222 Exhibition Street,
Melbourne, Australia

The hotelization of real estate

Service is not just for travel and leisure. It is quickly becoming the norm across all property types.

By Lisa Fu - 1 July 2019

From the concierges in apartments to day-by-day rentals in offices, more and more property types unrelated to travel and leisure are taking on 'hotel-like' characteristics.

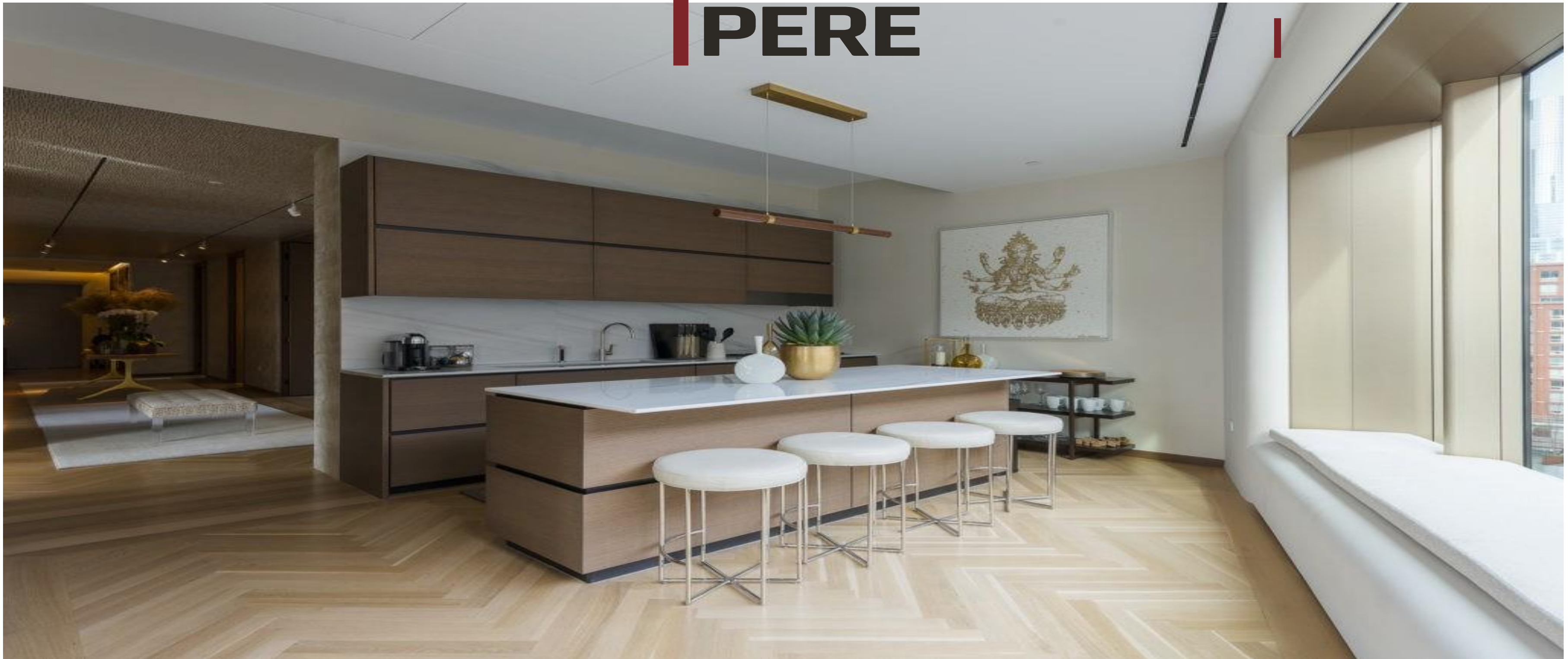
At the heart of this dynamic shift is the relationship between the world's biggest landlords, many of which are capitalized with institutional money, and their tenants, from the big corporations to the start-up businesses, the anchor department stores to the pop-up shops. The days in which landlords

offered inflexible space on rigid terms are becoming a thing of the past; negotiations surrounding an occupier's soft extra are becoming commonplace. Private real estate is fast evolving from an asset class to a service as the trend of 'hotelization' takes a grip it is unlikely

to relinquish.

The shift began with the occupiers. Specifically, it was triggered by the working and lifestyle preferences of millennials, the generation at the center of both technological and lifestyle transformations. Corporate employers and subsequently landlords around the world have targeted accommodating this generation as the key for the optimal built environment. They are seeking to shelter people highly motivated by operating in urban clusters and adopting a mobile lifestyle, placing a premium on experiences, says Byron Carlock, real estate leader at global consultancy PwC.

