Corporate Real Estate Strategies

Peter Linneman

Real Estate Department
The Wharton School
University of Pennsylvania

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In the near future, real rents for office space in almost every U.S. market will exceed replacement cost rents. Corporate space users cannot stop this from happening. They can, however, implement prudent strategies to deal with this impending phenomenon. A common reaction of corporate users faced with rising rents is to buy space in order to “lock-in” rents and reap the benefits of further price increases. Another reaction is to sign long-term leases while rents are still low. However, rising real rents should not distract firms from their primary mission: effectively deploying the firm’s scarce capital in order to increase shareholder value. Firms need to remember that competitors also face these same rent increases; they are part of the competitive cost structure. The real competitive challenge created by rising rents is to not make decisions that detract from the corporation’s value.

Corporate real estate strategy must recognize that long-term success is not determined by having the lowest occupancy costs over 3-5 years. In fact, reducing short-term occupancy costs in the face of rising real rents may seriously reduce a firm’s competitive position. For example, moving into poor quality space will reduce a high-end firm’s occupancy costs but may destroy shareholder value, since a firm using such space will not be able to attract and retain high-profit producers.

It’s Just Capital

Corporations take on several major problems when they commit to long-term leases. First, long-term leases create a serious mismatch between the life cycles of a corporation’s operations and its capital commitments. As change occurs, it alters the firm’s geographic focus, market share, personnel requirements, capital needs, and product mix. For example, in the financial services business J. P. Morgan, a commercial bank ten years ago, is a global investment bank today. Similarly, a merger can dramatically change a firm’s business strategy and optimal deployment of capital. The most successful firms will be those that correctly and rapidly deploy their capital to exploit these changing opportunities.

Long-term leases are excessively long-lived capital commitments relative to today’s rapidly changing product and corporate life cycles. It is imprudent management to make long-term capital commitments unless the returns are outstanding relative to alternatives, or unless the assets are sufficiently liquid to allow easy management of the duration mismatch. Unfortunately, corporate real estate offers neither high returns nor high liquidity. The illiquidity of corporate real estate is demonstrated by the fact that it generally requires 6-12 months to buy or sell a building, and 1-3 years to develop a new property. In addition, the fees and uncertainty associated with buying and selling corporate real estate often force corporate users to “stay the course”, rather than make rapid changes. In marked contrast, other long-lived, low-return assets such as the long-term government bonds held by corporate treasuries, can be traded in a few minutes--and at a cost of only a few basis points in fees.

Corporate owners often convince themselves that they will sell their buildings quickly and at a premium price whenever they decide to sell. Unfortunately, the history of corporate real estate does not bear this out, despite the fact that the corporate ownership of “excess” real estate is inevitably supported by an analysis indicating that these properties will substantially appreciate. Corporations acquire real estate because of business needs, not market timing. This means that corporate users will rarely be successful property traders. Since the logical buyers of corporate real estate are often other firms in the same industry, the forces that generate one firm’s real estate sale decision will frequently also affect competitors. Thus, when a firm most wants to sell its property, other owners are also trying to reduce their property exposure, causing soft property prices.

The typical pro-forma analysis for long-term leases assumes that if the tenant no longer requires the space, he will be able to quickly sublet the space at prevailing market rents (which are always assumed to be much higher than today’s). The reality is that the space will be sublet (less a 2-3 percent brokerage fee) only after the property is vacant 6-24 months, at rents about 70 percent of prevailing market rents. Further, the discount rate applicable to these sublease cash flows will be considerably higher than the discount rate for the original tenant, because sublet tenants are generally higher credit risks, and because of the danger that the space will not lease. These realities undermine the attractiveness of long-term leases unless firms are certain that they will need the space for the entire lease term. In today's world, where products, competitors, corporate strategies, and mergers frequently occur, such certainty is rare.

Capital committed to corporate real estate generally generates a lower return than the same capital committed to alternative business uses. In effect, capital committed to corporate real estate generates a negative arbitrage. This negative arbitrage is rarely, if ever, included in the standard pro-forma analysis of corporate real estate ownership. When this negative arbitrage is factored into the analysis, it demonstrates the unattractiveness of corporations owning real estate.

