

Improving Financial Performance: Leveraging Real Estate Investments

Manhattan Whitepaper No. 3

by Nancy Johnson Sanquist

Introduction

An overlooked area of financial control is explored in this white paper. Dramatic results await the CFO who understands how the cost of real estate can greatly impact financial performance. Insightful chief financial officers are assisting real estate professionals in applying the same level of fiduciary analysis to real estate as other cost centers in the organization and thus increasing their financial IQ. There are now enterprise technologies to provide CFOs, along with their real estate and facility management groups, the information to make informed decisions on this expensive asset base as they determine where their capital should best be deployed. By calculating the total cost of occupying real estate assets, then monitoring, controlling and reducing these expenses, it has been estimated that a potential gain of 37% in shareholder value can be achieved based on only a 15% reduction in these costs.¹

In fact, in today's M&A environment, real estate is often the primary reason for the acquisition, as CFOs are recognizing the hidden value in these assets.² According to Chris Price of King & Spalding, *"While real estate may not be a central component of a business, assessing real estate is often a central component of business deals. Lack of attention to even simple factors-think title and certificates of occupancy, lease provisions, and taxes-can turn a good purchase into a dog."*³

Keith Perske of Sun Microsystems has observed, *"If an increase in revenue causes an associated increase in expense, better management of facility resources that leverage existing investments can create a wider profit spread with less ongoing expenditures. A 4% reduction in operating costs can result in the same profit as a 25% increase in sales because we're able to shift the savings from RE actions to places in the company where it can be highly leveraged."* John Suyker of Johnson Controls, in a recent review of the internal infrastructure management of Johnson Controls, described how a 10% occupancy cost saving resulted in a 28% EBIT increase.

¹ Siems, Ole and Morten Dehli, "European Automotive Real Estate Benchmark Study," MBA Thesis for Univeriteit Nyenrode, September 10, 2004.

² See Don Durfee, "Putting Property First," *CFO Magazine*, May 2, 2005.

³ Jennifer Caplan, "Meet Your New Property," *CFO Magazine*, May 1, 2003.

The CFO and the CRE

When *CFO Magazine* recognizes the importance of corporate real estate as they just did in two articles in the first half of 2005, we can see that chief financial officers (of non-real estate companies) and Corporate Real Estate (CRE) executives are finally getting on the same wave length⁴. A stunning example is Deutsche Bank's realization that Sears real estate portfolio was of greater value than the company's entire pre-merger market value. In fact, Deutsche Bank realized their own real estate portfolio was not meeting the bank's 25% return on equity target and it sold its bank branches and offices for €1bn in 2003. CFO Clemens Borsig said, "*For a bank, owning real estate isn't a brilliant idea. We don't need to own the property that we use as a bank, and we can get a better return on our equity by investing in other parts of the business, not in real estate.*"⁷

The real estate academic community has written many articles during the last decade on the correlation between shareholder value and ownership of real estate. In one recent research study it was proven that companies leasing all of their property had 20% less debt, 25% more cash and held 40% less inventory as a proportion of their assets than organizations who owned all of their real estate. It was also proven that they also contribute to higher total returns for their shareholders.⁵

Then one looks at the transaction volume recorded for US commercial real estate properties. These properties rose to \$160 billion in 2004 from \$120 billion in 2003 and that was only transactions over \$5 million. In fact, in a USI survey of CFOs done in 2003, 55% say that they took an active role in real estate decisions and 67% believe that role would have increased by now⁶. CRE has become a critical part of the corporate strategy and needs to align more closely with the CFO.

The Problem

In the past, CFOs viewed real estate as risky fixed assets which had a long lifespan and did not require active participation on their part. For some corporations, these asset portfolios are quite complex and include headquarter buildings, operating centers, service centers, data centers, labs, regional offices, stores, retail branches and even plots of undeveloped land. What the senior financial executives found (as cited in the previously mentioned 2003 survey), was that these real estate assets were not being managed anywhere near as tightly as other corporate assets.

The major CRE problems they cited included:

- Lack of a unified approach to managing the entire real estate portfolio
- Unclear lines of authority between the C-suite and CRE
- No consistency among CRE processes
- A decentralized approach in CRE management
- Lack of concern in significantly reducing operating and occupancy costs

⁴ These two articles are the one referenced in Footnote 2 and the other is by Randy Myers, "Looking to Land," *CFO Magazine*, January 1, 2005.

⁵ Meziane Lasfer, "Driving Shareholder Value. Corporate Real Estate-Freehold vs. Leasehold." London: Donaldson Research, 2003.

