DISRUPTION = DEMAND

OCCUPIER DECISION MAKING IN AN AGE OF DISRUPTION

“Companies that recognise the contribution that real estate makes in delivering strategic intent are winning through.”

DR LEE ELLIOTT
Head of Commercial Research

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THE AGE OF DISRUPTION

There has arguably never been a more disruptive time to be in business. The orthodoxy surrounding the global economic cycle has been severely challenged.

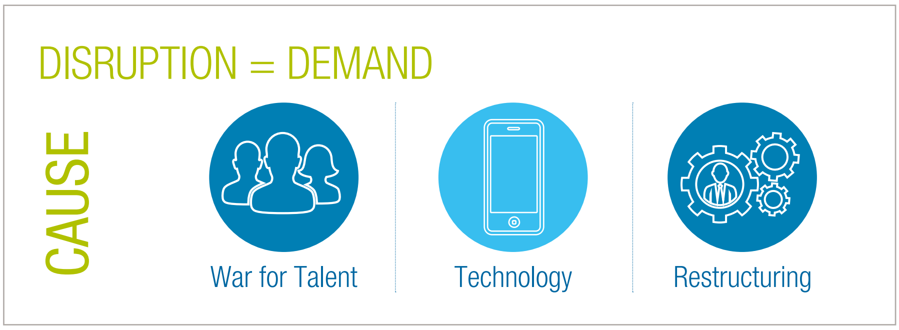
The onset and subsequent aftermath of the Global Financial Crisis (GFC) has reset the definition of normal and instilled a new, more cautious corporate mind-set. The need for businesses to respond quickly to changes in operational conditions has never been greater. At the time of writing, the modern business landscape is characterised by lower growth trajectories; lower levels of demand and lower levels of inflation. These are overarched by the increasing influence of globalisation, geo-political uncertainty and economic volatility. Put simply, business are faced with the most competitive, fast moving and disruptive business environment in memory.

It doesn’t end there. Structural disruption is at work too and is having a marked impact upon the operating models, competitive position and viability of businesses the world over. The foremost disruptive factor is the insatiable and inescapable rise of technology. As well as emerging as a dominant industry sector in its own right, technology has transformed the how, where and why of all businesses. It has redefined working processes, increased the speed to market, decreased the margin of competitive advantage, and has improved business productivity and efficiency. Furthermore, technology has necessitated and facilitated an on-line presence to promote brand, services and drive revenue.

But perhaps most fundamentally, technology has reshaped the very quantum and quality of skills required by modern business. All industry sectors are engaged daily in what has become termed the ‘war for talent’. This is a reflection of both the UK’s tight labour market conditions – UK employment is at its highest level since records began in 1971, 74% – and the search for the specific, specialist skills necessary to enable traditional businesses to transform into modern, digital and sustainable enterprises. Acute shortages of such skills are pitching prospective employers against one another and are strengthening the negotiating position of highly skilled employees.

Businesses therefore operate within a new landscape, with three disruptive forces constantly at work (figure 1). Competitive, compelling businesses must not only restructure to mitigate the effects of a changeable macro-

FIGURE 1
The 3 disruptive forces shaping occupier decision making



Source: Knight Frank Research

Please refer to the important notice at the end of this report economic environment but must also respond strongly to the twin challenges of technology and talent. It is against this backdrop that occupier's real estate decisions are made and market demand for office space emerges.

This paper argues that real estate matters.

Companies that recognise the contribution that real estate makes in delivering strategic intent are winning through. Resilience and competitive advantage derives from well considered real estate choices. In contrast, those that secure office space with a staid supply chain driven mentality accompanied by a steady-state projection of real estate needs, lose their edge. These organisations are challenged by the disruptive impacts of new technology and associated need for new talent to drive organisational change.

