UNEP Finance Initiative
Innovative financing for sustainability

UNEP

Implementing responsible property investment strategies

The fourth in a series of toolkits produced by the Property Working Group of the United Nations Environment Programme Finance Initiative (UNEP FI)

United Nations Environment Programme

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Message from the PWG

Property investors should mitigate risks to future returns by incorporating sustainability considerations into decisions about acquisitions, management and the sale of real estate. Investors will find numerous opportunities to capitalise on the market shift towards sustainable real estate. Property owners that fail to respond to the challenges posed by environmental, social and ethical criteria may find the viability of their assets being jeopordised.

These are all variations of common phrases that use language which we in the property investment fraternity have become increasingly familiar with in recent times. We recognise that this sentiment is being driven by a number of factors ranging from applied governmental pressures and the corresponding escalation of legislative interventions to the questioning of consumerist attitudes, from progressive corporate cultures to the increasingly frequent physical reminders of the power of natural phenomena. Never before have we had to contemplate so seriously the amount of energy we are consuming, or whether our fuel reserves will deplete, or whether our land will remain dry and capable of supporting life through agriculture or shelter, or how our populations and centres of industry and commerce will migrate, or how our ecology might be threatened.

...The crucial paradigm is one of embedding sustainability into conventional investment practice ... so that informed opinions can be reached and judgements made

What is plainly evident is that these issues will impact on all of our lives and therefore it follows that they must impact on the way we approach business. It will necessarily influence our decisions.

So whilst our earlier toolkits have focussed on the necessary and fundamental building blocks that together form the foundation of a responsible property investment strategy; committing, engaging, measuring and disclosing, this report – the fourth in our toolkit series – looks at how a responsible property investment strategy can be implemented in practical ways across funds and portfolios. From looking at how to establish a rationale for adopting certain measures to setting standards for stock selection, it is clear that the crucial paradigm is one of embedding sustainability into conventional investment practice by considering sustainability issues as risks that need to be researched and analysed so that informed opinions can be reached and judgements made. Crucially, we hope this report signals that sustainability criteria should be considered alongside conventional investment principles.

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Introduction

Responsible Property Investment (RPI) calls for investors to take account of core environmental, social, and governance (ESG) issues in their decision-making processes. As the field has advanced, an increasing number of investors have sought to develop coherent strategies that integrate ESG analysis across the various aspects of their key business practices.

The application of ESG issues to the design and implementation of property investment strategies is complex given the ever-changing kaleidoscope of interests and stakeholders involved at different stages of the life of a real estate asset. Furthermore, in comparison to other asset classes, property investment may involve longer time horizons, more active management of physical assets, or specific exposure to changing regulatory environments, consumer expectations, and physical risks.

In respect of property investment, ESG analysis may help investors to:

- Identify key property investment macro trends resulting from issues such as climate change, resource scarcity, mass urbanization, or changing expectations for corporate roles within society
- Enhance fundamental analysis of asset value and prospective investment performance by capturing efficiency gains from usage of resources
- Mitigate long-term risk to the performance of property assets and businesses through political, reputational, social, and physical actions

This toolkit outlines a set of core issues that property investors may wish to consider when implementing an RPI strategy within their organization, focusing on how an approach and related policy may be translated into practice.

A typical framework for implementing an RPI strategy

- **Building an investment rationale**
- **Integrating ESG into the investment process**
  - Asset allocation
  - Property selection
  - Property management
- **Build RPI capacity**
  - Catalogue potential RPI interventions
  - Carve out a subset of properties for analysis
  - Build RPI toolkits to engage key stakeholders
- **Engage in industry wide standard-setting and best practice setting**

II
Building an investment rationale

The first step in translating a general commitment to RPI into an implementable strategy is to identify the "business case" for adopting specific changes in business practice – the reasons why an activity might increase opportunity or mitigate risk. Investors may wish to undertake a review of the issues they believe material to their organizations in order to better articulate investment propositions that support organizational change.

