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ROUNDTABLE

Future-proofing property

Charity Times, in partnership with Swiss Life Asset Managers UK (formerly Mayfair Capital), hosted a roundtable to discuss the challenging environment of real estate investments for charities and endowments and how to make them fit for future purpose.

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The management of direct real estate portfolios for charities and endowments has become significantly more challenging post-pandemic and exacerbated further by the current cost-of-living crisis.

The ever-changing economic and social environment has highlighted the importance of investment diversification and the need to invest in areas of the market that will remain viable in the long term. Charity Times, in partnership with Swiss Life Asset Managers UK (Swiss Life UK), brought together finance professionals from across the charity sector to discuss the key property issues facing charities and endowments; assessing current and future challenges to understand how to make real-estate investments viable in the long term.

After introductions were made, the roundtable kicked off with a short presentation from Swiss Life UK's James Lloyd, Head of Charities and Endowments; Clare Berthoud, Director, Charities and Endowments; and Simon Martindale, Fund Director of PITCH, who gave a brief overview of the current real estate market.

It's a challenging time for charities with a property portfolio, they explained, "with some significant structural shifts in the market." Some of this happened pre-pandemic, with a noticeable shift from retail spaces on high streets, but other more structural shifts have now also taken place in the office market, due to an increase in hybrid working, which has affected the type of office space required by occupiers.

ESG was also a key theme of Swiss Life UK's market overview; the trio describing it as "incredibly important" for the way the firm currently manages real estate. Swiss Life UK's own Charity specialist Fund, the Property Income Trust for Charities (PITCH) announced its commitment to reaching net zero by 2050 or sooner, and a reduction in CO2 by 32% by 2030.

Looming on the horizon are also regulatory considerations. All buildings need to have an EPC rating of ‘C’ or above by 2027, or they won’t be able to be re-let with penalties applied for non-compliance. This will increase to a minimum rating of ‘B’ by 2030. Therefore, for charities, “ESG needs to be absolutely integrated into the strategy,” said Swiss Life UK’s team.

A challenging market

The group of attendees, which consisted of a mix of finance representatives from across a wide range of foundations and charities, agreed there will be few charity property portfolios that haven’t taken a valuation hit over the last six months – the result of an increasingly volatile market.

A lot of questions were raised among the group – ‘are we at the bottom of the market? Is now the time to deploy funds?’ – questions which aren’t easy to answer. Simply, all considerations relating to the current property market must be balanced against the individual obligations a charity has to deliver and provide for their endowments.

But there is opportunity too, one delegate pointed out. “I suppose it’s a case of getting charities comfortable to come back in [to the property market] and take the plunge.” ‘Taking the plunge’ does come with its fair share of risks, however, and mitigating those risks as much as possible is key.

“I think at the moment, we see a lot of charities with single sector exposure, and one of the features of the property market over the last ten years is the fact that individual sectors have performed well versus other sectors that have underperformed,” the team at Swiss Life UK said. “If you go back ten years prior to that, most property sectors behaved similarly to each other… this time around it’s been very different which reinforces the need for diversification.

“Charities with single-sector exposure in the wrong areas according to market conditions have been exceptionally challenged.” Taking a long-term approach, these challenges in an economic cycle could be weathered, but in the retail sector, for example, there have been long-term structural changes. “Even if you take a 2030 horizon, an exposure to retail on the high street is going to cause underperformance in your portfolio.”

Delegates with a diverse portfolio echoed this statement. One said that its industrial holdings have “increased quite a bit”, compensating for the drop in retail income. “Our overall income was maintained at the same level because of the diversification.”

Against the backdrop of economic challenges in recent years, charities are having to seriously consider how and where their investments lie,

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meaning a strong property strategy is essential and reviews might be needed earlier than expected.

One delegate agreed, explaining how their charity has had to take a step back and start strategically managing their properties. In the past they'd inherited the properties and managed them as needed, but now they're having to spend a "huge amount of time" on property management. "Our portfolio has performed well for hundreds of years, but we need to start strategically managing this. We can't be emotional about these properties… we need to make this work because we're not going to be able to deliver our actual charitable strategy if we don't have enough income."

It's becoming a drain on resources, they found. Previously, the properties could be managed easily with some lease renewals and quarterly income, but now they're seen as the "grim reaper", holding the charity back from doing work until a lease is renewed or a contract has been signed. The possibility of selling the properties is becoming increasingly likely and conversations among the board are imminent.

