

OUTCOMES
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IMPACTFUL INTENT

Housing for a sustainable future

Real Estate Debt

October 2019

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For institutional investors only

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IMPACTFUL INTENT CREATES HOUSING FOR A SUSTAINABLE FUTURE

Hermes is an asset manager with a difference, seeking to deliver holistic returns and outcomes for our clients that go beyond the purely financial. We carefully consider the positive (and negative) impact that our investment decisions can have on society and the environment, and each year seek to advance our holistic approach to real estate and real estate debt investment in the pursuit of delivering sustainable returns.

One aspect of our ongoing effort is our contribution to creating 'meaningful cities' of the future. These are places where people want to work and live, that foster a sense of civic pride and create a sense of belonging for those that live there.

This provides the backdrop that allows people to freely engage in social, economic, leisure and community-based activities. Cities and towns created around these holistic principles create a virtuous cycle which provides benefits for individuals, businesses, communities and local and regional authorities.

Meaningful cities can also preserve historic continuity and solidify the green credentials of a place, making real improvements to the circular economy and contributing to climate-change targets. These cities can sustain higher levels of economic and social growth through their ability to attract and retain talent and capital. This reduces risk for investors, increasing risk-adjusted returns as a result.

The concept of meaningful cities is at the heart of our vision for sustainable housing in the UK and elsewhere. Two key principles form the bedrock of our housing strategy:

1 Social:

Mixed-demographic residential schemes provide a more dynamic living environment than the single-demographic schemes that have become the industry standard. A higher quality of life, delivered by a vibrant community, can be catalyst for social mobility and civic pride. Rising inequality has meant that it is much easier to build housing for those that can afford it, rather than for those that need it. A balance is required to build a community that lasts.

2 Environmental:

Domestic dwellings are a key contributor to greenhouse-gas emissions and any new housing construction needs to mitigate carbon impact. Not only does this lower the costs of occupation, it is also one of the few ways that households can be a meaningful contributor to the UK's 2050 net-zero carbon target.

We now look in further detail at these two aspects.

Social

Urbanisation in the UK and other European countries has created a persistently high level of demand for housing, which is currently not met by supply. Housing has a significant negative impact on the environment, much of which can be mitigated by proper focus on sustainability goals.

The developed world has experienced unprecedented economic growth since the second world war, but this has also been accompanied by rising inequality. This acknowledgement that the world economy does not work for everyone has been reflected in the rise of populism and mass movements. The election of US President Donald Trump and the UK's vote to leave the European Union are examples of this, as are the Occupy Wall Street and Extinction Rebellion initiatives.

Inequality is exacerbated by public policies, as tax systems have grown less progressive over time, and also private pursuits like zero-hour or casual-labour contracts that provide no pay guarantee to workers. House-building patterns, which tend to be determined by economic class, perpetuate this further. Developments usually target a single use – like housing – and a single demographic such as luxury apartments, terraced family homes or social housing. The haves and the have-nots live distinct, separate existences. Gated private-housing developments may be the best example that seems to confirm that "never the twain shall meet".

The UK continues to suffer a chronic housing shortage, which has been exacerbated by a history of building for those who can afford it, not those who most need it.

By contrast, we believe that proper mixed-use schemes can help create long-term sustainability. The UK continues to suffer a chronic housing shortage, which has been exacerbated by a history of building for those who can afford it, not those who most need it.

According to Shelter, a housing charity, the UK needs to build more than 3m new social homes over the next 20 years. But the current rate of construction is nowhere near high enough to meet that requirement. This shortage means that house prices are high for both rental properties and owneroccupied stock, and as a result many young people are forced to live with their parents for much longer than was previously the norm.

Elevated prices also mean that people are forced to rent for longer, despite wanting to buy. The number of households in the private rented sector in the UK increased by 63% in the ten years to 2017. Even for people that do not require social housing, it is increasingly hard to get onto the housing ladder as the deposit required to obtain a mortgage is often unaffordable.

Homeowners will take comfort in the fact that real house prices have risen by 2% a year on average since 1975, even after accounting for the dampening effect of the 2008-9 financial crisis. But house prices have risen far above the rate of inflation, meaning that for those that don't own, buying a first home gets harder every year. Indeed, owning your own home before the age of 30 has become an impossible dream for many. The average age of a first-time buyer has risen from 23 in 1960 to 33 today.

The housing shortage has priced many people out of the market. Homebuilding does not provide different types of housing for a variety of needs, and while successive governments have recognised the problem, they have not yet found a sustainable solution.

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63% in the 10 years to 2017.

For example, the UK's Section 106 regulation requires new residential developments to make a social-housing contribution. Yet in practice, developers usually make a payment to the council instead of incorporating affordable housing into the scheme. If affordable housing is built at all, it is often delivered in alternative locations to avoid lowering the value of the rest of the scheme.

