

Implementing ESG in Private Real Estate Portfolios: The Case of U.S. and Pan-Europe Core Fund Managers

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Abstract This paper provides an overview of current environmental, social, and governance (ESG) practice with some of the leading U.S. and pan-Europe institutional real estate open-end fund managers. There were 18 firms that participated in the interviews, which were conducted with 36 persons, of which 72% were at the decision maker level. The participant firms represented over \$300 billion in assets under management at year-end 2009. The paper discusses how fund managers balance fiduciary responsibilities and sustainability goals, the impact of green regulatory pressures, holistic approaches to ESG implementation, green push/pull on tenants, perceived and realized economic returns to sustainability, and the need for internal and external “buy in” for sustainability implementation.

Environmental, social, and governance (ESG) factors represent a component of a full spectrum of sector attributes and manager skills for investors to consider in evaluating investment opportunities. Among the advantages of the real estate sector is that it offers the potential for a relatively practical, transparent way to connect progress on sustainability initiatives to the impact on an investment’s bottom line. Those managers who are farthest along in gaining momentum on initiatives that translate into positive investment returns are expected to be at a competitive advantage relative to their peers, particularly as regulatory and market forces increasingly reward strong ESG practices over time.

The focus is on managers of “core” strategy funds in the United States and Europe, which comprise a subset of Russell’s real estate private equity manager research coverage. Not all of the managers within the coverage universe participated in the discussions, and it does not reflect a scientific study or a statistically significant sample of the entire U.S. and European private real estate open-ended fund universe. However, the interview participants are leading institutional investment managers in private real estate (see the Appendix). The participants’ firms represented over \$300 billion in assets under management at year-end 2009. There were 18 firms represented, with interviews conducted with 36 persons, of which 72% were at the decision maker level. These decision makers included global and regional heads of real estate teams, members of the portfolio and asset management teams, sustainability officers, acquisitions officers, research

team members, and members of the development, environmental, and engineering teams. It is not unreasonable to presume that those fund managers who agreed to participate in the interviews are those who have conviction on their sustainability goals, and have experienced traction in implementation of sustainability initiatives within their respective portfolios. Thus, the sample is likely to be biased. Additionally, while the themes presented in this paper reflect current practice, they may also represent “best” practice in certain regards.

Increasing numbers of fund management organizations are becoming signatories to the United Nations-backed Principles for Responsible Investment (PRI) initiative, which carries responsibilities with regard to implementing ESG into business practices as well as reporting to the UN. What follows is an overview of current ESG practice—highlights from a series of discussions with some of the leading U.S. and pan-European institutional real estate open-end fund managers.

Major Themes in Current ESG Practice

Balancing Value with Values

Much of the emphasis among the fund managers interviewed was on the “E” (“environmental”) element in ESG, rather than on the social and corporate governance elements. In part, this is due to the increasingly quantifiable aspects of no- and low-cost sustainability initiatives, as well as return on cost and near-term payback periods on sustainable building systems replacement and capital programs. Fund managers are seeking to balance their fiduciary responsibilities, economic return targets, and sustainability goals. Thus, a financial analysis is typically a part of the consideration of a particular sustainability initiative. Fund managers generally spoke of payback periods within four years or, as core investors, over the anticipated hold period of the investment. They also evaluated the return on cost or investment and the internal rate of return (IRR) associated with the initiatives. In certain cases, fund managers indicated that the IRR was in the double digits, far higher than what is typical for a core real estate investment.

Green Regulatory Pressures

Regulatory pressures are expected to play an increasing role in the pace of sustainability programs within the commercial real estate markets in the U.S. and Europe. In the U.K., the Energy Performance Certificate requirement has been implemented for residential, commercial, and public buildings. The certificates are required for the rental, sale or development of buildings, and must be displayed for public buildings and larger commercial buildings. Though the program is a step in the right direction with regard to consistency and transparency, one of the challenges mentioned during the interviews was the “theoretical” nature of the certificates. Multiple fund managers noted that the certificates are based on the energy efficiency potential given the profile of the building, rather than the in-place performance of the building. According to Neil Harris, of Invesco, at present there is no single recognized pan-Europe survey or product that can provide,

across property types, an indication of in-place sustainability performance by use of investment criteria designed to provide a context for payback and timing considerations.

The advent of energy performance certificates is indicative of the growing regulatory push toward a greater emphasis on sustainability in the commercial real estate market and on developing market-accepted ways to measure sustainability performance. For both U.S. and European portfolios, fund managers spoke of engaging third-party “sustainability auditors” to conduct performance reviews and provide recommendations for improvements. Such recommendations were deemed useful not only for managers for internal considerations, but also for tenants, particularly in instances where tenants are directly engaged with the utility providers.

The connection between the regulatory framework and sustainability in commercial real estate investment is expected to grow stronger over time. The American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE), the U.S. Green Building Council (USGBC), and the Illuminating Engineering Society have published a new U.S. standard that “defines the minimum requirements for a high-performance green building” that will be code-intended (ASHRAE, 2010).¹ That work product, Standard 189.1, has five key focus areas: site sustainability, water use efficiency, energy efficiency, indoor environmental quality, and the building’s impact on the atmosphere, materials, and resources. The intent is for Standard 189.1 to be adopted into local building codes; if implemented, it would be part of a broader regulatory framework that increasingly rewards sustainable buildings.

