



New Foundations

**How will the UK real estate sector look
in 20 years' time?**



“What is the city
but the people?”

- Coriolanus



I Introduction

Shakespeare's Roman tragedy poses an important question, and one the real estate industry has not always considered, as it focused on style and scale ahead of the needs of individuals.

In the next 20 years, that balance will decisively tip towards the individual, as technology revolutionises the way we interact with the built environment. Both owners and occupiers will want very different things in 2036 - and greater connectivity will give them the power to make those demands.

Technological upheaval will create a number of challenges – and also opportunities - for investors, developers and landlords.

First, the industry will need to anticipate the very broad way in which technologies - some not yet even invented - will change the way people live, work and play.

Second, they need to get inside the minds of the millennial generation - those teenagers and young adults with their very different attitudes and habits - who in 20 years' time will be the most powerful group of homeowners, workers, consumers and decision makers in society.

Lastly, the industry must anticipate how the increasingly influential tech industry may disrupt the real estate sector, just as it is already shaking virtually every other sector. As Tudor Aw, our firm's Head of Technology asks: what is to stop the technology megaliths, with their deep pockets, disrupting our industry just as they are now disrupting the auto sector?

Inside this report, we have sought to interpret what these trends will mean for the real estate sector and to suggest how the most agile and innovative can respond.

I hope this report can play a part in shaping the real estate industry's response to the needs of the company and citizen of the future.



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Investors will have to work harder to make property pay



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Investors have long seen property as a safe haven. Bricks and mortar currently provides a relatively low risk environment for investment funds, as I'm sure the investors flooding into London property over the last few years would agree. The UK is short on space and there is plenty of demand from business and consumers. But 20 years is a long time. Increasingly flexible working and living models could make property a higher risk/higher return investment than it is today. Over the next two decades, changing technology, demographics and business requirements mean there will be a push towards shorter more flexible leases. Property is one of the major costs for many businesses – a workstation in central London currently costs £15,000 in annual rents, rates and service charges.¹ Reducing costs by using their space more efficiently is high up the agenda for many boards. Frequently this means being free to respond more swiftly to changes in demand.

Long-term, inflexible contracts can constrain business growth and agility

Today, landlords may feel insulated from risk during long lease terms, but there are a number of drivers leading to demand for a more flexible model. Responding to that need means greater risk for landlords who will require greater compensation in return. But organisations can still reduce their costs if they only pay for what they use, even if the rent per square foot is higher.

Start-ups and SMEs want the opportunity to grow in scale as their business expands. This is difficult if they are tied to long term, inflexible contracts. But not all companies will need flexible leases. If there is a core level of occupation, it will probably remain more cost effective for larger businesses to opt for a traditional long lease and seek flexible space on top of that core. Increased flexibility exposes investors to greater risk of voids, and technological change has led to faster rates of building obsolescence. Offices from as recently as the 1990s were not designed for a paperless and tech-driven workplace. It can be cheaper to tear them down and start again rather than reconfigure. But who

will be best placed to design the future workplace - the tech specialists or traditional developers? Only time will tell.

Investors must look ahead, not behind

The smartest developers are seeking to build flexibility into their business space. They have a tough job anticipating changes to their customers' businesses over the next 20 years, when those companies may not have thought that through themselves. Technology increases the possibility of remote working, but it should also unlock greater potential for different companies to share space as part of a mixed use development.

Some investors appear to be less focused on this prospective shift in the work and wider built environment, yet it is particularly relevant for those looking to hold a property portfolio over a period of 20 to 30 years. While they will think strategically about their investment, the risk is they view that investment through the lens of the last 20 years, rather than the next 20.

I would urge investors to consider the possibility of reduced need for office space, design in flexibility to adapt to future requirements, greater obsolescence driven by accelerating technological change, and the possibility of industry-wide disruption from new players entering the market.

