

# “FOLLOWING THE MONEY”

*THE ROLE OF CORPORATE PROFITS IN SHAPING REAL ESTATE MARKETS*

*SEC Registered Real Estate Investment Manager  
Qualified Professional Asset Manager (QPAM) Under ERISA*

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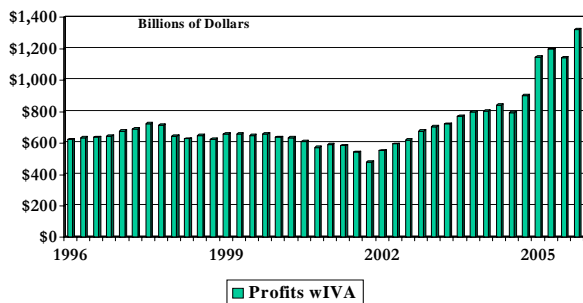
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## “FOLLOWING THE MONEY”

### *The Role of Corporate Profits in Shaping Real Estate Markets*

After-tax U.S. corporate profits<sup>1</sup> surpassed \$1 trillion at the end of 2005 for the first time in history, doubling since the end of the recession in the third quarter of 2001. The linkage between the profits earned by businesses and the performance of real estate investment assets is complex, but well worth exploring, as the investor who understands this linkage can be positioned to profit by structuring transactions to meet corporate America’s changing needs. As corporate earnings accelerate, what are the implications for commercial property occupancy and for rental performance in the years ahead?

#### U.S. Corporate Profits Have Enjoyed an Extraordinary Surge Since 2002



Source: U.S. Bureau of Economic Analysis

For commercial real estate, corporate earnings drive trends in several ways. Bottom-line considerations focus companies’ attention on dramatically different issues when profits are rising than when earnings are under threat. When profits are squeezed, real estate cost-cutting typically becomes a priority. Many firms see occupancy costs as the second-highest item of controllable expense, after employee

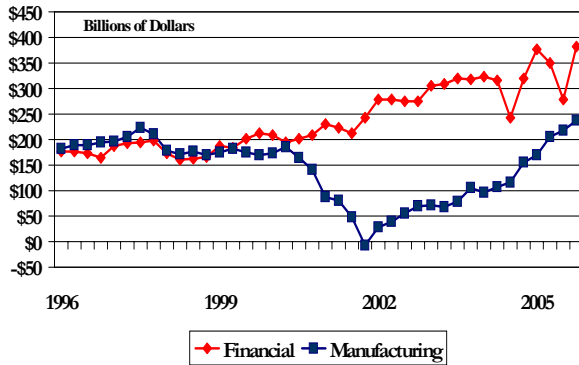
compensation. Layoffs, facility consolidations, outsourcing, facility sub-leasing and reduction of square-foot-per-employee ratios all come into play as financial officers attempt to squeeze as much expense as possible out of the operating statement. Low-cost rent and no-frills space become desirable, as do the generally lower expenses typical of secondary and tertiary markets across the U.S. (and abroad).

When earnings are growing, however, the key strategic dynamic is to leverage both physical and human capital to keep market share strong. Attraction and retention of personnel re-enter the equation -- headcounts rise and the cost of space becomes less critical than its productivity. The question becomes: what is the real estate location where workers can generate maximum value-per-employee? These tend to be higher-density primary markets with associated higher costs and where there is well-documented evidence that agglomeration effects have their greatest impacts.

The industry-specific breakdown of corporate profits shows the divergence between the financial sector and the goods-production sector in the early 2000s. Despite 9/11, New York City’s financial industry initiated a quick rebound in commercial property demand – a resurgence well-anticipated by investors who disproportionately committed funds to this market. Elsewhere, first quarter 2006 data show Charlotte’s banking-concentrated CBD with a scant 5.7% vacancy rate. Boston has shaved 2.8 percentage points from its vacancy total in the past year, and now is at 14.6%, while San Francisco’s recovery has brought its office vacancy down to 13.3%, a 3.1 percentage point improvement in the past twelve months. Close attention to trends in

<sup>1</sup> The exact measure is corporate profits after-tax, with inventory and capital consumption adjustments included.