Holistic Approaches to ESG Issues

The fund managers spoke of the goal of integrating sustainability into the investment framework for a more holistic approach. Among those interviewed, sustainability initiatives were increasingly included as part of the annual business plan and capital budgeting process within asset management, as well as asset strategy reviews with the fund management team.

The sheer size of these portfolios can enhance fund managers’ ability to implement holistic approaches. For instance, Michael Spies, of Tishman Speyer, spoke of the firm’s decision to buy “green energy” in bulk in Germany. The sponsor signed a three-year contract that locked in the cost structure during what was a volatile pricing period, purchased “green energy” and thereby helped to create the market. The contract pricing represented a savings to the portfolio, and now the German portfolio has green energy.

Giving another example of a holistic approach, Nicholas Stolatis, of TIAA-CREF, spoke of considering a capital program for replacing chillers and other building systems that are approaching their useful life expectancy, where earlier replacement with more efficient systems may have an accretive, positive impact on returns. The building systems emphasis had particular traction in the industrial sector, where tenants’ direct payment of utility bills and tenant uses within the spaces can pose challenges to landlord engagement.

“Buy-in” for Sustainability Implementation

To support successful implementation, stakeholders—the fund management team, property management firms, and joint-venture partners—need to be “on board” with sustainability initiatives. The ability to accelerate implementation of sustainability initiatives that positively impact the bottom line can, across a portfolio of assets, significantly impact the value of a fund. Successful implementation of accretive sustainability initiatives can help to protect and enhance property values through real estate market cycles (all other things held constant).

Setting Policy. The degree of internal, joint-venture partner, and property management buy-in and information sharing on sustainability initiatives can enhance traction in implementation, accelerating the impact to the bottom line. Fund managers spoke of members of the asset management team, engineering team, and property management team approaching the annual business plan and capital planning process with a holistic approach to evaluating ways to increase sustainability. They also noted the benefits of sharing sustainability “best practices,” based on actual experiences within the operating portfolios, with the acquisitions team. Additionally, the information sharing appears to span across regions. For instance, Tom Enger, of UBS Global Asset Management, spoke of ongoing “best practice calls” with counterparts in Europe to discuss certification efforts and property management practices.

Most of the firms have instituted a sustainability policy at the corporate level, which was readily available upon request. The corporate policy establishes a framework from which the investment teams can approach sustainability. The real estate groups that were a part of a broader organization had, in certain cases, developed their own sustainability policy or set of guidelines. As Preston Sargent, of Multi-Employer Property Trust (MEPT), put it, the mission statement “plants a flag” and establishes a context so that managers can “begin the process of creating coherent terms.” Even as the economic crisis affected the global private real estate market, implementation of sustainability into day-to-day fund management practices appears to have gained momentum in the last two years among the fund managers interviewed. While certain managers were actively evaluating efficiency initiatives for some years, others reported increased awareness and traction in just the last few years.

Implementing Policy. The implementation process requires buy-in not only from internal teams, but also from third-party partners involved in investment management. In most cases, third-party firms are engaged to provide property management and leasing services at the property level. Additionally, given the magnitude of the assets, joint-venture partners may have monetary interest in the investments, with some acting as general partners where there may be property management and leasing services provided as well (in “vertical integration”).

Certain fund managers have developed sustainability guidelines that are provided to joint-venture partners as well as property managers. These guidelines cover sustainable asset management, energy conservation, green cleaning, indoor air

quality, sustainable purchasing, solid waste management, and water conservation. Adrian Benedict and Aymeric De Seresin, of Fidelity's Europe team, indicated that there is variation by region in terms of property management engagement with responsible property investing (RPI)-type policies. They indicated that, in comparison to the U.K., RPI-type policies are relatively new for property managers in France and Germany, though potential changes in public policy would have an impact. They spoke of Fidelity's efforts to "go beyond the regulations of countries" in order to have a consistent set of sustainability goals and benchmarking tools across Fidelity's portfolios.

However, there is also increasing awareness that sustainability guidelines for property management must be nimble enough to account for variation by region or country. For instance, Brett Levy and Bill Anderson, of Prudential, talked of how the lighting guidelines for the U.S. are not globally applicable. Levy and Anderson spoke of "molding" guidelines for use in various regions.

Green Push/Pull on Tenants

Tenants play a critical role in sustainability efforts, in terms of investment performance from the demand side point of view and also in terms of the practical application of a landlord's sustainability initiatives. Depending on lease structure, a landlord may have limited ability to oblige tenant participation. Fund managers spoke of educational efforts to bring tenants up the learning curve with regard to occupancy cost savings associated with sustainability practices within their space.

