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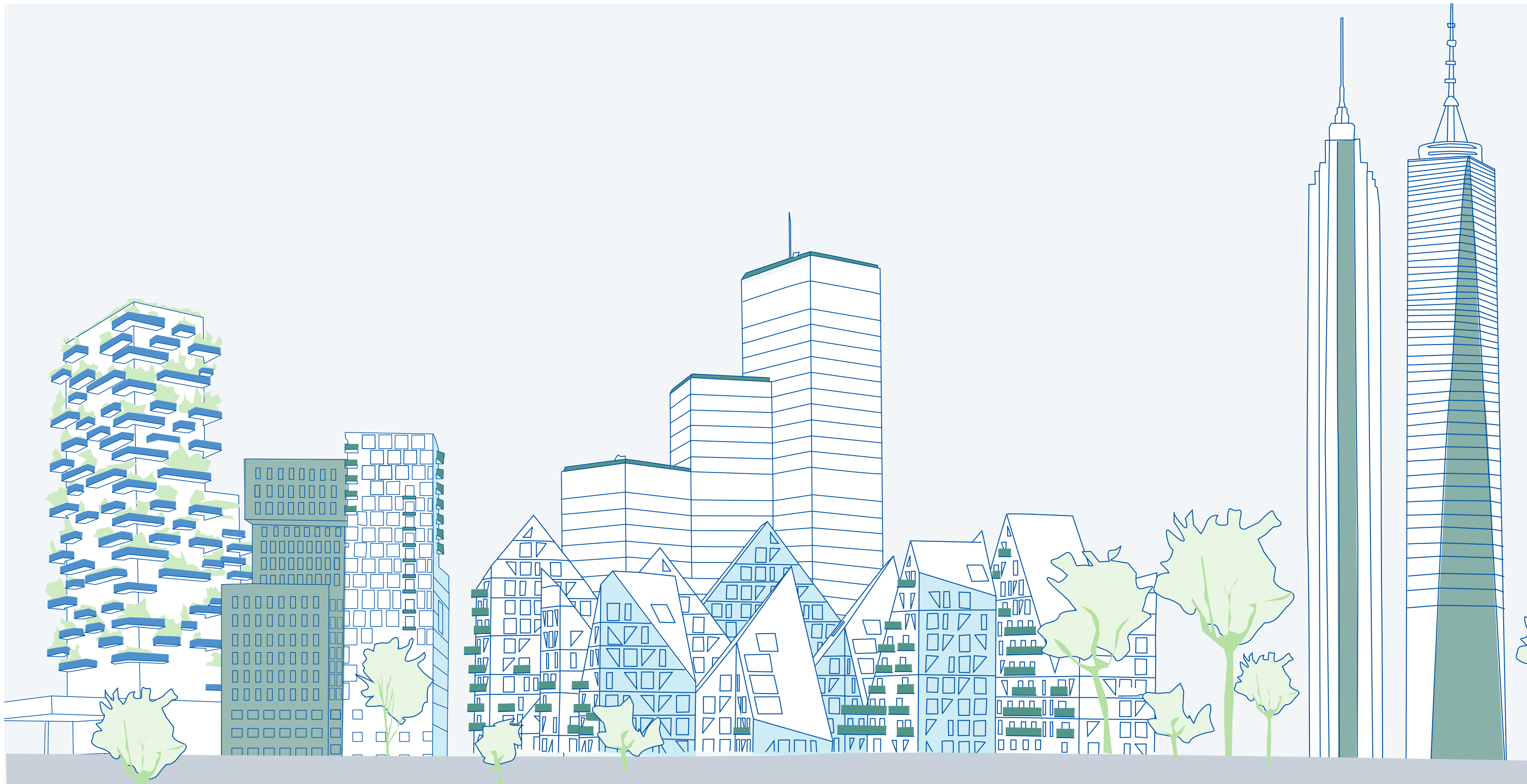

Long-term investment for Europe’s future: The critical role of institutional real estate investing **2020**

Public Affairs

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Our aim is to build a competitive and sustainable asset class for institutional investors by promoting greater transparency, accessibility, professionalism and standards of best practice.

INREV is Europe's leading platform for the sharing and dissemination of knowledge on the non-listed real estate industry.

INREV
ITO Tower, 8th floor
Gustav Mahlerplein 62
1082 MA Amsterdam, The Netherlands
+ 31 (0)20 235 8600 | research@inrev.org | www.inrev.org

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Executive summary

Long-term investment is critical to the European economy and society. Institutional investors such as pension funds and insurance companies are the source of much of the long-term investment in Europe, as they seek out investments that deliver long-term, stable income streams, and thereby enable them to meet their long-term liabilities to pensioners and policy holders.

Real estate makes up an important part of the investment portfolios of almost all institutional investors. Real estate investment, whether made directly by purchasing buildings or indirectly by investing collectively through funds, helps institutional investors meet their obligations. At the same time, it makes a vital contribution to the wider economy, society and the environment.

Long-term real estate investment strategies are distinguished from shorter-term strategies by the underlying investment intentions and by the structure and certainty of returns, for example, asset liability matching. Holding periods are an identifying characteristic and it is noteworthy that real estate holding periods are among the longest of all asset types.

Institutional investors acquire real estate as a financial asset and evaluate its risk characteristics using the same rational approach applied to all other asset classes. Although allocations to real estate have increased over the past decade, at 11.2% they remain a relatively small proportion of total European institutional holdings. However, because real estate can be accessed across the four quadrants of investing, the underlying exposure to real estate is likely to be higher where, for example, private debt or public equity allocations include real estate assets. Indeed, even within allocations to private equity investments there is a blurring of boundaries between asset types.

Institutional investors account for 80% of all long-term investment and they also have a leading role in the commercial real estate investment market. Pension funds and insurance companies are attracted to real estate's diversification benefits, its income generating qualities and its relative risk return profile. Like other asset classes, real estate offers a range of investment styles from low risk (core) to high risk. Institutional investors' long-term real estate holdings are concentrated in core assets, which account for over 80% of their real estate investments. Such assets offer longer-term, fixed and often inflation-hedged income streams that can be matched against future liabilities.

The activity of institutional real estate investors generates benefits for savers and pensioners. However, its secondary contribution to the wider economy, society and environment are arguably of even greater import.

Real estate is a factor of production for commerce and society. To ensure it remains fit for purpose requires the involvement of long-term investors, which are able to anticipate and respond to change. This enhances the productivity of the business and commercial operators that occupy them, making real estate a driver, rather than a drag, on profitability. They also ensure that the right assets are in the right place with appropriate accessibility and that the urban landscape is effectively managed, improving social well-being and quality of life along the way. Long-term institutional investors have spearheaded the United Nations Environment Programme initiative to move toward a more sustainable future over the past fifteen years. The demands of such investors have transformed the built environment and will greatly assist in delivering on the commitments made in the Paris Agreement.

Creating a sustainable future for Europe's urban ecosystems requires a viable economy to be equitable and accessible to the society it serves, and for both to have a positive impact on the environment, in turn improving well-being, society and the economy. Real estate, in tandem with other real assets including infrastructure, is the scaffold for delivering such a sustainable future. These benefits are natural outcomes of long-term real estate investment, particularly when undertaken by institutional investors whose wider remit ensures that universal objectives such as sustainability are intrinsic to their investment intentions. Any activity that has a positive impact on the long-term sustainability of the economy, society and/or environment assists in future proofing institutional interests because they are perpetual.

Section 1

Introduction

Introduction

The World Economic Forum (WEF) defines long-term investing as the ability to invest for an indeterminate holding period.[i] In the stock market, long-term investing is generally accepted as investments held in excess of one year. For real assets, such as real estate, assets held for less than three years would be considered short-term. This is because these assets, which are traded infrequently in comparison to stocks, take longer and cost more to buy and sell.

Given that the ability to invest for an indeterminate period is fundamental to the WEF definition, there are a limited number of investor categories that have the capacity to invest for the long term. These include institutional investors such as pension funds and insurance companies alongside sovereign wealth funds, certain large endowments, foundations and family offices.

