The future of the entire real estate asset class – and real estate investment management as a specialist industry – is under threat from broader and more sustainability-aligned real asset or infrastructure typologies

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2024

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Abstract

The future of the entire real estate asset class – and real estate investment management as a specialist industry - is under threat from broader and more sustainability-aligned real asset or infrastructure typologies.

Active real estate asset management is increasingly important in the delivery of real estate returns. In addition to the effect of legislation and taxation, this is the result of changing occupier preferences and increasing customer power; technology; and sustainability.

Demographic, lifestyle and political changes (primarily expressed through the privatization of former public services) have produced a need for new real estate formats, including private rental, affordable and senior housing; student accommodation; self-storage; co-working; medical centres; data centres; and others. The main effects of these changes on real estate investment are (i) a bigger range of revenue models for investors to consider, and (ii) varied degrees of operational leverage assumed by investors.

Operational properties are more directly dependent on the operation of the business carried out within the building. The heightened operational risk means that specialist skills are required to manage these real estate assets.

We are also witnessing the beginning of a long period of tension between the need for buildings which minimise waste, energy use and carbon emission, and the environmental and financial cost of producing those buildings. On the one hand, we need buildings and spaces which make a neutral or even positive contribution to the environment by operating efficiently, using limited energy, wasting little or no water; and on the other we need to conserve or not produce materials which consume energy in their production.

Owners of underperforming and / or stranded assets that exhaust their operational potential without significant capital expenditure on retrofitting and/ or change of use are facing a very challenging period in the current interest rate environment. Investment managers will need to consider very carefully whether they wish to become operators themselves.

Traditional investment managers can protect themselves from becoming obsolete by investing in operating businesses at the startup stage. This could be a highly productive marriage. The future for real estate investment management may be challenging, but necessity is the mother of invention.

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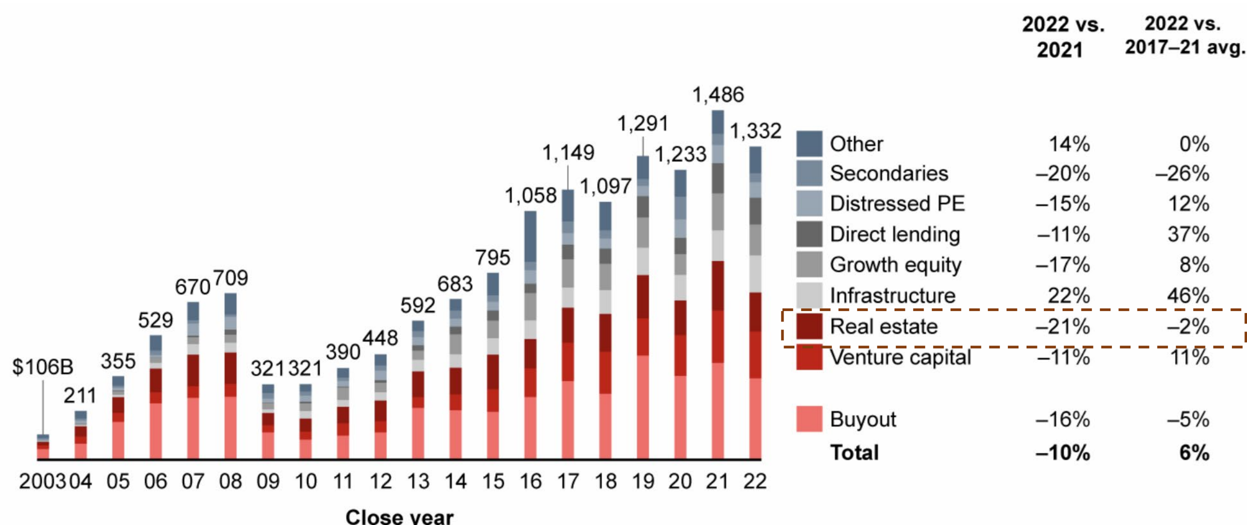
The real estate investment manager of the future[1]

1: Real estate - an increasingly operational business

Active asset management is increasingly important

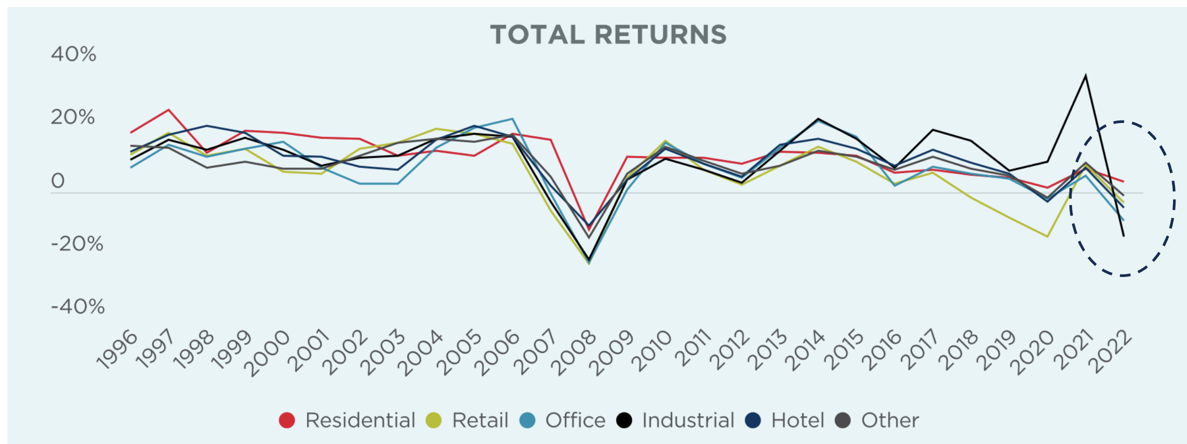
Active real estate asset management is increasingly important in the delivery of real estate returns. In addition to the effect of legislation and taxation, this is the result of three market drivers: changing occupier preferences and increasing customer power; technology; and sustainability. Added to that, the current higher interest rate environment means that real estate investment managers are actively searching for high-yielding asset management strategies to cover the cost of capital. Real estate's ability to protect real value during periods of higher inflation has historically been one of the biggest reasons for institutional investors to back real estate strategies, but real estate was the worst performing asset class by funds raised in 2022 relative to 2021 (figure 1), and returns collapsed in 2022-2 (figure 2).

Figure 1: Global private capital raised by fund type ($bn)



[1] Some of the content in this paper is drawn from Andrew Baum (2023): *Real Estate Investment, A Strategic Approach*, Routledge

Figure 2: Real estate returns, 1996-2022



Source: Cushman & Wakefield, MSCI

Shorter leases are a long term trend

The importance of active asset management and a stronger focus on the occupier has increased with the shortening of leases across all sectors of the UK market and others. The traditional UK lease structure of 25 years plus has been long extinct, with the crash of the early 1990s being the beginning of the end.

