Realizing the Value of Corporate Real Estate Management

Comparing the role of corporate real estate management in European and American corporations.

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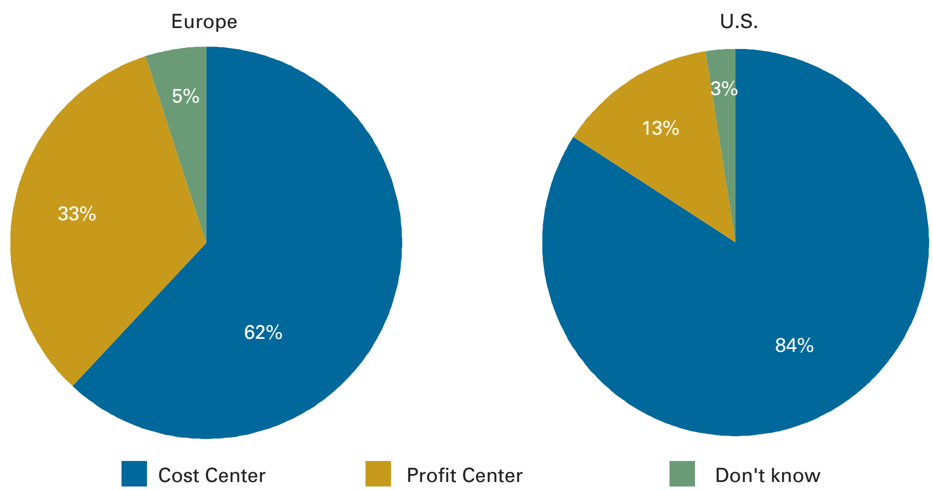
CORPORATE REAL ESTATE has always been a valuable asset on corporate balance sheets, even if many companies do not realize this is the case. Maximizing the value of real estate has become an increasingly important competitive factor in the ongoing globalization process. Various industry research studies over the last ten years indicate that more than 25 percent of corporate assets are invested in real estate and that total occupancy costs of corporate real estate represents 5 percent to 8 percent of total (pre-tax) gross sales, or 40 percent to 50 percent of net income. One study concluded that competition is forcing companies to examine both their assets—especially corporate real estate—

and their processes in order to increase market share, maintain competitive positions, and increase shareholder value. Thus, research recognizes the significant value of real estate (to non-real estate firms). But in spite of this recognition, corporations continue to "under-manage" real estate assets and resources. In part, this is because corporate real estate management (CREM) departments lack prominence in most companies. As a result, this valuable part of corporate balance sheets goes largely unnoticed and undermanaged.

We surveyed corporate real estate executives of European and U.S. non-property companies in the banking, energy, telecommunication and transport and logistics industries to assess how they manage their real estate holdings. The primary focus was on companies with a large number of leased and/or owned properties, with the majority of participant companies having annual total revenues of more than €1 billion (Europe, 27 percent; U.S., 21 percent) or more than €5 billion (Europe, 61 percent; U.S., 66 percent).

In order to establish the importance of corporate real estate, it is necessary to define the role of CREM in a company. The objective should be the creation of a return from real estate without distracting the focus from the firm's core business. Furthermore, CREM should make a contribution toward the strength and competitiveness of a company by ensuring that company-owned resources are used effectively. In short, increase profitability of the company from both core and non-core operations.

Figure 1: Cost vs. Profit Center (n=112)



It is interesting that nearly all (97 percent) of U.S. and 83 percent of European companies run their CREM departments as corporate divisions. CREM as a standalone legal entity is found in only 3 percent of U.S. and 12 percent of European enterprises. As displayed in Figure 1, most U.S. (84 percent) and European (62 percent) firms run their CREM departments as cost centers, and only 33 percent of European and 13 percent of U.S. CREM departments are organized as profit centers. Further, only 20 percent of European CREM departments have a real estate strategy against which they are held accountable. This means another 13 percent of European CREM departments are run as profit centers but without accountability. Further, a number of companies in our survey have the self-perception of running CREM as profit centers, but effectively are run as cost centers.

