Changing User Habits and Their Impact on Property Values

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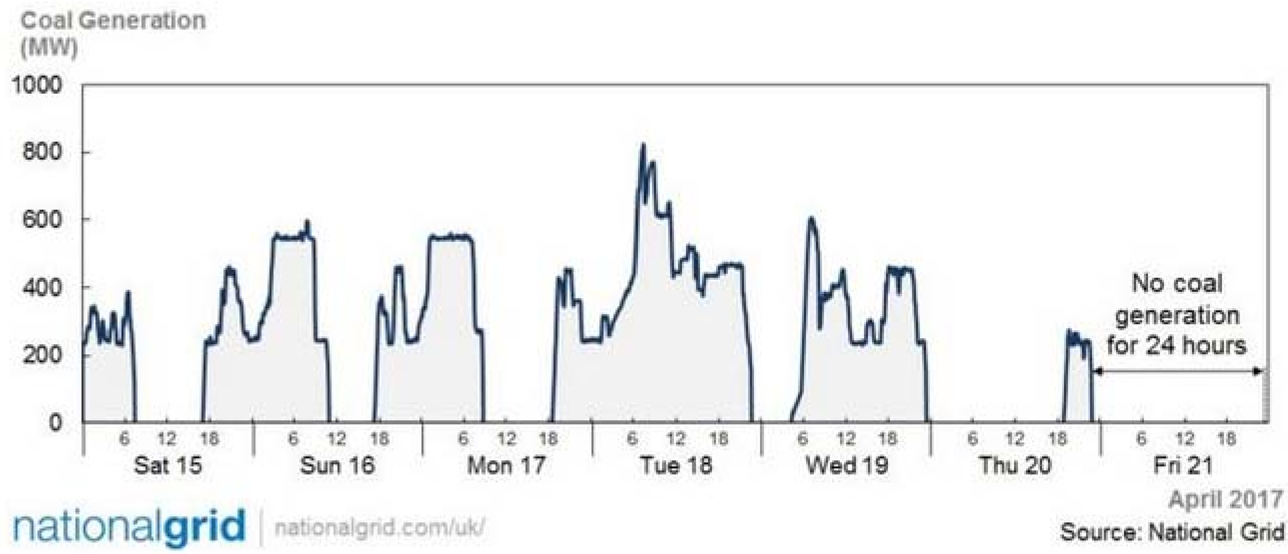
“The Stone Age did not end for lack of stone, and the Oil Age will end long before the world runs out of oil”
Sheik Zaki Yamani, Saudi Arabia’s Minister for Oil and Mineral Resources, 1962-86



21 April 2018: 1st day that Britain went a full day without generating any electricity from coal since 1880s. Reflects growth of renewable energy sources eg wind and solar power

