



Michael **Beaman** LIMITED
r e g e n e r a t i o n

Developing Space for Small Businesses

A Guide for Planners & Regenerators

Michael Beaman

2010 Edition

1 THE ECONOMICS OF PROVIDING SMALL BUSINESS UNITS

Introduction

In what follows the commercial characteristics of the various type of provision for small business are described together with the economics of development in each case. The absolute and relative viability of different types of provision are summarised using models of notional development schemes to explore the relatively complex economics of small providing small office and studio suites.

Office space

Small companies requiring office space have a wide range of opportunities. These include:

- Home working
- A unit in a converted or newly built business centre.
- A small office suite in a shared block or perhaps in or over a shop front

It is a common mistake to restrict efforts to provide additional space for small business to developing 'business centres' comprising small office suites. These only suit a minority but are the most common target of public sector support. This is normally justified by a perceived (but seldom analysed) failure of the private sector to provide the requisite quantity and quality of space.

The terms available for small offices of any type vary in terms of:

- The amount charged.
- The extent to which these charges cover costs such as rates, utilities, amenities and management services.
- The extent of the commitment required from the user.

At one extreme a licence arrangement is often based on month to month occupation in return for an 'all inclusive' fee that includes utilities costs and other services. At the other end of the scale a conventional lease will usually mean a commitment to a term of ten years or more and a service charge which will typically add £60 sq m (+/- approx. 33%) to the basic rent.

Unlike industrial companies, small scale office users rarely invest a lot in their premises, especially when there is a real prospect of business failure. They value a flexible arrangement at an all-inclusive cost as a means of avoiding:

- Long-term rental commitments which often need to be backed up by personal guarantees.
- The time burden of managing even a small self contained property with the numerous attendant responsibilities and outgoings and sometimes a higher need for initial capital investment.

For these reasons this section focuses primarily on the provision of buildings expressly built or converted to accommodate the office and studio requirements of small firms in the manner of traditional business centres. These can take a variety of forms. New buildings tend to be steel framed structures of between 1000 sq.m. and 5000 sq.m. gross floor space arranged over two or three floors. (Single storey buildings can make poorer use of sites which, even if inexpensive, are often in short supply in the best locations. The cost per square metre of constructing taller buildings increases with height so these are only really an option in areas where rents are high). Additional expense is incurred primarily when higher quality components and features are used such as glazed walls, atria and air conditioning systems which can be operated on a modular and

flexible basis. Internally, business centres cost more to fit out than ordinary office buildings because of the need to subdivide the space and the services because while many conventional offices also require some degree of subdivision but they normally have lower standards in terms of:

- The permanence and acoustic qualities of the internal walls
- The flexibility to accommodate different power and lighting requirements.
- The control that individuals have over their office environment. This is a major problem when air conditioning is required, because cheaper systems cannot be easily configured to respond sensitively to differences between the way in which different office units are used, for instance as a result of the amount of heat generating equipment in operation.

With renovated buildings the key cost driver is often the suitability of the structure itself for conversion and subdivision. A basic scheme of subdivision and redecoration is inexpensive but when a building is not well suited or needs substantial repair, total renovation costs can exceed the cost of new construction. More importantly from the point of view of a developer these costs can be unpredictable. It is often difficult to know the extent of structural problems until after the building purchase is made and the original finishings and fittings are removed, classic issues being structural degradation (e.g. rusting steel) and problems with the interstitial coverings on flat roofs.

Many buildings are intrinsically difficult to convert into space that is suitably proportioned and comfortable to work in. This sometimes occurs where there is a mixed motivation for the conversion. Local Authorities often promote schemes partly to provide space but also to conserve a structure that is valued for its character and contribution to the street scene. A classic example is Victorian schools where in many cases the layout is ill-suited to office use with thin internal partition walls and tall glazed windows which make subdivided spaces expensive to heat in the winter and difficult to cool in the summer. Another typical candidate building is the old flatted factory or warehouse. These can have advantages such as strong floors and suitable ceiling heights but many have deep floor plans which can cause difficulties in:

- Bringing light into the central areas following subdivision without creating a new lightwell.
- Creating acceptable means of escape arrangements.

It is not possible to generalise about the cost of conversion. At the low end, it will be significantly less than the cost of a new structure and simply involve basic structural repairs and subdivision using breeze blocks for better sound attenuation followed by renewal of heating, plumbing and wiring and a fresh coat of paint. Additional investment is sometimes focused on the reception area in order to give the building as a whole an image that is valued by occupants but not echoed in the quality of the interior. At the other extreme a scheme involving structural repair, alteration and refitting can as stated previously cost more than a new building.