The preference for experiences is best illustrated by the shift in global shopping patterns. Technological advancement has allowed consumers to buy products online conveniently, displacing many traditional retailers. Meanwhile, those that offer something new and experiential are proving more resilient.



As lifestyles become more mobile, product offerings are following suit the shift to urbanization has led workers to flock to the cities and settle into apartments rather than in suburban houses like in years past. Those that work within the gig economy on short-term contracts often do not want to, or cannot, commit to a year-long lease, given job uncertainty, according to PwC real estate leader Bryan Carlock. Millennial and Gen Z cohorts in particular do not want to burden themselves with a mortgage and commitment to a singular location, especially as they tend to stay single and without children for longer compared with past generations, he adds.

The result of this global lifestyle shift is urban living spaces that trade off space for more amenities and services, and a rising dependency on flexible housing provided by sub-leasing apps and businesses, according to Carlock. Tenants are also choosing to trade space for

convenience. He observes that renters are willing to pay more per square foot and accept smaller living accommodations if offered the right services and amenities.

New York-based manager MG Capital has taken 'hotelization' one step further, creating a residential product that essentially replaces hotels. Rather than booking hotel rooms for traveling executives, companies sign two-to 10-year apartment leases with MG Capital. A team greets the tenant, helps them move in and offers hotel-like concierge services, providing everything from Egyptian cotton towels to restaurant recommendations.

He believes the close relationship allows the firm to anticipate tenant need and the additional cost is a small price to pay for the reward of the zero vacancy the firm currently boasts. "Just a little bit more investment has reduced vacancy," Malley says. "There is a lot more to today's millennials. This is a lifestyle generation."

On the office side, companies caught in a war for talented workers are looking for amenitized workspaces to attract and retain employees, according to Mark Grinis, global real estate, hospitality and construction leader at PwC's rival EY. At the same time, corporate tenants are seeking shorter and more flexible leases to reflect shorter business cycles and the unpredictable staff headcounts they bring, he says.

Carlock and Grinis were among 25 private real estate professionals and executives PERE spoke to about the 'hotelization' of private real estate. While opinions differ about which

particular service provisions will stick indefinitely and which are passing fads, that the industry is becoming more accommodating to tenants was one clear consensus from the interviews. This is among the most important trends the sector is experiencing today.

From third-party brands like WeWork to in-house service providers like CBRE Global Investors' Hana, co-working and flexible space businesses have sprung onto the market.

Co-working brands are taking up a larger share of office space. In the UK, these flexible office providers have grown from taking up 3.9 percent of total office space in the country in 2016 to 14.6 percent in 2018, according to a UBS white paper.

Corporate tenants do not want to sign long-term leases that sit on balance sheets as liabilities, according to NeueHouse chief executive Josh Wyatt. At the same time, landlords still prefer long-term leases that provide steady, predictable income streams. Thus, third-party, flexible workspace providers or co-working brands have emerged as a risk matchmaker that would sign long-term leases with the landlord and sub-lease short- term to companies, he explains.

Typically, co-working brands provide amenities and services in addition to sub-leasing space, assuming operational responsibility from landlords. These add-ons can include shared meeting rooms, lounges and scheduled social programming such as a networking hour over drinks. Some businesses will offer month-to- month membership and the option for corporate tenants to sign longer-term one- to five-year tenancies. Co- working brands have shifted the concept of

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the office to a ready-to-go workspace catering to a company's every need from an empty box that a corporate tenant must take time and money to build-out. Rather than third party co-working platforms to capture some of the upside.

Product Evolution

The result of these global lifestyle changes is an evolution in the way tenants and landlords interact with one another. That has sparked a transformation in the property on offer. "We're focused on identifying the trends and shifts in demand, such as where tenants want to be and how tenants are using the space," Blackstone co-head of real estate Ken Caplan tells PERE. "We are thinking about how we can meet that demand on the operational side with capital investment or with overall building positioning."

