A sustainable approach to real estate debt

How lenders can play a part in climate change mitigation

ICG believes that the real estate private debt market has a vital role to play in driving the transition to a climate-resilient global economy with net zero carbon emissions, alongside direct real estate owners. The Paris Agreement (a global treaty on climate change agreed in 2016) stated that global warming had to be limited to no more than 2 degrees in order to address the risks associated with long-lasting or irreversible changes to the earth's atmosphere and ecosystems. However, the most recent report from the Intergovernmental Panel on Climate Change (IPCC) indicated that this may not be enough, citing 1.5 degrees as the necessary target. In order to achieve this, carbon dioxide emissions need to be at net zero by 2050. In setting this as a policy objective, as the EU has done, we have a clear indication of the fact that this needs to shape the agenda not only for legislators but also for the commercial sector, the driver of the economy, of which real estate is a substantial constituent.

Granite House built in 1905, owned in partnership with Ambassador Group and funded by ICG, saw its energy efficiency improve threefold and achieved an EPC 'A' rating after a major refurbishment which helped reduce annual electricity costs by over 50%

It is estimated that, globally, real estate is responsible for around 40% of carbon emissions. In Europe alone this figure stands at 36%1. While green building and sustainability have been enduring trends over the past couple of decades, tackling climate change in the real estate sector has gone from being a niche consideration to the moral and commercial imperative that it is today. And it is the latter – the commercial imperative – that is the most significant change. A recent study found that in both the US and the UK, REITs with a more sustainable portfolio benefit from higher rental income, higher operating expenses and lower interest expenses, increasing cashflows available for distribution to shareholders. They also carry lower systemic risk and attract higher premiums to NAV2.

The sustainability agenda is galvanising key players

Promoting sustainability in the sphere of real estate financing is critical to protecting investment value. Regulation is driving changes: an investor may own a building with an upcoming lease break, but the fact that it carries an EPC rating of F means that under current legislation it is barred from being re-let on the grounds of its energy ine ciency. Sustainable real estate development, refurbishment and operation reduces regulatory risk, leads to lower operating costs and stronger property values. Given the attractiveness of sustainable real estate to increasingly discerning prospective tenants, property value is enhanced through higher rental premiums, increased letting speed, longer lease lengths and higher occupancy rates.

Organisations such as the Better Buildings Partnership (BBP) are fostering the collaboration of some of the largest and most well-known real estate owners and investors in the industry around sustainable real estate and in particular the climate change agenda. It has worked collaboratively with its members to encourage them to establish what it terms a "Climate Change Commitment" based on a net zero carbon pathway. This concept has been committed to by several of the BPP's signatories, each of whom has publicly disclosed the pathways they have developed. In our view this constitutes a major shift in attitude and signals in some measure the determination of the real estate industry to take advantage of the opportunity it has to make a di erence.

Lenders also have a key role to play in realising a more sustainable built environment. Given the position in the capital structure, the means by which to influence and engage are more limited compared to the tools at the disposal of equity owners but lenders nonetheless have the ability to make an impact, particularly through the use of green or sustainability-linked financing that in turn incentivises more sustainable development and refurbishment. As things stand, the availability of these kind of products for borrowers remains limited but ICG is keen to play its part in redressing the balance.

Green Loan Framework (GLF)

The ICG Real Estate team has long aligned its investment practice with sustainable objectives on an informal basis, particularly in the case of its Partnership Capital strategy which focuses on the refurbishment of mid-market commercial real estate. With the aim of building on this and formalising the application of those objectives, from 2021 the strategy will o er funding within the parameters of a defined green loan framework. This framework will provide a structured and innovative approach to financing for commercial property investments and has been developed in conjunction with an external adviser to ensure alignment with current best practice. The framework is based on the Green Loan Principles, a voluntary set of guidelines formulated by the Loan Market Association