Concept of derived demand

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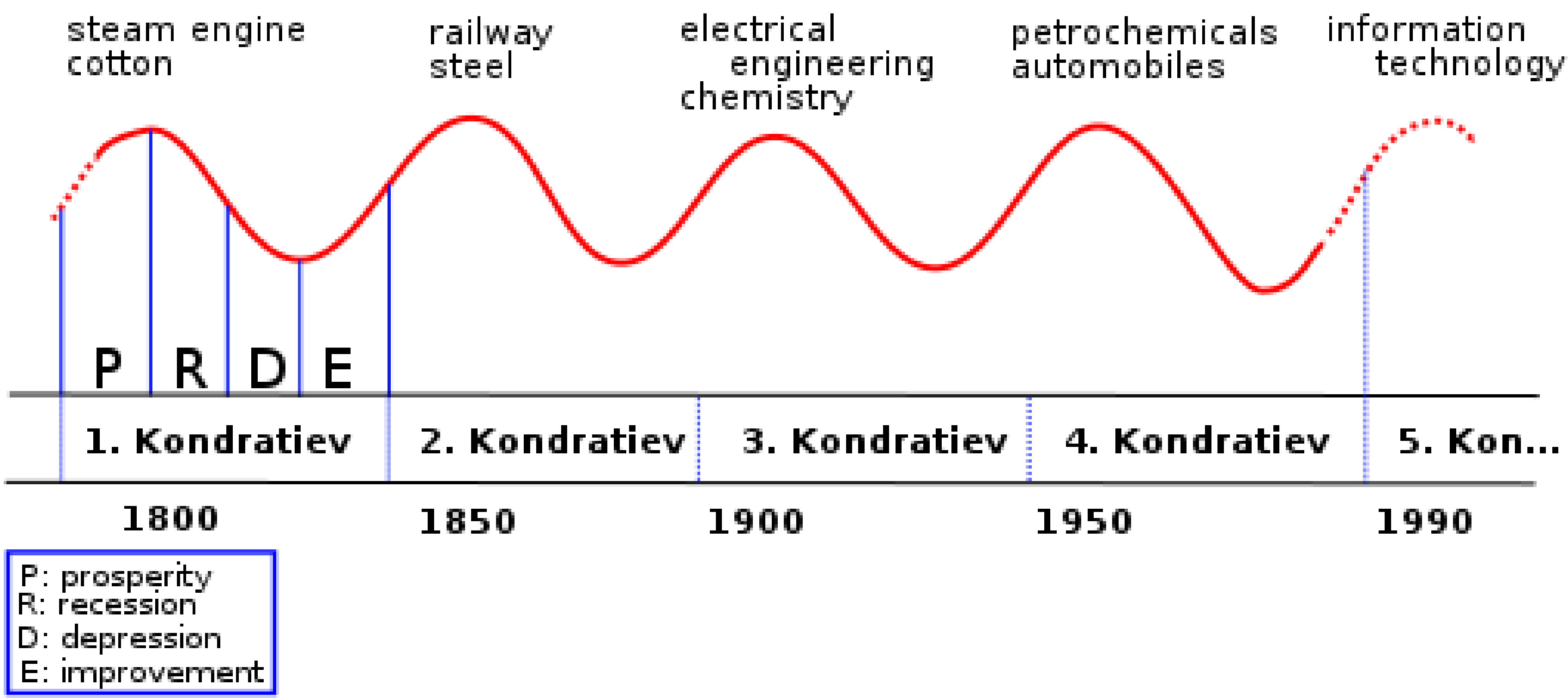
- Commercial and industrial property occupied by **inanimate non-sentient beings that** cannot feel satisfaction or utility
- **Concept of derived demand** – property demanded not because it generates satisfaction, but because it enables an organisation to achieve its goals – profit, market share, delivery of public services etc.
- Marginal benefit of property must be ≥ marginal cost
- Not rational to occupy premises where marginal cost > marginal benefit
- Value of property depends on its utility to its users
- Willingness to pay an amount of rent is determined by utility of premises

Kondratiev Waves



Šmihula, D. (2009), "The waves of the technological innovations of the modern age and the present crisis as the end of the informational technological revolution", *Studia politica Slovaca*, vol. 1, pp. 32–47

- Change is a normal feature of property markets
- Today’s unique selling point is tomorrow’s industry standard as businesses copy successful competitors
- Businesses that fail to adapt to changing circumstances do not survive
- Innovation is a normal part of the struggle for survival
- Innovation continues even in periods of recession
- Innovation occurs in products and services, inputs, and in methods of production and delivery
- Obsolescence is a consequence of innovation
- Investors in property must factor in innovations and obsolescence into their investment decisions
- Some buildings have the potential for adaptive re-use; others do not

Innovations are not isolated events

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- **Schumpeter**: Innovations are not isolated but occur in swarms. Swarms take place in periods of credit expansion, when finance is cheap and available. As cycle turns down and credit costs increase, non-innovators and those who backed the wrong innovations become unprofitable and fail.

  Schumpeter, J. A. (1942), *Capitalism, Socialism and Democracy*

- **Barras**: New investment increases productivity. In buildings, characteristic development associated with each period. The stock becomes obsolete simultaneously. Three tier market with endemic over-supply. Over-supply in boom allows occupiers to upgrade. When supply runs short, demand accommodated by good secondary space. Demand never eats into poorly located or poor quality space, which is redeveloped once market conditions improve. The greater the level of past innovation, the higher the amount of poor quality obsolete space in the future.