In both cases a key factor in the overall economics of development is the effective utilisation of the floor space. This tends to be poor in business centres where each floor is subdivided. In a conventional office building a developer might hope that rent can be charged for 85% (+/- 5%) or more of the floor space. (The reception area, lift and stair lobbies, toilet and storage space do not form part of the rented area). In contrast in a typical business centre space is also lost to provide internal corridor giving access to the various units, a management office and storage and very often meeting rooms and a café, (Whatever the aspiration the latter two rarely prove to be revenue generating). The result is space utilisation that is typically at best 75% (+/- 5%) in new buildings and lower still in small ones. The economics of property development are always sensitive to small changes in the value of the completed building so this inefficiency in space

utilisation has a disproportionately marked impact on the land values generated by a scheme. (Because land values = development value less development costs including any profit requirement).

Another key factor is the issue of economies of scale. This is particularly an issue in terms of staffing. If the centre has a common switchboard and staffs a reception desk from 8 a.m. to 8 p.m. there will be a need for at least two receptionists with a requirement for temporary support to cover sickness and holidays. Spread over 5,000 sq.m. in a higher value location that is perhaps not a significant cost. In a smaller building it is a real burden. Electronic access systems can work where there are a very limited number of occupants with a real sense of mutual responsibility but do not provide much security in other cases and can complicate insurance arrangements. In the same vein one additional cost that is frequently faced particularly in converted older buildings is a need for a handyman. A large building can afford to employ a full timer but a smaller building has to employ tradesmen on the job by job basis which is relatively expensive as well as time-consuming to manage. Finally a smaller centre makes less cost-effective use of other shared facilities whether a cafe, meeting rooms or something more mundane like a common switchboard or photocopier.

The extent of these shared services and facilities needs to be carefully considered. These are frequently assumed by public agencies to be desirable and to play a role in assisting the businesses and thereby economic development. This view is promoted by many so-called best practice guides published by the promoters of custom built business space but cannot be taken for granted. The scope of the shopping list of services and amenities and the relative desirability of the various items on it in the eyes of the occupants was assessed by UK Business Incubation, a not-for-profit organisation launched by the DTI and the Treasury in 1998, in "The UK Incubation Impact Assessment Study 1999\ 2000". Typically, this failed to relate the demand for services to the cost of providing them. Many occupants report a service as being useful when it is free! A broad impression based on this and other studies and direct experience might be that services such as advice and secretarial support are less valued than more tangible advantages such as parking, phone answering, 24 hr. access and a café if there are few nearby. It is noticeable that commercial operations which tend to consider adding services in response to stated need and willingness to pay tend to provide a narrower range of services than public sector schemes. Direct research suggests that many services and facilities in public sector schemes are under used. In some cases the additional services in public centres can be justified on grounds of evidenced economic development benefits, but in practice it is rare to find instances of the support package being considered through a cost-benefit analysis of any sort.

Finally, the intrinsic attractions of business centres need to be addressed as an investment competing with others in the property market. This typically manifests itself in the multiple of the net income that an investor might expect to earn from it both initially and in the future. Twenty years ago business centres was usually valued at a much lower multiple of the income than were conventional offices. The reasons for this were a view that in order to arrive at the net level of income from business centres for comparative purposes it was necessary to make allowance for:

- The need for direct management involvement – a particular disincentive for institutional investors.
- Repairing obligations lying with the landlord rather than the tenant
- A high level of letting voids.
- Problems in collecting rent from impecunious small firms.
- Difficulty in achieving full recovery of costs covered by service charges.

This combination of poor space utilisation, additional costs and low multiples of net rent paid by investors completed a 'triple whammy' which made the creation of business space an unattractive proposition. Some specialists correctly perceived that this was a one sided analysis. Business centre investments offered some key advantages:

- The risk of tenant default and voids was spread among a larger number of firms.
- Flexible letting arrangements meant that rents could be increased more frequently.
- Some older buildings could be purchased cheaply and which were suited to conversion for business centres.
- The corollary of low capital values was a high income return that could be used to service higher levels of debt.

In short, they viewed the 'product' more in the terms of a service business than a property business and planned retaining it to provide a growing income rather than to sell it on completion, so poor capital values were less of an issue. A good example is Workspace PLC. (www.workspacegroup.co.uk). As a result the gap between the multiple of rent that investors would pay for a business centre compared to a conventional office narrowed. But it still remains, and is marked if compared with a conventional office building secured by a single lease to a substantial tenant.