Short-term price movements are less important to investors focused on long-term value. Long-term investments are frequently held through a complete business cycle. It is the investor's higher tolerance for illiquidity that is critical, enabling an asset to be held through periods of downward pricing volatility.

Equally, long-term investors have the embedded flexibility to realise gains if market pricing exceeds expectations, with capital reinvested within the asset class to maximise future income returns. It is this agility, rather than holding period alone, that is fundamental to long-term investment strategies.

This paper focuses on the importance of long-term investing to institutional investment and the importance of the real estate activities of long-term institutional investors to the wider economy, society and the environment.

First, it differentiates long-term investment strategies and explains the long-term investment characteristics required by institutional investors. Second, the analysis defines what constitutes investable real estate from the institutional investor perspective and, importantly, its essential role in the risk management of institutional portfolios and, ultimately, to the underlying pensioners and savers they represent. Having established the importance of real estate to institutional investor objectives, this paper discusses the contribution of long-term institutional real estate investment activity to the European economy, society and environment.

[i] WEF (2011) The Future of Long Term Investing, A World Economic Forum report in conjunction with Oliver Wyman

Section 2

What is long-term investing?

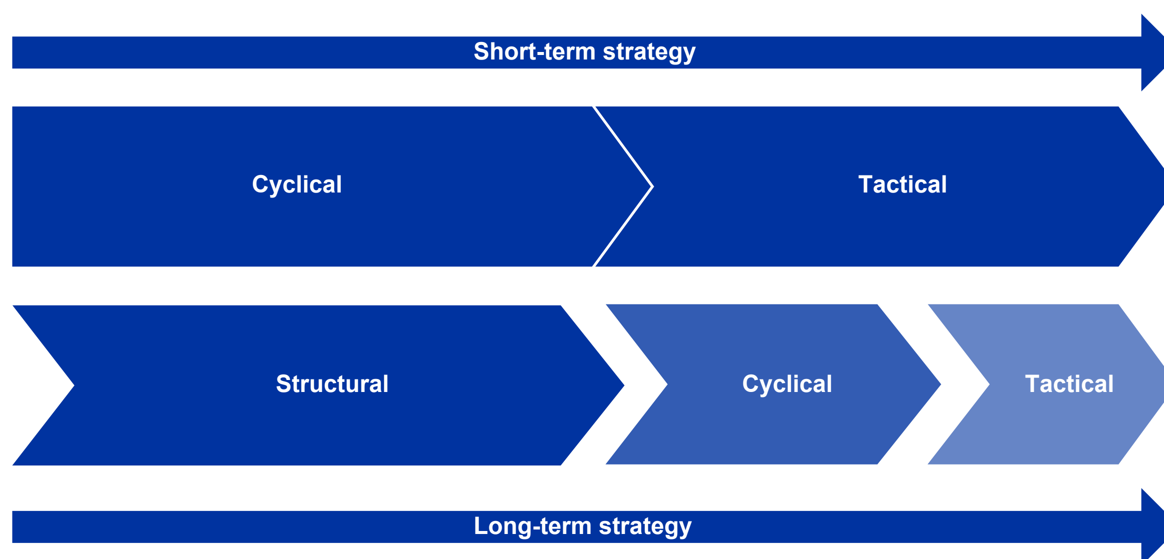
What is long-term investing?

At its simplest, long-term investment is a strategy that looks past the short-term price movements of stocks, bonds and real assets and, instead, anticipates and responds to fundamental changes in the financial markets, the economy and/or society.

Differences in the investment intentions of short- and long-term investors are manifest in different approaches to investment strategy (Figure 1). Being driven by current and expected price movements, short-term investing is driven by cyclical strategies that are adjusted using tactical tilts as expectations shift over the time-limited investment horizon.

This is distinct from long-term strategies that are anchored to the long-term mega-trends driving the economy and society. Through the analysis of structural trends, long-term investors can anticipate change and evaluate its likely impact on the demand for, and use of, real estate by its underlying occupiers. Cyclical pricing remains important as a second stage. It is used as a strategic overlay as long-term investors also have the capacity to be counter-cyclical in their approach to identifying investment opportunities and to managing portfolio risks. Although strategies are long term, regular strategic reviews provide for tactical adjustments to respond to the dynamics of structural, cyclical, legislative and regulatory trends, and expectations within asset management strategies.

Figure 1: Basis of Strategy - Short vs. Longterm



Source: RHL Strategic Solutions

Long-term investment characteristics

Together, pension funds and insurance companies account for an estimated 80% of capital available for long-term investing. These institutional investors have a fiduciary duty to their underlying policy holders that require low-risk strategies linked to the payment of their future liabilities, usually annuities for a duration of between seven to 15 years.[ii] Institutional investors seek to match their assets and liabilities, focusing on income duration and annuities. This is in contrast to endowments/foundations and family offices that can invest for indeterminable periods and focus on total capital. To this end, institutional investors have distinct long-term investment strategies that are manifest in holding periods.

Analysis of insurers' investment portfolios indicates that the average holding period for government bonds, corporate bonds and equities are 4.5, 4.0 and 3.4 years respectively. However, strategic asset allocations and asset plans differ depending on their function in satisfying the specific requirements of the liability portfolio[iii]. Although the European Supervisory Authority EIOPA identifies infrastructure and strategic private equity investments as assets used for insurers' long-term investing, insurers also identify other assets, notably private debt, real estate and private equity (other than strategic participations). The average holding periods for the assets identified as long-term are considerably higher than for the total portfolio, with real estate having the longest average

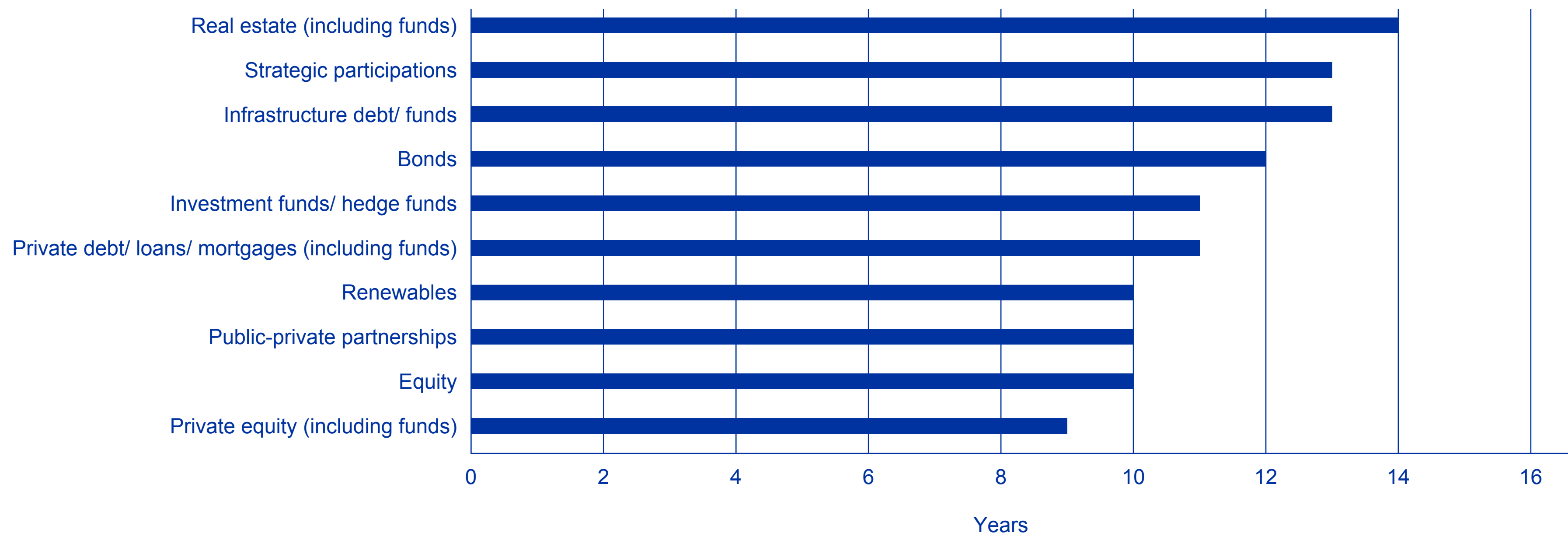
[ii] WEF (2011) The Future of Long-Term Investing, Oliver Wyman; [iii] EIOPA (2019) Report on insurers' asset and liability management in relation to the illiquidity of their liabilities

holding period of 14 years (Figure 2). Real estate does not function as a liquidity buffer within the portfolio and is held through periods of stress; it is held for its diversification benefits and the income annuities it generates by way of rental cashflows (Figures 3 and 4).

