FUNDAMENTALS

Investing in future cities

What determines a city's future success and how is this linked to property investment?

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Our key long-term themes of technology, energy and demographics are all having profound impacts on how we live and work. This has implications for the future of our cities. In this article we explore the factors which determine a city's success, what we look for as investors and how we might identify and replace key 'missing ingredients'.

How do you define a good city? This is in the eye of the beholder but as investors we look for areas where demand for services is sustainable and likely to grow. In real estate we believe we can demonstrate that employment growth is associated with the resilience and growth of property income and overall investment performance. Understanding what influences employment growth, therefore, is paramount.

EDUCATION, EDUCATION, EDUCATION

The provision of education is one of the single most important interventions a city can make. The second most important is retaining that education. There is plenty of academic research on this subject but one of the foremost proponents, Edward Glaeser of Harvard University, has been critical of 'vanity' infrastructure projects which might create a short-term political boost but at the expense of the enduring benefits which can be achieved from education[1]. Our research shows that the presence of a university in an area (we measure this by the proportion of residents who are students) can explain local differences in subsequent employment growth over a 10-year horizon. We also find that the proportion of residents educated to degree level or better similarly explains employment growth differentials. Linking the two together, we can conclude that areas which retain their students are more likely to outperform and those that do not are missing a trick. However, this is something that can be addressed with targeted inward investment.

DYNAMISM, TALENT AND GROWTH: HOW DO YOU MEASURE VIBRANCY?

We are also aware that business vibrancy matters. This can be measured by the churn in businesses – business births and deaths can be more important than stability in influencing overall

1. Themes taken from Edward Glaeser, 2011, The Triumph of the City, 2011 and Centre for Cities presentation of May 2015

jobs growth in an area; it shows a dynamic, business-friendly economy. The jury is out on sector diversity, though – while a skew to a particular sector will pay dividends when the wind is in that sector's sails, during a softer patch diverse economies tend to do much better and the two attributes tend to average out over the long term.

It sounds obvious to say that an expanding population is a sign of a good city and a growing economy. And indeed this is so; but perhaps more subtle is the distinction within population growth in terms of talent. Mobile labour tends to be better educated[2] and immobile labour tends to be more poorly educated. Growing cities, therefore, are improving their talent base. Stable or shrinking cities risk embedding decline.

Transport infrastructure can also influence subsequent employment growth. The more people who can travel into an area, the more growth that area's businesses can sustain. There are other implications of transport which we explore below.

Amenity is arguably a softer attribute, being harder to quantify, but is no less important. The proportion of leisure businesses or green spaces can be good proxies. A more intriguing method is to associate the unexplained gap between an area's average house price and average wage with amenity; an area must have something about it which is appealing if it is unaffordable, after all.

A QUESTION OF IMMIGRATION: COUNTRY AND CITY FLOWS

Education brings its own immigration: 19% of the UK's student population is from overseas[3]. Retention of this talent alongside domestic students will pay dividends, all else equal. As mobile labour tends to be better educated, immigration should be welcomed. Indeed the Migration Advisory Committee's September 2018 study found a positive net fiscal contribution of EEA migration and concluded there would be benefits in shifting the mix of work migration toward higher skilled workers.

Politically motivated migration restrictions in the context of Brexit, therefore, could set alarm bells ringing. But an implied £50,000 salary threshold for overseas labour, as a proxy for skills, should not deter growth in higher skilled workers in financial services or tech. Political messaging and an inference on welcomeness may matter more than the mechanics themselves.

But immigration does not have to mean new residents from overseas. City economies require daily immigration to function. For instance, London's City and Westminster population increases by a factor of six during the day, and in Manchester by a factor 1.4[4]. Transport is needed to make this happen and ensure flows are as efficient as possible – but also that travel time catchments are as wide as possible.

