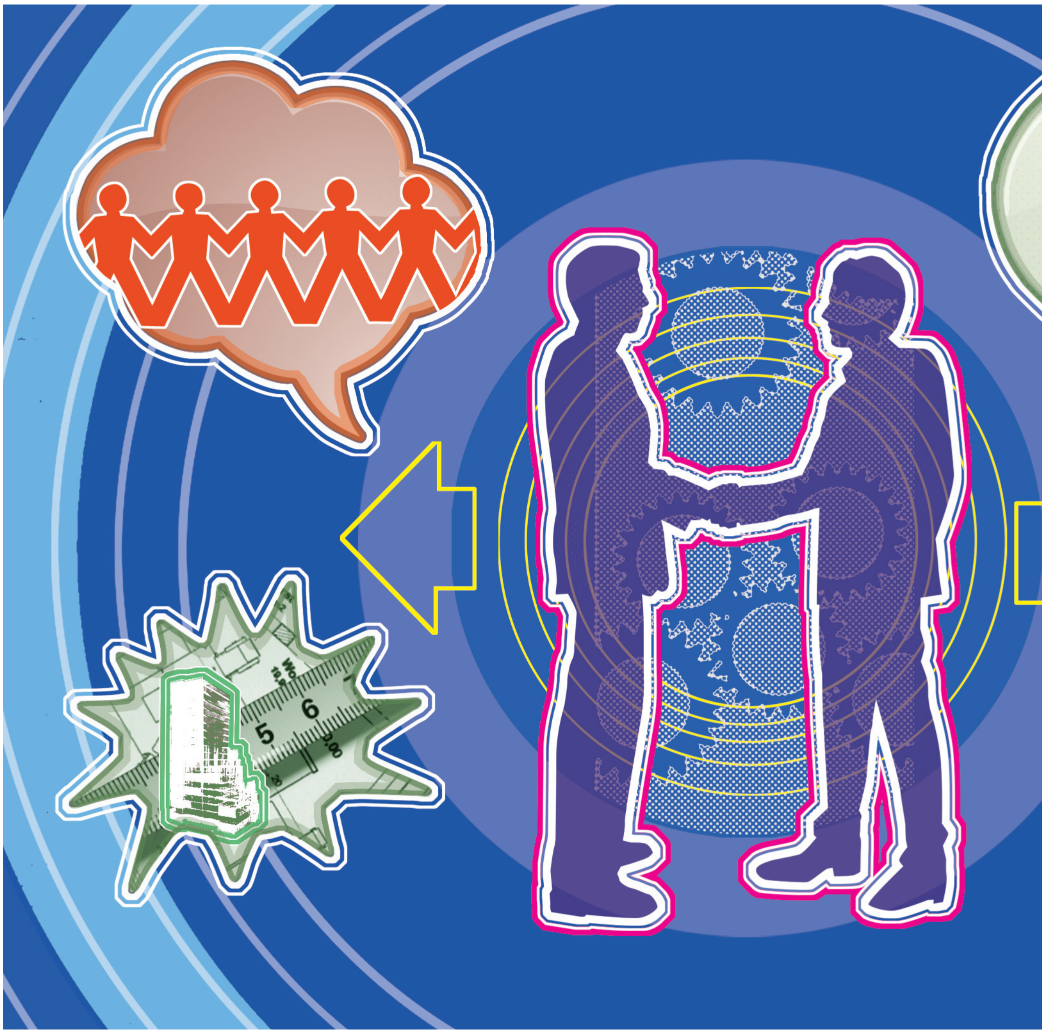
Size really does matter when it comes to premises

Property investment plays an integral role in a business and has a significant effect upon its long-term productivity and profitability. *Andrew Pegg* discusses the issues



The way in which a company handles its investment in property can make a significant difference, not only to productivity and profitability but also to long-term competitiveness. If the company gets it wrong, it can be left with property costs that it cannot offload or be held back by inadequate, perhaps outdated, premises in a marketplace in which flexibility, technology and high-calibre staff are key.

Right-sizing

It is crucial, in order to manage the property risk, for an occupier operating in markets that are undergoing significant change – whether expanding, consolidating or "right-sizing" – to get the property equation right. If it fails to do so, the business may be faced with unnecessary costs, excess space that it needs to sublet, or inadequate space that frustrates further growth, or fragmentation.

The London legal market is experiencing growth. A survey of City law firms by Atisreal found that in London over the next three years:

- almost 7,000 jobs will be created;
- this expansion will give rise to a potential demand of 1.3m sq ft per annum;
- it will cost a collective £86m, based upon today's rental charges;
- one-third of City law firms are expected to relocate to new premises.

Some firms that committed to new space a while ago are finding that it is now insufficient to meet their projected needs. However, markets such as the publishing sector are facing challenges that will lead to a significant reduction in staff. These include:

- a reduction in advertising expenditure;
- reduced margins;
- the rapid emergence of new technology;
- new web-based formats;
- alternative methods of remote or outsourced working; and
- excess capacity in the marketplace.