The average length of a commercial lease shrank from 22.5 years in 1990 to 5-6 years by 2020. Shorter leases carry several risks, including the following.

1. There is more cash flow risk from lease expiries. Each expiry carries the risk of loss of cash flow and additional costs to prepare the space for the next tenant if the tenant vacates.

2. Tenants have increasing customer power in lease negotiations

Both of these risks lead to investors spending more time and more money on occupier management than was necessary with longer lease terms. More than ever, investment performance is driven by an investors' ability to actively manage risk events such as lease expiries, break clauses, vacancies, and defaults.

'Lease events' include, primarily, any opportunity for the tenant to leave or to be ejected from a property, or for the rent payable to be increased or reduced. Managing lease contracts is a core component of an asset management strategy. The re-negotiation or 're-gearing' of leases usually has the aim of extending the investor's cash flow from a property and reducing risk. A longer lease, with regular or indexed rent increases and fewer break clauses, is believed to mean a more secure income and thus a more secure investment over a longer period of time, which will be valued more highly than a riskier property. In addition, leasing to a lower-risk tenant – sometimes called a 'better covenant' – will add value.

Vacant properties are a drag on performance, and new lettings will provide a big boost to returns. In a 2015 report, Goshawk/IPD identified this as the largest contribution to positive asset management. New lettings mean new income for an investor, improved security of cash

flow and typically an enhanced capital value through lower cap rates. Ensuring that a property is producing a consistent income stream and that vacancies are kept to a minimum is one of the most fundamental of active asset management activities, which seek to deliver the security of comfort that a long lease used to provide.

If we define the rental value of a property as the rent that could be charged if the unit were let in the open market on the valuation date, rental value growth between one period and another will reflect changes in the rental value of the property. By contrast, the income growth of a property between one period and another will reflect the change in the net income receivable by the landlord. To understand how the two can vary depending on the structure of the property lease, imagine a world in which the landlord negotiates the contracted rental value of the property every single day in a perfectly competitive market for space. In this case, in order to secure the tenant the landlord would have to adjust the contracted rent to the open-market rent in each negotiation, and estimated rental value growth would match income growth exactly.

Now imagine a situation at the other extreme, in which the landlord and tenant negotiate the contracted rent when the lease is signed, but make no provision for a further revision of that contracted rent for the duration of a very long lease (such as 42-year leases with a single review at year 21 as was common the UK in the 1930s). In this case, unless open market rental values are completely static for the lease duration, the rent passing will diverge from the open market rent of the property, and income growth will not match rental value growth.

Active asset management encompasses a constant effort to move the contracted income towards market rents, because simplicity is rewarded by valuation processes – market players have lots of confidence in the rent/cap rate formula, and any variations away from it driven by income complications can lead to (sometimes irrational) discounts. For this reason, below-market rents are sometimes 'topped up' by vendors, who are prepared to pay the difference between the market rent and the passing rent to buyers to avoid suffering the reversionary discount.

The value of a real estate investment is ultimately determined by the level, duration and quality of the rental income paid by tenants or by the cash flow the building is capable of generating. Whether a tenant is likely to stop paying rent at any time through bankruptcy or a company voluntary arrangement (CVA) is a key piece of information that will affect the value of an investment. As leases shorten, balancing default risk against weaker income quality is a challenging exercise for asset managers.

Emerging real estate sectors are operational

Demographic, lifestyle and political changes (primarily expressed through the privatization of former public services) have produced a need for new real estate formats, including private rental, affordable and senior housing; student accommodation; self-storage; co-working; medical centres; data centres; and others. These emerging residential and social infrastructure sectors have become increasingly popular with investors, and some have matured into core real estate investments, for example purpose-built student accommodation (PBSA). While the shift from retail to logistics has been a big story, UK sector

weights have also seen a significant shift towards what has become known as operational (management-intensive) real estate over the last 20 years (table 1). While any property type can be operated or managed intensively, the so-called operational asset types tend to be residential or living and other, including social infrastructure.

Table 1: UK sector weights, 1991-2021

	1991	2001	2021
Retail	37%	45%	24%
Office	47%	38%	27%
Industrial	13%	13%	27%
Residential	0%	1%	9%
Other	2%	2%	14%

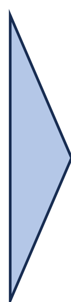
Source: MSCI

The current crisis in the office sector means that this trend is only accelerating, and the real estate landscape is breaking up into many asset types defined by increasing specialisms in delivering customer service. The Urban Land Institute (ULI), for example, recognises 27 real estate product categories suitable for investment and development in 2023, a significant change from only 8 categories in 2004 (figure 3).

Figure 3: Real estate product categories, 2004 and 2023

2004

1. Shopping Centres
2. Residential
3. High Street Shops
4. Industrial/Warehouse
5. Retail Parks
6. City Centre Offices
7. Manufacturing
8. Suburban Offices



2023

1. New Energy Infrastructure
2. Life Sciences
3. Data Centres
4. Self-Storage Facilities
5. Retirement/Assisted Living
6. Healthcare
7. Logistics Facilities
8. Affordable Housing
9. Social Housing
10. Private Rented Residential
11. Student Housing
12. Leisure Hotels
13. Co-living
14. Industrial/Warehouse
15. Serviced Apartments
16. Serviced Offices and Co-working
17. Leisure
18. Housebuilding for Sale
19. City Centre Office
20. Retail Parks
21. Parking
22. Business Hotels
23. Business Parks
24. High Street Shops
25. City Centre Shopping Centres
26. Out of Town Shopping
27. Suburban Offices

Source: ULI

Revenue models and operational leverage

The main effects of these changes on real estate investment are (i) a bigger range of revenue models for investors to consider, and (ii) varied degrees of operational leverage assumed by investors. Take the example of hotels.

Hotels had not been considered as core real estate investments in Europe up until the mid-2000s, and thus attracted relatively low capital flows. Depending on the operational model used, real estate-backed hotels might not earn stable lease rents and did not as a result have the 'fixed-income' aspect of other real estate investments. The freehold owner of a hotel might operate the asset personally, employ a manager or lease the asset to a hotel group. Similarly, a hotel group could procure its real estate in a number of ways: it could buy a freehold, it could sign a lease for the asset or it could enter into a management contract.

Where the freehold owner of a hotel operates the asset this is not regarded as pure real estate investment. Where (on the other hand) the hotel operator signs a lease, this arrangement can produce a traditional, low-risk real estate investment, especially when the operator is a well-known and financially secure company. Where the operator signs a management contract, the property owner's revenue will be the revenue of the operation, determined by the room rate, the occupancy rate and any additional revenue streams, less the manager's fees and costs (which may include a share of revenues or profits). In this case the property owner's revenue will not be a stable lease rent but will be exposed to the risk of the underlying business.

