Developing *asset resilience*

Assessing the trends & strategies shaping the future of real estate

Foreword

At the time of writing, our region remains under some form of lockdown with various measures imposed to ensure the containment of COVID-19. The health and wellbeing of our staff, partners and clients remains our priority. Looking beyond the immediate impact, and to support in planning ahead, we have compiled this research report looking at the various short-to-mid and long-term strategies and trends that are likely to shape our industry.

Real estate technologies

If there is one change COVID-19 has rapidly ushered in, it is the deployment of technologies in aid of remote working and collaboration to ensure business continuity. While the region is yet to return to some level of normalization in business activity, there is no doubt that various technologies, if adopted, can ensure the sustainability & longevity of assets and operations.

Life cycle asset management

"Out of sight out of mind" has characterized the traditional approach of many commercial landlords to the issue of deferred maintenance costs. There is however an increased realization that this approach has resulted in a serious lack of long-term capital planning that will increase future maintenance costs, reducing the value and performance of assets over the longer term. While some responsible investors are responding to this problem by adopting new approaches to life cycle asset management (LCAM), these tools and techniques are not yet as widely utilized in the region, as in more mature overseas markets.

Active (re)entry strategies

The property and facilities management industry in the Middle East (as in many other parts of the world), is currently focused on short term responsive strategies concerned with the mothballing (partial or complete closure of premises), due to restrictions imposed to limit the spread of COVID-19 As the situation stabilizes, attention will progressively shift towards reactivation & re-entry strategies, while the long-term goal remains unchanged from before the current pandemic, to re-imagine processes and approachesin a manner that will increase asset resilience and performance.

Going green

The short-term market disruption has drawn attention to the need for more robust business continuity planning on the part of occupiers, developers and owners of real estate. Sustainability measures can play a potentially important role in both these short-term plans and the longer-term resilience of assets. In some ways, the current crises may even enhance and exacerbate the longer term move towards more sustainable assets.

Digital evolution
Real estate technologies

"Deploying technologies that create a differentiated customer experience and support investors and landlords in understanding their asset better, will ensure asset resilience and longevity."

Dana Salbak
Head of Research, MENA

Looking beyond cloud computing & shared networks

While corporates might be inclined to adopt some level of remote working as a long-term strategy to mitigate risks and reduce costs, there is no doubt that as individuals we will continue to seek some level of human interaction.

Rather than becoming obsolete however, we expect future office spaces to offer more of a collaborative and social experience, rather than just a place to work. This includes modifying the design and layout of office spaces to address employee needs, in addition to adopting health and wellness standards (such as the WELL Building Standard Certification), and sustainability practices that ensure the wellbeing of employees.

This involves the adoption of various technologies that ensure all of the above. As we look East to our colleagues in China and how they are slowly moving back into offices, we expect landlords and corporate occupiers to implement new health-related technologies such as thermal imaging cameras, automatic digitized elevators, and building control systems.

From a landlord's perspective, being able to understand your building and drawing analyses and conclusions can aid in decision-making, whether pre-empting additional costs or understanding the overall performance and market positioning. Utilizing GIS technology, for example, to offer 3D replicas of the physical asset (Digital Twin) will reveal details of your space and can even benchmark your asset's performance against the surrounding area or wider market.

Similarly, technologies such as sensors can be deployed to understand the day-to-day performance of the asset. When accessible to potential investors, they are better able to assess the health of the property, and track metrics such as footfall, occupancy rates, and efficiency rates.

Advancing innovation in retail

While it might be a while before the true impact of retail-mall closures translates into the overall performance of the market and the liquidity position of retailers, this period nonetheless provides an opportunity to implement various changes to existing stores.

In the first instance, this includes a shift towards omnichannel retailing; complementing physical stores with online platforms. While this is already a trend that has picked up in the region, given the growth in e-commerce, we expect it to go beyond just being a complementary service, but also serve as a contingency plan in extreme cases.

