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# Real Estate Strategies

## FOR CYCLICAL INDUSTRIES

*October 2019*

# Many sectors of today's global economy are cyclical by nature.

Commodities industries like oil, natural gas, metals and similar resource-dependent businesses are especially prone to volatile boom and bust cycles, yet they are just as dependent on real estate for their operations as other industries.

Rigid real estate strategies that have served well in more stable industries, such as financial services or health care, do not provide enough flexibility for companies experiencing dramatic highs and lows. Cyclical industries demand a different real estate strategy that will enable them to adjust office space and lease terms to effectively meet a company's changing needs.

# Large and long is obsolete

In years past, large energy companies and other commodity-based businesses have operated like organizations in every other sector. They would typically sign large leases to lock in lower real estate costs for a long period of time.

While the lease seemed to meet the needs of the company at the time of signing, this strategy turned out to be quite burdensome during cyclical downturns.

For example, in November 2014 when the price of oil plummeted, many energy companies quickly downsized their workforce and attempted to sublease unneeded space to offload the burden of a rigid long-term lease. The real estate market for sublease space was soon flooded as Houston topped out at nearly 12 million square feet of sublease space -- more than any other city in the world. Even today only New York, whose office market is 3.5 times the size of Houston, has more sublease space available than Houston.

But energy companies have started to learn from these experiences that the large and long real estate strategy is obsolete.

### *INDUSTRY FUNDAMENTALS SHOULD DICTATE REAL ESTATE STRATEGY.*

The nature of the industry and the status of the business in question should dictate the general real estate strategy. Healthcare and financial services are generally stable industries that allow for a strategy of longer and larger commitments to real estate, while mining, oil, natural gas and other commodities-related industries are less predictable due to price volatility and other economic factors. These businesses should consider a more flexible real estate strategy with a minimum of long-term commitments.

***WHAT IS THE MINIMUM COMMITMENT A COMPANY OR A BUSINESS UNIT SHOULD MAKE TO REAL ESTATE? WHAT IS THE MAXIMUM?***

These questions demand a more in-depth study of the company and the market in question. Large companies tend to have certain "core" functions that are required even in down cycles in their industry. These functions can safely make longer term real estate commitments for cost control. Some portions of headquarters and research functions are classic roles capable of longer-term commitments. Business units that experience significant changes in size due to business cycle volatility should keep real estate commitments shorter and investments in real estate smaller.

***HOW LONG IS THE CYCLE? HOW LONG OR HOW SHORT SHOULD THE COMMITMENT BE?***

The answer lies in the length of the industry's cycle itself. JLL research of oil prices and oil industry cycles clearly shows the boom and bust nature of the energy industry. Although technology has altered the historical pattern significantly, the last downturn in the oil and gas industry that began in November 2014 was triggered by a very small imbalance between supply and demand. Small imbalances can trigger changes in the cycle because 80 percent of all contracts to purchase crude oil are held by Wall Street traders and speculators, with only 20 percent held by the refineries who actually process crude into refined products.

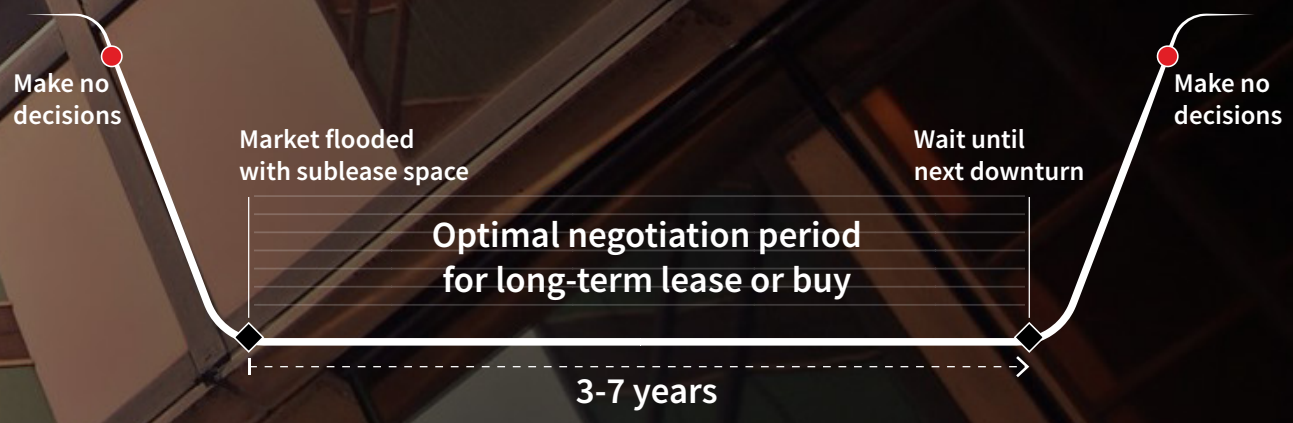
This and more detailed knowledge of oil supply and demand have led JLL to predict "bathtub" cycles of three to seven years in length for the foreseeable future. JLL calls these "bathtub" cycles because their shape has sharp downturns and upturns on either side of a three- to seven-year period.

