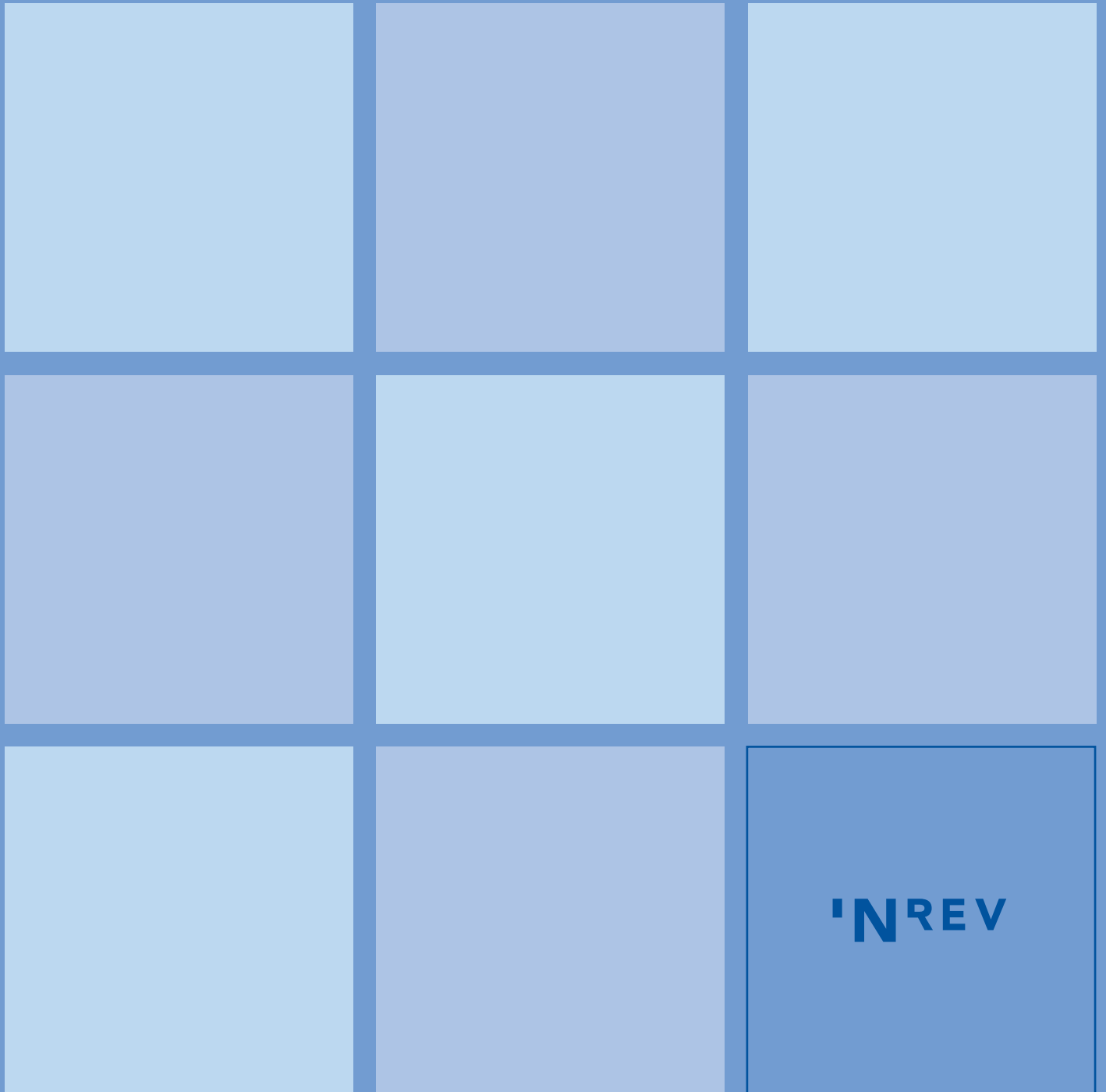


INREV RESEARCH & MARKET INFORMATION

SUSTAINABILITY REPORT



INREV
STRAWINSKYLAAN 631
1077 XX AMSTERDAM
THE NETHERLANDS

T +31 (0)20 799 39 60
INFO@INREV.ORG
WWW.INREV.ORG

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Our aim is to improve the accessibility of non-listed real estate funds for institutional investors by promoting greater transparency, accessibility, professionalism and standards of best practice.

As a pan European body, INREV represents an excellent platform for the sharing and dissemination of knowledge on the non-listed real estate funds market. The association's primary focus is on institutional investors, although other market participants such as fund managers, investment banks, lawyers and other advisors provide additional support.

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This report was produced by Jones Lang LaSalle's sustainability consultants:

- Ruben Langbroek,
- Laura Jockers,
- Pim Macke.

EXECUTIVE SUMMARY

The results of this INREV Sustainability Discussion paper shows that the topic of sustainability is firmly on the agenda for investors, fund of funds managers and fund managers. However, this report highlights several issues which must be resolved to build a firm foundation on which the non-listed property funds industry can take its next steps in this area.

One key factor is to determine the link between sustainability and financial performance. There is enthusiasm to incorporate sustainable practices, but until a firmer link is established with the financial incentives, investors will continue to see a conflict with their fiduciary responsibilities. Meanwhile, fund managers will remain cautious about pro-active programmes to improve existing assets or launching funds promoting sustainable practices.

A second factor is the lack of education and training, which is creating a barrier to integrating sustainability into the investment process. The study shows that there is a reliance on informal and ad hoc learning initiatives to raise the awareness of sustainability issues with few incentives for employees to acquire additional skills. Fund managers will need to establish appropriate learning and incentive programmes for their staff, as investors will expect them to be increasingly knowledgeable about sustainability in the future. Investors are also likely to expect a greater level of sustainability expertise from their investment teams.