Investors will have to work harder to think through possible disruptive changes in their real estate portfolio over a 20-year period. However, the outlook is still positive. With the development of large-scale private rental sector buildings, student accommodation and mixed-use property clusters, there will be some big opportunities for investors as well. They just need to evaluate the long-term sustainability of any opportunity and make sure they are compensated for the risk they take.

“I would urge investors to consider the possibility of reduced need for office space, greater obsolescence ... and the possibility of industry-wide disruption from new players.”

- Flexible working and living could make property a higher risk/return investment
- Smartest developers are building flexibility into spaces
- Investment decision no longer a simple question of condition and location



Large-scale private rental: a solution to our housing crisis



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When he's not at KPMG, Bill enjoys playing cricket and time at home in Hampshire.

Where will people, who are young today, live in 20 years' time? According to a report by the Resolution Foundation, just one in 10 young, lower-income households will be property owners in a decade's time.² I have little hope our industry will suddenly find the means to double or triple production to the level needed to address this issue, meaning that things are only likely to get worse. We must look for answers elsewhere.

The best long-term solution in my view lies in the private rental sector (PRS) – not today's fragmented and insecure market – but in large, purpose-built developments overseen by a large single management company. This model offers tenants greater quality of product and flexibility of tenure, but can the British change their aspiration to own and their antipathy towards renting? I believe we will witness such a shift in the next 20 years.

Ownership becoming a pipe dream

First, the British yearning for home ownership – in part driven by ever-rising prices³ – will wane. The desire of Londoners to own their own home may already be burning a little less brightly given that 39% of them were born outside the UK (presumably in countries that are more relaxed about living in rented homes?).⁴ Secondly, the sheer impossibility of buying a house - twinned with the millennial generation's desire for greater flexibility - will lead many to abandon the idea of owning altogether.

What is stopping more embracing the rental market is not only the aspiration to own, but the unappealing prospect of renting. According to a 2014 Countrywide survey, 81% of the UK's rental stock is owned by landlords who own just one property.⁵ The result is a huge variation in quality, insecurity of tenure and widespread fear of rent hikes.

We require an attractive alternative, and I believe the entrance of serious investors to finance a substantial number of large-scale PRS apartment buildings will offer that alternative.

A more flexible approach to housing

Developers are already looking to create PRS apartment buildings that offer quality accommodation and low cost services harnessing economies of scale. Serviced blocks in central urban locations, close to places of employment, with gyms, social spaces, dining rooms, in-house cleaning and laundry facilities chime with the way more young people are living.

Renting also provides the flexibility needed for what will be a more mobile workforce. A system that would allow you to leave one PRS building in Bristol and find a place in another owned by the same company across the other side of the country offers just that sort of flexibility.

Communal serviced PRS buildings do not just work for millennials. They could equally provide a sense of community for the retired. Taken to the extreme you could see private rental housing estates, designed for families, although I do think urban blocks are where we are likely to see most development in the next 20 years.

PRS will echo rise of student accommodation

With a greater proportion of housing stock being rented, I believe more residential properties will be valued on their potential rental income and the level of services they provide to tenants, rather than its straightforward sale value. That could in turn help regulate house prices. I suspect PRS will echo the journey of student accommodation, which has transformed into an increasingly organised sector and one that is extremely attractive to institutional investors.

Investors are already showing interest in PRS in the UK. That is starting to go some way towards solving the issue of housing supply. While it may take a generation to shift the British mind-set away from wanting to own your home, a high quality, flexible and service driven product that answers the needs of many young urban dwellers would make renting a far less bitter pill to swallow.

“Serviced blocks in central urban locations with gyms, social spaces, dining rooms, in-house cleaning and laundry facilities chime with the way more young people are living.”

- British obsession with owning a home will wane over coming decades
- Large-scale rental blocks to offer a real alternative to ownership or patchy rental market
- Serviced PRS buildings chime with demands of millennial and other groups



Landlords must rethink revenue as tenants get smart about space



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Landlords priorities are bound to shift markedly over the next 20 years, but one sure constant is their ever-present focus on location. Indeed the pressure on prime urban locations will only increase in my view. That doesn't necessarily mean endlessly spiralling rents. Data and analytics will allow more efficient sharing of space and lower costs for occupiers, while creating more income streams for landlords.