In the short-to-mid-term social media content, whether on Instagram, Facebook, or TikTok, is being consumed rapidly. This is driving retailers to live stream industry discussions or events (such as live cooking classes or workouts for example). Not only do these keep the customers engaged, but retailers (along with the F&B industry), can also promote and sell products. On the back of that, various contactless payment options have risen, ranging from QR codes to tap-and-go technologies.

In the mid-to-long term, and with the gradual relaxation of lockdown measures, we expect malls to adopt precautionary measures with temperature checks and social distancing in place. With some level of consumer hesitation expected, technologies such as virtual and augmented reality can come in place.

Delivering personalized recommendations from a virtual stylist, based on client data, might be the future of retail. Along those lines, stores might need to use technologies to reconceptualize their designs, in order to provide an engaging customer experience.

Living

With mobility relatively restricted and impacting the physical ability of landlords and agents to conduct viewings, going virtual and offering video-based home tours and location intelligence on surrounding areas would increase potential tenant and investor engagement. We can also expect this phase to usher in more momentum in tenant applications. Developing apps that connect tenants with their landlords to be able to convey messages quickly and seamlessly, whether in selected buildings or a wider portfolio.

With supply chain disruptions limiting access to raw materials, one way the living (or residential) sector can overcome delays in construction is through technology such as 3D printing homes or modular construction. Pre-fabrication has key benefits like being time and cost-effective and utilises eco-friendly materials which can preserve the longevity of assets.

Creating a differentiated experience involving digital tools and technologies will ensure you stay ahead of the curve in a post-COVID world. While uncertainty prevails around cash flows, planning ahead to ensure the resilience and longevity of your assets and operations is key for long-term survival.

Both eyes open
Life cycle asset management

“A failure to undertake adequate routine and preventative maintenance will result in long term costs that far outweigh any short-term savings.”

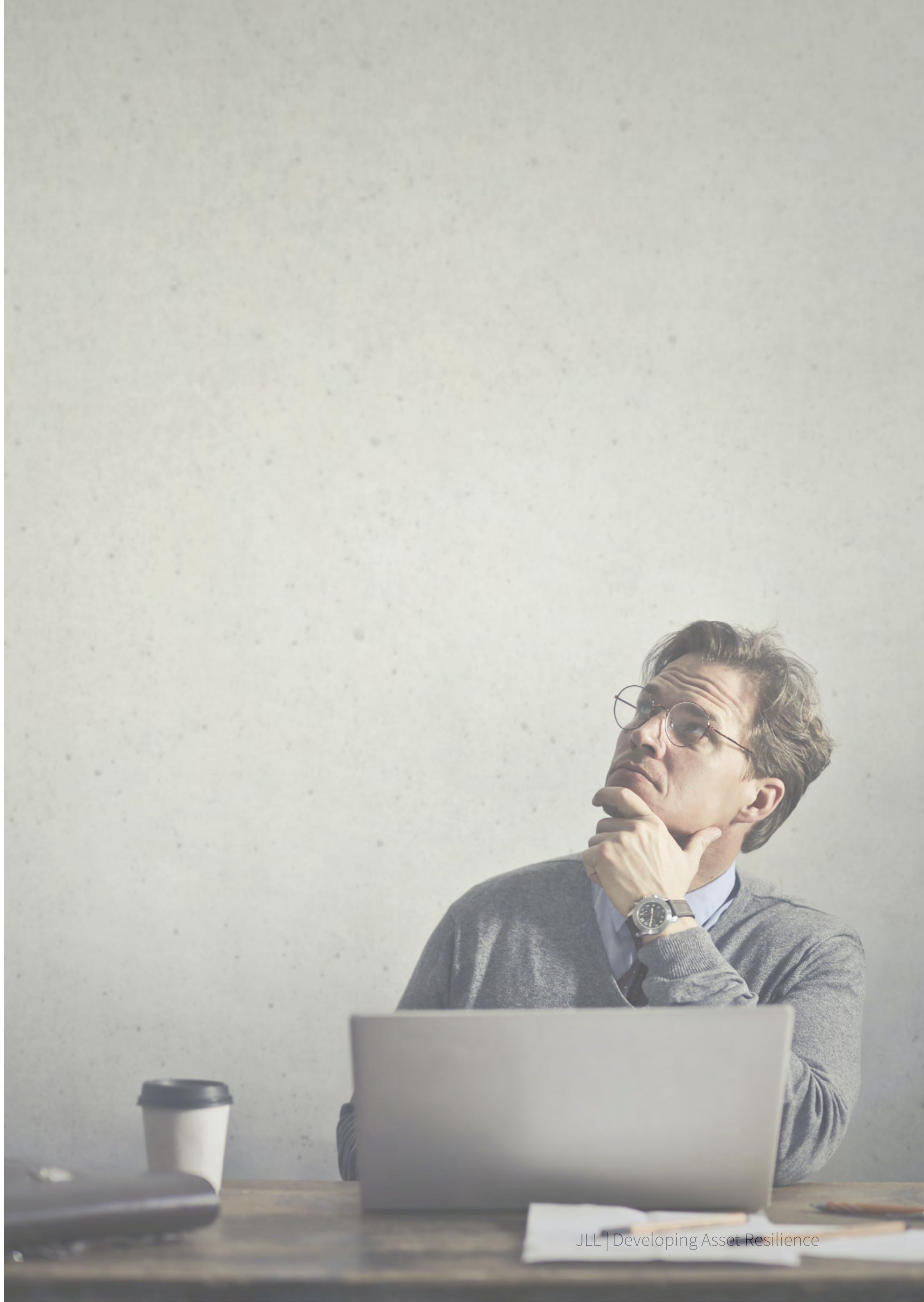
Evrim Ay
Regional Engineering
Corporate Solutions, MENA

