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News
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letter

Part 4: Invest wisely
Real Estate as a Service: All Change, All Change.

In 1962 Arthur C Clarke wrote an essay entitled 'Hazards of Prophecy: The Failure of Imagination'. It contained his 'three laws', the third of which states:

"Any sufficiently advanced technology is indistinguishable from magic"

In 2018, I bought an iPhone XS, and to unlock it all I have to do is look at it. That is Magic. Isn't it?

Well magic is exactly what it felt like for the first week or so of having the phone. After that, as is always the case with magical new technologies, it was something I no longer thought about. It was just how I opened my phone. Big deal. Yawn. We humans are very hard to please, for long. This, in a nutshell, is why the real estate industry is changing so very fast.

There is a 'Trinity of Transformation' underway, involving massive increases in the data we have available to us, the scale of the computing power at our disposal and significant advances in Artificial Intelligence, especially around the sub-set of Deep Learning. Combined, this Trinity is remodelling how we work, live and play.

All around us, to a degree already that most people are unaware of, artificial intelligence is performing a 'software update' to society. The renowned Chinese AI venture capitalist Kai Fu-Lee wrote last year:

"AI algorithms will be to many white collar workers what tractors were to farm hands: a technology that dramatically increases the productivity of each worker and shrinks the total number of employees required."

This will, absolutely has to, have a major impact on all real estate asset classes, and will pose both a significant threat and opportunity to investors. All the drivers we have discussed in the previous three articles in this series are obstacles, or flywheels, that investors need to avoid, or leverage, across their portfolios.

It is true that the market for trader developers will not change that much. Buy an asset, add some value through planning or repurposing and get out, is still a game that the technologically unsophisticated can play, and play successfully. A very wealthy investor recently told me he has no interest in PropTech, as 'they've said tech will change everything for ten years and nothing has changed'. So long as he sticks to real estate as a Product business, trading physical assets in short order, he is probably right. But this is a game of musical chairs; as the move to being a Service industry picks up pace, the necessity to become far more technologically aware, and data driven, will gradually intensify. Anyone in the medium to long term real estate asset business needs to be cognisant of genuine structural change. You don't want to be the one left with no chair to sit on.

We have seen how the nature of the office is fundamentally changing with #SpaceAsAService becoming the norm. Whether in terms of on-demand space, or as space that helps enable a productive workforce, flexible working is, as Google wrote in their research report 'Workplace 2020', set to become 'the defining characteristic of the workplace'.

Offices are going to be used differently, as catalysts for human skills and, in the context of CBD space, less as five day a week work locations than meeting and collaboration venues, where teams go to do what they need to do together, before retiring to places and spaces more conducive to singular, focussed work.

We know the direction of travel, but the exact route is hard to define. So any office investments need to be stress tested for flexibility. How easily, and cost effectively can this space be repurposed? This has to be the starting point; inflexible space can only really decrease in value over time. Add in the fast growing importance attached to sustainability, and we are certain to be looking at a significant amount of obsolete office space within a few years. You might not need to be technically advanced, but your assets have to be. As more building performance data becomes publicly available we are bound to find many #PropTech solutions helping buyers avoid space no longer 'fit for purpose'.

But what makes for a good investment, in this new world? How will space be judged, valued? It looks likely that the notional rental value will become less relevant, as the aggregate of income potential becomes a more accurate measure of value. Given an operator capable of creating a great user experience, what total income might this space generate? And of that, how much will go the operator themselves, in return for successfully monetising the space? Service costs.

Above this though, new KPI's, new ways of judging the quality of an office asset, will emerge. Principally 'Productivity, Wellness and Sustainability'. How suited is this space for creating a productive workplace, how well does the environment support the health and wellness of users, and how sustainable is the asset? Scoring highly against these three criteria is going to become the driver of medium to long term value. Partly because regulatory changes will carry a carrot and a stick to force improvement across the board in the built environment, but also because our customers are simply going to demand we deliver better real estate. A world aware of 'Extinction Rebellion' knows exactly how large an impact on the environment real estate has, and is not going to tolerant indifference in the years ahead. Best practice will be smart practice. Virtue will be rewarded. Doing the right thing need not damage the bottom line. Being a Service industry does have advantages, for everybody.

Alongside all of this is the rise of the real estate Brand. Historically the real estate industry has had no interest in brands and branding. It was a supposed truism that 'you cannot brand a building'. However, as landlords and investors get better at creating definable user experiences, tailored to the particular wants, needs and desires of their target customers, Brands are going to develop that have real value. You may scoff at WeWork's supposed $47 billion valuation but you cannot ignore that much of that is wrapped up in the WeWork Brand. Savvy investors will be developing standalone Brands that have real value in parallel to the physical assets they are 'applied to'. Adding X Brand to Y asset could, will, have an impact on the value of that asset.

And that's just offices, what about other asset classes?

You may or may not believe in the 'Retail Apocalypse' but it seems clear that this is an industry in turmoil. Following the developments in technology one would conclude that physical retail has to be one of the following: a 'destination', a proxy fulfilment centre or a supplier of cheap and everyday purchases. Being highly tuned to local particularities is becoming essential, and doing all of this based on highly granular real time data equally so.

