# Residential real estate: it's not just 'doing good', it also makes financial sense

## The growth of impact investing, and opportunities with residential housing

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The consideration of long-term investment value drivers and risks is a fiduciary obligation placed on fund managers. Environmental, social and governance (ESG) factors are increasingly recognised as being material to investment value creation and preservation. In this context, the systematic and explicit inclusion of ESG into investment analysis and decision making is a core principle under which we invest, launch new products and manage our existing AUM. The tangible nature of real estate assets, with their exposure to physical aspects and significance to policymakers, amplifies the importance of the ESG dimension.

The evaluation of positive impact criteria provides a deeper means by which to consider these ESG factors. Positive impact seeks a shift in approach such that market-oriented capital flows do more than minimise harm, but rather, create positive environmental, economic and societal outcomes, as well as contribute to solutions in underserved markets where government is increasingly seeking private finance to deliver.

The emerging consensus that capitalism should be less short-term and more inclusive to the wider society is quickly establishing itself in mainstream investment thinking. For years considered niche, the growth of sustainable and impact funds is facilitating genuine change in many areas of society and the environment.

The concept of "double bottom-line" investing considers not only the financial return provided, but also the positive impact that invested capital has been able to create. Impact funds range greatly across providers and asset classes. They are generally distinguished as seeking investments that support an intention to generate positive, measurable social and environmental impact alongside a financial return.

From an investment perspective, and in a low interest rate environment, the real estate sector is viewed as a way to diversify investment risk for life and pension fund portfolios. Taking long-term rental housing as an example, this particular asset class can act as a strong diversifier as it is less correlated to other more cyclical property types. The various leasing models associated with affordable housing also offer scope for inflation linking. The credit strength of this sector and its proven inelastic demand, has helped reinforce its appeal as a credible source of diversification.

> **"The myth that for high-quality impact to be achieved, financial returns must either be a secondary factor or an additional consideration, has been proven false"**

For investors who are seeking positive sustainability solutions alongside financial returns, real estate investment can have both important social and environmental benefits. On the social side, housing represents a key tool for developing cities looking to cope with growing, transient, and ageing populations that require employment and social infrastructure – housing, healthcare and education. And environmentally, the development and operation of housing presents the opportunity to drive long-term environmental change through forward-looking design that creates operationally efficient homes, reducing carbon footprints and enabling social benefits such as lower fuel poverty. Credible impact investment in real estate demands that investors consider both these aspects.

Finally, the myth that for high-quality impact to be achieved, financial returns must be sacrificed has been proven false. Certainly, in terms of real estate, the provision of well governed, affordable housing solutions offers clear social benefits, along with the advantages that new housing stock offers in terms of operational efficiency for the owner and occupier, reducing costs and returning income reliable back to the investor.

### How ESG supports our investment thesis

Our ESG objectives drive our thinking and are wholly embedded into our consideration of property fundamentals and determination of risk and opportunities, as illustrated below.

### Using the residential sector as an example

Different countries and cities are at varying points in the cycle linked to wealth, demography, affordability, housing stock, quality and tenure, planning regimes and migration patterns, and so it is not a one size fits all approach. The unique composition of each city and town creates an opportunity for various forms of residential investment and development going forwards. Across Europe there is a lack of the right size of quality stock in the right locations and it is clear that the existing market is not delivering enough supply.

The rising prices of home ownership in major European cities have made it unaffordable for some, pushing them to

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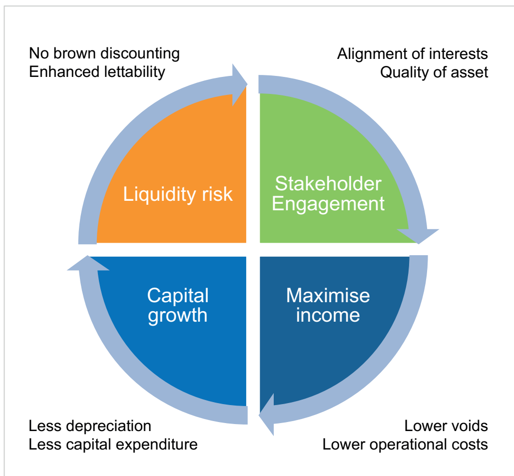
**Acquire properties thoughtfully**
Tighter controls into acquisition due-diligence with oversight from the Investment Committee and Head of Sustainability

**Design and refurbish buildings responsibly**
Using our bespoke Sustainable Development Brief to guide best practice

**Manage and operate assets sensitively**
Informing asset business plans with ESG profiles and priorities, determining existing credentials, opportunity and exposure to risk

**Engage with occupiers astutely**
Collaborate and share data to jointly understand the challenges and opportunities presented

**Create value within communities**
Social Impact Strategy that drives engagement with occupiers and wider communities towards positive outcomes




Source: BMO Real Estate Partners

the private rented sector as they do not qualify for social housing either - this is a key growth driver of demand for the rental market. Since 2000, the average house price across the Eurozone has risen by 3.1% per annum, while real wages have only increased by 0.4% pa, meaning that while earnings are only 8% higher in 2020 than 2000, house prices are 86% higher.

