BUSINESS BRIEFING
WORKPLACE STRATEGIES IN A FAST-GROWING MARKET
CHINA

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INTRODUCTION

In 2010, many occupiers in some of Asia's largest economic centers were confronted with an economic recovery whose speed and strength exceeded expectations. At that time, many enterprises, still reeling from 2008's global economic crisis, welcomed the growth opportunities that the Asia Pacific region had presented. Business enterprises would soon realize however, that renewed economic growth and business opportunities would be accompanied by significant operations and real estate challenges.

Following a precipitous decline in office demand over 2009, by 2010, Grade A office markets in many of Asia Pacific's major business centers began to see a sharp recovery. High absorption, accelerating rental growth, and rapidly falling vacancy rates quickly became the norm across the region. As a result, corporate occupiers seeking to establish or expand operations in major business centers such as Beijing and Shanghai were finding increasing difficulty in securing reasonably priced, contiguous prime-submarket office space.

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As the Asia Pacific economic recovery gathered steam, many enterprises across a spectrum of industry sector groups and backgrounds were experiencing rapid sales growth, and increasing profits. Their problems however, lay not in determining how to expand market share but rather in how they were going to manage growing space requirements and rising real estate costs given the dwindling number of options.

In markets such as Beijing, Hong Kong or Shanghai, these kinds of problems can pose serious challenges to business operations. For instance, a typical occupier who in 2009 capitalized on the economic crisis to secure a 3-year lease on 5,000 square meters (sq.m.) of Grade A office space in one of Beijing's prime sub-markets would have been in a very strong negotiating position.

At that point Beijing's average Grade A effective rents were approximately RMB161 per square meter per month (/sq.m./mo) and falling, while vacancy rates were just over 20% and rising. Generous incentives were being offered and landlords, anxious to stabilize cash flows, were becoming more flexible about deal structures.

As the 2009-signed, 3-year lease approached its 2011 rollover period however, the typical occupier would be confronted by annual rental growth well in excess of 50%. Additionally vacancy rates had fallen from 20% in 2009 to just 2.7% in 2011. Furthermore, many corporate occupiers, essentially playing a futures market, were scrambling to lock in rentals at a palatable level.

With market conditions such as these, a typical occupier looking either to establish or expand operations in Asia Pacific would have met significant challenges in finding contiguous, reasonably priced, prime submarket office space. Notably, tight conditions such as these have become commonplace in fast-growing markets across Asia. As such, C&W recommends a five-step approach to managing the workplace environment in a cost-effective way.

PLANNING

Business growth in an economy as dynamic and fast-moving as China's can be rapid as well as sudden so planning is paramount. While planning can help occupiers assess their current and future real estate needs, it must be acknowledged that in China, it is difficult to accurately predict the scale and speed of business growth. Considering this element of unpredictability and uncertainty, it is critical that occupiers devise real estate strategies that can simultaneously account for potential growth while building an effective hedging mechanism against rising property costs.

The importance of such strategies can be exemplified by the case of a Fortune 500 structural engineering and construction company that occupied 8,000 sq.m. of space situated in Shanghai's Hongqiao Submarket. The engineering firm was facing a challenging real estate predicament in Shanghai's high-rent, low-vacancy market. The crux of the challenge lay in the nature of the firm's business model. At any given time, the company would bid on several different potential engineering projects. In the event that they secured a contract, they would require an immediate expansion on employee headcount. As such, their real estate requirement could literally double overnight. Conversely, at the end of engineering contracts, they would execute sharp cost-cutting reductions in headcount that could lead to unused deadweight office space. This kind of business model presented significant challenges in planning and assessing the occupier's future real estate requirements.

For companies that are uncertain of their future space requirements, C&W recommends negotiating an expansion right contract on other units occupied by other tenants within the same building. Large occupiers typically pursue expansion rights for units on their current floor as well as the floors below and above. By negotiating expansion rights on other units within the same building, the engineering company would have expansion options as other tenants' lease periods came to a close. With other tenants' lease periods having expiry dates that are staggered throughout the year, the engineering company would periodically be presented with rolling options to lease new space.

