

It's not just 'doing good', it also makes financial sense

The growth of impact investing – in residential housing

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The consideration of long-term investment value drivers and risks is a fiduciary obligation placed on fund managers. Environmental, social and governance (ESG) factors are increasingly recognised as being material to investment value creation and preservation. In this context, the systematic and explicit inclusion of ESG into investment analysis and decision making is a core principle under which we invest and launch new products. The tangible nature of real estate assets, with their exposure to physical aspects and significance to policymakers, amplifies the importance of the ESG dimension.

The evaluation of positive impact criteria provides a deeper means by which to consider these ESG factors. Positive impact seeks a shift in approach such that market-oriented capital flows do more than minimise harm, but rather, create positive environmental, economic and societal outcomes, as well as contribute to solutions in underserved markets where government is increasingly seeking private finance to deliver.

The emerging consensus that capitalism should be less short term and more inclusive to the wider society is quickly establishing itself in mainstream investment thinking. For years considered niche, the growth of sustainable and impact funds is facilitating genuine change in many areas of society and the environment.

The concept of “double bottom-line” investing considers not only the financial return provided, but also the positive impact that invested capital has been able to create. Impact funds range greatly across providers and asset classes. They are generally distinguished as seeking investments that support an intention to generate positive, measurable social and environmental impact alongside a financial return.

From an investment perspective, and in a low interest rate environment, the real estate sector is viewed as a way to diversify investment risk for life and pension fund portfolios. Taking long-term rental housing as an example, this particular asset class can act as a strong diversifier as it is less correlated to other more cyclical property types. The various leasing models associated with affordable

housing also offer scope for inflation linking. The credit strength of this sector and its proven inelastic demand has helped reinforce its appeal as a credible source of diversification.

“The myth that for high-quality impact to be achieved, financial returns must either be a secondary factor or an additional consideration, has been proven false”

For investors who are seeking positive sustainability solutions alongside financial returns, real estate investment can have both important social and environmental benefits. On the social side, housing represents a key tool for developing cities looking to cope with growing, transient, and ageing populations that require employment and social infrastructure – housing, healthcare and education. And environmentally, the development and operation of housing presents the opportunity to drive long-term environmental change through forward-looking design that creates operationally efficient homes, reducing carbon footprints and enabling social benefits

such as lower fuel poverty. Credible impact investment in real estate demands that investors consider both these aspects.

Finally, the myth that for high-quality impact to be achieved, financial returns must be sacrificed, has been proven false. Certainly, in terms of real estate, the provision of well governed, affordable housing solutions offers clear social benefits, along with the advantages that new housing stock offers in terms of operational efficiency for the owner and occupier, reducing costs and returning income reliable back to the investor.

How ESG supports our investment thesis

Our ESG objectives help drive our thinking and are fully embedded into our consideration of property fundamentals and determination of risk and opportunities, as illustrated below.

Using the housing sector as an example

Different countries and cities are at varying points in the cycle linked to wealth, demography, affordability, housing stock and tenure, planning regimes and migration patterns and so it is not a one size fits all approach. The unique composition of each city creates an opportunity for various forms of residential investment and development

going forwards – but across Europe there is a lack of quality stock in the right locations and it is clear that the existing market is not delivering enough supply.

