



PLANNING FOR UNCERTAINTY: THE CORPORATE REAL ESTATE RESPONSE TO ECONOMIC VOLATILITY

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OVERVIEW

Occupiers have faced tough decisions over the past couple of years. Cost-containment has dominated the corporate agenda and, against the backdrop of a volatile economy, still remains a key business driver. However, the way in which key corporate objectives are delivered has shifted from cutting costs to effective management and delivery of real estate portfolio strategies.

As our annual survey of CRE executives suggests, the approach of corporates towards real estate procurement is evolving, as occupiers move towards more sophisticated and hybrid models that reflect the growing geographic and functional complexity of international organisations. As a result, going 'glocal' is a growing trend among real estate occupiers and one we expect to continue over the next few years.

Additionally, there is increased focus on ensuring that cost containment does not undermine business stability. As a result, expansion and relocation plans still remain a high priority for occupiers, although more so in certain sectors. As indicated in the survey, Asia and emerging markets continue to top the preferred locations, although the reasons cited for this trend are changing: access to skilled labour for the first time surpasses access to cheap labour. The challenge of sustainability is also highlighted in the survey results. This issue is felt strongly within the CRE community, but the ability to turn intentions into actions is limited in the current economic climate.

Note: The quotes contained in the ViewPoint are sourced from the CBRE Global Corporate Services team

INTRODUCTION

For the second successive year, CBRE has undertaken a survey of leading CRE Executives to examine and identify trends within the corporate real estate market. Against the backdrop of a volatile economy and a high degree of uncertainty, the survey looks at how corporate occupiers are behaving and whether real estate strategies have evolved or changed over the past year. The 81 respondents, mostly multinational occupiers, covered a wide range of sectors from Banking & Finance to Logistics & Distribution. Questions covered a variety of topics such as portfolio composition, real estate strategy and emerging markets. This year, we also augmented the survey with additional questions on emerging real estate issues such as corporate procurement practices and the impact of M&A on real estate markets.

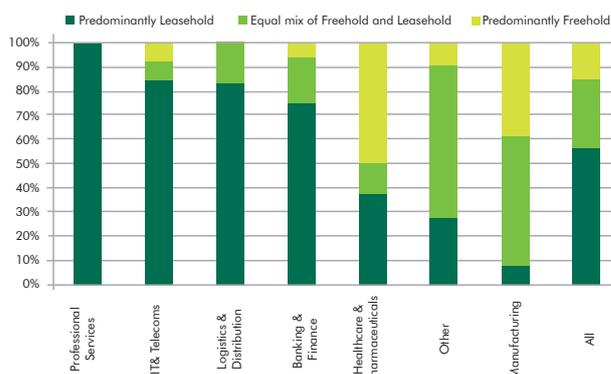
PORTFOLIO MIX AND MANAGEMENT

Across the sample, just under 60% of the companies surveyed occupy predominantly leasehold properties, 28% an equal mix of freehold and leasehold and 15% predominantly freehold. However, the survey highlights notable variations by sector.

For example Professional Services, IT & Telecoms and Banking & Finance companies have predominantly leasehold portfolios, in contrast to Manufacturing and Healthcare & Pharmaceutical firms, which tend to own a significantly higher proportion of their real estate portfolios. This is likely to reflect the need for more specialised assets, such as production plants, and a desire for ownership of the supply chain.

Looking ahead, the prospective changes to lease accounting standards will undoubtedly have some bearing on tenants' decisions on whether to rent or buy their space.

Portfolio composition varies with sector



By eliminating the distinction between operating and finance leases and requiring companies to recognise all their leases on their balance sheets, the new proposed regulation may reduce some of the advantages of leaseholds and encourage companies to reconfigure their portfolios. The new rules are not expected to come into force until 2013 at the earliest – there is no evidence yet of a wholesale shift in tenure preferences, but there certainly are indications of companies paying much greater attention to the collection and scrutiny of data on lease liabilities and lease administration.

Reporting Lines

The reporting lines of the Corporate Real Estate function remain somewhat mixed, but the largest single category is a reporting line to Finance, which accounted for 43% of the respondents compared to around a third last year. This stronger alignment of CRE with Finance reflects a more proactive approach to cost management, a far greater focus on compliance and financial control and a growing culture of CRE deals being finance-driven.

“As corporates have looked to become more pro-active on cost management, reporting lines into Finance departments have become more prevalent. Likewise, deal metrics are becoming more streamlined and sophisticated.”

