

# What's Next for Corporate Real Estate?

From his perch at Harvard, **Rick Peiser** has a unique view of the U.S. real estate market and its global counterparts. We asked him to comment on the trends and issues that are impacting corporate real estate and the CRE professionals, brokers, building owners, and developers who focus on it. Here's his informed take on where CRE is headed.

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## **Where do you see corporate real estate heading?**

**RP:** We're in a long-term trend of consolidation and more intense usage of space. The projection I've seen is that we won't need as many office buildings as we now have. That doesn't mean there won't always be demand for new office buildings that are more efficient. We're also still in the midst of a long-term trend of institutionalization of real estate. There is more transparency all over the world, more data available. That's just going to continue. All the reasons people have had offices for centuries are still here.

## **Corporate property ownership is slipping. Why?**

**RP:** Financiers have been steadily increasing the attractiveness of sale-leasebacks. There is more demand than ever for good quality properties, and we are at a point in the market where institutional financing is readily available for corporations with good credit. So corporate owners are in a good position to make deals, and they are able to lease those properties back at very favorable rates.

## **What issues could upset this equation?**

**RP:** The biggest issue is this: are we about to see the long-awaited inflation start to kick in? Most people are concerned about any impact this will have on interest rates. Whether we'll see this, and whether it will have an impact on capitalization rates and then on the market in general is what we are watching. We're now seeing some fairly sharp increases in short-term interest rates, along with the rising price of oil and other commodities. The bottom line is that we have been in a period of near historic low cap rates, and these are going to be under some pressure to rise along with interest rates. On the other side of the equation, though, there's still plenty of

capital flowing into real estate. That's likely to help keep cap rates down. But part of that flood of capital has been due to the relative unattractiveness of other sectors in the stock and bond markets. As that balance begins to shift—in other words, as interest rates rise—we'll begin to see flows of both institutional capital and private equity back out of real estate.

### **If this scenario happens, who will benefit?**

**RP:** It certainly would be good for opportunity funds and others who like to see a little stress in the marketplace.

### **How does the U.S. economy look to you?**

**RP:** If there's concern about rising interest rates, there is also concern that the easy liquidity we've had is going to change, and about how that may impact the business cycle in general. I do think we're in a growth cycle, although at this point it's hard to tell how robust it will be. But if you compare today's environment with conversations about the lack of employment growth that we were having about a year ago, everybody seems surprised that employment growth has taken off. We see that reflected in increased U.S. investment activity in China, for example. There's a huge amount of interest from U.S. companies looking to either increase the size of the offices they've already opened or to open new offices there. China is just one lens into the international expansion of these companies. It's a fairly robust expansion. If they are already established there, they tend to have people on the ground actively looking for expansion space. For new entrants to that market, there is a whole host of international real estate companies who are set up now to provide those services.

### **What kind of real estate are U.S. companies looking for in China?**

**RP:** We are seeing demand for Class A office space, which is surprisingly hard to find in Shanghai. It's not that there aren't a lot of office buildings there, but they often don't meet the standards that U.S. companies are used to. It's clear that land-use development policies in China are not unlike what I grew up knowing all too well in Texas, with no constraints on supply, and little consideration of market demand. It's fascinating to be witnessing a country moving so quickly toward urbanization and the development of more mature and sophisticated land-use planning and real estate practices.

### **What challenges do American companies face in that market?**

**RP:** Although there is more openness to foreign investment, there are lots of pitfalls. The laws that are on the books protecting corporate rights are what Americans would expect

to see in any country they're doing business in, but those laws haven't been tested in court yet. Can you foreclose and get access to property? What are your social obligations if you foreclose on a factory with employees? This is uncharted territory. China seems to have embraced market principles, but many of the key decisions are still made politically. To know who to see to get those decisions made, you need people on the inside.

### **Back home, property owners face an almost schizophrenic leasing market—very strong in some places, perennially weak in others. How are they coping?**

**RP:** Surprisingly well. Most owners are concerned more with the issues of running a real estate company—issues of transition, weighing the benefits of being privately held. People are fairly upbeat about the situations in their local markets.

### **What changes do you see in office building design?**

**RP:** The 9/11 aftermath has certainly affected the design and construction of new buildings. There is a lot more concern about hardening the buildings, especially if the buildings are in an area where terrorism is an issue. Another big change, which seems unrelated, is the increasing desirability of office buildings that offer some kind of 24-hour activity. Companies want to be in cities and locations within cities that have created a lifestyle that is attractive to hardworking young people. At the same time, I haven't seen any trend away from corporate campuses. I'm seeing those in China too, significantly in response to terrorism, security, and industrial secrecy concerns. There's still a trend toward having lots of flexibility in office design and redesign, more open space planning, and fewer designated private offices. In China, everybody's in an open-space plan in densities that even Wall Street would find appalling. The usage of space per person is three or four times more concentrated than what we're used to here.

### **What about sustainability? Are you seeing more of that?**

**RP:** Not really. So far, it's more in the number of presentations on the subject than in the number of buildings. But the number of students who are serious about sustainability has certainly increased, and the LEED standards have become a real marketing plus. And that's the way to go if you're going to get this into the mainstream. My sense is that there is a realism taking place and a serious analysis of what is cost effective and what isn't. The movement is still in its early phases, and there is a lot of hype. The true believers are promoting things like photovoltaic panels that have yet to be proven cost-effective.

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