INSIGHTS FROM THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

DOES LOCATION MATTER ANYMORE?

By Kristi Gibson, Brian Bader and Ian Shapiro

"Location, location, location" has long been the mantra of the real estate and, by extension, construction industries, but the global pandemic is upending how this philosophy has traditionally been interpreted. The effects of remote work, online shopping and the continued decline in business travel, among other phenomena caused by the pandemic, are forcing owners and investors to ask, *"Does location even matter anymore?"*

Key sectors may point to an answer. We take a look at the state of offices, industrial, multifamily, retail and hospitality real estate at this critical time and what it may indicate about real estate and construction's future.

OFFICES

Technology has made it easier for companies to allow their employees to work remotely, **upending** the traditional work model where employees commute to and from their jobs in cities and patronize city businesses. The knock-on effect of this "**great migration**" is that businesses and industries — office, retail and hospitality, for example — in the suburbs and secondary markets are seeing the benefits that primary markets have historically seen.

Though many employers had planned a return to office for early 2022, the late 2021 emergence of COVID-19's Omicron variant caused many to put these plans on hold. Optimistic companies are hoping to have employees back in the office, with many on a hybrid basis, before Q1 comes to a close.

When it comes to the office, location does matter. Though many employees moved farther away from the office in the last two years, others either stayed put or moved within a commutable distance from the office, anticipating that one day they'd be expected to return. The concept of the **hub-and-spoke model**, whereby companies retain a headquarters in a city but open satellite offices, or "spokes," located more closely to where employees live, is still very much in progress, though its adoption has been slower than initially predicted. Data and analytics will be key to identifying optimal locations.

The office space itself also matters: To accommodate social distancing, employers are increasingly focused on expanding existing office space and relocating operations to a location with higher square footage. Expansions by square footage in Manhattan, Boston and other primary markets jumped 24% last year, compared to 17% in the final three quarters of 2020, according to research from CBRE. More square footage reflects employers' confidence that the office will continue to be the hub of a company's activity and culture.

In major cities, a return to the office, even if employees are only expected to be there part of the week, could further improve the performance of multifamily housing, such as apartment buildings. At the height of the pandemic, landlords offered significantly reduced rents to attract tenants. As the market has recovered and the promise of a return to some sense of normalcy solidifies, renters who benefited from COVID-19 deals are being priced out by rising rents and a new cohort of renters moving in. According to research by St. Louis Fed economist Miguel Faria e Castro, COVID-19 pushed 3 million Americans to retire early, and members of the Gen Z and Millennial generations are pouring into cities like Manhattan to fill their spots.

INDUSTRIAL REAL ESTATE AND CONSTRUCTION

For industrial real estate owners and investors, location arguably matters even more now than it did before. The e-commerce boom has accelerated construction and development of warehouses — especially cold storage facilities or delivery centers within cities or just outside of them, a trend that began before the pandemic but that gained traction as online shopping increased.

Supply chain disruption also prompted many manufacturers to reevaluate where products were being produced and distributed, and many moved manufacturing sites from offshore locations to production sites in North America. And in a sign of the accelerated shift from brick-and-mortar retail to ecommerce, former brick-and-mortar retail locations were repurposed to accommodate manufacturing and distribution as well.

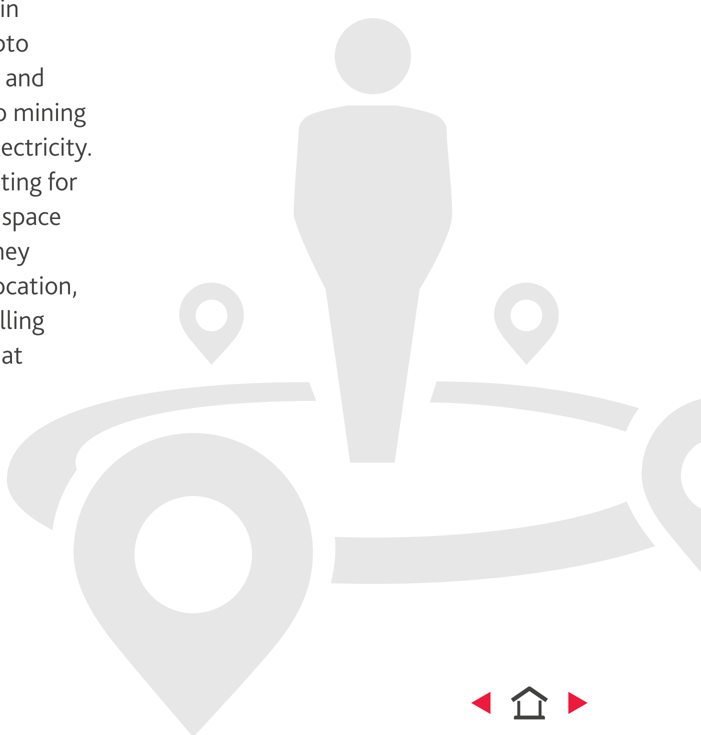
On the construction side, in “zoom towns” like Dallas, new construction has spanned real estate sectors. Industrial and residential projects have seen a boom in construction activity, but offices also have undergone extensive renovations in preparation for employees’ return.