Budgetary Controls

Arrangements for the control of real estate approvals and budgets are also highly variable. While around half of the respondents report that total control of real estate budgets is vested in the CRE team, for a further 43% the CRE team has just an advisory support function but no budget control.

The increasing geographic and functional complexity of major international companies is leading many to adopt a flexible ‘hybrid’ approach to best practice, in which the budget platform is centralised but execution is adapted locally to reflect different standards and practices.

Real Estate Service Procurement

This complexity is also reflected in evolving approaches to buying real estate services. Companies are learning fast about what platforms are most effective for the execution of real estate strategy. Many are both driving consolidation at the top of the supply chain - for efficiency and compliance reasons - and seeking to preserve their ability to adapt purchasing at local level across complex and emerging markets.

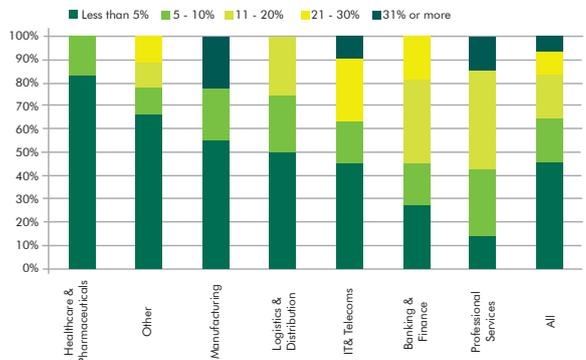
As a result, there are often multiple (and fluid) processes in operation, encompassing the twin goals of efficiency and flexibility. Reflecting this dual approach, the term ‘glocal’ is one we expect to hear more and more.

“One manifestation of this is that we are seeing the emergence of a growing need for an ‘integrator’ role, through which a primary global supplier is appointed to oversee multiple services. This generally involves co-ordinating and synthesizing multiple data streams and portfolio metrics, as well as advising on the development of global strategic plans and real estate standards.”

COSTS AND COST REDUCTION INITIATIVES

The need to control costs, including real estate, continues to exert significant influence on corporate strategies and business planning. The survey showed that real estate represents under 10% of the total costs for 65% of the respondents. This is true for the majority of Healthcare & Pharmaceutical companies. At the other end of the scale, 16% report that real estate costs account for over 20% of their cost base. This is the case for nearly 40% of IT & Telecoms firms interviewed.

Real estate as proportion of total cost

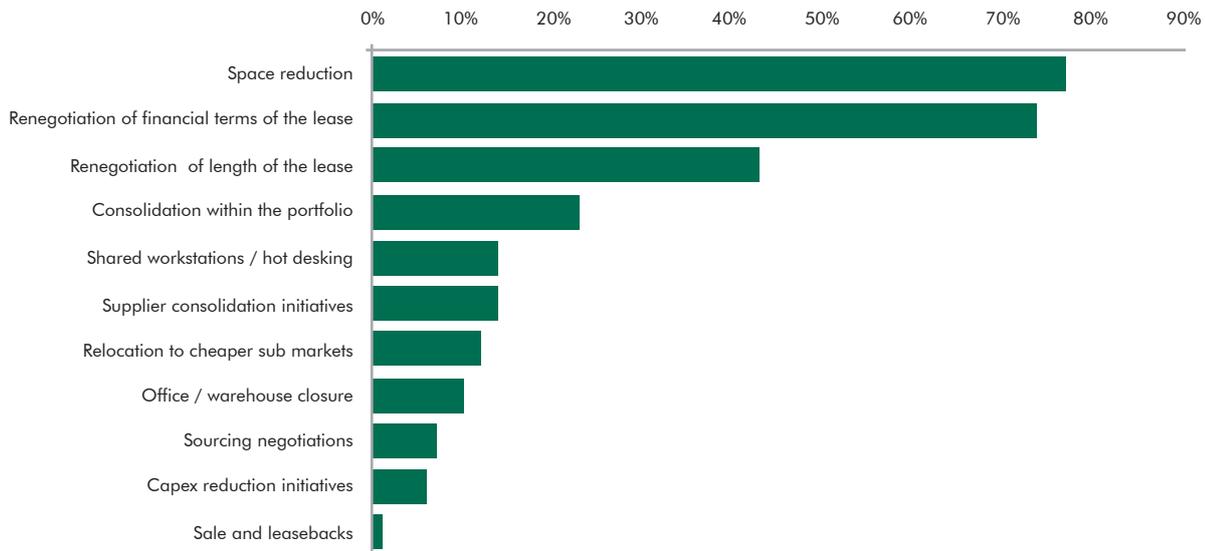


The survey showed that an overwhelming majority (88%) of companies surveyed have implemented some kind of real estate cost-reduction programme over the past two years, similar to last year’s result. It is notable that those organisations with centralised control of real estate were far more likely to have pursued such initiatives than firms where real estate decisions are mainly controlled by local businesses (93% against 67%).

