

**THE COST OF CHOICE:**  
*How Corporate Real Estate Managers  
Evaluate Business Space Options*

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# **THE COST OF CHOICE:**

## ***How Corporate Real Estate Managers Evaluate Business Space Options***

**Keywords:** *Corporate real estate, office space, decision-making*

### **Abstract**

*Firms are faced with a wider set of choices when they identify a need for new office space. They can build or purchase accommodation, lease space for long or short periods with or without the inclusion of services, or they can use “instant office” solutions provided by serviced office operators. But how do they evaluate these alternatives and are they able to make rational choices? The research found that the shortening of business horizons lead to the desire for more office space on short-term contracts often with the inclusion of at least some facilities management and business support services. The need for greater flexibility, particularly in financial terms, was highlighted as an important criteria when selecting new office accommodation. The current office portfolios held were perceived not to meet these requirements. However, there was often a lack of good quality data available within occupiers which could be used to help them analyse the range of choices in the market. Additionally, there were other organisational constraints to making decisions about inclusive real estate products. These included fragmentation of decisions-making, internal politics and the lack of assessment of business risk alongside real estate risk. Overall therefore, corporate occupiers themselves act as an interial force to the development of new and innovative real estate products.*

### **Introduction**

The nature of demand for corporate real estate is changing significantly as a result of both external economic shifts and the resultant organisational change. This has recently had an impact on the way in which real estate products are being supplied and packaged within the UK market. There has however been considerable debate in the UK surrounding the disconnect between the needs of occupiers and the real estate products and related services supplied by the real estate industry. Much of the blame for this divide has been placed at the door of the providers. It has been asserted that they do not understand occupiers’ increasing need for flexibility and diversity. Real estate owners, investors and developers continue to demand long-term onerous leases, albeit now reducing to 10 to 15 years, and offer little support or service to their tenants (Lizieri *et al* 1997).

There is evidence however of change. Increasingly there is a wider range of options available to fill occupiers’ varying needs. Serviced offices, private public partnerships, and an increased array of services, even with traditional leases, are now more commonly on offer. The supply side appears to be responding to the challenge by developing new and innovative solutions.

This increased diversity however poses potential problems for corporate occupiers. Although they have called for greater flexibility and choice, they need to have the means of evaluating the options in order to make rational choices. Like any choice, the appropriate solution will differ for each organisation and each circumstance. In some instances a short-term requirement may be best met by an “instant office” solution. In other circumstances a long-term solution is required. The key is selecting the right solution for the right situation.

Therefore, if there is this choice, occupiers need to be able rationally and consistently to evaluate the options available. That requires both data and a methodology for evaluation. Without these, enlightened decisions concerning space are impossible. Although there has been some debate in the valuation literature related to the pricing of shorter leases and options such as rent free periods and break clauses (Ward and French 1997), there has been little investigation of the process by which occupiers evaluate their choices. Similarly although there has been some attempt to investigate customer needs, particularly in relation to relocation (Healey and Baker 1989, Richard Ellis 1994), there has been no attempt to clarify how decisions are made within corporate occupiers.

This paper considers the question: *Are occupiers currently in a position to make rational decisions when faced with a wide and diverse range of choices?* The paper draws on the research findings from a study that took place during the autumn of 1999 and early 2000 which examined how occupiers make their choices. This paper will first consider the aim and methodology of that study. This is then followed by the key ideas and concepts related to both cost and choice which underpinned the work. The results of the research are presented in the following three sections. The paper is then concluded with a final section which draws together the key findings and makes some observations about the implications for both occupiers and suppliers of office space.

### **Research Aim and Methodology**

The aim of the research was to gain a greater understanding of the way in which occupiers estimate their requirements and assess the options available. In order to gain insight into the decision-making process, a number of aspects were examined. First, an understanding of the forecasting horizons related to the demand for office space within organisations was investigated. The notion was to link this to the way real estate is procured within the UK market and to consider the potential for disconnect. Secondly, any decision about a future requirement will be influenced by the current situation within the organisation. Therefore, the information available on occupational costs for the existing office portfolio was examined in order to gauge the general awareness of total occupancy costs. The final element considered was the process of evaluating new office requirements, examining both the general and financial criteria used in the final selection.

The research was undertaken in two stages. First, a questionnaire survey was conducted by telephone interview during November and December 1999. The interviewees were mainly (79%) individuals who were responsible for corporate real estate within their organisation with just under a quarter having responsibility for facilities management as well. In total 48 individuals agreed to participate from a total of 215 contacted resulting in a response rate of 22%.

The survey respondents mainly came from types of organisations where office space was likely to account for a very high proportion of their total occupational portfolio. In terms of sector, 45% came from the financial and business service sectors and 14 % from the IT, technology and telecoms sector. Just over a quarter of the respondents were from public sector bodies representing both local and central government. The respondents also represented large organisations with almost two thirds employing more than 5000 employees and over half having a turnover of more than £1 billion. In terms of their office portfolio, 63% had more than 100,000 square metres of space and for half, this was spread across 50 or more buildings or locations. Overall, therefore, the survey represented large organisations with significant

office portfolios in sectors which are office space intensive. These are the organisations which would have the most to gain from improved and innovative management of their office space and therefore should be at the cutting edge of current practice.

