

The green debate

Recently, **Sheila Hopkins**, managing director – Europe and infrastructure with Institutional Real Estate, Inc, spoke with **Bill Hughes** and **Debbie Hobbs** of Legal & General Property for their views on sustainability in the changing real estate landscape. The following is an excerpt of that conversation.

The green debate has been going on for a while. Where is it now?

Bill Hughes: Sustainability has become a real issue over the past decade. In the early stages, it was about assimilating knowledge and awareness. Then new regimes for dealing with sustainability were created. Then there was an interlude where some people mistakenly thought that because there was a recession, sustainability no longer mattered. During this time, we have fervently held a counter view, which is that when economic times are hard, sustainability is important because it is going to save money in terms of building operations and preservation of capital.

There has been some legislation encouraging sustainability. Is what's gone through good for the industry?

Debbie Hobbs: In the UK right now, new regulations are having quite an effect on the market. For example, if you have a building with an EPC (Energy Performance Certificate) rating of an F or G, the lowest available, it is possible that the forthcoming Minimum Energy Performance (MEP) legislation will not allow you to continue to let it post April 2018 without undertaking 'Green Deal' energy efficiency measures. However, these are currently hard to assess as they are down to the Green Deal assessors/assessment. This is causing quite a bit of stir at the moment, as people realise the implications for their portfolios. As a result, a consultation group has been developed by the British Property Federation in order to advise the Department of Energy Climate Change on how to frame the forthcoming MEP legislation from the perspective of the property industry.

Are regulations needed because managers aren't seeing the value of doing this otherwise?

Hobbs: In any market, you get leaders and followers, and then you get the laggards. Legislation is often seen as a way of making the laggards comply with what needs to happen. A lot of the legislation on sustainability is being driven by the EU, and it is a challenge to get a level playing field across Europe. Every country has different building regulations, and so a lot of the regulations are about getting everybody up to a certain minimum level. However, we see the value in going above and beyond the minimum legislative requirements.

Hughes: We take the view that sustainability matters and that there are a number of important steps you can take to enhance a property portfolio. It starts with measurement because you have to have the data before you can really take action. We need a standard approach across the industry because we need to be able to measure industry performance as a whole. Engaging in better practices is something everyone should be doing, not just some organisations. I think it is really difficult for the industry to do that on its own without some sort of external firm guidance.



Bill Hughes is managing director of Legal & General Property (LGP). He has overall responsibility for LGP and Legal & General's commercial lending team. He joined LGP in November 2007, having previously held the position of UK head of real estate at RREEF, now known as Deutsche Asset & Wealth Management. Prior to that,

he was deputy managing director and head of research at Schroder Property Investment Management. He also currently holds the roles of Vice President of the British Property Federation (BPF), succeeding to President in July 2014, and Chairman of the Green Property Alliance (GPA), amongst other industry positions.



Debbie Hobbs is sustainability manager at Legal & General Property (LGP), which she joined in 2012 from ENVIRON, where she oversaw the sustainability and climate change practise. She is a chartered buildings services engineer, with experience in low-carbon design and refurbishment. She previously held positions at

AECOM, West Sussex County Council and MEPC UK Ltd.

Hobbs: One of the big issues we face is we still don't have a consistent system across Europe for labelling whether a building is sustainable or not. We don't have a way of saying, "This building in the UK is more or less sustainable than this building in Australia or Europe or the US." There are no universal standards in ratings and lots of different schemes all around the world. In the UK we've got BREEAM, which is sort of the equivalent to LEED in the US, and also we've got DNGB and HQE in Europe. If we consistently had the same label, we could actually compare properties globally.

How does sustainability in the UK compare to the rest of the world?

Hughes: In cycling parlance, I feel the UK is probably in the peloton; we are in the chasing pack, not out in front. It is a developed economy rather than a developing economy, which means it faces a specific set of challenges. Sustainability in the UK by definition must be about retrofit and modification. We are a high-density population, which makes sustainability more manageable in terms of heating and power as well as infrastructure and transport policy. In terms of best practices around the world, Australia seems to be on the leading edge.

Hobbs: Germany has had better building standards than the UK for years, but their EPCs are generally much cheaper. Every market is starting to develop differently, which is why we've got so many different ratings tools. When I started going to the US, I was amazed at how the standard in different states varied. At one end, California's air quality regulations are driving carbon emission management to

quite a high standard, but some other states have not really gotten started.

Are investors focusing on sustainability?