# Avoid the peak of the cycle

The first objective of a successful real estate strategy for a company in a cyclical industry is to avoid taking space during the peak of a cycle. Conversely, the second objective is to commit, if possible, to acquire space during the trough of the cycle. Successful execution of these two objectives guarantees a significant reduction in the company's real estate costs over time.

To achieve these two objectives the company must have significant flexibility in its real estate commitments. Flexibility is therefore a third objective of the company's real estate strategy.

## BATHTUB CYCLE



# The Layer Cake Strategy

***HOW DO WE AVOID THE PEAKS AND TAKE ADVANTAGE OF THE TROUGHS? HOW DO WE ACCOMMODATE OUR CORE FUNCTIONS MOST EFFICIENTLY?***

The answer lies in a strategic portfolio structure that emphasizes flexibility and recognition of the cycle sensitivity of each business unit. JLL calls such a structure a "layer cake" real estate portfolio strategy.

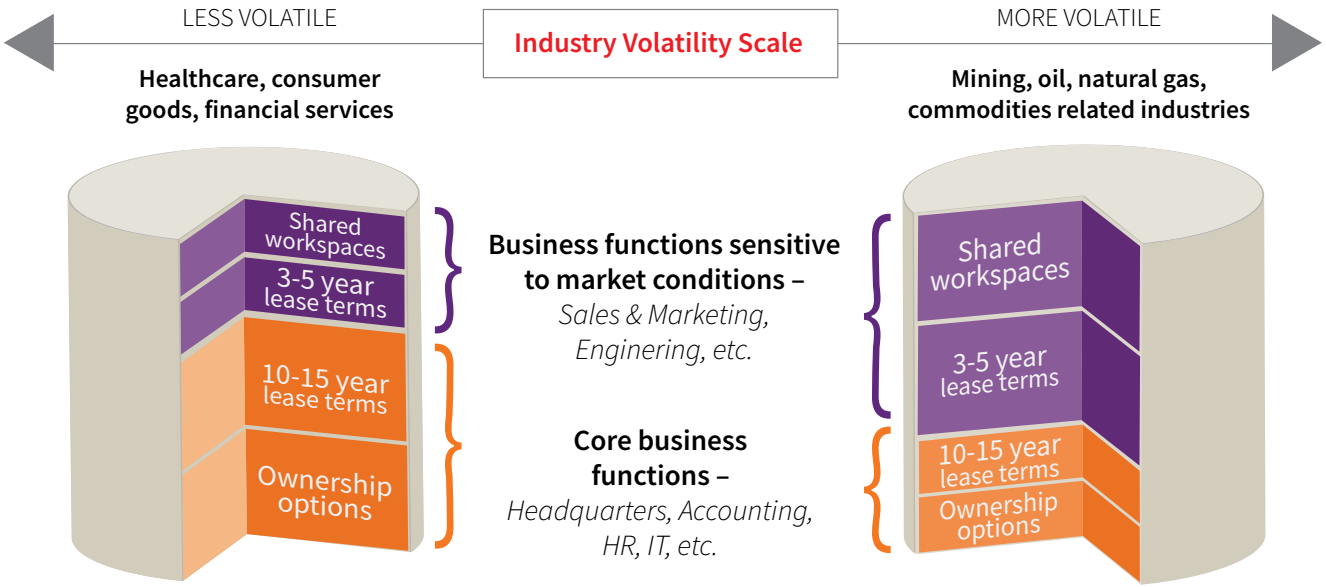
The business functions or units most sensitive to the industry cycle would be restructured to short term leases commensurate with the cycle or to "shared workspace" commitments. Short term leases might be three-year terms or five-year terms, preferably including early right -to-terminate clauses. These are the top "layers" of the portfolio strategy "cake". Business units or functions with more stable businesses could be allowed longer leases; possibly seven-year terms with the right to terminate after five years.

Notice that the right to terminate or a right to contract and reduce the space commitment within the term of the lease is negotiated into the lease whenever possible, even if there is no current plan to contract or terminate today. Such flexibility is crucial in dealing with unforeseen events and future market uncertainty.

The most stable business units may negotiate ten- to fifteen-year leases with multiple rights to terminate or contract within the term. These are the middle "layers" of the portfolio strategy "cake".

Core business functions should consider ownership, and lease contracts that approach ownership conditions such as "credit tenant leases" and "synthetic leases" (more aptly named "synthetic ownership"). These alternatives can minimize real estate costs but typically involve longer term real estate commitments. There are a variety of actions a company can take to mitigate these real estate commitments, but companies should use these alternatives only for the most stable "core" requirements.

## LAYER CAKE REAL ESTATE PORTFOLIO STRATEGY




## PORTFOLIO STRATEGY SAVES COSTS

Developing and deploying a real estate portfolio strategy such as a "layer cake" approach will save companies in cyclical industries significant real estate costs and improve the operating platform of the company in the process. This strategic approach should be reviewed and refined as necessary on a periodic basis for the best results.

JLL provides this portfolio review service annually for its partner clients. Is such a strategy right for your industry? Your company?

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