

OPPORTUNITIES TO ENHANCE SHAREHOLDER VALUE
THROUGH
REAL ESTATE ASSET MANAGEMENT

by

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Submitted to the Department of Urban Studies and Planning
in Partial Fulfillment of
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Master of Science in Real Estate Development

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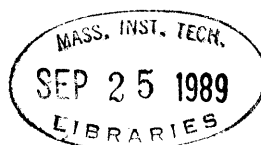
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ABSTRACT

Takeovers and other trends in the business environment have emphasized the need for corporations to manage their assets more efficiently. The purpose of this thesis is to explore opportunities for corporations to enhance shareholder value through real estate asset management. To accomplish this, it is useful to examine sources of hidden value and the role of corporate real estate assets in the market for corporate control.

Research for the thesis included interviews of real estate managers of several industrial corporations, mostly Fortune 500 companies, which are not primarily in the real estate business. Interviews and literature suggest that there is an increasing awareness of opportunities to minimize costs or, in some cases, to enhance the profitability of the corporation, by more actively managing real estate assets. For several reasons, however, these opportunities are often overlooked.

A survey conducted by the Massachusetts Institute of Technology in 1987 indicates that corporate real estate assets are generally "under-managed" and that these assets are typically 25 percent of total corporate assets. Since these assets are often undervalued, alternatives to ownership are explored in this thesis, along with relevant issues to be considered in evaluating alternatives. As found in several studies, the spin-off or sell-off of assets can have a positive effect on shareholder value.

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CHAPTER 1
INTRODUCTION

1.1 Purpose

With today's highly competitive business environment and heightened activity in the market for corporate control, it is incumbent upon management to more effectively manage corporate assets. The purpose of this thesis is to explore alternatives for corporations to enhance shareholder value through real estate asset management. In studying how existing corporations can create value, it is useful to examine incentives to corporate raiders in takeovers. Hence, these motives and the role of real estate in the market for corporate control are described.

1.2 Overview of Literature

An overview of the literature reveals an increasing awareness of the hidden value of corporate real estate assets, both as a source of premium in takeovers and as a means to enhance corporate profit. It is also apparent that institutional investors are increasingly cognizant of potential profit in corporate real estate. Despite the recent emphasis on real estate management, a 1987 study conducted by the Massachusetts Institute of Technology in cooperation with the International Association of Corporate Real Estate Executives, indicates that many corporations "under-manage" their real estate assets.¹ This study corroborates the findings in an earlier study, conducted by

Harvard Real Estate in 1981.²

1.3 Method

This thesis is based on primary and secondary research. Primary research consisted of in-depth interviews of several industrial corporations not primarily in real estate. The corporations interviewed were mostly Fortune 500 companies with a global presence. Secondary research was conducted using a variety of financial and real estate publications and literature specifically targeted toward corporate real estate managers.

For several reasons, many of those interviewed requested that information disclosed during interviews not be referenced in this thesis. It is my intent to respect this request for all interviewees. For this reason, the names of corporations are not disclosed in the summary of interviews.

It is difficult to distinguish between those companies that are in the real estate business and those that are not. In fact, the tendency for corporations to deny that they are in real estate, even though these assets are a substantial percentage of total assets, has in the past, resulted in sub-optimal management of these assets and potential value for corporate raiders.

CHAPTER 2
TAKEOVER AND BUSINESS TRENDS

2.1 The Business Environment

Several trends in the 1980's have illustrated the need for corporations to manage their assets more efficiently including: greater competition, the "restructuring of corporate America", changes in accounting practices that were designed to elicit more uniform, clarified and accurate information for investors, and increased takeover activity. As result, companies must seek out new avenues for maintaining or increasing their profits. According to David Shulman,

an economist would describe this process as a change in the demand curve, forcing a firm from a price-inelastic to a price-elastic curve.³

The wave of takeover activity in the 1960's and 1970's was driven by a very different motive than that of the 1980's; diversification. These acquisitions, which were not particularly successful, resulted in relatively large conglomerates. Many of the business units acquired during this period have since been sold off.

The "bust up" takeovers of the 1980's have continued this trend of sell-offs. Unlike past mergers, however, the "bust up" takeovers are typically financed with large sums of debt. In recent leveraged buyouts (LBOs), acquiring firms have used "as much as 90 percent debt to finance their

purchases...Companies are typically financed with 40 to 50 percent debt."⁴

To reduce the much higher debt burden from leveraged buyouts, assets are sold off. Another motivation of sell-offs is the belief that assets are more valuable if sold, because they have been inefficiently managed by the company.

Sell-offs can result in significant tax consequences. However, they are typically less to a raider than they would be to an existing corporation. This is because assets can be stepped up in basis to market value upon acquisition. A step up in basis reduces the gain recognized. Gain is calculated by subtracting basis (historical cost less accumulated depreciation) from net sales price.

2.2 Takeover Premiums and Benefits

Though management is responsible for maximizing shareholder wealth, another owner may be better able to fulfill this objective. According to Michael Jensen, takeovers serve to discipline management and ensure that shareholder's interests will be served;

the market for corporate control is creating large benefits for shareholders and for the economy as a whole by loosening control over vast amounts of resources and enabling them to move to their highest value use.⁵

He reports substantial financial gains to shareholders from mergers and acquisitions.

In dollar value, the gains to selling firm shareholders from mergers and acquisition activity in the ten-year period 1977-86 total \$346 billion (in 1986 dollars).⁶

The undervaluation of equity and opportunities to enhance the value of the target company motivate corporate raiders to pay a premium to acquire equity interests in the target company. These premiums, which are often substantial, can be explained by several factors including: expected increases in managerial efficiencies, expected benefits from transfers and synergies, and higher valuations by the acquirer. Some of these opportunities to uncover value in a company could not be utilized by the existing corporation i.e., some tax benefits and synergies.

Management Inefficiencies

Without takeover or the threat of takeover, it is often argued that management will allocate resources inefficiently. This occurs, in part, because management incentives are inconsistent with shareholder goals. For example, management compensation may be structured to encourage investment. In addition, a manager's influence often depends on the amount of resources they control.

The conflict between management and shareholders is intensified for "cash cows", corporations with large stable cash flows and low growth potential. In order to enhance

shareholder value, in these cases, "major restructuring, sell-off of assets, and/or measures to reduce costs must be accomplished."⁷ Since these are difficult measures to implement, they must often be carried out by corporate raiders.

Non-value maximizing behavior is also problematic in poorly performing industries. In these cases, resources need to be withdrawn. Since management often does not withdraw them, corporations in these industries are more likely to be acquired by hostile takeover.

Taxes and Other Transfers

Perhaps the most significant tax advantage to raiders is the opportunity to step up the basis of assets upon acquisition. If a corporation acquires "at least 80 percent of another corporation, it could elect to treat the stock purchase as a purchase of assets...this election results in the tax basis of the assets being stepped up or down to fair market value."⁸ Assuming that an acquiring company can step up the basis of assets and the market value of assets of the target corporation exceeds book value then, in most cases, the acquiring firm can benefit from increases in depreciation deductions.

The Tax Reform Act of 1986 effectively reduced many of the tax benefits of mergers and acquisitions. These changes included: the elimination of the General Utilities Doctrine,

modification of installment sales provisions, adoption of more stringent rules regarding the use of net operating losses, less generous depreciation schedules, an increase in the capital gains tax rate, and decreases in marginal corporate tax rates.

Another transfer which provides value to corporate raiders is the transfer from bondholders to shareholders. This transfer occurs because of additional leverage, which increases the risk of existing unsecured debt of the acquiring firm. As a result, this debt becomes less valuable whereas shareholders of the target firm gain a premium. In some cases, reductions in wages and/or labor have been a source of value to shareholders. It is often easier for outsiders to implement these "painful" measures, which may be needed to maintain competitiveness.

Synergies

Synergies, which are an outcome of mergers and acquisitions, may cause assets to be of greater value to the acquiring company. Potential sources of synergy include vertical integration, reductions in competition (monopoly power), financial diversification, extensions to related businesses, and economies of scale/efficiency gains.

Higher Valuations

It is likely that the market will undervalue shares at some time because of random fluctuations and other factors, such

as the discrepancy between information available to shareholders and to management. In addition, the market often discounts the value of fixed assets. Undervaluation of equity provides an opportunity for raiders to gain a premium upon acquisition.

In many cases, acquirers overpay for a firm's assets. This "winners curse" occurs because bidders imprecisely estimate the value of the acquisition. According to David Scharfstein, "winning means the bidder had the highest signal and suggests that the bidder overestimated the value of the object."⁹ As a result, "shareholders of target firms benefit most from acquisitions and few benefits, if any, accrue to shareholders of acquiring firms."¹⁰

CHAPTER 3
THE SIGNIFICANCE OF
CORPORATE REAL ESTATE ASSETS

3.1 Estimated Value

According to Ibbotson's estimate, corporate real estate is "seven percent of the total U.S. investable wealth, greater than the total of corporate bonds (3.4 percent) or government treasury bills (4.0 percent)."¹¹

The 1987 M.I.T. study indicates that "the market value of a corporation's buildings and land [as shown in Figure 3-A] represent 25 percent of total assets".¹² The range of estimates from this study are shown in Table 3-A.

Table 3-A

Estimated Market Value As a % of Total

Less than 20% of book value of total assets	45%
At least 20% of book value of total assets	25%
At least 50% of book value of total assets	20%
Greater than book value of total assets	13%

Source: Peter Veale, Managing Corporate Real Estate Assets: A Survey of U.S. Real Estate Executives, The Laboratory of Architecture and Planning, M.I.T., Cambridge, Massachusetts, February 1988, p.6.