In an age of disruption we maintain that occupier decision making is:

- More complex and has far greater strategic significance attached to it than ever before
- Increasingly predicated by the supply of talent, in particular digital talent
- Leading to new patterns of occupancy and new attitudes to space usage
- Heavily focused upon locations and buildings that offer a place of work rich in amenity

REAL ESTATE DECISION MAKING

The choice of an anchor location or building to house a business or business function is not a marginal decision. In our view it is a decision that is increasingly linked to the pursuit of corporate strategic goals. As such, it is a decision which has the keen interest and active input of a broad array of decision makers. Contrary to much recent interpretation, it is not a decision based simply on a desire to reduce exposure to real estate costs.

Increased strategic significance

The strategic significance attached to the corporate real estate decision is intensifying. It is of strategic importance because it has the potential to positively or negatively impact the success of wider strategic objectives such as corporate social responsibility (CSR); the enhancement of productivity and output; financial discipline and much more besides. No longer can property be dismissed as a simple factor of production. Choosing real estate options must be viewed as far more than simply selecting a container in which to place workers. Instead, property is viewed by the most enlightened businesses as something that can serve to facilitate productivity, bolster creativity and enhance efficiency. As this paper will illustrate, real estate is recognised and employed as a device to assist in the attraction and retention of talented staff. Furthermore, real estate, both in terms of its external façades and its internal fit-out, is being utilised by occupiers to articulate brand to both the wider market and prospective employees.

A broader church of decision makers

So there is a lot to gain from making the right real estate decision. It is unsurprising therefore that a widening spectrum of senior company figures are involved in the corporate real estate decision (figure 2). In this sense there is no one answer to the fundamental and often asked question of 'what does the occupier want.' The wants and needs of the CEO, CFO, the HR Director, the corporate real estate manager and indeed the wider workforce are divergent, but all have validity and all need to be addressed adequately in the ultimate property decision.

Senior c-suite executives all recognise that occupancy decisions, once viewed as ancillary to the core business, can have a significant impact on a company's strategic and financial performance. Boards are becoming aware that if their company footprint is misaligned with its operating needs, harsh penalties may ensue through asset write-downs and space shortages that impede competitiveness.

But in constrained labour markets where talent is at a premium, it is now vital that the input and considerations of the HR director are taken into account. The impact of any location or property decision on existing staff in combination with the potential of the new location to supply the right skills, in the right quantum and at an appropriate price-point, all need to be carefully assessed and satisfied. At Knight Frank we have seen growing involvement from HR directors in the procurement of space, and that involvement is occurring much earlier in the procurement process than ever before.

Finally, it is testament to the war for talent, that there is a growing trend for existing staff to be more readily consulted in property decision making processes. Human capital is fundamental to business, therefore it pays to ensure that key knowledge workers are included in and accepting of the process, in order to mitigate operational disruption. In a sense, people have the power.

FIGURE 2
Growing influence on real estate decision making

Source: Knight Frank Research

Cost considerations

The school of thought that suggests that the cost of real estate is an occupier's primary focus is out-dated. The reality is much more complex, for two principal reasons.

First, a new perspective on real estate costs is required; one which places those costs in relative terms against the overall costs of operating a business. For the occupier, direct real estate costs are a relatively small proportion of total operating costs. Indeed, a recent extensive study by the British Council for Offices maintains that real estate costs represent no more than 15% of an organisations total operating costs (figure 3). Real estate costs – expressed as the combination of rent, service charges and property taxes are almost four times less than the dominant operating cost, relating to staff. A greater number of occupiers are now appreciating, however, that the true cost of real estate is in its indirect effect upon the attraction and retention of staff, an issue considered in this report.

Second, attitudes towards the management of real estate costs have evolved. The Global Financial Crisis (GFC) placed huge scrutiny on company's real estate costs. Many were found wanting. Occupiers are now more attune to real estate costs with corporate real estate leaders, often through investment in lease administration systems, understanding their exposure.

