Corporate Real Estate Acceptance

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While often taken for granted, corporate real estate holdings are sculpting the financial DNA of firms around the globe. Ever since Zeckhauser and Silverman (1983) called upon corporate managers to rediscover their company's real estate, a large literature has evolved around the strategic importance of these corporate assets. But in this era of liquidity constraints and at the dawn of IFRS Lease Accounting transparency, it is time to also focus on the financial effects of corporate real estate decisions. In this article, we present the results of an international study on the financials of corporate real estate ownership with which we extend available CREM frameworks and provide corporate boards with good answers to hard questions that will soon be asked by their stakeholders.

Five Stages of Corporate Real Estate Management

In the early years, corporate real estate holdings were merely a necessity for firms to operate. In the absence of a well-developed commercial rental market, there was little alternative to developing or buying your local offices and shops. Hence, corporate growth would automatically result in the buildup of a portfolio of land and structures, which easily accumulated into significant proportions of the balance sheet. But how to manage these corporate real estate portfolios has long been a consideration that was simply not contemplated. In fact, the views on corporate real estate management, both from professionals and within academia, have evolved only gradually over time. This evolution of prevailing views on how to deal with corporate real estate needs exhibits strong resemblance with the Kübler-Ross (1969) model, which describes in five discrete stages a process by which people deal with personal grief – denial, anger, bargaining, depression, and acceptance.

Five Stages of Corporate Real Estate Management:

I. Denial

In 1983, Zeckhauser and Silverman offered convincing Harvard survey evidence, which showed that 60 percent of American companies was simply not evaluating the value and performance of their real estate assets. They treated property as an overhead cost like stationery and paper clips.

II. Anger

The rediscovery of real estate holdings on their balance sheet inspired firms to regard it as means of cutting costs. Managers were shocked by the amounts that these holdings represented and horrified by the incidents where this undermanaged and undervalued balance sheets item attracted hostile takeover bids.

III. Bargaining

After the rediscovery and consequential cutbacks, a new wave of opinions emerged. Corporate real estate started to become a strategic element, and was soon referred to as 'the fifth business resource', after capital, human resources, technology and information. Having the proper real estate facilities enhanced productivity and could strengthen the firm.

IV. Depression

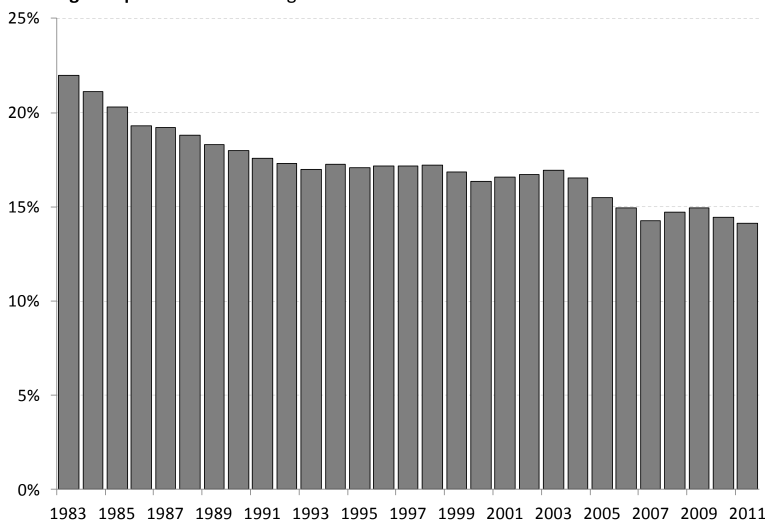
In this phase, firms start to sell of their corporate real estate assets, often by means of sale-lease-backs to free up cash when liquidity is constraint. Salvaging the firm swiftly emerges as number one concern, which often degrades the corporate real estate portfolio to a rescue capsule that need to be floated.

V. Acceptance

The final stage of CREM is one of overview, with which firms tradeoff all the advantages and risks that associate their property holdings. Here, financial and strategic considerations can melt into a sustainable state of mind, in which corporate real estate needs are serviced adequately and contribute to the firm's mission and valuation.

