



The New Sub

Cost

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“We need floor plate size (40,000 SF) and shape flexibility to accommodate both private office and open system design, minimal core area, superior floor strength (100 lbs. per SF), 24 hour HVAC/Digital VVT capability, at least two fiber optic systems, and redundant power (150% of normal). Also, we would like a nice entry (marble) for positive client impression, a higher ceiling, airy design for employee comfort, and abundant parking (five or six spaces per 1000 SF) that can be made available “free” to employees and visitors. Our preference is to be located near the airport with freeway visibility and easy access. One last thing, today’s high rental rates are unacceptable, occupancy costs must be less than \$20 per SF including operations. Oh, we need to be in this space within 12 months.”

Sound like a wish list from the CEO of a small, little or no credit company? Or maybe it reads like the dream space for a dot-com startup or an R&D company? You may be surprised to learn that conversations like this one, between facilities planners for large Fortune 1000 companies and brokers, take place daily in many markets across the country.

What may be even more surprising, however, is the growing role of the new

suburban office building, as it offers both a cost-efficient, high-performance alternative to traditional office and a venue that greatly enhances productivity and employee satisfaction. Tenants in these offices appreciate the benefits of low cost space that is tailored to growing businesses, while also providing the amenities that greatly assist in both attracting and retaining employees in today’s tight labor market.

In a word, today’s employers and employees are different from those of ten years ago, and that translates directly into evolving space needs.

As a result, astute building investors now are insisting on a whole-building approach to design and construction that considers location, materials, indoor light, air and acoustics, outdoor amenities, parking, etc., and how they are interrelated in the most attractive, cost-efficient package to draw and retain desirable tenants.

Space that Responds to “Needs”

The New Economy has incited not only innovative technology and a booming market, but it also has produced a new breed of employee as well. While employers traditionally have focused heavily on growth and return on equity, today’s employers now need to direct their attentions to recognizing the cost of employee turnover and the benefit of employee productivity.

Urban Office

Efficient—High Performance

The leading employers of today are committing resources behind mechanisms for innovation, at the same time eliminating barriers for people with creative ideas. Fast changes and flexibility in strategy are becoming the norm; as a result, employers are more willing than ever to consider the position of work environment in fostering growth. The following are the “drivers” of the new suburban office:

Location/Amenities

For today’s employee, work is no longer just a paycheck; a job now must also act as an enhancement to a person’s lifestyle. Increasingly, employees are choosing those jobs that offer perks in addition to a good salary.

One of the primary perks for today’s employee is the location of the workplace. The long commute to a CBD is time consuming, frequently frustrating and often expensive. On the other hand, the Efficient Office is built in the suburbs where many employees live, thus reducing drive time and increasing an employee’s personal time outside the office.

Then, once in the parking lot, employees do not want to have a long walk to their offices. Therefore, it is critical that free parking space not only be available to all employees, but it also must not be situated at a distance from the office. We have estimated that 5 or 6 spaces per 1,000 SF of office space affords all employees the opportunity to drive to work if they so choose. This benefit,



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coupled with an efficient office surrounded by multiple entrances and exits, will act as an appealing prospect for all employees.

Design

Want to increase employee productivity? Give them what they want, even if they don’t articulate it; a hi-tech “smart” building that can grow and change as their needs do is just the beginning. Then, make certain that the structure has only two or three floors, thus allowing a short walk from parking lot to desk. Next, add attractive exteriors and large well-appointed entries with open staircases that employees prefer to overcrowded, slow elevators. High ceilings with large floor plates also provide flexible configurations for single or multiple tenants. Column spacing must accommodate high-density use. Multiple zone HVAC and lots of natural light make extra work hours more pleasant. Abundant, lush landscaping with outside areas for work breaks, lunch and perhaps physical exercise contribute to high employee satisfaction. Even large, easily accessed and well-ventilated restroom and lounge facilities can contribute to employee morale and thus, greater productivity.

Availability

The question of availability also must address the issue of potential flexibility as tenants seek to grow their businesses. Simply stated, it is difficult for today’s

high growth employer to plan ahead for unknown space needs. New initiatives arise quickly, expanded contracts occur almost overnight and many acquisitions are unpredictable. As a consequence, initiating a two to three year plan for high or mid-rise space doesn't happen. Cost-efficient office space, on the other

hand, involves well-developed, tilt-up design and construction expertise that can bring to life two or three story space anywhere from 80,000 to 160,000 SF in less than 12 months.

Conning Advisors advertisement

Cost

A "best practices" approach applied to site work, shell construction and lobby, interior, and base tenant improvements can yield significant savings over costs of traditional office space, as can a close examination of design, engineering, approvals, taxes and legal fees. Savings of as much as 20%-40% in total costs can be achieved, which translates into rent at a 20% discount to comparable Class A property while also giving tenants exactly what they want.

