FEATURE

COVID-19 implications for commercial real estate
Preparing for the “next normal”

Jim Berry

THE DELOITTE CENTER FOR FINANCIAL SERVICES
Unlike past economic challenges, COVID-19 is having an immediate and widespread impact on the CRE industry across the globe. Learn how and why this is different, along with our take on what the post-COVID-19 recovery could look like.

Introduction

The human and business impact of the COVID-19 pandemic continues to unfold globally. The rapid pace at which the pandemic is spreading and global actions to curtail it are having an unprecedented impact on the way we live and do business. While it is too early to fully understand the impact of these events, history can serve as a valuable source of information as we look forward.

Over the past century, external shocks such as an epidemic or a pandemic followed by an economic downturn have had an immediate to short-term impact on commercial real estate (CRE) asset prices, but minimal influence on transaction activity. However, the CRE industry recovered from these events at varying paces: While event-oriented downturns showed a quicker rebound, longer-term events, such as the 2008 recession, resulted in a more protracted recovery (figure 1). As a rule of thumb, the industry has historically

FIGURE 1

The impact of past epidemics, pandemics, and economic downturns on commercial real estate

lagged the broader economy by six months in terms of experiencing the effects. But the expansiveness, depth, and unprecedented reach of this pandemic has started impacting the CRE industry much sooner.

The CRE industry before the outbreak

Unlike the 2008 economic downturn, the CRE industry was in a strong position before the onset of COVID-19. Balance sheets, capital availability, and liquidity were healthy; companies could manage their debt maturities to longer positions (figure 2).

In our 2020 commercial real estate outlook, which was based on a summer 2019 global survey of 750 CRE C-suite executives, nearly three-fourths of respondents expected capital availability to increase in 2020. Along with this, the US CRE markets continued to maintain global attractiveness, according to the AFIRE 2020 International Investor Survey released in early March.¹

The rapid impact of COVID-19 on CRE

Since the second week of March, when COVID-19 was declared a pandemic, spreading globally and, particularly, across the United States, financial markets have declined sharply. The S&P 500 and Russel 2000 declined by 13 percent and 29 percent year to date as of April 15.² The US 10-year treasury yields declined by 127 bps to 0.6 percent over the same time period.³

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**FIGURE 2**


<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Debt service coverage ratios</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrial</td>
<td>2.6</td>
<td>8.0</td>
</tr>
<tr>
<td>Office</td>
<td>3.1</td>
<td>5.3</td>
</tr>
<tr>
<td>Residential</td>
<td>2.3</td>
<td>4.8</td>
</tr>
<tr>
<td>Hotel</td>
<td>2.4</td>
<td>4.0</td>
</tr>
<tr>
<td>Retail</td>
<td>3.0</td>
<td>3.8</td>
</tr>
<tr>
<td>Brokers</td>
<td>3.8</td>
<td>6.3</td>
</tr>
<tr>
<td>REITs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Homebuilders</td>
<td>-5.3</td>
<td></td>
</tr>
</tbody>
</table>

**US CRE market fundamentals, 2007 vs. 2019**

- 4% **TRANSACTION ACTIVITY**
- 33% **COMMERCIAL MORTGAGE ORIGINATIONS INDEX**
- 36% **CRE PRICES**
- 134% **PRIVATE EQUITY REAL ESTATE DRY POWDER**
- 159% **FTSE NAREIT ALL REITS INDEX**

Sources: Real Capital Analytics, March 2020; Preqin Real Estate Dry Powder data (North America), April 23, 2020; FTSE Nareit U.S. Real Estate Index Returns, Nareit, April 16, 2020; Quarterly survey of Commercial/Multifamily Mortgage Bankers Originations, Mortgage Bankers Association, S&P Global Market Intelligence (number represent subsector average); and Deloitte Center for Financial Services analysis.
Rather than the typical lag, the CRE industry was affected immediately. This was because trade activities and occupiers’ businesses were shut down (figure 3).