Deferred maintenance can be defined as the practice of postponing maintenance costs from current budget cycles. Based on data covering more than 40,000,000 sq ft of commercial and residential assets across the UAE, we estimate the currently unfunded or hidden cost of deferred future maintenance could be as high as USD 50 per sq ft. While the data varies across and between portfolios, some owners are currently allocating just 10% of the likely actual capital renewal and replacement plan, resulting in a large and increasing unfunded financial shortfall. Three sets of disconnects have contributed to this problem.

The first of these is a financial disconnect between how current (OpEx) and future (CapEx) funding levels have been treated, resulting in a large liability gap on the books of many owners. This approach has been exacerbated by a second “structural disconnect.”

Many organizations operate in a siloed manner with a communication disconnect between those departments responsible for long term asset management (such as facility management teams) and their Corporate Real Estate (CRE), IT, finance and Procurement teams, that typically operate with a short-term focus. The problems have been compounded by a third disconnect, relating to data and intelligence. Most organizations have limited visibility of their physical assets and the corresponding level of maintenance required to ensure the efficient operation of these assets over time. Larger owners typically have an incomplete asset database with a limited history of asset purchases & historic maintenance. This disconnect is even greater within smaller and less professionally managed owners of real estate.

Given the ageing of the real estate stock in the region and the understandable current focus on short term priorities (due to the major disruptions resulting from various containment), the scale of the current funding shortfall is likely to increase unless a new approach is adopted.



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Why something, now more than ever, needs to be done?

When the “engine warning” light on your car dashboard alights, it is clear that some action is required to avoid subsequent and potentially catastrophic damage to both your engine and your wallet. The same logic applies to the various systems within buildings, a lack of spending on maintenance today, is likely to result in catastrophic and expensive results at some point in the future.

Fortunately, there is a growing body of evidence that allows building owners to quantify the risk they are taking by not undertaking a regular program of maintenance.
The research suggests the best case could be USD 4 of future capital spending for every USD 1 of money deferred today.

The worst case is clearly far worse, with the failure of relatively small and inexpensive components resulting in a catastrophic failure, that could easily cost USD 30 for every USD 1 of savings. The academic literature provides a useful rule of thumb suggesting the cost of keeping a component in service until it fails is likely to result in future costs equal to the square of the cost of the part itself.

While quantifying the impact may vary between buildings and across portfolio’s, the central point is clear. A failure to undertake adequate routine and preventative maintenance will result in long term costs that far outweigh any short-term savings.