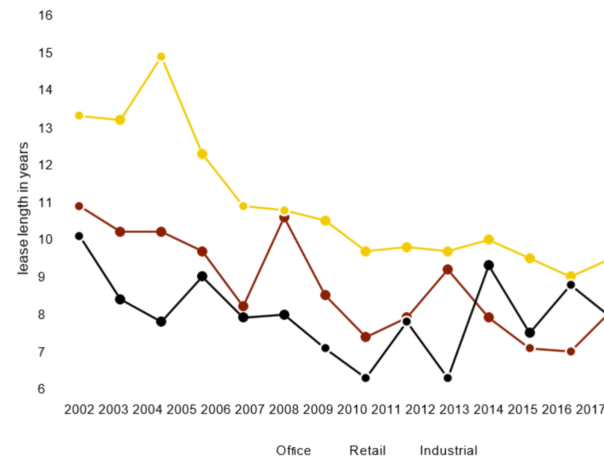
The firm's Willis Tower asset in Chicago, for instance, is undergoing a $500 million repositioning project, which includes physical improvements such as the addition of a food hall, rooftop park, amenities floor, skylight and windows to the exterior. Blackstone is also bringing value to the operations and services side of the business with the launch of a new tenant experience app for the tower in March. When the firm originally acquired the building, occupancy stood at around 80 percent and trended down. Today, *PERE* understands the building is 94 percent leased.

On the retail side, the firm increased events at its properties to create opportunities for community engagement and for brands to connect at the property without taking on a long-term lease, Caplan said. The experience-focused strategy supplements the more traditional long-term lease side of the

business rather than replacing it completely, he explains. Of transactions John O'Driscoll, tells *PERE*. "Every sector is becoming more operations-oriented."

AXA IM invests in office properties, and O'Driscoll says their corporate tenants want to blend fixed leases and flexible space options.

The demand for less leasing commitment from occupiers has led to a drop in average tenancies, although that average differs by market. In Switzerland, for example, a UBS study of institutional portfolios shows lease lengths greater than 10 years dropped from 38 percent in 2011 to just 6.8 percent in 2016. During the same period, the proportion of zero- to five-year leases grew from 38.8 percent to 67.4 percent.



Chris Urwin, director of research for real assets at UK insurer Aviva Investors Real Assets senior leadership team, agrees with O'Driscoll. Landlords need to respond by turning into a provider of As the relationship between tenants and landlords grows closer, institutional real estate is becoming increasingly focused on operations, Dutch pension manager APG, for instance, often favors managers with vertically integrated businesses involving operating capabilities. When the manager is not fully integrated, it might choose to invest separately in the operator, according to APG head of European property investments Robert-Jan Foortse.

New Partnerships

Hoteling' is about maximizing numbers and efficiency with the use of the sharing economy and flexible space, according to Kevin Colket, founder of Global Hospitality Investment Group, a Hong Kong-based hospitality real estate manager launched this year. 'Hospitality' is about providing customers with services, unique experiences and a space to connect with others. To be successful, one must look at the two aspects holistically and create a brand that is profitable, says Colket, who previously spent 11 years at hotel specialist Starwood Capital Group as managing director and head of Asia-Pacific acquisitions.

Colket, who sees many aspects of the hotel industry bleeding into other property types, points out that it is difficult to be good at both asset management and hotel investment – hotel managers are rarely trained in real estate and asset managers are not usually trained in hospitality – but having expertise in both is vital to maximizing returns.

To merge these two specialized skillsets, a series of different partnerships have emerged. Some landlords are partnering with third-party hospitality brands and flexible space providers. Others have hardly working or co-working Landlords hire JLL to bring in face-to-face services for tenants and a holistic approach in providing amenities that align with the tenant, according to Mark Zettl, JLL's president of property management for the Americas.

Then, there are firms that act as middlemen, signing long-term leases with landlords before subleasing space after adding various services and amenities. Convene is one example. The US operator partners with landlords to build and manage flexible work places, host events, cater food and provide tenant lounges. Convene is an amenity to the building and a tenant to the landlord by signing a long-term lease and subleasing to those that need flexible space for events and offices, according to Convene co- founder Christopher Kelly.

Meanwhile, managers GLP and Blackstone have taken to acquiring equity stakes in the third-party service providers. In June 2017, Blackstone acquired a majority stake in co-working brand The Office Group through its Blackstone Real Estate Partners Europe V fund. GLP launched its first non-real estate fund, the $1.6 billion Hidden Hill Modern Logistics Private Equity Fund, in May 2018 to promote technological growth in sectors that provide services to its main logistics real estate business.

