

The Impact on Real Estate II: An Investment Perspective

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Structure

- How the context for property investment is changing
- Reflections on what establishes the “worth” of a property investment
- How the components of “worth” are impacted by the changing context for property
- The Vancouver Valuation Accord and how it can help investors take action

30 months in a changing environment – UK Government measures

Climate Change Levy introduced, 4/01

**UK publishes ten year Climate change /
sustainable development programme**

**Renewable Energy Obligation tax
introduced, 4/02**

**UK Emission Trading Rules published,
4/02**

EU Emission -scheme starts 2005

**UK building regulations changed to
tighten energy efficiency requirements**

UK Minister for CSR appointed, 3/00

EU Pollution Liability adopted,2001

**Enhanced Capital Allowances for
energy efficiency equipment 04/02**

Carbon Trust Established

Aggregates Levy introduced, 04/02

**Company car tax based on emissions,
04/02**

**Draft EU directive on mandatory energy
audits for commercial property**

EU Directive on environmental liability

EU Directive on energy in buildings

**8 further EU directives and policies in
draft**

30 months in a changing environment: UK finance industry measures

UK 'Trustee Act' requiring pension funds to disclose policies on SRI, 7/00

UN Global Compact launched for multi-nationals, 2000

UK Social Investment Task Force established, 2000

Dow Jones Sustainability Index launched

BiE 'Index of Corporate Environmental Engagement conducted - 78/100 responded.

FORGE report published, 2000

UK DTI launches 'Business and Society' guide, 3/01

FTSE4Good Index launched, 7/01

EU publishes Green Paper on CSR, 7/01

ABI publish 'Investing in Corporate Social Responsibility', Autumn 2001

UK Carbon Trading Scheme launched, Spring 2002

Innovest report on Climate Change and the Financial Services Industry published, July 2002

FORGE 2 report – November 2002

Current initiatives impacting UK property investment

Revised Part L, 2006

London's supplementary planning guidance

DEFRA sustainable buildings code
PPS 22

EU Energy Performing of Buildings
Directive - imminent

Public sector building work – targets for energy efficiency

London Borough of Merton rules on sustainability options within developments

Carbon Disclosure Project – now launched

Hazardous Waste Regulations 2005 and PPS 10

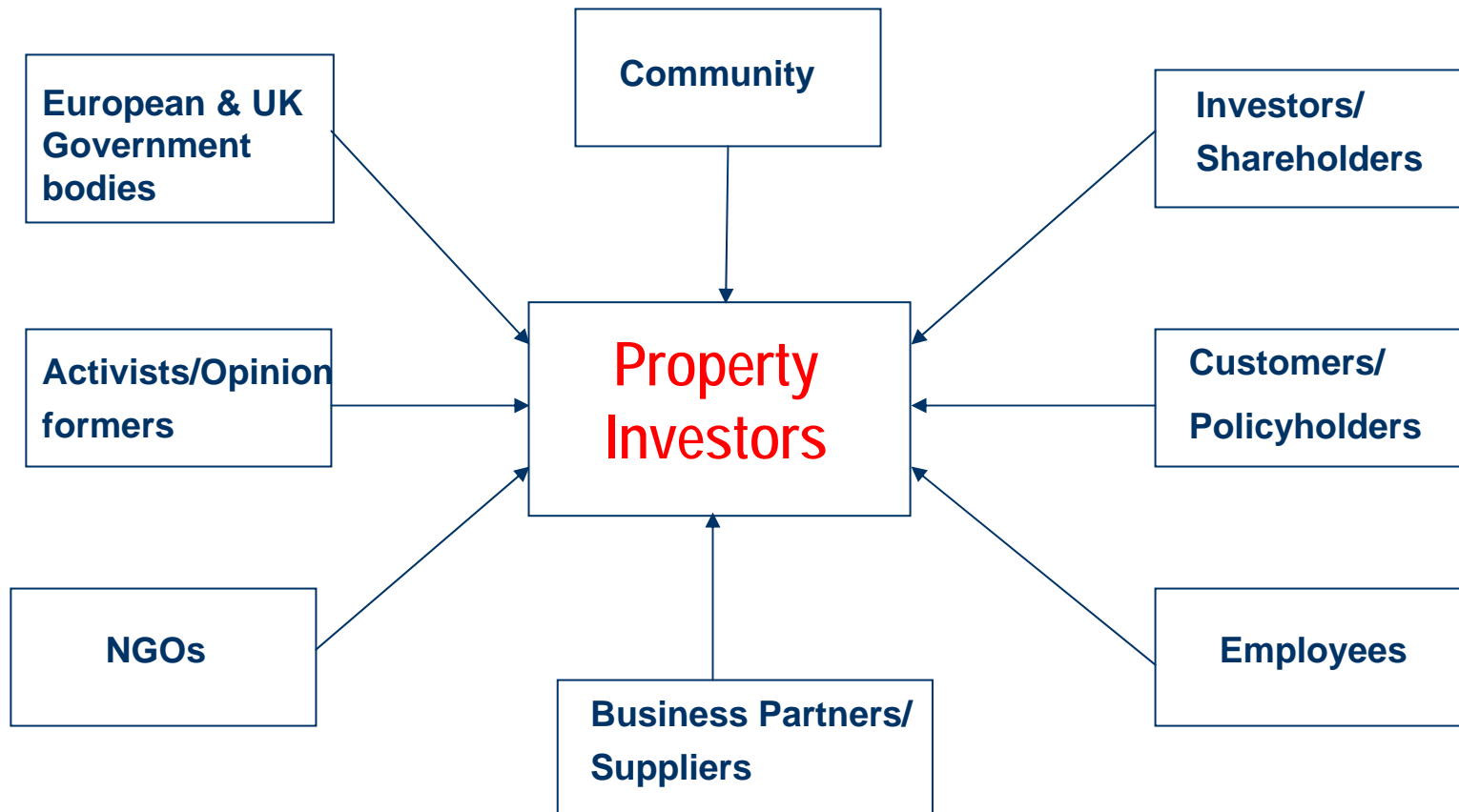
EU Emissions Trading Scheme – now launched

