# Redefining Corporate Real Estate

*Corporate real estate professionals are playing new and important roles in their organizations.*

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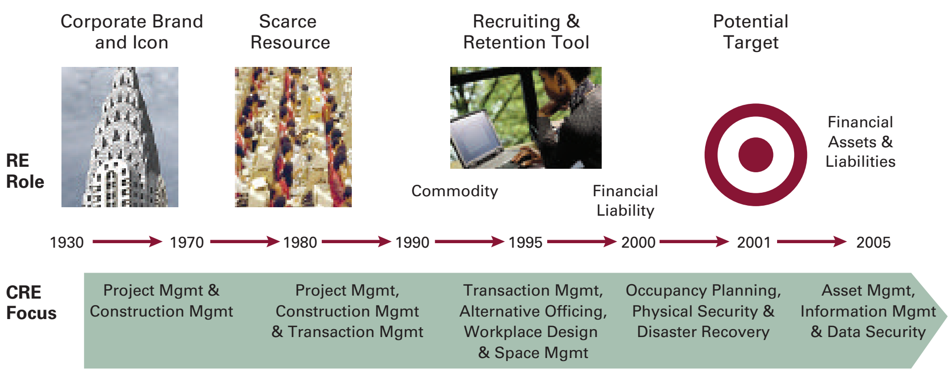
**A CASUAL OBSERVER** might conclude that traditional real estate professionals and corporate real estate (CRE) professionals have little in common. Traditional real estate professionals, such as investors, operators, and developers, focus on real estate as their core business, seeing it as an investment vehicle. CRE professionals view real estate as a non-core business, serving as an infrastructure asset to support a business other than real estate. Traditional real estate professionals are driven by profitability as measured by internal rate of return, net operating income, and earnings per share. CRE professionals historically have been focused on consumption—most notably cost per square foot and vacancy rates.

Until recently, the goals of the two real estate professions tended to intersect only across deal tables. However, that is changing as result of the impact of the twenty-first-century business landscape. The Internet as a primary channel of goods, services, and information has produced an environment in which global competition, technological advances, and warp speed are driving companies to become extremely cost-conscious and, at the same time, to pursue new sources of revenue. Against this backdrop, a trend is emerging among CRE professionals who are finding that, to be successful, they must shift from a role of service providers to their companies (transaction support, space planning, facilities management) to a role of managing the company real estate as an asset. In this new role, CRE professionals treat the real estate of the company much as a product manager would, managing costs and maximizing value throughout the life cycle in the much same way as their traditional real estate peers. While this trend is far from universal, those organizations that have adopted this approach have found that a shift from service to the management of a portfolio of assets requires not only a different organizational model than what was needed for real estate service delivery, but also a different skill and mindset for CRE staffs. In effect, they are changing their business model from a non-core business to a core business within a broader business enterprise.

## A BRIEF HISTORY

The role and status of real estate in corporate America has changed significantly from the days when company CEOs viewed their corporate headquarters as a

**Figure 1:** The changing role and status of real estate in corporate America



demonstration of their strength and staying power. Headquarters buildings were intended to be symbolic and iconic—legacies that would leave a lasting impression. Thus, in Manhattan in the 1930s, Chrysler and the Bank of Manhattan competed to build the tallest building in the world, only to be outdone a few years later by the Empire State Building (Figure 1). Corporate real estate, known then as "facilities," was a service function that carried out the directives of the parent company, operated buildings and supported architects, engineers, and other professionals on major projects. The role required primarily operational and tactical skills. Participation in the strategic planning of the enterprise happened by rare exception.

Over the next three decades, little changed for facilities organizations. Real estate was acquired incrementally as desired by the business units, placing a premium on near-term needs over longer-term capital planning. Facilities and construction management remained a focus. Requests for real estate were, in general, handled on a case-by-case basis. Facilities professionals were oriented toward service, but the service lacked a portfolio approach.

From the 1970s to the mid-1980s, real estate was considered a scarce resource. There was an undersupply of downtown corporate real estate, as downtown vacancy rates averaged around 5 percent between 1979 and 1981. In the early 1980s, interest rates hit historic peaks. The high cost of downtown real estate and the need to invest company capital in computing and telecommunications led to a flight of company offices to the suburbs. Interest rates began to drop, and by the mid-1980s had fallen to a point where, combined with generous tax credits and easy credit, they fueled a building frenzy. Companies that had banked land or held long-term leases profited. Owning became desirable to lock in current cost.

