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# Corporate Real Estate Acceptance

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

### Five Stages of Corporate Real Estate Management

In the early eighties, corporate real estate holdings were merely a necessity for firms to operate. In the absence of a well-developed commercial rental market, there was little alternative to developing or buying local offices and shops. Hence, corporate growth automatically resulted in the buildup of a portfolio of land and structures, which easily accumulated into a significant proportion of the balance sheet. But how to manage these corporate real estate portfolios has never been a very explicit boardroom consideration. In fact, the views on corporate real estate management, both from professionals and within academia, have evolved only gradually over time. This evolution of prevailing views on how to deal with the needs of corporate real estate exhibits a strong resemblance with the Kübler-Ross (1969) model, which describes in five discrete stages a process by which people deal with personal grief – denial, anger, bargaining, depression, and acceptance.

**Five Stages of Corporate Real Estate Management:**

**I. Denial**

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

**II. Anger**

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

**III. Bargaining**

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

**IV. Depression**

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

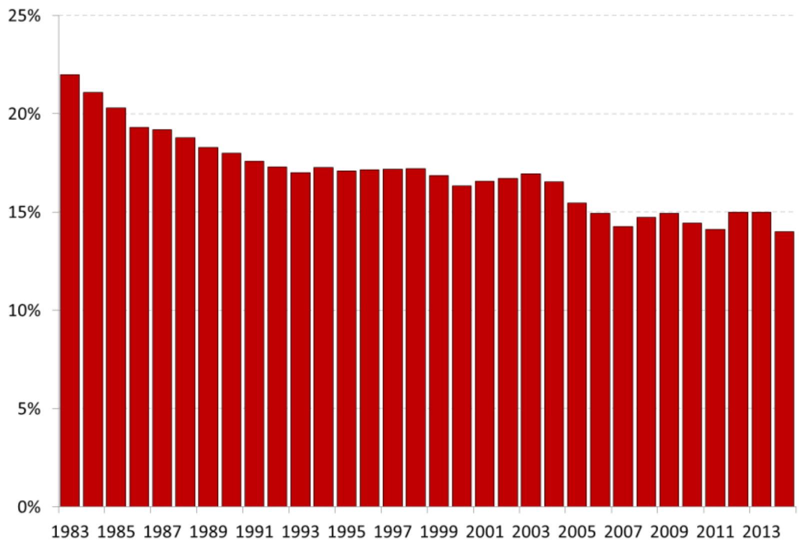
**V. Acceptance**

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

Although the literature on corporate real estate management has come a long way during the past thirty years, certainly not all firms have actually reached this 'final phase of acceptance'. No doubt, a lot has changed from the time of the call for rediscovery by Zeckhauser and Silverman in 1983. Apgar (1995) introduced his Real Estate Scorecard to help firms to swiftly gain a first snapshot of their company's real estate situation. By now, most firms have employed specialized corporate real estate managers, and have positioned corporate real estate departments that often report directly to the board. There is less 'denial' in corporate boardrooms when it comes to their real estate needs, right? In order to obtain the answer, we present the key results of the CoreNet/TIAS Corporate Real Estate Survey, in which we examine the level of real estate awareness among 291 firms worldwide, 30 years after Zeckhauser and Silverman's influential study.

Today, an increasing portion of corporate managers claim to have a full overview of their real estate assets. At the same time, we find that 34% of European respondents still admit to not knowing how much real estate they own. When checking the public records, we discover that the stakes have changed. Figure 1 reports the corporate real estate ratios – the book value of real estate assets over total assets – for the international constituents of the Dow Jones Global 1000 since 1983. While real estate assets accounted for over 22% of total assets in 1983, today thirty years later this number has gradually dropped to 14%. This trend can be explained by multiple factors. First of all, we have seen a wave of Sales-and-Lease Back (SLB) transactions that has helped firms to move some of their real estate assets away from their corporate balance sheet. There are multiple operational reasons for why firms prefer to rent rather than to own their real estate properties. For instance, to avail themselves of in-house professional property management. From a theoretical financial point of view, SLBs do not affect the value of the firm, as SLBs merely swap a sale price for a corresponding set of future lease payments. Switching from ownership to leasing should not reduce the importance of corporate real estate within the firm, it merely reduces the current weight on balance sheets -hence the upcoming IFRS Lease Accounting guidance-. In many cases this ratio has also dropped because the rate at which the total asset base increased has outpaced the real estate price trend.