The most common cost-saving approaches were reductions in space occupied (77%); renegotiation of the financial terms of the lease (74%) and renegotiation of the length of lease (43%). In all three cases, the proportion of respondents who have adopted these measures was higher than last year. Consolidation within the portfolio was also a popular approach (23%), but none of the other options attracted a response of more than 15%.

“It is no coincidence that the top cost-reduction initiatives are all things that are in the control of the real estate team. Other approaches, as well as being more remote from the CRE function, are often more difficult to implement.”

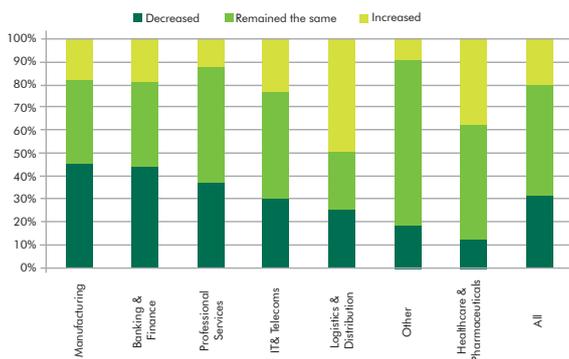
Main cost saving initiatives



Despite the high proportion of companies having adopted some cost-reduction initiatives in the past two years, around 20% of respondents actually reported an increase in their real estate costs. Some companies have pursued a ‘flight to quality’ policy during weak market conditions and/or renegotiated higher rents in exchange for more flexible lease terms, part of a more general emphasis on extending the life-cycle of capital investments.

Less than a third of respondents indicate that costs have decreased, compared with over 50% in the 2010 survey. Banking & Finance and Manufacturing firms appeared to be most successful at this task. By contrast, a relatively small number of the Healthcare & Pharmaceutical companies surveyed saw their real estate costs decline, and nearly 40% actually saw an increase. This is likely to reflect higher running costs of production space, and limited scope to trim costs on highly-specialised freehold buildings.

Evolution of real estate costs by sector



Extended cost-reduction programmes, however achieved, often plateau. Companies’ limited success in reducing their real estate costs therefore reflects the fact that ‘quick win’ savings have often been exhausted and, consequently, the pace of progress on year-over-year cost savings is slowing.

It also suggests that, as markets and corporate health have begun to improve, the focus has been gradually shifting away from pure cost-containment to a more balanced approach aimed at reconciling outstanding cost-control issues with planning for the future growth of the business.

“With the economic recovery still fragile, cost containment is clearly still a key driver for many corporates but it is not the exclusive and over-riding priority that it has been for the last two years. In part this is because the ‘quick wins’ have already been implemented and it is becoming harder to identify further cost-cutting measures that do not jeopardise business stability. More positively, we have detected a renewed focus on planning for future growth and investment which is starting to erode the focus on cost-reduction as the prime business driver.”

MERGERS & ACQUISITIONS

In answering the question “to what extent do you think M&A activity will affect demand for real estate over the next two years?” 29% responded “quite significantly” and 23% “very significantly”. Of the remainder, only 13% responded “not at all”. While this may reflect the anticipated real estate impact of corporate acquisitions that have already been completed, it clearly also reflects a view that future M&A activity will have a noticeable impact on the demand for real estate. Corporate growth strategies are likely to be underpinned by strategic M&A activity, targeting new geographies, products and services and a greater penetration of existing market segments.

Although the economic recovery remains fragile, many firms - particularly the ‘early movers’ who cut costs decisively in the initial stages of the downturn - now have stronger balance sheets and are looking to make strategic acquisitions, grow market share or enter new markets.

M&A can have a significant impact on corporate business activities, staffing levels and, consequently, on property

needs. CRE's ability to assess these needs and to allocate resources quickly and effectively can contribute significantly towards the successful execution of M&A transactions. Conversely, if unaddressed, these issues can adversely impact the operational efficiencies and other synergy benefits identified at the outset of M&A activity.

EXPANSION AND RELOCATION PLANS

Although corporate confidence seems to have improved and growth has reappeared on corporate agendas, many companies remain cautious about expanding.

