STRUTT & PARKER

PROPERTY FUTURES III

A FLEXIBLE FUTURE:

The rising tide of flexibility and the implications for property investment

We would like to thank MSCI for providing the data on real estate investment performance found in this publication.

CONTENTS

FOREWORD BY FRANCIS SALWAY

One of the biggest changes in the UK property market over the last 30 years has been the trend towards shorter leases. In 1990 the average length of newly granted leases was 23 years[1] . It is now 7 years (to the earlier of break clause or lease expiry). Yet surprisingly little research has been done on the relationship between lease length and investment performance, even though investors and their advisers regularly identify lease length as a key criterion in their investment decision making. So I am delighted that Strutt & Parker agreed to my suggestion that they extend their longstanding analysis of trends in lease lengths to looking also at investment performance by lease length.

What emerges is a picture of outperformance by long lease properties. This might be taken to imply a mis-pricing of short and long lease investments relative to one another. But further probing is called for as the conclusions to be drawn for the future would be different according to the reasons for the variance in the past. If the higher yield premium for shorter lease investments fails to compensate for loss of income and outgoings that is a fundamental pricing issue. However, if differential weight of money caused favourable yield shift for long lease properties and adverse yield shift for short lease investments, the implication is that investors have been risk averse and their capital allocation itself may have driven the differences in performance. If that is the case, the trend might be reversed in the future.

The importance of gaining an understanding of the investment performance of short lease properties is given further impetus by the future trends highlighted in this report - namely around occupiers' growing drive for flexibility and the pressure on landlords to accommodate this.

I would like to thank Strutt & Parker and MSCI for leading on this work, and I would also like to hold it out as an example of collaboration between property practitioners and academics. I had been giving a lecture at the London School of Economics highlighting an extended period of underperformance by short lease properties when an academic challenged me and asked how efficient capital asset pricing could allow an extended period of relative underperformance to continue in this way. Strutt & Parker's report sheds valuable light on this, and is also bold enough to attempt some predictions of future trends in occupiers' demands for flexibility.

[1] **Source:** MSCI

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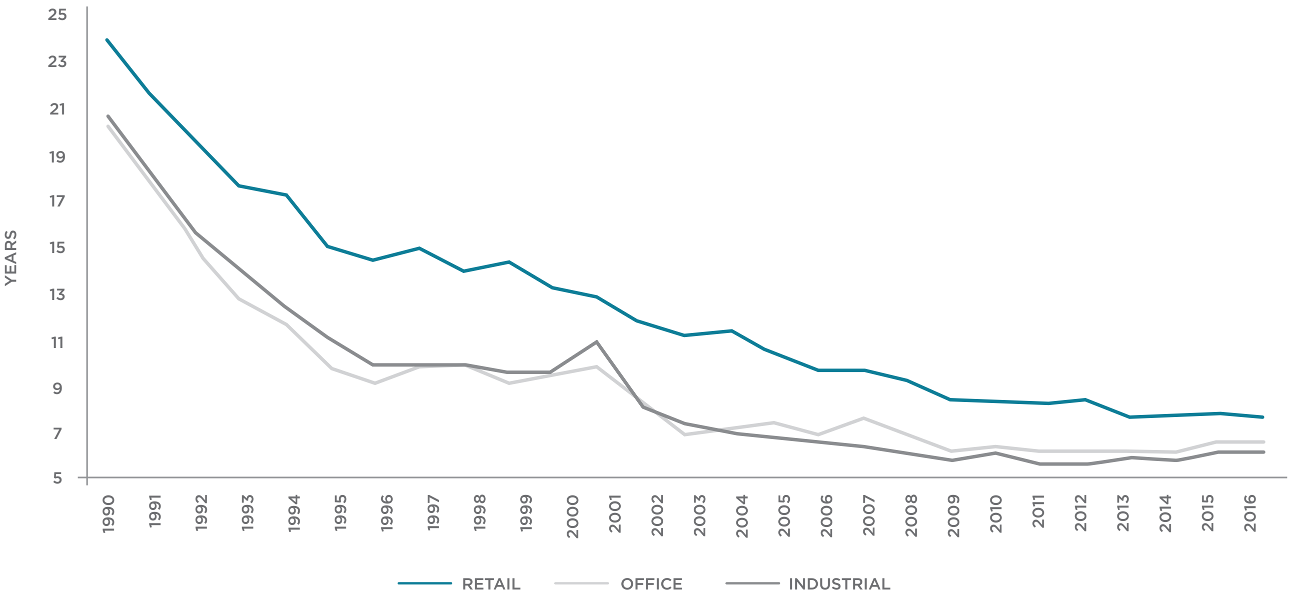
BACKGROUND

The model of property investment in the UK has changed dramatically over the past few decades. In the 1980s, and into the early 1990s, long, upward-only leases were still commonplace with tenant flexibility low and investors' income security high. However, as Figure 1 shows, UK average lease lengths have fallen sharply in recent decades. Furthermore, although average lease lengths appear to have levelled out in recent years, we would argue that tenant flexibility has continued to rise beneath this headline veneer of stability. For example, serviced office occupiers have taken a significant quantum of space in the London office market in recent years - often taking leases out in excess of 10 years but renting space on ultra-flexible terms to tenants.

FIGURE 1

Average UK lease lengths

Period to expiry or first break on all leases excl. those under 4 years, unweighted



Source: MSCI

Already, we have seen investors adopt strategies to mitigate the issue of shortening leases. Tenant relationship management has improved (albeit it has a long way to go to meet gold standards), and market data and research is of a greater quality and more widely used. Some investors are even beginning to embrace the concept of short leasing as a means to ensure the ongoing vibrancy of property assets. Pop-up retail and street food, for example, are increasingly seen as a key part of an asset management strategy, particularly on large contiguous retail ownerships such as shopping centres and retail parks, but also on office and mixed-use estates. Nevertheless, the long-let assets that remain are trading at a strong premium to the wider property market, with investors still seeking income security above all else.

In the following sections we will tackle:

- What MSCI's figures on property investment performance tell us about the impact of shorter lease lengths and more flexible tenancies, and the issues around pricing that the trend raises.
- What trends have and will drive further demand for flexibility.
- How investors can succeed in a world of increasingly flexible real estate.

1

SHORT LEASES AND INVESTMENT PERFORMANCE

1 SHORT LEASES AND INVESTMENT PERFORMANCE

All data in this section is sourced from MSCI unless stated otherwise.

The focus of this section is to examine real estate investment performance across different lease lengths. Notably, we aim to establish to what extent investors should continue to price assets with relatively long lease lengths at a premium to shorter-let properties.

