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Real Estate Practice

Six new imperatives for real estate players

Higher inflation, higher interest rates, and other challenges mean that the real estate industry needs new paths to success.

by Sophia Brañes, Daniele Chiarella, Aditya Sanghvi, and Brian Vickery

March 2023

'If you build it, they will come.' For decades, that's been as true for well-located office, retail, and residential real estate as for the baseball field in *Field of Dreams*. But today, paradigm shifts, higher inflation, higher interest rates, and climate change are forcing real estate investors and operators to face a fraught reality: today, if you build it—or buy it—in the usual way, they might not come.

It goes without saying that the COVID-19 pandemic upended where and how the world uses spaces. In some regions, office attendance is still dramatically lower than it was before the pandemic; in the United States, for example, it hovers at around 50 percent.[1] Consumers have returned to brick-and-mortar stores[2] but are shopping closer to home.[3] Greater expectations for same- or next-day shipping have increased demand for industrial square footage near the places where people live and work.

Perhaps even more transformative than altered demand is the fact that occupiers have a new set of needs, beyond what real estate companies have traditionally provided. Hybrid work and omnichannel sales require that landlords supply creative physical designs, as well as innovative services and solutions. Tenants, lenders, and other stakeholders increasingly look for buildings that play a role in fighting climate change. Digital sophistication has become essential to help real estate players act more quickly and make wiser decisions, to enable emissions reporting, and to track and analyze how space is used.

Complicating the panorama is the fact that after a decade-long growth market, capitalization (cap) rates have expanded across sectors.[4] Interest rate hikes,[5] combined with higher inflation in many parts of the world,[6] have dramatically altered the financing costs and expected returns for owners, developers, and managers. Coupled with lower labor availability, these higher costs have made development and redevelopment more challenging and less profitable.[7] Further, raising capital is more difficult today than it was just a few years ago,[8] since some limited partners have reduced their annual commitments—in part because their public-equity portfolios have declined sharply in value, so their real estate portfolios, as currently valued, exceed their allocation targets. (This is called the denominator effect.)

Inflation and uncertainty about the direction of the global economy have made housing significantly less affordable, made gaining access to credit even more difficult in emerging markets, and created a challenging fundraising, deal-making, and return-generating environment for real estate investors and operators. Those who invest in and operate real estate as they did five years ago may underperform and lose share. In this unique moment, real estate players should adopt a new mindset: replacing "if you build it, they will come" with "if you operate brilliantly and please tenants, they will stay." In the current market, the success of a real estate investor or operator hinges upon whether they adopt the following six imperatives:

1. Create solutions for clients, not just physical spaces.

2. Use developments to generate momentum, not merely to capture momentum.

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[1] "Getting America back to work," Kastle, accessed February 2023.
[2] "Quarterly retail e-commerce sales 3rd quarter 2022," US Census Bureau, November 18, 2022.
[3] "Commission's new consumer survey shows impact of COVID-19 and popularity of 'greener' choices," European Commission, March 12, 2021.
[4] "McKinsey's Private Markets Annual Review," McKinsey, March 24, 2022.
[5] "Central banks ramp up rates again but the pace slows," Reuters, December 15, 2022.
[6] Paul Hannon and Harriet Torry, "World Bank cuts 2023 global growth projection as inflation persists," *Wall Street Journal*, January 10, 2023.
[7] Austen Hufford, "Home building fell sharply in July as costs increased," *Wall Street Journal*, August 16, 2022.
[8] McKinsey analysis of Preqin data.

Today's competitive pressures mean that real estate owners and operators should rethink their purpose.

3. Find value creation opportunities throughout a project's life cycle, not just at the end points.

4. Embrace sustainability as an opportunity, not a compliance process.

5. Embed digital solutions and advanced analytics in everything, not just by sporadically adopting individual solutions.

6. Focus on operating efficiency, not just on income.

Acting on these six imperatives will require investments or partnerships to access technology, analytics, operations, and climate science capabilities. Investors and developers have long been the stars of real estate organizations, but today it's clear that the value created by people with digital talents and capabilities may come to equal that created by "traditional" real estate people.

Real estate executives face new challenges in navigating today's shifting demand patterns, the changing needs of occupiers, and a difficult macroeconomic climate—while transforming organizations both sustainably and digitally. In this article, we examine the actions that have become crucial for investors and operators seeking a competitive edge.

