BE NEWS

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FINANCING A SUSTAINABLE FUTURE IN REAL ASSETS

BE News and Newcore Capital brought together a panel of experts earlier this month to discuss how the industry is rising to the challenge of sustainable investing and financing

THE PANEL

Gregor Bamert, head of real estate debt, Aviva Investors
Joseph Michael Daniels, founder, Elixr
Louise Dooly, managing director, debt origination, ICG
Paul Edwards, NatWest on sustainability, NatWest
Helen Gordon, chief executive, Grainger
Olly Hughes, managing director, forestry, Gresham House
Anne Kavanagh, chief executive, Telford Homes
Hugo Llewelyn, Chief executive, Newcore Capital
Skye Macpherson, managing director, head of global asset management, Nuveen Natural Capital
Neil Sarkhel, chief operating officer, Newcore Capital

Helen Gordon

> ***We have to protect the view shareholders inherited a damaged infrastructure***
>
> *Helen Gordon*

As the market becomes challenging, companies have ended up with too much debt and are finding it hard to raise equity. But sustainable development, integral to the future of real estate, is not easy to deliver. So how are sustainable assets viewed, what are they and what does sustainable investing and financing looks like?

These were topics discussed by some of the industry's biggest names who joined *BE News* editor-in-chief Liz Hamson earlier this month for the 'Financing a sustainable future in real assets' roundtable debate.

We share the edited highlights of the wide-ranging debate – hosted by sponsor Newcore Capital – on how the market is tackling, adapting and rising to these challenges and opportunities.

QUESTION: Thames Water has had another £750m in emergency funding from its shareholders but has warned that significantly more investment will be needed, while it is also saddled with £14bn of debt. What impact does something like a Thames Water situation have, and can we think of any parallels in the pure real estate market that are aligned with infrastructure?

GORDON: There's a parallel with Railtrack, where they took it into railway administration in 2001. But a reason the government maybe pulled back from being so aggressive with the shareholders was the fact capital had gone into a company with a pretty broken network as far as the original investment.

Talk is about dividends, and everyone needs a return on their investment, but they [Thames] must [work on the] new super-sewer, and there's going to be work with the Thames Barrier.

The narrative has been about those 'awful shareholders', but actually we as an industry have to protect the view they inherited quite

Hugo Llewelyn

Joseph Michael Daniels

a damaged infrastructure; money had to come in and that money needs a return. This means there's disconnect between the pensioners, and you have pension funds investing and the requirement for a return.

Ultimately, Thames Water, unless this is handled very carefully, could put people off investing in other economic infrastructure quite significantly.

LLEWELYN: The problem is not with the current shareholders – it's the past owners. It's been widely reported they used a classic low interest, high leverage for short-term profits, not worrying about the long term, then clicking on to the next people. They made a massive profit, but the current shareholders have been left to pick up the pieces..

You can take equity risk in Thames Water, which is a company that provides services, owns its assets and does multiple things around, while having a major environmental impact. You can lend money to it, but you could own the property assets and lease them to a company. Also, you could lend to the people owning the property assets who lease it to them, and there's equity in that relationship.

Ultimately there are four different distinct investment groups there that you can choose. If it's the levered equity piece of a private equity business, as shareholders you've got to expect you might lose your money, particularly if you didn't do your due diligence.

The solution, however, is to deleverage and fast. Unfortunately, it means existing shareholders are probably going to get badly paid.

QUESTION: Is Thames Water going to be renationalised again, which was the talk before they got the £750m, and are we going to see a wave of renationalisation?

GORDON: There is a point about the regulator and how well informed it is. We should look at this quite carefully as the people who become regulators of industry because sometimes they don't understand capital markets, so don't understand the fact of who's buying.

DANIELS: Do the politicians just want wins all the time? Regulators are falling at the exposure to the local councillor, and it's this four-year cyclical event that we've all been through. It's just quantified change, with personal indifference, not social impact, and that is led by capital markets, which is led by what comes next, and how it's monetised and how it's going to work. Constant change in regulators, and the differences of views of the regulator to private markets, is going to continue.

QUESTION: Do we need a regulator then that understands and cares? What else do we need and is this problem going to be contained or spread across other real estate assets?

Gregor Bamert

Anne Kavanagh

Louise Dooly

BAMERT: Many years ago, there was a real estate investment philosophy that said you buy something, stick a long lease on it, forget about it for however many years and everything will be fine. That clearly doesn't work now.

It's the active management and whether you're on the equity side, on the debt side, having that ongoing constant of being able to recycle equity and value to keep buildings relevant to where they are today.

As a lender, you don't look at how long any one individual lease is, or how strong a particular tenant is in isolation.. The issue is what the whole picture is for that site.

