

Colonial First State Global Asset Management

Sustainability and the implications for property investment

RICS 2007 Sydney conference, global property investment: prospects and risks

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Research

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Outline

- ➔ Concept of sustainability
- ➔ Impact of sustainability
- ➔ Business initiatives on sustainability
- ➔ Outstanding issues
- ➔ Final remarks

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Sustainability

Sustainability

- part of a wider agenda in the investment world

➔ Sustainability

Adopting principles which more effectively utilise resources for current and future generations of people, with joint consideration to the economy, society and the natural environment

➔ Key considerations

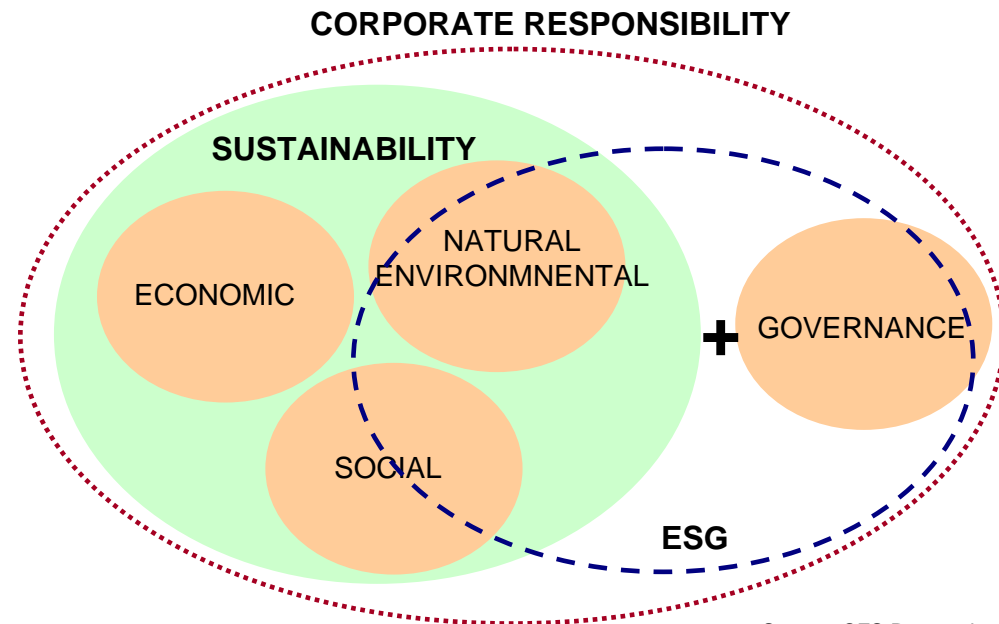
- economic prosperity
- social advancement
- environmental protection

➔ Industry momentum

Spurred on by global climate change with sustainability providing a platform framework

➔ Industry refocus

Sustainability now forms part of a wider agenda of corporate responsibility which includes governance issues



Source: CFS Research.

Aspects of sustainability

- risk management & external costs

➤ Sustainability provides a framework for risk management

Consider impact dimensions

- Time: short-term, medium-term, long-term
- Reach: local, regional, global
- Consequence: mild (reversible), severe, severe (irreversible)
- Likelihood (low, likely, high, almost certain)

