SHARING EVERYTHING AND THE LAST MILE

Key social trends changing global real estate

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Key social trends shaping global real estate in the next five years

**Adaptation and flexible spaces will be pivotal in successful real estate design and management in the next decade, driven by changes in the way that people shop, work and socialise. Some key social trends currently disrupting businesses will also present risks and opportunities for forward-thinking real estate developers and investors.**

Six years ago, few investors would have understood the risks and opportunities posed by the sharing economy. Many would have dismissed businesses including Airbnb and Uber as fads, part of an inner-city hipster trend that would never grow to become mainstream.

Fast forward to 2017 and most cynics are converts, evidence of the degree to which the sharing economy has grown. Airbnb now has a valuation of approximately US$31 billion, making it the most valuable lodging provider in the world without owning a single room. Uber was valued at US$62.5 billion in its May 2016 funding round.

As long-term investors, we are constantly asking ourselves, ‘What are our assumptions about the future?’ As Bill Gates once said, ‘We always overestimate the change that will occur in the next two years and underestimate the change in the next ten.’

This paper outlines the most significant social trends that we believe will shape global listed real estate over the next five years along with the investment implications for each. These are:

- The sharing economy
- Online moving offline
- Automating the last mile
- Demand for placemaking
- Supply chain scrutiny

**The ESG series**

Environment, social and governance (ESG) issues are key considerations for investors in global listed real estate. They represent the non-financial opportunities and risks that affect earnings and valuations, particularly over the long term. ESG issues are notoriously difficult to integrate in investment decisions but this is exactly why they are so valuable. They provide unique insights into the way in which sectors, industries and stocks are changing, and challenge the assumptions we all make about the future.

At AMP Capital, we study these trends in detail. It is an integral part of our investment process. In a series of reports, we are sharing our thoughts on the long-term environment, social and governance factors that we believe will shape global listed real estate over the next five to ten years, along with the investment implications for each:

- PAPER 1: Safe as houses? Global real estate is literally exposed to the weather
- PAPER 2: Sharing everything and the last mile: key social trends changing global real estate
- PAPER 3: Runaway pay and conflicts of interest: governance in global listed real estate

**Key points**

- Co-working spaces and shared workplace facilities
- Flexible leases
- Malls catering to changing preferences for socialising versus browsing to buy instore
- Seamless services enabling research through to purchase online or in store
Are REIT executives preparing for these trends?

The chart below depicts the level of preparation for the trends that Australian property chief executives consider to be the key disruptive forces through to 2030. It also depicts the industry's assessment of their likely impact. The top right quadrant shows the trends that property chief executives in Australia are taking seriously and preparing for. Omni-channel retail, the sharing economy and sustainability are examples of these. The bottom left quadrant shows the trends that property executives are dismissing as unlikely to occur or likely to have a minor impact on earnings or valuations. These trends can pose the most danger to investors. If any are likely to blindside global listed real estate (as some trends inevitably do), it will be these because their impact is unexpected. We cover some of these trends below.

The sharing economy – redefining the use of property

The sharing economy is expected to continue its rapid growth. By 2025, PwC expects the size of transactions in the UK alone to grow from £7bn-a-year to £140bn-a-year. This equates to 30% growth a year and revenue of £18bn for the UK sharing platform providers by 2025. The sharing economy is really about commercialising unused space, with customers valuing access over exclusive use or ownership, so sharing economy platforms could theoretically disrupt any class of real estate.

The uncertainties include the extent to which co-working trends will take off and whether there will be a material impact on commercial real estate, whether co-working is the natural extension of working flexibly, and whether the arrival of sharing platforms will affect warehousing and industrial real estate. The sharing economy is really about commercialising unused space, with customers valuing access over exclusive use or ownership, so sharing economy platforms could theoretically disrupt any class of real estate.

In commercial real estate’s favour, it is hard to see an office sharing platform disrupting traditional business models. Companies are unlikely to unleash their employees completely and allow them to work from anywhere at any time.