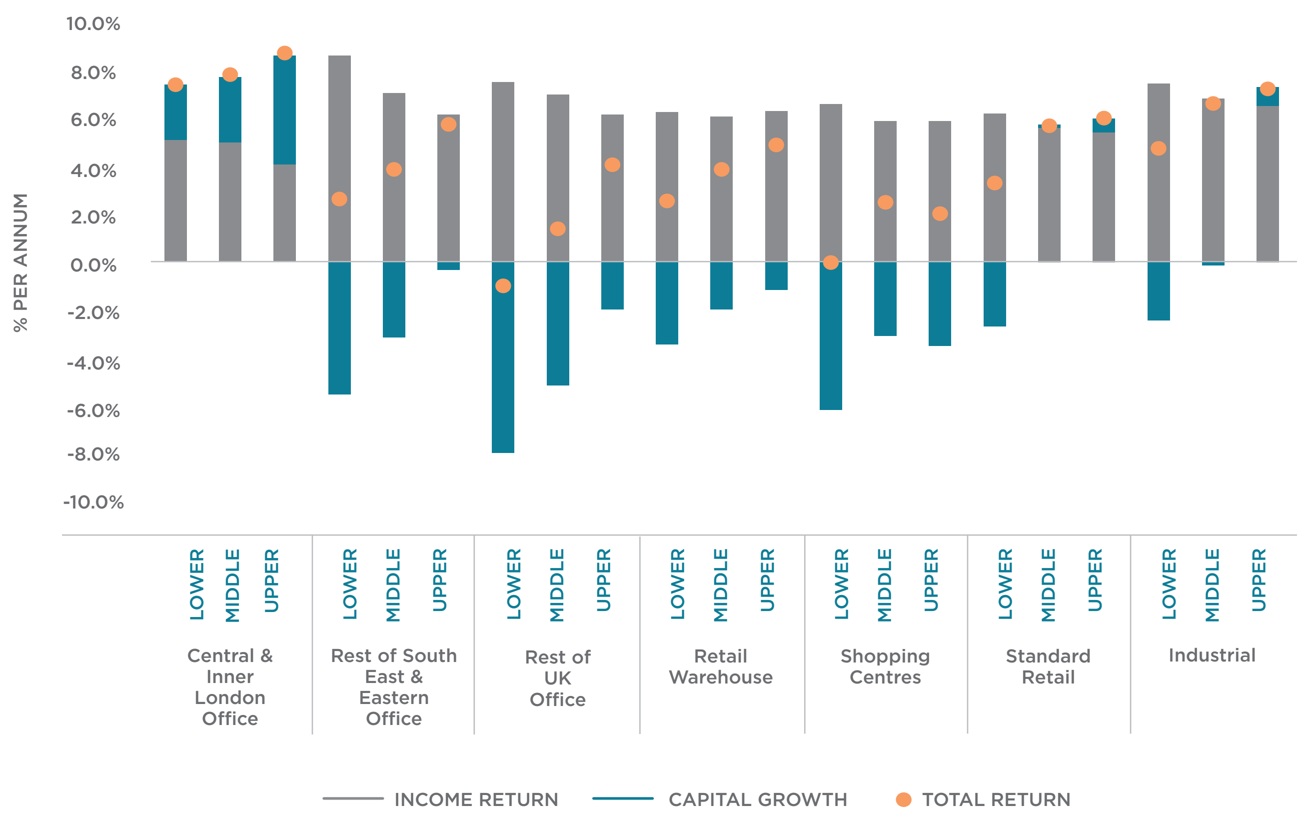
Investment returns of property by lease length

Figure 2 examines total returns per annum from the start of 2008 through to the end of 2016. The chart shows a comparison of the total returns for the main MSCI property segments when split into quartiles by remaining lease length (including breaks).

The Lower Quartile in each segment is those properties with the shortest remaining lease length, and the Upper Quartile the longest.

FIGURE 2

Total returns by remaining lease length, Jan 2008 to Dec 2016 (9 years)



What is clear from examination of all the segments is that, through the past cycle, longer-let property has outperformed shorter-let property. The latter may have either always have been short-let (and so will always have been in the Lower Quartile of remaining lease lengths) or could be properties that were originally longer-let but may have now fallen into the shorter-let category as they near their lease expiry.

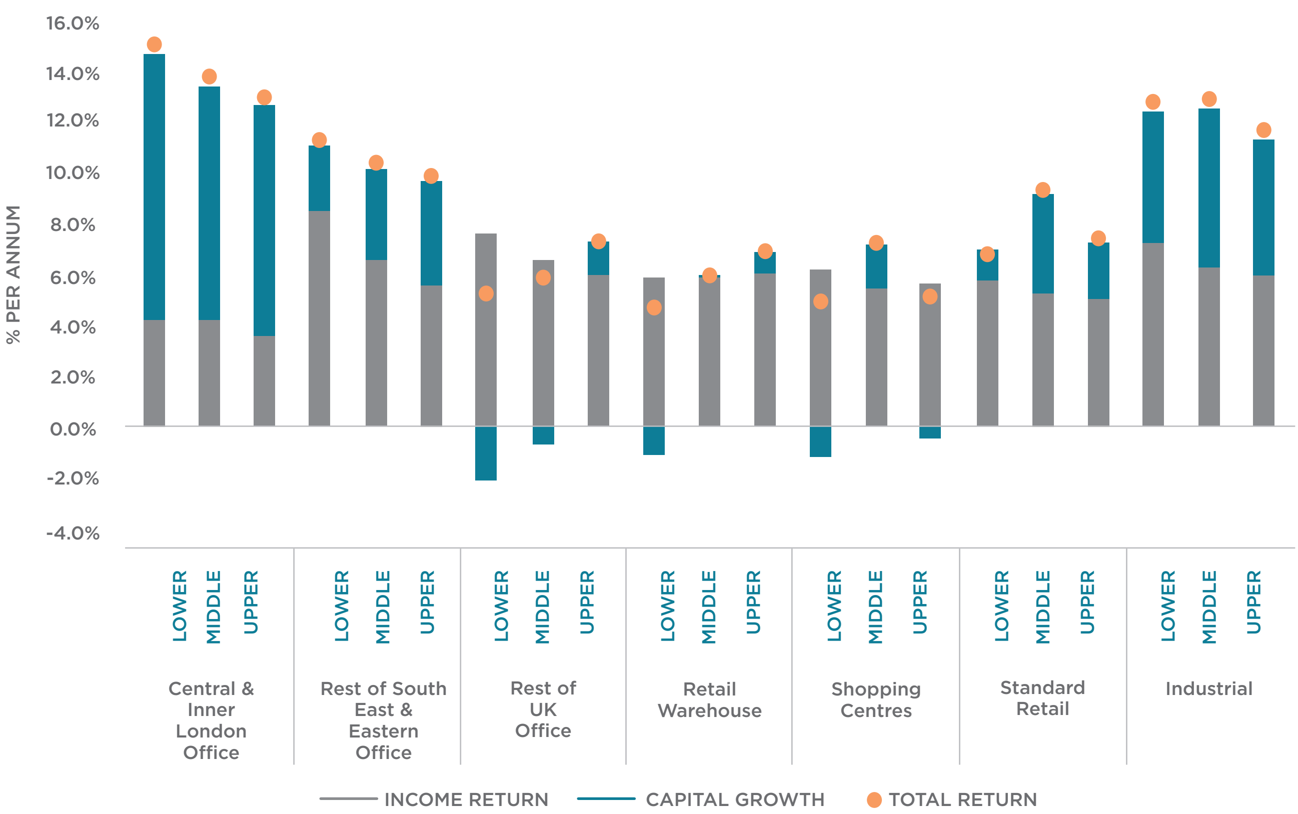
Although on a per annum basis the differences do not look vast, when analysed on a cumulative basis over the nine-year period the performance differential stacks up. For example, in the Retail Warehouse segment, the Upper Quartile saw a cumulative nine-year return of 55%, compared to 26% on the Lower Quartile.