Toolkit 1, "Committing and Engaging," pointed to a key first step in developing an RPI strategy – the identification of those key RPI issues that are material to an organization's business practice. RPI strategies will naturally differ from organization to organization, because different actors (investor, fund manager, property manager, developer), scale, real estate asset class specialties, commodity costs, regulatory environments, and tenant and community expectations will change the exact nature of how ESG issues affect investment performance.

Such a review may begin by listing a broad range of ESG issues and then identifying which of them has surfaced in internal discussions among business lines or external discussions with stakeholders. Issues may be ranked, for instance, by their immediate effect on income, or their potential to reveal future risks. An example of a ready made listing of issues could be those identified by the Global Reporting Initiative (GRI) – an NGO that develops industry-standard frameworks for corporate social reporting.

Such a process will help tie specific insights on the ESG performance of properties into their direct and indirect effects on asset value. The following table illustrates how this might work:

Climate change

If...	Investment Implications	Underlying effects on responsible property assets
Tenants prefer to occupy green buildings	Rental differentials should emerge between green and non-green buildings	Either rental growth higher or asset depreciation lower
Investors prefer to invest in green buildings	Green properties prove quicker to transact	Green properties are more liquid and should, therefore, attract a lower risk premium
Operating costs are significantly reduced in green buildings	A higher proportion of occupancy cost is allocated to rental	Rental growth should be higher for 'green' buildings
Regulators increase pressure on energy efficiency	Greener assets attract and retain more and better quality tenants	Risk premium is lower than for 'brown' buildings

Urban infill and regeneration

If...	Investment Implications	Underlying effects on responsible property assets
Demographic trends favor urbanization	Higher demand for urban properties	Rental growth, depreciation reduction
Consumer demand favors walkable communities	Premium for mixed-use, transit accessible properties	Rental growth, depreciation reduction.
Support for low- to moderate income exists from public bodies and mission-driven investors	Sources of subsidy for targeted areas, political risk mitigation	Reduced costs of capital for development and acquisition

Clearly, stating investment rationales may allow investors to more clearly articulate investment strategies. It also allows investors to identify analytical models and research needs which test their rationales.

Integrating RPI into the investment process

The real estate investment process is multi-faceted. Multi-asset investors must first decide on the relative place real estate will play in their overall allocations, a process determined by an investor's time horizon, risk and liquidity preference, and future liabilities, in conjunction with tactical market analysis of the relative performance expectations of the various asset classes over a given time frame. Studies by consultants Mercer and the FRR in France have looked at how issues of climate change are likely to impact the long run risk and return profiles of different asset classes, under a range of climate scenarios.

Fonds de Reserve pour les Retraites (FRR) have initiated an in-depth study of how environmental issues can be factored into their investment policy.

Identifying four critical environmental concerns – climate change, fossil fuel depletion, biodiversity loss and water shortage, FRR have constructed a number of scenarios and sought to model their potential economic, global and sectoral impacts across a range of investible asset classes including equities, bonds, commodities and real estate.

The conclusions from such a detailed examination are relatively novel and fragile but crucially will serve to stimulate and inform more rational research and identify justifiable avenues for asset allocation policy.

Within the real estate asset class itself, there are similar strategic allocation decisions made about real estate sub-asset classes (i.e. residential, commercial, retail, industrial), risk/return profiles (i.e. core, value-added, and opportunistic investments) and target geographies. Once allocation decisions are made, investors then decide on properties within those allocations to buy, sell or build, and how to manage the buildings within the portfolio.

Investa Property Group has created a set of Sustainable Responsible Investment (SRI) Guidelines that helps managers integrate such practices into their standard investment platform. The Guidelines look to identify criteria that sit with conventional investment considerations when engaging in key property investment activities such as:

- Selecting properties for acquisition
- Determining the net value that enhancements might add to the underlying asset

The guidelines focus on four key areas with each aspect having a number of statements identifying qualities, actions or standards that help to demonstrate alignment with core SRI principles.

