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ESG Investment in Uncertain Times

The last few years have been turbulent for the real estate sector. The black swan event of Covid-19 pandemic was followed in quick succession by the Russian invasion of Ukraine, triggering spikes in inflation, supply chain disruption, rising construction costs, interest rate hikes and significant increases in the cost of debt across almost every major market. Amidst the challenges presented by such a market landscape, however, we have seen industry stakeholders continue to voice their ESG ambitions.

What drives investor demand?

For an investment manager, it is critical to respond to investor demand around ESG capabilities and strategies. This, of course, is far easier said than done. The space is still fragmented; on a purely geographic level, there are marked differences between how investors in Europe, Asia Pacific and North America both define and prioritise ESG. Different regulatory regimes on regional and country levels further complicate matters. As such, to effectively raise and deploy capital, investment managers need to ensure that their strategies are tailored to specific markets – there is no "one size fits all" model, especially when it comes to data collection and reporting.

In addition to the considerations above, investment managers must ensure that when they deploy capital in such a way that meets their investors' ESG targets they are also meeting their return requirements. Ultimately, the investment strategies must be both sustainable and profitable, and the increase in both construction and financing costs has made that more difficult.

For European institutional investors, consumer appetite is a key driver of their focus on ESG. The last several years have revealed a clear preference to not only move away from investments in fossil fuels, along with other controversial industries such as defence and tobacco, but toward sustainable, responsible, green and/or ethical investments. (What qualifies as sustainable, responsible, green, or ethical is the next logical question, one to which it is difficult if not impossible to give a definitive answer given the inherent subjectivity of these concepts). As such, pension funds in particular have made concerted efforts to align their investment strategies with the values that their customers have identified as important when evaluating their providers.

This trend is reflected in a recent FTSE Russell survey of institutional asset owners, in which 83% of European participants cited member or client demand as the principal driver behind their initiatives for implementing sustainable investment practices.[10] Avoiding reputational risk and "societal good" were indicated by 37% and 36% of global respondents respectively, with key themes emerging around "brand trust, public relations, and reputation management." Notably, this was the first year in which consumer/member demand has been ranked as the top driver behind incorporating ESG into investment strategies and processes.

[10] FTSE Russell, global survey findings from asset owners, 2023.

Focus on consumer demand for green investments: UK pension system

With a market value of £3 trillion, the UK pensions industry is the second largest in the world and offers the British public an immediate and direct avenue to action their concerns around sustainability.[11] Though 75% of UK consumers have expressed interest in sustainable investment options for their retirement savings, only 10% have fully transitioned to green pensions due to a lack of information and access, presenting pension funds with an obvious opportunity to tap into this demand and differentiate themselves from their competitors.[12]

The prominence of Make My Money Matter (MMMM), a nonprofit organisation established to help consumers make more conscious choices around their finances by increasing transparency into where their banks and pensions invest, further reflects the power of consumer demand and its importance to investors. It is evident that industry participants are indeed responding to this demand, with MMMM's Green Pensions Charter having already been signed by firms such as Tesco, Riverford, Travis Perkins, EY and IKEA.

Sustainable real estate investment is also being driven by demand from occupiers, who show an increasing focus on ensuring that the spaces they lease align with their own sustainability targets around their carbon footprints and their employees' health and well-being. This is particularly important for knowledge- and service-based corporations who require substantial office capacity. For major multinationals, corporate net zero declarations have become the norm rather than the exception (though the time horizon for these commitments spans a significant range).

Sustainable investment in action

What does a simultaneously sustainable and profitable investment strategy look like in practice? The Cromwell capital, research and investment teams are continually working collaboratively to develop products and strategies with three crucial characteristics:

1. They respond to investor demand
2. Leverage macro-level trends
3. Can be effectively executed and scaled

Cromwell has recently brought an SFDR Article 9 fund that invests solely in mass timber assets and a brown-to-green office repositioning initiative to market.

[11] ICAEW, How green are your pension funds?, 2023.
[12] Opinium for Scottish Widows, 2023.

Focus on alternative building materials and carbon footprint: SFDR Article 9 pan-European multisector wooden building strategy

As a building material, cross-laminated timber (CLT) offers myriad benefits over traditional concrete and steel construction. Timber is an inherently sustainable material given that it can be regenerated with responsible forest management. From a carbon standpoint, it is also a circular material. The trees used to manufacture CLT are harvested at age 50, when they have absorbed the maximum amount of carbon possible. Buildings constructed using CLT actually act as carbon sinks, and at the end of the structure's life the wood can be repurposed or recycled to create new products.

As a result, the carbon footprint of a mass timber building is 61% lower than that of a traditional concrete and steel structure when factoring in operational, embodied and sequestered, or stored, carbon. Even when accounting only for embodied carbon, which refers to the emissions produced in the manufacture of building materials and the construction process itself, including processing, transportation, maintenance and disposal, the mass timber carbon footprint is 42% lower.[13] When considering that embodied carbon comprises 28% of overall emissions from real estate, the environmental benefits of investing in mass timber structures are abundantly clear.

There are also social benefits to constructing with CLT: prefabricated timber panels enable shorter construction times that can reduce vehicle movement by up to 60%, minimising disruption to the surrounding communities.[14] In addition, recent studies have shown that biophilic workplace design can increase employee well-being by 13%.[15] Environments featuring timber have specifically been shown to have stress-reducing effects comparable to direct exposure to nature.[16]

Critically, investing in mass timber real estate is also financially attractive and enables investors to tap into a burgeoning market at an early stage. The fact that building sections can be prefabricated off site and the lightweight nature of the material lends itself to larger and less frequent lifts means that timber buildings are typically 25% faster to construct than their concrete equivalents.[17] Along with the shorter construction times, which allows occupiers to start paying rental income earlier, onsite labor costs are significantly lower, further lowering site overheads and financial holding costs.