The way forward

The asset management industry needs to refocus its attention and approach to the problem of deferred maintenance with “both eyes open.” This requires a broaden of the lens away from its current focus on short term cash and inventory management, to include a more rounded view recognizing the importance of longer-term strategies to protect and enhance the value of assets (while continuing to recognize the importance of short-term cash management).

LCAM should be regarded as a critical component of this new approach. This involves taking a more integrated approach that optimizes the life cycle of physical assets from design to disposal. While the details of the resulting LCAM plan will be different for every building owner, the starting point will usually be the same, comprising of an asset condition survey to compile more accurate data on the cost, condition, and operation of each of the physical assets within a building.

Future stages will typically involve an assessment of the remaining economic life of critical components of the asset, and an assessment of the probability and costs of failures at the component, system and building level.
Helpful tools in this regard will include those that calculate the total cost of risk (TCOR) factoring in both the direct and indirect costs of any component failure. This allows owners to prepare more accurate maintenance procedures and schedules and prioritize alternative future capital funding scenarios.

One output of the LCAM approach is a Facilities Conditions Index (FCI) for each separate asset in any portfolio. The FCI is calculated by dividing the cost of deferred maintenance (Dm) by the asset replacement value (ARV) with this figure being expressed as a percentage score. The higher the FCI, the poorer the condition of the asset. The FCI provides an easily understood quantifiable score, that allows owners to assess the performance of their assets against local or regional benchmarks.

A LCAM study will also arm the property owner with the funding required to set aside on an annual basis for asset replacement. In Dubai, the Real Estate Regulatory Authority (RERA) has recognized the importance of reserve funding, making the provision of a capital reserve fund, a prerequisite for the approval of service charge budgets.

While the requirement for effective life cycle asset management strategies falls most directly on building owners, potential investors also have a strong vested interest in the long-term performance of assets they are developing or seeking to purchase. In short, responsible developers, investors, owners and tenants will all benefit from the more widespread use of LCAM planning. For once it appears that a “win-win scenario” is possible.

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Mothballing & beyond
Active (re)entry strategies

“The ultimate aim is to preserve your asset in the short-term, and adopt mid-to-long term reactivation strategies with minimal capital exposure and lowest possible risk.”

Colin Dowall
Head of Property and Asset Management, MENA

Short-term: respond

The degree of short-term disruption varies between cities, depending on the social distancing and isolation measures set. Despite that, the natural focus has been one of responding to short term liquidity & regulatory issues. What does this look like from a property and facility management perspective?

For some owners, it means the conversion of existing facilities into temporary healthcare uses, but for most it primarily revolves around measures to “lock down” facilities with implications for security & access, cleaning and building systems. Key questions that arise on the back of that include, how can operating costs be reduced while at the same time maintaining statutory and legal obligations in areas such as health and safety? How can we ensure the building is well maintained and is ready for reoccupation as the situation improves?

Many owners have taken advantage of the current mothballing to undertake deep cleaning in association with municipal decontamination and sterilization programs. While not always practical, we have also seen some owners bring forward those planned maintenance and repair programs that can be undertaken while the premises are unoccupied.

Communications with suppliers (service providers) and tenants is an essential part of the short-term response. Proactive owners are seeking to renegotiate contacts with service providers and to pass on energy and other savings to tenants through reduced service charges. We have also seen landlords taking the initiative by offering rent relief to tenants of closed assets (particularly in the retail sector). The extent to which landlords are willing to assist tenants in a period where their cash flows and liquidity may be under extreme pressure, speaks a great deal about how they value long term relationships that will assist in making their assets more resilient over the long term.

Medium term: (re)entry and re-activation

As the situation stabilizes and lockdown measures begin to ease, attention is turning to how assets can be reinstated and reoccupied as quickly, safely and efficiently as possible, with minimal capital exposure and the lowest possible risk.

Beyond the overall inspection of the site, other steps include the targeted recommissioning of the asset in an energy efficient manner, the reinstatement of building management systems, undertaking enhanced diagnostics, and the establishment of processes for the monitoring & inspection of facilities that will remain dark (mothballed) for some time.

