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Tenant Perspectives

Flexibility, Agility and Adding Value: Tenant CRE Needs

The corporate commercial real estate operation has traditionally centered around costs, rental rates, tenant allowances, and concessions.

However, cost is no longer the primary factor influencing corporate real estate decision-making as businesses look to optimize their real estate portfolios to further drive business strategy, improve talent recruitment and retention, and transform the corporate real estate strategy into a revenue-enhancing tool.

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>
> **Darcey Estes, T-Mobile**

Labor Considerations

Talent has become critical. While always a factor in market selection, talent retention and recruitment strategies are now impacting the choice of physical assets.

In particular, office tenants are emphasizing flexible, collaborative spaces—also known as activity-based workspaces—with a laser focus on employee experience and satisfaction. This trend comes as a response to cost pressures and the desire to improve space efficiency—as well as to labor availability, the low unemployment rate, and the widening skills gap among U.S. workers.

Wireless carrier T-Mobile has seen a "big shift" in its corporate real estate strategy towards "evolving our workplace to support the way our employees work today and into the future."

Darcey Estes, vice president of T-Mobile's U.S. corporate real estate and facilities group, said the corporation was "investing heavily" to modernize its workplaces to boost employee satisfaction and creativity by providing improved amenities and workspace designs to be more open plan and flexible.

"This is about making sure real estate supports both the needs of the company and a more innovative workforce," Estes said. "If you want to get talent through the door and keep them, the workplace has to support the work they do, be energizing, and be inspiring."

The Agile Office

Improved employee collaboration and satisfaction is one of the benefits of adopting an agile office design, according to information and analytics company RELX. The company has reinvented key office locations globally by removing assigned desks and providing fewer private offices, but increasing the number of

IN THIS ISSUE, INTERVIEWS WITH:

LKQ
27msf (U.S., Canada)
95% industrial, manufacturing
5% office

Plus **CBRE** and **JLL**

RELX
3.8msf (U.S.)
81% office
14% warehouse, manufacturing
5% data center

Siemens
33msf (Americas)
32% office
68% industrial
57% owned, 43% leased

T-Mobile
8.9msf (U.S.)
49% retail
27% office
24% call center

conference, group, and individual workspaces for employees.

Not only have agile offices allowed RELX to reduce its footprint in certain properties, they have also enabled the firm to create collaboration zones at the heart of each floor. "One of the most memorable pieces of feedback was a member of staff saying, 'I've been here for 10 years and I'm now meeting people I've never met before,'" said Michael Hartshorne, RELX chief real estate officer.

For both T-Mobile and RELX, future office space needs will center around open-plan, collaborative spaces. Increasingly important is furniture design, such as bench seating, adjustable height desks, and even movable walls to allow for greater flexibility.

A New Way of Working

Conglomerate Siemens has also moved away from a traditional office model by introducing Siemens Office. Also referred to as "New Way of Working" (NewWow), this is an agile workspace concept that allows employees to work "from anywhere, at any time," said Michael Kruklinski, Siemens head of Americas.

In locations where NewWow has been adopted, employees, including in some cases C-suite managers, are no longer assigned desks or offices, but instead select from a range of workspace options. Kruklinski himself shares two offices that are set up as regular meeting rooms without personalization with SRE Americas CFO and COO. When not being used by the leadership team, the offices become conference space available to everyone. Employees are provided open workspace stations and are asked to adhere to a clean desk policy.

"It's a new way of working," said Kruklinski. "The idea is to get your work done wherever you are, and it doesn't always have to be in the office." As a result, Siemens has improved space efficiency and introduced a desk sharing ratio of, on average, one desk to 1.5 employees where NewWow operates. Siemens is now on its second generation of calculating space efficiencies based on job families.

The reinvention of office workplace standards, according to Siemens, RELX, and T-Mobile, is therefore about creating diverse, inclusive work environments that support the corporate vision and brand. Employees are attracted to, and will stay, with companies that are innovative, stable, and provide career progression. Corporate real estate plays an increasingly important role in pursuing that strategy.

Industrial Efficiency

Tenants' desire for more efficient use of space is not restricted to office properties. It is also a critical need within industrial facilities.

Sy Finkelstein, director of real estate for LKQ Corporation, an alternative and specialty auto parts and accessories provider, said commercial real estate decisions were traditionally all about cost. Today, LKQ is as focused on features such as high bays, multiple dock doors, and efficient lighting, as well as adequate space for storage, generators, and distribution facilities to allow it to operate efficiently and effectively.

Value Proposition

"It's about bringing value to the table," Finkelstein said. "Whether it's negotiating a purchase, a sale, a lease, a sale-leaseback, or ensuring we have enough distribution space to hold [inventory for] in-stock positions to avoid lost business, I want to see value every day."

