2019 Commercial Real Estate Outlook
New rules of the road

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Investors tend to prefer agile, technologically driven companies

Technology innovation and evolving preferences of investors, tenants, and end-users seem to be redefining traditional commercial real estate (CRE) business models and the use of built space. Take the example of WeWork, the co-sharing space owner that is positioning itself as a “services” company rather than a property owner-operator.
Since its inception in 2010, the company has grown from a single space in New York City to 287 physical locations across 77 cities and 23 countries as of August 2018. At US$20 billion, WeWork is among the highest-valued tech startups, after Uber and Airbnb. The company's growth outstrips that of any traditional CRE company.

What are companies like WeWork doing differently? These change agents are retaining the core ethos of the real estate business—the importance of location—while changing perspectives about how the physical space is consumed. Their value proposition lies in augmenting the user experience through the use of technology. WeWork's goal is to create not just a functional but also a memorable experience through a vibrant ambience, varied open-seating options, amenities, and networking opportunities for the on-the-go millennial and Gen Z workforce.

Change agents like WeWork are repositioning the CRE asset as not just a physical space but a service hub. They are also trying to differentiate themselves with a nimble and flexible business model. Many traditional companies, on the other hand, seem to find it challenging to adapt to the fast-paced change and uncertain environment. It’s hard for many to see the appropriate path to transition from property management to augmenting tenant experience.

Our 2019 Commercial Real Estate Outlook dives deeper into the preferences of CRE investors to help CRE companies understand the new rules of the road. Our Outlook survey of 500 global investors, which provides insights on factors that are influencing their CRE investment decisions, revealed the following key themes:

1. Respondents plan to increase their capital commitment to CRE, with the United States, Germany, and Canada leading the way.
2. Nontraditional assets such as mixed-use properties and new business models such as properties with flexible leases and spaces are expected to attract more investment dollars.
3. The surveyed investors expect to prioritize their investments in existing and potential investee companies that they believe are responding to business model changes and adopting a variety of technologies to make buildings future-ready.
4. Survey respondents see a significant impact from technology advancements on legacy properties in less than three years.

With most investors seemingly committed to investing in newer business models and a tech-enabled ecosystem, how can CRE companies cash in on the gold rush? CRE companies should change how they approach change, remain competitive, and grow.

Let’s take a closer look at investor expectations on CRE capital flows.

Global CRE investments continue to rise on the back of steady economic and employment growth in key global markets. This is despite concerns about a flattening yield curve, various country tax reform initiatives, and the threat of trade tariffs as well as the yet-to-be-fully-determined impact of Brexit in Europe. In the first half of 2018, global CRE transaction volume increased 13 percent year over year (YOY) to US$341 billion. The Americas’ volume rose by 9 percent YOY to US$132 billion, with the United States leading with a volume of US$122 billion (+11 percent YOY).

The trend is expected to continue, as 97 percent of our survey respondents plan to increase their capital commitment to CRE over the next 18 months (see figure 1). Respondents from the United States plan to increase their capital commitments by 13 percent in this time frame, just ahead of those in Germany (13 percent) and Canada (12 percent). In terms of inbound capital, surveyed respondents said the United States is also the most preferred CRE market globally, followed by Hong Kong and China.

Surveyed executives plan to diversify their portfolios through increased investment in emerging business models and thematic strategies. Over half of them aim to invest or increase investments in properties with flexible leases, and 44 percent plan to do so in flexible spaces. Investors realize that their investments need to connect with the changing nature of work and tenant preferences. As such, the new capital commitment is unlikely to flow entirely into traditional CRE. Survey respondents specializing in mixed-use and nontraditional properties plan to increase their capital commitment by a higher percentage than those focused on traditional properties (see figure 1), especially in data centers and health care (including senior housing) facilities. Nevertheless, investors will likely continue to value traditional properties and longer-term and high-credit-worthy tenants.