KAVANAGH: There's a lot of learning from the continent on those structures. If you look at the way real estate and real assets have worked there for years, it is only the UK that's been stuck on long-lease, non-proactive management of real estate.

It is changing. But it's still part of the whole mentality. It's not changing fast enough and that's been one of the biggest issues in the retail sector, which has seen massive destruction of value. Assets need to be worked. They need proactive strategies.

QUESTION: In terms of leverage, and anybody who is leveraged at over 50% could be considered exposed, what are the sectors we are worried about?

DOOLY: The retail sector has gone through a revaluation and has come out with a lot of repurposing, but we believe the office sector is currently massively exposed.

Post-Covid, there is uncertainty about whether the office occupational market is really going to come back and in what format. There are many offices that were probably leveraged around 50% to 55%, when acquired four to five years ago, that may now be 70% to 75% loan-to-value and be coming up for refinance. It is estimated that there's £51bn of assets across all sectors that needs to be refinanced in the next two years. That funding gap is huge. However, this does provide for opportunities for funds like ourselves.

Additionally, at a senior level, if they were all in at 2%, now suddenly they're 6%, so there's also huge stress on the cashflows. That's a sector that may be at risk and one

> ***There is uncertainty about whether the office occupational market is really going to come back***
>
> *Louise Dooly*

which we are being cautious on.

When looking at opportunities, even if it ticks all the boxes on the ESG side, the question is whether you are going to be able to attract the tenants at high rents to cover the high finance costs. The cashflow is under such pressure it's just not sustainable.

EDWARDS: In addition to the direct impact of higher rates on more leveraged businesses, the interesting thing to my mind is what is the impact of rates going up on the robustness of tenants. I look after circa 11,000 businesses across the South West and Wales and through Covid, through the cost-of-living crisis, through the energy price spike, they've been remarkably robust and we haven't seen much stress. With those businesses generally, there's been a bit more cash and, as a result, a buffer.

We've seen resilience and adaptability, and while there's been a degree of government support and programmes that have helped, businesses have generally been much more adaptable than most commentators realise.

Lots of quite small ones you would have thought would have been hit immediately by the energy price rises in particular had fixed this for three or four years.

It seems they have got used to constant change, which is a good thing, but also for landlords a potentially double-edged sword as part of that adaptability could be focused on switching to a smaller office or a different type of space because during Covid some of them experienced no space at all.

Paul Edwards

Our perspective is that SME Britain is in better health than is expected.

> ***Businesses have generally been more adaptable that most commentators realise***
>
> *Paul Edwards*

QUESTION: Data, and how it's used and gathered, is a major talking point, but companies/people don't want to share data because they want a competitive market. What should we do about that? And who is gathering information like this and doing a decent job on the data front?

KAVANAGH: At the Urban Land Institute, there are a number of initiatives particularly around the institute's mission priorities of housing affordability and decarbonisation, related to developing international benchmarks and frameworks for sharing data that people will feel comfortable with. They are important to drive progress in the industry.

DANIELS: Ofgem and private energy companies do not want people getting access to energy data. When we can, we disprove a lot of the myths, but the reality is transparency isn't harnessed due to the regulatory and nonsensical controls of energy data. We should be more worried about our social data when this data is useful and can profile regulators and the public real information in real time.

If the regulators do care enough, they will allow anonymous regulation of data, and we'll see 40% of the market is overcharged or not thoroughly performing.

GORDON: In the BTR sector, people won't give us access to the data, for example to benchmark. There are all these smart meters in people's houses, and they've got that data but won't share it with someone who is trying to work with the community to reduce energy.

We invested £30m in infrastructure for the CONNECT platform to help us run the business more efficiently. This is because we don't lease through agents – we lease direct. Tenants give us data on where they work, what they're paid, and we're using it on things like affordability, but also on creating communities, so we don't have too homogenous a community.

QUESTION: Are there very specific sectors that people think are really resilient, currently, and people should be targeting?

HUGHES: Given the idiosyncrasies of forestry investment, we are a very unleveraged sector, and we've only leveraged for the purposes of acquisition historically. The reason is that we have a broad harvesting window of circa 15 years, and it effectively enables us to manage our way through downward pricing events within timber markets.

When you lever, you are removing that ability to be able to flex the timing of your harvesting. The result is resilience in downturns, and you don't see the same level of volatility because people aren't forced into selling an asset to manage cashflows.

We're seeing a floor in terms of our underlying values. Are we going to see a massive uplift in the next few years? Probably not. The flipside to that is we've had a good tailwind in the form of significant increases in timber value and yield compression as a result of excess liquidity in the wider market, which has driven returns. We've been delivering 14% IRRs [internal rates of return] for the last 10 to 15 years, which is great.