A major task of CREM is to identify strategic challenges focusing the company and to manage their effects on corporate real estate. The planning and decision horizon of CREM therefore is concentrated on the development of long-term potential for success. CREM should identify and evaluate the economic and technical trends driving the firm's real estate portfolio, improving the firm's competitiveness. A study by Asson in the *Journal of Corporate Real Estate* indicates that in addition to the financial optimization of real estate portfolios, this form of cooperation leads to greater flexibility, cost certainty, and higher service quality.

Figure 2: Property information system (n=112)

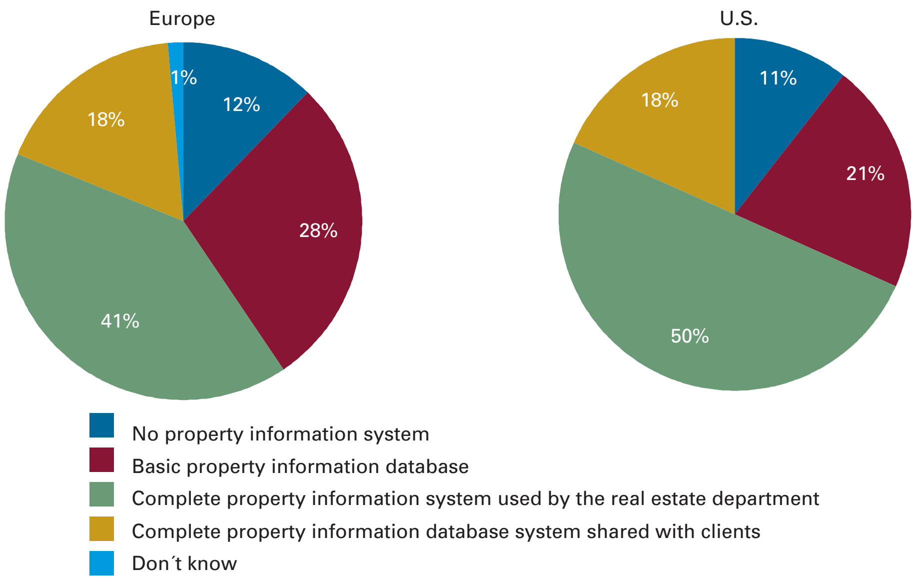
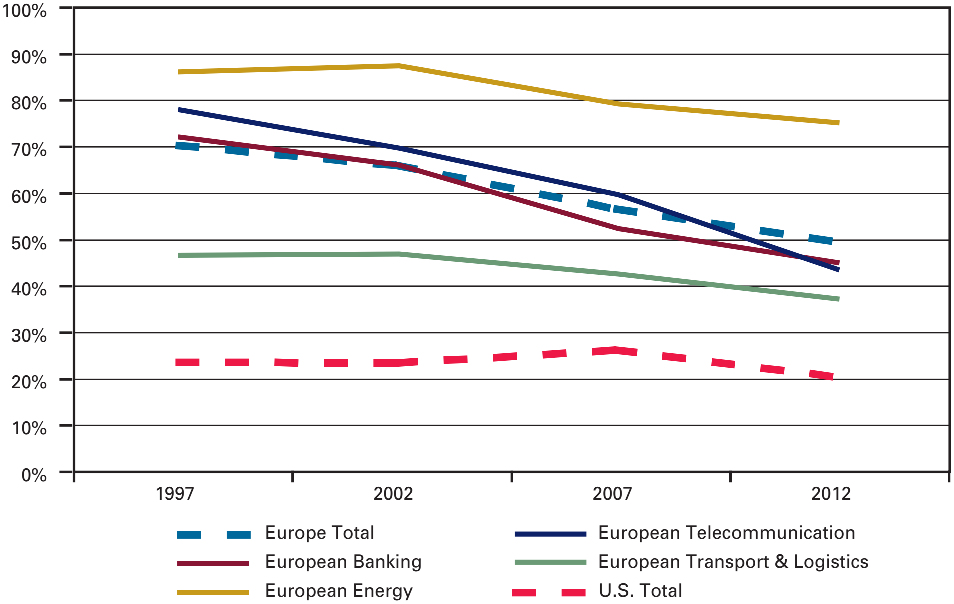


Figure 3: Ownership rates (n=94)



The existence of a property database that provides adequate and timely information (such as business needs, staff requirements, facilities, occupancy costs and market data) is essential for facilitating effective strategic planning of corporate real estate. But only 50 percent of U.S. and 41 percent of European CREM departments use dedicated property information systems, while 18 percent of both U.S. and European CREM departments have property database systems that are shared with the end-users. More than a quarter of European and U.S. CREM departments use only a basic property information system (or none at all) (Figure 2).

