responsible investor

RI Interview: Paul McNamara, co-chair, UNEP FI Property Working Group

Why sustainability has an impact on real estate value and should play a central role in investment decisions.

by **Martin Hurst** | February 22nd, 2008

Paul McNamara chairs the Institutional Investors Group on Climate Change (property workstream), and is co-chair of the UNEP FI Property Working Group. He is head of property research at Prupim.

Where does the sustainability debate stand at present?

Usually, when I speak on this topic I identify two paradoxes at the heart of the sustainability debate in property. One is that '98% of the debate is about 2% of the problem' by which I mean the focus is overwhelmingly on development but only 2% of the stock is being added to, each year. The industry needs to concern itself with existing stock; new development is the slow lane for property to make an impact. The second paradox is that 'those with the power don't have the knowledge and those with the knowledge don't have the power'. Until now, the investment community has sub-contracted this issue to the technicians in their organisations. Typically, these individuals don't make the major decisions on assets. Therefore, my sights are firmly trained on helping investment fund managers see that it is in their interest and, indeed, understand it as their fiduciary duty to understand this issue and what its likely impacts on value might be.

I am pleased to report that this issue has risen rapidly up both the research and business agenda. In 2003 we began researching the issue of how much is sustainability affecting current value. Around that time we also sponsored a session on 'sustainability' at the European Real Estate Society conference where we told academics that the industry needed them to focus more actively on this area. Sadly, for a variety of reasons, the wider property research community has only recently really started to show significant interest in this area.

Why should sustainability affect value?

Firstly, if tenants, perhaps through their CSR policies, increasingly decide that they want to be seen occupying green buildings, then a differentiation in rental levels will likely develop between green and non-green buildings. Such differences amount to a form of accelerated depreciation for non-green buildings as they gradually become relatively less attractive. Of course, the owners of non-green buildings might inject capital to get them up to the new standard – but that's just depreciation by another name. Either way, from an investment perspective, the owner of the non-green building has seen relatively lower performance. Furthermore, non-green buildings are, by definition, likely to be less efficient and a euro spent on electricity is a euro less the occupier can pay in rent. Energy inefficiency will restrict rental growth in non-green buildings and, thereby, impact value. Similarly, if tenants prefer green over non-green, it may take owners a little longer to re-lease non-green stock and all property investors know that interruptions to cash flow will increase the risk premium on an asset and depress its capital value and, ultimately, its performance. Finally, if investors prefer green buildings over non-green, then the latter will become even more illiquid and demand a higher risk premium than green buildings. As these tenant and investor preferences grow, the more they affect price in the future. Discounted cash flow theory tells you that anything affecting future values should be reflected in current values, albeit at a discounted rate. As such, it is the fiduciary duty of investment managers to understand the implications of the sustainability issue today. A study by Kingston University is still probably the leading attempt to try and quantify these effects. The research, led by Prof. Sayce, estimated that given the changing circumstances for property investments going forward, a non-green building could currently be worth 1-2% per year less than that of an equivalent green building (one case study suggested 7% less). If this was the case then, as the market moved to some new form of 'sustainability-informed equilibrium', this difference in present worth will manifest itself as a difference in performance, as the non-green asset's value falls and the green asset value holds steady. If this took 10 years and, for argument's sake, we said the current difference was 5%, this would generate 0.5% p.a. underperformance for the non-green asset in each of the next 10 years.

In terms of cost-benefit the sustainable real estate argument still seems rather nebulous. How do you see this?

With so much going on in the UK market, it is hard to discern any specific impacts of sustainability on value currently. However, I have heard at least one senior valuer opine publicly that it is there, underneath current market movements. In Australia, where these issues are probably taken more seriously than anywhere else, the evidence is mounting that it is impacting values.
But the valuation issue is an interesting one because, in essence, valuers are 'second phase' players in this game.

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I spoke at the recent Vancouver Valuation Accord conference which looked at how best valuers could respond to the sustainability issue and said that, in essence, it needs investors to incorporate this issue into their estimates of 'worth', which will then affect what they are willing to accept or pay for assets in the marketplace, and it is these offers and bids which will ultimately affect valuations and asset performance.
So, for now, prospective impacts on valuation remain an article of faith but, I have no doubt it will impact values in the future and everything you read suggests sustainability is going to matter a lot.
The interesting thing about real estate in the sustainability debate is that, not only is it a major conduit through which real estate emissions are made but it is also fixed in situ. This means that it is an obvious target for governments and regulators to direct policy at.

SRI has been around for many years in equities. Why has it been slow to take off in property?

Some of the SRI and ethical investment push that we have seen in the equity markets has not translated into the property markets easily because, until recently, property has been seen as a distinct asset class. This is changing partly due to the work some groups like the Institutional Investors Group on Climate Change (IIGCC) are doing to raise consciousness in this area – SRI equity analysts are increasingly asking questions about how companies occupy their properties. They are also increasingly interested in knowing more about institutionally-held investment property portfolios from a sustainability point of view. So, the pressure is coming from all sides.
Furthermore, the recent success of property as an investment class has raised its profile and reminded people of its importance. For example, in Europe, the European Social Investment Forum (EuroSiF) has done a report on real estate. In the US, the Boston College has done a review of sustainability and its implications for all the major asset classes.
So we have a coincidence of two trends – an upwelling of desire to understand sustainability within the property industry and the movement of property to centre stage in the investment world over the last few years.
Consequently, many more are now thinking about sustainability issues and how it will impact property investment.