Create solutions for clients

With some companies cutting back on the office space they own or rent, competition to attract tenants is stark. Over the past three years, a net 125 million square feet of office space became available in the United States and United Kingdom combined, the result of three consecutive years of more space being vacated than newly rented (Exhibit 1).[9]

Today's competitive pressures mean that real estate owners and operators should rethink their purpose. It's not enough to offer four walls; leading players will help tenants create workplaces that confer a competitive advantage.[10] Expanding into problem solving requires a new operating model, fresh talent and capabilities, and fundamentally different uses of technology.

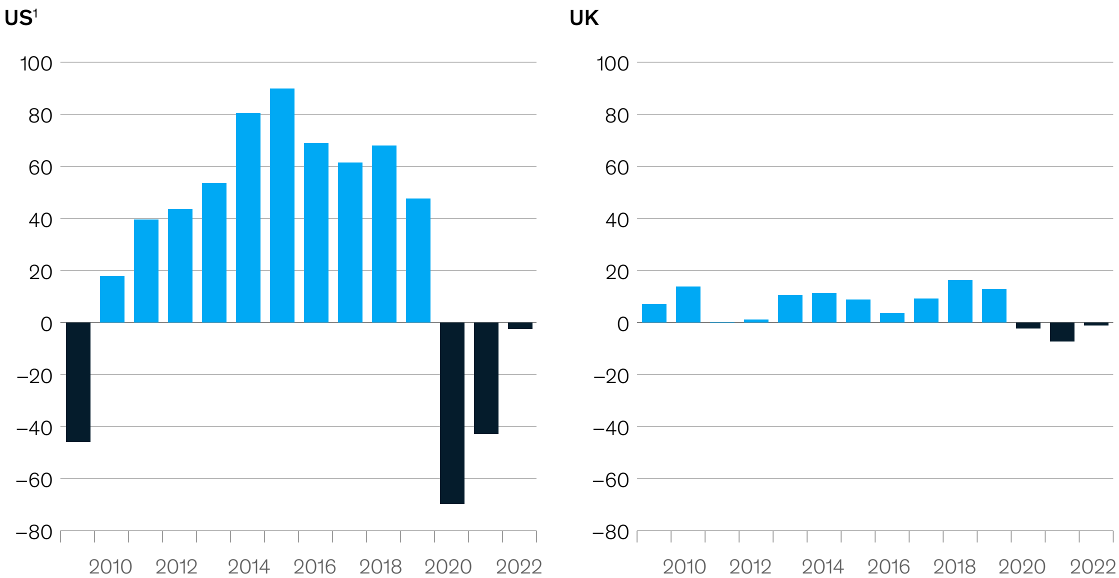
In office buildings, this new mandate means partnering with employers to understand how they want their employees to use spaces. Workplace solutions could include providing energizing locations where employees want to spend time, dynamic designs that can accommodate both collaborative and individual work, and sensors to track patterns of usage, which can inform an employer's approach to hybrid work.

[9] "McKinsey's Private Markets Annual Review," McKinsey, March 24, 2022.
[10] "The Future of the Workplace," McKinsey, accessed February 2022.

Exhibit 1

In some markets, lower net absorption of office space pressures owners to create new solutions.

Office space net absorption, 2007–21, square feet, million



[1]Top 50 US metro areas.
Source: CoStar

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In retail, there's an opportunity to offer omnichannel delivery solutions, requiring real estate players to view their roles not just as space providers but as lead generators. Solutions include offering new store formats, same-day delivery and fulfillment systems, industrial locations adjacent to stores, and mobile-shopping experiences that can compete with the best aspects of e-commerce.

The shift from providing a static product to providing solutions creates new business opportunities to supply, for example, technology for hybrid work, in-office digital systems for ordering foods and beverages, better omnichannel fulfillment systems, and smart-parking systems.

