



OAK INVESTMENT MANAGEMENT GROUP



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Office Real Estate

Office real estate constitutes approximately half of all commercial real estate. In terms of size and value, therefore, it is the most important segment of real estate but that does not mean that it is one without its own challenges. It is by no means clear what the consequences of technology and concomitant social trends will have on the physical office workspace going forward.

Typically, office real estate is characterised by secure income for the term of a granted lease. Should the quality of the covenant be sufficient and the tenant's underlying business prosper, the landlord reaps the reward of being a 'junior banker' to the business that requires the office space. Depending on the pricing power of the landlord, there are costs in order to secure a tenancy in the office market. These can take various forms such as rent free periods, landlord's investment in the tenant's space or some other variant of the two. The aim is to secure as long a tenancy as possible.

However, with an increased length of tenancy there comes another issue: that of re-pricing. It is widely considered acceptable to mitigate the effects of inflation in the rest of the economy with re-pricing of the base rent over a long tenancy. However, this is fraught with difficulties. As a starting position, on the one hand the landlord usually wants certainty and on the other hand the tenant wants flexibility. Adding future pricing to the equation tests the limit (now) of what each party to the transaction is willing to accept in the future. Re-pricing of the rental base can take the form of mandated steps up or according to a pre-agreed index. It is important to note that even if a landlord thinks that they have done a good deal on a contracted rental figure it is often hard to sell a building which becomes over-rented (over-charged) in comparison to its peers.

At the end of the tenancy there are also costs for the landlord to make the office space as good a space as possible for the next tenant. Sometimes a landlord can deal with much of this (especially in a long tenancy) with a dilapidation claim from the former tenant and / or a promise in the original lease to restore the premises (save wear and tear) to its original state.

Offices are a hub of activity, they are also a great catchment area of people with by definition higher than average disposable income. As a result, savvy landlords will seek to compliment the office offering with retail that works with this clientele and footfall. Management and concierge services (beyond building maintenance) are an excellent way to up-sell services as well as answer a client need. Correctly managed, the aim is to increase the bottom line with tailored services using the landlord's unique perspective of the tenants of a building. This must never be a distraction from the core competence of running and managing an excellent office environment.

In this way perhaps the future of the office market in real estate becomes clear. The classical office might well change radically – but the role of the landlord in providing a de-cluttered excellent work environment and responding to the occupational requirements of a tenant is the first and the last source of *alpha* in investing in office real estate.