The survey shows that just under 60% of the sample is considering any expansion between now and 2016 (55% in 2010). The majority of those considering expansion expect it to happen this year or in 2012, with only a small proportion (4%) expecting to do so between 2013 and 2016. This probably reflects the difficulty of formulating longer-term expansion strategies rather than genuine reluctance around prospective moves.

The survey reveals that Logistics & Distribution companies were the most likely to consider expansion, followed by Healthcare & Pharmaceuticals and IT & Telecoms. By contrast, over half of the Banking and Finance firms in the sample admit they are not envisaging any expansion of business over the considered time horizon. Interestingly, nearly half of Banking & Finance firms seeking to expand, expect to do so after 2013.

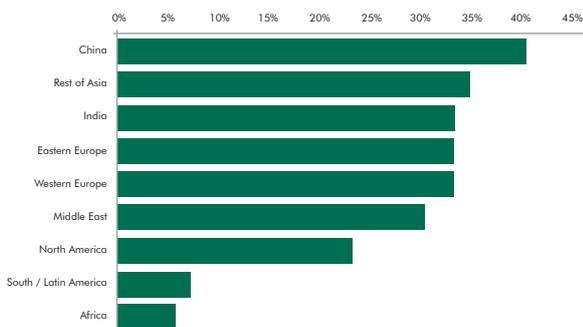
As was the case last year, office space is the most commonly-identified candidate for expansion (42%) followed by manufacturing (19%), R&D (17%) and distribution (16%).

In relation to the expansion locations, fast-growing Asia clearly represents the destination of choice for the majority of respondents. China in particular was the most popular choice (41%) followed by the Rest of Asia (i.e., Asia ex China and India, 35%) then India and Eastern Europe (each 33%).

With emerging markets driving global growth, companies are aware that the long-term growth of their business is increasingly a function of their ability to penetrate and establish themselves in those fast-expanding markets.

With regards to intentions for relocation (as opposed to expansion) nearly a third reported that they were considering relocating business units to another country in the next 12 months, and just over 40% in the next 12-24 months. The survey shows that IT & Telecoms firms were more likely to consider relocation over this period than any other sector.

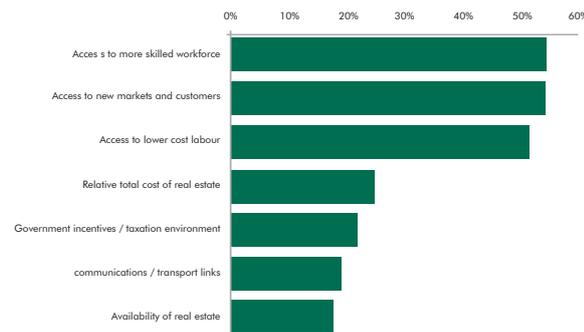
Expansion to which global region?



Again, China (34%), the Rest of Asia (34%), Eastern Europe (31%) and India (31%) occupy the top spots in the ranking of the preferred destinations for relocation.

As to the main reasons for considering relocation, whereas in last year's survey access to lower cost labour was the predominant factor, this year it is relegated to third place in favour of access to a more skilled labour force (54%) and access to new markets and customers (54%).

Reasons to relocate



Again this may be indicative of a more expansionary mindset among some corporates, and higher rates of labour productivity in offshoring locations, as opposed to an exclusive focus on cost-reduction. By comparison with the main determinants of locational decisions – many of which are related to labour and product markets – the cost and availability of real estate are very much second-tier factors, along with infrastructure and government incentives.

Relocation drivers tend to vary quite significantly across sectors. The desire to secure skilled labour is particularly strong among high-added value and human capital-intensive industries such as Banking & Finance and Healthcare & Pharmaceuticals. Perhaps unsurprisingly, Manufacturing firms identify access to lower labour costs and the possibility to gain access to new markets as the key priorities when relocating.

Experience suggests that most relocation activity continues to be off-shoring of operations from core locations to new emerging markets. As the survey

indicates, this process is far from being exclusively driven by cost considerations and has, to a greater extent, concerned movement of R&D and other specialist operations. In addition, many companies are adopting a 'follow the sun' approach for back-office functions, whereby they site each regional hub in a location that takes advantage of labour pools providing the ideal language, industry and technical skills required.

More broadly, locational decisions for different functions increasingly need to be rooted in good fundamentals of access to skilled labour and growing markets, and not just by cost minimisation. While expansion confidence is growing in the corporate community, it is a highly-targetted activity and so it is important to understand the drivers and consequences in each case. We are noticing more businesses balancing the benefits of relocation to cheaper locations against potential risks in terms of customer service and key staff retention which, in some cases, lead them to move to or stay in core markets. Companies are becoming a lot more judicious in deciding how best to distribute their various functions, and taking great care to safeguard the most business-critical services which, in many cases means locating them where support factors such as key staff are most plentiful.