Although the literature on corporate real estate management has come a long way during the past thirty years, not all firms have actually reached the final phase of acceptance. Surely, a lot has changed from the time when the call for rediscovery by ZeckHauser and Silverman in 1983. Most firms have employed specialized corporate real estate managers, and have positioned corporate real estate departments that often report directly to the board. There is no more 'denial' in corporate boardrooms when it comes to their real estate needs. Also the stakes have changed. Figure 1 reports the corporate real estate ratios – the book value of real estate assets over total assets – for the international constituents of the Dow Jones Global 1200 since 1983. While real estate assets accounted for over 22% of total assets in 1983, today thirty years later this number has gradually dropped to 14%. This trend can be explained by multiple factors. First of all, we have seen a wave of Sales-and-Lease Back (SLB) transactions that has helped firms to move some of their real estate assets away from their corporate balance sheet. There are multiple operational reasons for why firms prefer to rent rather than to own their real estate properties. For instance, because to avail themselves of in-house professional property management. From a financial point of view, in theory, SLB do not affect the value of the firma, a SLBs merely swap a sale price for a corresponding set of future lease payments. Switching from ownership to leasing does not reduce the importance of corporate real estate within the firm, it merely reduces the current weight on balance sheets. In many cases this ratio has also dropped because the rate at which the total asset base increased has outpaced the real estate price trend. In any case, 14% percent is still a significant number and judging by the wording in annual reports, we cannot claim that enough is communicated by firm management about this portion of firm value to claim the status of 'acceptance' stage V. In fact, using a simple symantec tool when analyzing a set of 100 different 2011 annual reports, we encounter the word 'real estate' 1.4 times on average, and mostly in technical footnotes at the end of the report. Which compares bleakly to the fact that 'sustainability' was raised 7.2 times, on average. Counting words is hardly an adequate measure of acceptance or importance, but it does indicate that stakeholders learn little about corporate real estate management from reading these public reports. This, however, will soon change.

Figure 1| Real estate holdings over total assets for the Global 1000

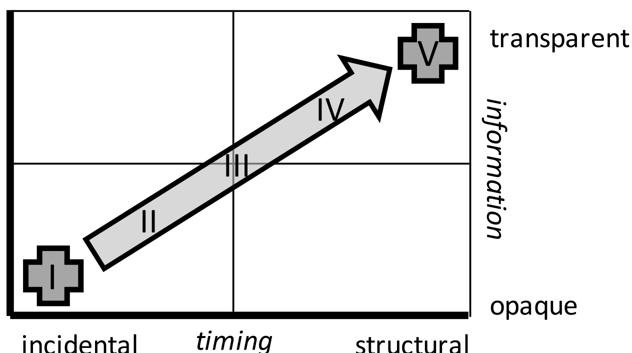


IFRS Lease Accounting, a Game Changer

Ever since the International Accounting Standards Board (IASB) has started its work on promoting a more unified and transparent set of International Financial Reporting Standards (IFRS) the standard IAS17 for "Leases" has been widely debated. While in the past, leasing meant that the use of assets would only run as costs through the annual profit and loss accounts, firms around the world awake to a future in which leases will appear much more prominently on their corporate accounts. As of 2014, the new IFRS lease accounting standard will eliminate off-balance sheet accounting; essentially all assets currently leased under operating leases will be brought on balance sheet. The lease contract will be recognized both at the asset and liability side of the balance sheet and carried at amortized cost, based on the present value

of payments to be made over the term of the lease. In other words, real estate use – both rented and owned – will appear explicitly in the books of firms. This shift will greatly enhance the visibility of corporate real estate stakes and costs. Certainly, in the first few years this will have an impact on balance sheet ratios and thereby raise questions among shareholders. Questions that have not been asked for a long while and that require a board to be more fully aware of their corporate real estate position. This change in accounting standards will automatically shift the way in which firms communicate about their corporate real estate management. While in the past information on CREM was often opaque and incidental, we now enter an era in which the financial reporting will ensure that the numbers appear more often and more prominently. In figure 2 we sketch a simple matrix of CREM communication. We consider information opaque when the numbers are scarce and