  Barras, R. (2009), *Building Cycles: Growth and Instability*

How manufacturing changed over a generation

- International supply chains – products assembled from parts produced in many countries – most international trade now within companies but between facilities in different countries
- Decline in tariff barriers for goods
- Reduction in non-tariff barriers through use of international standards and product approval processes
- Just in time delivery systems – high quality assurance
- Replacement of mechanical engineering by electronic
- Use of robotics in manufacturing
- Less space needed to produce a given output – but better transport links

Former BL Motorworks, Oxford: Three parts – Mini Works, Oxford Business Park, Oxford Retail Park

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How the service sector is changing

- International supply chains – why employ an English-speaking financial analyst with a PhD in London when you can employ an English-speaking financial analyst with a PhD in Mumbai?
- Communication systems allow work anywhere – hot desking – working from home – not from offices – How important is face-to-face communication?
- Non-tariff barriers to trade in services still significant but removal of exchange controls has opened up trade in financial services
- Use of Artificial Intelligence to undertake routine judgement processes eg cancer screening, Automated Valuation Models in mortgage decisions
- Delivery of public and private services to clients through the internet rather than offices

How retailing is changing in UK

- Growth of internet shopping – internet sales 4% of all UK retailing 2008; 2017 17% - impact of smart phones
- Growth of on-line retailers with no shops eg ASOS
- Decline in sales and bankruptcies amongst departmental stores
- Bankruptcies amongst retailers located in retail warehouses on edges of towns eg Toys R Us, Comet (electricals), MFI (furniture)
- Change in purchasing habits from weekly shop by car in out-of-town supermarket to frequent purchases of food in high streets or locally
- Growth of discounters – food (Aldi, Lidl); clothing (Primark, TK Maxx)

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Implications for logistics sector

- Significance of “last mile” delivery
- Expectation of next day delivery as standard
- Growth of decentralised warehouses
- Hi-tech automation within warehouses
- Pressure on reverse distribution chains – customers returning unwanted goods – order multiple products and keep one
- Need for large numbers of delivery drivers – cost pressures make them self-employed - part of the “gig” economy – pressure for driverless delivery systems

Case study: Tesco: the largest British retailer

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Expansion of the big 4 retailers in UK

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- From groceries into specialist food retailing:
  - Butchers
  - Fishmongers
  - Greengrocers
  - Bakery
  - Florists
  - Wines, beers & spirits

- Non-food:
  - Books
  - Music
  - Newspapers & magazines
  - Greeting cards
  - Clothing – adult and children
  - Electrical goods
  - Household goods
  - Banking
  - Insurance
  - Mobile phones
  - Gas and electricity
  - Petrol
  - Car washes
  - Garden centres

2014: the day of reckoning

- 2014 annual accounts Tesco announced a loss before tax of £6,376 million of which £4,727 million took the form of fixed asset impairment charges, mainly property write-downs. Included charge of £3,291 million against its UK properties
- 43 unprofitable stores closed and 49 sites in its property pipeline abandoned, including one brand-new store ready to open
- Other store groups also affected.

What was the reason?

Obsolescence caused by changes in consumer behaviour.

Philip Clarke, the then Chief Executive of Tesco, explained, this was the result of changing consumer behaviour:

“Overall, consumers are spending more carefully. They are increasingly choosing to shop online or in smaller convenience stores rather than in large stores, which presents a particular challenge for Tesco given the number of large stores we have around the world […] Given the change in shopping behaviours […], our larger stores have been a drag on performance and this is one of the most important areas that we need to address” (2014)