The significance of corporate capital invested in real estate assets further emphasizes the importance of these assets. According to the M.I.T. study

Typical U.S. Corporation Real Estate Assets As % Of Total

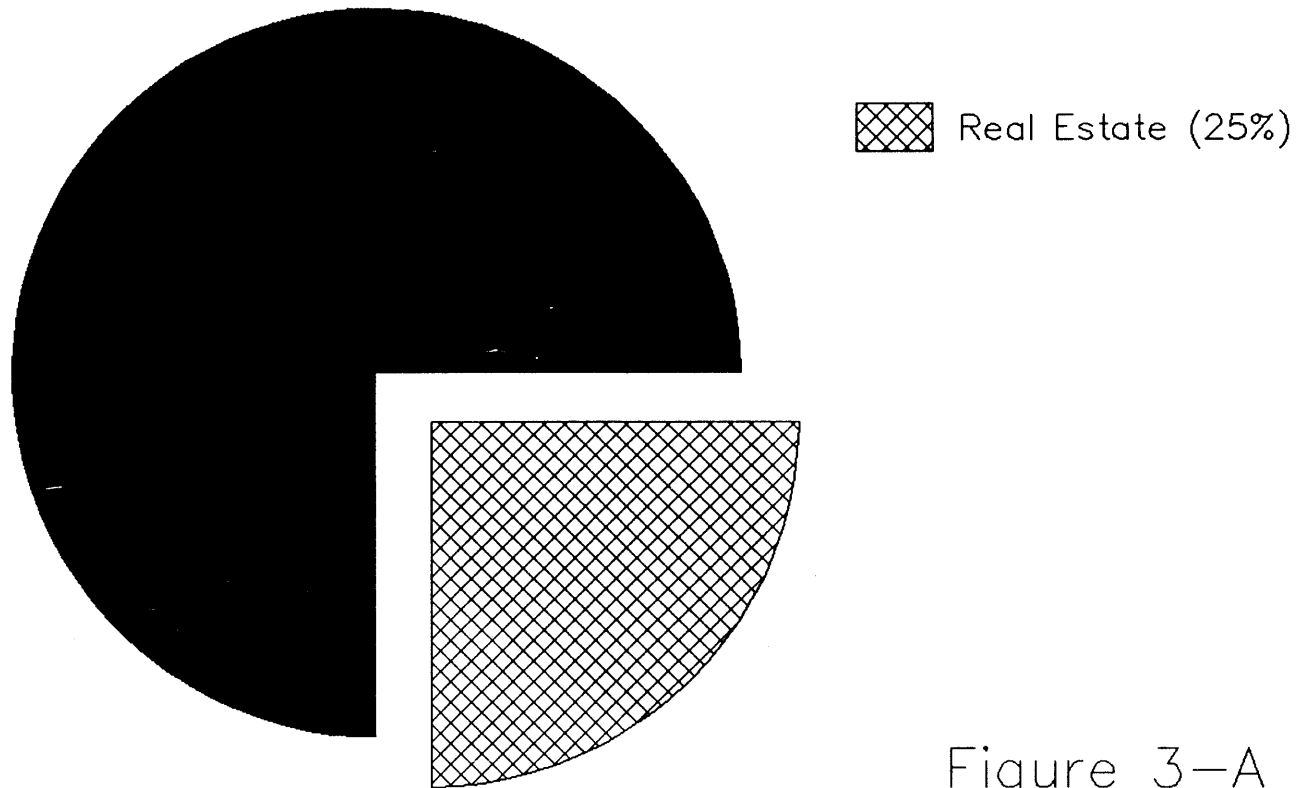


Figure 3-A

total occupancy costs for corporations can range between five and eight percent of (pre-tax) gross sales, which can be upwards of 40 or 50 percent of net income. These operating costs are second only to payroll costs in most organizations.¹³

3.2 The Market for Corporate Real Estate Assets

The potential for tapping undervalued real estate to create value has been exemplified in recent takeovers. Most of these cases involved acquisitions of real estate intensive businesses, such as hotels, restaurants, retail businesses, resort operations, railroads and natural resource companies.

The acquisition by Campeau Corporation (a Canadian real estate firm) of Federated Department Stores for \$7 billion, is one example. Another example is the acquisition, by Chicago based JMB Realty Corporation, of Amfac Company. Though Amfac is best known for its sugar business "it was clearly its real estate holdings that prompted JMB to go after the company."¹⁴

Other trends in takeovers further illustrate the importance of corporate real estate asset management including: the use of real estate assets to secure debt and thus reduce costs of capital and the trend to sell-off assets upon acquisition.

With a takeover pending, some corporations have voluntarily sold-off or spun-off real estate assets. For example, Harcourt Brace Jovanovich "put its six theme parks

on the auction block...The planned sale of this property was the latest in a string of actions Harcourt has taken since fending off British publishing baron Robert Maxwell."¹⁵

Other sources of increasing demand for corporate real estate assets are institutional investors and developers. This trend can be attributed to: reduced development opportunities, increased foreign investment in real estate, higher capital allocations by institutional investors to real estate assets, and new financing technologies, which facilitate larger transactions, such as the acquisition of entire real estate portfolios. For example, the Teachers Insurance & Annuity Association and the Rouse Company, a large Maryland based developer, purchased "roughly eight million square feet of office, commercial and industrial space from Maryland based McCormick & Company, this country's largest spicemaker for \$550 million."¹⁶

3.3 Management Inefficiencies

There has been a trend from a facility management approach to corporate real estate management to management as a profit center. Ferguson and Plattner, attribute this to

two developments [which have occurred] since the 1960's: The increasing complexity of corporate organizations and the inflation of real estate values...organizational changes accentuated the problem of integrating diverse and geographically dispersed operations into cohesive and manageable units...[as result] many firms subdivided themselves into independent profit centers, each headed by a manager entirely responsible for marketing, product development, and the bottom line - a profit.¹⁷

According to Robert Silverman, "companies adopting a clear corporate philosophy toward real estate have learned to control costs, generate supplemental cash, or diversify into the real estate business."¹⁸ Union Carbide, for example, with "diminished cash reserves and increased volatility of their stock, participated in a sale/leaseback of its corporate headquarters and land in Danbury, Connecticut to raise \$340.5 million to feed the corporate machine."¹⁹ Robert Silverman finds that generally "companies which diversified into the real estate business own valuable properties as a consequence of early business activities."²⁰

Despite these trends, the 1987 M.I.T. study does not reveal widespread recognition by corporate management of the potential for real estate assets to contribute to profitability. Peter Veale, the author of this study, concludes that

there is a relative lack of attention given real estate assets by corporate management...a lack of informed decision-making and awareness [which] characterized nearly every dimension of corporate real estate management examined in the survey. In general, under-management is a better descriptor of the situation than mismanagement.²¹

In comparing the 1987 M.I.T. study of corporate real estate management to a study conducted by Harvard Real Estate in 1981, Peter Veale found "little to suggest that things have improved significantly."²²

Several findings of the M.I.T. study corroborate these

conclusions.

- 49% of respondents in the M.I.T. study do not account for real estate on a 'property by property' basis as compared to 40% in 1981.
- 26% of respondents do not have a real estate inventory as compared to 34% in 1981.
- 74% do not have a real estate management information system as compared to 80% in 1981.
- 47% do not separately evaluate real estate assets as compared to 40% in 1981.²³

Specific examples of mismanagement are shown in Table 3-B.

Reasons for "Mismanagement"

Possible explanations for the "mismanagement" of corporate real estate assets include the view by many managers that these assets, especially those with more specialized uses, are factors of production only. Given this perspective managers often overlook opportunities for enhancing the value of these assets i.e., through redevelopment.

Contrary to this perspective, some highly specialized industrial real estate properties have been successfully redeveloped including: the conversion by American Aggregates of a gravel pit used to manufacture cement, into a lake, and the development of surrounding property into a residential planned unit development and the redevelopment of a steel plant for multi-tenant industrial users by Bethlehem Steel.²⁴

Table 3-B

Examples of Mismanagement

- Investments in real estate which yield lower returns on equity than the corporate rate of return on assets;
 - Inefficient use or design of facilities;
 - Unused or underutilized real estate property, such as property where zoning permits higher coverage than now exists;
 - Neglect by management of opportunities as a major tenant to reduce occupancy costs, including opportunities for consolidating or combining tenants, and to gain equity benefits;
 - Disposal of assets at distressed sale prices when more creative marketing, reposition or redevelopment of the property, or better real estate market timing could have yielded higher returns;
 - Inadequate property management; and
 - Poor planning, which causes delays and/or higher costs.
-

Past involvement of corporations in real estate has been unsuccessful, in many cases, because of management's lack of real estate expertise. According to Arch Jacobson, chairman and chief executive officer of Union Pacific Realty Company,

a lot of companies that have been involved in real estate as a profitable subsidiary have gotten very disillusioned and are going to take some serious baths.²⁵

In order to utilize real estate assets more effectively, corporate management needs to recognize their value not only as productive assets, but also as financial assets. They

must understand factors which affect their value: the risks and returns that are associated with operating cash flows, residual value, capital structure and cost, and tax effects.

A common misconception by corporations and developers is that operating risks are significantly reduced by a corporation's commitment to occupy space, without regard to the stability of that particular occupant. While such a commitment would reduce market risks associated with the initial lease-up, operating risks would not necessarily be reduced for more volatile businesses. This is because operating risk in real estate depends on who occupies it, much like the value of financial assets depends on the company's likelihood for success.

Conflicts often serve as an impediment to effective real estate asset management. Internal conflicts arise because of the ambiguity of the role of real estate management within companies. Rodrigo Brana finds that

the corporate real estate group occupies a special position within a corporation's structure...It is neither a division, in the sense that its activities are not part of a business of the corporation; nor is it a production function, as these are normally understood.²⁶

Discrepancies between real estate and other corporate businesses also cause conflicts.

corporate emphasis on today's profit makes it hard for many non-real estate firms to understand investments that might take years to produce a profit. They don't keep books that way.²⁷

In addition, company space requirements, corporate needs, and real estate market conditions often conflict. For example, if corporate earnings have diminished, a sale of surplus property could be beneficial. However, if real estate market conditions are weak, it may be preferable to hold on to surplus property until the market improves. Sources of potential conflict between operating and real estate groups are summarized in Table 3-C.

Table 3-C

Dynamics of Internal Corporate Conflict

	<u>Operating</u>	<u>Real Estate</u>
	<u>Groups</u>	<u>Groups</u>
Time Horizon	Short-term	Long-term
Earnings Perspective	Pre-tax Profits	After Tax Cash Flow
Value Preference	Short Term Gains	Cash Flow & Appreciation
Desired Debt Ratio	Lower Debt Desired	Higher Debt
Facility Location	Image Unique to Enterprise; or Low Cost	Configure to "Fit" Market; Speculative
Facility Standards	Maximize Utility	Maximize Market Value

Source: Kip Thompson (1986), "Corporate Real Estate Strategies for Structuring Development Joint Ventures," Master's Thesis, Department of Architecture, M.I.T., Cambridge, Massachusetts, September 1986, p.45.

3.4 Balance Sheet Effects

Book vs. Market Value

Discrepancies between book and market value of real estate assets and lower rates of return on assets due to higher levels of fixed assets, pose a dilemma for corporations with relatively significant real estate assets; stock prices typically do not reflect the true value of these assets.

In accordance with generally accepted accounting principles (GAAP) real estate assets are generally recorded at acquisition cost. Depreciation is accumulated against original costs to establish the book value of assets. Since the market value of real property typically appreciates, the book value of real estate assets often bears little resemblance to true market value.

Book value can only be adjusted if there is a substantial impairment in market value, or if the control of assets is transferred. Upon transfer of control, these assets can generally be stepped up in basis to reflect current market value.

If an acquiring corporation purchases at least 80 percent of the stock of another corporation, it could elect to treat the stock purchase as a purchase of assets. This election results in the tax basis of assets being stepped up or down to fair market value (although net operating loss and tax credit carryforwards are lost).²⁸

According to a survey of corporate real estate executives conducted by the Industrial Development Research Council (IDRC),

the market value of real estate assets is estimated to be almost twice that of book value.²⁹

Hence, as Figure 3-B illustrates, the opportunity available to step up the basis of undervalued assets can be a significant benefit to an acquiring company.