The driver of the performance differential in the case of every property segment examined has been capital growth, with the Upper Quartile samples showing superior performance. On the income return side, the shorter-let segments have generally seen mild outperformance. It is important however to remember that income returns reflect income relative to capital employed, and, with capital values having fallen in most of the shorter-let samples, they do not tell the full story.

In Figure 3 we have taken the same data set but looked at only the last five years of this cycle. What it shows is a more mixed picture of performance between the short and long-let quartiles.

FIGURE 3

Total returns by remaining lease length, Jan 2012 to Dec 2016 (5 years)



In the London and South East office market, shorter-let assets have outperformed since 2012. In the Central & Inner London Office segment, capital growth on short-let assets has been higher, alongside a stronger income return. Whilst in the Rest of South East & Eastern Office segment, capital growth on short-let assets still proved marginally weaker, a very strong income return drove outperformance.

This late-cycle outperformance by London and South East offices is not surprising, given the strong occupational market we have experienced since 2012. We would expect investors to become bolder during a positive occupational market in seeking shorter-let, higher-yield assets, bidding down yields and driving strong capital growth.

In contrast, the other segments continued to experience relative underperformance in the short-let quartiles, capital growth still proving the key differentiator. Investors seemingly nervous regarding occupational prospects in the latter half of the cycle and not prepared to take on leasing risk, with higher income returns failing to compensate for the subsequent lack of yield compression on short-let assets.

What are the underlying factors driving the significant differences in capital growth?

In order to understand the causes of the performance differential between long and short-let property, we need to establish the extent to which the higher capital growth of the longer-let quartiles has been driven by investor sentiment (yield impact) or by cashflows.

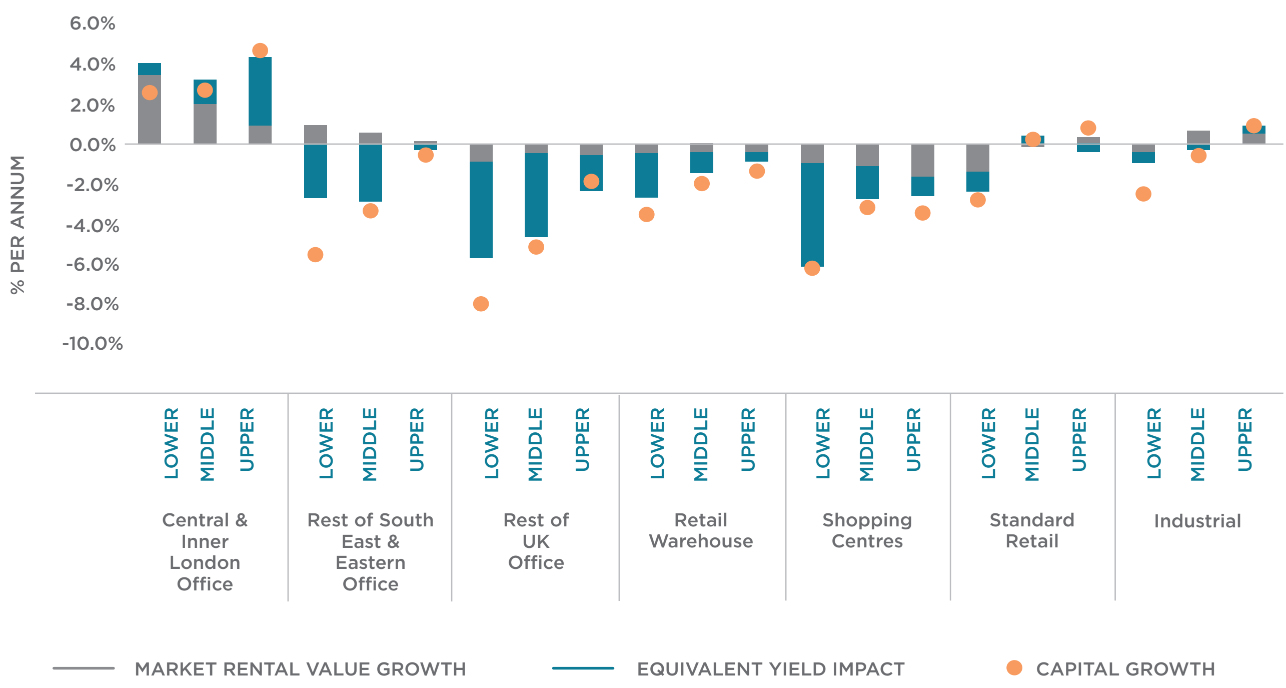
Put another way, are longer-let properties delivering superior capital growth purely based on differential yield impact, which could reflect a combination of risk aversion and expectations on future rental income growth? Or, are greater returns also being derived from stronger cashflows – justifying investors' preference for more secure income at the cost of lower yields.

In Figure 4 we have broken down capital growth into its main constituent parts: market rental value growth and equivalent yield impact.

The data demonstrates the extent to which, over the 9-year measurement period, the Upper Quartile segments' capital growth outperformance was driven by yield impact. In contrast, when we look at the market rental value growth figures, again split by remaining lease length, we can see far less distinction in performance. In the case of Central & Inner London Offices, we actually see strong outperformance on rental value growth by the Lower Quartile, with rental value growth of 3.4% per annum over the period compared to 0.9% per annum on the longer-let sample.

FIGURE 4

Capital growth breakdown by remaining lease length, Jan 2008 to Dec 2016 (9 years)



In summary:

- In virtually all sectors, the primary driver of underperformance of shorter-let properties is inferior capital growth (see Figure 2) and, within that, adverse yield movement is the primary driver (see Figure 4).
- In the Central & Inner London Office sector, owners of shorter-let investments enjoyed superior rental value growth. This may reflect their ability, in a sector enjoying good overall rental value growth, to drive the tone of rents in their buildings where they had short leases. However, rental value growth is only part of the story. It does not take account of the higher voids likely to be seen on short-let properties as leases expire more regularly.