1.  WeWork website, accessed on August 20, 2018.
5.  Ibid.
6.  Ibid.
Many traditional companies, on the other hand, seem to find it challenging to adapt to the fast-paced change and uncertain environment. It’s hard for many to see the appropriate path to transition from property management to augmenting tenant experience.
**Figure 1: The investor pulse: Global capital flows**

Investors plan to increase CRE capital commitment in the next 18 months

*Top and bottom two respondent types across categories*

<table>
<thead>
<tr>
<th>Property focus</th>
<th>% increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mixed-use</td>
<td>14%</td>
</tr>
<tr>
<td>Nontraditional</td>
<td>13%</td>
</tr>
<tr>
<td>Retail</td>
<td>10%</td>
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<tr>
<td>Hospitality</td>
<td>9%</td>
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</tbody>
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**Geographic focus**

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<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>US, Germany</td>
<td>13%</td>
</tr>
<tr>
<td>Canada</td>
<td>12%</td>
</tr>
<tr>
<td>China, Hong Kong</td>
<td>9%</td>
</tr>
<tr>
<td>Japan</td>
<td>8%</td>
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**Assets under management**

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<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Less than US $500 million</td>
<td>13%</td>
</tr>
<tr>
<td>US $1.1 billion – US $5 billion</td>
<td>11%</td>
</tr>
<tr>
<td>US $500 million – US $1 billion</td>
<td>10%</td>
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<tr>
<td>Above US $30 billion</td>
<td>10%</td>
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**Investor category**

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<table>
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<tr>
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<tbody>
<tr>
<td>REITs or real estate operating companies</td>
<td>14%</td>
</tr>
<tr>
<td>Banking or finance companies (asset management divisions)</td>
<td>13%</td>
</tr>
<tr>
<td>Private equity, Sovereign wealth funds</td>
<td>10%</td>
</tr>
<tr>
<td>Hedge funds, Pension funds</td>
<td>9%</td>
</tr>
</tbody>
</table>

**Most investors prefer data centers and healthcare among nontraditional assets**

*Percentage of respondents*

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<table>
<thead>
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<tbody>
<tr>
<td>Data centers</td>
<td>67%</td>
</tr>
<tr>
<td>(including senior housing)</td>
<td>3%</td>
</tr>
<tr>
<td>Health care</td>
<td>55%</td>
</tr>
<tr>
<td>Mobile towers</td>
<td>49%</td>
</tr>
<tr>
<td>Single Family housing</td>
<td>47%</td>
</tr>
<tr>
<td>Student housing</td>
<td>29%</td>
</tr>
<tr>
<td>Others</td>
<td>26%</td>
</tr>
</tbody>
</table>

**Investors interested in newer and emerging business models and thematic investments**

*Percentage of respondents*

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<table>
<thead>
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<tbody>
<tr>
<td>Portfolio and risk diversification</td>
<td>49%</td>
</tr>
<tr>
<td>Preference for new and emerging business models</td>
<td>48%</td>
</tr>
<tr>
<td>Focus on thematic investments</td>
<td>45%</td>
</tr>
<tr>
<td>Superior returns</td>
<td>44%</td>
</tr>
<tr>
<td>Lower competition</td>
<td>35%</td>
</tr>
<tr>
<td>Other</td>
<td>1%</td>
</tr>
</tbody>
</table>

Globally, US, Hong Kong, and China most favored CRE markets

Investment split across countries

Properties with:
- Flexible leases: 52%
- Flexible spaces: 44%
Investors plan to increase investments in mixed-use and nontraditional properties in the next 18 months

For mixed-use

Top 3 respondent types across categories

<table>
<thead>
<tr>
<th>Geographic focus</th>
<th>% increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada, Singapore</td>
<td>66%</td>
</tr>
<tr>
<td>US, Hong Kong</td>
<td>57%</td>
</tr>
<tr>
<td>UK, Germany</td>
<td>55%</td>
</tr>
</tbody>
</table>

