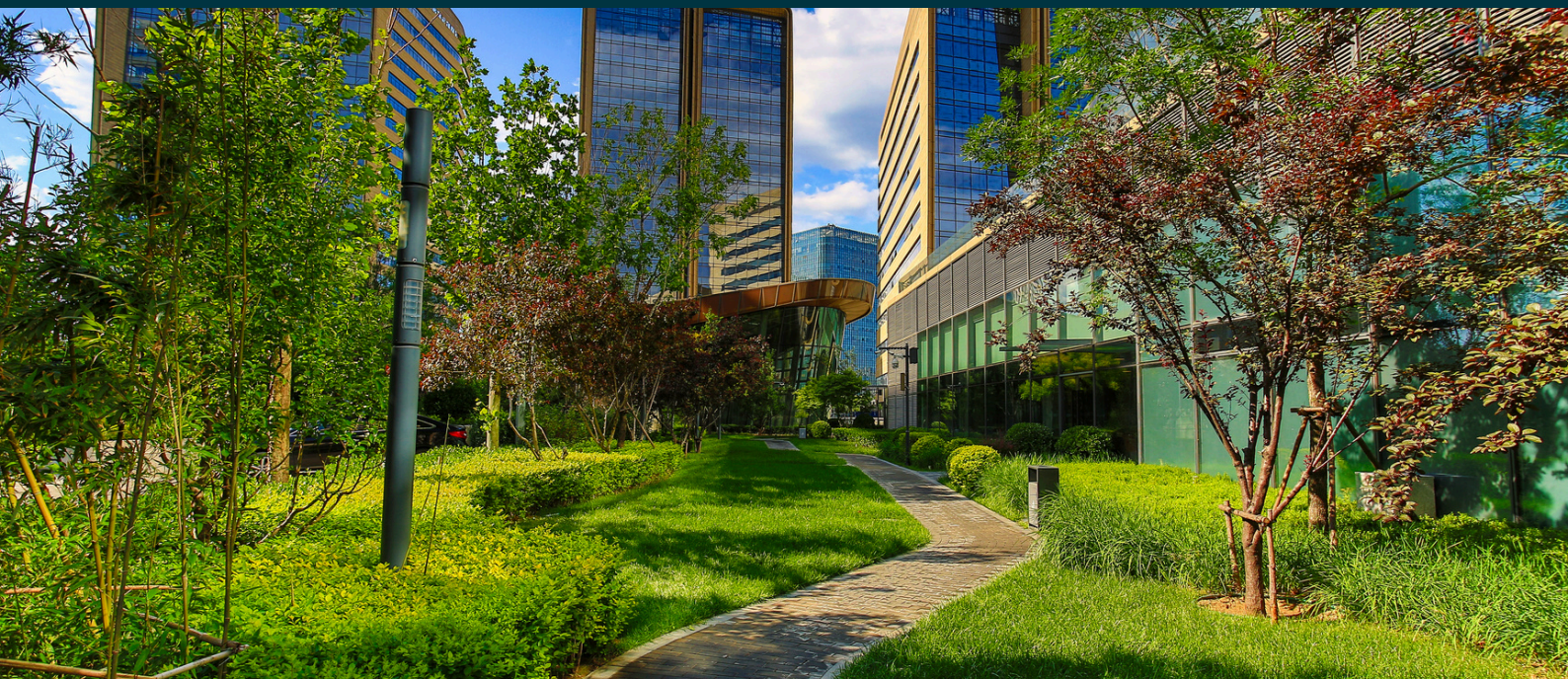


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IMPACT INVESTING IN REAL ESTATE



Over the last few years, as ESG has become increasingly integral to real estate strategies, we have observed a growing number of investment managers wanting to go the extra mile and launching impact funds. However, the process of designing and raising capital from institutional investors for these initiatives has proven more challenging than anticipated. There is a lack of clarity on what constitutes sufficient “impact” and whether impact funds can generate competitive returns.

To address these challenges, Bohill Partners convened a group of fund managers, investment managers, capital raisers and ESG professionals. The goal was to lead a discussion on viable solutions for the future of impact investing.

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WHAT IS IMPACT INVESTING AND WHY DO WE NEED IT?

The CEO of a leading impact consultancy opened the roundtable by reminding the panel that the financial sector's true purpose is to serve and improve society by maximising social and environmental outcomes. However, the financial sector has primarily benefited a small, concentrated group, exacerbating social inequalities. This is particularly evident in the UK's property sector. To address this, impact investing needs to realign finance with its fundamental purpose, which not only aims to generate returns, as traditional investments do, but to make a positive contribution to local communities. Examples include affordable housing, essential services such as hospitals and schools, and developing carbon-neutral buildings to promote decarbonisation.

