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Responsible Investing

By Sandra Carlisle

What Does It Mean and Why Does It Matter?

Responsible investment is better investment — but what does this mean? It strictly concerns the potential economic advantages and the belief that responsibly managed companies are better placed to achieve sustainable competitive advantage.

This is not just a theory. Academic research has found compelling evidence of the advantages to companies and their investors of pursuing environmental, social and governance (ESG) policies. A study[1] in 2012 by Harvard Business School of 180 US-based firms found that companies who are actively trying to improve their ESG credentials delivered above-market average returns some 4.8% higher than those of their less sustainability-focused counterparts.

The identification and analysis of, and engagement with, companies on ESG factors are vital for investors in order to understand potential opportunities and risks. What are the key issues that my team is looking at in this area today, and how can investors help manage the risks associated with them?

Case study 1: Environmental — Stranded Assets

What are the risks? In an environment where policymakers are increasingly becoming concerned about the effects of climate change, investors are beginning to ask if fossil fuel producers are investing shareholder capital

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National Real Estate Investor: Shadow Tenancy

By W. Stephen Hagenbuckle

Real estate gurus frequently talk about "shadow inventory" in residential markets. But there's a similar phenomenon occurring in the commercial real estate markets that should be encouraging for nearly every commercial real estate investor, especially ones involved in distressed deals. This new phenomenon, which we call "shadow tenancy," refers to pent up demand by prospective tenants for new available commercial space and it can be a significant return driver.

As general rule, commercial tenants are sensitive to basic customer service and they want responsive, well-capitalized landlords who are ready and willing to invest substantially in their properties. When lenders or special servicers own a property (typically because they've acquired it during foreclosure) prospective tenants become concerned about how much the landlord is willing to invest in the property and respond to the tenants as a long-term owner. They also know banks and special servicers are likely to sell the property in the short-term to an unknown buyer. Understandably, prospective tenants, even if they are keen on the property, are wary to commit to new space until they know the identity of their long-term landlord.

This creates a "shadow tenancy" where tenants are interested in specific properties and watch those properties with a willingness to commit to space once it's sold to a stable owner.

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Properties with low occupancies owned by lenders often must be bought on a price-per-sq.-ft. basis rather than a cap rate because they may be breaking even or losing money at acquisition.

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responsibly. More specifically, they want to know if their investments are at risk of becoming 'stranded.'

Stranded assets are investments which have suffered from unanticipated or premature write-downs or devaluations. This can come about as a result of changes in the market, for example if renewable energies became cheaper than fossil fuels, or via changes in the regulatory environment — perhaps if governments implemented carbon emissions penalties.

What Can Investors Do?

Active investors have the power to address the issue of stranded assets both directly in their active investment decisions and through effective policy and regulatory level engagement. For example, investors could ask companies to demonstrate how demand might be affected if carbon costs increased and prices rose, or whether potential future climate legislation is budgeted into their models.

> *Many U.S. companies still continue to award executive compensation packages with no performance conditions attached. This could promote dangerous short termism and incentivize risk-taking.*

Case study 2: Social
—Supply Chain Management in Bangladesh

What are the risks? Following a number of fatal disasters at garment factories in Bangladesh, most notably Rana Plaza in 2013, there has been increased focus on supply chain standards. Bangladesh is one of the cheapest places to manufacture globally, with many western retailers sourcing basic garments from the country.

The key risk to businesses and their investors is supply chain disruption. Companies with complex, opaque supply chains that do not effectively manage the risks this entails are vulnerable to unanticipated increases in the living wage, intervention from unions or strike action, all of which could increase costs and decrease productivity.

What Can Investors Do?

While most companies acknowledge supply chain risk, very few offer transparency across their supply chain; therefore, company engagement is vital. One thing to look for is whether a company has established a local sourcing office or if it sources via third parties. Employing local sourcing staff can improve supply chain visibility and avoid unauthorized subcontracting to cheaper factories with weaker standards.

Case study 3: Corporate
—Governance in the U.S.

What are the risks?

Once a niche area of specialist interest, corporate governance has become a key area of investor and regulatory focus. While several countries are adopting corporate governance codes and best practice, the U.S. remains a challenging market.

Many U.S. companies still continue to award executive compensation packages with no performance conditions attached. This could promote dangerous short termism and incentivize risk-taking. The combination of CEO and chair roles is also a concern, as is the length of board tenure, with critics of the current system concerned about a lack of diversity of thought and 'seat blocking.'

What can investors do?

In the U.S. market, where director and shareholder dialogue is often lacking, analysis, engagement and monitoring of such governance factors as board diversity, tenure and management incentive packages are all-the-more vital in order to ensure companies will be able to withstand the inevitable challenges they will face in the 21st century global market place.

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1 "The Impact of Corporate Sustainability on Organizational Processes and Performance, National Bureau of Economic Research, working paper 17950, April 2014. http://www.nber.org/papers/w17950

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The equivalent potential cap rate basis can be deep into double digits. One of our recent acquisitions in Florida, for example, was bought on per square-foot basis that translated into a 19 percent cap rate on net rents being signed now.

Currently, there are signs of "shadow tenancy" in nearly every deal we look at. We recently purchased a non-performing loan on a portfolio of 228,000 sq. ft. of office and distribution space from a special servicer at a basis of about 40 percent of replacement cost. Several tenants had left during 2008 and 2009 and the property was only 55 percent occupied at acquisition. Before negotiating for the building, we identified numerous businesses in the area that had expressed interest in moving into the property but were waiting for a new, financially stable, owner. These included credit tenants such as Nestle, Home Depot, Staples and Red Bull. Once the deal closed we were able to negotiate leases with those tenants-in-waiting and the property is now 85 percent occupied seven months after closing.

The phenomenon of "shadow tenancy" is occurring in many different markets across the country, especially in places where the economy and the residential market has already recovered significantly. For investors experienced in distressed commercial real estate situations, this means now is the time to be buying.

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