

Global Trends and Performance Effects in Corporate Real Estate

*Corporate real estate strategies
to increase shareholder wealth
differ very strongly across sectors.*

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REAL ESTATE IS not very prominent on the radar screens of corporate executives. For most, it is a peripheral asset, required to make and sell their products. As a result, corporate executives often have trouble suppressing a big yawn when the subject comes up. This lack of interest is not justified by the facts. A recent report by DTZ, a leading real estate broker, shows the immense value of real estate owned by European corporations. For the three largest European markets (Germany, France, and the U.K.) the estimated total values are approximately \$1,000 billion, \$700 billion, and \$710 billion. In contrast, IPD, a property benchmarking organization, estimates the total market

capitalization of institutionally owned real estate in these countries at \$117 billion, \$92 billion, and \$226 billion, respectively. Zeckhauser and Silverman, writing in the *Harvard Business Review*, estimated that in the United States, corporate real estate accounted for 25 percent to 40 percent of the total assets of the average firm. It is possible that these large amounts of corporate real estate are the result of markets where lease alternatives are lacking, leaving corporations little choice but to build or buy the properties they need.

The magnitude of corporate real estate assets is such that the costs associated with owning these properties are second only to payroll costs in many organizations. The existing research has concluded that it is generally a better idea for corporations to rent, rather than own, the

real estate they use, thereby freeing up capital to invest in their core activities. The shares of companies that sell their real estate are found to outperform the average, and firms with large corporate real estate holdings are generally associated with relatively low performance.

Many of the properties sold by corporations end up in the hands of institutional investors. This implies that the decisions corporations make regarding their real estate ownership to a large extent determine the portfolio allocation of institutional investors. If companies sell their offices, but hold on to their retail space and distribution facilities, institutional portfolios will be affected, irrespective of their real estate portfolio allocation models. Global corporate real estate ownership patterns and strategies remain murky due

Figure 1: Global Corporate Real Estate Ratios Over Time

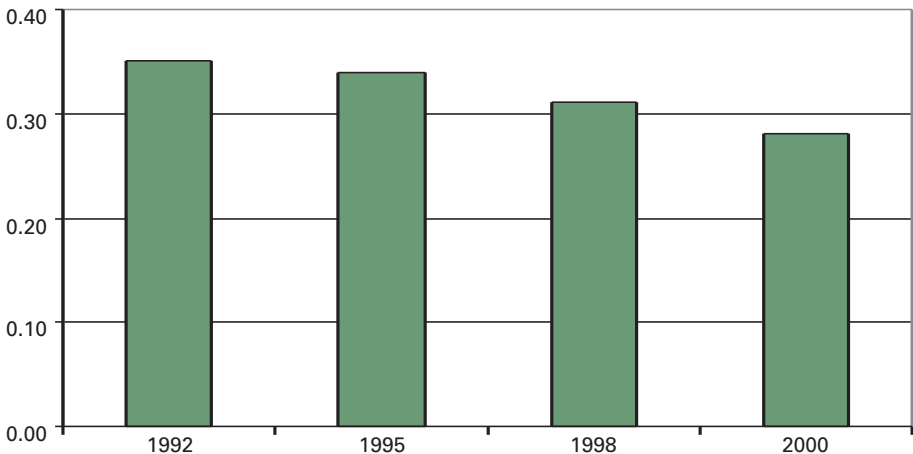


Table I: Corporate real estate ratio by country by year

	1992	1995	1998	2000
France	0.17	0.19	0.18	0.18
Germany	0.29	0.29	0.20	0.17
Netherlands	0.36	0.31	0.28	0.22
United Kingdom	0.40	0.37	0.33	0.29
Canada	0.43	0.44	0.44	0.41
United States	0.32	0.31	0.29	0.26
Australia	0.43	0.38	0.38	0.35
Hong Kong	0.25	0.28	0.40	0.30
Japan	0.30	0.30	0.32	0.31
Total	0.35	0.34	0.31	0.28

to the lack of research concerning these patterns across countries and industrial sectors. We partially fill this gap by looking at global corporate real estate ownership and at ways corporations in different countries and sectors treat their real estate.