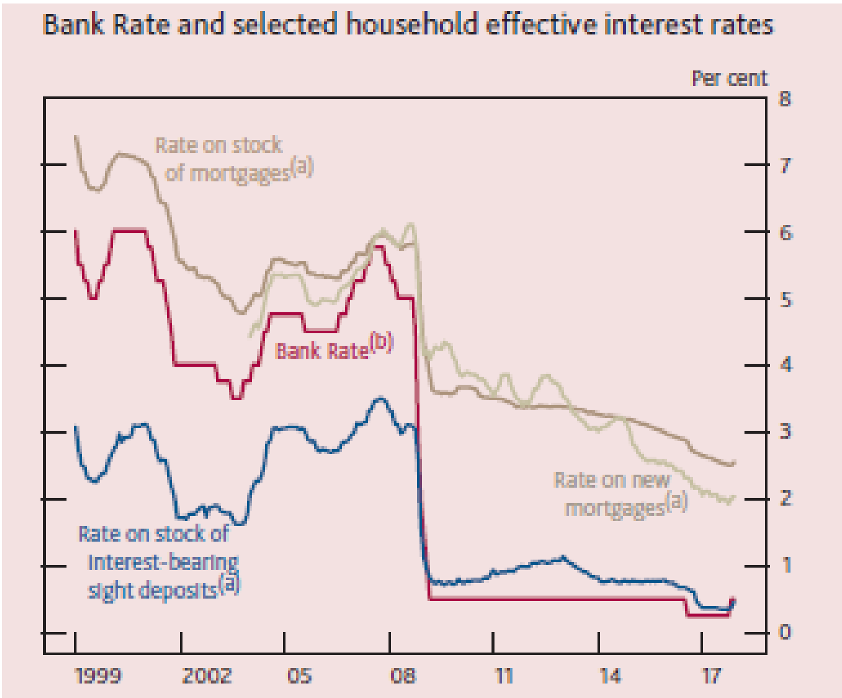
•Local
•Frequent rather than weekly
•In town rather than out of town
•On-line
•Competition from discounters

Retailing: new directions

The new business model

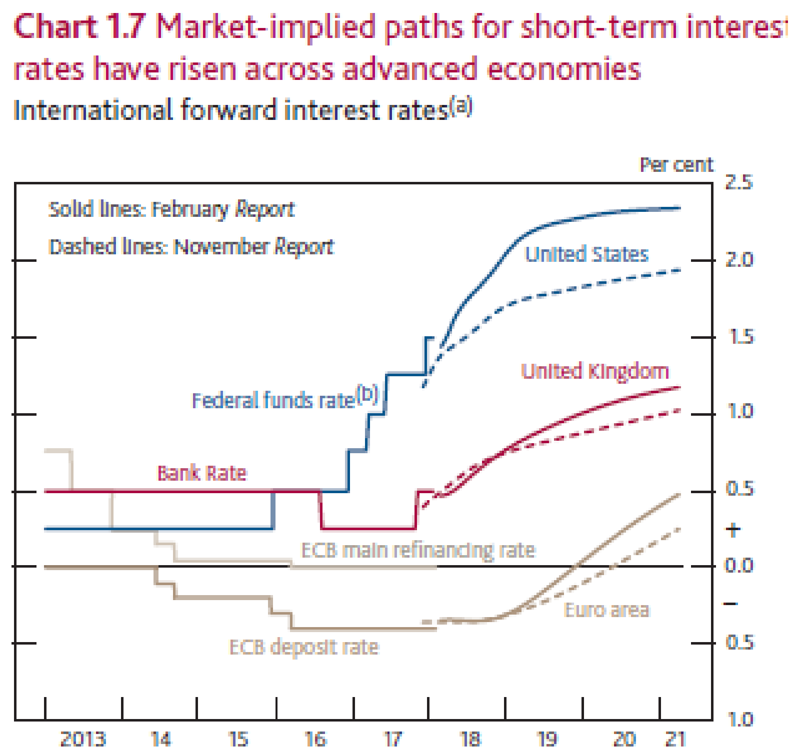
- Stores valued using income approach to obtain calculation of present value
- Income projections reduced => reduced valuations of stores => massive write downs of property portfolio
- Emphasis on smaller stores
- Growing of wholesale businesses supplying other smaller retailers through acquisition of wholesaler
- Reduction in non-core activities eg for Tesco sale of international stores and non-core retail activities and greater focus on UK and food and related products

Interest rate trajectories



UK policy since 2008 has been of low interest rates with quantitative easing
Result: Survival of indebted "zombie" companies, which will fail once interest rates return to normality.
Major upheaval already underway in retailing.

Are we be shielded from change by benign monetary policy?



Source: Bank of England, *Inflation Report*, February 2018

Implications for valuations

- How should valuers reflect changing user habits in their valuations?
- With the direct comparison method, price of comparable properties ought to reflect all that is known about them, if the market is efficient. Should include investors' expectations about obsolescence and potential for adaptive re-use. But is the market efficient? How well informed are buyers?
- With income approach, reductions in projected incomes and higher discount rates to reflect greater uncertainty about future.
- With cost approach, need to reflect obsolescence in calculations – not depreciation as a new building can be obsolete

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What potential is there for adaptive re-use?