Hughes: Over the past 12 or 18 months, we have begun to notice investors prioritising sustainability. They are not necessarily going to say, “Is the building sustainable?” But they are saying, “Are you as a fund manager fully conversant with the issues, and are you doing the right thing?” A number of times we have been selected as the fund manager for mandates ahead of others because we are deemed to be highly knowledgeable about sustainability. It is now an important selection criterion from public-sector UK investors and mainstream European institutional investors.

Do investors see this fitting into their fiduciary responsibility?

Hughes: There is a growing body of evidence that indicates a link between sustainability and investment returns. There is a positive correlation, and therefore you had better take it seriously. In our portfolio we have many examples of assets that are more sustainable than the average and where you can see that green measures are protecting capital value.

How do you underwrite the costs of bringing an acquisition up to your standards?

Hughes: Our investment process is very explicit about this. As an example, we are looking at investing in an office building in London that has an average EPC rating, and therefore Debbie has spent some time thinking very hard about what we could do if we owned that building to improve this.

Hobbs: As part of our due diligence process, we modelled it ourselves, so we could compare the current EPC to what it was when the certificate was originally done in 2008 and what might happen to that rating in the future as UK building regulations change. We then have looked at what the capital cost would be to upgrade it. All buildings deteriorate, and there are costs just to keep them at a level that will allow them to be let.

Have you been doing this enough to see positive effects in your portfolio's performance?

Hughes: It is harder to sell assets that have poor sustainability characteristics, and therefore they sell at a price discount. The reverse is also true. If you have, as we do, the capability to improve an asset, then that becomes a central part of asset management that delivers added value. I see sustainability as being closely linked to obsolescence and depreciation. If you can't let a building because it has a poor EPC rating, then it becomes functionally obsolete.

Both of you seem really passionate about this issue. How did this become a focus?

Hughes: For me, it wasn't about trying to save the world or do things because they seemed popular. I took over responsibility for the LGP portfolio around the time when sustainability was becoming more visible as an issue, and I felt, as someone newly responsible for a portfolio of assets, that I had better understand this topic. We then realised it was actually important in terms of our ability to deliver exceptional performance.

Hobbs: My background is one of physics and engineering. I like things working efficiently and effectively,

and when you start looking at building services, you see how badly operated and inefficient some buildings are. I was with a property company back in the 1990s doing just energy management, and slowly my focus grew from energy to the environment to sustainability.

I always think of office as the first one to lead the way, but are other property sectors involved in this, and to what degree?

Hughes: Sustainability is important in all sectors, and there are different solutions for each sector. The industrial sector is thought of as being the hardest in which to address sustainability, but we have made real progress in that area. In addition, we are establishing important and deep relationships with retailers because of sustainability. Retailers have begun coming to us and finding out what can we do to work together and, because retailers generally occupy multiple properties, it becomes a holistic portfolio view.

Are occupiers requiring this now from the buildings?

Hobbs: I think occupiers have started to focus on this not only because of operational costs but increasingly because of corporate policies. As an example, an office occupier came to us as they were approaching the end of a long lease and said, “Our corporate policies are telling us that we now have to occupy very sustainable buildings. We want this asset to continue to be our headquarters building, but we can't take a new lease unless it has got high sustainability credentials.” So I got involved and asked, “How do you measure that? What do you want?” They said, “We want a BREEAM Excellent rating,” and that was all they knew they wanted. As the UK market typically only has BREEAM ratings on new developments, this started a whole dialogue of how we could help. We have now commissioned a detailed report to look at every possible thing we can do to this building to improve its operational sustainability credentials, as opposed to just theoretical measurements, such as EPCs. This ranges from occupant engagement programmes, to installing new building services and renewable energy generation systems

Hughes: And employees care about it. PWC, for example, which is on the leading edge of sustainability and has a brilliant, outstanding office building in London, will tell you it found it easier to recruit talent with sustainable office space.

What is the largest challenge?

Hobbs: The biggest challenge is getting everyone working together with the same objective. We may own the building but not operate it, and where we do manage it, you've got tenants and supply chains to consider too. You might have two sets of maintenance engineers doing similar jobs, on behalf of both the landlord and the tenant, with their own separate supply chains, and all need to be working together to maximise the efficient operation of the building.

Hughes: A lot of what we are doing is not really to develop a competitive advantage for this business alone, but to try and show some constructive leadership for the sector as a whole. This includes working with major industry bodies to try and do the right thing for the entire UK property sector. As it happens, as a byproduct we have become a market leader, but that is not the only thing we are seeking to achieve. ❖