Additionally, it would be critical to secure a lease abandonment clause so as to avoid unused office space in the event of headcount reductions. Hence, the engineering firm was able to abandon 3,000 sq.m. when one of their contracts came to an end, translating to an approximate cost savings of over 8 million RMB on its lease commitments. Indeed, C&W's strategic approach of judicious planning and a thorough understanding of the firm's business model allowed the engineering company to save significant capital.

Successfully calibrating real estate strategy to an occupier's business model involves a commitment to and willingness to execute on business planning and budgeting. Building an effective real estate strategy must incorporate aspects such as, business growth/contraction, and office relocation contingency. Planning must be viewed from the prism of how business forecasts may affect workforce adjustments and therefore real estate requirements. When considering real estate requirements, occupiers should not only consider how many new employees they intend to hire but also what business functions they foresee expanding or contracting.

This consideration is important because the relationship between workforce adjustments and real estate requirements varies significantly across business units and office functions. For instance, the telemarketing staff's per employee space requirement ratio will typically be less than that of employees on the R&D team. An occupier with future plans to expand its telemarketing team would require a smaller space than if it were planning to expand its R&D workforce. At C&W, we typically provide occupiers with space analysis that includes space per employee industry standards as well as employee-space ratios currently used by an occupier's business competitors.

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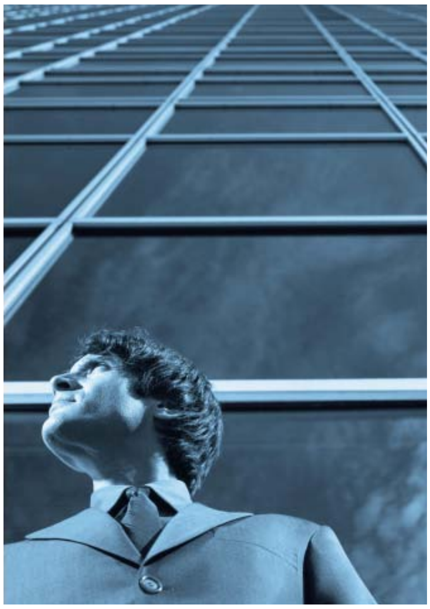
Many occupiers can be meticulous with regard to budgeting for business growth and or production volume changes. Oftentimes, occupiers develop careful understanding of how workforce expansions may affect costs such as payroll but neglect to thoroughly consider the extent to which these plans may also directly affect their real estate costs. Potential cost saving considerations such as, for example, the decision to purchase office space rather than leasing, are borne out of a thorough business planning and budgeting process. In a real estate market that is characterized by rapid growth and or high volatility, purchasing an office space not only represents an effective way to stabilize cost and reduce cash flow uncertainty but can also serve to achieve cost savings from mortgage expenses and property tax deductions.

By electing to purchase office space, occupiers can avoid short-term lease contracts with highly variable renewal pricing/terms and instead secure a set series of predictable mortgage payments. The final decision to purchase or lease should be based on the company's business plan vis-à-vis current and future real estate requirements. After establishing real estate requirements, the occupier should consider factors that are associated with owning office space such as relevant tax and depreciation laws as well as access to and the cost of acquisition capital.



UNDERSTANDING THE LANDLORD

Landlords are often perceived as solely focused on achieving the highest possible rental rate but this is not entirely the case. Landlords for the most part desire a stable reliable stream of income from high-credit occupiers. Landlords are also motivated by preserving their building's market positioning, quality and reputation. Of course higher rents are also desirable but many landlords are willing to consider trading higher but potentially erratic income streams from smaller occupiers for a reputed, credit-worthy tenant that has high name recognition, a significant space requirement and strong financials. In 2012, a well known Fortune 500 technology company located in Shanghai's Peoples Square submarket was seeking to expand operations and increase headcount. Unable to find suitable space within the submarket, the firm decided to move to Shanghai's iconic and expensive Lujiazui Submarket. Recognizing the value of its company brand as well as its large space requirement, the firm was able to secure space within one of Lujiazui's highest quality buildings at a steep discount.