### Recession Hit Manufacturing Profits While Financial Firms Prospered



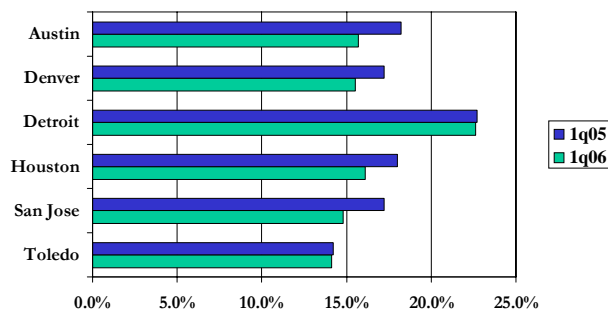
Source: U.S. Bureau of Economic Analysis

financial industry profits anticipated the strong performance of these key property markets.

Manufacturing areas, however, have experienced a lingering recession. The longest of the “jobless recovery” areas were those where goods production dominated the real estate landscape. Many of these markets may now be poised for a sharp real estate rebound. Again, corporate profits provide the clues. As the chart above illustrates, manufacturing profits have been rising much more steeply than financial profits over the past three years.

The trends have differed significantly from industry to industry. The enormous gains in the energy sector are rather well known. Likewise, the losses in the auto industry have made headline news. In the

### Vacancy Dropping in Energy And Tech Markets, But Stuck in Neutral in Auto-Based Cities



Source: CBRE First Quarter 2006 National Office Vacancy Index

technology sector, profits began to rise in 2004 in the information industry and computer hardware/software manufacturers moved into positive territory in 2005. In the energy and technology-based metro economies, we have begun to see significant tightening in office markets, and the pace of absorption is beginning even to outstrip the occupancy improvements in more diversified large cities like Chicago, Los Angeles, Atlanta or Dallas.

One sign of the spreading demand base can be seen in the list of corporations recruiting college graduates. CareerBuilder.com reports that 70% of hiring managers are actively recruiting, up from 62% in 2005. Defense contractors and energy-related industries join the big accounting firms on the top ten list. The table on the next page lists the top ten firms seeking college graduates, with two-thirds of the annual hiring projected to occur in the spring and summer months.

Martha O'Mara and Glenn Burdick, of Corporate Portfolio Analytics, have identified four trends that they believe capsule contemporary corporate real estate directions<sup>2</sup>:

- Consolidation to fewer cities
- Increased density within the office
- Shorter, more flexible leases
- Portfolio-wide planning

Our observation is that this broad description captures the key forces, but may have quite a few surprises in the execution. Investors attentive to both the basic trends and to the nuances will be best equipped to work profitably with corporate users in crafting mutually supportive real estate strategies.

The **consolidation** phenomenon is an important example. While many commentators have anticipated that technology would impinge upon the advantage of key locations, the exigencies of efficient business operations have in fact been pushing in the opposite direction.

<sup>2</sup> O'Mara and Burdick, “The Challenge of Long-Range Corporate Real Estate Planning,” *About Real Estate*, Torto Wheaton Research, April 1, 2005.

**HEAVIEST RECRUITERS ON COLLEGE CAMPUSES 2006**

<u>Firm</u>	<u>Headquarters</u>	<u>Industry</u>	<u>Projected New Hires</u>
Enterprise Rent-a-Car	St. Louis, MO	Travel/Transportation	7,000
Lockheed Martin	Bethesda, MD	Aerospace	4,400
Walgreens	Deerfield, IL	Retail Drug Stores	4,300
PricewaterhouseCoopers	New York, NY	Accounting	3,817
Deloitte & Touche	New York, NY	Accounting	3,500
Ernst & Young	New York, NY	Accounting	3,400
Schlumberger	Houston, TX	Oilfield Service/ Products	3,000
USDA	Washington, DC	Government	3,000
Hertz	Park Ridge, NJ	Travel/Transportation	2,500
KPMG	New York, NY	Accounting	2,240