Assets under management

| US $10.1 billion – US $20 billion | 69% |
| US $20.1 billion – US $30 billion | 66% |
| US $5.1 billion – US $10 billion  | 59% |

Investor category

| Pension funds | 75% |
| Hedge funds   | 66% |
| Sovereign wealth funds | 58% |

For nontraditional

Top 3 respondent types across categories

<table>
<thead>
<tr>
<th>Geographic focus</th>
<th>% increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>73%</td>
</tr>
<tr>
<td>China</td>
<td>70%</td>
</tr>
<tr>
<td>Singapore</td>
<td>40%</td>
</tr>
</tbody>
</table>

Assets under management

| US $10.1 billion – US $20 billion | 50% |
| US $20.1 billion – US $30 billion | 44% |
| US $5.1 billion – US $10 billion  | 41% |

Investor category

| Pension funds | 48% |
| Hedge funds   | 46% |
| Sovereign wealth funds | 40% |

Investors looking to pursue M&A, enhance user experience, and improve property features to generate target returns

Percentage of respondents

- Rebalance portfolio through M&A: 44%
- Redevelop to enhance user experience: 41%
- Invest to enhance property features: 41%
- Repurpose for alternative use: 38%
- Abandon: 10%

Note: The categories highlighted in the graphic tables suggest the following about the survey respondents:

Property focus: Property specialization of investors; Geographic focus: Home country of the investor; Assets under management: Investor size

Source: Deloitte Center for Financial Services Analysis
What should CRE companies do to be more agile in attracting capital?
To keep up with changing investor preferences, CRE companies should consider rebalancing their property portfolios, focusing on creating memorable tenant experiences and diversifying their investor base to attract higher capital investment.

Rebalance property portfolios
Investors’ capital commitment plans suggest CRE companies could be at an advantage if they stay close to their core investment strategies and risk alignment, while balancing and diversifying their property portfolios. Even the meaning of “diversification” should be challenged, since properties and portfolios could take different shapes and forms. These could include more flexible, experiential and engaging spaces.

Most traditional property real estate investment trusts (REITs), except industrials and certain classes of nontraditional REITs, are trading at a discount to their net asset values. CRE companies may also be able to take advantage of mergers and acquisitions and joint venture or partnering routes. Companies can use data to revise current market strategies and analyze how expansion into new properties could complement their existing ones. Strategy driven by supporting data can help demonstrate how a single investment could not only present operational synergies but can also evolve the broader portfolio. For instance, retail owners could conduct highest and best-use analysis based on location, surrounding demographics, and other macro factors. The end goal would be to repurpose some of their vacant assets into nontraditional uses such as data centers and senior housing and create new sources of revenue.

Increase tenant-centricity
CRE companies should reimagine the tenant experience by weaving technology into their buildings across the entire tenant life cycle. This can help strengthen tenant stickiness and, therefore, valuations. For instance, CRE owners and developers are using mixed reality, which is a combination of augmented (AR) and virtual (VR) reality, to attract tenants. This technology allows potential buyers or tenants to visualize the new property using a 360-degree immersive experience and offer multiple finished site options. This may also expand the reach to potential clients across different geographies. Companies could also leverage technologies such as the Internet of Things (IoT), artificial intelligence (AI), and predictive analytics to (re)develop and tailor existing or new buildings to suit changing tenant preferences and to anticipate tenant needs. This also provides an opportunity for CRE companies to partner with tenants to augment the end-user experience.

Companies should reconsider their existing tenant mix, as physical spaces that offer diverse experiences can also yield higher occupancy and rents. CRE companies should consider using traditional and alternative data, AI, and predictive analytics to reposition tenants for greater portfolio diversity. For example, some retail owners are now offering empty mall space to retail incubators or even co-sharing work spaces, which requires them to target a more diverse tenant pool.