A building's brand is to a certain extent, inseparable from the brand of its occupiers. Landlords have a keen understanding of this concept and will seek to incorporate into their buildings, goodwill derived from a well-known occupier's premium brand.

This is a prime example of using an understanding of what landlords want in order to negotiate strong positions and conserve on valuable capital. In this case, the landlord wanted to enhance the brand and value of the building and so was willing to offer an attractive lease package.

Additionally, landlords are typically able to demand higher rents from other units within the same building if they are able to point to the fact that a reputable tenant has selected their building premises for occupancy. This is even more so the case for well-branded occupiers who are considering establishing a regional or national headquarters office.

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Leveraging a well-known brand in order to lower cost requires strong advocacy from an experienced leasing team that intimately understands brand value and its role in tenant representation.

Landlords also prefer to lease space to a diverse group of qualified tenants from various industry sectors, and geographic backgrounds. Along with a blended tenant mix, landlords make significant efforts to stagger tenants' leases so that no one occupier or industry sector can significantly affect rental income-streams. For medium-sized buildings, landlords will be particularly reluctant to lease more than 30% of their available area to a single tenant. Dedicating a large area to a single tenant could severely limit the landlord's ability to optimize tenant-mix and industry sector diversification and thus lead to higher vacancy risk in the future. As such, even reputable tenants are likely to see a diminished bargaining position if their space requirement represents a large percentage of the landlord's office building.

Occupiers that elect to renew their current lease should also have a keen understanding of what landlords want. Employing an understanding of a landlord's desire for stable, uninterrupted cash flow can help occupiers to renew their lease with favorable pricing and terms.

When considering renewing a lease contract, occupiers should be aware that landlords have an incentive to renew leases. They wish to renew leases because there are costs and risks involved in finding new tenants. For instance, a landlord that takes possession of recently vacated space will suffer a loss in cash flow over the vacancy period. They will also have to spend time, energy and money to market and show vacated units to potential occupiers.

If the landlord is able to secure a tenant, they may have to absorb significant costs such as brokerage fees, as well as lost rental revenue over the new occupier's fit-out and rent free period.

Moreover, with new occupiers, the landlord will be exposed to a higher degree of non-performance risk. Even in bull markets, landlords are willing to pay a premium to avoid these uncertainties, revenue stream disruptions and costs. Prior to entering into negotiations to renew a lease contract, C&W will assist occupiers in first securing a list of potential feasible relocation options. Doing so will introduce competition into the negotiation process thus incentivizing the landlord to offer attractive terms. C&W will then typically provide a detailed analysis of the costs and risks that the landlord will encounter should the occupier elect to abandon its current space. These costs may be used as a negotiating tool to help arrive at a renewal rental level favorable to the occupier.

DECENTRALIZATION OF OPERATIONS AND FUNCTIONS

In an environment of rising costs, firms are compelled to rationalize operations. Decentralizing certain functions can be an effective way to control occupancy cost. Many occupiers have successfully achieved cost savings by relocating certain operations to decentralized areas. In the first quarter of 2012, there was a significant case in which a logistics firm committed to move their 7,000 sq.m. office from one of Shanghai's most central submarkets to an emerging market north of the city.

There are, of course, significant challenges to adopting such a strategy. Firms in the logistics, pharmaceutical, fast-moving consumer goods and industrial/construction sectors tend to have the most success and least business operation disruptions when decentralizing functions. Firms in the consulting, legal, banking, media/advertising sectors however, should carefully consider, the impact that decentralization may have on client interaction, business development and branding.

Some occupiers however, have been successful at relocating to other office markets entirely. A Global Fortune 500 shipping company, that originally occupied a 3,000-plus sq.m. office in Beijing's prime office submarket, elected to reduce their Beijing office size by 75% and move many operations such as back-office, call center, and support staff to the significantly cheaper Chengdu office market. This relocation allowed the occupier access to both a more affordable office market as well as a lower cost labor pool.

