CATELLA

MARKET TRACKER SEPTEMBER 2015

Sustainable real estate funds

Over the past decade, the issue of sustainability has become substantially more prominent within Europe's real estate sector, and, today, many issues associated with the "green idea" have become integral parts of the sector's day-to-day workings. It should therefore come as no surprise to learn that "green funds" are growing in importance in the property investment market.

The market is mixed

Take a look at the market's structure today, and this is what you'll notice: all over Europe, green building certificates are a vital requirement for **new builds at premium locations**. These considerations also normally feature in the due diligence analysis connected with purchasing processes.

For **existing buildings**, the European market is at present a highly dynamic one in terms of transactions. However, certificates are less frequently involved here: out of a sample of ten commercial (office) properties currently on sale, only one has such a document. The certificate issuers are making every attempt to gain some purchase in this sector. When it comes to the topic of sustainable assessment and renovation of existing buildings, focus is explicitly on the three major KPIs of energy, water and waste.

Regarding **upkeep and management** ("green facilities management", "green leases"), we are still in something of an exploratory phase. Certain exemplary activities are discernable here and there, but we are still far removed from an across-the-board development. Even within the premium new build segment, the scale of sustainability-oriented activities still remains rather modest.

How do things look on the market for sustainable funds? Though the market is constantly evolving, particularly in the field of equity funds, **sustainable real estate funds have yet to experience a similar surge in development.** In other words, while the sustainable financial investment sector enjoys strong overall growth (2014 volume in Europe: €5.2 trillion), real estate funds that are based on and managed in line with sustainable principles are still among the "also-rans" and can, after a long search, be located in the commodities category (2014 volume in Europe: €495 million).

Awareness of sustainability is increasing appreciably

The general restraint seems understandable at first glance as, in the classic investment view, it is the underlying, i.e. the item of property itself, that is the major source of value or the long-term asset. A word of advice, however: the market's awareness of sustainability issues has been undergoing a long gestation period. The classic doctrine is losing ground, and this has started to produce a fundamental paradigm shift in how real estate investments are viewed. This shift, in turn, is forcing investors to act. Three observations provide the evidence:

- The market is seeing an ever-growing volume of capital explicitly in search of sustainable applications (push factor driven by investors).
- Increasingly, fund management is also being judged according to ESG (environmental, social and governance) criteria, i.e. factors that are not directly derived from factors related to buildings (push factor driven by corporate governance).
- At present, asset overlays are of particular importance in this context: certain ethical and ecological considerations have conquered the mainstream market due to the fact that they are components of sustainable investment strategies.

It will therefore be necessary to pay far more attention in future to the questions of investment capital ("Why invest sustainably?"), fund managers' activities ("How is sustainability grounded in the core fund management processes?") and analysts ("What is the relevant and fungible market, which benchmark?").

The ability of a fund to create value on the market will be based on the interplay of the three factors of the **building** (location, quality and, by extension, market fungibility), the **return on the property** (sustainable maintenance and generation of lease revenue) and **sustainable management** (investment strategy, acquisition criteria and fund management, for example according to exclusion criteria, best-in-class, standards-based screening).

Catella is a leading financial advisor across Europe and asset manager for the areas of property, fixed-income and equity. We occupy a leading position in the real estate sector, with a strong local presence in Europe with around 500 employees across 12 countries.

Your contacts:

Dr. Thomas Beyerle
thomas.beyerle@catella.de
+49 (0)69 31 01 930-220

Vivian Schmidt
vivian.schmidt@catella.de
+49 (0)89 189 16 65-0

CATELLA

FUTURE TRANSACTION STANDARDS (IDEALISED)

1.	Location and building	■ Site's long-term perspectives ■ Quality of infrastructure ■ Efficiency and flexibility of building ■ Efficiency of resource consumption ■ Green building certificate
2.	Property management	■ Energy consumption ■ Legacy problems and physical structure ■ Emissions (gas, noise, odours) ■ Efficiency of overheads ■ Possibility of retroactive certification
3.	Asset and portfolio management	■ Cashflow hedging / increase ■ Ongoing sustainability check ■ Implementation of budgeted measures ■ Green lease management ■ Updating fund profile

SELECTION OF SUSTAINABILITY-FOCUSED FUNDS

Name of fund	Company	Established
■ CS Real Estate Fund Green Property	Credit Suisse	2009
■ Sarasin Sustainable Properties – European Cities	Catella Real Estate AG	2011
■ Immo Wert	AXA Investment Managers Deutschland GmbH	2012
■ Raiffeisen Futura Immo Fonds	Balfidor Fondsleitung AG, Basel	2014

Catella Research 2015

Summary:

Today, institutional investors such as pension funds, churches and insurance companies feel particularly obliged to do more than just generate good returns: they also want assurance that their potential investments have been assessed in terms of sustainability.