However, although holding periods can be an identifier of long-term investment strategies, they are a consequence, rather than a fundamental driver, of what differentiates short- and long-term investment. The investment strategies are more usefully discriminated by the underlying investment intentions both regarding the structure, profile and certainty of returns, their impact on portfolio risk, and their purpose in meeting future liabilities. For example, institutional long-term real estate investments are focused on the purchase of a long-term, certain income stream and sustaining capital value, rather than capital appreciation. The asset class can also offer valuable diversification benefits due to its lower correlation with other financial assets.

Core real estate investing focuses on stabilised income streams which are often structured to offer strong inflation hedging characteristics, with contracted income commonly linked to the consumer price index (CPI) or a similar pricing index. This is especially beneficial for matching investment assets to the institutions' future liabilities to pensioners, savers and other stakeholders. The investment profiles underlying long-term investing strategies contrast starkly with those of shorter-term strategies, which are often weighted towards capital growth, through exploiting more speculative and perceived short-term arbitrage pricing opportunities.

Figure 2: Average holding period



Source: EIOPA (2019) Report on insurers' asset and liability management in relation to the illiquidity of their liabilities

Figure 3: Assets sold after stress

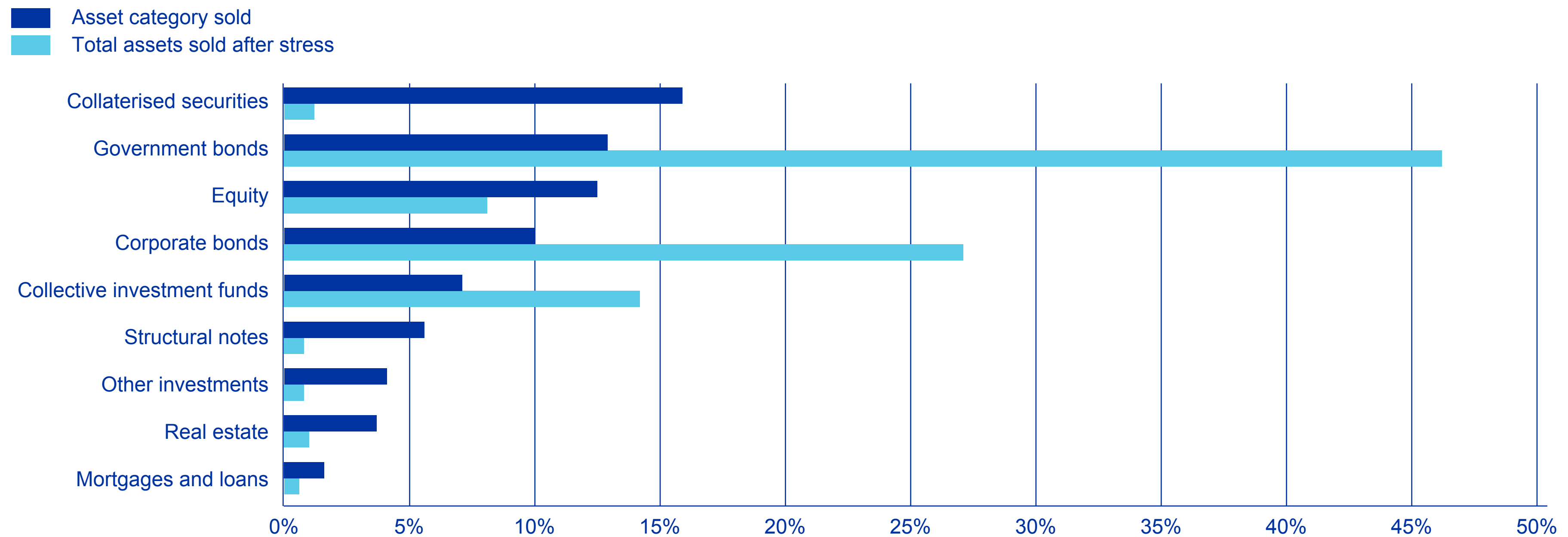
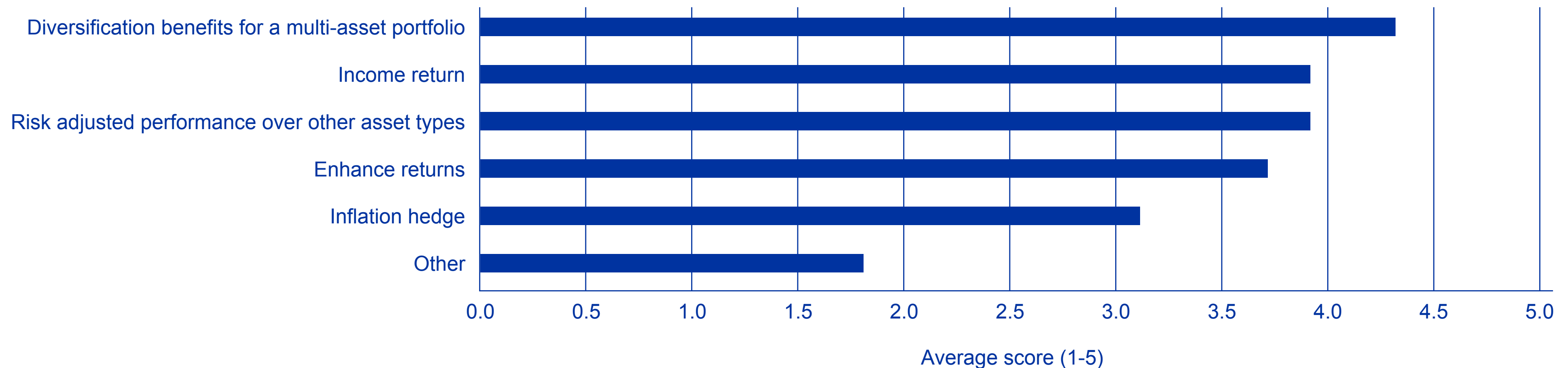


Figure 4: Reasons to invest in real estate (European domicile investors)



Source: EIOPA (2019) Report on insurers' asset and liability management in relation to the illiquidity of their liabilities

Source: INREV (2020) Investment Intentions Survey

Section 3

What is institutional real estate investment?

What is institutional real estate investment?

It is important to establish what constitutes institutional real estate. In short, unlike owner-occupied housing, institutional real estate is acquired as a financial asset, not as a consumer good or personal utility. The institutional real estate market comprises only those assets that are of institutional quality and held in third party ownership. This invested market is made up of commercial real estate in Europe's major cities, including offices, retail and industrial/logistics premises. In addition, residential is an important sector, represented by portfolios of professionally managed private rented sector (PRS) multi-family assets as well as social housing portfolios. The total value of the European commercial real estate market is estimated at €7.1 trillion and an estimated 37% is held as an investment.[iv]

European pension funds and insurers hold 8.1% of this invested market directly, with non-European institutional investors accounting for a further 2.2% (Figure 5). However, such investors also have significant indirect holdings through their investments in both real estate investment trusts (REITs) and non-listed real estate funds, which together represent 48% of the invested market. Indeed, pension funds and insurance companies account for 49% and 21% respectively of the €22.5 billion of capital raised for European-focused non-listed real estate vehicles between the end of 2014 and the end of 2018 (Figure 6). Analysis of investor domicile over the same period suggests that European domiciled institutions account for 45% of this capital.[v]

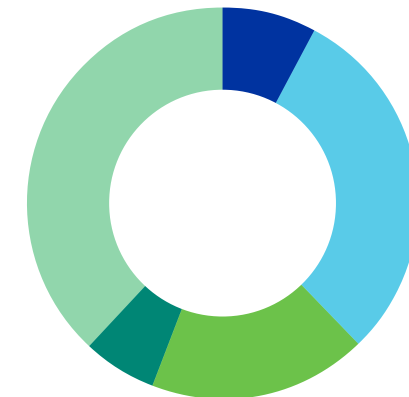
Student housing and senior living are small but fast-growing segments of the market. At €348 billion, total direct and indirect institutional investment in the residential sector is dwarfed by the scale of the wider residential market which, including owner-occupied dwellings, is estimated at €24.5 trillion. However, it represents the third largest sector for institutional investors and represents 17% of European institutional real estate holdings.