Figure 2| CREM Communication



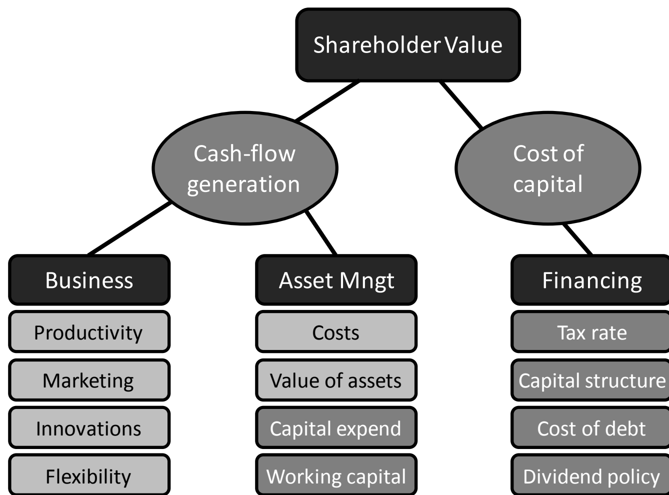
appear only in technical notes, while information is transparent when numbers are presented notably in combination with a clear discussion of CRE strategy and vision. Firms that are in the denial phase (I) tend to communicate only the bear necessities, as it is hard to talk about matters that one ignores. In case firms undertake SLBs or dispose of headquarters to free up capital, the numbers become more transparent as market values are typically involved here. But, these transactions are more incidental than structural. One may even go as far as claiming that IFRS Lease Accounting will catapult firms automatically into the acceptance phase (V), especially when CREM communication is concerned. The information regarding a company's real estate use and costs will become much more transparent and appear continuously in all reporting. So what kind of questions can managers expect when these new standards are implemented? And what are the financial implications of the answers they seek?

CREM and Firm Value

Improving communications is a means, not an aim on itself. But clearly, firms need to be able to articulate how much real estate they use, own and rent, and motivate the decision that have been made. All in all, corporate real estate, as any other assets for this matter, needs to be managed in order to maximize shareholder value. Clearly, much work has been done on how to align CREM with value maximization. A wide set of models and frameworks that take this corporate value perspective have emerged and can help us to identify the prime relationships that need to be considered when taking action. Remarkably little of this literature relate to the corporate financials. Figure 3 gives an overview of the key drivers of shareholder value that can be influenced by the corporate real estate decisions that need to be made. In essence, shareholder value is the result of cash-flows and the cost of capital. Generating cash flows comes from two main clusters, the business and the management of assets. At the business side, cash flows can be strengthened by increased productivity, strong marketing, successful innovations, and an adequate level of flexibility. The rich management literature offers a wide supply of studies that discuss how corporate real estate can help to increase productivity, can strengthen corporate marketing, help firms to trigger innovations, and foster flexibility[1].

[1] See Lindholm and Leväinen (2006) for a full discussion of the literature on corporate real estate decisions and the

Figure 3 | The Shareholder Value Driver Perspective



Regarding asset management, we have seen literature that discussed how CREM can assist in cutting costs, and increase the value of the asset base.

Regarding the cost of capital, remarkably little evidence is offered. Given the vast flow of funds that are involved with CRE, one would expect that a clear analysis on the impact of effective corporate tax rates, capital structure, cost of debt, and dividend policy is available. This however is not the case. Also when it comes to the working capital and capital expenditures of firms, we notice that little evidence is offered for how decisions on whether to own or to rent space has any pervasive effects on these two value drivers. To help firms to gain a fuller overview of the consequences of real estate decisions on their value drivers, we have performed the Global 1000 analysis. In this analysis we relate corporate real estate ownership of the 1000 largest stock listed firms of the world to the six financial value drivers, that thus far have been under-examined in the literature.