Soon factories, retail units, warehouses and offices will be filled with smart technology that monitors the precise use of data, energy and resources. Companies will pay for their specific use of services within the space rather than being tied into fixed leases priced on areas. More efficient use of space will reduce the floor space requirements and free businesses, from not only the expense of managing estates, but also any ancillary services

Property as a service

Property owners have three potential, interconnected income streams to offset reduced space usage and extract maximum value from their buildings:

- They can provide services like data analytics, advertising, automated support services, processing power, catering, laundry, and wider integration into other services (groceries, driverless taxis etc.);
- By analysing the use of their buildings they can open up any unused space to multiple users (who will also make use of these extra services) and drive up occupancy/utilisation rates;
- Landlords can collect and – with the requisite permissions - sell data on a building's occupants, such as information on their habits and needs.

In short then, property will become a service, rather than a space. Serviced office models are just the beginning of this trend and specialist companies will emerge to scale up and manage these income streams.

These might be joint ventures between existing property owners and technology providers, but I don't see this being tech-company led: property owners still own the title deeds and that gives them ultimate control.

In logistics, the revolution is already happening. A big divide exists between warehouses in prime locations that fit modern requirements around automation and warehouses that, due to their size or specification, are no longer viable.

In the near term, technology focused specialists will emerge who provide an integrated warehousing and logistics model, freeing retailers of the need to even think about this aspect of their business. This is not a new concept, some of the biggest online retailers have used this model for years.

Shop or data hub?

I suspect retail property will be the next to move to a service model. Shops are a treasure trove of insights and access to people, and are going to become concentrated data analytics hubs. The physical store will be able to recognise customers as they enter the space, track and target them with specific advertising and offers, and tailor their experience. Retailers themselves will not want to invest the necessary capital in this technology - the best retail landlords will offer this service as part of their rental agreement. Free Wi-Fi on Regent Street is just the start of this revolution.

In urban areas then, the new model of 'property as a service' holds true for all sectors. The downside will be increased rates of obsolescence in commercial property that is located in the wrong place or lacking the necessary services built in and where retrofitting is not cost effective.

One solution for landlords is to find alternative uses for buildings that reflect this new trend: something the government is already fostering by removing planning requirements for the conversion of office buildings to residential. In some respects, this is nothing new - the warehouses of Victorian times today make up some of London's most desirable flats. In this instance, as in every other sector, the same rule will apply: the building of the future will need service supplied as standard.

"Shops are a treasure trove of insights and access to people, and are going to become concentrated data analytics hubs."

- The demand for prime urban location is not going to change in the next 20 years
- Property will be about service rather than a space
- Poorly located or laid out buildings will need repurposing or become obsolete



Retail: a tale of two high streets



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Do not believe the naysayers: retail property will still be flourishing in 20 years' time, despite the inexorable rise of the online shopper. Where we will notice the difference is in just how different prime and secondary locations will look and feel in 2036. The latter in particular must transform itself to survive.

Online will drive a much more concentrated store network across all retail sectors. Rather than having large numbers of outlets, retailers will look to consolidate their presence in a few large stores. The emphasis on consumer experience and brand will permeate the future retail landscape.

The rise and rise of the mall

In an omni-channel world, retailers will need to focus on creating a consistent brand experience across online, mobile and in store. People may pre-order online and pick up goods in store or try on clothes in store and order online for delivery later.

Stores will either be concentrated in a mall environment, where they are already connected to leisure opportunities or themselves will provide leisure facilities like cafes, chill out zones or children's entertainment.

We are already seeing indications of a consolidation trend. Vacancy rates in shopping malls in the UK have fallen steadily over the last nine months⁶ and demand is particularly high for units in super-malls such as London's Westfield. In that sense, the UK retail environment is only catching up with where the US and Australian models already are - large malls that provide a leisure experience in a single, comfortable environment for customers.