Most institutional investors employ a range of investing modes including direct and non-listed products such as non-listed funds, separate accounts, club deals and joint ventures. Their preferred weightings vary across investors, reflecting scale, internal capabilities, differences in favoured real estate investment strategies, and the maturity profile of the institutional capital they are deploying.

The role of investor scale

The scale of large investors affords them a wider range of possible investment modes than their smaller counterparts. However, the choice of mode is also underpinned by their knowledge and expertise of the real estate market. Generally, investments in traditional sectors in domestic markets are primarily direct. For non-domestic investments, all investors continue to make allocations across the range of non-listed real estate vehicles. The extent to which they employ any particular product type varies according

Figure 5: Ownership of invested commercial real estate



Source: EPRA/ INREV (2017) Real Estate and the Real Economy

to their wider business strategy, investment strategy and the underlying real estate opportunity.

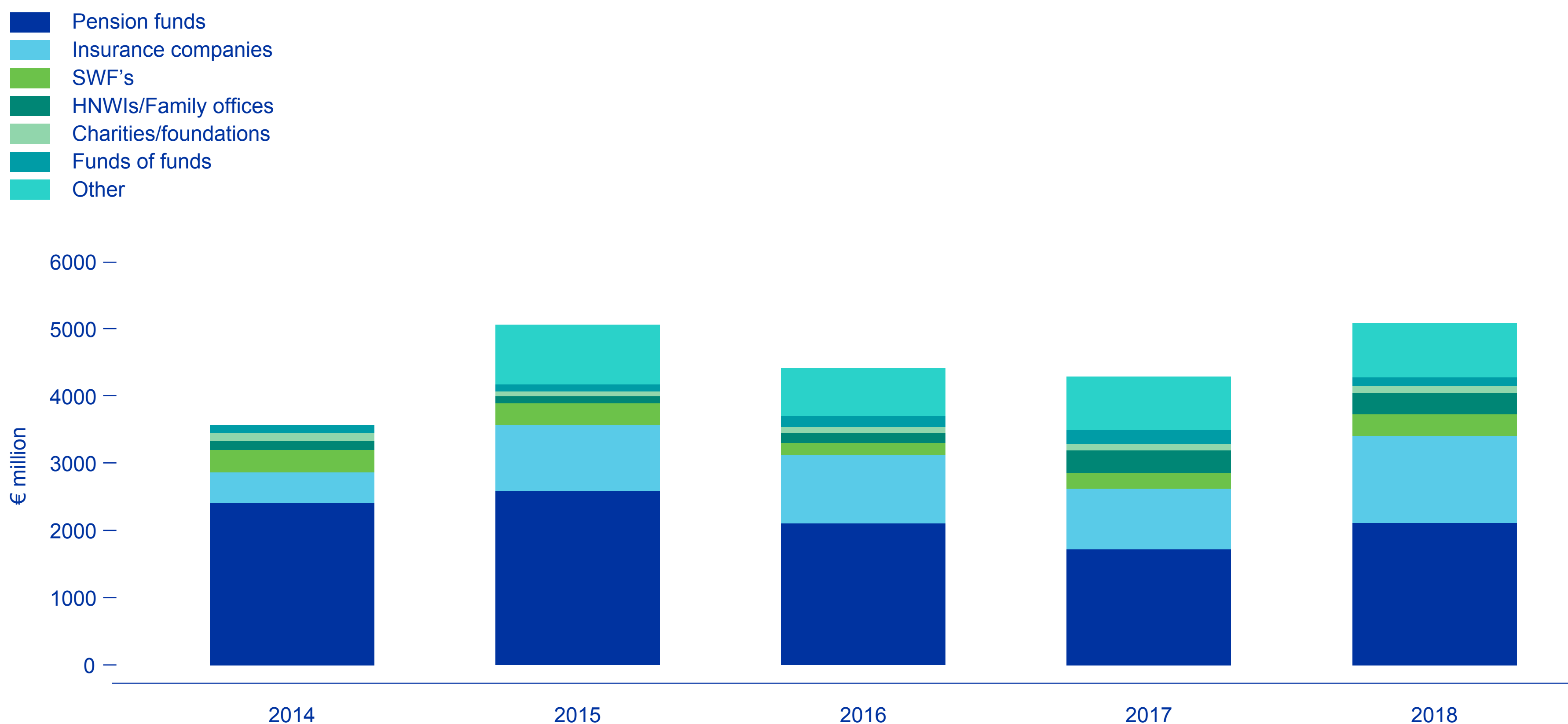
Smaller and less experienced institutional investors are able to access the returns and diversification benefits that real estate offers through open end and closed end non-listed

[iv] EPRA/INREV (2018) Real Estate in the Real Economy; [v] INREV (2019) Capital Raising Survey

funds. Smaller pension funds lack the scale of capital required to develop well-diversified proprietary real estate portfolios and are unlikely to have the necessary internal expertise and resources for effective real estate asset management. Non-listed funds are essential to extending the opportunity to benefit from long-term real estate investment to such institutions and to the pensioners and savers they represent.

In particular, open end, diversified, core equity (ODCE) funds offer such investors flexibility in the timing and duration of their investments. The scale of these funds in Europe has increased significantly post-crisis, partly as a result of merger and acquisition activity within the industry. The size of the largest ODCE fund in the INREV Index has grown from € 2.4 billion in 2008 to € 7.2 billion in 2019. This scale delivers high diversification benefits and improved liquidity, with investors able to trade in and out more easily, without any significant impact on pricing. Indeed, the significance of these funds is reflected in INREV's current development of a European ODCE index. These European funds are still dwarfed in comparison to the size of their US ODCE fund counterparts, but as they continue to grow, investors consider them to offer some of their attributes.

Figure 6: Capital raised for non listed real estate equity vehicles (European strategy) 2014 to 2018



Source: INREV Coming of Age: the rebirth and renewal of the non-listed real estate industry

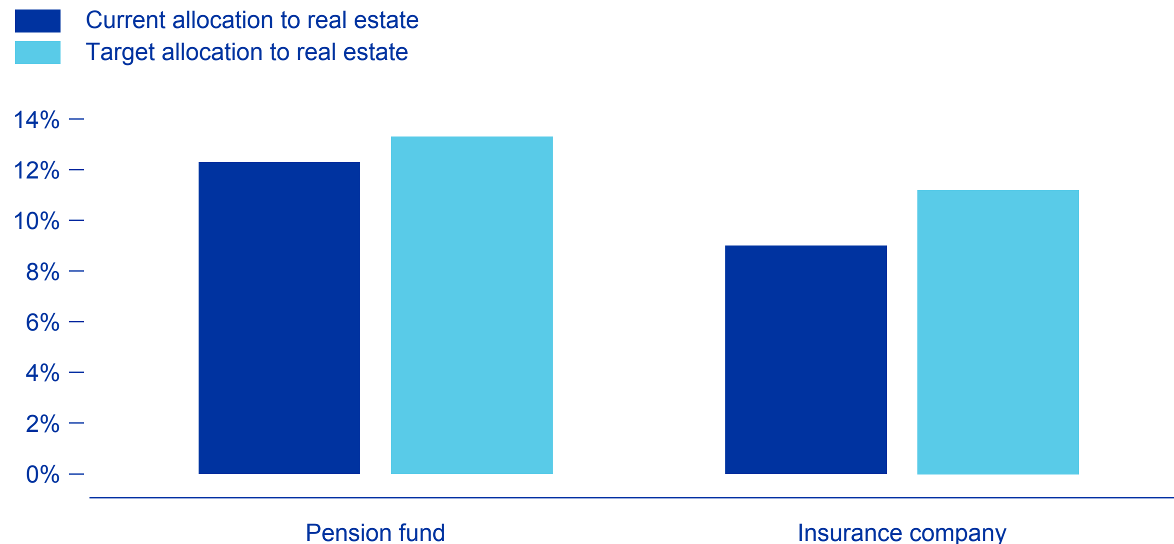
Institutional real estate investment employs the same rational approach to investment decisions that are used across all other financial asset classes. Its financial attributes are analysed using the same metrics — net income yield, equivalent yield, income growth, capital growth, internal rate of return (IRR) and total return. Indeed, how these metrics compare on a risk-adjusted return basis as well as their temporal movements underpins asset allocation decision-making. They are also a principal driver of strategic asset allocation across sectors within the asset class and for stock/asset selection.

