, taken from the Inter-governmental Panel on Climate Change suggests that the building sector has the greatest potential for carbon mitigation at lowest cost in both the developed and developing world, as the comments to the side of the graph suggest.

There are many policy-makers and others around the world who are puzzled by what they see in the real estate industry given that many ways to reduce carbon emissions already exist and are self-financing. Many politicians are puzzled as to why these are not being adopted. We may return to the potential impacts of this in the panel session.

But if we are a key part of the problem and a key part of the solution, it is hardly surprising that the property investment community is increasingly finding itself in the spotlight from a range of stake holders asking what is the property industry going to do about it. If I was addressing a conference of property occupiers, they may well, in all probability occupy a similar position - because they too are in the spotlight.

And, to be clear as part of this introductory commentary, we should be clear in this room. that the real estate contribution that might be made does have something to do with development, but development is only a small part of the issue. If we only focus on making our new building green, then this is the slow lane, the slow path for this industry to make its contribution to carbon emission reduction. This is because, in any single year only 1 to 2% of new stock gets added. So, this issue is about the existing stock, just not about new development.

Then, finally for this introduction, I identify three possibilities we should consider in this room. In terms of how we might act going forward, on the left hand side of this slide, we have a proposition that behaving responsibly enhances our fund performance.

If we can find evidence to this effect, then it becomes the financial duty of investors to pursue those responsible actions on behalf of our customers. On the right hand side of the graph is the position where financially social responsibility are not aligned. Clearly, if this were to be the case, that then create clear issues for finance institutions.

But we should never forget the position that is in the middle of the spectrum which you can express in two ways. First, if it seems to be the case that responsible management of property portfolios has no impact on investment returns, then it becomes a moral imperative to pursue responsible actions.

But if you are still concerned that such an approach could prejudice returns, I would invite you all to invert the problem and identify how much you <u>can</u> do within the economic bounds that you believe possible to meet your fiduciary duty.

OK, I'm now going to look at the area, the idea of responsible property investment in its various forms, and talk about the potential real estate has.

In the world of responsible investment, there are usually 4 techniques that are identified. These are listed here in terms of 'engagement', 'screening', 'best in class', and 'enhanced analysis'. I do not intend to cover the last 2 because they are, in my view, financial techniques and little to do with responsible investment. Rather, I wish to concentrate on engagement and screening.

Screening is where investors select assets either positively, to bias their allocation of capital to products and processes which they are approved, or it can be applied negatively such that capital is starved for processes and products that investors do not agree with.

Engagement does not enter into such forms of decision making. Engagement is where you are able to invest in pretty much everything but you will take direct action to improve the basis of the products or process es to make them more responsible. We will see that both of these techniques are visible in responsible property investment.

Let us have look at screening first of all. Screening might occur throughout the investment process. It could occur at the multi-asset level by which I mean the selection of equities or bonds or real estate.

It could happen within the real estate asset class itself, such that preferences are made for or against certain type of property, less industrial property for instance in favor of more office property. I think that's pretty unusual but it is possible.

Then, screens could be applied to the actual investments in particular type of stock.

To be clear, on picking up very much on Sueyoshi-san's presentation, some major state pension funds around the world are beginning to think about this issue of asset allocation and climate change very carefully. I put two examples up here, one from the French sovereign wealth fund (FRR) but also from the advisers Mercer, who are looking at the question of - in a world of great volatility driven by issues of climate change - how might they allocate their capital across the major asset classes., and the initial suggestion would be that the more volatile the world becomes the more likely funds are to move away from risk bearing assets like real estate and equities.

Let's look particularly at screening in property. One could screen in property by a number of different features. It could be by location. You might positively bias your fund toward properties near public transport nose and away from car dependency.

Most commonly around the world, and it has some downside environmentally, is the bias toward only occupying the highest grades of building and avoiding owning or occupying lower grade building.

I have already mentioned, it could happen by property type.

And there are some ethical investors that might screen property by property tenants. Only letting to tenants who, for instance, promote green products or policies or processes and avoiding tenants involved in armaments, pornography etc.

Could there be an investment logic to screening property portfolios? I believe when I spoke to you last year, I would have shown a slide similar to this one.

We would appreciate that if tenants and investors prefer green buildings over let's call them brown buildings then, over time, one would expect a rental differential to emerge for green over brown. One would expect green buildings to lease more quickly if green buildings are cheaper to run than brown buildings. Again, savings to the tenants might mean they have a greater ability to pay a higher rent.

And, if investors prefer green over brown buildings then those building will be more liquid, less illiquid.

This all suggests that green buildings should see higher rent or higher rental growth less depreciation, and less risk premium than brown buildings and that should amount to them having lower cap rates and higher prices.

Some early evidence from the US would suggest that green buildings give you a 3% rent premium. Because they are better occupied, they give you 6% income premium. Because they sell at lower capitalization rates, they give you a substantially higher price (16%).

These studies are not without their issues and in this particular case, what is missing is the cost of taking the building to that level of 'green-ness'.

So, sustainability will affect the evolution of asset values in real estate in the medium term and, therefore, performance going forward from here. It might not be identifiable in the price now, but the belief by many is that it will be in the future. And the more these issues matter, and we can assume they matter a lot, the greater the impact on value.

But screening in property is problematic. The obvious first problem is one which we will always appreciate is that if you artificially constrain your investable universe, then you introduce risks into your portfolio. If you deliberately turn away certain classes of investment which then perform well, your fund will do relatively poorly.

Similarly we still need a lot more information on both buildings and tenants in order to begin our screening processes in the first place. Then there are practical issues. For instance, what do you do about shopping mall with a 100 tenants within which you disapprove of, say, five. Do you buy or do you not buy that asset?

