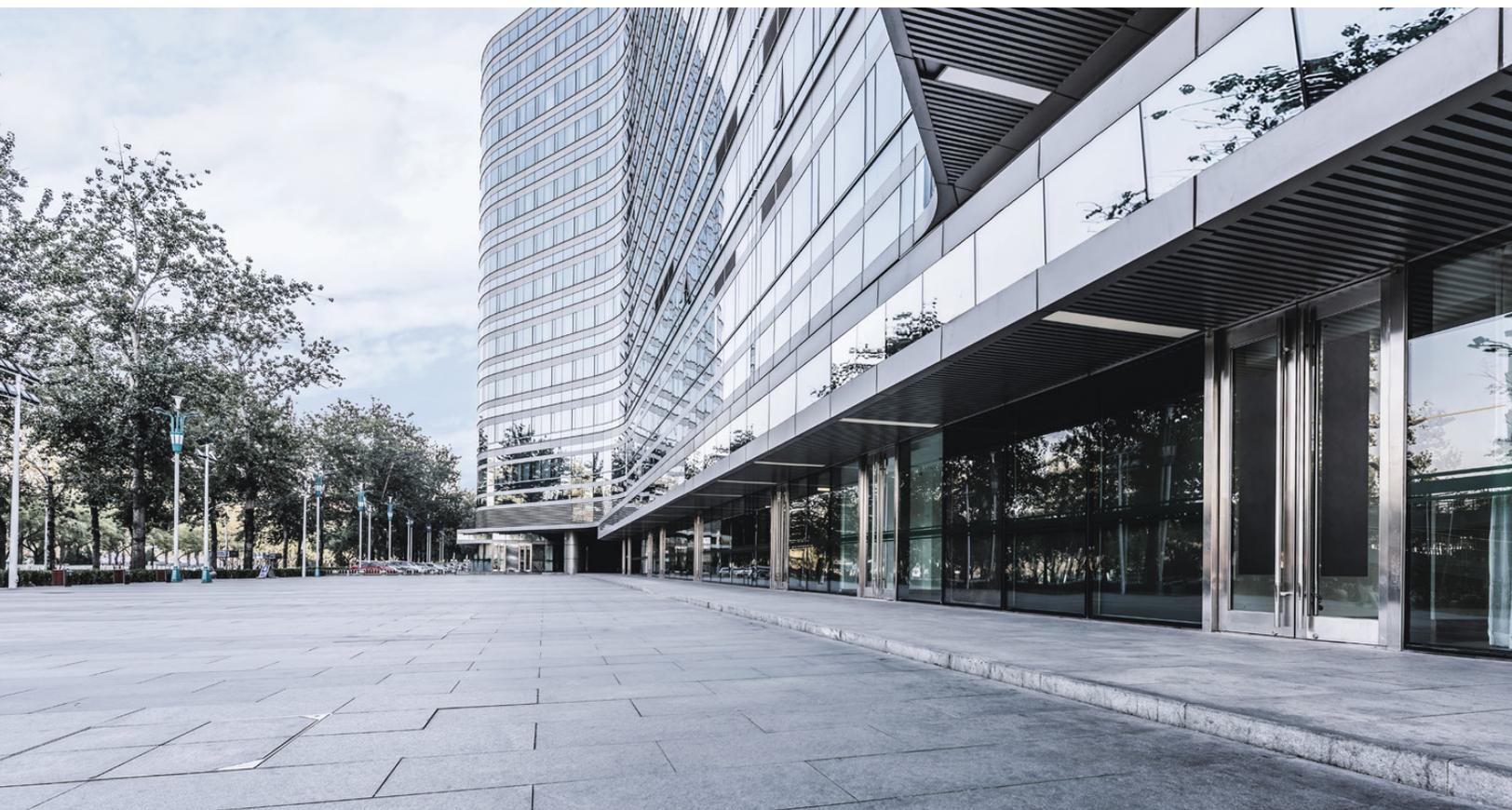


Private Equity & Principal Investors Practice

# Commercial real estate must do more than merely adapt to coronavirus

COVID-19 is a humanitarian challenge that will have lasting effects on how people live, work, and play. By acting today, real estate leaders can best serve end users and ensure their own viability.