In the wake of the GFC, businesses actively cut real estate costs through lease renegotiations and exits. Thereafter, they sought to control those costs by better utilising existing portfolios, reducing real estate run costs and limiting capital expenditure as they set about repairing the corporate balance sheet. In a third phase, as economic conditions settled and balance sheets were indeed enhanced, we witnessed the re-setting and transformation of occupier portfolios in response to business restructuring, with a greater willingness amongst occupiers to selectively invest in their real estate portfolios and, accordingly, increase the real estate cost base. In this sense, increased real estate costs are assessed on a broader 'return on investment' basis, whereby the relationship between real estate costs, overall people costs and wider strategic goals is more readily considered.

It could be argued that presently we are in a fourth phase of strategy. The term 'cost neutral' has emerged as part of the corporate real estate lexicon. Essentially this means that occupiers recognise the need to invest in their real estate portfolios to support wider strategic objectives or to facilitate restructuring. But with caution still very much a feature of the operating environment this investment can only occur on the basis of the costs across the entire real estate portfolio remaining neutral. Heightened awareness and scrutiny of real estate costs makes this approach possible and has served to further strengthen the rationale underpinning demand in real estate markets.

This broader and more forensic approach to real estate costs has brought with it a changing approach to real estate cost metrics. The post GFC period has seen attention turn from simple rent per sq ft costs, towards total occupancy costs and now, increasingly, the benchmarking of real estate costs relative to overall operating costs.

This is how modern thinking on real estate has evolved. Costs are registered as a relatively small component of operational cost but accepted as an element which influences much larger cost items. Importantly they are measured in entirety and considered as an overall return on investment.

THE IMPORTANCE OF TALENT

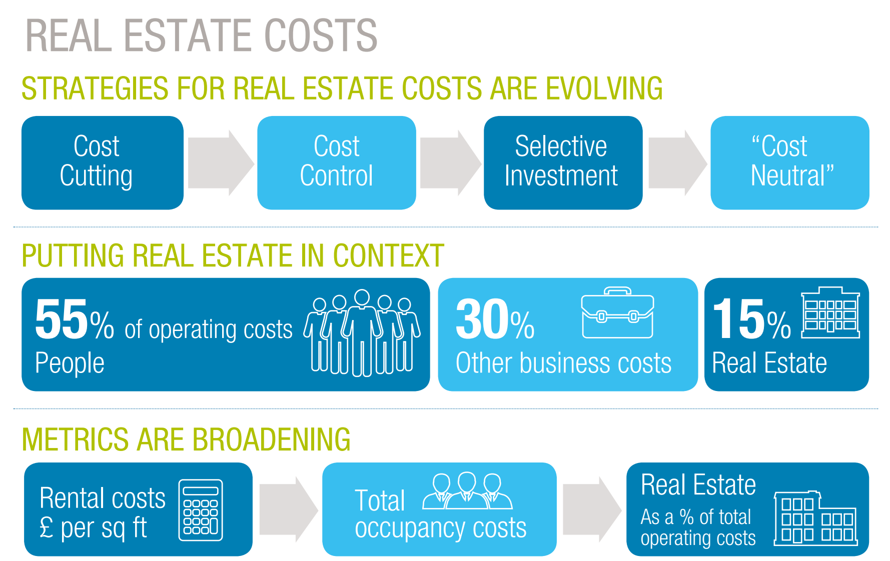
This paper argues that the 'war for talent' is one of three great disruptive forces facing modern business. As well as being the greatest operating cost, staffing is consistently recognised as the number one challenge facing business. With record employment in the UK combining with an acute national skills shortage occupiers are required to nurture and utilise every competitive advantage they possess in order to win in this war. Real estate is recognised as one of these sources of competitive advantage.

A high quality office environment located within a strong and vibrant setting can make a tangible difference to staff attraction and retention. Critically, it can mitigate the enormous costs and disruption of staff churn, with many occupiers now able to fully vindicate increased real estate costs on the basis of how that real estate option brings staff cost stability and greater value through enhanced productivity.

