CORPORATE REAL ESTATE MANAGEMENT

by

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Space is often the second largest expense within an organization--after personnel--and land and buildings are a considerable item on corporate balance sheets. European corporations have been slow to realize that real estate assets contribute to their financial performance. European managers of corporate real estate should be aware of the impact of corporate real estate on shareholder value. The fact is that corporate real estate in Europe is greater than the total European real estate investment portfolio. Further, the average return on a real estate investment portfolio is notably lower than the return of corporations at large.

European corporations are increasingly focused on improving shareholder value. Increasing global competition and pressure from shareholders have led to a reconsideration of core competencies, placing non-core activities under constant review. Although most corporations need to own real estate, it is generally not a part of their core business. This does not, however, mean that professional management of real estate assets cannot contribute to corporate performance.

Changes in corporate attitudes to internal service providers, triggered by changing relations between corporate centers and operating companies, have altered the traditional role of corporate real estate departments. Instead of acting as a monopolist, corporate real estate departments have had to compete with outside service-providers. After an initial wave of change driven by cost-cutting, European corporations are now turning their attention to productivity and shareholder value. A 1995 survey of European senior management by Arthur Andersen found that of eight corporate functions, the two considered to be “most important” were “meeting the needs of operating units” and “return on assets”; real estate was rated as “least important.”

Corporate real estate management is not the same as real estate investment (see “The Coming Disposal of Corporate Real Estate,” *WRER* Fall 1998). Corporations acquire real estate because of business needs, not according to market timing. This means that corporate users are rarely successful property traders. Since the 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 wants to sell property out of its corporate portfolio, often its competitors are also trying to reduce their property exposure, causing soft property prices.

Little is known about the financial impact of corporate real estate in the U.S. and in Europe. It is clear that it is a substantial asset base. For example, in 1994 the total real estate portfolio in the Netherlands was estimated to consist of 4.3 billion square feet of buildings with a replacement value of €170 billion. Based on the 1995 annual reports of more than 3,400 Dutch corporations, a selection was made of corporations employing more than 500 employees. (Given the specific nature of some corporate assets such as investments and loans, corporations in the banking and insurance industry were omitted.) Eliminating firms with incomplete data resulted in a sample of 533 firms. The selected corporations owned a total of €170 billion of fixed assets of which €33.5 billion was in corporate real estate. The total balance sheet of the corporations was €305 billion, meaning real estate represented 11 percent of total assets. With a value of €220 billion (book value), corporate real estate was worth more than 3.5 times the value of the total portfolio of Dutch real estate investors. A review of a number of annual reports reveals that the market value of corporate real estate (CRE) is approximately 1.5 times book value. Following this line of reasoning, the Dutch CRE portfolio would have a market value of €330 billion.

Dutch corporations appear to be relatively efficient in terms of corporate real estate ownership compared to those of other countries. A survey of 800 organizations in the United Kingdom found that more than half of the organizations surveyed had real estate assets worth 30 percent or more of their total assets. Japanese corporations had real estate assets worth 36 percent of their total assets, while for non-Japanese corporations in the Asia-Pacific the ratio is 39 percent.

An analysis by Yongheng Deng and Joseph Gyourko ("Real estate ownership by non-real estate firms: an estimate of the impact on firm returns," Zell-Lurie Real Estate Center,Working Paper 321) of 358 firms across 51 non-real-estate industries in order to relate non-real estate firms' returns to the degree of real estate ownership/investment found a consistent negative relation between the idiosyncratic component of firm return and the degree of real estate ownership. That is, within an industry, a firm's return is lower if it has a relatively high fraction of its total assets (measured by book value) in real estate (also book value). This supports the general concept that owning less corporate real estate contributes positively to a corporation's shareholder value.

Two examples provide insight to the impact of real estate on corporate strategy and finance. In 1990, Philips Electronics faced huge financial problems. Due to a heavy debt burden, banks were losing confidence in management, and the corporation was obliged to undertake a major restructuring, including laying off more than 40,000 employees. Philips' real estate portfolio was also radically restructured. In five years, more than €450 million was generated by selling more than 25 million square feet of real estate assets. In 1991, two Dutch banks, ABN and AMRO, merged into the ABN AMRO Bank. The merger created opportunities to both reduce operating expenses due to economies of scale and to increase the financial ability to handle major capital market operations. Five years after the merger ABN AMRO had reduced its operating expenses by €180 million. Thirty percent of the domestic branches had been closed, while the international branch network increased by more than 30 percent. In January 2000, ABN AMRO announced a long-term plan to redesign its organization for more effective customer service. As a result, by 2005 the bank will reorganize its Dutch branch network, further reducing its current manned branches from 900 to 750.