We examined the balance sheets of 4,636 publicly listed companies, in nine countries and 18 industrial sectors. For each company, we calculated a corporate real estate (CRE) ratio by dividing the book value of property, plant, and equipment by the book value of total assets. This ratio was calculated for each company for four years: 1992, 1995, 1998, and 2000.

In 1992, the global average CRE ratio was 0.35. In other words, roughly 35 percent of the book value capital of the average corporation was tied up in real estate. By 2002, this ratio had fallen to 0.28, a statistically significant decrease.

VARIATIONS ACROSS COUNTRIES

The basic arguments for companies to rent real estate holds for all countries, as it frees up capital for core activities, although capital and real estate markets are not equally efficient across countries. But selling off real estate assets is difficult if reliable buyers are scarce. Companies that sell and lease back seek reputable institutional investors with whom they can establish long-run relationships. In countries where such investors are rare or not well capitalized—for example because the local pension system is immature or not funded—companies may be forced to own the real estate they use.

Table I presents the average CRE ratios for nine countries in 1992, 1995, 1998, and 2000. In 2000, French and German companies owned relatively little real

estate, with average CRE ratios of 0.17 and 0.18. In the Netherlands, real estate ownership was also relatively low, at a ratio of 0.22. On the other side of the spectrum are Australia and Canada, with ratios of 0.41 and 0.35. An explanation for these differences probably lies in the economic structure of these countries. The French and German companies in our sample were to a large extent active in services, where the reasons to own real estate are relatively weak. In contrast, many Canadian and Australian firms were in the mining sector, where owning real estate (mostly land and what is under it) is crucial.

Over time the dispersion of the CRE ratios has decreased. In other words, there are signs of a global conversion of corporate real estate strategies. This development is particularly evident for the four European countries. In 1992, the European CRE ratios ranged from 0.17 to 0.40, while by 2000 this range narrowed from 0.17 to 0.29.

In 2000, German and Dutch firms owned substantially less real estate than in 1992, with the CRE ratio falling by a third. To a lesser extent, the U.K., Australia, and the United States also show a decrease in real estate ownership. France, Hong Kong, and Japan defy this pattern. Especially striking are Hong Kong companies, which notably increased their corporate real estate ratio. It is not clear what lies behind these divergent patterns, as they do not bear a

clear relationship with the maturity of local institutional property markets.

VARIATIONS ACROSS SECTORS

The variations in corporate real estate ownership are larger between industrial sectors, from a low of 0.13 for business services to a high of 0.63 for the mining sector in 2000. However, care is needed in the interpretation of these numbers, as the CRE ratio includes not only property, but also factories and fixed machinery. This is the likely explanation for high CRE ratios in sectors such as mining, utilities, and the oil industry.

The results displayed in Table II suggest that companies in business services and business advisory do not find it necessary to own the property they use. In 2000, the average CRE ratios for these companies were 0.14 and 0.16, respectively, much lower than the global average. The real estate used by these companies is mainly office space, for which relatively competitive rental markets exist in most countries, with a broad range of supply of standardized product. Further, an office is generally not a strategic production factor. As long as it's in the right neighborhood, the exact location is not very important. In contrast, companies in heavy industries often need tailor-made real estate that is