*by Vaibhav Gujral, Robert Palter, Aditya Sanghvi, and Brian Vickery*



**In a matter of weeks**, the lives of so many have changed in ways they had never imagined. People can no longer meet, work, eat, shop, and socialize as they used to. The working world moved rapidly from business as usual to cautious travel, office closures, and work-from-home mandates. Instead of traveling and going out to eat at restaurants, consumers across the world are tightening their purse strings to spend only on essentials—primarily food, medicine, and home supplies—and getting these delivered much more often.

Physical distancing has directly changed the way people inhabit and interact with physical space, and the knock-on effects of the virus outbreak have made the demand for many types of space go down, perhaps for the first time in modern memory. This has created an unprecedented crisis for the real estate industry. Beyond the immediate challenge, the longer this crisis persists, the more likely we are to see transformative and lasting changes in behavior.

To respond to the current and urgent threat of COVID-19, and to lay the groundwork to deal with what may be permanent changes for the industry after the crisis, real estate leaders must take action now. Many will centralize cash management to focus on efficiency and change how they make portfolio and capital expenditure decisions. Some players will feel an even greater sense of urgency than before to digitize and provide a better—and more distinctive—tenant and customer experience. And, as the crisis affects commercial tenants' ability to make lease payments, many operators will need to make thousands of decisions for specific situations rather than making just a few, broad-based portfolio-wide decisions.

Most real estate players have been smart to begin with decisions that protect the safety and health of all employees, tenants, and other end users of space. The smartest will now also think about how the real estate landscape may be permanently changed in the future, and will alter their strategy. Those that succeed in strengthening their position through this crisis will go beyond just adapting: they will have taken bold actions that deepen relationships with their employees, investors, end users, and other stakeholders.

## **The immediate challenge**

Over the past several years, real estate investments have generated steady cash flow and returns significantly above traditional sources of yield—such as corporate debt—with only slightly more risk. Since the virus outbreak, however, this reality has changed, and real estate players have been hit hard across the value chain. Service providers are struggling to mitigate health risks for their employees and customers. Many developers can't obtain permits and they face construction delays, stoppages, and potentially shrinking rates of return. Meanwhile, many asset owners and operators face drastically reduced operating income, and almost all are nervous about how many tenants will struggle to make their lease payments. “Concession” and “abatement” are the words of the day, and players are working rapidly to figure out for whom they apply and how much.

Not all real estate assets are performing the same way during the crisis. The market seems to have pivoted mostly on the inherent degree of physical proximity among an asset class's users—even more so than on its lease length. Assets that have greater human density seem to have been the hardest hit: healthcare facilities, regional malls, lodging, and student housing have sold off considerably. By contrast, self-storage facilities, industrial facilities, and data centers have faced less-significant declines. As of April 3, by one estimate, the unlevered enterprise value of real estate assets had fallen 25 percent or more in most sectors and as much as 37 percent for lodging (the most extreme example).<sup>1</sup> It's no surprise that—when shoppers avoid crowds, universities send students home, and retailers, restaurants, and hotels close their doors—owning and operating those properties is a less valuable proposition. As such, liquidity and balance-sheet resilience have become paramount.

## **Behavioral changes that may outlive the crisis**

Real estate owners and operators across almost every asset class are considering several potential longer-term effects of the coronavirus outbreak and the required changes that these shifts are likely to bring.

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<sup>1</sup> *REITs amid a pandemic*, Green Street Advisors, April 3, 2020, [greenstreetadvisors.com](https://www.greenstreetadvisors.com).

For example, within commercial office space, the multiyear trend toward densification and open-plan layouts may reverse sharply. Public-health officials may increasingly amend building codes to limit the risk of future pandemics, potentially affecting standards for HVAC, square footage per person, and amount of enclosed space. At the same time, just as baby boomers age into the sweet spot for independent and assisted living, fear of viral outbreaks like COVID-19 may prompt them to stay in their current homes longer. It is possible that demand for senior living assets could dampen, or the product could change altogether to meet new preferences for more physical space and more-intensive operational requirements. It is also possible that senior-living facilities could prove they are best able to handle viral outbreaks, accelerating demand.

The COVID-19 experience could also permanently change habits that may affect demand for other real estate assets, such as hospitality properties and short-term leases. Even a short moratorium on business travel could have lasting impact when alternatives such as video conferences prove sufficient or even preferable. Near-shoring of supply chains may further reduce demand for cross-border business travel, and consumers who are afraid of traveling overseas may shift leisure travel to local destinations.