Prime units on major high streets or malls then will remain attractive to investors, despite their relatively low yields. In secondary locations, the growth of online will inevitably lead to fewer physical stores.

Secondary and tertiary locations will have to adapt to survive. High streets need to become more of a lifestyle or leisure destination, offering their own, quite different

experience. Gyms, bars, coffee shops and restaurants could take the place of empty retail units.

A new role for the high street...

This is not to suggest the end of the traditional high street. High-quality specialist retailers will still play an important role - people will always welcome a good new restaurant or want the feel and touch in say, a jeweller. Pop-ups are likely to increase, as retailers trial products without wanting to commit to long leases. In fact, even large retailers are likely to demand a greater number of short, flexible leases to operate more flexibly as tastes and fashions change.

Other units could be part of a wider logistics hub. The biggest online stores are already developing drop off and returns points occupying retail units in towns and cities across the UK. Logistics companies are also investing in warehousing in a 'hub and spoke' model with one major central storage facility and multiple smaller warehouses in sites close to customers' homes.

Revitalising struggling areas will be a challenge. In some cases, they will be ripe for redevelopment and conversion into prime areas. Others may fare better if converted to residential property. Given the pressure on housing, I would not be surprised to see further relaxation of planning laws to allow this.

... But local demand won't disappear

Enlightened councils, planners and landlords can succeed in turning things around if they collaborate. One of the biggest advantages shopping malls have is that they are run by a single landlord without the competing interests of say shops wanting free street parking and councils wanting less congestion or car park charges to boost revenues. There will always be demand for local services and leisure facilities and high streets can provide that experience if they develop a holistic approach and if all stakeholders work together.

Where does the supermarket fit into this picture? I suspect that we will see far fewer in 20 years' time, except where they are anchor tenants in malls or clustered with other retailers. Don't worry about finding that pint of milk however - convenience stores are set to remain a fixed point in the retail firmament.

"There will always be demand for local services and leisure facilities and high streets can provide that experience if they develop a holistic approach."

- Retailers will concentrate on fewer but larger stores
- Large and small retailers to demand shorter, more flexible leases to react to changing tastes
- Traditional high streets will need to reinvent themselves to survive



How to build for the millennials and beyond



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Millennials - those born between the late 1980s and early 2000s - are the first truly digital generation. Accustomed to communicating continuously across multiple platforms, with a life lived both on and offline, they demand greater flexibility from their work and living arrangements. They will have less call on traditional office and residential space and will expect the freedom to move at a moment's notice. The property industry is yet to catch up with the demands of these digital natives.

Catering for this generation will require a new approach. Millennials are happy to check emails at home and social media at work, don't delineate between work and home as previous generations might have, and focus on experiences rather than possessions. They are global citizens who aren't tied to specific locations, career paths or life plans, and who take their online networks with them wherever they go. By 2019, they will number 17million – one in four of the UK population.⁷

Space and place

Sharing space is essential to this generation – whether by need or design. They are part of the new sharing economy - 81% of millennials in London have said they would advertise their property on Airbnb or LoveHomeSwap - not something that many developers think about.⁸ Equally, developers building private rental blocks must recognise that communal, shared space is incredibly important to young people because that's where the physical connections happen, whether that be on a roof terrace, a bar or in a communal dining room.

Location remains important to millennials, but they are less concerned about proximity to a transport node than proximity to work. In the next 20 years, driverless cars may reduce the need to live near to a station. Millennials will continue to seek homes within lively city centres. While current and projected housing costs in London make that a pipe dream for a large proportion, other UK cities are well-placed to respond to this demand.

Working patterns are more fluid for this generation too. The design of workspaces will need to acknowledge the blurring between personal and professional lives. People are increasingly demanding mixed-use environments, providing access to a gym, convenience shopping, eating out and socialising, as well as interaction with colleagues.