How many retailers are good at this? And how many real estate people really care? Not lip service, but really care, in a deep and meaningful way?

The better investors are going to become very skilled at understanding the value and power of data in retail real estate. Partly for their own use but also as a way to identify the best retailers to try and attract as customers. So they are going to embrace 'KYC' in a rich way, moving beyond basic data points to a deep knowledge of the demographic, psychographic and socio-economic profile of their market. They are going to use mobile phone data, and other non traditional real estate data sources such as credit card and transaction data, local event and physical conditions data to understand patterns of behaviour, footfall and customer characteristics in new and insightful ways. They are going to embrace geospatial and AI driven analytics to help them know where to buy, where to sell, where to scale up and where to refurbish. And above all they are going to target retailers who actively exploit the three 'superpowers' that Machine Learning is enabling in retail; personalised product recommendations, assortment and pricing optimisation. The best retailers are technologically sophisticated and in an apocalypse it is wise to back the best.

The industrial market is the ugly duckling of real estate. Not that long ago this was a sector all about dumb 'sheds'. Today industrial is perhaps the most highly technical real estate asset class. Stuffed full of robots, planned to enable the online retailers nirvana of same day delivery, increasingly vertical rather than horizontal, and nodes in new 'logistics as a Service' marketplaces.

Increasingly the industrial real estate market is going to be about matching short term demand. The growth of companies like Stowga point to a fluid, dynamic market that waxes and wanes, with a multitude of different players, each with requirements that if they can be fulfilled are lucrative and therefore high paying. All retailers, but especially the online breed, are obsessively trying to achieve ever faster delivery, which means 'the last mile' becomes hugely important. Who can help me get my goods to my customers faster? Who can provide me with this 'logistics as a Service'? Even the largest industrial REITS are small in the context of the size of the industrial market, so an increased focus on networks and ecosystems is likely. Today industrial landlords think little beyond letting their 'sheds', but in the future the smartest will endeavour to build complete 'solutions' for their customers. Every retailer has logistics problems, but only the largest have the capabilities to really solve them. As with office operators concentrating less on letting an office and more on enabling a 'productive workforce', the best industrial operators will be delving deeper into the real 'jobs to be done' of their customers and seeing how real estate can fit in to the equation, beyond being a 'dumb shell'.

And residential? Build to Rent, Co-living, Multi-function and mixed use are all growing fast. As the number of people renting rather than buying grows inexorably, this sector is awash in new business models. Residential developments designed for singles, for young families, for retirees, for business travellers, or digital nomads are all popping up. Each is designed for the particular needs of different types of people, with different layouts, features, amenities and attached services. Each is created and curated using strong human skills but in all cases it is, as we have seen before, a 'Human + Machine' game.

Particularly in the US the largest investments are going in to the 'iBuyers', those companies that will buy your home pretty much immediately. Billions of dollars has been invested in the likes of Opendoor, Zillow, Offerpad and Knock. Predicated on the hypothesis that with enough data one can buy and sell algorithmically, these investors are looking to make a lot of money by taking a small cut of a very large pie. How this pans out is one to watch, but it certainly provides an outlet for those investors looking to, or needing to, deploy a large amount of capital.

Across offices, retail, industrial and residential their is clearly much change ahead. The pitfalls are not hard to see.

Neither are the opportunities. Avoiding the former, and seizing the latter, is not a trivial, or easy, task. The one certainty though is that those who navigate these markets successfully will be highly skilled in much more than real estate alone. Data, technology, behavioural science, human psychology, anthropology and ethnography will all play their part. Above all they will be great learners. The tech industry lives by the mantra of 'Build, Measure, Learn', whereas in traditional real estate we largely stop at 'Build'. This is set to change.

For investors, the next 10 years will be complicated. They have to navigate the change that technology is bringing to how we all use the various asset classes. When people do not need an office to work or a shop to go shopping it fundamentally changes the dynamics of the office, industrial and retail markets. When residential property becomes too expensive for a significant percentage of people to buy it not only changes the nature of tenure (rent over buy) but where people wish to live. If you cannot afford to buy then you may as well try and live in the best areas you possibly can. Urban centres are more alluring to young renters than buyers. All of this means some assets are going to become significantly more valuable, but also some assets might well lose a significant amount of value. Quite a lot of real estate is going to simply become obsolete in its current form. Navigating these changes will require large doses of human intuition, judgement and imagination, but even larger quantities of data will be needed to really understand the patterns, correlations and causations in the market.

Beyond understand the changing dynamics of the underlying market new technologies and data sources are going to be a major aid in investment supply/demand matching. Richer data should allow us to match the right operator with the right property, the right tenant with the right space, and the right investor with the right asset. If you know enough about both sides of a market, efficient and effective match-making should be possible. Complete automation is unlikely but dare I suggest that only the best human participants should feel comfortable about the future?

The smartest, most successful investors will be technologically astute, and armed with data and analytics that today would look like science fiction. Arguably this is where #PropTech could offer the most value.

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