Across Asia Pacific, occupiers in the Finance and Banking have seen some of the strongest decentralization trends. Hong Kong's high-rent, supply-limited CBD has seen banking occupiers begin to employ decentralization strategies. Over the first quarter of 2012, two major banks committed to decentralize out of Hong Kong's central business district. One of the banks will decentralize back-office functions such as accounts, settlements and human resources. The other major bank will relocate their entire offices to non-central submarkets such as Quarry Bay or Causeway Bay where they can secure CBD-quality office space for less than half the cost.

Advanced information technology capabilities have afforded occupiers the convenience of moving certain functions to suburban, less expensive non-central submarkets while at the same time maintaining a cohesive flow of information and communication between head and satellite offices.

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INCREASING WORKSPACE EFFICIENCY

At any given time, occupiers should always explore options to maximize workspace efficiency. One method is a strategy commonly referred to as "hot-desking". Hot-desking is a phenomenon in which multiple employees share a single work station. Hot-desking is a particularly savvy option for occupiers that have a travelling sales staff, or employees who do not have over-lapping work schedules.

A pertinent example of this strategy is a multinational consulting company that C&W has advised on workspace efficiency. The company agreed to participate in a space utilization study that closely analyzed the movements of its employees. Using data that showed the timing and the average duration that employees used their computer workstations, C&W found that consultants only spent about 40% of their time at their on-site workspace. The firm's partners, however, spent 80% of their working time at their work stations.

As a result of this study, the firm instituted a shared work space policy for consultants while preserving private offices for the partners. By increasing workspace efficiency in this manner, the consulting firm was able to reduce their office requirement significantly.

Through a well-executed hot-desking strategy coupled with effective workplace management, occupiers can effectively cut down on space requirements and costs. Occupiers may also consider improving workspace efficiency through restacking current space. Restacking plans involve close communications and cooperation with operations teams. Having a clear understanding of linkages among business units is critical to executing a restacking plan that saves on occupancy cost.

Occupiers may also consider capitalizing on under-utilized spaces such as conference rooms or kitchenettes and restacking them into viable highly efficient work spaces.

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PRE-LEASING

Pre-leasing can be an effective cost-effective measure. In a real estate bull market, if an occupier's plan calls for an increase in workforce numbers along with a commensurate office space expansion, it is generally fiscally prudent to begin lease negotiations as early as possible. In rapidly growing markets, early contracts can help lock in lower lease rates and more favorable terms.

For example, a major pharmaceutical company was confronted with securing a 6,000 sq.m. office space requirement in the heart of Shanghai's central business district. Although the target handover date was more than a year away, because of market conditions, C&W advised that they begin negotiations immediately. In starting negotiations and securing contract commitments more than a year before their move-in date, the occupier was able to lock in a relatively low rental as well as advantageous terms.

Occupiers should also consider pre-leasing space in buildings that are still under construction as landlords are usually more flexible at this non-cash flow generating stage of their investments. By preleasing construction-phase buildings, occupiers can enjoy three significant benefits.

First, occupiers can capitalize on the low occupancy, construction phase to negotiate lower rentals and favorable terms. In a bull market such as Shanghai or Beijing, pre-leased rental levels will be lower than those of the prevailing market average rental at the time of building delivery. Second, once the space is delivered, occupiers can enjoy brand new building amenities. Lastly, as developers in major markets across Asia are increasing building standards to meet growing occupier demands, newer buildings tend to have the highest efficiency and sustainability. Newer buildings will have more energy efficient mechanicals and thus lower management fee costs.

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CONCLUSION

Occupiers seeking to establish or maintain a presence in the rapidly-growing markets across Asia will certainly have to contend with prohibitively expensive real estate costs and a dearth of contiguous high-grade office space. From both an operations and cost perspective, these challenges can represent serious obstacles to businesses.

Nonetheless, occupiers can elect to adopt a series of proactive and business-savvy measures that can generate substantial savings as well as secure suitable space in low vacancy markets. In summary, through careful business planning, a keen understanding of the landlord's bargaining position, operations decentralization, increasing work space efficiency and pre-leasing, prudent occupiers can effectively manage their costs while enhancing their business positions.

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