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Corporate real estate acceptance

Content table

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Introduction

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 the hard questions that they will soon be asked to respond to by their stakeholders.

Five stages of corporate real estate management

In the early eighties, 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 local offices and shops. Hence, corporate growth automatically resulted in the buildup of a portfolio of land and structures, which easily accumulated into a significant proportion of the balance sheet. But how to manage these corporate real estate portfolios had never 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 the needs of corporate real estate exhibits a 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 were 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. The vast amounts were trimmed and 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 needs 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 and use. 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.

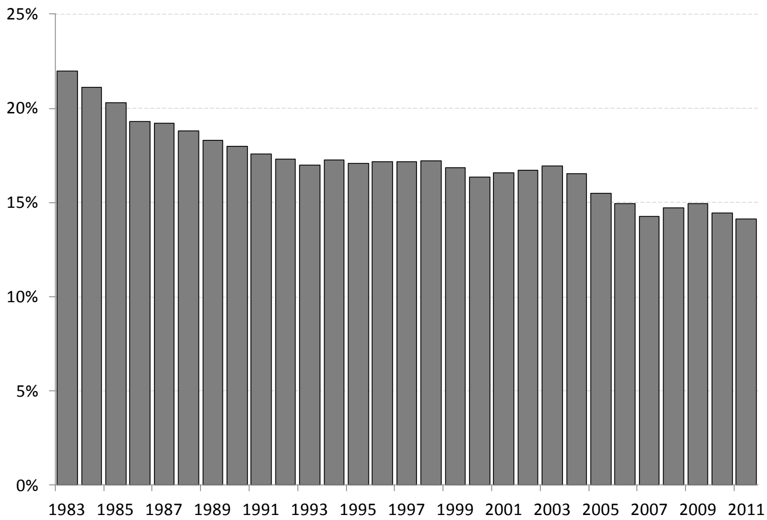
Corporate real estate acceptance?

Although the literature on corporate real estate management has come a long way during the past 30 years, not all firms have actually reached this final phase of acceptance. Surely, a lot has changed from the time of the call for rediscovery by ZeckHauser and Silverman in 1983. Apgar (1995) introduced his Real Estate Scorecard to help firms to swiftly gain a first snapshot of their company's real estate situation. By now, most firms have employed specialised corporate real estate managers, and have positioned corporate real estate departments that often report directly to the board. There is less 'denial' in corporate boardrooms when it comes to their real estate needs. On the next page, we present the key results of the 2013 *CoreNet/TiasNimbas Corporate Real Estate Survey*, in which we examine the level of real estate awareness among 291 firms worldwide, 30 years after Zeckhauser and Silverman's influential study.

Today, an increasing portion of corporate managers claim to have a full overview of their real estate assets. At the same time, we find that 34% of European respondents still admit to not knowing how much real estate they own. When checking the public records, we discover that 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 1000 since 1983. While real estate assets accounted for over 22% of total assets in 1983, today 30 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, to avail themselves of in-house professional property management. From a theoretical financial point of view, SLBs do not affect the value of the firm, as SLBs merely swap a sale price for a corresponding set of future lease payments. Switching from ownership to leasing should 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.

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



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 that we are fully in 'acceptance' stage V. In fact, using a simple symantec tool when analysing a set of 100 different 2012 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.

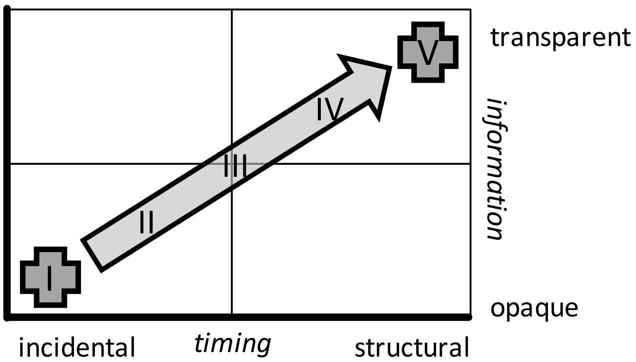
IFRS lease accounting, a game-changer

Ever since the International Accounting Standards Board (IASB) has started 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 count 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 2016, 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 recognised both at the asset and liability side of the balance sheet and carried at amortised 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 on the firm books. 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 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 bare 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?