The 1970s and 80s saw the introduction of real estate transaction skills into the facilities function, bringing in-house professionals with the ability to negotiate multiple real estate transactions. While companies continued with the facilities function, the addition of the real estate function brought the concept of managing the company real estate as a portfolio of properties. This approach brought with it strategic occupancy planning. While on its face this would seem to be a healthy development, CRE remained isolated from business planning despite the fact that many CRE departments reported to the CFO. That lack of involvement hampered many attempts to deliver optimal occupancy planning.

As a result of the savings and loans collapse in the late 1980s, real estate assets held by financial institutions were sold off to real estate investors. As rental rates plummeted in the face of massive excess supply, firms rationalized their CRE portfolios and exited unfavorable leases. During the mid-1990s, many companies undertook initiatives to cut sales, general, and administrative costs. Although many firms concentrated on increasing "density" of space use by reducing square footage per worker, corporations continued to look at the workplace as a means of branding. The competition for talent was heating up. Hip workplaces were positioned as a recruiting and retention vehicle. Amenities (health clubs, cafeterias, and casual collaborative spaces) were introduced into new corporate campuses that emerged. The workplace became more flexible and more supportive of mobile, networked workers. In this environment, alternative office and workplace design and space management were key attributes, especially for larger companies. Strategic occupancy planning stepped outside of conventional space planning to take into account the attraction and retention of a competitive workforce. Post-9/11, real estate entered another down cycle and corporate real estate portfolios experienced unprecedented vacancies. Transaction expertise was in high demand again—but now the emphasis was on dispositions.

The role of corporate real estate has changed throughout the twentieth century. However, nothing could have prepared CRE departments for the events that followed 9/11. All office buildings became possible terrorist targets. Corporations reexamined their occupancy plans to determine if consolidation of functions and locations was too risky. Physical security became a high priority and CRE departments expanded their scope to include business continuity planning and disaster recovery. Concern over physical security paved the way for concern over information integrity and security. In response to Enron, all publicly held firms became subject to Sarbanes-Oxley (SOX) compliance. SOX requires corporations to demonstrate that they have adequate processes and controls in place to safeguard the integrity of financial reporting data.

In this new climate, many CFOs have turned their attention to CRE, which is the second or third largest corporate expense. As a consequence, CRE departments are now expected to view real estate and facilities as a portfolio of assets and liabilities. Asset management functions and disciplines, most often associated with the traditional real estate sector, are appearing within corporate real estate, redefining the core in a non-core function.

The central issue for corporate real estate departments today is to show how they add value to the business enterprise. CRE professionals as well as industry pundits have looked at this issue in many ways. Three pathways to success have emerged: shifting the focus from transactions and project delivery to supporting the mission of the corporation; assuming the role of a corporate fiduciary; and restructuring the CRE function. When these pathways converge, the result is a blending of the corporate business with the real estate, integrating business acumen with traditional real estate expertise.