A better understanding of compulsory and voluntary benchmarking on sustainability is also required. Presently, both investors and fund managers lean on existing regulations at a European, national and local level as a basic benchmark that sustainability practices are being put in place in funds. More sophisticated benchmarking does exist, but the proliferation of standards has led to confusion among participants, and therefore take-up has not been significant.

Forward thinking firms have started to develop and implement benchmarking systems to reliably identify opportunities to enhance the value of the assets under management through sustainability initiatives. However, in most cases these are still in the early stages of implementation.

The general lack of reliable measures of success is likely to be one reason for the current mismatch between investor and fund manager views on progress. Several investors said that current funds are not meeting their sustainability expectations. In contrast, most fund managers are under the impression that they are meeting their investor's expectations because their investors are not pressing them to do more. The majority of fund managers that were interviewed said that the information requested by most of their investors is not demanding and does not challenge them to improve the sustainability of their assets beyond regulatory norms.

This is not to say that the industry has not made progress in the area of sustainability. Industry participants are integrating initiatives where possible, but these currently focus on quick wins or raising visibility. This includes the questioning of sustainability credentials during fund selection and a willingness to adopt third party standards for new developments due to their marketing benefits. More significantly, in some cases implementing sustainable practices at an asset management level has led to significant reductions in energy costs and carbon dioxide emissions, fortifying profitable long term relationships with tenants.

Looking forward, investors see the importance of implementing strategies for their existing assets rather than concentrating on the 1% to 2% of new stock being added to funds. They are therefore, generally not interested in niche 'green' funds, but more focused on fund managers looking to roll out sustainable practices throughout their companies.

Respondents confirmed that they saw a role for INREV in improving sustainability practices in the industry and made suggestions for work in the area of benchmarking, definitions, as well as investigating the link between financial performance and sustainability.

For this study, interviews were conducted with a cross-section of nine European institutional investment and twelve fund management firms. The interviews were designed to gain an insight into perspectives on sustainable real estate investment trends and practices, as well as on the challenges associated with improving the sustainability of the non-listed real estate sector. The contribution of the companies that provided information on their real estate investments and sustainability strategies is sincerely appreciated: this report would not have been possible without their contribution.

1 INTRODUCTION

Sustainability is an emerging and evolving issue for the European real estate market, and it at this stage it still remains unclear how regulatory (pressures at a European, national and local level) and market pressures (such as investor, tenant and future buyer demand) will impact future fund performance.

While limited, there is growing evidence to suggest that over time the market will increasingly reward sustainable buildings (or discount unsustainable buildings). For this reason, sustainability is becoming a key concern for many investors and fund managers in the non-listed property funds industry who feel it is their fiduciary duty to understand the implications of these issues on their portfolios and to seek ways to improve the sustainability profile of their assets and funds.

To this end, in late 2009, INREV created a Sustainability Working Group to drive its pro-active sustainability agenda, to explore the fund-level impact of sustainability, to raise awareness of the topic among its members, and to highlight best practice.

This first study INREV has conducted is a discussion paper that records the current sustainability practices and aspirations of its members and the non-listed real estate funds sector. It is intended to help address and identify gaps in sustainability research and knowledge for non-listed property funds and will be used to formulate appropriate next steps for the non-listed real estate funds industry and the INREV Sustainability Working Group. The project specifically aimed to:

- Identify key sustainability trends affecting the practices of investors and fund managers in the European non-listed real estate funds sector.
- Understand current sustainability practices in the European non-listed real estate funds sector, highlighting best practice.
- Identify the main barriers and challenges associated with sustainable property investment in the European non-listed real estate funds sector.
- Define next steps for the European non-listed funds industry and INREV's Sustainability Working Group.

This discussion paper presents the key themes and findings that emerged from this piece of primary research and examines the role that INREV should play in supporting the industry to overcome some of the challenges identified through this work.

The Sustainability Working Group will now take the results of this report to develop an action plan for future projects and priorities for INREV, which will be made available to members later this year. The working group, which can be contacted through INREV, welcomes any feedback from members in relation to this report and future priorities.

2 METHODOLOGY

This study has been conducted by Jones Lang LaSalle. The data was collected through in-depth face-to-face and telephone interviews with investors, fund managers, and fund of funds managers selected from INREV's membership.

The investors were chosen to reflect the ranges of size as well as nationality of INREV's membership base. The fund managers vary in scale and regional spread and comprise leading pan-European firms operating in a number of geographies, as well as smaller firms specialising in one or two core European countries.

The assets under management span across most traditional property sectors, including office, retail, residential, industrial and hotel, as well as niche sectors such as senior and student housing, and sports and medical facilities. The types of funds under management include all principal styles: core, value added and opportunity as well as closed and open ended funds.

Interviews were conducted with nine European institutional investors and twelve fund management firms between March and July 2010. A structured interview approach was used with questionnaires comprising a total of 29 questions and 40 questions developed for investors and fund of funds managers, and fund managers respectively.

The questionnaires contained a series of open ended questions. These were designed to provide an insight into perspectives on sustainable real estate investment trends and practices, as well as on the challenges associated with improving the sustainability of the non-listed real estate funds sector. Respondents were also asked to provide their opinions and views about the role that INREV should play in supporting the industry, to develop solutions to overcome some of these challenges and to move the topic further up the agenda of all stakeholders.

This report has been undertaken in conjunction with a separate project to develop a database detailing the characteristics and strategies of 'sustainable' non-listed European real estate funds. This additional resource will be available to members in quarter four 2010.

3 KEY RESEARCH THEMES AND FINDINGS

This section seeks to provide an overview of the key themes and findings that emerged from discussions with the sample of investors, fund managers and fund of funds managers.