Generate momentum via development

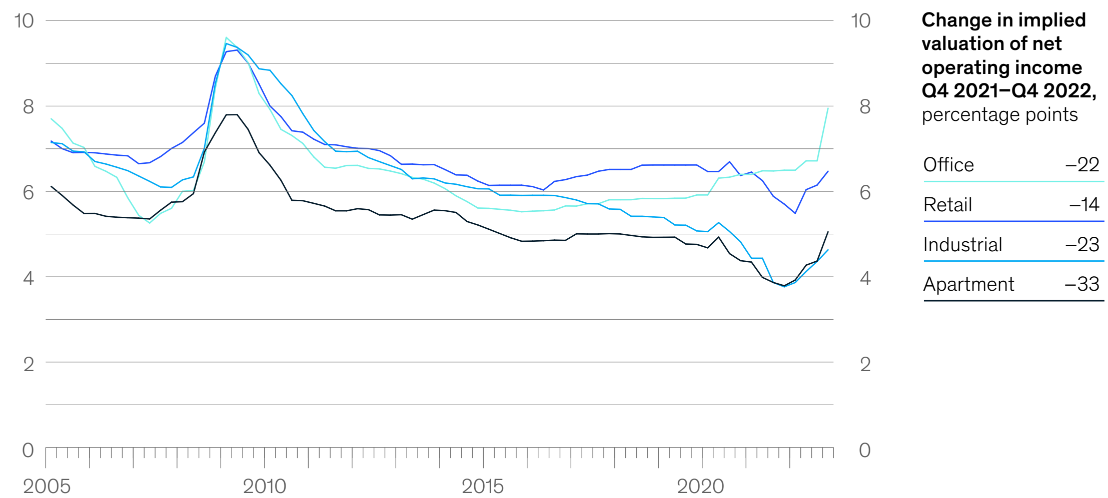
Forecasting the future—of industries, design tastes, or tenant behavior—has always been among real estate developers' most difficult tasks. But today, expanding cap rates, higher input costs, and lower labor availability[11] raise the stakes. At the same time, rapidly changing behavior makes traditional speculative plays less predictable (Exhibit 2).

[11] Lydia O'Neal, "Builders hunt for alternatives to materials in short supply," *Wall Street Journal*, October 6, 2021.

Exhibit 2

In early 2022, capitalization rates across all asset types started to increase.

Capitalization rates[1] and vacancy rates for major property types in the US, % (quarterly)



[1]Green Street data include all historical transaction data for asset purchases >$25 million across all asset classes in the top 50 metropolitan statistical areas.
Source: Green Street Cap Rate Observer

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Top-performing developers can intentionally create tenant ecosystems that go beyond landing an anchor tenant. Well-designed clusters have the potential to attract anchors and fast followers that benefit from being near one another. Some developments known as magnets for top-tier tech companies, for example, have also proved appealing to residential tenants and buyers—who may work for or with some of the on-site firms. They also attract retailers eager to serve tenants, workers, and visitors.[12] Our analysis points to rewards for players that successfully curate ecosystems based on how people will want to use spaces in five years: in our experience, innovation hubs enjoy a 10 to 12 percent average premium in commercial rents over nearby central business districts.[13]

Invest in value creation throughout the full life cycle

Outperformance in the decade preceding the pandemic required adept deal making. Buying right, making modest operational improvements, and riding contracting cap rates produced strong returns.

Buying right remains critical, but today's environment emphasizes operations—an area that has grown more competitive. Becoming an operating-platform owner is one critical way in which larger players are taking advantage of their scale and boosting returns.[14] Platforms give tenants a consistent experience and enable leveraged investments in technology (as further

[12] Katy McLaughlin, "L.A.'s new Playa Vista neighborhood is where Silicon Valley meets Southern California," *Wall Street Journal*, April 12, 2018.
[13] McKinsey analysis.
[14] Lisa Prevost, "Seeking an edge, developers and investors turn to 'proptech,'" *New York Times*, May 7, 2019.

discussed below), as well as efficient procurement and finance. Funds greater than $5 billion, many of which are platform owners or fully vertically integrated, outperformed funds investing less than $1 billion by 440 basis points in internal rates of return from 2009 to 2019 (Exhibit 3).[15] In combination, scale and vertical integration enable a consistent experience for tenants, better use of technology, and efficient procurement.