1 Will the Australian property sector seize the upside of disruption? EY, Green Building Council, Property Council of Australia, December 2016. Ernst and Young, the Property Council of Australia and the Green Building Council of Australia asked 550 executives and senior managers in the Australian property sector which megatrends are most likely to occur by 2030, their likelihood of occurrence, their expected level of impact, and how prepared their organisation is for that trend to manifest.
2 http://www.pwc.co.uk/issues/megatrends/collisions/sharingeconomy/outlook-for-the-sharing-economy-in-the-uk-2016.html
Nonetheless, commercial real estate will need to adapt to the social trend that is driving the sharing economy: flexibility. Corporate tenants are offering flexible work arrangements to their employees, largely because they are demanding it and there is perceived to be a war for talent. Large, dense, open plan offices are starting to be questioned, with research suggesting that this layout is damaging productivity. Corporate tenants are reporting that their employees are spending less time in the office so there is less demand for space. All of this means that there is increased demand for flexibility and shorter leases.

PwC and the UK’s Urban Land Institute noted this trend in Europe in its 2017 report, Emerging Trends in Real Estate. It asked 781 real estate executives, investors and fund managers about the changing needs of occupiers and reported the following:

- Occupiers will continue to focus on using their space more efficiently: 60% agree, 33% disagree.
- Occupiers are demanding more flexibility: 60% agree, 23% disagree.
- Occupiers are willing to pay for shorter leases and enhancing flexibility: 60% agree, 15% disagree.
- Occupiers are demanding shorter leases: 60% agree, 15% disagree.
- The trend towards flexible/homeworking has peaked: 60% agree, 6% disagree.

Source: Emerging Trends Europe survey 2017
Note: Excludes Don’t Know responses

Commercial real estate companies will need to respond with more than just flexible leases. They will offer the environment that enables flexible work: more communal and break out areas, a focus on wellbeing and highly geared IT systems. There may well be more layered leases, with arrangements for flexible space to meet peak demands and short-term needs for special projects. As demand for more flexible space and leases increases, commercial real estate owners that meet this need will capitalise on the opportunities. Those that don’t are likely to see their capex increase as retrofits become necessary, particularly in cities.
Airbnb for warehousing?

It is not just spare rooms or office space that is left to gather dust. How about warehousing?

There is theoretically room for a disrupter like Airbnb to emerge in industrial real estate. Retailers’ stock tends to fluctuate over time. Some periods require significant amounts of stock (e.g., at Christmas) and other periods require very little. Yet under a traditional warehouse lease, fixed space is leased at capacity. There are a few new businesses emerging to meet the need for more flexible space.

Flexe is one of the sharing platforms that has emerged in the US. Those firms with unused storage space can rent it to others who need it in the short term, and vice versa. For traditional industrial warehouse owners, the risk is that more flexible platforms pressure owners that benefit from fixed leases and long leases. This is the dynamic that has recently emerged in commercial real estate following the rise of co-working and flexible working trends.

Car sharing and autonomous vehicles

Driverless cars have attracted a lot of media attention but the reality is that they have the potential to dramatically change the way real estate is used and valued. Consider the impact cars had on real estate or the ways in which highways transformed once-remote land into valuable real estate by connecting them to cities.

The arrival of the driverless car has similar potential and is likely to trigger an increase in the density of the urban core as well as drastically cut the space allocated to parking. Fewer cars means better pedestrian environments and developments that will improve the live/work/play equation.

Consider these statistics:

- 15% of US adults used ride-sharing cars in 2015. This compares with 28% of 18-29 year olds and 26% of those with incomes over US$75,000, suggesting that the take-up will increase over time.
- In 2009, 62% of car trips in San Francisco were in single-occupant cars. KPMG expects this to decline to 40% in 2019.
- Apartment buildings in the US typically contain 1.5 parking spaces per unit. In April 2016, Austin’s first car-less apartment tower was announced.
- UC Berkley research found that for every ride-sharing car on the road there are 9-13 fewer cars.
- Licence rates are declining, suggesting that car ownership is also declining. In the US, the propensity to have a driver’s licence fell to 77% in 2014 compared with 92% in 1983.
- The estimated costs of car ownership vs car sharing are staggering: KPMG estimates that a car which is owned and travels 10,000 miles a year costs US$0.75 per mile travelled. A shared driverless car costs US$0.41 per mile.

