01:
Stephen Hayes
head of property securities
First Sentier Investors

Real estate for the new world

The real estate sector is one of the worst offenders when it comes to carbon emissions in the world.

It's a fact that's almost tough to wrap your head around given that, when we think about carbon emitters, we typically think of something or someone that is living, breathing, or moving.

According to Architecture 2030, nearly 40% of global carbon dioxide emissions come from the real estate sector, with 70% produced by building operations and 30% from construction.

With much of the world working towards a net zero target, it's important that something be done to address the issue, particularly given the sector's size, First Sentier Investors says.

"Firstly, on operational carbon, it's about reducing the energy intensity of the building," First Sentier head of property securities Stephen Hayes[01] says.

And the best way to do that is through modernisation; anything from maintenance capex programs to redevelopment. This can include something simple like upgrading equipment or can be more significant and be incorporated from the outset of a new development, with carbon reduction measures considered in a building's design, like its orientation to the sun and ventilation and air conditioning systems, and the materials used.

"If I take an ultra-modern office building and compare it to a 30-year-old office building, the modern building is up to 55% more carbon efficient," Hayes says.

Embodied carbon, which is the carbon emitted during the construction of a building, comes largely from the materials that go into a building, typically steel and concrete. Hayes says more needs to be done on this front.

"We need to start measuring this – we can't ignore it. It falls into the Scope 3 bucket and that's an airy-fairy bucket that nobody really needs to comply with, but the reality is it's very important for the real estate sector to consider these things, given its modernisation and development programs," he says.

"Firstly, measure it then seek to reduce it through design and use of materials, underwrite the cost of carbon into your development to make sure the feasibility stacks up and then offset the rest of the carbon to deliver a carbon-neutral development which is very operationally carbon efficient."

These are all factors that are considered by the First Sentier team when making investments via its Global Property Securities Fund, a portfolio with a net zero intention overlay. The fund invests in a range of real estate securities, including logistics and residential property through to healthcare and data centres.

When doing so, the team uses its own in-house, proprietary methodology. Hayes says this is because the Scope 1, 2 and 3 emissions categories we always hear about aren't easily applied to real estate assets and disclosures don't typically provide a full picture. Having its own analysis on hand makes it easier for Hayes and the team to measure which carbon reduction programs are effective and which companies are leading or lagging.

Sophisticated landlords with carbon reduction programs in place will be much better placed when carbon regulation comes in, which Hayes says is just a matter of time.

While ability to reduce emissions is a big factor in the sustainability of the real estate and real estate securities sectors, they are well placed going forward due to their strong operating fundamentals, Hayes believes.

"It's a really attractive asset class at the moment, driven by the new economy," he says.

"These are real assets and there's several characteristics associated with them. And it's simple things like they're fixed, you can't pick them up and put them in another market, so that makes them very lowly correlated. They're very cashflow stable assets in that majority of their cashflows come from contracted rental income streams and they are very secure; and they offer an excellent inflationary hedge.

"They also have very long economic lives, these assets can be generating investor returns for decades and decades, 60 or 70 years in some cases."

However, real estate assets are very capital intensive, meaning they require a lot of capital to be spent on them to remain competitive and maintain healthy, reliable cashflows. This makes access to capital very important.

"These assets with these characteristics, specifically in the publicly traded environment and the global REIT sector have access to capital, and that's what's really driving these consistent dividend growths and security of cashflows," Hayes says.

The other attractive thing about real estate is valuations, he adds.

"As central banks fight inflation and interest rates start to rise, quantitative easing programs are now a thing of the past in many countries and we're even looking forward to things like quantitative tightening," Hayes explains.

"The way that markets have dealt with this, particularly equity markets, is to sell anything more broadly that they deem to be interest rate sensitive. With that, we've seen a pullback in sector prices, so the valuations are really appealing."

Add to that the fact that these assets are rather rare and highly valuable, they're trading at large discounts to private market value, net asset value and replacement value, he says.

"We are seeing replacement values go up dramatically with inflation. The cost to build is expensive and it's rising further. On top of that, with COVID-19 and low interest rates, particularly in cities, we've seen land values become very elevated," Hayes says.

The asset class also offers a great inflationary hedge, he adds.

"Ironically, it's not the lease structures that are driving inflationary hedge at all – it's pricing power. There's a lot of major, strong long-term themes playing out, like the rise of e-commerce, data consumption growth, falling home ownership rates globally, ageing population," Hayes says.

The real estate securities sector is a massive beneficiary of these trends, and that's driving pricing power which is in turn driven by market rental growth.

"So, we can see into the future that these long-term themes are reducing the economic sensitivity of real estate, but the fundamentals are very strong and long dated, and that's what's driving this very strong inflation hedge that's coming through," he explains.

The fact that the fund's portfolio accounts for these themes and is also only investing in those assets that are actively working to reduce carbon emissions means it's well positioned in terms of investor risk and generation of strong, inflationary hedge type returns, First Sentier believes.

"By a building becoming more energy efficient, it is cheaper to operate. There is a cost saving there... That cost saving drives investor outcomes over time as these buildings are more efficient. It also improves the rentability of the assets and makes them more secure," Hayes says.

So, not only is the team's approach driving higher investor returns, but it's also getting more secure cashflows simply from the buildings being more efficient, thereby driving better investor outcomes.

"If I look at the cost of a carbon offset priced in US dollars, it went up over 150% last year. This is very early days for these offsets and the cost of carbon, so it's clear the cost of carbon offsets is going to go up materially in the coming years," Hayes concludes.

"Those landlords that are running more energy efficient portfolios with defined carbon reduction programs in place will be much better placed to deal with this regulatory risk when it comes." **FS**

The quote

If I take an ultra-modern office building and compare it to a 30-year-old office building, the modern building is up to 55% more carbon efficient.

Watch the video on www.fsitv.com