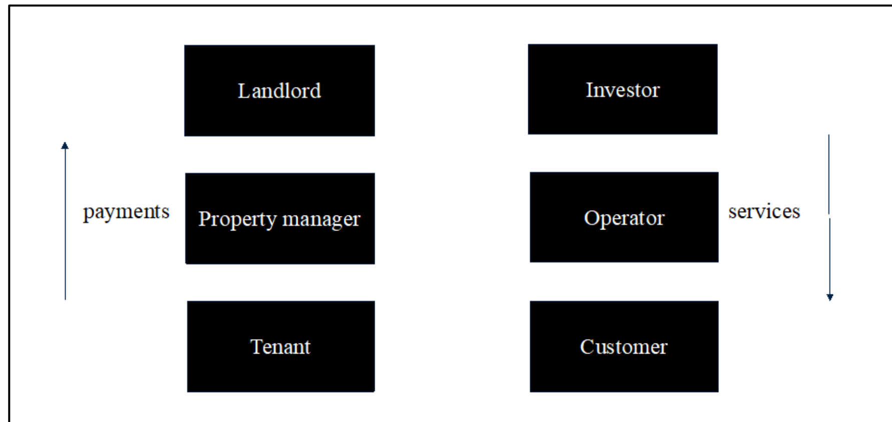
The same revenue model might operate in bars and pubs, restaurants, self-storage, cinemas and other revenue-generating property types. Owners of conventional offices and industrials will likely be excluded from the possibility of being exposed to the underlying operation but retail property, especially shopping centres, might be let on a lease with a rent component being determined by revenues or turnover (this is called a 'turnover' or 'percentage' rent).

Operational properties are more directly dependent on the operation of the business carried out within the building. The heightened operational risk means that specialist skills are required to manage these real estate assets. In addition, asset valuations are likely to be discounted because traditional valuation methods rely on an abundance of standardised transactional evidence (rent per square metre, for example) and longer lease contracts which support a simple capitalisation approach. Operationally leveraged properties present a challenge.

In accounting, the higher the degree of operating leverage in a business, the greater the potential danger that a relatively small error in forecasting sales can be magnified into large errors in cash flow projections. This concept has not been used in real estate, but recent market developments mean that it needs to be. Core real estate has been regarded as a low risk asset class partly because there is no operational leverage, especially if (more rarely these days) the lease is triple net/FRI (full repairing and insuring, meaning that the tenant is responsible for these costs). There is operational leverage if the landlord has external repair, management or common parts expenses. Some shopping centres have a lot of operational leverage where low occupancy and falling rents leave the landlord with a heavy and irrecoverable cost burden. Net operating income (NOI) is then much more volatile. Where the landlord is responsible for all operating costs, including staff, raw materials and so on, operational leverage levels (and risk) shoot up. This applies particularly to managed hotels, senior housing, and student accommodation. In such cases it should be possible to measure operational leverage and quantify risk.

Figure 4 illustrates what we call the traditional property management model (left hand side) and the operational model (right hand side).

Figure 4: Property management models

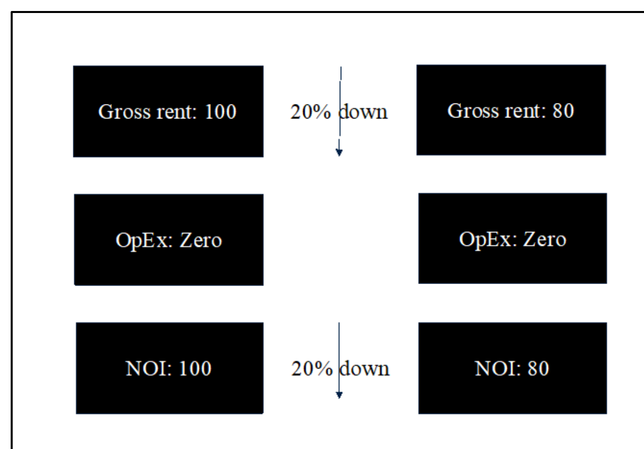


Source: Baum 2023

In the traditional property management model, landlords (an increasingly curious term) sub-contract tenant relationship management to property managers who perform a set of functions including the collection of rent from tenants, passing this up to the landlord. This could apply to multi-tenanted office buildings, shopping centres, industrial estates and apartment blocks. In the operational model, the landlord/investor appoints an operator to manage the space, and the operator sells services to the tenant/customer. This could apply to co-working space, co-living, student housing, senior living, hotels and other property types.

The revenue model for the investor could be to charge rent from the operator (WeWork grew by taking leases of conventional office buildings from property companies); to share customer revenues with the operator; or to have a base rent and a profit or revenue share on top. These different arrangements will have contractual implications, but there will also be a growing group of investor/operators, meaning building owners who sell bundled space and services (see part 3).

Figure 5: Operational leverage zero (FRI lease)

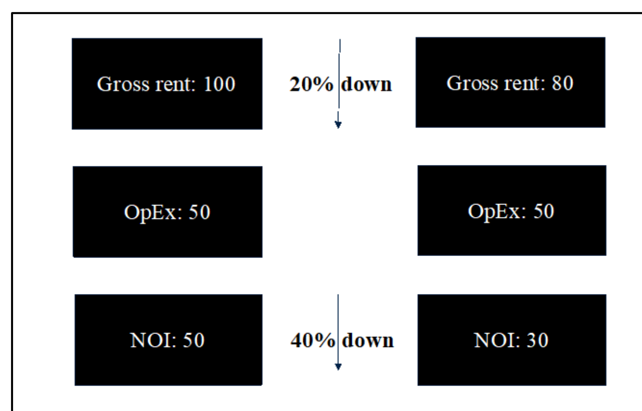


Source: Baum, 2023

In the traditional model, the tenant may be responsible for running the building and for repairs and insurance. The rent paid to the landlord is 'triple net'; the landlord has no costs, and therefore has no operational leverage. In this case, gross rent is equal to net operating income. If the gross rent falls by 20 per cent due to the market weakening or loss of a tenant, this 20% fall passes directly through to a 20 per cent fall in NOI.

In the investor/operator model, the investor/operator has to provide services. In an office building, these services may include coffee shops, exercise spaces, showers, meditation spaces and so on, and therefore has some fixed operating costs including staff salaries and software subscriptions. In this case, gross rent is no longer equal to net operating income. If costs are 50 per cent of gross rents, and the gross rent falls by 20 per cent due to the market weakening or the loss of a tenant, this 20 per cent fall is leveraged and drives a 40 per cent fall in NOI.

