Look back face forward

A review of 2019 and our predictions for 2020

January 2020

kpmg.com/uk/realestate

Introduction

2019 has undoubtedly been a much slower year for many real estate players. Whilst investor sentiment remains largely positive about the UK property market, Brexit and wider political and economic uncertainty have put a noticeable dampener on deal volumes. However KPMG professionals have found that this has been driven partly by a lack of opportunities, and while some investors have been reluctant to deploy capital during this period of uncertainty, our teams remained active throughout 2019 helping our clients transact. With an abundance of dry powder and available debt in the sector, it looks likely that the recent election of a majority government could provide enough certainty for an uptick in deal activity in 2020. What remains to be seen is how long that certainty will last as the government starts to negotiate new trade relationships.

A key theme we have noticed this year has been owners of real estate seeking to monetise their assets. Sale and leasebacks have been on the rise as owner-occupiers look to free up capital, and developers benefit from exiting whilst keeping the asset and operating business. There has also been a significant increase in refinancing over the last twelve months, whether that's as a result of holding onto assets for longer in order to deliver real estate allocations at a time when it has been challenging to redeploy capital, to protect value, or to fund growth. Real estate players have also sought to utilise and deliver uplift from surplus space.

Much of this fits in with the wider trend of investors introducing more opportunistic elements to their strategy, with many seeking to access and build out platforms that can identify, develop and operate assets. We expect this trend to continue as investors increasingly seek to build businesses, rather than simply buying and renting bricks and mortar.

The retail sector continues to struggle amidst ongoing structural changes and challenges, and 2019 has seen this distress increasingly translating to the retail landlords themselves. There is no sign of a reprieve in 2020 and there will likely be some distressed opportunities coming to the fore over the next twelve months. The challenge will be in finding buyers who are either comfortable that values have bottomed-out or that they have the tools required to successfully reposition schemes to ensure their long-term success.

Operational assets on the other hand continue to go from strength to strength. Build to rent has had a stellar year and other more alternative residential sectors are seeing increased attention. Senior living in particular has been on the radar of several real estate players and we expect that trend to continue into 2020. Co-living remains a niche but active sector, and despite turmoil for some high profile players in the co-working space we expect this sector to continue to flourish due to the level of demand for flexible and serviced offices. A number of players are entering this market and there will likely be some consolidation in the coming year.

Technology, innovation and disruption continue to rise up the real estate agenda. Property organisations have been reassessing their businesses as they look to adopt a more agile, customer-centric and technology-enabled approach, and we expect this to gather further momentum in 2020.

We also anticipate that economic, social and corporate governance (ESG) factors will continue to play an increasingly more significant role in decision making, both in response to customer demand and an acknowledgement by the industry of its importance.

Andy Pyle

Deals Board

KPMG in the UK advised on a number of landmark UK and European deals across commercial real estate asset classes in 2019.

InterContinental Hotels Group

Advised InterContinental Hotels Group on their acquisition of Six Senses Hotels Resorts Spa from private equity fund Pegasus Capital Advisors for US$300m million. The sale included the management of 16 hotels and resorts, 37 spas and sister companies Evason and Raison d'Etre. Following the acquisition Six Senses is now expected to grow to 60 hotels within the next 10 years.

Sekisui House

Advised Sekisui House on their acquisition of a 35% equity stake in Urban Splash's modular House business. Sekisui House is Japan's biggest housebuilder and a pioneer in modern methods of construction, where homes are built off-site in factories and then shipped to developments. This marks a decisive move into the UK housing market for Sekisui House and is viewed as a boost for the sector. Homes England have also contributed £30m of debt and equity via the Government's Home Building Fund.

Walker Group

Advised family housebuilder Walker Group on the sale of the company to Springfield Properties PLC. The group will retain the Walker brand, as well as their Livingston premises and 50 staff, with the acquisition enabling Springfield to strengthen their foothold in East Central Scotland.

AXA Investment Managers – Real Estate

Advised AXA Investment Managers – Real Estate ("AXA IM – Real Assets") on their acquisition of NYSE-listed real estate investment trust NorthStar Realty Europe Corp. ("NRE"), via the merger of NRE into a wholly-owned subsidiary of a fund managed by AXA IM – Real Assets. The acquisition provides AXA IM - Real Assets with immediate access to a €1.1 billion, 122,000 sqm (1.3 million sq ft) portfolio of modern, prime and well-located office space in key European cities within Europe's three core markets of Germany, the United Kingdom and France. The Portfolio also includes two hotels in Berlin which total 334 rooms across 12,000 sqm.

Logicor

Provided due diligence and tax structuring advice to Logicor on their refinancing through the placing of £900 million secured fixed rate notes. The notes are secured against 64 prime logistics properties within Logicor's UK warehouse portfolio.

Bargate Homes

Advised the shareholders of south of England housebuilder, Bargate Homes, on the sale of the company to housing association VIVID. Both businesses will retain their own identity and Bargate will continue to operate independently.

17 Columbus Courtyard

Advised Macquarie, Sun Hung Kai Financial and DPK on their £110m acquisition of Credit Suisse's Canary Wharf office at 17 Columbus Courtyard from HNA Group.