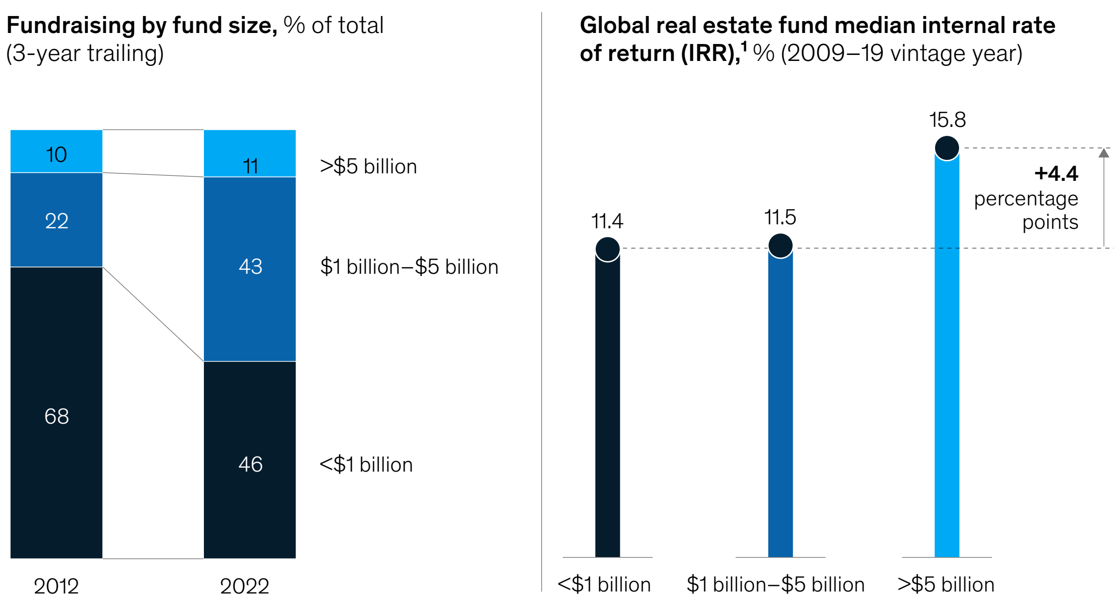
Embrace sustainability as an opportunity

Environmental, social, and governance issues—particularly sustainability—have moved from check-the-box items to value-creating activities. Real estate players can think about addressing sustainability in three ways: first, by analyzing existing portfolios through a sustainability perspective in a search for value; second, by decarbonizing existing buildings; and third, by building new sustainability-related businesses. Each of these will require cutting-edge digital and analytical tools.

Real estate players would be wise to assess their portfolios through a climate change lens, not least because climate change is already showing up in valuations[16] (Exhibit 4). Owners and operators that don't consider both growing physical risk (such

Exhibit 3

Scale is among the most sustainable advantages in real estate investment management.



[1]Net IRR to date through Sept 30, 2022.
Source: Burgiss; Preqin

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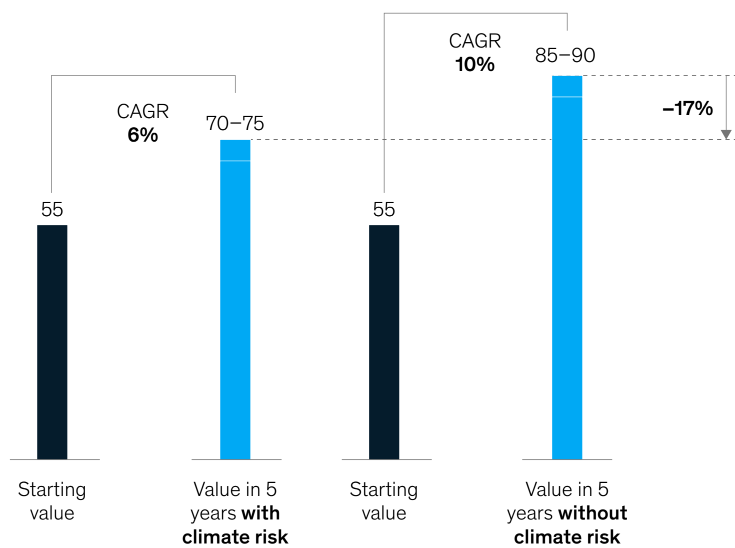
[15] McKinsey analysis of Burgiss data as of September 30, 2022.
[16] Brodie Boland, Cindy Levy, Rob Palter, and Daniel Stephens, "Climate risk and the opportunity for real estate," McKinsey, February 4, 2022.

Exhibit 4

Climate change is fundamentally disrupting the real estate industry.

