CREFC Europe

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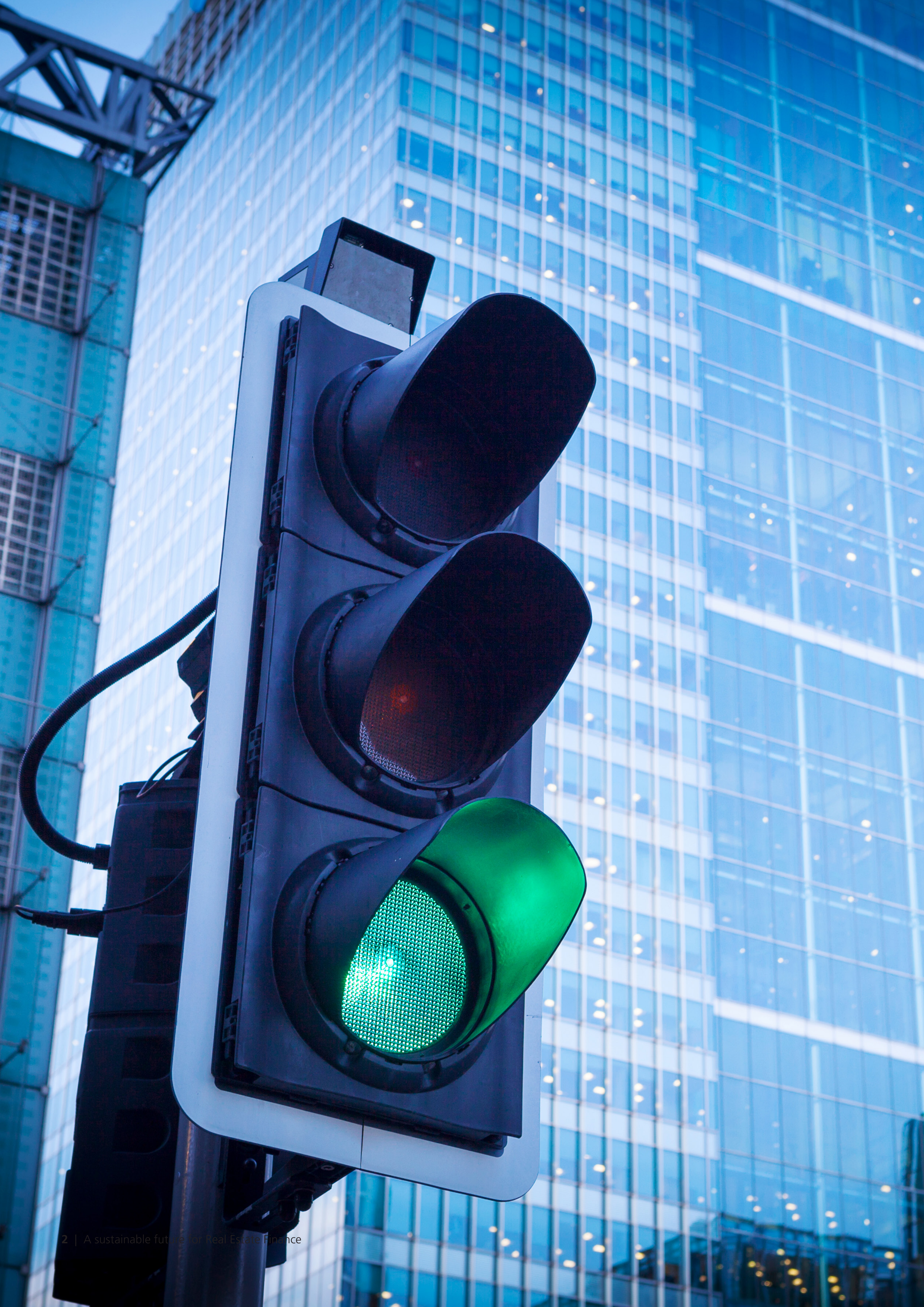
A sustainable future for Real Estate Finance