➤ Sustainability provides a framework for examining external costs

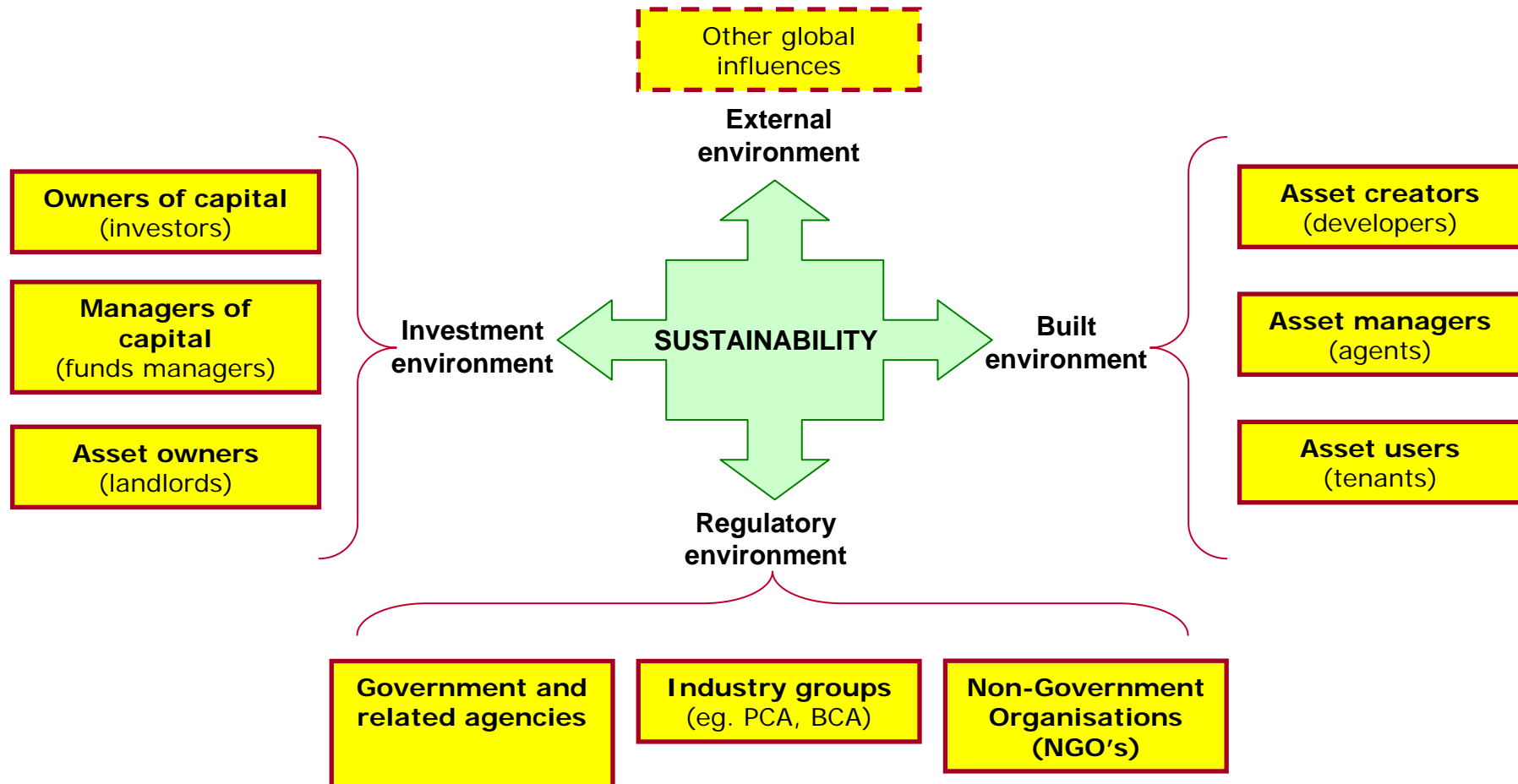
- External cost (environmental or social) not incorporated in the market price mechanism.
- External costs that have negative impacts are called 'negative externalities'.
- 'Internalising' an negative externality (incorporating its price into the market price), will lead to a reduction in output and an increase in the market price.
- However, the big dilemma for the industry is to place value or price on these external costs.

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Impact of sustainability

Impact of sustainability

- understand interplay between environments



Source: CFS Research.

- 7
- Opportunity for knowledge transfer between players.

Impact on investment environment

- focus on (socially) responsible investments (RI)

PLAYERS	IMPACTS	EVALUATION METRICS
Owners of capital (investors)	Investment performance <ul style="list-style-type: none"> ▪ Risk and reward parameters ▪ Valuation – cash flows ▪ Cost of capital (or discount rate) 	Investment performance <ul style="list-style-type: none"> ▪ Returns for assets incorporating RI ▪ Availability of investment indices ▪ Using transactional data or modified DCF model to account for externalities
Managers of capital (funds managers)	Investment products <ul style="list-style-type: none"> ▪ Product offering ▪ Nature of product offering ▪ Product marketing ▪ Product pricing 	Investment products <ul style="list-style-type: none"> ▪ Competitive product analysis ▪ Scope out global metrics on RIs ▪ Identifying investor demands for RIs ▪ Trade-between short-term and long-term returns
Asset owners (landlords)	Investment strategy <ul style="list-style-type: none"> ▪ Portfolio construction. ▪ Asset allocation decision. ▪ Investment mgmt requirements 	Investment strategy <ul style="list-style-type: none"> ▪ Portfolio analysis: RI versus non-RI ▪ Segmenting space market statistics ▪ Changing investment objectives for RI
	Corporate responsibility <ul style="list-style-type: none"> ▪ Fiduciary duty ▪ Business conduct – minimum level of corporate behaviour 	Corporate responsibility <ul style="list-style-type: none"> ▪ RI philosophy ▪ Company disclosure (transparency)