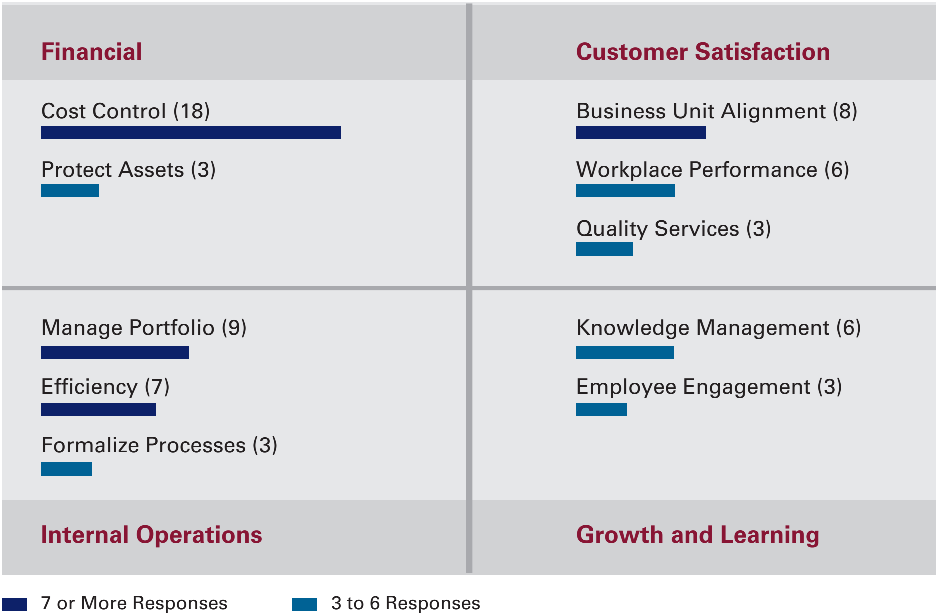
## SHIFTING THE FOCUS

Since real estate is the longest lead, least flexible, and second (or third, depending on the level of information technology infrastructure) most expensive item on a company balance sheet, past efforts to align CRE with the business enterprise focused on inserting CRE early into corporate business planning processes. Such early involvement allowed firms to right-size, time, and locate real estate for optimal pricing of leases, acquisitions and sales, materials and construction. Success today, however, requires dealing with global competition, technological advances, and the warp speed of a digital age. To beat these challenges, companies must find a way to reduce costs, move faster, and deliver more innovation than their competition. As a result, every department of a company has to focus on constant shifts and overhauls in products, markets, and services.

CRE professionals are refining their strategies and attempting to align them more tightly with the mission of the business enterprise. A recent survey of twenty-five corporate real estate organizations conducted by Alvarez & Marsal Real Estate Advisory Services LLC indicated that CRE is focused on both top-line and bottom-line issues (Figure 2). The study found that 80 per cent of CRE departments have strategic objectives. Although cost continues to be the number one strategic objective, CRE departments are increasingly taking a "balanced scorecard" approach to strategy—balancing financial, internal operations, customer satisfaction, and growth and learning objectives. Business unit alignment, portfolio management, and efficiency all ranked high. Taken collectively, they reflect the need for CRE to respond quickly and efficiently to the changing needs of the business, despite the fact that real estate is a long-lead-time asset. Workplace performance was also highly regarded, indicating a renewed appreciation that the physical workplace can positively impact productivity and ultimately revenues. Approximately half of the participants reported that the CRE strategy "directly tied back" or "somewhat tied back," to the corporation's overall mission.

Ideally, strategic objectives are complementary. For example, Cisco Systems recently built a new office building with no private workspaces or cubes. The Cisco worker functions without assigned space or other infrastructure than a lap-

**Figure 2:** CRE strategic objectives
The top reported CRE strategic objectives and number of participants sorted by balanced scorecard (some participants had multiple objectives)




top and various mobile devices. Not only does this reduce the demand for real estate, but it also more closely mirrors industry research that showed that workers are on average away from their desks 50 percent to 70 percent of the time. Further, it allowed Cisco to showcase its own technology.

### CORPORATE FIDUCIARY

Managing costs is the most obvious way that CRE can act as a fiduciary, but CRE can also be a source of capital and an annuity revenue stream. Actively managing the real estate portfolio in concert with the ever-changing needs of the business has financial consequences. Health South, the nation's largest healthcare services provider, is a case in point. In March 2003, the SEC launched formal charges alleging that HealthSouth systematically overstated its earnings to meet or exceed Wall Street expectations. With more than a billion dollars in debt and no access to capital, the company underwent a corporate restructuring and recovery in which CRE played a critical role. HealthSouth had more than a thousand properties nationwide and abroad. These properties were managed by the operating units in a decentralized fashion. Acting as the interim CRE department and working in conjunction with HealthSouth's operating units, Alvarez & Marsal renegotiated leases, eliminated under-performing assets, spearheaded buyouts for hundreds of properties, and executed facility sale-lease-backs. The total financial impact exceeded $100 million. To sustain this success, a new CRE organization was created around property types and geographies, standard policies and guidelines were instituted, and asset performance guidelines were implemented.

