Perspectives

CBRE Investment Management

Future-proofing Long Income
for the Sustainable Revolution

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Real Estate Long Income has a track record of providing real estate and fixed income investors with attractive risk-adjusted returns, whilst simultaneously providing inflation hedging characteristics and secure and long (20+ years) cashflow. Future-proofing assets, risks and returns have historically focused upon maintaining certainty of cashflow, and as a result, often asset-level characteristics were overlooked. Furthermore, in most cases, the occupier is responsible for all capital expenditure and maintenance, leading to a need for reduced owner management intensity. Whilst being seen as a benefit, this has historically left investors searching for a satisfactory answer in relation an investors' ability to control and improve Environmental, Social & Governance (ESG) matters. **It is now becoming increasingly clear that without proper attention, non-compliant properties will become stranded when leases expire.** To manage the risk this presents, nimble management as well as access to a deep pool of knowledge and expertise, not just in Long Income, but also in sustainability best practice, are needed.

In a world where a building's impact on the environment and occupier well-being is of utmost importance, ESG-induced obsolescence arguably poses a risk to returns equivalent to or indeed potentially greater than inflation and the investment cycle.

COP 26 in Glasgow has highlighted how dealing with climate change is at the forefront of the political agenda mirroring increasing investor focus in this important area. Meeting the 2015 pledge made by world leaders in Paris to limit global warming to no more than 1.5 degrees Celsius depends on societies, industries and markets embracing change. A major carbon emitter, real estate has a role to play: in the UK, the built environment is responsible for approximately 40% of the country's carbon footprint. With pandemic-induced shutdowns only resulting in an 8-9% reduction in carbon emissions, COVID-19 showed that behaviourial and policy changes are required for meaningful progress to be made if the UK is to meet its 2050 net-zero target.

By definition, the success of all real estate assets depends upon its ability to suit occupiers needs and meet regulatory requirements. In a capital-intensive asset such as real estate, if regulatory and occupier needs are not met, in the context of ESG, this will lead to the increased risk of owners holding assets that are, or will likely be, deemed obsolete.

However, a focus on ESG needn't be just about risk, successful ESG programmes enable the real estate sector to have a positive impact on the environment and occupier well-being. Embracing ESG can also unlock a range of opportunities for participants within the sector:

— **Attract investors:** to combat future risks and recognizing potential opportunities, investors are increasingly targeting strategies which help them to achieve their ESG goals.

— **Attract tenants:** the ability to evidence superior environmental and well-being performance attracts higher quality tenants seeking efficient, healthy buildings for their customers and staff.

— **Optimize building efficiency:** together with potential reductions in carbon footprints, seeking to reduce energy and water consumption will reduce like-for-like costs and improve a building's performance. This is not only pertinent for occupiers, but also for investors with operational exposure to their real estate.

— **Optimize investor returns:** In addition to driving tenant demand, ESG obsolesce, if left unaddressed, will redoubtably impact asset liquidity, which will lead to rapid value reduction on affected assets and result in a two-tier market.

A risk and an opportunity.

ESG-proofing applies to all real estate, but is particularly important for Real Estate Long Income strategies. Conventional real estate strategies often focus upon business plans extending to five years generally with opportunities for the owner to improve the specification of the property.

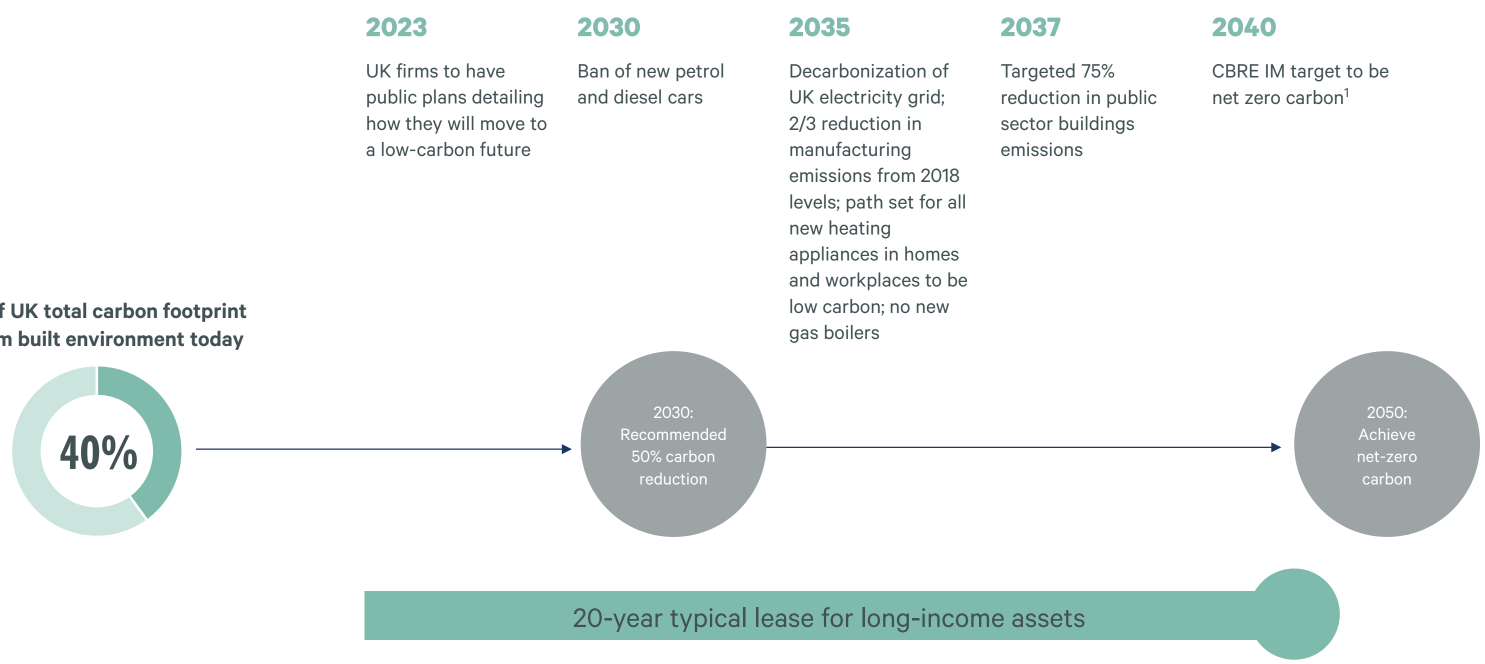
Conversely, investors and managers conducting Long Income strategies have, by design, longer hold periods extending to 15-20 years. Despite this, traditionally, the sector has often been guilty of overlooking the necessity to future-proof assets.