Effects from Fixed Assets

Return on assets (net income/capital) depends on two factors: capital turnover (sales/capital) and profit margins (net income/sales). Capital turnover decreases as fixed assets on the corporate balance sheet increase. This, in turn, causes the rate of return on assets to decrease, holding profit margins constant. Results from a study of price to earnings ratios, by Cohen and Smyth, indicate that

the rate of return on assets before taxes is by far the most important determinant of price to earnings ratios.³⁰

Since price to earnings ratios remain the most common method of valuing equity interests, an increase in fixed assets would have a negative effect on shareholder value. These effects and those due to discrepancies between earnings and cash flow are shown in Figure 3-C.

According to William Bennett, the logic behind this

Book vs. Market Value

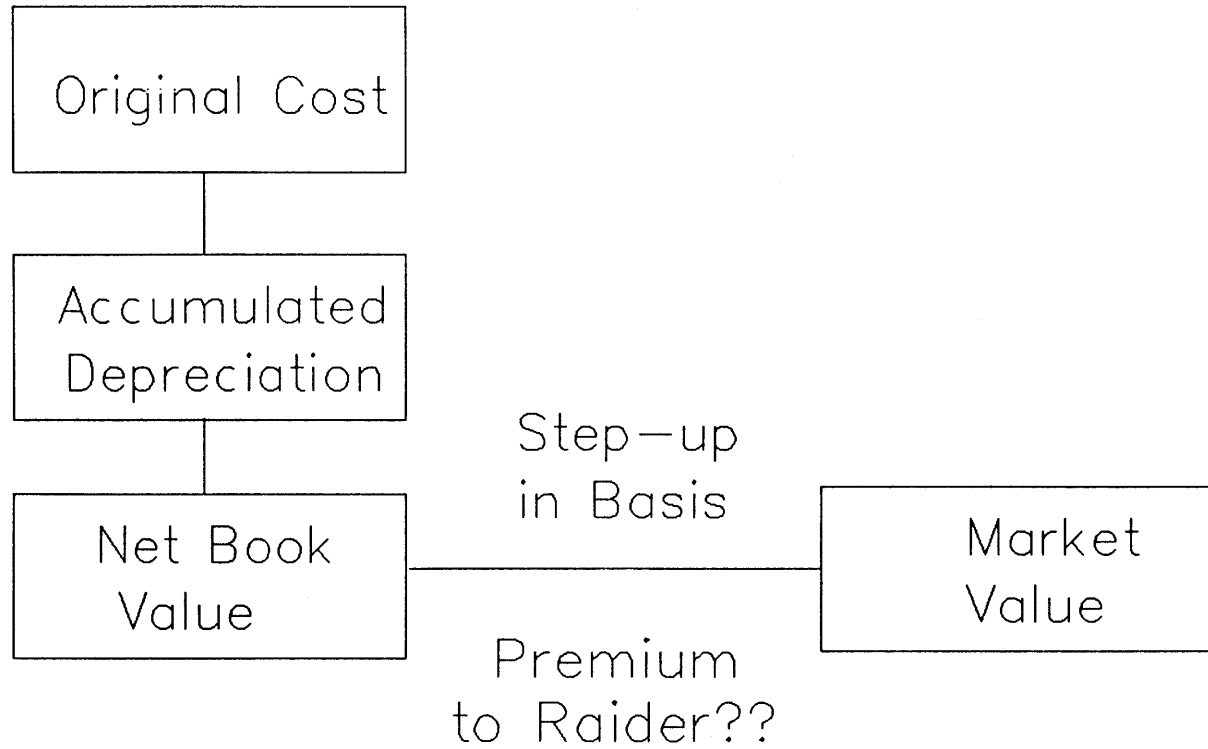


Figure 3-B

Effects on Shareholder Value

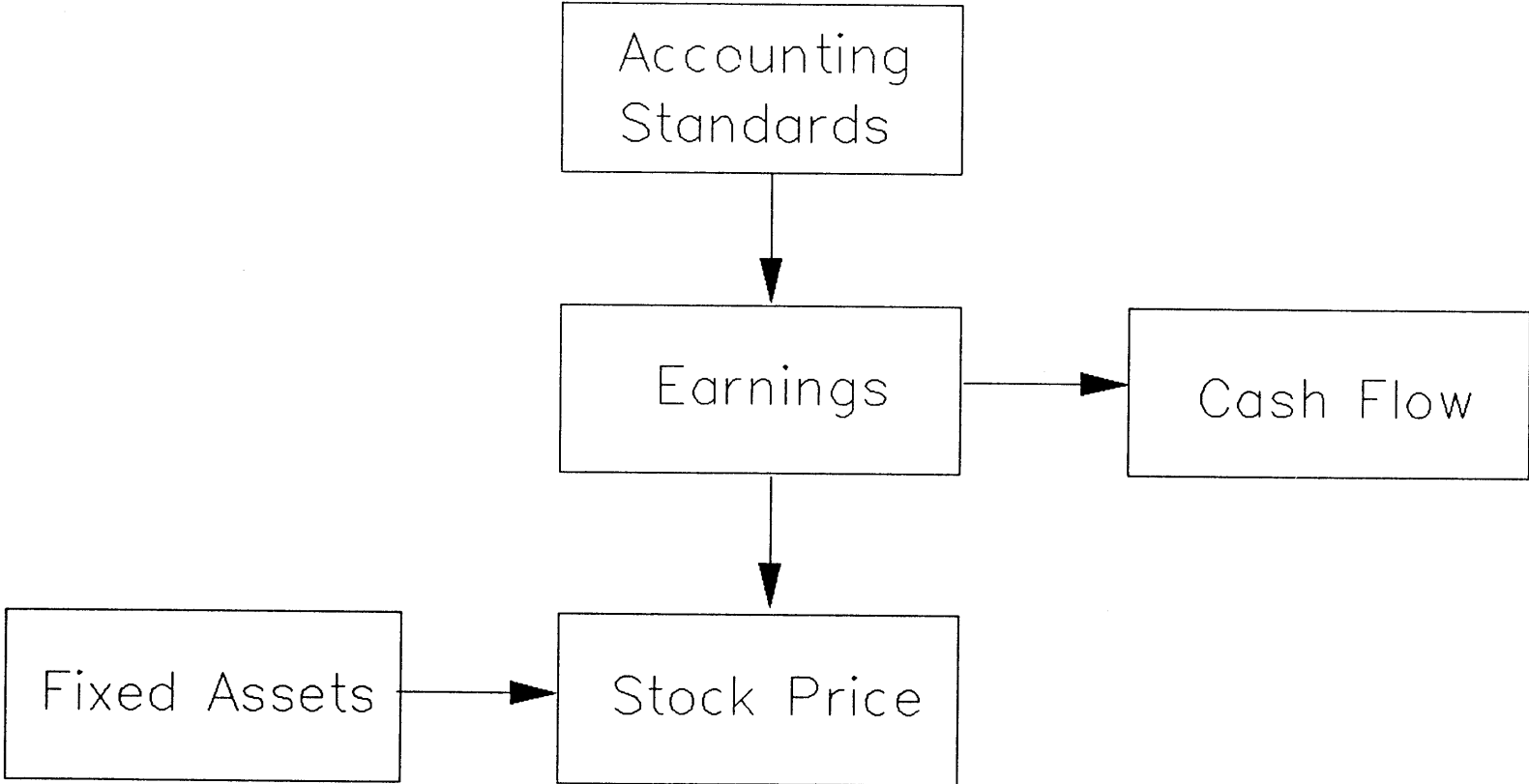


Figure 3-C

decrease in value with increased fixed assets, is that

it takes more capital to produce a dollar of sales than it used to, [as a result] the company must get a higher profit margin, or else recognize that it has been forced or has allowed itself to devote a certain amount of capital to its customers' uses without any return. If³¹ this trend persists, trouble is inevitable.

Several studies examining changes in share price associated with sell-offs and spin-offs further illustrate the negative effect of fixed assets on shareholder value. For example, Owers and Rogers found

the cumulative abnormal returns from spin-offs of real estate assets to be greater than those from sell-offs...[However,] in both cases, returns were positive and statistically significant.³²

Nourse and Rutherford studied the effects on shareholder value for spin-offs to different types of corporate real estate units. They found that, in all but one case, returns were positive "with largest gains associated with the publicly traded subsidiaries [and] the next largest gains associated with the Master Limited Partnerships and the wholly owned subsidiaries." On the other hand, the formation of a central real estate department "resulted in a decrease in equity value for the parent firm." Nourse and Rutherford conclude that the positive returns associated with spin-offs of real estate assets

are consistent with the claim that real estate assets have been underutilized, and that the active management of real estate is the responsibility of the firm if³³ it intends to maximize shareholder wealth.

3.5 Income effects

Negative effects of real estate assets on shareholder value can also be attributed to: the reduction of earnings, but not cash flow, by depreciation and opportunity costs associated with the use of capital for real estate rather than other investments.

Since depreciation, in addition to providing potential tax benefits, also lowers earnings (it is subtracted from total income to calculate earnings) conflicts arise in real estate investment decisions. Christopher Leinberger describes this dilemma:

Shareholders and management are more concerned with earnings per share growth, dividend policy, and stock and bond prices (normally on a short-term basis), while the real estate investment analyst is looking at available depreciation that can be added to net income.³⁴

Another accounting practice that can be misleading in evaluating alternative real estate strategies i.e., whether to own or lease, is the exclusion of opportunity costs in calculations of earnings and cash flow.

3.6 Implications for Real Estate Management

As exemplified by past takeover activity, real estate assets can provide significant benefits to corporate raiders. These benefits are largely attributable to the undervaluation of real estate assets on corporate balance sheets and discrepancies between earnings and cash flow, although "under-management" also has a role.

Given the value of real estate assets in relation to total assets, corporate managers should take notice of this often "under-managed" asset. Ennius Bergsma, a partner at McKinsey & Company, asserts that three conditions must be met to manage the value of assets effectively:

you have to use the right measures for performance, make sound reinvestment decisions, and determine whether you³⁵ continue to be the right owner of your businesses.

Regardless of the efficiency of management, other negative effects on shareholder value are associated with ownership of assets. Studies, indicating positive effects on shareholder value of spin-offs and sell-offs, support the theory that these assets are often not reflected in stock price. Hence, management should assess the pros and cons of owning real estate assets and explore alternative real estate asset management strategies to enhance shareholder value.

CHAPTER 4
DEVELOPING A REAL ESTATE MANAGEMENT STRATEGY

4.1 The Process

There are several steps involved in developing a real estate asset management strategy which are described in this chapter. These steps, along with several alternatives for each step, are outlined in Table 4-A.

Identifying Strategic Objectives

To identify strategic objectives for managing real estate assets, management must first assess corporate goals i.e., to increase earnings and strategies i.e., to decentralize the corporation, and evaluate relevant external factors i.e., the economic outlook. Finding objectives to be equally dependent on corporate politics and culture, Robert Silverman suggests that "senior corporate managers examine conflicts in the context of their own organization before deciding on a strategic path."³⁶

To respond to continual changes in the internal and external environments, in which real estate decisions are made, the development of real estate asset management strategies should be an ongoing process.