Many companies have utilized sale-leasebacks as a source of capital. Bank of America has recently sold 310,600 square feet and leased back 74 percent of the space for fifteen years with American Financial Realty Trust. Wachovia has sold sixty-six bank branches and twenty-nine unimproved parcels totaling approximately 242,000 square feet for $84.1 million with American Financial Realty Trust. Unilever has entered into a sale-leaseback of about 120,000 square feet with the Willet Co. for $87.5 million. Radio Shack has sold its Fort Worth headquarters to German-based KanAm, signing a twenty-year lease with renewal options for an additional twenty years. CRE professionals are also starting to look at ways to generate annuity revenue. Many firms are actively subleasing space, some as a means of managing vacancy, others, such as Bank of America, as part of their core real estate strategy.

Managing top- and bottom-line results is only a part of the fiduciary picture. In the role of fiduciary, CRE must also focus on compliance. With the advent of SOX and its focus on information transparency, activities that have a "material" impact on financial reporting get the attention of senior-level executives. As the second or third largest expense of a corporation, real estate has become an obvious place of interest to senior corporate executives. CRE professionals have always measured their success by the winning of competitive rates and prices. For SOX compliance the stakes are higher; firms must demonstrate that they have formal documented processes and adequate controls in place.

While few CRE executives have yet to sign the SOX compliance certification currently signed by CEOs and CFOs, the awareness that such certification can be compelled has increased the consciousness among CRE departments of their accountability to the companies. According to the Alvarez & Marsal survey, 80 percent of the participants reported that they went through a SOX compliance effort. However the degree to which the real estate organization was involved and the number and type of processes audited varied greatly, depending on how the company defined "material."

Experience shows that decentralized CRE business units with sole control over their infrastructure can produce significant waste. The real estate industry offers many stories of "Swiss cheese" real estate resulting from multiple moves within a business unit's buildings, leaving a significant amount of noncontiguous space. This practice has reportedly created cumulative vacancies of up to 20 percent. The real estate expertise within the organization is not fully leveraged and decisions are made with incomplete information and lack of strategic intent. To offset the negatives associated with decentralized CRE, or one in which real estate is managed solely by the business units, many organizations have "centralized" the CRE function. Centralization implies that both the real estate/facility assets and real estate functions (transactions, project management, portfolio planning, space management, and facilities management) are managed by a centralized corporate services organization. This model is also referred to as "aligned by function."

Centralization paves the way for consistent, accessible, and reliable data on corporate infrastructure, thereby enhancing the company's ability not only to measure and effectively manage its infrastructure, but also to plan, bend and change it with the changing needs of the business. Centralization is a popular structure for industries in which office is the predominant space type. Once the functions are centralized, an outsourcing analysis to determine which functions should be performed in-house is usually performed. It is worth noting that although total cost of occupancy that integrates real estate and facilities data is still considered the Holy Grail of CRE metrics, several organizations that have centralized still do not have responsibility for facilities.

McKesson Corporation, a $57 billion healthcare services and information technology company, currently manages 17 million square feet of real estate. The centralization transition occurred as part of larger enterprise centralization initiative to create more leverage, synergy, and shareholder value for the corporation. With such a mandate, the CRE unit had the authority to create a lean (ten people), centralized organization with two groups: Workplace Business Partners and Shared Services. Workplace Business Partners was charged with being a single point of contact for the business units. Key to their success was their ability to understand the business of each of their customers and to translate that business into real estate strategies. Those strategies were communicated to Shared Services, which instituted wide policies, procedures, standards and best practices, negotiated national contracts, monitored performance of national service providers, and served as a primary interface with other McKesson service groups. Essential to the success of both CRE groups was the ability to generate greater flexibility in space solutions to support an ever-changing, mobile workforce and to reduce the overall space requirements. Both goals are consistent with the overall enterprise centralization initiative to enhance shareholder value.

