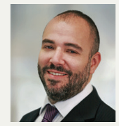
LaSalle

Impact Investing in the UK: What Real Estate Investors Should Know

JUNE 2020

In recent years, many institutional investors have embraced the principles of responsible investing (PRI)[1] in order to shape a sustainable global financial system. These principles seek explicit and measurable approaches to the adoption of Environmental, Social and Governance (ESG) standards in investment decisions and active ownership of assets. As a natural extension of the PRI, the field of "ethical investing" has grown quickly, as evidenced by rising capital allocations to vehicles that include ethical criteria *[see Chart 1]*. When these considerations are combined with financial criteria, the investment can be considered part of the growing universe known as "Impact investing".

Impact investing refers to investments made with the specific intention to generate a measurable, beneficial social and/or environmental impact alongside a financial return. This rapidly evolving investment practice relies on the concepts of intentionality and additionality, the notion of generating a positive impact beyond what would otherwise have occurred. At its core, impact investing include procedures for reporting and accountability that ensure strategy and practice are aligned with both societal goals and financial objectives. Whilst impact investing is a natural progression from ESG adoption *[see Chart 2]*, we firmly believe that there should be a clear distinction between the two. ESG standards can be integrated into any investment process to ensure investments are socially, environmentally and ethically responsible. Impact investing goes one step further and includes the achievement of positive social and environmental outcomes as measures of success, in addition to financial criteria and meeting minimum standards for ESG. Growing academic evidence supports the idea that "ESG incorporation does not come at a cost"[2]. The academic literature on "impact investing" is still in its infancy, although financial economists have surveyed the definitions used by the first wave of "impact investing products" and found them to be remarkably consistent in terms of their emphasis on intentionality, financial returns, and impact measurement across a wide range of asset classes[3].



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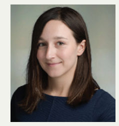

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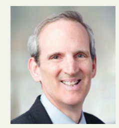

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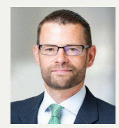

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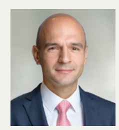

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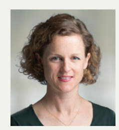

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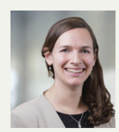

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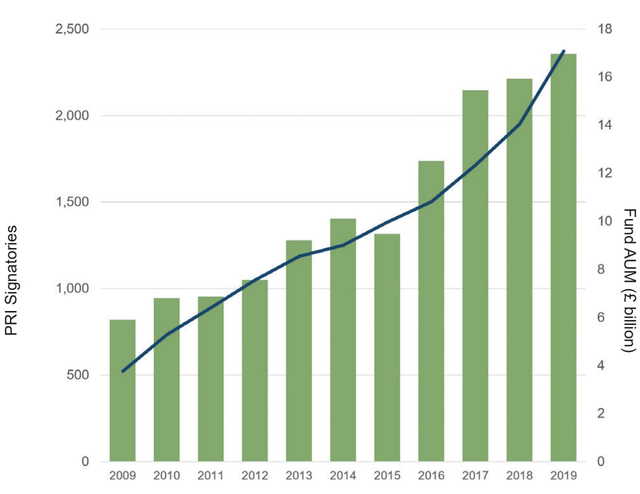
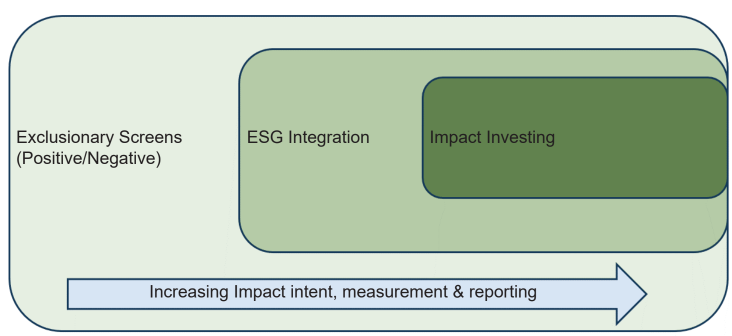
Chart 1: Ethical Finance



* Principles for Responsible Investment
Source: LaSalle (02/20) PRI (06/19) IMA (04/19)

Chart 2: Responsible Investment Spectrum



Source: LaSalle (02/20), Charting the Course, World Economic Forum Investors Industries (09/14)