Forget long leases

Millennials are a generation of problem solvers, more comfortable creating start-up businesses where they see inefficiencies or a market that does not work for them. Think Uber or Airbnb. It is only a matter of time before this spirit and ease with technology influences the development and possibly funding of property as well as current occupier models. The restriction of a long-term lease may not work for a business that is looking to grow quickly as it collaborates with a new partner before returning to its previous size at the end of a project.

Already known for their propensity to job-hop, the millennial generation will require fewer formal spaces in which to work. At ease with portable devices, they feel comfortable working anywhere. Where workspace remains important is once again in forging those connections - offering somewhere to meet, collaborate and interact. These new collaborative spaces are already in evidence across the UK, for example the models provided by Workspace and WeWork.

The level of connectivity between millennials only strengthens their confidence and provides a platform for them to quickly influence consumer choice, through sites like TripAdvisor, as they expect ever-higher levels of service. Their online existence makes them a power as consumers that previous generations lacked. Take retail: if stores are to exist at all in 20 years, they will need to become places that provide an experience and excellent service.

Leading retailers seem to be responding to that challenge by creating businesses focused entirely towards service excellence. I fear that so far, too few commercial developers have begun to follow their lead.

“81% of millennials in London have said they would advertise their property on Airbnb or LoveHomeSwap – not something that many developers think about.”

- The property industry is not yet tuned into the millennial mind-set
- Workspaces must reflect blurring lines between personal and professional lives
- Millennials will demand spaces to interact and collaborate, not work stations



The office is dead. Long live the office



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A graduate of the University of Wales, in his spare time he coaches at his local cricket club.

Rising rents in prime city centre areas are forcing businesses to review their property strategy. Large players like HSBC are moving some operations outside London as rents climb in the capital.⁹ As work patterns change, the demand for more flexible, short-term leases at reasonable rents has never been higher. The answer is a move to a new kind of office that is flexible and service-led.

Inefficient use of office space is a huge cost for companies. Small-to-medium enterprises in particular value agility and the ability to flex their space as the business grows. In fact, over 70% of SMEs rated flexible and shared office space as a priority in a recent survey.¹⁰ Long leases that tie business in to a particular building, with rent reviews that only go one way, do not give them that flexibility.

Shared service offices will be the new normal

Technology has changed the way we work over the past 20 years. The value of being physically present in an office today is in meeting with colleagues, creating the sense of a team, collaboration and the exchange of ideas rather than 'head-down work' - the latter can be done anywhere. As the proportion of people working remotely or at different times rises in the future, companies' need for fixed office space will naturally diminish.

Predictive modelling already allows companies to analyse what space they actually require - when staff are in situ, for how long and for what purpose. Rather than renting space for ghost workers, one answer is to share it. Shared serviced offices for smaller companies have tripled in number in the City of London over the past 20 years, and I think that this trend will continue.¹¹ However, the operating model existing today fails to address the needs of larger companies.

I believe we will see a new model, in which the landlord rents out core office space to a company, with a

much smaller footplate than today. The rest of the development would be dedicated to services - creating a 'village' with retail and leisure space for office workers to use during the day and the public in the evening and at weekends.

Rents based on use

This new model would also have more flexible lease terms, reflecting actual usage rather than square footage and length of lease. While increased flexibility might not sound an attractive idea to landlords, companies' demand for flexible, serviced offices will force this change in approach.

It is not all bad news for property owners. They can offset their risks by expanding the use of the space to a mixed-use office, retail and leisure development. Real estate owners could offer more competitive office rents by boosting their income from other leisure and retail businesses on site.

The lure of such a captive market of office workers is obvious for retailers and leisure businesses. Already a number of independent coffee and food concessions operate within office buildings around the UK, as do independently-run gyms and bars. In universities, we are also seeing the development of entertainment services such as cinemas. Why shouldn't landlords extend that trend to the office?

There will always be a need for some traditional workspaces – I am not forecasting the end of the office as we know it. Some large companies will continue to want their own signature buildings to help project their brand image. However, changing work patterns also mean that the office needs to be a collaborative community where people want to spend their time - not a workhouse. A shared, service-led model provides this village-feel, while reducing costs and allowing businesses greater flexibility. The old office is dead. Long live the future office.

