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SPECIAL REPORT

Driving an Aggressive Occupancy Cost Reduction Program:

A White Paper for Corporate Real Estate

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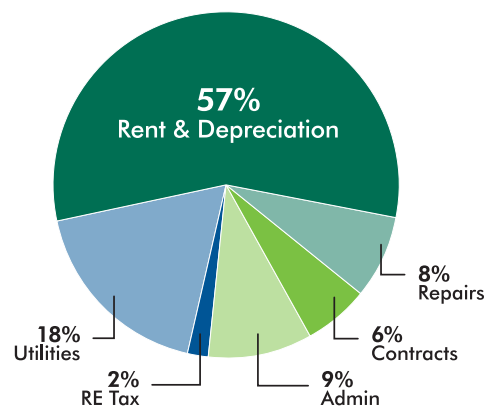
Real estate is often the second largest expense on the income statement for most companies—typically right behind labor. It can significantly impact a company's bottom line. In a contracting economy, an aggressive occupancy cost reduction program can translate into tens of millions of dollars in lower expenses—and mean the difference between success and survival. The challenge to capturing these opportunities lies in the fact that corporate real estate is often tied to multi-year lease commitments, making savings hard to realize quickly.

There are proven techniques to reducing occupancy costs that can be applied to your portfolio in these tough economic times. Use this checklist to assess how your firm is doing.

1. REDUCE SIZE OF YOUR PORTFOLIO

The most significant way to reduce real estate costs is to eliminate space. Any reduction in real estate commitments will result in a lower overall charge for rent—or depreciation for owned assets—and associated operating costs. To reduce your organization's footprint, work with your real estate services provider to:

- **Eliminate surplus space.** Getting rid of non-productive assets and excess space in a soft market can take time, but an aggressive subleasing/sales program and realistic expectations make a big difference. Get aggressive early, before other firms push their surplus space into the market for sublease. With subleases, getting a sub-lessee in early, even if the credit is not particularly strong, can make a big difference on your current earnings and NPV basis.
- **Improve space utilization.** Numerous industry and client studies have shown that the average maximum utilization rate throughout the day for most office space is just 48%. Alternative workplace strategies and an aggressive posture toward density can dramatically improve efficiency.
- **Eliminate shadow and swing space.** Shadow space refers to empty office and cubicle space stranded amidst various business units. Swing space is the extra space many organizations carry to accommodate moves/adds/changes. Both are a luxury, cost money and often result in your needing more space elsewhere.



How Does Your Portfolio Rate?

The simplest metric to use in assessing savings opportunities in your portfolio is to determine how much it is costing your organization to house its employees. Most benchmarks suggest that, by aggressively managing a portfolio of properties, an organization should be able to achieve occupancy costs of \$7,000 to \$8,000¹ per full-time equivalent (FTE) employee. Some organizations are even trying to drive this cost down to \$5,500 per FTE by utilizing alternative workplace concepts. The average is \$8,000 to \$12,000 per FTE.

An important component of the above metric is the ratio of sq. ft. per FTE housed. The most aggressive firms are achieving 200 sq. ft. per FTE in North America, with most ranging from 300 to 400 sq. ft.

¹CBRE Benchmarks – Office Portfolio – Including rent, facilities operating expenses, depreciation of capital improvements and charge-backs for corporate real estate FTE and downstream service contractors.

- ❑ **Close, and sublease, terminate or sell non-productive locations.** Measure the return on investment for each location to determine which sites should be closed. The best losses are the ones you cut short.
- ❑ **Consolidate or co-locate.** If your organization has several operating business units, you probably have duplicate types of space in the same market. Think across geographies. Consider consolidating call centers, data centers, accounting operations or client briefing centers. Two offices may be combined, eliminating the need for duplicate types of space that cost money (e.g., hallways, reception areas, copy rooms), but don't directly help staff.
- ❑ **Take advantage of mergers and acquisitions.** The best time to deploy cost reduction concepts is during a merger or acquisition. M&A accounting forces organizations to develop reserve estimates to account for potential real estate losses. Take realistic impairment reserves and move the properties quickly.
- ❑ **Allocate real estate costs.** Consider how your firm allocates real estate costs—Generally Accepted Accounting Principles (GAAP), Market Rate Allocations or Pooling—as this can drive good and bad behavior. For example, buildings purchased a while ago may look inexpensive to the business units occupying them when in fact the actual operating costs are high or the assets hold embedded equity. Are you missing opportunities to harvest the value of your assets or prune costs?

Your real estate services provider should be able to design a program for moving surplus space quickly, implementing alternative workplace strategies, reducing pockets of space, closing poor-performing sites, allocating CRE costs and developing the types of reserve estimates an M&A requires.

