Opportunities for Action in Infrastructure and Real Estate

Building Flexibility into Corporate Real Estate

THE BOSTON CONSULTING GROUP
Corporate real estate was once straightforward: identify good locations, negotiate long-term leases, and cut occupancy costs. Those days are over. New conditions now apply.

Managers find that steady-state projections of their facility needs are quickly made obsolete by new technologies and organizational changes. Executives recognize that occupancy decisions, once seen as ancillary to the core business, can have a significant impact on a company’s financial performance. Boards are becoming aware that if their company’s footprint is misaligned with its operating needs, harsh penalties may ensue through asset write-downs and space shortages that impede competitiveness. Investors, who have grown skeptical of the idea that companies can simply grow their way out of suboptimal sites, are favoring a more cautious approach to managing assets, margins, risks, and returns on invested capital. Accordingly, companies must abandon their traditional approach to managing real estate holdings as fixed assets.

The quick pace of change and the high cost of faulty predictions dictate that companies build more flexibility into their real-estate portfolios and decision processes. They can use a variety of financial and physical tools to increase flexibility, such as shorter leases, frequent lease breaks, options on adjacent space, and modular build-outs. However, flexibility always comes at a price—usually in the form of higher lease rates, build-out costs, churn rates, and the like. Moreover, the pricing picture is clouded by a complex, deal-driven real-estate supply chain that rewards transactions more than long-term value creation. To achieve flexi-
ility that lasts beyond the lease, companies must take a strategic approach to both evaluating their current choices against inherent real-estate risks and calibrating the appropriate degree of additional flexibility.

In short, companies would do well to think of real estate as a flexible resource and—in the mode of financial strategists—as a financial option that can be used to hedge against future adverse scenarios. This conversion presents a twofold challenge: for corporate real estate (CRE) groups, it means revising their portfolio strategies; for senior management, it means reevaluating the strategic and financial significance of the company’s real-estate holdings.

To fashion a flexibility-based strategy, CRE and finance executives should

- focus on building flexibility into all decisions about CRE
- understand that flexibility comes at a price
- recognize that flexibility is rooted in probabilities and life cycles

**Focus on Building Flexibility into All Decisions About CRE**

In negotiating for new office or commercial space, real estate executives should prepare for unexpected growth or contraction in the business units and corporate functions that will occupy the facility. In The Boston Consulting Group’s 2005 CRE benchmarking study, 41 percent of real estate executives said that business unit projections of space demands are typically off by more than 100 percent. Such discrepan-
cies result from a combination of new business launches, shifts in underlying market demand, and inaccurate forecasting methods.

The value of flexibility in CRE depends on how quickly changes are carried out and how much of a company’s real-estate portfolio is affected. (See Exhibit 1.)

### Exhibit 1. The Value of Flexibility in a CRE Portfolio Depends on the Time Available for Planning and Execution and the Amount of Affected Real Estate

<table>
<thead>
<tr>
<th>Predictability</th>
<th>Traditional</th>
<th>Time variable</th>
<th>Amount variable</th>
<th>Time and amount variable</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Amount</strong></td>
<td>Amount: very predictable</td>
<td>Amount: very predictable</td>
<td>Amount: very unpredictable</td>
<td>Amount: unpredictable</td>
</tr>
<tr>
<td><strong>Special characteristics or catalysts</strong></td>
<td>Incremental growth</td>
<td>Required regulatory approval</td>
<td>Technological disruption</td>
<td>Most in line with today’s business environment</td>
</tr>
<tr>
<td></td>
<td>Little divergence between minimum and maximum needs</td>
<td>Pending lawsuit</td>
<td>Increased M&amp;A activity</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Planned acquisition</td>
<td>Offshoring and outsourcing</td>
<td>Offshoring and outsourcing</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Upcoming cost-reduction initiative</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Value of flexibility</strong></td>
<td>Low</td>
<td>High</td>
<td>High</td>
<td>Very high</td>
</tr>
<tr>
<td><strong>Primary techniques to create flexibility</strong></td>
<td>Limited use of such techniques</td>
<td>Expansion options</td>
<td>Short leases</td>
<td>All available techniques</td>
</tr>
<tr>
<td></td>
<td>Multiple expiration dates</td>
<td>Early lease termination</td>
<td>Maximum ability to sublet</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Modular design</td>
<td>Expansion options</td>
<td></td>
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</tr>
</tbody>
</table>