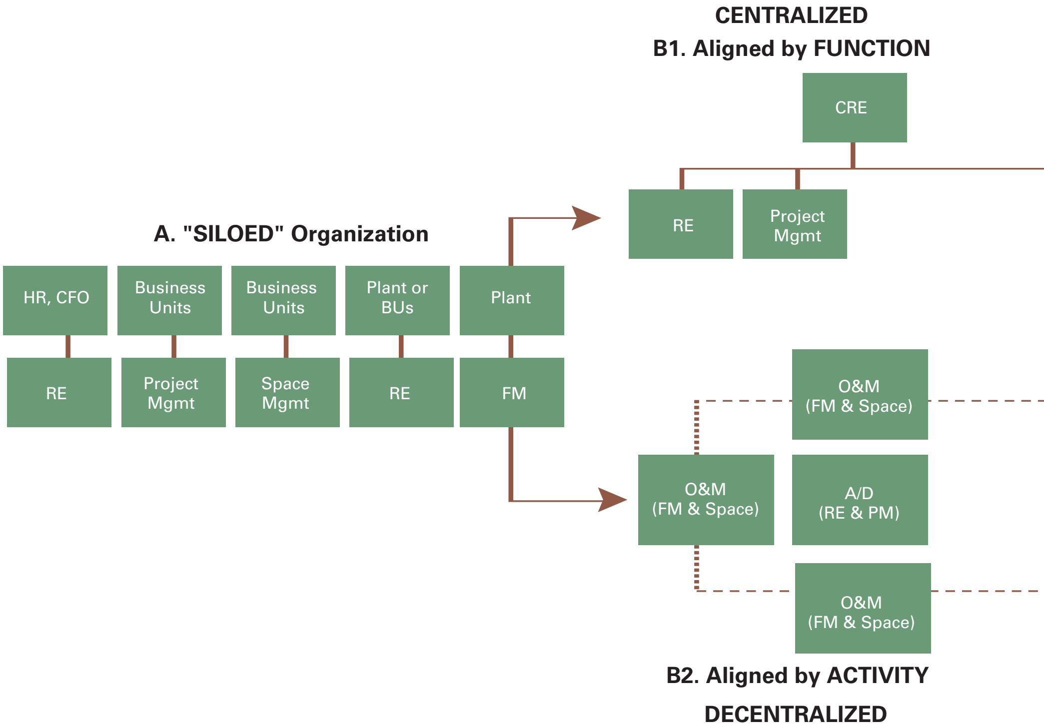
Despite some of the obvious benefits of centralization, many organizations continue to manage CRE in a decentralized fashion (Figure 3). The Alvarez & Marsal study indicated that approximately 8 percent of participants continue to describe themselves as "siloed," meaning that they worked autonomously. In addition, approximately one-third of participants described themselves as "aligned by activity," meaning that the acquisitions/dispositions function is centralized and includes both real estate and project management. Several decentralized operations and maintenance teams provide facilities management and space management. Often the operations and management teams report to plant operations, but they can also report directly to a business unit. The operations and management teams may, but often do not, share some common procedures. This is a popular structure for industries in which there is a mix of space type (office, manufacturing, distribution) or in which the facilities are closely tied to the overall operation of the company (retail, food manufacturing, pharmaceuticals).

A new model blends the positive elements of centralization and decentralization, combining centralized information with distributed yet highly integrated teams. This model, referred to as the life-cycle model, recognizes the vital relationship between the planning and delivery functions. Planning is cross-functional and most often centralized. There are several distributed delivery teams that perform a customer relationships management function that is usually organized around a geography or business unit. As in the centralization model, service providers often play a critical role in the planning and delivery functions. Regardless of the organization structure, there is a growing tendency for CREs to report to a CFO or treasury function.

## THE NEW CRE PROFESSIONAL

A direct correlation exists between the strategic, fiduciary, and organizational pathways to success and the required skills sets for a successful CRE professional. CRE participants in the recent Alvarez &

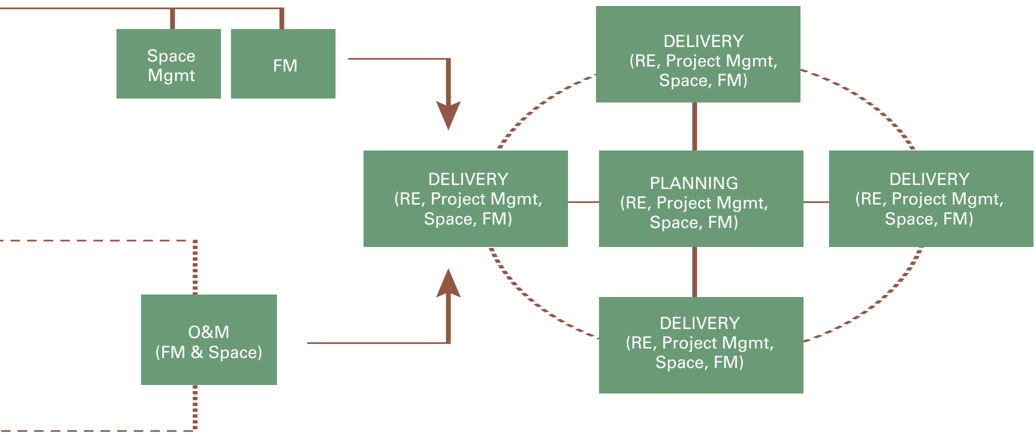
**Figure 3:** Corporate real estate organizational models




