Steering Capital to Build Sustainable Cities for the Future

BY MARTIN BRUEHL, FRICS

Speakers:
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Risk Officer, Pramerica Real Estate Investors

Frank Billand, Ph.D., FRICS, CIO
Member of the Management Board,
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Jeff Jacobson
CEO, LaSalle Investment Management

Robert White, Jr., CRE, FRICS
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About the Author

Martin Bruehl, FRICS, *is a Member of the Management Board at Union Investment Real Estate, a leading institutional manager of open-ended funds in Germany. He heads the international real estate investment business and oversees retail fund management. Martin's professional background is in appraisal and capital markets advisory, and prior to joining Union Investment he has worked for several international consultancy firms. He served as the 2016 President of RICS.*

Other major themes are responsible investment, both sustainable and ethically, as well as the recognition of international standards created in collaboration with other professional bodies around the globe.

As urbanization continues with unprecedented pace, demand for affordable and resilient buildings and infrastructure is growing rapidly. Sustainability is not simply being more environmentally friendly. It is an approach to a number of phenomena with profound implications for land and the built environment. For real estate, being a highly competitive and capital intensive industry, steering capital to build sustainable cities creates significant challenges. Speaking at the Global Cities Symposium at Stanford University, leading investment decision makers of funds totaling $150 billion in assets under management, discussed how cities might attract the long term capital needed to address ongoing environmental, social, and governance ("ESG") issues. Focusing on long term outcomes as opposed to the "feel good," politically expedient, short term results was also discussed. The panel, which I moderated, also featured Philip Barrett, managing director at Pramerica Real Estate Investors and global chief investment risk officer; Dr. Frank Billand, CIO, FRICS, and member of the management board of Union Investment Real Estate: Jeff Jacobson, CEO of LaSalle Investment Management; and Robert White, Jr., CRE, FRICS, founder & president of Real Capital Analytics. This article provides some background to the panel discussion and summarizes its major themes.

SUSTAINABLE GROWTH

As a profession we were challenged last year by leading economist Dr. Larry Summers to do more to drive sustainable growth.

The World Bank is predicting the population will rise by at least 40 percent in 14 of the 20 most populated cities in the world between 2015 and 2030. This figure is staggering. With such accelerating change, cities are taking on ever greater importance. They are our most enduring and stable social structures and have become the world's dominant demographic and economic groupings. The population of the greater Mexico City region is larger than that of Australia. And Super Cities are the destination of over 50 percent of foreign capital invested in the top 30 global cities.

Meeting the needs of new communities is a key challenge facing our profession, and attracting investment is vital to meeting it. This means creating whole cities, not individual homes. We need to ensure sustainability is fully considered across the whole real estate lifecycle.

INVESTMENT DYNAMICS — DENSITY

So how do we attract investment to build sustainable cities for the present and future? The good news is that cities provide attractive investment opportunities. Growing urbanization is positive for investors who look for density in urban spaces, because of the amount of activity you can have in any given area. If you have either a tall building, or one with flexible multi-use space, combined with appeal to high-end potential tenants, the rent is driven up.

Through density, resources can also be used more efficiently. For instance, the sharing economy works best in this scenario: if a central business district (CBD) is walkable, you reduce automobile use. Capital values have also been much stronger in walkable CBDs over the past 10 years than non-walkable ones.

With land in strong demand, adaptive reuse becomes valuable. From renovating brownfield, to reusing and repurposing rather than dumping, land shortages make these approaches worthwhile. Because there is more money available in compact spaces, investors can also afford to put money into innovation in the urban environment.

According to Jeff Jacobson, "If the right environment is available for investors, then billions will be invested into cities without any further subsidies."

Of course, density also comes with its challenges. Larger urban populations put more people in danger in the event of something catastrophic occurring, whether it's man-made or a force of nature. The World Bank has noted that many of the largest cities in the world are located in deltas and are prone to floods and other hazards. As these cities grow, an ever greater number of people and properties are at risk of disaster.

Deteriorating infrastructure is also a threat to these growing communities, as is the increasing gap between rich and poor. All of these problems will be magnified by poor governance.

"WHY DO YOU BUY LAND? BECAUSE THEY'RE NOT MAKING ANY MORE OF IT."

In the simplest terms, investors are evaluated on investment returns relative to the risk taken. So, despite societal pressures to invest more sustainably, investors look to see if it provides attractive risk-adjusted returns.

Very few funds will accept lower returns and higher risk simply to invest more sustainably. This is a particular challenge in today's distorted low interest rate environment that creates a fight for real assets and increasing demand, fueled by multiple geopolitical and economic uncertainties and is compressing returns further and further.

Reviewing the data for capital values and office buildings in the U.S. provided by Jeff Jacobson, three major factors are influencing capital values:

1. Demographics. As emerging economies are urbanizing, in developed countries there is a sea change in how people want to live within their environment. Millennials in general live and work differently than their predecessors. They would rather not be in a car and avoid living in the suburbs. They are willing to give up space to achieve this. This is also happening with aging baby boomers who want to move out of the suburbs and back into the city. Wherever you are in the world, people are moving into cities.
2. Technology. With technology clusters in cities, ecommerce changing retail patterns, workplace connectivity. and globalizing trade, culture and business, more affluent people are being attracted to ever-denser cities.
3. Urbanization. In both emerging and developed economies, urbanization is creating a positive network effect across social and economic vectors.

High demand and shortage of land in dense cities are creating strong incentives for investors to place their money in these centers.

TECHNOLOGY AND FUNCTIONAL OBSOLESCENCE

While technology is an incentive for investors in growing cities, technological change is also increasing the speed of functional obsolescence. Thus, sustainability needs to be considered from the point of view of technology.