Four quadrants of institutional real estate investment

Within institutional portfolios allocations, real estate is usually considered either as a stand-alone asset class, or as part of the allocation to real assets, private markets or alternatives (which also includes hedge funds, private equity and infrastructure). In this context, 'real estate' often represents a silo of private investment in standing — existing and income producing — real estate equity investments.

A survey of the investment universe of 102 long-term investors revealed that allocations to the sector have grown sharply from an average of 8.1% in 2012 to 11.2% at the end of 2018. This upward trend is continuing.[vi] Current allocations to real estate assets represent a relatively small proportion of European institutional investors' holdings.

Figure 7: European institutional investors allocation to real estate by AUM



Source: INREV Investment Intentions Database (2020)

Target allocations for pension funds (13.3%) and insurance companies (11.2%) indicate a moderate increase from current allocations by assets under management (12.3% and 9.0% respectively) (Figure 7).[vii]

However, investments in real estate occur more broadly across the four quadrants of investment: private equity, public equity, private debt, and public debt. Such investments are often considered to form part of the allocation to both fixed income and equities, as well as being contained within other asset allocations comprising alternatives, for example private equity or social infrastructure.

To some extent, this reflects the relatively recent ability to access real estate investments across the four quadrants. For example, the provision of real estate debt in Europe was highly concentrated in the banking sector prior to the global financial crisis. The scarcity and high cost of real estate lending immediately post-crisis created an opportunity for new sources of capital to enter the market. This was sustained by the cost of capital weightings in Basel III and IV, which narrowed the focus of bank lending.

Underpinned by institutional investor demand for the attractive risk-return characteristics that the provision of private real estate debt

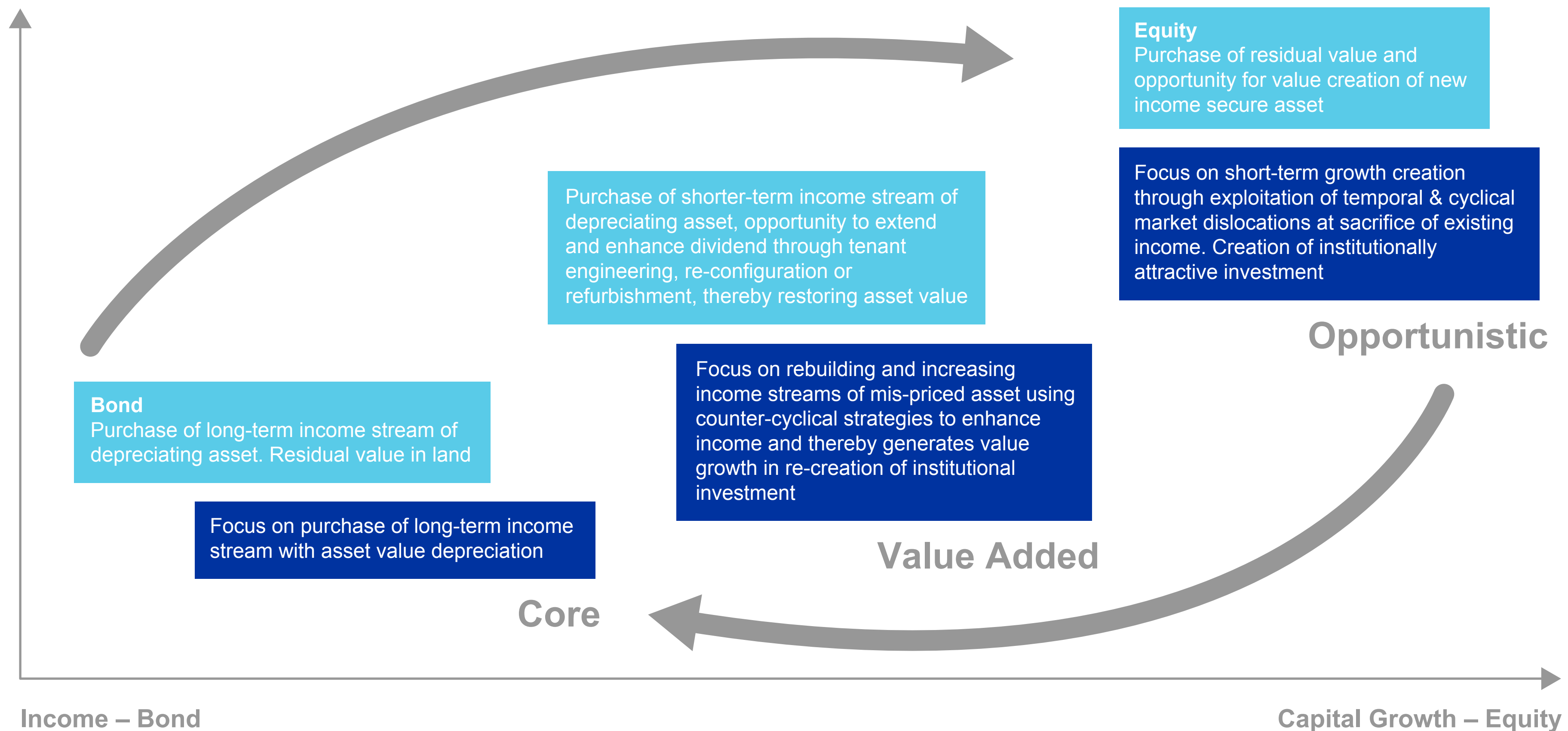
[vi] INREV (2019) Investor Universe Comparison Study; [vii] INREV (2020) Investment Intentions Survey

offered, a more diverse real estate debt market has emerged as a positive legacy of the downturn. Similarly, pressures on public finances have extended the range of infrastructure investment opportunities, with some social infrastructure investments in social or senior housing blurring the boundaries with real estate investment and vice versa.