Vita Student

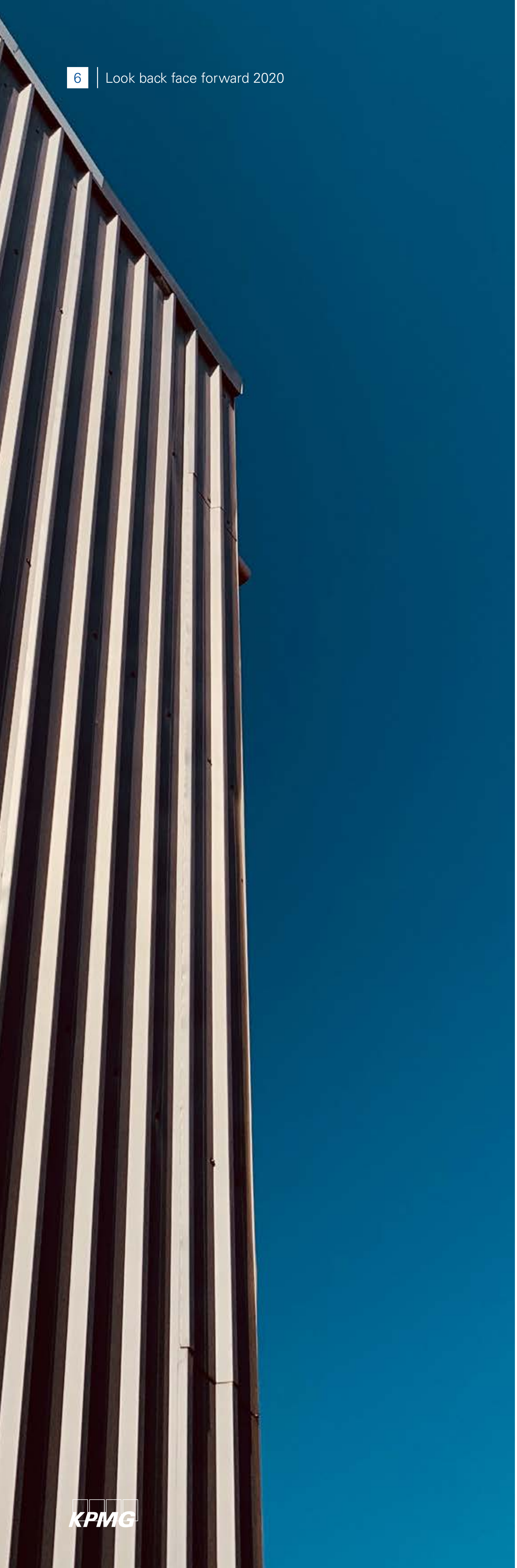
Advised Vita Student on raising c.£90m of financing to support the development of two premium purpose built student accommodation (PBSA) assets in Nottingham and Leeds.

Retail owner

Supporting a large retail mall owner with the renegotiation of its debt facilities.

London & Regional Properties

Advised London & Regional Properties on the sale and leaseback of their Atlas Hotels portfolio. Atlas Hotels is the largest group in the London & Regional Hotels portfolio, comprising 50 hotels located throughout Scotland, England and Wales.



Investor sentiment

2019 has undoubtedly been a slow year for commercial real estate (CRE) transactions in the UK. Real Capital Analytics (RCA) data shows that the first nine months of the year saw £32 billion invested in UK CRE – the slowest nine-month period since 2013. With the general election dominating much of the end of the year it is unlikely that Q4 will have deviated significantly from that trend, albeit there were some chunkier deals at the end of the year which should have bolstered the last quarter relative to the first nine months of the year. Q3'19 also saw Paris overtake London as Europe's most active property market, although the difference between the two is very marginal. This was due both to the strength of the Paris market (up 23% Y-o-Y) and a slowdown in London (down 32% Y-o-Y).

Buyers are still there for the right opportunities

However it is not all doom and gloom for the UK CRE market. It's clear that when well-located prime assets have come to market there has been keen interest and competition has often been fierce, particularly for larger deals. Alternative operational assets are continuing to attract a range of investors – logistics remains very active, build to rent has had a stellar year, and there are currently a number of interested buyers for a large UK student accommodation portfolio. Whilst the retail sector has clearly had its struggles, occupier demand for office space has remained robust and so far we have not seen signs of a max exodus out of the capital due Brexit. What could be interesting next year is how demand for office space is impacted by the changing fortunes for WeWork – a significant slowdown in their expansion, or indeed a scale back of their footprint, could well be felt in markets where they have been taking up space at a rapid rate until now.

What is clear is there isn't a lack of investors looking to deploy capital in the sector. There is an abundance of dry powder targeting real estate globally – the INREV 2019 Capital Raising Survey suggests a record €161.7 billion of capital was raised for real estate investment globally in 2018, there were numerous examples of significant fund raises in 2019, and many institutional investors are increasing their allocations to real estate. South Korean investors in particular have been very active in the sector, although generally continental Europe benefited more from this than the UK in 2019. Although Brexit and wider political uncertainty have cast a shadow on activity in 2019, it is expected that UK CRE will benefit from this weight of capital as the market picks up following the general election result. Investors continue to be attracted by the UK's transparency, strong occupational markets, attractive pricing compared with other developed markets such as elsewhere in Europe, and reputation as a hub for talent. Furthermore, it is a familiar market that investors are comfortable with and many have existing operations in the UK, with the European headquarters for investors from outside of the continent often located in London. While some clients have pressed 'pause' on their UK investment strategy during 2019, KPMG professionals are hearing from clients that the key issue slowing their deployment of capital in the UK has been the difficulties sourcing opportunities.

Similar dynamics can be observed in the CRE debt markets. There is an abundance of capital available for borrowers, from the traditional bank markets, debt funds, institutional lenders and pension funds. The year has seen an increase in the levels of ESG capital available to the sector as lenders utilise their social capital to support energy efficient projects and buildings, often with a pricing benefit available to the borrower. Something to watch in 2020 is the continued impact of tighter regulation on the UK banking market, which is likely to require UK borrowers to further diversify their options towards having more international banks and institutional lenders on their roster. The clearers will remain a critical plank for UK borrowers though, as they provide a wider range of services to corporates that the international banks are not currently set up to provide in the UK.

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Wait and see approach dampening activity

Given the market conditions during 2019, owners that do not need to sell have been tending to hold onto to assets in the expectation that they will achieve a better price once the political landscape stabilises. Investors are also holding onto assets in order to maintain allocations to real estate – as mentioned in the monetising assets chapter, many are taking the view that they may have difficulty re-deploying capital and are therefore opting to refinance or redevelop rather than sell.

