The sustainable private real estate debt investment opportunity

Martin Wheeler
Managing Director
ICG Real Estate

"Buildings account for 40% of energy consumption and 36% of CO_2 emissions in the EU."

Real estate continues to constitute a meaningful part of many institutional investment portfolios, offering the potential over the long term for attractive, resilient, diversifying, returns, backed by real assets, in particular through inflationary environments such as the one we are experiencing so intensively currently. Collectively the UK Local Government Pension Schemes allocated around 9% to property or pooled investment property vehicles, according to the 2020 Annual Schemes report.

At the same time, real estate's ESG credentials, consistent with all other asset classes, are under intense scrutiny. Buildings account for 40% of energy consumption and 36% of CO_2 emissions in the EU[1]. Decarbonising real estate is an essential part of delivering on the Paris Agreement goal to limit global warming to well below 2˚C and the more ambitious 1.5˚C target, discussed at COP26 in Glasgow last year.

This environmental imperative applies to existing estate as much as new build. Approximately 35% of European building stock is over 50 years old and almost 75% deemed energy inefficient[2]. Building stock refresh rates are low. Estimates suggest that 85% to 95% of the buildings that exist today will still be standing in 2050[3].

Sustainable real estate investing – responding to the policy call to action and an increasingly commercial imperatives

The urgent need for the real estate sector to put its "shoulder to the wheel" on sustainability and enable what might be termed a real estate "Green Transition" has been heard. Key industry players have been galvanised and we are already seeing environmental considerations moving from being a moral to a commercial, market-based imperative for owners, managers and underlying investors.

The evidence for an increasing correlation between environmental enhancement and financial value creation is stacking up across a range of metrics. These include the potential for more sustainable buildings to benefit from increased rents, reduced operating costs and higher occupancy rates. Importantly, investing in environmental enhancements can also reduce environmental regulatory risk. To take one example, only 20% of central London offices are classed as A and B on the EPC rating scale, whilst the majority (57%) fall into the most exposed D to G categories which may, in time, make them unlettable[4].

At ICG, we break down the sustainable real estate investment opportunity into three broad categories: refurbishments, new developments and investments into existing properties meeting high current sustainability thresholds. We see good investment potential and environmental benefits across all three categories, but refurbishments as the place where the greatest environmental gains can be realised. Industry forecasts suggest that it will be necessary to double refurbishment rates in the next 10 years to deliver the required enhanced levels of energy and resource efficiency[5]. Those that fail to refurbish existing building stock in favour of potentially higher shorter-term gains, risk finding themselves with stranded assets – ageing, energy-inefficient buildings that no-one wants, that regulation targets and that ultimately become economically unviable.

It follows that for fiduciaries such as pension trustees, these ongoing value shifts are bringing into sharper focus the debate on the optimal balance between trustee obligations to maximise financial returns as well as explicitly consider ESG factors. This evolving debate is highly nuanced, but market dynamics are increasingly pointing to environmental considerations being intrinsic to valuation, revenue and operational risk and therefore, by extension, intrinsic to financial returns. Put simply, any perceived trade-off is arguably disappearing or has already disappeared. In addition, trustees will be very mindful of increased scrutiny around ESG. A failure to act to improve ESG performance across portfolios, has the potential to increase trustee reputational and accountability risks.

> *"Decarbonising real estate is an essential part of delivering on the Paris Agreement goal to limit global warming to well below 2˚C and the more ambitious 1.5˚C target."*

Sustainable private real estate debt – more secure participation in real estate's "Green Transition"

As well as investing directly in sustainable real estate, there are significant opportunities for pension funds and other investors to participate in sustainable investment through private real estate debt. At ICG, we have been helping investors gain exposure to real estate debt, including whole loans and mezzanine, for over two decades.

The investment proposition for investors in real estate debt funds varies from fund to fund, but should broadly offer the potential for:

- Attractive risk-adjusted returns (with typical returns in the 4% to 10% per annum range, dependent on risk profile)
- Strong capital protection with defensive and predictable quarterly income distributions
- Enhancing overall returns through exposure to upside property performance from back-end fees
- Increasingly, a more explicit participation in real estate's "Green Transition" and an emphasis on measurable environmental impact

Picking up on that last bullet point, debt holders have less direct means to operationalise net zero commitments, given their position in the capital structure, but they are increasingly using innovative green or sustainability-linked financing to incentivise and benefit from more sustainable development and refurbishment by borrowers.