So for example:

- **Labour standards** – how to ensure provision of safe environments in which to work
- **Environmental considerations** – the setting of utility consumption performance standards
- **Social considerations** – accessibility characteristics of assets for disabled persons
- **Ethical considerations** – on avoiding conflicts of interest

The guidelines include a practical methodology for implementation for properties under management as well as indicating how SRI guidelines impact upon retention and realization strategies.

RPI has a role to play at each stage of the real estate investment process. These phases may typically be categorized as follows:

- Strategic/tactical allocation
- Property selection
- Property management

The list is not exhaustive and indeed as a relatively new but expanding field, we may envisage more creative application of ESG analysis as being especially fertile in the years to come.

RPI in strategic/tactical allocation

Incorporating RPI considerations into strategic and tactical allocation decisions involves the application of long- and medium-term trend analysis to asset classes and target geographies. For instance, issues such as climate risk analysis may lead investors to reposition the geographical weight of their portfolios in light of physical risks or potential resource scarcity in specific places. Within asset classes, analyses of demographic or consumer trends which favor denser walkable urban communities may lead investors to invest more in mixed-use and transit-accessible properties in their portfolios.

There are also specific RPI strategies which set clear standards and goals.

RPI as standard setting or "screening"

Some investors may choose to use RPI criteria to set baseline standards or "screens" for buildings they might develop or acquire. In the case of fund managers, setting clear standards can send a signal to asset owners about the nature of the portfolio in question. Clear standards may also help investors develop core in-house strengths in property management and development based on their familiarity with specific RPI issues.

Standard setting for RPI can be compared to similar approaches in public equity investing. Some investors may adopt a "best in class" approach to property selection. This method sets ESG standards by which to evaluate specific sub-sectors of investment, and then limits stock selection to the best performing buildings relative to their peers within those subsectors. For real estate, this would mean defining criteria by which to measure ESG performance for buildings and portfolios, and identifying what level of relative performance – say, the upper quartile of buildings in energy use per occupant – constitutes "best in class".

In the same way that "best in class" equities investment is determined by reference to external assessments of the credentials of companies, green or sustainable buildings can also be identified as being "best in class" though reference to independent third party ratings systems such as the United States Green Building Council's LEED ratings system, the BREEAM system in the United Kingdom, the CASBEE system in Japan, or Australia's Green Building Council`s Star rating system. Third party systems offer the advantage of coherent, comparable ratings, and a pre-existing system for engaging stakeholders on the meaning of ratings.

BNP Paribas Real Estate Investment Services adopts a three-pronged approach within its Implementation Plan for setting standards and screening in connection with its RPI activities.

At **strategic level**, the Executive Board delivers a strategy statement, sets objectives and sets mandates for policy settings.

At a **cross functional business level**, internal processes are set which inform operatives on investment strategies and highlights interventions to be adopted in order to meet strategic objectives.

At **operational level**, fund and asset managers apply sustainability assessment tools to measure, target and respond to sustainability conventions and to diagnose existing assets.

A key design feature of the plan is to provide a recursive system that provides a consistent and coherent methodology for integrating RPI practice into normal investment activity.

Other investors may choose to use absolute performance standards for their portfolios - in other words, adopting screens that mandate a minimum level of performance, or set of characteristics, required of every building in a portfolio. These 'screens' can be social as well as environmental. Workforce housing funds, for instance, may use traditional definitions of workforce housing (for instance, housing affordable to workers earning 80-120% of area median income) to demonstrate their investment approach. Urban regeneration funds may use government-designated target areas to build their pipelines for acquisition and development. In the United States, labor-friendly funds may focus on those opportunities where associated building operations and development personnel engage in collective bargaining.

Absolute performance standards may include third party ratings – targeting only buildings that achieve a certain level of environmental certification or some other conventional performance criteria.

Such standards may be especially relevant for those funds targeting a specific niche of investor, or which work with specific sources of public or mission-driven capital.

In each of these cases, RPI criteria set clear standards that help differentiate entire portfolios. They may aid in communicating value propositions to stakeholders, and in ensuring clarity of purpose in effecting RPI strategies.

