

Using Capital Improvements to Create Competitive Advantage in the COVID-19 Era

Owners of office and industrial spaces have quickly adapted their buildings to make them safer for tenants during the COVID-19 pandemic.¹ In addition to disinfecting common areas and promoting social distancing, some owners are investing in capital improvements designed to limit the spread of infectious diseases. This brief evaluates the merits of frequently discussed capital investments and their potential to create durable competitive advantages. It draws from an analysis of recent coverage in commercial real estate trade publications, as well as conversations with seven industry practitioners that took place in June 2020. Although the findings are arguably most relevant to owners of office buildings, they may also be of interest to owners of multitenant industrial buildings.

Building owners are actively considering capital improvements that may reduce the transmission of COVID-19, such as HVAC system upgrades, UV lighting technologies, antimicrobial building materials and touchless technologies. However, data about their efficacy against COVID-19 transmission remains limited, and it is unclear whether these improvements will be valuable to tenants after the pandemic ceases to be a major public health concern. For these reasons, many owners are deferring large capital investments related to COVID-19 and instead focusing on operational measures, such as enhanced cleaning and social distancing protocols.

Property managers play an important role in determining if new technologies are cost-effective, compatible with existing building systems and capable of delivering promised health benefits. Simultaneously, they are communicating with tenants to gain a better understanding of their concerns and how they can be addressed.

Most capital improvements that could make buildings more resilient to COVID-19 present advantages and disadvantages that should not be overlooked. Commercial property owners must therefore carefully weigh their options, seek out improvements that advance multiple objectives and invest in those that enhance the tenant experience.



Technology Promoting Health, Safety and Wellness

Capital improvements capable of limiting the transmission of COVID-19 generally fall into three categories: those that enhance air quality; those that prevent contaminants from lingering on surface areas; and those that reduce human contact with surface areas altogether.² A variety of technologies can be adopted to achieve these objectives, with the optimal course of action usually dependent on building, market and tenant characteristics.

HVAC system upgrades are perhaps the most widely discussed means of enhancing air quality.³ Systems that are compatible with HEPA filters, control humidity levels and facilitate a high number of outdoor and recirculated air changes per hour can reduce some of the risks posed by bio-aerosols.⁴ Equipping these systems with UV lighting or bipolar ionization tubes that deactivate airborne viruses can provide an additional line of defense,⁵ as can incorporating ductless mini-splits that prevent air from circulating across suites in multi-tenant buildings.⁶

Routine and thorough cleaning is perhaps the most effective way to remove contaminants from surface areas, but investments in UV lighting and antimicrobial building materials may also help.⁷ UV lamps have long been installed in commercial buildings to limit the spread of disease.⁸ They can be used to safely disinfect any number of high-touch areas, from elevator panels to water faucets to door handles, as long as safeguards are in place to prevent human exposure to UV light.⁹



Antimicrobial building materials with surfaces inhospitable to bacteria, fungi and viruses complement other solutions that reduce the transmission of contaminants.¹⁰ They trace their roots to the health care industry, but now come in a variety of colors and textures and can be found in all segments of the commercial real estate industry.¹¹ Some of these materials—such as copper and its alloys—are naturally occurring, while others are manufactured through the application of nanocoatings to wall coverings, flooring and bathroom fixtures.¹²

Touchless technologies that allow people to navigate the built environment without using their hands have also grown in popularity as a result of COVID-19. Doors with motion sensors and self-flushing toilets are well-known examples, but there are many more. Voice-, motion- and bio-activated technologies offer tenants the ability to control lights, adjust thermostats and move through security checkpoints without touching potentially contaminated surfaces.¹³ Smart-device and swipe-card technologies can also perform these functions, and can allow tenants to reserve conference rooms and operate office equipment.¹⁴

Making Decisions During a Period of Uncertainty

Despite the existence of numerous technologies that can make office and industrial buildings more resilient to the threat of COVID-19, many real estate owners are moving forward cautiously because it remains unclear how long tenant concerns about the virus will persist.¹⁵

“Generally speaking, owners don’t want to invest in systems that aren’t going to add value if a vaccine or treatment for COVID-19 comes out relatively quickly,” said Daniel Levison, CEO of CRE Holdings in Atlanta, Georgia. “Many are cleaning their buildings thoroughly and waiting for the market to tell them what to do next.”

Capital improvement decisions are further complicated by uncertainty about future demand for commercial real estate, particularly in the office market.¹⁶ The pandemic has led tenants in a number of industries to re-evaluate their space needs and explore the possibility of having a portion of their employees work remotely for an extended period of time, if not indefinitely.¹⁷ It remains unclear what types of real estate will experience declining demand as a result of this trend, but it does not bode well for antiquated urban or suburban properties that were already at a competitive disadvantage before the pandemic.¹⁸ Owners of such properties will need to weigh competitive pressures to make capital improvements against the very real risk that such investments may not increase a building’s market value.

Steve Martin, managing principal of SDM Partners in Atlanta, Georgia, succinctly described the dilemma owners of functionally obsolete buildings face when market disruptions provide tenants with an opportunity to reduce their real estate expenditures or upgrade their space in a cost-effective manner: “Owners of updated buildings are going to make it through [COVID-19], and owners of buildings that haven’t been updated are going to struggle.” Martin observed that current market conditions may not support significant investment in outmoded buildings.