Table II: Corporate real estate ratio by sector by year

	1992	1995	1998	2000
Agriculture	0.33	0.37	0.39	0.41
Mining	0.62	0.63	0.66	0.63
Food & Tobacco	0.36	0.37	0.38	0.38
Textiles	0.33	0.32	0.33	0.34
Publishing	0.32	0.30	0.28	0.24
Chemicals	0.30	0.29	0.29	0.27
Oil	0.50	0.49	0.51	0.46
Electronics	0.26	0.24	0.24	0.22
Transportation	0.54	0.51	0.53	0.52
Communication	0.40	0.37	0.36	0.33
Utilities	0.70	0.69	0.63	0.57
Restaurants	0.50	0.54	0.56	0.57
Supermarkets	0.42	0.46	0.48	0.48
Hotels	0.60	0.62	0.65	0.62
Personal services	0.39	0.40	0.39	0.36
Business services	0.24	0.22	0.17	0.14
Health	0.36	0.34	0.32	0.32
Business advisory	0.21	0.21	0.18	0.16
All sectors	0.35	0.34	0.31	0.28

not available in standardized rental markets. If, for example, Exxon-Mobil wants to expand in Europe, it will probably have to develop its own industrial complexes, since there simply is no supply of the appropriate factories.

Besides the high CRE ratios for heavy industry, we also find high degrees of real estate ownership for hotels, restaurants, and supermarkets, all sectors where real estate is a strategic production factor. For these sectors, the exact location of a property is crucial, as even being on the wrong side of the street can be deadly.

We find that the global trend of reduced CRE has been especially strong in business services, where the CRE ratio has

nearly halved. Australian business service companies show the most dramatic decline, with a reduction from 0.65 in 1992 to a mere 0.12 in 2000. Real estate ownership also shrank notably in communication and publishing, with CRE ratios losing a quarter of their values. In contrast, hotels, restaurants, and supermarkets all show a modest growth in corporate real estate ownership.

OWNERSHIP AND STOCK PERFORMANCE

As a final step, we examined whether the variation in corporate real estate ownership

translates into variation in stock performance. In order to analyze this relationship we focused on the total stock returns of the sample firms from 1997 to 2002. Since variations in real estate ownership are more compelling across industries than across countries, we performed this analysis on an industrial level, dividing firms in a sector into deciles on the basis of their CRE ratios, and calculating the average annual total stock returns for each decile. We compared the average annual stock returns for the highest and lowest deciles with the industrial average stock return, repeating this analysis for all 18 industrial sectors.

Our key results are presented in Figure 2. The differences in return

between the top and bottom CRE deciles are substantial for most industrial sectors. Firms with the highest corporate real estate ownership levels perform worst among high-yielding industries such as electronics and business services, and perform best in low-yielding industries such as textiles and agriculture. This result is probably due to the moderate return profile of real estate assets. Firms active in industries characterized by lower returns will profit from the return profile of their corporate real estate portfolio, whereas firms with high-yielding activities will reduce their corporate returns when investing their scarce corporate resources in relative low-yielding corporate real estate assets.

Figure 2: Corporate real estate ownership and industrial stock returns, 1997 – 2002

