



OCCUPIER STRATEGIES IN A FALLING MARKET

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OVERVIEW

The downturn in European property markets has so far been mainly driven by increases in yields, reflecting reduced liquidity and growing risk aversion among investors. The next phase will be driven more by falls in rental value, which means that attention is turning to the effect of economic conditions on occupier markets. These impacts tend to be late-cycle events, and there is still considerable uncertainty about their likely timing and severity. Nevertheless, landlords are critically concerned to avoid value erosion being further exacerbated by rising voids, and are under pressure to maintain income continuity, particularly where they have significant debt to service.

As a result, there are growing opportunities for occupiers to manage their real estate commitments by engaging with their landlords in innovative and flexible ways. In some cases, opportunity is also necessity: continuing constraints on credit availability are forcing corporates to consider a broader range of capital-raising or cost-saving measures, some of which may not be readily apparent without detailed analysis. While there is no universal formula, early planning and action, and a clear understanding of the landlord's position and concerns are critical.

The downturn in European markets that has been in progress since mid-2007 has been, at least so far, driven mainly by capital market adjustments driving yields higher. The CB Richard Ellis of capital values in the EU-15 area has fallen by 20% since then, and yields have risen by 130 basis points over the same period.

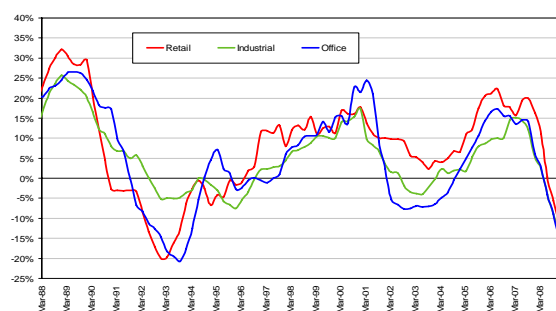
The deterioration in the short-term economic outlook over recent months has focussed attention on the next phase of impact via the occupier market. Rents are already falling - down 2.1% for all property in the EU-15 area over the past year - and are expected to fall in most major European markets this year, in some cases significantly.

In this environment companies across a range of sectors and geographies are experiencing weakening demand for their products and services, and in many cases price deflation as well. Many are therefore under increasing pressure to trim costs in any way possible, including through the real estate element of their cost base. On the face of it, current market conditions - falling rents and rising vacancy - are helpful to occupiers, and we expect occupiers' rent bidding behaviour to adjust where they are negotiating new leases. On the other hand, for existing lease liabilities, the ability to benefit immediately from falls in open market rents will be constrained by lease structures.

However, depending on specific circumstances and the individual landlord's position, this may not be an insurmountable issue. In general landlords, having already seen reductions in asset values due to yield shifts, are increasingly concerned to maintain the length and quality of rental income streams. This reflects a general desire to minimise voids in a weak market, and avoid the costs and uncertainty of re-letting. A tenant paying a reduced rent is usually better than no tenant at all!

In cases where the landlord is either considering sale of an asset, or has significant debt to service and banking covenants to preserve, the imperative is likely to be even stronger. This will tend to make landlords more receptive to discussions that result in a reduction in tenants' costs, but which avoid a vacancy and hence support the value of the asset.

Figure 1 - EU-15 Capital Value Index (% p.a.)



Source: CB Richard Ellis

Equally, there are pressures arising from structural changes in some sectors that are compounding the issue. In the legal sector for instance, the shift away from joint and several liability towards limited liability partnerships has eroded lenders' level of loan security, and encouraged banks to adopt a more restrictive stance towards new lending. This is forcing corporates to look for new ways of raising capital.