It is imperative that U.S. and European companies grasp the financial burden real estate ownership places on the bottom line. Real estate ownership rates remain excessively high among European companies as compared to their U.S. counterparts. The ownership rate in Europe is about 56 percent versus only 25 percent in the United States (Figure 3).

While European companies have reduced the property ownership gap relative to their U.S. counterparts, Europeans still own far more corporate real estate, though slightly decreasing real estate ownership is the norm. Five years from now, European companies still intend to own 50 percent of their portfolios. Hence, the top level of European corporations fails to assess the value of capital tied up in corporate real estate. Moreover, given that the respondents are CREM staff and may fear that less "owned property" translates into lower employment for their group within the corporation, there is a natural bias among CREM towards owning corporate real estate. There is no reason to believe, however, that this effect influences results to a greater or lesser degree in the United States or Europe. Finally, higher ownership rates among European companies result from less pressure to maximize profits and corporate value.

Focusing on the higher rate of European ownership, considerable differences are found across industries. The highest ownership rate is in the energy industry, where European companies own about 79 percent (expected to drop to 75 percent by 2012), due to special-use properties and the formerly government-controlled energy markets in many European countries. A large decrease in ownership rates is forecast for the telecommunication and banking industries. Over the last ten years, real estate ownership rates in the telecommunication sector decreased from 77 percent to 59 percent, and from 72 percent to 52 percent in the banking sector. In both telecommunication and banking, the ownership rate is expected to drop further in the next five years (to about approximately 45 percent). The ownership rate in the transport and logistics industry is lowest, decreasing from 46 percent to 42 percent from 1997 to 2007, and is expected to drop to 37 percent by 2012.

The sale of portfolios and individual properties is necessary at European companies to move from the predominant ownership model to the more efficient lease model. Exceptions exist for highly specialized assets, but the general rule of thumb should be to lease and deploy capital to core business activities.

Although the challenges for CREM departments are quite similar in the United States and Europe, there are marked differences in the rationales for leasing versus owning corporate real estate. Specifically, European companies show a much greater desire to shield internal processes (Europe, 58 percent; U.S., 16 percent) and maintain independence from outside landlords (Europe, 53 percent; U.S., 21 percent) (Figure 4). The desire to keep processes and management internal to a CREM department is possibly the result of less well developed rental markets.

Research by Linneman and Pfirsching (*WRER*, Spring 2008) demonstrates that current corporate real estate standards used to make the own-versus-lease decision are seriously flawed:

> The decision rule generally employed is that only if the present value of future rent is less than the present value of costs of self-ownership of the space (net of depreciation benefits and expected proper-

ty appreciation) should the firm lease rather than own… The correct model for the own-versus-lease decision must compare the present value of profits the corporation expects if they lease versus the present value of expected profits if the company decides to own its real estate.

The authors analyze the difference in profits generated when a company leases versus owns, concluding that "The intuition of this result [to lease] is simply that by moving capital from low yielding real estate to high yielding core operations, companies increase profits."

For 57 percent of European companies, maximizing real estate-related economies of scale plays an important role, compared to only 26 percent of U.S. companies. This indicates that European companies either mistakenly believe real estate is a core operation if done on a grand scale, or that that U.S. companies have learned that non-core functions should remain non-core. In fact, such non-core functions have higher costs, especially when done on a grand scale. Further, portfolio flexibility (relocating personnel, downsizing, expanding) is important for approximately 55 percent of both U.S. and European respondents. This is not surprising, as portfolio flexibility is a prerequisite for satisfying the rapidly changing space requirements of corporate end-users in an ever more global and competitive environment.

