Insight | August 2022

Long income, short ESG windows

Matching real estate long income and responsible investing timelines

Luke Layfield

Luke Layfield

Fund Manager

Main responsibilities

Luke manages the LCIV Inflation Plus mandate, a bespoke portfolio of inflation protected cashflows managed on behalf of the London borough pension schemes.

Luke is also co-Fund Manager of the Climate Transition Real Assets Fund which invests sustainably in value-add real estate and infrastructure across the UK and Europe, as well as directly owned forestry in order to achieve net zero by 2040, as well as the REaLM Multi Sector Fund, which provides access to a diversified pool of commercial real estate, ground rents, social housing and renewable infrastructure assets.

Experience and qualifications

Luke joined Aviva Investors in 2008 and previously led the portfolio analysis team, where he was responsible for the financial underwriting of transactions and quantitative portfolio analysis. He has previously worked on the real estate research team and as an analyst for the UK specialist real estate funds.

Luke holds an MSc in Real Estate Investment from Cass Business School and an MA in Politics and Economics from the University of Cambridge. He also holds the Investment Management Certificate and is a CFA® charterholder.

Contents

Introduction

Inflation hedging, stable cashflows and liability-matching are all well-established and recognised characteristics of real estate long income. The combination of these benefits has led to sustained demand by institutional investors for many years.

More recently, environmental, social and governance (ESG) considerations have come to the fore, as investors seek to marry their return aspirations with making a positive difference to economies and societies.

But in a long-income context, this is easier said than done. The objective is to align values, objectives and timeframes within such long-term contracts. The climate crisis and our dwindling window to act serves as a vivid example. We know action is required now, yet many tenant and landlord agreements last ten to 20 years, and sometimes even longer. The same characteristics that have made them attractive to long-term investors pose challenges when dealing with near-term environmental and social concerns.

There are two main ways of thinking about how to affect change: investment and engagement.

> Investors seek to marry their return aspirations with making a positive difference to economies and societies

Investing for change

Let's take investment first.

ESG screening is an obvious, but important hygiene factor. We use a proprietary tool to assess the sustainability risks of new deals by considering the ESG profile of the tenant and the building (for example, exposure to climate transition risk; physical risks such as flooding or contamination; and the corporate social responsibility policy and performance of the tenant).

If any specific aspect, or the overall picture, flags potential ESG risks, the investment is escalated for independent assessment by our Global Responsible Investment team. This tool allows us to measure and score the ESG characteristics of our investments, screen for any ESG concerns and consistently apply our framework across transactions.

We also use green-lease terms for new assets – for example, when we are funding a development or sale and leaseback transaction where a new lease is being created. These seek to factor ESG considerations into the landlord-tenant relationship. This includes a requirement for tenants to carry out any works in a sustainable way and procure green energy where not materially more expensive; an agreement for tenants to share their energy use data so we can assess the asset's performance; and nomination of a named contact to lead on ESG collaboration. The last two are essential for effective ESG engagement across an asset's lifecycle, which is covered in more detail below.

> Green-lease terms seek to factor ESG considerations into the landlord-tenant relationship

It is also important to influence the sustainability and ESG characteristics of new developments we fund, and we have a partnership with specialist sustainable design consultants Buro Happold to deliver this. Our intervention here focuses on doing development more sustainably – ensuring lower embodied carbon through the use of locally sourced and recycled materials – and improving the operational design of the finished product to ensure it has a lower ongoing carbon footprint when in use.

Achieving a positive social impact, through the use of local labour, job creation and skills training, and the payment of a living wage, is also important.

This range of targeted interventions results in an all-round better project outcome, benefitting our investors as well as our developer and occupier partners.

Bournemouth Premier Inn

FOR EXAMPLE, We recently worked with a developer on a Bournemouth Premier Inn that was awarded a Certificate of Excellence in the Considerate Construction scheme. Supporting initiatives included: school visits with pupils designing posters for the site hoardings; a school rock project; and a time capsule cast in concrete to be dug up ten years later.

Our investment involved significant engagement with the local community, using a gatekeeper to facilitate speaking with the public, newsletters and other initiatives to minimise disruption. Eighty per cent of the workforce was local to the site and most of those from further afield stayed in the locality. Graduate and apprenticeship schemes were also heavily promoted.

Engaging for change

Now let's look at engaging with the assets we own.

Making sure commercial buildings are fit for the future, both in terms of environmental footprint and social impact, is an increasingly important factor for landlords. Relationships are critical: managers can achieve ongoing improvements via structured interactions on environmental and social issues with the occupier.

The 'agency' issue is well known in commercial real estate; to decarbonise buildings, both the owner and the occupier need some level of autonomy to make changes. However, both must collaborate to ensure they are implemented safely, practically and with appropriate contractual and legal administration.

> Owners and occupiers need some level of autonomy to make changes

In addition, energy performance data is rarely shared between parties, meaning it is difficult for both parties to know where to start. This creates a significant hurdle to practical decarbonisation projects and is a major cause of inaction on climate in the real estate sector.