How do we differentiate an impact fund from a typical value-add fund? There are three main criteria:

1. Intentionality - the specific social or environmental outcomes aimed for and the approach to achieving them;
2. Additionality - unique approaches taken compared to others;
3. Reporting - methods for measuring and reporting on performance. Various international norms, such as SFDR Article 8 and Article 9, help define these criteria further. However, impact exists on a spectrum— some impact strategies are going to be more impactful than others. To avoid greenwashing allegations, transparency about what can and cannot be achieved is crucial.

However, institutional investors exclusively seek to invest in the most effective impact funds, creating several challenges for investment managers when designing and delivering their strategies. One investment manager noted the need to establish rigorous impact measurement frameworks to assure investors that their investments would create a significant impact. This can add complexity to the process of identifying suitable investments, particularly in commercial property. Another investor highlighted that even with affordable housing, now a favoured impact strategy, raising capital is difficult unless projects are launched in areas with high homelessness rates. This can be frustrating for impact investors who prefer their work to be driven by outcomes rather than constrained by initial limitations.

PERFECTIONISM VS JUST TRANSITION

Another key topic raised during the roundtable was the concept of a just transition, which refers to the approach of ensuring that the shift to a sustainable and low-carbon economy is equitable and inclusive, providing fair opportunities and support to all stakeholders. Amid the challenges of raising capital and delivering impact investments, it is easy to get bogged down by ever-changing regulations and definitions, leading to inaction due to fear of making the wrong investment decision. For instance, research increasingly highlights the negative impact that large regeneration projects, aimed at improving communities, can have on biodiversity. This has led some ESG professionals to question the efficacy of such projects in the context of an impact strategy.

However, participants found it encouraging to recognise that even “imperfect” impact investments can yield significant outcomes and provide valuable learning opportunities. A leading ESG consultant in the room shared an example of a large regeneration site that, despite its disruptions, offered numerous apprenticeship opportunities for disadvantaged communities, enabling individuals to acquire life-changing skills in building green assets.

Similarly, an investment professional shared an illustrative example from an affordable housing project in Scotland. They realised that to deliver truly affordable housing for the local community, they had to forgo advanced electric systems and instead develop quality homes powered by gas. Although their investors, the Scottish National Bank, were initially hesitant, they believed in the efficacy of a just transition and were ultimately impressed by the capacity of the development to serve their customers effectively.



THE INVESTOR LANDSCAPE

While it is commonly believed that Europe is at the forefront of ESG and impact investing, one investment manager reported that most of the capital for their two value-add impact funds came from Japanese, Australian, and Canadian pension funds and insurance-backed investors. They experienced a smoother capital raising process compared to another investment manager in the room, who was raising capital primarily from UK based investors. Two reasons for this difference emerged in the discussion.

First, which is probably true at a global level, our participants from investment management felt that they are ahead of institutional investors on the topic of impact. They shared that they often need to educate and motivate institutional investors to raise capital for impact initiatives. One investment manager noted a significant lack of innovation in their investment strategies: institutional investors are still primarily motivated by returns rather than impact. Consequently, they struggle to invest in areas without a strong track record, such as impact investing.

Second, in the UK, local government pension schemes, that have been more open to impact investing, prefer to allocate capital to investments that directly benefit their members. This approach is convenient for small developers and investment managers who are willing to raise capital on a deal-by-deal basis. However, it can pose challenges for larger firms trying to raise commingled funds and aiming for a broader reach. As a result, many of our participants feel they must meet the need of the investors rather than focus on specific needs or communities, creating additional hurdles in designing a strong impact framework.

Nonetheless, it is challenging for institutional investors to adopt a different approach. Their capital often comes from a very specific demographic and can only be deployed under specific requirements. It can be difficult to make a compelling internal case for how a given impact fund can be a viable investment opportunity if it cannot meet those requirements. This is also true for other asset owners, such as endowments and insurance-backed schemes. For example, one investor in the room from a health foundation noted that they would only allocate capital to a real estate fund if it aimed to impact the local community by investing in healthcare infrastructure.



BEHAVIOURAL CHANGE AND PROMISING RESULTS

At the end of our discussion, we asked participants what motivated them to launch impact funds, especially given the challenges of raising capital and delivering on investments. Our group unanimously agreed that their drive stems from the potential for behavioural change. Although we are currently in a transitional phase, requiring investor education and distinctions between Article 8 or 9 funds and Article 6 funds, they believe that impact will eventually become an integral aspect of all real estate investments. Arguably, it was the same for ESG—initially met with scepticism and seen as, at best, a checkbox exercise, it is now increasingly recognised as a performance driver and a crucial component of real estate investment strategies.

Several investment managers highlighted the positive outcomes already visible in this nascent field. One manager shared how their property investments have provided housing for numerous individuals in a specific community. Another pointed to Beijing's transformation from one of the world's most polluted cities to a place where residents can enjoy outdoor activities, thanks to the government's investment in electric vehicles. As these results become more evident and impact funds establish a solid track record, they will emerge as a viable investment strategy for mainstream real estate investors.

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