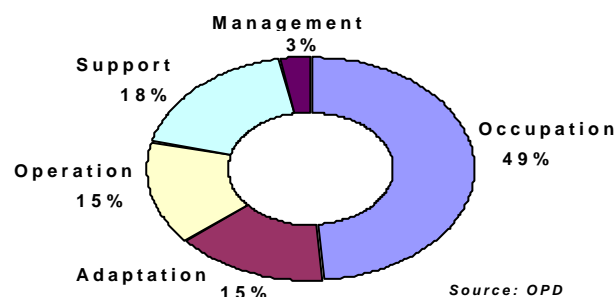
For the second stage of the research a focus group meeting took place in early January 2000 which reviewed the survey results. The aim was to discuss the validity and implications of the findings in order to gain a broader perspective of the issues. Ten individuals took part in the meeting: six from organisations which had responded to the telephone survey and four members of the research team.

### ***Understanding Choice and Costs***

During the last decade a new way of thinking about office space has started to emerge. A working environment is created by a combination of space, associated infrastructure and services. The infrastructure includes not only the fitting out of the office space but also any other generic equipment required to make the office usable such as the provision of IT infrastructure, telecoms and office furniture. Additionally the servicing of the space also needs to be considered. Both facilities management services and basic office support such as reception, reprographics and post handling must be provided. Increasingly it is recognised that, in order to understand the cost of providing a working environment, a wide range of both capital and annual costs needs to be analysed. The value (and cost) of an office portfolio to an occupier is therefore a combination of real estate plus workplace infrastructure supported by services (facilities management and business support).

This perspective of an inclusive occupational cost base is best articulated by the recently developed OPD Total Occupancy Cost Code (TOCC) (IPD 1999) which seeks to provide clear definitions for each of the key cost headings. The rationale for this development was that not only must occupiers understand their own cost base, but that they also need to be able to compare these costs with other organisations and/or against an index and by implication to help them make better decisions. To date, this has been difficult as each organisation has its own internal management accounting system which defines, collects and analyses data on different bases making comparison invalid.

**Figure 1: Estimated Breakdown of Average Total Occupancy Costs**



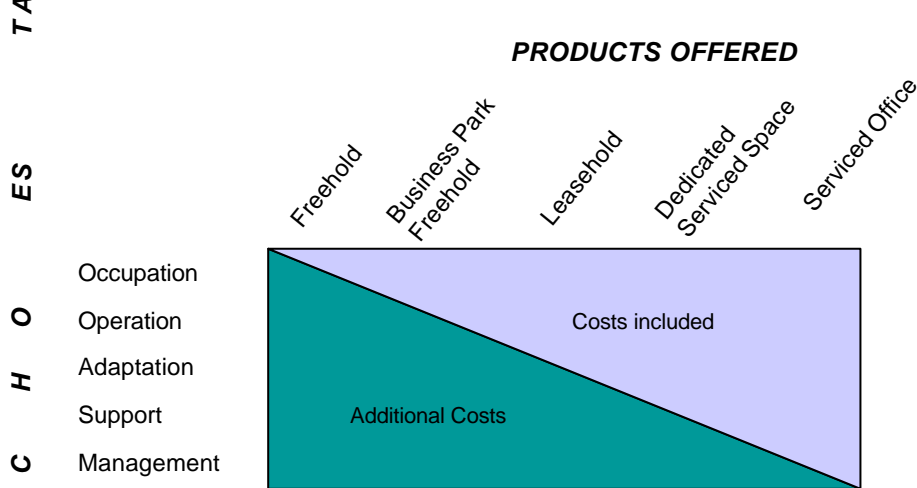
The importance of considering Total Occupancy Costs (TOC) when making real estate choices is highlighted by Figure 1. Although occupation costs (rent, rates) account for a significant proportion of the total cost, it is estimated that on average this may be only about half of the TOC. Adaptation (fit-out), running the office space and providing business support can together account for over 50% of the total.

The other issue raised by wider cost perspective is that the range of elements which need to be combined to create a working environment are likely to be controlled by a number of departments or groups within a large corporation. Additionally, the drive to focus on core competencies has led organisations to outsource some of the elements of a working environment. The traditional view has been to outsource specific functions such as office space planning and fit-out or facilities management functions. This could be described as vertical outsourcing where one or more functions are contracted out for part or the entire office portfolio. The cost of this function is therefore spread across the whole portfolio and may be difficult to allocate to a particular building.

The other situation that has emerged is the augmentation of space with some or many features and / or services. A serviced office epitomises this situation where a full package of space and service can be acquired crossing the space / service boundaries. This might be described as horizontal outsourcing. This product therefore can only be compared to a more traditional real estate solution if the additional costs related to the infrastructure, services and management are built into the analysis. In order to do this occupiers would need good quality data related to each of the elements.

The increasing range of options available to an occupier make it difficult to ensure that each alternative is being examined on the same basis. Acquiring office space can range from purchasing a freehold where all the provision of infrastructure and management would be the responsibility of the occupier to using a serviced office where a complete package is offered. This range is sometimes known as the office product-service continuum (Gibson and Lizieri 1999).

**Figure 2: Occupational Options and Costs Analysis**



The cost allocation perspective is demonstrated in Figure 2. This schematically shows which costs are likely to be included in the “price” of the product offered and which would be additional. Moving through the product-service continuum, a greater proportion of the total occupancy costs is included with the package. There is, therefore, a real danger of comparing the price per square foot or square metre of a standard lease with that of a serviced office. What is often not made transparent is that the first price excludes many of the costs that ultimately must be borne by the occupier, such as facilities management and reception, but which are included in the second. A further complication is that capital costs of equipment and furniture may not be fully taken into account when making the comparison. This may

partially be the reason why some occupiers consider serviced offices to be an expensive option. The second reason is that, in the case of a serviced office, risks have been transferred from the occupier to the provider because of the short-term commitment to, and instant availability of, the space. It is this risk transfer element which is much more difficult to price.

