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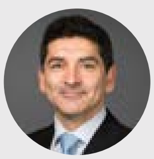
How sustainability fits into commercial real estate debt



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Key takeaways:

- Commercial real estate (CRE) debt can provide stable and recurring, income-focused returns
- Article 8 funds provide a wider opportunity set for sustainable investments
- Brown-to-green as well as development projects can effectively support the transition to a low carbon economy

Two prominent themes in the commercial real estate investment market are an increased demand for investments with strong sustainability features and a bigger role for CRE debt in portfolios.

Almost three-quarters of institutional investors consider or plan to consider the environmental and societal impact of their investment decisions, according to Nuveen's third annual EQuilibrium global investor survey. And 83% of investors surveyed consider or plan to consider climate risk when making investment decisions. The same survey also reports that 47% of investors want to increase allocation to private credit.

Combining these trends, CRE debt funds that offer investments with strong sustainability features could become a firm investor favourite, but practical implementation of ESG-related regulation is sometimes hampered by a lack of regulatory detail.

THE SUSTAINABILITY LANDSCAPE

CRE debt funds raising capital in Europe are now subject to the EU Sustainable Finance Disclosures Regulation (SFDR) which sets standards for the reporting requirements of funds. CRE debt funds can choose which disclosure standards they follow via Article 6, 8 or 9 – determined by whether the investment strategy is focused on considering sustainability risks only (Article 6), promoting environmental or social characteristics (Article 8), or having sustainability as an objective (Article 9).

Moving through the disclosure requirements aims to deliver to investors the rewards of deepening green credentials, but ascending the SFDR categories does not, by itself, imply a stronger sustainability performance. The EU Sustainable Finance Action Plan provides several avenues for sustainable investing, which will be explored further below.

Investors also have the option under SFDR Article 8 strategies to target investments which are recognised as 'sustainable investments' – which require compliance with the technical criteria set out within the SFDR regulation, or via the European Taxonomy regulation which imposes a stricter set of definitions. SFDR Article 9 strategies require compliance with the SFDR technical criteria of a 'sustainable investment' for all investments, however compliance with the European Taxonomy remains optional.

EU Taxonomy-alignment could deliver superior sustainability results beyond a fund's commitment to Article 8 or 9, or having SFDR-defined sustainable investments alone.

Given the voluntary nature of delivering Taxonomy-aligned investments, it has not yet been established as a key preference for investors to target funds based on whether they have exposure to such investments. This may change over time as the greater impact of taxonomy-alignment on sustainability outcomes becomes increasingly recognised.

Currently, however, gathering the necessary data to assess and report against taxonomy-alignment presents real practical challenges for lenders as they typically do not have access to the information required. This may prevent many lenders from setting goals for a proportion of taxonomy-aligned investments, particularly while the industry is still adapting to these regulations. For this reason, this paper will focus primarily on SFDR's function within CRE debt funds.

Why CRE debt?

Since the 2008 financial crisis, markets have seen major shifts in sources of lending. With traditional lenders taking a more conservative approach to loans, the opportunities for alternative lenders have increased considerably.

CRE debt has demonstrated its ability to provide effective portfolio diversification, with low correlations with other asset classes.

The structure of debt investments allows investors to enter into junior or senior loans which delivers different levels of risk, provides steady income potential, while a selective approach to investments can provide low volatility, fixed income-like return. The relative capital security of CRE debt investments, as a result of the significant equity cushion, offers medium to long-term stable returns through different market cycles.

Alongside the financial characteristics the asset class can offer, the relationship between CRE debt and sustainable investing is also being cultivated. This provides investors with further diversification options as sustainability considerations in portfolios become increasingly important from a regulatory standpoint.

SFDR IMPLICATIONS FOR CRE DEBT FUNDS

An ***Article 6 CRE debt fund*** must explain how sustainability risks are incorporated into investment decisions, and how these decisions may affect financial returns. These disclosures must be made clear to investors during pre-contractual discussions, such as in an investment prospectus, and where sustainability risks are assessed to be relevant, how they are assessed.

An ***Article 8 CRE debt fund*** must promote positive environmental and/or social considerations in its investments. The loan sponsors/borrowers of an Article 8 fund portfolio must also follow good governance practices. While sustainable investment is not an objective of an Article 8 fund, it remains an aspect of the investment process. Funds need to disclose the proportion (if any) of the portfolio that can be categorised as 'sustainable investments', a term which has specific meaning under the regulation. In time, investors may come to base allocation decisions on the proportion of 'sustainable investments' that Article 8 funds commit to.

An ***Article 9 fund*** has sustainable investment as a key investment strategy and must demonstrate how the fund will advance that objective, or show how any index used as a performance objective aligns with that objective in a different way from the broader market. All investments in the fund must meet the European Securities and Markets Authority sustainable investments criteria, which in real estate terms means it must not make investments whereby the underlying real estate meets the following criteria:

First, real estate directly exposed to the use of fossil fuels, usually petrol stations. Secondly, buildings that are inefficient, defined as EPC C (or equivalent) or below in buildings built pre-2020, or not meeting the nearly zero energy building standard for buildings built post-2020.

