ESG Investing

ESG Investing Awards 2023 Interview
Franklin Templeton

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Franklin Templeton is one of the world's largest independent investment firms, bringing together leading investment brands to provide our clients with deep expertise and specialisation across asset classes, investment styles, and geographies. We are the world's top cross-border asset manager[1], managing over $1.4 trillion on behalf of clients in more than 155 countries.

> Franklin Templeton was awarded Best ESG Investment Fund: Real Estate at the ESG Investing Awards 2023.

Interview

Raymond J. Jacobs
Managing Director, Franklin Real Asset Advisors

Raymond J. Jacobs is managing director of Franklin Real Assets Advisors and a member of its Management and Global Investment Committees. Mr. Jacobs heads European private real estate investment and portfolio management and serves as portfolio manager on a number of value-add and core real estate funds. Prior to joining Franklin Templeton in 1999, Mr. Jacobs worked in real estate investment and asset management functions at Dutch firm GIM Capital, Swedish property company PriFast and the New York office of a private Japanese property firm. Mr. Jacobs entered the real estate industry in 1990. Mr. Jacobs holds an M.B.A. from Aston University (U.K.) and a B.B.A from Nyenrode Business University (Netherlands). He is a former six year term board member of INREV and serves on the advisory committee of a number of private equity funds.

Fund and Company Info

Please provide an overview of Franklin Templeton and its Social Infrastructure Strategy.

Franklin Templeton is one of the world's largest independent investment firms, bringing together leading investment brands to provide our clients with deep expertise and specialisation across asset classes, investment styles, and geographies. We are the world's top cross-border asset manager[1], managing over $1.4 trillion on behalf of clients in more than 155 countries.

Franklin Real Asset Advisors (FRAA) started in 2016 with a real estate impact investment strategy as an initial offering for clients. From that, we pioneered the world's first social infrastructure strategy, named Franklin Templeton social infrastructure strategy which was awarded "Best ESG Investment Fund: Real Estate" at the ESG Investing Awards in 2023. The strategy was launched in 2018 with the dual return objective of seeking to achieve a social and environmental impact alongside a financial return at market level. It aligns itself with seven of the Sustainable Development Goals (SDGs) of the United Nations.

What is your AUM in this strategy and size of investment team?

We have currently invested around €800 million in gross asset value and we're managing it with a team of 20 dedicated professionals across fund management, acquisition, impact and asset management, legal, finance and business development.

What is your investment strategy?

The strategy focusses on social infrastructure investments across Europe. FRAA defines social infrastructure as the physical real estate assets that accommodate and facilitate social services, helping to build strong communities. In our view these services and the assets that support them help develop a more inclusive and sustainable society. Examples of social infrastructure assets include healthcare and education facilities, social and affordable housing, and buildings related to justice, emergency, and civic services.

Our portfolio is diversified by sector, geographic location, tenant, asset strategy, and lease expiry to achieve a high level of risk diversification. Investments are selected for their long-term performance potential using a stringent bottom-up approach to due diligence and selection of investments, with a broad top-down macro perspective, focused on structural and cyclical changes.

Asset-specific strategies are employed to optimize the financial and the social & environmental impact returns generated by the investments.

The challenge we're addressing with our impact investment strategy is a lack of quantity and quality social infrastructure across Europe. The Theory of Change asks what can our strategy do about it? We have identified five contributions. The first contribution is the provision of long-term aligned capital. Second, we improve the assets that we buy. Many of the properties are bought in a sale and leaseback transaction from providers of essential services who do not necessarily have the means to keep the buildings up to the level they need to. Buying the properties from those providers and then leasing them back allows them to focus on services while we manage the properties. Improving those properties is part of our mission and we do that in the most sustainable manner. We also support purposeful development by expanding existing assets and creating new social infrastructure. Lastly, from a social perspective, we work with the stakeholders of those assets (who are not only the operators, but in most cases the broader community) to ensure those properties are functioning as they should, with the optimal goal of creating sustainable communities. These types of assets are the glue for a sustainable community.

In the UK, for example, we are supporting operators that are active in special needs education with their expansion of existing and new school properties. In Ireland, we own and develop social housing, while in Italy we acquired and improved a hospital and nursing home by partnering with two new healthcare operators.

Where has demand for your strategy come from?

The demand has mainly come from institutional investors. Impact investing is still relatively new, and most investors prefer to support impact investing in their home country. This means the strategy in Europe attracts mostly investors from Continental European countries, as well as the UK. There are some exceptions. Countries that look at impact investing from a more global perspective are few. Canada is one of them. Australia would be another one, but generally we see that most countries are looking towards supporting impact closer to home.

How do you assess the impact of your strategy? What independent verification do you get for this?

Impact investing is less developed and standardized than ESG strategies in the public markets. We developed, together with an impact consultant, a proprietary impact measurement and management framework that aligns itself with seven of the 17 UN Sustainable Development Goals. We assess and score each of our assets within this framework and use various KPIs from mostly existing standards like IRIS and GRESB to measure and report on our progress.

Do you have an explicit commitment to Net Zero?

