## What's Really Needed to Optimize Real Estate Flexibility

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Response to GlobeSt.com article "Study Finds Need for Flexibility" (4/27/2006), GlobeSt.com Interview with CoreNet Global's Eric Bowles (5/19/2006) and similar article in NREI

It was great to see coverage of CoreNet's research on flexibility on GlobeSt.com. I was disappointed however to see that the research focused on survey responses from tenants and their advisors. The conclusion: tenants aren't getting the flexibility they want at an appropriate price. The research provided three reasons: landlord and broker intransigence, the lack of good data, and the lack of appropriate processes and tools for real option analysis. Many landlords, brokers, consultants and others would disagree.

My work for major landlords and Fortune 100 corporations includes several projects that provide alternative explanations for the "lack of flexibility." The problem's not landlord and broker intransigence or the lack of processes and tools. Even the lack of good data can be overcome in many cases. The barriers are first, the lack of budget within corporate real estate departments, and second, corporate real estate executives apprehension of something new. These observations apply primarily to the US market where we do most of our work; in the UK market, landlord intransigence plays a greater role. The following comments describe these projects and the lessons we've learned.

First a bit of background. While teaching at the University of Chicago Graduate School of Business, I became fascinated by the real estate industry and how the financial and mathematical techniques I taught could improve real estate decision making. Since then I've worked at several real estate organizations -- on the investor, landlord and tenant sides. In 2002, I founded Critical Core to refine techniques for better real estate decision making for corporations and other large organizations.

***Valuing options.*** In the mid-1990s, I worked with landlords and tenants in Chicago using real options analysis to estimate the value of cancellation and expansion options. CoreNet's research indicates that software using this approach would help tenants get the flexibility they want. So why didn't we continue to use this approach? We had the tools. Landlords were willing to consider the options. The problem was the lack of good historical data on market rent trends. Without good data, these models can't estimate a value that is more precise than users' initial expectations. In the financial world, where these techniques started, stock and bond markets provide the data needed for options analysis. In the UK, where these tools are being used, historical rent information is better. Since the mid-1990s, US rent information has become better and estimates are likely to be more precise, but the results may still be disappointing. Users should understand the possible data limitations before making decisions based on this approach. For tenants, there is another problem: real option pricing doesn't capture all of the important factors.

***Modifying the question.*** Given the limitations of the real options approach, we've used other approaches to identify the right amount of flexibility. In our experience, landlords were providing

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flexibility and tenants were paying for it. A short-term lease was likely to be more expensive than a long-term lease. During negotiations, landlords reduced rent concessions when tenants requested cancellation or expansion options. For our analysis for tenants, we asked landlords to provide alternatives with different lease terms and options. Then using the same simulation techniques that underlie real option analysis, we selected the term length and options that were best for the business case. This approach doesn't require as much historical rent data and can capture the relevant factors.

We started using this approach to evaluate flexibility when we saw tenants signing short-term leases and then renewing them, sometimes several times. We worried that tenants might be overpaying for flexibility. Once landlords have a tenant in the space, the landlord's bargaining position is improved. In many cases, we were surprised to find that if the probability of renewing was just 50%, a longer-term lease with a cancellation option was better than a short-term lease. We had enough rent information for this analysis, but we needed better business information, specifically how likely it was that a tenant of this type would renew or cancel a lease. Corporations setting portfolio optimization strategies should track both cancellation rates and renewal rates.

***What about management risk?*** As we started working on this analysis, we found that there was another barrier to better management of flexibility. In many situations, our portfolio analysis showed that a longer-term lease - for example, six years with a cancellation option instead of three years - could save millions of dollars. So why so much focus on flexibility? While there were financial benefits to longer-term leases, the benefits weren't there for the corporate real estate (CRE) executive. When markets turn bad and corporations find themselves paying for excess space, CRE executives are blamed. The excess space and cancellation penalties are more obvious than the possible savings from longer-term leases. The problem wasn't the cost of flexibility, it was the cost of losing your job. CRE executives should be able to show senior executives that their strategy -- whether it is short-term or longer-term leases -- is the most cost-effective one from a portfolio perspective. They need to show that the outcomes result from well-reasoned analysis rather than real estate managers' intuition and mistakes.

***Providing flexibility internally.*** One CRE organization considering the portfolio perspective noted that the corporation as a whole had a relatively steady need for space, but internal business units -- the corporate real estate department's clients -- needed more flexibility. So instead of relying on the outside market for flexibility, CRE management looked at how to provide it internally. This fall, we helped them review these policies. They wanted to determine whether they should charge internal clients the short-term market rent, the rent in the lease contract, or some other rate that was lower than the short-term rate but still high enough to offset the corporation's risk of holding excess space. Using software tools similar to those for real options pricing, we found that the corporate real estate department could provide the needed flexibility at a better rate than the outside market.

***Limits to landlords' offers.*** The factors that were important in this analysis provided us with insights on why landlords are unwilling to provide more flexibility at a lower cost. In our analysis, good corporate space standards enabled different groups to move in and out of spaces with few changes and thus low costs. As we increased the changes required, the cost of providing the flexibility increased. With

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landlords' providing tenant improvement allowances for each tenant and facing the risk of vacant space, their rents for short-term leases can only go so low.