Sustainable Finance and Responsible Investment

Summer 2020

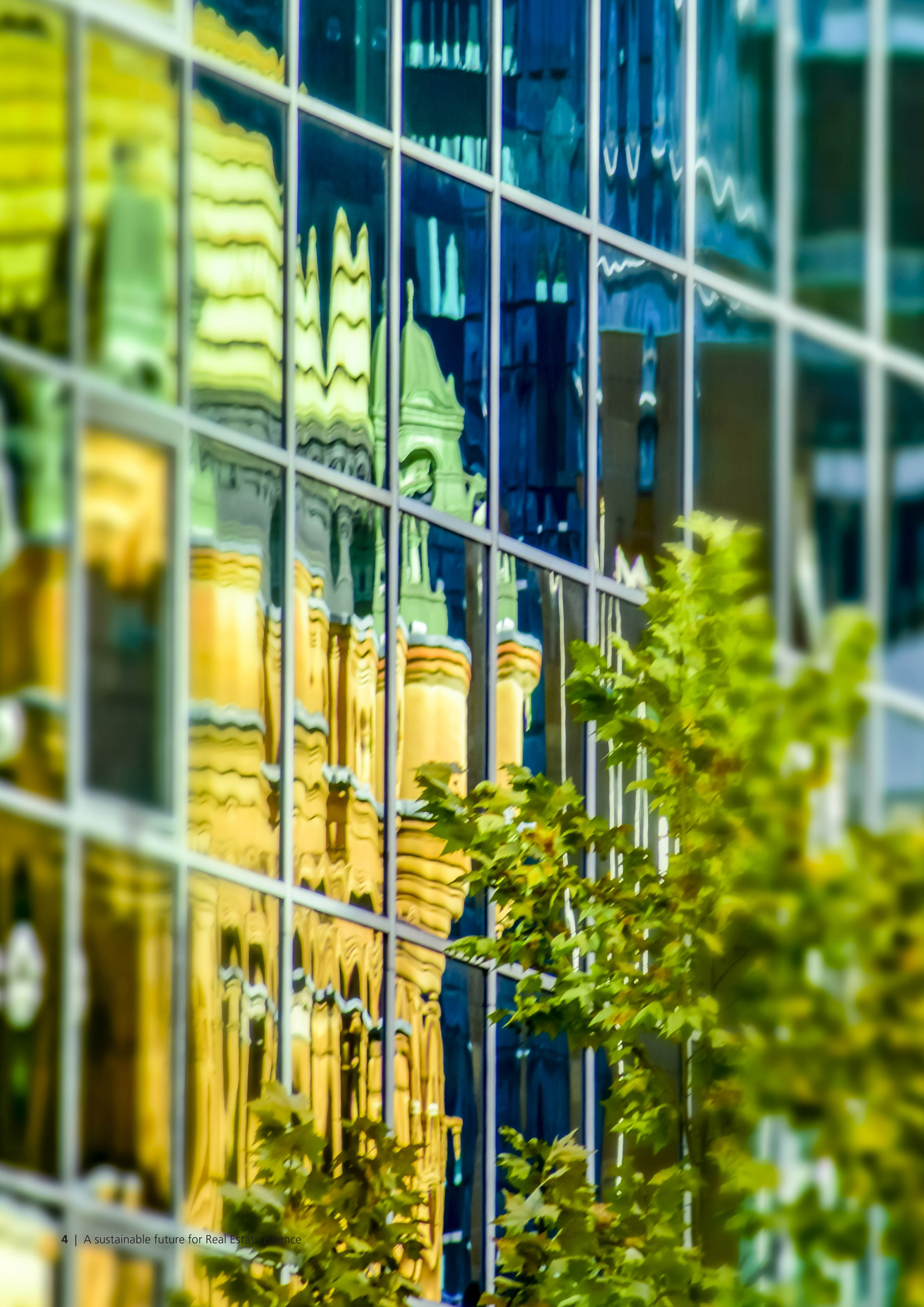


Introduction

Recently, CREFC Europe and CMS brought together real estate finance lenders and property owners from the UK and US, along with the Green Finance Institute, to discuss their experiences and thoughts in relation to Environmental, Social and Governance (**ESG**) matters. Amongst topics discussed were the challenges and opportunities in this area, how ESG has been impacted by Covid-19 and what could be next for the real estate industry.

With increasing regulation and political focus in this area alongside a growing body of global caselaw in support of climate protection, discussion on ESG factors can no longer be ignored as a passing trend. The opportunity to benefit from the rising tide of capital flowing into all things 'green' and growth of sustainable financing and impact investing is further encouraging businesses to review their ESG position and in the area of real estate finance the trend is no different.