TRANSPORT AS AN ENABLER FOR GROWTH AND DEVELOPMENT

Since a transport hub can 'process' more people, more people can live and work close to one. Development can be higher and denser. As well as more real estate (and more business rate revenue) this enables clustering and the associated sharing of ideas – known as agglomeration economies. Increasing economic mass (defined as number of workers in a city, or a travel to work area) has been shown to increase economic productivity by between 4 and 8%[5]. More theoretically, transport enables specialisation and trade; two unconnected cities making the same good will perform all tasks. Two connected cities with competitive firms will specialise in one task, double scale, improve efficiency and gain an export base[6].

2. See, for instance, Centre for Economic Performance, 2015, *Why are Higher Skilled Workers More Mobile?*
3. UKCISA, 2018
4. Figures from UK Census 2011 as displayed on Nomis
5. Rosenthal and Strange (2003) in Rosewell, *High Speed Rail, Transport Investment and Economic Impact*
6. These ideas are explored in Rosewell, *High Speed Rail, Transport Investment and Economic Impact*

FLEXIBILITY, NEW TECHNOLOGY AND AGEING

Flexible working was meant to have changed the nature of office work 20 years ago, but it did not. Much of this was down to human nature; people want to work with other people, entertain clients and generate ideas. People are (were?) also worried about being seen – in a recession, out of sight might mean out of mind and finding oneself off a shortlist. More recently such psychological barriers to working have been removed and more flexible approaches normalised - partly as an imperative to keep the workplace costs down.

'Home working' has evolved to be 'flexible working' and can mean from coffee shop, building reception, train, office or home and we are working as flexibly as we ever have done. This will only increase as technology and society adapt. This has not diminished the importance of a central office as a place to gather, but it has questioned its relevance as a place for desk-based work. London office stock has grown by far less than its office workers (0.7% p.a. versus 2.5% since 1992) meaning intensified space allocation and a requirement for flexible working. Meanwhile WeWork has become the second biggest occupier of space in London after the government[7].

We have seen some overestimations in passenger numbers. In May 2018 it was announced that TFL's passenger income fell 3% after journeys fell 1% and journeys on the underground fell 1.5% versus expectations of 2.5% growth. This increased its operating deficit[8]. We can't prove this was due to flexible working (the increase in cycling or slower population growth are also likely influences) but it does mean we should use caution in assumptions over extrapolating trends.

Transport technology may also affect the way we associate with cities. Automated electric vehicles (AEVs) are no longer science fiction. Ubiquitous access to AEVs from workers could influence locational preference over the very long term. In London a good office location may no longer be next to a train station. In regional economies (and let's not forget that an average of 76% of workers still drive to work outside London, compared to 28% in Greater London[9]) good road networks and buildings enabling AEV drop-off and pick-up may differentiate.

An ageing population produces a conundrum. Cold-hearted statistics show a strong association between economic growth and a younger age cohort. We would also challenge lazy assumptions that older generations desire rural tranquillity instead of city vibrancy. However, any friction in the ability of a city to house its talented workers risks that city's growth prospects. This provokes thoughts around encouraging downsizing or 'rightsizing', but people, naturally, do not appreciate being told what they should do.

There are other significant frictions in the housing market, frustrating the ability of younger generations to access a city, most notably stamp duty on purchases. For retirees there is also a question of shifting requirements of independence and dependence. Mixed generational neighbourhoods and the provision of age appropriate – and un-patronising – housing is part of the solution.

7. Financial Times, 23rd January 2018
8. Financial Times, 16th May 2018
9. Department for Transport

INVESTING IN FUTURE CITIES

We believe investment out-performance is possible by understanding what drives city success and identifying locations that have the right mix of attributes today to enable growth in the future.

Real estate income is linked to jobs. This motivates us to both predict jobs growth but also, where capital is longer term, enable it via investment into physical assets. Of the many things which grow cities, getting residents educated, housed and to and from work are the most worthwhile, in our view.

It is not yet clear what impact agile working will have on the precise location of jobs growth – it's no longer about measuring bums on seats in an office – but we have conviction that cities will retain their gravitational pull as a place to collaborate. Their role as a focal point for culture, leisure and amenity will continue to draw population, young and old, creating opportunities for appropriate product for all generations.

LGIM Real Assets is actively investing in cities and, across our group, the different motivations of different pots of capital provides an opportunity to make really meaningful investments in the growth factors which matter.

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