Commercial real estate portfolio climate risk (illustrative),[1] $ billion



Real estate will be valued, built, retrofitted, and capitalized differently because of climate change

$7.5 **trillion** in total global property value is at risk of "stranding" (major write-downs because of climate risk or inability to decarbonize)

1,300 **major companies** have committed to reducing emissions in line with the 1.5°C pathway

$17 **trillion** in capital committed to real estate targeting net-zero emissions in 2021

[1]Sanitized portfolio with diversified locations across the US. Devaluation due to combination of physical risks (especially flooding, heat) and transition risks (especially lower rent in markets with carbon-intensive industries).
Source: Example analysis on real estate portfolio; Glasgow Financial Alliance for Net Zero; International Renewable Energy Agency; Science Based Targets

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as floods) and transition risk (such as regulatory requirements) may underestimate cap rate expansion, the cost of reducing emissions, or both. With $7.5 trillion globally at risk for climate-related write-downs,[17] much is at stake.

Climate analytics can help identify mispriced assets and determine whether it's wisest to buy, sell, or retrofit them. Our research indicates that in a diversified commercial real estate portfolio, only 10 percent of the assets drive 80 percent of the risks and that some assets (for example, those in markets with a significant renewable-energy industry) actually benefit from the climate transition. Acquiring assets strategically and adding value through decarbonization improvements strengthens portfolios. The ability to generate returns while meeting climate objectives can also help real estate owners access more capital on better terms.

Decarbonizing buildings requires investments but also opens doors to lower energy and operating expenses, as well as a potential green premium on rental income.[18] The smartest operators will not only identify assets that would benefit from

[17] Jean Eaglesham and Vipal Monga, "Trillions in assets may be left stranded as companies address climate change," *Wall Street Journal*, November 20, 2021.
[18] Christian Ulbrich, "The conversation about green real estate is moving on as corporates prioritize sustainability," World Economic Forum, January 12, 2022.

Today, the largest real estate owners are collecting and harnessing the power of their vast data troves to make better decisions.

improvements (including better insulation, more efficient windows, heat pumps, and rooftop solar) but also find opportunities to improve the economics of their net-zero pathways. We have found that the typical path to net zero is net-present-value (NPV) negative. Operators can create positive NPV-net-zero pathways by using analytics at the portfolio level to figure out the right order for implementation, which assets to invest in at what times, and how to link actions at the asset level with strategies for purchasing renewables. Operators can also significantly increase the value of their assets and portfolios by taking additional steps, such as measuring emissions and communicating them to tenants, leveraging scale for better procurement, and incorporating these insights into the investment process.

The climate challenge also introduces opportunities to build new businesses, such as offering emissions reduction services to other owners, generating and storing energy on-site, or providing climate resilience services to local communities.

Embed digital in everything

Real estate was once an industry years behind in digital capabilities,[19] but it is now catching up. Today, the largest owners are collecting and harnessing the power of their vast data troves to make better decisions and build applications that serve asset managers, tenants, and residents alike. The next phase of the industry's digital transformation requires improved change management and fundamentally new ways of approaching the business. It also calls for investments in new types of talent (including developers, engineers, and data scientists) to build, maintain, and enhance the tools that the transformation requires.

Traditional valuation methodologies rely heavily on comparable sales. Greater uncertainty in the demand for commercial properties, the macroeconomic environment, and the impact of climate change on valuations all render these less effective. Players using nontraditional data and advanced analytics to value properties and negotiate leases can often move more quickly and confidently, winning more deals and paying the right price. Advanced analytics and climate analytics can both confirm experienced-based knowledge and create new insights (Exhibit 5). In one digital-analytics-powered model we built for a US West Coast city, for example, we learned that proximity to a gas station had a negative impact on the growth of rents, but proximity to a high number of five-star Yelp-reviewed restaurants had a strong positive effect on it.

Applications are not only using data to improve decision making but also making the lives of residents and tenants easier—for example, with

[19] Gabriel Morgan Asaftei, Sudeep Doshi, John Means, and Aditya Sanghvi, "Getting ahead of the market: How big data is transforming real estate," McKinsey, October 8, 2018.

