Getting to today's truth in office real estate

Starlight Investments

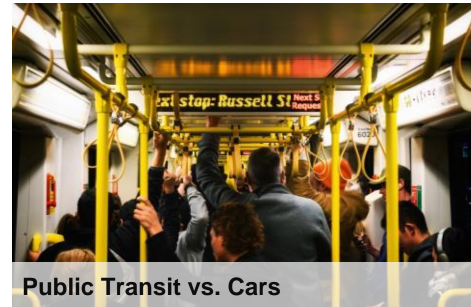
To anyone who regularly follows the commercial real estate sector, the dominant theme in media for most of the past decade has been the evolution of office space: how we interact with our office spaces, how we connect to our office spaces, and how 'real estate-as-a-service' has been reimagined to improve health, productivity and general well-being.

Unique Workspaces

Most of the trends and changes proposed have been reasonable, rational and positive: functional collaboration spaces; wellness and green building standards; and new workspace configurations which reflect the diversity of needs in the workforce. Some changes are proving harder to assess in terms of impact for investment. Demands that bike racks be staffed with full time bike mechanics; bean bag chair conferences rooms; and niche diet food retailers to name a few.

Unique Workspaces

What cannot be denied is that all these changes amount to a great deal of 'noise' in the commercial real estate sector. Noise which must be filtered in order to make an informed and, importantly, profitable investment decision. Investment decisions, first and foremost, should be based on the latest available data, but more critically the data must be reliable.



Public Transit vs. Cars

As an owner or investor, what do you listen to when making your commercial real estate investment decisions and providing services to tenants? Is a bike mechanic a better investment than a lighting retrofit? Could an unused common area better serve the building occupants by being converted into a retail amenity and generating extra revenue, or as a pop-up yoga studio to help balance the tenants, and make them happier and more productive?

Collaborative Efficiency

Further, how impactful are the changing characteristics of office employees now that the millennial cohort is materially the largest demographic. How will their tastes and requirements translate into the decisions made by their employers (who themselves are increasingly Millennial)? Importantly, when it comes time to sign a lease, will they divert capital for these perks and benefits, or will that same capital be reinvested into their business?

Mississauga Executive Centre, Greater Toronto Area

Bloor Islington Place, Toronto

Source: Statistics Canada

Careful assessment will show some of the new trends in the office space are well worth the investment and will stand the test of time in terms of return on investment (ROI), while others are either unproven, transitory, or worse, unprofitable. The more things change, the more they stay the same, and in real estate investing that always means is location, location, location.

Where do employers want to be?

The new argument for employers is if your offices are not located within walking distance from the condominiums where young professionals live, you will struggle to hire and retain talent. The corollary of this for investors is that assets not centrally located will not be able to compete for tenants and are thus not worthy of investment.

However market trends and data do not back up this supposition. While it is true that suburban markets have struggled of late (although perhaps no more than is historically normal), deeper analysis shows that the truly struggling assets all share a commonality: lack of access. Assets on or near transit lines, preferably public transit rather than highways, fare better in terms of leasing than less connected locations, and command higher rents as a result.

This has to do with many factors, not least of which include traffic congestion making commutes unacceptably long, commuters who would rather utilize public transit (and use their mobile devices while they are on it), and low car ownership amongst younger generations. Employees are still willing to commute to work, but not if that commute involves owning and driving a car.

In Starlight's experience, a public-transit connected asset is a very attractive option for tenants looking for space, particularly in the 'near-urban' nodes. These are properties that, while technically urban, are on the outer periphery of the urban catchment and easily accessible by both urban and suburban employees.

Near-Urban Assets: Illustrative Case Study – 5775 Yonge Street, Toronto

Starlight's Investment Thesis

- Suburban assets with urban-like features and amenities
- Connected to major transportation nodes and have access to public transit and ample parking
- Benefit from strong demand from tenants
- Offer relative cost advantages compared to comparable surrounding as well as downtown office buildings

Starlight's experience has proven these assets benefit from higher occupancy and leasing velocity compared to their typical suburban peers but also benefit from a greater ability to charge higher rents.

Submarket / City	North York, Toronto
Public Transit Access	Yes; including subway
On-site Parking	Yes
In-place Occupancy	100%
Submarket Occupancy	92%
In-place Rents	$15.90psf
Asking Submarket Rents	$21.37psf

 Source: CBRE

Where will people work, office or other?

The next major trend which has cast a shadow over the office market conversation for the past decade has been the threat of remote work arrangements replacing the need for office space. The theory is, as technology improves communication and collaboration, fewer and fewer employees will need to work in traditional office space, and those that do will require less office space.

6865 Century Avenue, Greater Toronto Area

80 Whitehall Drive, Greater Toronto Area

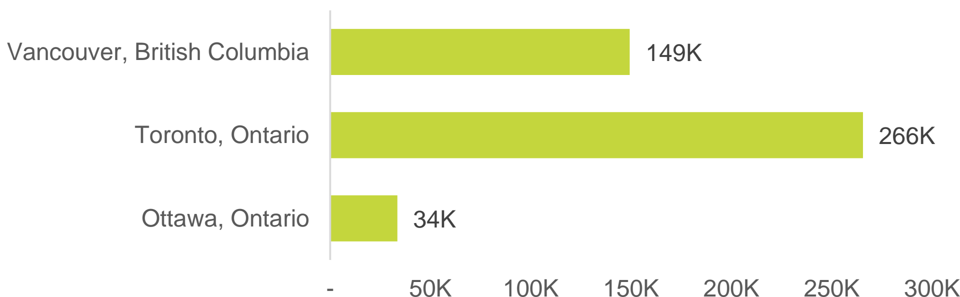
340 Laurier Avenue West, Ottawa

From an investment perspective, the risk is whether to invest in an asset that allegedly has declining demand amongst employers. Especially when the rise in industrial demand and shortage of housing has made other real estate classes very desirable in terms of investment returns.