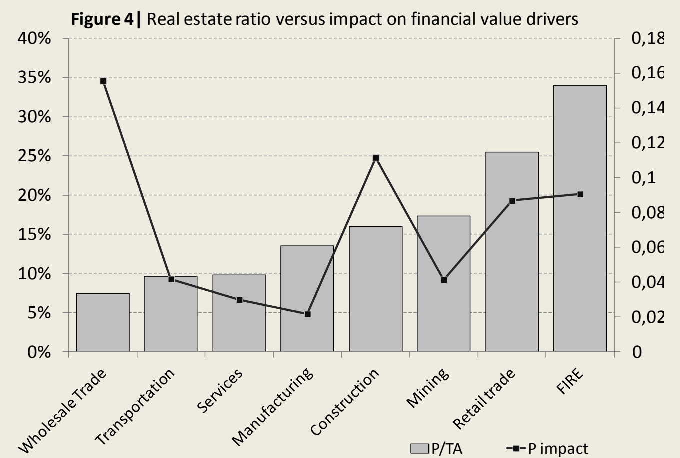
Overall, this analysis shows, that after correcting for the wide variations that we observe across industries, that owning more real estate than your competitors tends to weaken cash flow generation measured as sales growth and profit margin, and lower the cost of

effects on firm productivity, marketing, innovations, and flexibility.

The Global 1000 Analysis

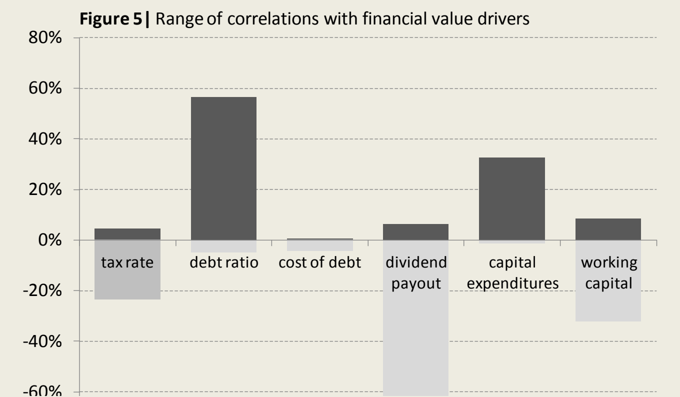
In order to quantify the mostly unexplored relationships between corporate real estate and the set financial value drivers in figure 3, we set up a database for the world's 1000 largest stock-listed companies. For each firm we compute the ratio of real estate value (ownership) to their total asset base, and standardize these ratios across industries, as real estate ownerships tends to vary greatly across SIC industries. Next analyze the financial value drivers of figure 3 and measure the impact of firm's real estate ownership on these drivers. In figure 4, we plot the results.

Figure 4 | Real estate ratio versus impact on financial value drivers



Here we compare the average impact of real estate ownership on the six different value drivers with the level of real estate ownership for each industry. Besides the magnitude of the real estate ownership impact on value drivers, we also examine the nature of this impact. In figure 5, we plot the range of correlations between real estate ownership and value driver variation that we find across the eight industries.

Figure 5 | Range of correlations with financial value drivers



capital. The reduction of the cost of capital is the combined effect of a lower tax rate, higher debt rate, lower cost of debt and a higher dividend payout.

These effects, however, are moderate in seize and vary greatly across industries. We find that the financial impact of real estate ownerships varies with the relative size of real estate portfolios, and with the strategic value of this real estate. For firms with little or standard real estate, the effects are almost absent, while firms where corporate real estate holding are vast and buildings and locations are important for the primary business process, we find the strongest financial effects.

Phase V: Real Estate Acceptance

Companies have many options when it comes to how to deal with their corporate real estate management. On the one hand, they need to decide how to configure their real estate needs, and at the other hand they need to decide on how to communicate these decisions. The first will be very firm specific. Clearly, for firms that face very special real estate needs it will not be easy to find a rental alternative for building up ownership. For other firms, that are more reliant on standardized office space, leasing may well be a viable option. In all cases, it is important to make the decisions in line with the overall corporate objective. Assuming that this relates to maximizing shareholder value, one needs to be able to explain to stakeholders how the CREM will affect the value drivers. On the part of how to communicate CREM policy, firms face a future in which they are forced to speak out. Future annual reports will leave little room to maneuver as both rental and ownership will become balance sheets items that need to be presented and discussed. This is not a problem, if firms get prepared.

A first condition is that firms have passed phase I (denial) and are positioned well to evaluate their corporate real estate portfolio. That means that the internal information systems are able to offer a full overview of current real estate use, costs and values. Given this condition, we offer a framework that presents how financial value drivers are affected by real estate ownership. Combining the internal overview with this framework positions firms well for any real estate debate with their stakeholders.

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