Talent – the #1 business challenge and cost

It has already been established that costs relating to staff are the main operating cost of a business, constituting some 55% of

FIGURE 3
Real estate cost considerations



Source: : Knight Frank Research; British Council for Offices total operating costs (figure 3). These costs are escalating significantly in high demand, low availability areas of the labour market, notably the technical, digital and creative skills readily associated with the growth of the TMT sector.

It is this dynamic which has led to the notion of a 'war for talent'. The language is not misplaced. The battle to access and retain in demand skills is fierce and is regularly recognised in global and national business surveys as the number one operational challenge facing business today. As businesses restructure, particularly in response to the growing influence of technology on both industry orthodoxies and operational models, demand for these skills escalates further and leads to both wage inflation and, accordingly, higher levels of labour market mobility by those with the required skill-sets.

The rise of the Millennial

The notion of a war for talent has, to some extent been usurped by a deeper debate about the generational dimensions of this talent. The heavy demand for technology and creative talent has exposed businesses to the 'unique' wants and needs of a new generation of worker – the so-called Millennial. This technology savvy group, born in between 1980 and 2000 – has been the subject of a veritable cottage industry of analysis and appraisal.

We believe that much of the analysis concerning this specific demographic grouping is misleading and misplaced. How is it possible to accurately articulate the thoughts and actions of a demographic cohort that covers a 20 year period – and indeed a period that had been one of the most volatile eras of the modern age? We believe that much of the analysis is built on flimsy evidence and can be somewhat self-fulfilling. There are four key points to make in bringing clarity to the issue.

> "MILLENNIAL'S DO THINK AND ACT DIFFERENTLY BUT NOT AS RADICALLY DIFFERENT AS SOME WOULD HAVE YOU BELIEVE."

It is absolutely true that the millennial generation have grown up fully exposed to technology. Devices, data and instant communication are all ubiquitous for this generation. Moreover they have a deep understanding of the mechanics and code of such technology and they are comfortable adopting and adapting to new technologies as they emerge. It is for this very reason that Millennial's are sought after – they have the very skills most required by business in order to drive transformation and maintain business relevance.

Yet at the same time, the burgeoning literature maintains that this generational grouping think differently about the how, why, when and where of work. They are said to bring different value systems to the workplace, ones that are in distinct contrast to previous generations. For example, they are said to be less careerist than their forefathers; they are thought to thrive in collaborative work-settings and are less comfortable working independently; and they are said to be less loyal than the baby boomer generation. Yet there is growing evidence that such statements are questionable. For example, by definition the Millennials are earlier in their careers than other generations and as they advance their careers – for they are at least as ambitious as those before them – they will be more prone to move from company to company in order to develop these early careers and skill-sets. Millennials do bring a different dynamic to business and the workplace, but it is largely a difference around the application and utilisation of technology – a disruptive force for sure – rather than a fundamental shift in their mind-set or value-systems.

> "LIFE-CYCLE CHANGES WILL FURTHER IMPACT ON THE NEEDS, DECISIONS AND VALUE SYSTEMS OF THE MILLENNIAL GENERATION."

Much of the dominant literature relating to the Millennial's could lead you to believe that these underlying value systems and mind-sets are static. Yet, as previous generations, can ably illustrate, progression through the natural human life-cycle will invariably bring change. So whilst Millennial's do presently favour city centre living, as they evolve and build their own families will city centre living be such a cast iron guarantee – particularly in cities where the cost of accessing housing is a significant proportion of income? The point is that Millenial's are exposed to all the same life changes and challenges as their forefathers and their reaction is unlikely to be much different. In this sense some of the characteristics and behaviours of Millenial's will inevitably change over-time.

This is even more so when one considers the geographical bias at work in much of the US focused Millenial's literature. The relationship between Millenial's and cities shown in the US is perhaps not as solid in countries where (sub) urbanisation has played out differently over time.