The sentiment is echoed across the industry, with corporate real estate portfolios critical to helping businesses pursue strategic goals, act as a revenue-enhancing tool, and tackle labor needs.

"We recognize today that the way we work and the drivers of business are changing. Workspaces should be flexible to those needs," said Estes.

Siemens, which operates its corporate real estate group as a profit center charging market rate rents to internal groups as well as to external clients co-locating in Siemens' properties, said it is also about understanding the return on investment and preserving the value of the assets. "It has to be the right price, the right site for attracting talent, and close to customers and vendors," said Kruklinski, "but it's also about the return on investment and how we can maximize value for the company."

Technology

The Role of Data in CRE

Data has become a critical tool for tenants looking to optimize their real estate portfolios and to make their buildings more efficient.

Both Siemens and RELX have embraced technology and data collection to improve the use of their owned and leased assets.

Using Sensors

Siemens has deployed sensors to create heat maps to better understand its space utilization. This allows the conglomerate to a develop variable seating assignment ratio for certain offices, not least those operating an agile (or activity-based) workspace design.

"Employees in software development need to sit at the same desk at the same time as colleagues and can't be as flexible as, say, salespeople who can have a desk sharing ratio of 1:3," said Michael Kruklinski, Siemens' head of Americas.

To determine its real estate needs, RELX has also used anonymous live tracking desk sensors in addition to building security data, creating monthly occupation reports, and having employees take an annual facilities survey.

"Data is everything," said RELX chief real estate officer Michael Hartshorne. "It is 100 percent part of the commercial real estate role today. Without the right data, you can't make informed decisions."

Research

How Talent is Reshaping Corporate CRE Decisions

Class A offices are increasingly outperforming Class B products as tenants target high-end space to support efforts to recruit and retain talent.

The 20 percent spread in long-term rent growth between Class A and Class B offices comes on the heels of CRE market and building selection decisions that focus on amenities and enhanced workplace strategies to attract talent and increase employee satisfaction.

Suburban and CBD Class A office rent growth outperformed corresponding Class B product by at least 7 percent and up to 20 percent between 2010 and 2017, according to JLL. Class A suburban and CBD offices also saw significantly greater absorption over the same period, with new suburban inventory reporting a 7.9 percent spread over Class B product[1]. Class A office space accounted for 84 percent of all space absorbed in Q4 2017[2].

"The competition for talent is real and intensifying," said JLL chief economist Ryan Severino. "Increasingly, users of space are giving that greater consideration in their corporate real estate decision-making process than they did in cycles past."

According to CBRE's Americas Occupier Survey 2017, 58 percent of corporate real estate professionals reported labor was their primary challenge, a 32 percent increase on the prior year and ahead of economic uncertainty, technological disruption, tighter regulation, and cost escalation. Eight in 10 executives said labor cost and availability was the primary driver of market location[3].

Corporate real estate decisions, which formerly focused on facilities and cost, are now made with an "understanding that employees really are the company's greatest asset and that real estate can play an integral role in keeping them happy," said Julie Whelan, CBRE's head of occupier research, Americas.

This intensified competition for talent is focusing the attention of users of space on "the location of talent and the ease of attracting and retaining it," added Severino.

While corporations have always been mindful of talent pools, particularly when selecting new markets, Severino said an aging U.S. population and the exit of baby boomers from the workforce would result in labor considerations becoming a more important driver of corporate real estate decisions over the next 5 to 10 years than they are today.

As a result, 84 percent of corporate tenants are reinventing or adapting workplace standards, typically in favor of activity-based workspaces which allow employees to move freely between a variety of individual or collaborative work areas, in a bid to attract and retain talent as well as improve space efficiency and seek better employee productivity[4].

"While real estate costs and availability are very important, what is also extremely important are workplace strategies, which are being used to directly increase talent retention and as a lever to differentiate corporations from the competition," said Whelan. "Satisfied employees yield engaged employees."

Class A Office Rent Growth Outperformance, 2010–2017

	Rent growth 2010–2017	Net absorption (% of inventory) 2010–2017	Average rent (% change) 2016–2017	Vacancy rate (%) Q4 2017
Class A CBD	35.70%	8.60%	-1.50%	10.90%
Class A suburban	19.70%	11.60%	3.60%	13%
Class B CBD	15.60%	2.10%	n/a	n/a
Class B suburban	12.70%	3.70%	n/a	n/a

Source: JLL and Colliers International. JLL U.S. Office Outlook, Q1 and Q3 2017. Colliers International Q4 2017 U.S. Office Market Outlook Report. Rent growth data as of Q3 2017 and reporting the rent growth percentage change from Q1 2010 to Q3 2017. Net absorption data as of Q1 2017 and reporting the net absorption percentage change from Q1 2010 to Q1 2017. Average rent data as of Q4 2017 and reporting the average rent percentage change Q4 2016 to Q4 2017. Vacancy rate data as of Q4 2017