Figure 2| CREM Communication



CREM and firm value

Improving communications is a means, not an aim in itself. But clearly, firms need to be able to articulate how much real estate they use, own and rent, and motivate these real estate decisions. All-in-all, corporate real estate, as any other asset for this matter, needs to be managed in order to maximise shareholder value. Clearly, much work has been done on how to align CREM with value maximisation. 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. This far, remarkably little of this literature relates to the corporate financials involved.

Figure 3 gives an overview of the key drivers of shareholder value that can be influenced by corporate real estate decisions. Along the lines of fundamental value analysis, shareholder value is the result of cash-flows and the cost of capital. Generating cash flows comes from two main clusters of value drivers, the business and the management of assets.

Shell Real Estate Services: acceptance in action

A Business Case

Mike Napier, Executive Vice-President (EVP) for Real Estate at Shell, has been in his position for the last thirteen years and witnessed a corporate real estate evolution within his firm. An evolution that resembles the five stages of corporate real estate management. He is responsible for the global real estate portfolio of Shell, which includes commercial office buildings, but also large amounts of land, industrial sites, residential dwellings, and recreational amenities. A very large and varied portfolio, which he and his team of well over 600 people at Shell Real Estate (RE), need to align with the company's needs. Shell RE reports directly to the HR director, who is on Shell's executive committee. In practice the EVP of real estate also interacts on a regular basis with both the CEO and CFO directly. But that is today, and used to be rather different in the past.

Back in 2000, when Napier took his current position, Shell RE was relatively small, had only responsibility for the offices in London and the Hague, and was very much related to day to day office services and facility management. At that time, Shell RE reported quite low down within the Shell organisation. But that was soon changing, as Shell RES was created as a response by the company to a number of bad property deals that Shell did in 1999 and 2000. In a period of low oil prices the firm tried to reduce costs by disposing of some key property assets, which subsequently proved to be bad deals in that Shell sold them below market value. This triggered the awareness in the board room that Shell needed a professional real estate organisation that actively manages the asset portfolio and that doesn't make the same mistake again. In that Shell moved from the denial phase fairly quickly into phase 2, and ever since worked actively to keep this progress going. According to Napier, Shell reached the acceptance phase in around 2009, when the real estate function grew into its current position.

That process involved a lot of hard work and did not come easily. In the early years up until 2003, Shell RE was rather introspective, looking at the portfolio and trying to understand the scale of the challenge they had, trying to understand the portfolio, the value it represented, and its opportunity area. This Shell RE did themselves, without talking with anyone within the business.

Only when they really understood the portfolio and the value that could be delivered, did they then started to involve senior leaders and senior stakeholders. That was a time, after 2003, that new conversations started about how real estate could be turned into a real good source of shareholder value. This shift in the internal process, when discussions with stakeholders started, can be marked as a transition into phase 3 (bargaining). From 2003 onwards, Shell RE started to gradually build their reputation and credibility year by year actually just by delivering the numbers.

At Shell RE decisions are always made with a sharp eye on the financial implications. Every decision is based on NPV (net present value), with risks factored into this. Obviously, this will only work adequately once phase 5 has arrived and when a full overview and awareness is in place. The real estate dilemmas themselves are resulting from the larger strategic process at Shell that questions what the firm will need in the future. But every strategic choice at some point involves a real estate footprint, and once that point is reached Shell RE is ready to make sure that the best deals are made in the market.