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




In any case, 14% percent is still a significant number and judging by the wording in annual reports, we cannot claim that enough or transparently is communicated by firm management about this portion of firm value to claim that we are fully in 'acceptance' stage V. In fact, using a simple symantec tool when analyzing a set of 100 different annual reports, we encounter the word 'real estate' 1.4 times on average, and mostly in technical footnotes at the end of the report. Which compares bleakly to the fact that 'sustainability' was raised 7.2 times, on average. Counting words is hardly an adequate measure of acceptance or importance, but it does indicate that stakeholders learn little about corporate real estate management from reading these public reports. This, however, will soon change.

### IFRS Lease Accounting, a Game Changer

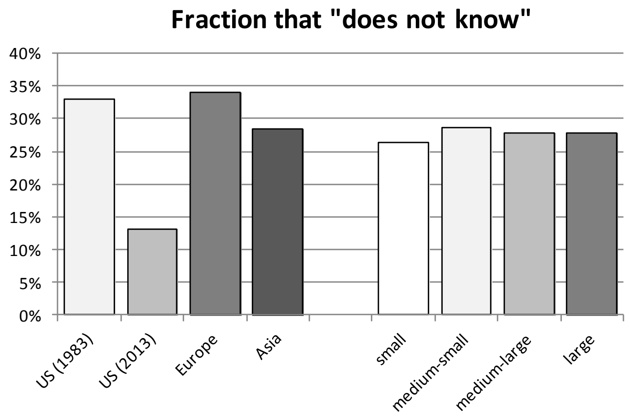
Ever since the International Accounting Standards Board (IASB) has started work on promoting a more unified and transparent set of International Financial Reporting Standards

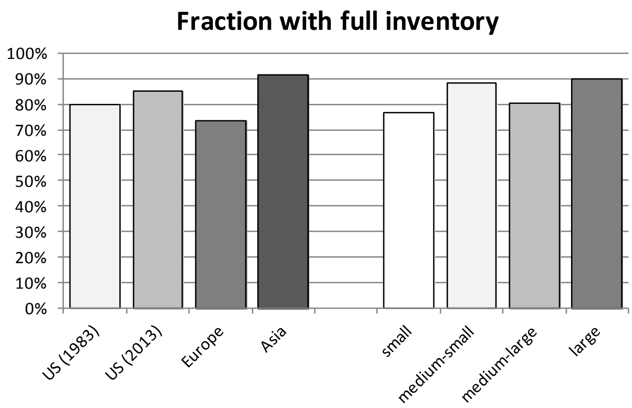
## The CoreNet-TIAS Global Real Estate Survey

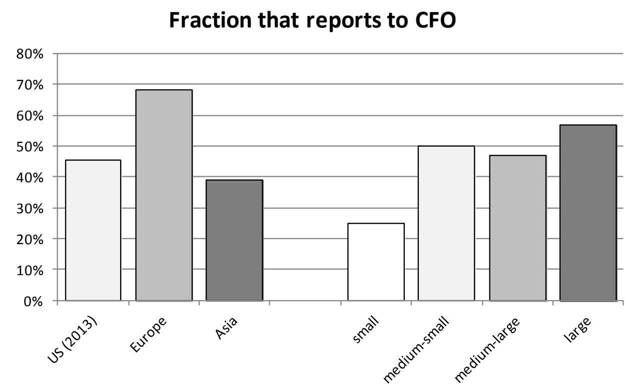
In 2013 TIAS School for Business and Society and CoreNet Global jointly surveyed over 3,000 CoreNet members on a variety of corporate real estate topics. This survey was designed after the 1983 Harvard Real Estate Survey by Zeckhauser and Silverman, which allows for comparisons over time and across continents.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