The overall dynamics of the relationship between the occupiers and the suppliers of space and services have become much more complex. There appears to be a wider range of new products and services being offered in the market place. Some relate to providing a bundle of services through a portfolio while others are linking the services to a specific building. If occupiers are to make sound procurement decisions about any of these new offerings then they need to have an explicit and rigorous framework for evaluating their choices. The following sections seek to examine if this is the case.

### ***Business Change and the Corporate Real Estate Portfolio***

In order to understand the broad context and key drivers for new office space, the research investigated the business planning horizons and the suitability of the current portfolio to organisation. There is a view that the search for more flexible real estate solutions is driven partly by the increasing pace of change within organisations. This therefore is the first aspect considered. Additionally, corporate occupiers are often attempting to rebalance or restructure their portfolios so that they better match their current and future requirements. This is the second aspect investigate.

### **Planning and Forecasting**

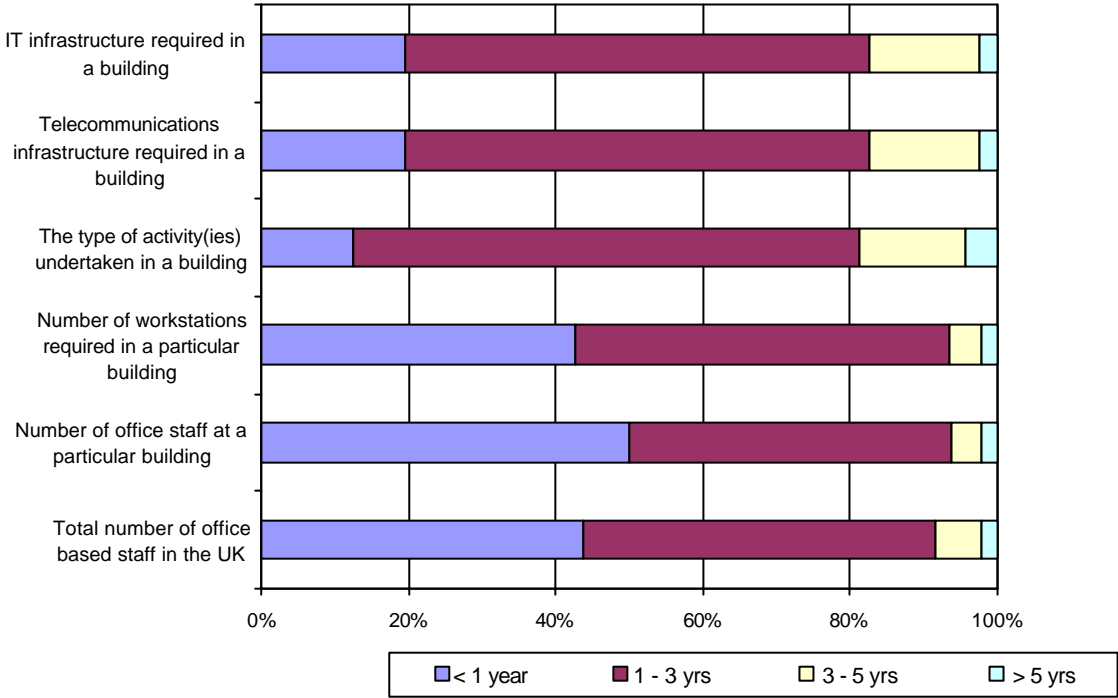
It is often contended that organisations have difficulty in projecting more than one year ahead and certainly not more than three. This was fully supported by the results (Figure 3) with less than 20% of the organisations claiming to be able to forecast any aspect more than three years. In fact between 40% and 50% of organisations were unable to forecast the number of office staff in the UK, the number of office staff in a building or the number of workstations required in a building for more than one year. This demonstrated that organisations consider that they are changing rapidly and are having to react to shorter product and business cycles, mergers and acquisitions, e-commerce and globalisation as well as wholesale corporate restructuring.

We also examined the lead-time given on recent acquisitions which showed that in just over half of the cases less than six months was available to obtain an appropriate office building. This places considerable pressure on the real estate manager as there may be little choice within the market during the acquisition period. To some degree this will depend on the criteria used to select office space, but from past research it has been found that there are often there are a limited number of options available in practice which meet the locational and space (volume) requirements at any point in time (Rowley *et al* 1997). Such pressure is typically exacerbated by the transactional and legal delays that real estate managers face in the UK. The heterogeneous and fixed nature of real estate, and the thin markets, mean that in contrast to all other factor inputs, it is virtually impossible to match requirement to product.

The focus group provided a broader perspective on this data. There was general agreement that time horizons were shortening but this varied both between and within companies. The point was made that North American and UK-based companies were driven by the associated capital markets where the performance of equities was tracked on a quarterly basis. The

individual company therefore had to conform to the importance of short-term measures of performance. On the other hand German and other Northern European companies have traditionally relied on a greater proportion of debt financing and their capital market appeared to be structured around longer-term returns. This therefore allowed the organisation to adopt longer-term planning horizons. Given that all the participants, bar one, worked for UK or US based organisations, it was difficult to tell if this was a genuine perception or a case of *‘the grass being greener on the other side’*.

**Figure 3: Forecasting Period for Components of Office Space Demand**



Even within companies there were some parts of the business which were easier to predict than others resulting in a split between a core and periphery requirements<sup>1</sup>. Another analogy was used which described organisations as *‘lava lamps with some parts of the business ascending and others falling. Each takes its property with them and that is when the adjustment is necessary. This is often hard to predict.’* Looking at the issue of time horizons appears to be more varied than one might first anticipate.