“The new model would have more flexible lease terms, reflecting actual usage rather than square footage and length of lease.”

- Companies will reject the large office footplate in favour a space-sharing model
- Landlords will be forced to charge tenants on usage rather than space or lease length
- Mixed use offices with concessions offer expanded revenue opportunities for owners



No sector is an island: property companies face digital disruption too



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Real estate has so far avoided the disruptive effects technology and digital models have wrought to virtually every industry. Not for much longer. Tech companies will move onto property companies' turf in the intensifying battle to 'own' the customer and their data from connected homes, offices and retail spaces.

Traditional property developers need to grasp the implications of this shift. Today, buying, leasing and rental decisions by customers continue to be driven by traditional factors such as cost, location, build quality and architectural design. Going forward, customers will be more influenced by the technology in that property and the way it is updated.

Property must learn from automotive's mistakes

Tech disruptors move fast, have deep pockets and are looking for the next investment frontier. Property companies would do well to learn the lessons car makers failed to in the 1990s. Take Tesla: in 10 years the electric vehicle maker has grown from a start-up to a \$20billion business, led by a visionary technologist rather than a car industry veteran. Its unique selling point is its technology rather than the horsepower under the hood.

From smaller car park spaces for driverless cars and drone landing pads, to online services that manage your energy use or insurance premiums, everything about smart buildings is enabled by technology. I believe a property's value will directly relate to the level of technology within it and the way this is managed and upgraded. Right now, technology companies are best placed to deliver that value and service.

While many commercial developers are already looking to add tech into their developments, they may still face disruption, and even extinction, given the likely speed of change. In 20 years' time, the operating system of your building will probably update every few weeks, much

like your smartphone does today. Tech companies can deliver those constant upgrades far more effectively than property companies. Buyers are more likely to trust a tech innovator to deliver and update leading edge technology than a traditional builder. Wouldn't an 'Apple or Google Home' seem more appealing?

Who owns the customer now?

Tech companies have another advantage: their experience of fast-moving business models and the ways they can monetise value. Unlike property developers who focus on an upfront, one-off sale, tech innovators have alternative approaches, including low-margin equipment sales, supplemented by ongoing service revenues and royalties.

Tech companies will seek to 'own' end customers by offering cut-price properties and then offering premium rated services such as health monitoring or collecting data they can monetise. Smart building data will become an extremely valuable commodity.

Transplanting the tech business model into property could have a major impact on prices. Given the numbers of people struggling to buy today, lower upfront costs on the 'hardware' – read bricks and mortar – would appear particularly attractive and would undercut traditional players.

Then there are those deep pockets. Apple and Google together have over \$200 billion in cash - a wall of money waiting to be put to work. They and other tech firms can easily afford to buy land and subcontract construction, installing their own technology to generate revenue from the data. And it's not just new-builds - they could easily retrofit existing properties.

Rethinking R&D and strategy

Much of that revenue could come from providing Connected Home services such as security monitoring, healthcare systems, utilities monitoring, predictive analytics and home delivery services. Technology companies owning smart houses, or offices, powered by apps can charge a fee to the developers of those apps in return for access to their property portfolio - much in the same way they already take a cut from app providers on smartphones. They would also take a cut of the usage fees charged to occupants.

If they want to compete, today's property companies need to think about developing and managing technology themselves, not just buying it. Investing in technology companies or rethinking their people strategy to bring in more tech specialists would be a good start. How many property companies can currently claim to have a Head of Virtual Reality? Investment in R&D and keeping up with the latest in cyber security, virtual reality, connectivity and smart technology will be vital if they are to avoid being left behind.

Smart homes will require smart management.

- Like automotive, property developers face major challenge to their business model
- Buyers will place greater emphasis on tech inside buildings and the way it's updated
- Tech companies have a 'wall of money' waiting to be put to work



| Footnotes

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