RPI in property stock selection

Due diligence in the acquisition and disposition of properties is at the core of real estate investment. Beliefs about the quality of a building and its location, consumer demand, regulatory and political environments in which the building operates, and its price relative to its long-term value all naturally underwrite investment decision-making.

For many investors, RPI is seen as enhancing the existing analysis that customarily lies behind investment decision making. ESG analysis offers an expanded set of tools to measure a building's value, and can play an important role in more fully justifying business decisions. This can mean identifying buildings where changes in operating systems, energy efficiency, tenant engagement, or labor strategies can improve performance.

ESG analysis may also enhance an investor's capacity to see how trends are currently underpriced in the market – climate change, increased urbanization, demographic and consumer preference changes – may increase risk or opportunity in the future. Toolkit 2 offered a sample "sustainability scorecard" to build on traditional property analysis and integrate RPI issues into investment analysis. The information gathered by such a scorecard can lead to specific decisions about whether to acquire or dispose of a property, or identify which properties would benefit from specific RPI interventions.

RPI as an approach may help identify opportunities to improve the environmental and social performance of existing buildings, for example, taking advantage of RPI interventions to improve operational efficiency and tenant satisfaction. In terms of building stock selection, RPI can be applied to underperforming buildings that can be repositioned or otherwise made more valuable through an improvement of their ESG performance.

PRUPIM has developed a mechanism that allows RPI considerations to be evaluated alongside the more traditional factors that have typically driven property investment decisions.

The process provides for a checklist of specific sustainability criteria to be scored, and for the responses to be critically appraised and processed so that the results can be judged, in complementary fashion, alongside other measurements, opinions, and judgements.

The rationale behind this instrument is to provide a platform to reflect on the potential impacts that the sustainability characteristics of an asset may have on a forward looking environmentally and socially aware property landscape, and as such it applies this methodology to both existing held assets and those it considers for acquisition.

Building stock selection, in these cases, may be the specific application of a set of standards to a particular property, or it may be the result of building an expanded toolkit for property analysis.

Climate Change Capital adopts a carbon reduction strategy for its building acquisitions, targeting non-car dependent locations in the UK, and using carbon reduction as a tool for future proofing against regulatory and other risks in looking to improve building performance and value.

Asset management and RPI

A further area for strategic integration for investors is in asset management. Focusing on asset management, and the existing stock of buildings in a portfolio, allows investors to cover the fullest range of investable assets – unlike more "absolutist" standard setting, RPI in asset management does not necessarily limit the range of investable assets, and investors can therefore exploit opportunities across all. Furthermore, if such investors can, often at low to no cost, better future proof their assets then they can stave off the accelerated depreciation and increasing risk premium that will impact unimproved assets.

Learning Links Centers LLC acquires underperforming multi-family properties in disadvantaged areas. The company integrates building rehabilitation strategies with the provision of education centers, staffed by teachers in subsidized units, to improve tenant satisfaction, and to build a sense of community in their properties. The goal is to achieve higher occupancy rates, lower turnover, and enhanced community participation that will instill and maintain a positive environment for the building.

The Jonathan Rose Smart Growth Fund acquires office buildings in transit-oriented locations, and uses environmental performance analysis to determine how best to make the buildings more energy efficient, healthy, and comfortable for tenants, to increase the attractiveness of properties and reduce tenant turnover.

There are also implications for sustainability in asset management strategies. Investors engaging with their properties, leases and tenants also make an immediate and not insignificant contribution to the ESG performance of properties.

A recent **UNEPFI Property Working Group** (2009) report entitled "Owner-Tenant Engagement in Responsible Property Investing" noted that property is unusually rich with respect to engagement in that property investors can engage with:

(a) the physical structure of buildings by carrying out works;

(b) the legal structure of buildings by entering into "green lease" arrangements; and

(c) the tenants of buildings by sharing environmental best practices and other dialogues.