A relatively recent innovation has been the concept of "green leases." In such leases, fund managers have revised their standard tenant leases to include certain provisions, which might include tenant reporting on energy performance within the tenant unit, compliance with landlord sustainability guidelines, and terms that support a landlord-tenant "partnership approach" to sustainability within the building. For the fund managers with U.S. portfolios, the U.K. Energy Performance Certificate program and innovation in leasing for green elements is especially timely, given movements in Washington, D.C. and California (and possibly other states, in the future) to require the provision of energy data in commercial transactions.

It is clear that multiple forces are at work in putting sustainability initiatives on the agenda for fund managers. Though the current period represents the early stages of ESG development in the U.S. and European commercial real estate markets, the discussion above suggests that regulatory (i.e., federal, state, and municipal policy) and market (i.e., investor, tenant, and future buyer demand) pressures will increasingly reward high-performance buildings (or discount low-performance buildings). Thus, those fund managers who are able to construct property portfolios weighted toward high-performance buildings will be better positioned to maintain or enhance the value of their portfolios over time.

"Getting Paid to be Green"

A "green premium" is not yet believed to be manifest in the transaction market. However, certain fund managers indicated enhanced traction in tenant retention

and tenant appeal associated with ESG initiatives. For U.S. commercial buildings in the CoStar database, Fuerst and McAllister (2008) identified lower vacancy rates and higher rents in Leadership in Energy and Environmental Design (LEED)-rated buildings. However, they noted “significant differences between the sample and the wider population” that were not controlled for, such that certified buildings tended “to be newer, owner-occupied or single tenanted, concentrated geographically and sectorally (in the office sector).” Generally, the fund managers did not believe that the current market offered a green premium on the sale of high-performance buildings.

It is widely believed, however, that high-performance buildings are able to enhance tenant appeal and retention through lower total occupancy costs (rent plus the tenant’s share of other expenses associated with tenant space and with use of common areas of the building). In today’s market, wherein many businesses are retrenching and competition for tenants is fierce, the ability to attract and retain tenants and hold occupancy is no small feat.

The “future proofing” idea, to be discussed in more detail below, suggests that the rewards to high-performance buildings will increase over time. Over time, the market is expected to increasingly differentiate between high- and low-performance buildings. If high-performance buildings become the new standard for high quality “Class A” institutional buildings, then the buyer base for such properties may become deeper relative to low-performance buildings. A deeper institutional buyer base offers the potential to translate into upward pressure on pricing in the event of a sale of the property.

Increased Fortune 500 Interest in Sustainability. A recurring theme in manager discussions is that Fortune 500 tenants are particularly interested in sustainability labeling or “green certification” as they seek to meet their own sustainability goals. Such labeling might include ENERGY STAR and Leadership in Environment and Energy Design (LEED), in the U.S.; Building Research Establishment Environmental Assessment Method (BREEAM), in the U.K.; Haute Qualité Environnementale (HQE), in France; Protocollo ITACA, in Italy; and the German Sustainable Building Council (DGNB), in Germany (see the Glossary). For the U.S., recent federal policy is such that building owners seeking to attract federal agencies as tenants must have the ENERGY STAR label.

Saving Money May Boost Valuations. Fund managers indicated that independent surveyors or appraisers are recognizing in-place operating expense savings associated with ESG initiatives when estimating the market value of properties. Institutional real estate private equity open-end funds are distinguished from their unlisted closed-end counterparts in part by the scheduled external appraisal and “mark to market” processes, which may be applied on a monthly, quarterly or annual basis. In-place vacancy and leasing assumptions have a significant impact on the discounted cash flow analysis performed to value properties. Thus, the tenancy of investment properties and the appraisers’ or surveyors’ view of the prospects for leasing up vacancy and near-term lease expirations over the forecast horizon have a meaningful, ongoing impact to the valuation of the funds.

According to the fund managers, the surveyors are incorporating in-place operating expense savings into their valuation analyses. However, prospective

savings associated with sustainability initiatives that have not been completed are not included in the discounted cash flow. Additionally, the fund managers' general view was that U.S. and European surveyors were not impacting the discount rate or exit cap rate associated with the sustainability performance or certification of a given building. To the extent that operating expense savings have been achieved by a specific asset relative to its peer set, it is reasonable to conclude that sustainability initiatives leading to incremental expense savings and higher net operating income will translate to a higher property value (all other things held constant) or a higher purchase price for a future buyer.

Development of Frameworks/“Scorecards”

Certain managers appear to be developing their own performance measurement frameworks, or “scorecards,” to compare the sustainability performance of assets within their portfolios across property types and countries. Michael Loose, of UBS, described how the UBS construction and development team in Europe was taking elements of existing certification programs, such as LEED and BREEAM, and incorporating them into an overall framework that could be applied consistently across their portfolios. Nicholas Stolatis spoke of developing a proprietary benchmarking system for the retail portfolio, with an emphasis on tools to measure energy efficiency, even though there is limited labeling opportunity. More than one sponsor spoke of the ability to do the initial training of property managers and internal engineering teams with third-party consultants, particularly at the acquisition phase, and then to conduct the ongoing sustainability evaluation without the third-party consultants. This approach offers the potential to significantly lower the year-to-year costs associated with monitoring progress on sustainability performance at the asset level. Michael Loose indicated that his comparison test of performance data from property management staff and third-party consultants showed little variation, which supported his view that there was sufficient integrity in the data gathered by the property managers.