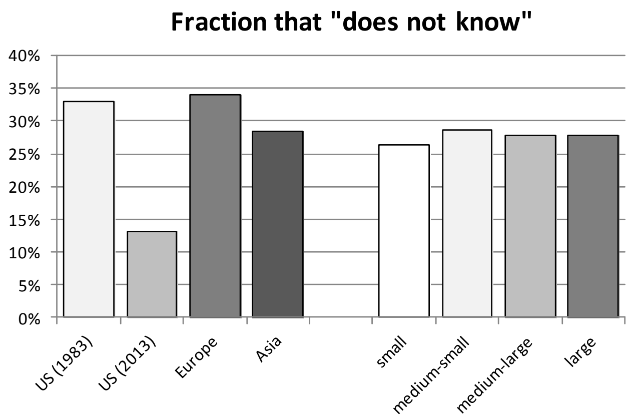
Thus far this process of moving towards acceptance has been a fairly organic and internal process. This is likely to change in the next few years, as the veiling glare of new lease accounting rules will put external pressure on this process as well. "I think these accounting rules will change our role quite a lot, and it will change the way we operate. From a very practical point of view, we need to make sure that we keep extremely accurate records of our portfolio and our leases, as they need to be properly accounted for. This database is not very common yet among large corporations, so this will soon need to change. But these changes also involve new interactions with our finance colleagues, and we likely need to reset some of our policies and objectives around how we manage our portfolio" says Mike Napier. Old questions will return, like: what are the new financial implication of lease versus own decisions in different markets? What are the tax effects of taking real estate off balance? The tradeoff between the various consequences for corporate flexibility and risk management of corporate real estate will be continuous and explicit. At Shell, Real Estate will be on top of it, as it is fully accepted within firm.

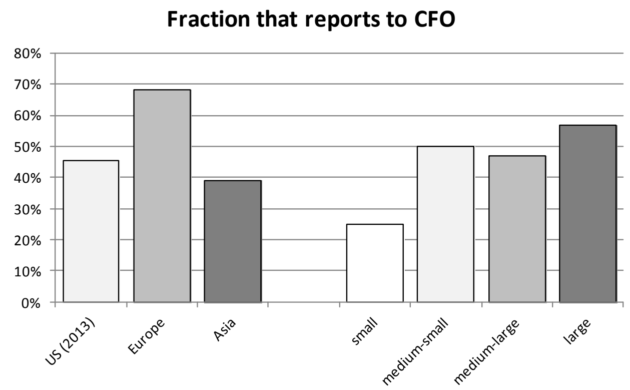
The TiasNimbas global real estate survey

In February 2013 TiasNimbas Business School and CoreNet Global jointly surveyed over 3,000 CoreNet members on a variety of corporate real estate topics. This survey was designed after the 1983 Harvard Real Estate Survey by Zeckhauser and Silverman, which allows for comparisons over time and across continents. In total 291 (24 Asian, 45 European, 218 North-American) full responses have been collected, and here we report the main findings (the full report can be viewed at www.tiasnimbas.edu/CRE2013).

We address several issues, but start by examining the state of corporate real estate awareness. By posing simple questions on the knowledge and overview of own real estate assets, we can assess in which phase firms are today. For instance, on the question "how big is the stake of CRE as a percentage of your firm's total assets?" 28% admits not to know this. A percentage that is higher among our European respondents (34%), and has decreased from 33% to 13% in the U.S. since Zeckhauser and Silverman asked the same question in 1983. We also asked "Do you have a full inventory of all your real estate assets?" 84% of our respondents confirmed that this was indeed the case. Again, compared to the 80% that Zeckhauser and Silverman reported in 1983 this awareness increased to 85% in the U.S. and is weakest in Europe (73%). We also find that the largest firms (over 100,000 employees) have the best overview on the real estate assets. It seems that a large fraction of smaller firms has still not progressed into the fifth phase of real estate acceptance.

One of the key questions is how corporate real estate is managed and positioned within the firm. 79% of firms manage their real estate within a separate department (instead of a subsidiary) and in 73% of all cases they manage this as a cost center (instead of a profit center). Two numbers that have hardly changed since Zeckhauser and Silverman (1983). Also new questions were asked. This way, we now learned that in 48% of these real estate groups report to the CFO, in the other cases we discovered a hierarchical link to 'facilities', 'production and operations', 'marketing', 'HRM' and often even 'legal'. This line of command may well be relevant for the level of (financial) real estate overview and the forward looking behavior when it comes to real estate regulations. We find that 18% of respondents claims to wait to prepare for IFRS until it's implemented. A passive attitude that is most dominant among the smaller and European firms in our 2013 sample.





