ESG RISKS AND OPPORTUNITIES IN AFFORDABLE HOUSING INVESTMENTS

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The PRI's Fixed Income Case Study series highlights examples of interesting and innovative approaches to responsible investment. Written by fixed income practitioners from around the world, the case studies cover topics such as integrating ESG, negative and positive screening, thematic investment and engagement.

Sharing these examples will enable investors to collectively build a concept of emerging good practice. The PRI aims to publish a set of these short pieces every quarter. If you would like to learn more or contribute your own case study please contact us.

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WHY DO ESG ISSUES MATTER FOR AFFORDABLE HOUSING?

The investment opportunity of affordable housing, especially in emerging markets, is massive: the McKinsey Global Institute estimates[1] that construction investments of between US$9 trillion and US$11 trillion will be necessary by 2025 to replace today's substandard housing and build necessary additional units, and that an additional US$16 trillion will be needed for land. The growth of green bonds is further stimulating interest in socially-themed fixed income investments, including in sustainable affordable housing.

However, prominent examples of default, including in Brazil, China and Mexico, demonstrate risks for investors.

The affordable housing sector has wider relevance too: expanding credit and product access to lower income households underlies many impact investments, and broader financial instability has increasingly been linked to rapid credit expansion in real estate, which generates bubbles that create deep recessions and long, slow recoveries. Energy and housing policies in developed as well as emerging markets are increasingly prioritising energy- and location-efficient housing, focusing on the quality and the environmental footprint of housing development.

Environmental and social factors can also offer a useful lens on the robustness of a company's overall business model in emerging markets. Businesses in emerging markets, which often present challenges related to asymmetric information and low transparency, also generate specific ESG issues relevant for credit analysis. These include labour conflicts; regulatory instability or lack of visibility into regulatory evolution; weak minority shareholder rights; impact on lower income populations; and severe environmental conditions, such as pollution and drought. The general lack of material ESG disclosure complicates investors' ability to assess these factors from afar.

THE DEFAULT OF MEXICAN HOMEBUILDERS IN 2013

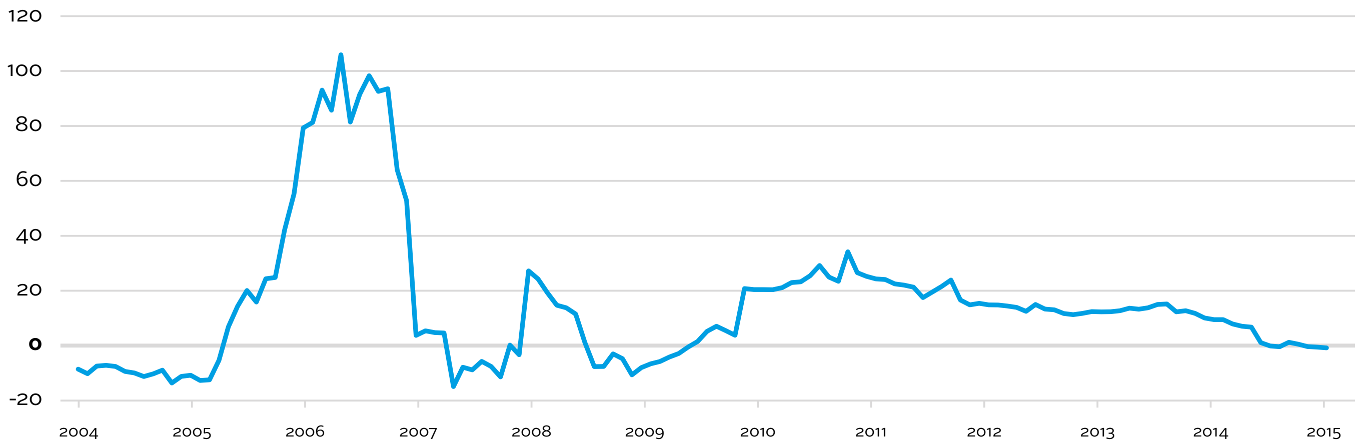
In the fourth quarter of 2013, Mexican homebuilders defaulted on approximately $2.7bn of public debt, issued in the US, that was widely held by both foreign and domestic investors. The business of developing housing communities in Mexico had appeared to be a robust, low risk growth story with state support and positive development impact – so what went wrong?

For a decade prior, the business models of these homebuilders were driven by:

- government mandates and regulatory action to address Mexico's housing deficit, which stood at over 12 million households in 2012;[2]

A surge in credit for low income housing helped drive homebuilders' business models.

Source: Bloomberg, Banco de Mexico. Mexico bank lending for low income housing, year on year % growth based on value of existing mortgages.



