Challenges, trends & opportunities for CRE beyond COVID-19 - by Vikash Jha

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COVID-19 has posed unprecedented challenges to all aspects of our lives and across every industry, but the commercial real estate (CRE) industry definitely is among the hardest hit.

This is partly since most sectors within this industry have not been prepared to deal with extreme stress-scenarios that we are witnessing currently. This lack of preparedness is evident across structural (design, architecture, functional), financial, operational, technological, and customer-orientation aspects. However, the current crisis presents opportunities to re-invent and adapt to the new normal in the several ways.

Like any major disruption, there will be winners and losers, but if the investors and operators in CRE are open and willing to change by identifying and capitalizing on the opportunities while keeping medium- to long-term mindset, they will emerge as winners from this crisis.

This would require a combination of reassessing past strategies, re-organizing resources, restructuring businesses and operations and, building long-term resiliency (survive, thrive and sustain systems and mindset) to be better-equipped for 21st century's challenges.

CRE is defined as investment or income properties intended to generate a profit, either from capital gains or rental income. These include hospitality and leisure (hotels, resorts, membership-based clubs, sports facilities, gyms), office buildings (single tenant, small professional office buildings, skyscrapers), retail (malls, retail stores, strip malls, neighborhood shopping centers, restaurants), multifamily housing, healthcare facilities (hospitals, medical centers and nursing homes), undeveloped land, and other miscellaneous assets (student housing, self-storage, warehouses, garages, industrial facilities). Additionally, the industry is divided into three broad components–construction/development, sales and leasing.

Challenges and evolving trends

Unlike previous recessions and disruptions, the current one has a potential to change the landscape of CRE industry forever. Some of the key indicators noted over the last six months support this view–businesses adopting a work-from-home schedule for their employees even for medium- to long-term after seeing consistent productivity of a largely remote work-force during pandemic, substitution of business travel and conferences with online events and meetings, near universal availability and access to broadband making it easier and reliable to work from anywhere and still be productive, flexibility in employer and client attitudes towards remote working and leveraging this as a tool to retain talent and, signs of changing customer attitudes towards leisure travel, to list a few.

In Manhattan, for example, many large firms who either own or lease skyscraper office buildings, are assessing how they can operate with 25-50% on-site capacity as long-term strategy (new normal) with the rest being supported remotely or by rotational on-site attendance. Many medium and small firms are moving out permanently to the locations that score high on fixed and operational cost parameters (i.e. cheaper real estate and support services) and greater room for safety and wellness of workers and clients should a similar crisis arise again. Some of the winners from these moves are nearby suburbs, but also Upstate New York, Florida, Colorado, Arizona, Georgia, Texas, the Carolinas and other southern and mid-western centers. Similar trends are seen to be emerging from other high-density urban centers across the U.S., and other parts globally.

The business decisions currently being made across the industries will not only have profound impact on supply-demand dynamics of office spaces, but will also have ripple effects on all the allied services that cater to this sector–retail, hospitality, restaurants, groceries and convenience stores, residential real estate, medical facilities, security and administrative services, transportation, aviation, entertainment, non-profits and many others.

Over the next few months, I will be discussing some of these critical commercial real estate sectors through focused articles and explore solutions that may be applied to help these sectors prosper again. This current article introduces the framework that I will be using for the analysis.

The 4-R Framework: Reassess, Reorganize, Restructure, Resilience

Reassess: The CRE industry will be well served if it takes a longer view of recovery. It needs to first accept the reality that the business environment in post-COVID-19 world will be quite different than what it was prior. While trying to identify the root causes of the issue, consideration also needs to be given to the drivers–changing tenant and customer preferences of what/how/how much they would rent/own based on their evolving business models, how almost all businesses or jobs are moving into an online-offline model impacting future demand of CRE, potential changes in building codes and standards that could be mandated in different jurisdictions (closed office layouts as opposed to open layouts, HVAC changes, touchless systems throughout the building, leveraging technology in all spheres, etc), holistic and data-driven financial and operational management, among others.

Reorganize: For the entities holding CRE, the assessments should lead to re-organizing business models, reallocating resources, identifying new sources of revenue to first address short to medium term (0-2 years) challenges (through grants, governmental help, borrowing, sell-offs of troubled assets) and, then creating long term value (>3 years).

Some markets considered blue-chip for certain sectors of CRE, may no longer remain so, leading to major price corrections and sell-offs that we are already starting to see. Others will adopt structural changes–e.g. many office-only buildings could be converted into mixed-use or fully residential buildings, hotels converted into housing facilities. While also a new wave of construction could take place adopting new building code requirements across markets. Additionally, price per seat for commercial buildings may need to be increased to address new safety and wellness requirements demanded by tenants/owners.

Restructure: The structural, financial, and operational models will need to change. Investors will need to take into consideration greater capital and operational expenses to cater to tenant and customer preferences. Some of it will be offset in medium to long term by achieving economies of scale due to consolidation in the industry, centralization of management/financial decisions, operational optimization and widespread digitization.

Build Resiliency: While CRE industry is reinventing itself, it needs to take a long view, 15-, 30- even 50-years' view while developing infrastructure, adopting technology, optimizing financial and operational performances, developing human capabilities and adapting to climate change mandates that would be able to deal with any future disruptions. This could be achieved by private-public sector convergence.

I remain optimistic and am confident it will chart a new journey learning from this crisis.

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