There is some expectation in the industry that the election of a majority government and signing of a Brexit deal will spur on a flurry of deals as political and economic certainty is restored. However the signing of a deal is only the first step in a long process of separating the UK from the European Union, and establishing new trade deals and relationships. This will take time and meanwhile the threat of a no deal exit at the end of the 2020 transition period still looms on the horizon, and the strength of the Scottish National Party north of the border will no doubt spur on talk of a second independence referendum. Some may be heartened by the size of Johnson's majority and the flexibility this may allow him when it comes to negotiating our post-EU relationships, but if politics has taught us anything over the last few years it is to be prepared for the unexpected.

As we have already seen with fluctuations in the financial markets since the election result, this new sense of certainty is fragile. It will be interesting, therefore, to see to what extent the expected uptick in UK CRE deal activity delivers, and how long for. It could well be that the renewed confidence of the first half of the year is short-lived as the realities of new trade deals becomes clearer.

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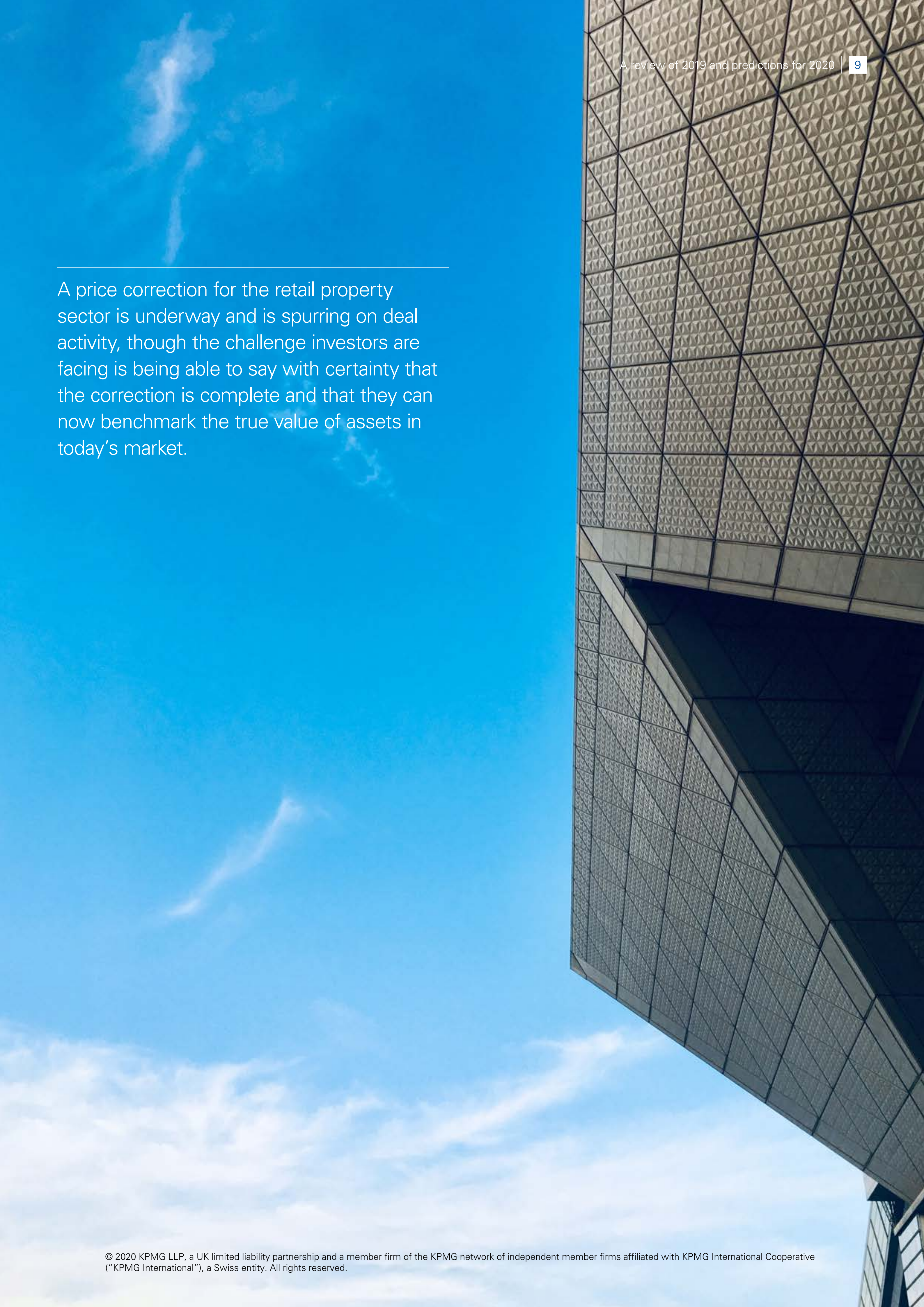
Key challenges remain for certain areas

Retail property in particular will be one to watch next year as occupiers continue to struggle with ongoing structural changes and Brexit uncertainty. Retailers will be paying close attention to how our new trading relationships will impact their supply chains for example. There is unlikely to be any let up for struggling retailers as we move into 2020, which could well lead to further distressed retail asset sales coming to market. A price correction for the retail property sector is underway and is spurring on further deals, though the challenge investors are facing is being able to say with certainty that the correction is complete and that they can now benchmark the true value of assets in today's market.

There could also be some interesting months ahead for property funds, particularly if there is further instability. As discussed, the underlying fundamentals of the UK CRE market remain strong and the overall expectation is that the long-term prospects for the sector are positive, but this may not be enough to reassure nervous investors or regulators. There can be a herd mentality in the retail fund market when it comes to investing, which could prove difficult for open-ended funds invested in real estate if there is an unexpected surge in demand for redemptions. The idea of daily access to a fund invested in illiquid assets such as real estate is a complicated one, the challenges of which were highlighted when a number of open-ended property funds were forced to suspend trading in the wake of the Brexit referendum result in 2016 and a flood of investors sought to withdraw their cash. The Financial Conduct Authority has since addressed this concern with enhanced guidance, but it is likely to receive further attention in future, particularly with more fund suspensions at the end of 2019 and a recent Bank of England report. We could well see an evolution of the product on offer here, where access to funds is better aligned with the liquidity of the assets they are invested in. At the very least, fund managers need to undertake a thorough review of their liquidity risk management processes.