*Source: CollegeGrad.com*

The banking industry is a case in point. Deregulation in financial services first spawned a host of new banking offices, the market Darwinism weeded out the weak competitors mercilessly and this led to the rise of regional and super-regional banks. There were clear winners – most notably Charlotte, North Carolina – but also Boston, Chicago, and a few others. New York’s giant commercial banks were challenged and Manhattan saw in the 80s and 90s a net reduction of space use by its standard-bearing institutions: Chemical and Manufacturers Hanover merged, and the combined entity was acquired by Chase Manhattan, eventually to become JPMorgan Chase Bank.

After 2000, the regional banks themselves came under threat of consolidation, and Manhattan looks to be the winner as institutions position themselves as truly national and international financial service companies. JPMorgan Chase has taken the combined First National of Chicago and Bank One under its wing. Fleet Bank was acquired by Bank of America – which now is the lead tenant in one of the biggest towers under construction in Midtown Manhattan. HSBC has also turned out to be a voracious space user – and commercial banking employment is on the rise again in New York City.

This is, however, not simply a big city story. Secondary markets have enduring appeal, especially for “back-office” operations. The 2006 Corporate Real Estate Survey by Coldwell Banker Commercial reported that 42% of its corporate respondents are likely to enter secondary markets in 2006, versus an expectation of just 30% in primary markets. For office space, this may mean Minneapolis, Tampa, or Phoenix; for industrial space, Tacoma, Indianapolis, or Charleston, SC. The median space unit expected to be taken by the corporate survey panelists was over 120,000 square feet.

**Increased density**, or lower space allocation per employee, has been a mantra in the corporate real estate field for as long as we can remember.<sup>3</sup>

O’Mara and Burdick cite studies showing that even management personnel (not sales persons or customer-oriented workers needing to be in the field frequently) occupy their assigned workplaces

<sup>3</sup> For example, see “Forecasting Office Space Demand,” a research paper by Prudential Real Estate researchers Will McIntosh, Youguo Liang, and John Kim (November, 1997), which examined the common belief that office space compression was a defining trend, and found that since the revolution in office technology there has been little overall change in square-foot-per-worker. Moreover, changes in occupational profiles suggest that space allocation may *increase* as more technology is introduced.

only 60-70% of the working day. Space compression strategies have ranged from the open-plan or cubicle arrangement (the “Dilbert” workplace), to the “hoteling” concept promoted by management consultants a while back where workers “checked in” each morning and were routed to workstations re-assigned on a daily basis.

To be sure, we see some prominent examples of aggressive space management. Sun Microsystems, for instance, has attracted a lot of attention with its “iWork Solutions” initiative, whereby 20,000 of its workers don’t have assigned seats, but simply log in at workstations at any of Sun’s facilities worldwide. Reportedly, this has saved Sun more than \$500 million in real estate operating costs. Cigna also indicates that it has 4,400 of its 32,000 employees designated as eWorkers (someone should be trademarking these buzzwords!), jobs without assigned workspaces.

Although these initiatives garner a lot of attention, they are not in the mainstream of the actual behavior of most companies. Space planners may say, “Conference rooms are really not an efficient use of space because they’re dedicated to one function that’s used only 15 to 20 percent of the time” (*Buildings*, December 2005). In arguably the highest rent district in the country, Midtown Manhattan, the new New York Times building will have four times the number of conference rooms as the Gray Lady’s old building on West 43<sup>rd</sup> Street, and, right in the midst of New York’s concentration of great restaurants, Conde Nast’s new tower features a Frank Gehry-designed cafeteria.

What is behind such seeming anomalies? More and more, companies are focusing on the perennial truth that profits are directly related to productivity and innovation (the affirmative strategy) even more than to cost-control (the defensive strategy). A significant strand of research has documented that physical surroundings influence workers’ ability to concentrate and perform.<sup>4</sup> Richard Florida’s

provocative books, *The Rise of the Creative Class* and *Cities and the Creative Class*, both stress that knowledge workers – the core of today’s key office users – require substantive interaction to function optimally. Ideas need to propagate across the enterprise, and office designs that promote formal and informal communication enhance productive efficiency, based on Florida’s statistical and survey research. The benefits of a bit more space generosity may pay high dividends in terms of output, and in profits.