For CRE debt funds, these conditions focus on the assets collateralised against the lending, and not the sponsors of the borrower. But sponsors do need to report the carbon efficiency of their buildings to the fund.

Increasingly, investors are coalescing around the standard "at least Article 8". Article 8 status is more about transparency and disclosure than it is about hitting specified standards. But the most positive environmental outcomes could come from funds that can invest in the move towards the low carbon economy, and this increases the focus on Article 8 funds rather than Article 9 funds, which are precluded from brown-to-green transformation projects.

Where Article 6, 8 and 9 funds differ

	Article 6	Article 8	Article 9
Disclose sustainability risks	Yes	Yes	Yes
Disclose proportion of Sustainable investment	No	Yes (no minimum requirement)	Yes (all investments must be sustainable)
Brown-to-green loans	Yes	Yes	No
Developmental loans	Yes	Yes	Yes (if doesn't require a brown>green strategy) and if the development passes the 'Do No Significant Harm' (DNSH) test
Inefficient buildings	Yes	Yes	No
Fossil fuels	Yes	Yes	No

Source: Nuveen Real Estate, 2023.

DEVELOPMENT LOANS OFFER OPPORTUNITIES ACROSS THE BOARD

CRE debt funds can generate higher nominal returns by lending against development projects, versus financing projects with no development activity. Funds can also raise risk-adjusted returns if the construction lending strategy is managed to limit development risk; for example, a fixed-price construction contract can mitigate much of the cost risk, and selecting an occupier market with low vacancy levels can eliminate much of the underlying letting risk.

The different SFDR disclosure regimes are not prescriptive on development activities, even though the carbon impact of development often outweighs the carbon impact of the energy used in the day-to-day operation of buildings. Development can be included in CRE debt funds that report as Article 6, 8 or 9 funds. Having said that, the developments included in an Article 9 debt fund would need to pass the Do No Significant Harm (DNSH) test, which has particular implications for embodied carbon. These requirements would limit the universe of new developments available to this type of product considerably.

CRE debt funds have no operational control over the assets to which the fund is exposed, so their main focus is on manager due diligence around the sponsor's ESG data collection, commitments, and governance. CRE debt funds that deliver on an Article 8 environmental objective will need to prioritise ongoing collection of ESG and financial data to verify that any green covenants are being met and to enable principal adverse impact disclosure to investors.

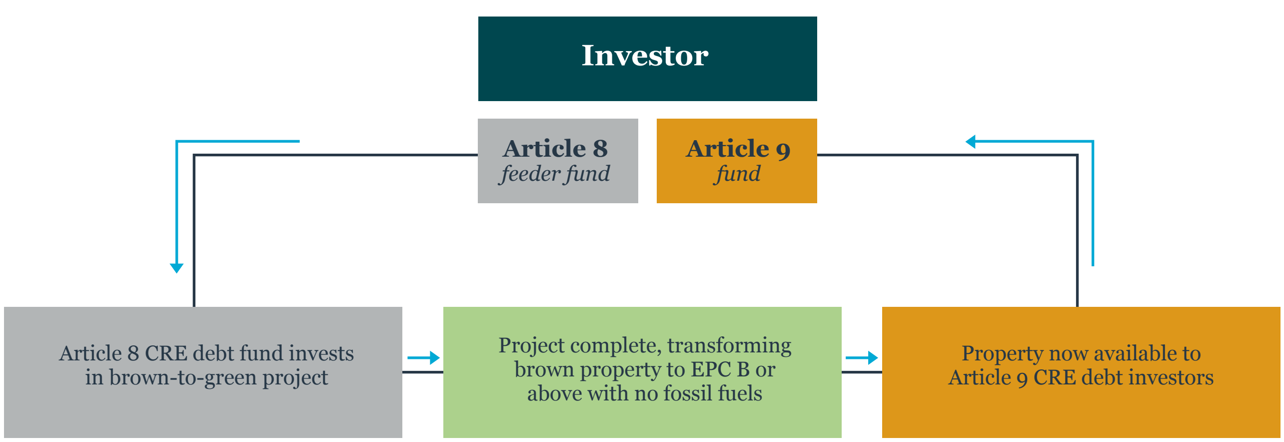
HOW IS LENDING TO BROWN-TO-GREEN TRANSFORMATION PROJECTS TREATED?

Lending potential to support sustainability upgrades to brown assets is expanding rapidly. The move offers CRE debt funds opportunities to possibly reduce risk by lending to assets that will increase in value as their valuation basis moves from brown discount to green premium.

SFDR allows participation in these transformations by Article 6 and Article 8 funds, but Article 9 funds are precluded because all assets in an Article 9 fund must be sustainable assets and the initial brown asset would not qualify.

One possible way for CRE debt funds to achieve Article 9 status while participating in brown-to-green transformations would be to separate the lending between two separate funds that are linked such that one became a feeder fund to the other.

Article 9 funds can still benefit from brown-to-green loans indirectly



Source: Nuveen Real Estate, 2023.

SUSTAINABLE INVESTMENT'S POSITIVE IMPACT ON LENDING RISK

Lending to sustainable, instead of brown assets, can offer a CRE debt fund a route to reducing its lending risk without tightening lending conditions, or loosening lending conditions while maintaining its level of lending risk.