Full repairing and insuring (FRI) lease terms mean the tenant is responsible for maintenance of the asset and the landlord's input is limited to approving certain changes. These traditional RELI leases don't place any obligation on tenants to share energy or other ESG data for the asset (which they may not themselves measure closely, if at all). This makes it hard for owners to understand or influence the ESG characteristics of the asset.

To counter this, we initiated a real estate occupier engagement programme which aims to develop relationships with tenants to encourage data sharing and energy saving improvements to the building. Engagement is further incentivised by the fact we will share energy saving advice based on the data provided and then help unlock ideas and capital for energy and cost saving initiatives on their asset. More than half our RELI assets have been covered through this engagement programme to date, with plans to roll it out across the portfolio.

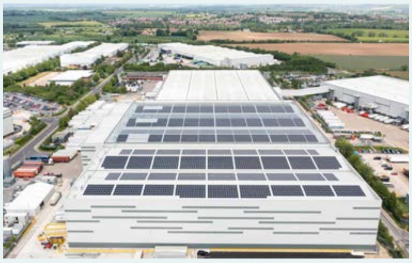
Our real estate occupier engagement programme aims to encourage data sharing and energy saving improvements to the building

Where energy data is not readily available, we can use benchmarks to fill the gap and give a good estimate of the carbon footprint of the assets until that data is obtained. This helps our clients meet their own ESG reporting requirements.

We can also increase transparency by reporting on the climate value-at-risk of assets. This metric quantifies the expected financial impact of climate change on an asset or portfolio over the next 15 years by assessing the likely physical and transitional impacts. By looking at the location of the assets, we can estimate the likely cost of damage due to physical risks such as floods and excessive heat, cold or wind. We can also put a price on the carbon emissions reduction needed to align assets with a net-zero pathway, helping deepen our understanding of the climate risk of our investments with a view to improving them.

As well as data collection, meaningful energy saving improvements are encouraged through engagement, by exploring the tenant's appetite for a range of measures. These can include introducing EV-charging infrastructure or solar panels; replacing gas heating with electric; or less invasive changes such as switching to a green energy tariff or upgrading lighting to LEDs. We then work with the tenant to implement this, including providing funding of the required capital expenditure. We believe these initiatives have the potential benefit of improving the value of our underlying asset and reducing ESG risk, as well as an opportunity to provide an attractive financial return for our investors.

Solar photovoltaic



Next in South Elmsall, West Yorkshire is a good example that illustrates the benefit of working with tenants to deliver ESG improvements to our assets. We funded the installation of a solar photovoltaic (PV) installation at the retailer's distribution centre, producing 1,980 MWh of clean energy and avoiding an estimated 1,027 tonnes of carbon dioxide emissions each year.

As landlord, we footed the upfront capital cost of the installation, which Next will repay through an increased rental payment over time (at a cost below the level of its annual energy savings from the project). This has resulted in a better climate outcome, reducing the carbon intensity of our asset and leading to tangible cost savings for the tenant. It also makes the asset more resilient, as well as providing a tangible return from financing this capital expenditure.

Another strand of our engagement is through our Smart Buildings Programme, where we partner with consultant Carbon Intelligence to assess and optimise the energy use of our buildings. The programme delivered more than £800,000 of savings in 2021, bringing the total savings to £3 million to date.

Ignoring ESG risks is not an option

We are in the midst of the greatest transition humanity has ever faced. And while our approach of engagement seeks to help transition assets, there may be some that carry too much risk from a sustainability perspective. if we are unable to improve them, we will seek to exit before a 'brown discount' crystalises, and the asset becomes stranded.

Ultimately though, asset managers have a fiduciary and ethical duty to engage with all stakeholders on market failures like climate change to ensure clients' capital is safeguarded and used to drive positive change. However, the risks of asset obsolescence and being left behind is very real. Real estate long-income investors who ignore them under the false security of long-term contracts do so at their own peril.

Ten key ways to incorporate ESG in real estate long income

Investments

- ESG screening
- Independent assessment by GRI team
- Green-lease terms
- Influencing ESG characteristics of new projects
- Setting social impact objectives

Engagement

- Close collaboration with tenants
- Occupier engagement programme
- Data collection
- Reporting on climate risk
- Financing capital expenditure for asset improvements

Key risks

Investment risk

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

Return profile

Long-lease assets are expected to be comparatively resilient at stress points, but may lag when traditional real estate markets are booming.

Real estate risk

Where funds are invested in real estate, investors may not be able to redeem any units in the fund when they want because real estate assets may not always be readily saleable. If this is the case, we may defer a request to switch or cash in shares or units.

Valuation risk

Certain assets held in the fund could, by nature, be hard to value or to sell at a desired time or at a price considered to be fair (especially in large quantities), and as a result their prices could be very volatile.

Important Information

279204 - 31/08/2023

Contact us

Aviva Investors
St Helen's, 1 Undershaft
London EC3P 3DQ
+44 (0)20 7809 6000

www.avivainvestors.com