Understanding the true cost of property:

What every financial executive needs to know

Rent typically represents only 1/3 of total property costs. Financial Directors face the significant challenge of considering all associated costs, from a diverse range of internal and external sources.

This paper, researched and written by a leading financial journalist details the broad range of costs that comprise the total expenditure of acquiring and managing property. It provides the insight of relevant experts, and highlights the key issues. In addition, to enable Finance Directors to make informed decisions, it also presents a range of property strategies available.

"What's absolutely essential is that companies look at their real estate strategy in the context of their business strategy. Commercial property is a big cost and a big commitment – it's not just about the here and now, it's about asking yourself where you will be in the next five to ten years."

Howard Freedman, head of Baker Tilly's Real estate and construction group

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Rachel Fielding is a freelance business journalist with 15 years' experience working in the finance, IT, accountancy and management press. Highly regarded in these sectors, she has forged relationships with high level business contacts, and profiled C-level executives at some of the UK's biggest corporations. Her work has appeared in many financial titles including; Accountancy, Economia, Accountancy Age, Financial Director and Finance Week.

Introduction

For many companies investment in commercial property costs can be a significant factor; second to people it is likely to be your most expensive outlay. Despite the huge financial implications of getting it wrong, not all CFOs are being provided with the information required to make an educated evaluation of property costs. Inherently, property encompasses a multitude of costs, from many different sources, throughout the entire organisation, therefore it is not surprising that some of this data is not readily accessible.

The commercial real estate landscape is also undergoing significant change. Today, organisations have more choice than ever before on what type of property acquisition strategy to adopt. This may include models and strategies that they have not previously used, or even been aware of.

The costs of acquiring and maintaining property can, therefore, be large and complex and the reality is that the cost of real estate goes way beyond these headline figures. There are also a multitude of costs that are either overlooked, or hidden, having a potentially big impact on a company's bottom line.

At the same time, the landscape is changing as new models for sourcing commercial property evolve; models that allow a shift away from capital expenditure to a more flexible operating expenditure model. This may challenge the traditional view of owning or indeed running your own property portfolio. CFOs have an absolute responsibility to place themselves at the middle of this debate and ensure that the right property decisions are arrived at, and that all hidden costs and departmental costs and efficiencies are challenged.

This white paper will address the questions facing CFOs in their quest to ensure that stakeholders involved in property decisions are aware of all of the costs that need to be taken into consideration. It will compare the main models of commercial property acquisition and highlight the expenditures that often fall under the business radar.

Avoiding the 'Black Hole' of property costs – why commercial property should be on every CFO's agenda?

As the economy struggles to emerge from recession, ensuring that your business understands the myriad costs of each commercial property decision has never been more important. While an analysis of headline rents per sq foot may dominate the property press, the reality is that rent as a separate cost head only represents an average of 35% of the total cost of occupation of offices. According to analysis by Actium Consult being aware of these costs could prevent a future "black hole" in corporate cash reserves developing, and identify areas where the CFO could make tangible savings.

Is your business aligned to your property, or your property lease?

As the need to align commercial property and business commitments and strategy grows apace, the idea of being tied into long property leases is leaving many businesses cold. Instead the onus is on FTSE 250 boards to ensure they have a business strategy in place that offers a solid platform for business growth without the nasty surprises of hidden costs or onerous liabilities.

> "Flexibility in commercial property strategies is essential. There is always a risk of onerous leases, either too long or with short notice break clauses and with more flexible working, office space capacity or empty surplus may be a risk."
>
> Michael Power, Professor of Accounting at the London School of Economics and Political Science (LSE) and director of the LSE's Centre for the Analysis of Risk and Regulation

At the same time, the business environment has radically transformed over the last few years; economic uncertainty has propelled 'agility' up the business agenda and flexible working has become an employment imperative for staff as well as a cost-saving opportunity for business. Indeed, British businesses could save up to £34bn a year by freeing up desk space and working more flexibly, according to research by YouGov. Savvy organisations recognise the value of transforming work and workplaces to cater for the demands and aspirations of agile organisations and an increasingly mobile workforce.

The maturity of the outsourcing model, its acceptance within the commercial property sector and its extension to the property market means that business executives are now able to delegate responsibility of the minutiae of commercial property decisions to third party experts. Outsourcing offers the benefit of a fixed-price, all-inclusive model that allows businesses to focus on their core activities and inject some certainty onto the balance sheet.

"Much depends on the specific managed solution contract. Office property values are very volatile and cyclical, so risk-averse CFOs are attracted by managed solutions, particularly if there is a dearth of skill sets to provide oversight of property portfolios, including strategic let/buy decisions," says Professor Power, of the London School of Economics.