Reinventing the Workplace: It's about Space and Talent

84% Corporations in the U.S. are reinventing or adapting workplace standards*

48% Seek better space utilization

43% Seek talent attraction and retention

44% Seek better employee productivity

37% Seek operating expense savings

Source: CBRE Americas Occupier Survey 2018, as of March 2018. * 84% of 138 corporate real estate professionals interviewed by CBRE said current workplace standards were ineffective relative to the future demands of the organization or were in need of amendment to be effective

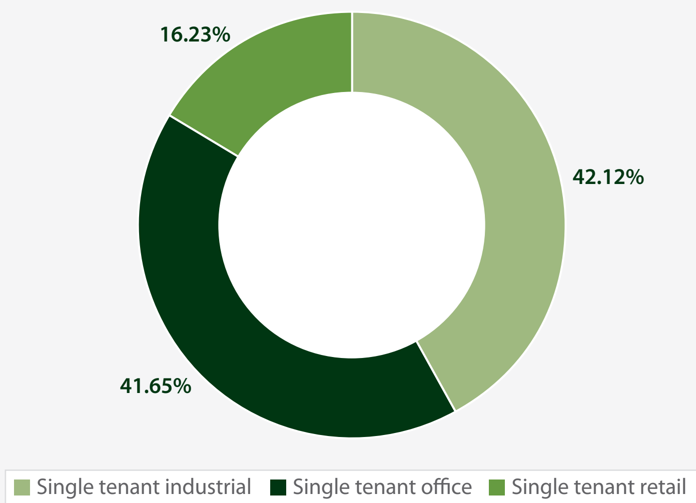
1 JLL U.S. Office Outlook, Q1 and Q3 2017
2 Colliers International Q4 2017 U.S. Office Market Outlook Report
3 CBRE Americas Occupier Survey 2017
4 CBRE Americas Occupier Survey 2018

Net Lease Trends

Pricing Performing Amid Moderating Deal Activity

The net lease market bucked national U.S. commercial real estate trends in 2017 by recording a 3 percent increase in transaction volume, driven by industrial and retail deals. While volume dropped 8 percent below the 2015 peak, valuations continue to increase year over year in the net lease office and industrial sectors.

Net Lease Volume Breakdown by Property Type, 2017



Source: Real Capital Analytics, based on transaction volume for full year 2017

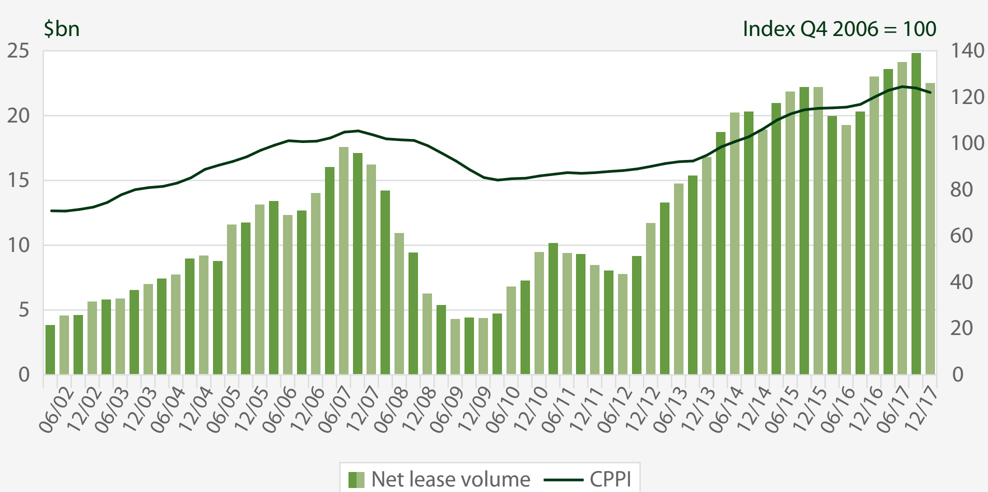
Office and industrial dominate U.S. net lease activity

Office and industrial continued to comprise the majority of U.S. net lease market activity in 2017. Office had a market share of 41.65 percent, despite deal volume falling 2 percent between 2016 and 2017. Industrial and retail volume increased 3 percent and 10 percent, respectively, during the same period, leaving the property types with a 42.12 percent and 16.23 percent share of the U.S. net lease market.

