

SCENARIOS

for older office buildings





The office market in Poland has been growing fast, and the wide-ranging offer of attractive office space is strengthening tenant negotiating positions, systematically „raising the bar” for office building owners. These changing market conditions are witness to increasing tenant requirements for arrangement of space, range of offered facilities, working comfort, and green initiatives from building owners.

With an increasingly wide range of available office space, it is essential for a landlord to develop very good relationships with tenants to maintain a high level of leasing in buildings. As a consequence, a number of changes in the office sector have been observed in recent years. More and more innovations are being introduced to office buildings. By putting capital into new investments, developers have access to advanced new technologies and green solutions that fit well with ideas of sustainable development. Emphasis is placed on the energy efficiency of the building and its green certification, as well as the creation of offices that meet the needs and aspirations of employees. Furthermore, attention is paid to the creation of public space around office buildings as meeting points, accessible not only to tenants of office buildings, but also local residents.

Adapting to current trends can prove more difficult for existing buildings. Aging office stock with outdated technical parameters and inadequate planning of floor space, coupled with increasing tenant expectations, all require property owners to change their existing strategies. When the renewal of the lobby or the execution of sophisticated marketing activities in older offices are no longer sufficient since they are not guaranteed to stir tenant interest, large scale change becomes a go-to option. In such cases, investors may decide to withdraw the building from service for an extended period, in order to carry out a thorough modernisation of the office space and more. If the urban spatial development plan permits, the function of the building may also be changed, or buildings may be demolished in order to increase the efficiency and effectiveness of the planned new incarnation.

There are many possible scenarios, and each office building may face different challenges. A competent team of experts, following regulatory changes, familiar with market trends and up to date with changes in the office sector, working with finance specialists, and making effective use of good governance, innovation, negotiation and strategy, serve to facilitate an appropriate solution.

As the office sector is becoming increasingly competitive, Knight Frank offers solutions that are effective in setting up new visions and spaces for older buildings. In the publication below, Knight Frank consider solutions that can be applied to regain the interest of tenants – solutions that recreate a building “from the beginning”.

Enjoy reading!



Daniel Puchalski
Managing Partner
Knight Frank Sp. z o.o.



Monika A. Dębska-Pastakia
Partner, Chairman of the Board
Knight Frank Sp. z o.o.

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WHAT DRIVES THE CHANGES in the office sector?

INTENSIVE DEVELOPMENT OF THE SECTOR

The past 5 years in the Polish office market have stood out as a period of intensive development and dynamic change. During this period, the office market in the country's biggest business hubs has grown by almost 4m sq m - a 50% increase in total stock. Developer and investor attention was turned both to Warsaw and regional cities, yet the largest increase in new supply occurred in regional cities, where the existing stock doubled. Kraków saw the highest increase in office stock - with over twofold growth - although remaining regional cities (Wrocław, Tricity and Poznań) had similarly positive results.

One particular change in the Polish office market in recent years has been the size of projects under construction. Currently, the share of large-scale projects stands at its highest level in the history of the Polish office market (taking into account both individual buildings and office parks). In Warsaw, the average size of office buildings currently under construction is 32,000 sq m; the average was just over 14,000 sq m in the previous three year period, while the average before 2005 was some 9,000 sq m. The situation for regional hubs is similar - the average size of projects currently under construction is significantly greater than the average for the last three years. The most visible change occurred in Wrocław - currently 23,000 sq m vs. 8,000 sq m in the previous three-year period; in Kraków the figures are - 16,200 sq m and 8,300 sq m respectively.

Developer activity shows no signs of abating, with one of the highest volumes of office space in history currently under construction (1.6m sq m at the end of H1 2019). This strongly suggests that the owners of the older assets will face, and indeed are already facing, stiff competition from more modern projects.

AGING OFFICE STOCK

In Poland, buildings designated as "old" are those built before 2005 - a categorisation determined by the high volume of new supply delivered to the market in recent years. At the end of H1 2019 the total stock in the biggest office markets in Poland (Warsaw, Kraków, Wrocław, Tricity, Poznań, Katowice, Łódź) exceeded 10.3m sq m, of which 30% was in office buildings completed before 2005.

It is worth noting that those buildings contain different technology and have different technical standards, as well as being finished with different materials than those currently in use. Some of the older buildings may have a relatively high common area: office area ratio, along with higher consumption of utilities resulting from the older technologies in use. This translates into higher office maintenance costs for tenants, borne out by the fact that operating costs have increased by over 10% in the past 2-3 years.

Additionally, technologies that were widely used at the time of construction are less green; important as current tenants consider it to be one of the key criteria influencing the decision-making process when choosing a new office. Furthermore, the range of those criteria is widening due to changing tenant preferences.



CHANGING TENANT PREFERENCES

We are, therefore, witness to the changing nature of the workplace becoming a significant issue. At the moment, instead of the traditional model of individual desk working, the office is becoming a space primarily for the exchanging of information and in-team cooperation. This phenomenon is determined by changes in our communication and the availability of new technologies. Nowadays, an employee needs only a single device with internet access to be able to communicate and work – perceptions of the workplace are undoubtedly changing. Furthermore, the increasing dispersal of organizations is becoming a key factor in the changes taking place. Due to the outsourcing of services, teams working on common projects are often spread around the globe. As a result, companies are introducing alternative methods and systems, and 'the office' as we once knew it is systematically changing its function, needing to offer something more attractive than before. Therefore, one of the trends currently observable in human resource management is the use of attractively arranged office space to motivate and satisfy employees.