**Impact by CRE subsector**

How is the pandemic impacting tenants’ businesses? The evolving economic situation has had a significant influence on property owners,

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**FIGURE 3**

**How COVID-19 is impacting CRE fundamentals and operations**

<table>
<thead>
<tr>
<th>CRE fundamentals and operations</th>
<th>Current impact</th>
<th>Trending toward</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lending</strong></td>
<td>• Markets have remained accessible, but given the enhanced risk, most lenders are treading with caution.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td></td>
<td>• Commercial mortgage–backed securities (CMBS) delinquency rates moved up slightly in March to 2.1 after three years of consistent low levels.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>• Some property owners face short-term liquidity management issues due to delays in rent collection and increased costs. For instance, shopping center REITs received only 46 percent of their typical rent in the first few weeks of April.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td></td>
<td>• Many CRE borrowers, especially from the most affected sectors, such as hotels, have applied for debt relief due to a short-term liquidity crunch.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td><strong>Leasing volume</strong></td>
<td>• Some of the submarkets, such as Manhattan, saw a 25 percent YoY decline in leasing volumes, the lowest since 2013.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td><strong>Capitalization (cap) rates</strong></td>
<td>• Cap rates have varied by property types. Between January 31 and March 16, cap rates for hotel and mall REITs rose by 402 basis points (bps) and 206 bps, respectively.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td></td>
<td>• In contrast, cell towers and data centers have shown more resilience, with moderate cap rate increases of around 30 bps.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td><strong>Investments</strong></td>
<td>• New investments are slowing down, due to increased uncertainty and valuation concerns. However, there is significant dry powder, and other sources of capital are poised for opportunistic investing.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td></td>
<td>• In a March 24 survey by Pension Real Estate Association, nearly 74 percent of respondents have shelved their CRE investment plans and 63 percent were worried about uncertainties in property appraisals.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td><strong>Operations</strong></td>
<td>• As a result of social distancing and government directives, many hotels, shops, malls, offices, and coworking/living spaces have been closed.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td></td>
<td>• Higher operational costs due to enhanced focus on cleaning and sanitation, security, and thermal checkpoints.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
<tr>
<td></td>
<td>• E-commerce players, grocery stores, pharmacies, and warehouses experienced a surge in demand.</td>
<td><img src="image" alt="Trending toward" /></td>
</tr>
</tbody>
</table>

Source: Deloitte Center for Financial Services analysis.
brokers, developers, and proptechs. Here is a breakdown of the impact on CRE subsectors.

**REITS**
With REITs, there has been varied impact across property types based on the pandemic’s influence on tenant businesses. As of April 15, the Data Center REITs index was up 34 percent year on year, while retail and hotel REIT indices were down 48 percent and 53 percent, respectively (figure 4). Broadly, the immediate leasing risk is softened for REITs because they have long-term lease contracts. However, leases associated with the most impacted segments have immediately felt pressure because tenant businesses and liquidity have been affected. In addition to base rents, percentage rents, which are calculated as a proportion of sales volume, are significantly impacted by business shutdowns.

As buyers and sellers take a wait-and-see approach and CRE deals are delayed, most brokers feel the effects. Even property touring activity has declined considerably in the current environment. For instance, US CRE transaction volume declined 27 percent year on year in March. In early April, most realtors reported a decline of over 30 percent in buyer traffic.

**DEVELOPERS AND HOMEBUILDERS**
Developers’ project timelines and cash flows are affected due to the slow pace of activity and a halt in certain types of construction, including new developments. A recent contractor survey revealed that more than one-half of US construction firm respondents halted or suspended projects and more than two-thirds experienced delays due to a shortage of materials and personal protective equipment. Project sites that are still active have to adhere to guidelines on social distancing and frequent cleansing of common areas and construction equipment. Further, the Fannie Mae Home Purchase Sentiment Index (HPSI) declined 11.7 percent in March to 80.8, its

![Figure 4: Returns on REIT property indices](image-url)

**Returns on REIT property indices**
Year-over-year percentage change in US REIT property indices as of April 15, 2020

<table>
<thead>
<tr>
<th>Property Type</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Data centers</td>
<td>34%</td>
</tr>
<tr>
<td>Cell towers</td>
<td>31%</td>
</tr>
<tr>
<td>Industrial</td>
<td>14%</td>
</tr>
<tr>
<td>Multifamily</td>
<td>-15%</td>
</tr>
<tr>
<td>Office</td>
<td>-17%</td>
</tr>
<tr>
<td>Health care</td>
<td>-25%</td>
</tr>
<tr>
<td>Retail</td>
<td>-48%</td>
</tr>
<tr>
<td>Hotel</td>
<td>-53%</td>
</tr>
</tbody>
</table>

lowest level since December 2016, indicating a potential decline in new home sales.¹⁷

PRIVATE EQUITY REAL ESTATE (PERE)
There is no immediate decline in PERE investments, due to their nonpublic status. Currently, investors are, for the most part, focusing inward by helping portfolio companies manage costs and liquidity.¹⁸ To manage risk and allow for opportunistic plays, allocations may shift. Some investors could increase focus on more resilient assets, such as those supporting the digital economy. Others are expected to look for valuation plays in gateway markets or to invest in distressed assets.