Interest in impact investing is gaining momentum within the real estate industry in certain countries around the world, with many real estate investors in Europe now moving impact investing up their list of priorities. This increased interest mirrors the traction impact investing is receiving in other asset classes; according to the Global Impact Investing Network (GIIN), the impact sector's estimated AUM is US$502 billion, most of which is managed by specialist asset managers[4]. These investors are leveraging private capital to help achieve societal and environmental goals which are not currently being met by either the public or private sectors. This is not a philanthropic movement, instead the mantra adopted by many impact investors is "doing well by doing good". However, the inherent tension between the desire to create social benefits and to earn a competitive return is controversial. Critics have pointed out that tech employers and some investment managers have adopted the language of impact investing to attract younger employees and investors and to improve their public image[5]. However, this cynical scrutiny has helped the impact investment community tighten up on its definitions and its reporting standards in response. Peer data-sharing networks such as the GIIN produce performance metrics, databases, definitions, case studies and training for the growing number of investors interested in learning about impact investing.

Recent events may prove to be a pivotal moment for the impact investing sphere. The Covid-19 pandemic has had enormous public health ramifications across the globe, and it has also exposed many of the systemic problems in advanced economies. As a result, it is likely to raise awareness of the wider needs of society and the role that investors can undertake to tackle structural problems, while also earning a competitive return. Whilst we believe that the long-term structural drivers for impact investing in real estate remain relatively unchanged by the pandemic, we do think that changes in behaviour and attitude will have a profound effect on the demands of investors to see returns beyond financial ones. This should lead to more capital entering the sector, when stability and liquidity returns to the market. We also recognise that national and local government are often seen as the natural impact investor and, given that the governments of most developed nations have stepped-in with unprecedented economic support in the wake of the pandemic, we expect this to limit their ability to fund critical areas of need in housing, health and education in the future. This is likely to lead to an increase in the need for private funding to support such initiatives, and hence the investment opportunities for an impact strategy in real estate may well increase.

Impact investing in Real Estate necessitates a broad approach

Impact investing, at its core, sets out with the intention to address shortfalls in investment across both social and environmental needs. Investment shortfalls tend to become increasingly prevalent during times of global economic stress, such as we now face, with investment either reduced or diverted to other areas. These shortfalls create a scarcity value that can be a necessary condition for a successful financial investment as well.

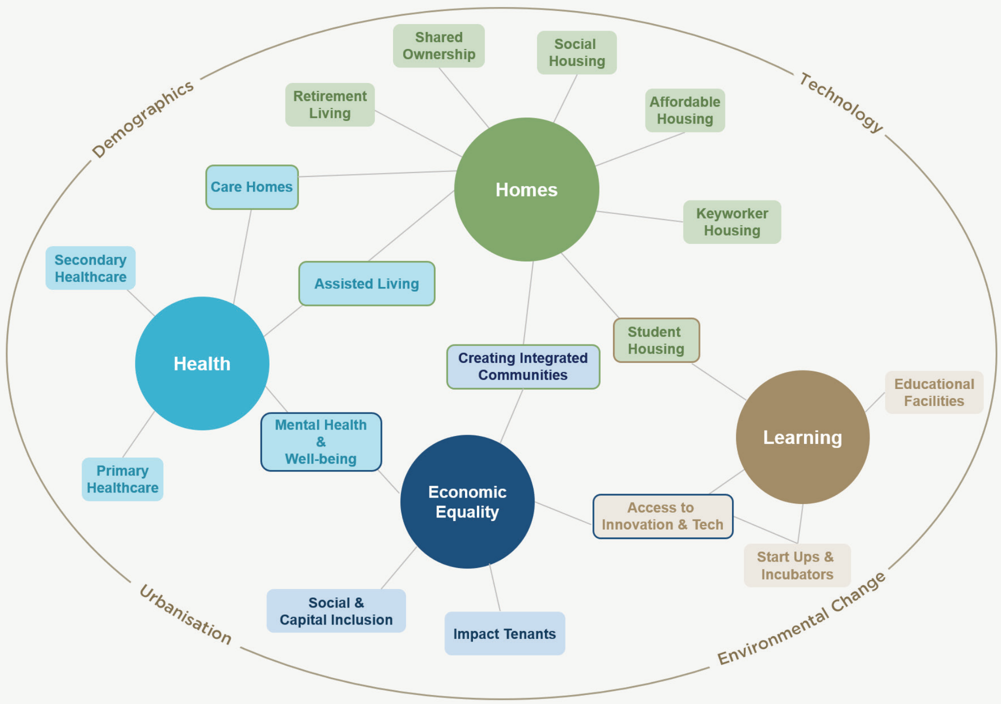
Up to now, many investors within real estate have tended to focus their impact investing on acquiring or lending to either affordable or social housing. These are the largest and most liquid impact sectors in most countries, although there are many other asset types capable of producing a sustainable stream of financial and social benefits that warrant consideration. It is our view that adopting a broad sector approach allows for diversification and flexibility especially in light of the rapidly changing world in which we find ourselves. A broader approach also lessens exposure to sector specific regulatory risk and reduces development or operational partner concentration. It also increases the ability of the manager to be opportunistic across a range of asset types and thereby tackle a broader range of societal needs, while also seeking competitive financial returns.