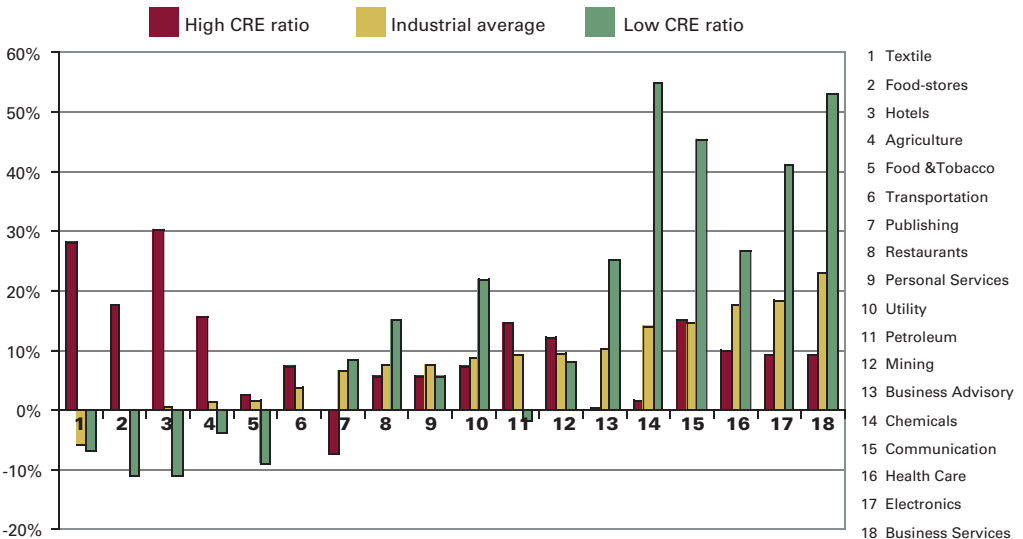
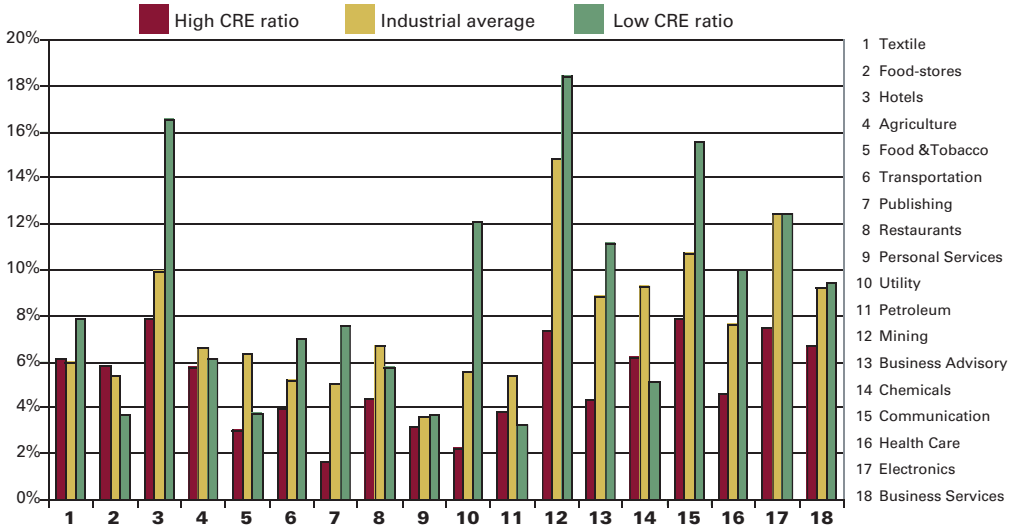


Figure 3: Corporate real estate ownership and industrial stock volatility
The annualized standard deviations are based on monthly total returns for the period 1997 – 2002.



When analyzing the variations in stock risks, measured by the annualized standard deviations for the period from 1997 to 2002, we find a robust negative relationship between corporate real estate ownership and stock volatility. The results in Figure 3 show that firms with low corporate real estate ownership are generally associated with standard deviations exceeding those of high CRE firms, reflecting the low risk/return profile of real estate assets compared to other corporate assets. But this result also probably reflects the relatively low correlation between real estate returns and operational profits of non-real estate firms. This diversification effect reduces the overall firm return volatility.

CONCLUSIONS

The main practical implication of our results is that corporate real estate strategies to increase shareholder wealth differ very strongly across sectors. For some sectors, holding on to real estate creates shareholder value, and in other sectors the exact opposite is true. Our findings suggest that corporate managers generally treat their real estate in a rational way: in corporate sectors where real estate is a key value driver—retail, mining, and hotels—the level of corporate real estate ownership is generally high and stable, and sometimes even growing. On the other hand, in sectors such as business services and advisory, for which real estate and the micro-location of

the business are not crucial, it is low and shrinking. The corporate performance affects points in the same direction. The fact that we find a global trend of decreasing corporate real estate ownership, and a diminishing dispersion of this ownership level, suggests that leasing is becoming a credible alternative to owning worldwide. The question is, however, how far this trend can continue. Real estate ownership in business services and advisory, the sectors where the trend is most significant, is already very low. That makes it likely that the decrease in corporate real estate ownership will slow down.