Definitions of real estate for allocations

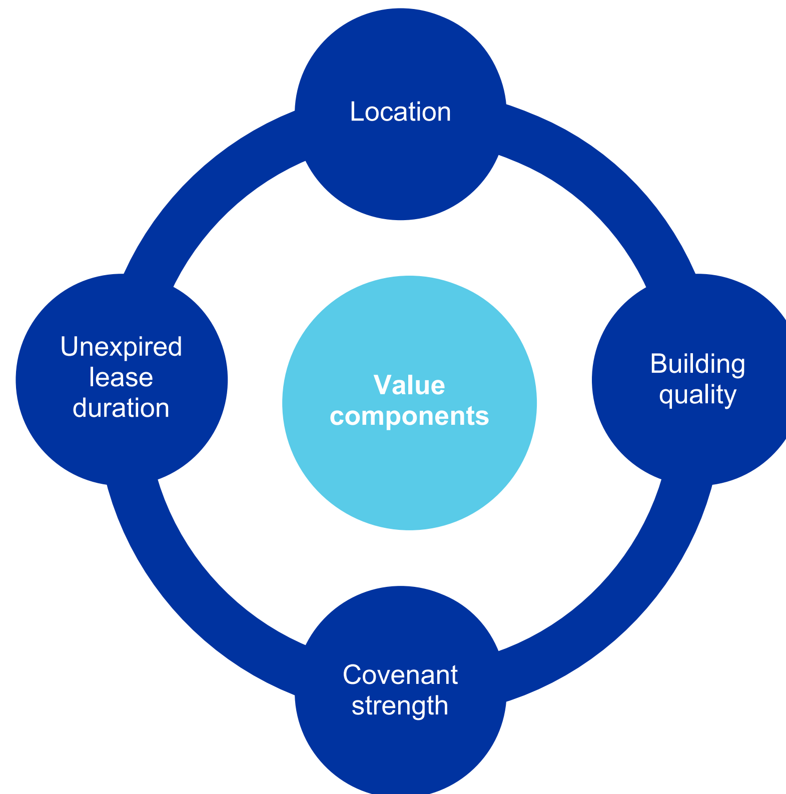
Institutional investors differ in how they delineate asset classes, with some permitting real estate allocations to extend to certain debt products or to social infrastructure. Most such investors recognise that regardless of the asset class to which an investment is assigned, its effective asset management may require a blend of specialist expertise. For example, the effective management of a senior real estate debt loan will require fixed income and real estate expertise. To this end, it is not just the investments that have blurred boundaries, but also the teams ensuring their effective asset management.

Figure 8: The perpetual real estate life-cycle



The blurring of boundaries between asset classes and allocations within them is also resulting in a shift in approach to asset allocation modelling and investment decision-making. Increasingly, investment analysis is undertaken using a risk matrix that cuts across allocations, enabling real estate investments across quadrants that share similar investment profiles to be compared side by side on their risk return metrics. This enables more appropriate groupings of investments based on risk characteristics, enabling better investment decision-making. For example, the risk-adjusted return characteristics of senior debt and mezzanine debt are quite distinct, with senior offering a low-risk fixed income return more similar to income secure real estate, whereas mezzanine offers a higher risk debt product more similar to private equity returns.

Figure 9: Risk components of value



Source: RHL Strategic Solutions

Risk characteristics of institutional real estate

Real estate is unique in that it is one of the few financial assets that can transform its risk profile over its lifecycle in both directions (for example, from lower risk/core/fixed income to higher risk/ opportunity/capital growth, Figure 8). This is because it is a real asset anchored to land, giving it a perpetual lifespan. Over its lifecycle, a bond-like investment could be embedded in the lease contract of an asset, offering investors a secure income stream to a for a medium to long-term duration. Towards the end of the lease contract, or upon expiry, the same asset could offer investors a capital growth opportunity by undertaking activity that enables the bond-like qualities of the earlier investment to be restored through redevelopment, refurbishment and/or leasing activity.

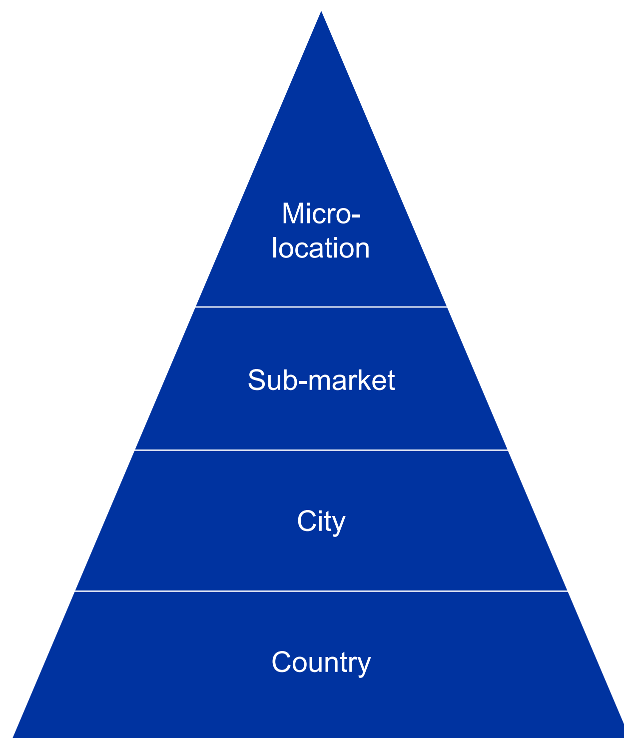
Contingent on the quality of its value components, real estate may be considered to have a low, medium or higher income risk profile which is embedded in three real estate investment styles — core, value added and opportunity. The principal value components are location, the duration and quality of income, the quality of the covenant underwriting the income and the building's quality (Figure 9). It is the combination of these characteristics that determine an asset's risk profile.

Institutional investors focus on prime

Assets with strong location, income and building-quality characteristics are termed 'prime' and are the focus of core investment strategies and institutional investment. The location and the quality of the building are fundamental to determining the weight of occupier demand and its competitive positioning within the market. When defining prime, location is generally more important than building quality, primarily because it is a fixed characteristic. Finite supply within the best location supports pricing as well as other aspects of the lease such as duration. However, it is the blend of risks that determine risk profile and therefore its attractiveness to institutional investors (Figure 10).

The perceived quality of a building can change over time, with new regulations, innovation and changing business practices all impacting on a building's performance and functionality over its life cycle. However, it is unusual for the prime location within Europe's historic cities to shift.

Figure 10: The components constituting of prime



	Location				Building quality		
					High	Medium	Low
Mature	Major economy	Principal city	CBD	Premier	Prime	Prime	
				Peripheral	Prime		
			Sub-market	Premier	Prime	Prime	
				Peripheral			
		Regional city	CBD	Premier	Prime	Prime	
				Peripheral			
			Sub-market	Premier	Prime		
				Peripheral			
	Sub-regional economy	Principal city	CBD	Premier	Prime	Prime	
				Peripheral	Prime		
			Sub-market	Premier	Prime		
				Peripheral			
		Regional city	CBD	Premier	Prime		
				Peripheral			
			Sub-market	Premier			
				Peripheral			

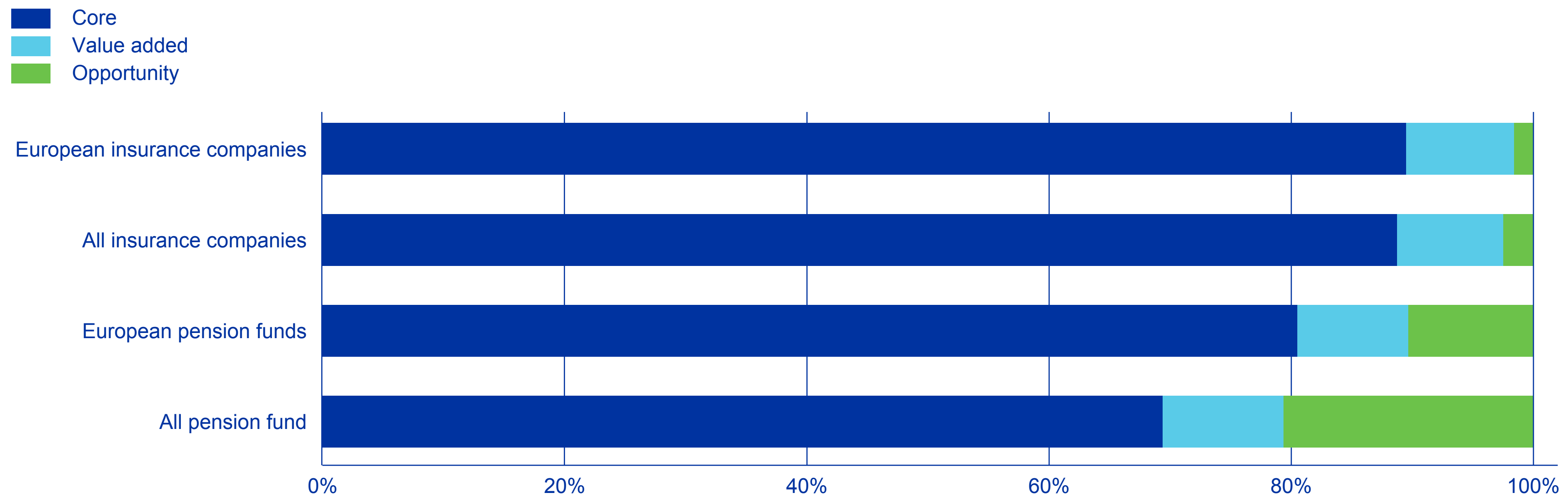
Source: RHL Strategic Solutions

Core investment strategies are focused on prime assets that offer longer duration, secure income streams. Essentially, the lease provides long-term institutional investors with a coupon by way of the rent determined by the lease, often providing inflation hedging characteristics. This makes it particularly suitable for asset liability matching. It also delivers a higher yield due its risk premium over bonds and strong diversification benefits for the portfolio.