Each of these assets are likely to be impacted if driverless cars operate on roads:

- **Parking**: The number of spaces required could decline by 90% in the US if mass adoption occurs; Green Street Advisors says a 50% reduction in 30 years seems more reasonable.
- **Billboards**: Values may decline if there are fewer drivers looking out the window in traffic.
- **Low-quality retail**: Cars could pick up supplies for drivers so no need for sub-quality retail.
- **Residential real estate**: If access to public transport is no longer as crucial, those with great access may not attract the premiums that they do today.
- **Industrial**: Automation could increase space efficiency, reducing space required.
- **Office**: The CBD may once again serve as the centre of activity; commutes no longer incentivise regional offices.
- **High quality malls**: Parking spaces can be redeveloped.
- **Storage**: Empty garages may mean reduced need for storage.
Multi-channel retail – online is offline is online

The store versus online debate has been dead for a while. It is now clear that neither of these channels will win at the expense of the other and that the future of retail is multi-channel with the big online businesses like Amazon moving offline. Customers expect a seamless service across both channels and expect to be able to buy the goods via any channel and pick up the goods in store, from a post box, from a collection centre, or have them sent to their home.

For retail this means rejigging store formats with click and collection centres and becoming much more experiential. Shops will be more akin to showrooms where consumers go in to play with products, buy the product online or offline, and choose a delivery format at the time of purchase. There will be fewer stores in number, with the stores that do exist more like destinations for customers who are searching for a ‘touch and feel’ brand experience. One of the first stores created globally that met this criteria was Apple’s store on New York’s Fifth Avenue.

The following multi-channel examples demonstrate the challenges posed for retail, industrials and malls:

- Click & collect: Buy online then pick up the good in store or from a point of collection.
- Visit the store and order online via an ipad or kiosk.
- Visit the store and order via mobile phone.
- Show rooming: Visit the store and scour the web for the best prices.

Multi-channel retail: the investment implications

Traditional stores need conceptual overhauls. During the next five to ten years, they will be fewer in number and more akin to showrooms and collection points for online purchases. For global listed real estate, this poses a few challenges, as well as opportunities:

- **What's the value-add?** How do you prove location is helping the retailer grow the business?
- **Justifying rent:** If rent reflects foot traffic or lead generation, how will property owners deal with stores as collection points? If in-store sales shrink but foot traffic stays the same, expect downward pressure on rent.
- **Assets need to be 'hot':** Destinations that customers will go out of their way to visit and where retailers will pay to secure a spot. A McCann World Group study found that 66% of US consumers say they want to be inspired while they shop. Environment, catering, car parking/transport accessibility, entertainment, all of which is known as ‘placemaking’ will be crucial.
- **Stores need to be dynamic, relevant & wired up:** Shopping centres need to have a social media strategy and free wifi. Retailers will demand data on customers’ footprints and behaviour.
- **Online will open bricks and mortar stores and vice versa.** Amazon Go’s announcement in December 2016 is evidence of this trend to multi-channel retail.
RETAIL IS SHRINKING

In the United States alone, just over 13,100 stores are expected to have closed in the decade to 2017, which equates to about one-quarter of the original 2007 store base, according to research that Deutsche Bank published in February.

According to the World Economic Forum, there are about 1,050 shopping malls in the US, well above other national averages, translating to five times more square feet of retail space per capita than any other country. The World Economic Forum expects 15% of these malls to close over the next decade, with lower grade malls most at risk. Green Street has reported that only six new malls have opened in the US since 2006. While we expect some A grade malls to still flourish, over 700 malls across the US are below A grade.
DELIVERY BY DRONE?