Figure 6: Operational leverage 50% (operator model)



Source: Baum, 2023

Co-working and traditional lease economics

Offices in particular are increasingly becoming subject to operational leverage.

Regus pioneered the workspace-as-a-service concept in the 1990s, first in Europe and later in the Americas. The original idea was to provide space for self-employed workers and for the small number of corporate employees that were traveling or working remotely. However, the proliferation of technology in today's market has enabled a fresh approach to this concept based on efficiently employing spare capacity, minimising the cost of a transaction and adding attractive benefits beyond space.

Much has been written about the collaboration encouraged within shared office spaces. In a 2016 JLL poll, 74 per cent of respondents indicated that *"thinking, talking, and brainstorming create the most value for an organisation. In response, companies are turning to alternative*

workplace solutions such as co-working to encourage collaboration" (JLL, 2016). The impact of COVID-19 and the increased level of working from home has resulted in a lot of tenants reducing their space commitments, pushing more office occupiers towards such third spaces.

The changing cultural demand for shorter leases[2], smaller spaces and enhanced collaboration has driven the occupier markets closer towards the operational customer-centric model found in hospitality, where a positive or negative user experience is capable of being publicised by platforms such as Trip Advisor.

The rise of space-as-a-service should allow the desk utilisation rates of individual offices to increase. The average workstation in Central London costs £17.5k pa, yet the average desk utilization rate is only 45 per cent. As a result of the high cost of the average workstation in New York and a low desk utilization rate, JLL (2019) predicted that 30 per cent of all U.S. office space will be operated under a space-as-a-service model by 2030 (the 2020 proportion was 5 per cent). The shifts in real estate markets that this growth would facilitate would be game-changing.

With shorter contractual obligations comes increasing choice. The end user of the space is now able to leave relatively quickly without penalty if that space does not meet their expectations or requirements. Accordingly, managers of flexible space have begun to compete by offering more amenities, often including a host of luxuries as a part of their service offering (free beer at WeWork, for example).

Co-working is a good example of an operationally intensive way to lease out office space. Just as in the hotel market, building owners have several options, from direct lettings of desk space on a short term basis, through employing a manager to run the space for a fee or revenue share under a management agreement, to leasing the space out to a single tenant for 5-10 years.

Table 2 shows an example of the economic drivers of (column 2) the direct-let co-working model and (column 3) a traditional lease.

[2] In addition, accounting standard IFRS 16 requires lessees to recognise assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value.

Table 2: Co-working and traditional lease economics

	Co-working	**Traditional lease**
Total sq ft	70,632	70,632
Gross revenue per sq ft	£92	£31
Indexation	2% per annum	2% per annum
Average lease term	6 months	5 years
Service charge	£10 per sq ft pa	£10 per sq ft pa
Fit-out cost	£140 per sq ft	£10 per sq ft capex
Additional capex in years 5, 10 and 15	£5 per sq ft pa	£0
Location operating expenses	£20 per sq ft pa	£0
Marketing costs	£4 per sq ft pa	10% rent
Vacancy	10%	0%
Tenant's moving expenses	£0	£25,000
Business operating costs	£5 per sq ft pa	£0
Rent free period	£0	12 months
IRR	17%	5%

Source: Lisa Cations, IWG

A co-working business will charge much higher rents per square foot, but will spend hard cash on location-specific operating expenses, including utilities, cleaning, coffee, snacks and happy hour drinks, community manager support on the ground, IT/AV support and printer maintenance and repair. In addition, flex operators allocate business operating costs to traditional and digital marketing to focus on the key activity of selling seats.

Clearly, the direct-let co-working model is expected to deliver more return to the investor (an IRR of 17% v 5%). Equally, there are many more things that can go wrong. For example, the vacancy assumption is crucial - it is full of alternative outcomes (and therefore risk) in the co-working model, with less variability in the traditional lease as long as the tenant does not have much chance of going bust (described by the market as a ‘strong covenant’). There is also much more fixed-cost overhead and therefore operational leverage in the co-working model.

In the WeWork example, operational risk was fully shifted onto an operator (WeWork). The giant became troubled because (despite an original intention not to take any real estate risk) the company was forced to sign long leases to gain access to space. As a result, the major risk facing WeWork was how the company could maintain revenue during an economic downturn. While tenants value short-term flexibility, long-term leases protect the landlord. Small businesses and start-ups, the most common occupiers of co-working spaces, are the first to fail during recessions, while successful entrepreneurial workers can opt to work from home. Large corporations would also likely opt to terminate co-working leases when belts need to be tightened. Signing long term leases for retail distribution under an asset light strategy was a fundamental mistake.

Nevertheless, the co-working concept was a major breakthrough, and major landlords and service providers are now producing their own flexible working spin-offs. Is that the right choice for office owners? We will come back to this question in part 3.

2: The stranded asset problem and the inflexibility of built assets

Operational leverage is just one of the increasing risks facing investment managers. Stranded assets and locations are another layer of challenge.

Stranded assets

A stranded asset is an asset that has suffered write-downs or devaluation, sometimes to the point where it has become a liability. Climate change and regulations are expected to cause a significant increase in stranded assets for carbon-intensive industries such as the built environment and real estate.

We are at the beginning of a long period of tension between the need for buildings which minimise waste, energy use and carbon emission, and the environmental and financial cost of producing those buildings. On the one hand, we need buildings and spaces which make a neutral or even positive contribution to the environment by operating efficiently, using limited energy, wasting little or no water; and on the other we need to conserve or not produce materials which consume energy in their production.

Accounting rules and the absence of a proper market pricing mechanism for carbon might complicate this, but every building is a store of the carbon used in the manufacture of its constituent materials. Every year that goes by, we are using that carbon and depreciating the remaining balance. It may be that the energy saved by developing and using a brand new building is greater than the energy used as we depreciate it; it may not.

It is clear which variables will shift these relative calculations. The initial cost of developing the asset is a big factor: building cost inflation mitigates against new development. Pricing the carbon which is used when developing the asset is another big factor: the current absence of a full market price for poisonous carbon encourages new development. When (as is inevitable) carbon is fully priced, we will have to focus on how we can make existing assets more efficient.

We can envisage tech-enabled solutions to reduce waste in all areas of a building's operations, as it is inevitable that occupiers will pay less rent for buildings which waste expensive resources and/or emit carbon and investors will also part with less capital for buildings which waste expensive resources and/or emit carbon. Retrofitting existing assets will become the key to minimising risk and capital losses.