Marsal survey reported that the most critical CRE skills were general business management, financial management, and customer relationship management. When comparing what is required today versus what was previously required, CRE professionals often describe it as shifting from execution functions to strategic planning and management functions (Figure 4). While making the shift from execution to strategic planning and management skills, it is imperative that CRE professionals do not overlook the importance of general operations skills in the process. While outside service providers can help fill the execution void, knowledge and an understanding of real estate and facilities fundamentals and one's own industry remain prerequisites for CRE success.

One would assume that shifting from execution to strategic planning and management requires a retooling of skill sets. In actuality it is more like fine tuning. The ability to manage the relations across functions, negotiate, project manage, coordinate multiple agendas, and communicate difficult messages are all skills

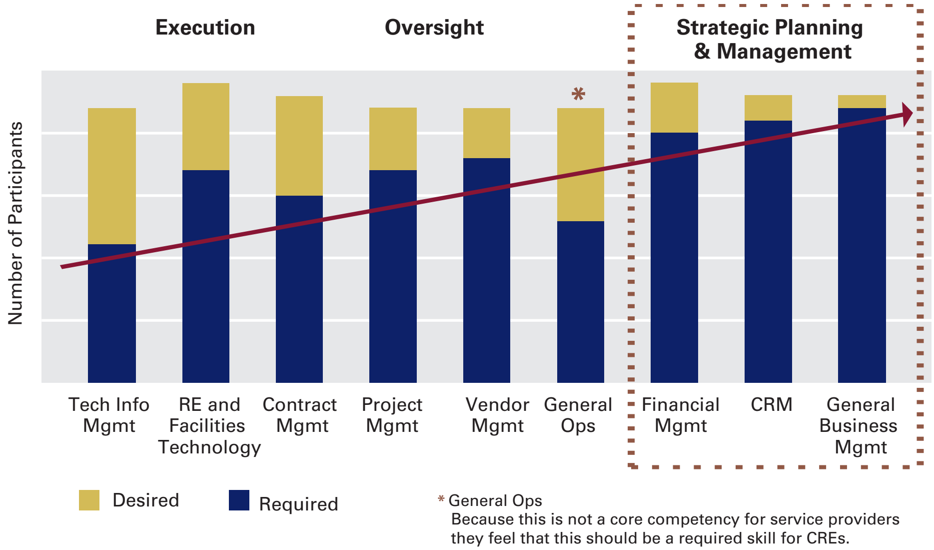
C. LIFECYCLE APPROACH




that are well known to real estate professionals. Despite the fact that CRE professionals agree with the need to shift and already have several of the fundamental skills required to successfully make the transition, there is surprising resistance among CRE staff to identify themselves as business people first and real estate professionals second. Somehow shifting the discussion from dollars per square foot, cost per head, and market rents to lifecycle costs, exit strategies, and cycle times is causing an identity crisis among some CRE professionals.

To move through this identity crisis, CRE should redefine itself in a way that more closely resembles its business unit clients and peers in traditional real estate. Recasting themselves as real estate and facilities product managers, as opposed to internal service providers, allows CRE professionals to have the best of both worlds. By reframing the corporate real estate function as one of managing a highly significant, capital-intensive product in a business enterprise, CRE professionals in fact redefine themselves as responsible for a core function in much

**Figure 4:** Required CRE skills




the same way as traditional real estate professionals. This shift has the benefit of developing a generation of corporate real estate professionals who combine both business and traditional real estate skills. It also increases their alignment with their business unit customers and the contribution of real estate to the bottom line of a business enterprise.

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The authors acknowledge and thank Colette Temmink (Boeing Realty Corporation) and Frank Robinson (McKesson Corporation) for their vital contributions.