Monthly Research Briefing: September 2007

Driving Portfolio Strategy

Simplify the Message to Senior Management

A recent engagement with a Place Strategy™ Partner got us thinking about how to best present an integrated corporate real estate portfolio strategy to senior management. Our Partner was challenged with taking their 2008 strategic plan, with all of its complex portfolio capacity analysis, demand planning, market intelligence, duration matching analysis, and alternative officing business case, and summarizing it into a few PowerPoint slides. We realized that the "C Suite" folks are very busy people, and that they would only have a short time with them to get the message across and gain their buy-in. Granted, complex multivariate modeling and cost analyses are essential to identifying and then optimizing portfolio options. And we all fall in love with our hard work and want to show it off. However, most non-real estate executive's eyes will glaze over when shown too many graphs and charts. **The question we grappled with is "How do you simplify, and amplify, the *portfolio strategy story?*"**

This Brief takes somewhat of a different focus than those previously published. It pulls together concepts presented in those topical briefs into a framework for action. Rather than focus on a "what", here we present a way of framing the "why" of portfolio strategy in a simple, direct way. **At its essence, portfolio strategy drives three key initiatives. We all want to use less, pay less and need less.**

"Use Less" refers to the never-ending problem (for most large companies) of underutilized facilities. **"Pay Less"** focuses on acquiring and disposing of space by aligning negotiating strategy with current and future real estate market conditions to ensure the best deal for your company. **"Need Less"**, our most radical call to battle, advocates designing the workplace to better fit the way today's highly mobile team-oriented workers actually behave, which often brings the pleasant additional benefit of decreasing office space per worker. All three initiatives directly support one of our unofficial "Place Strategy™ Partnership" mantras:

"A Dollar of Real Estate Cost Saved Is a Dollar of Net Operating Income."

We explore each strategy in turn, and identify the most relevant portfolio management tools to address these challenges. The next time you present your strategy recommendations to senior management, consider framing your discussion with these three simple objectives.

"Use Less"

Nearly all companies we work with have excess vacant space in their portfolios – at best most are "constantly chasing that 12%". There are different reasons, and thus different solutions, for why internal vacancy continues to plague large organizations, and each requires different senior executive buy-ins. The challenge is not just documenting how much it costs to carry the vacancy; your portfolio strategy needs to identify how you plan to get rid of it.

Swiss Cheese This is the most difficult source of internal vacancy to address. When a company reduces overall headcount, the personnel who leave are usually scattered throughout the portfolio. Those ubiquitous "10% across the board" cost reduction initiatives are the worst culprits. Excess vacancy show up in your metrics, even if there are no identifiable "chunks" of space to eliminate. Capturing internal vacancy into manageable portions to dispose of or redeploy, incurs move and reconfiguration costs. Since "swiss cheese" is often caused by economic pressures on the company, freeing up capital to spend on moving within the current envelope can be difficult. In order for senior management to support consolidation, you need to know what you'll do with that excess space once you free it up. Can you sell it? Sublet it? Even mothball it to reduce operating expenses? You can quantify potential savings gains by **monitoring your potential exit options in the local real estate market**, taking into account the configuration of your properties, local demand and market rates relative to your own lease terms. Leased, multiple tenant building often allow more flexibility for downsizing floor by floor. It also may be more cost effective to dispose of owned assets rather than to buy-out leases.

For companies with multiple facilities in a metro area, **a robust Metro planning process will constantly scrutinize options for rapid portfolio downsizing** though duration matching and probably-based demand forecasting – two Place Strategy™ tools. Keep in mind that while impending lease expirations create what we call a "real estate moment" to downsize the portfolio, the property that can be vacated the soonest may not be the best to vacate in the long run. Market intelligence highlights other properties that may have exit options or bargaining leverage with landlords and be a better choice to exit based upon operational needs.

"Hangover" Space" Vacancy resulting from exiting a business is highly visible. While dramatic "here today gone tomorrow" exits such as the collapse of Enron and the demise of Arthur Andersen are rare, it is more common for a company to shutter an entire line of business, witness today's mortgage banking industry. The impact of a major write-down on share price is foremost in senior management's mind and customers and employees are their greatest concern. Real estate losses get tucked into a much larger exit cost reserve charge so most won't notice a "fire sale" on assets. However, by using market intelligence and portfolio prioritization to examine the relative cost position (over/under current market) of each lease to be exited, you can quickly **establish your potential bargaining power with landlords and find opportunities to reduce losses through subletting.** Micro-market level intelligence also serves as a reality check when landlord buy-out offers are being evaluated. Senior management will not complain when fewer real estate related losses need writing down - there will be plenty of other places to sock away those reserves.