Core assets represent 80.5% of European pension fund and 89.6% of European insurance company real estate assets under management by value (Figure 11). This greater weighting to core represents a lower risk appetite, particularly for pension funds, compared with their non-European counterparts.

As assets have a residual value upon lease expiry, value-added and opportunistic investing are fundamental to the functioning of the real estate market. Both restore wasting or obsolete real estate assets back to core assets. From a myopic real estate investment perspective this is essential to ensure the future supply of core investment product. However, from a broader perspective this activity is essential to ensure that the built environment is able to anticipate, adapt, and transform to fulfil the evolving requirements of the economy, society and the environment.

Figure 11: Real estate investment by style



Source: INREV (2020) Investment Intentions Database

Section 4

Significance of institutional real estate investment to the wider economy, society and environment

Significance of institutional real estate investment to the wider economy, society and environment

Creating a sustainable future for Europe's urban ecosystem requires a viable economy to be equitable and accessible to the society it serves, and for both to have a positive impact on the environment, in turn improving well-being, society and the economy. Real estate, in tandem with other real assets including infrastructure, is the scaffold for delivering such a sustainable future. These benefits are natural outcomes of long-term real estate investment, particularly when undertaken by institutional investors whose wider remit ensures that universal objectives such as sustainability are intrinsic to their investment intentions. Any activity that has a positive impact on the long-term sustainability of the economy, society and/or environment assists in future proofing institutional interests because they are perpetual.

Economic benefits

The economic benefits of long-term institutional real estate investing are multi-layered. They may be categorised into benefits for underlying investors (pensioners and savers), the wider financial markets and commerce.

Pensioners and savers

The rationale for undertaking long-term investing is that it can provide superior returns through exploiting liquidity and/or market risk premia. Long-term investors have the capacity to invest counter-cyclically, thereby amplifying this enhanced return. Based on the premise that most investments will move back to a mean reversion value over the long term, acquiring assets at or below their long-term real value trend is prudent. As well as providing further protection against downside volatility for the investment, such long-term counter-cyclical strategies provide a floor for real estate markets during downturns as well as for the real economy and economic value growth.

Market stabilisation

The counter-cyclical nature of long-term investing greatly assists the stabilisation of financial markets during downturns. The re-emergence of such investors into the market as prices decline below their long-term trend provides a much-needed liquidity injection. In turn, this enables markets to bottom out. Without this floor, markets are at risk of entering protracted crises. Low liquidity causes a downward spiral in value and in the quality of stock as asset management recedes. This results in further capital — and economic value — decline.

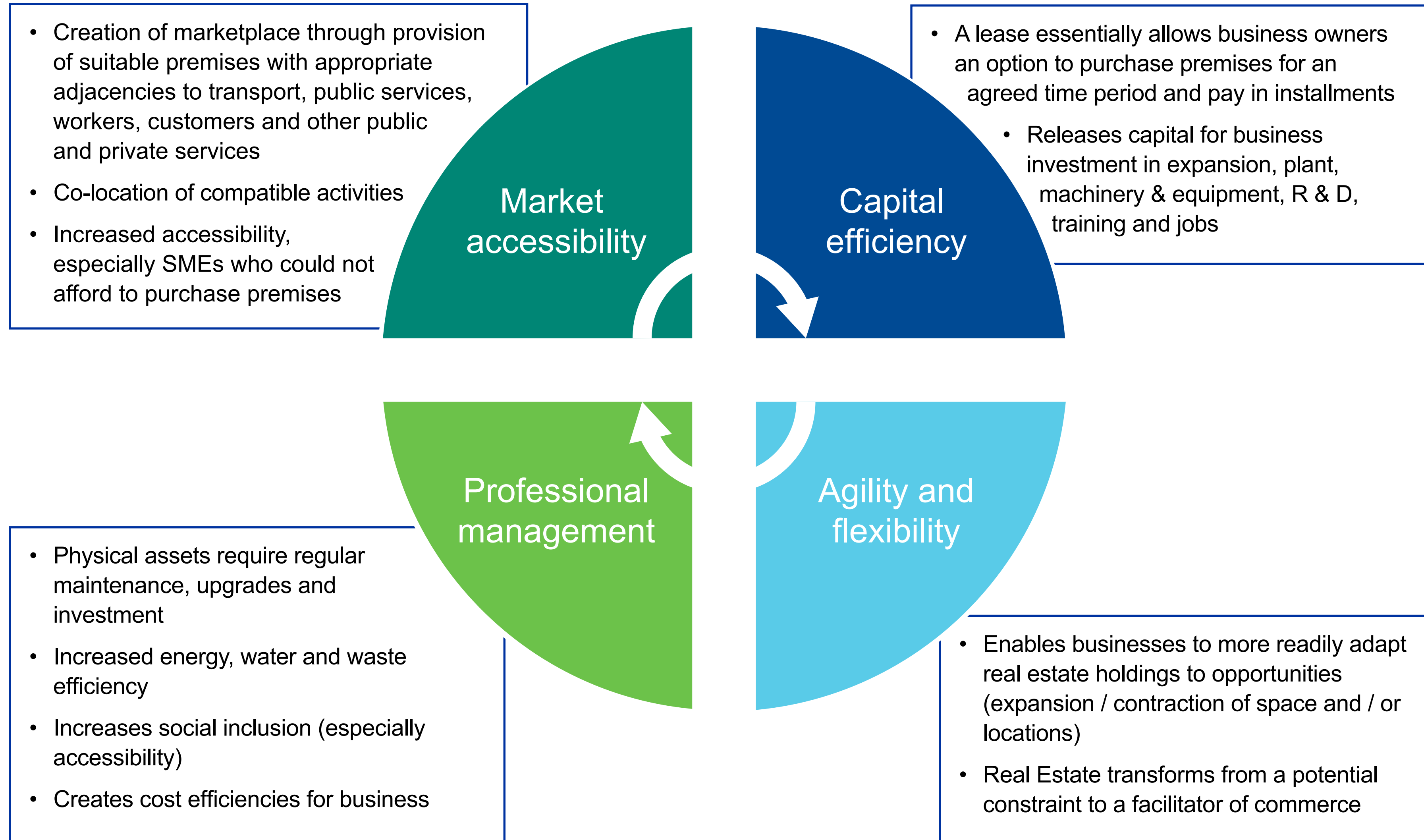
Counter-cyclical investment by long-term institutional investors is especially important for real assets. The lifecycle of real assets means that they generally lose both functionality and value unless money is periodically spent maintaining, refurbishing and sometimes redeveloping them. Investment, development and refurbishment of existing buildings requires significant annual investment in European real estate. Over the past decade, this has represented approximately 10% of total fixed investment in Europe.[viii] A further 45% is accounted for by investment in the inter-dependent housing and infrastructure sectors, totalling over €1.7 trillion. As well as protecting the value of investments, this activity also improves economic productivity.

Business and commerce

Real estate essentially acts as a factor of production for business and commerce, providing an appropriate, efficient built environment in the location and fabric of suitable offices, retail outlets, industrial premises, leisure facilities and residential

[viii] EPRA/INREV (2018) Real Estate in the Real Economy

Figure 12: Real Estate as an Enabler of Business and Commerce



Source: RHL Strategic Solutions

units as well as hotels, educational and healthcare facilities. Essentially, it represents the required infrastructure fundamental to ensuring a productive and efficient economy and to meeting the changing needs of business and society (Figure 12).