3.1 Sustainability is here to stay but different markets and sectors will evolve at different rates

It is clear that several drivers are working simultaneously to place sustainability on the agenda of European property investors and fund managers. Although sustainability is still an emerging and evolving issue across the non-listed European real estate funds market, discussions with respondents suggest that regulatory pressures at European, national and local levels as well as market pressures from stakeholders, such as investors, tenants and future buyers will, increasingly reward sustainable investments and practices.

Evidence of the effect on investment returns is currently limited, but all respondents clearly anticipate that sustainability issues will positively affect property values and/or returns although many were unsure exactly how or when these aspects would be reflected in the marketplace.

Generally, respondents did not believe that the current market offered a premium for sustainable investments but the belief is that it will over time (the so-called 'future-proofing' impact). A range of potential upside and downside benefits may arise, including enhanced capital growth and rental income, but also lower operating and depreciation costs when compared to non-sustainable investments. Some respondents also argued that sustainable investments can also enhance tenant appeal and retention, leading to stronger tenant covenants, longer lease terms and increased occupancy rates, thereby also improving the economic sustainability.

For this reason, several respondents feel that it is their fiduciary duty now to understand the implications of these issues on their portfolios and to seek economic ways to improve the sustainability profile of assets. Furthermore, some respondents said that it is important to take some action now – even if the benefits are unclear – due to the considerable time it takes to measure, benchmark and improve large portfolios. However, to counter this, many respondents also expressed concern about the availability of sound evidence to support enhanced market performance of sustainable assets, making it difficult to justify investments to improve the sustainability profile of the assets within current investment guidelines. This means establishing the link between sustainability and financial performance is essential for improving the sustainability profile of the existing stock.

All respondents said that there are strong reasons to believe that sustainable property investment is here for the long run and sustainability issues are likely to become increasingly important in the next couple of years, especially if the correlation between sustainability and financial performance becomes clearer with the availability of more sophisticated benchmarking tools.

For example fund managers said that in the future more investors will seek to hold a 'future-proofed' real estate portfolio, while large corporate occupiers and retailers will want to occupy sustainable properties to maximise public relations value and reduce occupancy costs.

Furthermore, the majority of respondents believe that strong political will to tackle issues such as climate change means that the property sector will remain a prime target for policy action and more regulations will be introduced to reduce the environmental impact of the built environment in coming years. Several respondents said that understanding and complying with the vast array of new regulations affecting their large, global investment portfolios presented a significant challenge. They said that this is one area where INREV could help its members, by simplifying and summarising the current and planned legislation and policies introduced in all key markets.

Despite a general agreement that sustainability issues are likely to become increasingly important for the real estate funds sector in the next couple of years, several respondents acknowledged that the pace of sustainability initiatives would be highly dependent on drivers and pressures associated with each market, sector, investment strategy and investor base, leading to a highly localised and client-specific approach. This may mean that action is not required in some cases, while significant sustainability improvements will be required in others.

3.2 Different approaches to governance, management and resourcing have evolved

The results of the interviews clearly indicate that sustainability is currently a key issue for many organisations, and more resources are being dedicated to understand and manage it. Most respondents said that sustainability is already a very important issue for their company – receiving the attention of senior executives – and will continue to be equally or more important over the next two years.

In terms of human resources, respondents tended to highlight very different approaches to managing sustainability, depending on factors such as company size, the total value of its real estate investments or assets under management and its level of commitment towards sustainable development.

For many of the investors surveyed, real estate assets typically represent less than 15% of their portfolios, which may not justify the employment of a member of staff dedicated to managing sustainable real estate issues. However, several investors said they have needed to manage broader environmental, social and governance (ESG) issues for sometime now and most have created a specific department, or have tasked a specific employee or group of employees to manage this across the entire business. In these cases responsibility for implementing sustainable real estate initiatives typically resides within these central teams, which are supported in varying degrees by individuals in other departments who have sustainability added to their normal responsibilities and obligations. This approach creates a specialised and centralised resource that is able to keep better track of the fast-moving world of sustainability and can better integrate and champion new ideas into company practice.

However, in most cases dedicated in-house staff or teams to implement sustainable real estate initiatives and policies do not exist. In these cases companies have formed cross-functional teams or working groups consisting of individuals from different departments and regions that determine collectively where opportunities exist for enhanced investment analysis and risk management. These teams are responsible for developing company-wide strategies, supporting the implementation of these in their business units or regions and for sharing best practice across the firm. In most cases these implementation teams are overseen by an Executive Steering Committee (or equivalent) that is chaired by a member

of the senior management team (or in most cases the Board), which has overall responsibility for defining the firm's policy. Although this approach has the advantage of encouraging innovative and pragmatic initiatives from employees possessing a variety of experiences and expertise within the company, it can be challenging to maintain momentum among disparate individuals who have competing demands on their time.

Those firms without dedicated in-house resources, perhaps unsurprisingly, have a greater dependency on external advice, resources and tools provided by specialist technical sustainability consultancies or by their external asset managers. Out of all respondents, a couple of fund managers said that they have recently hired or intend to hire a dedicated resource once their policy is defined and enters the implementation phase, if their investors require this level of expertise or if their company expands in the future.

Although most respondents said that lack of knowledge was a significant barrier to integrating sustainability into the investment process, only a few have established formal training programmes to improve the understanding and expertise of their staff. Instead of developing formal training programmes, the majority of companies encourage internal awareness-raising and sharing of best practice through informal learning channels, such as round table discussions, presentations, intranet sites and forums, conferences and ad hoc training. Furthermore, most companies do not encourage their employees to take extra steps to acquire knowledge by establishing relevant financial or other incentives. However, a couple of respondents said that they do encourage individuals to gain relevant accreditations by raising their internal profile through announcements or listings on the company's intranet site. Another respondent said that financial incentives and internal awards are available for property managers for implementing aspects of the sustainability policy. One example was provided where sustainability objectives and performance-related bonuses are available for all staff, ranging from secretaries to board directors.