On the other hand, Rockpoint Group, a Boston-based private equity real estate firm, launched an

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in- house service provider, RockHill, two years ago to focus on transforming office buildings, specifically bringing in 'hotel-level' services. Similarly, New York's Tishman Speyer launched Studio, an in-house co-working brand, to offer flexible workspaces, and Zo, to provide a suite of services and amenities such as catering and travel planning counting the costs offering flexible space does not have to mean smaller margins either, says AXA IM-Real Assets' O'Driscoll; providing solutions to tenants, such as increased services or a flexible and fixed blended lease, can improve relationships. The investment translates into a stronger brand and reputation, which yields better financial results, he explains.

For APG, investing in operations is a way of staying close to tenants and assessing how occupational demand is shifting. Foortse adds its longstanding in hotels investment has given it added comfort with the inherent risks too.

The increased focus on operations is expected to benefit global property managers, which provide real estate and asset management, leasing management, asset maintenance and support services such as space reservation management. According to a 2018 study by MarketsandMarkets, a Pune, India-based business-to-business research firm, the trend is expected to drive that market's growth to $22 billion in 2023 from the $14.5 billion reported in 2018.

For the sovereign wealth fund Abu Dhabi Investment Authority, the costs of adding services to its real estate assets do not outweigh the benefits stemming from the extra investment. The investor has seen better rents and higher tenant retention and demand as a result of the extra capital

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expenditure, according to global head of real estate Tom Arnold. Slower economic times will be a challenge for all properties, but it will be the older buildings without amenities that will face vacancies, he believes.

Costs depend on many factors and some investors say they do not need to be punitive to performance. Another investor, Bouwinvest, which works on behalf of the Dutch construction pension fund in offices, for example, Bouwinvest rents out space to retailers like coffee companies or grocery stores. This tenant diversification creates a mixed-use environment where different businesses thrive off one another, improving rent and tenant retention, according to Bas Jochims, director of Dutch office and hotel investments at Bouwinvest.

However, effective execution requires enough scale so one does not lose too much space to lower-paying retail tenants and enough office workers to frequent the retail businesses, he adds.

Although landlords have been incorporating amenities into suburban offices for years, urban offices have historically lacked these additions, Rockpoint managing member Tom Gilbane says.

Companies wanting to attract skilled staff are realizing millennials work differently to previous generations. They value amenities such as fitness centers. Consequently, corporate tenants are willing to pay higher rent for offices that provide these benefits, he says. Understanding that attractive office space helps corporate tenants with recruitment and branding, Rockpoint has been adding amenities such as food halls, conference rooms and fitness centers in its office

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properties.

In the span of a few years, consumers have let old, big box retail disappear, choosing brands that exist online or in a more ephemeral state instead.

The way people use retail space and the way people shop has evolved, says John O'Driscoll, European head of transactions at AXA Investment Managers-Real Assets. Disruptive forces, including online shopping that allows customers to 'click and collect,' have forced stores to

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offer greater convenience or something more experiential to differentiate themselves. Though holiday-related pop-up shops have long existed, retailers are now having to become more innovative to attract customers, CBRE executive vice-president of global retail services Steven Gartner observes. Short-term leases can be expensive to the retailer because they have to put effort into building the space out, but pop-up shops have the benefit of allowing them to experiment and understand consumers before committing to long-term strategies, he explains.

In 2018, online retailer Alibaba opened 60 physical pop-up locations in China for Singles Day. Similarly, US retailer Macy's launched its own dynamic shop concept called 'STORY' in April 2019 to constantly partner with new businesses and give customers variety.

Sovereign wealth fund Abu Dhabi Investment Authority extended the pop-up shop concept to restaurants in its retail spaces with the aim to keep the customer experience fresh but also grow its next full-time tenant in- house. The investor is building flexible commercial kitchens that tenants can rent by the hour or day, as the weighing the risks shifts Shifts in tenant preferences, increased maintenance costs and shorter or more flexible lease terms have resulted in a new risk assumptions, making underwriting increasingly difficult.

Historically, investors viewed prime real estate as bond-like when underwriting, emphasizing lease length and credit quality, according to Aviva Investors' Urwin. While these factors still matter, Aviva Investors now also puts together a rounded assessment of how an asset's location

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and physical characteristics will play into the team's ability to operate the property successfully, he says.

Landlords must forward-plan significant capital expenditure in their underwriting and cannot expect income assumptions to remain consistent, adds O'Driscoll.

New York-based NeueHouse views itself as a matchmaker for risk, taking on the liability of short-term leases on behalf of more cautious landlords and providing space for tenants that do not want long- term commitments. Underwriters need to consider what operating company or co-working brand is best positioned to manage an asset given the risk and the capital structure, according to its chief executive Josh Wyatt.