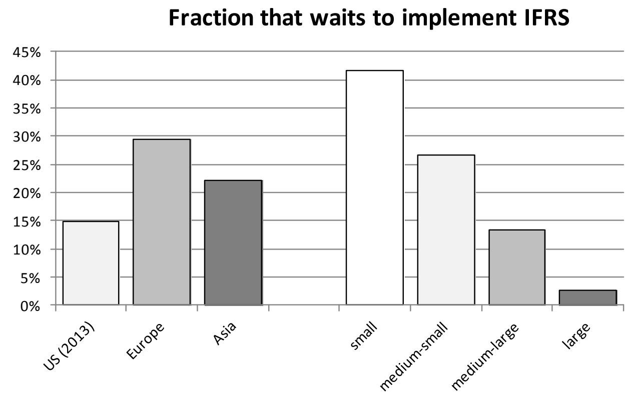
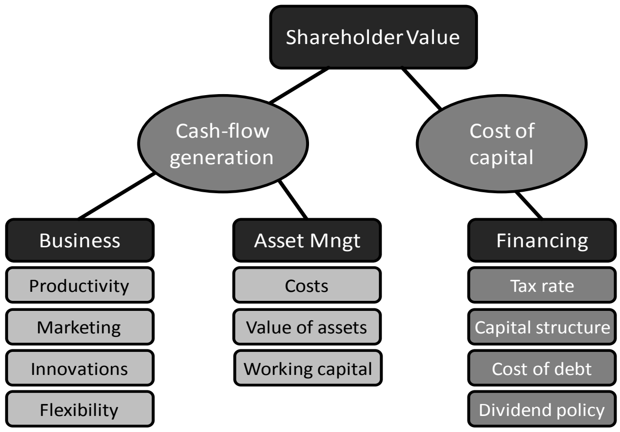


Figure 3 | The Shareholder Value Driver Perspective



On the business side, cash flows can be strengthened by increased productivity, strong marketing, successful innovation, 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 innovation, and foster flexibility[1]. Regarding asset management, there is a wide literature that discusses how CREM can assist.

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.

To help firms to gain a fuller overview of the financial consequences of real estate decisions, we have performed a Global 1000 Analysis. In this analysis, we relate the corporate real estate ownership levels of the 1,000 largest stock listed firms of the world to the four financial value drivers of figure 3.

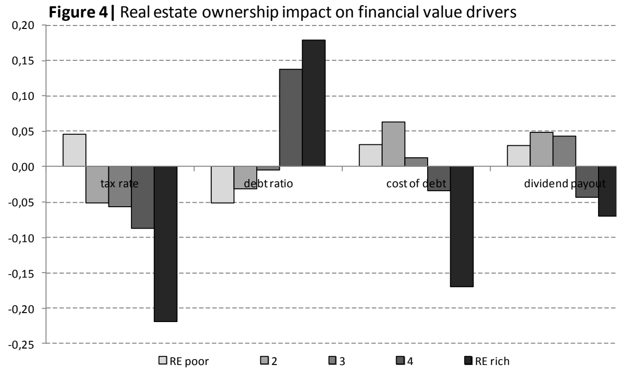
Overall, this analysis shows that the impact of corporate real estate ownership is different across firms. There appears to be a clear tipping point in our data, after which real estate decisions start to affect financial value drivers. This becomes clear after we split our sample into clusters, based on the relative real estate ownership rates of firms. Firms that are *real estate rich* – the firms that real estate to assets ratio that exceeds the industry average by 15% - profit from a lower cost of capital.

The Global 1000 Analysis

In order to quantify the unexplored relationships between corporate real estate and the set of financial value drivers in figure 3, we constructed a database for the world's 1,000 largest stock-listed companies. For each firm, we compute the ratio of real estate value (ownership) as a percentage of their total asset base. Next, we standardised these ratios across industries, as real estate ownership tends to vary greatly across SIC industries. In other words, we measure whether each firm is real estate rich or poor, compared to their industry competitors. We split our sample into five groups, ranging from those that have the lowest percentages of real estate on balance within their industry – the real estate poor, versus the ones that are the largest owners of corporate real estate within their industries – the real estate rich.