In summary, our discussions indicate that the current lack of sustainability knowledge is exacerbated by inadequate learning and incentive programmes required to improve skills and knowledge in this area. However, this situation is likely to change as investors indicated that they will expect their fund managers to be increasingly knowledgeable about sustainability in the future. This implies that both investors and fund managers will need to establish appropriate learning and incentive programmes for their staff and for many this will naturally emerge as they define their sustainability policies and establish appropriate goals, responsibilities and accountabilities to implement these.

3.3 Sustainability expertise will be an increasingly important factor in selecting fund managers but will not be a critical factor in most cases

Fund managers indicated that investors expressed greater interest in their sustainability initiatives largely through the use of one-off questionnaires or requests for proposals. The majority of respondents strongly agreed that sustainability issues play an increasingly important role in the selection of new investment partners and suppliers. However, opinions are divided over the weighting given to sustainability expertise when selecting new fund managers with approximately 50% of both investors and fund managers stating that it is currently a key selection factor.

One respondent commented that the relative importance of sustainability in the selection of fund managers would to a certain extent also depend on whether there is sufficient evidence to support enhanced investment performance of sustainable assets compared to unsustainable ones. Until this link is proven, the investment community is likely to remain polarised – some cautious while others optimistic.

Of the respondents who said that sustainability expertise is a significant factor in the selection of fund managers, most believe this is because increasing regulatory and market drivers mean that these issues can no longer be ignored. They also think that having a leading approach to sustainability is indicative that they are leaders in other areas as well and are therefore more likely to be better fund managers than less sustainable counterparts. Some examples were provided where a fund manager's sustainability capabilities and experience had been a definite advantage in winning work and had directly contributed to a successful appointment.

Of the respondents who said that sustainability expertise is not a significant factor in fund manager selection, most said that it is considered alongside other factors used by investors to select or differentiate between potential fund managers and that those other factors are generally given a greater weight in the selection process. A number of respondents also commented that the need for sustainability expertise will vary between regions, due to differences in local regulatory and market drivers and it is likely to be more important for large funds spanning several sectors and markets or for those pursuing sustainable investment strategies.

Despite differing opinions over how important sustainability expertise is in the selection of fund managers, almost all respondents said it would certainly play an increasingly important role within the next two years, as investors will seek to invest in new 'future proofed' portfolios and select fund managers that can deliver this aspiration on their behalf.

3.4 Unclear if funds are currently meeting investors sustainability expectations

While some investors think that current funds are meeting their sustainability expectations, several said they were unconvinced or unable to judge whether this is the case. In some cases this is because investors have not determined what their sustainability policies or requirements should be yet. Others said that funds were meeting current market and regulatory requirements, but they did have concerns about their ability to meet future requirements which will only be apparent over time. One investor said that current property funds are not meeting sustainability expectations and this had been revealed through poor performance in an external environmental benchmark.

In contrast to investor opinions, most fund managers are under the impression that their current funds are meeting their investors' expectations because their investors have not asked them to do more. This implies that investors could be doing more to engage, influence or express their concerns to their fund managers.

Furthermore, in most cases there is no accountability for sustainability at the fund level or any incentives linked to the sustainability performance of the fund. Some said that this is because they cannot define appropriate reward criteria until they have established policy objectives. However, in most cases this tends to be because sustainability benefits are often indirect and difficult to quantify or link to fund manager performance, particularly when fund performance is so dependent on wider market factors. As a result some funds

are considering introducing 'soft' incentives to encourage the uptake of sustainability initiatives at the fund level. Others suggested that the emergence of more sophisticated benchmarks linking sustainability and financial performance may help establish appropriate financial incentives and rewards in the future.

3.5 Investors are likely to request more sophisticated sustainability information and data from their fund managers

Investors generally request information about the sustainability initiatives of fund managers through the use of one-off questionnaires or requests for proposals. The more advanced investors also use benchmarking surveys and rating agencies, while others rely on informal sources to judge the sustainability credentials of firms such as the opinions of other market players. The majority of fund managers that were interviewed said that the information requested by most of their investors is not demanding and does not challenge them to improve the sustainability of their assets beyond regulatory norms.

Most fund managers said that the questions typically asked by investors are very explorative, seeking general information about their policy and approach, with no right or wrong answers. In most cases investors do not typically place any requirements on them and simply want to be convinced that a sustainability policy exists and that it is properly implemented – they are less concerned about details and outcomes of the policy or in influencing these.

Some fund managers also expressed frustration with the vast array of different questionnaires developed by different investors. The variation between these creates significant and unnecessary rework, requiring reanalysis of data and information for each response. They said that INREV could help to avoid this by producing standard questions to be included in the requests for information/proposals (RFI/RFPs) issued by investors. The updated Due Diligence Questionnaire included a section of sustainability, but was released as these interviews took place.

Although these issues suggest that investors do not generally use sophisticated tools or information to scrutinise the sustainability track record of their fund managers, nearly all respondents believe that this is likely to change in the near future. Investors are likely to increase the level of detail requested in future RFI/RFPs and will expect fund managers to participate and improve their performance in relevant benchmarking surveys and rating schemes. Fund managers can also expect investors to request that they incorporate sustainability metrics into investment reports for underlying funds. In some cases fund managers may also be asked to become signatories to organisations that support transparency in sustainability reporting, such as United Nations Principles for Responsible Investment (UNPRI) or to develop sustainable investment policies that are aligned with those of their clients.