Another perspective on business change related to how that change actually takes place. It was noted that in reality companies cannot grow organically that quickly and therefore are probably not taking on significant amounts of new space. However it was also noted that

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<sup>1</sup> Corporate property portfolios can be divided into core and periphery space. The core space would be held long-term but the organisation would need functional flexibility to alter it to the current business needs. The periphery space would be shorter term with financial flexibility being most important. See Gibson and Lizieri (1999) for more discussion of this model.

growth through merger was increasingly the norm and that this approach created a range of other problems and could fundamentally and quickly change any well laid plans.

Overall, the shortening time horizons were confirmed but it appeared that there was also considerable diversity with some organisations and some activities being easier to plan than others. This provided evidence of the developing core-periphery portfolio concept.

### Portfolio Balance

The problem of mismatch between an organisation’s existing office portfolio and its current needs particularly relates to the tenure and length of commitment. To gauge the degree of mismatch between what they currently occupy and what they would prefer to occupy, the we asked respondents to estimate the proportion of office properties in a number of categories related to the tenure and length of contract. This is shown in Figure 4.

**Figure 4: Average Proportion of Portfolio by Tenure and Length of Commitment: Current vs Desired**

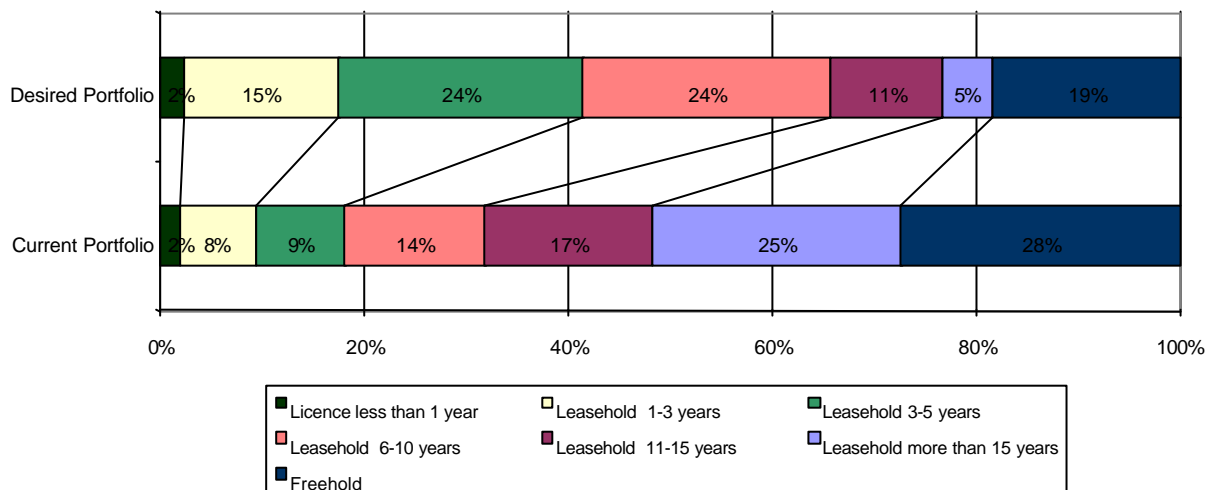


Figure 4 shows the contrast between the current and the desired situation. At present there appears to be an emphasis on long-term contracts which are at odds with the above analysis on time horizons. Respondents desired a greater proportion of their portfolio in shorter term contracts. The most significant increase in the proportion held would be in short term leases of between one and five years. The current proportion held in this category was estimated to be 17% on average where as ideally it would be as much as 39% of the total portfolio. This finding reflects clearly the influence of shortening business cycles on organisations generally.

There were some other interesting observations which could be drawn from the responses to this question. The shift towards shorter leases was further reinforced with almost 60% of respondents stating that ideally they would not hold any lease of more than 10 years and almost 30% stated they did not want leases of more than 5 years in length. Of the third of organisations which stated that they would desire at least some of their offices held on a freehold basis, this was likely to be a significant proportion and in a few instances the entire portfolio.



This emphasis on freehold could well reflect the financial policy of the organisation or the view that real flexibility is only possible if there was total control of the asset which can only be achieved through freehold ownership. Both of these factors have been identified in previous research (Avis and Gibson 1995).

The other aspect considered was the provision of services with the space. As organisations are showing a migration to shorter contract periods, there is a possible requirement for more “packaged” office products. The survey showed that for almost all tenure lengths there was a demand for the provision of more services.

The shift to short-term requirements was confirmed and reinforced by the focus group. The need for ultimate flexibility was stated by one participant: *‘I want it [space] today but if I don’t want it tomorrow, next month, next year then I want to get out!’* This desire to be able to terminate a contract, albeit with a pre-agreed penalty, was widely accepted as the better solution. Their current position was that freehold was still seen as the only option where they could gain this flexibility. *‘If I own the building and I don’t need it, at least I can shut it down and reduce the running costs to a minimum’.*

There was considerable debate over the way services were delivered and the way in which they might be delivered in the future. The participants stated that most of the hard FM and at least some of the soft FM were already outsourced and therefore there was little concern whether a property owner / landlord or another outside contractor provided these services. The important point from the participants’ point of view was ensuring that the appropriate level and quality of service was being delivered and that over time they built a relationship with the provider. *‘The key is having a tightly drafted SLA (service level agreement) with a provider I can trust.’* It remains to be seen whether outsourced contractors or serviced offices can better provide this level of reassurance.

Short planning horizons and lead-times were a reality in many organisations. The way the organisations currently held their portfolio was not ideal. Shorter contracts and increased services were increasingly desired.