⁶ "Controlling Costs is Top Priority, CFOs Say," *NAIOP's Development Magazine* (Issue 01, 2004)

Since only 8% of the CFOs in the survey group gave their CRE function an 'excellent' rating, it is time for CRE executives to take more of an investment approach with their real estate assets and utilize more of the financial analysis tools available in the market today. But before they can do any analysis, they need to have a clear understanding of the inventory of that portfolio of assets and how they are performing, both financially and functionally. Sarbanes-Oxley (SOX) has also put pressure on CRE executives to change how their real estate assets are reported whether that means expenditures, revenues, liabilities, forecasts or specific transactions where creative financing (i.e. sales/leaseback) or debt structures are part of the deal.

The Solution

In order to satisfy this financial reporting, as well as resolve the problems the CFOs have observed in their CRE departments, it is time to create a unified corporate approach to managing both inside plant and outside plant assets. Management must streamline, document and, where ever possible, automate paper-based processes and spreadsheet analyses for real estate infrastructure management. An integrated, centralized database is required to determine where all of the real estate assets are located, how they are performing for each business unit, what their current market value is, as well as what is it costing to maintain and manage them. Gartner classifies these tools as Integrated Workplace Management Systems (IWMS). Manhattan Software is one of the world's leading IWMS providers. Without the implementation of an enterprise system like Manhattan, creating the high performance workplace to satisfy the needs of the enterprise is only a distant vision.

The Methodology: Decision Support and Performance Metrics

Gartner has recognized (May 2005) that in order to improve competitive advantage and employee impact, new innovative business models must be created⁷. Therefore, they have defined the 'high performance workplace' (HPW) which integrates technology (including IWMS, business intelligence and collaborative support), business process improvements and management, with the physical workplace and infrastructure. In order to define how this model would work in a particular organization, we must start with the following questions: 'What does the business need from real estate to satisfy their enterprise strategies to enable the creation of the HPW?', 'How will the performance of this HPW increase shareholder value and satisfy the compliance regulations?' and 'How will it impact the productivity of the employees?'

In order to provide answers to these questions for the HPW, an integrated IWMS must be designed around improved business processes. The business must have a clear understanding of what information is required to effectively demonstrate how real estate can have a positive influence on business-related performance measures by:

- **Operational Metrics: Improving the efficiency and affordability of operations:** An IWMS provides the framework to be able to capture all the costs of occupying owned and leased space (called the Total Occupancy Cost-TOC or the Total Cost of Ownership-TCO). This cost can then be a key performance indicator when it is divided by number of occupants, square feet/meters, total revenues, business unit revenues, total SGA (sales, goods and administration) costs, business unit SGA and invested capital. We suggest that TOC, and its accompanying metrics, should be made more transparent to the C-suite and shareholders and found listed in the Annual Report.

⁷ Tom Austin et al, "Introducing the High-Performance Workplace: Improving Competitive Advantage and Employee Impact," Gartner Research Publication ID Number: G00127289, 16 May 2005.

- **Productivity Metrics: Improving the productivity of people and place:** By creating KPIs that measure revenue/person (gross), Ebit/person (net) and comparing these to revenue/sf (particularly with commercial space), the productivity of the employees can be measured by location and benchmarked with others both within the company and outside. In addition, metrics which determine how efficiently an organization is making use of its real estate include identifying total cash occupancy costs and doing a comparison with the company's turnover and operating costs.
- **Value Metrics: Improving Return on Assets:** ROA is often the key value driver in a company. Therefore, ROA metrics should define how the real estate portfolio is affecting the value drivers in the organization. They include determining what the CRE cost of capital is and comparing it to the company's cost of capital, as well as calculating the TOC as a percentage of the free cash flow the organization generates. Another metric would be to capitalize the value of the CRE's debt and equity and measure it against the company's enterprise value. The ROA KPIs aid in setting key targets for measuring the High Performance Workplace. An IWMS was the only way a global financial institution was able to increase their ROA and proved so valuable that they were able to realize a ROI for the implementation in 18 months with the investment coming right out of the business units budgets.

We believe Real Estate professionals can help the CFO realize a higher return on both assets and equity. By investing in the implementation of IWMS systems, processes and education, the CFO can be assured not only that controls are in place for more efficient and effective standardized business processes, but there is better management financial reporting. This should ensure the decisions that are made on the real estate portfolio are done so in light of the business strategies and increased value is created for the enterprise.

This is the third in a series of Manhattan Whitepapers written by Nancy Johnson Sanquist, Vice President, Marketing Manhattan Software, Inc. She can be reached at nsanquist@manhattansoftware.com