We believe that the best strategies for impact investing in real estate should begin by combining the United Nation's Sustainable Development Goals (SDG)[6] along with something similar to LaSalle's DTU+E themes[7]. These should align with a clearly defined impact framework; including assessment of the specific societal and environmental need, beneficiaries and wider societal impact. The growing academic and practitioner literature on impact investing helps define terms and establish frameworks that are useful for setting specific goals before embarking on an impact investing program.[8]

Mapping the property types

Impact investing frameworks can range from the broad (e.g. "Regeneration") through to the specific (e.g. "Homes"), filtering down to known real estate use types, such as care homes, retirement living, and educational facilities *[see Chart 3]*. This thought-process of distilling over-arching frameworks to specific assets types with common characteristics permits the development of a targeted investment strategy, delivering tangible business plans.

Chart 3: Impact Investing Targets are Aligned with Secular Trends



Source: LaSalle (02/20),

Within the **Homes** category of impact investing, sector-specific fundamentals typically lead to more stable and predictable net operating income (NOI) growth. For example, there has been a growing scarcity of social and affordable housing stock in the UK since the introduction of the tenants' Right to Buy legislation in 1980. Up to that point, c.125,000 homes for social rent had been constructed each year for thirty years. Thereafter, completions fell to less than 30,000 per annum[9]. The owner-occupied housing affordability crisis, fuelled by decades of house price growth and the rise of the private buy-to-let landlord, has created an entrenched supply/demand imbalance in affordable housing in many UK cities. In England, there are at present c.1.2 million households[10] on the social housing waiting list, with many of those living in unsanitary/overcrowded conditions or listed as homeless. This is not unique to the UK; in many countries such as Australia and United States, shortfalls in affordable or social housing are of major societal concern. We believe that demand for both social and affordable housing will far outstrip supply for many years to come. Even fundamental changes, such as exponential growth in construction activity or any changes to regulation and taxation, would in our opinion take many years to reverse the inherent imbalances in the sector.

The Healthcare sector has been at the core of the response to the coronavirus pandemic, further cementing the strong response of society to the rising need for adequate health care of aging populations. However, as the pandemic has also made clear, idiosyncratic risks can also be higher in this sector (for example senior care homes). Backed fully or in part by the public sector, both **primary** (GPs, medical offices) and **secondary** (hospitals) healthcare offer strong creditworthiness. Yet the healthcare sector brings with it a reliance on government funding that may be cut in times of austerity. In some cases, the highly-specialised nature of the buildings increases the likelihood of obtaining a long lease and/or renewal at lease end, although running costs can be high and alternative use options may be limited. There are also potential opportunities when considering life sciences centres of excellence, combining the educational and healthcare sectors. By overlaying our Demographics, Technology, Urbanisation, + Environmental Change (DTU+E) principles and considering where need is great, an investor could gain exposure to healthcare and life science assets designed to withstand demographic and urbanisation trends. This enables the provision of healthcare and scientific research where it is most needed now and in the future.

The developed world's ageing population is an enduring trend and one which is accelerating in the UK and many other developed countries. Specialised real estate is needed to accommodate this ever-growing ageing population, as human populations are living longer and maintaining an active lifestyle well beyond prior norms. Institutional provision of **retirement living** with shared facilities is not a new concept but one that is rapidly gaining momentum, especially in English-speaking countries such as the US, Canada, Australia, New Zealand and, more recently, the UK[11]. Active retirees seek to capitalise on their better health and mobility compared with previous generations of retirees whilst unlocking the store of value in their owned-homes and then recycling these gains into private, continuing-care facilities. These property types ultimately benefit from both rising demand and limited supply and, by extension, greater or more stable NOI growth.