TABLE 4-A

DEVELOPING A REAL ESTATE ASSET MANAGEMENT STRATEGY

1. Identify Corporate Needs and Strategies.

Desired Results

- Increase earnings
- Reduce debt on balance sheet
- Eliminate undervalued assets from balance sheet
- Generate cash
- Reduce tax liabilities
- Minimize risk

2. Identify Real Estate Asset Management Objectives.

- Cost center
- Profit center
- Strategic assets (integrally related to corporate needs and strategies)
- Diversification into real estate business

3. Organize Real Estate Management Efforts.

- Separate business units
- Separate business units with consulting from central real estate managers
- Central real estate group, division or department with input from business units and
- A real estate subsidiary

4. Identify Decision-Making Criteria and Process

Process

- Define involvement of business units, real estate group and corporate management; and
- Develop method for comparing alternatives, including time sensitive financial analyses

Criteria

- Corporate goals and strategies (i.e., growth)
- Organizational issues (real estate expertise, corporate culture)
- Opportunity costs (investment alternatives and return on assets)
- Financial needs (earnings, cash, reduced debt ratio, and lower cost of capital)
- Tax Effects (Capital gains, corporate, and state and local)

- Risks (i.e., market, macroeconomic and financial)
- Takeover threat (undervalued equity and assets)
- Qualitative issues (image, identity, quality of work environment, and public and union relations)
- Business needs (use, size, degree of specialization, capital investment requirements, need for control and flexibility, duration of need, location criteria)
- Real estate market (appreciation potential, stability, and availability and costs)
- External market (availability and cost of capital, industry and macroeconomic trends, technological changes, inflation, competition, takeover legislation and trends)

5. Evaluate the Real Estate Portfolio.

Assess Company Space Needs and Compare Value with Alternative Uses and Identify:

- Surplus properties
- Underutilized/opportunity properties
- Opportunities to reduce risk i.e., diversification

6. Identify and Evaluate Alternatives

- Maintain company control and occupancy
- Value enhancement
- Liquidation (MLP, REIT, liquidating trust, tax deferred exchange, charitable donation)
- Sale/leaseback
- Spin-off and leaseback (MLP, REIT, subsidiary)
- Lease surplus property
- Equity leases/joint venture development
- Recapitalization
- Acquisitions

7. Monitor the Effectiveness of Strategies

- Develop and maintain inventory; and
- Measure financial and non-financial performance i.e., business unit satisfaction

Organizing Real Estate Management Efforts

Corporate real estate activities are defined in Table 4-B. There are a range of alternative structures from decentralized structures, where responsibility is delegated to business units, to centralized structures, where a

separate subsidiary is established.

Table 4-B

Corporate Real Estate Activities

- Acquisition and divestiture;
- Finance, including capital budgeting, financial analysis and property tax evaluation; and
- Custodianship, including property management and real estate record keeping.

Source: Robert Silverman and Sally Zeckhauser, "Rediscover Your Company's Real Estate." Harvard Business Review, January-February 1983, p.116.

According to Silverman and Zeckhauser, "companies profiting most from real estate centralize responsibility in real estate groups that are consulted when any decision affecting real estate is made."³⁷

With a subsidiary, many transactions can be completed outside of the corporate bureaucracy. This can be a considerable advantage since, as Leonard Bogorad suggests, "senior offices do not understand real estate and decision-making is slow."³⁸

Developing the Decision-Making Criteria

Real estate decision-making criteria are dependent on internal factors, i.e., business needs, and external factors i.e., industry trends. Table 4-A outlines criteria that are generally applicable to these decisions. Since internal and

external factors are constantly changing, decision-making criteria must also be modified on a continual basis.

Evaluating the Real Estate Portfolio

Several characteristics of different corporate real estate uses (as shown in Table 4-C) influence real estate strategies and decisions. These include the size and duration of business needs, the need for control and flexibility, whether the need is general or special purpose, and capital investment and location requirements.

4.2 Evaluating Alternative Strategies

Assuming that more strategic investments would yield higher returns, then the use of corporate capital for real estate investments may not be appropriate. Management should distinguish between assets that, for strategic and other reasons, they should continue to own and those for which alternative forms of control and alternative capital structures should be examined. This decision process is illustrated in Figure 4-A and Table 4-D.

Management must consider existing "debt covenants that may preclude spin-off or liquidation of assets or recapitalization. Management should determine whether shareholder approvals are required or advisable, whether they are entitled to appraisal rights, and whether any exchange or other regulatory approvals are required."⁴⁰

Process to Evaluate Real Estate Assets

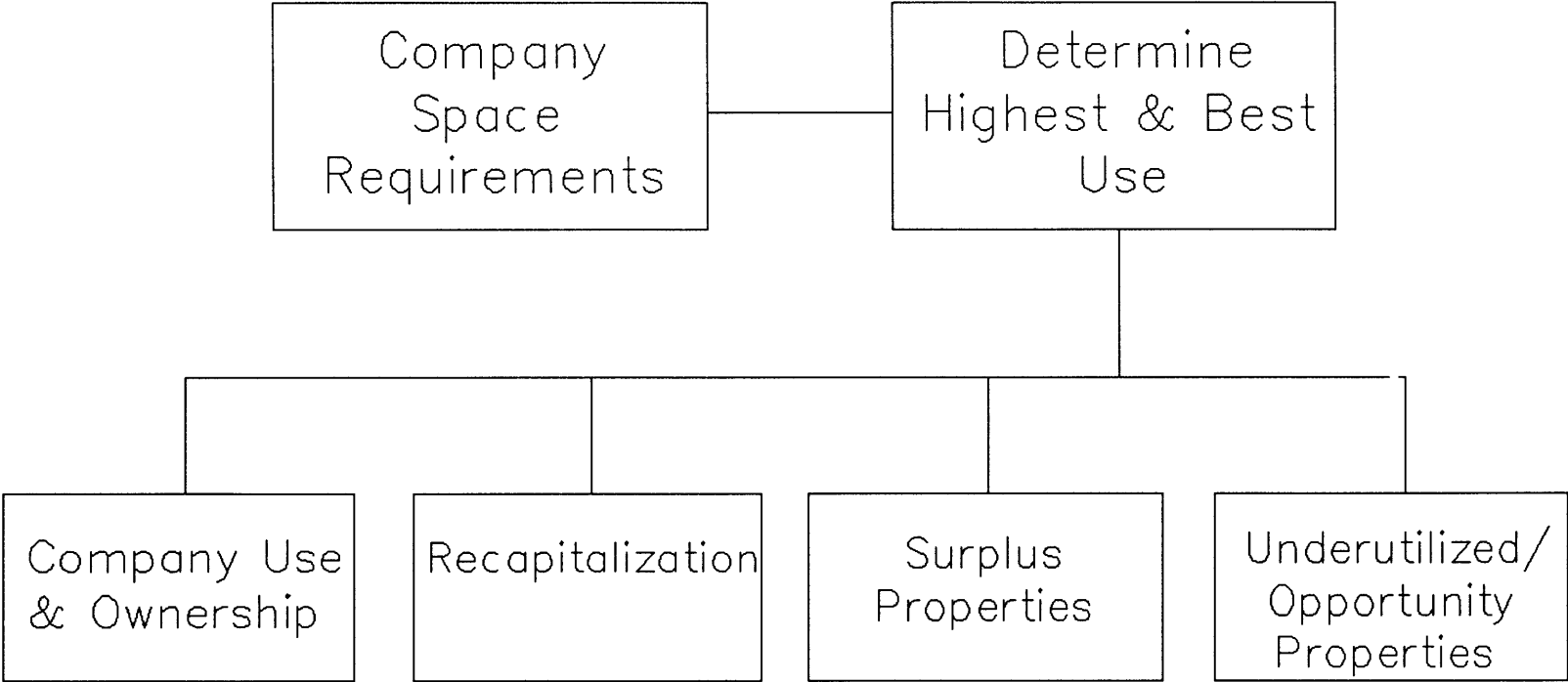


Figure 4-A

Table 4-C

Characteristics of Corporate Real Estate

General purpose

- Administrative offices
(headquarters and "back" offices)
- Marketing/sales offices
Retail
- Research and development/flex*

Special purpose

- Manufacturing/industrial
- Research and development/flex

Stable/Longer term

- Administrative offices
(headquarters and back offices)
- Manufacturing/industrial
- Larger marketing/sales office (in major cities)

Less Stable/Shorter term

- Research and development/flex
- Smaller marketing offices
- Smaller retail

* Research and development/flex space is becoming more general purpose but, in some cases, it is still rather specialized.

Assess the Company's Needs

An analysis of real estate investments should begin with an assessment of the company's space needs including an assessment of possibilities to consolidate and to more

efficiently utilize facilities.

Table 4-D

The Decision Process for Evaluating Alternative Strategies

1. What are the company's needs?
 2. Are there alternative uses for real estate assets which create opportunities for the company?
 3. What assets does the company want to control? Which properties are surplus? Underutilized/opportunity properties? Should it acquire and/or develop other property to meet business needs?
 4. What form of control should the company maintain for the properties they want to occupy i.e., lease or own?
 5. Should the company dispose of surplus property or create value through development, redevelopment, repositioning, or expansion?
 6. What means should the company employ to dispose of properties? What strategy should be utilized to enhance asset value (i.e., zoning)? How should this be accomplished (i.e., joint venture)?
 7. Are there opportunities for recapitalization that should be considered (i.e., increased leverage)?
-

Identify and Evaluate Alternatives

Management should consider whether there are alternative uses for their real estate assets or other opportunities to enhance their value. Surplus properties (those the company does not anticipate needing in the future) and underutilized/opportunity properties (those the company needs but for which there are opportunities to create value) should be identified. To accomplish this, management should compare the book value of assets with the market value of

alternatives (with development, repositioning, redevelopment, expansion and/or recapitalization).

4.3 Surplus Properties

Management needs to decide whether to retain surplus properties or dispose of them, what strategies for value enhancement are appropriate if they are retained, and what strategy should be employed to liquidate them.

Opportunities for Value Enhancement

Management might prefer to retain ownership of surplus property, if there are opportunities for value enhancement or if the real estate market is weak.

Value is added by taking property through various stages of the life cycle of property. According to the Property Research Corporation, substantial value is added to property during the predevelopment phase, which includes zoning and planning, it increases to a lesser extent during development, its value then decreases during misdevelopment, and it increases once again during redevelopment.⁴¹

It is important to assess risks in deciding on the level of corporate involvement i.e., at what stage should the corporation sell its interests in the property. By participating in a joint venture partnership, some of these risks can be shifted to the development partner.

Liquidatation of Surplus Properties

Tax Deferred Exchanges

If a company simultaneously needs a facility and plans to dispose of surplus property then it may affect a tax deferred exchange. Like kind exchanges can be accomplished without recognition of capital gain and thus they can reduce tax liabilities.