The variations in approaches to sustainability and the challenges inherent in developing benchmarks applicable across both property types and countries signal that the evolution of ESG is still in the early stages. However, they also represent an opportunity for fund managers to develop and implement sustainability initiatives that will have a positive impact on their portfolios' bottom lines—ahead of their peers, and in line with anticipated changes in regulatory environments. Implementing sustainability initiatives is not only a strategy to potentially enhance investment performance; it can also be viewed as part of a broader risk management approach.

“Future Proofing”

Fund managers expect that the market will increasingly differentiate between high- and low-performance buildings. Fund managers spoke of the “future proofing” impact of implementing sustainability initiatives. Richard Schaupp, of ING, indicated that from an efficiency and sustainability standpoint, high-performance buildings are becoming “the standard for being Class A” buildings in “top-tier

markets.” Jim Kennedy, of J.P. Morgan, said that “at some point, inefficiency will translate into a competitive disadvantage.” That disadvantage may result in a reduced pool of potential buyers, particularly institutional investors, in the event of a sale of the property.

Regulatory changes that have been implemented or that are perceived to be on the horizon are also having an impact on sustainability initiatives. Andrew Smith, of Aberdeen Asset Management, spoke of proactively going “beyond the minimum in each country” to ensure that the appropriate energy performance ratings were in place, in an effort to preempt anticipated regulatory changes. Tom Enger indicated that UBS’s U.S. team uses regulatory and technology changes in Europe as a proxy for what is to come in the U.S.

There is also the view that high-performance buildings will gain momentum with regard to tenant demand and market rents, particularly during the growth phases of a real estate cycle. Michael Kirby, of Invesco’s U.S. team, believes that “in five years, and especially in ten years, buildings that have the right sustainability designation or policy will garner higher rents.” Dave Morrison, of Morgan Stanley, believes that the “tremendous payback in cost savings” translates to limited downside risk associated with implementing certain sustainability initiatives, but that the “unknowns are risks to upside.” (PRUPIM took the “future proofing” idea a step further by incorporating a sustainability questionnaire into its asset appraisal process, the output of which is a “statement on future proofing” by building. An associated impact is the ability to “evangelize” the issue among surveyors.)

Approaches to Sustainability

The fund managers are engaged in an investment process that they expect will yield compelling economic returns associated with specific strategies. The implementation of each strategy is typically executed over the “life cycle” of an investment, which includes acquiring the asset, implementing a business plan during the investment period, and disposing of the asset, with ongoing reporting of asset performance. This section looks at how fund managers are approaching sustainability over the life cycles of investments within the fund portfolios. As will be discussed herein, there is significant variation in the scope and traction of sustainability initiatives by property type and region. Among the fund managers interviewed, sustainability programs within the investment framework typically included combinations of the following:

Acquisitions/Development

- Sustainable real estate development
- Pollution prevention
- Benchmarking and certifications under regional programs that identify environmental “best practice”

Portfolio/Asset Management

- Energy conservation and carbon reduction
- Water conservation
- Solid waste management, including construction waste management
- Indoor air quality
- Green cleaning
- Green leasing
- Sustainable procurement/purchasing
- Benchmarking and certification under regional programs that identify environmental “best practice”

External & Internal Engagement

- Sustainability awareness and training
- Reporting
- Public engagement/consultation

Acquisitions/Development

A key part of the investment proposition is the ability to “buy right.” Incorporating ESG into the acquisition and development stages can enhance the competitive positioning of an asset within its submarket, as well as its investment performance. Some fund managers have begun specifically to include ESG components in their investment opportunities review process (by including sustainability in a separate section of the investment committee book), while others are focused more on operational review of a particular acquisition (by including sustainability in the acquisitions checklist and asset management review).

The fund managers did not indicate that they were currently including the economic benefits of implementing sustainability initiatives in their acquisition pro forma underwriting. However, they did speak of their increasing expertise in quantifying the economic benefit and timing for specific sustainability initiatives as contributing to upside potential.

For new development, there was an emphasis on certification. The fund managers spoke of the limited incremental costs associated with developing new projects to meet sustainability certification standards, due to local regulatory requirements and to expected gains in tenant attraction, particularly large corporate (i.e., Fortune 500) tenants seeking to meet their own sustainability goals.

Due to the core strategy orientation of the sponsor funds, many of the fund managers take a relatively conservative approach to environmental pollution, particularly with regard to liability risk. Typically, core funds take minimal environmental risk in the acquisition of assets. These funds tend to require completion of cleanup efforts to regulatory standards at a minimum, and a notice of regulatory compliance (such as, in the U.S., a “No Further Action” letter) prior

to acquisition, with the asset management and engineering team engaged to address any pollution matters that arise post-acquisition.

Portfolio and Asset Management

The asset management stage represents the fund manager's opportunity to execute a business plan that will enable the fund manager to monetize the value creation upon sale of the property. Most of the world's building inventory is in existing stock, and as Paul McNamara, of PRUPIM, put it, existing stock "is the major battleground" for implementing sustainability in commercial real estate.