As it stands the key to the value of the business centre as a business proposition is:

- To construct new buildings economically and to select the most suitable buildings for renovation, designed to achieve the maximum ratio of usable to gross floor space
- In every case to try and achieve economies of scale by concentrating on developing the largest building that can be built in any given market. (I.e. being careful not to build more space than can be reliably let).
- To achieve a high and sustainable margin of income over costs by ensuring that all additional services and facilities demonstrably add value in excess of their cost.

This might sound self-evident but in practice many centres promoted by the public sector are small, have a poor net to gross ratio and achieve a net income after costs which makes it clear that the full cost of providing additional services is not being fully accounted for in the charges. Often the underlying reason is that the rationale for the investment is not purely commercial. Typically the motive might be a desire to promote or form relationships with growth business or technological innovators or to find a use for a building that was valued for its character rather than its suitability. Again, the lack of objective research means that a positive and cost effective economic impact cannot be taken for granted.

One peculiarity of business centres is that new space does not invariably command a significant premium over old. There are two reasons for this.

- Occupants are unlikely to be responsible for major maintenance expenses and thus have less incentive to buy a new and presumably 'low maintenance' building.
- Differences in the nature of local demand.

Sometimes, if local businesses need to project a modern image, perhaps because they are predominantly technology-based, they will welcome the higher quality services and more modern image provided by a new building. On the other hand, in areas where the creative industries predominate, there can be a preference for character buildings especially if this is skilfully exploited to combine a funky image with a low cost structure.

Another oddity given that business centres and incubation centres are to some extent service businesses is the predilection for using freehold rather than leased buildings for conversion. Although this mirrors conventional practice in the commercial world it is by no means universal. One of the largest upmarket operators is Regus who lease a lot of the space that they run as office centres. Leasing a building is effectively another form of gearing alongside borrowing funds. The downsides in terms of loss of long term control over the building are obvious but equally the short term benefit of making available capital go further in terms of creating space are equally obvious and should in theory appeal to public agencies who value short term employment impacts. In many areas the best candidates in this respect will be buildings that can be leased and converted cheaply so that the cost of conversion is adequately rewarded by the premium income receivable.

To illustrate some of these points in quantitative terms a model of the economics of a business centre development was constructed with the assumption of financing using a mixture of equity and debt. Table 1 below shows the impact on the net income and value of the scheme of a variety of assumptions in relation to space utilisation and services offered. No allowance is made in these figures for the cost of buying a site because the affordable land value is effectively an output rather than an input into a calculation of this sort.

Table 1 : Comparison Between Different Models of Business Space Provision

	Typical Office Scheme	Standard New Build Business Centre	Standard Business Centre Conversion	New Build Incubation Centre
Gross Floorspace sq m	4000	4000	4000	4000
Ration of usable to gross floorspace	85.0%	75.0%	75.0%	70.0%
Lettable Floorspace sq m	3400	3000	3000	2800
Development Cost sq m	£1,400	£1,700	£1,000	£1,800
Dev Cost £	£5,600,000	£6,800,000	£4,000,000	£7,200,000
Rent Per sq M £	150	180	150	150
Allowance for irrecoverables £ sq m	0	5	5	5
Allowance for voids £ sq.m.	0	10	10	20
Allowance for repairs£ sq.m.	0	5	5	5
Net rent sq m	£510,000	£432,000	£360,000	£294,000
Capitalisation %	7.0%	7.5%	8.0%	7.5%
Value £	£7,285,714	£6,400,000	£4,875,000	£4,480,000
Capital return on cost %	30.1%	-5.9%	21.9%	-37.8%
Net rental as % of cost	9.1%	7.3%	10.1%	4.9%

In this model the typical office scheme is a comparator scheme and is taken to be a new office block on a business park designed for letting to a single tenant. In the new built Business Centre model a premium rent is charged for the smaller suites but the effect of this is more than offset by the lower space utilisation within the building and the need to deduct an allowance for running voids and irrecoverable income to arrive at the effective net rental income. The converted business centre model assumes a lower development cost, comprising the purchase of a suitable multi storey industrial building and a basic repair and fit out; and a commensurately lower rent. In practice, a wide variation in costs is encountered. The incubation centre model assumes a slightly

more impressive specification and the higher voids allowance in this case reflects the higher risk of default among start up businesses and the prevalence of rent free period offers.

It must be stressed that this is not intended to be a current illustration of the economics of any particular scheme but rather to illustrate the comparative economics of provision using figures that will be broadly recognisable particularly in the more prosperous areas of England. Typically values in the south east will be higher and in the north and far west they will lower. The capitalisation figures represent averages over the last property market cycle. Any attempt to reflect current (2009) extreme market weakness in these figures would undermine their capacity to illustrate the applicability of the reasoning in normal market conditions and endanger the world supply of red ink.