Charitable Donations

By donating surplus property to non-profit organizations, the company gives pre-tax dollars, which results in a larger tax offset for the company and more cash for the foundation. A survey conducted by the Real Estate Research Corporation finds that donations are accomplished for "public relations purposes, to reduce taxes and to sell the properties that could not be sold in the private market."⁴²

Liquidating Entity

According to Berman, Cudd and Jinnett, a liquidating entity is advisable when a company has a number of disparate properties and wants to sell them over a long period of time to avoid a distress sale situation...Generally, a liquidating trust would be utilized in situations where the real estate holdings could be treated as a passive investment, not requiring any management activity by the trustee during the liquidation process, such as timberland or raw land. A liquidating partnership may be advisable in situations where the real estate portfolio requires active operation and management.⁴³

Since the repeal of the General Utilities Doctrine with

the Tax Reform Act of 1986, a corporation will be taxed on the distribution of appreciated property, "as if such property were sold at its fair market value...It also constitutes a taxable dividend to the shareholder to the extent of the accumulated earnings and profits of the corporation...Under certain conditions it may be possible to affect a tax-free spin-off to liquidate assets to a real estate investment trust where the real estate is used in an active trade or business."⁴⁴

4.4 Underutilized/Opportunity Properties

Before deciding among strategies to enhance shareholder value, through the management of underutilized/opportunity properties, management must first weigh the pros and cons of alternatives along the spectrum from ownership to gross lease. Market conditions and business needs are primary factors in deciding among alternative forms of control.

Alternative Forms of Control

With ownership, the corporation receives maximum benefits from appreciation in property value, assumes more risk, and its equity value may be negatively affected, thereby increasing the threat of takeover. According to Rodrigo Brana, many corporations argue that full control over their production facilities is necessary given the specialized nature of the production function.⁴⁵

These benefits and disadvantages of ownership are traded

off as one goes toward the other end of the spectrum: the gross lease. In addition, leasing frees up corporate capital for other investments. On the other hand, it raises debt ratios since leases are generally considered as debt on corporate balance sheets.

Corporations have increasingly recognized the value they bring to a development project as a tenant. As result, they negotiated better lease terms and rates and/or equity participation. Rodrigo Brana explains that

by moving to an equity position...corporations are trying to internalize some of the external benefits that their presence as tenants generate...such as better financing terms and shorter lease-up period.⁴⁶

Joint Venture Partnerships

Depending on the structure of the joint venture partnership, they potentially yield several benefits to corporations including: cash plus tax benefits (depreciation and interest expense deductions), participation in residual values from appreciation, and reductions in premiums available to corporate raiders. The corporation also benefits from the developer's expertise and management and, in some cases, control of the site. Additional benefits accrue to the corporation, if the equity method of accounting can be employed.

The equity method of accounting can be used if the investor "can exert significant influence, generally by

owning 20 percent, but not more than 50 percent of the voting stock of another company."⁴⁷ Off-balance sheet financing usually accompanies this method, which enables corporations to gain positive benefits of ownership without the venture's debt appearing on the corporate balance sheet.

Disadvantages to joint venture development include the loss of partial control, potential conflicts with the development partner, and increased risks. Risks can be somewhat reduced if the corporation assumes a limited partner status.

Other "Middle Ground" Options

Other "middle ground" options include equity leases, mortgage leases and leases with an option to purchase. Mortgage leases, for example, give you the rights of ownership without the balance sheet effects.

Sale/Leaseback, Sell-Off and Recapitalization

For properties which the company needs to occupy but not necessarily own, alternative strategies should be considered to dispose of or recapitalize including: sale/leaseback, spin-off (and leaseback) to a subsidiary, master limited partnership (MLP), or real estate investment trust (REIT), and increased leverage.

Sale/Leasebacks

Two primary factors in these decisions are the cost of

capital with sale/leaseback relative to other sources of capital and tax effects i.e., whether the corporation would have to recognize a substantial gain upon sale. Although the sale of assets reduces the potential to benefit from appreciation in value, it may be possible to structure sale/leasebacks so that the corporation retains an equity interest in the property. With the increased securitization of real estate, it is likely that sale/leasebacks will be increasingly attractive in the future.

Potential disadvantages of sale/leaseback include the loss of control and negative effects on image. Depending on lease structure and term, the corporation may be subject to greater occupancy costs and inflation risks. In a tight market the corporation may have greater difficulty expanding.

Spin-offs to a Subsidiary

Another means for raising the target company's stock price, by eliminating undervalued real estate assets from the books, is to spin-off these assets into a subsidiary entity, either a wholly owned or publicly traded subsidiary, that can be separately valued. One explanation for the resulting increase in share price is that prior to the spin-off, shareholders did not have information regarding current market value.

Unconsolidated subsidiaries, which are possible if the 'parent' corporation has only minority interests in the

subsidiary, have the advantage of off-balance sheet financing. There are additional limitations on its use. As result "it is used mostly in operations which differ significantly from the primary operation of the company."⁴⁸

Spin-offs to Master Limited Partnership

The company could spin-off real estate holdings into a master limited partnership (MLP), which is

like a limited partnership whose interests are tradable on a securities exchange and which would...be a holding entity...Generally, the parent company will not recognize any taxable income on the transfer of property to the MLP, to the extent that liabilities assumed by the partnership create a deemed distribution of cash or the target company sells a portion of its assets to the partnership for cash or other property....the shareholders [will take] into income the fair market value of such units as a dividend, to the extent of the current or accumulated⁴⁹ earnings and profits of the target company.

It is "possible that future tax reform would eliminate a corporation's ability to avoid the corporate-level tax on operating income."⁵⁰

Real Estate Investment Trusts

In certain instances,

real estate holdings may be suitable for spin-off into a Real Estate Investment Trust (REIT), which is generally a corporation or a business trust that invests in a 'passive' manner in real estate mortgages or takes 'passive' equity interests in real estate...It is generally not subject to a corporate level⁵¹ tax but must satisfy...other requirements.

Recapitalization

In addition to sell-offs and spin-offs, management should consider opportunities to maintain ownership but to increase leverage. The attractiveness of this alternative depends on the cost of capital, liquidity, opportunity costs, tax considerations, risk profile and threat of takeover.

Acquisitions

For strategic purposes, corporations may need to acquire additional real estate. In some cases, more advanced planning is beneficial including: where further delays in the regulatory approvals process are anticipated, land is scarce, or property values are appreciating rapidly. Of course, there are carrying costs and risks associated with this strategy, not to mention opportunity costs. If developed properties are acquired, it may be feasible to lease them until the company needs them. By reducing costs and enabling company's to meet their goals, these strategies can enhance shareholder value.

Property/Facility Management

It would be an oversight not to mention the tremendous potential that corporations have to minimize operating costs and thus enhance value through property management. This includes more efficient utilization of facilities, which can facilitate cost saving consolidations.

CHAPTER 5

SUMMARY OF FINDINGS FROM INTERVIEWS

5.1 Methodology

The primary research for this thesis included interviews of several industrial corporations; Fortune 500 as well as smaller corporations. The intent of the interviews was to gain an understanding of the real estate asset management strategies that corporations are currently employing and their reasons for employing these strategies. The businesses these companies are involved in varies substantially, although most are involved in information and other high technology businesses. An additional bias in the research is attributed to the process used to select the companies to interview. In some cases, companies were selected because they are known to be relatively active in managing their real estate portfolio.

5.2 Summary of Findings

Findings from the interviews include:

1. Undervaluation and Threat of Takeover:

Managers do not consider real estate assets to present a significant opportunity for potential corporate raiders. One explanation they offered is that they do not consider "special purpose facilities", such as manufacturing, to have much value, except as an ongoing concern.

Just a few of the companies interviewed had conducted an analysis to determine whether there is potential value for corporate raiders in real estate assets. This analysis, they believe, prepares them for takeover, to some extent. Others interviewed do not know current market value for properties, especially for manufacturing facilities. One manager said that an assessment of market value of properties "would be too costly to do."

Most companies "acknowledged at least some discrepancies between book and market value." One manager, denied "that the market value of real estate is a significant proportion of total assets." Generally, managers concluded that any potential value to a raider from real estate assets would be "insignificant relative to total firm value and costs of takeover." When asked whether threat of takeover affects real estate decisions, interviewees responded, that

- in considering takeover threats, there are a dozen considerations before real estate.
- Most property, since it is so specialized [i.e., manufacturing facilities] has little value, if any, except as an ongoing concern.

In many cases, managers agreed that offices have greater market value because they are "general purpose" uses. However, they indicated that offices "are not of much value to a raider because they are leased or owned by a joint venture partnership."

2. Objectives:

There was a fairly even split between companies managing real estate as a cost center and those who treat it as a profit center. In addition, one company manages it as a factor of production. Of those managing it as a profit center, most do not consider profits to have a significant effect on the bottom line of the company.

Objectives for real estate management varied. They include:

- Real estate is a cost of doing business...The concern is over the value of the product being turned out relative to the total plant investment rather than occupancy costs for manufacturing facilities.
- The satisfaction of business units is their primary concern.
- To identify opportunities to minimize costs and thus enhance profits.
- To improve the financial performance of the company through the management of real estate with the ultimate goal of increasing shareholder value.
- To redevelop existing assets to their highest and best use...generate current earnings through development and other service fees in external markets, and build an appreciating portfolio that will provide steady and growing earnings through a program of planned asset turnover.

A few companies consider profit from real estate to be a "contributor to the bottom line in absolute dollars, but to have minimal effects on shareholder value." One company, however, considers profits from real estate to "have a not insignificant effect on [the company's] performance." They

"identify the highest and best use for their properties ...look for hidden values...and how to realize value for the corporation." Their real estate management strategies are integrally related to corporate strategy and are modified "almost continuously" to respond to changes in corporate needs.

3. Organizational Issues:

The greater is support from corporate management and cooperation of business units, the more likely it is that corporate real estate assets can be used strategically to enhance shareholder value.

The historical function of corporate real estate and the resistance to change within organizations make it more difficult to effectively manage these assets. "A lot of corporations start off with facility management and then can't cross over." This issue is heightened by conflicting goals of operational and real estate managers.

- The real estate group sees opportunity for profit, the operating units see housing their people as the goal of real estate management.
- They would prefer to spend their money on production.

In one company, the real estate manager, who is "like a consultant", describes the relationship with operating units "like walking a tight rope." The problem is that everyone thinks "since they bought and sold a house they are a real estate expert."

To address this issue,

business units have to go through the central real estate group for any lease over five years or five million dollars.

[One manager tries] to assign people to individual business units to understand their needs better.

They will pay business units to move and give them profits from the venture as incentives.

[Many companies] charge the low end of market rents to 'clients' to motivate them.

Regardless of strategy entailed, it is clear that this issue needs to be addressed, if corporations are to manage real estate assets efficiently. Recognizing the need to better manage real estate assets, many companies have centralized real estate management over recent years.

Corporations have to bite the bullet...change it or bring in outside people ...[they must] understand how the organization works.

According to one interviewee, their ability to "focus on financially driven rather than facility driven asset management" has been facilitated because he "came with a clean slate." There was no real estate group before he was transferred to develop it. He also attributed their success to corporate management's support for and involvement in their activities.

We talk regularly with management of the corporation...this is their project and everyone knows that, so it works.