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Monetising assets

It is hardly surprising that in the current market conditions KPMG professionals have seen a rising trend over the past twelve months of owners of real estate looking to monetise their assets. Whether that be through refinancing, sale and leasebacks, or making use of surplus space. There are a number of reasons for this, and the driving factors will vary – for example it may be cost-saving pressures, the need to look for alternative sources of cash (either proactively or reactively), a subdued transactions markets, favourable borrowing conditions, or a combination.

A rise in refinancing

There is clearly an abundance of dry powder in the real estate investment sector – the INREV 2019 Capital Raising Survey suggests a record €161.7 billion of capital was raised for real estate investment globally in 2018, and there were numerous examples of significant fund raises in 2019. However, investors have struggled to deploy this capital in recent times as some sellers have adopted a wait-and-see attitude in bringing assets to market. Competition amongst buyers has often been fierce when assets have become available, particularly where there have been opportunities to deploy large amounts of capital.

Many of the largest global investors are now building businesses, rather than simply buying and renting bricks and mortar.

As such, investors need to consider their ability to maintain allocations to real estate when reviewing their existing portfolios as there may be limited opportunities to re-invest the proceeds of a sale.

We have seen an increasing number of investors hold investments longer than would have been the case previously, transforming these portfolios while doing so through partnering with different types of skills and talent. For example, most global investors KPMG professionals speak to have introduced or are introducing more opportunistic elements to their strategy, with many seeking to access and build out platforms that can identify, develop and operate assets.

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The price sellers are able to achieve is also something to consider when weighing up whether to sell, redevelop or refinance. In some areas of retail, for example, some landlords are opting to review their financing options in order to hold onto and revisit their strategy where assets have been subject to negative value movements.

Aside from these driving factors for investors, refinancing has also become an attractive option due to the availability and cost of debt. Interest rates have remained persistently low, both in the UK and further afield. , and though the first half of 2019 saw predictions of a rate rise in the UK it now seems just as possible that the next change could see a cut. There are also a range of debt providers available, with alternative lenders continuing to enter the market. There is a significant amount of dry powder here too and also availability of higher leverage for those that want to utilise it. As we've seen over the past twelve months, making predictions in the current climate is not easy, but if market conditions remain similar over the next year we expect refinancing to continue to be an attractive option for investors with the right assets and/or the right strategy for delivering growth.

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Releasing capital through sale and leasebacks

The number of sale and leasebacks KPMG professionals are seeing has also increased across the sector this year. Owner-occupiers such as corporates are using sale and leasebacks to free up capital to invest elsewhere in the business, or to reduce existing debts. This is not a new trend but, following accounting changes that gave pause for thought, it is becoming more commonplace, particularly as businesses value cash over 'accounting' and review their property portfolios and seek efficiencies in what is often a wider organisational transformation. Developers are also using this method of releasing capital as it allows them to effectively exit whilst keeping the asset and operating businesses. For example, KPMG professionals have advised a number of hotel organisations on the sale and leaseback of both single assets and portfolios. It can provide an attractive proposition for investors looking to purchase assets with an established operator already in place. It's also fair to say that the range of different long income options and flexibility of them is increasing, which allows investors to take varying degrees of asset ownership and financial risk.

Interestingly, KPMG professionals have seen more examples of sale and leaseback of development sites recently, where the finance provider is effectively funding the actual development. There is clearly a risk factor for the funder is take on here, compared with buying a completed building and stabilised income stream, but the risk/reward profile seems to fit for a number of funders. This is perhaps due to the wall of capital looking for a home in the real estate sector, with investors having to be more flexible and explore alternative opportunities in order to deploy this capital.

Making use of surplus space

As mentioned above, many investors are shifting strategies and taking a more opportunistic view on their portfolios. Whether through partnering or through building their own platforms, KPMG professionals have seen many clients seek to utilise and deliver upside from surplus space: whether through selling land strips; developing bolt-on space; or through developing alternative use buildings that drive value-uplifts through place-making.

Changing demands for space have presented both opportunities and challenges for landlords. In particular, the rise in occupiers seeking flexible office space has seen a rapid expansion in this previously niche sub-sector. As noted in last year's Look Back, Face Forward report, this demand is coming from both small and medium-sized enterprises (SMEs) and large corporates, attracted by space that provides the agility to scale up or down. Working from home is also on the increase as businesses seek to reduce their office footprints and provide employees with a better work-life balance, which in-turn is driving a rising interest in co-working space.

A number of real estate players have been capitalising on this trend, with a rapid rise in the number of flexible office providers in recent years as well as some traditional office landlords establishing sub-brands in this space. However a more recent trend emerging is landlords repurposing vacant or under-used space to provide flexible working and meeting solutions. Hotels, for example, are increasingly monetising their communal spaces. For some this is simply through informally allowing workers to set up their laptops in lobbies, in the same way that cafes have traditionally done for some time, where the return is income through food and drinks purchases. But others are establishing a more formal product, either through partnering up with a flexible office operator, or running their own set up.

A key part of the flexible office offering is the level of service provided by the landlord – the appeal of an all-inclusive rent that covers a number of features typically either covered in an additional service charge with traditional leases or viewed as "add-ons" or the responsibility of the occupier. This idea of Property as a Service is something that hotel landlords have been at the forefront of, but is increasingly gaining traction across the wider sector. As more investors dive into so-called "alternative", and typically operational, sectors such as student accommodation, hotels and build to rent, they are becoming more comfortable with needing to provide a service (or partnering with an operator who can) in addition to the building itself. As such, 2020 could well see more landlords entering this space as they seek to maximise returns from their portfolios and ensure their buildings appeal to occupiers. For example, landlords in residential sectors such as build to rent and co-living may consider adding a flexible office offering in order to appeal to homeworkers, and it could provide an opportunity for retail landlords to fill vacant units and reposition shopping malls.