This is not a matter of ivory-tower academic theory. Mahlon Apgar, of The Boston Consulting Group (BCG), says, “By relentlessly decreasing operating costs per square foot – the agreed-upon ‘best practice’ in corporate real estate – real estate executives risk under-managing one of the largest variables on the corporate books.” Apgar believes that the real ‘best practice’ is to pay a bit more upfront for flexibility. One big problem is that corporate real estate executives – the corporate sources that the property industry is most in touch with – are themselves out of touch with the decision-makers in their business units. The result, according to BCG’s corporate real estate benchmarking survey, is that more than 40% of projections of space demands are off by 100% or more.

**Flexibility** is especially important, given the incidence of rapid change in business according to Cornell University’s International Workplace Studies Program. Companies need to consider working environments that can accommodate changes in the size of project teams and the diversity of requirements for differing functions. One size does not fit all. Cornell cites the case of financial firms, where equity traders, the IT department, research analysts, human resources teams, and investment bankers have vastly different workspaces. Even in smaller, tech-oriented start-up firms, Cornell’s researchers noted the need to balance issues of communication, flexibility, and cost in optimizing work effectiveness. “Space, ultimately, is not about real estate. It is about using

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<sup>4</sup> See articles cited in Colliers International’s *OfficeTimes.com*. Also, Hugh F. Kelly, “Productivity in the Workplace: All Square Feet Are Not Created Equal,” *SIOR Professional Report*, Washington DC (Spring 2003).

all the organization’s scarce resources to their fullest potential.”<sup>5</sup>

Apgar’s research at BCG indicates that a majority of corporate real estate executives would pay up to a 9% premium to build flexibility into leases. But it appears that a lot more can be done in understanding just how flexible a building can be as user requirements evolve. Think about how the cabling system or the HVAC ductwork can support or hinder the “re-zoning” of space without costly physical reconfigurations. A building’s ability to bring productivity enhancing natural light to all workers, to provide easy circulation and a variety of venues for workers to interact on an ad hoc basis, to have acoustical and visual characteristics that respect the need for privacy and concentration during significant parts of the workday – these are all attributes that support, rather than inhibit, today’s corporate management styles and worker efficiency. In searching for investment properties with maximum appeal to corporate users, appropriate workplace flexibility widens the market for potential tenants and should earn a premium in office markets that are getting tighter by the month.

For corporate real estate, then, the revolution in thinking concerns how facilities contribute to enterprise value. Since corporations are complex entities, almost by definition, real estate is a *portfolio* issue – not just a series of one-off location decisions. Commercial real estate investors who can

engage corporations at the level of their portfolio space requirements – across geographic markets, with a variety of space options, and with a critical sensitivity to the evolving nature of corporate management and productivity needs – are especially well-positioned to secure corporate tenancy.

The key insight is that it is profitability, not cost-cutting, that drives business. Cost-cutting is a means to an end, even if it is often expressed as an end in itself. We often hear the mantra, “Better, Faster, Cheaper.” A laudable slogan, but in the real world it is most often the case that you have to pick the best two-out-of-three as far as those attributes are concerned.

The bottom line is: the bottom line! Knowing where corporate profits are coming from, how they are earned, what cities are best positioned to facilitate profitable operation (industry by industry), and how real estate facilities can contribute to corporate earning potential are all critical elements in investment success. It is surprising, then, how infrequently the subject is explored in depth among real estate practitioners themselves. Metrics for analyzing demand for space are not static. Those investors nimble enough to first recognize and then capitalize on dynamic shifts in the motivation of today’s corporate innovators stand to be the first to gain as the business climate evolves.



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<sup>5</sup> Franklin Becker and William Sims, “Offices That Work: Balancing Cost, Flexibility, and Communication,” Cornell IWSP, 2001.