



Portfolio Optimization 2020

Responding to New Corporate Real Estate Demands in 2020 and Beyond

As companies across the globe begin to plan and implement a Return to Office (RTO) program, many are left wondering what our work life will look like going forward. There is a widely shared belief that things will be different, but we are far from a consensus on which lasting impacts will shape how and where we work.

Social distancing and personal protective equipment (PPE), not even in our vernacular just four months ago, may change space requirements and possibly even building codes in the months ahead. Remote work has sky-rocketed and most RTO programs will include a mix of options encompassing remote work, shift work and increased physical distance between occupied workspaces.

As new programs are tested and rolled out, employers will be faced with an office portfolio that is misaligned with their actual demand for space. At the same time, booming real estate markets across the country are now anticipated to experience a downturn with vacancy rates climbing while rental rates and valuations decline. Once immediate operational and human resources needs are met, employers will need to pivot to rationalize their long-term real estate costs.

While the changes around us are significant, many of the new demands facing real estate professionals are a continuation of trends that first took root 20 and 30 years ago. If we employ the tried and tested discipline of portfolio optimization, we will be well prepared and capable of delivering safe, productive and financially viable workplaces.

Portfolio Optimization

Portfolio optimization strategies anticipate and respond to any number of changes in internal and external real estate drivers and identify the most effective and efficient path forward. In this white paper, we examine how portfolio optimization strategies can enable employers to manage and leverage changes happening across four key areas in the current environment.

A portfolio optimization strategy starts with defining a desired end state and then creates a roadmap to get from the current to the target state. The end state is envisioned by integrating business, financial and human resources strategies along with a variety of other factors including how and where work gets done. The roadmap leverages portfolio-wide real estate contractual positions relative to local real estate market conditions in order to drive change.

Real Estate Market Demand Drivers



While the long-term impact of the pandemic on real estate markets is unknown, there is generally consensus that net absorption of office supply will go negative and rental rates will decline. From an occupier perspective, real estate market downturns provide several levers for optimization.

Above Market Leases with Term Remaining

If you have leases with years remaining at above market rental rates, a lease restructuring tactic called a “blend and extend” may be a viable option. A blend and extend trades a commitment for a longer lease term (which the landlord may find attractive) for the opportunity to re-amortize above market rent over the new term. A blending of the current contractual rental rate with the lower current market rate unlocks an immediate cost reduction without needing to wait years for the lease to expire and having to roll the dice on what market rents will be in the future.

Above Market Leases with Upcoming Expirations

If you have an above market lease with a near term expiration date, this puts you in the proverbial “catbird seat” as a tenant. You can renew at a lower rental rate, relocate to a lower cost location and/or leverage your position to contract your footprint or demand other concessions from your landlord if you decide to stay. One note to consider is that relocations come with a switching cost to construct and furnish new space. The scales generally tip in favor of relocation if a move enables a square footage reduction and/or a lease renewal would also require a major space renovation in any event.

Real Estate Market Drivers



Changes in real estate market conditions that create new leverage for making changes to a real estate portfolio in a timely and cost-effective manner.

Location Strategy



Selection of physical locations that optimize access to talent, customers and other factors of production.

Remote Work



On-going program allowing certain employees to work from home (or other locations of their choosing) either some of the time or all the time.

Space Design



Construction, furniture and space usage protocols that meet business and operational needs.


Below Market Leases with Upcoming Expirations

If you are currently in a lease that is due to expire with a rental rate below market, you may want to consider offsetting an increase in rate by reducing your space volume or trading down to a lower cost location. If you find yourself in this situation after rental rates have come down – at a minimum you will enjoy the benefit of a cost increase less than it would have been if the market were still at a peak rental rate.

Owned Assets

If you are an owner-occupier, a down market may not be the time to sell or even to lease excess owned space to third parties. However, if you consider your owned asset as core to your long-term portfolio, then shedding leases and consolidating into your owned asset can deliver significant savings. If your owned asset is non-core and you want to consider an exit, then a sale-leaseback can leverage your own tenancy to create an attractive income stream for an investor. By paying market rents in what was formerly your owned building rather than other leased assets, you can maximize sale proceeds and also set the foundation for an exit in the future when the resulting lease contract expires.


Location Strategy

 Another factor in your portfolio plan is location strategy; the selection of geographic locations that optimize access to talent, customers and other factors of production. Location strategy should drive the identification of a new location, the decision of which location to close across several options housing the same function, as well as a holistic balancing of your entire portfolio's geographic footprint.

Geography can play a big role in acquiring and retaining appropriately skilled workforce at the right price. Other factors include community presence, client reach, access to suppliers, time zone coverage and business continuity planning, just to name a few. From a financial standpoint, portfolio strategies involving shifts in geography should factor in labor costs and economic incentive opportunities in addition to real estate.


Richard Florida, a leading urban studies theorist, predicts a residual fear of public transportation after the pandemic could result in more cars on the road and in our parking garages. Florida also predicts that some portion of the labor force may avoid cities which could spark increased growth in the suburbs. Conversely, Florida also cites an increased demand for live/work/play centers and walkable/bikeable living among the younger demographic, which may thwart a mass exodus from urban centers. How will your company's workforce be impacted and how will your real estate portfolio accommodate them?