As can be seen, the rental return exceeds the (then) cost of well secured loans in every case except the incubation centre where an element of the return is effectively being channelled into supporting start ups. But only the 'comparator' office building and the converted business centre provide a reasonable return on capital, with the attraction of the latter mainly reflecting the total cost of buying and converting the building.

Table 2 below shows how much subsidy is required based on this model to achieve:

- Value equivalent to cost - the point at which the development of the space by a public body doesn't require long term subsidy.
- A 20% margin on the capital employed - a normal commercial rate of return
- An 8% rental return on capital invested - a reasonable test of the capacity to support the investment with a mortgage to cover part of the investment cost without running undue risk.

Table 2 : Analysis of level of subsidy needed to achieve notional projects (assuming free land).

Public subsidy per sq m to achieve:	Typical Office Scheme	Standard New Build Business Centre	Standard Business Centre Conversion	New Build Incubation Centre
Value in excess of cost	Nil	£100	Nil	£680
20% margin on capital	Nil	£370	Nil	£870
8% return on capital	N/a	Nil	Nil	£700

Again, these figures are hypothetical and any specific proposal will differ to some degree, but they serve to illustrate key points which can guide policy.

- If development is undertaken by a non profit making body, the amount of long term subsidy needed to achieve a rolling programme of development of new standard business centres is potentially fairly limited. In this case at £100 sq m, the permanent subsidy for a 4000 sq m centre would be £400,000.
- A non profit making body should be able to secure substantial debt finance towards development costs without running undue risks especially if a portfolio of buildings is developed (over space and time) to spread those risks.

- On the same basis, the subsidy required to build innovation centres could be significant which makes it more important that the anticipated economic development benefits fully reflect the additional public investment. This is rarely tested.
- Converting buildings to business centres makes commercial sense, which is why this approach is common among developer / investors. But the choice of building is crucial because procurement and development costs need to be tightly controlled.

Other provision for office and studio users

The competition for many business centres is not just other centres but the alternatives of home working, space in or over a shop or (for larger concerns) a conventional office suite.

Space in a shop or over a shop can offer an economical alternative that is more completely controlled by the occupier so that the terms for customisation, access and use are less of an issue. On the other hand lease lengths are usually longer and capital investment can be required to bring the property up to standard. The supply of suitable premises of this sort can be an intended or unintended victim of planning restrictions which can influence:

- The acceptability of the proposed use in the context of the desire to protect local retailing.
- Security and privacy (use of shutters and blinds etc.)
- Access to upper floors - rear access is seldom an attractive option but planners tend to resist front entrances which perforate the retail frontage.

A careful appraisal of the impact of planning policies in this respect might be advantageous in some areas perhaps coupled with a general relaxation of use controls to allow more office uses of all types in declining frontages perhaps with a view to encouraging groups of conversions to office use. Similar thought could be given to small scale commercial uses in residential areas where it is at least arguable that nimbysm has pushed the balance too far towards protecting amenity and away from providing the flexibility that supports entrepreneurialism.

One specialist form of provision for the smallest desk-based businesses has been drop in / hot desking facilities not unlike the 'business centres' frequently provided at airports and hotels. In essence these provide a small firm with a business address and the necessary space to work when needed. These can be particularly valuable where:

- There is a need to support micro-businesses in places like the more difficult housing estates where people can find it difficult to work in the family environment in cramped accommodation and the business address doesn't inspire customer confidence.
- For women insofar as it removes the need to disclose their home address.
-

However the advantage of spaces of this sort has declined as laptops have become relatively inexpensive and mobile phone usage almost universal. In practice they are very management intensive and varying and unpredictable levels of demand makes them an unattractive business proposition on any scale in most places.

Industrial

Industrial provision for small businesses is rather more straightforward. The structures themselves are simple and standard lease terms are more commonly used, in part because the occupier is normally making a greater capital commitment to buying equipment or stock and thus wants more security of tenure.

A typical development of small industrial units (sometimes referred to starter units even though most of the firms in them are neither start ups nor even growing businesses) comprises:

- At the better end of the market, a terrace of load-bearing brick units each with a manually operated roller shutter door and perhaps including small office, toilet, lighting and a substantial heater in the workspace.
- At the cheaper end of the market basic shells with no internal fittings and capped service connections, often built using steel frames and cladding. The latter can deteriorate quite quickly in circumstances in which it is exposed to damage.