Typically, upon acquisition of an investment property, the asset management team undertakes day-to-day operations management. The team works with the portfolio manager and is closely engaged with the third-party property management team. To the extent that implementation of ESG initiatives at the asset management stage translates to enhanced revenue or reduced operating expenses for a property, the fund manager should be able to realize a higher value for the investment (all other things held constant).

External and Internal Engagement

As discussed above, the actual implementation of sustainability initiatives involves the successful engagement of internal and external stakeholders over the life cycle of an investment. These stakeholders may include members of the fund management team, as well as third-party property management team members, joint venture partners, and even tenants. Certain fund managers have implemented sustainability policies that have direct application to the internal real estate investment "practice," as well as policies and procedures that have been incorporated into the governing documents for property operations and management. The policies help to build awareness and, to the extent that they incorporate reporting guidelines on sustainability initiatives, support the development of a benchmarking framework across an investment or property management portfolio. The reporting element may feed into internal and external reports, such as a firm's overall annual sustainability report or a fund's quarterly investor report. Generally, the sustainability benchmarking and reporting frameworks are still in the early stages, with varying degrees of traction across certain property types, markets, or countries. However, the development of a reporting process supports an ongoing feedback loop between the stakeholders engaged at the investment level (i.e., fund management team, joint venture partner, property management team, tenants) and the broader investor base for a given fund.

Low- to No-cost Approaches

Fund managers appear to be pursuing low- and no-cost sustainable operational initiatives across property types (office, retail, industrial, and multifamily). As Paul McNamara, of PRUPIM, put it, "the low-hanging fruit of portfolio management" is in the "myriad of small actions that can lessen the environmental footprint."

Fund managers often spoke of the “practical aspects” of sustainability initiatives, such as installing energy-efficient light fixtures or transitioning to green cleaning. (A frequently cited no-cost strategy is simply turning off the lights in vacant spaces.) This orientation is supported by industry research in energy efficiency projects reported by real estate decision makers. In the 2009 Johnson Controls Study, companies that allocated capital to energy efficiency projects targeted “energy efficient lighting (77% response), adjusting HVAC controls (64% response), and educating facilities operators on efficient building management practices (62% response)” (Peterson and Gammill, 2009).

Michael Spies, of Tishman Speyer, gave an interesting example of a practical no-cost approach to reducing energy consumption in an office building. One of Tishman Speyer’s assets under management is occupied as the European headquarters of a multinational company. With the prior agreement of the company’s senior management, Tishman Speyer adjusted the building controls to raise the temperature by one degree every few days and waited until the calls came in—at which point, Tishman Speyer knew that the adjustment had gone too far. The simple strategy translated to a change of about 2 degrees Celsius or 3 degrees Fahrenheit, yet had a material impact on that building’s energy consumption during the hot summer months.

Industrial Properties Lag Behind. Generally, the fund managers interviewed reported much less traction in the industrial segment of their portfolios, due to lease structures and variation in tenant uses of space. According to the U.S. fund managers, the industrial sector lacks an energy benchmarking system that provides meaningful data. The application of ENERGY STAR to industrial buildings has not translated well thus far; and a USGBC working group is engaged in creating a LEED standard for warehouse and distribution centers. For Aaron Binkley, AMB’s sustainability officer, the emphasis was on retrofits and upgrades for water and energy conservation from a building systems approach. According to Binkley, the building systems approach serves as a proxy for a sustainability benchmarking system.

Fund managers have also been proactive in reaching out to regulatory authorities for assistance in developing useful tools for benchmarking industrial properties. For instance, Prudential found that industrial tenants engaged in laboratory work tend to be “voracious users of energy.” Brett Levy and Bill Anderson spoke of approaching the U.S. Environmental Protection Agency to develop an ENERGY STAR subset for laboratory users, to encourage best practices for that tenant set.

The Residential Sector Also Lags. The fund managers interviewed typically do not invest in the residential sector for the European portfolios. In U.S. multifamily, the fact that tenants typically deal directly with the utility companies has been cited as limiting landlord sustainability initiatives. From an alignment of interest point of view, however, the perception is that there is limited financial incentive to lower operating expenses in this sector, given the muted impact to the landlord’s bottom line.

Dave Morrison, of Morgan Stanley, spoke of “baseline measurements” performed by a third-party consultant on a subset of apartment properties within the core

fund portfolio. For that fund, the property management firm's (AMLI's) engineering team accompanied the consultant to train the team to conduct energy audits on multifamily properties. The plan is to transition the ongoing sustainability audits to the property management team, rather than continue to use third-party consultants.

AMLI then began to incorporate sustainability elements into its operating performance "dashboard," which uploads data from all assets under management for comparative statistics on tenant retention, leasing velocity, cost controls, etc. (The statistics are shared across the entire company and serve as a motivation tool for performance. The dashboard is referenced on national meeting calls and serves as the basis for rewarding outperformers.) A "green dashboard" will have data for electrical consumption in the common areas and vacant units; water usage; "green spend" (i.e., appliance purchases); nontoxic material for recaulking and painting; cleaning/gardening materials; education for tenants on green practices; and overall recycling volumes. Through its energy performance audits and active property management engagement, this sponsor demonstrated the potential for considerable traction in the multifamily sector.

