

Sharing responsibility - 4 March 2009

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The real estate investment industry seems to be playing catch-up with equity markets when it comes to responsible investing. However, as Paul McNamara explains, it is not feasible to simply take successful approaches developed in one asset class and transfer them to another



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The Property Working Group (PWG) of the United Nations Environment Programme Finance Initiative (UNEPFI) has published a review of the similarities and differences between responsible investment in equities and in direct real estate.

Socially responsible investment (SRI) practices are well established in the equity market and utilise a number of approaches. The PWG has reviewed these various approaches and assessed their transferability to the burgeoning field of responsible property investment (RPI).

Mark Mansley defined responsible investment in 2000 as follows:

“Where social, ethical or environmental (SEE) factors are taken into account in the selection, retention and realisation of investment, and the responsible use of the rights... attached to such investments.” (Socially Responsible Investment: A Guide for Pension Funds.)

responsibly. However, it is equally clear that the rights pertaining to direct property It seems clear from the above definition that – in aspirational and definitional terms at least – property and equity investments can similarly explore ways to invest investments differ markedly from those pertaining to equities and, therefore, what property investors can do to invest responsibly may well differ to what equity investors can do.



FIGURE 1: DIFFERENCE BETWEEN EQUITIES AND REAL ESTATE

Characteristics	Equities	Property
Nature of asset	Single entity – the company	Many entities – the building and the tenant
Relationship with asset	A form of dispersed ownership	Full ownership of asset but with rights of occupation split off for fixed periods of time
Nature of investment returns	A combined flow of income	A combination of all of the above income flows resulting from a sequence of rentals
Differential liquidity and transferability	Liquid and cheap to trade	Harder and expensive to trade
Investable stock	Continuous and continuously	Properties can be managed and improved but are essentially legacy assets reflecting a fixed commitment or vintage

Figure 1 shows some important differences in the nature of property and equity investments that may lead to different approaches to responsible investment in the two asset classes. Of greatest importance is that equity investors, as conjoined owners of companies, possess and can use voting rights in broad proportion to their level of ownership.

By contrast, the property investor flips from having very little control over the use of an asset when it is leased and occupied, to having full control when it is not. As we shall see, this difference significantly influences the nature of RPI and the approaches taken to it.

property rights noted in Figure 1, explore how property investors are able (or In the following section, we review the various approaches equity investors take to invest responsibly. We will then, and in light of the particularities of property and otherwise) to adopt such approaches with respect to direct property.

FIGURE 2: APPROACHES TO SOCIALLY RESPONSIBLE INVESTMENT

Responsible Investment

Figure 2 illustrates there are two main active approaches to responsible investment and two somewhat indirect approaches; SRI equity

investors tend to use a mixture of them all. Engagement is where investors are relatively uninhibited by what they invest in but, having gained rights associated with their investments, such as voting rights, then use them (alongside direct contact) to influence a company to operate more responsibly.

Screening is where investors filter or constrain the investable universe to select investments and bias the constitution of their portfolio towards (positive) or away from (negative) companies deemed acceptable to them or not, however determined.

Best in class allows investors to invest across the various equity sectors but select the companies run most responsibly. Somewhat similarly, enhanced analysis attempts to price the behaviours of companies with respect to environmental, social and governance issues, in the belief that more responsible companies will outperform

Such approaches are deemed responsible since, by directing capital to responsible companies, the others will experience higher costs of capital, underperform and, as a result, change their behaviour.

Given that best in class and enhanced analysis approaches are indirect and largely unaffected by the nature of the underlying assets, they are equally as applicable to property as equities. In what follows, we will concentrate on the more active engagement and screening approaches and assess how to adopt them for responsible direct property investment.

Arguably, the binary nature of property investments means there is scope to engage with both the built structure and the tenant. However, the nature of that engagement is rather dictated by the rhythm of leasing. When the property is unoccupied, the owner has full scope to engage with all aspects of the building within relevant regulatory frameworks. But given that a lease effectively sells occupation rights to a tenant, when the lease is in place it is only the common parts of the built structure that can be engaged with.

Everything else needs to be done through engagement with the tenant. If the tenant is uncooperative, the landlord has only limited influence – there is none of the leverage through voting rights that equity investors possess.

Clearly, if requirements and obligations can be secured at the outset, through some form of green lease, then more can be done. Given the environmental impacts of buildings are more holistically controlled when tenant and landlord co-operate, it is not surprising that the notion of green leases is rising rapidly up the agenda.

FIGURE 3: DIFFERENT FORMS OF ENGAGEMENT WITH BUILT STRUCTURES

	Frequency	Impact per engagement	Tenants	Environmental impact
New development	Rare	Very high	Not (yet) in occupation	Expend embedded energy to contain future emissions
Refurbishment	Low	Potentially high	Unlikely to be in occupation	Expend embedded energy to reduce current emissions
Property and asset management	Very high	Low	Likely to be in occupation	Reduces current emissions

Source: Property

Figure 3 outlines the different forms of direct engagement with a building. It contrasts the significant, yet occasional, contribution that new developments can make to containing future carbon emissions, with the multiplicity (and possibly overall more significant effect) of property management actions taken every day to

contain and reduce current carbon emissions.

First impressions are that there should be substantial scope to screen property investments across a range of property attributes like proximity to public transport, greenness of building and greenness of tenant. However, with the exception of the former, practical difficulties soon emerge.

First, the investable universe of green buildings is currently small, hard to identify and – being focused on office (often let to government) and residential properties – leaves the investor with a relatively unbalanced portfolio. This may improve over time as more information on the greenness

of stock emerges and more green buildings become developed.

Second, notwithstanding the difficulties of defining an acceptable tenant, many practical issues arise for investors seeking to screen by tenant. Owners of un-let properties already have substantial capital invested, so to then be picky about who to let to, especially in secondary assets, could materially impact returns. Similarly, owners of let properties with unacceptable tenants would find it costly and time consuming to either sell the asset or persuade the tenant to move.

Third, even if a green building with a green tenant is found, the process of assignment, which is typically only opposable on financial grounds, might result in a less acceptable tenant taking over the lease.

Fourth, how do such investors deal in multi-let buildings that have only one unacceptable tenant out of dozens? Do they compromise, have a minimum threshold proportion of rents paid? Do they offset through payments to charity or do they reject the asset?

Property and equity investments possess different rights and these dictate the nature of responsible investment in the two asset types. While the level of direct control a property investor has over an un-let building is far greater than anything an equity investor possesses to drive responsible behaviour, that level of control is greatly reduced when the building is let.

Screening seems to have the same – and more – problems in property than is the case in equities. Property investors are, in theory, equally as able to adopt best in class and enhanced analysis as equity investors. Sadly, in practice, they have only a fraction of the amount of data to operate with.

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