From ESG compliance to impact investing: the extra mile of the real estate fund industry

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The fund industry has absorbed many regulatory reforms in a decade, most notably with the AIFMD first and the increased level of risk management, monitoring and reporting required from both legislators and professional investors. From a very liberal world of real estate private equity investment in the 2000s to the highly regulated fund industry as we know it today, a number of reorganisation steps have been undertaken and new standards have been set when it comes to the expectations of investors. The 2020s are starting with a massive change of paradigm for the real estate fund industry — not only because of the current pandemic, which will no doubt redefine economies and the globalised society.

New acronyms have been flourishing over the last five years, starting with the United Nations' adoption of the 2030 Sustainable Development Goals (UN SDG). Real estate asset managers cannot put these goals aside, as the private sector is also fully aware that it is accountable, alongside governments, for our future on our planet.

The financial industry has seized this trend, channelling the desire of our children to address climate change issues sooner rather than later as well as addressing the realistic approach that changes are needed for the environment and society. It is recognised that the world's most pressing challenges for the biosphere, society and the environment are interconnecting social and environmental issues. While making investment decisions, private and institutional investors also have a crucial effect on the state of our planet and our communities, and they cannot ignore it any longer.

The unexpected immediate result is a kind of standardisation of offering for real estate funds addressing environmental, social and governance (ESG) criteria into their investment strategies. Many institutional investors have adopted internal policies in this respect and make clear that any commitment to a fund is subject to the fund manager adhering to these criteria. To a certain extent, mainstream investments in real estate funds are already adding to the focus on maximising risk-adjusted returns, ESG screening and even ESG integration. ESG screening could be described as leading a particular asset to be excluded or positively selected to become part of the portfolio according to the ESG performance defined at inception. ESG integration goes further by systematically and explicitly including ESG factors in the financial analysis, risk assessment and monitoring. ESG metrics have become standard for a majority of players in the real estate industry.

The outperformance of ESG funds is likely helping in adopting the next step. Now, private and institutional investors are ready for the next evolution. They want their investment to have an impact. Energy, financial services, food, agriculture, healthcare — all of these industries are concerned. However, terms should be clearly defined, as the level of professionalism and expectations are high, and no greenwashing or impact washing shall be tolerated.

Thus, it is not only about being ESG compliant. Impact investment means that the intention is to generate a positive, measurable social and/or environmental impact alongside a financial return (as defined by INREV).[1]

A recent survey led by the Global Impact Investing Network[2] evidenced that, as of the end of 2019, the size of the impact investing market exceeded USD 715 billion spread across 1,720 impact investors, and impact investing allocations are expected to continue to grow in the near future.

What differentiates investors focusing on mainstream investments from an investor targeting impact investments is their appetite for environmental and/or social impact. The spectrum of impact investment approaches adopted by investors consists of the following:
- traditional investors exclusively focusing on maximising risk-adjusted returns
- investors considering ESG factors in portfolio selection and management, using either positive (selection of investments with positive ESG performance) or negative screening (exclusion of certain companies, practices or sectors based on ESG criteria)
- investors explicitly and systematically integrating ESG criteria in their financial and risk assessment and monitoring
- investors seeking investments with risk-adjusted returns and addressing environmental and/or social issues

Conversely, philanthropy/government grants and support have a strong focus on impact and may accept capital losses, while impact investors consider that both financial returns and impact are motivating factors in their investment decision.

The qualification of impact investments is reserved for investments with both clear objectives related to environmental and/or social outcomes and the expectation of a positive financial return. An analysis of the «impact» nature of an investment strategy leads us to identity three core features of impact investing.

First, the key criteria for an impact investment strategy are the investment's intentions to generate a positive impact from an environmental and/or social perspective and to generate a market rate of return. This intention is central to the investment strategy. Using, for instance, UN SDG and real estate impact investment objectives can address goals across numerous categories, such as affordable housing, healthcare facilities, educational facilities, green buildings and regeneration.

Second, the impact investment strategy should integrate the concept of additionality. This means that the positive impact would probably not have occurred naturally without the investment. Measured either in terms of quantity or in terms of quality, the social and/or the environmental outcome of the investment should be beyond natural evolution.

Third, an impact investment strategy should be measurable to enable the fund managers to manage the impact's results. The measurement and management framework should be professionally designed and tested by experts. Specific performance metrics are currently being developed to permit the monitoring as well as the comparability of the impacts targeted and achieved in real estate fund sectors. General frameworks, such as the UN SDG as well as the Global Reporting Initiative (GRI) disclosures and the Global Impact Investing Network with the Impact Reporting and Investment Standards (IRIS) Catalog of Metrics database, provide guidance on key indicators to measure and report on without being specific to real estate funds.

The growing attention on impact investing from local and international governments and organisations will undoubtedly result in the evolution of guidelines and regulations to make impact investing a standard. It is essential for managers to be constantly on alert in relation to investors' demand, their own appetite to have an impact and the new rules or tools that will emerge, so that they can adjust their impact investment offering.

1) INREV, European Association for Investors in Non-Listed Real Estate Vehicles, Impact Investing Paper 2020.
2) Annual Impact Investor Survey 2020, Global Impact Investing Network, the 10th edition.