IV

Building Capacity for Strategic Implementation of RPI

Investors can adopt a variety of techniques to improve their RPI asset management and, thus, build the capacity for efficient implementation RPI strategy. These might include:

Creating a catalogue of tailored RPI interventions

One approach would be to create a catalogue of potential activities believed to further RPI strategies. Such a catalogue offers a strategic approach to defining options for action. It may also help investors more rigorously track the success and/or failure of such activities across portfolios, which can then lead to more effective cost/benefit analysis over time.

It should be noted that different interventions may well require different forms of measurements. HVAC system upgrades, or training programmes that encourage energy efficient building management, should yield relatively immediate results for the reduction of operating costs in the near term. Similarly, the value proposition for urban regeneration strategies may offer immediate outcomes in terms of political and community support, or public private partnerships.

On the other hand, community engagement programmes, or formal green building certification of existing buildings, may require a longer period of review to determine whether they increase tenant satisfaction, as might fair labor practices meant to increase worker productivity. Efforts to reduce future regulatory or reputational risk may prove difficult to measure quantitatively.

Nevertheless, a catalogue of interventions can provide a baseline for rigorous review of policies and procedures that put general RPI strategies to the test.

In its RPI report of 2009, **Hermes Real Estate** includes a catalogue of dozens of sustainability strategies, ranging from energy efficient refurbishments to community engagement to sustainable procurement policies. The company then applies an internally developed a Cost Benefit Analysis system to determine which issues are most likely to produce financial value in a given situation.

Carving out a subset of properties for analysis

Another approach is to separate a discreet number of properties from a larger portfolio for intensive analysis. The reduced number of properties will offer investors a clearer view of what information is currently available, how that information can be normalized across different types of properties and different geographies, and what gaps can be filled with new data gathering or information management systems.

The lessons learned in gathering data from this subset of properties can make full-scale information gathering across the portfolio more effective. This approach may be especially effective for large asset owners and managers, and for addressing key RPI issues in resource efficiency – energy and water use, waste management – or human resource management – health and safety issues, worker productivity.

Between 2009 and 2010, **UBS Global Real Estate** ran a pilot project on one of its smaller funds. This pilot portfolio was assessed with a series of sustainability key performance indicators as well as a sustainability rating system that was internally developed covering areas such as flexible use, resource use, health and comfort. After analyzing the collected data and making an adjustment to both systems, three larger portfolios were evaluated. In each case, the inventory of sustainability performance served to set clear targets for improvement in forthcoming years.

Building toolkits for RPI implementation by internal and external stakeholders

Practitioners often point to the difficulties in translating RPI measurement and management systems into terms and techniques that stakeholders less familiar with these issues will understand. Implementing RPI strategies may require a relatively labour-intensive effort to set clear guidelines and build easy to manage tools for property managers and developers, for instance, to report back on their properties.

These toolkits may be supplemented with online or in-person training sessions that help familiarize internal and external stakeholders with their role in gathering and reporting data. The toolkits themselves may be seen as written manifestations of the governance systems meant to drive RPI management processes through organizations. The goal of these governance systems is to define RPI management as part of the normal course of a company's business.

As part of its RPI programme, **Bentall Kennedy** partnered with the US Green Building Council to pursue volume LEED Existing Buildings Operation and Management certifications across more than 5 million square feet of office assets within a portfolio under management.

Bentall Kennedy developed sustainable policies, processes and procedures capable of being scaled up to achieve the necessary pre-requisites and credits for LEED certification. In addition, a comprehensive tracking toolkit was created which, together with technical assistance templates and education and training regimes, was able to facilitate ongoing monitoring and management.

The developed toolkits were able to offer Bentall Kennedy asset management teams an instrument that could act as an engagement tool for third party property managers, engineers, and agents, etc.

Apart from establishing a consistent means by which to track RPI performance within a diverse range of assets in numerous markets, the mechanism also delivered quality assurance and control.

This key RPI intervention has allowed Bentall Kennedy to institutionalize core concepts and measurements across its property investment activities.