Most fund managers also pointed out that investors do not currently require individual fund managers to possess certain sustainability qualifications or attributes. However, the majority of investors said that although these requirements may get tougher, individuals will not be required to possess specific skill sets or qualifications. Instead investors will expect the investment team to be knowledgeable about the legislative landscape and to have a combination of sustainability and real estate investment experience.

It is clear that forward looking fund managers are already increasing their sustainability expertise. For example, a fund manager said that it has commissioned a specialist sustainability consultant to provide dedicated sustainability advice for its clients and assets under management. This is designed to attract investors in the future. This strategy is likely to become more commonplace over the coming years. However, one investor emphasised that real estate investment skills will always be paramount and expressed concern that sustainable funds, although strong in sustainability expertise, often lack the necessary financial expertise/track record. In some cases this has led to investment in sustainability improvements that have not added value or provided pay back.

3.6 Green building ratings and certifications are generally limited to new developments

In recent years a number of third party standards for rating buildings on sustainability, particularly environmental issues, have emerged across the globe. Examples are:

- BRE Environmental Assessment Method (BREEAM)
- Leadership in Energy and Environmental Design (LEED)
- Green Star
- Comprehensive Assessment System for Built Environment (CASBEE)
- Deutsche Gesellschaft für Nachhaltiges Bauen (DGNB)
- Haute Qualité Environnementale (HQE)

Based on discussions with interviewees, there is little interest in third party standards at the present time, but these will be increasingly important in the future, particularly in regions where they become incorporated into local building regulations.

Discussions revealed that in general, third party standards have found more uptake from investors and fund managers on new developments than on existing buildings. For example a small number of respondents said they require new developments to comply with internationally recognised third party standards, while others said they apply internal standards – often based on external ones – to new development projects. The slightly greater emphasis on standards for new developments rather than existing buildings is for a number of reasons. Most notably investors have substantial control over how a building is originally designed and developed, making it easier to intervene and less costly to achieve standards for new developments compared to existing buildings.

Some respondents said that third party standards for new builds had resulted in an increase in the marketing and leasing value of the asset or the ability to achieve standards at lower costs than competitors by being an early adopter. In some cases it is also easier to achieve in-use standards such as LEED-EB, if the asset achieved an equivalent standard during the construction stage. These benefits are very clear to one fund manager, whose goal is to gradually increase the proportion of its assets under management which meet third party standards.

In contrast with new developments, almost all respondents stated that investors do not generally require existing properties to go beyond regulatory standards or to comply with certain third party standards. Reasons mentioned for this dearth of interest included: a lack of investor pressure and understanding of the different standards available; the high costs of meeting standards for existing buildings; a lack of investor control during the use phase; and an absence of a regionally applicable standard. Despite these challenges, it is clear from discussions that some investors do encourage compliance with third party standards

that are relevant to local markets, meaning that some standards have been applied in a number of locations. However, these decisions are highly dependent on the local context, client aspirations and fund style and tend to happen on a case-by-case basis. Some investors also said that they encourage the rollout of self-certified standards across the existing stock in order to limit costs, but generally speaking the majority trust (and expect) their chosen fund managers to manage these issues appropriately on their behalf.

While there is clearly a general lack of investor interest in third party standards, some examples were provided where investors have asked fund managers to adhere to specific standards or labelling schemes. In one case feedback derived from an internal investor survey highlighting demand for funds that comply with green building standards in some countries which led to a new green fund being launched in Germany. A couple of examples were also provided where fund managers have taken elements of existing certification programs, such as LEED, and incorporated these into their own standard being applied consistently across their portfolios – in exceptional cases these internal standards may also be externally endorsed. In rare instances internally developed standards can also provide companies with a competitive advantage, and one example was mentioned where a fund manager won a competitive tender to manage a new green vehicle, largely because it had established a green rating tool which could meet the client's expectations regarding sustainability standards.

The majority of respondents said that the vast number of incompatible standards available in the marketplace has led to confusion among investors, who often do not understand them and lean on their investment managers for advice. It is therefore, important that fund managers continue to remain informed and knowledgeable about developments and initiatives in this space.

3.7 Investors are not generally interested in 'green' funds

While sustainability is becoming increasingly important for the majority of property investors, it appears that there is still a lack of interest in creating so-called 'green' portfolios. The overwhelming majority of respondents said that they have little interest in investing or launching niche 'green' funds, for a variety of reasons explained below. However, a minority of fund managers said that they have already established such a fund, were preparing a launch, or were considering launching one in the future.

Most investors said that they were not interested in investing in 'green' funds, because they would rather integrate sustainable practices across all investments, in line with their fiduciary duties. In fact, most respondents advocated an investor-led engagement approach to improving the existing portfolios whereby investors favour investment partners who are aligned with their own sustainability policies and principles. Several respondents also expressed a range of concerns about 'green' funds which included;

- Difficulty in justifying why large funds should go beyond legal compliance, without greater evidence that this will lead to enhanced financial performance.
- A 'green' investment strategy is at odds with some investment styles. For example, opportunity funds seek out assets which have the potential to be improved through sustainability and other improvement measures. In this instance, it would therefore be contrary to the investment strategy to acquire assets that already meet high sustainability standards. Furthermore, most existing funds do not have 'green' investment strategies and it is difficult to substantially change these once agreements with investors and other stakeholders are already in place.

