



SUSTAINABLE INVESTMENT IN REAL ESTATE... YOUR FIDUCIARY DUTY

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EXECUTIVE SUMMARY

- There is a growing body of evidence which supports the case for investment in sustainable real estate. This evidence suggests that real estate with sustainable characteristics can generate superior returns or at the very least “future proof” your investment.
- Trustees and investors are increasingly acknowledging the link between environmental practice and financial returns.
- Political and social pressures will ensure sustainable investment in real estate remains a important issue.
- There are limited ways to invest in sustainable real estate products however demand for such products is growing.
- Therefore it is the fiduciary duty of trustees and investors to understand and consider Sustainable Investment issues when looking at investing in real estate.

Introduction

Real estate, through its construction, use and demolition, is responsible for around 30-40 per cent of global carbon emissions¹. Indeed, the Intergovernmental Panel on Climate Change identified buildings as offering the most significant opportunity for cost-effective emissions reductions worldwide². With real estate now a key constituent of most institutional investors' portfolios at around 10 per cent of their overall assets, we believe there is a very real opportunity for real estate to play a much more significant role for concerned investors wishing to support, among other things, a reduction in greenhouse gas emissions and a reduction in building obsolescence. This paper examines the argument that it is the fiduciary duty of trustees and investors to understand and consider Sustainable Investment (SI) issues when looking at investing in real estate.

¹ Price et al, 2006, Sectoral trends in global energy use & GHG Emissions; UNEP SBCI (2006) Sustainable Buildings and Construction Initiative, SBCI Secretariat, Paris.

² <http://www.ipcc.ch/pdf/assessment-report/ar4/wg3/ar4-wg3-chapter6.pdf>

Sustainable Investment... sustainable returns

Sustainable Investment (SI) can be defined as investment decisions and ownership practices that incorporate Environmental and Social issues into their investment decisions and ownership practices. SI should also meet the investors' financial goals and fiduciary responsibilities as these principles can affect the performance of their investment portfolios³. Conceptually it is easy to understand the ethical case for investing in SI real estate. However occupiers and investors will ultimately want the economic case for SI to be made. This will include:

- Creating brand value and reputation benefits;
- Enhancing capital growth and rental income;
- Lowering operating costs;
- Improving tenant retention; and
- Lowering depreciation costs compared to non-sustainable buildings.



³ http://www.unpri.org/property/PWG%20PRI%20report_final.pdf

Trustees and investors will want to have the costs and benefits quantified as well as the intangible benefits of investing in sustainable real estate. Coupled with regulation in the sector by policy-makers acting to curb future climate change is also increasing and will encourage real estate owners to adapt their assets to SI criteria. This should mean that by investing in sustainable or “future-proofed” buildings, real estate owners will over time have a better chance of securing higher values and better returns.

The evidence is growing

Investors and trustees need hard evidence in order to justify such investment decisions. Research in this sector is increasing and the evidence supporting the case for SI in real estate includes:

- Kok in his “Doing Well by Doing Good: Green Office Buildings” study of 7,488 US buildings found real estate that met certain green building standards demonstrated that they generated higher occupancy by 7.5 per cent; higher rents of 6-9 per cent; and higher selling prices than buildings that did not meet the green criteria of 16-17 per cent⁴;
- Hall in “Current Opportunities for Investing in Sustainability in the Property Sector” found that although there is an initial 2 per cent higher cost of construction for energy- efficient and sustainable buildings, the financial benefits over the lifetime of the asset outweigh these additional costs through reduced operating costs of 8-9 per cent, increased building values of 7.5 per cent and occupancy rates increased by 3.5 per cent⁵;
- Other studies found that sustainable buildings can save 25-30 per cent in energy costs compared with buildings that do not meet a green building standard with a payback of three to five years. These buildings can also provide significant health and productivity benefits⁶; and

⁴ Nils Kok & Piet Eichholtz – ‘Doing Well by Doing Good: Green Office Buildings’, 2008.

⁵ Hall et al., 2009, Current Opportunities for Investing in Sustainability in the Property Sector, 2009.

⁶ IPF Summary report, McAllister et al., 2009. Watson and Katz, Green building impact report, 2008.

- GVA Grimley found that 79 per cent of surveyed occupiers in the finance and business service sector said that they would be willing to pay more for a “green” building⁷ e.g. through higher rents. This view is supported by McGraw Hill⁸.



The tipping point is already here

A recent survey by Aviva Investors also found that 95 per cent of UK real estate fund managers perceived there to be a link between environmental practice and financial returns⁹. Finally, there will be a tipping point which...