This can be achieved because asset valuations will potentially be more resilient, reducing the risk of loan impairment. The value of sustainable or taxonomy-aligned assets is likely to be more resilient because they are less likely to become stranded by future ESG regulations, and because they tend to have higher quality attributes that will not be damaged by the flight-to-quality trend in the investment market.

Simulations analysis can help quantify the impact on loan performance for a CRE debt fund investing in sustainable assets compared to inefficient assets. The simulations below use the Paris CBD as the example market and are based on Nuveen Real Estate's May 2023 forecasts. They assume that brown assets have 2% lower annual rental growth than green assets, that outward yield shift removes 1% annually from capital values of brown assets relative to green assets, and that volatility of capital values of brown assets is 10% higher.

This exercise suggests that over the course of a five-year senior loan, the risk of impairment for green assets is around 5-10 percentage points lower in low loan-to-value (LTV) senior loans, and that the difference increases to 25-30 percentage points in high LTV senior loans. This translates into a lower average loss of loan capital for the green assets compared to brown assets.

At lower LTV loans, the loss of loan capital is estimated to be 2 to 5 percentage points lower for green assets, and this difference increases to 12 percentage points for an 80% LTV loan. This risk reduction is significant and implies that lower margins should be available for green assets.

Green assets imply greater stability than brown assets

Paris CBD prime office lending 5-year term				
Loan LTV	Green asset		Brown asset	
	Risk of impairment (%)	Average loss of loan capital (%)	Risk of impairment (%)	Average loss of loan capital (%)
40%	2.30	0.55	10.10	2.62
45%	4.00	0.77	13.80	3.42
50%	6.00	1.08	18.60	4.40
55%	8.70	1.50	24.60	5.69
60%	12.70	2.08	32.10	7.29
65%	18.20	2.88	41.20	9.36
70%	26.10	4.00	52.10	12.04
75%	37.00	5.61	64.00	15.52
80%	50.70	7.95	75.70	20.07

Source: Nuveen Real Estate, 2023.

SFDR OFFERS OPPORTUNITIES AND DRAWBACKS FOR CRE DEBT

Article 8 funds have started to emerge in the CRE debt market, and we can expect to see an increase in the number of both Article 8 and Article 9 funds being established. The stricter requirements imposed upon Article 9 debt funds could result in the potential to deliver better risk-adjusted returns to debt investors by reducing the risk of value loss; they could also deliver green incentives to borrowers by using this risk reduction to fund lower lending margins, however they will have a restricted investment universe.

Article 9 funds may not be able to deliver the best sustainability outcomes because they are limited to lending in respect of assets that already meet the SFDR 'Sustainable Investment' definition. This prevents them from participating in the brown-to-green transition, which is both an investment opportunity and essential for meeting the Paris Accord goals to limit global warming. Article 8 products may well be where the greenest CRE debt strategies will be found.

Case study: CRE debt and sustainability in action

Nuveen Real Estate's U.K. debt strategy made a brown-to-green loan in 2022 to fund the substantial refurbishment of the former Methodist Church headquarters at 25 Marylebone Road. The loan qualified as a green loan under Nuveen Real Estate's Green Loans Framework which has been in place since 2021. The project is designed to improve the workplace environment as well as the efficiency of an existing office building in central London, facilitating significant increases in rental values and improving the buildings performance ratings from EPC D to EPC B and achieving BREEAM 'Excellent' rating.

A key part of the strategy is to retain the existing structure of the building and avoid demolition and redevelopment. This approach touches upon some of the ethos of the EU Taxonomy in the way that it in part mitigates climate change by avoiding the negative carbon impacts associated with traditional development activity. Thus, it can achieve a more economically sustainable outcome for the building while also delivering a positive sustainability outcome.

Glossary

SFDR	The EU Sustainable Finance Disclosures Regulation is the European standard for sustainable investing. The SFDR framework works across three tiers: Article 6,8 and 9. Funds seeking to be recognised for one or more of these tiers must adhere to selected requirements.
Taxonomy alignment	An alternative route for sustainable investing, taxonomy alignment that advances at least one of the six environmental objectives listed by the EU without materially harming any of the other objectives, while at the same time complying with minimum social safeguards and technical screening data. The six objectives are climate change mitigation, climate change adaptation, sustainable use of water/marine resources, transition to a circular economy, pollution prevention/control and protection/restoration of biodiversity.
Brown-to-green	The process of refurbishing an existing, inefficient property to reach a more positive environmental efficiency level.
Developmental loan	Tends to be new construction projects aiming to target positive environmental or social goals, such as affordable housing.
EPC	The European rating standard for energy efficiency, properties rated C or below are deemed inefficient.
BREEAM	A globally recognised certification organisation for sustainable building.
SFDR	The Sustainable Finance Disclosure Regulation (SFDR) is a European regulation introduced to improve transparency in the market for sustainable investment products, to prevent greenwashing and to increase transparency around sustainability claims made by financial market participants.

For more information about investing in CRE Debt, visit us as nuveen.com/debt

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