The new business model for commercial real estate: Service provider

Whether it is a boutique hotel or a multibuilding, multiuse major development, the brick-and-mortar aspects of real estate may soon be meaningfully influenced by the value of services provided.

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Real estate is rightly considered a long-term investment, with commitments pegged to decades rather than years. However, the sector is poised for a potentially revolutionary transformation from an economic model based on brick-and-mortar assets and long-term leases to one more akin to a service industry. In this new model, building occupants become subscribers instead of tenants, and commercial real-estate (CRE) companies create value by continually providing new amenities and rapidly anticipating clients' changing tastes and needs.

This transformation has been influenced, in part, by the rapid rate of digital disruption and the rise of shared and on-demand business models. Millennial and Generation Z consumers have decidedly different attitudes, needs, life paths, and expectations than previous generations: notably, ownership is less important, and experiences take a higher priority. Furthermore, a new generation of CRE companies have spotted new economic opportunities and now provide services such as coworking spaces, cohousing with hotel-like amenities, on-demand storage, and pop-up space for retailers. As a result, some real-estate companies may not see a need to adhere to CRE staples such as the triple-net lease, in which a lessee covers all costs, including real-estate taxes, building insurance, and maintenance.

The service-provider business model offers CRE practitioners the flexibility to take advantage of these new opportunities, adjust more quickly to such market shifts, and diversify their revenue streams. And while boutique-style properties appear most prepared to be service providers, the service-based model certainly applies to major projects; it helps differentiate the component properties, provide an affordable point of entry for smaller tenants, and allow for boutique-style experiences within a larger project.

Commercial real estate is evolving

Marty Burger, CEO of Silverstein Properties, the New York City firm that developed the new World Trade Center, has predicted that real estate will evolve much as the software industry did, moving from releasing programs on compact discs to signing up users for cloud-based apps such as Google docs or Evernote.[1] Burger has also said that the leaders of his firm feel as if they are in the hospitality business, treating office and residential tenants as if they were guests and offering not only fitness centers and similar amenities but also events and experiences.

Aside from coworking provider WeWork—the highest-profile example of the service model—the US-based cohousing company Common offers amenities ranging from cookware to movie nights. And Clutter, a service-oriented spin on the storage business, picks up subscribers' surplus possessions and transports them to underutilized industrial storage space on urban outskirts.

Some large developments already are looking to the service model. For example, in Boston's South End, coliving provider Ollie will operate a 14-story tower in National Development's seven-building Ink Block and provide amenities—ranging from juice bars and communal lounges to curated day trips—so that tenants aren't so much renting living space as subscribing to a lifestyle service.

Challenges for financiers and investors

The shift to real estate as a service has a historical precedent in the hospitality industry, which provides a template for how property owners and operators can sell services and experiences. And the new model is rapidly taking hold in some parts of the world. Additionally, blockchain-based investment platforms may foster creativity by making it easier for small investors to participate in innovative real-estate projects that embrace the service-based model.

Service models, however, may prove difficult for existing valuation methods. Long-horizon investors, such as sovereign wealth funds that have been attracted by the prolonged and predictable return on real estate, may find their investment models challenged. For example, it's currently unclear who will ultimately bear the burden of the new risks and opportunities presented by the service model—the building owner, or a tenant. If the tenant does not achieve the desired economic result from their business, what becomes of their obligation to pay rent? Burger has noted that he expects few property owners will go to a shorter-term lease environment until tenant improvement allowances become more aligned with that model.

Ways to capitalize on a service-based approach

New players in real estate as a service are pioneering different revenue boosters. Some rely on arbitrage to increase utilization rates—whether geographic (using discounted space in low-demand locations) or rental arbitrage (leasing space and then subleasing it at a higher price). Others take relatively affordable occupied spaces in desirable areas (such as self-storage facilities in or near city centers) and convert them for a more profitable use. Still others take advantage of space in desirable locations not currently being used, similar to Airbnb.

CRE companies that want to effectively monetize their service offerings should consider taking the following actions:

- Regularly solicit the opinions of building occupiers to discern which services they value most. While brick-and-mortar investments take time and money to reposition, services can be adapted quickly.

- Use services as a point of market differentiation, reinforcing the house brand. Hotel properties have long followed this model, differentiating themselves with premium bedding, restaurants, and even toiletries.

- Monetize club-like amenities for residential rentals as a method of diversifying the revenue stream, or use them to support higher rents.

- Carefully evaluate risks and returns associated with adapting to a time horizon that is shorter than usual for traditional commercial leases. As technologies and consumer habits evolve rapidly, property owners may be rewarded for the ability to evolve with the market, free from the constraints of some long-term tenants that may be slow to adapt their business models.

- Frequently evaluate how technology-based solutions and partnerships with other business providers can enhance or broaden the scope of services. These partnerships can dissipate risk and allow occupants to tailor their environment to their budgets.

As the real-estate-as-a-service model becomes more prevalent, the CRE sector will need to innovate more rapidly than in the past. Just as in other industries, viability and success will depend on making better use of data, understanding customers, and moving quickly to take advantage of changing conditions. Ultimately, that evolution could help make the CRE sector more resilient and more profitable.

[1] Marty Burger says, "Similar to how the software industry moved from shrink-wrapped software to new models such as SaaS (software as a service), your industry will look at real estate as a service;" for the full interview, see Christian Brazil Bautista, "Silverstein Properties CEO expects real estate to evolve like the software industry," *Real Estate Weekly*, October 19, 2017, rew-online.com

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