This does nothing to create dynamic neighbourhoods and we fully reject the premise. Mixed neighbourhoods with both larger and smaller dwellings provide better social cohesion than singularly targeted neighbourhoods.

Our basic premise is neither revolutionary or controversial. We believe that people enjoy living in dynamic and varied communities, and that when individuals from different backgrounds, with various abilities and levels of wealth come together, a more rewarding living environment is formed.

Whether this is in a village, a city or a neighbourhood, the idea of a community is key. A community is not just a group of people residing together, but a collection of individuals living and working together in one social system.

A neighbourhood of multi-million-pound houses rarely generates a community under our definition, excluding an occasional outburst of NIMBY-ism. Parallel societies that occupy the same geographic area do not form a community unless there are ways for people to interact meaningfully. We look to support the building of physical infrastructure that allows communities of people across the income spectrum to flourish and jointly take pride in the property or neighbourhood that they live and work in.

If affordable housing is built at all, it is often delivered in alternative locations to avoid lowering the value of the rest of the scheme.

The ground-breaking developments at Poundbury are evidence of this in practice. Types of housing range from cottages and apartments to large townhouses, which cater for small families, the elderly and everything in between. Houses are interspersed with cafés, restaurants, supermarkets, schools, a garden centre and offices.

First developed two decades ago, Poundbury is now a town of 5,000 people. Housing is built to modern efficiency standards, the streetscape is interesting and the community functions in a way that largely eliminates the need to use a car on a daily basis. Similar schemes are planned elsewhere, one being the regeneration of the Fawley power station site near Southampton.

Although our focus is on residential property, provisions for retail space can also add significant social value. Subsidised rents for family businesses can help create more diversity within the retail landscape, giving space to the 'mom and pop' greengrocers, the pet shops or corner stores that are often priced out by big-box stores.

Providing space at low or even zero rents can revive the look and feel of neighbourhoods, creating communities that all residents can be proud of. This could be mistaken for nostalgia, yet in reality these retailers often provide services that in many places no longer exist, but that are nonetheless appreciated in areas where they have survived.

These retailers are not meant to compete with larger shops, but can arguably improve the quality of life of residents in a way that is akin to providing a local park or playground. These retailers are the constituent parts of meaningful cities – they help drive demand for properties, and thus underpin the long-term sustainable value of the surrounding houses.

87% of retirees prefer to live in mixed-age developments

Developments where a large share of housing is social and affordable also offer opportunities for a full range of tenures; completed units can be let to tenants, to housing associations or sold to occupiers and professional private rented sector landlords. Local authorities – which we may be able to form joint ventures with – are actively seeking opportunities to deliver blended sites that offer a holistic solution to different local needs.

We see an opportunity to improve the social impact of a development while also seeking strong relative value and a positive internal rate of return. One way of doing this is to blend social and affordable rental units with their private counterparts, as well as private sales.

Another is to create wheelchair access and supported units for the elderly. Research shows that 87% of retirees prefer to live in mixed-age developments, rather than an age ghetto. This is clearly a demographic that wants to live semi-independently and is willing to pay a premium to do so.

Long-term value in real estate is generated by the ability of the assets to attract occupiers. If we can combine green construction with these social considerations, we will be better able to create self sufficient housing that is attractive to occupiers in the long run.

Environmental

We can contribute to the UK government's five-year housing strategy and its 2050 net-zero carbon goals by deploying modern construction methods. Making housing more energy efficient and construction less prone to waste are key goals of any new housing development, not only explicitly sustainable ones.

One of these modern methods is modular housing, something we see as the single most promising trend in residential construction in the last 20 years. Modular sections are manufactured in factory conditions, then installed on the building site. The modules can be placed in a variety of configurations and, after they are joined together, are indistinguishable from traditionally built homes.

The new generation of modular-housing units are more sustainable and can deliver a roughly

30% increase in energy efficiency

But modular housing has suffered from its association with post-war 'prefabs', which in fact have very little in common with contemporary modular construction. The new generation of modular-housing units are more sustainable and can deliver a roughly 30% increase in energy efficiency. They also have the potential to deliver social value through training workers in modular construction methods.

The modular supply chain is controlled from when the materials are sourced at the start of the project, all the way through to practical completion. This means that modular construction offers a unique opportunity to carry out an analysis of environmental impact throughout a building's lifecycle.

The potential for off-site manufacturing varies between projects, but modular construction can deliver everything from individual building components, like systemised wall panels, through to complete, ready-to-occupy buildings. One of the most rapidly developing areas is where complex, complete sections of a building are manufactured in controlled factory conditions and then assembled on site. Entire sections of a house, potentially comprising of multiple rooms, doors, plumbing, wiring and tiling, can be completed in a factory.