**Source:** BCG analysis.
There are many ways to create flexibility, including

- acquiring options on adjacent land for possible future expansion

- allowing for a higher vacancy level in order to accommodate unexpected growth

- analyzing the downside risks to both the income statement and the balance sheet of various real estate scenarios, such as leasing versus buying

- entering into shorter leases with more frequent and earlier termination, expansion, and renewal options

- coordinating the end dates of leases, subleases, and exit clauses of adjacent spaces

- designing facilities for reuse, subdivision, and sublease with minimal customization

- exploring alternative workplace arrangements, including home offices, telecommuting from non-company locations, and shared-office programs

One leading financial-services company is using a combination of these techniques. In 2003 its average lease term was 17.5 years; it is now negotiating three- to five-year leases and adding lease breaks and extension clauses. Longer-term leases can still work, provided the facility is designed for easy subdividing and subleasing. But when negotiating long leases, real estate managers must consider the probability that the company will need to replace one occupant with another over time. They must also analyze the potential volatility in real estate market conditions over the life of the lease.
Understand That Flexibility Comes at a Price

Executives need to be prepared to pay more in order to create flexibility. In corporate finance, options are often used to achieve this goal. The price of an option, according to the Black-Scholes model, increases with its anticipated volatility. The corollary for CRE is that the greater the uncertainty in real estate requirements, the more willing the company should be to purchase advance rights to change its footprint, build-outs, and financing terms. The idea is not to spend more on improving and converting a facility over its life. Rather, much like buying an equity option as a hedge, the CRE buyer pays somewhat more up front to guard against unexpected swings in the future.

Higher costs are associated with shorter and non-standard leases, with build-outs that create easily reusable space, with options for expansion space, and with higher near-term vacancy rates. For one company, lease negotiations are managed like new car purchases: establish a base price and define a wide array of options for which the company is willing to pay a premium, depending on the degree of flexibility it needs. By understanding the variability of a company’s needs, CRE managers can make intelligent decisions about what they are willing to pay. In volatile times, the up-front costs are small relative to the hidden operational costs of having too little or too much space or the wrong type of space.

The challenge for real estate executives is to persuade senior management that fixating on today’s costs often produces much higher costs tomorrow. The task is doubly difficult because the “savings” from avoiding adverse events in the future may not accrue during the tenure of a company’s current managers. But the traditional approach to managing CRE as a fixed asset or
a series of one-off leases has manifold hidden costs. For companies with too much space, lease termination costs often equal or exceed the full value of the remaining lease. And the focus of many architects and developers on creating “curb appeal”—expensive embellishments intended to make speculative buildings more marketable—can backfire if they skimp on functional elements that improve utilization and cost effectiveness. When the novelty of odd shapes and trendy features wears off, new occupants may require substantial reconfigurations as well as shorter leases, generating heavy expenses for the developer-owner. Those who later must sell or lease out such buildings because of unforeseen changes in occupants’ space requirements may lose the excess amount spent on opulent headquarters and customized build-outs.

But the reverse can be worse. In a just-in-time, war-for-talent economy, insufficient infrastructure can cause serious business disruption, forcing divisions to relocate unexpectedly and individuals to work in suboptimal sites. The sanctions for such inflexibility, which can run to hundreds of millions of dollars or more, may dwarf the gains from carefully managing occupancy costs across the rest of the portfolio—and also produce unintended reductions in productivity, recruitment, or retention rates.