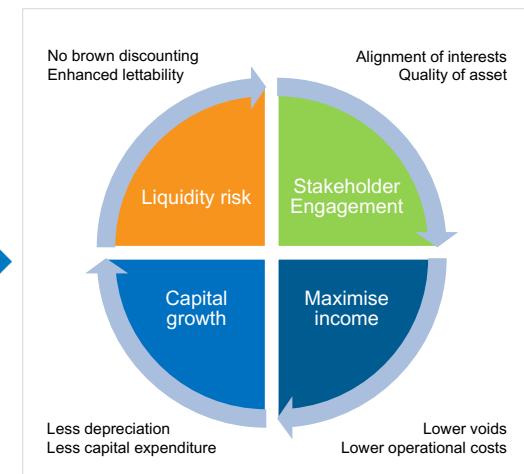
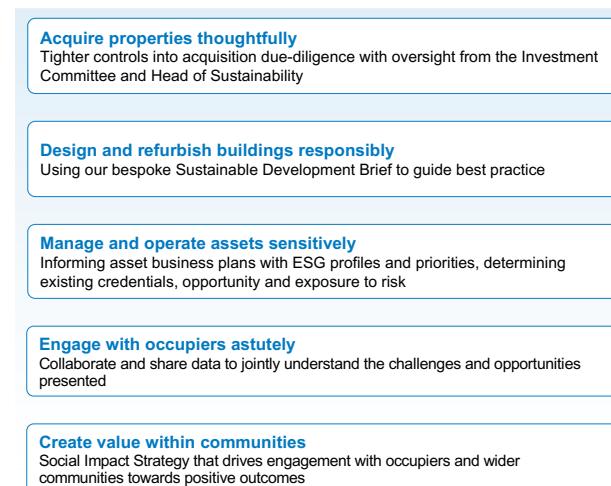
The rising prices of home ownership in major European cities have made it unaffordable for some, pushing them to the private rented sector as they do not qualify for social housing either - this is a key growth driver of demand for the rental market. Since 2000, the average house price across the Eurozone has risen by 3.1% per annum, while real wages have only increased by 0.4% pa, meaning that while earnings are only 8% higher in 2020 than 2000, house prices are 86% higher.

The pressure on prices is exacerbating the affordability gap, making it very difficult, in particular for first time buyers, to afford a suitable home, in spite of the low interest rates. This means that a large, typically young and mobile, group is dependent on the rental market – especially in mid- to large-scale cities across Europe.

Furthermore, there is a growing proportion of existing stock that is facing obsolescence. The levels of owner occupation vary across Europe - 31% of European households live in private rental homes, up from 26% a decade ago - but, by and large, there remains a large and growing proportion of the market that could benefit from institutional

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investment, in particular the Social Housing and Private Rented sectors.

As well as demographic changes (growing population + urbanisation + migration), COVID underpinning the value of the home, legislative pressure and tax changes are contributing to a reduction in supply. This leaves the door open for institutional investors to step in and fill the gap, offering some important advantages over the traditional model of individual private landlords, for both the tenants and for society.

The fundamental shift stimulated by the introduction of institutional investment is a movement in the parameters for the underwriting and operation of real estate, with the investment being long term in nature resulting in a different approach to valuation (income focused, rather than capital driven) and efficiency.

Having larger, commercial property management companies overseeing rental properties can offer a higher, more standardised and professionalised level of service for tenants. Commercial property management companies are often able to offer longer tenancies, in contrast with private landlords where tenancies may be shorter, creating a lack of certainty for tenants. Longer tenancies allow individuals to integrate into the wider community and contribute more freely, with the knowledge that the area is their home and not just a stopgap.

Efficiencies for the landlord will be reflected in the operational costs to the tenants, meaning their rental payments are more affordable – which often leads to higher occupation rates that in turn underpin financial returns. Where new

build is possible, there is an opportunity to design, construct and operate new homes that will almost certainly have a better environmental profile than older housing stock. This not only improves the carbon intensity of the property stock, but can also support the development of modern construction technologies, stimulating new industry and the associated employment opportunities.

These benefits do not come automatically with the shift from private to institutional money. A willingness, the right partnerships and management structures have to be in place to ensure that benefits to tenants, communities and the environment are realised.

Measuring impact

Impact is driven by intentionality. This must then be translated into objectives which are held consistent and measured over time. Feedback can then be generated to assess effectiveness and what can be done to improve the targeted outcomes. Fundamentally, to have impact, the objectives should improve the market and do more than might ordinarily be delivered by other market participants – this is additionality.

Given the many ESG interventions possible for real estate investors through the acquisition, development, operation and disposal of physical assets, not all can constitute impact. Being transparent, understanding the impact achieved and being able to consistently measure it are core factors to ensure that investors and wider stakeholders understand investments in this area.

Accusations of 'greenwashing' can be extremely detrimental to the reputation

of a fund and the wider sector. It is therefore essential that measurement frameworks are created for products to allow priorities to be determined in the pursuit of objectives and that this process can be communicated to stakeholders when necessary. Internal and independent impact assessments can also be conducted on a periodic basis to provide fresh perspective and the test practice.