Yes, we do. The real estate industry in general has an important role to play in the fight against climate change. Real estate uses more energy than any other industry and is expecting to emit more CO2 between now and 2030. Therefore, it's very important there is a focus from the real estate industry on providing a commitment to Net Zero. According to the World Bank, the real estate sector needs to reduce their carbon emissions by around 36% between now and 2030 to align itself with the Paris Climate Agreement. This translates to a reduction of about 1.5% annually in energy usage and about 3% in the reduction of annual emissions for our fund. We've set higher targets. For our strategy at a portfolio level, we're looking at a 2.5% reduction in energy consumption per annum and a CO2 intensity reduction of 5% per annum. So, we are more ambitious than the World Bank recommendations.

How do you measure the climate risk associated with your property portfolio?

There are two elements that we're looking at in relation to climate risk. One is physical risk and the other one is transition risk. The physical risk, in our case, is the risk related to damage to buildings from extreme weather conditions and shifting climate, for example from flooding and wildfires. For that, we use an external service provider which provides us with the fiscal risk of a particular asset in a particular location. That assessment is used to analyse which risks we should be aware of during our acquisition process as well as during the long-term ownership of the assets.

Then you have the transitional risk. These are the risks associated with the known and unknown costs of transitioning to a low carbon economy and for fighting climate change. And there we assess existing regulations, policies and potential new legislation that could lead to unknown cost factors. We use that kind of assessment to analyse local demand for clean buildings and to better understand our future liquidity and, for that matter, also the pricing assumptions of assets we are acquiring.

How would your portfolio have been different had you ran an equivalent real estate strategy without ESG considerations?

The key here is that we intentionally integrated an impact objective into our investment strategy. You could argue that if we had done this 10 years ago with a pure financial objective, impact would have been an afterthought. With our strategy it is there from the very beginning. Our objective is to deliver social and environmental impact to the assets and communities that we invest in. The second difference is that we measure impact. Again, 10 years ago without that intentionality, we probably would not have the means to measure our achievements. Reporting is the third difference of an intentional impact strategy; reporting our measured impact to stakeholders and to others in the industry so they understand what we do.

My belief is that many more investors will be looking for investment strategies with dual return objectives that not only achieve a required financial return but also intentionally focus on making and keeping the world a better place. Each investor will have to determine what is important to them and what impact objectives they align with.

What benchmark do you use to assess financial performance and how has the strategy performed since inception?

There are no benchmarks for social infrastructure across Europe or globally. As such, we follow a total return objective. We underwrite our assets on a ten-year basis and are looking to achieve a 6 to 8% IRR over those ten years. This translates into a "core real estate"-type return.

If we look at our four-year track record, I am pleased to say that we have been able to achieve our performance target to date. More recently, with interest rates going up and assets in real estate, fixed income and equities re-pricing themselves we're seeing some volatility. That said, we believe that in the long-term, our aim of a 6 to 8% IRR is achievable and in line with a core real estate return.

What do you think are the biggest risks to a strategy like yours and to the ESG investment sector as a whole?

Achieving future impact is never a guarantee, and a critical aspect of our impact measurement and management framework is assessing drivers of impact risk, whether they be factors preventing the achievement of positive impact or the existence of known and unknown negative impacts.

In our assessment of impact, we look closely at the factors that may prevent us from achieving positive impact. We identify specific risks, identify the level of each risk (high, medium, or low), and suggest mitigation strategies when plausible. We map our top risk drivers for each asset to the nine categories of impact risk from the Impact Management Project.

Do you think the UN SDGs provide an adequate guide to sustainability?

I do think so, but it has to go beyond just alignment. UN SDGs are global goals to address the main issues in the world. They were not created to support investment strategies and do not necessarily provide a roadmap for how to achieve these goals, whether it's no hunger, good education good healthcare or clean energy. However, below the main SGDs are targets and below these are SGDs KPIs that can provide guidance to sustainable investment strategies. It is for each manager/investor to decide what it is that they would like to support and align themselves with and subsequently implement this via their investment strategies. We've just done that and have selected the targets within the seven SDGs that we align ourselves with and can contribute to via our proprietary impact measurement and management framework.

What impact will new regulation have on ESG funds and their viability?

Regulation is just coming into play, such as the Sustainable Finance Disclosure Regulation (SFDR) in the European Union. The regulation is designed to provide investors with more transparency on the social and/or environmental sustainability objectives of the various investment strategies and products offered in the market. While I believe that regulations such as SFDR are important and needed to provide guidance and standardization, it does come with some drawbacks. The regulation was not specifically created for real estate and therefore the interpretation and implementation of the regulation is not straightforward. It also comes with additional cost and time involvement to both investment managers and investors.

Is getting the right ESG data for your strategy an issue?

I think getting the right ESG data is an issue in every asset class, not just real estate. It's not just the sourcing and collection of the data, but it's also the standardization and comparability of that data. In the real estate industry, data needs to be collected from tenants, utility providers etc, and it is not always easy to get this information or compare various data sources. There is complexity but, personally, I believe some of that will resolve itself as generally accepted standards are set. For many of our KPIs, we tap into IRIS standard performance metrics, which are offered by GIIN (the Global Impacting Investing Network). Using the standards that are out there rather than inventing your own is part of how we move towards a broader acceptance.

For further information on anything you've read, please don't hesitate to get in contact with one of our team:

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All data as of 31 December 2022 unless otherwise noted.

1. Franklin Templeton was ranked first in the cross-border management group category by PwC in their 2022 Benchmark Your Global Fund Distribution Report, which ranks asset managers on the number of countries in which their cross-border funds are distributed.

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