Real Estate

Sector Report - 7th in a series

Eurosif

This Eurosif sector report has been compiled by Dutch Sustainability Research, on behalf of SiRi Company. It describes the major social and environmental challenges facing the European real estate industry and the associated risks and opportunities these pose for long-term financial returns.

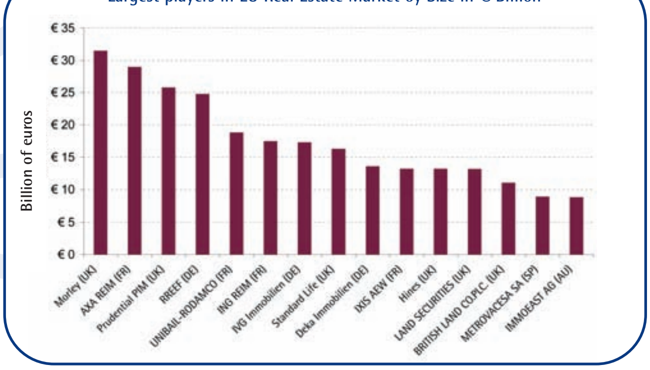
REAL ESTATE OVERVIEW

- Main real estate segments comprise commercial property (including office buildings, industrial buildings and shopping centres), and residential property. Activities of companies in the sector include: renting property to tenants, facility management, property management & development, asset management, and property trading.

- The total Pan-European investment market value increased by about 7% to a total value of €1360 billion at the end of 2006.[1] European direct real estate investment volumes have increased by €68 billion (39%) to a total of €242 billion by the end of 2006.[2] Property companies, REITs (Real Estate Investment Trusts)[3] as well as specialist property fund managers linked with insurance companies, and pension funds are the biggest players in the market.

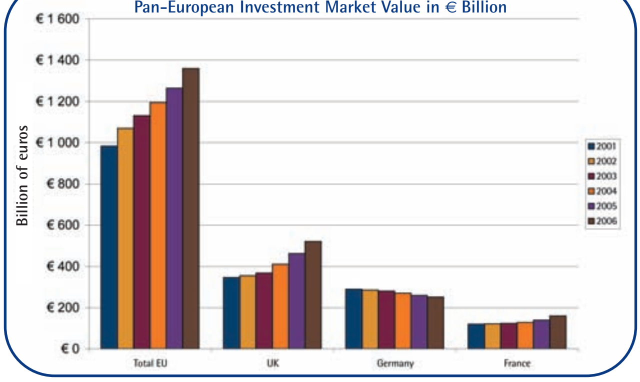
- European all-property gross returns in 2006 totalled 23%.[2] Most of this return has been generated by increases in the value of property driven by yield compression in the market. This is now generally believed to be easing and returns are expected to be lower going forward.

- As of May 2007 there were 317 publicly listed European companies in the ICB (Industry Classification Benchmark) Real Estate Holding and Development and REITs subsectors.[4] These companies represent a total market capitalisation of around €275 billion.



Largest players in EU Real Estate Market by Size in € Billion

Sources: Europroperty/INREV (December 2005) & Datastream (December 2006)



Pan-European Investment Market Value in € Billion

Source: IPD (December 2006)

REAL ESTATE TRENDS

- Cross-border investments in Europe have significantly increased recently and are expected to continue to grow. As a percentage of direct real estate investment they have grown from 37% in 2000 to 62% (€150 billion) in 2006. By expanding their investment horizons to new markets, real estate companies have access to new growth opportunities, less competitive (and more profitable) markets and further risk diversification. Areas of interest include Central[5] and Southern Europe as well as emerging markets.

- Divestment of direct property by institutional investors and the substitution of much of this exposure through reinvestment in indirect property vehicles are also occurring in this sector. Retail investors have been utilising listed and unlisted property vehicles to enter the real estate market in great numbers. REITs have been adopted in several EU member states and are planned in others (e.g. Germany and Italy) offering tax transparency to investors and an enhanced liquidity of real estate. There is also a burgeoning market in property index based derivatives, as well as a growing use of Commercial Mortgage Backed Securities.

- The search for high yields and low risk and the increasing emphasis on customer relations, is leading companies in the industry to diversify their portfolios and provide extra services such as catering, security and information technology services. This can add value for users and improve client satisfaction.