Wrong Space in the Wrong Place Internal vacancy can be hard to ferret out when a company has both contracting and expanding lines of business. While the overall internal vacancy rate may seem reasonable, it masks that some facilities might be highly underutilized, and others are bursting at the seams. Building or cluster level vacancy should always be tracked along with overall portfolio level vacancy. Mergers force companies to choose between operating locations. Changes in workforce requirements may also drive the need to shed space in one location while simultaneously taking on obligations in new locations. Integrating workforce analysis with location analysis enables better footprint decisions. These tough decisions need to be guided by labor and cost structure concerns first, real estate second, but in the long run it may be more advantageous to vacate entire locations or metro areas than to manage an increasingly scattered workforce.

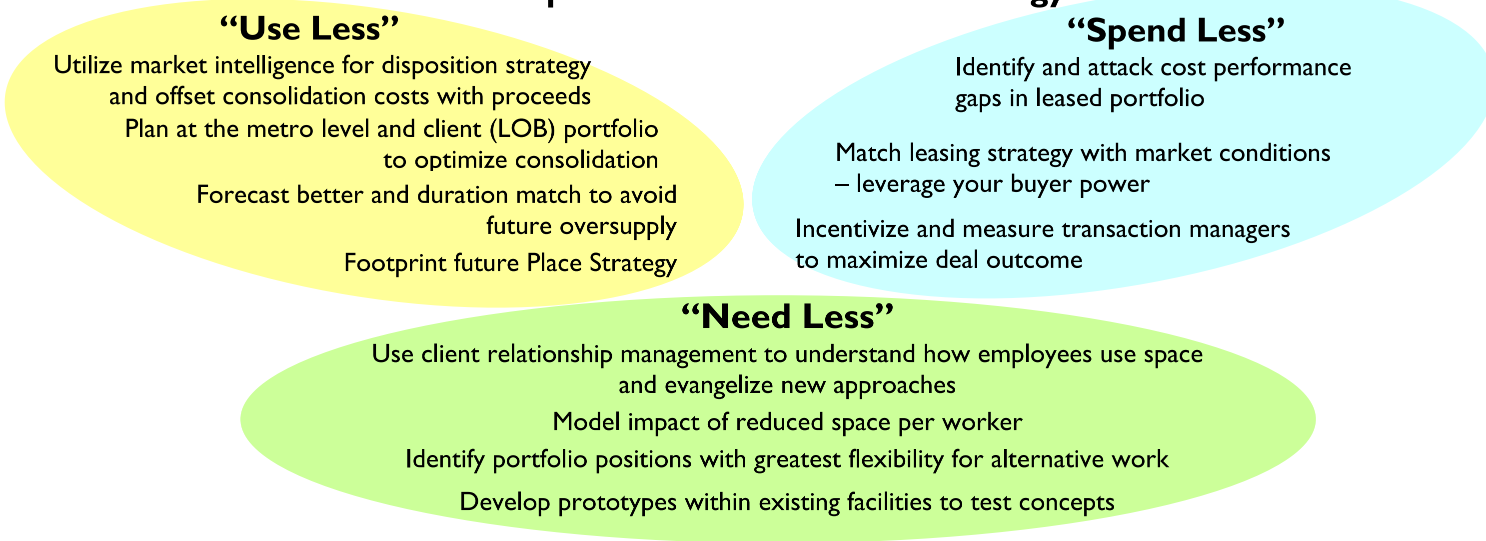
Of course, the most important long term solution to "use less" is to employ fully integrated portfolio strategic planning so that you can react more quickly to changing demands and build in more flexibility over time. **Every major property in your portfolio should have an exit strategy thought out, even if it is not an attractive option, so that portfolio risk can be more accurately assessed.**

"Pay Less"

A second key deliverable of portfolio performance is to simply pay less for the space you do occupy. "Pay less" is a two-fold strategy. In the short term, there may be opportunities to restructure current leases in your portfolio. In the longer term, you can ensure you are getting the best rate possible in a deal negotiation by utilizing impartial market intelligence in addition to your broker's on-the-ground perspective.