A growing awareness of the human impact on the environment and climate change has also had a significant influence on the office sector. Companies are focusing more on pro-ecological activities, whilst expecting the same from property owners.

These are just some of the factors that are affecting the office sector, and in response to new trends on the office market, building owners, responding to the evolving demands of tenants, are making significant changes in office buildings or pursuing unconventional initiatives.

Knight Frank has analysed evolving trends in the office market (see: "Trends in the Office Sector", Knight Frank) which has allowed the identification of the currents of change appearing in the office sector in recent years.

The question can now be posed: how can older office buildings cope with the changing preferences of demanding tenants, more vigorous competition and new market trends?

NEW TRENDS

First and foremost, workplace strategy has changed. An effectively designed office, which is not only a workplace, but also a space where the employee is the focus, is playing an increasingly important role in company policy. In addition to the office itself, it is also important to have an arrangement of space around the office building, along with attractive amenities available in the building and its immediate vicinity. Additionally, office buildings are seeing the introduction of; more places to rest, opportunities for relaxation, more green spaces for employees to commune with nature (green terraces, vegetable gardens, green walls). At the same time, environmental awareness has increased significantly, leading to green certificates becoming standard for office buildings. The perception of the workplace has also changed significantly in recent years. In addition to work-related duties, employees want to be part of a larger community, and to mix and spend time together both inside and outside business hours. This has stimulated office building owners to undertake numerous marketing activities, including, among others, the organization of various types of cultural, charity and one-off, special events. The impact of new technologies on the work environment is also important - steadily shaping and changing the common area equipment and furnishings in modern office buildings.

The employee is now recognized as being the focus of attention, and all changes are designed to forge a work environment conducive not only to professional development, but also to a fulfilling time spent at work. As a response to the changes taking place, attractively arranged coworking offices are gaining in popularity. In Poland, this sector is only at the beginning of its developmental journey, even though coworking operators are already offering over 200,000 sq m of office space in Poland. Coworking spaces are becoming an attractive alternative for tenants due to their flexibility in an environment of highly variable and somewhat uncertain business conditions. At the same time, coworking becomes element of sharing economy (which has gained popularity recently) as apart from access to workspace, it offers also community perspective, more and more desired by employees.





THE CHALLENGE
of aging
properties



Izabela Miazgowska
Head of Property Management, Knight Frank

The management of aging properties is a very demanding task and should be entrusted to someone with considerable experience in this area. It is important to bear in mind that the aging of property means not only the loss of aesthetic value, but above all a decline in the technical characteristics of various elements of the building, its installations, and equipment. The speed of this process is determined by the standard to which the building was originally constructed, and how it has been used.

Many property developers seek to reduce building maintenance costs, preferring to fix problems as they arise rather than conduct regular inspections of installations and the like. The potentially higher number of maintenance issues that result, reduce the building's tenants' comfort, and may cause a deterioration in the relationship between tenants and landlord. To give two specific examples: the lack of regular exchange of filters can lead to air conditioner contamination, negatively affecting the system's efficiency, causing uncontrolled spillage of condensate, which can often wet or flood leased space; insufficient inspection of chiller units may result in leakage from the installation and the subsequent contamination of environments. Such cases, end with the building owner having to bear the additional cost of the repair; they may also entail losses connected with environmental damage and the paying of fines or associated additional fees.

There are many similar such cases. In order to avoid this situation, it is important to carry out preventive reviews at pre-set dates. Moreover, an important issue is the setting up of facilities and installations in a proper way, since inefficient operation may cause unnecessary usage of media and increased service fees. Modern buildings have intelligent monitoring to collect necessary information and analyse the systems' operation. In mature properties, devoid of modern technologies, there is no such option, and performance data collection and analysis should be the responsibility of an experienced technical service team, under the supervision of the property manager. Experienced technicians should continually update control algorithms for individual parts of the system. It is important to set up the schedule of operation in a way which reduces the working of systems and devices at times when the building is less used, such as at night. This includes, for example, the operation of the air handling units, and the lighting of the building. During the day, particular attention should be paid to effective, optimal use of daylight as, besides energy consumption issues, the lighting system may unnecessarily generate large amounts of heat, which must be cooled during the summer period.

The care of the technical condition of older properties is a very important aspect, presided over by a professional property manager acting on behalf of the building owner. It is not, however, the only aspect. It is also important to build and maintain a very good relationship with current tenants encouraging them to remain in the building and, therefore, generating stable income for the owner of the building. This is facilitated by appropriate communication, good response time in addressing more frequent faults,

minimising of operating costs, and transparency in service charge reconciliation. Tenants should feel as though they are fully supported by the property manager. An individual approach to each tenant plays a key role because, by understanding their needs, the manager is able to meet their specific requirements. In maintaining a fruitful relationship with tenants, an appropriate marketing strategy is also very helpful, and it need not necessarily generate high costs. It is important since this expenditure is not included in the catalogue of service charge and is paid for by the property owner. The competent property manager is one who is able to organise a small number of worthwhile events (e.g. parade of food trucks, charity actions, blood donation, collections for other charitable purposes, and educational actions such as 'Zero Waste'). Such activities result in the integration of employees and add to the building's sense of community. At the same time, by integrating marketing activities with communication activities via appropriate channels, the property is perceived as more attractive not only by the tenants but also by their commercial leasing advisors.