Other factors to be addressed in these re-entry plans include cleaning regimes, access/reception queuing, elevator protocols, and the phased reopening of food & beverage and other shared amenities.

Long term: re-imagine

The long term aim of responsible owners is to improve the performance and resilience of their assets over its entire lifecycle. While this overall objective remains unchanged, there are a number of implications and lessons that can be learnt from the current crises.

The clearest lesson probably relates to the need for more business continuity planning. While many owners would claim to have these in place for their properties, very few have been sufficiently robust to deal with the level of change that has been experienced over recent months. The current challenge has driven home the need for more vigorous and detailed scenario planning to address potential disruptions and threats to the continuity of building operations.

Another enduring shift we expect to see, is an increased focus on how owners can increase the long-term resilience of their assets, through a greater understanding of the occupancy strategies of their tenants, in the face of new ways of working in the office sector. Changes in corporate occupancy strategies is likely to result in changes at the level of both individual assets (social distancing protocols, workspace design, building densities and workstyle requirements) as well as across wider portfolios (metro level consolidations, hub and spoke strategies, use of co-working facilities, continued working from home).

Sustainability and wellness are also increasingly featuring in discussions around long-term asset resilience. The extent to which health and wellness considerations are addressed in the operation and management of assets will be a key factor in determining their long-term attraction. Typically if the central building management system (BMS) does not provide the option to track sustainability metrics, systems and sensors can be installed to assess the health of the building (such as provide an indoor air quality reading and rating).

To this extent, proptech and digitisation are having an increased impact on the way that office buildings are managed and operated. There is a vast amount of new data available from both sensors within the buildings and external data sources, which is only expected to increase over the next few years as we move towards the fuller digitisation of assets. This provides property and facility managers with the insight they require to ensure buildings are operated more efficiently.

The extent to which owners understand and respond to these changes through the re-imagining of their office assets, will go a large way to determine which will be the most resilient and better performing assets over the longer term. In an increasingly competitive market, there will be an increased gap between the performance in those buildings that provide what tenants are seeking and those that fail to do so. In short, owners need to recognise what defines the preferred post pandemic workstyle and proptech environment and ensure that these are reflected across their portfolio.

Going Green
Sustainable real estate

“There is a growing body of evidence that shows a reduction in operational costs and a premiumin returns for more sustainable assets over the longer-term.”

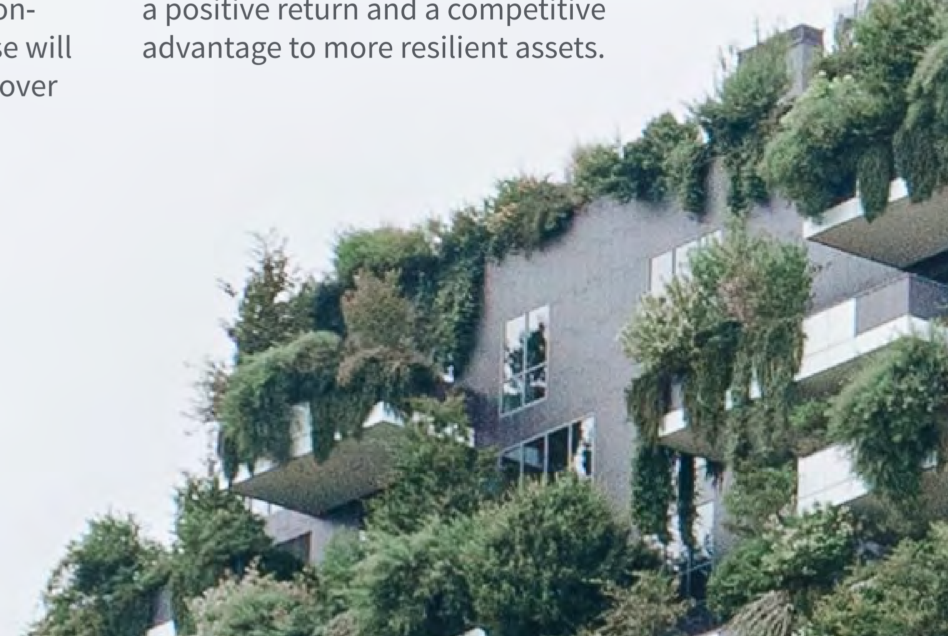
David Pine Coffin
Head of Property Asset Management, UAE

The growing conversation around climate change and environmental sustainability has been one of the major themes shaping the real estate sector globally over the past couple of years. The current disruption is expected to fast-forward this conversation and shift the occupier and landlord focus towards incorporating sustainability in the built environment, as a way to increase asset resilience in the long-term.