At the recent European Public Real Estate Association (EPRA) conference there seemed to be little interest in sustainability. Why do you think this is?

My general impression is that the property investment community is in a quandary over sustainability; it wants to help but doesn't know how. Over a 10-year period we have moved from a position where sustainability in property wasn't thought about at all or not believed, through a transition period where people acknowledged the issue of climate change but saw it as a long way off in the future and couldn't

see how they could influence it; now people are starting to realise that the issue and the policy responses to it are going to impact value in the long and short term respectively – but they don't know by how much or what they can do about it. For example, the Investment Property Forum (IPF) sustainability group were holding workshops on this issue in 2004. They were typically attended by 30 – 40 people who were already persuaded by the issues. By contrast, IPF with IIGCC held two similar sessions in 2007 – both were attended by over 100 senior investment professionals. There is a real sea change happening around this issue. The most recent Investment Property Forum (IPF) workshop looked at how sustainability links to fiduciary duty – the usual first barrier put up by investment professionals to doing something in this area. We have to find ways in which social and fiduciary responsibilities can both be honoured together.
For example, if we can show that managing property portfolios responsibly enhances performance then it is the fiduciary responsibility of every fund manager to do so – because it enhances returns. However, if even if one can only demonstrate that there are forms of responsible investment that don't harm performance then, arguably, it becomes the fund manager's moral duty to implement them. The same IPF workshop also looked at how this issue is seeping into the property manager selection process. This will be another major influence and pressure on fund management houses to develop their skills in this area.

What is the level of involvement and understanding of pension funds of sustainable investment?

I would hope that most of the major insurance companies would now be thinking about these matters seriously. In the pension fund industry, USS and Hermes in the UK are notable powerhouses in this area.
The local authority pension funds are also very conscious of these issues and thinking hard about what they can do; fund managers which are well positioned in this area should be a natural ally. Property companies like Land Securities, British Land, Quintain and Hammerson are all very active in this area.

How might there be broader cooperation between industry associations on these issues?

In truth, I think there is a real issue surrounding the proliferation of organisations and consultancies in the sustainability arena – it is daunting and off-putting for any stranger to sustainability to look at the
'alphabet soup' of forums, groups and associations out there. The Green Property Alliance – the green dimension of the UK Property Industry Alliance (PIA) is chaired by PRUPIM managing director, Martin Moore – is a key means by which to bring the industry together on this issue. Four of the big UK trade organisations – Investment Property Forum (IPF), British Property Federation (BPF), Royal Institute of Chartered Surveyors (RICS) and British Council of Offices (BCO) – are all active on sustainability issues. They all have their own particular focus and can articulate different aspects of the green agenda through that. The IPF is interested in how sustainability will impact worth and the value and efficiency of the marketplace; BPF, amongst other things, has an interest in ensuring that related regulation comes forward in a way that is implementable. The BPF have done some terrific work on landlord energy statements and tenant energy records (LES-TER). The RICS is interested in how this fits into valuation, professional conduct and all manner of other areas, and the BCO naturally has a focus on how this affects the occupation and operation of office buildings. Outside the PIA, the British Council of Shopping Centres is also doing major work in this area now. I am also pleased that the academic research community is starting to get more actively involved. The IPF has commissioned Oxford Brookes University to do some work on tenant attitudes to occupying green buildings, specifically whether it's just about corporate image and CSR brochures, or whether it truly influences their decisions on what buildings to occupy.
Kingston University have been similarly commissioned by IPF to look at how sustainability influences landlord-tenant relationships, in particular whether the lease contract could play a role here. The issue of 'green leases' is now coming to the fore and it will be interesting to see if the Green Property Alliance can build links to tenant organizations in this regard.

How far are Europeans involved outside the UK?

If the UNEPFI PWG is anything to go by, there is a very strong interest in this issue in mainland Europe. My co-chair is Blaise Desbordes, of Caisse des Dépôts in France. AXA REIM is also represented on the board, as well as a German property investor. We are still trying to grow membership. We would expect Nordic investors to be very advanced in this area and from southern Europe Sonae are known activists in this area. The Dutch are interesting in that they now manage much of their property through indirect investment. As such, they are probably locking into the debate through their property securities portfolios. PGGM and BNP Paribas are both very active on IIGCC, which is increasingly developing its European profile.

What is your opinion of the commonly held view of the US as a sustainability pariah?

It would be wrong to characterise the US in this way. At corporate, state and metropolitan level; the US is doing a great deal in the sustainability field. For example, both Scott Muldavin of the Green Building Consortium and Gary Pivo from University of Arizona are global figures in this field. Fund-wise, CalPERS is very committed in this area (viz. the Green fund it has set up with Hines). This said, we hosted our recent UNEPFI meeting in New York because we were keen to promote the issue further in the US.

What is the key contribution of UNEPFI to the sustainability debate?

Its main contribution is to maximise the arena to exchange ideas and best practice literally from around the world. The other great benefit is that when UN headed notepaper lands on the desk of a policy-maker or a CEO, it gets noticed! In late 2007, the UNEP FI Property Working Group published a set of examples or ‘briefs’ to show the various ways property investors can ‘do well by doing good’. These covered everything from environmental to more social issues and illustrated social responsibility in its broadest sense.
Martin Hurst is Editor of IPE Real Estate: http://www.ipe.com/realestate/ where this article first appeared.