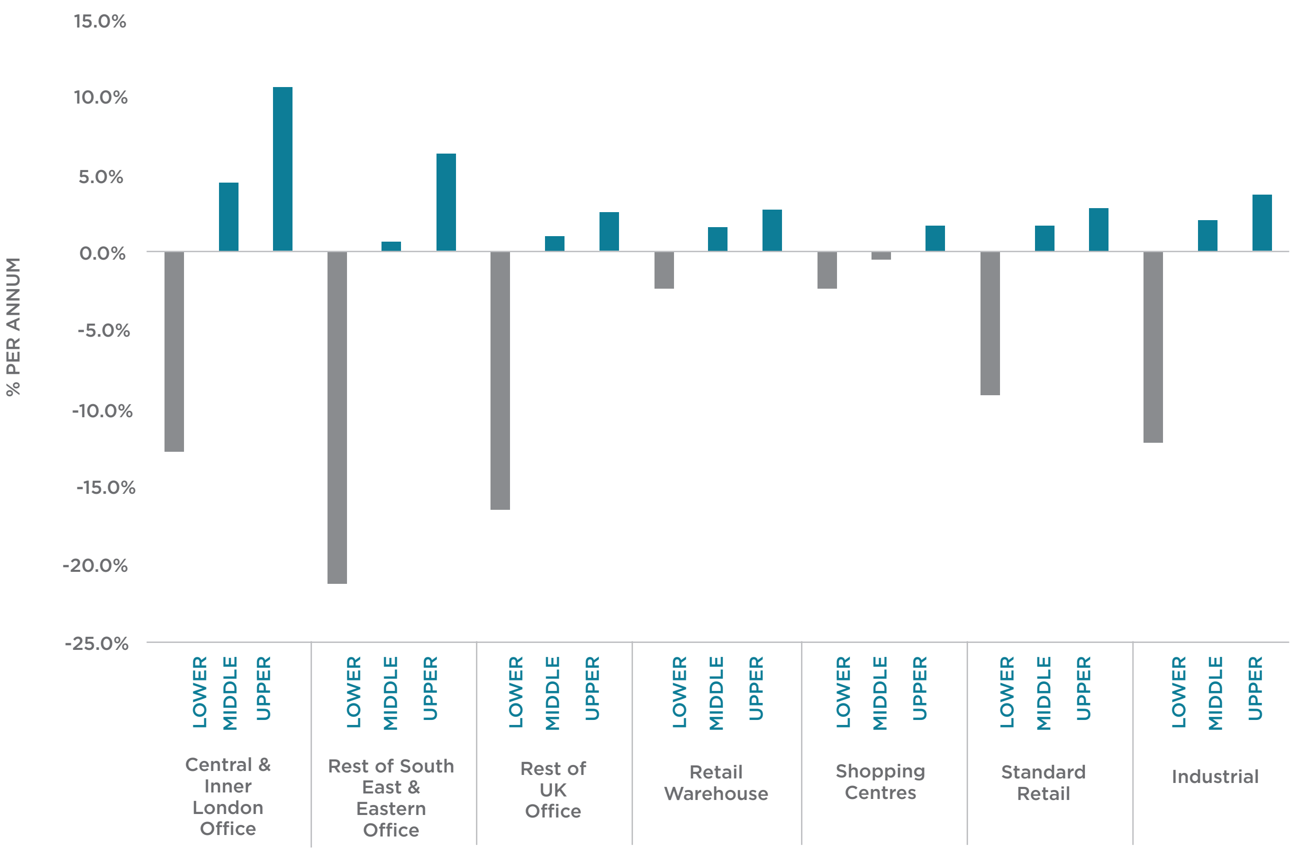
Analysing the underlying cashflow

To take the analysis further, we need to look at changes in actual income received. Figure 5 shows the changes in gross rent passing over the nine years to the end of 2016.

In every one of the segments analysed, the Lower Quartile (by remaining lease length) delivers growth, or rather decline, in gross rent passing below the longer-let samples. This is notably the case in the office sector, where gross rent passing appears to have declined significantly across the measurement period.

FIGURE 5

Gross rent passing growth by remaining lease length, Jan 2008 to Dec 2016 (9 years)



There are, however, caveats to this data:

- We don't know the extent to which the Lower Quartile samples are split between properties that were short-let in the first instance, or properties that were let on longer leases in the past - with these leases now running down to expiry.

- Neither do we know the age breakdown of the assets across the different quartiles. Looking at the Lower Quartile (or short-let) sample, this may mean that better quality short-let assets are having their performance dragged down by a part of the sample that reflects the performance of older properties that will likely need significant refurbishment when they fall vacant.

- Nor do we know the extent to which the assets in the Lower Quartile are seeing floors (or units) become vacant and left so until the rest of the building (or site) falls empty and the property can then be fully refurbished or redeveloped. This would have the effect of making standing investments appear to have declining contracted income, and rising vacancy, even though they are effectively being held for redevelopment. Such strategic activity would account for the very sharp declines in gross passing rents seen on the office segments, where the practice described is common.

- Furthermore, over time property assets can move between the quartiles as they are relet or fall vacant. If, for example, a property in the short-let quartile experiences new lettings/renewals/re-gears that see its weighted remaining lease length increase, its current quartile will enjoy some of the performance benefits in that quarter; but then the asset will be reclassified and leave the sample. On the other hand, as assets in the longer-let quartiles see their weighted remaining lease lengths run down, these assets will fall into the shorter-let quartile.

Notwithstanding these caveats, it is clear that the shorter-let properties exhibit greater volatility in income and potentially declining income. However, the fact that income returns are slightly higher on shorter-let properties than longer-let (see Figure 2) indicates that this volatility in income is being compensated for by a higher initial yield.

Looking forward, there would seem to be a number of major issues for property investors to consider:

1.
Although the outperformance of the Upper Quartile of assets (by remaining lease length) cannot be doubted, it is primarily attributable to stronger yield compression driving capital values, as opposed to market rental value growth.
So, in effect, it reflects investors' risk aversion to the undoubted future volatility of cashflows on shorter-let investments. However, if the differential yield shift has run its course, could investors become attracted to the slightly higher income return on shorter-let investments?

2.
If tenant demand for flexibility were to continue to grow in the coming years (which appears likely), and the supply of core, long-let assets to continue to shrink, must landlords increasingly face up to their demands and develop new business models?

3.
The better performance on rental value growth for shorter-let investments in the Central & Inner London Office segment is clear-cut. Will it encourage more investors to drive outperformance through investment in shorter-let properties in areas where overall demand, and specifically demand for flexibility, is strongest?

4.
Will technology - having proved a significant driver of occupier flexibility - now prove to be investors' saviour in enabling them to meet the challenge?

The following sections pick up on these thorny issues.