PROPTECHS
The impact on proptechs varies by the type of products and services they provide. Coworking/coliving/holiday rental spaces have seen an adverse impact; users are unlikely to return to a short-term lease model in the near future.¹⁹ However, proptechs that offer digital solutions related to property and building management might fare better, as CRE companies could rely on technology to manage operations and interact with tenants.

Government actions that impact the CRE industry
The US government and Federal Reserve have taken multiple measures to respond to the impact of COVID-19, some of which impact the CRE industry. With rising selling pressure and illiquidity concerns in the agency commercial mortgage-backed securities (CMBS) markets, the Fed provided short-term financing to investors.²⁰

Further, the federal government passed the CARES Act to boost cash flows and liquidity. The act includes several tax and business spending provisions that can be leveraged by CRE companies; it increases bonus depreciation, utilizes net operating losses from prior years, and allows companies to obtain cash refunds for carryforward of minimum tax credits. For more detailed insights on regulations and potential benefits, please refer to Deloitte’s recent report, COVID-19 stimulus: A taxpayer guide.

With rising selling pressure and illiquidity concerns in the agency commercial mortgage-backed securities markets, the Fed provided short-term financing to investors.

The way forward: Respond, recover, and thrive
Compared to the epidemics, pandemics, and economic downturns over the last century, COVID-19 has been unique in its global reaction and reach. Entire countries, regions, and cities have instituted shelter-in-place orders or have been locked down. This abrupt change in the way we work has required mass remote working, a complete lifestyle change, and has created a fair amount of fear. These converging factors, which may prevail over a sustained time period, will likely continue to influence occupiers and end users of real estate in unprecedented and unique ways, which is expected to have implications for the CRE industry.

Based on three economic scenarios laid out by the Deloitte Economists, the US real GDP growth could be -5 percent in a best or mild case scenario and -10 percent in the worst or severe case scenario in 2020 (figure 5).²¹
FIGURE 5

Future economic scenarios: Estimated real GDP growth and potential year of recovery

<table>
<thead>
<tr>
<th>Economic Scenarios</th>
<th>United States</th>
<th>European Union</th>
<th>China</th>
<th>Japan</th>
<th>Global</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mild</td>
<td>-5%</td>
<td>-5%</td>
<td>3%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>When the recovery will start</td>
<td>First half of 2021</td>
<td>First half of 2021</td>
<td>Second half of 2020</td>
<td>Second half of 2020</td>
<td>ROW*: Recession, with recovery in first half of 2021</td>
</tr>
<tr>
<td>Harsh</td>
<td>-8%</td>
<td>-8%</td>
<td>1%</td>
<td>-3%</td>
<td>-3%</td>
</tr>
<tr>
<td>When the recovery will start</td>
<td>Second half of 2021</td>
<td>Second half of 2021</td>
<td>Second half of 2021</td>
<td>Second half of 2021</td>
<td>ROW: Recession, with recovery in second half of 2021</td>
</tr>
<tr>
<td>Severe</td>
<td>-10%</td>
<td>-10%</td>
<td>-3%</td>
<td>-6%</td>
<td>-6%</td>
</tr>
<tr>
<td>When the recovery will start</td>
<td>2022</td>
<td>2022</td>
<td>Severe outbreak in 2021</td>
<td>2022</td>
<td>ROW: 2022</td>
</tr>
</tbody>
</table>

*ROW: Rest of world.

According to Deloitte’s The heart of resilient leadership: Responding to COVID-19 report, a typical crisis plays out over three time frames: respond, when companies deal with the present situation and manage continuity; recover, when companies learn and employ strategies to emerge stronger; and thrive, when companies prepare for and shape the “next normal.” To respond, recover, and thrive, each CRE organization will have to chart its own path based on the pre–COVID-19 state of its business and decisions and actions made since then. Below are a few themes that may play out over the respond and recover phases and scenarios for the thrive stage (figure 6).