In the effective management of mature properties, not only thorough knowledge and experience are needed, but also an ability to make appropriate recommendations concerning changes in direction to the management when the property becomes less attractive and less able to meet tenant needs. In such cases, it may be necessary to modernise the building, replace certain building installations, and even change some of the functions, whilst simultaneously rebranding the property - all of which require the owner to commit to higher investment costs. Without the support of an experienced property manager, the above objectives may prove very difficult to implement.



**SPACE-
as-a-Service**



Marta Sobieszczak

ACE Product Manager, EMEA Strategic Consulting, Knight Frank

The current situation on the office market is forcing owners of buildings to change the way in which they cooperate with tenants. A strong pro-client trend is also having a noticeable impact on approaches to new business, which is visible across all service sectors. The need to build a positive customer experience is becoming necessary in areas where it was once not so needed. This change in market conditions has forced building owners to engage more in creating the kind of office space that will meet tenant expectations not only in the standard sense, but also with a wide range of supporting services. This type of business model, based on the addition of services to leased space, is the increasingly popular Space-as-a-Service.

An example of this type of response is the co-working space, which offers tenants not only office space, but also a number of other services which tenants are freed from when organizing themselves. Such services provided to tenants by building owners include; round the clock IT support, office space furnishings, essential facilities (constant access to Wi-Fi networks, printers, fax, etc.), and the provision of guest greeting and mail handling services by main-desk reception staff. The range of services for tenants is usually agreed individually, but the range of overall services offered by building owner distinguishes their offer from others.

The change in the relationship between landlords and tenants is becoming more pronounced, and in time it will become a characteristic feature of the office market. Building owners will have to listen carefully to tenants to understand their needs. Without openness to change, the potential business opportunities for properties will decrease drastically. However, as in other sectors today, the future of the real estate market will rely on creating the office building as a space for a wider and deeper user experience. Furthermore, the building owner, in addition to simple rent collection, will be called upon to prepare a wide range of services. In such activities, the landlord is supported by new technologies, which are often seen as a key element in building competitive advantage. At the same time, it should be remembered that it's not the new technology itself which creates added value in business, but first and foremost the data which that technology provides.

Nowadays, new technology is a rich source of extremely valuable data, supporting owners in steering their business models in the direction of Space-as-a-Service. The building data may, for example, be obtained from; BMS systems, access cards, wi-fi, sensors, and beacons. Furthermore, the building does not necessarily need to be technologically advanced in order for the owner to collect valuable data for analysis.

Thanks to the information gathered from such research, a better understanding can be gained of how space is exploited and optimized. Additionally, strong indications are given on parts of systems that are operating inadequately and which should be improved.

What steps should the building owners take when they become aware that without changes to the status quo and building strategy, they will be unable to meet market challenges in the medium and long term? The first step should be gaining a good, detailed

understanding of the tenants, enabling the situation to be properly addressed and suitable solutions to be found.

In this phase, making use of a methodologically sound, qualitative survey, interviews should be conducted with representatives of key tenants. Furthermore, a firm understanding of the owners' opinions is key, along with the findings of studies conducted among tenant employees. The scale of the group of users is very important, since the building and its use can be effectively evaluated. At this stage, a review of global market trends is informative, as is a precise definition of the needs and vision of the building owner.

An important addition to this knowledge is a general building analysis based on available data sources. The building system data audit aids greatly in understanding how the space functions, and what is the employee experience. In such a way, the elements that negatively affect the user's satisfaction with the office space can be identified. By neglecting building data analysis and focusing only on information from qualitative research, it is likely to be difficult to prepare a precise building condition diagnosis. The completion of the research phase is an ideal moment to begin working with the building owner to redefine the building strategy.

The new strategy should be based on a combination of trends and other market solutions, as well as the owner's vision and, probably the most important, insights from the research about tenants. The tenant focus trend is very popular. It is therefore important that the research findings from tenants drives the direction of strategic changes for a building. It may happen that the results of research work turn out to be a big, sometimes even surprising discovery for the owner and that is why it is so important that the research is conducted in an objective and methodologically correct manner. Certainly such a project will require the building owner to be open to a new market concept.

The last phase of the project should be a clear summary of the activities, the planning of further steps, and their careful and effective implementation. It is also worth considering a set of next steps to help maintain user experience at a high level. Technology and dedicated tools can also prove beneficial in allowing the observation and analysis of the customer experience based on available data sources.

Owners of existing buildings, with a good strategy at the ready and up-to-date findings on user satisfaction with buildings, will be able to face market challenges such as a high volume of new office supply, or a rapid growth in co-working solutions.

The EMEA Strategic Consulting department in Knight Frank helps our clients to adapt to the changing reality using innovative analytical tools and creating solutions for the individual needs of clients.





**CHANGING THE TARGET
group and landlord
expectations**

**FLEXIBLE STRATEGY
for key tenant
(or potential tenant)
integrated in process
of change**



Izabela Potrykus-Czachowicz
Partner, Head of Office Agency, Knight Frank

Whenever older buildings require work of a structural nature, or market re-positioning through, among other things, increased marketing activity, there is the potential for significant financial outlay.

A dynamic Polish real estate market and its demanding tenants, changing macroeconomic conditions and risk aversion, together with the need for the creation of an investment strategy – such considerations will cause some landlords to decide against radical changes to a building for fear of possible failure.

To remain competitive on the market a comprehensive strategy should be created, which will compensate for the lower standard of the building. Activities should be based on changing lease parameters and reshaping the target group of the building. The solutions in this area should be based on thorough analysis and mutual co-operation and consider: asking rents, rental periods, amount and distribution of additional incentives, level of fit-out works.