Elsewhere in Texas, the **explosion of the cryptocurrency market** is ushering in “boom towns” and a new kind of competition for commercial real estate. Crypto mining — the process by which people (miners) verify blockchain transactions and generate new units of currency — requires large amounts of energy. For crypto mining to be profitable, miners need to site their activities in areas that have cheap electricity. Texas’ deregulated energy markets fit the bill. Crypto miners are either competing for old or underused manufacturing buildings and warehouses or looking for new space with short-term leases that have both the cooling systems and the wattage they need for their operations. In what may be the ultimate bellwether regarding location, portable data centers are being used throughout the country at oil and gas drilling sites to utilize gas byproducts, which are normally flared, to fuel generators that produce the required energy for crypto mining.

MULTIFAMILY

Spurred by the pandemic, demand for multifamily space in secondary markets strengthened in 2021. Migration out of major cities had been percolating for several years; the pandemic only accelerated that trend.

Owners and investors have been following this trend and many are pursuing this migration and capitalizing on it: Given the imbalance of supply and demand, real estate in secondary markets will continue to increase in value. Location in primary markets will continue to matter but will expand, with secondary markets attracting more investment.



RETAIL

When lockdowns were put in place across the U.S. in 2020, retail pundits posited that the pandemic would result in the extinction of brick-and-mortar retail locations. But industry dynamics are far more complex. Retail had been in the process of adopting e-commerce platforms for a decade prior to the pandemic. COVID-19 merely accelerated this march. The pandemic saw e-commerce's share of global retail trade jump from 14% in 2019 to 16% in 2020, but as stores and businesses began to reopen in 2021, e-commerce's share of total retail sales fell again; as of the third quarter of 2021, it stood at 13%, according to Statista.

Retail's interpretation of "location, location, location" is evolving. Savvy retailers are using digitalization initiatives to bolster brick-and-mortar establishments. Large retailers have outfitted locations with touchless devices and designated curbside pickup areas, where customers can grab items they ordered online. Some clothing retailers have started to offer customers virtual consultations with stylists.

Meanwhile, owners of major shopping malls have added healthcare and educational facilities to their shopping centers, and may turn vacant retail space into COVID testing sites, reinforcing the importance of physical location in the retail sector as well as their faith in the future of certain tenants.

The retail sector is recovering relatively well from the pandemic's major disruptions. Cautious optimism remains prevalent. Existing retail space has become more efficient, with rising sales per square foot due to limited new construction. Digital native companies are actively seeking out flagship space to support branding and customer experience. Even in hard-hit Manhattan, key market metrics, such as foot traffic, sales, and tourism, remain below pre-pandemic levels but continue on an upward trajectory,

After a year of emergency measures like air shipping and ship chartering (for those retailers that could afford it), 2022 could be a year for evaluating, rethinking and investing in supply chains in the long term, which will be critical to mitigate risk. Building agility into the supply chain will be a priority.

HOSPITALITY

Hospitality was one of the industries hit hardest by the COVID-19 pandemic. Restaurants have had to contend with lockdowns and new social distancing protocols in some parts of the country that affected where and how many customers could be seated indoors. Supply chain disruption led to scarcity of ingredients and supplies, causing many restaurants to alter their menus.

Hotels were hurt by these same restrictions as well as a dip in business travel. Even as vaccination rates rise, the Omicron variant and any subsequent variants threaten to bring these struggles once again to the forefront. Of all the hurdles the hospitality industry has faced, its labor crisis might be its largest. Hospitality workers do not have the option to work from home. The threat of illness from COVID-19 and the inconvenience and uncertainty of pandemic safety protocols pushed many hospitality workers out of the industry.

Hospitality is taking steps to operate within the confines of a labor shortage and prevent the situation from worsening. For example, many hotels have suspended daily cleaning services, only providing cleaning when guests explicitly request it and after checkout. Though corporate travel has yet to return to pre-pandemic levels, leisure travel is on the rise, and Class A hotels are faring better than Class B — in some cities, class B hotels may be repurposed for residential or business use.

Similar to its effect on retail, the pandemic has forced hospitality to get creative. Investors are turning their attention away from city center hotels and focusing on resorts, which provide guests with a more insular experience and offer amenities like meditation sessions that lean into post-pandemic wellness trends. As Americans grow accustomed to takeout dining experiences, more restaurants are embracing the concept of a ghost kitchen, which can be a lucrative operation a fraction of the size of a traditional restaurant that requires half the capital investment. For the hospitality industry, location dictates how a space can be used to fill in the gaps created by pandemic disruption.

Business travel is expected to increase in 2022, along with leisure travel. This should bode well for the hospitality sector. Luxury and high-end hotels will continue undertaking major renovation projects to meet guest expectations.

Location, redefined, still matters

The sectors identified here provide snapshots of the real estate and construction industries' uneven pandemic recovery. Given that most sectors' plans for the future entail structural changes (increased wages, greater workplace flexibility, a growing emphasis on in-unit apartment amenities), it seems that post-pandemic, a space's value will not only be more closely linked to its interior but its strategic proximity to neighborhoods emerging and flourishing in secondary markets.

Real estate continues to be a local business with certain markets seeing upward trends in rents and occupancy levels recovering at a faster pace. Part of the recovery is a growing focus by owners, investors and occupiers on ESG, decarbonization and health and wellbeing.

Location is still everything. While COVID-19 and societal responses to the virus rippled through all sectors of real estate, affecting workforce trends, renter priorities, consumer expectations and everything in between, astute observers of population migration, spending patterns, and other trends will fare well in the post-COVID economy.

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