These new arrangements are designed to be beneficial to all stakeholders, even though these new forms of tenants occupy a relatively small portion of the leasable space. Retail incubators get a marketplace to demonstrate their products before they expand their physical presence, and workers using the co-working spaces get more networking opportunities and more “walkable” options for their eating, shopping, and entertainment needs.
Retail owners can benefit by providing a higher-value experience for the entire property due to an attractive tenant mix and increased retention of existing tenants through higher foot traffic.

Companies can also enhance existing lease administration processes to offer short-term leases or a hybrid along with longer-term leases. With increased business uncertainty, traditional tenants are looking at more flexible leases, while the newer form of tenants discussed above thrive on such models. Landlords see a direct benefit to their net operating income as they lease out vacant spaces. Moving from longer-term to short-term leases may require a change in financial forecasting techniques, as it would impact revenue stream predictability.

By revamping the user experience, tenant mix, and lease administration processes, companies can not only reduce tenant risk but also create a differentiated brand.

Diversify investor base
Real estate has arrived as a meaningful and strategic long-term play for many investors. REITs can expand and diversify their investor pool because of this increased investor interest. They can take advantage of the separate Global Industry Classification Standard (GICS) of real estate and help generalist investors to better understand the nuances of REIT operations, performance, and valuation. Companies can frame a targeted expansion strategy for generalist investors such as pension, endowment, and foundation funds, which have traditionally under-allocated to REITs but are warming up to REIT investments.
For instance, pension fund respondents to the Deloitte survey plan to increase CRE capital commitment by 9 percent on average in the next 18 months (see figure 1), and a significant portion of this could be directed toward REITs. Smaller REITs (market capitalization of less than US$1 billion) in particular can gain exposure to more institutional investors, benefiting from investors’ plans to expand beyond core markets in search of yield. CREs can also use data insights to diversify geographically by targeting investors from different countries. Survey respondents from Canada (55 percent) are interested more in the Northeast region of the United States, while Chinese respondents (40 percent) focus on the Sunbelt.

The bottom line is that most investors expect CRE companies to reassess property and tenant mix to attract more capital. They also have distinct preferences about the use of technology, cyber risk management, employee experience, and the role of proptechs, which generally influence their CRE investment decisions. Read our ‘2019 Commercial Real Estate Outlook: Agility is key to winning in the digital era’ to gain in-depth insights into investor preferences in each of these areas over the next 18 months.

We recommend reflecting on a few questions that can help you evaluate your agility to navigate these forces of change:

- Do you position your real estate as a service? Is there additional value to capture by prioritizing tenant expectations and experience while selecting, designing, and leasing a location?
- How are you realigning business and talent engagement processes in light of increased technology usage, newer risks such as cyber-attacks, and the advent of proptechs?
- Are you innovating continuously, breaking down silos, and enabling cross-functional collaboration?
- Are you running pilots of new products and services with a “fail early, fail fast, learn faster” approach?
- Are you proactive or reactive to change?

CRE companies should consider using traditional and alternative data, AI, and predictive analytics to reposition tenants for greater portfolio diversity.

Companies can use data to revise current market strategies and analyze how expansion into new properties could complement their existing ones.

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**Survey methodology**
Our survey elicited responses from C-suite executives of 500 real estate institutional investors globally. The survey was conducted in July 2018 and covered investors from 10 countries across the Americas, Europe, and Asia Pacific with assets under management (AUM) ranging from less than US$500 million to more than US$30 billion. The investors surveyed include private equity firms, hedge funds, mutual funds, asset management arms of banks and insurance companies, SWFs and pension funds, and REITs. The survey also included a fair representation of investors focused on a variety of traditional and nontraditional properties.

The respondents were asked questions around themes such as capital flows, influence of technology, cyber risk management, evolution of talent and culture, and the role of proptechs, to understand the factors that are driving their CRE investment decisions.

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