FSR Insights

Financial Instruments, Structured Products & Real Estate Insights

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Business transformation: Real estate impact

Introduction

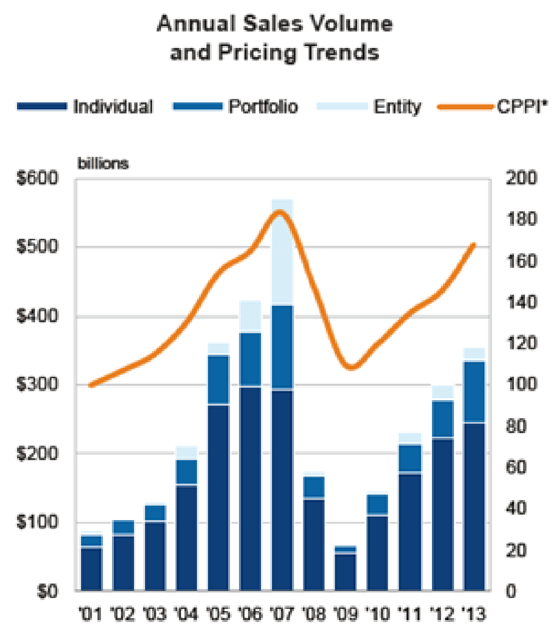
Business transformation is directly impacting real estate at all types of organizations within industries such as financial services, healthcare, energy, consumer products and transportation. The property types which these users typically occupy are office, retail, industrial and specialty-use (including medical, ports, and education).

By almost any metric, business transformations are taking place at an increasing pace. According to Thomson Reuters, M&A activity in the United States was valued at just over a trillion dollars (approximately 8,700 acquisition transactions) in 2013. This represents an increase of 11% over 2012.[1]

According to Real Capital Analytics, a leading real estate research company, sales of significant commercial real estate totaled $355.4 billion in 2013, a 19% increase from 2012 and the most activity since 2007.[2]

***FSR Insight**: A strong economic environment coupled with low interest rates and financing available to credit and credit-like borrowers is triggering an increase in activity through mergers, acquisitions, restructurings, spin-offs, consolidations or the creation of new subsidiaries.*

The total size of the commercial real estate market is colossal. CoStar (a market leading real estate data and analytics company) most recently reported the total inventory of the office, retail and industrial markets in the United States are 43.6 billion square feet comprised of 2.2 million buildings.[3]



Source: RCA
* RCA's Commercial Property Price Indices (CPPI) uses qualified repeat sale observations to measure price change in commercial real estate

In order to optimize efficiency and compete in today's business environment, companies need to keenly focus on specific actions to shave costs, improve operations and strengthen financial viability.

[1] Thomson Reuters, Mergers & Acquisitions Review, Full Year 2013

[2] Real Capital Analytics, US Capital Trends, 2013 Year in Review

[3] CoStar National Office Report Year End 2013; CoStar National Retail Report Year End 2013; CoStar National Industrial Report Year End 2013

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What is the real estate impact?

The impacts of business transformation to real estate are wide reaching and should be given significant focus.

Specific challenges

Challenges could be broad, but most often are tied to the following keys areas:

Financial reporting is a main focus as it affects the bottom line influencing public companies' stock prices, private companies' unit values, executive compensation and balance sheets. It is of the upmost importance to ensure financial statements are consistent and have the ability to be dissected in order to support a decision making process (i.e. down to the regional, operational or property level).

Future space needs and the associated strategic planning that accompanies this includes space programming and management's forecast of headcount, contractors and outsourcing.

Internal systems integration needs to be thoughtfully considered between asset management, leasing, and IT. Clear and robust policies and procedures can serve as a framework and reference for organizations to maintain consistency, accountability and tracking.

Communication is another critical component as companies should have clear, established lines of communication especially between business units such as management, marketing, facilities and finance.

Portfolio risk identifies potential deficiencies or gaps in allocations (including between property types and geographies). It is often challenging for mid-to-large sized companies with footprints that span regionally, nationally or internationally to identify portfolio risk without a robust process or platform in place.