> MILLENIAL'S ARE INCREASINGLY ATTRACTED TO EMPLOYMENT OUTSIDE OF THE BIG CORPORATE ENTITIES AND ARE COMFORTABLE WITHIN START-UPS, SMALL AND MEDIUM SIZED ENTERPRISES (SMES) OR THEIR OWN VENTURES

Much of the talent that is being sought by modern business does not necessarily wish to work within large corporate environments. This is a function of both the marketability of their talents at a time of great dearth, but also a desire to put those talents to work in an environment that rewards them beyond their basic salary. There is a proclivity towards entrepreneurial start-ups or small scale, lean organisations that focus on pure delivery of technological or creative skills. This is creating further challenges for big business in accessing skills. It will increasingly lead to a symbiotic relationship between large scale business and small specialist niche suppliers – a relationship envisioned at the turn of the century by Charles Handy and embodied in the phrase 'Elephants and Fleas'.

> BUSINESS RESILIENCE AND COMPETITIVENESS IS ULTIMATELY ABOUT SOURCING, ATTRACTING AND RETAINING TALENT

In our view business success and resilience is all about accessing and retaining the services of required skills and talents. To us, the issue is less of a generational one and rather one concerning the specific skills or talents being sought. Attracting and retaining talented people does require appreciation of their wants and needs but it should never be simply about responding to the sweeping and often questionable generalisations about a particular cohort of society. In short, it is about much more than generations – Millenial's or otherwise. It is about addressing the wants and needs of people with specific skills and talents not only to benefit from such but also to ensure that the costs of continually seeking such are mitigated. This is where high quality, well located real estate has a role to play.

The true cost of staff retention

In the current competitive environment, businesses are adopting mitigating strategies to ensure that talent, of any generation, is attracted and retained. As a consequence we have seen the rise of sabbaticals, increased staff mobility within global corporates, provision of staff stock options, significant attention paid to career development paths and, more prosaically, subsidised gym memberships – all aimed at attracting and retaining talented individuals.

Real estate too has a role to play. Businesses are far more conscious of the role that a vibrant, diverse, amenity rich, collaborative and fun workplace can have in winning through in the war for talent. It is no coincidence that some of the most well recognised names within the technology sector have become synonymous with the provision of such places – and that lessons learnt from these experiences are now being transposed across a range of industry sectors, such as legal services, that have not been traditionally associated within anything other than uniform and cellular workplaces.

The attraction of staff through such environments is important, though we should recognise that the workplace is well behind salary and financial incentives when recruiting staff. The key contribution that enhanced workplaces play is in controlling the potentially enormous cost of staff churn by elevating retention rates. This is creating more occupier mobility and transforming the perception of the office from a business expense to a place that firms use to inspire and energise their staff.

A study by Oxford Economics found that the cost of replacing a member of staff averages US$50,000, with over 80% of the cost in lost output while the new employee gets up to speed. If the new worker is in a leadership or 'rainmaking' role, the loss of output will filter down to other staff where a line of dependence is in place.

On top of the replacement cost, there is also the loss of value that goes out of the door with the departing employee, such as training, knowledge, reputation and client relationships. Some studies therefore estimate the total cost of losing an employee can be equivalent of 150% of salary.

For the typical office worker in London, the total cost of their workstation in rent, local taxes and service charge, is around US$16,000 per annum. The median salary is London is US$54,000, so based on the 150% figure their replacement cost is US$81,000 or five times the cost of a workstation. It should be noted that most professional workers earn far more than the US$54,000 figure with the average newly qualified commercial lawyer earning US$91,000 according to recruitment firm Michael Page, suggesting a replacement cost of nearly $143,000.

Given that the cost to the business of replacing the worker vastly overshadows property costs, more firms are questioning the logic of achieving a small saving by either moving to a more peripheral business location if it increases staff turnover or moving to cheaper building. Those who look beyond a rent per sq ft metric understand the true value of space as a powerful means of winning in the war for talent.