Impact on investment environment - investment performance

➤ Impact on property value

- Space market drivers (consider impact on net rental level & growth)
- Capital market drivers (consider impact on capital flows & pricing)
- **Consider DCF**

$$P_0 = \frac{C_1}{(1+r_e)} + \frac{C_2}{(1+r_e)^2} + \frac{C_3}{(1+r_e)^3} + \dots = \sum_{t=1}^{n-1} \frac{C_t}{(1+r_e)^t} + \frac{TV_n}{(1+r_e)^n}$$

Terminal value.

Net present value at period zero (P_0).

Estimated cash flow paid at period t.

$$C_t = D_1(1+g_t)$$

Anticipated growth rate of rents in period t.

➤ Cost of capital

- *Direct impact* – greater risk due to impact of negative externality on cash flows
- *Indirect impact* - when comparing against competing asset classes.
- **Consider modified CAPM**

$$r_c = r_f + \beta_1[E(r_m) - r_f] + \beta_2' X$$

Additional risk due to external costs

Impact on investment environment

- the impact on value: a pragmatic approach

➤ Holistic approach in market valuation

- Valuers jointly assessing key items such as demand determinants, rentals, ops costs and risk premium in deriving a discount rate

➤ Rents (level and growth rate)

- Tenancy:
 - type - government versus non-government
 - retention and screening (eg. non-terrorist groups)
- Leasing structures
 - many building ratings (Green Star/ABGR) are being incorporated into leases
 - if building specs don't meet stated criteria, then impact on rent reviews

➤ Operating costs/capex

- Focus is not so much about cost/benefit equation, but cost reduction strategies
- Drive for buildings efficiency – focus on utilities (energy, water & gas)
- 'Future proofing' – incorporating expected future costs

➤ Discount rate

- Preserving and enhancing the quality of net rental cash-flows
- Impact on risk premium – certainty surrounding cash-flows

Impact on investment environment - investment products

➤ Product offering

- Repositioning of existing products
- Mainstreaming practices for RI

➤ Nature of product offering

- *Passive strategies*: aimed at mitigating the risks associated with sustainability
- *Active strategies*: dual aim of mitigating risks and increasing competitiveness

➤ Marketing

- Product differentiation
- Pricing strategies
- Green branding

Impact on investment environment - investment strategy

➤ Portfolio construction

- Portfolio tools:
 - screening or selecting assets on RI
 - metrics for evaluating portfolio exposure
- Existing portfolios of assets which are non-compliant with ratings standards
- Transactions
 - filters or checklist with PRI in deal origination (eg. carbon standards on assets)

➤ Asset allocation decision

- Revised criteria; maybe not RAR.
- Short-term versus long-term

➤ Investment management

- Investment objectives based on Fund and investor requirements
 - many investors now seeking RI
- Managerial skill set and market information on RI – expertise externalised/internalised
- Investment deliverables – include sustainability targets
- Platform – general business versus fund specific

Impact on built environment - improved quality of buildings

PLAYERS	IMPACTS	EVALUATION METRICS
Asset creators (developers)	Construction <ul style="list-style-type: none"> ▪ Employing new technologies in design and construction phases ▪ New standards (eg. Green Star, BCA) ▪ Urban redevelopment / regeneration 	Construction <ul style="list-style-type: none"> ▪ Specified in new buildings ▪ Flag upgraded buildings ▪ Analysis of CO₂ produced & embedded in buildings
Asset managers (agents)	Asset managers <ul style="list-style-type: none"> ▪ Use of more efficient techniques in operations ▪ Adopt risk-management practices 	Asset managers <ul style="list-style-type: none"> ▪ List of alternative practices and their costing / savings ▪ Performance rating: ABGR & Green Star
	Property management <ul style="list-style-type: none"> ▪ Initiatives to cut carbon emissions ▪ Use of renewable energy source ▪ Waste management & recycling ▪ Water management ▪ Indoor air quality 	Property management <ul style="list-style-type: none"> ▪ Cost/benefit analysis ▪ PCA quality matrix ▪ Utilisation indices (eg. NSW BASIX) ▪ Performance index (eg. NABERS)
Asset users (tenants)	Users <ul style="list-style-type: none"> ▪ Demand green buildings (slowly but growing) ▪ Expect discount on occupying non-RI buildings, and impact on value 	Users <ul style="list-style-type: none"> ▪ Additional (quality) features in terms of amenities