- With new buildings being added to the existing stock at a rate of only 1% to 2% per year on average, the bulk of investors' existing portfolios typically consists of older and less sustainable buildings; many of which will need improving to ensure that they are 'future proofed' against modern market and regulatory requirements. For this reason, the majority of respondents said that making improvements to the performance of existing buildings is more important than acquiring or developing new sustainable properties or investing in 'green' vehicles. However, 'greening' the existing stock will take time to achieve and different assets will be at different stages of the 'greening' process at any one time.
- The market for niche 'green' funds is too narrow to provide investors with guaranteed returns. In particular, such funds are challenged by the limited availability of 'green' building stock, which may drive up prices which may not be returned in the long run. This will be exacerbated if the 'green' fund criteria are too restrictive, i.e. requiring 'sustainable' occupants or compliance with costly standards.
- Although strong in sustainability expertise, 'green' fund managers may lack the necessary financial expertise and track record – and there are examples where 'green' fund managers have invested in sustainable improvements that have not added value or provided pay back.

Despite these concerns and challenges, a small sample of fund managers have successfully launched or are planning to launch 'green' funds in the near future. In most cases these opportunities have arisen as a result of discussions with investors who asked them to launch a new vehicle, to meet specific sustainability criteria or because they have made a conscious decision for all funds to be 'green' going forward. In the latter case, one fund manager explained that this approach naturally evolved from a strategy which focused on prime assets and quality tenants – attributes that are synonymous with sustainable assets. In one example of a new fund being established, the investor has commissioned an external consultancy to manage sustainability aspects. Another fund manager provided an example where its sustainability credentials had been a key factor in winning a mandate to manage a client's new 'green' fund.

Some respondents also pointed out that the terms 'green' and 'sustainable' are poorly defined and open to (mis)interpretation – even assets that appear to be 'sustainable' can be viewed as 'unsustainable' from a different angle. They also said it is difficult to differentiate between 'green' and 'non-green' funds/buildings and that investors should be aware of the differing shades of 'green'. This means that investing in what is considered 'green' will vary over time, as the criteria change and as general understanding of the issues advance. For example, it is clear from discussions that the criteria applied to existing 'green' funds vary substantially between providers. In some cases, properties must meet high compliance with recognised third party 'green' building standards, while in other cases fund managers have established their own 'green' standards which vary from fund to fund. For instance one fund manager explained that its 'sustainable' fund criteria even extended to potential tenants, whereby industries deemed unsustainable would not be able to occupy the fund's assets. To help understand the range of different 'green' funds on the market, INREV has commissioned Jones Lang LaSalle to develop a database of the 'sustainable' non-listed real estate funds (and their characteristics) available in Europe – this resource will be available to INREV members in quarter four 2010.

A number of respondents who said that they were against the concept of a 'green' fund have, however, started to evaluate the sustainability profile of their new and existing portfolios. For example several fund managers have established due diligence and acquisition checklists for their new investments, as well as tools to evaluate whether less sustainable assets should be improved or sold.

3.8 Early efforts to benchmark the sustainability profile of the existing stock

The majority of respondents said that making improvements to the performance of existing buildings is more important than acquiring or developing new sustainable properties. This is primarily because only approximately 2% of new buildings are added to the stock through development each year, thus existing buildings make up the bulk of the market and the majority of the respondents' portfolios. Unfortunately this vast stock of existing buildings typically consists of older and less sustainable buildings; many of which will need improving to ensure that they are 'future proofed' against modern market and regulatory requirements.

Exacerbated by the heterogeneity of built assets, the sustainability risks and improvement opportunities at each building will depend on a range of property characteristics including its type, age, size, location, and occupant and leasing arrangements. For example, it may be harder to improve old buildings where the costs of improvements are likely to outweigh any financial gain. Similarly it is difficult to take action at buildings where the leasing arrangements leave investors with little control or incentive to change the way the property is used and managed (except in common areas). This means that fund managers need flexible benchmarking systems which can be rolled out across the whole portfolio to identify appropriate sustainability improvement options for each property that are within acceptable investment criteria.

Discussions with fund managers confirm that forward-thinking firms have already started to develop and implement benchmarking systems to reliably identify opportunities to enhance the value of the assets under their management through sustainability initiatives. However, in most cases these are still in the early stages of implementation, and have been introduced with varying degrees across different property types, markets, and countries.

Most fund managers with international or regional portfolios said that they have been unable to identify a sustainability benchmarking system that is applicable across different countries and property types which can evaluate sustainability performance and identify improvement measures that take into account investment criteria, payback periods and timing considerations. One fund manager also stressed the size and complexity of the challenge of benchmarking large international portfolios, and making improvements at the pace required to keep abreast with regulatory changes. Considering the significant time, resources and effort required to benchmark sizeable portfolios, fund managers need pragmatic systems which can be rolled out quickly across the whole portfolio to identify sustainability improvement measures (within applicable investment criteria).

As a result of the limitations of existing third party standards (such as LEED, BREEAM etc.) for benchmarking and analysing portfolios, most fund managers that have started to benchmark some or all of their portfolios are using systems developed in-house, by a specialist consultancy or in collaboration with third parties. In most cases these systems use criteria which draw upon third party standards and also use investment criteria (such as cost-benefit analysis and pay back periods) to evaluate different improvement options. For example, one fund manager said it has developed its own green rating tool in collaboration with other investment managers and external consultants. According to the interviewee, this tool is significantly cheaper to implement than third party standards and has the added advantage of identifying improvement measures which will enhance the value of the property. It is also intended to help investment managers work with investors to create sustainability criteria for new funds and could also be applied on new developments if required.

Some fund managers said that they are focusing on measuring existing funds now in order to develop tools and standards which could be applied to new funds. While others are trialling benchmarking tools on a sample of property types, funds or countries with the intention of developing and applying appropriate benchmarking systems across their entire existing portfolio. For example, one fund manager described a pilot project to benchmark the sustainability performance of 15 offices. The lessons learned from this pilot project led to the development of a benchmarking tool which is being rolled out across the rest of the office portfolio. Building on the success of the initial project, a similar pilot was recently launched on a sample of the residential portfolio. The fund manager in question said that these initiatives have not only helped generate sustainability criteria for assessing their portfolio, they have also initiated constructive dialogue with their investors, and have helped evaluate whether less sustainable assets should be improved or sold.