A clear conclusion from the meeting was the sense that the momentum behind an ESG focus in commercial real estate is sent to grow, driven both by the requirements for a resilient recovery from the pandemic, and increasingly visible alignment with financial outcomes, as regulatory and tenant demand drivers push in the same direction.



ESG and the investment and lending decision making process

'Green' premium, 'brown' discount

Whilst there is no doubt ESG principles are important and firmly on the board agenda, there is some debate on the manner in which they should be integrated into the investment decision and credit committee process. It also remains to be seen how long it will take for capital to change direction. Obviously no one will make a positive investment decision on a building exclusively because of its environmental rating but equally, negative investment decisions are already being taken against low scoring properties. Whilst some may be sceptical on the moral pronouncements of certain US asset managers these should not detract from the very real factor of transition risk and being left holding stranded assets as investors move elsewhere.

Tenant demand, the growth of sustainable finance and increasing regulation will influence allocation of capital in our space

When attempting to anticipate future influence of sustainability issues on the commercial real estate industry, it is useful to look at three main areas which are already being impacted by ESG. First, there is increasing pressure from tenants who are demanding healthy spaces that they can offer their customers and employees and that is driving the revenue being generated from 'green' buildings. This point is already echoed in the UK. Second, capital markets are similarly responding to investor demand and are keen to offer green financial products further evidenced by the growth in sustainable linked loans (that offer a reduced margin for meeting ESG targets). Third, regulators are becoming more active and examples include New York's recent carbon emissions law that issues fines to property owners that breach certain carbon emission levels. The proposed EU Taxonomy Regulation is another development closer to home that will change the market across Europe.

Importance of having an ESG strategy or policy

Having a clear position on ESG is viewed by some asset managers as almost a licence to operate. The key is then demonstrating how you have integrated ESG factors into your decision-making process and why that is beneficial for the investor. Responsible investing is considered a risk reduction mechanism which in time may drive return but only time will tell.

> Investors are demanding a clear position when it comes to ESG issues and it's no longer a 'nice to have '.
>
> *Market Commentator*

Retrofit schemes, green leases and the role of the GFI

Green residential mortgage finance

The recently established Green Finance Institute (GFI), is a UK government sponsored body that seeks to encourage greater cooperation between the private and public sectors and focuses on 'financing green'. This includes financing the retrofit of UK homes to more energy efficient and climate resilient standards. As part of its initial due diligence process, the GFI wanted to understand the barriers to UK homeowners retrofitting their properties and then find solutions to overcome those issues. Consequently, the GFI has designed a set of financial incentives and some of the following solutions may be relevant to commercial real estate:

— **Green Leases** – the GFI is hoping to develop a Green Lease that would overcome the traditional landlord/tenant split incentive, i.e. where the landlord has no desire to retrofit its building as all the benefits will pass on to the tenant. This standard lease will allow the landlord to benefit from the energy savings and effectively act as a capital repayment for the initial investment. The inspiration has come from the energy alignment clause recently used in New York State leases. The GFI is also exploring the solution that Green Leases can use an additional service charge to recoup costs associated with building an energy efficient property in the 'Build-to-Rent' market. Green leases have been around in the UK real estate market for a while but perhaps this Green Lease 2.0 will be more successful?