Other less-tangible areas of impact investing such as **placemaking, amenity provision** and **community integration** could also play an important role but the metrics used to gauge the ultimate impact will require careful consideration. Yet investors and tenants alike continue to think that these "neighbourhood effects" are critical to tenant and staff retention respectively[12]. Ultimately, investors can no longer expect to be a passive recipient of the benefits of placemaking. Future investments should involve an active contribution. By integrating our DTU+E themes alongside social goals for local job generation or increased use of public transport, opportunities for investment in placemaking and urban regeneration developments could open up in areas overlooked by other investors focused on maximising returns.

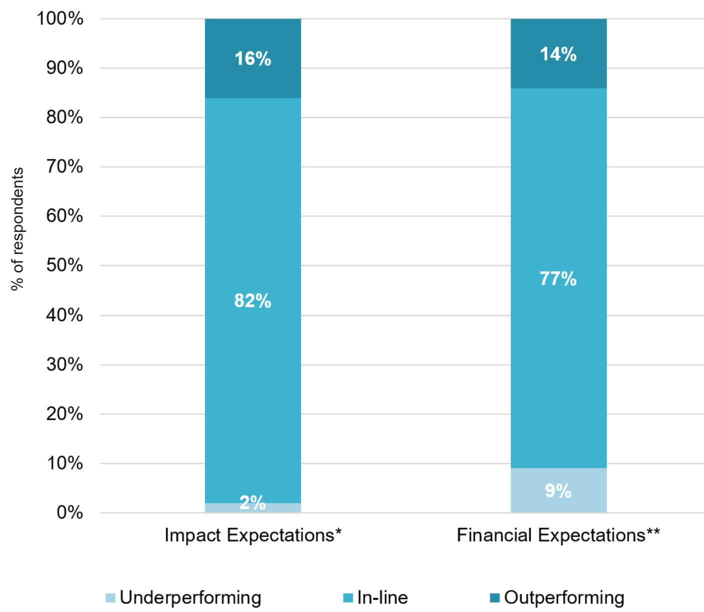
Enhanced risk-adjusted returns

As illustrated, there are entrenched supply/demand imbalances and deep societal needs present within several real estate sectors in the UK, many of which may be exacerbated by the Covid-19 pandemic. These current imbalances provide opportunities to create a positive societal and environmental impact through real estate investment. However, this need not come at the expense of financial returns. It is our view that the inclusion of impact investing within a multi-asset portfolio offers diversification and solid risk-adjusted returns based on robust underlying fundamentals. This belief stems from our successful experience with sectors like healthcare and urban regeneration, both of which provide societal benefits.

A recent survey of impact investors conducted by GIIN highlighted that 66% of respondents target market-rate returns, with 20% targeting below-market returns, although still close to the market rate, and 15% targeting returns closer to capital preservation[13]. In addition to this survey, a further survey reported on respondents' realised performance relative to both impact and financial expectations[14]. This demonstrated that only a minority saw an underperformance in their expectations on either measure *[see Chart 4]*. In UK real estate, we believe that high-impact investments that meet the needs of under-served populations, for example providing affordable homes, or emerging sectors like life sciences or medical facilities, are deep enough that financial returns can be commensurate with lower social impact (i.e. conventional) commercial real estate investments.

Expanding on the theme of risk-adjusted returns, in 2017 LaSalle published its first global white paper on **Environmental Factors & Real Estate Demand**. The paper detailed the link between green buildings and lower risk and/or even higher returns. There is evidence that points to these assets being less costly to finance, more liquid to trade, having lower vacancy risk and higher credit quality tenants, providing operational cost savings to tenants and lower requirements for future capital investment. The paper concluded that in converting from "non-green" assets to green assets, investors would likely achieve a better risk-adjusted return and that over time the market would require a lower return for a green asset due to its inherent resiliency. This would result in a lower exit cap rate, which would reward the investor with the skills to convert assets from "non-green, to more-green". Over the last ten years, there have been many academic and practitioner studies, including LaSalle's own research, that point to these dual, positive environmental and financial impacts that accrue to well-credentialed green buildings[15].

Chart 4: Realised performance relative to expectations



*253 respondents
**254 respondents
LaSalle (02/20), Annual Impact Investor Survey. GIIN (06/19)

Yet, given the emerging nature of many of the property types that comprise impact investing, performance data that supports the belief that such a strategy would deliver solid risk-adjusted returns (beyond these environmental attributes) is difficult to come by. Some evidence comes from performance data within the MSCI UK universe covering the existing "Healthcare" and "Residential Non-Market Lets" sectors. Although far from being a comprehensive representation of impact investing, these sectors will form an important part of such a strategy. Their annual returns have proved to be 50% less volatile than the rest of the market since 2009[16].

