How sustainability fits into commercial real estate debt

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Two of the strongest current themes in the commercial real estate (CRE) investment market are an increased demand for sustainable investments and a bigger role for CRE debt in investors' portfolios.

Almost three-quarters of institutional investors consider or plan to consider the environmental and societal impact of their investment decisions, according to Nuveen's third annual EQuilibrium global investor survey. And 83% of investors consider or plan to consider climate risk when making investment decisions. The same survey also reports 47% of investors want to increase allocation to private credit.

Sustainable investing is becoming an essential part of portfolio construction, but how does it work alongside an asset like CRE debt, and why is the asset class becomingly increasingly popular among investors?

Why CRE debt?

Since the 2008 financial crisis, markets have seen major shifts in sources of lending. With traditional lenders now reducing the supply of loans and taking a more conservative approach to loans, the opportunities for alternative lenders have increased considerably.

CRE debt has demonstrated its ability to provide effective portfolio diversification, with low and even negative correlations with other asset classes.

The structure of debt investments, allows investors to enter into junior or senior loans and thereby determine the level of risk they undertake. CRE debt investments also provide steady income potential, while a selective approach to investments can provide low volatility alongside a primarily current pay, fixed income-like return. The relative capital security of CRE debt investments, as a result of the significant equity cushion, offers medium to long-term stable returns through different market cycles.

The current high interest rate environment has significantly boosted the income return available from debt investments making a compelling relative value case for CRE debt investment. Alongside the financial characteristics the asset class can offer, the relationship between CRE debt and sustainable investing is also being cultivated as sustainable considerations in portfolios become increasingly important from a regulatory standpoint.

CRE debt funds that offer sustainable investments could become a firm investor favourite, but practical implementation of ESG-related regulation can be challenging.

Two options for sustainable investment

There are two leading options for defining sustainable investments: EU Sustainable Finance Disclosures Regulation (SFDR), and EU Taxonomy for sustainable activities. The latter has established a taxonomy which sets sustainability standards for investments, whilst the former enables a manager to self-define sustainable investments – whilst meeting specified minimum standards. Meeting the taxonomy standard is voluntary, so investors have been focussing more on SFDR requirements.

CRE debt funds that are raising capital in Europe are now subject to the SFDR which sets standards for the reporting requirements of funds.

Funds can choose between three disclosure standards (Article 6, 8 or 9). Ascending levels of disclosure requirements seem to promise investors the rewards of deepening green credentials, but moving through the SFDR categories does not, by itself, imply a stronger sustainability performance. For example, an Article 9 fund can invest in assets that are already considered to be highly sustainable and therefore are not considered to produce a positive change in sustainability outcomes, but cannot invest in a brown-to-green transformation project that will produce a positive outcome for a building currently not meeting minimum sustainability thresholds.

Where Article 9 falls short for CRE debt investments

Article 9 funds have sustainable investment as a key investment strategy, meaning they must demonstrate how the fund will advance that objective, or show how any index being used as a performance benchmark aligns with that objective in a way that is different from the broader market. All investments in the fund must meet the ESMA sustainable investments criteria, which in real estate terms means it must not be exposed to two types of asset: fossil fuels, which would usually mean petrol stations within CRE debt, and buildings which are deemed inefficient according to EPC ratings.

The criteria means that Article 9 funds are largely restricted to investing in assets which are already among best in class from an environmental perspective. The restrictions on investing in inefficient buildings with an improvement plan means that Article 9 funds are missing a potentially high demand area. This is where Article 8 funds have greater freedom and scope to create positive change.

Article 8 status is more about transparency and disclosure. This focus means a CRE debt Article 8 fund could invest in, for example, funding the transition of an inefficient building to an improved EPC rating.

An increasing amount of real estate is becoming obsolete in terms of energy efficiency, as environmentally-friendly construction methods and technology become available, but new construction itself has significant implications in terms of embedded carbon. In light of this, development/refurbishment lending to transform existing inefficient "brown" properties to environmentally friendly "green" buildings can potentially offer a wider opportunity set.

CRE debt and sustainability in action

CRE debt has the capabilities to provide funding for development/refurbishment projects which can deliver positive environmental changes. Like any other CRE debt investment, doing so from a sustainable investment perspective requires selectivity and clear goals.

An example of this is a transaction that Nuveen Real Estate identified as a low risk loan that could deliver steady income alongside positive environmental changes.

The project comprises the refurbishment and extension of an existing well located but only EPC D rated office building in central London. The sponsor was seeking to refurbish and extend the existing seven storey building as well as adding wellness features including end of journey facilities and external terraces to a number of levels. With a target of "Excellent" rating from the ESG-focused certifier BREEAM and EPC target rating of B achieved through construction methods, the project will substantially reduce the amount of energy wasted, create a sustainable repurposed building as well as utilise the existing carbon embedded in the building's structure.

The future is looking green

While SFDR regulations are still being stress tested by investors, the new requirements for investors and funds alike will mean new approaches to impactful and financially sound investing must be identified. Assets such as CRE debt have proven the potential to deliver effective portfolio diversification alongside steady income. Now, the growing focus on sustainability in investing is providing a new opportunity set within CRE debt, tapping into the increased demand for improved, sustainable buildings.

SFDR regulations mean some funds may be more limited than others to act on this demand for refurbishment projects, though investors looking at Article 8 funds may have a greater opportunity set to consider.

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