Each square foot of rent should be viewed like a bond, with tranches where the landlord underwrites for the co-working tenant's sources of income, he explains. With NeueHouse, the income to pay the rent per square foot breaks down to the 50 percent that comes through membership; around 40 Bridge Investment Group, which leans heavily on its in-house operating company Bridge Commercial Real Estate for a value-add strategy in office, is focusing on modernizing its assets and buildings in both amenities and flexibility. The investments it has made have resulted in a noticeable increase in rental income that have offsets costs, it says, but increases in construction costs have been a challenge, according to Jeff Shaw, a partner at the Salt Lake City-based group and Bridge Commercial Real Estate's chief executive.

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As a result, it is not unusual to see 30-40 percent increases in project costs over the span of just a few years, he says. When underwriting, this means the firm includes high levels of amenity packages and consideration for rebranding, which includes logos and flyers but also architectural design, he explains.

‘Hotelization’ also has implications for real estate lenders. Toronto-based TD Bank has begun to look at real estate deals involving robust amenity and service packages or short-term leases for tenants. When the bank engages in these deals, it looks for sponsors with existing relationships with the bank and significant experience with these projects, according to TD Bank regional director for commercial real estate Mark Santasieri.

Lending to landlords with flexible space tenants requires greater access to equity, a strong track record and a high-quality location, he explains. The bank also conducts due diligence on all key members of the project development team, including third-party property managers, Santasieri says.

While the rise of e-commerce has created cracks in retail, investors in logistics properties found they bet on the right horse

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Run rate capital expenditures remain low, corporate tenants leasing facilities tend to have good credit, portfolios can achieve scale and investors have access to stable and diversified cashflows, says Alan Yang, chief investment officer at Singapore-based logistics giant GLP. Coming out of the global financial crisis, However, the growth from technological and e-commerce evolutions benefiting the logistics property space can be just as easily disrupted and taken away by the same forces. “Technological and demographic shifts have been a boon for logistics real estate but also

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can be a potential disruptor," Yang says. "We position ourselves both offensively and defensively as the logistics and supply chain landscape continues to evolve."

Over the last few years, the firm made a conscious effort to stay ahead of the 'hotelization' trend by adding office spaces, nurseries and cafeterias to warehouses in high-density cities in Asia. GLP now sees technology as the next service offering its tenants will want and need. If tenants are given the technology to manage their businesses better, they will be willing to pay a premium, Yang argues. These technologies include software, fleet management systems, artificial intelligence, robotics and the next generation of vehicles.

Though flexible leasing has not taken off in the industrial property market, Yang believes it is a matter of when. Again this will command a rent premium. Smaller retailers are joining the market and distributing product, and industrial landlords need to figure out how to offer these tenants flexible space alongside traditional tenants that will sign on for long-term fixed space, he says.

To be sure, not all properties warrant extra capital expenditure or require shorter or more flexible leases. Most investors see real estate as providing stable income, says Prashant Tewari, partner at Cleveland-based private real assets consultancy Townsend. In the US, they seek core assets where income accounts for around 60 percent of the returns, he adds.

By his reckoning, allowing shorter leases means the quality of income must be high; the sacrifice of its stability should be in favor of higher returns. "We want income potential over the next seven to

10 little capex required. Townsend is selective about the assets that should be amenitized and service-providing. While high quality assets in good locations can handle increased capex, Tewari expresses concern over high cost services and amenities put into lesser quality assets as landlords are often unable to charge higher rents to justify the investment. Investors can wrongly assume high occupancies in low quality location assets will continue to perform. They underestimate vacancies that might result in a downturn, he says.

With strong tenant demand, landlords should not have to sacrifice much in capex to attract tenants, Tewari thinks, labeling today's arms race for amenities and services a symptom of the late cycle.

However, landlords still need to track tenant behavior and strike the right balance, he adds.

US pension Oregon State Treasury is also taking a careful and calculated approach to the 'hotelization' trend. "We don't need to be the first mover," says Anthony Breault, Oregon State Treasury's senior real estate investment officer.

To minimize risk to the pension's own investments, Breault says he prefers asset managers experiment with newer, untested investments on the firm's own balance sheet. Like Townsend, the state pension is hedging bets on flexible leases, capping co-working space at 30 percent of a building, for instance, and only offering short-term leases or early termination if the costs are shouldered by the tenant. Real estate has existed for as long as humans have required

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accommodation – it will not disappear from investment portfolios. However, the way real estate is occupied has changed and landlords will adapt to keep their assets relevant.

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