4. Opportunities to Capture Value:

Companies interviewed are increasingly aware of opportunities to cash in on the value they add as a major tenant in a development. As a result, their involvement in joint venture partnerships has expanded, and this trend is expected to continue in the future.

Companies recognize that they "have left money on the table in years before, where they have been a significant tenant...Now they are looking at it hard..."

They want to use their leverage as a large company to pick up extra money, negotiate better leases, use properties more efficiently to save in costs, and locate uses with these considerations in mind.

Most of those interviewed "limit their participation to certain [general purpose] uses and developments where they will have a large presence, in a populated city." One company reported looking "first at the company's requirement then secondly at the market and whether [they] would want to move." Although many of these companies look at joint ventures as opportunities to earn a profit

they are not interested in speculative development.

They will only participate in joint ventures to take advantage of land holdings or if there is a company need they could leverage.

One company interviewed makes exceptions to this rule. Although they consider themselves to be involved in projects that are only "half way between speculative and

non-speculative development, they have been involved in joint ventures, where they have not had a specific need, because of limits in the growth rate [of their primary business] which lead them to look at other sources of income.

5. Key Decision-Making Criteria:

Most companies view real estate decisions as capital budgeting decisions. However, market conditions and non-financial criteria, such as image, are also important.

At most companies, real estate decisions are capital budgeting decisions and the Treasurer, Chief Financial Officer or other financial managers are involved.

- The Treasurer makes the decision on whether to lease or buy.
- Decisions are based on availability and cost of capital.
- The Treasurer and finance group view development as a source of capital, something to invest in now with potential to sell later if they need the capital.
- The decision to participate in a sale/leaseback is based on a comparison of the cost of capital...to the corporate cost of debt.
- Real estate managers submit plans for the annual capital budgeting cycle... cash commitments are made then.

Most companies prefer to

- allocate [capital] to research and projects and not to things they can acquire otherwise.
- Management considers whether they need the cash for other investments.

In all cases, interviewees emphasized market conditions in real estate decision-making. Image appeared to be another key consideration. One manager said that one of the motives for their involvement in joint ventures is that

they are very interested in design and aesthetics
...If [they] are going to do things with [their]
name on it, [they] want it to have a good image.

6. Changes in Strategies:

Increased competition and other changes in the business environment have caused corporations to implement organizational changes, such as reorganization and decentralization. These changes, in turn, have accentuated the need to more actively manage real estate assets.

Many companies have been more "cost conscious" in managing their real estate and other assets as result of changes in the business environment and concomitant internal changes.

- As a result of reorganization and... decentralization, relocation studies and other analyses have been conducted to compare costs of different alternatives...these issues were there before but were accentuated by this.
- With greater emphasis on separate business units, there is pressure to maximize each business unit's performance.

Several companies have consolidated to reduce costs and increase operational efficiencies. One company has been "significantly reducing the number of headquarter buildings...and decentralizing some of the headquarter functions...to other areas to pursue organizational and

financial objectives." Corporations in technological industries have been particularly affected by increased competition. As a result,

- they need to look harder at how to preserve the margins.
- Flexibility is a key operational goal.

7. Characteristics of Business Needs:

A major factor in considering whether to lease, buy or participate in a joint venture is the need for flexibility of the business user. This depends on the type of use, duration of the business need, size, whether it is a special or general purpose use, and the capital investment required.

Different uses have different needs. For example,

- convenience to customer is particularly important for marketing/sales offices
- Manufacturing and research and development are more concerned with availability of labor and access
- Client access and image/identity are important in decisions regarding corporate headquarters.

Most companies have "rules of thumb" for decisions of whether to own or lease. One company does not have standards because they feel it is contrary to goals to maintain flexibility. Generally, companies interviewed own manufacturing facilities

- since [these uses] require relatively large investments
- They want the flexibility to make changes to the facility without having to get the landlord's

permission.

One interviewee considers marketing/sales offices to be "mostly predictable ...generally growth is stable...unless all customers move out we'll be there. Yet they are still concerned about flexibility...In most cases offices are leased."

Leasing is necessary for sales office...it gives them flexibility.

For larger office uses in major cities, many companies own or retain some form of equity interest in the property. Whether research and development uses are owned or leased depends on the predictability of their needs. One manager reported that

while they would prefer to own research space, if they can't predict the needs far enough in advance then they will lease.

At one company, they find research and development facilities to be "too unpredictable and unstable to justify participation in joint ventures themselves, but by combining both uses in joint venture developments in major cities, a core of corporate users is established, which may not have existed with marketing uses alone...This enhances flexibility for users by affording greater opportunities for relocation or expansion within the development...They consider research and development and marketing/sales offices to be interchangeable...[with both these uses in a development] it's easier to plan."

8. Proactive vs. Reactive:

Real estate asset management is generally conducted on a reactive basis. Business units identify needs. Real estate managers then assess alternatives to address these needs.

Most companies are

- driven by the company's requirements ...that is how they start their planning.
- Real estate decisions start with facility planning...[business units] determine the need, then once they decide to relocate they do a market analysis and evaluate alternatives.
- The operating group goes to the real estate department with a need for space in x location...then the real estate department does the site search.

Some companies prepare strategies by region. This facilitates pro-active planning. At one company, the business unit is responsible for developing the regional strategy to encourage them to plan further in advance. The real estate group then reviews and approves it.

Regional strategic plans are the main vehicle for them to know what opportunities there are.

Other companies plan pro-actively by designing and developing facilities that can be more easily adapted to other uses or tenants. A few companies are even more pro-active. They evaluate properties to identify those with opportunities to extract value. However, in most cases, business units make the final decisions.

9. The Future:

Trends that will continue, or possibly intensify in the future include: more active management of real estate assets in foreign countries, design of multi-corporate use facilities with some equity participation by the corporation, participation of institutional investors and capital markets increasing, and less ability to predict business needs.

Changes in the business environment which reduce the planning horizon are expected to continue. This trend affects real estate management strategies i.e., it further emphasizes the importance of flexibility. Managers interviewed noted that

- business has been changing more rapidly within the last ten years.
- They are already getting more short term proforma oriented, it is getting harder to do large upfront investments as result.
- They no longer do five year forecasts anymore since they were constantly changing.

The design of multi-corporate use facilities with some equity, would enable companies to maintain flexibility and simultaneously capture some of the value they contribute as a tenant. Some companies interviewed already employ this strategy. On the other hand, one manager stated that, given the complexity of joint ventures, they anticipate

a move to the capital markets rather than developers to get value for their status as

tenants, such as through sale/leasebacks.

Corporate managers will focus more on opportunities to reduce costs and to extract value by managing real estate assets abroad. All of the companies interviewed had real estate in several countries. One company has roughly "45 percent of real estate in other countries...Since there has been a lot of growth in Europe and the Far East they plan to consolidate a lot." They are also "encouraging advanced planning by managers in other countries, which is important because land is often more scarce in these countries."

CHAPTER 6
CONCLUSIONS

1. Asset management has become increasingly important

Trends in the business environment have contributed to the greater emphasis on asset management as a means to enhance shareholder value. With reduced profit margins they are finding themselves under greater pressure to minimize costs. The increasing number of takeovers, in which relatively high premiums have been paid to shareholders of target firms, illustrate the opportunities which are available to enhance shareholder value, if resources are put to their "highest and best use."

2. There is often substantial value to tap in real estate assets

Real estate is a significant proportion of total assets of U.S. industrial corporations. Since management views these assets as productive assets, having value as an ongoing concern only, they often underestimate their value. This is one explanation for the "under-management" of these assets, as compared to other corporate assets. Other explanations include slow decision-making of corporations, organizational conflicts and the corporate culture in general. Management, especially operational management, has not readily accepted changes in real estate asset management strategies. They can not imagine alternatives, they can not distinguish between market and operational value, and they can not imagine doing

that business in another facility or location. Joel Parker, a research manager at the Industrial Development Research Council, illustrated this issue very well when asking

how many chemical executives would raze a manufacturing facility and put up a golf course?

Though real estate assets remain under-managed relative to other assets, management has become increasingly aware of the potential value in these assets. Several companies have implemented strategies to "extract value." One example is the increased tendency of companies to share the benefits that they bring to developments as a major tenant i.e., through participation in joint venture developments. Some of these strategies have had a significant effect on the bottom line of the corporation. These cases, however, appear to be the exceptions.

In addition to management inefficiencies, several other factors contribute to the undervaluation of these assets including: discrepancies between book and market values and between earnings and cash flows, the effect on corporate return on assets and thus share price of low capital turnover, which is associated with higher levels of fixed assets, and opportunity costs associated with ownership.

3. Given the negative effects of ownership, management should consider whether alternative forms of control or capital structures are appropriate, given corporate strategies and space needs.

Reductions in shareholder value which may be attributed to ownership of real estate assets are evident from studies of spin-offs and sell-offs of these assets, which found positive effects on value as result. Unless the company has, for strategic purposes, decided to diversify into real estate, one would question whether corporate capital should be invested in real estate rather than alternative positive net present value investments.

In exploring alternatives, companies must look at real estate market cycles, company space requirements and corporate strategies and needs. These factors often conflict, yet they all contribute to shareholder value. In light of these factors, corporations should consider opportunities to increase leverage, to spin-off real estate assets, to participate in sale/leasebacks or joint venture developments, and other possibilities to enhance shareholder value.

5. Future possibilities

With greater investment in real estate by institutional investors and the increased securitization of real estate by capital markets, it is likely that corporations will find these sources of financing to be more attractive in the

future i.e., to participate in sale/leasebacks or spin-offs. As a result, there may be a trend to view these assets more like financial assets, and to further consider alternative strategies that enhance shareholder value.

APPENDIX A

Summary of interviews

Company A

Mission

Company A's mission is to minimize costs, which helps to enhance profits in their primary business. They do not consider themselves to be in the real estate business. Real estate is a cost of doing business.

Portfolio

They develop real estate for their own needs only. They consider these needs to be fairly specialized. They own 50 percent of their real estate; approximately 25 percent is located in one state with the remainder dispersed around the world.

Strategy

Technological advancements, increased competition and changes in the "focus of the industry" have led to changes in company needs. These changes, in turn, have affected real estate strategies. They are in a very competitive business in which the profit margin has declined. Thus they need to look harder at these strategies to preserve the margins.

Real estate management is one such strategy that is

being utilized. For example, possibilities to more efficiently use space and to increase flexibility are being examined. Having become a "global" company, they have been more involved in foreign real estate. They also try to plan acquisitions and development with greater foresight in anticipation of delays in the approvals process.

With the concern that land is becoming increasingly scarce they are acquiring property to ensure that they can meet future business needs. They are more selective now in acquisitions than they were a decade ago.

They might consider selling property as business needs change not to raise capital as cash is relatively easy and inexpensive to obtain. Consistent with the company's low debt to equity ratio and high availability of cash, they use internal capital to finance real estate ventures.

They have been involved in joint ventures to satisfy business needs and have simultaneously gained long term equity benefits. They consider joint ventures in larger sales or other offices where they would be a major tenant and limit them to office space, since it is easier to release this space if needed.