Remote Work

 It has been reported that up to 20% of the US workforce is currently working from home – nearly a 300% increase from pre-pandemic estimates. Employees and employers who were not participating in remote work prior, have now been plunged into a forced experiment with some surprising outcomes. Many have been pleasantly surprised at how productive remote work has been. Others have struggled with obstacles such as lack of a conducive physical work environment at home or attempting to work while caring for young children or elderly parents.

While there is no “one size fits all” solution that works for every company, employing a holistic strategy from a foundation of existing industry best practices is a winning formula. Engaging a consultant to help design and implement your long-term remote work program is an effective way to gain immediate access to the best remote work solutions that have already been tried and tested.

Space Design

 Remote work may decrease the need for office space while, on the other hand, social distancing requirements may increase the allocation of square footage per seat. Industry experts are predicting outcomes ranging from a sharp reduction in demand to a large increase in office space demand.

The good news for tenants is that you have choice in the matter. While there are certainly external drivers that will impact the amount of office space you will need (and those drivers are moving in different directions), the physical design and furniture configuration of your office space is within your control and can move the needle up or down on the amount of space your company consumes.

Unassigned seating is a natural companion to a remote work program that could represent an important lever to offset other drivers that increase square footage needs. Changes in amount and configuration of collaborative spaces might also be re-imagined in response to social distancing needs and the rapid proliferation of highly functioning remote collaborative technologies. As new space design solutions are developed, disinfecting and air quality will be elevated in priority.



Agenda
Setting



Baseline
Assessment



Scenario
Modeling



Recommendations



Implementation



Refresh

Creating a Portfolio Optimization Strategy

Every portfolio optimization plan should follow six basic stages.

1. Agenda Setting – Strategy starts with well-defined objectives. Engage key stakeholders and identify “critical to quality” (CTQ) expectations and target business outcomes; gain alignment on scope and key demand drivers, for example:

- a. Headcount forecasts - increasing, decreasing or flat
- b. Remote work and/or unassigned desking programs – in scope or out of scope
- c. Space design changes and density targets
- d. Shift in geographic locations
- e. Building class migrations (e.g. city to suburbs, Class A to Class B etc.)

2. Baseline Assessment – A baseline assessment will illuminate the gaps, opportunities and risks in your current portfolio. Gather standard metrics including cost per person and square foot, vacancy rates, utilization rates and square feet per seat. Aggregate these metrics as well as your unique business CTQs to shed some light on where to focus your strategy.

3. Scenario Modeling – Creating scenarios to improve your portfolio will leverage contractual and market opportunities and align them with your needs.

Define scenarios: Aim your spotlight on a short-list of the most viable options. After brainstorming a more exhaustive list of scenarios, rule out those that are clearly sub-optimal without needing to “do the math.”

Model scenarios: Scenario modeling should include a holistic financial analysis that calculates the cashflow, GAA and after-tax impacts of each scenario including on-going costs as well as one-time costs and write-offs. Summarize financial metrics and create a scorecard to illustrate how each scenario delivers against your defined performance metrics (both quantitative and qualitative).

4. Recommendations – Throughout the scenario modeling process, socialize proposed scenarios with key stakeholders to gain alignment. Next, package final recommendations into a formal strategy and business case to be presented to your approving executive or leadership committee.

5. Implementation – The implementation of your portfolio strategy will be made up of some number of individual real estate transactions, renovation projects and moves that often will span several years.

6. Refresh – The final step in a portfolio strategy is knowing when it’s time to develop a new one; triggers may include changes in internal business needs, changes in external market drivers and/or substantial completion of the last portfolio optimization roadmap. Even the passing of time alone will reduce the cost of exiting a contractual obligation that may be cost prohibitive in the current planning horizon.

Balancing 2020 Portfolio Cost Drivers

A holistic portfolio optimization strategy delivers an analytical framework for balancing the scales of change and optimizing across numerous business objectives and trade-offs. If we look conceptually at changes in the current environment – we can identify real estate cost impacts driving potential increases as well as decreases.



One of the biggest obstacles companies face in creating a portfolio optimization strategy is dealing with the unknown. “How can I create a plan if I do not have an accurate headcount forecast, know how building codes will change, or know what rents will be three years from now?” and so on. However, unknowns can be effectively managed within the construct of a portfolio optimization plan. An experienced portfolio strategist will lay out a roadmap that not only identifies what can be executed now, but also specifies future implementation plans that can be triggered if and when certain conditions materialize.

If you find yourself stalled by not having all the inputs needed to create your plan, it is important to remember that doing nothing is also a strategy, but not likely the strategy that will generate the best outcome. If you do not have the necessary expertise and resources in-house to spearhead a portfolio optimization plan, consider bringing in outside expertise to help you effectively navigate uncharted waters. This investment in the future will likely deliver value at least ten-fold the upfront investment.

About the Author



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