1 "A blueprint for addressing the global affordable housing challenge," by Jonathan Woetzel, Sangeeth Ram, Jan Mischke, Nicklas Garemo and Shirish Sankhe. McKinsey Global Institute. October 2014.

2 Agenda Estratégica Infonavit 2012." Infonavit. September 2012. Infonavit, The Workers' National Housing Fund Institute, the government agency charged with managing mortgage credits and other housing finance for formal sector workers, breaks down their survey of the housing deficit to various segments of the population.

- rapid growth in credit to the housing sector from government, development finance institutions (DFIs) and banks;
- expansion of mortgage lending for lower income homebuyers to meet pent-up demand and new demand from growth in new household formation ;
- acquisition and land-banking of low cost, undeveloped land on the outskirts of Mexico's cities;
- the use of industrial manufacturing techniques – new to Mexico and other emerging markets – to rapidly roll out large housing communities.

Although these factors underpinned the cash flow to pay bondholders, some companies' growth aspirations and the high demand for mortgage credit outpaced companies' ability to deliver. The regulatory landscape also began to shift in response to apparent challenges that were inherent to the business model of these homebuilders.

The challenges in Mexico's mass housing business model were on the public record as early as 2008. Public agencies and private NGOs highlighted social and environmental concerns such as urban sprawl,[3] lack of services and the large total carbon footprint from the rollout of thousands of single family homes, as well as their residents commuting hours to work without public transport.

The reliance on land banking far from city centres meant residents were isolated and beleaguered by poor services and increasing crime. Thousands of houses also lacked key infrastructure, including contracted security, power, drainage and water storage.

The government's stance on housing shifted clearly in 2010. Infonavit, the agency that extends subsidies and credit to workers for housing, acknowledged excessive sprawl, high levels of abandonment, crime and social dislocation and shortcomings in delivery such as lack of schools, health care and transport infrastructure. CONAVI, the Mexican Housing Commission, began to emphasise sustainable urban planning: green, resilient, well-serviced, mixed-income development closer to city centres. Housing subsidies were accordingly reprioritised.

Amid rapid growth and bright projections of future expansion, investors' capacity to assess potential extra-financial risks was compromised by the lack of reporting. Bloomberg's ESG Disclosure Score for these companies as of 2012 illustrates this, as the scores of three defaulted issuers were well below the Mexican average ESG Disclosure Score for that year of 23.9.

There was limited ESG disclosure among increasingly indebted Mexican home builders

Source: Bloomberg. The Bloomberg ESG Disclosure Score and its three sub-scores quantify a company's transparency in reporting environmental, social and governance data. The score is based on 100 out of 219 raw data points that Bloomberg collects, weighted to emphasise the most commonly disclosed fields. This weighted score is normalised to range from 0 for companies that do not disclose ESG data to 100 for those which disclose every data point collected.

Company	Default Amt ($mn)	ESG Disclosure Score	Debt/EBITDA	
			2012	2009
Urbi Desarrollos Urbanos SAB de CV	993.5	13.22	6.5	2.5
Corp GEO SAB de CV	738.5	7.85	4.1	3.1
Desarrolladora Homex SAB de CV	900	5.37	5.6	3.2

3 "La Expansion de las Ciudades 1980-2010," p. 8. SEDESOL. 2011. SEDESOL, the Secretary for Social Development, estimated that, between 1980 and 2010, the urban population in Mexico doubled, while the urban footprint grew on average 10 times.

With the new government of President Pena Nieto came a new National Housing Policy at the beginning of 2013 that advanced this shift in priorities. By this stage, the housing sector was already undermined by reputational, product delivery and service issues. The new framework devalued existing land banks of major developers and forced them to change their business models fundamentally in favour of denser, more capital intensive real estate development closer to city centres, as well as more consumer-oriented, climate-resilient and energy- and water-efficient housing products.

The change in regulation was the final straw. Several companies had already attempted to limit and diversify their exposure to affordable housing. ICA, an infrastructure leader, sold its low-cost housing business. Homex diversified into vacation housing and penitentiary construction. All faced the accumulation of reputational attacks, vocal protests from dissatisfied customers, the loss of market confidence and, finally, large salary arrears to staff.

Defaults and long restructurings that have involved major foreign investors are still being addressed today.

Homebuilder equity market performance was swamped by value destruction.

Source: Bloomberg. The Mexico Habita Index is a capitalisation-weighted index that measures the performance of the market's six home construction companies. The Mexican IPC index is a capitalisation-weighted index of the leading stocks traded on the Mexican Stock Exchange.