Are landlords sure they can't lower rents for short-term leases? In the US, competition between buildings provides pressure to lower rents. The brokers want to get the deal done, but the asset managers have a responsibility to provide a return to the building owners. To find the lowest rent they can offer, they use property valuation systems to evaluate the impact of different assumptions for current rents, term lengths, renewals, and market rent trends. This analysis helps them understand how much flexibility they can provide and determine the price required to maintain a profit. They are not using sophisticated real option pricing tools, but this approach is sophisticated enough to complete a basic test of the different alternatives. And they are trying to offer more flexibility in other ways. For corporations with leases in many markets, landlords are providing more flexibility by agreeing to lease reductions in one market in exchange for increased leasing in other markets.

***The UK situation.*** Here landlord intransigence may be limiting flexibility. While the GlobeSt.com article indicates that UK leases are more flexible, most numbers show the opposite. For example, in 2006, US office leases average 4.7 years according to Grubb & Ellis, while UK office leases averaged 6.7 years in 2004, the most recent year for the BPF / IPD survey results. More detailed comparisons show similar results. The UK landlords are receiving attention because they are using software to value options, while US landlords continue to use intuition, market competition, and property valuation systems to set parameters for lease terms, rents, and options.

In Britain, landlords have been so reluctant to offer flexibility that the British government threatened regulation. US tenants may want more flexibility, but is the situation so bad that we would consider government intervention? Until the property crash in 1990, tight property markets meant UK landlords offered only the standard lease terms, typically twenty to twenty-five year leases with upward-only rent reviews every five years. Weak markets after the 1990 property crash pressured landlords to offer shorter lease terms and "breaks," cancellation options in US terms, but terms were still less flexible than in the US and elsewhere. In 1995, the British government started expressing concerns that landlord practices threatened business viability during recessions. It commissioned a thorough review of more than 60,000 commercial leases including lease terms, options, and rent review policies. And, they threatened government regulation that would require landlords to provide more flexibility. Real option pricing software showed UK landlords that they could still make money with more flexible leases.

***Scenario analysis.*** While landlords use property valuation software to look at different scenarios, most corporations continue to rely on spreadsheets for their portfolio analysis. This approach provides little ability to evaluate flexibility. Recognizing the need for better tools, we developed a system to complete scenario analyses and evaluate flexibility when corporations are restructuring or consolidating. With this system, we can look at different consolidation strategies and forecast the costs with different demand forecasts. In these cases, a mix of owned and leased properties with staggered lease terminations and cancellation options can provide the needed flexibility. But picking the wrong properties to keep or dispose can cost millions.

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Based on our experience, the reasons CRE executives think landlords are not providing enough flexibility are different than those noted by CoreNet's Eric Bowles.

- It's not the lack of processes and tools. They exist, we've used them, but they aren't commercially available, for reasons to be described later.
- In the US, it's not a problem with landlords and brokers: most offer flexibility. The pricing may not be explicit because it's part of the negotiating process or the price may be too high.
- Better data would definitely enable better evaluation of flexibility. But even where we can modify the questions so that less data is needed, few corporations are taking advantage of this analysis.

What's missing is the market to develop these techniques and tools for the general real estate user. For some reason, the corporate real estate budget doesn't include sufficient funds for this type of analysis or for the tools to support it. The lease, operating expense and construction budgets total millions of dollars, but in most organizations, there is almost no budget for consulting and software tools that could save millions in these areas. Real estate database developers have faced this challenge for years.

Why no budget? Maybe it is because CRE organizations are used to "getting something for nothing" when landlords pay brokerage fees. Those advisory fees don't need a budget line of their own -- they're included in rents. Maybe it's because CRE organizations don't think they have to do it. Corporate real estate executives pay for tactical services like facility management and architectural design because that work has to be done. But strategic activities and tools are often considered optional: "we don't really need them, so we can't afford to pay too much."

And the final reason for the lack of budget: corporate real estate executives tend to be apprehensive about doing something new and different. They are beginning to accept new workplace design ideas and more environmentally-friendly buildings, but, for most, using techniques from "rocket science" just seems a bit much. Their apprehension could be reduced by considering how these techniques create benefits elsewhere in the organization. In leading companies, marketing departments use them to target customers and determine the profit-maximizing prices. Manufacturing and distribution groups use them to set production runs, manage inventories, and set up efficient distribution systems. For initiatives requiring major investments, many companies use these special techniques to estimate the real value of the potential benefits. Some apprehension is warranted. CRE executives need to make sure that those promoting these techniques really understand them. Users in other corporate disciplines can help them understand when it is smoke and mirrors and when these techniques can add real value.

It's time to take advantage of these techniques in real estate, and pay for them. If corporate real estate executives want to think strategically and gain respect within their organization, they will have to strive for improvement, which means doing something different. CoreNet's attention to the value of the techniques and tools may be a first step in increasing awareness, reducing apprehension, and developing this market.

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