BMO REP's overarching framework is shown below as an example.

Impact in real estate cannot be distilled to a single metric. There are different aspects of impact which need to be recognised and measured, and any potential housing investment can be market-leading in some areas but only reaching minimum standards in others. It is the combined output and progress against the product's objectives that are significant.

Residential investment represents social infrastructure and there are many ways to promote ESG or to be impactful, whether through a focus on the provision of a specific type of accommodation for an underserved or vulnerable market, or the associated uplift in building quality and operation. It may even be the wider economic significance of the housing in terms of the regeneration of areas and support of economic growth through the provision of work (a direct result of construction) and retention of staff for local employers. Significantly though, each product should set out its objectives and prioritise its interventions to protect against regulatory and reputational risk, but also to credibly assess the level of impact achieved.

European Residential Fund

The BMO European Residential Fund, launched under SFDR article 8 and with a target GAV of €800 million, is underpinned by a strategy to acquire and manage high-quality residential properties across the full Private Rented Sector (PRS) spectrum. While the focus is on mid-market and affordable long-term rental accommodation, it also includes premium and senior living.

The fund will focus primarily on locations in Austria, France, Germany, Italy, the Netherlands and Spain with up to a maximum of 40% of GAV in any one country, thus diversifying risk. A further diversification comes through targeting a mix of quality, income-producing standing stock as well as forward funding build-to-rent investments, albeit with limited exposure to development risk. The fund targets established top economically performing European cities and those where we have identified long-term growth and expansion prospects, focusing on sustainable micro-locations where connectivity is key in reducing carbon footprints. Individual units will offer efficient floorplates in modern, flexible housing schemes that are integrated into the communities where they are located.

UK Housing Fund

Launched under SFDR article 9 the UK Housing Fund is targeting a GAV of €600 million with lot sizes ranging between €10 - €50 million and combines a mixture of multi-tenant units and single family housing. There is a clear focus on delivering affordable homes for local people in underserved markets across the UK, with an emphasis on supporting key workers and, through ongoing partnership with Local Authorities, to embed housing priorities into individual strategy and establishing Engagement Committees made up of residents and local community representatives [THIS DOESN'T MAKE MUCH SENSE TO ME].

The fund is targeting the mass market, aiming to provide rental accommodation for households that are caught between traditional social housing and existing PRS, with the basis that the provision of accommodation does not overburden its tenants, defined as spending 'more than 35% of gross income on rent'. BMO Real Estate Partners is working in conjunction with Home Group, a social enterprise and charity who is one of the UK's largest providers of high quality housing and integrated housing, health and social care to deliver accommodation for generations throughout their life cycle.

Defining ESG and Impact and its importance to BMOREP

The systematic assessment of material environmental, social, governance and impact factors and applying these factors into product strategy, investment analysis and decision making

The business imperative

• Building value:

Anticipating market sentiment to offer products that are widely sought after e.g. defining a product that provides additionality for investors seeking social purpose

• Impact on performance:

Fostering positive landlord-tenant relations

e.g. funding solar panel for an occupier to reduce their opex whilst increasing asset income and improving carbon position for both

• Asset performance:

Resilience and lower liquidity risk

e.g. forecasting climate risk, such as flooding or energy efficiency performance to avoid asset stranding

• Regulatory:

Standards that influence a product's license to transact

e.g., disclosures required to promote ESG under the EU Sustainable Finance Disclosure Regulations

Source: BMO Real Estate Partners

Our ESG objectives

Environment: tackling the environmental deficit

Carbon, climate resilience, circular economy, biodiversity

Social: having purpose and value

Community, prosperity, inclusivity, wellbeing

Governance: working with integrity and rigour

Certifications, accreditations, awards

Impact – investing for sustainable outcomes

Financial-only	Responsible	Sustainable	Impact	Impact-only
Delivering competitive financial returns				
	Mitigating Environmental, Social and Governance (ESG) risks			
		Pursuing Environmental, Social and Governance opportunities		
			Focusing on measurable high-impact solutions	

BMO Real Estate Partners

 BMO Global Asset Management

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