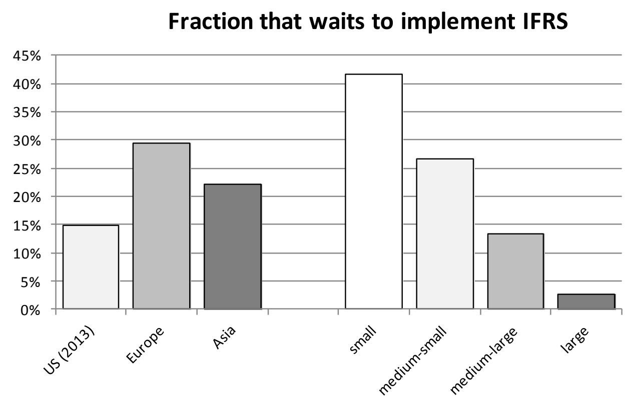
We address several issues, but start by examining the state of corporate real estate awareness. By posing simple questions on the knowledge and overview of own real estate assets, we can assess in which phase firms are today. For instance, on the question "how big is the stake of CRE as a percentage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

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



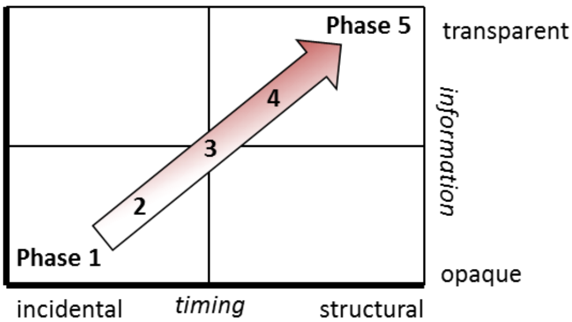



(IFRS) the standard IAS17 for "Leases" has been widely debated. While in the past, leasing meant that the use of assets would only count as costs through the annual profit and loss accounts, firms around the world awake to a future in which leases will appear much more prominently on their corporate accounts.

The IASB is close to finalizing a new Leases Standard that it plans to issue before the end of 2015. This new IFRS Lease Accounting standard will eliminate off-balance sheet accounting; essentially all assets currently leased under operating leases will be brought on balance sheet. The lease contract will be recognized both at the asset and liability side of the balance sheet and carried at amortized cost, based on the present value of payments to be made over the term of the lease. In other words, real estate use – both rented and owned – will appear explicitly on the firm books. This shift will greatly enhance the visibility of corporate real estate stakes and costs. Certainly, in the first few years this will have an impact on balance sheet ratios and thereby raise questions among shareholders. Questions that have not been posed for a long while and questions that require a board to be more fully aware of their corporate real estate position. This change in accounting standards will automatically (because compulsory) shift the way in which firms communicate about their corporate real estate management. While in the past information on CREM was often opaque and incidental, we now enter an era in which the financial reporting will ensure that the numbers appear more often and more prominently.

The same quest for 'enough' and transparent real estate data holds for standards such as Basel III, Solvency II and AIFMD; In figure 2, we sketch a simple

**Figure 2|** CREM Communication




## Shell Real Estate Services: acceptance in action

A Business Case

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

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

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

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

**CREM and Firm Value**

Improving communications is a means, not an aim in itself. But clearly, firms need to be able to articulate how much real estate they use, own and rent, and motivate these real estate decisions. All in all, corporate real estate, as any other asset for this matter, needs to be managed in order to maximize shareholder value. Clearly, much work has been done on how to align CREM with value maximization. A wide set of models and frameworks that take this corporate value perspective have emerged and can help us to identify the prime relationships that need to be considered when taking action. This far, remarkably little of this literature relates to the corporate financials involved.

Figure 3 gives an overview of the key drivers of shareholder value that can be influenced by corporate real estate decisions. Along the lines of fundamental value analysis, shareholder value is the result of cash-flows and the cost of capital.