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It is, however, a crowded market and vulnerable to fluctuations in demand. There are also risks when the landlord is not the freeholder. Landlords should ensure that they have carefully evaluated the risks involved, and that they really understand their customer and can adapt their product to keep them satisfied. Whilst flexible offices may be the first to suffer if occupier demand drops, it is also a more agile operation than traditional office leases and therefore able to adapt and recover quicker. Should supply start to outstrip demand, it will be those who are really catering for their customers who will survive any bumps in the road. It is also important to be diligent when selecting an operator to ensure their offering and values match your own, and that their business model is robust.

Repositioning retail

It would be hard to have missed some of the turmoil experienced by the retail sector in recent years, with no let-up expected as we move into 2020. On-going structural changes and challenges including the rise of e-commerce, Brexit uncertainty, fragile consumer confidence, high operating costs, regulatory pressure and high levels of legacy debt, are putting retailers under increasing pressure and forcing many to rethink their offering in order to remain relevant. Coupled with increasingly fickle shoppers who are willing to vote with their feet if their desire for value, convenience and experience is not met, even some well-known and historically resilient brands have crumbled and several more are struggling.

2019 has seen this distress increasingly translating to the retail landlords themselves, and there is no sign of a reprieve in 2020. As more retailers collapse or re-valuate their physical store footprint, all but the super-prime retail landlords are finding the environment challenging. With fewer and fewer suitable tenants available to back fill vacant space, those that do remain are seeking reduced rents, longer rent-free periods and additional incentives.

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The next year will likely see distressed retail opportunities coming to the fore, but the question of who has the tools to successfully reposition them remains, and indeed whether such 'saviours' will continue to bide their time until a clearer solution for the future of retail is visible and, ultimately, pricing bottoms out.

Physical stores remain a huge part of the retail sector, but it is clear to all that the role stores play in the customer journey is changing and landlords face a steep learning curve as they seek to understand the impact on demand for space and the value retailers ascribe to that space, now and in the future.

With it now harder than ever to future-proof retail assets, most landlords and investors have been revisiting their strategies. Examples include reducing total exposure, shifting exposure to other related activities (eg logistics), and pure-play retail landlords have been considering selling off or repurposing assets. As cash flows come under increasing pressure, the need to reduce gearing has also increased significantly. Investors that remain in the sector, or indeed those that opt to enter it, will need to have a deep understanding of both their immediate customer (the retailer) and the consumers of the space (the ultimate retail consumers) in order to design and deliver physical assets that meet the needs of both. The expertise, capital and long-term commitment required to build new or repurpose existing locations will be key to success. This isn't a case of waiting for the cycle to bounce back – retail property is changing for the long-term and a different approach is needed.

Re-evaluating existing models

Landlords have a key role to play in creating a space that consumers are drawn to in the age of online shopping. We are seeing a blurring of sector lines as success increasingly requires a degree of placemaking – locations where one might work, play and sleep are becoming more attractive as the way in which we use space evolves. Consequently there is an increased focus on tenant mix and ancillary services, and a need to rethink, for example, the shopping centre as an entertainment, transport or community centre rather than simply a collection of shops. This means retail landlords will need to take a holistic approach to their portfolios, and consider how repurposing some assets to office, residential, logistics or leisure space may complement the retail offering. Or indeed whether certain retail sites should be entirely repurposed – and whether the numbers add up to do this. Last-mile logistics, for example, is an obvious alternative for some edge of town retail parks or town centre schemes but it is not always practical to deliver this. Whilst retail units are generally large with regular floor plates and good vehicular access there may be challenges around increased heavy goods' vehicle movements, particularly in established residential locations, and the target delivery routes need to be carefully understood and mapped.

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There is also an opportunity to convert distressed and disused retail spaces for much needed homes. Some retail parks and retail warehouses are providing an affordable land supply for developers to repurpose as high-density residential, usually through demolishing existing buildings and starting from scratch.

Whilst the pool of potential buyers for retail assets is limited at this time, more specialist distressed funds are raising capital to invest in the sector as soon as they have comfort that values have either bottomed out or they truly understand the route towards, and the upside that could be delivered, from repurposing the assets.

Parts of town centre retail schemes are also being converted to residential, although this route requires careful consideration and planning. Starting from scratch is rarely an option here and it will be important to integrate any new developments with the existing facilities, as well as considering the long-term viability of the scheme as consumer habits and preferences continue to evolve. Placemaking here will be key. Furthermore, town centres vary much more significantly than retail parks and shopping malls, and will require a tailored approach to ensure success. This will often need buy-in and support from the local authority and will likely form part of a wider town centre regeneration.

Another interesting challenge for owners, developers, planners and architects is how best to incorporate industrial and manufacturing units and residential schemes as part of a wider redevelopment of a retail or town centre scheme. Traditionally, these uses have not co-habited well (and have arguably been avoided), but with the advent of electric vehicles, better construction methods and a demand from consumers to be closer to the origin of products, now is the time for exploring and implementing innovative solutions.

Retail property is owned by both passive and active investors. Active investors will appreciate the need to repurpose their assets to maintain income and value over time and will be prepared to re-write and implement revised business plans, assuming they have sufficient capital and support from lenders to do so.

Passive investors may not have the necessary expertise or sponsor support to implement large scale redevelopment and may therefore prefer an exit. Whilst the pool of potential buyers for retail assets is limited at this time, more specialist distressed funds are raising capital to invest in the sector as soon as they have comfort that values have either bottomed out or they truly understand the route towards, and the upside that could be delivered, from repurposing the assets. In the meantime it is likely that income and value will continue to decline where the strategy is 'business as usual' as the impact from retail insolvencies hits home.

The importance of having an in-depth understanding of assets

Potential buyers will need to carry out in-depth due diligence to ensure they have assessed the real opportunities and challenges of the asset, and be prepared for the potential pitfalls. Shopping centres and large retail parks have multiple income streams and a mixture of recoverable and irrecoverable costs. Understanding the inherent risks to the 'steady state' income and cost base that an investor will be exposed to while longer term

strategies are worked through is critical. For example, the large number of retailer Company Voluntary Arrangements (CVAs) has resulted in lease and rent terms being varied, which may not always be reflected in the property owner's tenancy schedule. Understanding the reliance on retailers own performance (eg turnover rents) as well as understanding the complex service charge accounts structure becomes essential. In the experience of KPMG professionals, service charge accounts are an area often overlooked and yet include substantial liabilities on the landlord that are not always fully understood or accounted for.

