April 2021

BMO UK Property Fund

Key themes to watch in 2021:

Automation and artificial intelligence: The impact on commercial property

The robots are coming! An opportunity for well positioned portfolios.

- In an ever faster moving world, with technology causing widespread disruption in the way companies and individuals use commercial property, how can we continue to build resilient portfolios?
- The disruption to physical retail by the online revolution, steadily progressing over the past 20 years, has jumped forward 10 years in 12 months, causing substantial obsolescence across the UK.
- The 'forced' home-working experiment has altered the future role and use of the office, with the likely outcome of causing aggregate demand to fall and companies, large and small, to review their future occupation requirements. Virtual meetings will additionally reduce business travel, impacting hotels and wider hospitality.
- The logistics and industrial sectors appear to be the clear winners, with notable increased occupier demand. But could the fourth industrial revolution of automation, robots and artificial intelligence (AI) further benefit this sector – or does this technology represent a threat?

Key risks

The value of your investments and any income from them can go down as well as up and you may not get back the original amount invested.

BMO UK Property Fund invests in assets that may at times be hard to sell. This means that there may be occasions when you experience a delay or receive less than you might otherwise expect when selling your investment. For more information on risks, see the prospectus and key investor information document.

Guy Glover
Fund Manager

Emma Gullifer
Assistant Fund Manager

Contact us

bmorep.com

+44 (0) 20 7499 2244

Intermediary sales:

sales.support@bmogam.com

bmogam.com/adviser

Telephone calls may be recorded.

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By 2025 digital platforms could generate $60 trillion in revenue **– roughly 30% of all global corporate revenue.**

World Economic Forum, 2019

Overview

Technological advances are often viewed as a threat, but as a business we tend to hold the view that technological development is a significant positive for society and wider business efficiency. With each industrial revolution comes change but also progress. We now cannot imagine a world without a telephone, cars or the internet. Each of these transformations, despite the significant disruption they caused, brought with it a greater range of opportunities for businesses to evolve and to reach more and more customers across the planet.

We have a similar mindset in relation to automation, robots and AI. For real estate owners, automation is an opportunity, not a threat – after all, robots need to be housed somewhere!

Drivers behind automation

There are three simple drivers behind automation:

- **Improved efficiency** – automated sites are more productive, run more smoothly, have faster processing times, improve worker safety and are more efficient from a total cost standpoint
- **Staff** – availability, their efficiency and proximity to customers
- **24/7 operations** – responding to an 'always on' world

Automation

The scope of automation and AI now being adopted in logistics and industrial processes:

- Supply chain technologies
- Internet of Things
- Cloud Computing & Storage
- Sensors & Automatic Identification
- Blockchain
- Robotics & Automation
- Wearable & Mobile Technology
- Driverless Vehicles & Drones
- 3D Printing
- Predictive Analytics
- Inventory & Network Optimization
- Artificial Intelligence

What will this mean for logistics and industrial real estate?

$46 billion

The warehouse automation market is forecast to see a Compound Annual Growth Rate (CAGR) of **12.6%** to reach **$46 billion** in 2023.

Location drivers

There are two competing forces at play here. Firstly, more efficient and automated logistics operations, and in time the potential for more driverless vehicles, should facilitate businesses to be less reliant on availability of staff and accordingly seek to minimise the cost of their real estate. This would lead them to occupy more remote locations or be concentrated near ports to minimise multiple movement of goods.

An opposing view, and one we subscribe to, is that automation will open up higher-value locations where staff availability and cost have previously been prohibitive for an occupier. Businesses naturally want to position themselves near the end consumers, so they can deliver on the promise of ever-shortening delivery timeframes. Additionally, a focus on more direct-to-consumer operations, which also facilitate a business to retain a greater element of profit, will mean occupiers will focus on urban and edge of city locations.

As ever, the pull/push of each factor will be dependent on the purpose of operations (logistics or manufacturing) and there will inevitably be a trade-off between cost of labour and capital cost of automation – the latter for many businesses is still prohibitive. An increasing trend is for businesses to recognise their limitations here and to outsource an increasing amount of their storage, packaging and delivery operations, which historically has been seen as a core part of the business – 'Fulfilled by Amazon' as only one example.

> Between 2019 and 2024, Amazon will invest $100 billion more in IT than any of the other top 10 retailers in the world.
>
> **Marc-Andre Kamel, partner leading the global retail practice at Bain & Co**

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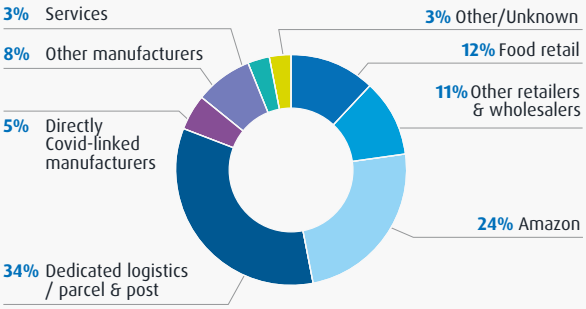
The impact of automation on building design

Big box, mid box or urban logistics?