2. TAKE ADVANTAGE OF MARKET CONDITIONS

Real estate is a cyclical industry. It is not always possible to time market swings, but there definitely are times when it makes sense to act. The current credit crisis is causing an inflection point. Now is the time to examine every major asset your organization occupies to determine whether you want to be in that market long- or short-term, and expand there or contract. It may be best to have your broker:

- ❑ **Renegotiate early—blend and extend.** If your lease is higher than current market rates and you are planning to stay, consider approaching your landlord early with an offer to extend—provided your landlord is willing to give some relief on your current rent or allow you to reduce the total square feet/meters under lease. Weigh current and projected market conditions, as well as any operating leverage you have with your landlord regarding its broader tenancy base and asset financing structure.
- ❑ **Buy low/sell high.** Consider buying space instead of leasing it, particularly if your organization plans to be there for the long run. Most analyses show that it is best to buy when you intend to occupy an asset for more than 12 to 14 years. This strategy also allows your firm to take advantage of low acquisition costs and sell when the market recovers.

- **Buy out and terminate the lease.** Buying out the lease may be cheaper than subleasing. Most landlords prefer to keep credit tenants on the lease for the duration, but will consider alternatives that provide the greatest net present value to their asset.
- **Appeal property taxes.** As property values decline, there may be an opportunity to appeal your assessed taxes. Consult an expert who can help you identify savings and work through the appeal process.

In today's current commercial real estate market, your real estate service provider should be able to negotiate some relief on an early renewal, or property tax appeal, locate suitable property priced below market value, as well as devise a termination strategy that should appeal to your landlord.

3. OPTIMIZE HOW CAPITAL IS DEPLOYED

How your organization accounts for real estate and its value compared to the market can result in significant savings or the ability to raise capital. Consult with your corporate real estate department to determine whether you should:

- **Own instead of lease.** Buying the assets you occupy may allow you to record the occupancy cost over a longer depreciation schedule. This can be particularly advantageous in foreign markets if your firm has large sums of cash offshore and is reluctant to repatriate the funds for tax reasons.
- **Monetize embedded equity through sale/leasebacks.** Compare the book value of your assets to potential market value to assess how much embedded equity can be harvested. If you have owned the asset for a while and are willing to lease the asset back, there probably are investors willing to buy it. For a portfolio of assets, pairing less desirable assets for sale with more attractive ones also can be an effective monetization strategy.
- **Generate cash through sale of assets.** Weigh the opportunities for disposition of vacant or underutilized assets: joint developments; sale of air rights over valuable property; decommissioning and sale of plant/materials/business processes; and cell towers. These and other cash-generating strategies can offset the upfront expenses related to portfolio restructuring.
- **Segment costs.** Many firms simply depreciate their tenant improvements and other infrastructure on a straight-line basis over the lease term or as part of the capital investment for owned assets. If properly accounted for, depreciating many of these assets on a shorter schedule can result in lower upfront operating costs.

Solid financial management doctrine should underpin your decisions in each of these four areas. However, there are times when GAAP considerations predominate or when the location of your building—along with your firm's credit rating and the lease terms you are willing to sign—will drive up the value of your assets. You should seek experts who specialize in these areas to review your portfolio.

4. REDUCE YOUR FACILITIES OPERATING EXPENSES

Most good internal real estate departments have implemented operating expense reduction initiatives. But there still may be plenty of savings opportunities that your facilities department should be able to help you capture through:

- ❑ **Facilities procurement leverage.** Good supply-chain management techniques like streamlining your number of vendors, negotiating appropriate service level agreements and seeking volume discounts and/or performance-related compensation can be applied to reduce facility operating costs.
- ❑ **Energy management.** Energy tracking software, high-benefit light refitting, and hyper-efficient data center power and cooling techniques can all generate significant energy cost savings. Sustainability and LEED programs also are proving to have a positive return on investment, while reducing operating costs over time.
- ❑ **Operations and maintenance.** With the advent of process automation and labor leverage via call center and wireless work-order dispatch applications, many new ways to operate and maintain a building exist that require less maintenance personnel support.
- ❑ **Facilities asset planning.** Rigorous facilities capital planning allows a firm to manage more tightly the trade-off between capital investments and obsolescence. Asset planning for each building can also help ensure that significant investments are not made in facilities you plan to vacate.
- ❑ **Value engineering capital investments.** Construction management, design and planning functions—like leveraging the supply chain and purchasing power associated with real estate construction costs, such as raw materials procurement—also can help control costs.
- ❑ **Rent/lease invoice auditing.** Landlords can make mistakes. Have you audited the operating pass-through costs for your largest leases lately?

Smart demand- and supply-side management techniques, more often than not, fund themselves. In fact, when systematically deployed by your facilities department or procurement group, all six of the areas above can deliver major savings.

5. REFINE YOUR ORGANIZATION AND PROCESSES

Sometimes it is easier to reduce space than headcount. Concern for staff, organizational inertia and antiquated information systems make it hard to right-size a department or eliminate unnecessary space. Outsourcing may be a faster and less expensive way to:

- ❑ **Reengineer your real estate department.** Ensuring that your real estate team's performance goals are aligned with your firm's evolving needs often leads to significant savings and headcount reductions.

Case Study: McKesson Corporation

The Challenge:

With a lean organization possessing a history of strong savings results, McKesson requires the continual surfacing of buried occupancy expense reduction opportunities to improve services and reduce costs.