> British businesses could save up to £34bn a year by freeing up desk space and working more flexibly. Source: YouGov

Mitigating the risk of property – What every CFO needs to know

For CFOs, the implications of the uncertain business climate need to be considered seriously; enormous increases in volatility and the added pressure of economic instability are placing business overheads under more scrutiny than ever and propelling risk and the ability to manage it up the CFO agenda.

CFOs understand that at the core of their agenda lies risk management – the ability to link risk with strategic planning, financial management and performance, monitoring and managing the cost of capital, and having a complete understanding of the many risks relating to the assets and liabilities within the balance sheet.

But despite its growing relevance to the risk agenda, Professor Power said CFO attention to commercial property decisions remained patchy: "Much depends on the balance sheet and operational materiality of the property, involving physical management and investment and on-going costs as well as planning for capital spends. It gets on to the risk agenda if it is (a) a big number and (b) essential to operations (a single dedicated location is more risky than several dispersed locations)."

"The amount of attention given to leases in recent time – in particular onerous leases that simply aren't viable – is driving a whole life view of property," warns Eric Tracey, non-executive director and chairman of the audit committee of FTSE 250 power back up company Chloride Group.

Despite the advancement of the purchasing function, the savings promised by in house procurement experts are in many cases failing to materialise. Analyst Aberdeen Group blames passive involvement by finance in procurement decisions for contributing to a savings 'gap' across most procurement programmes. Commercial property procurement is no exception.

"Large companies often have a property department and there has been a tendency for board-level property decisions to become a rubber stamping exercise," says John Gotley, Portal's managing director. But as the UK government takes steps to address its own property estate as an opportunity to cut costs, new approaches to property acquisition are starting to gain traction. "The whole nature of thinking about that cost area has changed," Gotley adds.

> "Property has been a headache for CFOs and I would certainly expect it to be on the radar. It's clearly attractive for companies to know what their costs are but collating all of these costs in one place may be quite difficult."
>
> Eric Tracey, non-executive director and chairman of the audit committee of FTSE 250 Chloride Group

It is difficult enough to make an informed property choice even when faced with a simple property transaction but coordinating these decisions in a larger organisation with a complex portfolio of properties is an unenviable undertaking requiring significant financial expertise. At a time when CFOs are grappling with ever more regulations and pressure from stakeholders, it is at best an added distraction and at worse an unnecessary and cumbersome burden.

How to determine the true cost of property?

Incorrect property procurement decisions can be very expensive and legacy property costs can haunt you for many years. With balance sheets under increasing scrutiny, the days of even large, profitable organisations absorbing such costs are numbered.

Whether buying, leasing or opting for a managed service approach, it is important to ensure that all relevant factors are taken into consideration to give an accurate picture of all the costs associated with any particular approach. Here we outline the main costs – both identifiable and hidden -- that should be factored into the acquisition and operation of a property over its contract term.

Identifiable Costs

Rent: Rent is the most significant cost in percentage terms as well as actual costs. Although per square foot figures grab the headlines, rents represent on average only 35% of the total cost of any commercial property decision, according to Actium Consult. Given that there may well be a collection of incentives attached to a lease (for example rent free or discounted periods) it is important to make sure you have an accurate picture of the rental cost.

Rates: Business rates, a form of property tax, are pegged to inflation and property values and as such are dynamic and subject to fluctuations. Last set in 2008, at the height of the property boom, a revaluation had been due in 2015, but the government is delaying this by two years. Prior to 2007, empty industrial properties were exempt from business rates and empty commercial properties were subject to extensive reliefs and reductions. These exemptions were abolished at the 2007 Budget.

Annualised costs: This includes furniture and fit-out. Bear in mind that the way you fit out and furnish an office can have a dramatic impact on factors including productivity, attendance and even innovation (see Hidden Costs section).

Not surprisingly the cost of workstations can vary dramatically. Fit-out and design need to factor in an environment that caters for both information sharing and collaboration but also deep thinking and heads-down focused work.

Facilities Management (FM): Includes insurance and general maintenance, security, waste disposal, and energy. Although analysis suggests that the cost of energy has not increased greatly over the last year, longer term this is likely to be an area prone to increase, particularly in older office buildings. FM costs will also include other items such as, catering, IT & telecommunications, reception, post and couriers, printing and reprographics and on average will represent between 11% and 13% of the overall cost of an office depending on its age.