RESPOND
Since the pandemic began, CRE companies have generally focused on addressing short-term liquidity issues, accessing and securing their facilities, maintaining tenant engagement, complying with governmental directives, and managing the virtual close of their financial information. Below are some of the steps taken so far:

1. **Liquidity management.** Given rising liquidity risks and the need to pay out 90 percent of taxable income, most REITs are preserving cash. Some are delaying or suspending dividend payments; others are cutting dividend rates and giving a majority of the dividend as stock instead of cash. Companies have also drawn on their credit facilities and are exploring refinancing options, establishing new or expanded facilities, and debt offerings to maintain liquidity in the short term to midterm. In addition, to preserve liquidity and reduce fixed costs, companies
have suspended bonus programs and furloughed employees.\textsuperscript{23}

2. **Operations and tenant support.**

   a. *Adapting properties into quarantine centers*. Some owners and prop-techs have offered to use their real estate assets to support the current crisis. In New York City, the Four Seasons has offered its midtown Manhattan property to accommodate doctors and nurses on duty at nearby hospitals.\textsuperscript{24} Airbnb is reaching out to its hosts, around the world, to provide accommodations to health care staff at their properties.\textsuperscript{25} In Madrid, 40 hotels have been converted into quarantine centers, adding 9,000 beds to meet demand.\textsuperscript{26}

   b. *Optimizing operational costs*. Many owners, especially in hospitality and retail, have temporarily closed properties to reduce the spread of the virus and save on operational expenses.\textsuperscript{27} Many apartment landlords and property managers have temporarily closed shared amenities and canceled nonessential property maintenance activities.\textsuperscript{28}

   c. *Executing a virtual financial close*. Along with property operations, companies have looked at accounting and reporting processes and are developing appropriate internal control and monitoring mechanisms. To learn more, read “COVID-19: Virtual close preparedness.”

   d. *Adjusting rents*. Many tenants are experiencing a sharp decline in cash inflows, especially in the retail and hotel subsectors. Tenants and landlords are proactively negotiating rental payments. Many retail tenants have served *force majeure* notices to their landlords, indicating their inability to pay rent due to unforeseen
circumstances and government-imposed closures. A variety of arrangements are being considered based on the comfort level of each entity. For instance, some landlords have provided temporary relief in parking costs, while others are offering rent abatements. Some tenants are extending their leases in exchange for rent reduction. Landlords and tenants could work together to seek government assistance that would benefit both parties. However, as tenants’ business remains impacted over a period of time, landlords could see more rent relief requests and a potential decline in rental revenue.

3. **Use of technology.** Some owners, managers, and brokers are using technology to enhance tenant engagement and experience. Mall owners in Asia-Pacific are using virtual reality (VR) to engage shoppers from their homes. For instance, the Mixc mall in Shanghai is using VR to enable shoppers to take 360-degree tours inside the mall, where they can then browse and choose products to be purchased. The mall generated nearly US$71,000 in sales through its VR channel over Valentine’s Day weekend. In the senior housing sector, landlords are providing tenants with free digital resources. Some proptechs have set up digital competitions and live meditation classes to help owners and managers engage with tenants virtually.

4. **Remote work.** Some CRE companies are also adapting to today’s remote work requirements. Proptechs are providing employees technology equipment, such as monitors and headphones, and offering them child care vouchers while schools are closed. A few brokers are increasing the use of digital communication channels, organizing virtual property tours for potential buyers and tenants.

**RECOVER**

As Deloitte’s Resilient leadership framework mentions, companies can start recovering by learning from the current pandemic and taking targeted measures to emerge stronger in the medium-term. To get their companies ready, the CRE C-suite can focus on the following:

1. **Prepare for reentry to physical spaces.** Having an effective and structured plan to transition back into different physical spaces such as offices, retail spaces, and hotels could be a differentiator as companies recover and return after the pandemic-related restrictions are removed. Leaders can explore different approaches to reopen properties and make decisions about remote versus on-site jobs. They should factor in tools and technologies that enable effective remote working and measure productivity; some companies, for example, are now using more cloud-based tools for remote working and collaboration. On an immediate basis, CRE companies may have to adjust their physical spaces to comply with the latest guidelines and tenant preferences around hygiene and sanitization, and health and safety. The return to physical spaces will likely be guided by different reasons: mandates, patron needs, and/or employee needs. Therefore, leaders should use data, collaborate closely with tenants to gain a better understanding of end-user behaviors, and build out and analyze multiple scenarios to ensure a successful reopening.

2. **Promote employee well-being and remote working.** Many CRE companies are neither used to nor equipped for working remotely. With the pandemic forcing organizations to rethink how and where work gets done, CRE leaders could have to reevaluate their existing talent strategy. Companies will likely have to invest in technology and tools that enable virtual working and collaboration, track
well-being, and create an environment that promotes the mental and emotional well-being of employees. Unlike the past, a virtual work environment will likely become the default. CRE companies may have to adapt the workforce and culture to recover fully and thrive in the future.