They have executed some sale/leasebacks in the past because of a policy to never own sales offices. Upon realization of the value of these properties, they were,

however, repurchased.

Decision-making

Business units determine needs. Once needs are identified, real estate management estimates size and cost and chooses a location. There are some standards used in these decisions. For example, they lease most sales offices to provide flexibility and lease all buildings under a minimum size.

After considering corporate needs and goals, they evaluate different alternatives in light of market and other conditions. Alternatives include lease, ownership and joint venture developments. In a soft market they would be more inclined to lease. In other countries, they consider currency and political risks.

They recognize that real estate is a substantial asset that is recorded on books at less than market value, and that some leaseholds have extra value. However, in their opinion, there are other reasons for takeover that pose greater threats than the potential for extracting value from undervalued real estate assets. In addition, they consider much of their property to be valuable only as an ongoing concern since it is so specialized. They estimate market value to be much lower than the amount they have invested in the property, with the land being the most valuable part. Generally, they consider manufacturing facilities illiquid.

Future plans

They aim to own more and lease less since a lease is considered to be debt. They have begun to look more at possibilities to consolidate leases. They are interested in the operational benefits from consolidating multiple leases. For example, the individual operations could share support staff. In addition, they predict that they will dispose of more properties in the future. These plans are consistent with their goal to minimize costs and thus increase margins through real estate asset management.

Company B

Mission

Their mission is to provide two functions; corporate oversight that involves the "intelligent" management of assets and service to users. They are aware of the possibilities to manage real estate assets to contribute to the bottom line. At the same time their goal is to try to determine the best way to service the customer.

Portfolio

Generally, marketing/sales offices are leased, and headquarters and manufacturing facilities are owned. Marketing offices vary in size from 300 square feet to 200,000 square feet. More locations are offices, but the bulk of space is for manufacturing, distribution and engineering.

Strategy

A centralized real estate group is responsible for everything from planning and development to facilities administration. To manage the relationship between the real estate and operating groups, individual staff has been assigned to separate business units. This approach is used so that real estate staff can better understand business needs.

After a major restructuring of the company, management recognized the benefit of approaching real estate from an asset management perspective. The industry and also the company have been changing rapidly. They have experienced and continue to plan for relatively fast growth. As a result, they have difficulty planning for future needs, and flexibility has become a key operational goal. With rapid change and growth, identity and image are also major issues.

To benefit from the value that they provide as tenants, they have equity leases on some of their larger marketing offices and they have been involved in joint venture development. A joint venture partnership was created to improve a property that they ultimately planned to dispose of. Without improvements, they predicted that they would not have received a "fair" price for the property.

Sale/leasebacks have been done in the past for financial reasons. They were able to raise cash at a lower cost of

capital through sale/leaseback. They use a mixture of debt and equity to finance real estate.

Decision-making

The financial and real estate groups make most final real estate decisions with input from the operating units.

Location is a joint decision. Their goal to reduce costs influences their location decisions.

They have developed an elaborate procedure for real estate decisions. Cost of capital for debt and equity is used to analyze alternatives. They look at opportunities for appreciation in a market in lease versus buy decisions.

Future Plans

Although they are not in a land banking mode, they plan to acquire more properties as internal needs arise. They want to use their leverage as a relatively large tenant in developments to generate income by negotiating better leases and through equity participation (i.e., through joint ventures). They also hope to reduce operating costs by operating more efficiently.

Company C:

Mission

Real estate at Company C is managed as a cost center. "The objective is to maximize flexibility."

Portfolio

This company has real estate in 34 countries. Generally, it owns manufacturing and larger distribution facilities, although they lease some manufacturing space. Most of the leased space is smaller, such as sales offices.

Strategy

Since everyone thinks that "having bought and sold a house they are a real estate expert" and since "they enjoy doing it" some painful mistakes have been made by operating divisions in real estate transactions. As a result, they are more sensitive to the cost of poor real estate decisions. Real estate management is trying to get more involved. In doing so, they are sensitive to the operating division needs. It is "always like walking a tight rope."

In the early 1980's, the company contracted. They took some large hits at this time in the disposition of properties that they had owned for a long time. Currently they are in an expansionary mode. For example, they are looking to expand their headquarters. They may participate in a joint venture development in which their headquarters would be located. The joint venture would be structured as a limited partnership. This would be their first joint venture in the United States.

They are considering joint ventures more now because

they recognize that they have left money on the table in years before where they had been a significant tenant. Another reason for a joint venture is to maintain a desired image. They have not been involved in any sale/leasebacks because they do not need the cash.

Decision-making

This company is decentralized to foster entrepreneurship. Consistent with this strategy, real estate decisions are the ultimate responsibility of operating divisions. Although operating divisions must refer to the central real estate group for certain transactions, this group serves in more of an advisory capacity.

The central real estate management group encourages operating divisions to plan in advance and helps them assess their needs. In lease versus buy decisions, the Treasurer makes the final decision, with recommendations from the central real estate group.

The key criteria in real estate decisions is to provide flexibility. For example, while there are tendencies to own or lease in certain cases, no standards have been adopted per se. This is to allow flexibility since some subsidiaries cannot predict their needs very far into the future. In these cases they may lease initially and move into their own space later.

Other real estate decision-making criteria include the company's outlook and the economy. To respond to these changing external conditions, decisions are short term, made from quarter to quarter. For example, if the company is short on capital at the time, they may lease rather than buy. They also look at earnings and cash flow. They compare costs of owning and leasing, the Treasurer and Chief Financial Officer arrive at a cost of capital to analyze alternatives.

They are aware of the significant discrepancies between book and market value. Threat of takeover, however, is generally not an issue unless the "stock goes crazy." Management, however, has undertaken measures to reduce this threat. One tactic employed by real estate management to increase awareness of potential sources of value in corporate real estate is to appraise property every five to seven years. They also distribute quarterly reports to management.

Future Plans

No significant changes in strategy are on the horizon. Some manufacturing facilities will be relocated. These include properties that were acquired as part of a relatively recent business acquisition. The real estate manager hopes to persuade corporate management of the benefits of acquiring land in anticipation of needs for expansion, possibly on a speculative basis.

Company D:

Mission

Real estate is managed as a cost, not profit, center.

Portfolio

Real estate is owned and leased in their base city. Sales offices are leased all over the world. Most are triple net leases so that they are responsible for management.

Strategy

In their primary line of business, they cannot plan much ahead of time. As a result, they constantly explore possibilities for expansion. They are currently constructing offices that they will occupy 100 percent of. These offices are being constructed on land that was purchased as a means to invest cash before going public. They hired a development management firm for a flat fee to oversee the development process since the company lacked construction expertise. This building was designed with reuse in mind. For example, it was designed so that half the building could be sublet to another tenant. Although participation in the cash flow and residual value of real estate is not a criteria in decisions per se, they successfully negotiated a major lease with an equity interest.

Decision-making

One of the key criteria in real estate decisions is the effect on employee productivity and availability of labor.

They want new space to be close to existing space. As an alternative, they have considered relocating to a campus-like setting. They have thus far chosen to stay at their current location. They are concerned about losing key employees if they relocate.

Generally, real estate is treated as a capital budgeting decision. They look at availability of cash and investment needs. The Treasurer and finance group are involved in these decisions. They view real estate as an investment to make now and sell later, if they need to generate cash in the future.

Future Plans

Although they have not really considered this yet, they plan to consider whether cash is needed to book a profit in making real estate decisions. For example, if they experienced losses or cash flows were otherwise reduced they might sell corporate real estate.

Company E

Mission

Company E's real estate group emphasizes service to its clients, the operating groups. It seeks to provide for the operating needs of the business.

Portfolio

Their portfolio consists mostly of handling, production, and warehouse facilities. They own the manufacturing and distribution facilities and warehouses. Most research laboratories are owned since they require relatively large investments and they want the flexibility to make major changes to these facilities. Most offices are leased. 90 percent of offices are field offices. They do not own these facilities because they are small (under 20,000 square feet) and used for a relatively short term.

Strategy

They consider their manufacturing facilities to have value only as an ongoing concern. They see little, if any, potential for reuse of their manufacturing facilities. On the other hand, they do see opportunities for reuse of office and, to some extent, research laboratories.

They own some undeveloped land that is farmed. This gives them a sufficient reserve of property in case they need it. A consulting firm was recently hired to assist in the sale/leaseback of research laboratories and their headquarters. Corporate management made this decision in response to a recent takeover threat and substantial reductions in cash.

Decision-making

The real estate manager works for individual divisions. The occupancy group goes to the real estate department with a

need for space in a particular location. The real estate group then searches for the site. The occupancy group would prefer to spend their money on production. For example, they may prefer to lease office space since they believe that they can earn a higher return on production and sale of goods. Generally, they are not particularly interested in investing in real estate for profit, unless there is an opportunity to sell at a high price.

If an operating group decides that a facility or site is no longer needed, it is declared surplus and will be sold. They make exceptions to this rule, if it would be more advantageous to lease the facility from a market perspective. They would not take it through the development process because they lack the necessary real estate expertise. On the other hand, they might hire a planner to explore possible uses for marketing surplus property.

They consider potential residual values in real estate decisions by evaluating market conditions and trends. They are more concerned with the value of products sold relative to total plant investment rather than occupancy costs (cost per employee). They also consider cash availability, the investment required, and the duration of the operating need.

Although they have a fully computerized inventory of all property, they are not aware of the current market value of property. They consider this to be too costly an

undertaking. For example, testing of property for compliance with environmental regulations would be necessary. Real estate is not considered to be a substantial proportion of total corporate assets.

Future Plans

They find it very difficult to plan for the future. As a result, they no longer complete five-year forecasts.

Company F

Mission

Company F explores creative ways to reduce operating costs. While they recognize the potential profits from real estate they do not see it as "making a difference to the bottom line." They are not expected to generate earnings for the company through real estate management. Instead they are expected to make the most cost-effective decisions.

Portfolio

Their real estate portfolio consists of manufacturing, research and development, and office facilities, 55 percent of which is in the United States. Just over half of this space is owned, the rest is leased or in joint venture partnerships. Manufacturing and research facilities are generally owned and marketing, branch and service offices are generally leased. Exceptions include large marketing offices in major cities. Some marketing and other office facilities,

approximately 25 percent in the United States, lease space in joint venture developments.

Strategy

Real estate functions within this company were split up along with other decentralization that occurred recently. One function that went to business units is the responsibility for developing a real estate strategy for each city in which they are located. These strategies include inventories and an assessment of needs. The real estate group reviews and approves these strategies. This process enables real estate management to familiarize themselves with potential opportunities in advance.

Five years ago, management made the decision to participate in joint ventures, which were considered to be the "third leg of the stool." Joint ventures were selected as an offshoot of the leasing side as opposed to the owning side. The impetus for this decision was that they had large presences in major cities. Management realized that as those offices grew, they would want to consolidate and did not want to merely hand over a large lease to a developer.