Unlike office units, industrial units are conventionally let on the basis that the entire internal area of the unit is treated as usable space. From a developer's point of view this removes the problem of having to build space which is not included in the rental calculation. But industrial development brings its own design problems and a key issue which afflicts the development of small units compared with larger ones is the efficiency in the use of the site. Quite simply, larger units normally make better use of a regularly shaped plot because they use the external space more efficiently and a single occupancy reduces security problems. In addition many smaller developments cannot provide an adequate area for an articulated lorry to park or turn and the result is that access is frequently blocked. Even pantechnicon lorries can cause problems particularly in places where the available hardstanding has been used for car parking in excess of the design limits. It follows that the most advantageous sites for small new industrial unit development are those which are not suited in terms of size to providing a larger unit but which can provide easy access and off-site manoeuvring and parking space for larger lorries.

Once again there are economies of scale in terms of costs. A small unit has a higher ratio of building envelope (floors and walls) to usable floor area and the cost of providing expensive elements such as utility connections and a roller shutter door is proportionately greater.

In contrast to office type business centres there is invariably a significant gap between the rates charged for new and much older industrial units especially those created from conversions of larger units. This is an advantage for many industrial and distribution firms who want functional space at the low price in order to remain cost competitive but who do not need to project a modern image. The needs of such firms can sometimes be well met by the subdivision of units on older estates even when that subdivision is not accompanied by any further renovation work at all. (Once again, the major costs will include providing the additional roller shutter doors and separate utilities connections). From the developer's point of view the aim is usually to buy an old estate suited to the purpose and to make sure that the cost of conversion is kept down to the extent that they are more than adequately recompensed by the premium income achieved on reletting.

As with offices, investors require a premium return for the extra costs involved in managing smaller

units and the perceived risks associated with smaller companies. The latter can be more pronounced in the industrial sector where the risk of default is seen as greater. (I am unaware whether there is any evidence to support this). While there is usually clear evidence of a rental premium being paid for smaller units - perhaps typically £20 sq.m., this is not usually sufficient to compensate for higher development costs and the lower rate at which the income is capitalised.

The situation is therefore that the land values generated by developments of small industrial units are typically lower than those achievable where larger buildings are an option.

Development will therefore tend to occur in the limited number of situations in which a site:

- Does not lend itself to development of a larger unit - perhaps because it is elongated or can't provide the quality of access required in a building which will be sold to an institutional investor.
- Is required through the Town Planning process.
- Is located in an area where there is known demand for small units but no demonstrable demand for larger ones.

The first of these is probably the most common.

But once again the lower rate at which the market values the income from smaller units means that, where development is practicable, the income yield from development is comparatively generous. This in turn means that the developments lend themselves to mortgage finance in a situation in which the plan is to retain the units as a medium or long term investment.

Our conclusions here echo the conclusions about standard business centres i.e.

- If development is undertaken by a non profit making body, the amount of long term subsidy needed to achieve a rolling programme of development is potentially fairly limited.
- A non profit making body should be able to secure substantial debt finance towards development costs without running undue risks if the portfolio of locations is reasonable in terms of quality and diversified.

Comments on Financing & Development

The traditional approach of the public sector to financing the provision of small business space is inefficient in three ways:

- It uses a mixture of funding that is rich in grant rather than using loans or leasing to maximise the impact of the available capital.
- It pays insufficient attention to the real impact achieved from investment both in the buildings and in the services offered by them
- It ignores the wider spectrum of ways in which small business needs can be met.

The implication of the analysis in this note is that there is scope to devise approaches that achieve a lot more in terms of space provision per pound of public support by paying attention to:

- Maximising net income.
- Making good use of debt funding.
- Leasing rather than buying buildings for short term impact at reduces capital cost.
- Considering the full range of the types of space used by small businesses.

Consideration also needs to be given to encouraging private sector provision. It is axiomatic that a publicly funded programme of effectively subsidised space provision will actively undermine and discourage private investors. Conversely, most firms only have a limited capacity to search for new

opportunities so an effort to identify potential schemes that might appeal to them can pay dividends and lead to real competitive advantage.

NOTE

I assert authorship of this note which is distributed free of charge but it has not been peer reviewed or meticulously checked and sub edited so I will apologise now for any shortcomings that result. Use it as you will but please acknowledge my work where it is appropriate to do so. In the emerging tradition of the new economy, I am describing this as a 'beta version' and will be very grateful for feedback, correction and additional information.

Michael Beaman

URL : www.regenerate.co.uk

E Mail : beaman@regenerate.co.uk

Tel: : 079 44 00 6891