Office valuations continue to perform

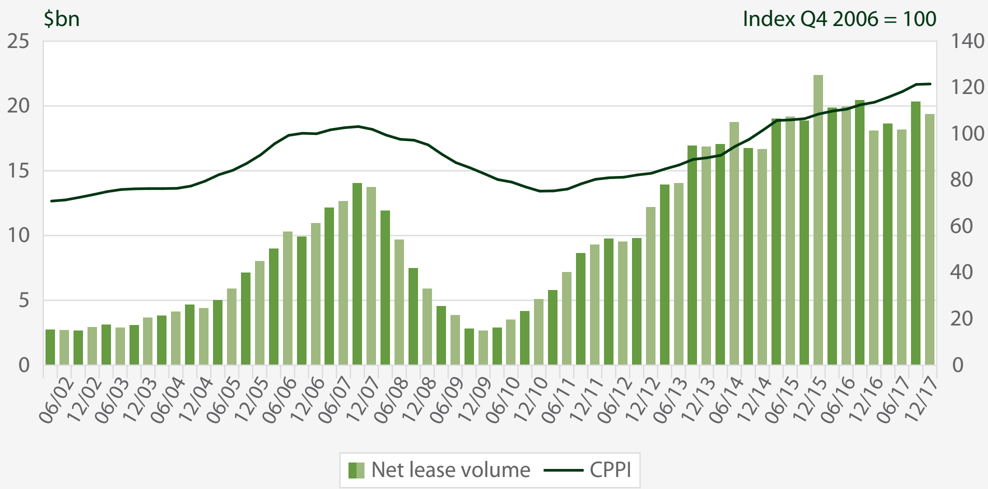
Transaction volume for net lease offices fell slightly between 2016 and 2017, with year-on-year deal volume decreasing 2 percent to $18.6 billion at the end of 2017. However, deal volume remained above 2015 levels, and since 2010 have increased more than 110 percent. Despite the year-on-year decline in deal flow, net lease office valuations increased 2.5 percent between 2016 and 2017, and have risen by more than 42 percent since 2010.

Net Lease Transaction Volume and Pricing: Office



Source: Real Capital Analytics, data as of December 31, 2017. Single tenant office transaction volume displayed as 12-month totals. Based on independent reports of properties and portfolios $2.5m and greater

Net Lease Transaction Volume and Pricing: Industrial



Source: Real Capital Analytics, data as of December 31, 2017. Single tenant industrial transaction volume displayed as 12-month totals. Based on independent reports of properties and portfolios $2.5m and greater

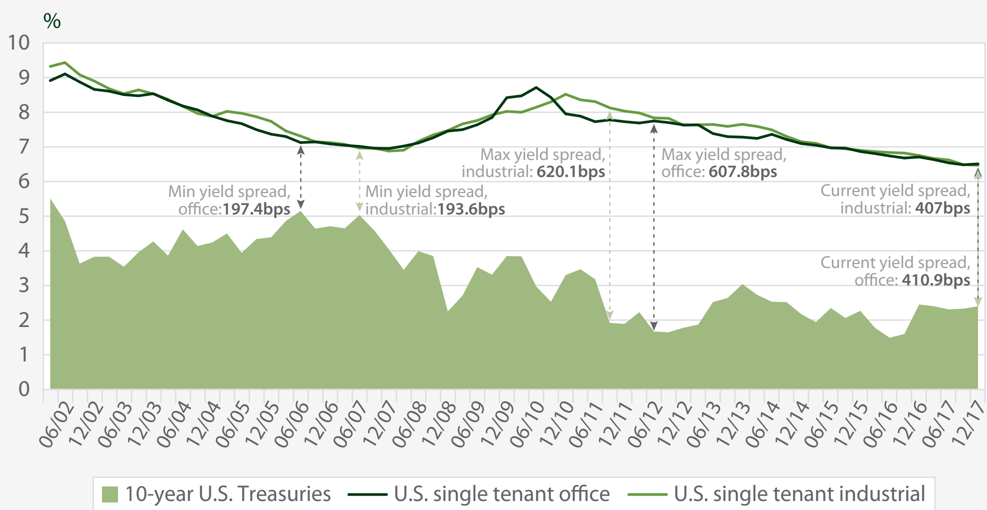
Increased industrial deal flow and pricing

Net lease industrial deal volume mirrored national trends for the property type, recording a 3 percent year-on-year increase between 2016 and 2017. Total transaction volume for 2017 was $18.8 billion, below the peak of $22.4 billion recorded in 2015, but a 275 percent increase over 2010 volume. Net lease industrial valuations have increased year on year since the financial crisis, increasing 7 percent since 2016 and 62 percent since 2010.

Spreads over Treasuries continue to compress

Spreads between net lease office and industrial cap rates and 10-year U.S. Treasury rates remain healthy, at 4.11 percent and 4.07 percent, respectively, as of the end of 2017. The pre-recession (2002–2007) average spread was 350 bps. Cap rates for both net lease office and industrial assets continued to compress throughout 2017, ending the year down 19 bps, 4.4 percent lower than the previous year.

Net Lease Cap Rate Spreads: Office and Industrial



Source: Real Capital Analytics, Federal Reserve Bank. Data as of December 31, 2017

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