Figure 4: Criteria for owning or leasing (n=112; multiple answers allowed)

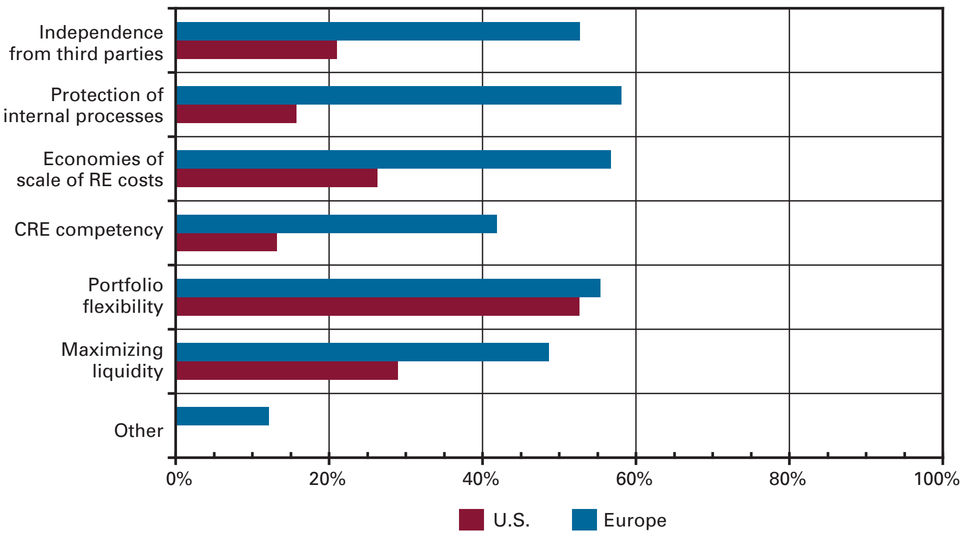
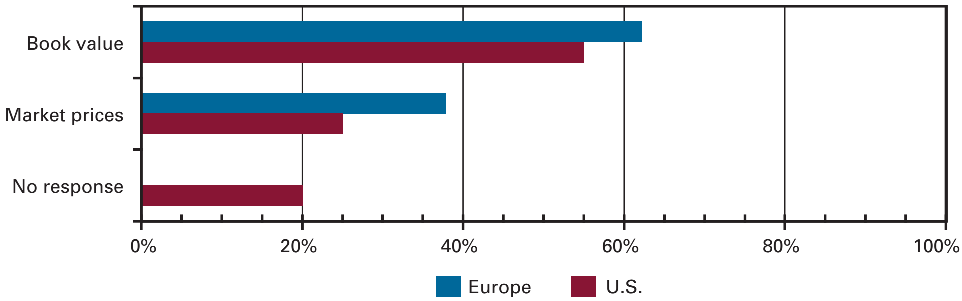


Figure 5: Basis for ascertaining tied-up capital (n=112)



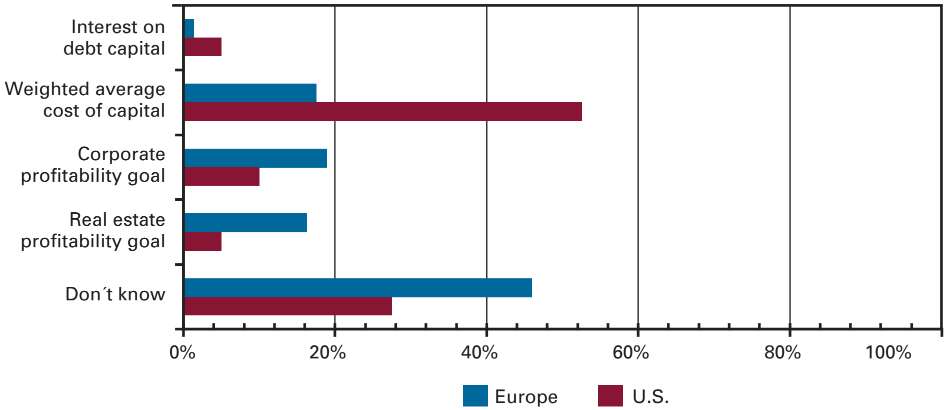
One of the main tasks of CREM should be to measure capital requirements and the opportunity costs of real estate capital. Unfortunately, most CREM departments use metrics that fail to capture the true opportunity cost. As shown in Figure 5, a stunning 62 percent of European and 55 percent of U.S. companies measure their capital on the basis of book value. In comparison, only 38 percent and 25 percent of respondents in Europe and the United States, respectively, use market values to determine the value of tied-up capital.