Functional resilience

The most direct benefit to building owners from sustainability measures is likely to be a reduction in energy and other operating costs over the longer term. Obtaining a LEED or other sustainability rating, requires attention to be paid to not just energy costs and usage, but also factors such as the quality of facility management (FM) and maintenance contracts, processes and procedures. These will be important factors in reducing costs over the entire life span of a building.

Another component of resilience that has been recently highlighted, is the ability to respond to short term shocks to the operation of assets (mothballing of many buildings). As the situation stabilizes and buildings are recommissioned and re-occupied, investment in smart and sustainable systems will provide a positive return and a competitive advantage to more resilient assets.



Competitive resilience

Landlords and owners are becoming increasingly responsive to the demands of existing and potential tenants, in order to ensure continuity in occupancy levels. This particularly includes incorporating wellness into their facilities.

The wellness of a workplace is impacted by a range of factors including noise, air quality, fitness, comfort, and communications (with more stringent measures regarding building cleanliness and sanitization currently being incorporated). With tenants benefiting from an increasing range of alternative locations from which to operate in the future (including co-working and working from home), landlords will have to compete even more intensively to fill their space, resulting in a greater focus on wellness as a means of increasing asset resilience.

Legislative resilience

Legislation has been a major factor in promoting more sustainable practices in the real estate sector in Europe and other mature overseas markets. While the Middle East currently lags behind other regions in legislation on sustainability, there are signs that this is now changing.

In a landmark ruling, the Abu Dhabi Securities Exchange (ADX) has issued new environmental and social governance (ESG) guidelines that require all companies listed on their exchange to prepare and publish independently produced annual sustainability reports that comply with globally agreed standards. This move form part of the government’s desire to promote more sustainable practices, with the ESG reports to be used as an important tool in allocating government funding to local businesses. They will also allow external investors, fund managers and other stakeholders to compare and rate the environmental, social and governance performance of all listed companies in Abu Dhabi.

There are various other regulatory changes that are likely to increase the sustainability of real estate assets in the UAE over time. One of the most important initiatives is that of the Dubai Government to establish an operational energy rating system for existing buildings. This rating system analyses actual data from a range of existing residential, hospitality and commercial buildings, and assesses this against the most suitable benchmark data for that type, size and activity of building. It will then apply a rating to that building against preset criteria, allowing both owners and tenants to benchmark their space against their competitive set.

Financial resilience

Combining the above factors will ultimately enhance the financial performance of more sustainable assets. While it is sometimes difficult to demonstrate a direct cause and effect between investment in sustainability and the financial returns of the asset in the region (partially due to the lack of reliable public benchmarks of long term performance), there is a growing body of evidence from overseas markets (where more accurate data is available), that shows a premium in returns for more sustainable assets over the longer term. An increasing number of tenants will be willing to pay a rental premium for more sustainable space. Combined with the higher occupancies (reduced rental voids), this should ensure that sustainable buildings achieve higher capital values and lower investment yields than less sustainable competitors.

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Contacts

Dana Salbak
Head of Research, MENA
Dana.salbak@eu.jll.com

Colin Dowall
Head of Property and Asset Management, MENA
Colin.dowalll@eu.jll.com

Evrim Ay
Regional Engineering - Corporate Solutions, MENA
Evrim.ay@eu.jll.com

David Pine Coffin
Head of Property & Asset Management, UAE
David.Pine-Coffin@eu.jll.com

MEA offices in:
Dubai, Abu Dhabi, Cairo, Riyadh, Jeddah, Al Khobar, Johannesburg and Casablanca