The pressure on prices is exacerbating the affordability gap, making it very difficult, in particular for first time buyers, to afford a suitable home in spite of low interest rates. This means that a large, typically young and mobile, group is dependent on the rental market – especially in mid- to large-scale cities across Europe.

There is also an increasing proportion of existing stock that is facing obsolescence. The levels of owner occupation vary across Europe – 31% of European households live in private rental homes, up from 26% a decade ago - but, by and large, there remains a large and growing proportion of the market that could benefit from institutional investment, in particular in the Social Housing and Private Rented sectors.

As well as demographic changes (growing population + urbanisation + migration), COVID underpinning the value of the home, legislative pressure and tax changes are contributing to a reduction in supply. This leaves the door open for institutional investors to step in and fill the gap, offering some important advantages over the traditional model of individual private landlords, for both the tenants and for society.

The fundamental shift stimulated by the introduction of institutional investment is a movement in the parameters for the underwriting and operation of real estate, with the investment being long term in nature resulting in a different approach to valuation (income focused, rather than capital driven) and efficiency.

Having larger, commercial property management companies overseeing rental properties can offer a higher, more standardised and professionalised level of service for tenants. Commercial property management companies are often able to offer longer tenancies, in contrast with private landlords where tenancies may be shorter, creating a lack of certainty for tenants. Longer tenancies allow individuals and families to integrate into their wider community and contribute more freely, with the knowledge that the area is their home and not just a stopgap.

Efficiencies for the landlord will be reflected in the occupational costs to the tenants, meaning their rental payments are more affordable – which often leads to higher occupation rates that in turn underpin financial returns. Where new build is possible, there is an opportunity to design, construct and operate new homes that will almost certainly have a better environmental profile than older housing stock. This not only improves the carbon intensity of the property stock, but also supports the development of modern construction technologies, stimulating new industry and the associated employment opportunities.

These benefits do not come automatically with the shift from private to institutional money. A willingness, the right partnerships and management structures have to be in place to ensure that benefits to tenants, communities and the environment are realised.

## Measuring impact

Impact is driven by intentionality. This must then be translated into objectives which are held consistent and measured over time. Feedback can then be generated to assess effectiveness and what can be done to improve the targeted outcomes. Fundamentally, to have impact, the objectives should improve the market and do more than might ordinarily be delivered by other market participants – this is additionality.

Given the many ESG interventions possible for real estate investors through the acquisition, development, operation and disposal of physical assets, not all can constitute impact. Being transparent, understanding the impact achieved and being able to consistently measure it are core factors to ensure that investors and wider stakeholders understand investments in this area.

Accusations of 'greenwashing' can be extremely detrimental to the reputation of a fund and the wider sector. It is therefore essential that measurement frameworks are created for products to allow priorities to be determined in the pursuit of objectives and that this process can be communicated to stakeholders. Internal and independent impact assessments can also be conducted on a periodic basis to provide fresh perspective and the test practice.

BMO REP's overarching framework is shown below as an example.

Impact in real estate cannot be distilled to a single metric. There are different aspects of impact which need to be recognised and measured, and any potential housing investment can be market-leading in some areas but only reaching minimum standards in others. It is combined output and progress against the product's objectives that are significant.

Residential investment represents social infrastructure and there are many ways to promote ESG or to be impactful, whether through a focus on the provision of a specific type of accommodation for an undeserved or vulnerable market, or the associated uplift in building quality and operation. It may even be the wider economic significance of the housing in terms of the regeneration of areas and support of economic growth through the provision of work (a direct result of construction) and retention of staff for local employers. Significantly though, each product should set out its objectives and prioritise its interventions to protect against regulatory and reputational risk, but also to credibly assess the level of impact achieved.

## Defining ESG and Impact and its importance to BMO Real Estate Partners

**The systematic assessment of material environmental, social, governance and impact factors and applying these factors into product strategy, investment analysis and decision making**

### The business imperative

- **Building value:**

Anticipating market sentiment to offer products that are widely sought after

e.g. defining a product that provides additionality for investors seeking social purpose

- **Impact on performance:**

Fostering positive landlord-tenant relations

e.g. funding solar panel for an occupier to reduce their opex whilst increasing asset income and improving carbon footprint for both

- **Asset performance:**

Resilience and lower liquidity risk

e.g. forecasting climate risk, such as flooding or energy efficiency performance to avoid asset stranding

- **Regulatory:**

Standards that influence a product's license to transact

e.g., disclosures required to promote ESG under the EU Sustainable Finance Disclosure Regulations

Source: BMO Real Estate Partners

### Our ESG objectives

**Environment: tackling the environmental deficit**
Carbon, climate resilience, circular economy, biodiversity

**Social: having purpose and value**
Community, prosperity, inclusivity, wellbeing

**Governance: working with integrity and rigour**
Certifications, accreditations, awards

**Impact –** investing for sustainable outcomes