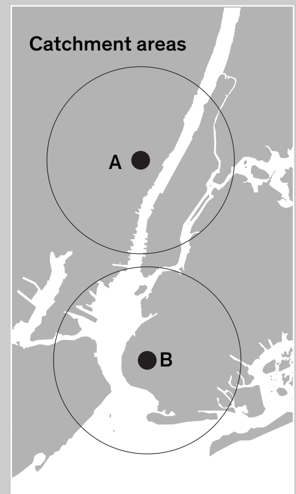
Exhibit 5

Advanced analytics can unearth real estate opportunities by using dynamic nontraditional data.

Advanced analytics real estate illustrative dashboard

E-commerce warehouse property search

Traditional data	**Property A**	**Property B**
Submarket	Waterfront	Waterfront
Rent per square foot (sq ft)	$9.41	$14.00
Rentable area per sq ft	56,251	58,000
Building class rating	B/3	B/3
Year constructed	1929	1930
Nontraditional data		
Household income	$37,600	$46,939
Population density	63,162	58,370
People aged 22–35[1] inflow	12%	3%
Average annual payroll growth	9%	2%
Average change in furniture spending	8%	5%
Average distance to truck stops	0.21 mile	0.58 mile
Cargo flights at nearest airport, annually	22,835	15,523
Attractiveness score	**7.3**	**2.4**



[1]Statistics calculated based on US Postal Service address change data.

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online rental platforms, maintenance request forms, and community engagement apps.[20] Other tools can help make operations more efficient: digital implementation can increase net operating income (NOI) by 10 percent or more—a dramatic improvement on traditional levers.[21] It's not surprising that property technology (proptech) companies have been highly attractive for venture capital and private equity investors: investment topped $50 billion for the first time in 2021.[22] The most advanced operators are doing more than merely buying or subscribing to proptech applications: they are building their own and transforming their processes to maximize the value created by the tech they build.

Focus on operating efficiency, not just on income

Input costs—including labor, materials, and financing—have grown rapidly. Meanwhile, inflation exceeds previous norms for contractual or episodic rent increases in commercial real estate. To keep pace with the changing economics, owners and managers must act on both costs and revenues.

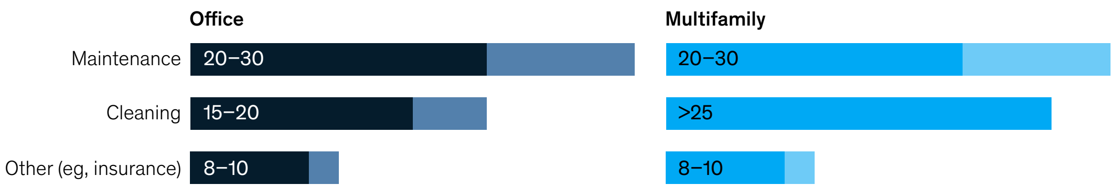
On the cost side, building resilient supply chains and controlling operating costs can offset potential NOI margin declines (Exhibit 6). Large owners in a given market can, for example, centralize leasing teams and give them digital tools that help make value-creating leasing decisions. Owners can

[20]Stefanos Chen, "Covid pushes real estate into the future," *New York Times*, November 13, 2020.
[21] McKinsey analysis.
[22]McKinsey analysis of Pitchbook data.

Exhibit 6

Real estate operators can reduce property-level costs in key categories.

Estimated savings potential as a share of existing cost, %



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also consider consolidating and renegotiating contracts for energy and maintenance services across a portfolio's properties. With financing costs higher, maintaining high credit ratings, finding low-cost capital, and refinancing regularly will also be necessary to produce returns.

On the revenue side, current market conditions require greater leasing intelligence. Commercial rents can match rising prices if operators flex all their levers (including leases with duration and escalation clauses) and tools (including advanced analytics and superior market research). Real estate has long been considered an inflation hedge for limited partners; to deliver on that promise, general partners must keep pace to ensure that commercial rents match the rising price environment.

Sea changes in behavior and mindsets, as well as current economic conditions, are converging to create an era of change in real estate. Those who embrace the challenges—rethinking what the market demands, which technologies are required, and how to use new talent—will position themselves for success. Competitors who fail to adapt may be left behind. Build the real estate that tenants want, and provide the experience that employees, shoppers, and residents need, and they will indeed come.

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The authors wish to thank Brodie Boland, Sudeep Doshi, Anna Fu, Ryan Luby, Jan Mischke, and Robert Palter for their contributions to this article.

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