2

THE RISING TIDE OF FLEXIBILITY

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The last 20 years have seen a significant increase in the flexibility of real estate occupiers: shorter lease lengths, increasing use of break clauses, and lower levels of renewal at lease expiry. The UK Lease Events Review that we publish alongside MSCI and the British Property Federation explores these issues in detail.

In our background section, we touched on trends such as the rise of serviced offices and pop-up retail, as well as investors' more progressive attitudes towards customer services and research, as they have striven to stay on top of these trends.

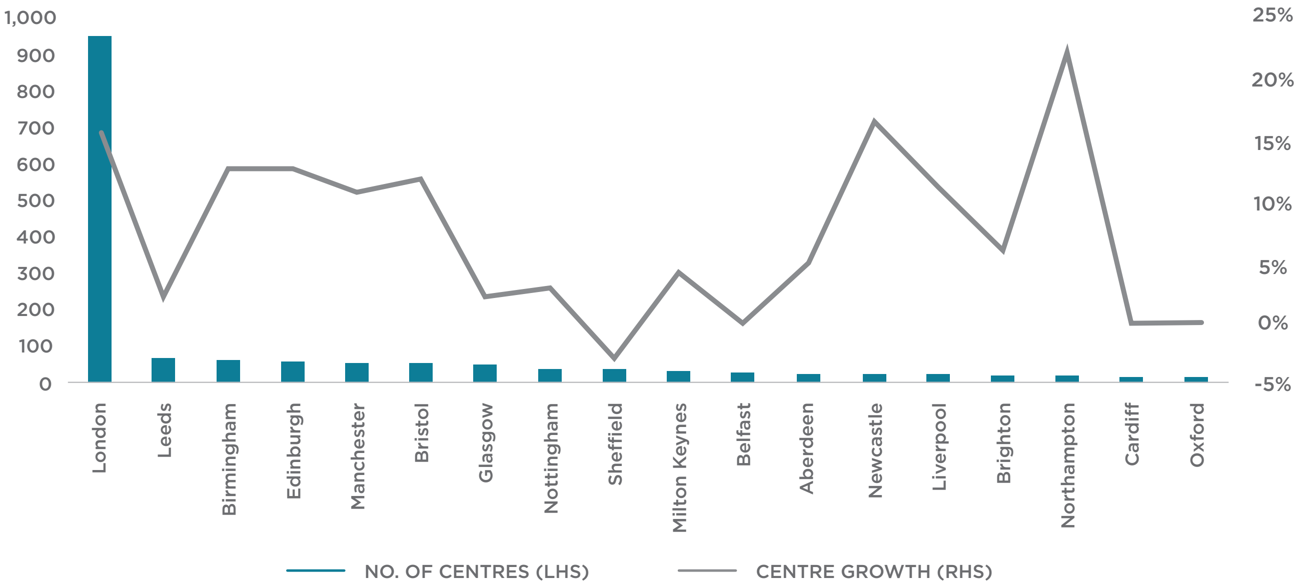
In this section, we consider in more detail the underlying drivers of demand for more flexible space and tenants' seemingly far greater propensity to 'get up and leave'. We also look at whether we should expect these trends to accelerate further, putting greater pressure on investors to adapt.

The serviced office sector comes of age

Figure 6 shows the extent to which the growth of serviced office centres (including 'coworking' spaces) continues apace. In 2015/16 the number of centres tracked by Instant Offices (a serviced offices broker) in the UK rose by 11%. London now has 944 centres (and rising), having swelled its numbers by 16% during that year.
In contrast, other key UK business locations have low levels of centres, although in many cases their numbers are growing at double-digit percentage rates.

FIGURE 6

Serviced office centres, 2015/16 numbers and annual growth



Source: Instant Offices – Flexible Workspace Review 2016

What should we expect in the future? A further expansion seems inevitable, given the run on serviced office or 'coworking' spaces we have seen in recent years.

Looking at the issue more fundamentally, the reality is that businesses in the UK, even large ones, have come to recognise that their business turnover (and implicitly employment base and space requirement) does not remain unchanged for 5, 10, 20 years. Thus fixed real estate over that period no longer aligns with business strategies. This does not mean the fixed-term lease is dead; far from it. However, it does mean that businesses increasingly treasure the idea that their use of office space (and what they're paying for it) should rise and fall in tandem with their business fortunes.

Consequently what we are increasingly seeing is medium-to-large sized companies taking serviced office space as an overflow solution, satellite or project space. Businesses recognise that having a portion of their corporate real estate footprint in serviced offices provides a vital level of flexibility that more than compensates for the higher marginal costs incurred during the period of occupation.

Smaller companies dominating employment growth

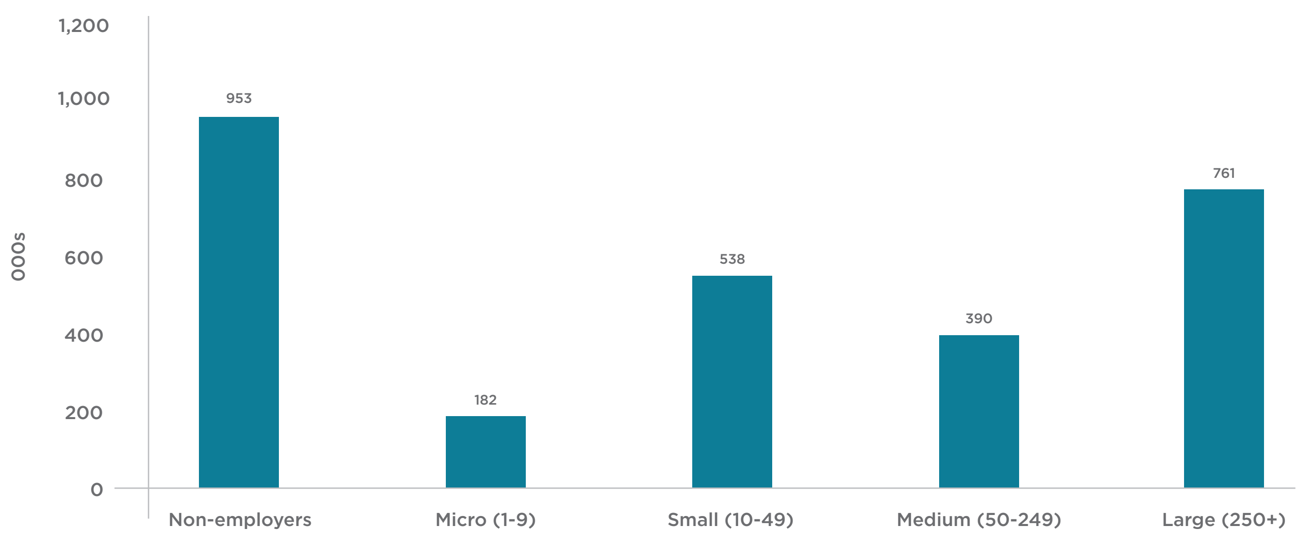
Providing further evidence to support the idea that demand for short leases will continue to advance, the Office for National Statistics (ONS) publish statistics that suggest growth in private sector employment levels is being driven by smaller companies. Figure 7 shows the net change in private sector employment levels in the UK from 2010 to 2016.