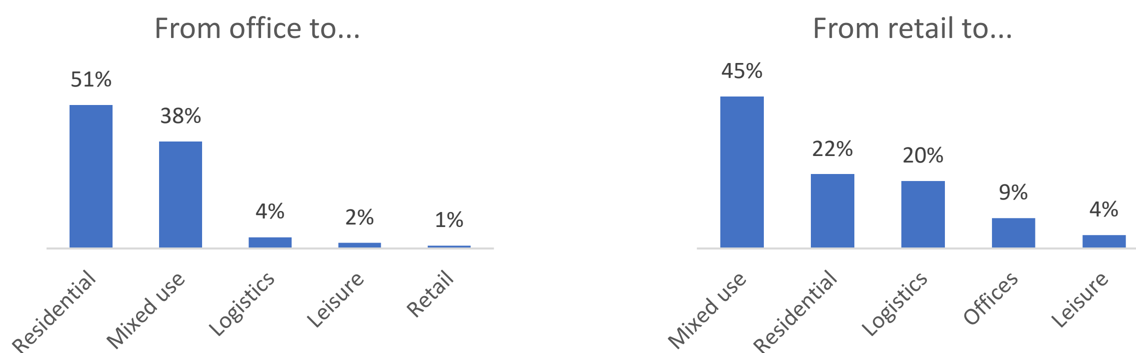
For assets with no effective retrofit options, real rent growth will be damaged as occupiers seek more efficient/greener buildings. Depreciation rates for inefficient buildings will increase, expressed through higher operating expenses, higher and more frequent capital expenditure and lower resale values. Full carbon pricing will rapidly accelerate this process. There is no magic bullet technology that will avoid the inevitable increase in risk premiums which investors will require in anticipation of falling values, falling rents or government penalties.

How much money can be spent on retrofits?

According to real estate consultants Savills[3], the global real estate market is worth $380 trillion in 2023. The commercial market alone is worth $51tr. Depreciated over (say, generously) 100 years, that's $500 billion of commercial property value every year to be protected or lost, justifying massive amounts of refurbishment expenditure.

Some assets, on the other hand, may not justify the expenditure required to deliver what customers require, either because they are in the wrong place – and the nature of real property as a fixed asset (immobilier) means that it cannot be moved – or because their design and condition makes refurbishment uneconomic. Asset conversions and repurposing to find the next highest and best use for buildings to justify retrofit capital investments are widely anticipated, with office to residential conversions paving the way (figure 7). Once the less complex single use conversions have been exploited, we will begin to see the true magnitude of the stranded asset issue.

Figure 7: Likely repurposing by asset type, 2023-2028



Source: PWC, Emerging Trends Real Estate, Europe 2023

From stranded assets to stranded locations

Proximity to the market has always been regarded as a powerful determinant of land value. Victorian cities in the UK were typically composed of a central marketplace, surrounded by industrial and storage space which could service retailing and be serviced by office occupiers, in turn surrounded by housing, which was encircled by agricultural land. This setup allowed physical agglomeration of retailing, office users and (most importantly) industrial activities, which needed physical proximity to reduce transport costs and to allow the vertical integration of manufacturing activity.

By the early 21st century industrial production came to rely less on physical agglomeration (due largely to advances in communication technology) and transport links to the central business district (CBD) became much less important. Thanks to specialisation, manufacturing

[3]https://www.savills.com/impacts/market-trends/the-total-value-of-global-real-estate-property-remains-the-worlds-biggest-store-of-wealth.html

businesses now need to supply goods to national and international marketplaces via motorways/highways and airports situated outside the city core. Distribution space was also required to service these markets, but was now also increasingly required for last mile delivery to residential areas.

Meanwhile, residential occupiers expressed a change in choice. Giving up the pleasant garden and long commute associated with suburban living, knowledge workers were pulled closer to the centre by an appreciation of the value of agglomeration and a higher value placed on their own travelling time.

Urban land use in 2050 will have moved on again, but cities are very likely to retain their locational value in the long run. That is not to say that all locations in a city will remain valuable. Access to efficient public transport and great connectivity will be vital; witness, for example, the decline of Canary Wharf as a financial centre and the success of Kings Cross.

How should the owners of urban assets respond?

Case: Kings Cross Central

Property development and infrastructure development are extremely co-dependent. For a property development or regeneration project to be successful, it needs to be well-connected to transport facilities; to education and health facilities; to leisure developments such as hotels, museums, theatres, libraries and cinemas, as well as shopping; and to office employment. Much of this infrastructure will be paid for by the community.

Governments often need to finance infrastructure for the greater benefit of the electorate, but on occasion their investment can pay off. This can happen directly, where the value of government-owned land within the project or regeneration area is immediately increased by the scheme. It can happen semi-directly, as a result of higher property values leading to higher local tax and property transaction tax revenues. It can also happen indirectly, as a result of accelerated economic activity leading to more employment, higher wages and more spending leading to greater income tax and VAT receipts.

There is no better example of these principles than Kings Cross Central in London. The site is uniquely well connected to transport infrastructure: it is served directly by six London Underground lines, two national mainline train stations, and the Eurostar high-speed rail connection to Paris, Brussels and beyond. It is also the main site of the University of the Arts, London.

King’s Cross Central (KCC) is a mixed-use urban regeneration project in central London located behind two major rail stations (St Pancras and Kings Cross) on the site of former rail and industrial facilities. The KCC scheme arose as a result of the two key historic landowners, London & Continental Railways and DHL Supply Chain, agreeing in 1998 to work together towards the promotion of their land. They in turn appointed Argent (King’s Cross) Limited (which is still, in 2023, the development manager and asset manager) as their development partner and land promoter in 2000.

The 67-acre (27 ha) redevelopment involves the restoration of historic buildings as well as new construction, organised around new and existing internal streets and 26 acres (10.5 ha) of public open space. The principal uses include 4 million square feet of office space, 2,000 residential units, 500,000 square feet (46,400 sq m) of retail and leisure space, a hotel, a theatre, and educational facilities centred on the University of the Arts, London.

Mixed use brings financial benefits, both because of synergies and diversification. Mixed use drives pedestrian flow and liveliness: a vibrant, popular residential location is close to transport, leisure facilities, social infrastructure and workplaces; a popular office location is close to transport, leisure facilities, social infrastructure and homes. In the case of Kings Cross, the office and residential markets were in a pit in 2008, but universities still needed space and accommodation; by 2015 the office and residential developments were really paying off.

Also, the quality of public open space can only be justified by a developer with almost 8m sq ft in mind, not a single phase. A business plan that from the outset assured that KCCLP/Argent would deliver the whole and (as far as possible) retain responsibility for a large estate has required stewardship, which has been a buzzword ever since the London Estates started developing the West End of London and delivering superior long-term returns. All of this required a mix of long-term debt and equity, with suitably patient suppliers of capital.

The developer, investors and debt providers have been well rewarded. The government realised a sizeable portion of its investment in the St Pancras and Kings Cross station regeneration projects, which will also deliver tax revenues and economic benefits for decades. London, and (arguably) a majority of local community stakeholders have a facility to enjoy and be proud of. The result was a clear win-win.