Using book value to calculate the opportunity cost of tied-up capital is inappropriate. Not surprisingly, costs come into play when companies are faced with the decision to choose a method to value company portfolios (book versus market). Since updating market value is more costly than calculating book values, the latter is a less expensive—though misleading—approach. Interestingly, only 46 percent of CREM departments that are run as profit centers measure their opportunity costs of corporate real estate on a market value basis, while more than two-thirds of cost centers use book value.

Another factor driving the opportunity cost of tied-up real estate capital is each firm's required rate of return. As depicted in Figure 6, more than half of U.S. companies use the weighted average cost of capital (WACC), 10 percent refer to corporate profitability goals, and 5 percent use real estate profitability goals in their cost of capital analysis. In contrast, a mere 18 percent of European companies use WACC, 19 percent rely on corporate profitability goals, and 16 percent use real estate profitability goals.

It is interesting to note that a high percentage of respondents either do not have a required rate of return for their real estate holdings, or do not know if they have one. This suggests that many senior executives have not recognized the significant value tied-up in their real estate assets. In addition, CREM departments generally do not

Figure 6: Required rate of return for ascertaining opportunity costs in tied-up capital (n=112)



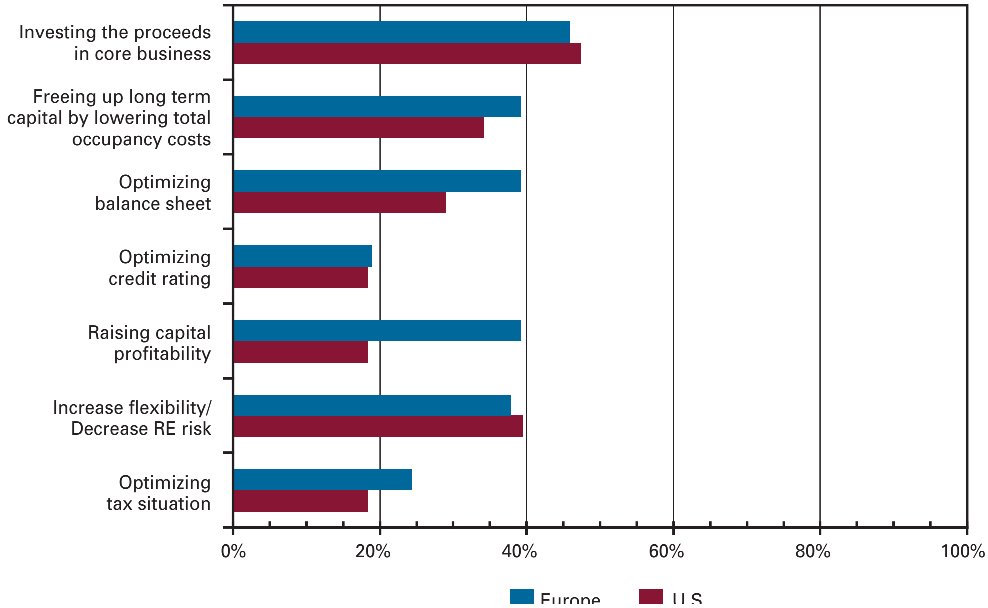
know how to measure the opportunity costs of capital tied-up in real estate. Since most companies view real estate as an operating asset, they place little emphasis on the opportunity cost of these assets.

Although only 10 percent of respondents in both Europe and the United States note problems stemming from earlier acquisition decisions on CREM portfolio management performance, CREM is rarely an integral part of the corporate acquisition process. Hence, there is little or no consultation with CREM as part of acquisitions, with CREM consulted as to potential effects only after the acquisition strategy has been developed by senior management.

