SUSTAINABLE BUILDINGS BOOST VALUE OF INSTITUTIONAL PORTFOLIOS

PENSION FUNDS, LIFE INSURANCE COMPANIES AND OTHER BIG INVESTORS ARE GRADUALLY GREENING THEIR REAL ESTATE PORTFOLIOS, AND ENJOYING ABOVE-MARKET RETURNS.

BY FRANCISCA QUINN

Canadian pension plans hold more than $100 billion of real estate assets. In 2012, pension plans allocated on average 10 per cent of total assets to this investment type, the highest number on record.

With this clout, institutional investors play an important role in promoting sustainable building practices in new construction and existing building retrofits.

"Pension plan-owned real estate companies have done more to drive green buildings in Canada than market demand or government regulation," says Lisa Lafave, senior portfolio manager of real estate at Healthcare of Ontario Pension Plan (HOOPP). "Our fiduciary mandate to maximize financial returns and minimize the risk of asset depreciation fits very well with green buildings," she says.

The role big investors can play is varied. They can throw capital behind green developments and retrofits of existing buildings. They can take the step of certifying their assets through green labelling systems such as LEED (Leadership in Environment and Energy Design). They can build sustainability criteria into investment decisions by establishing sustainability objectives for asset and property managers in advance. Asset owners can also choose to openly share their buildings' energy and water usage data through industry benchmarking programs (when mandatory programs are not in place). Altogether, their actions send the important message that sustainability matters throughout the entire value chain, from material suppliers engaged during construction to tenants who end up occupying the building space.

Such actions tend to lead to stronger returns. Sustainability leaders such as HOOPP and Cadillac Fairview (owned by the Ontario Teachers' Pension Plan), which are current or previous clients of mine, have consistently outperformed the industry index over the past three years with average real estate returns of more than 17 per cent (compared to an index average 13.6 per cent).

The data shows that green-certified buildings with superior comfort and good air quality have, on average, higher occupancy and less lease turnover. These are probably the most important drivers of cash flow in a building portfolio. As an example, Toronto-Dominion Centre, one of the crown jewels in Cadillac Fairview's office portfolio, has a 97 per cent occupancy rate, significantly higher than other comparable downtown properties. During the past five years, TD Centre has structured its entire business plan around sustainability excellence and it appears to be paying off.

Sustainability programs also improve operational efficiency, which leads to operational savings. "Investments in equipment and operational procedures can reduce or cap our operating costs," said TD Centre general manager David Hoffman. "It is a smart decision for our tenants, for our business and for the environment."

There's also the long-term perspective to consider. This is the notion that a sustainable building is a way to manage financial risk. Buildings are, per se, more resilient to regulatory changes and market demand when investment criteria such as energy efficiency, climate resiliency, transit-friendly location and healthy indoor environment are incorporated into the investment decision.

This is why in the Canadian commercial real estate sector, LEED certification is a market expectation in core markets such as downtown Calgary and Toronto. Also, many public sector tenants now require green certification. It has become the price to play. However, these tenants will stay longer and contribute to high occupancy rates, which ultimately achieves portfolio return objectives.

Indeed, very inefficient buildings can sometimes become stranded assets. The European Union launched the Energy Performance of Buildings Directive in 2005, where each office building is given an energy performance rating. Now, the U.K. is making it unlawful to lease or sell any building with the least desirable F and G energy performance labels as of 2019.

If the institutional real estate investors' most important role to date has been to secure meaningful pensions or insurance payouts for its members, their legacy will be at the macro level. Through their current strategies, institutional investors are changing the real estate industry by integrating sustainability into day-to-day management and building industry competencies along the way. At the local level, their contributions reduce the toll on sewers, energy and roads and contribute to improved air quality and human health.