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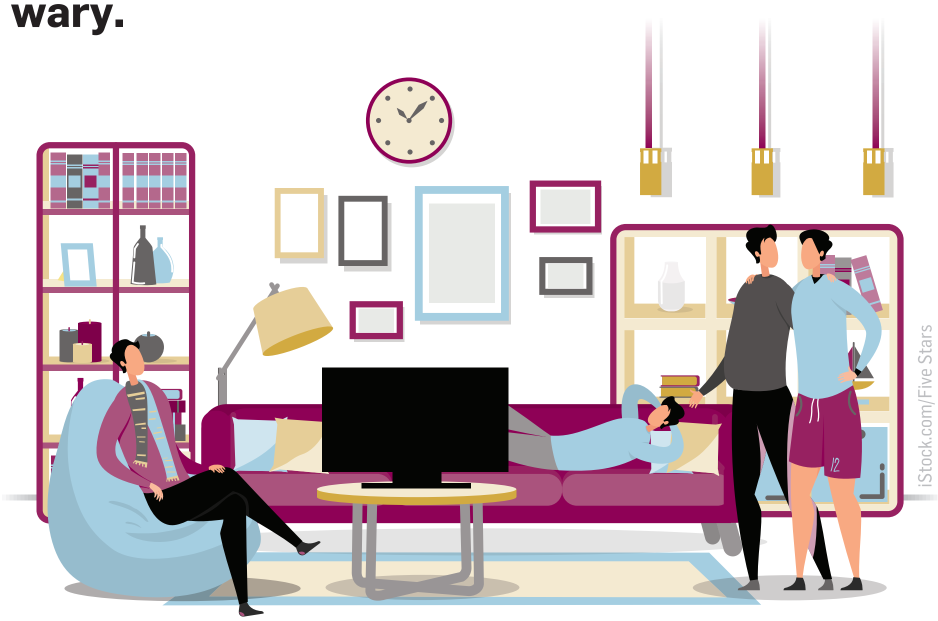
CO-LIVING: *A* new sector, *or a* new way *of doing* old things?

The concept of co-living is gaining momentum, but institutional investors and debt lenders remain wary.



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By Deborah Smith,
The CenterCap Group

When you ask real estate professionals what "co-living" is, and how it works, answers vary substantially. In my view, at its most basic level, co-living is simply formalized room-mating. If you are from out of town and heading to New York City, cannot afford to live alone, and do not have any roommate prospects, pursuing a co-living option may be perfect for you. Instead of veering towards Craigslist, typing "co-living" into an Internet browser will yield a plethora of co-living operators that offer an affordable, convenient apartment with one or more roommates to make living in the Big Apple as cost-effective and convenient as possible. Furthermore, reputable co-living operators will prequalify and prescreen tenants through background checks.

Plenty of bells and whistles talk about "experience," "shared interests" and "specialty designed" in a typical co-living marketing pitch. Yet, at the end of the day, it is still just formalized room-mating. However, there are a few differences from traditional rental properties that are mainstay to the structure and marketing of the co-living concept.

First and foremost, the properties are marketed on a "per bedroom" basis rather than a "per unit" basis. Therefore, they are at a lower price point than the cost of renting a similarly situated apartment by yourself. This makes it affordable. Second, the co-living operator typically furnishes the units, pays utilities, and may provide cleaning and linen services. This makes it convenient. Third, it's a fairly straightforward and streamlined process for the tenant that can be entirely managed through a phone or computer. This makes it efficient. But

> "The successful players have figured out that technology is the linchpin to mastering the execution."

when all is said and done, you probably have two or three people in an apartment, each with their own bedroom, and sharing a kitchen, bathroom(s) and other common spaces.

Beyond the basics, operational sophistication rolls in. The infrastructure behind the thriving co-living operators are technology platforms that play a prominent role in their marketing, leasing and property management strategies. It is about drawing in potential tenants, converting them into tenants and keeping them at the operator's property(ies).

The successful players have figured out that technology is the linchpin to mastering the execution. I like to call this niche sector "technology-enabled" apartment operators. The phrase "We have an app for that" is used more often by co-living operators than by any other real estate professional. Renters can download an app and find co-living apartments, rent an apartment and, once moved-in, organize their day-to-day lives at a touch of a fingertip. Traditional sales and retention tactics such as apartment tours (ditch that for an online virtual tour), picking up a phone to call maintenance when the dishwasher doesn't work (no need because there is app that handles the entire service request), even meeting or speaking to an actual person through the entire rental process (of course, there is an app for all of it) and after you move in (there's that app again) — are relics of the past. For millennials, this is an iPhone paradise.

A tenant need not bring anything other than an Away carry-on (the millennial's suitcase of choice). Think fully furnished. Turnkey. Travel right. Travel light.

An evolving model

The co-living operating model is still evolving. Operators are still experimenting with optimal tenant lease terms (which can range from one to 365 nights), amenity packages (cookware, cleaning product and toilet paper make all the lists, but there is a vast spectrum of amenities after that), furnishing mix and quality, target rental rates, whether to own (and how much of) the real estate, and appropriate benchmark comparisons. Underlying these conflicts is an identity quandary which overlaps between hospitality, student housing and traditional rental apartment living. As the sector continues to define itself, there will be a wealth of opportunity for market leadership.

What is in it for institutional investors? To date, institutional capital has been cautious. But it does seem clear that investment dollars are wading in. Market leader versus fast follower is a tale that is playing out real-time. For investors, co-living units can offer a 20% to 30% net rent premium per square foot as compared to traditional apartments. Higher rents mean comparably higher yields. Co-living operators such as Common, Quarters, The Collective and Ollie have collectively raised hundreds of millions of dollars in third-party capital to acquire and manage thousands of co-living units. In 2019, Quarters, a subsidiary of Germany-based Medici Living Group, announced it had raised $300 million for its American venture; Common, which is backed by tech venture capital, announced a partnership with Tishman Speyer to develop product offshoot, Kin; while UK-based The Collective has raised $800 million to do ground up development across Europe and the US.

One major inhibitor to product growth is the availability of debt. As a perceived new asset class, most, if not all, lenders are underwriting projects to a conventional rental scenario. In some cases, lenders are requiring relatively higher equity stakes and/or replacement reserves just to make it a little more painful. Lenders remain concerned that "co-living" is unproven. Underwriting material premiums, which translates to significant jumps in dollar per square foot pricing, require proof in spades. But, for what it is worth, my view is that the underlying question whether renters are willing to focus on total rent versus dollar per square foot rent was answered affirmatively years ago. The concept of highly amenitized apartment buildings, focusing on more amenity-centric common spaces at the expense of apartment size, is more prevalent in the industry today than ten years ago. The emergence of the urban "micro-unit" — e.g. really small apartments typically less than 400 square feet — is further evidence of the shift in renter mindset. Over time, hopefully lenders will evaluate current lending standards and adjust accordingly.

While it is unclear who ultimately will be the winners and losers, the real disruption to the sector that these co-living operators bring may not be in creating the "new new thing" but in its contribution to redefining the role of technology in the housing sector (and perhaps beyond) in general. I suspect we will look back and realize that a lot was learned from the co-living entrepreneurs who entered the real estate sector with an undeniable flair for marketing and micro-targeting techniques, an abundance of fresh new ideas, incredible talent and, most importantly, a new way of doing old things. ◆

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