Amazon, DHL, Matternet and Flirtey all have drone trials underway. We’re still highly sceptical of their broad adoption as a delivery mechanism in urban areas, mainly for safety and operational concerns. Imagine the fallout if a heavy parcel was dropped by a drone and caused injury. Having said that, drones may well form part of a large warehouse/distribution centre in roles comparable to those that robots are fulfilling today.
Automating the last mile

The biggest challenge for e-commerce is the ’last mile’ – the last leg of delivery to the consumer’s door. For the retailer, this is where a disproportionately large component of the cost of delivery lies. The solutions so far have been region specific because of the distance required, population density of various regions, the cost of freight and the ability to leave parcels at front doors, but none of the solutions to date have proven the perfect fit. The fact that no delivery method has proven dominant means that disruption is on the horizon. The problem is that the large warehouses are too far away from consumers expecting extremely fast delivery.

The chart below shows the different delivery methods that have been used in the UK, France, the US and Germany in the past 12 months:

The UK is a case in point. A report published by Barclays estimates that home deliveries direct to a consumer’s address will fall from 72.3% to just over 64% of total physical deliveries by 2018, while Click & Collect volumes are anticipated to rise from 26.1% to just under 35%. Just over 38% of retailers are expecting Click & Collect to grow more in terms of usage than any other delivery option.

Contrast this with France and Germany where many homeowners have secure boxes on their property to receive packages whilst out. Germans also have access to free lockers operated by Deutsche Post DHL. About 90% of the population is thought to live within ten minutes of these. In France, Chronodrive’s drive-through supermarkets allow customers to purchase online and collect their order from a specialised distribution warehouse within 90 minutes of placing the order. In the US, The Container Store delivers customers’ orders to their cars within an hour of purchase online.

The missing link is warehouse and logistic facilities close to the consumer. Distribution options are likely to include a combination of these, all of which have significant implications for the type and location of warehouse space required in the future:

> Demand for consumer collection centres, 24-hour lockers, perhaps out-of-town warehouses for large shopping centres in the middle of town.
> Customer fulfilment centres, distribution hubs, dark stores (online warehouses where online orders are picked and fulfilled). The larger the spread of consumers, the greater the demand for satellite hubs.
> Changing demands for particular sizes of warehouses, particularly as drones are trialled for use in warehouses (Amazon) and robots create much more efficient pick and pack lines.
> Greater need for local distribution and warehouse facilities.
Demand for placemaking

Placemaking is a design process that prioritises people over function. It represents an intention to create a space that feels inviting, that draws people in, that employees or shoppers (for example) want to spend time in. It represents a subtle but important focus in architecture and urban planning that some say has been missing for decades: putting people and how they experience space at the centre of the design.

It reflects a relatively recent recognition among leading real estate owners that buildings and developments must be designed specifically for the people that will use them to attract quality tenants in the long term. For example, an office building might look impressive as an architectural model and in 3D drawings but if the spaces below the building are wind tunnels without direct sunlight, restaurants and cafes are unlikely to flourish there, and quality corporate tenants are less likely to pay premium rents for the office space.

This sounds like common sense but most of us could probably make a list of office blocks or shopping malls that no doubt made sense on paper but left us feeling a bit cold when they were built. A well-known Danish architect, Jan Gehl, says this typically occurs when spaces like malls and office buildings are planned from an aerial view, irrespective of the space between buildings that really makes the area appealing to people walking around.

For investors, it is crucial to consider whether real estate owners’ assets have incorporated placemaking or whether retrofits will be made with placemaking in mind. In retail real estate, for example, as bricks and mortar shopping in malls shrinks and consumers flock to malls where they meet friends or have dinner, placemaking is crucial. It is likely to be the factor that separates the wheat from the chaff.

In commercial real estate, placemaking is being driven by real estate owners seeking a competitive advantage. In Australia, where office buildings are relatively advanced on water, energy efficiency and other environmental credentials, leading office owners are focusing on tenant engagement as a point of difference. It basically means putting corporate tenants and their employees’ needs at the centre of their model. They are prioritising health and wellness initiatives for tenants, end-of-trip facilities (basically bicycle parking and change room facilities) and childcare.

Real estate owners will increasingly be expected to be service providers to their tenants, rather than the hands-off suppliers of bricks and mortar. Those who integrate placemaking in their capital expenditure will have much more sustainable assets with greater longevity.