Assuming, that the real estate market is evolving at a steady pace, maintaining historical asking rates or lease agreement lengths may be unrealistic. Taking into account the aforementioned parameters, tenant expectations can be addressed as follows:

- decrease in base rental rate;
- reduction of lease term to 3 years; indefinite lease term; „break option” mechanism;
- more incentives offered by owners for tenants; division of incentives over the whole lease term; cash contribution;
- turnkey fit-out.

Often, the motivation of the landlord to consider the renovation of a whole building or selected elements comes when contracts with key tenants are being renegotiated, or there are negotiations on a new lease agreements with potential tenants interested in leasing a large volume of space within the building. In such cases, it is much simpler to economically justify changes and the costs associated with them. Expenditure incurred on refurbishment works is amortised almost immediately since the undertaking the refurbishment works depends on signed lease agreements.

In the case of a single tenant building who makes contract extension conditional upon the completion by the owner of certain work to increase the standard of the leased space or the office building in general, the landlord should consider the situation, regardless of the tenant’s expectations. We should remember that successful renegotiation with a tenant occupying whole building will ensure cost savings connected with:

- building marketing campaigns;
- division of space into smaller office modules for multiple tenants;
- lack of income due to the absence of a tenant;
- usually higher incentives to new tenants.

When preparing to renegotiations with key tenants, the landlord should be open for a dialogue with them.

It’s worth mentioning, that quality of older buildings often differs from the market standard. Therefore, their landlords’ should be more flexible when signing lease agreements. The fact that the owners of older buildings are not bound by loan agreements with banks gives them a competitive advantage.

The decisions of the landlord concerning which of the above points to implement will depend upon their investment strategy. Due to rising construction material and labour costs, price pressure on rental rates may no longer play the central role it once did.

When defining new target groups, it is worth considering and paying attention to:

- office space availability – the availability of office space „immediately” to satisfy the needs of smaller tenants for whom the decision-making and the time to move to a new office space is usually short;
- rent currency - payment in PLN may contribute to more interest from Polish companies.

Interesting solution for both landlords and tenants of older buildings is a coworking-like concept. With this idea, tenants have the opportunity to wait on temporary space for completion of construction works or modernization period. Additionally, the owner of the building can expect income from the vacant office space. Such solution widen the spectrum of new tenants: from start-ups to renowned corporations.

Proper identification of needs help to react in effective manner which leads to signing a transaction. In order to deal with such a situation, the landlord of older buildings should allocate investment resources to the property in order to make the property attractive on the commercial market and for potential tenants. Nowadays, there are many elements to a successful regeneration strategy: the renovation of common areas; marketing activities that change the image and perception of the building; the introduction of mobile applications to integrate building management, which gives a feeling of a modern building that is in harmony with current market trends. Each building requires an individual approach, but a professional advisor familiar with the market situation, current tenant expectations, investigating the development of new proptech technologies and office market trends, is able to guide the owner through the steps that are appropriate to the situation.

The condition of common areas, lobbies and receptions is among key issues raised by tenants during negotiation process. This results mostly from the current situation on labour market, and from companies who expect their office to allure employees already at the entrance door to the building. Responsibility for this elements is taken by landlord and therefore he may decide to prepare the facelifting of the building sooner (as this action becomes indispensable anyway).



FACELIFTING



Urszula Łuszczyńska

Senior Technical Director, Project Management, Knight Frank

The dynamic development of the office market in Poland, as well as the high volume of new supply in the last three years, mean that among the conditions for maintaining the competitiveness of pre-2005 office buildings is the renewal of the shared spaces of the building. Building owners may undertake modernisation measures to improve the aesthetics of buildings, so-called facelifting, to give them a look in keeping with contemporary trends. The modern arrangement of lobbies and how the entrances to offices appear may be of great importance, but the functionality of implemented solutions is a key element. The layout of the space and its proper purpose can be an asset for tenants, providing them with a place to rest or conduct informal meetings.

Before the start of the implementation phase, a number of factors have to be taken into account. These are primarily connected with the needs of building users, but also need to consider the necessary business environment of the building, along with the offer of competing offices, in order to match the standards adopted by the local market in newly built office complexes. Using well-conducted studies, and taking into account the planned budget, the project may then be implemented.

A visual freshening up of an office building is usually accompanied by the complex and often lengthy process of obtaining necessary permits. Furthermore, it's important to limit disruption connected with elevation work, as well as changes to small architectural elements and the immediate vicinity of the building, whilst at the same time conforming to the local land use plan and time schedules agreed with the relevant authorities upon which building works are predicated.

Such a project requires an experienced team who understand the needs, challenges, objectives and capabilities in both technical and financial terms. It is important to be able to foster effective and efficient working

relationships between the selected project supervisor and the architects, along with the marketing team, leasing agents and the owner of the building.

In implementing the concept, it is essential to prepare good, industry-standard, executional projects and to have them thoroughly checked by appropriate professionals - the smallest, unidentified mistake during the planning process may well impose a significant burden on subsequent work flow and contribute to unnecessary additional effort. A key phase of the project is to analyse, in detail, the technical documentation on the spot - i.e. to confirm whether the various modifications of the elements are actually feasible before work begins. This ensures that specified deadlines are met and unnecessary labour costs are avoided.