Another charity explained that they set their strategy every five years, but that "it constantly changes". "When it was set in 2014, a significant focus on the environment wasn't on the agenda, which it clearly is now, so in our next strategy, we're looking at how we prioritise that."

Future-proofing

Much of the session revolved around the environment, ESG regulations and the many ways it is going to impact property holdings in the future. As of 1 April 2023, it is an offence to continue to let or rent out a property if it does not have an EPC rating of at least E, unless exempt. There are proposals that by 1 April 2027, commercial properties will need a rating of C, and B by 2030.

For residential properties, the E minimum has been in place since 2020; from 2025 it is proposed that this will need to be C or higher for new lettings, and by 2028 it will apply to any on-going tenancies. That means for a lot of charities, these changes are on the horizon. "Over the next five years we are going to have to look at substantial expenditure," said one delegate, with many others nodding in agreement.

Others are working with tenants to bring their buildings up to standard. A traditional commercial lease means the tenant is responsible for everything (energy, repairs, maintenance etc), but the responsibility for the EPC rating lies with the landlord, meaning there's potential to fall foul of the regulations unless the tenant works with the landlord; something charities need to be mindful of lest risking a fine.

As with many rules and regulations, there are some exemptions and it's worth looking at these before committing to work, but keep in mind the attitudes of future tenants too.

"The younger generation are not going to accept [low environmental standards]…they actually want a building that suits their lifestyle and an EPC inefficient one probably doesn't satisfy them," pointed out a member of Swiss Life UK 's team.

Similarly, when discussing net zero goals, many charities had set dates and goals but not put a clear strategy in place. Some charities have already organised the installation of solar panels on roofs, others are looking at bringing in consultants, or extending their initial commitments. "Net zero on property is far more impactful than net zero on equities," one delegate pointed out, but it can cost more to implement. "You can – through your own initiatives – really improve those assets and reduce the carbon emissions on those buildings, which in turn actually might make them more attractive to occupiers," but this is no guarantee.

No matter what road charities choose to travel for meeting environmental goals, it's clear the whole sector will need to do a lot of work to weigh up the cost of EPC ratings in relation to reaching net zero in coming years.

Direct vs indirect property ownership?

With direct property investments proving to be a challenge operationally, delegates asked: why are they so attractive and are they still worth it? "Some charities do like to have control of their assets. They can know exactly what they're investing in, where it is…whereas if they're a smaller party in a much wider fund they can't make their exposure as bespoke as they would like," pointed out one delegate.

But, getting exposure to good properties "is quite difficult," said another. "If you're trying to buy them individually, you have to go and buy that specific property in that specific place…it's not like a stock market where you can see what the price is on a daily basis and you can buy it or sell it."

Of course, this comes in addition to technical property knowledge and the operational management style necessary in a post-pandemic world. Five to seven years ago, charities could collect rent and the property mostly looked after itself. "Now, as a landlord you've got to be almost operational in the sense that you must understand exactly what the tenants want out of their building, particularly with offices. What does that mean in the hybrid workplace?" questioned Swiss Life UK 's team.

In London, another delegate explained how there's an expectation to provide a fit out, "so that a tenant can effectively move in, plug in their laptop and start working from there." This not only reduces capital growth, but lease lengths are also getting shorter which adds another layer of impact. "So you've spent all this money on the fit out, but you're not getting the rent back you're expecting and you're getting a shorter lease, which then carries the prospect of renegotiating everything again in three years' time. Historically, leases used to be 25 years," they added.

This is where indirect investment in property, such as through a pooled fund, will provide extra appeal for charities, who simply don't have the time or money for direct property management. An example is the Property Income Trust for Charities (PITCH), which aims to provide charities with a high, sustainable and tax-efficient source of income by investing in properties on the charity's behalf. The key benefits of this form of investment are that they allow charities to benefit from an exemption to Stamp Duty Land Tax (5% on commercial property above £250,000) and offer a diversified portfolio, with a strict ethical conscience and integrated ESG.

As the discussion wound down, it was clear that the coming years will be challenging for charities with real estate investments and the uncertainty may make other organisations wary about taking the risk. ESG, the environmental impact of property, changing work habits and inflation will all have an impact and there is no right way to handle any of these. It's inevitable that strategies will need to be reviewed and difficult decisions will need be made, but there are a wide variety of potential solutions available to be embraced. ■