Ethical investors have invented some rules of thumb to get around such issues but they are difficult to implement. Finally, I would ask the question - is screening responsible? It might be intelligent because we saw earlier these assets might do very well. However, by screening, aren't you just passing the problems of the asset of which you disapprove on to someone else for them to deal with.

So in my view successful investors might screen asset towards green and away from brown. But it is only responsible in the smallest way, namely, by driving down the cost of capital on green assets and raising it on brown assets.

Let us now turn to the issue of engagement.

Here I would suggest to you that real estate is more endowed with engagement opportunities than is the equity market. It is more endowed because they are three dimensions at least in which the real estate investor can engage with the properties in their funds.

We know very well that they can engage both structures making the building greener but there is also the chance to engage with the tenants to make that occupation of the building greener and, increasingly, there is the opportunity to engage with the legal structure. The lease contract itself is available to help drive green behavior forward.

Let us look first at investor engagement with buildings, the first of these 3 dimensions. Clearly, when one creates a new building one has an occasional, once in 50 years chance for control but that control is complete. On a more frequent but smaller scale, a refurbishment might occur every 10 or 15 years but that still gives a chance for the investors to improve a building.

But in a management of the property there are a myriad of things that can be done - small things that can be done everyday. One can do many things when managing a property but, clearly, we can't move buildings from the site they occupy. However, we can engage with what geographers call 'the situation', namely, how the location is positioned against other land uses. We can, perhaps, make it greener to bring goods and people on to and off your site – through green travel plans, for instance.

However, engagement does have its problems in that when tenant is occupation it is hard for an owner to make improvements. When the tenants vacates at the end of the lease, that is the chance to make improvements. So, the benefits of engaging with buildings tends to be "stop - start".

(I don't intend to go through these provided examples in any detail but I leave them for you to read. But there are examples of, for instance, in this case, a chance to make some simple improvement to a building with the result of 13% improvement in a rent and 25 basis points reduction in the capitalization rate in the yield.)

Clearly, we can also engage with occupiers and, in some ways, occupiers are even more important than we are, in driving the property industry forward. And probably we need to engage informally with tenants. For example, my company welcomes new tenants to its properties by sending them information packs as to how they can save resources and save money by things like energy reduction measures.

The lease is also clearly an important area where agreements between landlord and tenant can be structured to more responsibly manage properties.   This is an example really - again I won't go into any detail of working closely with tenants. In this particular case, to reduce energy cost and save carbon, we were able to secure that tenant in our property for further period of time by sharing some of the benefit.

Both sides were happy and in this particular case we were driving down the cost of energy in the central mall of a shopping mall and reducing the service charge for our tenants. We believe such action improved the loyalty of our tenants to the center.

For those interested in how to improve an owner and occupier relationship I recommend to you piece of work by the UNEP FI and the web links are there.

But the lease is a clearly very important and certainly in Australia, North America and Europe, there is an increasing interest in predetermining the nature of the relationship between the investor and occupier. The aim here is, when the occupier is in occupation, it occupies the property in a responsible way. This is notion of the green lease or placing certain green conditions into leases which specifically regulate what responsibilities, or place obligation on all the parties on what they should do in order to pursue an environment-friendly way.

I will again recommend to you report by the Better Building Partnership which is London based organization to give you an idea about what is going on there.

OK, I am reaching the very final part of my presentation now. When we hear about responsible property funds we tend to hear of the 3 different main types, namely, Green Development fund, Dark green screened funds, and improver funds.

This slide just talks about the environmental and economic logic of each type.

As the name suggests, green development funds are interested in 'green development'. However, we all know from our experience in real estate that development is risky in itself. So, a fund that just does development seems risky instinctively.

From an environmental perspective, we know that developments are only profitable at certain times in the property cycle. Therefore, if this was the only approach we had, it would be a 'stop-start' green approach.

However, in any event, green development mainly ensures that problems will not be aggravated for the future. And that we should all remember that development is itself a carbon event and, to knock a building down and to reconstruct, requires some sort of 'environmental payback' for the energy used in the construction process.

So, I think from both investment and environmental terms, green development fund raise some interesting questions.

A dark green screening approach also raises investment and environmental questions. The investment question is that, certainly in Europe, the investable universe is so small and so specialized that investment only in such brings risks into the investment process. Because you are not engaging, you are missing out on many investment opportunities, but also, in my view, I see this as a potentially intelligent but not necessary responsible approach in that you leave the problem of the existing stock to other people probably less educated in these matters than you, to deal with.

At PRUPIM, would very much endorse the improver approach because we can use our tactical asset allocation of ability to invest across all types of property but we also feel we are making immediate and positive contribution to carbon emission reduction.

If you are thinking about launching a responsible property fund, I can guarantee the first question you will be asked is that “if responsible investment for this fund, why don’t you do it on all of your funds?” Your response might relate to ‘increase focus’ but you will be given that question.

So, as a fund manager, you will need to address the question of do we attract capital by having this specific green fund or do we attract capital by been as a green property fund manager that knows how to do well by doing good.

Personally, I question how long ‘green funds’ will last because eventually, in many parts of the world, green will simply become the way in which property fund are managed.

So by way of conclusion, I would say we must recognize that property is both a major part of the problem and the solution to mitigating carbon emission.

We all, as property fund managers, need to understand it is our fiduciary duty to understand these trends and their impact on value and performance.

Property investors will increasingly be faced with many questions and choices in how to respond to the challenges laid down by Sueyoshi-san, namely, to get involved or not get involved, to screen or to engage, to create new funds or to be green management house.

My view is that intelligent investors can profit from the knowledge which we discussed today. However a truly responsible investor strives to do well by doing good through improving the existing stock.

And the final question you will need to resolve is whether if you are going to be manager of green funds or green fund manager.

Thank you very much, for your attention - thank you.