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As huge carbon emitters with a low stock turnover, those who manage buildings face challenges that are underestimated by investors. Mike Scott talks to Paul McNamara of Prupim about the future of the industry

Buildings are one of the biggest contributors to carbon emissions – responsible for 44 per cent of carbon emissions in the UK, according to the Green Building Council – and a major asset class. But their impact is often ignored by even seasoned property investors, says Paul McNamara, head of research at Prupim, the property investment arm of Prudential, which has about £15 billion of assets under management.

'I see my role as trying to alert people to the significance of the building sector in the whole issue of carbon mitigation,' he continues. 'It is a relatively modest part of investors' portfolios but an important part of the problem.'

The property investment sector suffers from a paradox, he explains, because 98 per cent of the talk is about two per cent of the problem. 'Many people think it is all about new development, but in carbon terms, only two per cent of stock is added each year so my focus is on getting people to think about existing stock. The big challenge is to find cost-effective ways of improving energy performance. Making improvements there will dwarf the impact of higher standards for new developments.'

However, there are some tricky issues for the property investment sector when it comes to improving environmental performance, not least the disconnect between landlord and tenant.

Retrofitting properties is the responsibility of landlords, who bear the expense of improving the energy performance of buildings, but it is tenants who reap the reward in the form of lower energy bills. One way around this is to introduce green leases, whereby owners can help occupiers manage their energy performance and both parties commit to make environmental improvements.

A responsible approach can also help retain tenants. In one building where leases were due for renewal, Prupim agreed to replace an obsolete air-conditioning system with a more energy-efficient system that could cut tenants' energy costs by a quarter.

'Property fund managers need to see it as part of their fiduciary duties to understand the implications on their existing stock,' says McNamara, who is also co-chair of the UNEP Finance Initiative Property Working Group and a board member of the Institutional Investors Group on Climate Change. This means looking at what happens to returns on investment if tenants prefer green to non-green buildings.

'There is every indication that this is becoming more important for tenants, so you would expect green buildings to attract a higher rent,' he adds. 'However, the differential might emerge not as excess rents for green buildings but as excess depreciation for non-green buildings.'

Property as an investment class attracts a risk premium related to its illiquidity – if you need to raise cash quickly, selling a property is not the answer. Increased demand for retrofitted buildings would tend to make inefficient properties more illiquid, leading to a higher cost of capital.

In addition, a number of studies have identified energy efficiency as a quick win when it comes to cutting emissions, so it seems likely that regulations will get tighter. 'From a risk perspective, being conscious of heightened regulation is one thing, but there is also the risk of unforeseen costs from a step-change in standards, as happened with the introduction of the Disability Act,' McNamara concludes.

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