The aim of this investment is to provide an increase in the comfort associated with the use of the building and, by doing so, meet (or surpass) the standards offered by the competing office buildings that have been built in recent years. Inevitably this leads to the attracting of new tenants and the creation of added value for the building's users.

The completion of the facelifting of the building can lead to some inconvenience in the building's use, but need not require the building's complete closure. The limitations imposed by such projects require a team to exercise particular care and efficiency when creating schedules, along with a strict adherence to time limits so as not to hinder the access of office users to the building.

CASE STUDY:

Completed in 2005, Warsaw's **Zaułek Piękna** office building was partly renovated in 2015. During the renewal, the building's lobby received a new look, including a new colour scheme, and changes to cladding and materials. Furthermore, the lift halls and toilets received a facelift.

Łódź 1, an office building completed for use in 2006 in Łódź, underwent modernisation of the lobby area in 2016, receiving a more contemporary architectural look.

In 2000, the **UBC II** complex was constructed in Warsaw. In early 2016 modernization works were carried out in the lobby and reception area of the building. The work included changes to the building's entrance design, lighting, and a revamp of the lift hall. An access control gateway has also been introduced to upgrade the security of the building to current standards.

Bokierska Office Center A & B in Warsaw - buildings completed in 2000 saw a rebuild of lift halls on the ground floor and toilets in 2016, enabling the building to secure new tenants.



BROWNFIELD

**Piotr Litwin**

Associate Director of Land Advisory, Knight Frank

Despite a growing lack of vacant plots with appropriate legal status, there is little slowdown in the speed of development in Poland's largest cities. The declining amount of empty land for development has led to ever-closer cooperation between architects, investors, and city and town hall planners, adding a new dimension to existing zoning plans as well as creating new utilisable spaces in attractive locations.

As a result, brownfield investments have become an increasingly attractive proposition for developers. Projects of this nature are based on the recycling, renovation and upgrading of rundown areas, dilapidated buildings and outdated industrial infrastructure, breathing new life into them in the process. Brownfield investments regularly offer the opportunity to purchase well-situated development land at attractive prices, facilitating the acceleration of general business growth in the areas in question. Such sites come with existing infrastructure, which can be used by investors both at the planning stage of the investment, during construction works, and beyond. Existing utilities and installations beneath the lots in question tend to speed up the investment process and greatly assist in the obtaining of required approvals and permits. Furthermore, they are an asset in the delivery of projects to the market, although there exists the possibility of unexpected challenges associated with inappropriate information and documentation regarding below-ground infrastructure - such issues having possible consequences for the costs of investments.

The revitalisation of historical buildings, a particular case in point, often requires a substantially extended investment process; one which can be expensive, and which necessitates close cooperation with the authorities and restoration experts. That said, such projects, when combined with placemaking, offer the chance to breathe new life into structures and architecture which are unique and culturally valuable. Placemaking compliments historical and often forgotten places, highlighting the character and spirit of revitalised properties, as well as incorporating new functions; for example, office space may be blended with living or meeting places, along with event and festival hosting, both of an indoor and outdoor nature. There is already a growing body of examples in most large Polish cities: Centrum Praskie Koneser and Elektrownia Powiśle in Warsaw, Textorial Park in Łódź, and Garnizon in Gdańsk.

A further aspect of revitalisation concerns buildings which are already older than the 10-year mark. A visible trend in Polish cities is a shift in perspective when it comes to the ethos, aim and direction of spatial development patterns and local zoning plans. Old marine infrastructure, low-rise office buildings in the vicinity of skyscrapers, abandoned factories, and tall chimneys rising above residential buildings housing former factory workers, may all receive new senses of space and purpose, opening a new chapter in the life of the city. The scale effect of such changes in city centres is clearly visible nowadays, feeding through into growing transaction prices, and resulting in, for example, higher building densities for given plots.

In addition, given the rising costs of property management, landlords are opting to sell assets or work hand-in-hand with investors to create independent enterprises to implement specific, joint investment projects. The resulting opening up of fresh development markets creates a synergy effect – a pointed example being the creation of new office destinations, such as those on the former site of the Armatura Kraków factory at ul. Zakopiańska, in Zabłocie in Kraków, and the projects that are to be found in Warsaw's Służewiec Przemysłowy district.

The Investment Land Department at Knight Frank offers advisory services for entities requiring search and purchase support in investment areas, and who benefit from a professionally prepared and conducted sales process, which takes into account the potential of a given area, whilst defining an optimal, effective marketing strategy often resulting in the creation of new functions.





FUNDAMENTAL
revitalization
of office buildings



Grzegorz Chmielak

Partner, Head of Valuation & Advisory CEE, Knight Frank

Due to the growing number of buildings in business districts of big cities, developers are finding it increasingly difficult to purchase attractive investment opportunities in central locations. This doesn't apply exclusively to cities with high density city centres - not only Warsaw, but also regional markets are affected.

The office market in Poland is relatively young compared to Western Europe countries. Given the availability of land and technological progress, office buildings built before 2005 will face growing difficulties in terms of competition from the plethora of new investments. Modern buildings make use of the kind of technological solutions lacking in buildings over 10 years of age. Several years ago, different material finishing standards were the norm, along with visible differences in the way the installations were fitted and environmental protection arrangements applied.

Moreover, significant disruption of installations, or even building construction work, usually requires the withdrawal of the whole property from the market for the duration of the work. However, market examples suggest that this is a solution that can have significant benefits for the owner while extending the economic life of the building.