3. **Accelerate technology usage to make more informed decisions, drive efficiency, and improve tenant experience.** The pandemic has created a greater sense of urgency for CRE companies to increase technology usage to drive both top- and bottom-line growth. Additionally, digitizing processes could also help companies plan business continuity. Warehouses and fulfillment centers, for example, are catering to increasing online sales by using faster and significantly higher levels of automation. With an eye toward future crises that may emerge, leaders can review existing processes and develop a digital road map to automate processes that would yield cost and time efficiencies and maintain business continuity. Increasing the use of technology can also help CRE organizations enhance tenant engagement and experience. In general, companies are likely to benefit from using apps and other tools to communicate with tenants and other stakeholders. Using a wider variety of traditional and alternative data and analytical tools and techniques could enable companies to make more informed decisions.

4. **Increase focus on cybersecurity and data privacy.** With the increased use of technology, more cybersecurity and data privacy concerns have emerged. According to a recent Deloitte global survey, more than 60 percent of users are now working remotely and 1,000+ insecure personal devices connect to enterprise networks every day in 30 percent of US, UK, and German companies.\(^9\) Given these statistics, CRE companies should continue to strengthen cybersecurity and privacy measures. Read our [2020 commercial real estate outlook](#) for more detailed actions to consider.

5. **Adapt to longer-term shifts in tenant preferences.** The stay-at-home orders will impact all businesses, some more than the others. Consider this: The global services\(^9\) PMI dropped to 37.0 in March compared to 47.1 in February. The services PMI for the United States fell sharply, more so than the manufacturing PMI.\(^9\) The numbers are likely to nose-dive further in April due to the wider lockdown or stay-at-home orders that are disrupting all services, especially travel, retail, and restaurants. This could have a significant influence on tenant and end users’ mindsets about engaging with different real estate spaces. With offices being shut down for extended periods of time, remote working is likely to be more accepted and may even be an element of the next normal. Even when restrictions are lifted, the return to physical spaces will be gradual. When people return, it won’t be the same as it was before. They will interact and engage with spaces differently; their demands and services from the spaces they work in, or shop at, or stay at will evolve. CRE companies should consider more real-time analyses of changing user preferences and prepare to adapt design and (re)develop space and tenant engagement strategies. They may have to consider designing multiuse and flexible real estate spaces or even look at new leasing models.

6. **Reassess asset portfolio for longer-term risk mitigation.** Companies can revisit their asset portfolio and expand risk factors to include pandemic-like scenarios and tenant concentration in a single industry. Leaders could conduct a strategic review of core competencies, such as running a REIT or property specialization, and then decide if they should diversify into properties that are
complementary to their existing portfolio. This may result in shedding noncore assets or unlocking value through spinoffs or purchasing similar or complementary properties. Additionally, demand for multiuse properties is likely to continue to grow and would require companies to learn how to develop and manage diverse properties.

7. **Manage capital and liquidity.** CRE companies will remain focused on balance sheet and cash flows. Leaders will need to make choices between capital expenditures on existing properties, especially those related to health and safety, investments in technology, and potential M&A opportunities. Many companies may need to explore creative funding options.

8. **Develop business continuity and disaster recovery plans.** According to a March 2020 survey, only 37 percent of US companies were equipped with the required technology to have employees working from home. As many CRE companies react and respond to the pandemic, it has become clear how important it is to develop robust business continuity, crisis management, and disaster recovery plans right now. CRE companies should consider their own and tenants’ operations as they develop these plans.

THRIVE

Each CRE company is likely to prepare for the next normal, or to thrive, in a different way and over varied time periods, depending on their unique circumstances. Deloitte’s futurists collaborated with Salesforce to develop four potential future scenarios to help leaders envision and prepare for the next normal, which are outlined in Deloitte’s *The world remade by COVID-19: Planning scenarios for resilient leaders*. When reviewing these scenarios, CRE company leaders should consider the following questions as they plan ahead:

1. Which of your previous expectations need to be rethought? Which prospects that seemed unlikely or far-fetched could be accelerated?

2. What will tenants and end users likely value most? How might that vary by property type, region, and demographics?

3. What will be the biggest threats to your current business in the postcrisis environment?

4. Which new services, companies, business models, and ecosystems might emerge?

5. Which capabilities, relationships, and assets will become most important postcrisis?
Endnotes

3. Ibid.
9. Ibid.
23. Ibid.


31. Ibid.


33. Ibid.


36. Ibid.


39. The services sector is defined as most nonconstruction and nonmanufacturing economic activities including finance, telecoms, transportation and distribution, retailing and wholesaling, professional and business services, utilities, health care, and education.


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