[13] Buro Happold, Waugh Thistleton Architects, Q1 2023.

[14] Build Off Site, Offsite Construction: Sustainability Characteristics, Q2 2013.

[15] Stora Enso, Building Concepts, Q1 2018.

[16] Fell, DR, Wood in the Human Environment: Restorative Properties of Wood in the Built Indoor Environment. University of British Columbia, 2010.

[17] Think Wood: Four things to know about mass timber, Q1 2022.

Focus on alternative building materials and carbon footprint

Upon the construction and lease-up both being completed, CLT structures continue to provide financial benefits. When prefabricated correctly, timber building sections are highly effective insulators,[18] improving energy efficiency for occupiers and avoiding moisture damage. Perhaps counterintuitively, they are also fire resistant thanks to the inherent qualities of the material – timber burns slowly, at approximately 0.02 inches per minute, with the char that forms on the surface helping to protect and insulate the unburnt timber below, retaining 85-90% of the structural integrity.[19]

One of the clearest financial benefits to investors is

the fact that in the European markets CLT buildings have commanded a 10% rental premium when compared with traditional concrete and steel structures.[20] They are also leased more quickly, a trend that aligns with increasing occupier demand for sustainable spaces that demonstrate commitment to their own ESG targets, including employee well-being.[21]

[18] Vox, Susan Jones, Atelier Jones LLC, Q1 2000.

[19] International Timber, Q1 2022.

[20] Cromwell Property Group internal analysis, 2023.

[21] Gardiner and Theobald, Vasakronan, 2020.

Focus on brown-to-green: UK Regional Office Repositioning Strategy (UKRORS)

Due to recent revaluations and the Covid-19 pandemic fundamentally changing the way people live and work, the office sector is not the darling of commercial real investment the way that it was in 2019. However, in select office markets in Europe, it is an opportune time in the cycle to take advantage of structural change and occupier demand. North American and Australian investors, in particular, have been wary of the sector as a result of their domestic markets continuing to suffer. But for those willing to be first movers back into the space, there are particular niches that offer extremely attractive value add and competitive returns.

The strategy targets standing assets in UK regional markets such as Manchester, Birmingham, Leeds and Bristol, where Grade A+ offices -full service and premium amenity-rich buildings in the most sought-after micro locations - have experienced 20% rental growth since 2020.[22] Because there is less international capital pursuing these regional metropolitan areas, it is possible to acquire the target assets at advantageous prices, invest the CapEx necessary to elevate them to Grade A+ standard (which includes the caliber of ESG credentials increasingly demanded by occupiers), and exit in approximately five years, when core capital is anticipated to return to the office sector.

In the brown-to-green aspect of the repositioning strategy, there are four key criteria:

Energy efficiency

assets will be energy efficient, be free from any fossil fuel-based heating and aim to include onsite renewables where practical.

Net zero targets

finished assets will be capable of being operationally net zero.

Green leases

green leases will be the targeted default to ensure maximum transparency of energy consumption.

Embodied carbon

business plans will be put in place to minimise embodied carbon emissions during the refurbishment through low-carbon construction activities and the usage of raw materials that have low embodied carbon and can be recycled at the end of life.

[22] Colliers, 2023.

How does an investment manager best monitor such an asset to ensure that it truly has gone from brown-to-green?

Although the ESG certifications landscape is still evolving, Cromwell has identified NABERS, BREEAM, EPC, WiredScore and Well/Fitwel as the paradigms best suited to responding to investor and occupier demand in the office sector as per the table below.

Certificates	Target	Minimum
NABERS UK	NABERS Design for Performance Energy Rating at the refurbishment design stage: 5-star rating	NABERS Design for Performance Energy Rating at the refurbishment design stage: 4-star rating
BREEAM	BREEAM Refurbishment and Fit-Out Rating of Outstanding	BREEAM Refurbishment and Fit-Out Rating of Excellent
EPC	EPC A	EPC B
WiredScore	Wired Certified Platinum	Wired Certified Gold
Well/Fitwel	Designed to achieve Well Certified Platinum or 3-star Fitwel Rating	Designed to achieve Well Certified Gold or 2-star Fitwel Rating

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Conclusion

There remains a high degree of uncertainty around ESG as a facet of real estate investment. But this uncertainty does not pertain to its importance: it is abundantly clear that climate change is an imminent and global threat. And given that the industry is responsible for nearly 40% of greenhouse gas emissions, it is critical that the real estate sector addresses and reduces its carbon footprint.[23] (Such a statement, of course, focuses only on the "E"; though this arguably poses the most immediate and highest risk, the criticality of the "S" and "G" should not be downplayed from a sustainability perspective).

Rather, the uncertainty surrounds the operationalisation of ESG. As a still-nascent discipline, there is minimal standardisation around data collection, data analysis, regulation, disclosures, reporting requirements, commercialisation and incentives (financial or otherwise). The fragmented nature of the sector poses a challenge for investors and investment managers when it comes to effectively meeting their legal, moral and fiduciary obligations. But it also presents a vast array of opportunities, and industry managers would be well served to dedicate the necessary resources to innovating within the space.

[23] International Energy Agency, December 2019.