Measuring Success and Creating Standards

As discussed above, the desire to reliably identify opportunities to enhance the value of a property or portfolio through sustainability initiatives leads directly to the issue of benchmarking. Fund managers have not been able to identify a sustainability benchmarking system that is applicable across countries. For instance, Michael Loose said that he "could not compare a BREEAM 'excellent' to a LEED 'gold'." A number of managers cited the sheer volume of sustainability labeling products and benchmarking certifications in the global market as a challenge to increased engagement, since it does take time and resources to sift through the various programs.

Generally, managers of U.S. portfolios seem to have had the most traction with sustainability initiatives within their office portfolios. This is due in part to the dearth of benchmarking systems in the U.S. that translate well for retail and industrial property types. Additionally, the structure of tenant leases and allocation of operating expenses may pose challenges. Some U.S. fund managers had moved subsets of their office portfolios, and others, such as Invesco, had transitioned their entire office portfolios into ENERGY STAR as a baseline. Jay Butterfield and Paul Vacheron, of American Realty Advisors, both spoke of using ENERGY STAR within the asset management process, such that low-end scores trigger more analysis of ways to increase efficiency. According to Preston Sargent, if an asset is seen to fall below a target threshold for portfolio operating efficiency, it may be put on an accelerated track for consideration for sale. Over the long term, active culling conducted from an operating performance perspective may enhance the quality of the portfolio and the competitive positioning of the holdings in their respective markets.

An interesting development with regard to U.S. LEED for Existing Buildings (LEED-EB) is a pilot program for certification of portfolios of office buildings, instead of the typical individual asset certification process. Certain fund managers spoke of the costs associated with involving consultants in the LEED certification process, which impacted the economics of seeking LEED labeling even for high-performance buildings. The pilot will enable portfolios of office buildings (including suburban and urban, single- and multi-tenant, and multiple markets profiles) to proceed through the certification process at once. MEPT is participating in the pilot with a high-performance subset of its portfolio. In theory, the process will establish a consistent set of policies and procedures that would be structured as a one-time cost to the fund; then the process could be replicated on a lower-cost basis across the fund. The economies of scale associated with such a process for owners of large portfolios may fit well within the open-end fund investment framework.

According to Jack Beuttell, of Hines, the company is participating in the ASHRAE pilot program, Building Energy Quotient. For that program, the visual and labeling scheme is based on the European Energy Performance Certificate program. Building Energy Quotient will have two key labels, “As Designed” and “In Operation.” The labels can be compared side by side to determine any gaps between design and operations, why those gaps occurred, and how to correct them. Beuttell indicated that the ASHRAE pilot offers the potential to be a comprehensive energy tool, due to its dual labeling process.

Interpreting the “S” and “G” in ESG

Much of the emphasis among the fund managers was on the “E” (“environmental”) element in ESG, rather than on social and corporate governance. In part, this is due to the increasingly quantifiable aspects of no- and low-cost sustainability initiatives, as well as return on cost and near-term payback periods on sustainable building systems programs. However, overall there was a sense that responsible property investing was “the right thing to do” and that it fit well within a fiduciary framework emphasizing sustainability initiatives that enhance economic value for investors.

Developing a Common Language on ESG

Even though many of these open-ended core funds have a significant proportion of their portfolios in urban infill communities and transit-oriented locations in major markets, there was not necessarily a strong identification with such portfolio characteristics as part of the social component of ESG. Similarly, it is standard practice among these funds to seek to comply with the regulatory framework in the communities in which they invest. Yet that approach is not necessarily viewed as a “governance” component for ESG. This may be due in part to investment managers being in the early stages of developing a common language around ESG, which will continue to evolve as more sponsor firms sign on to the UN’s PRI initiative and the definition of “sustainability” is more broadly considered.

Investor Base Impact

The composition and orientation of the underlying investor base also plays a role in the interpretation, as does the investment strategy. For instance, a U.S. fund with a high proportion of building trade unions and pension plans may be likely to have a responsible contractor policy that emphasizes fair labor practices (i.e., living wage, health care, pension benefits), such as MEPT's and American Realty's. That orientation may be supported by a belief that the responsible labor policy will result in projects that are more likely to be completed on time, on budget, and at a high level of craftsmanship. The series of interviews for this research paper targeted "core" real estate private equity open-ended funds, where there is typically less emphasis on development/new construction and redevelopment strategies.

Corporate Governance Orientation

From a corporate governance standpoint, the fund managers tended to talk of efforts to share information with the shareholders and investor base through annual reports (and in certain cases quarterly fund reports). Fund managers did indicate increasing investor interest in sustainability initiatives, but that interest had been answered largely through use of one-off questionnaires or review of investor requests for proposals. Certain fund managers will be issuing annual company sustainability reports, which will include progress on sustainability initiatives for underlying funds. Fund managers have also become signatories with organizations that support transparency in sustainability reporting. For instance, in addition to participating in the UN's PRI, TIAA-CREF joined the Carbon Disclosure Project, which is a mechanism for organizations to "measure and disclose their greenhouse gas emissions and climate change strategies" (Carbon Disclosure Project, 2009). Fund managers spoke of compliance with ISO 14001,² which is part of the International Organization for Standardization of good management practice recommendations. If compliance builds momentum within the international fund manager community, it may provide a helpful framework for supporting transparency on sustainability.

