

Market mechanism needs a helping hand

Large allocators of capital could and should play an important role when it comes to reaching a net zero world. Regulations that limit the harm created to others are necessary. Making sure those new regulations are not too heavy-handed will be crucial for them to get the necessary democratic support.

By Joost van Mierlo

Vincent Nobel is a fund manager at Federated Hermes, responsible for real estate debt investing. As such, he contemplates what role his sector could play to achieve the climate goals as defined by the Paris Climate Accord. 'As a private investor you have to realize that your actions have consequences for others. It's not just a matter of taking a certain amount of risk and trying to achieve a certain amount of return. And it's also not a situation where maximizing profits should be achieved at all costs. Certain responsible investment principles can be expected from private market participants, but there are limits. That's where regulation needs to help us push the envelope.'

What is the current situation around commercial real estate and green standards?

'I think we've come a long way. Evidence is slowly accumulating that the greener the building, the higher the rent that tenants are willing to pay. In markets where that evidence is still weak, there is at least growing evidence that the greener the space, the shorter any vacancy period when a tenant leaves.'

Though real estate was never only valued on location, location, location, it is fair to say that the energy efficiency standard of a

building was not previously a major factor in determining tenant demand. It's not only that a green office is more attractive because it has lower running costs. There's also a qualitative aspect to it. A company located in a green office becomes more attractive to its employees and to its customers, all of whom prefer to be associated with a firm that values the environment.'

That sounds fine. Pretty soon everyone will be working in a green office then?

'Perhaps a more important question the real estate sector is facing now is who will be working in a dedicated office building at all. It does seem true that greener offices in good locations still attract tenants, even in the current market. But we have also seen large blue-chip tenants walk away from large and long lease obligations to seek smaller but better quality space in better locations.'

The real challenge when it comes to green offices, is that the cost of making offices green is substantial. And this significant capital investment is needed, not to drive rents higher, but to protect current rent levels. It is not the most exciting narrative. What it requires is a considerable value correction, which is what is happening. Of course, these corrections usually cause some cognitive dissonance. Sellers are loath to acknowledge the fall in value. Rents, after all, are still the same in the short run, and isn't it the rent that determines the value? In volatile markets of illiquid assets, transaction volumes fall well before prices catch up.'

Transform the offices into flats or apartment buildings?

'As a matter of principle, I am a big fan of sensible change-of-use. Old warehouses can become wonderful loft apartments, and luxury town houses can make great offices et cetera. Tenant requirements change all the time, but the physical asset is less flexible, yet must remain viable for longer than some of these demand changes. This is a challenge though. Most modern offices are absolutely unfit for housing conversion. At times it is economically more attractive to knock them down and replace them with buildings that are fit for purpose. But the carbon impact of demolishing buildings is high. The modelled lifespan of new buildings is no more than fifty years, yet some of the properties that seem candidates for demolition are not even that old yet.'

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So what needs to be done?

'The free market drives investors towards the best risk adjusted return. If this consistently leads to outcomes that as a society we are not, or should not be, happy with, democratic intervention can be a great solution. What this really means is taking some of the alternatives off the proverbial table. This can include requirements on minimum energy efficiency standards, or regulation that promotes refurbishment over replacement. If not mandated by regulation, many private investors will build the assets that give the highest financial return.

To create meaningful change in energy performance, it is crucial that we understand the baseline. As a sector we need to be able to collect lots more information on buildings' energy performance. Some information rests with tenants and is not even available to a landlord, let alone the lender. There should be clear regulation about information sharing regarding energy performance and the circular economy. We have started with this kind of regulation of course, like with the EPCs, energy performance certificates, that are publicly available. But we need to go further. Much more progress on net zero can be expected if the sharing of information around energy, climate, waste and social standards is mandatory. Only in that case will it be possible as an investor to collect this information and compare the data with an effective benchmark.'

Can you give an example?

'Retail warehouses are a great example. The tenants control the units they lease and the landlord is not entitled to information about energy use in each individual unit. As a result, we as lender do not get this information either. Technical due diligence might tell us how well the asset should perform in terms of energy efficiency, but there is no way for us to verify this.'

You're in a powerful position as capital allocator. Why don't you just demand this kind of data as a sector?