While the initial trend observations bore this theory out, particularly in terms of square footage per employee (Starlight Commercial White Paper, March 2018), there has been an interesting reversion taking place in many offices whereby employers are effectively cancelling their remote-work experiments. Notable recent examples of this reversal have been Yahoo, Aetna, and Best Buy. Even IBM, who famously invented and championed remote work in 1979 with their first five remote computers has brought their employees back under one roof.

The reasons for a return to traditional office space are as unique as the employers themselves, but the overarching reason given has been that while virtual collaboration tools are unquestionably better than ever before, they still cannot replicate the effectiveness and cohesiveness of face to face interaction. It is telling that some of the companies most widely acknowledged as being on the cutting edge of creativity and innovation, namely Apple and Google, have never embraced remote work policies: any company which values collaborative efficiency cannot afford to rely on remote work alone.

New Jobs Added (2014 – 2018)



Job growth remains high in industries such as technology and business services. These industries require a high degree of collaboration and employee communication. Of the 853K jobs created in Canada between 2014 – 2018, jobs in technology and business services represent more than 30%.

Source: The Atlantic, Statistics Canada, CBRE, Starlight Analysis

How are employers allocating their capital?

For employers, particularly the person ultimately signing the rent cheque, the Chief Financial Officer, the decision when it comes to office space is not much more than a line item on an operating budget. Occupancy costs tend to equal between 5-10% of costs, whereas talent (salaries and benefits) can represent upwards of 70%. Those of us in the real estate industry tend to lose sight of the fact that for most employers, office space is not their most pressing issue 99% of the time: profitably running their business is. Thinking about office space is realistically a once every five to ten-year exercise.

6 Staples Avenue, Greater Toronto Area

However, the argument being put forward recently is if employers don't spend more on their office space perks, then they will need to spend more on staff retention. The supposition is an employee will readily change jobs for better perks. Therefore, employers should opt for office space which meets all their staffing needs and desires, even if it means an increase in occupancy costs.

3650 Victoria Park Avenue, Toronto

This may hold true for a very small subset of companies, but for most companies cost cutting is a daily fact of life, and very few operating budgets allow for large increases in non-core operating expenses such as rent. When profit is the bottom line, quarter after quarter, it seems hard to imagine a Chief Financial Officer agreeing to lease more expensive space because it has a yoga studio and a bike mechanic, over reinvesting that money in operations and new technologies which will ultimately drive revenue.

9200 Glenlyon Parkway, Greater Vancouver Area

What is materially important in terms of assessing new office space is value for money: can a tenant lease Class A space for Class B rents? Will a long-term commitment to a property be welcomed by a landlord who is committed to lowering operating costs year after year through capital investments and efficiency upgrades, or will that money be spent reacting to the latest trend?

Cutting through the noise to find opportunity

Starlight's position is that once the media 'noise' is dialled down, and the focus is put squarely on value for money and fundamentals, the state of the office market is as healthy as ever in Canada. Clear expectations and careful due diligence can assist commercial investors and operators determine what is required to keep their tenants happy and renewing, and what is transitional, or worse, unprofitable.

More appealing, for a real estate investor partnered with an operator who understands what 'noise' is and what is 'substance', there is a great deal of value to be unearthed in previously overlooked opportunities. For example, creativity in looking beyond the current usage of space can reveal new space plans which can increase gross leasable area, and thus asset value; repurposing challenged spaces into tenant amenities (shared boardroom for example) can create new leasing opportunities; and activating previously unused space into areas which help tenants become more productive creates tenant retention and a desirable product. All of which helps drive an investor's ROI.

Post acquisition, it takes active and disciplined ownership to fully capture the value of an asset in the modern setting, however location remains the bedrock of real estate investing with an expanded definition: in addition to where the property physically is, how landlords spend their money and where they accommodate their tenants matter just as much. Once again, location, location, location remains paramount.

32071 South Fraser Way, Greater Vancouver Area

777 Brock Road, Greater Toronto Area

About Starlight Investments

Starlight Investments is a privately held Toronto-based, full service, multi-family and commercial real estate investment and asset management company driven by an experienced team of over 220 professionals. The company currently manages over $13.0 billion of direct real estate as well as real estate investment securities. Investment vehicles include institutional joint ventures, True North Commercial REIT, Starlight U.S. Multi-Family Funds and Starlight Capital Funds. Starlight Investment's portfolio consists of approximately 36,000 multi-residential units across Canada and the U.S. and over 7.0 million square feet of commercial properties. Please visit us at www.starlightinvest.com and connect with us on LinkedIn at www.linkedin.com/company/starlight-investments-ltd-

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