It is worth noting that the pool of funds that were the focus for this paper are institutional core private real estate funds that, typically, include advisory councils or committees as part of the standard fund governance structure. The advisory councils often comprise a range of investor types, including larger investors and consultants. The advisory councils provide policy guidance, review matters relating to conflicts of interest and act as "sounding boards" for the fund manager. Representatives are typically nominated for a specific advisory council term. Additionally, the U.S. funds may also include a fund board of directors, with independent director participation. Generally, the advisory councils further support the feedback loop between the investor base and the fund management team and, in certain cases, the fund board of directors. It is reasonable to consider the advisory council governance mechanism as standard practice among these types of institutional open-ended private real estate funds.

Conclusion

The recent financial crisis and economic slowdown impacted real estate portfolios worldwide, and the fund managers interviewed have not been immune. However, the interviews suggest that they are finding ways to leverage their sustainability initiatives to attract and retain tenants, reduce operating expenses, and more thoughtfully craft their building systems and capital investment programs—all of which can have a positive impact on the bottom line and potentially “future proof” their assets for enhanced competitive positioning and valuation over the longer term. The emphasis on performance measurement offers a way to quantify the impact of sustainability initiatives and tie it back to financial performance in a consistent, measurable way.

Though there is still significant progress to be made with regard to benchmarking tools across property types and consistency in certification standards across regions, some fund managers are moving forward with innovative approaches to track sustainability performance for their portfolios. These “early movers” appear poised to reap near-term economic benefits associated with low- to no-cost initiatives, enhanced tenant appeal, reduced operating expenses, and lower volatility in asset cash flow. Over the long term (all other things held constant), traction on accretive sustainability initiatives can position properties for higher overall performance—due to a broadened tenant pool, increased tenant retention, a deeper buyer base (particularly among institutional buyers), and higher asset valuation.

Glossary

BREEAM	BRE Environmental Assessment Method (U.K.); the system considers a broad range of environmental impacts under the following issue categories: management, health and well-being, energy, transport, water, materials and waste, land use and ecology, and pollution. Versions are updated regularly in line with U.K. building regulations. Current versions include Court, EcoHomes, Education, Healthcare, Industrial, Multi-Residential, Office, Prisons and Retail. Versions under development include Developments and In-Use. Versions of BREEAM have been adapted for use in other countries (Lowe and Ponce, 2009).
Protocollo ITACA	Istituto per l’Innovazione e Trasparenza degli Appalti e la compatibilità ambientale (Italy); Federal Association of the Italian Regions. The full version of the system includes the following categories: site quality, energy and resource consumption, environmental loadings, and indoor environmental quality. Versions of Protocollo ITACA currently exist for residential buildings, with systems under development for office, retail, school and tall buildings.

	<p>Protocol ITACA is an adaptation of SBTool, which has been adapted for use in several countries (Lowe and Ponce, 2009).</p>
HQE	<p>Haute Qualité Environnementale (France); National certification system for residential and non-residential buildings. The system identifies 14 environmental issues and covers two aspects: environmental quality of the building and environmental management of the entire project. Current versions of HQE include: commercial centers, hotels, schools, houses, residential, offices and in-use. Versions that are under development include healthcare, sports buildings and operational buildings. Versions of HQE have been adapted for use in other countries (Lowe and Ponce, 2009).</p>
High-Performance Building	<p>The United States National Renewable Energy Laboratory definition is a building that “integrates and optimizes on a life cycle basis all major high-performance attributes, including energy conservation, environment, safety, security, durability, accessibility, cost-benefit, productivity, sustainability, functionality, and operational considerations,” (Peterson and Gammill, 2009).</p>
LEED	<p>Leadership in Energy and Environmental Design (U.S.); Each version of LEED covers a range of environmental impacts under the following issue categories: sustainable sites, water efficiency, energy and atmosphere, materials and resources, indoor environmental quality, and innovation. The following LEED versions currently exist: New Construction, Existing Buildings, Commercial Interiors, Core and Shell, Schools, and Homes. The following versions are under development: Retail, Healthcare, Neighborhoods. Versions of LEED have been adapted for use in other countries (Lowe and Ponce, 2009).</p>

Appendix

Interview Participants

I would like to extend special thanks to all those persons who generously gave their time for interviews.

Andrew Smith, Global Head of Property/*Aberdeen Asset Management*, €24.6 billion gross private real estate AUM at December 31, 2009, Signatory to UN PRI.