### ***Information for Decision-Making***

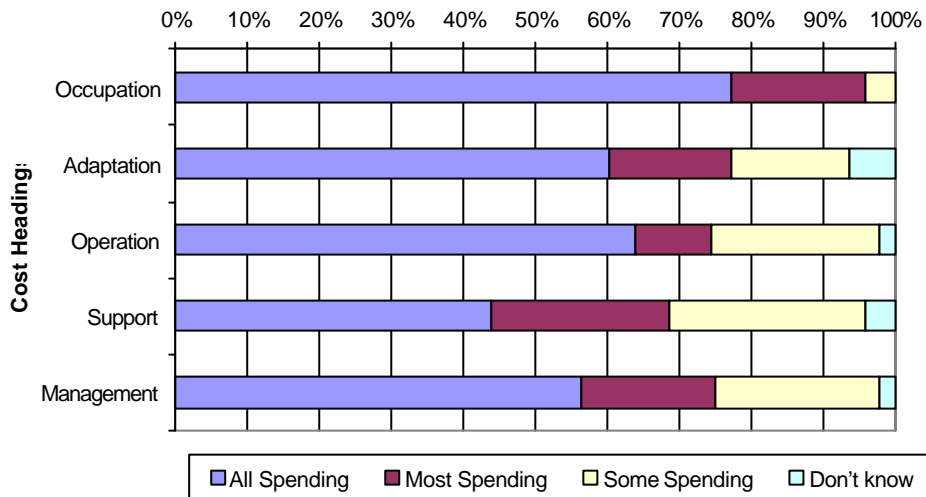
When making a decision about a new requirement, real estate managers are likely to use their knowledge of their existing office portfolio to help inform that decision. This would be influenced by the available information on the cost of their current office space and the scope of their responsibility. Before corporate real estate managers can evaluate their choices, and especially before they can start modelling alternative options, they would need to have a good understanding of their own organisation’s total occupancy cost base. This section considers the data available within the organisations. It also examines the role and responsibility of the different groups within each organisation in relation to the elements which make up a total working environment.

### **Information Availability**

For the survey each respondent was provided with the total occupancy cost framework developed by IPD where costs are grouped into the broad categories of occupation, adaptation, building operation, business support and management. As shown in Figure 5, 96% of respondents claimed to have data related to the occupation costs for *all* or *most* of their

occupied office portfolio while 69% claimed to have data related to the business support costs for *all* or *most* of their offices. These represent the best and the worst categories in terms of the likelihood of data being collected. However both these figures appear surprisingly high when compared to previous research which has investigated real estate data (see Gibson and Hedley 1999, Avis and Gibson 1995). For example, the most recent study found that over 60% of occupiers reckoned that they had insufficient information to support some of their most important decisions including relocation, outsourcing, identifying under-utilised space, and sale and leaseback decisions (Gibson and Hedley 1999).

**Figure 5: Proportion of Organisation's Collecting Data by Category**



The focus group provided another way to interpret this data and was best summed up by the following quote. “*What we like to think we know, what we actually know and what we want to know are very different.*” The key point was that the senior manager responsible for corporate property (the respondent to the survey in most instances) often had an inflated view of the cost data that was available. This was reinforced by a comment that “*the information is available – somewhere - because we paid for it but that data is often not accessible—even in the medium term*”.

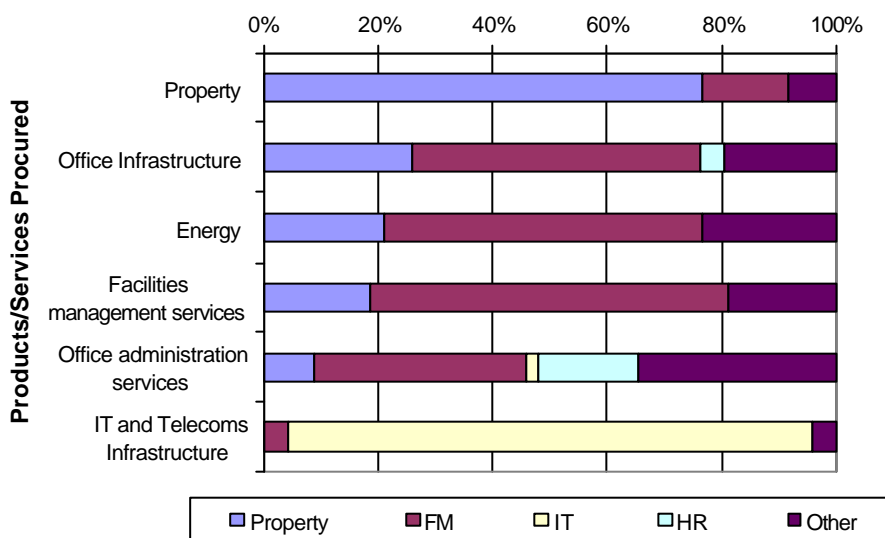
This lack of availability of data was debated at some length. The participants agreed that often the data was split between different decision-makers or departments. Often the only place where all the information required to calculate total occupancy cost was available was at a high level where there was probably only marginal interest in the issue. There was also the problem of the division between those who use (occupy) the space and those who pay for it, making it difficult to assess the cost effectiveness of any particular office. Overall there was agreement that, although much of the data may exist, at present there were few organisations which could access it readily and report the information to an appropriate level.

### **Responsibility for Real Estate Functions**

The way in which real estate products are being augmented with a range of services has led to an offering which probably crosses organisational boundaries. Space, facilities management services and business support services grouped as one seamless product do not necessarily fall neatly into the remit of any one department as has been shown in the discussion above.