Initiatives by property industry players

- review of sustainability rating tools by PCA

Rating Tools						
	BASIX	NatHERS	ABGR	Green Star	Green Globe 21	NABERS
sustainability issue	NSW Sustainability Index	The National House Energy Rating Scheme	Australian Building Greenhouse Rating	The Green Building Council of Australia (GBCA) Green Star		The National Australian Built Environment Rating System
Management				✓	✓	✓
IEQ				✓	✓	✓
Energy	✓		✓	✓	✓	✓
Transport				✓	✓	✓
Water	✓			✓	✓	✓
Materials				✓	✓	
Land/ecology				✓	✓	✓
Emissions				✓	✓	✓
Innovation				✓		
Waste				✓	✓	✓
Thermal	✓	✓		✓		
Occupant satisfaction				✓		✓
Source: PCA and CFS Research. Note: ✓ indicates criteria incorporated in rating tool.						

- NABERS and Green Star ratings tools used to assess the performance of an existing building.
- Green Star rating tool for new building at the design or built stage.
- Rating tools will differ in relevance across property sector (eg. Green Globe 21 for Hotels).

Impact on built environment - opportunities with new and existing stock

➤ Office stock

- 20 million sqm of which 8.5% (or 1.7 million sqm) is premium grade

➤ New stock

- All new buildings being build with a minimum 4 star (Green Star/ABGR) rating or better
- Cost becomes an issue when considering moving between 4 , 5 star and 6 star.
- Embrace technologies which make buildings more efficient
 - i.e., smart metering, efficient & effective BMS (Building Management systems)

➤ Existing stock

- Rating score
 - many buildings in portfolio can't currently be rated due to lack of data or are designed in such a way to be rated poorly with little scope for improvement
 - GBCA developing tool for rating existing office buildings
- Planning for capex:
 - upgrades - use of quality products (eg. lighting, chilled air-conditioning)
 - refurb - more efficient designs and fit-outs
- Green leases – tenants conforming with sustainability principles
- Lease expiry profiles - opportunities in office due to expiry of existing leases.

Impact on regulatory environment

- regulation to assist market with price signals

PLAYERS	IMPACTS	EVALUATION METRICS
<p data-bbox="286 507 622 603">Government and related agencies</p> <p data-bbox="286 743 622 839">Industry groups (eg. PCA, BCA)</p> <p data-bbox="286 948 622 1082">Non-Government Organisations (NGO's)</p>	<p data-bbox="920 432 1106 464">Regulation</p> <ul data-bbox="712 485 1301 943" style="list-style-type: none"> ▪ Force market pricing to embed externalities (eg. carbon credits, NGACs-NSW only) ▪ Regulate on development and planning - buildings codes ▪ Impose reduction targets ▪ Govt accommodation standards ▪ Kyoto / Climate change ▪ Regulation from quasi government agencies (eg. ASIC) & industry bodies (eg. ASX). 	<p data-bbox="1615 432 1800 464">Regulation</p> <ul data-bbox="1391 485 1928 683" style="list-style-type: none"> ▪ Record and map out sustainability legislation initiatives ▪ Monitor reduction targets ▪ Measure cost of construction of changing buildings codes
	<p data-bbox="808 1011 1218 1043">Corporate responsibility</p> <ul data-bbox="712 1059 1301 1394" style="list-style-type: none"> ▪ Devise and promote policies for RI. ▪ PRI (UN Principles for Responsible Investment) ▪ Business conduct – minimum level of corporate behaviour ▪ Governance: propose self-regulation initiatives ▪ Reporting: internal & external 	<p data-bbox="1503 1011 1912 1043">Corporate responsibility</p> <ul data-bbox="1391 1059 1973 1187" style="list-style-type: none"> ▪ Track record on RI policy. ▪ Track reporting external reporting via surveys

Initiatives by industry players

- Governments – leading the way

➔ Federal Government

- Tenancy requirements
 - Release of Energy Efficiency in Government Operations (EEGO) Policy 2006
 - Essentially requiring that Govt tenants with occupancy floor area $\geq 2,000$ sqm require a minimum rating of 4.5 stars ABGR or equivalent.
- Sustainability reporting
 - Dept of the Environment and Heritage releases document on sustainability reporting in 2005.
 - Surveyed S&P/ASX300, top 100 private coys, top 100 unlisted coys
 - Monitor reporting levels, reporting content and recipients
- Natural environment policies
 - Tax deduction on costs for establishing carbon sink forests
 - Funding for water planning initiatives & grants for solar panels for houses

