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The standing value of the “core & shell” can make properties more economical than new construction - by Bill Norton

April 06, 2018 - Northern New England

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As spring approaches, our clients are wondering what lies ahead for commercial real estate. (So do we!). Many buildings age and some become either functionally or economically obsolescent. Some of these need to be replaced. Today’s high construction costs can make this very challenging. But there are a number of properties waiting to be repurposed - office buildings into residential, former churches, now schools and soon malls and retail centers. The fact that the site work and utilities are in place, and the standing value of the “core & shell,” can make these locations and properties more economical/competitive than ground-up new construction. Thus, in the past two years, older buildings have been getting a second lease on life.

It is the Yankee way to recycle, reuse and repurpose. Another driver is energy efficiency. Tenants have to consider more than the net rent paid to the landlords. They have to consider the triple net (NNN) costs too. While property taxes seem to go up every year, energy costs have as well. Some of this is the cost of the electricity (including air conditioning), gas or fuel oil for heating and, now, water and sewer (for example, Portsmouth has recently undertaken a major upgrade of its water and sewer infrastructures so its rates have jumped substantially). But at the same time, density of office space has increased the number of workers per square foot, or more accurately the number of square feet per worker has shrunk, which impacts operating costs. Thirty years ago a rule of thumb was 200 s/f per employee, 15 years ago this dropped to 150 s/f and today it is approaching 100 s/f. Much of this is enabled by technology. Computers have gotten smaller, email and electronic media means fewer printers, less paper storage, etc. But increased density comes with a cost - more energy use (AC and power) per worker and per s/f. Older buildings often do not “modernize” well. They have structural columns that interrupt work space layouts. Their mechanical designs are old and inefficient and they may have too many offices (usually on the window line). These spaces do not accommodate teams and flex space. So, it is a fact that in some (few) cases new construction, even at today’s high costs, can achieve cost savings. But more and more we are seeing rehab as a faster and more economical approach.

As a commercial real estate practitioner for more than 40 years, I would hear tenants and users complain about the high costs of space. But the economics are pretty straight forward. Whether office space costs $20, $30 or $40 per s/f per year, the workers who occupy that space cost considerably more. Space is a cost, yes, but it is also necessary to create your service or product. It is a cost of doing business, one which needs to be managed.

Today's younger workers (Millennials and Gen X'ers) seem to care about their work space more, which is to say they expect newer, cleaner, modern work environments with good lighting (for computer-based work) and air conditioning. If they are going to spend the majority of their day in front of one, two or three computer screens, they want (and should) be comfortable in order to be productive.

This is not a simple transformation. We hear continually that there is a shortage of skilled workers and, thus, some of us Boomers are staying on and working longer. Some of us would prefer to keep our private walled office, even if the lighting is not great and the AC is just okay, rather than to move out to an open floor "cube farm." I myself moved out of a walled office 12 years ago, but some of my peers are surprised when they come to our office and see me sitting in an interior workstation with no view! I like it, as I am open and available to everyone in the office. I can monitor the flow of work. Those who are there most of the time should get the windows. My time in the office is no more than 50%. As the saying goes, nothing happens until something gets sold and that most happens face-to-face in the real estate sector (i.e., outside the office).

Over the years, I have worked out of an array of office environments. When asked by clients to analyze their occupancy costs, frequently we would point out that large conference rooms cost the organization 24/7 but are really used no more than 10-15 hours per week. Again, technology has changed and there are now stand-up meetings. Small conference/meeting offices near the front door of a suite or floor are more the norm. If a client (or prospect) comes in, we do not draw them into the core of our space to meet in an office. We meet them up front in a small office with a round table and 4 chairs. This is more efficient and more economical. The evolution of work space is far from over. Technology will keep driving further changes. Virtual meetings, Skype, etc..., means that multiple, large conference rooms are not likely to return.

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