Limiting the Cost of Your Real Estate Obligations

Companies in all industries would do well to take advantage of the current downturn in the economy to right size their occupancy cost base. The silver lining of the current real estate recession is the opportunity for companies to create a real estate savings and build in long-term shareholder value.

Real estate is important to companies in most industries. It is a representation of corporate values and an enhancement to productivity, providing the environment to make money and serve clients; however, real estate is also a challenge to manage globally across varying market practices and cost structures. As a result, companies sometimes suboptimize their real estate decisions and are saddled with costly results for the long term.

Real estate cost is also a large proportion of the asset base and operating cost structure of companies in most industries, sometimes as much as 15% of non-personnel operating cost; for professional and financial service firms, the percentage is even higher. A recent study we made of the largest global law firms showed that real estate costs range from 29-45% of their non-personnel operating budget. For large banks, such as Goldman Sachs and Wells Fargo, occupancy cost as a percent of total non-compensation expenses exceeds 10% and 13%, respectively. For retailers and tech firms, the percentage of their assets in real estate often exceeds 40%, for example, Target at 45%.

Exhibit 1. Elements of a Real Estate Strategy

An integrated approach

It is well known that commercial real estate values have been on a significant decline throughout the last 2 years with, for example, office buildings losing 50% of their value in some markets, as measured by net effective rental rates, since the 2007 peak. Most experts believe that commercial real estate values will not fully recover in 2011. This creates a distinctive opportunity for companies to restructure their owned and leased holdings and set the stage for long-term savings. Companies will need to

act soon because restructuring takes time and negotiations require many iterations. To exploit today's soft marketplace, companies should develop an integrated occupancy strategy that covers cost, space and flexibility. *See Exhibit 1.*

There are four fundamental ideas about occupancy cost that facilitate the cost reduction effort. Together, these four ideas set the framework to accomplish real estate cost reduction.

- *Total cost.* Real estate includes all of the components relating to space and cost management, all of which can be measured and benchmarked internally and externally.
- *Long-term strategy.* To be cost effective, real estate decisions must serve the company's goals in its primary business. Long-term and short-term planning for real estate should dovetail with company objectives, all the while adding flexibility and control to commitments, and timing decisions to adapt to local market trends.
- *Governance.* Successful real estate management requires an initiation, approval and implementation process that is sufficiently nimble to meet strategic objectives. In addition, there should be CFO level accountability and share of mind in order for real estate to be truly optimized.
- *Internal organization.* Companies must determine the need for internal capabilities, on the one hand, or external service providers to effectuate their real estate needs, including brokerage, legal, finance and design real estate functions. Performance of both the internal organization and the external functional support should be measured regularly and on a consistent basis, thereby ensuring that the most cost effective approach, whether in-house or outsourced, is applied.

Optimizing occupancy costs starts with the fundamental equation that occupancy cost is the product of the amount of space used by the company and unit cost of that space. If the number of square feet or square meters of space can be reduced, or if the cost per square foot or square meter can be lowered, or both, the company's occupancy costs will go down. If that reduction can be locked in globally and over the long term, then the cost structure of the company will have a long-term improvement. Managing occupancy cost centers around opportunities to reduce space, unit costs (rents and operating expenses), fit-out expenses, and occupancy structure.

Space reduction

Cost reduction opportunities around space are easy to envision: if a company rents 300,000 square feet and has an annual occupancy cost of $32 million, reducing the footprint by 25% will save $8 million annually. On the space side, rentable area can be reduced if it is designed densely or has a higher utilization rate. If a 50,000 square foot office was designed to hold 500 people and the company tightened design density to house 1,000 people, savings could be accomplished by reducing the total amount of space needed. Moreover, if the company

with that 50,000 square foot office with 1,000 workstations filled up all of the seats, then that increased utilization would create a further space and cost savings.

There are numerous levers to pull to accomplish this. Take, for example, the law firm with an average density, among the highest of any industry, of 600 square feet per person. (This compares to the other companies having 250 square feet per person or half of that for those companies using hot-desking or workstations.) In a study we performed, we learned that the following levers can reduce law firm annual occupancy cost by 28%: reducing the size of partner offices, doubling associates for their first few years of tenure, and eliminating some library space. In this case, pulling these levers produced an $18 million per annum savings.

Rental and operating cost reduction

After right-sizing the real estate, companies should look to reduce their unit cost of rent and operating expenses. Companies with strong credit and good growth prospects can particularly take advantage of today's economy and make or save money from their real estate. Because investors and landlords view a building occupied by such a company as more valuable than others, a strong company can negotiate a rent at the lower end of the market together with the desired flexibility on space and term.