Aaron Binkley, Director-Sustainability Programs/*AMB Property Corporation*, gross private real estate AUM of \$12.5 billion at December 31, 2009.³

Jay Butterfield, Managing Director–Fund/Separate Account Operations, and Paul Vacheron, Managing Director–Asset Management/*American Realty Advisors*, \$3.3 billion gross private real estate AUM at March 31, 2010.⁴

Brian Murdy, Portfolio Manager/*Cornerstone Real Estate Advisers*, \$31.0 billion gross private real estate AUM at December 31, 2009.⁵

Adrian Benedict, Investment Director–European Real Estate, and Aymeric De Seresin, Portfolio Manager/*Fidelity International Limited*, AUM not available.

Jack Beuttell, Global Sustainability Manager, Daniel Chang, Asset Manager, Andrew Joyner, Fund Analyst, and Andy Smith, Associate/*Hines*, \$22.2 billion gross private real estate AUM at December 31, 2009.

Richard Schaupp, Senior Vice President and Chairman of ING Clarion Partners' Sustainability Task Force/*ING Investment Management*, \$21.4 billion gross private real estate AUM at December 31, 2009, Signatory to UN PRI.

Neil Harris, European Head of Asset Management, and Michael Kirby, Managing Director–Director of U.S. Operations and Asset Management/*Invesco Real Estate*, \$26.5 billion gross real estate AUM at March 31, 2010.

Ann Cole, Client Portfolio Manager, and Jim Kennedy, Managing Director–Head of Development and Engineering/*J.P. Morgan Asset Management–Global Real Assets*, \$38.4 billion gross private real estate AUM at December 31, 2009, Signatory to UN PRI.

Wendy Lowe, Associate, and David Morrison, Executive Director/*Morgan Stanley*, \$50.5 billion gross private real estate AUM at December 31, 2009.⁶

Preston Sargent, Executive Vice President–MEPT Portfolio Manager (Kennedy Associates Real Estate Counsel), Pamela Silberman, Senior Vice President (Landon Butler & Company), and Vanessa Parrish, Senior Associate (Landon Butler & Company)/*Kennedy Associates Real Estate Counsel and Landon Butler & Company*, \$12.2 billion gross private real estate AUM at December 31, 2009, Signatory to UN PRI.

Tuba Malinowski, Director–Marketing and Client Services, and Meighan Phillips, Assistant Portfolio Manager/*Principal Real Estate*, real estate AUM of \$33.0 billion at December 31, 2009.

Bill Anderson, Principal–PRISA Asset Management, and Brett Levy, Director of Sustainability/*Prudential Real Estate Investors*, \$22.1 billion gross private real estate AUM at December 31, 2009, Signatory to UN PRI.

Paul McNamara BSc (Hons) PhD ASIP FRSA OBE, Director–Head of Research, and Robert Tidy, Director–Fund Management/*PRUPIM*, \$23.4 billion gross private real estate AUM at December 31, 2009, Signatory to UN PRI.

Vadim Goland, Assistant Portfolio Manager, Nicholas Stolatis, Director–Strategic Initiatives Asset Management, and Cherie Santos-Wuest, Director–Global Social and Community Investments/*TIAA-CREF*, \$39.2 billion gross private real estate AUM at December 31, 2009,⁷ Signatory to UN PRI.

Michael Spies, Senior Managing Director–Head of Europe, and Sarah Warmisham, Director–Equity Capital Markets/*Tishman Speyer*, \$31.7 billion gross private real estate AUM at December 31, 2009.

Tom Enger, West Region Head for Asset Management, Michael Loose Executive Director–Head Construction and Development Europe, Deborah Ulian, Director, and Roberto Varandas, Head of Business Development–Continental Europe/*UBS Global Real Estate*, \$54.1 billion gross private real estate AUM at December 31, 2009,⁸ Signatory to UN PRI.

Endnotes

¹ ASHRAE Standard Project Committee 189.1 (SPC 189.1) Standard for the Design of High-Performance, Green Buildings Except Low-Rise Residential Buildings: www.ashrae.org/greenstandard.

- ² ISO 14001 “gives the requirements for environmental management systems, confirms its global relevance for organizations wishing to operate in an environmentally sustainable manner” (ISO, 2009). The standard provides “a framework for a holistic, strategic approach to the organization’s environmental policy, plans and actions...by establishing a common reference for communicating about environmental management issues between organizations and their customers, regulators, the public and other stakeholders,” (ISO, 2009).
- ³ AMB AUM represents the company’s estimate of assets owned or managed through co-investments.
- ⁴ Firm private real estate AUM of \$3.3 billion represents gross market value of all assets and accounts managed by American as of March 31, 2010, excluding partners’ share of equity and partner’s share of debt on partnership investments.
- ⁵ Firm private real estate AUM of \$31.0 billion as of December 31, 2009, and includes subsequently combined entities.
- ⁶ Real estate AUM represents gross fair market value of the real estate assets managed by Morgan Stanley on behalf of the firm and its clients, presented at direct ownership interest. Real estate AUM for certain minority interests represents Morgan Stanley’s equity investment in the entity, rather than the gross fair market value of the underlying real estate assets.
- ⁷ Real estate AUM represents real property direct investments (gross), fund investments, and commercial mortgages.
- ⁸ AUM stated on gross asset value basis, reflecting property values as at December 31, 2009, where available. Includes assets managed by the joint venture with Mitsubishi Corporation, Japan.

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