To complicate matters further, the future income, costs and capital receipts will depend largely on the redevelopment and repurposing strategy for the centre.

A large scale redevelopment of a centre should be supported by detailed appraisals and cash flows reflecting the project team's designs and cost estimates – the loss of income and additional property holding costs during the build period should not be underestimated. Projects of this nature are often long term and a lot of weight is placed on future exit values.

This is highly subjective and assumes market conditions remain relatively unchanged over the duration of the project. KPMG professionals would always advocate that detailed sensitivity analysis supports development appraisals as small movements in key assumptions (i.e. build costs, estimated rental income, or yield) can have a significant impact on the overall income or value of the project. What is vitally important is the ability to understand what truly drives value, and how to leverage this to create and maintain value.

The traditional approach to valuations has its drawbacks in the digital age, and increasingly there is a need to focus more on the underlying strength of the asset and operational performance. This should consider the landlord's level of control over the environment, KPIs such as footfall, spend per visitor and visit duration, and the tenant mix. Churn of tenants should not always be considered a negative – for example online-only retailers may use temporary pop-up stores, and new store openings can create a buzz that benefits the wider space.

> The expertise, capital and long-term commitment required to build new or repurpose existing locations will be key to success.

As a consequence the traditional valuation methodology that capitalises income based on a market yield may no longer be suitable. As landlords take more operational control of assets the fair maintainable turnover of a centre will become increasingly important.

Not only will this provide management with better information on which to make decisions, but it will also provide more clarity and assurance to lenders on the borrower's ability to meet loan obligations.

Landlords (and potential landlords) and other key stakeholders should also ensure they understand and proactively monitor warning signs to be able to identify and address issues before it is too late. Data and analytics can help decision-making through improving visibility of portfolios and individual tenant performance. The ability to gather clear information can help to understand real asset profitability, identify risks from anchor tenants, assess re-investment and targeted cost reduction and turnaround of underperforming assets, and allow for rapid delivery of solutions.

What can we expect for 2020?

Although retail values have started to drop and some owners are being forced to sell, we have not yet seen a rush of interest from opportunistic investors that some might have expected, and there is debate as to whether 2020 will see this increase. This is perhaps partly due to the uncertainty around rental values, which are widely predicted to fall further, and reducing capital values. Many existing landlords also appear to be holding out hope that things will improve over time. But, as mentioned previously, retail property in the digital age demands a new approach, and making a success of it requires investment and the knowledge and entrepreneurial expertise to deliver a vision for the space. It also needs an ability to be flexible on timescales.

This certainly limits the number of potential buyers, and most will require strategic partnerships with asset managers and perhaps local authorities. In many ways repositioning assets will be easier for shopping centre owners than high street landlords due to the ownership model of high streets and lack of shared accountability, but it could be that 2020 starts to see more local authorities, landlords, operators and indeed retailers joining forces in order to overcome these challenges and create thriving high streets of the future. The next year will likely see distressed retail opportunities coming to the fore, but the question of who has the tools to successfully reposition them remains, and indeed whether such 'saviours' will continue to bide their time until a clearer solution for the future of retail is visible and, ultimately, pricing bottoms out.

Alternative residential

In the search for returns and long-term income, the UK residential sector is increasingly attracting a range of real estate players. So-called alternative, and typically operational, assets have become more mainstream each year as investors have recognised the opportunity and developed, recruited or partnered up with the sector expertise required to succeed in this area.