CORPORATE PERFORMANCE

There are two basic types of sustainable competitive advantages for a firm: lower cost or product differentiation. During the life cycle of a corporation the focus on the nature of competitive advantage changes with increasing market share generally being the most important performance criteria in the growth phase, while as the firm matures controlling costs becomes more important.

Corporate resources and capabilities are now seen as the primary determinants of profitability. An organization's resource choices are an integral component of its strategy and structure. The firm's valuable resources include the organizational processes, information, and physical resources that improve its efficiency and effectiveness. Real estate is undeniably one of the most important physical resources. A key concept of the resource-based view is synergy, represented by such notions as related diversification, corporate coherence, parental advantage, and core competence. Advantages are created when economics of scale and speed are combined with administrative coordination. Creating and maintaining such synergies is a key role for corporate real estate managers.

Financial and economic criteria are no longer the only basis for determining the added value of corporate real estate. Following the post-World War II economic boom, sophisticated companies concentrated on discounted cash flow. This analytic tool helped managers decide among proposed projects, each with a unique capital requirement and anticipated cash stream. Two forms of discounted cash flow analyses are widely used for project analysis – internal rate of return and net present value. Yet, to gauge overall corporate success, most companies simply rely on bottom-line net income growth.

Most European corporations have made size a proxy for value. Acquisition-oriented executives trumpet their expanding corporate assets, and management boards link compensation to total assets. European corporations still primarily focus on net earnings and growth of net earnings as the proxy for value. What has made net earnings the most utilized proxy for value creation is the consistency required by accounting and tax principles in calculating this measure. With net earnings determined, other performance measures naturally follow: return on assets (ROA), return on investment (ROI), and return on equity (ROE) are the most common.

The growth of net earnings per share remains a popular measure of success among European corporations despite three major shortcomings. First, it mixes historical concepts like depreciation, past costs and accruals and with the current market value. Second, it does not reflect different levels of risk among different corporations. Finally, it ignores the amount of capital required to achieve growth. And utilizing ROA and ROE to determine whether value creation has occurred ignores the timing of both costs and benefits, and thus ignores the full impact on the shareholder.

Traditional corporate belt-tightening tools such as cost benchmarking or process reengineering typically do not recognize the value created by resources, but focus instead on the cost incurred. They present a one-time "snapshot" that overlooks important shifts in the business. This shortsighted attitude is common among corporate real estate managers. As an antidote, in the 1980s Stern Stewart & Company reintroduced Economic Value Added (EVA)--a performance measurement concept first used by the General Motors Corporation in the 1920s. EVA is a replacement for the traditional measures of value creation such as ROA and ROE, defined as the net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise or project. EVA comes closer to capturing the true economic profit of an enterprise, since it measures the value created during a defined period of time through increased margins and profitable redeployment of under-utilized assets.

Every real estate investment a corporation makes must be a balance of the costs and the expected returns. The return on invested capital (ROIC) in a project must be compared to the return that could be received when investing the capital elsewhere. The rate of return which has to be earned in order to satisfy investors (shareholders and debtors) is referred to as cost of capital, generally measured by the weighted average cost of capital (WACC). Given the fact that the ROIC of European real estate investments is generally lower than the WACC, corporations have to do something to get the capital back to work. In order to increase shareholder value, there is an increasing trend to outsource non-core support services, including real estate

CORPORATE REAL ESTATE

Decades ago, due to an absence of a well-developed commercial real estate market, European corporations had little choice but to own their land and buildings. Today alternative methods of financing enable corporations to release capital from low earning capital investments to higher yielding investments in core activities. For example, whereas the FTSE Euro top 300 had an average return on equity of 38.3 percent over the last 2 years, the GPR General European Property index only gained a 3.8 percent return over the same period. A similar discrepancy can also be seen within individual organisations, whose real estate investments fall well below the average corporate return target of 15 percent. Stated differently, when a corporation decides to invest in real estate - an investment with an expected ROI of roughly 7 percent - the corporation has chosen to lose a potential return equal to the difference between the ROI of the core business activities and the return on real estate investments. Instead of investing in real estate the corporation could have invested in its core business activities, or returned the money to shareholders. The question corporations should be asking themselves is how can they destroy as little value as possible when investing in corporate real estate.

Simply stated, owning less corporate real estate increases shareholder value. The potential value gains associated with reducing corporate real estate holdings can be shown using Dutch data. Although information is available on the asset-side of real estate, there is little data on expenses related to real estate. A number of simulations were made of real estate asset-reductions. The impact on two corporate performance ratio's: return on net assets (RONA) and return on capital employed (ROCE) were then calculated. As expected, both ratios improve as a result of reducing real estate holdings. As the reduction increases, the improvements continue. The effects are more extreme when the percentage of corporate real estate to total assets is higher. Figure 1 shows the average effect of real estate reduction on both ROCE and RONA for corporations in which the corporate real estate assets are between 20 and 30 percent of the total assets.