We then relate the cross-sectional variation in this real estate ownership ratio of firms, to financial value drivers: the corporate tax rate; the debt ratio; the cost of debt; and the dividend policy.

Figure 4 | Real estate ownership impact on financial value drivers



In figure 4, we show the resulting correlation coefficients for each value drivers, across the five real estate ownership levels. Clearly, size matters. As we find that the relationships are most compelling for the real estate rich firms. Or perhaps maybe even more importantly, we find that the financial effect of real estate ownership does not matter to firms that have a moderate or low real estate exposure through their corporate real estate ownership.

Once, firms have a real estate to total assets ratio that is 15% higher than the industry average, we find that this ownership reduces their cost of debt and corporate tax rate, and increases their debt ratio. Effects that align with corporate finance literature on tax shielding and balance sheet tangibility. For dividend policy real estate ownership decisions appear to have only limited effect.

[1] See Lindholm and Leväinen (2006) for a full discussion of the literature on corporate real estate decisions and the effects on firm productivity, marketing, innovations, and flexibility.

This reduction of the cost of capital is the combined effect of a lower tax rate, higher debt rate, and a lower cost of debt. These relatively high levels of corporate real estate come with tax deductible debt levels, and the tangibility of the underlying assets appear to drive the cost of debt down. For firms that have a corporate real estate ownership level that is around or below their industry average, we find no pervasive financial effects at all.

Phase V: Real estate acceptance

Once firms have rediscovered their real estate, they face many options on how to deal with it. They need to decide how to configure their real estate needs across ownership and rental markets. This remains a firm specific challenge as some firms face very special real estate needs that require full ownership, while others may do fine with leasing more standardised office space. However, in all cases firm management needs to get ready to communicate their real estate deeds and strategies publicly.

In the new IFRS era, firm management will need to accept that stakeholders will start asking questions, as soon as a full overview of corporate real estate use appears in their public records. Already today, we find that firms that own their corporate real estate in proportions that exceed their industry average – that are *real estate rich* – have profited from a lower cost of capital. For firms that are real estate poor, these effects are not there. This link between the corporate properties and value will soon become part of discussion at annual meetings with shareholders.

Hence, in the final phase of real estate acceptance, firms need to have a full overview of their real estate records, and assess whether they are among the real estate rich ones in their industry. If that is the case, they ought to ensure that the financial value driver effects are clear, to them and their stakeholders.

But in the veiling glare of new IFRS Lease Accounting standards, we move into an era in which annual reports disclose more than corporate real estate ownership levels alone, as real estate leases will soon appear on balance as well. Also for firms, that own only little of their real estate needs, corporate real estate decisions will become more explicit and relevant. Signing longer term leases will affect the balance sheet, and thereby raise questions. This is not a problem, if firms are prepared and accept that this will soon be the case. This includes internal information systems that are able to offer a full overview of current real estate uses, costs and values. Some 30 years after the call for real estate rediscovery, stakeholders will be keen to hear what was found.

Conclusions: Implications for the REIT market

Obviously, game changers will have effects. IFRS Lease Accounting as such will raise questions and trigger new boardroom debates. For the real estate market this new wave of corporate interest is a positive trend, as this attention opens the door for smart solutions and value enhancement. For some firms these debates will end in the conclusions that the firm uses and owns the appropriate portion of real estate, while other will be inspired to cut back on their corporate real estate portfolio.

For the listed real estate market, this trend will start a new wave of reconsiderations. The trade-off between owning and leasing corporate real estate will alter, and for some firms this new tradeoff and enhanced awareness may well be the start of opting for asset carve-outs. As part of the TiasNimbas Corporate Real Estate Survey we asked our respondents whether they are considering to spin off parts of their corporate real estate portfolio as investment funds. No less than 13% confirmed that this was indeed the case. When combining this number with the 14% that real estate assets represent on corporate balance sheet, and scaling this to the EUR 10.2 trillion market cap of the European stock market, we are looking at a real estate pool of 186.5 billion euro's that may well start moving towards the financial markets. An indicative number that deserves attention from the REIT market.

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