- Sustainability issues in the real estate sector are rapidly gaining more attention and are emerging as significant concerns for both investors and developers in European real estate markets. However, there appears to be a gap between the awareness phase and actual concrete actions regarding sustainability from many companies in the sector.

- The real estate investment market is becoming increasingly transparent. Countries with the highest levels of cross-border investment activities are found to be the most transparent markets when it comes to sustainability reporting.[2]

1 www.ipdglobal.com.
2 www.joneslanglasalle.com.
3 A REIT is a vehicle under which investment can be directed in a tax efficient manner into the real estate sector.
4 www.thomson.com/solutions/financial.
5 Volumes in Central and Eastern Europe more than doubled to €13.3 billion in 2006.

SOCIAL & ENVIRONMENTAL ISSUES | KEY CHALLENGES | MATERIAL RISKS & OPPORTUNITIES

Climate Change

- According to the European Commission, some **40% of the total final energy consumption in the EU is related to buildings.**[6] A 2004 study found that electricity causes almost half of the environmental impact during the life-cycle of an office building.[7] The European Commission estimated that 30% to 50% of energy use on lighting for offices, shopping centres and recreation areas could be saved by using state-of-the-art systems and technologies.
- In 2006 the EU introduced the European Energy Performance of Buildings Directive (EPBD) that aims to reduce the energy requirements (by 30% by 2010) and CO_2 emissions for the buildings sector.[8] The **building stock of the original EU 15 countries accounts for 678 million tons per year of CO_2 emissions.** The EPBD directive is expected to reduce CO_2 emissions by 34 million tons per year by 2010, when applied to all buildings greater than 1000 square meters. EU member states will have to implement the directive into their national legislation. This directive is seen as an important part of the EU's strategy to comply with the Kyoto protocol. It can be expected that in the future, legislation on energy efficiency of buildings will be further tightened.

- The extension of European green house gas (GHG) legislation to the real estate market, which could mean **new GHG maximum quotas on buildings and occupiers, may be costly** for big energy consumers in this sector.
- Energy prices have increased in recent years and are expected to stay at relatively high levels. High prices have **raised awareness about energy** costs and provide a stronger **incentive for end-users to reduce energy consumption.**
- Leading companies have implemented environmental **due diligence procedures** when purchasing new property to ensure that potential environmental risks are properly assessed and managed and to **avoid a potential increase in insurance costs** for the properties.
- In Germany, France, the UK and the Netherlands, **new legislation** is being introduced following the EPBD directive. Large buildings are required to have an **energy certificate** indicating their energy consumption. The introduction of this legislation will raise awareness of tenants and occupiers and could be a **market opportunity for energy efficient properties.**

Sustainable Buildings

- **Sustainable buildings** are designed to have a **minimal impact on the environment** during their construction, operation and demolition. They make use of sustainable building materials, use energy and water saving technologies, and are located close to public transportation and social infrastructures such as schools and health care facilities.
- SiRi Company researched 27 stock-listed European companies in the real estate sector. Out of these 27 European companies, 26% publish a CSR report, 7% base their reporting on GRI guidelines, 60% have a publicly reported environmental policy, 56% have programmes for energy and CO_2 emissions reduction, and 37% have programmes to increase the use of renewable energy. None of the companies report on actual renewable energy use. Compared to other sectors this shows that the **real estate sector is lagging behind in terms of environmental practice and reporting.**
- With respect to appropriate environmental indicators, no consensus has been reached in the sector. At this stage there are **no best practice guidelines** for the industry on the preferred indicators to use.