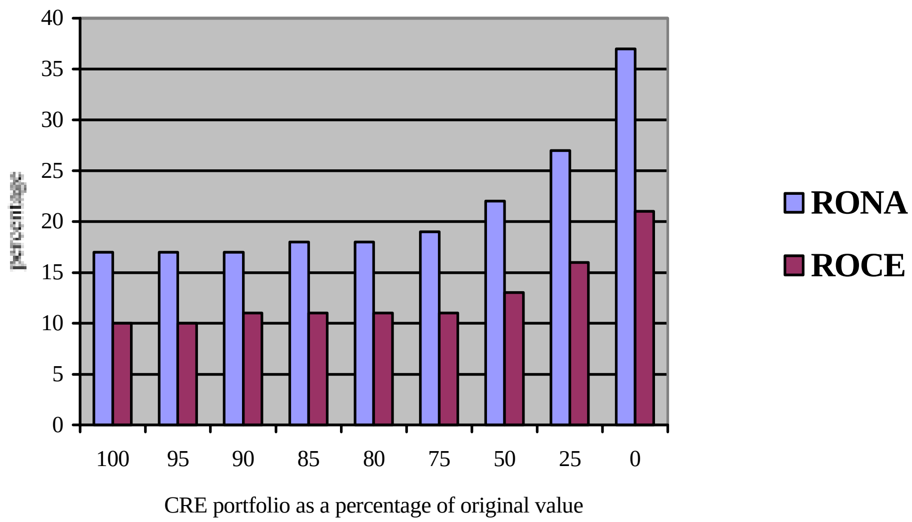

Figure 1: Effects of reducing corporate real estate on corporate performance ratios

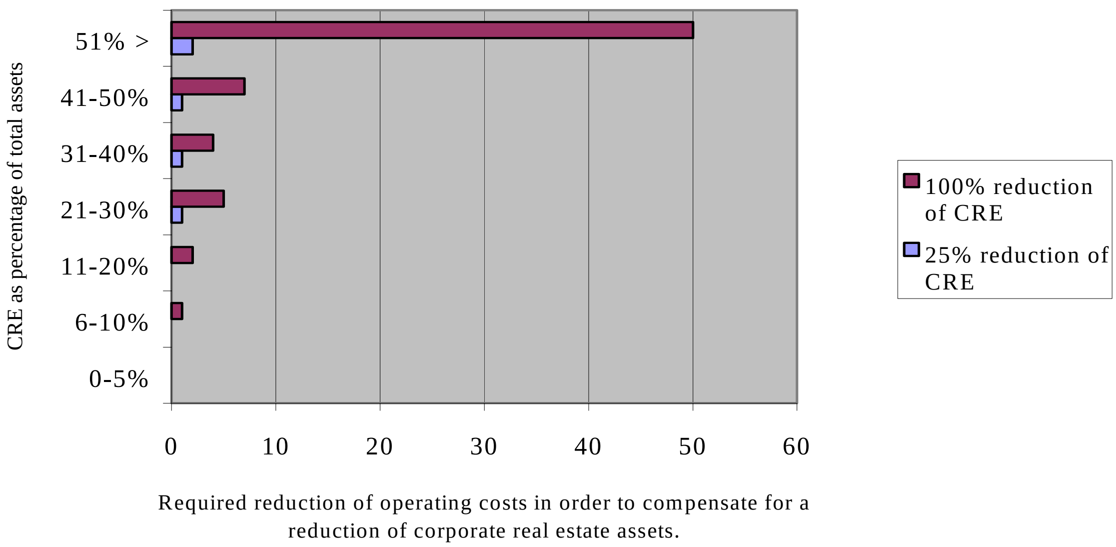

Figure 2: Required expense and cost improvement in order to compensate for real estate reduction

A comparison of the effects of asset reduction and the required profit improvements which are necessary to achieve equal value increases enables corporations to make a deliberate choice between allocating resources to reducing assets or to improving revenues or cost of sales and expenses. The required revenue/cost improvements increase when there is a radical reduction, or if real estate is a considerable percentage of the total assets. Figure 2 shows the required reduction of operating cost in order to compensate for two scenarios: 100 percent reduction of CRE, and 25 percent reduction of CRE. The effects are influenced by the percentage of real estate assets compared to the total corporate assets. Although the required sales/cost activity might appear to be small, most corporations would be happy to realize a revenue growth rate of 3 percent (e.g. Philips Electronics) or 7 percent (e.g. Unilever) versus results of 1 percent for a 25 percent real estate asset reduction.

A great deal of capital is locked-up in corporate real estate assets. But because it is not part of the core business, corporate real estate contributions are mostly considered to be of little interest. Most real estate managers, investors and consultants still focus on financial and operational issues unless a corporation is in financial distress. Linking real estate and corporate finance, on an on-going basis, is essential in determining the overall performance and success of managing corporate real estate.

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