What is clear is that small and medium-sized enterprises – typically defined as any business with fewer than 250 employees – have been the dominant drivers of employment growth as the UK has recovered from the global financial crisis.

As a caveat, this does not mean that this trend will continue unabated. However, the data does suggest that the number of people employed by smaller organisations is on the increase, with smaller firms inevitably needing more flexible and shorter-let space.

FIGURE 7

Net change in employment levels in the UK private sector, 2010-2016



Source: ONS Business population estimates 2016

International lease accounting standards draw near

We expect occupiers' drive towards more flexible leasing to be given further impetus by the introduction of the new leases standard – IFRS 16 Leases – by the International Accounting Standards Board from 2019.

This will mean that the rent due on operating leases will appear on balance sheets as both a liability and asset (reflecting the right to use), with the rent no longer recognised as a rent expense, but rather appear as interest and depreciation expenses.

In short, the liabilities of companies with large lease commitments will increase sharply, given the newly established explicit link between contractual promises to pay rent over time and firms' balance sheets.

We expect this will further drive companies, where appropriate, to seek more leasing commitments with a maximum term of 12 months or less, which are not considered by the new standards. In the UK, the standards will impact all companies reporting under IFRS guidelines.

Bricks-and-mortar retail and leisure gets flexible

Although the rise of serviced offices and flexible working has garnered a lot of attention in the real estate world, leases have shortened to the same degree in the retail sector. The contributing structural factors are, however, quite different.

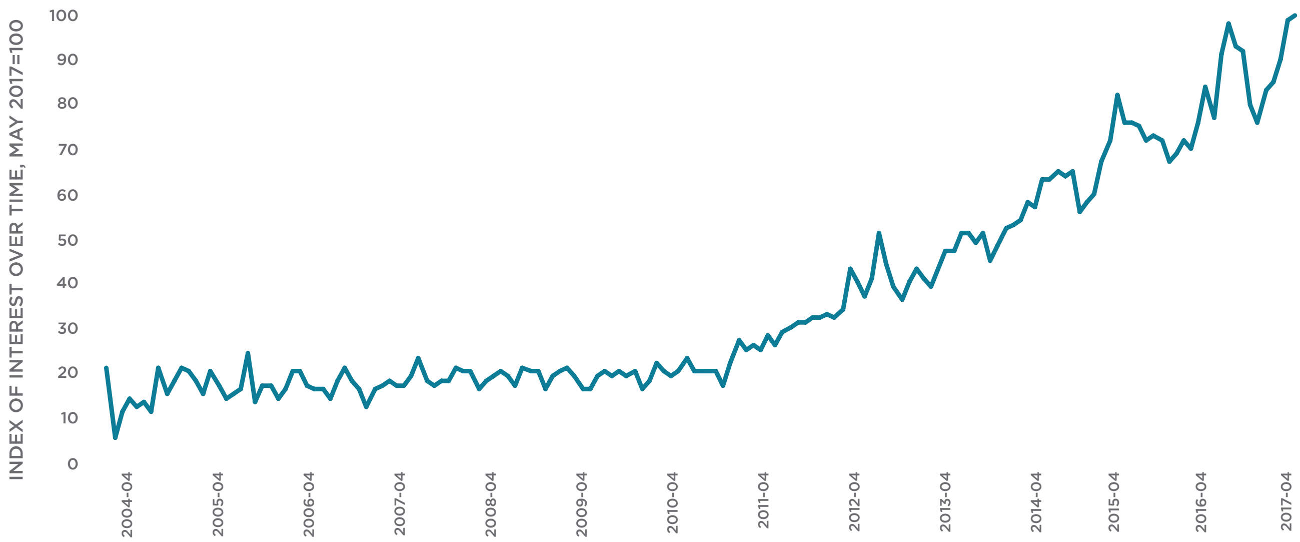
On the best high streets, and in the best shopping centres and retail parks, retailers continue to actively seek long lease terms for strategic reasons. Retail/leisure location plays a key role in success, and the best units are something occupiers remain willing to fight for; they continue to crave inflexibility (in other words, certainty of occupation). On the flipside, the rise of online retail – which represented 15%[2] of UK retail sales in 2016 – has weakened, and in some cases devastated, non-prime retail locations. This gives us two markets to analyse: prime and the rest.

In prime areas, landlords have not had to embrace short leases as a market necessity – retailers still want to be there. They are, however, increasingly using them in a strategic sense. Because, although prime retail areas have weathered ecommerce well, they have still seen, and had to respond to, structural change. For example, large shopping centres – in seeking to differentiate themselves from online retail and become genuine retail and leisure destinations – are increasingly making use of pop-up retail in some areas in order to keep the retailer line-up fresh. Providing 'curated' retail space enables up-and-coming retailers - who cannot afford, or do not want, to pay for longer leases - to lease space in prime destinations and contribute to their overall vibrancy. In other words, pop-up retail is increasingly an asset management or placemaking tool.

[2]**Source:** Office for National Statistics

FIGURE 8

Google search term: Street food (United Kingdom)



Source: Google Trends as at 23 May 2017

Furthermore, a flexible food offering is playing a role in landlords' attempts to turn office districts into mixed-use, seven-day, destinations. In Canary Wharf (an office district becoming increasingly mixed-use), street food is being seen as playing a key role in placemaking with the opening of a permanent street food operation by Street Feast (an established food market operator) called Giant Robot in the new Crossrail Place development.

Our Office Futures: Workshift research (published in 2016) suggests that food options play a key role in the attractiveness of office environments to employees, with street food ensuring an exciting offer. Figure 8 shows the increasing Google search interest in 'Street food' in the UK. Aptly illustrating the extent to which the sector has taken off in the last five years.

Mobile technology has freed tenants from 'sunk costs'

A fundamental, and sometimes overlooked, part of tenants' growing flexibility is the growth of new technologies that enable them to lower the costs of moving in and out of property. The removal of these 'sunk costs', a cost that has already been incurred and cannot be recovered, is fantastic from an economic efficiency point of view, even if for landlords the benefits are not immediately obvious.

The growth of mobile payment solutions has freed retail tenants to operate in a more flexible fashion than previously; not having to transport cash registers and cables around, operating in whichever environment proves most suitable – something epitomised by the growth of high-quality street food markets around London and other parts of the UK.