In Real Estate Long Income, the day-to-day operations of the building lie with the occupier, the traditional argument therefore followed that an owner has minimal control and influence to drive forward an ESG strategy. Delivery of ESG initiatives depends largely on the willingness of the occupier to collaborate with the owner, at least until the existing lease expires.

Waiting for leases to expire however is not an option when the average lease length is 20+ years. Existing assets in Long Income portfolios could have leases which are decades old where ESG was not a consideration. Even new assets are not immune, 20 years from now, in 2042, the world will be a very different place.

The key to ongoing investment is the minimization of carbon, improving ESG factors in assets and avoiding a liquidity cliff edge upon lease expiries. To do so, requires a deep understanding of the future trajectory of the regulatory landscape and occupier needs in the context of the strategies time horizons (see **Figure 1**).

Figure 1: Timeline of major UK sustainability milestones over the next 20 years



Source: CBRE Investment Management.

1. CBRE IM commits to achieve net-zero carbon performance in long-term core strategies where we have direct management control by 2040. All sustainability commitments are forward-looking statements that are inherently uncertain and subject to change. There can be no assurance that any initiatives, goals, targets, commitments, intentions, projections or other forward-looking statements herein will ultimately be achieved or that they will be successful. Actual results may vary. The views and intentions of CBRE IM professionals as of November 2021 and is not current as of any later date. CBRE IM reserves the right to change any such views or intentions and will have no obligation to provide notice of any such change.

Staying ahead of the curve.

Identifying the issue is clearly the easy bit. However, to ensure Long Income strategies are, and remain, ESG-aligned requires:

— **Expert Knowledge** – a deep pool of knowledge and expertise in the Long Income space is, on its own, not enough. An understanding of ESG best practice in the real estate sector and a willingness to deploy this both at an asset and a corporate level is a prerequisite for success.

— **Data** – robust data collection via green lease clauses, evaluation and monitoring systems, covering every aspect of a building from energy consumption to waste management, enables remedial action to be taken, supports risk management and potentially generates cost savings.

— **Collaboration** – we all share this planet and the risks of not solving this issue, a Long Income ESG strategy can only be successful if all parties are aligned. Sourcing Long Income investment opportunities often involves structuring tripartite agreements between occupiers and developers/vendors. It is key that during these discussions investors leverage their relationships and understanding of the other parties' needs to design buildings with suitable specifications and agree on leases with appropriate clauses to enable future ESG improvement. *Pre-execution agreement on these points is pivotal in the context of Long Income.*

— **Constant Monitoring** – the regulatory landscape, occupiers' demands/needs, ESG best practice – all are constantly evolving. So too must ESG programmes to ensure they do not fall behind the curve. If properties are no longer fit for purpose an investor should seek to partner with occupiers to improve its credentials or be willing to incur a reduction in valuation due to decreased liquidity.

— **Nimble Management** – identifying trends early, working with occupiers to incorporate green clauses in leases, nimble management allows ESG to be treated as an opportunity rather than a risk.

ESG is not just a risk but an opportunity for Long Income: long-term leases allow the asset class to have a positive impact on the environment and society. But in order to achieve this, an understanding of ESG best practice, not just for today but also for tomorrow, is required, as well as an executable strategy that places ESG at its core. This way investors can stay ahead of the curve and assets/returns can remain future-proofed.

If you would like to discuss the contents of this paper with our Long Income solutions team, or would like more information about sustainable real estate investing, please contact:

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