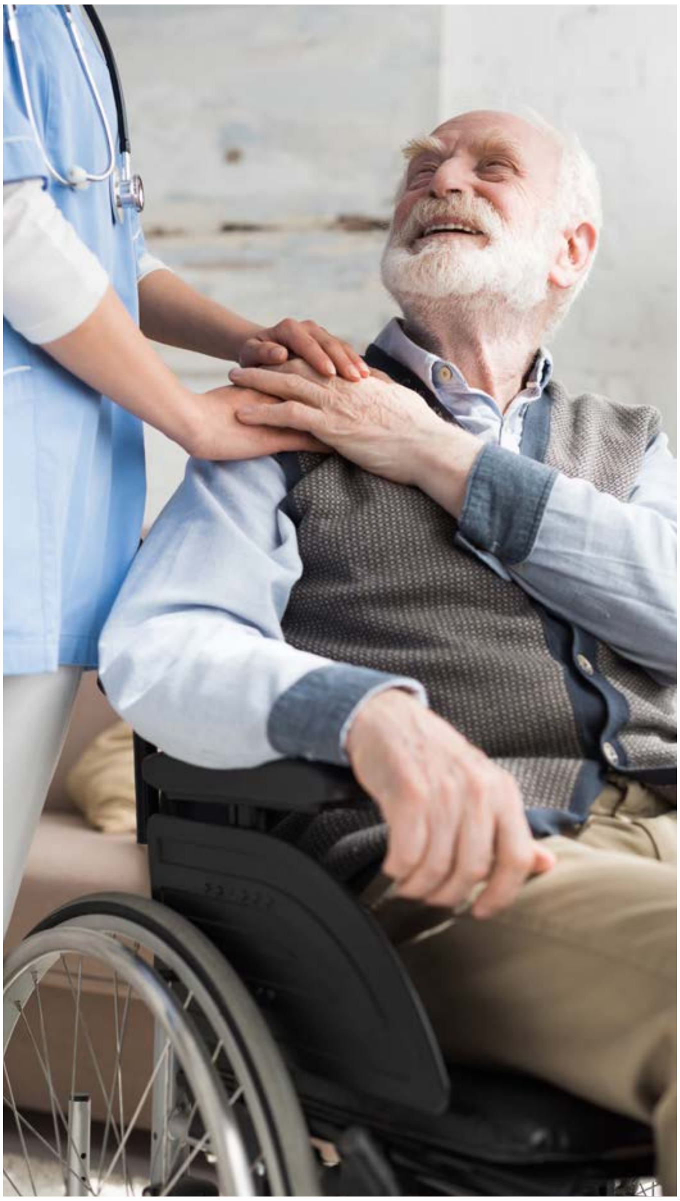
Build to rent alternative no longer

Having been an emerging sector to watch for a number of years now, 2019 saw some tangible progress for build to rent (BtR). Investors are attracted by the secure, long-term income profile and the strong supply and demand fundamentals. With housing supply continuing to be an issue for the UK and a priority for all of the political parties, it looks likely this will continue to gain traction in 2020. Lifestyle changes are also impacting the demand dynamics – whilst some rent out of necessity due to the expense of getting on to the property ladder, increasingly people are also attracted by the convenience, flexibility, service and community that the professionally managed private rental sector provides.

Until recently some investors have been hesitant to enter the market due to the lack of benchmarking data available, and pioneers have often been those with experience in the more established multifamily housing sectors in the likes of Germany and the US. However we are seeing a wider range of investors taking interest as more data becomes available, and more are expected to join them. Investors are also expected to expand into other areas of residential. Whilst there are some clear differences between the residential sub-sectors, the synergies between them are also evident and it makes sense that players would dip into more than one. Indeed some are starting to catch on to the idea of building a client for life – providing products that cater for students, young professionals, families and seniors under one brand banner.

Affordability constraints are generating opportunities for investors

Two still fairly niche sub-sectors are emerging in response to societal changes that are seeing young professionals living alone for longer, coupled with the affordability constraints of getting on the property ladder or renting solo. By reducing unit sizes and investing instead in communal facilities and amenities, the co-living sector is aiming to provide an attractive and flexible offering for young professionals that won't break the bank. Like with co-working, there is also an emphasis on fostering a community and advertising a certain lifestyle. Another offering that could help to overcome the lack of appropriate and affordable housing for young professionals is employer-backed BtR.



Key for success in this sector, as it is for most "alternatives", is to truly understand the customer and to provide both quality service and product.

The idea that employers could block-book large numbers of rooms that could then be leased to employees, in the same way that higher education institutions stimulated investment in the purposed built student accommodation sector by offering 'nomination agreements'. This would free investors of the risk of voids, the credit risk of tenants defaulting and the costs of finding and contracting renters on the open market – all providing a volume of guaranteed demand that would permit investors to build rental properties at scale, and generating savings that could enable a discount on market rents for employees. For employees this would mean conveniently located high-quality homes at a possible discounted rent, as well as a social network of other young professionals on their doorstep. Whilst for employers it would provide a stronger offer for new recruits in a competitive job market. Some employers might opt to fund these schemes themselves, but KPMG professionals expect the main appeal would be to institutional investors seeking long-term income but cautious of the management risks and uncertainty of investing directly in BtR. Although the current uncertainty and challenging circumstances for businesses may cause some to hold back on such an idea, there is a clear opportunity to use this as a means of differentiating themselves in the war for talent, and success for any pioneers would likely spur on others to follow suit.

Lifestyle changes are also impacting the demand dynamics – whilst some rent out of necessity due to the expense of getting on to the property ladder, increasingly people are also attracted by the convenience, flexibility, service and community that the professionally managed private rental sector provides.

Elsewhere, the provision of affordable housing remains a contentious issue for many as developers and investors struggle to make financial models work when competition for land is so high. Some, however, are starting to see affordable housing as an opportunity rather than a challenge to overcome. In particular, those with long-term capital to deploy are recognising that the sector actually aligns with their need for stable, long-term income. With the majority of UK housing associations typically not-for-profit organisations unable to raise the levels of equity they need to match demand, there is a clear opportunity for investors to step in. As more institutional investors become comfortable with alternative sectors such as BtR, it is likely that the affordable segment of the sector will see further interest in the coming year. Furthermore, with an ever-increasing focus on environmental, social and governance (ESG), actively investing in the sector rather than simply providing the minimum requirement in order to get schemes signed off enables real estate players to demonstrate a commitment to benefiting society.

Catering for an ageing population

The ageing population and increased demand for retirement villages, supported living and care homes, as well as the need to free up housing stock for younger generations, is driving a wave of interest in the later-living housing sector. The rental model is particularly attractive to investors due the long-term income stream, however this involves overcoming an embedded culture of home ownership, tax challenges and providing a product that customers feel is affordable for the long-term – running out of money and providing security for the next generation are key concerns for customers. Planning hurdles and incentivising potential customers to make the move are also challenges. Some in the industry have questioned whether the government should help to stimulate supply through revising planning rules, or reforming tax policies to support demand. Build to rent, the private rented sector and student accommodation clearly benefited from government-backed initiatives that helped to establish the sectors, and it will be interesting to see whether the new government takes a similar approach to support the vital senior living sector.

Key for success in this sector, as it is for most "alternatives", is to truly understand the customer and to provide both quality service and product. For most investors, delivering this will require partnering up with experienced operators, particularly where additional healthcare services are needed. Landlords also need to think about how the space is used and what the customer really values. One area that could see increased attention is a multi-level service offering, whereby customers are able to stay on the same site and upgrade to additional support services as required. This would particularly appeal to couples who may need different levels of support as they age but understandably don't want to be separated when one requires more care than the other, and it allows customers to really settle into their community and view it as a home for life. Value for money is also critical.

Inter-generational living is also gaining some traction. There have been various studies over the years looking into the benefits of mixing care homes and nurseries, with some examples of intergenerational care facilities in Japan and the US as well as a couple of pioneers in the UK.[1] Whilst this is yet to become a mainstream offering, there does seem to be an increased appreciation for the need to consider multiple generations when developing communities that will be attractive to customers and all users of the space. Whether that be adding a library or children's facilities to a retirement village to draw in a mix of visitors to the site, or providing additional retail amenities such as a supermarket so that visiting residents fits in with day-to-day life. Overall the focus is increasingly about creating a community that people want to move to, rather than seeing it as a last resort.