However, are we going to be able to continue to deliver that? The temptation is to enhance those returns through leverage, and so we've got to make sure we stick to our fundamentals.

We are also trying to encourage a circular economy. This is an important message: it's about growing timber, which is sold into our own UK-based processors; the resulting timber is going into properties that are being owned by pension members so when they look at a forest on a hill they can say: "I am part of that."

Olly Hughes

> *"What we're trying to encourage is a circular economy. That's really the message"*
>
> *Olly Hughes*

QUESTION: Can you use debt to structure your deals, and if you aren't, what are you doing instead?

KAVANAGH: We're not using much. But we think that'll change over time. The markets are dysfunctional currently, particularly in the living sector and for development. There were huge challenges with inflation last year and then new regulations this year such as the consultation on second staircases.

On the debt side, all the lenders we talked to would love to lend more to the living sector, but the pricing currently is volatile, and we're seeing an inverted curve. How long it will last for is another question. I'm saying to our teams: we're in the market, we're looking, bidding. We're not in a rush though to do anything. Effectively we're still in pricing discovery that usually takes some time to play out, and it will depend on how much volatility we see and how much distress, as to when we'll see an adjustment in prices.

[In terms of raising capital] we are backed by one of the largest balance sheets in the

industry - CBRE. It's a massive support. Not only that, to play in this field, you've got to be investing in innovation, in technology and with a large balance sheet we can do that.

We are post-Brexit, post-Covid, post-QE. We're at the beginning of what I think will be a transformative decade for the living sector, but it will require investment. For players who are well capitalised, it will be an interesting period.

QUESTION: Is there a view on rising interest rates? And have gilt rates have gone up?

LLEWELLYN: I have a bearish view. In 2008, the banks basically went bust, while this time they are much better governed. But sitting around us are the water and electricity companies and the grid. They're all quite leveraged, and to survive they'll want to put their prices up, which customers pay for.

With much more enduring high inflation, and therefore higher interest rates, for those exposed to higher leverage everywhere the hope is that the five-year curve is going to drop, which means they can fix in, in a year or two's time, at an affordable rate.

Humanity being sustainable on the planet is incredibly inflationary. We've got to invest in all these areas. We weren't before. For example, the price of carbon credits is much too low, so that's got to go up – and it's unlikely to remain voluntary – as have the price of food and water.

Low interest rates have led to a sloppy idea this stuff is free, but it's not free as we know from looking at any David Attenborough programme. That will keep coming through. With higher interest rates, there are lots of places where we are going to pay for things that are going to stay more expensive, if we want to solve the issues which humanity has too.

A recession, reducing consumer spending, all these things take pressure off, but they're not pretty for business or individuals.

QUESTION: What are your hopes, fears and expectations over the next 12 months in terms of sustainable real assets and sustainable financing of those assets?


Skye Macpherson


Neil Sarkhel

DANIELS: My hope is that we will start working more cohesively as an ecosystem and that the fear of technology, and its rapid evolution, won't hold us back, as we learn to manage and work with it for our greater good.

My expectations are that our economy will grow once we realise we can resource our data and manufacturing internally, and start utilising things to benefit the good.

MACPHERSON: We're dealing with natural capital assets that don't follow the performance of traditional financial assets. We often say to investors that natural capital assets have inflation-hedging capabilities and are not correlated with traditional assets.

In the last two years, [we have] delivered on that in terms of performance. Prior to 2021, nobody cared about inflation, and for a decade, people did not value this aspect of the asset class.

Because we need to invest in a green economy, to make things more sustainable, this is inflationary. My hope is that people will think of investing in natural capital assets as part of the road to do that, because we must protect and restore biodiversity and nature along with the climate goals.

I don't know if it's a fear but more of a challenge that things are changing so rapidly, such as regulations and accounting standards for carbon. While exciting, it's a lot to keep up with.

My expectations for the natural capital asset class are that it continues to perform well this year and into 2024.

SARKHEL: The last three years have seen many things change, with Covid, an increased focus on climate change and the energy crisis, which has given perspective to businesses. Within our own company, a change came when we became certified as a BCorp in 2020, which helped us structure and orientate the firm. We've just raised our latest fund with £190m of equity, and BCorp helped us do that.

So, if I was asked this question two years ago, I probably would have talked specifically about some economic drive this way or that way and what happens over the next few months. But now I've got an 18-month son, and he's changed my life, and given me different perspectives.

While I think the next year is going to be very painful, whatever happens, I hope we can continue through to make a better life and world for everyone, and we don't lose sight of that over the next few months. □