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In the Wake of the World Trade Center Attack

Fundamental Assumptions of Commercial Real Estate Will Be Scrutinized; Trend to Massive Decentralization Strategy?

HIGHLIGHTS:

- Predictable patterns of real estate cycles uncertain in wake of World Trade Center tragedy
- 13 million square feet of office space wiped out in Manhattan; instantaneous supply shortage of epic proportions
- Events point out the importance of human capital and the need to preserve this precious resource
- Placing all key employees in central location exposes companies to risk in the event similar activities are carried out in future
- Even the most seasoned professionals are reluctant of the prospect in remaining in New York on a long-term basis
- Many corporate headquarters are in New York, and decision makers might adopt a decentralization strategy that will have rippling effects throughout the world
- Decentralization has been occurring over past ten years, but this trend could heighten
- Extent to which decentralization occurs depends on fundamentals of that particular business model
- Emerging technologies are quickly neutralizing the negatives associated with decentralization
- Basic fundamentals of real estate management will change

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Introduction

Commercial real estate markets have settled into predictable behavioral patterns over the past several years. Economic peaks give way to economic troughs, which in turn recover again. The astute tenant or investor gauges the market's activity and accordingly makes their buy or sell decision. The market has matured in many ways during this period as well. The savings and loan crisis of the 1980's lead to more stringent underwriting standards associated with the purchase of investment real estate assets. The dotcom frenzy taught a hard lesson to owners about the importance of analyzing their tenant's businesses before committing to long-term leases. Despite the negatives, the market was usually quite predictable, and the fundamental dynamics were always expected to remain the same. Indeed, the battle cry of the industry continued to be: "Location, location, location!"

Everything changed on September 11. In a matter of minutes, the financial district of New York was leveled. An estimated 13 million square feet of office space was immediately wiped out. Never before had an urban market experienced such an instantaneous supply shortage. The dynamics of commercial occupancy needs will change as a result of these events. Until the moment of the attack, it was assumed that a corporate entity could house its entire operations under one roof. Although this assumption may still be true, larger companies staffed by some of the world's foremost business minds must now address the issue of decentralization.

This brief provides a range of discussion points that will probably become more topical with real estate professionals over the coming months.

The Loss of Human Capital, The Lingering Fear

One of the tragic realities that came into sharper focus as the initial shock of the World Trade Center disaster shifted toward longer-term analysis was the tremendously talented human capital that instantaneously disappeared. Although 3,000 Morgan Stanley employees were able to escape, the firm still lost an estimated 700. Even more dramatic is the case of the bond-trading firm Cantor Fitzgerald, which until this past Tuesday handled fully one third of the volume of trading for treasury securities in the United States. Thus far, not one employee has been found. These numbers are staggering considering how difficult it is to replace such significant brain trust.

One of the comments I overheard in the hours following the tragedy was that the stock of airlines and insurance companies was going to plummet. My retort was simple: the stock of New York will plummet even farther. This reaction, although somewhat extreme, suggests that New York commercial real estate, and commercial real estate decision-making in metropolitan centers will be transformed by the bombing.

During the five days I was stuck in southern Connecticut during the grounding of all commercial air traffic, I was able to gauge the reactions of commuters who made the trek into Manhattan every day. Fund managers, investment bankers and attorneys alike echoed a chorus of familiar refrains throughout the week: "it's just not worth it", "my family's too important", and "I don't want to be target", to name just a few. Even the presence of Donald Trump at the WTC site who vowed to rebuild did little to restore the confidence of workers, who are genuinely frightened by the prospect of working in an area that is a prime target for terrorism.

The point of all this is that many American corporations traditionally based in New York will have to rethink their entire corporate strategy as it pertains to their facilities. Although there are other cities across the western world that may not be as prime a target as New York, the very fact that many global companies are headquartered there assumes that changing facility strategy could indeed become a global in its scope.

The First Wave of Decentralization

The first World Trade Center bombing in February of 1993, provided companies with the initial impetus to make changes. Corporate giants such as GE Capital, and UBS Warburg got a head start when they announced the relocations of their head operations to Stamford Connecticut. The primary drivers of this decision were to address employee concerns of congestion into Manhattan, lengthy commutes, cheaper facilities and heightened security concerns. Clearly, the last point has become to the front and center in the wake of September 11.