'Where the data is available to the landlord we do require it to be shared. And our borrowers are generally very happy to share this information. The next step is what we do with the information, and what asset improvements we require. As an asset manager we do allocate capital and this comes with a balance of influence and responsibility. But we allocate on behalf of the beneficiaries of pension funds and insur-



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Vincent Nobel

Vincent Nobel joined Federated Hermes as Head of Real Estate Debt in January 2015. Today, he is responsible for all asset-based debt strategies. From 2011 he was a senior member of the M&G Real Estate Debt team, where he helped create and develop the Senior Real Estate Debt Fund. Before that, he spent three years at Barclays Corporate in their specialised debt team and at Barclays Capital, from 2004. Nobel holds an MSc in International Business Studies from Maastricht University and an MA from Sciences-Po (IEP) in Paris.

ance policies. Without specific impact instructions, we fall back on our general responsibility principles. We share these principles with many of our borrowers, but they fall well short of clear impact targets. In many cases impact targets may come at the expense of financial return.

As an asset manager we work for our pension and insurance clients. These have taken on pension and insurance liabilities in exchange for payment. Their primary goal is, and must be, to meet the liabilities they've taken on in a commercial venture. So to ask the sector to self-regulate towards impact targets is really quite a tall order. But that doesn't mean there's no understanding that different stakeholders have to be taken into account. What I am asking for is a situation where governments change the frame of reference, with regulation that doesn't lead to excessive friction in the system.'

Like the current situation in the Netherlands regarding farming reforms?

'Exactly. It's not for me to say if that regulation is fair or not, but reforms must take into account both their destination and their journey. That means they have to be made acceptable for the ones in society that are most affected by it. A bottom-up kind of reform works better than a top-down approach. I thought that was the original basis of the 'polder model''

Are there better examples?

‘There are areas where I think we may be on the right track, even if it perhaps doesn’t go far enough. The housing shortage, particularly for affordable and social housing, remains a big issue. Housing can be built affordably, but in the cities land values are too high to do this purely as a commercial venture. Or rather, if you had the choice, you would build housing for those that can afford to pay more for it. And this is really what it comes down to. In certain circumstances that choice may need to be removed. In the Netherlands, just like in the UK, already a certain percentage of newbuilds have to be affordable houses. However, over the many years that these requirements exist, it hasn’t yet made a significant dent in the housing shortage. I think the requirement to build affordable homes is a good mechanism, but perhaps the percentage is too low.’

Ultimately, one asks for sensible decisions by politicians. Is that reasonable?

‘Where free markets fail to deliver the outcomes that society wants, we ought to be able to look to our elected politicians to deliver this change. However, one has reason to be skeptical when, here in the UK, green measures are being revoked or delayed, seemingly because an election is coming up. What we need is a transition towards a more sustainable economy, and for that transition to be fair and equitable. Ignoring the pain that this transition causes or failing to make the transition are both cause for justified grievances. Whether it is Occupy Wall Street, Just Stop Oil, or the farmers, these protest groups will continue to emerge. One could disagree with their methods, but there’s a genuine feeling of disenfranchisement and concern that must be addressed.’

There’s quite a bit of concern regarding greenwashing of investments. What’s your view?

‘There are two kinds of criticism. On the one hand there may be investments sold as green, while in reality they may be anything but. It takes only a few such examples to damage trust in any sector. We need to continue to improve the standards and certifications to prevent this from happening. The other criticism is that some of the so-called green activities do not in practice achieve the change that’s needed. Impact investing is not just withholding of capital from certain sectors. It’s not enough to stop

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investing in oil and gas and to say one has a green portfolio, when one has just sold all the non-green assets.

The same holds true for us real estate investors. It would be quite easy to only invest in new buildings with strong green credentials. But the reality is that a high proportion of the real estate that will be used in 2035 already stands today. What the climate really needs are activities, or investments, that make these existing buildings better and lower their carbon footprint. That’s where our focus should be.’

What about the growing discrepancy between the developed world and emerging markets and lowering the carbon footprint?

‘Everybody is working on reducing their impact on the environment, or at least everyone should be. But let’s be honest: it is the developed world that is responsible for most of the global carbon emissions. I am keen to avoid a new type of green colonialism where we tell emerging markets what they must do. It probably helps that my own investable universe only covers the developed world.’

It seems like the sector has a lot to stomach. Will it work?

‘It’s clearly an enormous challenge to reach net zero by 2050, not just for real estate investors. Most countries have fallen behind on their climate commitments. More work is needed, but there is a lot of enthusiasm in this process too. However, the reality is that the climate cannot rely on the free market alone and needs the help from a well-designed regulatory framework. Let’s face it: to reach net zero by 2050, we are in part relying on technologies that don’t exist yet. Let’s embrace them when they become available! In the meantime, knocking down buildings just because they have grown out of favour must be approached with extreme caution.’ ■

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SUMMARY

The greener the building, the higher the rent tenants are willing to pay.

In volatile markets of illiquid assets transaction volumes fall well before prices catch up.

There should be clear regulation about information sharing regarding energy performance and the circular economy.