Existing real estate

An immediate consideration for all companies is their existing real estate and whether they need to maintain, expand or consolidate their existing footprint to meet current and future business demands. Companies should be adept at asset managing current properties to understand their strengths and weaknesses.

***FSR Insight**: Each potential decision about the future state of the real estate can begin by considering future upside and any downside risks. These decisions must align with the business strategy.*

Maintain If the decision is to maintain the existing footprint, identifying underutilized assets as well as potential pros / cons is a must. In addition, a strong in place asset management function and facilities team allows for efficiencies to be gained.

Expand If the decision is to expand beyond the existing footprint, several factors must be examined including maximizing future flexibility, forecasting future company growth, understanding the cost of capital, and identifying target markets and submarkets to move into. Specific considerations for new real estate can include the important lease vs. buy decision, which is magnified when applied to a portfolio. Leasing new space triggers a market rent analysis to understand subject rents, potential new markets, and opportunities. Buying could mean purchasing an existing building, construction of a new build-to-suit or retro-fit of an older building.

Consolidate If consolidation is being considered, an evaluation of cost-benefits for all sites should be performed to identify essential locations. Specific factors evaluated should include profitability of specific sites, efficiencies, write-offs, proximity to customers and other existing sites, and limiting interruption of business operations. Cost mitigations such as lease buy-outs, subleases or downsizing the footprint in current space can all be effective strategies.

Dispositions The disposition of real estate is normal throughout the life cycle of real estate users. In order to maximize the return and minimize the disruption to company operations, a careful analysis should be performed to identify optimal timing and essential steps to consider when selling an asset. Value creation and monetization of an owned asset can also be completed by executing a sale-leaseback or re-financing.

Financial impacts

The financial impact is a critical component that any CFO, board, procurement or facilities platform must consider.

Occupancy costs The first and perhaps most direct impact real estate has on financial statements is on real estate operating costs which influences internal operating results. Typically, real estate expenses are the second largest operating expenses after payroll. Any cost mitigation in real estate operating costs immediately drops to the bottom line. As a simple example, a reduction in annual real estate operating expenses of just $5 per square foot at a single 20,000 square foot facility would be $100,000 annually. If capitalized at an 8% cap rate, it could represent an increase of $1.25 million in value and if applied to an EBITDA multiple of 10.0x, it could represent an increase in value of $1.0 million.

Structuring Another consideration that can reduce real estate operating costs and add significant value is proper real estate structuring, including understanding if the situation best calls for owning or leasing. Specific factors to consider include future flexibility, a company's cost of capital and management's forecasted growth (both operationally and headcount).

Tax impact For taxable entities, more detailed considerations should be given to the tax impact, which includes taxable income classification, depreciation, distributions and any applicable write-offs.

Accounting impact Another critical piece to the mosaic is the accounting impact which includes lease accounting guidance, lease classification (operating vs. capital), financial statements (income statement, balance sheet and cash flow statement), business combinations, write-offs and remaining liabilities.

Funding When expanding a current footprint, it is essential to consider the availability of funds, alternative sources of funding, leverage ratios and impact to debt covenants. Consolidation or monetization of owned real estate can offset or mitigate funding requirements.

Conclusion

All the real estate impacts touched on previously drive the most important element companies undergoing business transformations want to get right: business decisions. The corporate real estate strategy needs to be aligned with, complement, and support the larger business plan and carries through to internal approval processes, documentation and support and other critical considerations such as shareholders, partners, existing loan covenants, and disclosures / recourse required by lenders and partners. The failure to address and explore these critical items puts a company at a strategic disadvantage.

> ***FSR Insight**: Companies of all sizes are being impacted by the disequilibrium of their real estate portfolio, but perhaps the most at-risk are the middle market companies whereby the growth of the company has outpaced the size of the real estate portfolio, existing processes or platform.*

Understanding the real estate business transformation needs can have a positive impact on a company's financial and strategic strategy. It is a critical component to identifying significant cost savings, unlocking hidden value, and establishing a clear real estate strategy.

Additional information

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