Case Study of a Satellite Community: Stamford CT

Two days following the disaster I made the short drive to Stamford to see for myself the infrastructure factors of that city and to analyze some of the specific things that made that positioned that town as a desirable alternative to Manhattan.

The Good...

Stamford is located relatively close to Manhattan (roughly 40 miles) and is connected via two major highway arteries (Interstate 95, and the Merit Parkway), and also is connected via convenient commuter train service (through Metro North Rail). In addition to its proximity to Manhattan, it also provides fairly direct service to points in Connecticut, New Jersey and Long Island areas that are well known as bedroom communities to Manhattan.

Although Stamford lacks a subway, the financial core is concentrated in an area approximately five blocks by five blocks. Within this area there is a generous mix of commercial buildings that can accommodate numerous uses. Additionally, there is a wide range of supporting infrastructure such as hotels, restaurants and retail.

The city and the state have obviously offered generous tax incentives for these companies to relocate. Additionally, the State has undertaken a campaign to rid the downtown core of outdated buildings in order to free up new development sites. Currently, there are several of these sites that are now ready for new construction.

The Bad...

The major problem associated with Stamford is the underdevelopment of transportation arteries and supporting infrastructure required to move commuters in and out of the central core. Although there are numerous routes set up to go toward Manhattan, little has been done to shore up the infrastructure required to handle the additional commuter traffic to secondary points mentioned above. The result? Even though distances may be shorter for workers to their homes, the lack of supporting infrastructure has caused gridlock, and workers are in fact no better off than they were in New York.

In addition to traffic issues, there is limited rail service to points other than New York. During a discussion I had a Senior Vice President with GE Capital Finance, I was told that the crush on infrastructure has been a large part of the reason why developers are reluctant to move on new developments. He

The Local Spin...

mentioned that until the State commits additional resources toward highway and railway improvements, developers would continue to waffle.

Given the extent to which companies such as Cantor Fitzgerald and Morgan Stanley have suffered incomprehensible losses, it only stands to reason that the pillars of Canadian industry will gradually adopt a strategy that disperses all of its executives and key staff to scattered locations. It now seems difficult to imagine that large companies in financial services and information technology will group all their best minds into one location.

Cities such as Toronto have numerous satellite communities that could be incorporated into a corporate decentralization strategy. Many commercial brokerage firms already have branch offices in areas such as North Toronto and West Toronto, however, it will become increasingly important for brokerage personnel to start understanding the individual nuances associated with a particular business so teams can be formed to support decentralization in a meaningful and informed manner

Degrees of Decentralization

The extent to which a particular organization may be willing to decentralize their facilities depends largely upon:

1. *How reliant are professional workers on a centralized infrastructure?*
2. *How well technology can create alternative solutions that connect many offices beyond the basic networking concepts?*
3. *The incentive a particular firm may for efficiency*

Let us examine each of these areas.

Reliance on a Centralized Infrastructure

The most common elements comprising a centralized infrastructure would include phone, fax and network connections, photocopying, supporting departments (e.g. marketing, production, etc.), as well as support and secretarial staff. The two biggest advancements that have reduced worker's reliance on support staff, mainly secretaries has been e-mail and voice mail. However, transcription and documentation remain key functions that are not easily transferable.

I had a discussion with a New York-based attorney for a prominent global telecommunications firm, who until recently had been working in the company's corporate headquarters in Manhattan's financial district. Due to the cutbacks associated with the decline of the IT sector, my attorney friend was recently informed of the company's decision to decentralize his job function and install the necessary hardware that allowed him to work from home. In recent discussions with our case subject, I was told that the first area where he feels a real change is not having the support staff he once had, including a secretary. It is very difficult, in his estimation, to place a price or a value on one's ability to have face-to-face contact with a support worker such as a secretary. Having junior lawyers to handle some of the more mundane aspects of his job description became more difficult in a decentralized location.

This example clearly demonstrates that even though IT pundits have predicted that people will eventually all be able to telecommute from their homes, the extent of decentralization depends upon the nature of the business

State of Existing Technology

Although most functions that can be performed by an individual in a solitary environment could easily be performed at home, the major characteristic that will be compromised is the significant reduction in human contact. New technologies are currently being tested that provide a glimpse of how the virtual office is shaping up for the years ahead. Take the example of video conferencing. The visual quality of such technology has significantly improved even over the past twelve months. Once video conferencing protocols are better established and people become more accustomed to the medium, it will be increasingly adopted by more and more organizations.