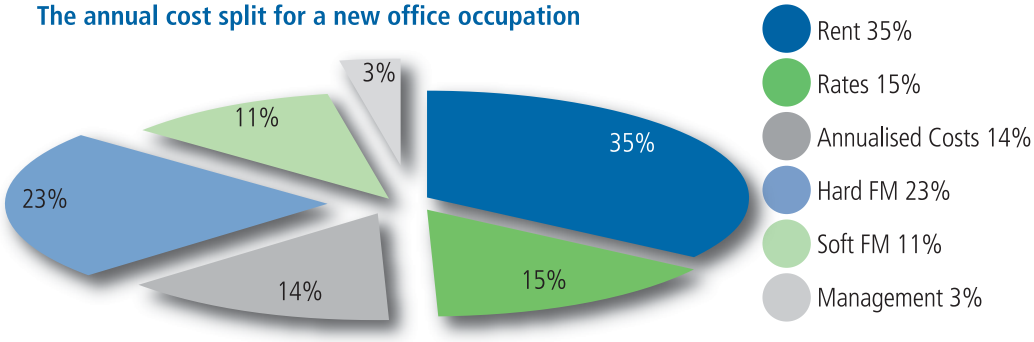
Dilapidations & Exit Costs: Clauses often require a tenant to reinstate the property to the same condition it was in when the lease was first completed. These costs can be prohibitively high and are often designed to force a tenant to renew their lease rather than exit the property. Legal fees and dilapidations should be factored into your exit costs, with experts warning that businesses should consider an exit strategy at least 18 months prior to lease expiry.

Management: Includes professional fees and project management time. This typically represents around 3% of overall property costs, according to Actium Consult.

> "Headline rent per sq ft is very far from the whole story of total office costs. The reality is that rent on average only accounts for an average of 35% of total cost of office occupation"

Andrew Procter, Actium Consult

The annual cost split for a new office occupation



Source: Total Office Costs Survey 2013: Actium Consult

Hidden Costs

It is vital for management to recognise the host of hidden costs that, while notoriously difficult to quantify, can have a huge impact on your business. The location of buildings has long been recognised as having a knock on effect in terms of employment rates, the cost of recruitment and attendance. Similarly, office design can have a huge impact on productivity, attrition rates and even innovation. For example, if it is important in your business to have an environment where people can easily interact, you may need to spend more on your café or staff break-out areas.

True understanding of space utilisation is an area often overlooked by businesses, but thanks to the emergence of analytical tools, it is now something to which companies can apply some form of strategy. Andy Gilbert who provides strategic consulting for corporate workspace and data centre environments, says businesses should be aspiring to a desk utilisation rate of between 70% and 80%.

"It's about changing the way you work and having the right mentality to embrace hot-desking. People realise there's a lot they can do in terms of the look and feel of an office but they need underlying data to design the workplace for the future; the number of desks they'll need, and the size and type of meeting rooms depends on how people work," Gilbert explains.

Analysing business needs and understanding staff behaviours is key to making the most of your office environment. But Gilbert also accepts that planning your office space needs for the future is notoriously difficult. "When people want more space, they typically need it tomorrow."

A building that meets the needs of the business, with a working environment that has been adapted to meet your working practices and also represents your office culture, does more than send out the right message to clients; it will deliver significant cost benefits as well.

Other costs –
that tend to be forgotten

- The cost of money for capital expenditure
- The cost of overruns – 90% of implementations in the industry go over time and over budget
- Project management of the implementation
- Legal costs associated with the lease
- Maintenance contracts - building, plant and machinery, ground maintenance, day to day (for example carpet cleaning), technology hardware
- Inflation
- Support contracts - technology, plant and machinery
- Real support people costs - recruitment, training, support, attrition, salaries, salary increases, sickness and holiday cover
- General housekeeping
- The cost of unused space during roll out
- The cost of unused space once the operation is up and running
- Future upgrades - forced through health and safety regulations, technology advances
- Cost of getting things wrong - such as employee numbers, business forecasts, installing the wrong equipment

Commercial Property Strategy Options

Lease

Historically this is the most common of all commercial property acquisition strategies in the UK. Leases will require an upfront deposit with rents typically payable on an annual or quarterly basis. The uncertainty of business rates can result in fluctuation in charges. Similarly service changes can vary dramatically. "Companies want visibility but they don't always get it and the problem is you're hostage to fortune once you're in," warns Howard Freedman, head of Baker Tilly's Real estate and construction group.

However with businesses remaining nervous at the prospect of being tied into long term contracts, downward pressure on leases has, according to Howard Freedman, seen 10 to 15 year leases become the norm compared to 25 years a couple of decades ago.

Although contracts will dictate some certainty in terms of the rent you pay, that is just the tip of the iceberg in terms of the cost you will incur. And while most landlords are happy for companies to refit buildings to meet their specific requirements, there is a hefty price tag attached to the fit out. Landlords may offer to spread that cost out over the term of the lease and offer off balance sheet accounting. Be aware, though, that the cost of dilapidations can be significant and exit costs high.

