The ‘hotelization’ of real estate

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What’s the Deal By Daniel Lesser

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(The views and opinions expressed in this blog are strictly those of the author.)

Full-service hotels are an example of multi-use real estate. They primarily offer guestroom accommodations, restaurants and lounges, meeting and event spaces, recreational facilities and retail shops primarily in urban locations. To complement these amenities, services such as concierge, front desk and housekeeping are commonly offered. Hence, the finite physical space in a hotel is utilized to provide multiple products and services to enhance the guest experience and improve the return on investment per square foot of real estate.

In recent years, office and residential spaces seemingly have drawn inspiration from the lodging sector. Traditional business models merely providing floor space in return for a stable and predictable rental income stream via long-term leases are making way for flexible spaces with hotel-like services and amenities to attract, retain and maximize the number of tenants.

Several drivers have fueled the trend of the “hotelization” of real estate:

- Seeking experiences, mobility and flexibility, millennials and Generation Zs who comprise much of the workforce today are willing to sacrifice square footage for convenience, more amenities and value-added services. Many of them do not wish to lay anchor in one location and are looking for places to stay and work that support their nomadic lifestyle.
- The advancement and use of technology are diminishing the need for large, permanent office buildings and increasing the demand for flexible workspaces.
- There is a rising preference for shorter or more flexible lease terms in response to business uncertainty and ever-changing market conditions. This is more apparent in the case of startups that often prefer to avoid a long-term lease or to invest in furnishing the workplace due to an irregular headcount and unpredictable funding cycles.

Consequently, there is a marked increase in the demand for office spaces, with on-site amenities and services coupled with short lease tenures.

For landlords the uncertainty in not securing steady, long-term rental income due to short-term leases can be offset by increasing the number of tenants in a multi-tenant facility. Based on the risk appetite of office landlords, several approaches are being taken to adapt to this trend:

- **Low risk:** Risk-averse landlords are partnering with flexible workspace providers like WeWork and Convene, who enter long-term leases with them (7-10 or more years), and sub-lease the space for shorter periods to smaller companies or tenants. The flexible workspace providers convert the empty box space into a ready-to-use facility along with various desirable on-site amenities and services like in hotels – fitness facility, lounges, conference and meeting rooms, networking spaces, concierge and housekeeping, among others. This scenario can be a win-win for all parties, as a landlord is guaranteed stable rental income while smaller companies enjoy shorter lease duration and overall flexibility. This business model also allows the workspace provider to attract more tenants with diversity throughout various industries. While there is little apparent operating risk for the landlord under this model, the business forecast of the flexible workspace provider needs to be thoroughly evaluated.
- **Medium risk:** Several landlords are taking an equity position in the business of flexible workspace providers and staking a claim in the upside potential. Others are engaging the flexible space operator in a management contract, similar to what is utilized by the lodging sector. Under this premise, the landlord is responsible for supplying and furnishing the space, while the flexible workspace brand manages the operation for a fee or revenue share.
- **High risk:** Landlords with a higher risk appetite, are adopting the “hotelization” model themselves, providing not just the space, but flexibility in terms of lease durations and add-on benefits and services, like housekeeping, concierge, events, Wi-Fi, etc., in return for premium rents, higher occupancy or both.

According to various industry estimates, flexible workspace will constitute 30% of the overall stock in the U.S. office market by 2030 from the less than 5% today.

For residential spaces, with many millennials delaying buying a home, there is a newfound vigor in apartment leasing. Adapting to the changing marketplace and tenant preferences, residential landlords are partnering up with co-living brands, such as Common, WeLive and Open Door, to name a few. Under this model, fully furnished apartments with shared supplies, services and utilities are provided to tenants who share an apartment or unit. There are common areas, very similar to a hotel, such as a lobby with seating, workstations, television etc.

A co-living suite may sell at a 20% to 30% discount on a regular apartment, positioning the rent more affordably for tenants. Additionally, co-living allows for greater socialization, a sense of community and belonging, yearned for by the millennials and Gen Z. On the other

hand, the building should generate higher net operating income per square foot for landlords, as more tenants occupy the available space.

Some landlords are leasing fully furnished apartments complete with amenities (like cleaning supplies, linen, toiletries, etc.) to companies for a two- to 10-year period, offering a reception area, concierge and housekeeping services. Companies use these apartments for their employees travelling to the city instead of booking hotel rooms.

Thus, the urban office and residential landscapes are changing in the backdrop of the popularity of the sharing economy. Notwithstanding this, simply jumping on the bandwagon may not be a good idea.

“Hotelization” of real estate increases costs, and while one hopes that this investment will result in lowering vacancy, incurring this added expenditure in a poor location may fail to produce the desired outcome.

Some locations are better off entering low-risk, long-term leases, while others in high-demand areas may benefit more from offering flexible spaces with added services and amenities for shorter periods in return for higher rentals or higher occupancy (though there is a risk in terms of volatile income streams). Another option is to adopt a hybrid model – i.e., distribute the real estate between a traditional, long-term lease and flexible space depending on the market conditions. Moreover, developments that allow an office building to remain active beyond the typical office hours by way of food and beverage outlets and retail stores that share the premises are adding optionality to the complex landscape of mixed-use real estate in today’s market.

Branded residential condominiums as part of luxury hotel developments have been prevalent for more than two decades. Residential-only projects are becoming central to the business strategy of luxury hotel brands, and opportunity exists for upper-upscale and upscale hotel brands to penetrate the space as well. The developing trend of “hotelization” of real estate is an opening for lodging companies to further leverage their brand(s) and property management expertise toward all types of commercial and residential assets.

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