NEW PATTERNS OF OCCUPANCY AND NEW ATTITUDES TO SPACE

The disruptive influence of the war for talent, technological advancement and ensuing business restructuring, impacts the way in which office occupiers think about space. As figure 4 shows there are three discernible effects from this disruption – new approaches and attitudes towards office space; greater mobility from those occupiers; and new models of space provision that combine collaborative and creative space with increased flexibility of tenure – the rise of the so-called co-working phenomenon. This paper will elaborate on the first two of these effects.

A new approach to space

In response to the aforementioned disruptive forces, office occupiers have developed new approaches and attitudes to space. These attitudes encompass issues relating to space utilisation, space densification and space beautification and all are premised on the need to increase staff attraction, retention and productivity.

In the 1980s and 1990s the key metric of workplace efficiency was the number of desks as a factor of a building's net internal area; however by the turn of the century corporate occupiers had become more sophisticated and were paying ever greater attention to the effect of the working environment on the productivity of their staff. Research undertaken by the Commission for Architecture and the Built Environment (CABE) and the British Council for Offices (BCO) in 2006 looked into the impact of office design on business performance. It found that differences in productivity as high as 25% were reported between comfortable and uncomfortable staff. As the connection between wellbeing and productivity began to be taken more seriously, the efficiency metric moved from sq ft per workstation to income per sq ft. This has led to a change in the ways occupiers think about space in terms of its utilisation, its density and its quality.

It is widely recognised that only around 40% of office space has historically been utilised at any one time. When set against the backdrop of the global financial crisis and an environment in which cost reduction was paramount, this level of utilisation has steadily been challenged. As a consequence, we have seen the widespread adoption of hot-desking, flexible working and, most recently, activity based working (ABW), as a means of reducing the amount of space vacant at any one time. When such strategies have been adopted with clear appreciation of working styles and potential impacts on staff they have generally been regarded as successful. When they are implemented purely out of a desire to reduce costs they tend to be detrimental to both productivity levels and worker satisfaction.

The same point is true in respect of the densification of space. When occupiers sought to squeeze more staff into smaller amounts of space without actually changing the underlying work settings, the results were damaging. However with the advent of ABW, occupational densities can be increased with the provision of a broader range of work-settings capable of accommodating different tasks and work-styles. When the occupier thinks beyond the binary distinction of open plan versus cellular office space, a whole range of opportunities open up for creating more efficient space that is productive, effective and, critically, represent spaces that people actually want to work in.

Attempts at increasing the density of occupation and the extent to which space is utilised is linked to a further change in attitude towards space from occupiers – the beautification of space. We are witnessing a far greater attention from occupiers in creating beautiful spaces through office fit-outs drawing heavily on high quality finishes, vibrant colour schemes and technology to create compelling and attractive workplaces. This is where the link between office space and talent strategies is most tangible. In a sense the embodiment of corporate brand through space has been internalised. The internal specification, style and structure of space tends to say a whole lot more about the occupier, its culture and its work-style than the external branding of buildings could ever manage.

Occupier mobility

As disruptive forces impact on occupiers, a new attitude towards location is also becoming evident. We have seen in recent years the rise of the 'shoring' phenomenon in which different corporate functions, with different degrees of criticality and different cost profiles have been steadily moved outside of expensive core markets to more appropriately priced or resourced locations. This has led to the growth of business process outsourcing in Central and Eastern Europe and India. But it has also driven increased occupier activity in the UK regional markets through what has commonly become referred to as 'north-shoring'. Whatever the destination, the process of occupier restructuring has led to new geographies entering the corporate portfolio. Mobility has been on the rise.

Mobility has another dimension though. In the context of a city such as London, we are witnessing increased mobility between traditional markets and submarkets as occupiers search for property solutions, cost effectiveness and, crucially, locations that appeal to the talented and highly skilled. In this sense, for many industry sectors, the importance of clustering has weakened, while the importance of the working environment has risen towards the top of occupiers' check-lists. Knight Frank's research has shown that businesses are increasingly willing to relocate from their traditional London districts to take advantage of mixed-use developments, offering high quality, flexible and vibrant stock in locations surrounding the traditional core markets, such as the Northern Corridor, Paddington and the Southbank.