3: Innovation in real estate investment management

Asset repurposing and operator power

While Kings Cross is clearly a big success, owners of underperforming and / or stranded assets that exhaust their operational potential without significant capital expenditure on retrofitting and/ or change of use are facing a very challenging period in the current interest rate environment. The cost of debt to fund asset turnarounds reached low double digits in 2023, and this adds an additional time bomb to the refinancing risk of existing loan facilities. It may not be overly dramatic to suggest that the future of the entire real estate asset class – and real estate investment management as a specialist industry - is under threat from broader and more sustainability-aligned real asset or infrastructure typologies.

While the risks are clearly skewed to the downside for investment managers, there is however some upside for asset managers as the right operators can command significant rental premiums. Mixed use hubs are likely to drive further rental upside through synergies driving yields. These two factors might contribute to sufficient returns to unlock a wave of repurposing projects.

Designing an operational asset requires either an operational owner or close co-operation with an operator in order to define project specifications. A financially viable project that complies with zero carbon needs efficiency of design (a capital item) as well as efficiency of operation (a revenue item). The latter implies constant re-commissioning, tenant engagement, the development of tenant apps and so on. This partly explains why (for example) Greystar is a successful developer: their experience of operating their residential assets feeds back into their development design. And this also explains why the right operator can command a rental premium.

Technology and space as a service

The combined value of alternative sectors in the UK today is in excess of £240bn[4]. It is estimated that this could increase to well over £750bn if we reached the levels of saturation seen in other countries and current growth trends continue[5]. Given higher fee levels for operationally intense sectors, there is a lot of potential revenue in play, and considerable room for technology-based streamlining of headcount and cost.

Common among all operators (including owner operators) are two things. Firstly, they deliver space as a service, and space as a service is concerned with the occupational management of real estate assets. Space as a service has developed as an idea alongside the concept of the shared economy and the returns created by more intensive short-term use of space. With the appropriate software, a space offering which is fractionalised by time can be offered to a large marketplace, with economies of scale justifying heavy investment in high quality UI/UX (the user interface/user experience). This idea is a long way from the traditional long lease to a

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[4] Macfarlanes (2023): Operational Real Estate

[5] Macfarlanes ibid.

single tenant, which requires very little expenditure on innovation and customer service. The rise of space as a service has been enabled both through the emergence of smart building technologies, allowing for an accurate measurement of real estate spare capacity, and the development of technologies able to reduce the associated search, bargaining and enforcement costs of a transaction, facilitating a more efficient allocation of unused space. As a direct outcome of the above, operators control building performance. Smart building technologies are being utilised to provide information about building performance, or to directly facilitate or control building services addressing social sustainability criteria such as occupant wellness, productivity and satisfaction, as well as building energy performance and waste reduction. This drives the sustainability agenda.

Under a full repairing and insuring lease, tenants take care of operational expenses directly and there is no way for the landlord to control energy usage and building environmental performance unless tenants volunteer to submit such data to the landlord (a huge area of conflict between tenants and landlords across all real estate segments). In operational real estate, all building-related expenses are managed and controlled by an operator, whose interests are aligned with the real estate owner through their contractual relationships (or because they are the same business). In addition, an increasing body of research links environmental factors such as air quality to social factors such as wellness and productivity meaning that smart buildings are part and parcel of the green building movement.

The emergence of modern operators will put them in control of both the customer relationship and the building performance, facilitating the integration of sustainability economics and a power shift towards operators. Shifting from a B2B to B2C model in real estate will create branded spaces (such as we see in the hotel market). Real estate will be increasingly becoming a branded product where brand drives premium value. There will be Marriotts and Hyatts in the worlds of working, living, wellness, entertainment, healthcare, student living and life sciences to add to the existing branded hotel and shopping centre operators. This may not solve the stranded asset problem, but it will shine a new light on an issue traditional investment managers will find difficult to resolve.

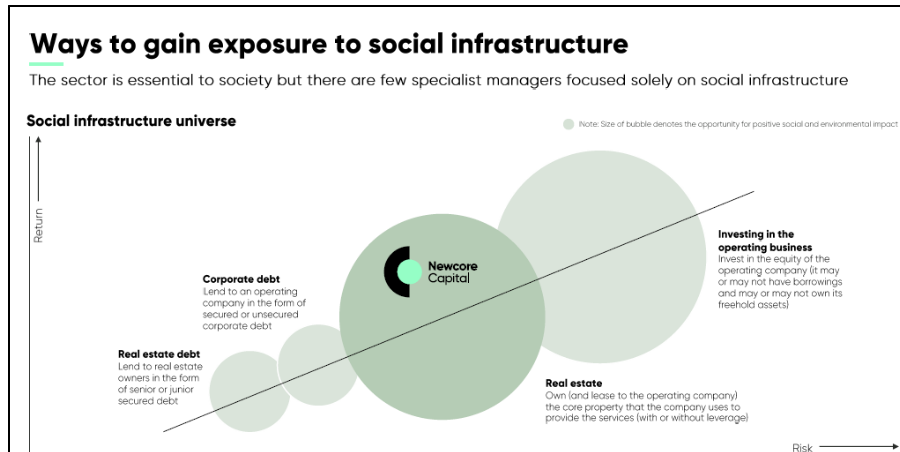
Will investment managers become operators?

Investment managers will need to consider very carefully whether they wish to become operators themselves – or vice versa. This decision is sector-specific, and highlights the distinction between general space management and specialist service delivery. Figure 8 shows how Newcore Capital, an investment manager of social infrastructure assets, thinks about its risk-return choices. Investing in operational businesses is high risk, high return.

Investing in operational businesses implies developing strong relationships with customers. The customer for this purpose is defined as a buyer of space and space-related services. Hence a retailer is the customer of a shopping centre operator, while a shopper is the customer of the retailer. However, a private hospital or a senior living provider is the buyer of space and the customer of a social infrastructure investor while an unwell elderly person is the customer of the hospital or care home provider.

These are very different propositions; retail space is much more of a commodity than is a private hospital, care home or school. An investment manager could reasonably be expected to develop operational expertise in the provision of retail space, just as a housing rental company can develop expertise in the design and operation of residential space. But an investment manager should not reasonably be expected to develop operational expertise in the provision of specialist service areas like hospitals or schools. And there is a grey area in between. For example, should an investment manager operate a hotel?