The survey again confirmed this as shown in Figure 6. What is striking about this figure is the range of departments involved in the procurement of an operational workplace. The real estate department is most likely to be responsible for the procurement of space, the facilities management department with the procurement of office infrastructure, energy and FM services, and the IT department with the IT and telecoms infrastructure. Not only does this split of responsibility highlight the need for good co-ordination in order to make sound workplace decisions, it also becomes difficult to identify which group should take the lead if an innovative product with extensive services is being considered. Consequently, the fragmentation of procurement leads not only to a potential lack of data, but also to a lack of clarity of responsibility and potential blockages in the decision-making process.

**Figure 6: Departments Responsible for Procurement of Real Estate, Infrastructure and Related Services**



This was confirmed by members of the focus group who not only identified the problem based on function but that it was also hard to identify who had responsibility for any real estate related decisions. In different organisational structures it was often difficult to determine where responsibility lay. For instance in one organisation the products were managed globally yet the costs were managed geographically. There were lots of individuals who had a stake in the real estate decisions and associated costs but no one group who carried the responsibility for all of these, except for the real estate group and only in an indirect way. An additional complication was that business managers changed role every two or three years and therefore left the legacy of their real estate decisions to the next incumbent.

This organisational structure issue was clearly related to the problem of data availability. The structure determined the accounting framework which in turn determined the way data was analysed and reported. In the example above revenues were reported by product line while costs were reported by location. Additionally it was acknowledged that different managers were likely to have responsibility for specific aspects of the workplace and report through different lines. Overall therefore, the lack of accessible data and the fragmentation of decision-making were both constraints to a rational choice.

## Selecting Office Space

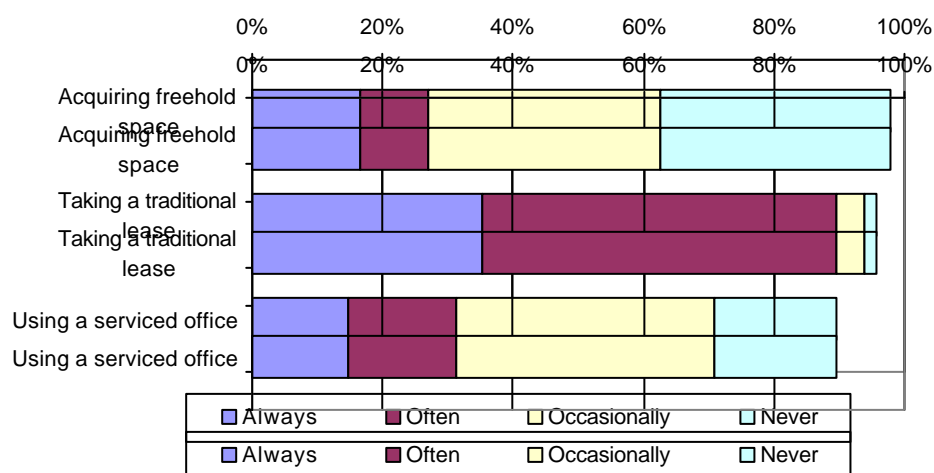
There was evidence from the research that organisations required different office space solutions for different situations. The research investigated two aspects of how organisations evaluate the choices open to them. Initially the survey examined the types of real estate considered. How broad was the remit in terms of the range or products from freehold space to serviced offices? The second theme was the criteria used to evaluate the options. This latter aspect first considered a broad range of potential criteria from location to speed of occupation and then focussed particularly on the financial criteria. This was intended to draw a link between the investigation of total occupancy costs and the way occupancy decisions were made. Finally the type of financial analysis used to evaluate the acquisition of new real estate was examined to gauge the level of sophistication.

### Alternatives Considered

Examining the first aspect, Figure 7 shows that considering a traditional lease was by far the most likely with serviced space more likely to be considered than freehold. We also asked if they had changed the type of real estate they considered within the last three years. This was the case for just over a third of organisations with the key reason being related to the increasing importance of flexibility. The availability of serviced office space and the move to shorter leases were also mentioned as important drivers to change.

Given this and the above analysis of the desired balance of tenure within a portfolio, it may be considered surprising that the traditional lease was so often considered. As outlined earlier however, previous research has highlighted that often occupiers are left with little choice as there are few office properties on the market at any one time which actually fulfil their requirement (Rowley *et al*, 1996). Of those that are available, the vast majority are likely to be on offer on a leasehold basis, with a “traditional” lease being the starting point. Additionally, if the shortening of lease lengths is genuine, then occupiers may be obtaining at least some flexibility through traditional leases with shorter terms. The split shown in this figure however might reflect the structure of the real estate market more than what the occupier would actually prefer.