Capital purchase

The requirement of a large upfront capital investment to purchase commercial property is particularly unattractive during an economic downturn when many businesses want capital to invest in their business or the security of a financial cushion to fall back on.

Whilst the availability of property may not be an issue in the current climate, the difficulties of sourcing bank funding for such purchases have certainly been exacerbated as a result of the financial crisis. Owning property gives you the flexibility of being able to sell it when it is surplus to requirement but then you are beholden to the vagaries of the property market.

Indeed many organisations have become victims to changes to business circumstances; business rates on empty buildings forced landlords to fork out a staggering £1.1bn in taxes in 2012 representing a 19% hike on the previous year, according to an analysis of figures by the Taxpayers' Alliance.

Large upfront capital investment aside, the purchase model offers many of the advantages and disadvantages of the leasing model. You are responsible for the management and cost of design and fit-out, installation of IT and the on-going support and management of the building, which offers the benefit of control but the disadvantage of additional cost and the headache of managing the process. Although the capital cost of building or buying business premises is not tax-deductible, capital allowances are available to give owner-occupiers tax relief for expenditure on plant and machinery in new or second-hand commercial property. Companies can claim tax relief on fittings such as air conditioning, cabling, and security systems or anything relating to the intrinsic fabric of the building.

However there is always a danger with a capital purchase that the building in question won't match the needs of your business going forward or will incur additional and potentially significant costs further down the road.

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Professor Power, London School of Economics

Managed Office Solutions (MOS)

Managed Office Solutions, which should not be confused with the serviced office model, refer to the provision of accommodation configured to the exact requirement of the occupier at a location of their choice, comprising of completely managed facilities with a fixed price per workstation during the contract length, with no capital expenditure or risk carried by the occupier.

By adopting MOS you have a choice of location, and buildings can be fitted out to meet your exact requirements. Opting for MOS ensures the building meets the needs of your business – today and in the future, this ensures that your property is driven by the needs of your business and is continually aligned to your on-going objectives.

The knowledge of outsourced experts brings other tangible benefits, especially insight into areas including space utilisation and the impact of effective office design on productivity and the bottom line. If you're paying a per-desk rate, understanding the way staff work can allow you to optimise your desk usage. By paying a fixed price for the service, and delegating responsibility to a third party, offerings are not only often cheaper than you could procure for yourself but also reduce the risk of cost creep, throughout the lifetime of the contract. This ensures greater cost clarity over the entire term; quite simply, you mitigate your property risk.

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Conclusion

The true cost of property encompasses a multitude of inherent costs, both identifiable and hidden, from many different sources. In many companies gathering this information can be difficult and time-consuming as some departments maybe slow or unsure of what data is really required or relevant.

Furthermore, there are now more property strategies to consider. Solutions are available that have the potential to better align a company's commitment in property with its foreseeable business planning horizons, and provide longer-term cost clarity. These options however, often sit outside the existing corporate property acquisition model. Because of this, many internal property staff are either unaware that these options exist or do not have the experience to communicate their potential benefits effectively over and above more traditional, but potentially more risky offerings.

While this is a significant challenge, being aware of all of the property acquisition options available, plus all the internal and external factors that make up the true cost of property, presents the CFO with a major opportunity to clarify and therefore control costs throughout the entire life of the property contract. The result: long-term property risk could be a thing of the past.

"One size doesn't fit all," warns Howard Freedman at Baker Tilly. "But what's absolutely essential is that companies look at their real estate strategy in the context of their business strategy. Commercial property is a big cost and a big commitment – it's not just about the here and now it's about asking yourself where you will be in the next five to ten years."

About the sponsor

Portal's unique Occupier Solutions approach provides an innovative, tailored, cost-efficient Managed Office Accommodation; increasingly utilised by leading corporations to mitigate risk, provide cost certainty and enable them to focus on their core competency.

Portal can partner you through the entire process. We can help you evaluate your current property portfolio, assess costs and provide workplace analysis utilising non -intrusive sensor technology. Location analysis can assist in selecting the building that meets your operational requirements. Portal's consultative approach enables decisions to be based on a true understanding of your needs and provides expert support all the way through to delivery.

Portal provides an optimised solution, delivering a bespoke infrastructure solution directly aligned with the client's requirements, including:

- Acquired/new build or portfolio property fitted out to your exact business requirements.
- Qualified site management.
- All hard and soft FM delivery (security, cleaning, canteen etc).
- IT and telephony (supply and support).

For further information on how we can provide you with an alternative property strategy suited for today's dynamic business environment please e-mail info@portalgroup.uk.com, phone 0207 495 5672 or visit www.portalgroup.uk.com.