Owners frequently consult with their property management teams on building improvements related to COVID-19.¹⁹ Experienced building operators are well-equipped to evaluate which upgrades are effective against viral transmission, compatible with existing building systems and valued by tenants.

Property managers are also often the first to hear from vendors and contractors promoting new building technologies, and they have developed a healthy skepticism about solutions that have a limited track record. “Not a day goes by that I don’t receive information about a product purported to reduce the risk of COVID-19 transmission,” said **Kathy Huckabay**, a senior director of property management at Colliers International in Birmingham, Alabama. “A lot of the products are costly and unproven.” Huckabay observed that tenants are often interested in emerging technologies, but can be less interested in paying for them.



Michael Lanning, senior managing principal of U.S. Asset Services in Kansas City, Missouri, emphasized the importance of explaining to tenants why some capital improvements are being made and others are not: “Tenants are asking more questions than ever. They want to feel comfortable in their space and confident property management is doing everything in its power to minimize risk. Those feelings come from talking with people about what you are doing, why you are doing it, and why it is appropriate.”

Recommendations

Since many factors affect whether individual capital improvements will enhance the competitive positioning of an office or industrial building, it is difficult to make broad recommendations about specific improvements that owners should consider. However, most owners would benefit from a holistic review of their properties and whether new capital improvements would add value by making these properties more competitive in the future.

Owners should view the pandemic as an opportunity to review the properties in their portfolios for any potential weaknesses, not just those exposed by the health crisis.²⁰ In many cases, weaknesses unrelated to COVID-19 may pose a greater threat to a property's long-term financial performance.

Alex Klatskin, general partner at Forsgate Industrial Partners in Teterboro, New Jersey, noted the importance of remaining focused on improvements that yield durable benefits. “Every market downturn has a different cause, but the effects are always the same: vacancy goes up and rents go down. All capital improvements should make buildings more resilient to these things, but sometimes it takes a market disruption to remind you.”

Additionally, property owners should prioritize improvements that reduce the risk of viral transmission while also improving operational efficiency or addressing perennial tenant concerns about sustainability and corporate social responsibility.²¹ For example, installing new HVAC systems may improve indoor air quality, reduce operating expenses and demonstrate a commitment to resource conservation all at the same time. This type of improvement can generate a considerable return on investment and is less likely to diminish in value if and when COVID-19 ceases to be a threat.

Warren Snowdon, managing director and principal of Foundry Commercial in Charlotte, North Carolina, acknowledged that landlords must remain cognizant of tenant concerns, both old and new. “A lot of companies that shut down their operations due to COVID-19 are still in the process of coming back. It's too early to tell how their demands have changed, but there is no reason to believe the things that were important to their businesses just a few months ago are irrelevant today. Capital improvements need to be made with that in mind.”

Finally, property owners should consider capital improvements that enhance the tenant experience. In the COVID-19 era, this requires reconsidering how tenants interact with the built environment and reassessing what contributes to their satisfaction. Neither of these tasks are easy, and both require ongoing customer service.

Chris Keenan, senior vice president of property management at Ciminelli Real Estate Corporation in Buffalo, New York, observed that property owners can still add to a building's value by enhancing the tenant experience. “COVID-19 has completely changed the way people use common areas, but that doesn't mean they want to work in environments that are sterile or unwelcoming. Owners still have to activate common areas and make them appealing in order to differentiate buildings from their peers. Those who do it right have a real advantage.”

Conclusion

This research has revealed that capital improvements are not a panacea. They can help to assuage tenant concerns about COVID-19 but cannot replace cleaning and social distancing protocols. That said, commercial property owners should not dismiss emerging technologies as a passing fad. Sophisticated HVAC systems, UV lighting, antimicrobial building materials and touchless technologies are all here to stay as tenants seek out ways to provide their employees with healthier work environments. The challenge for property owners lies in determining when and how to invest.

Owners of office buildings are leading the way in the adoption of these technologies because they generally have more responsibility for the maintenance of common areas and mechanical systems than do owners of industrial buildings. However, the capital improvements, management challenges and best practices discussed throughout this brief may have important implications for owners of multitenant flex space and other industrial product types that serve relatively large workforces. Real estate practitioners working in the office and industrial sectors should therefore take them into consideration.

Further, owners of office and industrial space should closely monitor technology adoption by peer and exemplar organizations. This is important because uncertainty surrounding the value of emerging technologies usually dissipates over time. Tracking technology-related successes and failures in the marketplace can position owners to make capital improvements when the time is right.



About NAIOP

NAIOP, the Commercial Real Estate Development Association, is the leading organization for developers, owners and related professionals in office, industrial, retail and mixed-use real estate. NAIOP comprises some 20,000 members in North America. NAIOP advances responsible commercial real estate development and advocates for effective public policy. For more information, visit naiop.org.

The NAIOP Research Foundation was established in 2000 as a 501(c)(3) organization to support the work of individuals and organizations engaged in real estate development, investment and operations. The Foundation's core purpose is to provide information about how real properties, especially office, industrial and mixed-use properties, impact and benefit communities throughout North America. The initial funding for the Research Foundation was underwritten by NAIOP and its Founding Governors with an endowment established to support future research. For more information, visit naiop.org/researchfoundation.

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Endnotes

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