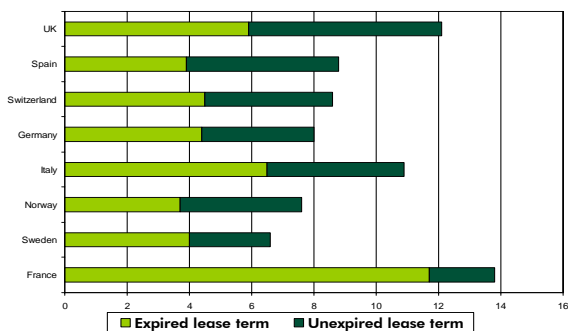
There is growing evidence of occupiers in all sectors looking to renegotiate their lease terms: a recent CoreNet survey found that 48% of the world's leading companies are reviewing options for exiting their leases early. The range of tactics available is potentially extensive, and includes:

- **Rent reductions / cash premium in exchange for a longer lease or rolling lease extensions.** This so-called "blend and extend" device recognises the fact that income duration is increasingly important to landlords and, with rents generally under downward pressure, can be used in the tenants' favour. While there is evidence of this being proposed even where there is no upcoming lease break or expiry, it is more likely to succeed where there is a break or expiry scheduled in the next two years.

- There is considerable variation in the average length of outstanding lease across Europe. On the basis of lease profiles within IPD portfolios, France and Sweden and, to a lesser extent, Germany and Norway appear to offer greater potential to occupiers than, for instance, Italy, Spain or the UK.

- **Unique local lease structures or legal provisions** may facilitate this approach. For instance in France, renegotiations are being driven by Article 145-39, which allows rents to be readjusted (downwards) to a market rent once indexation has pushed the rent more than 25% above its initial level.

Figure 2 – Lease terms and duration, All sectors



Source: IPD

- A variant of this approach is to **waive existing break options in exchange for longer fixed lease terms.** This can be successfully deployed in situations where a company occupies several buildings owned by the same landlord. Clearly this confers value benefits to the landlord, which can be shared with the tenant or used to negotiate other concessions within the portfolio.

- At the other end of the spectrum, some corporate are **renegotiating shorter leases** to save costs in the short-term, sometimes to buy time ahead of more substantial changes to their occupation pattern. In Germany for example, many corporates are looking to renegotiate leases from a traditional five-year term to shorter periods of two or three years. In isolation, this would seem to offer very limited benefits to a landlord and may therefore need to be combined with other measures.

- **Subletting of surplus space.** In some cases this is a response to an inability to secure revised terms in any other way. For instance in Moscow, lease terms tend to be long with no breaks, which reduces tenant leverage. As a result around 30% of the space on offer in the market is available as sublet space.

- Subletting space through formal channels incurs marketing and other costs, and may be inefficient or unworkable where a company has piecemeal vacancy (as opposed to large contiguous areas) distributed within their building. One approach in these situations is to mark several floors as available simultaneously, in the hope of attracting a sublet for any (and only) one of them – "baiting a number of hooks to get one nibble". If successful, the company can then consolidate into the remaining space having already secured a sublet, rather than incurring the associated costs at the beginning of the process.

- More generally, as has been observed in previous cycles, some tenants will continue to occupy space at lower densities for a period of time, while being more receptive to unsolicited approaches for that space.

- **Buying in leases from distressed landlords** with a view to undertaking a sale and leaseback into a stronger market at some point in the future. While forced sales have so far been relatively scarce, instances where distressed landlords need to raise capital may offer opportunities for tenants to become owner-occupiers for a temporary period.

▪ **Sale & leaseback initiatives.** With other sources of capital difficult to obtain, this is a viable means of capital-raising for strong covenants. This provides the type of secure long-term income that is appealing to investors at present, and accounted for nearly 20% of investment transactions in Europe last year.

▪ **Implementing (or threatening) relocation plans**

There are several European office markets, including Frankfurt and Barcelona, where recent leasing activity has been heavily influenced by occupiers favouring cheaper off-prime or decentralised locations. An example is Deutsche Boerse's relocation from central Frankfurt to nearby Eschborn. As well as the cost-saving benefits, improved transport infrastructure in some places means that tenants can move without sacrificing much in terms of operational efficiency. Of course, relocation decisions need to be consistent with wider corporate objectives and involve substantial capital costs. Threatening relocation merely as a device to squeeze other concessions out of landlords can be risky: any threat needs to be credible.