“...will reach the critical mass when green buildings account for enough of the building stock that tenants have a choice. At this point, the performance premiums for green buildings will flip to a discount for older, less efficient, conventional buildings. We are... at or near this point ... Ignoring this impending market transformation would be risky and imprudent, and the current recession will provide little cover to owners failing to adapt.¹⁰”

⁷ GVA Grimley, Towards Sustainable Offices, 2007.

⁸ GVA Grimley, Towards Sustainable Offices, 2007. McGraw Hill, Construction Survey, 2006.

⁹ Aviva Investors, Unlisted Real Estate Funds – Environmental Review, 30 November 2008.

¹⁰ Nelson, How Green a Recession? – Sustainability Prospects in the US Real Estate Industry, 2009.

We therefore strongly believe that the evidence cannot be ignored, and that investors and trustees need to consider the SI criteria of their real estate investments in their decision-making.

How to invest in sustainable real estate

The next question to address is: How can investors access this market? There are numerous ways to invest in SI equity products, but the investment universe for real estate is much more limited.

The market for SI equity products is well-established. SI equity products make up 17.5 per cent of the total equities asset management industry in Europe having reached Euro 2.7 trillion (about US\$3.9 trillion) in 2007. This demonstrates growth of 102 per cent since 2005¹¹. SI equity investment has also delivered financial outperformance. The average SI equity fund outperformed the MSCI World Index by 36 per cent¹² over the last five years.

The SI real estate market, however, is much less mature and the question of which real estate products incorporate SI principles needs to be addressed. Looking at the UK market there is no real route for retail or high net worth investors to invest and only a limited market for institutional investors. Institutional investors have the choice of a few pooled fund products which include the igloo (an Aviva Investors Fund), Bridges and Climate Change Capital funds. Companies such as PRUPIM and Hermes have their own internal portfolios which adhere to SI principles, although these are not accessible to outside investors.

¹¹ Eurosif, European SRI Study 2008.

¹² Aviva Investors, Average of Lipper Global Equity Sector Sri funds Vs MSCI world index, 31/7/09 to 30/07/04.

Demand is growing

Demand for SI real estate investment is growing. For example in the UK the West Midlands Pensions Authority (one of the UK's largest pension funds) has allocated part of their portfolio to SI real estate investment. Their main objective is to invest in assets that generate consistent and strong returns that adhere to SI and good governance practices. They are not alone: CalPERS and CalSTRS in the US, the Universities Superannuation Scheme in the UK and VicSuper (an Australian A\$3.3 billion (about US\$2.9 billion) superannuation fund which awarded a direct property investment mandate to a fund manager on the basis of the fund manager's sustainability credentials) take this type of investment seriously and engage positively within a SI framework. Developments to date indicate that there will be increasing demand for SI real estate investment products as investors seek to hold a "future-proofed" real estate portfolio.



Sustainable Investment's importance will increase despite the current economic crises

We currently live in difficult economic times and as a result we need to address the question of whether SI real estate investment is viable or indeed whether it remains on the corporate agendas of trustees, investors and property companies. There are strong reasons to believe that SI investment in real estate is here for the long run. Two principal reasons

are the political and social will to tackle climate change as well as the potential energy crises.

As a result we believe that SI investment is unlikely to be sidelined by short-term economic difficulties. Real estate will remain a prime target for policy action e.g. the UK's carbon disclosure project will increase institutional investors' awareness of their fiduciary responsibilities to address climate change risk in the built environment. There is also pressure on tenants and investors to behave in an environmentally and socially responsible way. This has not diminished in the current economic environment and may have actually increased, for example by increasing pressure on reductions in energy usage. In addition, as governments find that their resources to tackle these issues are finite, they will increasingly look to the private sector for assistance¹³. Therefore there is strong evidence that SI in real estate is here to stay.



¹³ The Death of Social Responsibility in Property is Much Exaggerated, UNEP FI Property Working Group, May 2009.

A fiduciary duty to consider sustainability in real estate portfolios

In conclusion it is without doubt that trustees and investors with interests in real estate have a vested interest in the long-term health of the world and its resources. If SI investment in real estate can deliver equivalent or superior returns or, at the very least, future-proof one's investment, then it is the fiduciary responsibility of trustees and investors to understand the implications of these issues and to seek economic ways to improve the sustainable assets and funds they buy and hold¹⁴. Trustees and investors should seek to divert capital towards investment in sustainable real estate (e.g. through a pooled fund with SI characteristics) and can help set the agenda of long-term sustainable investment. By doing this they will be undertaking their fiduciary duty to protect the long-term financial futures of their members and investors.

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¹⁴ CEO Briefing, What the leaders are doing? UNEP FI Property Working Group, Oct 2007.

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