Based on this assumption and for illustrative purposes only, we compared this proxy for impact investing to the rest of the market during a major period of market distress; the Global Financial Crisis (GFC). In early 2007, pre-GFC UK consensus forecasts were predicting robust real estate total returns of 6.2% p.a. over the next five years[17]. By contrast, what transpired was a -0.4% pa total return. If the impact sectors fell just 50% of the overall market average (as suggested above), they could have conceivably generated a return of 2.9% p.a., equivalent to 330 bps outperformance each year. We are now facing a new period of market stress. Real estate will be impacted, although the extent remains as yet unknown and will vary across sectors. The very nature of the pandemic leads us to believe that the healthcare and residential sectors will again prove to be more resilient than the wider market during this period.

Facing up to the risks

As with any investment strategy, impact investing within real estate does carry associated risks. With a likely focus on new and emerging real estate sectors, there are inherent risks in their relative market illiquidity. Building on themes we have studied at LaSalle, concerning what occurs when previously non-mainstream property sectors gradually earn widespread market acceptance, as the impact investing movement gains traction, it should move from a higher-cost-of capital or pre-core status toward lower-cost-of-capital. This occurs when pioneer investors help secure greater institutional acceptance through openly sharing their financial results. In the case of impact investing, the societal benefits would also be shared transparently. Over time, this transparency will shift the perception of risk and drive improvements in market liquidity[18]. This notion, alongside the long-lease nature of many impact investments, should help mitigate liquidity risks.

In property, higher risks typically apply to development. For impact investing, there will likely be a need to commit to higher development levels in order to address supply imbalances and secure social benefits or “additionality”. This could be mitigated by undertaking forward funding on developments with committed tenants and working alongside experienced development partners. On the tenant side of the equation, the nature of impact investing means some leases may fall below investment grade from a credit perspective. Where appropriate, this risk could be in part mitigated at a portfolio level, with other assets let to government or quasi-government tenants. Further to this, ensuring that assets are situated in enduring locations with well-established, ongoing social requirements improves future letting potential. Moreover, an enduring and deep level of networked access contributes to residual site value and optionality of use.

Whilst landlords can provide the physical environment to generate a positive impact, without the engagement of the tenant these efforts may not have the desired results. The specialised nature of tenant/landlord relationships in the high-impact property sectors means that owners should take the time to understand the social and business pressures that each tenant category faces. This knowledge can establish a service provider relationship moving forward, enabling investors to create impact beyond the built environment by fostering new relationships between landlords and tenants, and thereby improving tenant satisfaction. This commitment to reciprocity between tenants, other community stakeholders and landlords will enable investors to maximise and assess the impact of their investment through operational transparency and efficiency.

Recessionary periods typically result in investors seeking out relative safety. As mentioned, impact investing within real estate will carry inherent operational risks, some of which may be exacerbated by a recession, though at least partially offset by stability of income. In the aftermath of the current global health crisis, investor perception of risk and future risk may begin to alter. Impact investing into assets underpinned by structural societal demand could offer investors an opportunity to build resiliency and recovery into their portfolios, and to “do well by doing good.”[5]

Measuring Impact

The starting point for impact investing is to clearly identify the impact that an investment is looking to achieve. It is therefore critical to have robust measurement practices for the purpose of evidence and transparency. This informs decision-making and improves operations with the aim of delivering maximum positive impact for all stakeholders whilst also contributing to a better understanding of financial performance. Key issues for consideration depend on the specific investment and contextual factors but might include additionality, affordability, the environmental efficiency and quality of the accommodation/operator and the extent of community initiatives and engagement.

At present there is no universal framework through which to screen and measure impact. Managers use a variety of approaches, methodologies and data sources, both qualitative and quantitative, to appraise the potential impact of an investment prior to acquisition, and to monitor the impact created on an ongoing basis. Incorporating existing frameworks and impact practice standards, such as the UN Principles for Responsible Investment and UN SDGs, alongside the advice of specialist impact advisors, is a practical means of ensuring impact standards are met and have credence within the wider investment community.