Operating costs can also be reduced by smart negotiation at the right time, by managing the service levels requested (for example, for overtime air conditioning and extra cleaning), by gaining the right to perform services through the tenant's own vendors and not solely the landlord's, and, perhaps most importantly, by implementing green operating practices such as light sensors. Regular auditing of landlord charges is also helpful from time to time.

Manage the construction cost of fit-out

Another fruitful area in which to save cost is related to fit-out expenses. Construction prices are at a 5-year low and not expected to improve in 2011. As a result, contractors are competing for work. Tenants can take advantage of the competitive pricing by improving their office space today, and using such improvements to increase density and make space more functional long-term. Key levers to pull to reduce capital spending for improvements include lump sum bidding, value engineering materials selections and standardizing components, such as workstations and furniture, across multiple locations.

Restructure leases and ownership arrangements

By far, the best forms of cost savings are through the introduction of options in occupancy arrangements to create flexibility. A company that has optionality around expansion and contraction of its space, or cancellation or renewal of its lease, all arising at times useful for the company's business and all optional on the part of the company, will allow that company to make good use of market conditions to make decisions at low points rather than at more costly

points in the real estate cycle. In addition, lease options allow the tenant to retain control over not only its committed space but surrounding spaces as well without actually incurring cost or liability.

Tenants can benefit from today's economic climate because landlords will allow tenants to restructure and reduce their occupancy cost. In fact, they will encourage it so long as landlords get something in return which they need today: a long-term commitment from a tenant who can pay the rent. So today's soft markets allow a win-win for restructuring transactions to occur, with the balance of benefits on the occupiers' side. Although financing is very difficult today for property owners, recent sales of office buildings in cities beginning to rebound, such as Washington, D.C., have closed as high as $900 per foot because one or more strong tenants lengthened the term of its lease.

In addition, with today's low interest rates, a company with a robust balance sheet which owns its real estate and is not getting any return on it can enter into a favorable sale-leaseback with an option to repurchase, thereby monetizing at a favorable level the cost of occupancy and freeing money for more strategic corporate purposes.

To get started on the program to reduce real estate cost a company should: first, engage an experienced real estate advisor to develop a strategy and an architect to test its feasibility and cost; second, review all existing real estate commitments, contracts, debt and leases; and third, renegotiate everything with a remaining term of 5 years or less. *See Exhibit 2.*

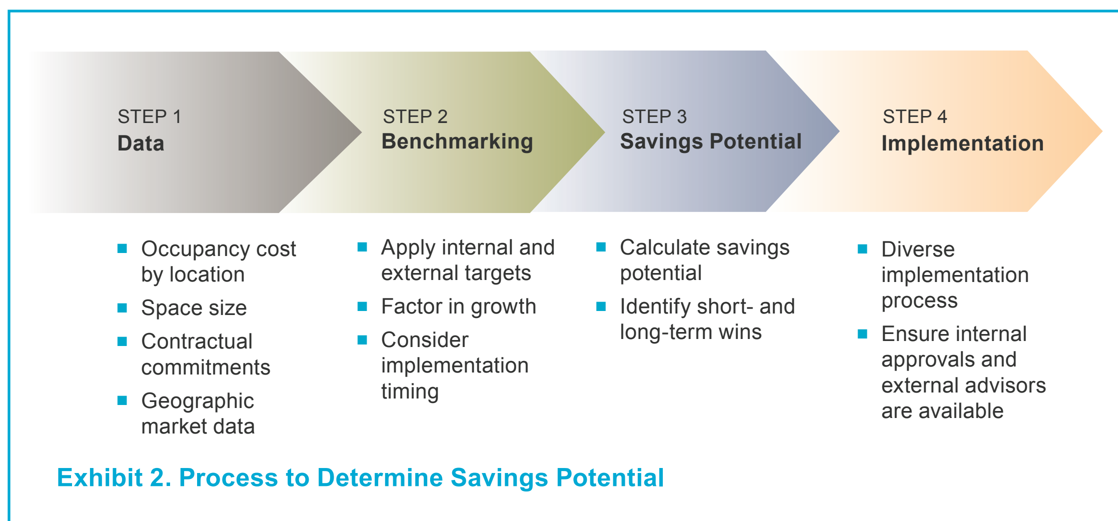

Exhibit 2. Process to Determine Savings Potential

Following this process, the company can measure its true cost of occupancy, optimize its savings strategies, seize the opportunity to reduce the cost of occupancy and unlock shareholder value for years to come.