UBS Asset Management, Real Estate & Private Markets

Sustainable investing — credit's greater checks

In addition to standard underwriting metrics, private real estate debt fund managers are increasingly taking a hard look at the sustainability of the assets they lend against. The notion of sustainability in the context of real estate is not new for equity providers, but it is now beginning to also become part of the due diligence done by debt providers.

With institutional investors asking how investments measure up across all asset classes, and tenants expecting more from the buildings they occupy, a growing number of credit fund managers — particularly those with real estate roots — are taking into consideration sustainability practices around the assets they back. A trend not driven by regulation, the benefits of downside protection and potential value enhancement — besides upholding fiduciary responsibility — are nonetheless compelling reasons to conduct what is essentially advanced due diligence.

It started with GRESB

Sustainability, as a topic, was picked up by institutional investors of real estate equity about five to 10 years ago. Today, it is a well-established metric in deciding whether to invest in an asset or not. Lenders are now pushing in the same direction.

UBS Asset Management was one of the first debt managers to complete the GRESB Real Estate Debt Assessment, which has become the global real estate debt sustainability benchmark. Only 10 funds responded when the assessment was launched in 2015. Last year that number was 18, and this year it stands at 25.

The GRESB Real Estate Debt Assessment measures funds' overall sustainability program across portfolios — 88 percent of UBS Asset Management's REPM AUM is submitted to GRESB[1] — through a series of questions against which you are scored.

Do you have an underwriting process and lending checklist? What sustainability features are on that checklist — things such as contamination, energy, water, waste, certifications? As an investor, we would want to know there has been adequate environmental clean-up in the event an asset is constructed on the site of a former factory, for example. Other questions might include how we look at business plans with an eye to improving value. A suggestion we might make is that environmental certifications are obtained on refurbishments. Do you have a committee or responsible people, or is your lending committee at least seeing the topic? Are you reporting back to investors?

The experience we had in direct real estate informed what we've done on debt investing, which means debt funds like ours, bred out of a real estate group, have got a massive head start on understanding the topic. That premise is confirmed by the Debt Assessment rankings. Our UK and US debt funds ranked first and second, respectively, in 2015, the survey's inaugural year, and first and third in 2016. In the 2017 results released in September, the funds each placed first in their respective peer groups.

I remember five years ago, sitting in a conference room of lenders, who did not understand the topic at all. Their main focus was: "What's the value impact?" rather than the way we've come at it: there may be value impact, but the chief aim is to *protect* value. In the United Kingdom, for example, in April 2018, an underlying asset with an "F" or "G" energy performance certificate (EPC) rating cannot be leased or sold until the building's standard is improved.

Benefits of complying with GRESB standards

Downside protection: There are regulatory obligations surrounding the underlying asset and occupier risks associated with poorly performing buildings. As a lender, you are taking security on a property, so you need to know the security is worth what you think it is. If it is a poorly rated building, you have to factor in some capex or risk it becoming obsolete.

A few years ago, lenders did not understand that. Now people are more cautious in their underwriting, and there is lots of competition to lend against buildings that are fully leased to good covenants. Where traditional lenders have stepped back is from more interesting deals, where you have to make an effort to understand the property.

Upside benefits: There is potential to improve a building's desirability and market rent, as well as reducing occupancy costs through features such as voltage optimization and LED lighting.

Please note that past performance is not a guide to the future.

Whole loan lenders like UBS, that think of real estate debt as more of a partnership, may share in any capital appreciation.

Real estate debt fund managers also have a fiduciary responsibility to their investors to be doing the right thing. The work we do to improve sustainability does not cost our investors any more; it pays for itself. It is really a case of enhanced due diligence.

Incorporating sustainability principles

The first step to incorporating sustainability principles into a debt strategy is to understand the topic, potentially engaging a third-party specialist to support your work. Then, it is a matter of creating a policy on sustainability, perhaps setting up a working group and putting it into your underwriting processes. You may want to include loan covenants that dictate EPC ratings are at set levels, for example.

To an extent, certain features of sustainability, such as the presence of asbestos, are already taken into account as part of environmental surveys that are carried out upon purchase of a property. There are other things managers can do to be proactive and think about things in a bigger way, however, from bike racks and car charging points to waste management and air quality.

UBS does not have set criteria, but works with borrowers to understand what improvements can be made on the sustainability front, encouraging them to carry out initiatives by granting a "green discount" of 15 basis points.

Unfortunately, we can not always do everything we would like to increase an asset's sustainability. There is, instead, a sliding scale of possible interventions. If you are talking about a standing investment, with one tenant occupying the whole building, there is nothing you can do to improve sustainability on site without the tenant's agreement. When developing from scratch, a lender can insist on a certain standard as part of the loan agreement. The targets we have set are focused on what we can impact and where it makes financial sense. There's a balance to be struck. We are not going to insist on BREEAM certifications for the sake of it — only if it saves costs.

Moving from light to dark green

If you are a fund manager with an institutional investor base like UBS is, no matter what the asset class, you're starting to get questions about what you are doing to promote sustainability in your individual assets and across your portfolio.

UBS Asset Management takes improving sustainability as a fiduciary responsibility, and we are building a culture of sustainability not just around individual real estate assets, but around all second-line investments, including infrastructure debt.

UBS Asset Management is creating a chain effect by asking our suppliers and advisers to comply, as well. Specifically, with regard to debt, we are ahead of the market. But other people are now talking about it, which is encouraging. Lending to smaller borrowers that are not necessarily thinking about sustainability means debt fund managers have the potential to make a real impact. Debt funds are only a small proportion of the overall lending market though; the banks have the potential to make a massive difference, likely over the next five years.

Author
David Hirst
chairman of the sustainability workgroup within Real Estate & Private Markets

CORPORATE CONTACT

Eoin Bastible
Head of Business Development – EMEA ex CH
UBS Asset Management,
Real Estate & Private Markets
5 Broadgate | London, EC2M 2QS
United Kingdom
+44 (0) 20-7901 5000
eoin.bastible@ubs.com
www.ubs.com

CORPORATE OVERVIEW

UBS Asset Management, Real Estate & Private Markets

UBS Asset Management's Real Estate & Private Markets (REPM) business actively manages circa £73 billion worth of real estate, infrastructure and private equity investments globally and regionally within North America, Europe and Asia Pacific, making it one of the largest asset managers in real assets worldwide. REPM comprises three investment platforms: direct real estate, direct Infrastructure and multi-managers.

The direct businesses offer both equity and debt investment opportunities, while the multi-managers business provides exposure to leading real estate, infrastructure, and private equity managers. Investors can access our diverse product range across open- and closed-ended private funds, investment trusts, listed funds and bespoke separately managed accounts, and our capabilities reach across the risk / return spectrum, ranging from core to value-add and opportunistic strategies.

[1] *Of assets under management for all funds eligible to participate in the GRESB Assessments*