Consumers forced to shop online because of closed malls and shopping centers may permanently adjust their buying habits for certain categories toward e-commerce. Before the pandemic, consumers were already shifting their spending away from physical stores. This long-term trend may accelerate even faster after the crisis—especially as many previously struggling brands are tipped over the edge into bankruptcy or forced to radically reduce their footprint. Early evidence from China shows some staying power in the coronavirus-driven shift to e-commerce. Within certain product categories where supermarkets or mainstream retailers competed with online retailers, substantial market share could transfer to online players.

The shift to e-commerce may also further boost already high demands for industrial space. Relatively niche asset classes (such as self-storage and cloud kitchens) could see an improvement in their unit

economics, as demand density goes up when more people work from home, while other asset classes (such as coliving) may suffer. And universities forced to educate remotely for entire semesters could convince students and other stakeholders that existing tools are sufficient to provide a high-quality education at a lower cost, and a new type of hybrid (online–offline) education could become even more widely embraced.

The depth and breadth of economic impact on the real estate sector is uncertain, just as the scale of human catastrophe from the pandemic is yet to be seen. However, behavioral changes that will lead to significant space becoming obsolete in a post-coronavirus environment seem imminent. Given the potential for transformative changes, real estate players will be well served to take immediate action to improve their businesses but also keep one eye on a future that could be meaningfully different.

### **How leading real estate owners and operators are navigating the crisis**

While the longer-term consequences are difficult to predict, the immediate market consequences of the coronavirus crisis have been made clear—the public market sell-off in certain real estate types has been nothing short of dramatic. All companies, public and private, are working hard to navigate the immediate crisis with respect to staff, tenants, and end users of space, while also facing tough business trade-offs. Most industry leaders seek to strike the right balance between capital preservation and further strengthening their competitive differentiation.

Over the past several years, industry leaders have been diversifying sources of revenue, pursuing digital strategies, and focusing on tenant experience. The COVID-19 crisis has accelerated the need for those strategic changes—and highlighted that those that haven't yet made such investments will probably need to catch up quickly. For example, while relatively few real estate companies were actively developing or pursuing digital and advanced analytics strategies before the pandemic, such strategies can help with tenant attraction and churn, commercial lease negotiations, asset valuation, and improved tenant experience and operations. Other direct results of the outbreak include the need to meaningfully engage with customers and employees on health and safety in physical spaces.

In the wake of the coronavirus outbreak, real estate industry leaders are taking on a set of common imperatives.

### **Earning the respect, trust, and loyalty of customers and employees**

Above all, owners and operators have an obligation to protect the safety and health of people by all reasonable means. For leading operators, the need to overcommunicate—to both make sure they fully understand tenants' needs in this moment and help protect everyone in their ecosystem—is leading to some changes in behavior. This may make the practice of communicating as a company-level brand (rather than property-level brand) more common, speeding up an existing market trend. In B2B environments, such as offices and retail stores, CEOs and management teams may join asset managers and property managers and engage directly with tenants. They should follow up quickly on the actions they have discussed with tenants. Not only are such changes the right thing to do—they're also good business: tenants and users of space will remember the effort, and the trust built throughout the crisis will go a long way toward protecting relationships and value.

### **Centralizing cash management**

Real estate has always been highly decentralized: many important decisions that impact cash flow have been made at the property level. But given the uncertainty around the duration and depth of this crisis, top management is now providing more centralized direction on property-level cash management in addition to company-level balance-sheet decisions and credit lines. All levels of management—including those at the property level and company level—are beginning to identify efficiency levers and when to pull them based on the underlying performance of properties and the business as a whole. In the past, few properties and companies took a lean-enterprise mentality toward capital and operating expenses. Those that do adopt lean practices and eliminate inefficiencies, however, can buy themselves a little more time to work through uncertainty. But creativity can also be employed more often, as not all cash-creating activities need to involve cutting costs. For example, some developers engaged in residential sales are looking into innovative ways to liquidate new inventory, such as lease-to-own programs and financing partnerships.