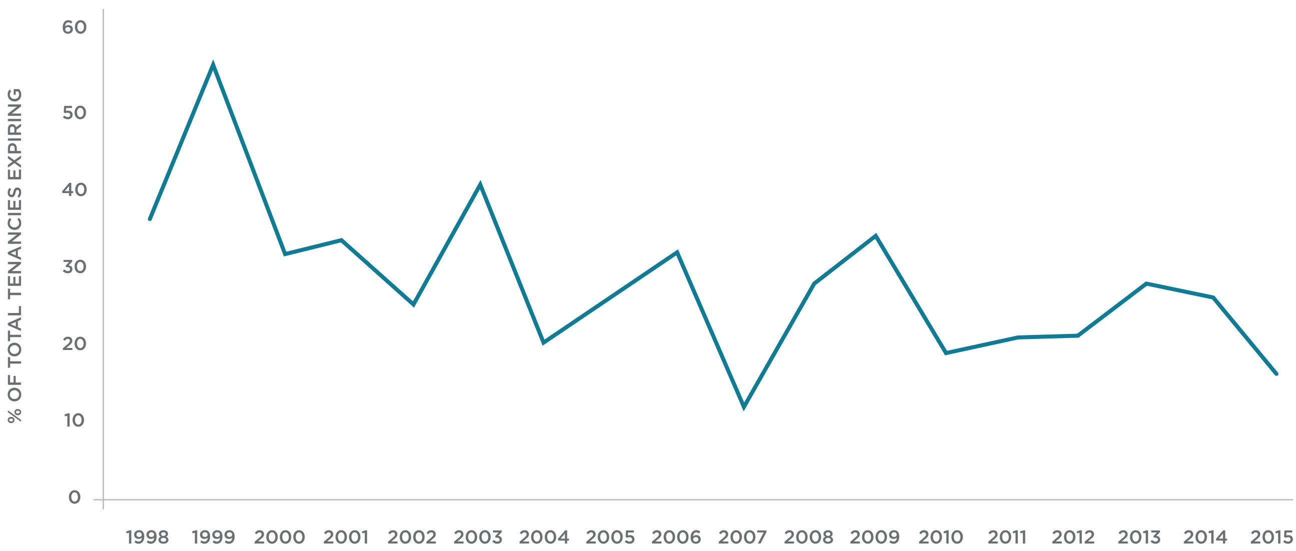
Looking at the office sector, the ascent of laptops, tablets and mobiles, alongside cloud servers, is also reducing the moving costs for office tenants, as well as encouraging them to move to more flexible models of leasing with less long-term fixed space.

Both of these trends are likely to continue, decreasing the extent to which tenants feel 'wedded' to any particular premises. From a landlord's perspective this growing mobility is a negative. The UK Lease Events Review suggests that, over time, tenants have becoming increasingly willing to leave their premises at the end of leases instead of renewing them. Figure 9 demonstrates this trend in the office sector, where it has been particularly notable. Technology will continue to support that trend.

However, as we discuss in our conclusion section, it is not all doom and gloom, and perhaps technology also holds the key to enabling landlords to adapt to occupiers' rising flexibility.

FIGURE 9

Rate of renewal at lease expiry, All Office, weighted as % of previous rent passing



Source: UK Lease Events Review – MSCI/Strutt & Parker

3

INVESTOR SOLUTIONS

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Looking forward, issues will centre on how investors can minimise time between rent-paying tenants when voids occur and how void costs can be minimised. More strategically, can they use short-let tenants to attract longer-term tenants or ensure that when tenants' leases/licenses expire they will be keen to stay on?

The proposed and possible solutions to such issues will ebb and flow – particularly given the increasing rate at which technology is penetrating the property industry. Throughout the rest of this section we offer suggestions and predictions for both investors and developers.

In summary, it is clear that tenants increasingly want (and can get) flexibility. From an investment standpoint that creates more volatile cashflows, although the income return figures from MSCI suggest that higher yields for shorter-let properties can compensate for this to a degree. On a positive note, industries that give their customers what they want are usually successful, and there is some evidence that shorter-let property can deliver strong market rental value growth for precisely that reason.

REDUCING THE TIME BETWEEN TENANCIES AND MINIMISING TRANSACTION COSTS

A major issue with short leases (or leases with limited time remaining) has been landlords' void costs in the aftermath of a tenant leaving, not to mention any necessary refurbishment. As the trend towards short leases continues, it will be vital for investors to make the transition to new tenants as efficient as possible.

Bring greater speed, efficiency and transparency to the leasing process

It will be vital for the real estate sector to keep driving efficiency in the letting process, and providers seeking to achieve this are already entering the market. For example, commercial property leasing and asset management software platforms, such as Rialto and VTS, allow agents, developers and landlords to view their leasing activities and portfolios in real-time, with the objectives of driving greater transparency and efficiency in leasing and management. LeasePilot, a US–based company, has developed a document automation platform allowing the process of drafting and editing leases to be sped up significantly.

Without doubt, we will see this part of the market grow quickly in the coming years and pressures from the occupier market's desire for flexibility will drive landlords and agents to seek greater efficiencies through automation and technology.

Many experts believe Blockchain – the encryption technology underpinning the online currency Bitcoin – will revolutionise the way commercial (and residential) property is leased and sold, by allowing buyers and sellers to conduct secure, rapid transactions via secure Blockchain networks. Sweden is trialling the concept of putting the country's land registry on the Blockchain, with the long-term idea that fraud will be reduced whilst real-time record keeping of land and property ownership, and changes in ownership, will be much improved.

Turning to office leasing specifically, the Cambridge Innovation Centre (CIC) in Rotterdam - a start-up hub for innovation companies – is working with the city of Rotterdam and Deloitte Netherlands to develop a Blockchain-based app to record lease agreements, enabling both the city and companies housed in CIC office space to conclude contracts for space faster and more efficiently.

Adjust to tenants' shift from fixed to flexible space demand

The industry needs solutions to the disparity between the innate complexity of property as an asset and the needs of modern tenants for flexibility.

Fortunately, solutions are appearing. Liquid Space, an online platform that functions rather like an AirBnB for offices - currently operating in the US, Canada and Australia – uses the web to connect those looking for space directly with those looking to provide it. This also speeds up the process of taking space by means of a proprietary license agreement that allows some of the legal complications and delays to be removed.

Similarly Hubble HQ, a UK-based firm, connects start-ups and other small businesses with those who have space to rent out, and automates the licensing process online. In both cases, the online platform allows companies to filter for available space using very detailed criteria around the space itself and the surrounding area.

Operators are providing a solution for one of a landlord's chief problems; they allow landlords to cheaply match space to smaller, flexible tenants and get them into the building and paying rent more quickly than a formal leasing process. Practically speaking, they allow investors to fill in the space in their buildings that emerges between longer leases from major tenants, or, perhaps, to fill space quickly and effectively, whilst positioning the building for a major refurbishment or redevelopment. On the flipside, the service is also of great use (and comfort) to tenants, who may find themselves with excess space - which would normally be tricky to let – and the ability to sublet it (alienation provisions notwithstanding) for a period of their choosing.