**Shell Real Estate: awareness in action (continued)**

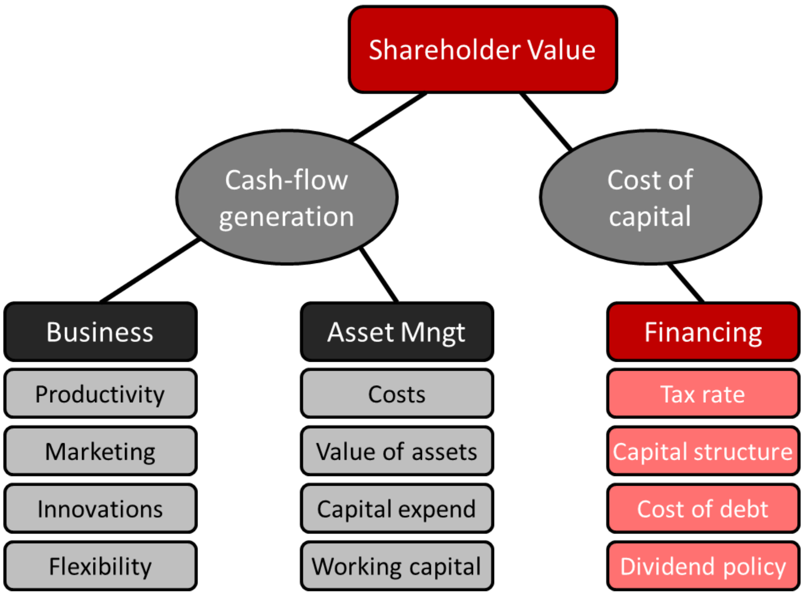
Only when they really understood the portfolio and the value that could be delivered, did they then started to involve senior leaders and senior stakeholders. That was a time, after 2003, that new conversations started about how real estate could be turned into a real good source of shareholder value.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

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

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

Generating cash flows comes from two main clusters of value drivers, the business and the management of assets. On the business side, cash flows can be strengthened by increased productivity, strong marketing, successful innovation, and an adequate level of flexibility. The rich management literature offers a wide supply of studies that discuss how corporate real estate can help to increase productivity, can strengthen corporate marketing, help firms to trigger innovation, and foster flexibility [1]. Regarding asset management, there is a wide literature that discusses how CREM can assist in cutting costs, and increase the value of the asset base.

**Figure 3|** The Shareholder Value Driver Perspective




Regarding the cost of capital, remarkably little evidence is offered. Given the vast flow of funds that are involved with CRE, one would expect that a clear analysis on the impact of effective corporate tax rates, capital structure, cost of debt, and dividend policy is available. This however is not the case.

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

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

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

**Final Steps towards Real Estate Acceptance**

Thirty years after the call for real estate rediscovery by Zeckhauser and Silverman, and, in the veiling glare of new standards as IFRS Lease Accounting, Basel III, Solvency II and AIFMD, we move into an era in which annual reports disclose more than book values of corporate real estate ownership alone. This new transparency will trigger dialogues that require firms to swiftly move into phase five: real estate acceptance. There is no one-size-fits-all solution for corporate real estate challenges. But in all cases, firms need to get ready to accept that stakeholders will start to ask corporate real estate questions.

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

Therefore this article is not about providing exact answers, but about reducing surprises of new posed questions and mitigating the effects for the firms that are not yet in the fifth phase of real estate acceptance.

Of course every corporate real estate manager knows about the importance of Business Intelligence, industry benchmarking and the effects on their financial value drivers. But it all starts with good records and a clear corporate real estate position within the industry. A general principle is that, while in the four stages you can use the best set of information you can find, and rely on it, doing so can be harmful in the sense of raising a lot of questions that are hard –or maybe impossible- to answer. In other words, not being in the fifth stage is where the difference between absence of information and information of absence becomes acute.

Luckily there is time to make these steps and gather this information, but agility is key. Because; in the end it is those who derive consequences and seize the importance of the ideas, seeing their real value, who win the day. They are the ones who can talk about the subject.

In case the value chain is not responsive enough to jump to real estate acceptance, we offer a final advice. Every board should spend 45 minutes a year on Real Estate Pursuit. A board game in which vital real estate questions are asked, and where correct answers can be formulated collectively. Five themes are discussed, each in nine minutes, resulting in a total score that indicates the phase in which your firm's real estate is currently at. A game that is entertaining and revealing at the same time. Fun to play, and a good exercise for when these questions will soon be asked by your external stakeholders.

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