- Companies in the real estate sector can reduce the environmental impact of their existing property holdings by minimising energy and water consumption, recycling used materials, increasing their use of renewable energy and by performing life cycle assessments (LCAs) when developing new property. By actively applying these measures, companies can decrease operating costs and differentiate themselves from competitors. Given that **new developments represent only around 2% of built property stock,** reducing the impact of existing property holdings is considered by many to be the most important issue facing the real estate industry.
- Top performing companies in the sector that have an **active dialogue with their tenants and other stakeholders about ways to reduce their buildings' environmental impacts can reduce their energy costs.** Office occupiers recognise the benefits of such buildings and would even be prepared to pay more for them.[10] 88% of industrial occupiers said they would pay higher rent and rates for a 'green' building, but only if it brought them much lower running costs. **Green properties** will also **protect asset values better** against new risks and avoid exposure to accelerated depreciation of traditional real estate.
- There are several **initiatives to promote sustainable buildings.** In Europe these include: Euroace,[11] GreenBuilding,[12] UNEP FI,[13] UNEP SBCI[14] and the WBCSD EEB project.[15] Real estate companies can join these initiatives to proactively contribute to/and anticipate developments in the sector.
- In 2008 **Energy Performance Certificates will be introduced** in Europe. The most frequently used property environmental assessment standards for certification are BREEAM[16] in the UK, HQE[17] in France and LEED[18] in North America. Having property certified could **create a competitive advantage and mitigate the risk of environmental liabilities.**

Community Regeneration and Consultation

- With an increasingly competitive real estate market, European investors and developers are placing **more focus on urban regeneration opportunities** than in previous years. Urban regeneration may include economic, physical, social and/or environmental initiatives.
- Productive regeneration programmes can improve the environment, the quality of life and bring greater prosperity, especially to poorer communities.

- Best performing real estate companies on sustainability create community commitment by stimulating tenants to **hire local staff** and introduce programmes to **improve the social environment** of their property. Community regeneration provides tenants and visitors of property with a safe, clean and accessible environment. This helps protect and **increase the value of the property,** as it improves client satisfaction, prevents vacancy and increases rental income.
- Involving local communities will increase acceptance of their projects and can also **reduce planning and project development time,** thereby reducing costs. Effective community programmes can also provide a stimulus for local economies and thereby protect property value.

Supply Chain Issues

- During the planning, construction and operation phases of a property's life-cycle, real estate companies work with many contractors including architects, construction teams, and cleaning and catering companies. In some of these areas such as construction, **business ethics issues** including corruption have been a significant problem.
- Of the 27 European companies in the sector researched by SiRi Company, 37% have a publicly disclosed policy on contractors and social issues and 22% have a monitoring system to ensure contractor compliance. Furthermore, only 37% have a publicly disclosed formal **policy on bribery and corruption.**

- Leading real estate companies that set **strong standards** for themselves and their suppliers/contractors can **protect their reputation** and attract high-profile companies as tenants for their properties.
- Investors could play a role in exerting pressure on their suppliers to act responsibly in order to reduce fraud. Strong business ethics standards will also **shield companies from potentially costly lawsuits** and **reduce risks** of project delays.

Occupier Satisfaction

- Tenants and occupiers are becoming more demanding in the fields of service and building design. PROBE (Post-occupancy Review of Buildings and their Engineering) studies have shown that **occupier satisfaction is higher in energy efficient buildings.**
- According to the UK Occupier Satisfaction Index 2007, occupiers want a more innovative approach to be taken by the property industry, and they believe strongly that property owners should at least share the costs of meeting the new standards.
- Of the 27 European companies in the sector researched by SiRi Company, 17 companies (63%) have a policy on quality or customer satisfaction in 2006 and only 7% report on the number of ISO 9000 certified sites. These figures show that customer satisfaction is perceived as an important issue in the sector even though there is a **lack of visibility as to steps actually taken to promote high standards.**

- To retain increasingly demanding tenants, property managers will rely on increased attention from the customer relations departments. By applying a pro-active approach towards changing market demands, real estate companies can improve occupier satisfaction. In theory, **satisfied occupiers should be more likely to extend leases thereby reducing vacancy rates.** Several studies have found that **green buildings** can decrease employee absenteeism, health care costs and work losses, as well as increase **worker productivity.**
- Quality certifications such as ISO 9000 and ISO 14001 provide a positive signal to possible tenants. It can be expected that energy performance certification and sustainable building certification will be the next steps.
- Some clients may also be willing to pay **higher rents for buildings with strong environmental standards,** as these may be important for their own clientele and reputation. With more and more corporations committing to become fully carbon neutral, demand for energy efficient office buildings, retail space and industrial sites is likely to increase.