Increasing use of specialist plug-and-play (or 'white box' property)

Although serviced offices or leased 'plug-and-play' spaces have been around for some time, they have seen a sharp expansion in recent years. Moreover, the sector's offering has widened considerably to include 'coworking' space, 'accelerator' space and others, marking its maturation from a fringe sector to one actively sought out by tenants seeking to support their operational business needs.

Looking forward, we expect this trend to continue; but perhaps with an even wider offer and some small structural shifts as landlords become more involved in the market.

Indeed, we are seeing some office investors take the view that rather than outsourcing the issue of tenant flexibility to serviced office providers - with the providers taking on the management and being rewarded with the 'profit rent' – they should more directly engage and take charge of the underlying cashflow themselves.

ADVANCED TENANT RETENTION STRATEGIES

Aside from the operational issue of decreasing the costs and voids inherent in short-let property, investors will inevitably become more customer focused – something which is well-established amongst some of the investor community.

Creating genuinely mixed-use developments, where different property types serve to complement each other, and placemaking is fundamental to tenant retention

This may, of course, seem fairly obvious. Larger investors - such as British Land and GIC at Broadgate, and Landsec at Victoria – have already put the public realm, and a real mix of amenities (with a very strong food offer), at the heart of what they are doing on their major office estates. However, it is not a strategy that is easy for everyone to deliver. For investors without large-scale estate-like holdings, engaging in such a strategy means substantial engagement with other investors in order to form a strategy. Business Improvement Districts can help to align and manage competing interests to a degree, but certainly not to the same extent achieved by those that own and manage whole estates.

In the world of retail this issue is much discussed; the fragmented ownership of high streets, and consequential lack of a focused placemaking strategy, is seen as a major contributor to their malaise. Though it could be argued in many areas that dismal local economics has swamped this issue somewhat. Looking to shopping centres, we have already seen their allocation of food & beverage and leisure space trend upwards – our Property Futures research (published in 2015) predicted a 50% share in the largest centres by 2025, a prediction that is starting to look a little unambitious. Retail parks are beginning to follow a similar strategy. In both cases, they are likely to have a range of town-centre-like services in the not too distant future, alongside flexible business space.

In both the cases described, the strategy has really evolved from the simple fact that mono-use real estate is simply not competitive in the modern world: people's different lives as employees and consumers are no longer so easily segregated.

Using smart buildings and ancillary services to support occupiers' day-to-day business activities

Smart buildings are a hot topic and covered exceptionally well elsewhere; however, it is worth briefly covering their contribution to the debate around tenant retention in a short-lease world.

The data produced by smart buildings will enable occupiers to track building usage over time in great detail, using the insights produced to achieve far higher levels of space efficiency than currently achieved. On the surface, this new tenant efficiency would seem disadvantageous for landlords (given its likely translation into lower space demands); however, the flip-side should be a far better understanding of occupiers' demands and an early warning system of the likely changes in said demand over time. Who the data belongs to and how it is charged for is a matter that will need detailed debate. Tenants may choose, for example, to 'hoard' their data by installing smart building apps as part of their fit-out, or they may have an explicit agreement that data collected by the smart building belongs to them (with the service paid for implicitly in the rent agreed).

Taking things further, smart buildings and Big Data also give landlords the chance to offer services to tenants to drive employee productivity – the UK does have a well-documented problem with productivity after all. Giving occupiers' employees tailored lighting and air-conditioning control – alongside a multitude of other options – is clearly a positive with a growing number of studies suggesting a translation into better productivity. Something that should appeal to occupiers even if some are taking a while to cotton on to the link between the workplace and employee outputs...

We have focused on the office, owing to what we have seen in the market so far. However, smart buildings are unlikely to be confined to this sector when they have so much to offer retail and logistics tenants too.

Predictive analytics on occupier behaviour

The use of Big Data for business is growing exponentially as governments, investors and firms seek to mine every bit of information they can to gain a leading edge over competitors or drive efficiency savings in their daily operations. With the availability of data from platforms such as Twitter, government open-data sources, Google and many others expanding at a seemingly ever-increasing rate, property investors have the opportunity to garner much greater insight and foresight into likely tenant behaviour and financial viability.

It is now possible to track a firm's Twitter followers, Google searches for it or its products and its job listings - all giving insight into company activity in real-time, and certainly faster than trawling through quarterly reports. Even basic Google users have the ability to look at a restaurant's predicted level of visitation on a day at any time for free, with the recent addition of a 'live' tag allowing users to see up to date nowcasting of a location's popularity using anonymised location data from other Google users.

We are only really scratching the surface here, and over time this form of data will allow investors to have superb live insight into tenants, and adjust their strategies in line with the risks and opportunities being presented.

A new kind of lease?

An issue we have somewhat glossed over in this paper is that of the impact of declining income security on valuations. Regardless of improvements we are likely to see in the coming years in terms of delivering smoother, more consistent cashflows from short-let property, valuations are still likely to suffer as income security declines. And landlords will still be incentivised to pursue long contracted income – particularly those having to report quarterly valuations to investors.

We believe that in the multi-let office building there may be an answer. A possible model would be a 'core and flex' model, whereby tenants rent a fixed square footage over the lifetime of a lease, with the lease granting them, over the same lease period, the right to a certain amount of bookable space on a 'flexible floor,' space that can be booked by the hour, or week. This solution protects average lease lengths, whilst allowing tenants to flex their space requirements effectively over the time of a lease.

It is perhaps a slightly contrived solution, but one we believe in and are also aware is now on a number of investors' radar.

IN CONCLUSION

Technology is now moving at a rate at which it is hard for businesses to keep up. No one can truly predict the impact of automation, artificial intelligence, Big Data and other innovations on business; hence the need for investors to understand their current and future tenants' needs becomes ever-more important. What we do believe, however, is that tenants' desire for real estate that more closely matches the ebbs and flows of their businesses, and shakes off its innate inflexibility, is only going to increase in the coming years.

For many investors, the temptation will be to increasingly chase a shrinking base of low-yielding, long-let assets. However, for those seeking higher returns, embracing the challenge presented by changing occupier demands will be key to consigning short-let property's recent underperformance to the past.

CONTACT US

A DIFFERENT APPROACH TO HARNESSING INSIGHT

Research at Strutt & Parker is about understanding the markets, knowing what the trends are, and identifying and monitoring those drivers that will impact property over the short, medium and longer term.

A flexible team, we are focused on the vital insight necessary to assist our clients across all our market areas, from commercial, development and residential through to consultancy, farming and land management.

We are different from the traditional property research model in two key ways. The first is that, instead of a group comprised of specialists, we have taken an alternative and holistic approach with each of us working across all sectors, allowing us to spot convergence and divergence between property asset types. Secondly, we partner with best-in-class specialist research groups to ensure we are always open to new ideas, learning new tools and delivering the excellence our clients deserve.

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