Big Box	Mid Box	Urban logistics
250,000 sq ft +	Typically 50,000 sq ft +	

2020 take-up by occupier type



Source: Gerald Eve, Prime Logistics, Q4 2020 Bulletin

As owners of big boxes say, 'There would be no urban logistics if it wasn't for big boxes'. The truth is each size bracket fulfils a wider function in the supply chain. We continue to question what building size is most suitable for automation and will attract future occupiers. With such a diverse range of occupiers across each segment of the market, there is no clear answer here, but it's key to ensure any building is not too specialised for one occupier. Each business will be considering how automation will enhance efficiencies on a per sq ft basis and how they can drive more sales per sq ft from a unit they occupy to ensure competitive advantage is maintained.

Often it is not realised that fitting out a building can be as expensive, or more, than creating the asset itself. At Ocado's recent development in Bristol, the cost of building the 'box' was £25m, but the occupier's fit out was £67m.

The intensification of use is now leading to more innovative solutions in urban areas, from multi-storey warehousing to subterranean developments. Automation may facilitate further growth of this concept as goods can be taken through multiple levels of a warehouse, using anything from simple conveyors and autonomous forklifts to more advanced concepts of automatic retrieval and delivery systems, or even autonomous mobile robots feeding directly into more specialised automated boxing and trailer packers. Maybe the future will be taller industrial buildings with a lower physical footprint?

An industrial building can sometimes be simply viewed as a square box; however, occupier requirements are much more detailed, with varied demands for cross loading facilities, yard depth, power requirements, etc. For us, it is key that any asset has to be suitable for a range of occupiers and it is this diversity of appeal which is key in building a portfolio to deliver a resilient income.

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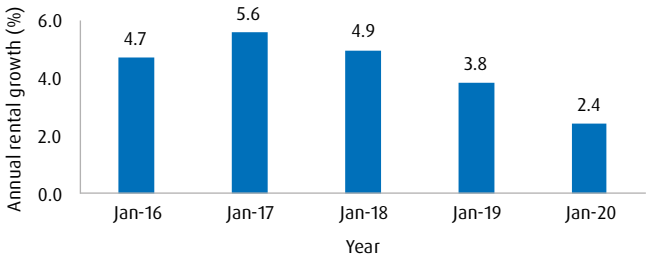
Impact on rents

Automation driving business efficiencies should mean each square foot is used more intensively and theoretically enable an owner to seek a higher rent and capture rental growth. We feel this will have a relatively small impact compared to the standard equation of demand and supply dynamics of a local market. The drive to be close to the consumer, combined with loss of land to competing uses, mainly residential, has driven rents up in the South East tremendously over the past 5 years. The supply constraints are felt even more keenly inside the M25 with 20% of industrial floorspace lost over the five year period.

Market Rental Value Growth – South East Industrials



Source: MSCI Annual Digest Reference Table UK 2020

> Amazon only needs a minute of human input to shift your next parcel – the rest is done by automation.

Considerations for our investment strategy

How does the growing trend of technological disruption and automation inform our investment strategy for the BMO UK Property Fund? We have already communicated our decision to tilt the portfolio towards industrials and logistic assets, given the strong fundamentals and compelling drivers for outperformance forecast over the next five years. One of the key factors contributing towards forecast performance from this sector is the fact that technology advancements represent significant opportunity for both occupiers and owners of these assets for a number of reasons.

1. A move towards greater reliance on online interactions only increases occupational demand-side fundamentals, and underpins the relative resilience of industrial and logistics assets. This demand is not just driven by the growth of online retail, but also a growing need for support infrastructure such as data centres, R&D facilities, IT manufacturers etc. Compare this to the way the same structural change is impacting rents and performance in bricks and mortar retail, and the case for tilting a property portfolio away from physical retail and into industrials and logistics is clear.

2. The growth of automation underlines the versatility of industrial and logistic assets and therefore the breadth of their appeal to occupiers. All automation, no matter how bespoke to the occupier, needs to be housed and a warehouse unit can be easily adapted to suit the technology needs of a business. Our strategy is to ensure we continue to invest in good quality, well-specified units that will appeal to a wide range of occupiers, positioning the Fund to benefit from the growth and opportunities brought by increased technological adaptations.

3. It is clear that location will, as ever, be key to capturing rental growth potential and occupational demand and this will remain the case with the increased use of automation. We believe that the already significant demand for urban logistics will only continue over the next five years as both manufacturers and distributors strive to be ever closer to their end consumer. While automated processes may cut costs and therefore open up higher value locations to businesses, they are still only part of an effort to speed up the supply chain, and proximity to customer base remains key for reducing delivery times. We are focusing future investment on increasing our existing exposure to assets located close to town and city centres, where supply is increasingly constrained.

Final thoughts

With a well-positioned portfolio, advancements in technology and automation can represent a real opportunity to capture growth potential and benefit from structural changes in supply/demand fundamentals. By tilting the Fund's portfolio towards a high weighting to industrials and logistics assets, as well as targeting future investment to urban logistics, we believe that the Fund is placed to capture these opportunities and drive both rental growth and performance over the next five years.

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