6 2003 Work Programme for SAVE (www.save-foundation.net).
7 Life cycle assessment of environmentally significant aspects of an office building - Seppo Junnila (2004).
8 http://ec.europa.eu/energy/index_en.html.
9 Based on the largest companies in the MCSI World Index. SiRi researches over 2000 stock-listed companies.
10 GVA Grimley, Research Sustainability, Towards Sustainable Offices (Spring 2007).
11 European Alliance of Companies for Energy Efficiency in Buildings (www.euroace.org).
12 www.eu-greenbuilding.org.

13 The United Nations Environment Programme Finance Initiative (www.unepfi.org).
14 The United Nations Environment Programme Sustainable Building and Construction Initiative (www.unepsbci.org).
15 World Business Council of Sustainable Development European Energy Efficiency in Buildings (www.wbcsd.org).
16 The Building Research Establishment's Environmental Assessment Method (www.breeam.org).
17 Haute Qualité Environnementale (www.assohqe.org).
18 Leadership in Energy and Environmental Design (www.usgbc.org/LEED).
19 More information on these studies can be found at: www.usgbc.org.

British Land Encourages Responsible Property Design

In late 2004, British Land issued a 'Sustainability Brief' for its development department that encourages its property designers to consider a host of social and environmental questions such as how to reduce waste in construction, whether it is possible to use recyclable building materials, and how best to consult local interests. This has been applied to one of British Land's developments, Ludgate West, an 11,800 square-metre office complex in central London, which has a design brief that lists 89 separate areas where sustainability is now being considered. These range from regeneration and local economic impact to energy use and noise pollution. Each area has a sustainability objective, target and completion date. By the time Ludgate West opens in late 2007, it will feature a sanitation system that uses harvested rainwater, sustainably sourced timber throughout the building and even 152 square metres of vegetation on the roof.

Source: www.britishland.com

Triodos Bank: Sustainable Real Estate Fund

In 2004 Triodos Bank launched the Triodos Vastgoedfonds nv (sustainable real estate fund), which exclusively invests in sustainably constructed business premises and monuments. The investment fund was the first sustainable real estate fund in Europe. The methodology used for the selection of the premises was developed for the fund by Triodos Bank in exclusive cooperation with SenterNovem (Dutch Organization for Energy and the Environment). Triodos Bank, which bills itself as a pioneer in sustainable banking and green banking, says that this will set a market standard for sustainable real estate in the Netherlands. The fund stimulates more careful use of building materials, raw materials, energy and water and invests in the most innovative sustainable offices and shops, as well as in existing buildings that are subsequently renovated and managed in a sustainable manner.

In addition to sustainable buildings, the fund has a special interest in investments in historical buildings that have been officially designated as monuments due to their beauty, their scientific significance or their cultural/historical value.

Source: www.triodos.nl

PRUPIM 'Improver Portfolio'
A Sustainable Property Investment Initiative

PRUPIM has set up an innovative project called the Improver Portfolio – to examine ways it can reduce a 'typical' property portfolio's carbon footprint while maintaining or even enhancing investment returns. This portfolio consists of a sample (£500 million) of assets taken from its two main life funds (Life Fund and SAIF) with an aim to decrease their environmental impact. Given the desire for this exercise to be a general learning experience capable of providing lessons for wider application across all PRUPIM client funds (£19 billion), assets for the portfolio have been drawn from across the full spectrum of asset types.

Once the subject properties were identified, a 'base-line' environmental audit was carried out on these properties. This base-line will be used to measure changes in environmental terms and assess how much the impacts of the buildings have been reduced progressively and cumulatively since the inception of the initiative. A plan of action to reduce environmental impacts will be drawn up for each asset. At the end of each year, for a proposed experiment period of five years, the original base-line environmental audit will be repeated on each property to identify how much improvement has been made.

Source: www.prupim.com

Eurosif wishes to acknowledge the support and direction provided by the Real Estate Sector Report

Steering Committee: & Researcher:

UNEP Finance Initiative
UNEP-FI Property Working Group
www.unepfi.org

SiRi Company
Dutch Sustainability Research
www.dsresearch.nl • www.siricompany.com

This sector report has been created with the support of the European Commission.

Eurosif

11 avenue de l'Opéra • 75001 Paris, France
Tel/Fax : +33 (0)1 40 20 43 38
contact@eurosif.org • www.eurosif.org

June 2007