The price a building can command, its leasability, its resale value and the returns it generates are already dependent to a significant degree on ecological standards. Properties that have lower energy consumption ratings and that surpass the usual ecological expectations are easier to lease. New buildings constructed and managed with a view to sustainability possess this advantage over conventional portfolio properties, and this advantage will become even more pronounced in the event of a market downturn.

The lack of uniform standards for assessing and certifying buildings remains a problem. There is no generally applicable seal of approval for sustainable real estate funds, nor is there a benchmark for a peer group comparison – two vital elements necessary to trigger competition.

Catella Research expects that the **sustainable real estate fund sector will see investments of some €850 million in Europe by mid-2016**. It should be obvious that funds banking on sustainability have thought their investments through very carefully, as not every sustainable investment project will be able to generate a corresponding return on investment within a short period of time. There is a risk of overinvestment in sustainability when legislation results in the wrong kind of stimulus, as was recently the case in the solar power sector.

SUSTAINABLE REAL ESTATE FUNDS – PROS & CONS

Pros

Advantages regarding building features (at level of physical structure)

1) Lower management costs due to energy efficiency (reduced energy/water consumption).
2) Lower risk of failure of technology in building due to energy efficiency (lower resource consumption; overall higher-quality standard (newer)).
3) Boost to marketing and image due to enhanced functionality, serviceability, longer lifespan, flexibility and less need for maintenance and upkeep measures.
4) Lower risk of remaining empty due to less market influence/risk; cost benefits within scope of ongoing management.
5) Stable cashflow due to less market influence/risk.
6) Lower incidence of illness due to reduction of "sick building syndrome" due to less environmental influence/risk and enhanced sense of wellbeing among building's users; greater sense of comfort ("well building factor").
7) Greater employee productivity due to improved workplace and building climate conditions (enhanced sense of wellbeing) and enhanced functionality, flexibility, serviceability and longer lifespan.

Advantages from fund manager's point of view (at level of fund manager's/investor's actions)

1) Stable value of sustainable real estate due to energy efficiency and, by extension, lower volatility in fund's performance.
2) Potential for higher leases due to stable value of sustainable real estate and, by extension, higher potential returns for investors.
3) Enhanced potential for better sales opportunities and sales revenue.
4) High returns potential coupled with long-term stable returns.
5) Legal requirements regarding buildings' energy efficiency contribute to enhanced average performance (stricter construction regulations in Germany); relatively quick compliance with legal standards can represent advantage over competition ("green core competencies").
6) Investing in energy efficiency is a good hedging strategy as energy prices are extremely volatile.
7) Boost to image: investors like the green image and therefore invest in sustainable funds; tenants like the green image (lower risk of remaining empty).
8) Green buildings as the market standard – "if you don't invest sustainably today, you will have trouble selling tomorrow" (comparison with pro no. 5).
9) Classic real estate items risk failing to attract lucrative tenants due to prospect of energy efficiency measures in coming years ("beggar-thy-neighbour" spiral).

Cons

1) Higher purchase price, higher costs of property; sustainable measures entail corresponding start-up costs – certified buildings have higher start-up costs (8% on average (LEED Platinum Standard) and additional 2% (LEED Silver)).
2) "Gap" between ACTUAL and TARGET figures: sustainable investment has to be handled carefully as not all activities generate a corresponding return on investment; danger of overinvestment in sustainability.

   Reasons:
   – Wrong incentives
   – Inadequate information
   – Difficulty assessing return on investment
   – Over-allocation regarding best-in-class
3) Wrong allocation of capital: many sustainability-focused activities are driven by state subvention programmes and are therefore not based on market factors (again danger of overinvestment).
4) Investing in sustainability does not of itself deliver any advantages if a tenant fails to act in a sustainability-aware manner: the best insulation is useless if a tenant turns their heating up but leaves their windows open. Virtually no tenants live up to the image of the "green-minded homo economicus".
5) Greater demands in terms of reporting.

Comment: the expected reasons for the boom in sustainable real estate for institutional investors are marked in red.

Catella Research 2015