MEASURING HEALTH & WELLBEING IN THE WORKPLACE

Some commercial real estate owners are investing in scientific monitoring devices that are being created to measure the indoor environment in work places to improve productivity for corporate tenants and their employees. Investa in Australia is trialling a device called SAMBA, developed by the University of Sydney, which measures air temperature, radiant heat, air movement, humidity, light, sound, carbon dioxide and carbon monoxide along with various pollutants emitted from building materials such as volatile organic compounds.

It is hoped that measuring and improving all of these indoor ambient factors may improve productivity metrics like absenteeism levels, workers’ compensation claims, employee engagement and staff retention. All are being tracked to test the correlation.
Supply chain scrutiny & human rights abuses

Global listed real estate has been shielded from most of the investor scrutiny on supply chains that other sectors have experienced in the last few years. This is partly because other sectors have been embroiled in high profile disasters like the Rana Plaza factory collapse in Bangladesh, which killed 1,129 garment workers.

As investors see companies taking steps to control their supply chains in some of these high risk sectors, it is inevitable that their attention will shift to other sectors such as global listed real estate.

There are supply chain risks at every stage in the real estate chain from development and construction to the operation of buildings as assets. The risks obviously depend on the business model and the type of asset. A developer and owner’s risks are the largest and include worker abuse, environmental damage, safety risks, poor quality building materials and labour rights abuses among contractors including cleaners.

The manifestation of any of these risks carries financial and reputational consequences. That is why it is in investors’ interests to understand these risks. If the risks do materialise, they are often material to earnings and, accordingly, valuations. In some cases, they can affect portfolio returns.

Some of the issues that we are considering in our global listed real estate portfolios are listed below.

**Labour Standards & Safety**

Underpaying workers seems to be a global issue, present in even the most stable economies with strong legal frameworks like Australia. In fact, a spotlight has been shone on wage abuse in Australia in the last year, with revelations that some companies appear to have been underpaying workers in the retail and convenience store sector.

In less developed countries, however, the instances of worker abuse can be much more extreme. Amnesty International has reported that some building companies in the Middle East have charged immigrant labourers recruitment fees, withheld wages and confiscated their passports, effectively turning them into slave labour⁶.

Global listed real estate is exposed to this risk. In Australia, the most advanced commercial real estate owners on ESG issues are starting to audit their supply chains on building services such as cleaning. While a real estate asset owner might contract out cleaning services so is not strictly in control of the cleaning services provided, it is no longer acceptable to draw a line of responsibility at employees.

Cleaning has been highlighted as a supply chain component that requires scrutiny because of the suspicion that workers are vulnerable to abuse in that industry. Australia’s Fair Work Ombudsman is auditing 1,000 cleaning contractors at the moment to check whether they are paying workers their minimum entitlements. An investigation in 2010 found that 149, or 40%, of 376 cleaning businesses audited were non-compliant with workplace laws. In announcing the inquiry, the Fair Work Ombudsman noted the industry employs large numbers of migrants and young people who can be vulnerable to exploitation.

**Implications for investors**

Investors and the community increasingly expect real estate owners to control their supply chains; this means monitoring who is carrying out the services and under what conditions. At the very least, they require certain standards from suppliers to reduce the risk of worker abuse.

In the UK, this expectation has now been codified. The *Modern Slavery Act 2015* requires businesses with a revenue threshold of £36 million to issue a public statement on the steps taken to ensure that slavery and human trafficking are not taking place in the business or in any supply chain. While there is no legally binding requirement to conduct due diligence on the supply chain, the statement itself is likely to drive companies to manage their chains much more deeply and will equip investors with another tool to hold companies to account.

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In Summary

Buildings are where we live, work and play, so any social, technological and demographic trends that shape the way we use buildings will have a material effect on investments in global listed real estate.

If real estate owners do not position their assets to meet the new wave of social trends, they will be left with underperforming assets on their books. It is for this reason that AMP Capital pays particular attention to social trends.

Listed real estate managers with a track record of deeply integrating these issues in their investment process will be best placed to construct a portfolio that will deliver an attractive, resilient, long term exposure to this asset class.

CONTACT DETAILS

For more information on how AMP Capital can help grow your portfolio, visit our website, www.ampcapital.com

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