The GIIN published a set of guidelines for impact investment which provide a useful step by step framework to follow when considering how to measure impact[19]. In the first instance, impact goals must be outlined and a framework and set of metrics identified. Data must then be collected, stored, validated and analysed. Findings should then be reviewed, reported and used to drive investment management decisions in order to ensure improvements are made.

Real Estate is the Ultimate Impact Investment Asset Class

Given it is physical, local and with site-specific dimensions, designed explicitly with people in mind, real estate has the potential to be a preeminent impact investment asset class. We believe that identifying the right assets based on enduring environmental and social benefits will deliver an enhanced risk-adjusted return relative to traditional real estate assets. Alongside this, they will also generate positive social and environmental impacts at a time when they are highly valued by investors and by society at large.

Endnotes

1) The PRI website introduces the principles for responsible investment here: https://www.unpri.org/
2) See "What is the PRI?" https://www.unpri.org/
3) Höchstädter, A.K, and Scheck, B. (2015) What's in a Name: An Analysis of Impact Investing, Understandings by Academics and Practitioners. Journal of Business Ethics 132 (2), pp 449-475.
4) Sizing the Impact Investing Market. GIIN (04/19)
5) Helen Avery, "Impact Investing: The mindless mantra – 'doing well by doing good'." Euromoney January, 2019.
6) SDG3 (good health & well-being) SDG7 (affordable & clean energy) SDG8 (decent work & economic growth) SDG11 (sustainable cities & communities) SDG12 (responsible consumption & production) SDG13 (climate action)
7) LaSalle's investment approach known as "Demographics, Technology, Urbanisation + Environmental Change" focuses on the hypothesis that these four secular drivers shape real estate markets in ways that supersede and outlast the shorter-term property cycles. In other words, investors in long-term strategic assets should look beyond the ebb and flow of supply-demand cycles to understand long-term trends in real estate demand.
8) One of the best sources of reference materials was published by the Rotman School of Management, University of Toronto in May, 2018: Review of the Academic and Practitioner Literature on Impact Investing.
9) "A Vision for Social Housing". Shelter (01/19), Ministry of Housing, Communities & Local Government (2019)
10) Ministry of Housing, Communities & Local Government (01/20)
11) Other rapidly ageing countries such as Japan, Germany and Italy have a stronger reliance on government-run elder care facilities and/or a tradition of multi-generational family care.
12) "92% of building owners believe that offering enhanced amenities will increase leasing velocity and rental rates within their buildings". The Agile Advantage. CBRE (2018); "81% of respondents to an occupier survey by JLL in 2018 perceive "smart buildings" can improve worker retention". Case studies of specific amenities—event spaces, tenant lounges, on-demand food, hospitality services, and wellness offerings—are profiled in "These six office perks are here to stay" February 2020 JLL Flexible Office Report
13) Percentages stated do not equal 100% due to rounding error. The State of Impact Measurement and Management Practice. GIIN (01/20)
14) Annual Impact Investor Survey. GIIN (06/19)
15) Attributes that contribute to a property's environmental sustainability include access to renewable energy, energy-conserving building systems, water and waste recycling facilities and processes, access to transit, and facilities that contribute to the well-being and fitness of the tenants. Environmental Factors & Real Estate Demand. LaSalle (06/17)
16) MSCI (09/19). Residential Non-Market Lets include Ground rent, Protected/ statutory tenancies, Fair-rented tenancies, Student direct let, Student nomination agreement, Student sale & leaseback and Mixed tenancies.
17) IPF (02/07)
18) ISA 2016. LaSalle (2016)
19) Guidelines for Good Impact Practice. Working Group of Impact Measurement, GIIN (09/14)

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The outbreak of the Novel Coronavirus (COVID-19) was declared by the World Health Organisation as a "global health emergency" on the 30th January 2020 and was then characterised as a pandemic in March 2020. COVID-19 has impacted global financial markets, severely restricted international trade and travel, disrupted business operations (in part or in their entirety) and negatively impacted most investment asset classes (including real estate (whether held directly or indirectly, or whether as a result of being a lender to owners of real estate)).

As a result of the above factors, conditions exist in the real estate markets that may result in value uncertainty and valuations are reported on the basis of significant valuation uncertainty or extraordinary assumptions related to the impact of COVID-19. Consequently, less certainty – and a higher degree of caution – should be attached to valuations than would normally be the case. Given the foregoing and the unknown extent of the impact of COVID-19, LaSalle accordingly highlights that the reliability of real estate values in this report may be significantly under- or over-stated and subject to material variance on a short term basis.

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