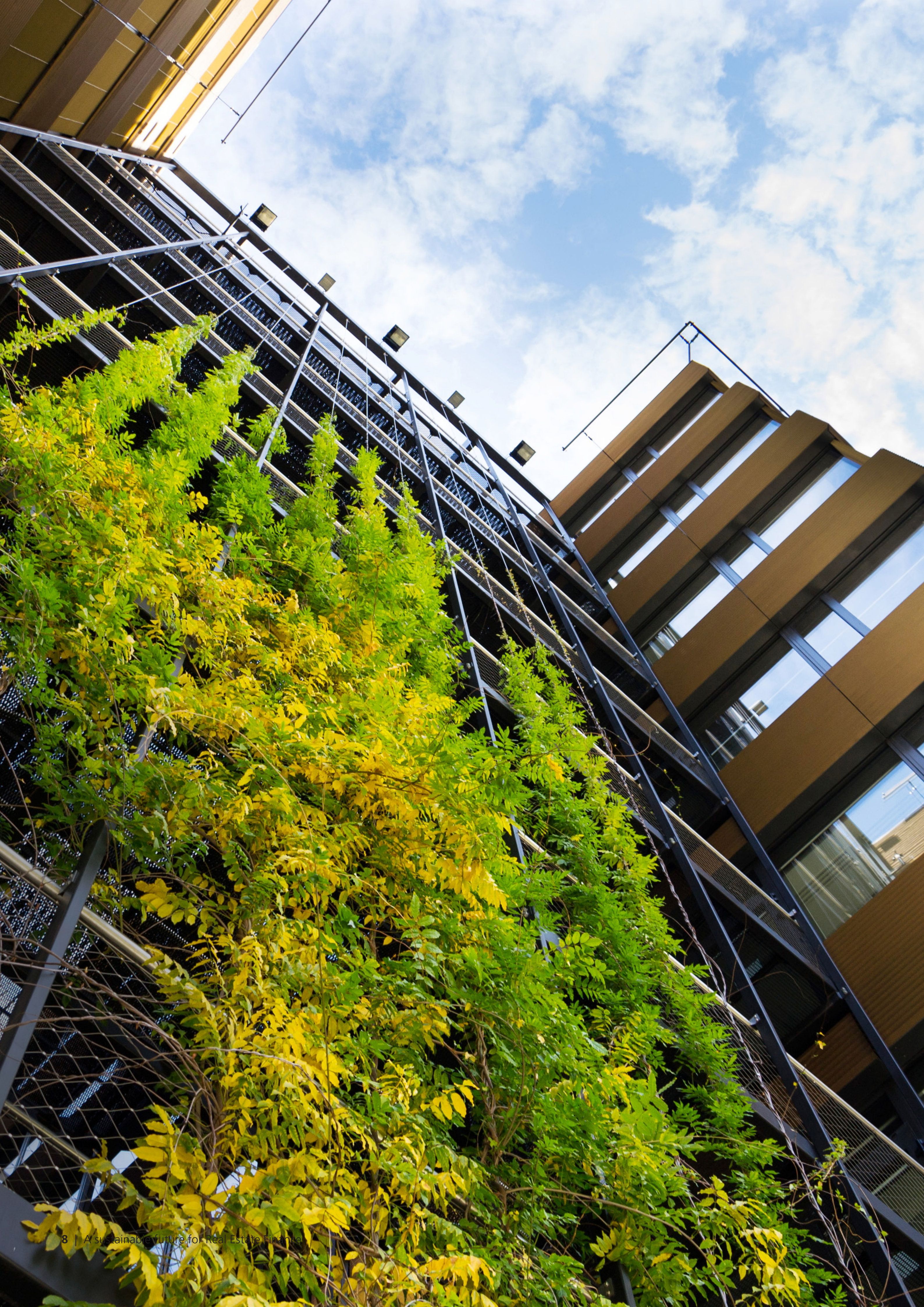
— **Development of Property Assessed Clean Green Financing** – this has already been well established in the US market and has raised over $6bn for retrofitting properties across both residential and commercial properties. These loans are usually backed by the local government by a senior lien over the property with repayments being collected through an additional property tax. Most importantly, when the home changes hands, the debt remains with the property, overcoming the problems faced by those wishing to retrofit properties, namely the payback period (the time it takes to realise any investment). There may be scope for this scheme to be applied in the UK without the loans having to rank in priority to mortgage lenders and so watch this space.

The payback period conundrum

Property owners and asset managers welcome these initiatives, particularly as they seek to address some of the previous challenges of retrofitting properties by ensuring the landlord/tenant relationship is more balanced with the costs (and benefits) being shared in a more appropriate manner. Nonetheless there remains the inherent tension between the continuing trend of tenants wanting shorter leases but having to wait over a longer payback period to see the benefits of any investments. There may be a way to address that payback period issue via service charges.

The huge opportunity of financing retrofit of commercial buildings

Historically for lenders in the commercial sector there has not been a focus on retrofitting as development finance related only to new builds. However, that view is changing and major banking institutions are shifting the focus to retrofitting and how this may be financed. Lenders are supporting their commercial borrowers through the creation of several online tools. These enable clients to input details of their building or portfolio with the tool listing different measures clients can take to improve energy efficiency, whilst also estimating the cost of the changes and the payback period (and ways that banks can help finance 100% of that cost). This was initially rolled out in the Netherlands and has proven to be very popular with similar apps are being rolled out in the UK.



Social and Governance considerations in the property industry

Climate change has its own challenges but one can broadly understand how you measure change when it comes to carbon emissions and related factors. But how do you measure social or 'community' aspects across a portfolio of assets?