The move away from traditional building methods has been gradual, but prefabrication is increasingly used by developers. Laing O'Rourke, a building company, used some form of off-site production for about 85% of the construction of the Leadenhall Tower – more commonly known as the 'Cheesegrater' – in the City of London.

The wider adoption of modular construction is timely. The UK construction industry faces tough challenges: a looming skills shortage which could be exacerbated by Brexit, increasingly complicated technical design and more demanding carbon-reduction targets.

The government has called for a significant increase in off-site construction for some time. A recent government-commissioned review identified off-site construction as the most efficient means to deliver the scale of building required to address the country's housing crisis and the shortage of new school stock.

Incorporating solar energy into housing design can help to significantly lower the requirements placed on the electrical grid. Retrofitting solar panels and ground-source heat systems can be expensive, but incorporating this into the design from the outset can materially reduce the cost of these systems.

Prefabricated components are an attractive commercial proposition because they result in faster construction on site. Quality standards are easier to achieve in factory conditions, and fewer on-site activities and more controlled assembly processes offer safety improvements and reduced programme volatility. There are also sustainability benefits, as waste is minimised. A faster on-site build time means that disruption to the local community is limited, with less heavy construction work, fewer deliveries to the site and reduced road congestion.

Incorporating solar energy into housing design can help to significantly lower the requirements placed on the electrical grid. Retrofitting solar panels and ground-source heat systems can be expensive, but incorporating this into the design from the outset can materially reduce the cost of these systems. It should be possible to design housing that is efficient enough to be largely energy self-sufficient. For large-scale developments, biomass converters can provide gas for cooking, although in most residential developments electricity will probably become the main energy source in the future.

CONCLUSION

Mixed-use housing developments have the potential to create dynamic, vibrant spaces that allow people of all backgrounds, ages and income levels to live and work together. Indeed, we believe that these communities can improve both perceived and actual social mobility.

Moreover, modern construction methods have made it possible to build housing that can exceed the highest energy efficiency standards, and that go well beyond the government's current requirements. Properties that are equipped with on-site, renewable electricity sources have the potential to be effectively carbon neutral. By working with local stakeholders, Hermes can support the UK in its quest to solve the housing shortage and meet its net-zero carbon targets over the next few decades.

We believe that we can use our platform at Hermes to deliver a vision of a sustainable future in little pockets or large areas

There are numerous examples of large-scale housing developments that have incorporated social principles into their design. Housing projects that combine an emphasis on social values with sustainable and environmental discipline are rarer. We have, however, seen a few projects in the UK that could meet the requirements of this thesis.

We believe that we can use our platform at Hermes to deliver a vision of a sustainable future – in little pockets or large areas – that helps create social cohesion and hastens the transition to a post-carbon economy.

THE THREE SITES

Verified carbon offsetting with Trees for Cities

In 2018 Hermes Investment Management offset its operational carbon emissions by working with Trees for Cities. For every tonne of greenhouse-gas emissions that Hermes generates from its day-to-day operations and its business travel, it purchases verified carbon offset from Trees for Cities, which guarantees an equivalent amount of greenhouse-gas emissions are reduced in the atmosphere. In 2018, our offsets of 834.5 tonnes of CO₂e were generated by planting 2,229 trees in order to ensure that 557 trees, the amount required to offset the specified quantity of CO₂e, are in a healthy condition after 100 years. The planting took place over three sites and, in addition to offsetting carbon emissions, provides important environmental benefits, including increased biodiversity, improved resilience to changes in climate, flood alleviation and mitigation of air pollution.

Offset by:



The sites

- Roding Valley, near Onslow Gardens in London, in collaboration with Redbridge Borough Council to make improvements to outdoor green spaces across the borough on a site that has been a high-priority area for woodland planting.
- Odda Bank Quarry in Hawksworth, Leeds, on the border between Leeds and Bradford. Planting at this site will regenerate the former quarry and increase canopy cover in this area of urban fringe.
- Rush Green Recreation Ground at Clacton-on-Sea, in partnership with Tendring District Council. Rush Green is widely used by local residents for recreation and the complex includes a bowling green, rugby and football pitches. Planting at this site will regenerate a section of amenity grassland that has been established on a former landfill site.

Verified by:



HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets

Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities

Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit

Absolute return, global high yield, multi strategy, unconstrained, real estate debt and direct lending

Stewardship

Active engagement, advocacy, intelligent voting and sustainable development

Offices

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Why Hermes Real Estate?

Hermes Real Estate is one of the largest real estate investment managers in the UK, with £7.3bn GAV¹ of assets under management in both UK and International portfolios.

It offers client-focused, property investment solutions through segregated and pooled structures.

¹ Hermes Real Estate as at 31 March 2017

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BD004417 0007517 10/19