Similarly, another fund manager said that the fund has already benchmarked and identified financially viable improvement measures (using cost benefit analyses) for all assets in one country and intends to undertake a similar review of all funds across Europe at a later stage. However, this will take time since a variety of systems will need to be developed containing different assessment criteria for different property types. The fund manager also explained that where possible the assessment systems would be linked to applicable third party standards such as BREEAM, LEED etc., but the real challenge will be in developing systems for property types where there is currently a dearth of applicable standards to draw from e.g. residential and industrial properties.

3.9 There are significant barriers to improving the sustainability profile of the existing stock

Most respondents said that even after properties have been benchmarked and potential improvement measures identified, the extent to which these improvements are implemented depends heavily on the characteristics of the fund – particularly, its property type(s), geographical reach, investor base, and investment criteria, but also the fund's investment period and if it is closed or open ended.

This means that no single improvement strategy can be developed for every asset or fund and instead a highly localised approach has evolved with significant variation in the scope and traction of sustainability improvements by property type and region. For example, several fund managers said that they have started to assess the sustainability profile of their existing portfolio and where possible they have introduced improvement measures. These were not part of a systematic improvement programme and tended to be limited to 'quick wins', made on a case by case or incidental basis though. Some of the reasons mentioned for this include a combination of the following:

- The vast majority of investors and fund managers expect no more than compliance with local environmental laws. This means that improvement measures will be limited to minimum compliance measures required at some properties, in countries which have introduced tighter environmental regulations.
- A couple of fund managers said that they look at opportunities to improve the sustainability of an asset as part of the exit or refurbishment strategy. However, the weighting given to sustainability depends on the interests of the potential tenant(s) or purchaser(s) and the cost of improvement measures must be counterbalanced by the expected return on investment and what is needed to make each building value enhancing.

- Respondents often emphasised that it is difficult to justify substantial investments required to improve the sustainability profile of older buildings, without clear evidence that these will enhance the financial performance of the asset. Until such evidence is available, fund managers and investors will typically take measures to improve the sustainability profile of individual assets as far as possible without hindering achievement of investment returns. This ultimately limits improvement measures to those which require little capital expenditure and favourable payback periods. This means that establishing the link between sustainability and financial performance will be critical for improving the sustainability profile of the existing stock, which forms the bulk of the market.
- Improving existing buildings is significantly more difficult than designing and developing a new 'green' building from scratch. For example, in existing multi-tenant commercial buildings, any sustainability retrofit or technology upgrades require the cooperation and participation of a wide range of stakeholders (i.e. owners, managers, occupants and contractors), dramatically affecting the scope for action.
- Tenants play a critical role in sustainability efforts, in terms of driving demand and in determining the success of sustainability initiatives. Unfortunately, investors and asset managers typically give up most of the control over how the property is used and managed during the lease period, retaining only direct control of the common areas. Therefore, if the tenant does not wish to take action, the scope for improving a building's environmental performance is significantly reduced.

As a result of these challenges, significant sustainability improvements are not generally commonplace within existing funds, except where a 'green' investment strategy is aligned with the fund's investment strategy and style. For example, value added and opportunity funds tend to acquire assets which have the potential to be improved. In these instances, it is easier to justify sustainability improvements on financial grounds, especially if they are simply incorporated into other improvement measures identified within the asset's investment plan such as retrofits and upgrades.

Despite these challenges several fund managers are taking positive action largely through the day-to-day management of property assets to reduce the sustainability impact of their property portfolios. Some companies have also developed sustainability guidelines for other stages of the asset's lifecycle, including refurbishments and lease renewals. By incorporating sustainability considerations into property operations, management and leasing contracts, these fund managers are helping to raise awareness and, to the extent that they incorporate reporting guidelines on sustainability initiatives, benchmark the investment or property management portfolio.

For example, some fund managers have implemented policies and procedures that have been incorporated into the governing documents for property operations and management. Furthermore, leading organisations have started to find innovative ways to promote collaboration with their tenants, by including the topic within agendas of occupier conferences and working with tenants to agree green leases.

In the case of green leases, both sides agree at the outset of the lease to undertake certain actions to manage and monitor the environmental impacts of property. One fund manager provided an example where collaboration with one of its tenants led to significant reduction in energy costs and carbon dioxide emissions, which has fortified tenant – landlord relations, helping it become recognised as a landlord of choice.

4 INDUSTRY CHALLENGES

Fund managers and investors were asked to provide their perspectives on the challenges associated with improving the sustainability of the non-listed real estate funds sector and on the role that INREV should play in supporting the industry overcome these. This section seeks to provide an overview of the key challenges and corresponding INREV actions raised by respondents throughout the course of this research.

INDUSTRY CHALLENGE #1: Limited knowledge

Lack of knowledge is a significant barrier to integrating sustainability into the investment process, and yet few companies have established formal training programmes to improve the understanding and expertise of their staff. There is a growing need to establish appropriate learning and incentive programmes, to encourage members of the investment community to increase their understanding of the implications of sustainability issues on their portfolios and to seek ways to improve the sustainability profile of their assets.

HOW COULD INREV HELP?

The biggest contribution that INREV can make to improve its members' understanding of the issues, is through communicating and engaging with its members and encouraging them to take action. For example, by undertaking some of the actions listed in this report, and communicating the outcomes of these to its members, INREV will significantly increase their understanding of the issues. Furthermore, INREV should take extra steps to engage its members in the debate, by adding sustainability topics and discussions to member newsletters and events. INREV should also consider developing or endorsing relevant award and training schemes that would encourage its members to participate in.

