Re-purposing real estate: adding value to your property

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Deep changes in the global real estate market

Panta rhei – „Everything flows“. When the Greek philosopher Heraclitus created this famous phrase around 500 B.C., it was certainly not the world of real estate that he had in mind. Nowadays, however, his quote aptly describes the developments that affect this critical investment class, which is likely the most important globally.

In the pre-COVID era, real estate investments had almost across the board generated steady cash flow and returns significantly above traditional sources of yield – such as corporate debt – with only slightly more risk.[1]

The outbreak of the pandemic has impacted the investment profile of real estate remarkably, and has in part stimulated, and in part accelerated, developments in the real estate market that only few had anticipated would happen so quickly in the period of a single year.

Accelerating Trends & Paradigm Shifts

Hotels, brick-and-mortar – retail and offices in decline

Hotels – Particularly urban hotels, once highly sought-after investments - are ailing around the globe, as business travellers and tourists have become a rare species. Now, after more than one year in crisis mode, the sobering revelation for many is that this is a situation that could last for several years, and that the guest levels of 2019 might not be back for a long time to where they had been before the crisis. Some also expect that because of the negative impact of air travel on climate-change, pre-pandemic guest levels will not return.

Brick-and-mortar retail – Once not large and expensive enough to satisfy the demand of institutional investors, brick-and-mortar retail has now turned into a questionable, if not problematic asset class for many types of investors. Since the 1950s, when the Austrian born architect Victor Gruen pioneered the concept of enclosed malls in the United

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1 McKinsey, Commercial Real Estate Must Do More Than Merely Adapt to Coronavirus, April 2020

States, shopping malls had been a huge success story that continued well into the early 2000s, when the demise of the mall began – not of all of them, but certainly of the poorly developed ones in over-retailed areas.

Ever since, the phenomenon of the “dead mall” became the investor’s nightmare. The emergence of new retail formats such as online retail most importantly, and other changes in consumer behaviour have worked as accelerators on this development. In 2020, the COVID crisis has turbo charged the problem. Lockdowns, shop closures, distancing rules, bans on entertainment activities, and concern of infection are not generating a climate that stimulates shopping sprees in crowded places.

Offices – particularly the larger ones - are standing on very shaky ground now. When looking at Manhattan for example, traditionally one of the world’s flagship office markets, the picture is one of leading employers that are scaling down their office capacities quite substantially since the outbreak of COVID.

“A year after the coronavirus sparked an extraordinary exodus of workers from office buildings, what had seemed like a short-term inconvenience is now, as it seems, becoming a permanent and tectonic shift in how and where people work.”

Employers and employees have both embraced the advantages of remote work, including lower office costs and greater flexibility for employees, especially those with families.[2] The situation is comparable to NY in other large cities. “Hybrid work” and “Hybrid offices” are the magic words now. This leads to an increased demand to downscale office facilities on the one hand, and for a new office design on the other hand, as open space concepts, shared workplaces, and co-working models are not pandemic safe.

Industrial, logistics & warehousing, and urban residential are prospering

With respect to **logistics and warehousing**, this shows a remarkable shift of preferences. Formerly, most developers and investors would always have given retail a preference over a logistics development. This is because with an ever-increasing base of consumers, the productivity per sq.m of a retail project would always have been in excess of a logistics project. However, in today`s world, for logistics projects, demand drivers have changed materially – *they are now driven by changing consumption patterns*. Especially for so-called last mile logistics, supply is mostly considerably lower than demand. The reason for this is also that in urban locations, logistics projects are competing with high-value uses such as residential.

Residential real estate has proven to be one of the hottest markets over the last few years – interestingly even more so since the pandemic. The reasons are manifold. On the one hand, cities have grown, and there is always the need for more housing. On the other hand, people are moving elsewhere not the least because of the effects of COVID – they are either looking for an apartment with an extra room for their home office, or for a place that offers more amenities in the instance of the next lockdown, or for more green space nearby. Finally, people look for a safe haven to invest in crisis situations, and to hold real estate is associated with crisis safe investment.

To summarise, what can currently be seen is a paradigm change, or, to be more precise, a change of a number of paradigms – regarding what

2 Remote Work is Here to Stay – Manhattan May Never be the Same, New York Times, March 29, 2021

developers and investors want to develop and/or own.

Repurposing to maximise yields

Powerful market shifts make repurposing a smart option

It is increasingly difficult to fulfil such demand through new developments. The availability of land and space for development and construction in good locations poses an increasing problem. Furthermore, for the owner of an asset that has become – in view of its current use – problematic, a repurposing / change of use could be the preferred route to maximise the yields from the property and/or to prepare the ground for a lucrative sale of the property.