The complete modernisation of the building, including the replacement of mechanical, electrical and fire installations, also allows the rearrangement of space, often necessitated by the fact that the building was occupied by a single tenant. Furthermore, adapting of the leased property for use by several tenants may result in an increase in the leasing space and thus translate into a higher rental income.

The decision to revitalise a building is a complex process requiring the involvement of many specialists. The revitalisation is a multi-stage process covering several areas. Different teams will be involved in the different stages of the project; from the project management team and the project and execution teams, to the marketing department engaged in the rebranding and relevant promotional communication for the building, and the agency responsible for its re-commercialisation. Fundamental renovations of buildings involve considerable financial expenditure, often comparable in scale to the construction of a new building. The profitability of such investments is determined mainly by their location, which determines the availability and price of land for investments, as well as rent levels. This is one of the reasons why the modernisation of office buildings can only prove profitable in locations in the city centre.

CASE STUDY:

Piękna 2.0 is an office building dating from 2001, located in the heart of Warsaw, offering 16,000 sq m of office space, and rented by a single tenant. The property, sold to a fund managed by Griffin Real Estate, was modernised in 2016 - a process which included the renewal of the elevation, the rearrangement of common spaces, and the modernisation of installations and fittings. The success of the activities carried out, the increase in value of the real estate, and the increase in the attractiveness of the project is evidenced by the fact that in 2019 it was bought by Generali Real Estate.

The **Ethos** building is located at one of the most prestigious locations on the map of Warsaw, on Trzech Krzyży Square. It offers 13,000 sq m of office space and 2,500 sq m of commercial space for boutiques and luxury brand stores. The modernisation and reconstruction of the project was completed in 2016. The works included the construction of a new 5-floor wing on the side of the Vistula River, the reorganization of underground parking, the construction of inner green terraces, and an expansion of the shopping area. After a thorough upgrade and reconstruction, Ethos offers highest standard A+ space and possesses 'Excellent' level BREEAM certification.

The **Spektrum Tower** is a 29-floor office building, offering 28,000 sq m of space, and located on Twarda Street in Warsaw. After 11 years of market operation, it has been modernised to freshen up its image, obtain a certificate attesting to its energy efficiency, and make changes in preparation for the presence of multiple tenants (formerly it was single tenant occupied). The work carried out in the building included the replacement and modernisation of installations, the construction of open terraces, and the reconstruction of the lobby, along with a renovation of the façade. At present, the Spektrum Tower holds a 'Very Good' BREEAM certification.



CHANGE

of building function



Elżbieta Czerpak
Head of Research, Knight Frank

In the office sector, an attractive location and good access to public transport play a key role in a tenant's choice of office. However, no less important for them is modern design. Furthermore, technical solutions are also becoming important in terms of lowering operating costs for office space, improving the energy efficiency of the building, and contributing to the well-being of employees. Consequently, we increasingly see that the owners of older office buildings, because of a lack of effective floor-planning, outdated technical solutions, and locations that have waned in popularity, need to consider a change of strategy.

In cases where the renovation or revamp of office space and shared space, or the enriching of the offer of office facilities, become insufficient incentives to attract tenants, a large-scale change may be appropriate. One of the possible scenarios in this situation is a change in the function of the building, preceded by a *highest* and *best use* analysis. Its purpose is to identify the most profitable use of real estate under current and future market conditions.

The start point for this type of analysis is a recognition of the general business climate of the city. This is to be followed and accompanied by; an analysis of the legal aspects related to current and potential future use of the real estate; an examination of the current situation in specific, individual market segments; the identification of potential competing projects; an estimation of local market absorption rates for specific functions. In this process, an analysis of the real estate itself is key. A detailed examination of the technical condition of the building(s) in particular is necessary, in order

CASE STUDY:

CHANGE OF OFFICE COMPLEX INTO RESIDENTIAL DEVELOPMENT

Due to a high availability of office space in the Stuzewiec office district of Warsaw and a growing demand for flats in this part of the city, the part of the **Empark** office complex with the oldest office buildings was sold to Echo Investment. According to the new development concept for the office space, a housing estate is to be constructed.

CHANGING OFFICE BUILDING TO STUDENT DORMITORY

An example of the conversion of an office building into a private academic dormitory is the office building located at 9 Prusa St. in Wrocław, which the Probuild company has converted into a modern private dormitory, 'LAS' (Living and Studying). Within this investment, the existing office part has been modernised, and one floor in the higher part, along with two floors in the lower part, have been built, providing a total of 97 micro-apartments. In addition, the investor plans to build a new building within the courtyard containing a further 100 micro-apartments.

to estimate the possibilities and costs of adapting space for the potential intended functions. At this stage, it is desirable to work with an experienced architectural practice - one which will carefully consider local conditions and then help to develop the mix and balance of functions that are possible from a market and legal perspective.

The results of the market analysis are harmonised with financial assumptions, making it possible to draw up alternative scenarios, including; the demolition and construction of new functions and facilities; or the maintaining of existing land use with modification of the building's intended use.

If the *highest* and *best use* analysis indicates that an aging office building, due to strong competition, may have difficulties with commercialisation for the desired property owners, a change of function may well turn out to be a good solution, whether it encompasses the whole, or parts of the building.

A change of building function is a strategy adopted the world over; one which can be applied to both small-scale and large-scale projects, and one which affords the perfect opportunity to implement unusual, non-standard ideas. A particularly spectacular example is the Queen Elizabeth Olympic Park in London, where, after the 2012 Olympic Games, what was initially a sporting facility is being systematically turned into a new district with residential and office developments, a university, and parks - extending a very wide cultural, commercial, recreational and sporting offer. Another transformation of great interest is De Ceuvel in Amsterdam, where, in former shipyard areas, the barges and water-borne vessels have been utilized and adapted to create coworking spaces and an innovation hub.