Waste Electrical and Electronic Equipment Regulations, 2005

Joint UK and Sweden Initiative on Environmental Construction

DEFRA discussions on Energy performance Commitments

Pressures for Change



How investors think about “worth”

- **What (else) can I get for my money?**
 - Baseline investment – Risk Free Government Bond (**Rf**)
- **How much risk is there to my enjoyment of returns: how certain are my returns?**
 - The higher the risk, the higher the Risk Premium (**Rp**), the lower the price
- **How might the income from my investment change over time?**
 - The greater the rate of increase over time, the higher the price (**G**)
 - Markets rise and fall but all buildings depreciate (**D**)

Determining “worth”

- The yield I want from my money is therefore (roughly)

$$R_f + R_p - G + D \text{ (essentially a Gordon's Growth model)}$$

We also know, crudely, that

$$\text{Yield} = \text{Income} / \text{Capital Value}$$

- So,
 - if Y is set, I is broadly known, CV can be determined
- Anything that affects R_p , G or D will affect yields and, therefore, feed through into capital values

How might sustainability issues impact asset worth?

- **'Unsustainable' assets become less desirable.....to tenants**
 - reduced attractiveness, rent levels reduced relatively, **(G down, D up)**
 - increased time to re-let **(Rp up)**
 - Increased need to re-position asset, **(D up)**
- **...to investors**
 - Increased time to re-sale **(Rp up)**
- **Increased costs (especially energy), (G down)**
- **Increased minimum standards**
 - Increased need to inject capital to meet new standards, **(D up)**
- **Rp up, D up, G down → Yield up, Capital Values down**

Calibrating the impact on worth – some observations

- Not in pricing now, but will be in the future
- It is an investor's fiduciary duty to understand these phenomena and incorporate them in investment decisions
- The more it “matters”, the greater the impact on worth will be
- The realisation of this should feed naturally into what investors will pay (and accept) for assets
- This, in turn, should feed naturally into valuations
- **So, how might the Vancouver Valuation Accord help in this process?**

Worth, Value and the Vancouver Valuation Accord

- The most common understanding of valuation is ‘establishing the current exchange price’ of a property
- In this sense, ‘value/exchange price’ is distinct from ‘worth’
 - Property market ‘inefficient’ - ‘bargains’ and ‘rip offs’ occur
- As investors appreciate the ‘worth’ implications of sustainability issues,
 - their pricing behaviour will evolve, and
 - valuations will naturally evolve with them
- But this is **NOT** to say valuers must wait or have no contribution to make – quite the contrary!

Investment and Sustainability – the current view

- **Three Possibilities**

Behaving Responsibly
Enhances Fund
Performance

Fiduciary Duty
to act this way

Behaving Responsibly
Has No Effect on Fund
Performance

“Moral” Duty to
act this Way

Behaving Responsibly
Harms Fund
Performance

Dilemma - Client Guidance
Required

Perception is.....



Valuation – a current impediment to action?

- **A key impediment to investor action is**
 - taking action on assets (and incurring some cost) but not receiving recognition for it in year end valuations
 - Cost for no increase in valuation leads to a dilution of that year's performance
 - This poses a dilemma for property fund managers
- **But.....DCF tells us that**
 - factors which affect future cashflows and values require representation in current 'worth'
- **Kingston University work**
 - we may already be paying too much for some properties

How valuers and the Vancouver Valuation Accord can really help

- **Crucial that valuers reward investors promptly for the actions they take on the sustainability of their assets**
 - This will give investors greater confidence that their actions will not dilute short term performance
- **Valuers should help educate investors about thinking through sustainability and its impacts on value over the long term**
 - Setting the present value of ‘doing something now’ against the present value of ‘not doing something now’
- **Valuers should keep as well informed as they can about how investors are responding to these issues – there is a lot going on!**
 - UNEP FI Property Working Group
 - (UK) IIGCC/IPF Property Working Group
 - RICS, BPF, BCO, IPF, Property Industry Alliance work

Conclusions

- **The social and policy context for investing in property is changing rapidly**
- **Property assets will increasingly be differentiated on their social and environmental credentials**
- **This will inevitably feed into differential pricing over time**
 - these influences should be reflected in current pricing (albeit, at what level?)
- **In line with the Vancouver Accord, valuers should**
 - seek to reward investors promptly for the actions they take; and
 - help educate investors on the positive implications that taking action can have on value and performance