Approximately 37% of commercial real estate is held as an investment and is professionally managed and leased to business operators. Across Europe, this provision of what is essentially infrastructure for business is equal in value, and in importance, to that of plant and machinery. Business enterprises are essentially able to pay for their premises in installments. This assists free cashflow that can be invested in the operational business, releasing capital for investment in expansion, productivity gains, and research and development. It also results in greater flexibility and agility for European businesses as they are able to adjust their location, space requirements and associated costs more readily to opportunities in new markets and sectors.

These benefits are relevant to all firms, but scale is a significant factor. Large, stable firms may prefer to own part of their core occupational portfolios. However, like medium and smaller enterprises, most will also have a significant portfolio of leased real estate as it offers them flexibility, agility and capital efficiency. Being able to rent allows businesses to convert infrastructure space requirements from a constraint into a facilitator of business plans.

As well as leaving businesses to focus on what they do best, it ensures that the best organisations are focusing on real estate. This ensures the built environment is appropriately managed, upgraded and retrofitted, which in turn creates further efficiencies for business, society and the environment. The capacity to undertake long-term investing enables structural, macro and sectoral trends to be factored into asset management.

Major structural macro-economic trends are well established and include ageing society, depleting natural energy resources and climate change, urbanisation, wealth polarisation, technological revolution and the shift from a service to a knowledge-based economy. The built environment continually adapts, anticipating and responding to such change through building design itself, the repositioning or re-purposing of established sectors and the emergence of new real estate sectors (including big box retailing, hotels and resorts, senior living, student housing, business parks, science parks and leisure). Long-term institutional investors have been a critical facilitator of such change, creating solutions that act as a factor of production.

This activity generates efficiencies in business operations through increased functionality of the actual space and the creation of a wider marketplace across the micro-location. Businesses are continually under pressure to improve productivity and lowering the cost base is an important component of achieving such gains. Many companies have achieved this through greater efficiencies in their occupational portfolio, enabled by advances in the (re-)design and (re-)construction of assets that have delivered greater space efficiency, higher functionality and reduced energy costs resulting in a lower cost of occupation per employee. It also greatly lowers the environmental cost. Yet, such advances also benefit savers and pensioners. Such buildings command higher rents and being in greater demand, at a lower risk. This delivers greater security of income and further supports their role in funding pension funds' and insurers' obligations.

Social benefits

This professional management of the built environment that follows such investment includes the delivery and upkeep of many public services, spaces and streetscapes. This creates an upward spiral that benefits the economy, society and the environment. It represents an informal and synergistic partnership with public sector efforts to promote the civic realm. In the same way that agricultural activity ensures management of the rural landscape, the activity of long-term real estate investors protects and enhances the urban environment. Investment and management maintain the historic fabric of buildings while reducing obsolescence through refurbishment, repurposing and redevelopment. As well as retaining value, this activity increases accessibility and enhances the local environment.

Social responsibility is a growing focus for long-term institutional investors. Many recognise that as real estate essentially provides the social infrastructure within which citizens work, rest and spend leisure time, their portfolios have always had a social impact. The current challenge is to create objective measures and to quantify and benchmark it. For some investors, activity in this area focuses on wellness initiatives in location and design, and on the impact on occupier productivity. Other investors are focusing on how their portfolio management impacts social sustainability. For example, prioritising affordability for existing residents over maximising the potential market price within residential portfolios to support the sustainability of the community.

Demographic, economic, technological and environmental megatrends create waves of societal and behavioural change in how we live, work and play. Adapting to these dynamics demands a long-term real estate investment horizon to enable asset strategies to respond. Over the past forty years, the design of office space has evolved in several stages to match changing business and social culture. For example, the shift from a cellular office and central admin pool model common to the early 1980s, to the current model of activity-based design to accommodate multiple working modes. Moreover, the role of the space and its immediate micro-environment in attracting and retaining talent is central to its purpose. This has led to mixed-use assets that co-locate retail, leisure and residential amenities and, at the same time, build social activity.

Megatrends such as ageing society create new demands for senior housing and/or healthcare facilities that have materialised in an era of constrained public finances. Long-term institutional investors have responded through investing and funding senior housing and care facilities, leased to specialist operators. This has helped the public sector to provide services to its citizens and, at the same time, enabled specialist operators to develop economies of scale as they are able to expand their activities by leasing rather than owning their premises. This requires the activity of long-term institutional investors, which are attracted to the sector by the long income duration leases the sector offers, while contributing to solving a societal challenge.

Social and technological change are also transforming the retail sector from being a mere point of sale to a sector focused on delivering experience and a sense of place, community and belonging. Retail spaces are transforming into people places, increasingly anchored by social space and services, where real and virtual worlds collide to enhance consumers’ knowledge, choice and experience.

Environment

Directly and indirectly, commercial and residential buildings account for approximately 40% of the European Union’s (EU) energy consumption and around 32% of carbon emissions. Long-term institutional real estate investors are pivotal to untapping the significant potential to reduce carbon emissions embedded in the sector.

In 2004, institutional investors signed up to the United Nations Environment Programme’s responsible investing initiative, with the aim of placing environmental, social and governance (ESG) policies at the heart of investment decision-making. In 2006, the UN published its Principles for Responsible Investment (PRI), which applied to all financial assets. On the basis that ‘what gets measured gets done,’ leading European institutional real estate investors established the Global Real Estate Sustainability Benchmark in 2008, to enable portfolios to be measured and benchmarked against ESG criteria.

Longer-term holdings in real estate provided institutional investors with an opportunity to begin to apply ESG policies that could have an impact. Initially, ESG focused on environmental considerations. Ensuring new developments are carbon neutral is standard, but to have impact, existing assets require retrofitting with new technologies that assist occupiers in reducing their energy use. Improving the efficiency of Europe’s existing built environment can untap environmental benefits that can make a difference. Activities also expanded to the efficient use of other resources including water and, importantly, an emphasis on building materials and also on recycling them, evolved.

For many investors, the role of ESG has evolved significantly over the past fourteen years. Initially, ESG criteria were overlaid

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on post-acquisition business plans and, while important, were therefore a secondary investment consideration. In recent years, ESG shifted to become a primary consideration in investment decision-making and it is now embedded in every stage of the real estate investment process from acquisition through disposal.

At the end of 2017, energy use in commercial buildings across Europe had declined by 6% over the previous three years as a result of investment in in renewable and clean technologies.[ix] Despite growth in housing units, emissions from residential buildings fell by almost 1% from 2013 to 2016, while those from commercial buildings decreased by 2.7% and from social infrastructure facilities (health, education etc.) by 5.8%. This achievement is even more significant when considered in the context that total energy consumption in the economy increased by 4% and total emissions by 5.2% over the same timeframe.

The role of long-term institutional investors is fundamental to achieving such change. In 2006, green developments had higher costs and the payback period required demanded a long-term investment strategy. Retrofitting existing assets was even more demanding. Such payback was also uncertain and demanded investors with universal objectives for whom it was both possible and prudent to incorporate long-term sustainability criteria into investment decisions. Their importance to the real estate market meant that the shift toward responsible investment strategies led the market. A clear value differentiation for efficient buildings emerged by 2014, with a shorter timespan than the initial payback periods for investment that was cited in 2006.

It is hard to quantify the exact impact of environmental initiatives on value, particularly as it is becoming standard to good asset management practice, with the emphasis starting to switch to how much an asset will underperform if it is not optimised. Energy efficient buildings command higher rents, have lower vacancy and being lower risk, are valued more highly. For occupiers, their efficiency delivers a lower cost per worker. It is a win for investors, occupiers and the environment that simply would not have occurred were long-term investors such as pension funds and insurance companies not driving the sector forward. Looking ahead, the long-term horizon of institutional real estate investors enables them to play an important role in meeting obligations under the Paris Agreement and commitments related to reducing carbon emissions.

[ix] Ibid.

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