INDUSTRY CHALLENGE #2: Multiple definitions of sustainable / green funds and properties

The terms 'green' and 'sustainable' are poorly defined and open to (mis)interpretation – even assets or funds that appear to be 'sustainable', can be viewed as 'unsustainable' from a different angle – making it difficult to differentiate between 'sustainable' and 'unsustainable' funds or buildings. This is partly because a number of terms are now commonly used to describe sustainable property investment, including: environmental, social, and governance (ESG), sustainable investing, triple-bottom-line investing, responsible property investment, corporate responsibility, social responsibility and so on. Each of these will have a specific emphasis, meaning, history, and local context and although there will be considerable overlap in application, there may also be substantial differences in the terminology and approach taken by different fund providers. It is important that investors are aware of the differing grades and facets of sustainability represented by different investment vehicles on the market.

HOW COULD INREV HELP?

To help investors understand the range of different 'sustainable' funds on the market, INREV has commissioned Jones Lang LaSalle to develop a database of the 'sustainable' non-listed real estate funds (and their characteristics) available in Europe – this resource will be available to INREV members in quarter four 2010. At a later stage, INREV could also consider using this information to develop a Sustainable Fund Framework, outlining the elements that should be considered when establishing or investing in a sustainable fund. For example, this may include guidance on incorporating environmental, social and governance issues throughout the key stages of the property lifecycle – development/ acquisition, refurbishment, operation and management (including leasing) and disposal.

INDUSTRY CHALLENGE #3:

Keeping abreast with the rapidly changing legislative landscape

The property sector will remain a prime target for policy action and more regulations will be introduced to reduce the environmental impact of the built environment in coming years. This is due to the widely acknowledged negative environmental impacts associated with commercial buildings, combined with the strong political will to tackle issues such as climate change. Several respondents said that understanding and complying with the vast array of new regulations affecting their large, global investment portfolios, presented a significant challenge.

HOW COULD INREV HELP?

INREV could help its members keep abreast of and be proactive in preparing for new legislation within a rapidly changing legislative landscape. For example, INREV could simplify and summarise the legislation and policies (local, national and regional as well as existing and planned) in all key markets to create a catalogue for members which could be refreshed on an annual basis. Furthermore, to be effective, regulations need to be developed in partnership with industry and INREV should support the development of new legislation by influencing and contributing to discussions with key decision-making authorities and regulators.

INDUSTRY CHALLENGE #4:

Questionable link between sustainability & financial performance

Sustainability is still an emerging and evolving issue for the non-listed European real estate funds market, and it is unclear how regulatory (i.e., European, national and local policies) and market pressures (i.e., investor, tenant and future buyer demand) will impact future fund performance. This means that many investors and fund managers are cautious about 'green' funds, or about making substantial investments (often required to 'green' older buildings) without clear evidence that these will enhance the financial performance of the asset. Until such evidence is available, fund managers and investors will typically take measures to improve the sustainability of individual assets, providing that they will not risk achievement of investment returns. This ultimately limits improvement measures to those which require little capital expenditure and have favourable payback periods.

HOW COULD INREV HELP?

INREV could support efforts to prove/disprove the emerging body of evidence which suggests that over time the market will increasingly reward sustainable buildings (or discount unsustainable ones). For example, INREV could participate in and/or lead empirical research projects and compile case studies that demonstrate financial benefits arising from sustainable real estate investments. INREV could also participate in and/or lead the development of a pan-European fund benchmark, which attempts to demonstrate the link between sustainability and investment performance. Through collaboration with relevant professional and industry bodies, INREV should also support and influence the development of third party tools used to demonstrate the business case.

INDUSTRY CHALLENGE #5:

Reporting and communicating progress consistently to investors

Investors are likely to increase the level of detail requested in future RFI/RFPs and will expect fund managers to participate and improve their performance in relevant benchmarking surveys and rating schemes. They may also expect sustainability metrics to be included in fund reports and in some cases to comply with initiatives to improve the transparency of reports such as the UNPRI. However, fund managers are already frustrated by the vast array of different (and in most cases inconsistent) questionnaires, benchmarking and reporting schemes. The variation between these creates significant and unnecessary rework, requiring reanalysis of data and information for each response.

HOW COULD INREV HELP?

INREV could help to avoid these issues by producing standard questions to be included in the RFI/RFPs issued by investors, and by recommending key fund-level sustainability metrics that should be included in investment and annual sustainability reports. However, INREV should avoid developing new guidelines/standards and should merely summarise, condense and prioritise the information and common data requirements of the various guidelines and standards that already exist, such as the Carbon Disclosure Project, GRI CRESS, UNPRI, UNEP FI Property Working Group, UNEP SBCI, GPA etc.

INDUSTRY CHALLENGE #6:**Vast array of inconsistent standards and benchmarking tools**

In recent years, a number of third party standards for rating buildings on sustainability, particularly environmental issues, have emerged across the globe, including BREEAM, LEED, Green Star, CASBEE, DGNB and HQE. However, there is still no single sustainability benchmarking system that is applicable across different countries and property types, which can evaluate sustainability performance and identify improvement measures that take into account investment criteria, payback periods and timing considerations.

As a result of the limitations of existing third party standards for benchmarking and analysing portfolios, companies are using systems developed in-house, by a specialist consultancy or in collaboration with third parties. The result of these efforts is a proliferation of inconsistent standards and tools which has led to confusion amongst investors.

HOW COULD INREV HELP?

INREV can help investors and fund managers remain informed and knowledgeable about new developments and initiatives in this space, by summarising the standards and benchmarking tools that are already being used in key geographies and by leading companies. Such a summary could explain the rationale and methodology behind each approach and identify synergies that could be achieved for fund managers operating across various regions.

5 CONTRIBUTORS

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