Flexibility is essential because structural changes from M&A, offshoring and outsourcing, technological innovations, and regulatory scrutiny can quickly overwhelm growth projections. A blue-chip company builds its state-of-the-art headquarters, only to merge with its largest competitor. A financial institution negotiates a 15-year lease for a call center and then shifts the entire function offshore. A retailer spends years shoring up its core business, only to be acquired for its real estate. And a high-tech manufacturer expands its plant after winning a crucial contract,
only to lose the business to a foreign competitor when
the contract is rebid. Global competition can create
or destroy carefully crafted product-market strate-
gies—in months. Shorter business cycles—extending
from one to five years—are the “new normal.” Real
estate strategies that assume straight-line growth rates,
incorporate 10- or 20-year leases, and disregard exit
clauses no longer match the businesses they support.

The lesson is clear: in CRE, form should always follow
function, and function should be defined with great
flexibility. One powerful way for real estate executives
to frame the discussion about flexibility and costs is to
take a life cycle view, suggesting analogies to options
pricing, as discussed above, and creating net-present-
value scenarios for real estate commitments (which
we discuss in the following section). The challenge
for senior leaders is to consider how the company’s
real-estate portfolio fits into its overall strategic plan.
Much as business strategists increasingly embrace
uncertainty and unpredictability in their planning for
the future, real estate executives must persuade
senior managers to support nimble choices for loca-
tions, layouts, leases, and overall network configura-
tions to fit the new competitive conditions.

**Recognize That Flexibility Is Rooted
in Probabilities and Life Cycles**

More flexibility is intuitively better than less flexibility.
But how much flexibility should a company buy—and
at what price? Is an early termination clause worth a 1
percent or 5 percent lease premium? What should the
company pay for an option to purchase contiguous
space? The best way to answer these difficult questions
is to understand the financial and operational costs
of both overestimating and underestimating real es-
tate needs.
Economists and financial experts have developed many tools to sort through uncertainty in other contexts. Net present value, standard deviation, and probability analyses can help shape real estate decisions. But even more than it needs such tools, an organization needs the strategic capability—and the will—to break from the past. By relentlessly decreasing operating costs per square foot year after year, regardless of how the business might change in the future, real estate executives may be undermanaging one of the largest assets on the corporate books. They may also be missing an opportunity to engage with top corporate executives about the strategic importance of real estate decisions.

Exhibit 2 depicts four scenarios for a hypothetical CRE portfolio and the significant differences in the timing and amount of space required under each. The first scenario shows a traditional approach, in which the business plan projects increasing space needs in a straight line over time. The other scenarios are more in line with today’s reality: businesses may be uncertain of when their space needs will change, what space they will need at a given time, or both. The traditional approach builds in little flexibility, which can create problems if business projections do not come true. In the other three scenarios, recognizing uncertainty allows a company to build in the flexibility it will need to increase or decrease space. In essence, businesses with greater uncertainty in their real-estate needs should place a higher present value on obtaining real estate flexibility.

* * *

To build sufficient flexibility into their portfolios, most CRE organizations will need to devote a significant amount of time and effort to prepare for the unexpected. Real estate executives should rely less on expe-
Exhibit 2. The Need for Flexibility Depends on a Company’s Space Requirements

Source: BCG analysis.

Note: The shaded areas represent the potential flexibility of each hypothetical scenario.
rience and intuition—honored as their instincts may be—and more on portfolio visualization, life cycle analyses, and the other proven techniques of long-range strategy. They should start viewing themselves as strategists, collaborating with senior managers and business unit leaders to understand and plan for upcoming challenges. Some real-estate organizations may need new people, from both inside and outside the organization, to institute these new principles.

In the days when real estate managers kept to a traditional straight-line course, the message of “strategy over tactics” could be ignored with a minimum of risk. But that time is gone. The message has become a mandate. If your organization is still resisting it, you now face substantial risk.

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