V
Collaboration and industry partnerships

As noted before, RPI is a relatively young and dynamic field. Industry standards and best practices are evolving, and many innovations in investment strategy and implementation are the result of formal and informal collaboration among key investors and other stakeholders.

For many investors in the field, RPI itself is a strategy to build corporate reputation, and enhance relations with investment partners, employees, community groups, government bodies, and others. As a result, the role of industry collaboration in RPI is particularly relevant. There are a number of groups facilitating the exchange of information, supporting academic and practitioner research, and building networks of practitioners engaged in the field.

The *Sustainable Investment in Real Estate: Driving Sustainable Financial Value on Real Estate (SIRE)* academic research project offers an example of how institutional investors can cooperate in order to establish some scientific basis for RPI.

The aim of this current empirical study is to identify and quantify a "green alpha" – a systematic over-performance of buildings displaying some RPI criteria – in European commercial property; in other words the measurable impact of environmental criteria on the financial performance of the property assets studied, thereby creating a credible reference for RPI on a purely financial basis, most notably through cash flow growth, reduction in vacancy costs, operating expenses and capital expenditure.

Industry trade associations have taken up sustainability as an important topic, and some have identified responsible property investing in particular as a field worth exploring. Investor networks such as the Investor Network on Climate Risk, or the Institutional Investors Group on Climate Change, and the Investor Group on Climate Change have begun to focus attention on real estate as an asset class.

The result has been a rapid growth in research and information exchange on topics such as the financial value of green building certification, urban regeneration, or access to transit; and an explosion of forums where like-minded practitioners can meet and learn from each other.

The goal of the UNEP FI Property Working Group/UN Principles for Responsible Investment is to facilitate the transition of RPI into real estate investment best practice. The growth of industry collaboration is, from this perspective, a welcome development, and its continuation is vitally important for the growth of the field.

From the investor's perspective, such collaboration ideally will help both develop institutional capacity to develop RPI strategies and translate them into practice, and also to build capacity and spur innovation throughout the industry, so that industry-wide ESG investment performance improves, and the built environment becomes more sustainable in turn.

A 2010 report from the **Institutional Investors Group on Climate Change** entitled "A Climate Impact Reporting Guide for Property Investment Portfolios" outlines a framework for reporting on climate related building portfolio performance between asset managers and asset owners. The report also highlights the potential for institutional investor networks to use their influence to standardize industry-wide environmental reporting metrics that ensure comparability for investor analysis.

About UNEP FI and its Property Working Group

United Nations Environment Programme Finance Initiative

The United Nations Environment Programme Finance Initiative (UNEP FI) is a global partnership between the United Nations Environment Programme and the private financial sector. UNEP FI works closely with the 170 financial institutions that are signatories to the UNEP FI Statements, and a range of partner organisations, to develop and promote linkages between the environment, sustainability and financial performance. Through regional activities, a comprehensive work programme, training activities and research, UNEP FI carries out its mission to identify, promote, and realize the adoption of best environmental and sustainability practice at all levels of financial institution operations.

UNEP FI Property Working Group

The aim of the UNEP FI Property Working Group is to encourage property investment and management practices that achieve the best possible environmental, social and financial results.

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Toolkit 4
Implementing Responsible Property Investment Strategies

This is the fourth in a series of toolkits produced by the United Nations Environment Programme Finance Initiative Property Working Group (UNEP FI PWG).

The first toolkit covered commitment and engagement, whilst metrics for performance management were addressed in the second, and the third focused on disclosure of performance.

Toolkit 1: Committing and Engaging
http://www.unepfi.org/fileadmin/documents/responsible_property_toolkit1.pdf

Toolkit 2: Metrics for Performance Measurement
http://www.unepfi.org/fileadmin/documents/responsible_property_toolkit2.pdf

Toolkit 3: Disclosing Responsible Property Investing Strategies and Performance
http://www.unepfi.org/fileadmin/documents/responsible_property_toolkit3.pdf

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