The fact that investment in the core business was, by a slight margin, the goal most cited with respect to divestment suggests that there is some understanding among corporate real estate staff that core operations should be the prime destination of capital (however flawed the perception of those same individuals may be that holding real estate is a means to this end).

U.S. companies indicate the goal of investing in the core business is of primary concern at a response rate that is almost identical to their European counterparts. At the same time, U.S. respondents lag their European counterparts when it comes to believing that increasing profitability by raising capital through the sale of assets is a key goal. Other important reasons for property divestment include optimization of balance sheets and generating long-term equity. Operationally, CREM respondents also believed that increased flexibility in their portfolios was a divestment goal (Figure 7). All too often, they sell only when they are distressed and such

Figure 7: Corporate goals achieved through divestment (n=112; multiple answers allowed)



sales access urgently required capital. But such sales generally occur into weak economies and capital markets, as that is when corporate distress generally occurs.

Sale-leasebacks, while utilized by both European and U.S. respondents, trailed outright sales of (primarily) individual properties to private investors (Figure 8). This suggests such sales occur only when they are no longer of use to the company. The lack of responses of U.S. participants with regard to use of securitization of properties results from a combination of two factors. First, there may be a hesitancy to disclose such confidential information. Alternatively, it is possible that U.S. respondents have discomfort with the uncertainty of securitization success. Obtaining capital from properties is something that corporations typically prefer to do quickly, quietly, and with certainty (Figure 9). Securitization is the exact opposite.

The divestment of properties is generally achieved via single-property sales, as opposed to portfolio sales. This indicates that divestment occurs on a reactive basis, as opposed to part of a larger strategy. We conclude that in both Europe and the United States, the strategic involvement of CREM in corporate divestment activity is limited, with dispositions driven by necessity. In such distressed circumstances, firms are not basing sale decisions on market

Figure 8: Vehicles used for divestments (last three years; n=45; multiple answers allowed)

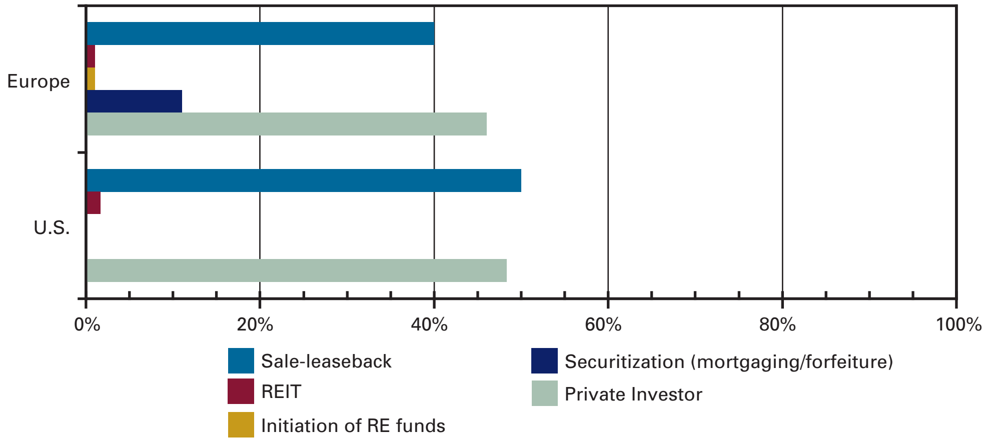
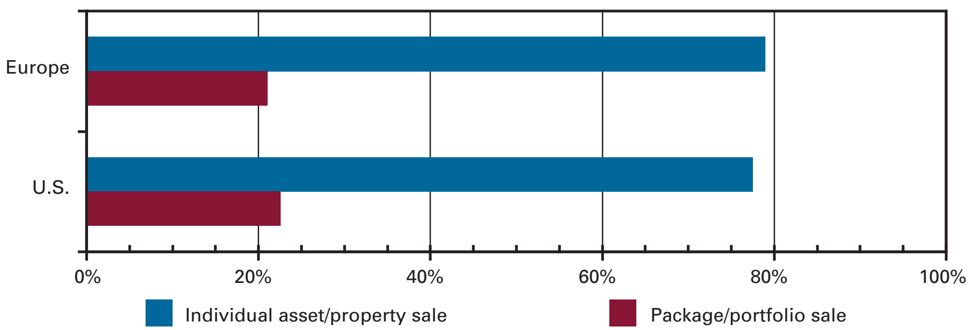