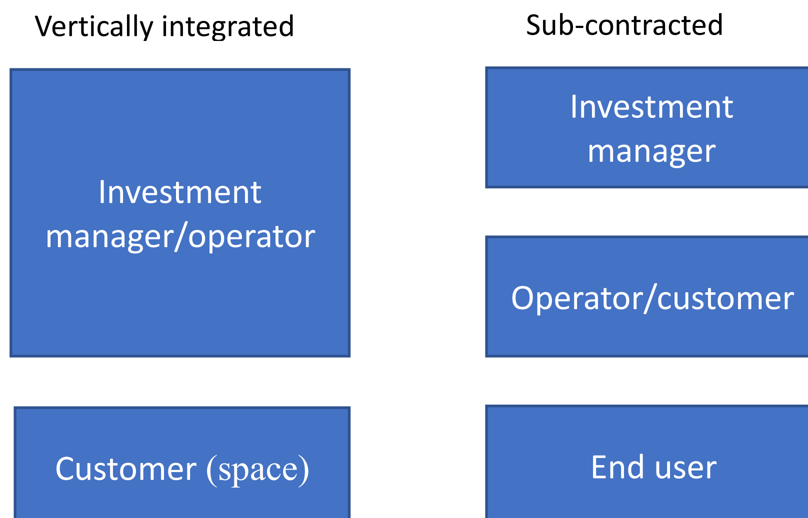
Figure 8: Risk increases with operational intensity



Source: Newcore Capital

This challenge leads to alternative operational models (figure 9). The vertically integrated investment manager/operator can be observed where space is something of a commodity in office, industrial/logistics, shopping centres, retail parks and the high street, and in private rental housing. In these sectors the customer is a buyer of space rather than a buyer of specialist services.

Figure 9: Integrated and sub-contracted operations



Source: Authors

This model is less likely but possible in social housing; student housing; co-working space; self-storage; and data centres. It is highly unlikely in hotels and social infrastructure uses such as care homes, medical and educational property, forestry, energy generation and any emerging real estate, real asset or infrastructure sector in which space management has yet to become a commodity. In these sectors operational management will have to be sub-contracted, and the end user is remote from the investment manager[6].

The growing appeal of mixed use schemes

Things get more complex with mixed use developments such as Kings Cross, since executing such projects requires an owner to be a master of all trades. The benefits of a mixed-use scheme are that higher rents can be charged because of the synergy between uses and cash flow volatility can be reduced by diversification. However, operational complexity is intense and mixed use developments have traditionally been harder to value and to exit, with corresponding damage to the value of the platform.

So far, there is a limited pool of natural buyers for mixed use assets[7]. Real estate funds tend to have single sector focus, and if they buy assets in a mixed use scheme they are likely to do so building by building, cherry picking what best suits their strategy. This can lead to parts of mixed use developments not being monetised though exits, or whole buildings not selling if the building itself has multiple uses. There are two ways out of this. Investment managers could seek an exit via IPO, or LPs could start backing investment managers of mixed use schemes on the promise of a superior risk-return profile of those strategies. Arguably, this is what happened with residential strategies and there are signs that mixed use schemes could become much more popular for larger investors valuing place-making over asset simplicity. Also, the UK government's placed-based investment push might stimulate such a move among local government pension pools.

Because some property types will require specialist operational management, the only viable way for an investment manager to deal with ULI's 25+ real estate product categories, mixing and matching them as appropriate, is by developing an infrastructure that enables a close cooperation with specialist third party operators of various spaces.

Hybrid investment management models

Hence managing mixed use real estate will lead to the so-called hybrid model, where an investment manager grows operational teams in certain verticals in-house and outsources operations in others. There are a number of considerations that drive this decision by an investment manager. This includes the appeal of retaining operational control over assets; limited appetites to grow large asset management teams[8]; and a necessary decision over

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[6] No doubt over time specialist operators might decide to own the space they use, but they are less likely to move into investment management.

[7] Some large sovereign wealth funds have the appropriate appetite, such as Norges (Regent Street) and AusSuper (Kings Cross).

[8] Unibail-Rodamco-Westfield, a large property company, employs 2,000 staff; Hilton employs 159,000.

whether the business constitutes a traditional investment management enterprise or (typically more challenging) a fully integrated operating platform.

Will operator/investment managers emerge at scale? There are several exemplars: Greystar, for example, is a good example of an operator which grew into an investment manager, successfully competing for capital through its track record of managing operations in management-intensive asset classes (student accommodation and multi-family residential). However, there are no obvious horizontally diversified and vertically integrated investment managers we are aware of.

Will more hybrid models emerge? Which verticals are investment managers likely to outsource and which ones are they likely to incubate in house? How will hybrid models be developed – through organic growth, or through M&A? To what extent is Blackstone's model of operational intensity and big sector bets (Biomed Realty, Hilton, Mileway) replicable, and how sustainable is it?

The evolution of the operational investment manager

There are three credible models for the interface of investment management and operational management.

Sub-contracted operations

Property managers may attempt to evolve into operators and continue to provide sub-contracted services to investment managers. This is the least disruptive trend for the market. Examples would include CBRE launching its co-working space brand HANA, followed by a large investment in Industrious, the largest operator of co-working space in the U.S.

It seemed a surprising move to many, but it looks highly logical, as it has helped CBRE to evolve from a traditional property manager to an operator which has a deep understanding of building and customer requirements in a specific property type. This enables it to operate at scale, offering a customer-centric, modern system for operating buildings with a centralized customer relationship management (CRM) system and in-house leasing teams with deep relationships with enterprise customers.

Multi managers and other indirect specialists (such as CBRE Investment Management Indirect, with $45bn of assets under management AuM), will continue to thrive. Under this model, operational management is very deliberately out-sourced. The barriers to entry for such a model are very high – minimum AuM levels to achieve profitability are significant.

Specialist, vertically integrated manager/operators

New generation specialist investment managers will start to emerge from operators of niche spaces (Greystar is a good example). As operator expertise becomes a core skill in a specialist sector, an investment management business can be built around it. This is a market threat for investment managers competing for LP capital.

Observing this trend, other investment managers will go deeper into operational excellence (arguably, as Hines, SEGRO and Prologis and newcomers such as Matter have done).

Hybrid model

Investment managers will increasingly use the hybrid model by going deep within certain operational strategies, hiring specialist teams and running selected operations in-house. As an example, NREP has launched Urban Partners with a focus on decarbonisation across a series of urban verticals. Larger managers like Blackstone and Brookfield will continue to build operational intensity, using M&A to backfill areas of relative weakness. The resultant loss of flexibility in sector focus will lead to a lower return on capital but this will be the price of building significant market share.

Neither the hybrid nor specialist owner-operator model is ideal for investment managers at present. But how can traditional investment managers protect themselves from becoming obsolete and replaced by operator investment managers without becoming a fully-fledged operators themselves?