They have taken advantage of land holdings by employing them in joint venture developments. With joint ventures they can make long-term real estate decisions but maintain flexibility since they lease space in these developments. Joint ventures were initially used for large marketing

offices in major cities. They do not consider the marketing and research and development tenants that occupy space in joint venture developments to be special purpose. As a result, re-leasing is not much of a concern.

With the instability and resulting unpredictability of their business, flexibility is key. This is particularly an issue for research and development uses. By aggregating several office (i.e., marketing) and research and development users in large joint venture developments, reorganizations can occur with minimal disruption to operations.

Although the company's borrowing rate is relatively low and although they are not restrained by borrowing capacity, they still allocate capital among investment alternatives. Corporate policy is that capital should be allocated to research and other projects related to their primary business, not to assets that they could acquire otherwise. In addition, if they used their own capital they would just prefer to own 100 percent. As a result, minimal amounts of capital are allocated to joint ventures.

Another goal in real estate financing decisions is to limit the amount of debt on the balance sheet. By structuring joint ventures so that their participation is recorded using equity accounting, debt is off-balance sheet. Joint ventures are typically financed with all non-recourse debt. A disadvantage of outside equity is the difficulty in

managing the relationship with three partners.

Another advantage they recognize with joint ventures is that, "with a three to seven year holding period," financing is off-balance sheet. Since losses from depreciation of real estate are insignificant relative to the company's earnings, "depreciation does not affect earnings". Hence, the effect of real estate decisions on earnings is not an issue. On the other hand, tax considerations are a factor in real estate decisions. Since development partners are often more interested in tax benefits, taxes are considered in developing deal structure.

They will not acquire or develop property on a speculative basis, only if they anticipate a requirement. Some consolidations of manufacturing facilities and headquarter offices have been accomplished recently. Manufacturing consolidation was feasible because of increased space efficiencies in these operations. An innovative approach to reducing operating costs was to swap interests in property.

Decision-making

Business units assemble business cases, which include growth projections. The real estate group evaluates alternatives to satisfy their needs. Alternatives explored depend on the type of use, how specialized it is, and how stable their needs are. Another primary consideration is the need for

flexibility.

Real estate decisions are not just made for financial reasons. For example, joint ventures are done in part because it gives them more control over the design process. This is important since they are very concerned with image and quality of the environment for their employees.

They have undertaken studies to compare market and book values. Takeover threat does not affect real estate strategies. The majority of real estate owned is manufacturing, which would be unlikely to be "flipped at twice the value". They own relatively few office buildings and research facilities are predominantly leased.

Market considerations are a major factor in real estate decisions. For example, this company will lease surplus property rather than sell in a soft market. In addition, properties are sold if the right price is offered regardless of what the company's need for corporate earnings may be. This approach is consistent with their assessment that real estate, while generating profits, can not have a significant effect on the bottom line of the corporation. To minimize market risk, this company seeks to balance ownership and leasing of different types of uses within geographic regions.

Future Plans

They continue to encourage joint venture development as the

middle ground between leasing and owning. They hope to use this approach more in other countries. Since land is more scarce in other countries they are encouraging those responsible for managing real estate abroad to plan in advance, whenever possible.

Company G

Mission

Company G's objective for real estate asset management is to improve the financial performance through the management of real estate with the ultimate goal of increasing shareholder value. They view their real estate portfolio as assets from which they can extract value. They look at real estate as having a significant effect on the company's performance.

Portfolio

They own and lease real estate worldwide. They own all core facilities. Marketing offices are predominantly leased since they are relatively small. They have large marketing offices in major cities throughout the United States. If marketing offices occupied a significant proportion of total space within a building in major cities, they would consider owning these offices. With the relatively small sales/service support required for their business, they are able to own a high percent of their real estate.

Strategy

Real estate management has the support of top corporate management and regularly communicates with them. This enables real estate management to employ a strategy that is integrally related to corporate needs and strategies. To respond to constantly changing corporate needs and strategies, real estate asset management strategies are developed almost continuously. For example, they consider whether earnings are lagging, whether capital is needed, debt to equity ratios on the corporate balance sheet, or whether there are capital losses to be offset with capital gain to minimize capital gains taxes.

Several years ago the company undertook a major reorganization. These changes accentuated real estate issues that needed to be addressed. A new real estate management group was established. Since this group started with a clean slate, they were able to be financially driven rather than facility management oriented.

They are not in the speculative real estate business. If they already own land or there is a company need they can leverage, they will then participate in that value with the proviso that they do not use corporate capital. For example, instead of disposing of surplus property at a loss, they converted a manufacturing facility into an office park. They persuaded corporate management that by putting a little more money into the facility they could earn a profit (after debt service). In another case, they used a joint venture to

develop a portion of surplus property. This development would serve as the magnet that would enhance the value of the remaining surplus land. They act as a limited partner in joint ventures so that they can book the interest in the partnership with equity accounting. They use non-recourse debt to finance joint ventures.

In addition to joint ventures, they have also participated in tax deferred exchanges. They have not used sale/leasebacks because their current corporate borrowing rate is better.

Decision-making

This company analyzes its real estate portfolio to assess current and future utilization of the company properties. Then they look at the market value. They identify what the highest and best uses are for their properties. While they do not evaluate all properties in this manner, they look for properties where there are opportunities to create value. They start by comparing the value of property with existing and potential uses for more valuable properties. In one case they extracted value from a development on which they had a long term lease by selling development rights on the property. They relocated some of the users and cleared a substantial profit.

They have established a real estate subsidiary so that transactions can be completed with minimal delays and

bureaucracy. Sometimes operating divisions are given financial incentives to facilitate the desired real estate transactions. For example, expenses and some of the profits were paid to relocate a research facility. Real estate management had recognized that there was potential to enhance the value of this "underutilized" property and thus would generate profits for the corporation.

The real estate market, financial needs of the company, and corporate strategy are key real estate decision-making criteria. They consider market risks that result from owning substantial amounts of property within a geographic area. In one case, they sold a property to minimize these risks. In addition, they explore opportunities to improve operational efficiencies of business units.

Depending on the use, other factors influence real estate decisions. For example, the future needs of some marketing offices are hard to predict. These offices are leased to provide flexibility. Although threat of takeover has been considered, they do not see it as a significant threat because most office buildings are leased.

Future Plans

Their strategy has changed because of recent changes in the company. Since earnings (and losses) must be consolidated now, they are not willing to run large losses in real estate deals as they did before.

Company H

Mission

The mission of real estate management at Company H is to optimize value while servicing internal occupancy needs. They look for ways to realize value for the corporation through real estate asset management strategies. However, the real estate group's most important compensation is client (business unit) satisfaction.

Portfolio

This company's real estate portfolio contains approximately one-third special purpose facilities, such as research laboratories, and two-thirds general purpose, offices. Special purpose facilities are predominantly owned because of the large investment they require. However, if the special purpose business unit cannot predict its needs much in advance, then they will lease rather than own. They also own a lot of land. However, they have not acquired much additional land within the last five years. Recently they have been disposing of several smaller surplus properties.

Strategy

A few years ago they realized that several different organizations within the corporation were competing for real estate. To prevent this from occurring and because of the Chairman's interest in real estate management, they formed a

central real estate group and began managing these assets more aggressively. They find that the central real estate group can better manage their entry into the marketplace. As a result they can better negotiate deals.

They have undergone a lot of internal reorganization recently that has affected their real estate strategies and needs. For example, decentralization into separate lines of business has encouraged them to conduct relocation studies and to compare costs of different alternatives. They explore several ways to satisfy client needs and create value. With the emphasis on individual business unit performance, real estate management tries to structure deals to provide benefits to the units that occupy the facility in addition to corporate benefits.

The corporation plans to grow in strategic areas. Real estate, however, is not one of those areas. It is just a factor in decisions. They have found, however, that joint ventures can contribute to the bottom line in absolute dollars. In terms of impact on share price, the effect is much smaller.

They will not develop property on a speculative basis. However, they do pursue strategies to benefit from the value they bring to properties by being a major tenant. They participate in joint ventures, to benefit not only from equity but also from the developer's management and

expertise. The developer may also control desirable land. With joint ventures they have a financial commitment to the lease but not to the project. They recently completed a large joint venture development in a major city. They consolidated business users from several facilities within this new facility. Together, business units will lease approximately 55 percent of phase one of this project.

They also look at potential to create value by selling underutilized property. For example, they are selling a warehouse which was situated on a prime location in an urban area. They have been able to minimize occupancy costs by consolidating clients in some cases.

They have looked at sale/leasebacks but have found them to be more costly sources of capital than corporate debt. They have also resisted them thus far because they want to take advantage of the appreciation of real property.

They review opportunity costs to determine the optimal amount to be financed with corporate capital. Joint ventures are financed with non-recourse debt so that debt remains off-balance sheet. In addition, they want to reserve corporate capital for strategic business investments and debt is less costly than equity. They have participated in interest rate swaps to minimize interest rate exposure from floating-rate construction loans.

Decision-making

Real estate decisions are capital allocation decisions. Real estate management assesses capital needs for use in the annual capital budgeting cycle. Net operating cash commitments are made at this time.

They get corporate approval before negotiating deals to enhance their position in negotiations. Prior to obtaining corporate approval they determine facility needs and prepare a market analysis. The corporate strategy group is responsible for capital allocation decisions. Management reviews opportunity costs to determine needs for capital. Their assessment of capital needs influences the structure of real estate deals. For example, they may finance development on property they own with a joint venture structure that enables them to get cash out of the property.

Their real estate decisions are economic ones. They also give high priority to market conditions in real estate decision-making. For example, if they are optimistic about a market, then they will want to get equity benefits.

They explore different scenarios along a continuum from leasing to owning for each property. They then compare the value of different alternatives including owning, leasing, joint ventures and sale/leaseback. Tax implications are also important considerations. In lease versus own decisions they compare the net present value of lease payments to the net of

investment costs and benefits (tax benefits and residual value) of owning. They compare future values of the property with different uses to estimate potential residual values.

To minimize market risks in a geographic area, they aim to balance ownership structure and stagger leases within a region. In most cases, they do not develop property without a developer. In particular, they do not want to assume development risks without a partner in unfamiliar geographic markets. The use of a joint venture partner also reduces their vulnerability to development extractions by government agencies. They are concerned that extractions may be higher for them since governments, and others, perceive them as having deep pockets.

They have recently completed an analysis comparing fair market and book values. They also determined how much capital could be available to raiders by leveraging real estate assets. They have determined that there is not much risk of takeover because of undervalued real estate assets.

They are also interested in non-economic issues in real estate decisions. The most important of these is image. The decision to relocate headquarters to a "better address" was made at the Chairman's discretion, with image being a key consideration in this decision.

Future Plans

As their corporate planning horizon shortens, it is becoming increasingly difficult to make large up-front investments. In the future, they may look to capital markets to participate in sale/leasebacks of real estate. They view this strategy as a potentially superior alternative to joint ventures. Sale/leasebacks could be structured to generate profits in addition to providing needed capital. They also are much less complex than joint ventures. Another strategy they envision is the design of multi-corporate use facilities with some equity participation.

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