All-in costs (land, construction, and normal tenant improvements) are significantly less than alternative traditional office designs. The cost of land is clearly variable by specific location and in markets across the country. Hard costs, however (shell construction, site work, lobby interior, base and tenant improvements, hard cost contingency, etc.), for traditional suburban office can be as much as \$95-\$140 per SF or more. By comparison, brick and mortar costs for efficient office space average \$60-\$90 per SF. Soft costs (architecture, engineering, soils report, title/survey reserve, development fee, taxes, etc.) for efficient office can be less by \$12 to \$18 a square foot. How is this possible? A thorough examination of each part of the process

is critical to understanding how the cost efficient office is created and leased.

What does this Mean to Institutional Investors?

Developers tend to “build to the market” (low vacancy and high rents support ever increasing land and construction cost) and they tend to forget that it doesn’t last. Cost-efficient office space can be a great equalizer in less exciting times because it is not as vulnerable to elasticity in price fluctuations as mid or high rise office buildings. A combination of natural economic cycles coupled with the potential for investors to over-respond to increased demand have caused high levels of cyclicity in rents, historically. The lower cost basis of efficient office allows it to withstand a narrowing in the overall market rent while retaining acceptable levels of profitability even in soft markets.

With costs 20% to 40% less than comparable space and rents a bargain for the tenant at 20% less than attractive alternatives, it’s not hard to see the probability of institutional quality cash flow at double-digit rates of return. Tenant improvements (TIs) are generally minimal or paid entirely by tenants, as are all costs of operation. Occupied by credit tenants on 7 to 10 year leases with periodic rent increases, this new, state-of-the-art property takes on the characteristics of a triple net leased asset and becomes a star performer

in the institutional investor’s Core portfolio.

Additionally, this asset is highly marketable to a broad array of buyers

at a cost lower than they have been accustomed to paying (10% capitalization rate) but at a price for the seller well above all-in costs.

Low Enterprise advertisement

Risks

Just as there are risks involved in investing in companies as shareholders or capital providers, there are risks in developing their workplaces. Innovation implies risk, but the risk can mean higher reward. Essentially, an investor can capture the same type of innovation premium available to tenants in their enterprises – targeting specific tranches of customers, and tailoring the product to their specific needs and preferences.

While the workplace is being defined by the workforce, the fundamentals of supply and demand are reinforced, not changed. What has changed in the

cost-efficient model is timing. Historically, the stock of rentable space does not respond quickly. By decreasing the time it takes to enter into the market with a fully operational and attractive product, real estate investors are better able to respond to shifts in demand.

Investing in the right markets remains a key component of investment success. The demand for cost-efficient office depends on economic activity specific to the users of a particular type of space. Service sector and white collar economic growth must still take place to drive creation of new and expanding office-based enterprises. Increased demand

without increased supply will always result in the most motivated tenants bidding the least motivated out of the market, using price to balance demand and supply. With cost efficient space, value from tenants that may otherwise have abandoned a market or foregone expansion can be captured.

However, risks such as cost overruns, punitive time delays and extended leasing periods can be substantially mitigated through comprehensive and careful underwriting to ensure that tenant demand is greater than supply. This makes it possible to lease the property during or shortly following completion of construction. Speed to market, typically, a quick 8 to 12 month construction period, reduces risk of substantial market dislocations. Costs well below prices for comparable office space result in rent flexibility to capture the most desirable tenants. To further mitigate risks, developer compensation can be structured with earnout incentives to reward them for rapid lease-up, and for completing construction on time and on budget. Similarly, the investment advisor is highly motivated to produce successful projects in order to protect and/or enhance their reputation and to participate in returns realized by the institutional investor.

Operating and ongoing capital costs for this product are substantially reduced due to both building design and the structure of leases. Ongoing capital expenditures (cap x) are much lower than



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traditional multi-story office because of the open floor plan and concentration of common area facilities in the core. Leases are generally long term, triple net by tenants with good credit who also pay for overstandard improvements.

Future

So, has there really been a shift in the paradigm from the traditional to the new suburban office building? Can these cost-efficient structures really attract tenants away from those traditional workplaces? It is our belief that demand not only exists, but may

continue to grow for some time to come. To date, our firm has developed more than twenty of these "Efficient Office" projects across the country. We have gained success in ten major markets, laying out over 4 million SF. Our average size for one of these workplaces runs between 95,000 and 150,000 SF, while the project cost for each averages between \$12 - \$15 million.

We are convinced that cost-efficient, high-performance office projects will be the office space of choice for many employers in the new millennium. While inexpensive and quick to build,

they provide state-of-the-art design, power, security, fiber optic and environmental control capabilities along with abundant free parking. We have experienced rapid lease-up primarily by credit tenants, producing superior cash on cost returns (11% to 14%) and very high internal rates of return of 20% to 60% when sold. Today's demand at modest levels will grow dramatically as more employers visit and understand the economics of this well located, efficient and cost-effective space. Since supply of the right product remains constricted, current market conditions continue to be very favorable. ■