Changing the existing function of a property is always time- and capital-consuming, but at the same time it is often a chance to create a unique project in a place seemingly of little investment potential, thereby creating a valuable location from scratch. This is a scenario that investors in Poland are increasingly being drawn to. We have a salient example in Warsaw, in the shape of the Stuzewiec Przemysłowy area, where many investors, having conducted highest and best use analyses, confirmed their assumptions and changed what were originally intended to be office functions in their projects into residential or hotel developments.

CHANGE OF OFFICE BUILDING INTO APARTHOTEL

Growing interest in the aparthotel sector was stirred by the JW Construction Holding's project to convert an office building on Aleje Jerozolimskie Street in Warsaw into an aparthotel complex. The 87 Varsovia Jerozolimskie apartments were built in a former Jerozolimskie Point office building in the years 2009-2011.



INCREASING
the intensity
of development



Krzysztof Cipiur

Director, Capital Markets, Knight Frank

The real estate market is a true beneficiary of the positive sentiment in the Polish economy, gaining from vigorous activity in the economy, easy access to global finance, and a generally high optimism among Poles about the future. The favourable market conditions increased appetite not only of the owners of flagship towers, but also the older and less 'efficient' office buildings. Rapidly growing land price - going up by tens to several hundred percent over the last 3-4 years - accompanied by strong demand for office space, have allowed the realization of ambitious purchasing strategies based on additional real estate development potential.

Good examples are the purchases of buildings in Warsaw, such as the centrally-located Ilmet and Atrium International buildings. Ilmet is an office building built in 1997 and located beside the ONZ roundabout. In 2016, it was purchased as investment land by Skanska. The GLA office area of Ilmet is under 21,000 sq m, but at the time of the building's sale, the architectural plans in place allowed for upgrade of the GLA to some 60,000 sq m - by increasing the building height from the current 103 meters to almost 190 meters. The demolition and construction are planned for 2020. The unique location and scale of the project seem to guarantee the success of this investment.

There is no doubt that disposal strategy concentrated on development potential chosen by the previous owner (UBS) maximized the exit price. During dozens of months of preparation process, a number of concepts were weighed up, and many hours were spent on negotiations with the Warsaw authorities on obtaining a zoning permit (so called "WZ"). Such an attractive sale price would not be possible without chosen strategy and long-term preparations.

A similar strategy was followed by Patrizia's sales of Atrium International (12,000 sq m GLA) as an investment product this year. Strabag, the purchaser, in implementing the new building concept, will attempt to maximize the building's potential. According to Knight Frank's calculations, the existing area can be increased 3-4 times. Thus, the actual leasable area will grow by the significant increase in the building's height from the present 25 meters to 135 meters.

Transactions for the acquisition of existing buildings with the intention of demolition, are carried out mainly by developers who are interested in commencing the construction of a new investment as soon as possible. The reasons for such an approach is minimizing the planning risk and decreasing the burden of high cost of capital utilized for the purchase of the land in the pre-construction phase. These elements imply the highest prices being paid for the properties where the development potential is proved by valid building permits, the master plan, or at least zoning permit (WZ).

The Polish market still lacks entities with a combined investment and development profile which would allow them to take full advantage of cashflow from the existing buildings and after obtaining the required construction permissions, to develop a new project multiplying the potential and most importantly, increasing the value of the property.

Due to chronic shortage of development land in attractive locations in Warsaw we can expect more similar transactions. Very good examples of this trend are the recent purchase by Echo Investment of Tesco in Kabaty (retail function) and the Empark office complex in Mokotów (office function) - both of which appear to be implementing a planned strategy for purchasing existing projects with hidden potential. In both cases, the aim is to increase the development intensity, whilst also changing the profile of the properties - for example, by introducing a residential function.

It is worth noting that asset management strategies aimed at creating and obtaining additional potential for the existing buildings maximize the value of real estate by diversifying the strategy of investment output and expanding the investment base from typical investors to investors and developers.





NEW LIFE

for office buildings

EQUITY WAREHOUSING

- change of controlling entity



Maja Meissner

Partner, Head of Asset Management, Regional Director, Knight Frank

With the rapidly growing competition and changing market conditions which are being currently observed, there are certain situations in which attention should be paid to the perception of the building from the outset. To give an office building a new life, a comprehensive strategy with the involvement of the asset manager is needed. The asset manager's role is to increase the value of the property by preparing and implementing strategies that meet this purpose, including maximising returns and the profitability of investments. For each project, the asset manager dedicates an individually selected team of experts with a range of specializations, aimed at creating a tailor-made strategy, which can take the form of a one-off project or a phased arrangement (e.g. multi-year plans). The asset manager must optimize costs in relation to revenues, often seeking additional income from a property by analysing its optimum use. At the same time, emphasis is required on the renegotiation of existing lease agreements and effective management of vacant space.