**Figure 7: Type of Real Estate Solution Considered by Respondents**

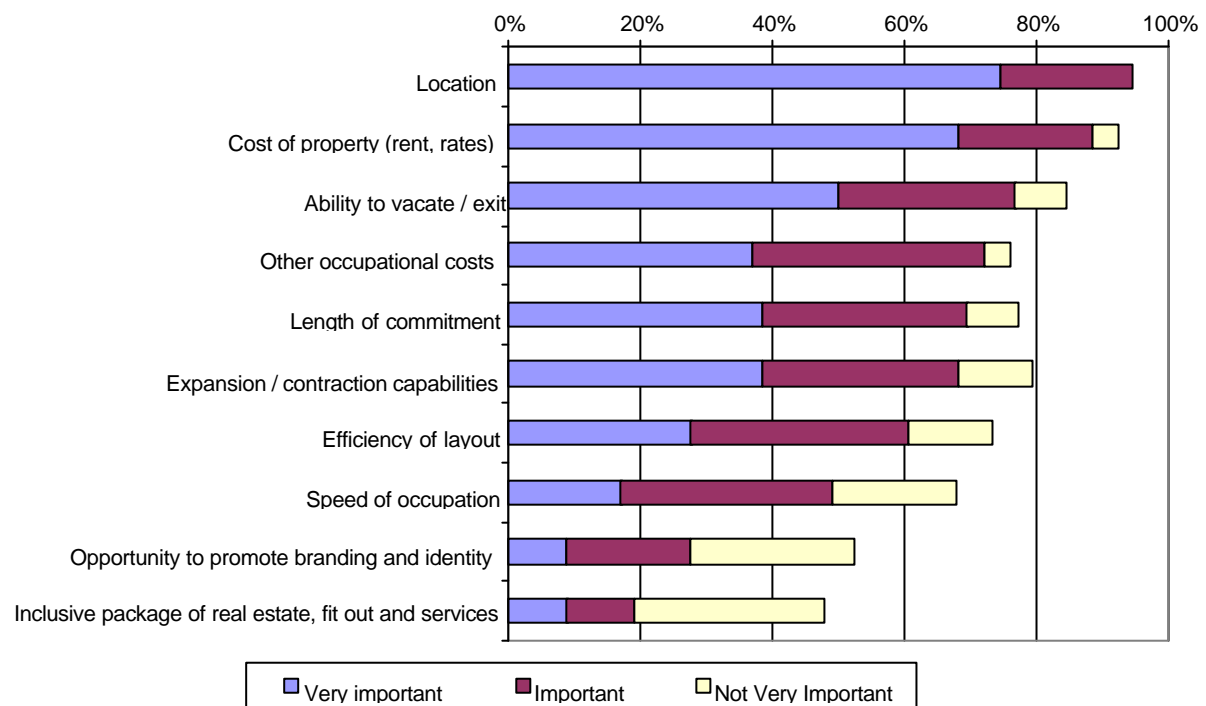


When we discussed this with the focus group, they stated that this was a realistic finding and confirmed that it related more to the structure of the real estate market than to their preferred choice.

### Criteria for Selection

The criteria used to select new office accommodation is shown in Figure 8. Location is the only criteria to be considered by all respondents as either very important (75%) or important (20%)<sup>2</sup>. This is closely followed by the cost of real estate with 88% rating it as important or very important. The third most important criterion was the ability to vacate/exit with 77% rating it as very important or important.

**Figure 8: Criteria Used to Select New Office Space by Importance**



The focus group made some important observations about these criteria. First, location was seen as “*too woolly a term*”. Location will mean very different things depending on the perspective and circumstances. It could be related to access to staff, clients or the quality of location in terms of resale or re-let. They felt that to really understand the issue, the variety of components needed to be unbundled.

Secondly, using flexibility as a criterion was also seen as a problem. Having flexibility was only appropriate if it is required. One participant was adamant that the flexibility should only be paid for when the option was exercised. For instance if a break was negotiated, the cost of the break should not be built into the rent but rather there should be a penalty for exercising such as 2 years rent. This was but one occupier’s view. While some of the other participants

<sup>2</sup> The remaining 5 % did not respond to this question.

indicated that they had negotiated similar terms, other remained silent. This highlights one of the major problems in the real estate sector: how to develop and price a contract with options of flexibility. At present it appears to be rather ad hoc with each landlord and occupier agreeing terms as necessary but not really understanding the real estate market reaction to this in terms of property value.

The other key theme to this part of the discussion was how decisions on new office accommodation were made. This was described as an iterative process, often originated by a business unit which might indicate it needed a new office in a particular location. The corporate property team might examine this request and find that some of the staff may be better (more economically) housed in alternative accommodation. This was then suggested to the business unit which adds other dimensions to the request and so on. Through this process it was often difficult to identify explicitly any of the criteria used as they would have evolved throughout the process.

Confirming the earlier conclusion, the focus group acknowledged that once the general criteria had been identified, there often was little if any choice within the real estate market at any time. *“None of the buildings available is ever perfect... it’s a matter of compromise.”*. Not only that, often the deciding factor was very subjective: the look or feel of the building, proximity to senior manager’s home, golf club were all mentioned as the ultimate deciding factor.

This led to a discussion of who had the ultimate power in any property decision. There was considerable variation from one instance where property was seen as a corporate resource and allocated centrally with the little input from the business unit manager to another situation where the business unit manager had the final say as they were the one to sign off the business case. In this instance the business unit manager is all-powerful.

Therefore, the criteria identified in the survey were seen to accurately reflect the way corporate occupiers made their choices. It was however also noted that the way these criteria evolve and how they are used in practice may not be particularly systematic. The heterogeneous nature of office products and the lack of real choice in the market were a key inhibitor of any more rational approach being developed.