### **Making tailored, informed decisions—particularly in commercial lease concessions**

While it may be tempting to make reductive assumptions about the coronavirus outbreak's economic impact, the corresponding policy responses at city, state, and federal levels will not be uniform across real estate portfolios. Even within a single asset, needs will vary among tenants. Thanks to the richness of available behavioral data, select real estate leaders will use analytics to generate fact-based insights on local epidemiological and economic scenarios, what is happening to competitive assets around a property, and the impact of the crisis on individual tenants. These perspectives can inform highly targeted decisions, rather than a one-action-fits-all-tenants approach.

Nearly every landlord is preparing for the effects of the downturn, when scores of tenants across asset classes will ask for lease concessions or abatement. While a single policy across all tenants and properties may be easier to implement, decisions must be made for each situation, starting with a consideration of tenants' safety and well-being. In the office sector, factors such as price point in the market, tenant-renewal probability, tenant-default probability, local regulations, building appearance due to vacant spaces, and potential reputational risks should inform individual decisions. Few real estate players have information about these on hand, and even fewer have the right tools, processes, and governance to make decisions. For instance, they rarely have detailed protocols in place for what can be decided at a property level versus what should be decided centrally, as well as what tools can be used for leasing or which asset-management professionals must make these tough decisions daily. Properly implemented, a set of clear protocols along with structured, fact-based decisioning will ensure fairness and procedural justice for tenants and help operators communicate their actions with key stakeholders, including tenants, investors, and lenders.

### **Taking the digital leap**

Before the crisis, the real estate industry had been moving toward digitizing processes and creating digitally enabled services for tenants and users. Practically overnight, physical distancing and the lockdown of physical spaces have magnified the importance of digitization, particularly by measures such as tenant and customer experience. Within

residential real estate, players that have invested in digital sales and leasing processes—using virtual open houses and showings; augmented and virtual reality; and omnichannel, targeted, and personalized sales—will more quickly allow their residents to find the right space for themselves.

When an operator may have to keep its amenity spaces closed for months, creating a differentiated experience will necessarily involve a suite of digital-first products and experiences: telehealth, on-demand delivery and concierge services, virtual communities, contactless access for residents, guests, and maintenance staff, and much more. As more users adopt these digital-first products and services, users' expectations will be raised, and players that provide a differentiated post-crisis experience will stay ahead of the curve. These digital offerings will pay dividends in the form of superior loyalty and the ability to create brand new revenue streams while better meeting the needs of tenants and end-users.

#### **Acquiring operating companies, not just single assets**

In the context of a post-coronavirus world, most investors and operators are reconsidering all capital decisions. Extreme uncertainty surrounding the duration of cash-flow depression and exit capitalization rates make it exceedingly challenging to underwrite acquisitions and discretionary capital expenditure with confidence. And private market players that are *not* facing near-term financial distress intend to hold assets through the downturn—some view the current environment as a valuation issue, not a value issue. Still, record-high dry powder is influencing investor attitudes. Many have already shifted their mindsets toward finding single assets at bargain prices, though the current difficulty in accessing capital markets has delayed action, and supply may remain constrained as potential sellers wait for valuations to return. These

combined complications have caused many real estate leaders to focus on acquisitions of operating companies, large asset portfolios, and public real estate investment trusts.

#### **Rethinking the future of real estate, now**

Some landlords are now starting the process of thinking ahead to when the crisis is over. Strategic review processes aim to understand how real estate usage might change going forward. However, rather than relying on traditional economic or customer-survey-driven approaches, real estate leaders are looking to psychologists, sociologists, futurists, and technologists for answers. Will employees demand larger and more enclosed workspaces? Will people decide not to live in condominiums for fear of having to ride elevators? While uncertainty currently reigns, by employing a range of creative personnel and using new methodologies—such as deep design interviews—business leaders may find new and more predictive insights.

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As during the period following the global financial crisis of 2008, while some real estate players go beyond just adapting and flourishing, others fade. Individual firms' abilities to weather the storm will depend on how they respond to immediate challenges to the industry—particularly the current declines in short-term cash flow and demand for space, as well as the uncertainty surrounding commercial tenants' ability to pay their bills. In the medium to long term, the changed behaviors forced upon the industry will have likely altered the way consumers and businesses use and interact with real estate. The critical question is which of these changes will stick. Throughout, acting quickly and smartly will help determine the fate of players not only in these challenging times but also as the industry emerges from the current crisis and inevitably reinvents itself.

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