A reduction in employee numbers in the traditional sectors will result in many businesses having an underlying surplus of property, in terms of void buildings and/or void space in occupied buildings. This, in turn, will give rise to waste and inefficiency. It is therefore crucial that the property management strategy employed by a company is able to adapt to changing operational needs and to mitigate the property risk in the medium and longer term.

Take the longer view

For many companies in a wide range of sectors, new technology is producing new working styles. These are based upon greater mobility, outsourcing, improvements to productivity and a need for greater flexibility. The rate of change is forcing companies to respond to planned and unforeseen opportunities and challenges.

How well businesses in these sectors, particularly people-intensive industries, respond to opportunity and challenge will depend to a large extent upon how closely they integrate their property assets with their business projections and thus accommodate changing commercial needs. This is where the true value of a property strategy lies – to factor in flexibility at all levels so the business is best able to respond to changes in its marketplace.

When a business is growing, there is a tendency for it to hurry to obtain new premises and new staff. In the rush not to miss out on market opportunities, long-term risks and liabilities are not always sufficiently considered at the due-diligence stage. Thus, the business may take on dilapidations and other liabilities that might otherwise have

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been mitigated following expert advice and forward planning.

The business might want to consider whether capital investment in the property will increase its value. The landlord, where there is one, might undertake the work, thereby removing the need to take cash out of the business or to increase debt.

It is important to consider whether debts and outgoings can be consolidated or reduced. The occupier should continually assess whether a property is relevant to its business requirements and whether there are any issues or risks relating to business continuity.

All businesses require comprehensive operating procedures and protocols; these should incorporate property issues. If such protocols are not in place and are not managed centrally, unnecessary liabilities could be incurred where the organisation already has excess capacity. Any acquisition or disposal of property will therefore need to be consistent with the objectives of the business. Effective collaboration within a company will help to achieve long-term value and not merely short-term wins, which could hinder a business.

Occupiers' challenges

The challenge for occupiers in maximising the value of their property assets is that many landlords take advantage of their less sophisticated approach to property transactions. Landlords will press for 10- to 15-year leases. A senior management team, however, may have to work to a much shorter horizon of, say, one to three years. Landlords will also look to transfer liabilities, including:

- service charges;
- improvements under Building Regulations, disability discrimination legislation, and so on;
- the reinstatement of premises prior to letting.

These liabilities can often be negotiated down at the acquisition stage, provided that the occupier approaches the negotiations in the correct way. However, the business has to know what it wants at the outset.

The occupier must ensure that the break clauses – for example – that are negotiated relate to its recruitment projections, contract cycle and growth forecasts. Such clauses should be tailored to the nature of the occupier's business and to its organisational strategy. They should also reflect the "life cycle" of the property on a whole-life basis.

The early-warning procedures adopted by landlords are an important element in helping to identify the relevant business issues. They will also assist in identifying the need for future requirements should the business change. These procedures will include:

- an up-to-date property database to produce a "flag";
- a review 12-36 months out depending on the size of the business unit under review;
- an accommodation review;
- a market review;
- due diligence at the appropriate time;
- negotiation.

The lease may contain break clauses that provide advantages to both parties. Yet, a landlord will rarely approach a tenant for fear of losing that tenant. Both landlord and tenant should embrace break clauses and view them as an opportunity to enhance the terms of the letting so that both parties achieve value through the "right-sizing" of the business.

In the event of a downturn or business failure, the degree of flexibility within property holdings will play an important part in any restructuring plan or refinancing of the business. Many occupiers are not always fully aware of the part that property can play in restructuring the business.

When seeking to release cash, a company will often focus on freehold sales or sale and leasebacks. However, the latter may not always provide the best long-term value and a company may not be aware of other options. For instance, it may be able to sublet, transfer, transact with adjoining tenants, renegotiate or surrender.

Businesses need to consider how overall liabilities can be better managed. They should adhere to the principle that, when property is acquired, it is necessary to have an exit plan in the event of a downturn.

When it comes to selling assets, such as a company, property will often be a key consideration. However, should the property/asset be retained in the business or should the value be extracted prior to the sale? The inclusion of property in a sale may increase the profitability of the business and it may enhance the attractiveness of the business sale.

If there is time, it may be possible for the occupier to mitigate any associated liabilities prior to the sale and therefore make it more attractive. As in any sale, the buyer must "beware" and, all too often, businesses look only at the larger picture and forget the small print.

An objective view

Business needs are becoming more complex in terms of property and many occupiers are beginning to realise that the property transaction forms only one part of the overall accommodation infrastructure and plant solution. They recognise the importance of working with specialist corporate real estate advisers who can provide impartial strategic consultancy rather than transactional advice influenced by vested interests.

A strategic approach enables the occupier to arrive at the correct solution – one that unlocks the value of the business potential, improves productivity, minimises risk and keeps costs at an affordable level. This necessitates an objective view of property options, one that takes into account and integrates with future organisational strategy and performance.

Investment decisions concerning property should therefore be driven by the principle that the company's operational property strategy should dovetail with the overall organisational strategy of the business in order to achieve an integrated, sustainable and beneficial solution.

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