A few years ago, people were talking about the death of office and retail space because of advancing technology. But Philip Barrett noted the, "benefit of collaborative use," and the nature of humans as social beings, which has prevented this from occurring.

However, Barrett flagged other disruptive technology that, when it starts, will have a major impact. Technology such as driverless cars has the ability to free up large amounts of real estate, particularly in the U.S. where office buildings have large parking lots attached.

Protecting buildings from functional obsolescence requires two approaches. The first is using land where there is demand and will be for a long time. In the U.S., for instance, we are witnessing the death of the suburban office building. Instead, offices need communities around them.

The second is adaptability, because the technology we use today will be leap-frogged in 10 years or less. We must instead focus on buildings that can adapt to different functions or needs.

SUSTAINABILITY IN INVESTMENT DECISIONS

Currently, for most investors, sustainability is a piece of what they do. They're interested and focused on it, but at the end of the day the priority is investing for clients and getting the risk-adjusted return.

Jacobson noted that he only has one investor who currently prioritizes sustainability objectives even if it means a lower return. Ultimately, the source of capital and time horizon of the investment determines whether one can afford to be sustainable.

For Union Investment Real Estate, the policy to include sustainability criteria in investment decisions began a few years ago. With a plethora of different sustainability ratings globally, they introduced a simple scoring system. Frank Billand explained the buildings are scored on a green/orange/red scale. It must rate in green or only slightly into the orange to commit to invest. The only exception is an older building that can be brought up to standard post-acquisition, through replacing the façade for instance.

But fundamentally, sustainability criteria are important to investors if they're important to their clients. "Real estate is about the income stream," explained Barrett. "… Investing in places where people want to live or work." So, if the clients and tenants see the benefit, so will investment funds.

FROM 'DOING GOOD' TO ECONOMICS

Luckily for this dynamic, more people do want to invest sustainably. The problem, as described by Robert White, is that, "the investment universe of sustainable buildings is still very small." In the U.S. for instance, only 13 percent of commercial buildings are certified as sustainable. In major German cities, this figure is 5.6 percent. Certification tends to come on 'trophy' buildings, on the headquarters of major companies such as the big four audit firms and major law firms, rather than as a general rule.

There's also a big issue with data. With over 200 different certification and rating regimes globally for sustainability, comparability is difficult. On top of this, many of the certified buildings are newly constructed, so it's hard to judge the long term effects over their life-cycle.

Nevertheless, there's a change from investing in sustainable buildings because investors want to "do good," to doing so because of customer supply and demand. It's now starting to make economic sense.

A study of BREEAM certification looked at the effect of sustainability on investments. It found 80 percent had superior risk-adjusted returns and superior stock market performance for the REITs. In 90 percent of cases, sustainable practices led to lower costs of capital and lower default rates for lenders. This is all good news for the business case. The problem is that it's difficult to quantify exactly how much sustainability increases a building's value.

However, this all refers to major capital investment decisions. There are smaller things investors and tenants can do to make buildings more sustainable. As an example, retrofits, such as LED, lighting which provide quick payback. Cooperation from tenants is vital here.

STANDARDIZATION OF CERTIFICATION

At all levels of investment, being able to measure sustainability is important. Real estate has a big challenge ahead with the built environment contributing up to a third of global greenhouse gas emissions. Assets worth U.S. $158 trillion will also be in jeopardy from climate-related disasters by 2050 without preventative action (World Bank 2016) strengthening the business case for energy efficiency measures by building capability among valuers (appraisers) and increasing market confidence in climate change commitments by supporting internationally standardized and vertically integrated measurement and reporting.

These steps will facilitate more consistent measurement of sustainability around the world exemplified by newly developed International Property Measurement Standards (IPMS). By applying these standards, the measurement of carbon emission targets becomes more comparable.

Professional standards give the industry the confidence to commit to sustainability targets. Real estate asset owners, investors and related stakeholders must recognize they have a clear fiduciary duty to understand and actively manage environmental, social, governance and climate-related risks. It needs to become a routine component of business thinking, practices and management processes.

INCREASING SUSTAINABLE INVESTMENT

It's clear that, as an industry, we still have a long way to go to steer capital to build the sustainable cities of the future.

Money will flow to sensible opportunities and environments designed to be economically vibrant. Smart regulation is at the heart of making this a success, but there is too much regulation that creates unintended consequences.

Capital is expensive, and the more time you spend reaching a deal, the harder it gets. As Barrett noted, "time kills deals." By removing roadblocks — this doesn't necessarily mean deregulation — decisions can be made more quickly. This requires better cooperation between local authorities and private capital, working together to create public spaces and infrastructure. Sustainable cities can be built this way.

A vast majority of institutional investors have Corporate Social Responsibility (CSR) policies for investment. The demand is there, but CSR and returns aren't always aligned. When underperforming, it isn't CSR that will save the organization.

OUTPERFORMING ON THE GLOBAL STAGE

So, what do cities need to outperform on the global stage in terms of sustainable investment? Panelists participating in this session agreed on three key elements:

1. Good infrastructure, particularly public transport in all its forms, to encourage more sustainable and affordable travel options.
2. Good planning that is thoughtful but not overly rigid. Again, adaptability is important.
3. Education. Almost all cities have strong relationships with universities to attract knowledge-based workers. But a big Achilles' heel has been the primary and secondary level. Great education at these levels is essential to retaining a skilled population.

The panel also concluded that responsible action in real estate markets needs to become 'business as usual,' helping to drive prosperity, innovation and investment. Bringing sustainability to the forefront is a challenge, especially in times of artificially low interest rates and the consequential global compression of real estate returns, but one that is necessary for the future of the industry and the planet. We can only make this change with creativity and collaboration. ■