"Therefore, a wider trend is noticeable: the repurposing of property from uses that are at present seen as increasingly obsolete – and hence less profitable – towards real estate that meets current demands."

This wider trend is backed by surveys such as the recent one by the Urban Land Institute (ULI) together with PwC[3], that found that almost 50% of respondents increased the quantity of real estate they repurposed in the last 12 months, whereas 2/3 of survey respondents expected such repurposing to rise over the next five years.

Office real estate as serviced apartments

What the survey revealed, among other things, is that office real estate is more often subject to a change of use than retail. This is not surprising, as usually retail space is more geared to its specific use than office space (usually location on ground floors, direct entrance from streets, location in shopping malls or other specific retail facilities etc), which limits conversion to other uses.

It is said that the end game prevalent in European cities is often some form of residential or mixed-use strategy. According to investors quoted in the study, **the biggest opportunity would lie in the conversion of office buildings into serviced apartments or other type of residential properties with characteristics and offerings similar to hotels**. Such strategies sound quite plausible and are supported both by a currently attractive price level for urban housing as well as by the demand driving such prices.

Hotels may be repurposed as residential space

As regards hotels, the industry is by large holding out and hoping for some sort of recovery to happen within the nearer future as a consequence of global vaccination efforts, and travel restrictions being gradually lifted. Many believe that after a long period of restricted travel, the pendulum will swing back, and people will want to travel again. Also meetings, conferences, and other events that are traditional drivers of the hospitality industry will be kicking in again.

Other expectations are more cautious or even pessimistic in this respect, with some being of the view that the pre-COVID levels will not be reached again for a long time, if ever so. Irrespective of the position taken, not all hotels will be able to hold out and survive the current industry crisis. Therefore, it will be advisable to consider alternatives.

A possible conversion of urban hotels into residential space is – at least as regards the practical requirements of construction – in many cases easier than in the instance of hotels, as hotel rooms are already equipped

3 "Emerging Trends in Real Estate – Climate of Change", Europe 2020, by PWC and ULI

with the utilities required for residential living, and in particular a conversion into servicedin the instance of hotels, as hotel rooms are already equipped with the utilities required for residential living, and in particular a conversion into serviced housing could seem logical in many cases. Also the presence of a restaurant or a café in a building can be an interesting feature for a possible conversion into serviced housing.

Retail conversion brings its own challenges

The conversion of retail space is without doubt a more complex undertaking. A shopping mall as such and as a whole does usually not allow for the repurposing for an entirely different use, which is why – once again looking at the situation in the USA – problematic malls usually end up being entirely vacant.

Usually, a shopping mall only allows for less dramatic adjustments such as the re-adjustment and optimisation of space, the addition of leisure and gastronomy features – but also the conversion of otherwise empty units into office space or medical facilities might be viable options, with the USA as the cradle of the concept of the mall and usually at the forefront of developments in retail offering interesting examples.[4]

> “For vacant urban and high street retail space, there are usually more feasible options and interesting alternatives available.”

As the research carried out by PWC and ULI in 2020 showed, the most common assets to repurpose are Office (72%) and Retail (64%), with leisure (25%) and logistics (24%) in the end of the line. These most common assets were repurposed mostly to Residential (68%), Mixed Use (54%), and Office (36%), with Logistics (19%) and Retail (11%) as the least frequently chosen routes.

Repurposing requires expertise

In summary, and as a bottom line, to find an alternative use for existing real estate can be an interesting alternative to holding out and waiting for times that may (or may not) be better again, and a better alternative than watching property values decline. **To successfully do so is without any doubt a challenging exercise that requires both creativity as well as cross-disciplinary expertise (in terms of market knowledge, architectural and technical know-how, and sound legal expertise)**. Obviously, there are no off the shelve-solutions, and each individual case and situation requires a case-by-case assessment whether the necessary investment of time and resources will pay at the end of the day.

Last but not least, the increasingly scarce resource of land for development and construction is yet another factor that speaks for smart new solutions for existing real estate.

Active support of local and municipal authorities is a must

A final, but important point to be made when looking at the tight and at times confusing network of administrative rules and regulations applicable for construction and development in basically all European countries is that at present, without the active support of local and municipal authorities, it is hard to impossible to realise new concepts.

In order to allow for an efficient realisation of repurposing projects – and thus to avoid vacancies as far as possible – it would be appreciated to increase

4 See e.g. the 2019 paper of NAIOP Research Foundation “Repurposing Retail Centers: Profiles in Adaptation, Repositioning and Redevelopment”

the flexibility of zoning and re-zoning regulations, to find ways to accelerate permit processes, and to also allow for only temporary alternative uses of real estate.

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