Mining for Dollars By benchmarking your current lease positions to market, you can identify where the rent you pay is higher than current market rent for similar space. If that lease is in a location where prices

Three Simple Drivers of Portfolio Strategy



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are rising, that cost gap may disappear by the time the lease turns over. On the other hand, in a weakening market with declining prices, chances are you have a stronger bargaining position with the landlord on your renewal than you may think. **By identifying those positions with significant current cost gaps and determining which are core long term locations for your company, selective early renewals can reduce short term operating costs.**

"Go to the Mat" on Deals The current commission-based system of compensating brokers on size of deal runs directly counter to corporate interests of minimizing lease rates, increasing flexibility or shortening term. By benchmarking transaction performance using impartial market intelligence, you can make sure the landlord's offer is within the "Deal Zone" of the current local market, and factor in the impact of future anticipated changes in market rates. To benefit from this information, you may need to alter the way you manage your transaction process and reward your external brokers, perhaps developing incentives to reward brokers who "beat the market". **You don't get what you don't measure or reward.**

Incidentally, we suspect that large, geographically diverse corporations may routinely "overpay" to the overall market, particularly for smaller leases where we are finding otherwise unexplainable price premiums from 5% to upwards of 20%, especially on lease renewals. It may be that small companies, with fewer transactions to manage and perhaps privately owned, tend to scrutinize deals in greater detail than large companies, and end up paying less. We hope to test this hypothesis in the coming year.

"Need Less"

Most of corporate America's offices no longer fit the way people work today. Studies of office utilization across disparate industries (technology, financial services and government administration are some) similarly report that over 30% of workers assigned to a building are not present on any given day. Other studies observing actual occupancy of workstations (using tools first developed by anthropologists to observe indigenous peoples) find they are **empty anywhere from 35% to 75% of the time.** Image what would happen to the head of manufacturing for your company if the factories ran at less than 70% capacity!

The ubiquitous cubicle is poorly suited to the many different ways people work. It has too much space for individual quiet work, it isn't big enough for group meetings, and it isolates workers from each other. While US workers occupy on average over 200 sf per person, office utilization per worker in the United Kingdom metrics can be found at half that amount. While alternative approaches to office design (AO) that break out of the "one box - one body" paradigm, deserve extensive discussion in a later Brief, the relevant point here is that these configurations typically use less space per worker – from 30-50% less. Further, surveys of occupants who switch from conventional to alternative work settings report greater employee satisfaction, higher productivity and better work-life balance. **Imagine what your cost metrics would look like if you could house your workforce in one-third less space, while providing a better workplace to support mobility and teaming requirements?** Improving office space utilization benefits the environment as well as the balance sheet, as houses and buildings contribute the lion's share of greenhouse gases and consume about 70% of electricity generated (American Institute of Architects).

Unfortunately, your real estate portfolio may form a formidable barrier to higher utilization and density. Some buildings cannot support the accompanying increases in power usage, elevator traffic, or parking requirements. It is important to know which buildings in your portfolio are "AO design friendly" prior to selling the idea throughout the organization. When downsizing, those buildings should be retained. For those buildings which can support higher densities, the implementation of alternative office design must be closely linked with portfolio strategic planning. AO changes the standards by which we determine acceptable internal vacancy levels. Assigned workstations require a certain amount of internal vacancy to allow for reorganizations and growth. The exact amount needed is debated, but can range between 5-8%. AO reduces or eliminates the need for any internal vacancy space because incremental change can be accommodated within the footprint. You will need to set more aggressive vacancy reduction targets if you anticipate greater use of AO by your company in the future. Assumptions about adaptation rates of AO should be modeled into long range space forecasting. While there is debate as to how fast and how broadly AO will be adopted by large companies, the way we work will continue to evolve with dramatic implications for future corporate real estate requirements.

Final Thoughts

While effective portfolio strategy development requires analytical depth and sophistication, our job is also to present options clearly and simply to enable effective and timely decision-making at the executive level. By clarifying the objectives of an integrated Place Strategy™ to "Use Less, Pay Less, and Need Less" we can build support for investing in the longer view. We invite you to test this communications strategy and give us feedback on its usefulness.

Future Briefing Topics:

Future topics related to this Brief include:

- Place Strategy™ – Concept and Application
- Demand Forecasting Methods
- Applying Duration Matching to Portfolio Planning

Additional forthcoming briefing topics:

- Aligning Service Provider Incentives with Deal performance
- Developing the Metro Strategy
- Line of Business Profiling

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