The CRE Solution:

Through an outsourcing partnership, the following programs/activities were implemented:

- A Cost Savings Initiative program to collect, track, report and invoice all savings for McKesson.
- Systematic nationwide reviews of all spend areas for McKesson's facilities.
- Participation in provider platform-sponsored initiatives like group bidding
- Implementation of platform tools such as the Program Management process, PortfolioIQ™, Standards of Sustainability and MarketStrike™.
- Introduction of incentives for team members to identify new savings and additional cost savings review rigor.

Results:

Client achieved real estate run rate reductions of approximately \$4 million annually over the last five years. The top contributors include:

- Improved space utilization/reduction
- Energy management – lighting retrofits and HVAC upgrades
- Procurement savings
- Security efficiencies
- Improved lease terms in select locations

Our team needed to find new ways to be more efficient, more opportunities to reduce expenses and better methods to track those results. CBRE utilized its expertise to collaborate with us to continually improve our operating model, processes and technology, which has netted additional cost avoidance and savings, as well as increased communication and reporting.

Frank Robinson, Vice President, MRE
McKesson Corporation

- **Standardize processes.** Leveraging methodologies such as Lean Sigma leads to fewer work steps, subsystems and opportunities for errors. It also typically results in the need for less staff and fewer vendors, reducing time and costs.
- **Automate systems.** Deploying the new web-enabled building and real estate technologies to automate works steps allows your systems to be integrated and may even provide decision-support data for identifying new savings opportunities.
- **Consolidate suppliers.** Consolidating your vendor base frees your procurement staff to capitalize on your firm's purchasing power and economies of scale as well as track performance.
- **Strike gain-sharing agreements.** Providing incentives for capturing savings helps offset the costs of partnering with a real estate services provider while reducing operating costs long-term.

A real estate services provider can help you build a business case, as well as assist with determining optimal processes and organizational infrastructure.

6. RECONSIDER YOUR WORKPLACE, WORKFORCE AND LOCATION

How your company's real estate portfolio is configured impacts long- and short-term costs. Before making any real estate-related decisions, be sure to work with real estate specialists who can help you identify:

- **Labor longevity and costs.** Competition, cost of living and the availability of appropriately skilled labor within a local market all drive labor rates. If you are not studying the depth and cost of qualified labor between markets, you should be.
- **Alternative workplace strategies.** Shared space, remote work and mobility all offer opportunities to save on occupancy costs while increasing productivity. Using alternative strategies, some organizations have shrunk their portfolios by more than 10% to 20%,

Case Study: HSBC

The Challenge:

With 23 call centers across North America, HSBC was looking to optimize its current portfolio by migrating to five core centers in an effort to minimize operational costs while enhancing performance.

The CRE Solution:

CBRE's Labor Analytics Group evaluated the cost, quality, availability, longevity and competitive presence of human capital to provide neutral and objective analytics for formulation of a five-year migration plan.

Results:

- Identified several locations with a sustainable, high-quality/low-cost labor pool as core expansion markets
- Reduced risk of damaging operational performance by ensuring a cost-effective supply of labor
- Demonstrated potential annual savings of \$55 million, or 17% of HSBC payroll

"...Labor Analytics...brought objectivity to a difficult discussion around call center consolidation. Acknowledging both the depth of research and precision in modeling, business leaders were able to test the impact of different variables. This engagement in real-time alternatives enabled faster and more confident decisions designed to improve performance and bottom line results."

Alan R. Drake, Senior Vice President
Workplace Strategy and
Financial Operations
Corporate Real Estate – North America

while having the ability to grow headcount without increasing overall corporate footprint.

- **Economic incentives.** State, local and federal entities, as well as private institutions, offer incentives to large employers willing to relocate to specific areas or communities or initiate specific programs. If your firm can consider relocating a portion of its employee base, you should take advantage of these incentives.
- **Workplace standards.** Uniform standards can create economies of scale, lower cost of churn and result in greater flexibility within a portfolio. If your firm has a high churn rate, developing these standards will provide a short-term payback and future cost savings.

Relocating is not strictly a real estate decision. Have you considered whether there is labor arbitrage savings available for your locations? Research and real estate specialists are available to assist you.

Before getting started, consider which initiatives are feasible in your current environment. A complimentary PortfolioIQ™ Occupancy Cost Reduction Calculator available at www.cbre.com/ocr can assist in determining potential savings. Consider balancing these savings initiatives with their impact on your facilities operations and FTEs.

With tens of millions of dollars at stake, it is critical to ensure you are doing everything you can to reduce your occupancy costs. Talk to your real estate department or call a real estate services provider. Regardless of how much real estate your firm occupies, chances are there are savings to be found in your real estate portfolio.

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For more information on CBRE's Occupancy Cost Reduction program, related subject matter expertise and specialty practice groups, as well as a handy **PortfolioIQ™ Occupancy Cost Reduction Calculator** to help you estimate potential savings from these initiatives, visit www.cbre.com/ocr