We analysed all Central London leasing deals since 2006 involving units in excess of 20,000 sq ft, with particular reference to the submarket in which the tenant had previously occupied space. We found that between 2006 and 2013, an average of 33% of occupier relocations (by number of deals) involved a move between submarkets (the highest annually during that period being 40%, the lowest 27%). In 2014, this rose to 47% before increasingly sharply in 2015 to 68%. The City Core, Clerkenwell / Shoreditch and Aldgate / Whitechapel markets were the locations which attracted the highest number of tenants from other markets, suggesting a flight to value. However, more anecdotally, tenant demand has targeted quality product and urban environment, upon which new development in these markets has focused. While of course the low level of supply and cost would have influence, it is clear that occupiers are comfortable to consider moving submarket boundaries in order to secure the high quality, amenity rich space.

FIGURE 4

The effects of disruption on future occupier demand

Source: Knight Frank Research

CREATING TALENT MAGNETS

Despite an era of increased mobility and greater lease flexibility, occupiers continue to make strong financial and psychological investments in a location. Given this occupiers will stay rooted in an area if it can sustain them in responding effectively to disruptive forces. The most successful office locations therefore serve to consistently address the key concerns of occupiers as outlined herein. They attract in the highly skilled and retain them in the urban setting. They are talent magnets.

This magnetism occurs at the macro scale – through the provision of a strong sense of place, as well as the micro scale – through the provision of high quality, flexible and diverse workplaces. At both scales, successful office locations create well connected, high quality, culturally strong, amenity rich environments. Occupiers are seeking cohesive, vibrant, dynamic and fun places in which to operate, as this chimes with the needs and desires of their most valuable commodity, their most expensive outgoing and their greatest risk to becoming uncompetitive – their staff.

In conclusion, we believe that there are five key features of successful talent magnets:

1. **Amenity rich** – locations need to have a vibrant mix of uses that combine high quality office settings alongside a strong retail, food and beverage and leisure offer. The office buildings themselves need to be amenity rich and highly serviced with facilities inclusive of wellbeing initiatives such as cycle parks.
2. **A sense of place and community** – talented workers want to feel part of something bigger than just their business. Successful talent magnets promote and further a strong brand identity through active estate management and the creation of on-site communities.
3. **Connectivity** – successful locations are well connected. While strong and multi-modal connection extends reach into talent pools, connectivity also refers to the connection between those workers and the location quickly, efficiently and regularly.
4. **Supporting health and well-being** – Modern employees give greater emphasis to health and fitness. To attract the best talent, occupiers are providing this through the provision of trails, running and cycling clubs, gym environments, yoga classes, healthcare facilities and the like.
5. **Strong brand and identity** – talent magnets must have a strong branding and visual identity in order to attract occupiers. A key consideration is the office fit-out / design as a representation of the occupiers brand and brand values. A sense of place is an important attribute of a successful office building. Occupiers are seeking flexible workplaces that accommodate a range of working styles; allow people to collaborate; and which embody brand values and corporate culture. This has led to the growing popularity of Activity Based Working (ABW). The quality of the workplace, its amenity provision and its connection to the outside are all crucial.

Locations that embody these key features have the greatest chance of attracting occupiers in this age of disruption.

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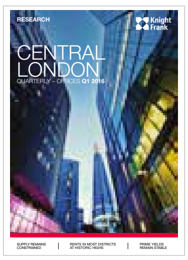

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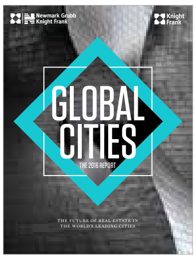

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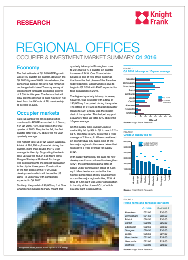

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