The property sandbox

One way of doing so is to start investing in operating businesses at the startup stage. There are hundreds of operators emerging in sector-specific operational real estate strategies. Many of these startups will need proof of concept by having captive real estate assets to pilot their business, but this is a huge barrier to entry for the emerging operators. This could be a highly productive marriage: operators can develop into investment managers, while real estate investment managers which are accumulating exposure to underperforming assets can avoid platform obsolescence. This corporate venture model would sit alongside the venture capital funds many investment managers have already introduced as part of their innovation teams.

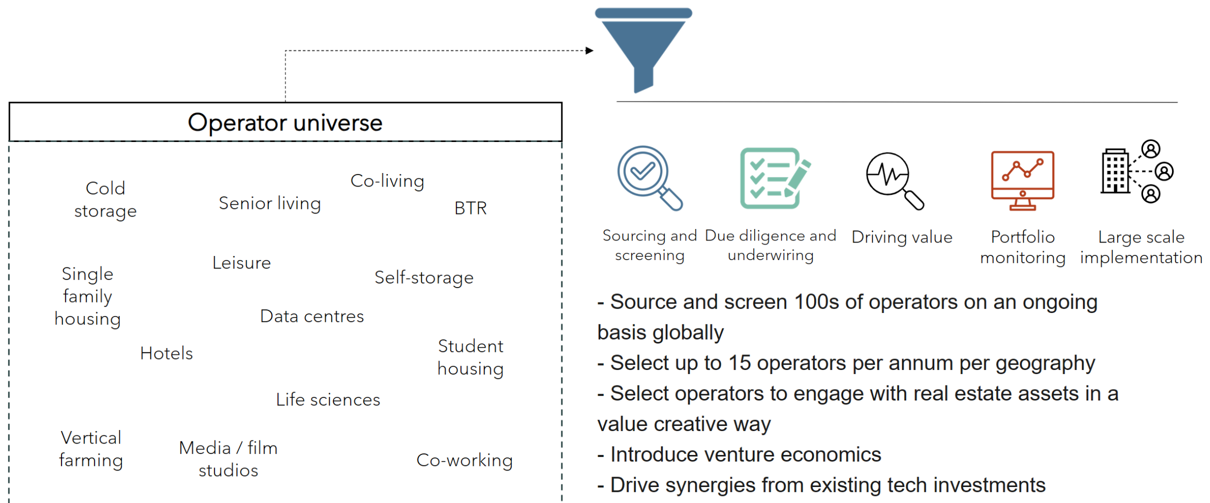
The attractiveness of this model is supported by the fact that this large but newly emerging sector of operators has no natural investor. Venture capital investors are too focused on Software-as-a-Service (SaaS) as just about the only model suitable for venture funding. Real estate investors, because of the nature of their investment mandates, do not identify asset-light operators as an investment target. And most of these operators are as yet too small to qualify for private equity funding. Arguably, this is a value arbitrage opportunity for profitable and/or well-capitalised investment managers facing a troubled future.

Investment managers with in-house expertise of the operator landscape and technologies across the full spectrum of verticals would be able to access new markets faster than their competitors, and would be able to execute on mixed use developments in the most value accretive way.

Ideally, experiments in bringing investment managers and tech-driven operators together could be possible, without compromising the values of either, through what we call the

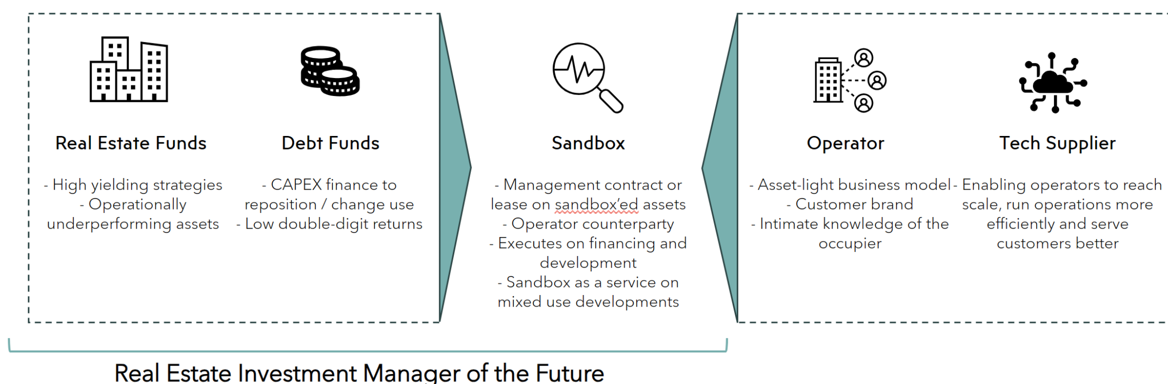
property sandbox[9]. In innovation and business, sandbox is a term used to refer to a safe, controlled environment in which businesses, developers, and entrepreneurs can test and experiment with new ideas, technologies and products without the risk of causing harm or disruption to the larger system.

Figure 11: Operational venture and innovation model in real estate



Source: Authors

Figure 12: The property sandbox



Source: Authors

Conclusion, further work and next steps

Active real estate asset management is increasingly important in the delivery of real estate returns. The current higher interest rate environment means that real estate investment managers are actively searching for high-yielding operational strategies to cover the cost of capital, and the drive towards sustainability is ramping up the cost of prolonging the life of real assets and avoiding the stranded asset problem. Traditional real estate investment and investment management looks like an increasingly troubled sector, which needs to innovate its way out of a growing hole.

[9] Hines EXP and PGIM's RealAssetX may be emerging examples.

The emergence of modern operators will facilitate the integration of sustainability economics and deliver a power shift. Given this, there are three ways the market environment for operational management is likely to evolve. Property managers will evolve into operators and continue to provide sub-contracted services to investment managers. New generation specialist investment managers will start to emerge from operators of niche spaces. Investment managers will be using the hybrid model by going deep within certain operational strategies, hiring specialist teams and running selected operations in-house.

Neither the hybrid nor specialist owner-operator model is ideal for investment managers at present. But traditional investment managers can protect themselves from becoming obsolete by investing in operating businesses at the startup stage. This could be a highly productive marriage. This could be a highly productive marriage: operators can develop into investment managers, while real estate investment managers which are accumulating exposure to underperforming assets can avoid platform obsolescence.

The future of the entire real estate asset class – and real estate investment management as a specialist industry - is under threat from broader and more sustainability-aligned real asset or infrastructure typologies. The future for real estate investment management may be challenging, but necessity is the mother of invention.

Acknowledgements

Andrew Baum and Valentina Shegoyan would like to thank the following for their feedback.

Andrew Allen, Savills IM
Peter Ferrari, Ashby Capital
Gregory Flash, DTZ IM
Achal Ghandi, CBRE IM Indirect
Natalia Kolotneva, LaSalle IM
Josh Panknin, Columbia University