Figure 9: Packaging of divested properties (last three years; n+77; multiple answers allowed; response rates were Europe 66%, U.S. 75%)



timing or opportunistic pricing, and fail to capture the highest value for their assets.

Once the decision is made to divest, the allocation of divestment proceeds is an essential component of corporate real estate portfolio management, as the benefits of divestment proceeds should align with corporate interests. One of our questions addressed the internal destination of proceeds when a property is divested (Table I).

The preponderance of companies, regardless of where CREM is housed or reporting responsibilities, indicates that proceeds from divestment of property go to the general corporate treasury. Among

European companies, seven companies noted that 100 percent of divestment proceeds go to the unit that used the real estate. A further eight responded that users share the proceeds either with the finance or CREM department (or with both). In only six of the companies do the divestment proceeds go to the CREM department. In practice, the most common model is that the corporate treasury receives all sale proceeds. Only a small number of corporate users benefit from divestments of surplus properties they formerly occupied. Nearly half of European and U.S. companies say they reinvest divestment proceeds into core business activities.

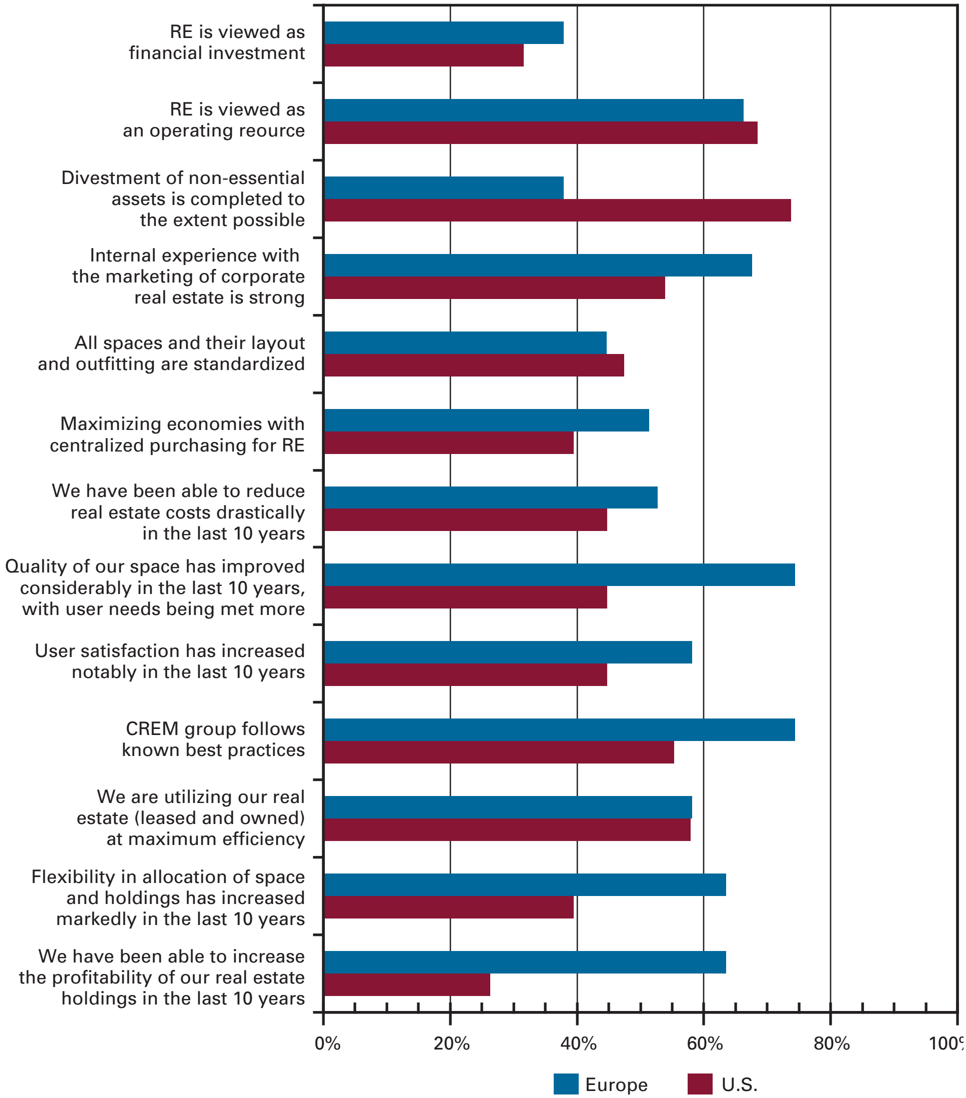
In spite of its relatively low corporate status, CREM staff generally perceive the status of real estate within their companies in a positive light. With some exceptions, the views are similar across U.S. and European companies (Figure 10). There is agreement among U.S. and European CREM staff that real estate is predominantly an operating resource, with some believing it is also a financial investment. However, we question their belief in real estate as a financial investment, as when asked how opportunity costs of corporate are measured, less than 20 percent of European respondents used WACC. Corporate and real estate profitability goals were both mentioned by just under 20 percent of European respondents and fewer than 5 percent of U.S. respondents. Of European and U.S. respondents, 47 percent and 28 percent, respectively, said