The value of the property can be increased by taking a number of measures aimed at reducing the costs of property maintenance (in close cooperation with the property manager) and maintaining the maximum level of building rents (in close cooperation with the commercial agency department). Taking into account the aging of office buildings and fierce market competition, it is extremely difficult to maintain a 100% occupancy throughout the building's

In the most problematic cases, when the owner faces the risk of losing liquidity, and the property being taken over by the bank, he may consider changing of controlling entity. For assets that are not in an investment fund portfolio, the solution to a crisis may be a change of ownership of the special purpose vehicle that owns the shopping centre – the process of equity warehousing. This response is beneficial for both the landlord and the bank, avoiding 'forceful' solutions such as the liquidation or bankruptcy of the company. The bank's reluctance to resort to such measures is understandable – they are obliged to create appropriate reserves in such cases (with knock-on effects for financial results), and the acquisition of shares requires the presence of a dedicated team within the bank's structures with responsibility for, amongst other things, the asset itself and legal services. Equity warehousing allows the landlord a discreet withdrawal from a failed project, without exposure to the market or damage to their image, along with the possible legal and financial consequences.

Equity warehousing entails the use (or creation for a symbolic amount of money) of a new SPV, and the amicable acquisition of shares in the company that owns the shopping centre, along with the appointment of new board members and asset management team. From a formal and legal point of view, such a transaction is neutral for the bank, as the borrower remains the same. The purpose of these activities is to hand over the project to a professional and experienced advisor, who will facilitate the desired NOI increase in accordance with best business standards and market practice.

life cycle. Of course, in order to ensure lease profitability, the actual demand for office space and the structure of lease contracts must be thoroughly corroborated. It is important to create an appropriate tenant profile suitable for the location. What, however, should be done when a building is being leached of tenants by fast-growing and aggressive competition? Keeping an empty, or indeed half-empty, building in a portfolio is costly and results in financial losses. In such cases, the owner may choose to update the profile of a building, after having examined trends; for example, in the residential, hotel and academy markets, they may opt for modernising and commercialising the building while maintaining its original office function. Further, more drastic options, usually viewed as a last resort, may be considered; such as the sale of a property, or even its demolition to make way for a new project.

It is worth pointing out, that the growth of the private student accommodation sector visible in recent years (visible also in regional academic towns and cities) has given the opportunity for the creation of new investment products, breathing new life and profitability potential into office properties after their change of use.

Asset managers, by creating and effectively implementing appropriate strategies for even the most vulnerable buildings, can also give tired, dated projects a new lease of life.

Knight Frank's experience shows that the effects of this strategy when adopted are visible within approximately two years of its implementation.

The return to profitability of an office building following challenging times may require the setting up of a new strategy. To do so, advisors may well need in-depth analyses of both the building itself and the business environment in which it sits. Furthermore, knowledge is required of competing offices, and other circumstances that may affect the success of the given project, among them; cost optimization, legal and financial analysis and, often, personnel changes or changes in individual service providers.

A team of experienced specialists prepares strategy tailored for a specific office scheme, contributing to maximizing the effects of the strategy and, thus, maintaining or improving a building's market position and income level. Depending on the results of this analysis, the new strategy may require; repositioning of the scheme, diversification of its functions (e.g. by adding retail space), modernization, reconstruction or extension, renegotiation of lease agreements, monitoring of the competition's activities – and all of this for a modest sum of money.

As one of the largest and most experienced research teams operating across Polish commercial real estate markets, Knight Frank Poland provides strategic advice, forecasting and consultancy services to a wide range of commercial clients including developers, investment funds, financial and corporate institutions as well as private individuals.

We offer:

- ◆ strategic consulting, independent forecasts and analysis adapted to clients' specific requirements,
- ◆ market reports and analysis available to the public,
- ◆ tailored presentations and market reports for clients.

Reports are produced on a quarterly basis and cover all sectors of commercial market (office, retail, industrial, hotel) in major Polish cities and regions (Warsaw, Kraków, Łódź, Poznań, Silesia, Tricity, Wrocław). Long-term presence in local markets has allowed our research team to build in-depth expertise of socio-economic factors affecting commercial and residential real estate in Poland.

Contact in Poland:

+48 22 596 50 50
www.KnightFrank.com.pl

RESEARCH

Elżbieta Czerpak
elzbieta.czerpak@pl.knightfrank.com

ASSET MANAGEMENT

Maja Meissner
maja.meissner@pl.knightfrank.com

CAPITAL MARKETS

Krzysztof Cipiur
krzysztof.cipiur@pl.knightfrank.com

LAND ADVISORY

Piotr Litwin
piotr.litwin@pl.knightfrank.com

COMMERCIAL AGENCY - OFFICE

L-REP Izabela Potrykus-Czachowicz
izabela.potrykus@pl.knightfrank.com

T-REP Karol Grejbus
karol.grejbus@pl.knightfrank.com

COMMERCIAL AGENCY - RETAIL

Marta Keszowska
marta.keszkowska@pl.knightfrank.com

PROPERTY MANAGEMENT

Izabela Miazgowska
izabela.miazgowska@pl.knightfrank.com

**PROPERTY MANAGEMENT
COMPLIANCE**

Magdalena Oksańska
magdalena.oksanska@pl.knightfrank.com

PROJECT MANAGEMENT

Urszula Łuszczyńska
urszula.luszczyńska@pl.knightfrank.com

VALUATION & ADVISORY

Grzegorz Chmielak
grzegorz.chmielak@pl.knightfrank.com

STRATEGIC CONSULTING EMEA

Marta Badura
marta.badura@pl.knightfrank.com

MANAGING PARTNER

Daniel Puchalski
daniel.puchalski@pl.knightfrank.com

CHAIRMAN OF THE BOARD

Monika A. Dębska-Pastakia
monika.debska@pl.knightfrank.com

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