Commercial buildings and the community

The UK seems to be trailing the US in the sense of the use of office lobbies as social settings but that feature of community engagement and bringing communities into commercial buildings has stopped in light of Covid-19 and may take some time to recover. However, real estate can contribute to the wellbeing of a local community, for instance, by grouping together buildings and releasing the free space back to local residents. Examples of this are to be found in the redevelopment of Paddington, Kings Cross, the Bloomberg Arcade and the Victoria areas of London and clearly demonstrate the role developers and property owners can play in creating interesting and vibrant social settings. This kind of placemaking is not a new phenomenon, so one could argue about whether it should benefit from ESG brownie points or form the baseline for development and regeneration. When local property owners and the business community come together such as via the 1928 Project in the Paddington Estate to support the key workers at nearby St Mary's Hospital by providing food gift cards it is easy to see the mutual benefits of a positive contribution to the local community. If we see a movement away from skyscrapers to groundscrapers in response to Covid-19 related concerns about elevators, that could create new capacity for more interaction and engagement with the community at street level. The wider debate around reinventing the High Street should also offer opportunities to regenerate local communities.

What about the "G"?

Governance is a separate issue that again is hard to measure but a key feature of ESG considerations. One meeting participant noted they already had signed their business up for the 1% For The Planet initiative, offsetting the fund's carbon footprint. They also separately pay for their employees to engage in charities and social enterprises as part of their daily role. The business is also keen on apprenticeships and building a culture that employees can be proud of. They do not really see this exclusively as an ESG topic but simply something that should be more common practice across the industry. Perhaps less 'greed is good' and more 'green is good'!

On the subject of good governance, participants also reflected on the US concept of B Corporations whereby firms write into their constitution certain principles to ensure they balance profits with responsibilities to their employees, customers and the community. This kind of approach is expected to rise in popularity in years to come.

The future of ESG

A sustainable, resilient recovery?

ESG principles should not be viewed as niche or a separate topic but will simply be how responsible businesses will operate in the future. Provided they continue to provide enhanced returns, greater resilience and reduced risk, market participants will remain happy with the continued momentum of ESG funds and the growth of sustainable financing. Indeed, the capital flow into this area may be seen as helping kick-start a green led recovery with acquisitions of social infrastructure assets recovering quickly and clients wanting to know what green products lenders have to offer as they rebuild their businesses. This financial driver aligned with the importance of the wellbeing of employees and the newly recognised ability to work remotely have been accelerated by Covid-19 and gives the entire sector an opportunity to reflect upon how their businesses operate and how the built environment is likely to develop to meet those needs.

For more information on the latest developments in ESG, as well as on the ongoing commitment CMS has to a more sustainable future, please get in touch with your regular CMS contact and also check out the additional resources available on our Sustainability Insight page on cms.law.