How sustainable private real estate lending works in practice

Investment processes vary from manager to manager, but broadly speaking sustainable private real estate debt investing can be divided into five phases: screening; evaluation and scoring; incentivisation; monitoring; and reporting.

On incentivisation, stepped coupon reductions of, for example, up to 5% of headline return are achievable by borrowers that meet relevant criteria and are linked to specific environmental impact project deliverables.

We firmly believe these incentivised environmental projects can improve overall risk-adjusted returns through enhancing the occupational demand, value and liquidity of the underlying assets held as collateral. Overall, this can have the effect of reducing investment risk by a significantly larger factor than the financial incentive, securing better outcomes over the long term for underlying investors.

On reporting, the transparency that can be delivered to underlying investors on these types of projects, can also help these investors to report tangible, quantified reductions in greenhouse gas emissions and other environmental and social performance metrics to their own underlying beneficiaries on this part of their portfolio. This can enhance their overall portfolio sustainability metrics and evidence trustee and other fiduciary commitment to sustainability.

Allocating capital to sustainable real estate

With significant capital now increasingly being allocated to sustainable investing more generally (and sustainable private real estate debt as a sub-set of that), investors are rightly wary of "greenwashing". Industry standards are evolving rapidly to respond to this concern by helping to provide accepted frameworks for managers to invest, and assurance to underlying investors on authenticity. To take one example, the Green Loan Principles, a set of guidelines formulated by the UK Loan Market Association and related industry peers, clarifies the basis on which UK loans can be classified as “green”.

In addition, expert specialist consultants are being used by managers to provide detailed third party accreditation for manager investment approaches and processes that underpin targeted sustainability outcomes. These include substantial targeted reductions in carbon emissions and lifetime energy consumption. A tangible, beneficial effect of this “market demand for authenticity” is that we are seeing managers who adopt the right approach going significantly beyond current building standards to target and enable more ambitious environmental enhancements.

Adopting these and similar frameworks is also enabling European private real estate debt funds, which meet the criteria to classify as Article 8 SFDR Funds, recognising that these funds “promote environmental or social characteristics”. Some funds (wholly or partially) are able to go further still to meet the more stringent Article 9 requirement of “sustainable investment as a core objective”.

All of these developments are feeding through into investor due diligence checklists on sustainability which now include as standard: regulatory approval for the fund; evidence of a best practice approach tested by third parties; and, importantly, from the manager itself, the right track record, culture and behaviours to support positive change on ESG more broadly. The ESG credibility of managers is as much on the line here as their investment strategies.

The real estate “Green Transition”: a win, win, win opportunity

The current adverse environmental impact ascribed to real estate has a flipside. There is a very significant investable opportunity in real estate private debt to help move the dial on that impact by enabling significant emissions reductions, energy efficiency enhancements and other environmental gains. We see three potential wins at various levels, flowing from this opportunity.

For pension scheme trustees and other investors, we see the potential to generate diversifying, defensive and long-term returns from a familiar asset class in a way that can make a meaningful contribution to the fiduciary’s ESG obligations, strategy and ambitions.

For managers, such as ICG, it is an opportunity for us to step up and make a positive difference, as well as performing for our clients.

Perhaps most fundamentally, participating in the real estate’s “Green Transition” has the potential to do something even bigger by helping to fund a better future for our planet.

1. In focus: Energy efficiency in buildings, European Commission, February 2020, https://ec.europa.eu/info/news/focus-energy-efficiency-buildings-2020-lut-17_en#:~:text=Collectively%2C%20buildings%20in%20the%20EU,%2C%20usage%2C%20renovation%20and%20demolition

2. In focus: Energy efficiency in buildings, European Commission, February 2020, https://ec.europa.eu/info/news/focus-energy-efficiency-buildings-2020-lut-17_en#:~:text=Collectively%2C%20buildings%20in%20the%20EU,%2C%20usage%2C%20renovation%20and%20demolition.

3. European Commission, Renovation Wave August 2021

4. Colliers, https://www.colliers.com/en-gb/news/09-08-21-10-percent-of-london-office-stock-may-become-unusable-in-2023-due-to-low-epc-rating

5. European Commission, Renovation Wave August 2021