➔ State Governments

- Tenancy requirements - similar occupancy rules to Federal government.
- NGACs (NSW Greenhouse Gas Abatement Certificates)
 - encourage businesses to reduce their greenhouse gas emissions
 - attempt to market price carbon – currently valued at \$11/11.50 per certificate

Initiatives by investment community - commitment to UN-PRI

- United Nation's Principles for Responsible Investment (UN-PRI) developed in 2005/06 by UN and world's largest institutional investors.
- A voluntary program which encourages best practice in environmental, social and corporate governance issues.
- Signatories:
 - Australian pension Funds (ARIA, HESTA & Vic Super)
 - Fund managers (Portfolio Partners, Colonial First State, AMP and BT).
- CFSGAM became a signatory to UN-PRI in March 2007.
- Six principles of UN-PRI include:
 - incorporate ESG issues into investment analysis/decision making
 - active owners & incorporate ESG issues in business policies
 - seek disclosure on ESG issues by the entities in which we invest
 - promote acceptance of UN-PRI within the industry
 - work to enhance our effectiveness in implementing UN-PRI
 - report on our activities & progress towards implementing UN-PRI

Initiatives by industry players

- selected industry groups

➤ **Property council of Australia (PCA)**

- Education programs – increase awareness of sustainability issues
- Rating tool consistency – aim for common branding to avoid market confusion
- Create property sector fund – to initiate abatement activity in existing buildings
- Establish minimum standards (eg. grey water standards for high-rise buildings)

➤ **PCA/IPD Governance Committee**

- Considering investment indices which segment assets by sustainability metrics

➤ **Investor Group on Climate Change Australia/NZ (IGCC)**

- Consisting of various investment industry players (- fund managers, investors)
- Consider the impact of climate change on investment decisions
- Currently formulating study on property investment sector.
- Support Carbon Disclosure Project – global request by institutional investors for disclosure of information on Greenhouse Gas Emissions

➤ **Green Building Council of Australia (GBCA)**

- Recently developed Green Star rating tools for sectors other than office: retail SC, health, education, convention and mixed use (including residential)

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Business initiatives on sustainability

Initiatives by property industry players - investment fund manager – CFS GAM

➤ Sustainability unit

- Dedicated (people) resources to develop and support sustainability programs - mainly targeted at the asset management level.
- Sustainability manual – aimed at the operational level.
- Focus now extending to the broader investment level

➤ Investment indices

- Both CPA (Commonwealth Property Office Fund) & CFX (CFS Retail Property Trust) have been included in the:
 - Dow Jones Sustainability Index – assessed on environment, social, economic, biodiversity and stakeholder management
 - FTSE 4 Good Index – measure performance of coys that meet CR standards.

➤ Reporting

- CPA intends to produce a stand-alone sustainability report in 2007. The aim is to translate the cost-benefit of many sustainability initiatives into standard financial valuation measures.

➤ Engagement

- Commitment to United Nation's Principles for Responsible Investment (UN-PRI).
- Supporting the Warren Centre for Advanced Engineering with the Low Energy High Rise (LEHR) project.

Outstanding issues

Outstanding issues - for investment industry

- **Data collection and analysis**
 - Identification and quantification of key performance indicators (KPI)
 - Measurement of the impact of these KPI on investment

- **Development of responsible investments**
 - Mainstream management processes

- **Pricing and valuation**
 - Operational (asset) level versus investment level.
 - Require new/modified concepts that can be used to effectively evaluate RIs.
 - Identification and assessment of risk factors

- **Standardisation of tools**
 - Consistent framework in industry for identification, reporting and evaluation processes

- **Regulation**
 - Debate shifted from if legislation will be enacted to when and form/structure

Final remarks

- Sustainability principles form part of the wider agenda of corporate responsibility
- Investors seeking companies to adopt sustainability as part of pursuing best-practice.
 - An expectation that should ultimately be reflected in improved investment performance.
- Sustainability considered as a risk-management tool
 - Key risks include: regulation, supply-chain, product and technology
- Pricing and valuation of RI will remain a challenge
- Businesses need to develop strategies for managing risks and converting these into business opportunities
 - Competitive advantage for industry players who effectively embrace RI

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