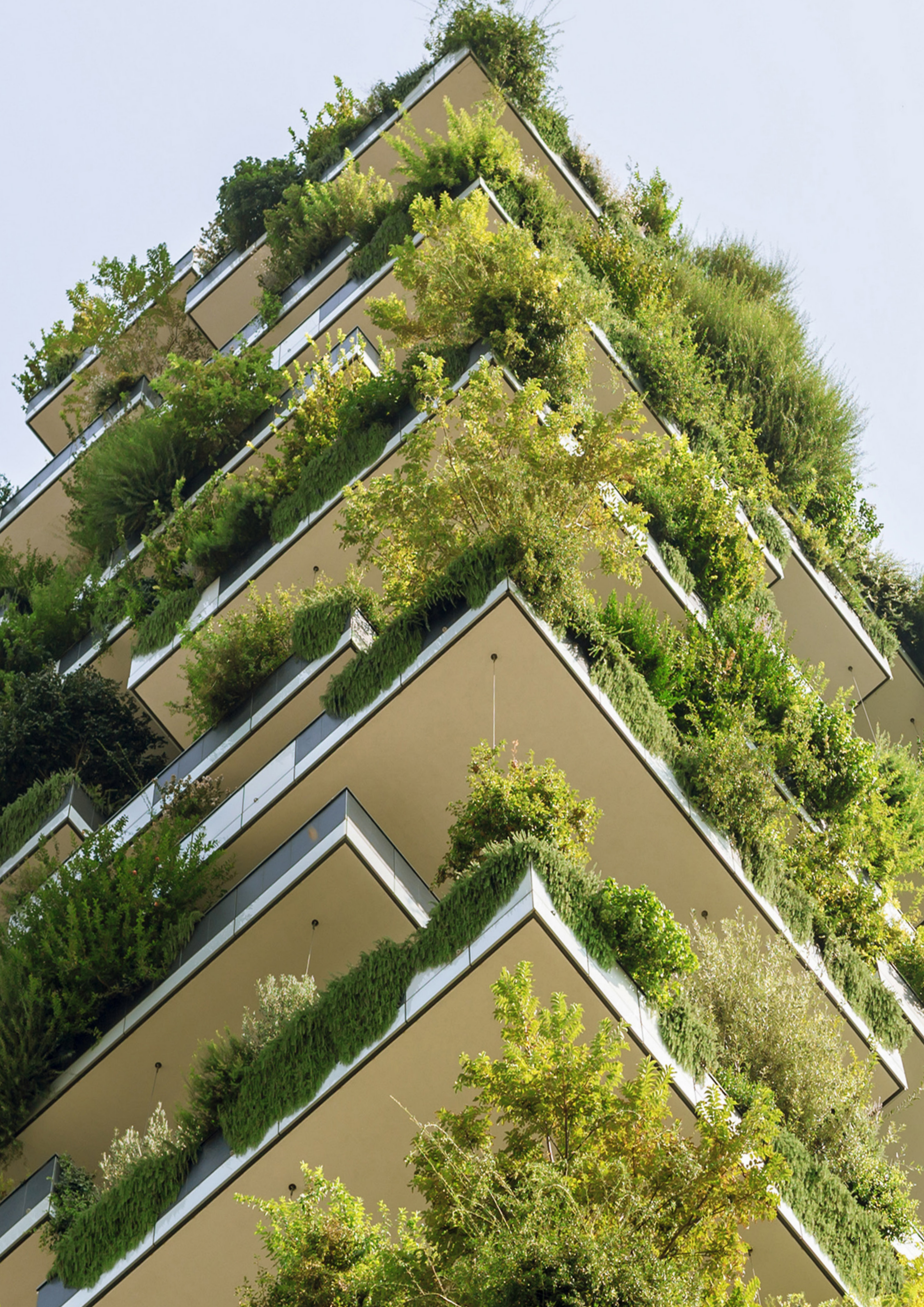
The impact of Covid-19 and the role of policy tools

It is expected Covid-19 will have a positive impact on the ESG debate and bring certain themes to the forefront of companies' considerations especially around health and wellbeing. However, there remains the need for increased central and local government intervention including tax or capital requirement incentives, to improve the returns to developers, investors and debt capital especially if one looks at promoting private investment into the SME sector which arguably needs the most focus to create a real difference in this area. Recent Covid-19 related funding pledges from London, Paris and Berlin are all being linked with a sustainable and green recovery and that could be an important step in this direction.

This roundtable discussion was sponsored by CMS as part of their ongoing ESG program for clients, in collaboration with commercial real estate finance trade association, CREFC Europe. Particular thanks to the following participants, Chris Bennet (Deka Bank), Nisha Raghavan (EQT Partners), John Levy (Franklin Templeton), Aditya Gokal (Great Portland Estates), Emma Harvey (Green Finance Institute), Natalya Tueva (HSBC), Sofya Shuster (ING), Laura McMahon (Lloyds Bank), Sanjay Sethi (Tokoro Capital) and Mike Delaney (CMS).

We attach some links provided by these respective organisations with more details about their ESG policies and related matters:

1. https://www.deka.de/deka-group/sustainability (Deka Bank)
2. https://www.eqtgroup.com/sustainability/ (EQT Partners)
3. https://www.franklintempleton.co.uk/investor/our-company/our-firm/responsible-investing# (Franklin Templeton)
4. https://www.gpe.co.uk/sustainability/ (Great Portland Estates)
5. https://www.greenfinanceinstitute.co.uk .(Green Finance Institute)
6. https://www.business.hsbc.uk/en-gb/corporate/gb/campaign%20sub%20page/energy-sustainability (HSBC)
7. https://www.ing.com/Sustainability.htm (ING)
8. https://resources.lloydsbank.com/insight/sustainability-real-estate-housing/?utm_source=email%20banner&utm_campaign=real_estate_housing_june20&utm_term=sustainability (Lloyds Bank)
9. https://cms.law/en/gbr/insight/sustainability (CMS)



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