[1]https://www.ageukmobility.co.uk/mobility-news/article/intergenerational-care

Rethinking the industry

Technology, disruption and innovation have been rising up the agenda of real estate decision makers for a number of years now, and KPMG has been tracking the industry's journey into the digital age through our annual Global "PropTech" survey since its launch in 2017.

Developing digital and data strategies

The 2019 survey results showed that there continues to be progress but at a predictably slow rate. 58% of respondents say their business has a digital strategy in place – up an encouraging 6% on the previous two year's findings.[2] However, only 29% of respondents have an enterprise-wide digital strategy in place and a fifth say they have no strategy at all. The rest either have one in parts of the business, or something in development. The results are more concerning when it comes to data strategy, with nearly a third of respondents not having a data strategy in place and a further 5% who do not know if they have one. It's clear that there is increasing acknowledgement of the need for more agile, customer-centric and technology-enabled business models, but challenges and stumbling blocks remain and many real estate businesses are either lost, bamboozled or simply overlooking the threat and opportunity from technology.

On the plus side, digital transformation does seem be to gaining greater priority in the sector and getting focus from senior levels. 95% of respondents said their business has a designated person leading digital transformation, and in nearly two-thirds (62%) of cases it's a senior employee – often a c-suite individual – reporting directly to the business' overall leader.

[2]KPMG, Is your digital future in the right hands: KPMG Global PropTech survey, 2019

However, in 65% of cases this isn't someone with a digital or technology background, and often instead these individuals come from a core real estate, construction or finance background. Whilst real estate sector expertise is important, a detailed understanding of the technology and transformation side of things is equally relevant. Often this will need to be sourced from outside of the industry, and indeed this has added benefits through bringing in fresh perspectives and a new approach to established ways of doing things.

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Looking to 2020 we expect to see more real estate organisations paying closer attention to their digital and data strategies, and a continued trend of senior individuals being appointed to lead digital transformation. We also anticipate that organisations will become increasingly comfortable with recruiting from outside of the industry in order to bring in the right skills for the business to thrive in the digital age – that means more CTOs, CDOs and CIOs, right through to entry level roles in data science and technology specialists.

Overcoming historic under-investment in IT infrastructure

Digital transformation goes hand in hand with investing in IT infrastructure. The vast majority of property organisations currently have a multitude of systems that are neither properly integrated nor cloud-based and mobile-enabled. When asked to rate the integration of their internal systems from 1 to 10 (with 1 reflecting a patchwork with no integration and 10 representing fully integrated internal systems), the mean score for respondents in 2019 was 5.38.

KPMG's anecdotal evidence suggests that the average self-assessment of 5.38 is at best optimistic. Real estate firms are still getting to grips with their technical debt caused by over a decade of underinvestment in IT. According to our estimates, a property manager or developer can operate up to 30 standalone systems to manage finances, operations and different stages of the property value chain (acquisition & construction, marketing & sales, property management, customer & facility services, portfolio optimisation, etc.). The lack of integration across systems and functions results in inefficiency, task duplication and, most significantly, unreliable reporting and several variations of the truth.

Fragmented IT infrastructure is also making it very difficult for real estate organisations to achieve agility. The constraints of legacy IT and the lack of collaboration across organisational silos make it impossible for companies to be nimble and responsive to changes in their environment.

KPMG professionals are increasingly hearing from real estate organisations looking to address this, and 2020 is expected to see an increase in investment in fully integrated systems as firms get to grips with the ingredients required to make digital transformation a success. Furthermore we expect to see an increased use of technology such as data analytics and artificial intelligence in order to improve accuracy and efficiency throughout the business, as well as benefiting customer experience.

Understanding the importance of customer

Central to the theme of digital transformation is the rising awareness of the importance of brand and customer experience. Across all areas of life we have grown accustomed to responsive, intuitive, customer-centric providers of goods and services, and expectations of real estate are no exception.

For example office customers want the space they lease to be high-tech, design-led, and smart, with facilities that promote wellness, collaboration and productivity. In the competition for talent and custom, a company's real estate forms part of their brand and appeal, and they want their landlords to cater to that. Businesses also want to ensure that they are making the best use of their space and desire flexible leases to be able to scale up and down as their business evolves.

Real estate businesses are adapting to this, with many having at least taken the initial steps of referring to customers rather than tenants and employing staff with expertise in 'customer insight' and/or customer service. Those leading the charge in this space are putting customer experience at the heart of their business and seeking to deeply understand customers' needs, wants and their unarticulated or, as yet unidentified, aspirations. To do this they are getting closer to their customers (as well as the ultimate users of the space), gaining and acting on insights, and delivering a connected experience.

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We dive deeper into this in our 2019 report Why brand and customer experience matter in commercial real estate, exploring some of the key areas that property companies should consider when thinking about how to develop a strong brand and improve customer experience.

KPMG professionals are seeing more real estate businesses waking up to the need to be more customer-led in order to remain competitive and relevant, and we are increasingly seeing a move towards business-to-consumer rather than business-to-business interactions. This trend is expected to gather pace as more real estate organisations acknowledge the commercial advantages of a customer-centric approach and become more acquainted with providing a service as a core part of their offering. Those operating in the so-called "alternative" real estate sectors, such as hotels, student accommodation and build to rent, are leading the charge here, but traditional commercial real estate is also picking up pace. Many are learning from other sectors and understanding that as customer expectations evolve real estate organisations need to act in order to keep up. Today's customers are fickle when their needs are not met, and real estate organisations that do not take action will quickly learn this.

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KPMG is a leading provider of professional services, with 14,500 partners and staff across the UK and an international network operating in over 150 countries.

Our real estate professionals draw on experience from a variety of backgrounds, including accounting, tax, advisory, banking, regulation and corporate finance, to provide informed perspectives and clear solutions throughout the asset and investment lifecycle.

Our client focus, commitment to excellence, global mindset and consistent delivery build trusted relationships that are at the core of our business and reputation.

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