GREEN BUILDINGS

The survey reveals that well over half (60%) of the respondents would be prepared to pay more for an environmentally-friendly ('green') building. This proportion is roughly unchanged compared to last year. In the same vein, over 90% reported that environmental specifications are either "quite important" or "very important" factors in building selection.

There has been a view that the importance of sustainability issues had diminished or disappeared as a result of the recession. These results and other indications suggest that this is not the case, but that the green agenda needs to find its place in the spectrum of locational and building-selection factors. Corporates are becoming more informed on these issues, and capable of assessing the benefits of different green features through improved operational efficiency, cost savings and life cycle optimisation, alongside established CSR motives.

VACANCY

Vacancy rates within companies' European portfolios are under 5% for half of the sample and between

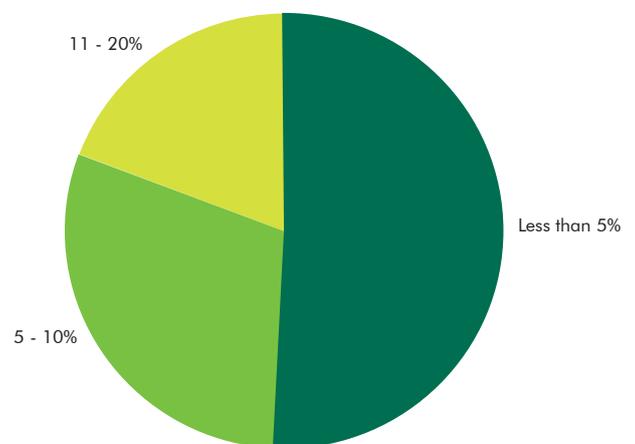
"Sustainability issues are clearly influencing corporate real estate behaviour but to highly varying degrees in different situations. Reputational standing counts, so size and profile are important: large companies taking pre-lets or new build-to-suits are more likely to prioritise green aspects over other factors than are small companies renewing leases."

5-10% for a further 30%. Nearly 20% have vacancy rates of between 11-20%, but in contrast to last year, none reported vacancy rates of over 21%.

This suggests that corporates, helped by the general improvement in business conditions, have experienced some success in reducing voids over the past year. This view is also corroborated by the fact that 84% reported that vacancy had not risen in the past year and only 16% saw an increase in voids, against 36% last year.

This change may be the result of the extensive use of space reduction measures on the part of companies, the growing emphasis placed by CRE teams on right-sizing and optimisation of corporate real estate portfolios and the fact that some corporates have begun to re-hire. Equally, differences in definition and interpretation of the term 'vacancy' among different respondents may be a factor.

Vacancy as a % of corporate RE portfolios



CONCLUSIONS

Companies' approaches towards real estate vary from one sector to another, reflecting industry-specific dynamics and different property requirements. However, the survey shows that, regardless of the sector in which they operate, corporates continue to see real estate as important source of cost-savings in the current economic climate, although they have not been uniformly successful in reducing costs.

At the same time, evidence suggests that occupiers' emphasis on costs is gradually diminishing in favour of strategies aimed at supporting longer-term growth of the business. Balancing these two imperatives is now a key challenge. The survey also found that corporates' approach to buying real estate services is changing as global organisations are quickly moving towards more complex procurement models that best serve their strategic business objectives. In many cases this is driving consolidation at the top of the supply chain for efficiency and compliance reasons, combined with a desire to preserve the ability to adapt purchasing at local level across complex and emerging markets – and a growing need for an 'integrator' role to oversee these processes.

Corporates increasingly recognize the importance of effective real estate management in their business strategies and are learning quickly and developing real estate approaches that enable them to rise to the challenges posed by a rapidly-changing economic and business environment. This in turn is heightening the focus on the collection, management and quality of key data and portfolio performance metrics, and is also reflected in the stronger linkage between CRE teams and Finance departments.

HOW THE SURVEY WAS CONDUCTED

A total of 81 companies were covered in the survey, compared with 75 in the survey reported last year. The denominator used to calculate the percentages reported here was not always identical, as it reflected the pattern of responses. This is mostly relevant where those who answered "no" or "don't know" to a general question were excluded from analysis of specific follow-up questions. For example, 12 respondents reported that they had not implemented a cost saving programme over the past year or preferred not to state. The analysis of the most popular specific cost-saving measures was therefore based on the 69 respondents who had.

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