Table I: Appropriation of divestment proceeds

European respondents				
Model	Corporation/Finance	Unit using real estate	CREM group	# of mentions
A	100%	0%	0%	33
B	50%	50%	0%	2
C	0%	50%	50%	3
D	80%	20%	0%	2
E	0%	0%	100%	6
F	0%	100%	0%	7
G	50%	30%	20%	1
H	Don’t know/No response			20

U.S. respondents				
Model	Corporation/Finance	Unit using real estate	CREM group	# of mentions
A	100%	0%	0%	26
E	0%	0%	100%	2
F	0%	100%	0%	7
H	Don’t know/No response			3

Figure 10: Perception of real estate among CREM staff



they did not even know how corporate real estate opportunity costs were measured at their firms.

Finally, we take issue with the claim by 63 percent of European respondents (versus just 23 percent of U.S. respondents) that their companies have been able to increase the profitability of real estate holdings over the past ten years. Aside from reiterating the problem we see with measurement, we note that 60 percent of European respondents admitted real estate is a cost center within the company, with just over 30 percent viewing it as a profit center (U.S. participants responded to the same cost versus profit center question, with roughly 83 percent and 17 percent, respectively). Of the 63 percent that responded that the profitability of the real estate had improved, we believe some focus only on land values that probably have generally risen over the past decade.

Financial education and performance standardization within the field of corporate real estate management must improve both at the upper echelons of executive management, and within the CREM departments. Without a proper understanding of the financial and operational impact of corporate real estate on company balance sheets, senior management will continue to own their corporate real estate. In turn, decisions on how to manage that real estate, whether owned or leased, remain based on flawed reasoning. While survey respondents indicate that CREM performance has improved over the last several years, it is unclear what metrics they use to arrive at that conclusion, given that in some cases, they "work independently," while in other industries basic financial metrics were not referenced in terms of measuring the opportunity cost of corporate real estate.

Despite a growing body of research on best CREM practices, the "under-management" of corporate real estate assets continues. Inadequate attention is paid to resource allocation, and the skill sets required to effectively manage key functions of CREM are lacking. The inability to define the role of corporate real estate, combined with the inability to measure the lost opportunity cost of corporate real estate, obscures senior management's view of the underlying value which is locked into many corporate real estate portfolios. Among CREM staff, real estate is still primarily viewed as a cost center, which further supports evaluating corporate real estate from the perspective of both the balance sheet and operating resource allocation. Corporate real estate is not a core business of these firms. However, regardless of whether companies recognize it or not, corporate real estate remains a valuable and under-utilized asset.