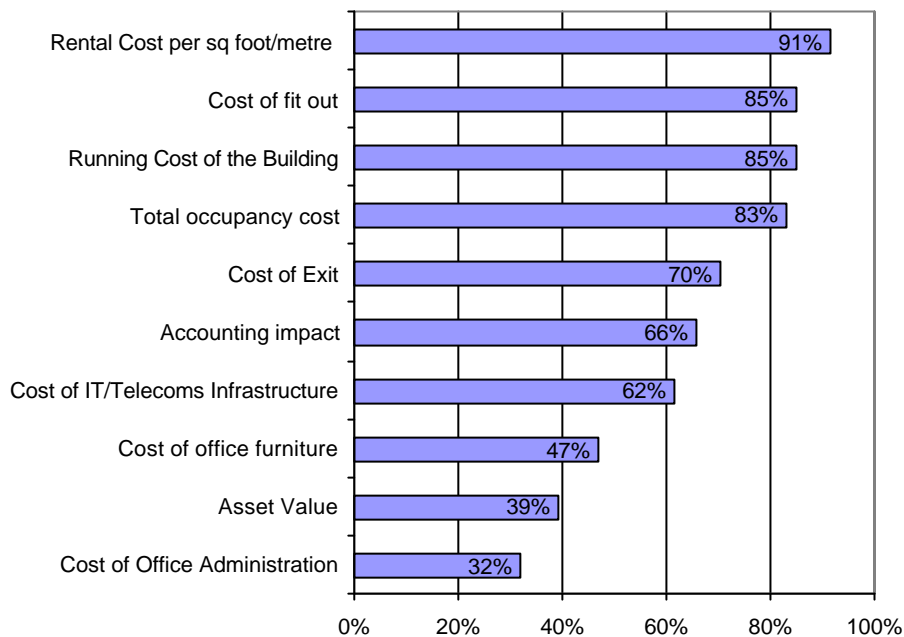
## **Financial Evaluation**

We also asked respondents to consider what financial criteria they would use to evaluate a choice between more than one appropriate office (Figure 9). Rental cost per square foot / metre was mentioned most often: by more than 90% of the respondents. This seems to reflect the tendency to focus on direct real estate costs alone without regard for the amortised fit-out and infrastructure costs or the running costs, although they might be judging that such costs would be similar for all potential buildings.

However over 80% claimed to consider the running cost of the building (85%); the cost of fit out (85%) and the total occupancy cost (83%). This last figure must be drawn into question as only 47% claim to consider the cost of office furniture and 32% the cost of office administration. Regardless of how these are defined, if total occupancy cost is to be taken into account, these costs must be built into the equation. This continues to highlight the difference between organisations’ understanding of the term “total occupancy cost” and the way in which they use this data. Concern continues to be expressed that organisations are comparing

“apples with oranges”. If a total office solution, such as a serviced office, is being considered, then there needs to be a mechanism to ensure that the costs being compared are equivalent. This means that costs need to be considered, not only in terms of space and square footage, but also in terms of the total service package included in the offering. At present it appears that few organisations are able to do this analysis.

**Figure 9: Financial Factors Considered when Selecting New Offices**



Following this one step further, the financial analysis used when selecting new office accommodation appeared, in the main, to be based on a Discounted Cash Flow (DCF) analysis with Net Present Value (NPV) or Internal Rate of Return (IRR) as the final criteria. Almost three-quarters of respondents stated that they use this method. Although this was laudable, and a vast improvement on the more traditional real estate analysis, there appeared to be limited awareness of the usefulness or insight to be gained from this technique. Only one-third claimed that they used sensitivity analysis in their evaluation. If this figure is correct, given the uncertainty unveiled in the section on forecasts and lead-times, it is worrying that different business assumptions of the future are not routinely tested. An early exit, an unanticipated expansion or an extension to a project could have a highly significant impact on the final value of any proposed solution.

The focus group claimed that this underestimated the rigour with which they did their financial analysis. What emerged from the discussion was that, because of the interactive decision-making process, this type of testing was done through the process. It was, however, still unclear whether the sensitivity analysis related to testing real estate assumptions, or whether changes in the business requirement were being explicitly built in. Given that the aim of sensitivity analysis is to determine how vulnerable or robust any option might be to both real estate market and business change, it is key to determining the risks associated with any one option and therefore should be explicit.

## **Conclusions**

The real estate market in the UK has changed significantly within the last decade. Both the demand for and supply of office space have particularly been affected. Occupiers' requirements for ever-greater flexibility and the landlords' continued search for sustainable returns have resulted in a range of new real estate products. Shorter contracts, serviced space and outsourcing have increased the diversity of property solutions available to occupiers.

This research sought to answer the question: *Are occupiers able to assess these new choices and make informed property decisions?* In order to do this, they must have adequate cost data and a framework for evaluation which ensures that they are comparing equivalent situations. If a serviced office is to be compared with a more traditional leasehold situation, the extra costs of fitting-out and servicing the latter must be incorporated into the process.

The time horizons for business activity within organisations were often between one and three years. This sharply contrasts with the traditional real estate contracts on offer in the UK. Organisations felt that, in an ideal world, they would like much shorter-term commitments to property but, most importantly, the ability to exit when the space was no longer required. They were willing to pay for this option but there was a lack of clarity over how much or when.

The results indicated that there was a problem of availability of and access to occupancy cost data for many organisations. There were a number of organisational constraints to collecting this data including fragmentation of property responsibility and internal reporting structures but there was a desire to overcome these. The need for more comprehensive occupancy cost information was stressed in order to make better quality decisions and externally benchmark performance.

Occupiers also wanted more services to support the running of an efficient office. They were clear that the key to receiving a good service was a well-drafted service level agreement with a provider they could trust. Whether the services were linked specifically to a property appeared not to matter.

The flexibility theme also emerged in the criteria used to select new office accommodation. Ability to exit was ranked third after location and direct property costs. There was some concern that the financial risks associated with property decisions were not fully evaluated and therefore the value of any flexibility to the occupier was unknown.

There appeared to be broad acceptance of the new products such as serviced offices. However there continued to be a perception that these were expensive. The lack of maturity of this sub-market and the limited cost transparency were seen as blocks to further development.

Overall, therefore, there are some forces of resistance to the changing real estate market which come from occupiers. The lack of occupancy cost data and an inability to explicitly separate the cost of the services from the cost of the risk transfer for greater flexibility are inhibiting occupiers from evaluating the new real estate products in a rational way. Additionally there are organisational constraints including the fragmentation of decision-making, the internal politics and the focus on short-term returns which also undermined organisations ability to systematically consider a range of options. These constraints are in turn acting as an inertial force on the further development of the serviced office market and other innovative business space solutions.



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*If you are interested in obtaining a copy of the full research report, *Evaluating Office Space Needs and Choices*, please contact the author.*

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