Corporate real estate officers frequently buy before rents and property prices rise, or sign long-term leases in order to lock-in low rents. These are nonsense strategies, as sellers of space base their prices upon both the rents they can get today, *and* the higher rents they expect in the future. Present-day real estate prices capitalize expected future rents, so that buying property merely locks in the higher expected future rents, a fact obscured by the "magic" of straight line depreciation. Much the same happens when signing a long-term lease instead of a series of shorter leases. Landlords do not lease space for fifteen years without receiving payments that reflect the present value of future expected rents. Attempting to eliminate the impacts of rising rents by making long-term capital commitments is an exercise in chasing rainbows.

Real Estate Is To Be Used

Space needs are dictated by the anticipated growth of business activities, the optimal location for operations, industry dynamics, corporate image, and the availability of real estate properties. For most firms, 3-7 year leases offer the best match to their changing needs. Just as firms must maintain cash balances in order to operate the company in spite of the negative arbitrage of holding cash, they may occasionally have to purchase (or build) properties in order to satisfy their space needs. This is particularly true if the local property market is inefficient, or if a firm requires special operating facilities. Such firms require long leases or ownership. A computer chip company, for example, may need to own its space for trade secrecy and technical reasons, and it may not trust the management of its highly sensitive facilities to an outside operation. However, ownership and long-term leases should be viewed as the last resort. Whenever a firm is tempted to buy (or, even worse, develop), it should remember that it did not buy a paper mill to satisfy its paper products needs--it entered into short-term supply contracts with third party vendors with expertise in the paper business.

When determining the length of leases, corporate users should err on the side of too short, rather than too long. This is because the cost of leasing too short is relatively calculable and manageable--a few dollars per foot more than if they had signed a longer lease. On the other hand, the cost of signing a too-long lease is larger, harder to calculate, and much harder to manage. The cost of leasing too long is not only the obvious cost of unnecessary space, but also the foregone return from deploying this capital to take advantage of more attractive business opportunities, as well as the loss in operating flexibility associated with illiquid and immobile assets. The loss of a few dollars per foot for several years is generally a small price to pay in order to “keep one’s powder dry,” insuring that the firm will capture high yielding opportunities as they arise. Short leases also allow the firm to operate out of the most competitive facilities, rather than the best facilities of ten years ago.

An alternative to signing a standard 15-year standard lease is to sign a 15-year lease with a buy-out option. This means that if the user stays for the full term of his lease he will realize the benefits of a long-term lease. If, on the other hand, business strategy changes and he wants to redeploy his capital and operations, he can terminate the lease at a predetermined cost. While buy-out penalties reduce the return on the redeployed capital, they amount to sharing the benefits of the new business opportunity with the landlord. In many ways buy-out leases are like callable bonds: the borrower compensates the long-term lender for the change in the borrower's business plan by paying the call premium when they refinance their debt.

Corporate real estate owners should liquefy their current ownership positions. This can be accomplished in several ways, including matching non-recourse debt financing which reduces the amount of capital tied up in the corporate real estate. Alternative strategies include selling properties one at a time as a portfolio, swapping properties for shares of publicly traded entities, or a tax free spin-off to shareholders of a new stand-alone real estate entity. The sale of corporate real estate is best viewed as exiting a business activity that is not in the corporation's core competency.

Another interesting strategy is to set up a real estate operating subsidiary inside the company, hence creating a mechanism whereby the capital deployed in corporate real estate is priced separately. Currently most operating companies simply roll their real estate capital costs (usually at book depreciation rates) into a corporate overhead charge, instead of charging the corporate user for the true value of the capital they are using. Not surprisingly, the failure to correctly price capital usage leads to gross misallocations--and to the destruction of shareholder value.

Forming a separate real estate subsidiary also creates an identifiable metric for calibrating the success of corporate real estate operations, a major shortcoming for most corporate real estate departments. The ability to "profitably" lease space to various departments generates a "bottom line" for the real estate subsidiary, while the willingness of the firm's departments to do business with this subsidiary (as opposed to third party vendors) provides senior management with an indication of the competitiveness of the real estate subsidiary. A further advantage of a real estate subsidiary is that if the firm decides to dispose of its corporate real estate operations, it can do so relatively quickly. Forming a real estate subsidiary when times are good and there is no pressing need to "do something" creates value by increasing corporate asset flexibility and asset liability. Stated differently: Prepare assets for sale when you can, not when you must.