The incentive to become efficient

I previously cited the example of how an attorney's workplace may be affected by decentralization. How about his industry in general? The Legal field is dependent upon hourly billing and the economics of the industry suggest that it may not have a strong incentive to become more efficient. We should accordingly assess the individual nuances of many industries and try and gauge their own incentive to become more efficient.

Projected Outcome

Companies will move toward a decentralization strategy. This is a given. However, the question remains to what extent will this occur? Using a simple example, if company A has 100 employees at a central location and now wishes to decentralize, will it: a) maintain 25 at the central location and open up three additional locations of 25 workers each; b) maintain 20 at the central location and open up four additional locations staffing 20 each; or, c) maintain ten workers at a central locations and allow 90 to telecommute from their own homes. It is our job to help create a procedure to help companies remedy this issue in the future. Consulting groups are equipped with the tools necessary to help organizations map out these new corporate directives.

The Second Coming of IT

The first internet bubble burst over the past year largely because the "space" was largely occupied by marketing people who really did nothing more than shift massive amounts of capital from venture capitalists to advertising agencies (at least these were the organizations that were receiving the most press). When the bubble burst, all players were hurt.

It's reasonable to assume that one of the significant areas of recovery in the wake of the World Trade Center disaster will be the reemergence of those companies focused on infrastructure, better known as the "guys who have the pipes." Examples of such firms are obviously Cisco Systems and Nortel. Most of the infrastructure is already in place, greatly underutilized and ready to go.

Companies will rely on greater connectivity between work and home, as well as work and other satellite offices to support activities extending beyond simple networking. This includes the ability to teleconference and allow workers to interact in real time and in a manner that successfully emulates face-to-face contact.

How Events Affect Basic RE Fundamentals

From a Developer's perspective:

It might be safe to assume that at least in the short term, the trend of "bigger is better" may not be as applicable to large building construction as it once was. The emphasis may now focus on smaller structures that carry less risk (not just security risk, but financial risk as well), and capture higher leasing

rates than those that existed before.

Rollover of Leases:

The standard real estate model that existed before last week was that in the course of economic cycles, some tenants would move to the CBD when prices were lower (the down portion of a real estate cycle), and move away from it when rents became cost prohibitive. Given the assumptions tabled in this brief, it is also fair to assume that a higher proportion of tenants will opt to scale down their CBD premises and open new premises in satellite locations when leases roll over. This phenomenon will not be attributable to price increase, but diversification mandates of corporate entities.

Diversification of Real Estate Portfolios:

There are many institutions that have adopted particular strategies to the acquisition and disposition of real estate assets. Given some of the changes that have been hypothesized here, it stands to reason that these strategies might have to change in some instances as well. There are large real estate investor firms whose strategy for office acquisition is to concentrate on CBD buildings that are tightly concentrated within tight nodes (to perhaps take advantage of a central administrative staff that can be deployed to one of many locations or to facilitate cross office networking). Such operational decisions may have to be revisited assuming that companies will proceed with decentralization. All of a sudden, what was once considered fringe real estate now may look significantly better.

Summary

The events that transpired in New York on September 11, 2001 were unprecedented and the loss of life tragic. In the wake of this event, there is a tendency for people to over analyze the fallout that will ensue. Just as financial markets brace for the opening bell of the Dow on September 16, it is widely believe that when emotions simmer, the market will restore itself back to where it should be.

The commercial real estate market will also gradually adjust, however, the World Trade Center attack clearly demonstrated the vulnerability of tightly grouped clusters of people. In order to preserve precious human capital, it will become increasingly important for organizations to address how these resources are spread. The tragic example of Cantor Fitzgerald demonstrates the immediate need for some companies, especially those with the country's brightest minds, to decentralize their operations. Accordingly, the fundamentals of real estate will adjust as well. Most of the drawbacks that have commonly been cited against this trend are now being addressed through technology.

The way we look at our world will never be quite the same, and given the new dynamics of society, it is vital that we be prepared for the changes that ensue. The notion of "location, location, location" may very well be turned up on its head as institutions across the world will have to rethink many of their business fundamentals, first and foremost among these, the spreading out of their facilities.