▪ **Other lease alterations** may include :

- seeking additional rent-free allowances;
- expanded fit-out or other contributions;
- earlier break options than provided for in the current lease; and
- attempts to alter the treatment of specific lease items (such as dilapidations or reinstatement clauses) in order to reduce or remove future provisions and release what had already been provided for.

▪ The last of these is an area where the scope for discussion is heavily influenced by specific lease terms, and where detailed advice is likely to be needed to establish the best negotiating stance. Equally it is an area that could be easily, but wrongly, overlooked in favour of some of the more obvious measures relating to rent level or lease length. However the benefits to occupiers can be significant.

▪ Variations on the theme of higher landlord contributions are evident in a number of retail markets, with rent-free incentives reportedly rising sharply. Some landlords are offering to pay fit-out costs in order to secure deals, which would have been unnecessary until quite recently.

▪ The need for retailers to pay key money to secure units has declined, as has the typical level of payment, a trend that is particularly evident in Germany and the UK.

▪ There is still a need to pay key money in order to secure units in the highest-quality prime locations, and in situations where landlords are offering rare strategic opportunities such as big flagship store locations in key markets.

Cost savings from reviewing occupational portfolios

▪ A number of organisations, particularly in the banking and finance sectors, are looking to rationalise their office portfolios, either alongside headcount reductions or to align their occupation with the broader aims of the business. Doing this at a time when rents are generally under downward pressure and landlords keen to minimise their downside, can generate very significant savings.

▪ Several recent instances in which CB Richard Ellis have been involved have seen companies reducing the number of buildings they occupy while securing other financial or operational gains in the process.

▪ One saw a two-thirds reduction in the number of buildings occupied, accompanied by significant rent reductions and other incentives as the market weakened during the negotiation process.

▪ Another involved a company waiving break options on two of three buildings leased from the same landlord, in exchange for longer fixed terms on both. The resulting value gain to the landlord is to be shared via early surrender of space in the remaining building, allowing a reduction in overall occupation.

CONCLUSION

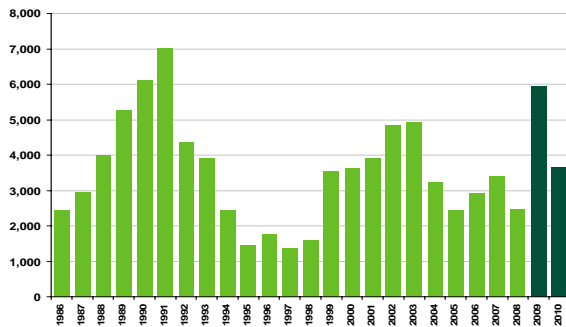
In the current market, landlords are increasingly open to any discussions that will help secure their income. The ability of occupiers to take advantage of this is a function of market conditions, and the opportunity won't last for ever. In fact, in markets where there is scope for values to recover relatively quickly, the time window to benefit from these opportunities may be quite short. Depending on circumstances, value for the occupier may be extracted via some or all of:

- direct capital contributions from the landlord or a share in their upside;
- reduced costs in respect of rent and/or other liabilities such as alienation;
- greater certainty around long-term rent or cost liabilities; and
- improved lease terms.

Those who have a lease break or expiry in the next two years are perhaps in the strongest position to leverage the combination of a weak market and rising vacancy to their advantage. Thereafter the slowdown in development activity will alter this dynamic, producing a sharp decline in the choice of new buildings, thus strengthening landlords' positions again. Completions of new office developments are expected to peak this year and, with new building starts having virtually stopped in response to the lack of development finance, the subsequent slowdown in completion levels could be quite sharp.

Most importantly, there is substantial variation in the position of individual landlords, and so what works in one situation may not work in another. Understanding the specific concerns of the landlord in each individual case is vital to framing a proposition that is likely to be acceptable, and to producing a "win-win" outcome.

Figure 3 – Office development completions ('000 sq m), Western Europe



Source: CB Richard Ellis

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