

Section III

Real Estate

All facility managers are in the real estate business. As a minimum, the company leases its space. Some facility managers have full-blown real estate divisions or departments in their organizations.

In this section, I look at standard options for a growing organization: buying or leasing and at what site. Also, I look at the considerations of becoming a lessor. Since many facility managers have some property management responsibilities, I also discuss that function.

7

Real Estate Options

Pulse Points

- *The facility manager must coordinate the user, legal, and financial requirements for good purchase-lease decisions.*
- *The facility manager should actively participate in site evaluation and acquisition.*
- *The facility manager should have an active plan to manage the inevitable politics of site selection.*
- *The facility manager should learn as much as possible about any site to be acquired, but enter all negotiations knowing that he probably knows less than the current owner.*
- *When considering a real estate acquisition, the facility manager must also think about an exit strategy.*

The decision to purchase or lease real estate goes to the very heart of a company—its culture, investment strategy, and desire for control. It is important for decision makers to identify the opportunity costs for each option, in present value terms, but the final decision may just as likely be made for subjective reasons. Nevertheless, in this chapter I discuss the factors that go into this decision as they relate to facility management, including the consequent responsibility of site selection, should that be within the manager's realm.

Purchase or Lease?

Although there are two major applications of the lease versus purchase process—the acquisition of major properties and sites, or major equipment—this chapter deals with the lease or purchase of real estate. The lease versus purchase analysis is a capital budgeting analysis that compares the pertinent costs of each method on an equal basis. Most facility managers need help in making these decisions. Joseph Horowitz, the director of administration for CBS, Inc., discusses user requirements and provides a predecision checklist for real estate decisions.¹ In addi-

tion, building assessment is a fledgling technique that helps managers match an organization's needs to a proper building. For the financial aspects of this decision, there are accepted accounting principles regulated by the Financial Accounting Standards Board.² But to begin, let's look at the factors to be considered in the lease versus purchase question.

The Buy-Lease Analysis

In theory, the analysis is quite simple. The net present value (NPV) of the cash outflow associated with the lease option is compared to that for the buy option. The lesser value is the preferred option.

Most companies have a financial analyst or accounting firm capable of computing cash outlays and NPVs for each option. You'll need the following information:

- The company's cost of capital
- All lease terms having a financial impact, especially the lease payment
- The purchase price of the real estate or equipment plus any other financial terms related to the purchase
- The company's incremental cost of borrowing

Answers to the following questions must be obtained, compared, and analyzed to make an appropriate decision:

1. Has there been an appropriate in-house evaluation?
2. Has there been an independent evaluation?
3. Is the primary issue least-cost financing?
4. Is the purchase or lease decision to be treated as an independent project?
5. Is the lease to be considered a financial or an operating lease?
6. Have options been maximized?
7. Will the value of the property decline at least 75 percent over the term of the lease?
8. Have Internal Revenue Service (IRS) guidelines been checked?
9. Will the lessor absorb operating or maintenance charges?
10. Who will receive the investment tax credits?
11. How much equity is available from expendable property?
12. Will additional property be required to make this project operational?
13. What is the estimated productive life of the property?
14. What is the inflation trend?
15. What is the trend of interest rates?
16. Have state and federal legislative agenda been checked for pending legislation?
17. What are the additional expenses chargeable to this project?
18. What is the marginal tax rate?
19. If the real estate is purchased, how will the project be financed? (term and rate)

20. If the property is leased, how will the project be paid? (term, rate, options, and taxes)

Risk is a major criterion in a number of lease versus purchase decisions. Ideally, there should be no significant difference between the risk of owning and of leasing the same property. However, management's perception of the company's strengths and weaknesses, the economic climate, and governmental constraints may drive the decision.

Based on cash flow, each project should be evaluated independently. Items such as investment tax credits, other accrual items, return on assets, effect on working capital ratios, and effect on debt-equity ratios must be considered when analyzing a buy situation.

The asset will definitely become part of the business, but it must be determined how that will happen. Should the business pay rent, or should the business purchase the asset? There are benefits to both situations. Therefore, a financial analysis will be a present value comparison of cash flows resulting from purchasing an asset on the one hand or leasing the same asset on the other hand. The objective is to select the particular action that minimizes the present value of cash outflows.

The following information is required to perform a buy/lease analysis:

1. Purchase price of the asset
2. Other terms of the purchase option
3. Company's incremental borrowing rate
4. Lease payment
5. Other terms of the lease, including buyout costs, cancellation costs, and length
6. Company's cost of capital

A buy/lease analysis requires finding the cash outflows associated with the lease option, determining the cash outflows associated with the purchase option, and computing and then comparing the net present values of the cash flows. For an example, see Exhibit 7-1.³

Whether purchase or leasing is preferred varies also according to the investment capability and philosophy of the company. For instance, certain government agencies are regularly either owners or lessors. Manufacturing companies are more likely than service companies to choose ownership.

Advantages of Purchasing

Although it is seldom stated, most arguments for buying are emotional, political ones. Companies like the control inherent in purchasing, particularly real estate. For organizations that want to convey a high standard or a unique look, the purchase option greatly enhances that. In fact, the desire for control is so strong—

Exhibit 7-1. Buy versus lease.

Your company's lease is coming due next year and you need to decide whether you will remain at your current address and sign a new lease or move to a building that your company would then purchase. The cost of capital is 10 percent. The tax rate is 40 percent. The building would be depreciated using straight line with a \$800,000 salvage value. Current IRS law requires a building to be depreciated 31½ years, but for purposes of this example, the building will be depreciated only 5 years.

Alternative A: Sign a five-year lease with annual lease payments of \$700,000. Your company is currently in this building and will not need any major modifications to the building.

Alternative B: Purchase a building for \$2,000,000 and spend another \$600,000 in renovations for your company's needs.

Alternative A

	Years	0	1	2	3	4	5
Lease payments		(700)	(700)	(700)	(700)	(700)	
Tax shield		280	280	280	280	280	
Net cash flow		(420)	(420)	(420)	(420)	(420)	
Discounted cash		(420)	(382)	(347)	(316)	(287)	
Cumulative		(420)	(802)	(1,149)	(1,465)	(1,752)	(1,752)

Alternative B

	Years	0	1	2	3	4	5
Buy building		(2,000)					
Renovation cost		(600)					
Depreciation			(360)	(360)	(360)	(360)	(360)
tax shield			144	144	144	144	144
Salvage value							800
Net cash flow		(2,600)	144	144	144	144	944
Discounted cash		(2,600)	131	119	108	98	586
cumulative		(2,600)	(2,469)	(2,350)	(2,242)	(2,144)	(1,558)

Preferred Alternative: Alternative B. Your company should move into the new building and make the purchase.

Source: Heidi Lord Butler, notes from IFMA "Facility Accounting" seminar, Seattle, November 1989.

particularly in large, well-established companies or smaller companies greatly concerned about their image—that "doing the numbers" is often a waste of time.

Other advantages of purchasing are that property appreciates in value over its life; in fact, some view purchase as a good hedge against inflation. Also, life-cycle costs are normally less, property has a disposal value at the end of its use, property can be a source of later financing, and annual depreciation can be writ-

ten off. Finally, expansion and alterations at an existing site can usually be accomplished more rapidly.

Advantages of Leasing

Leasing certainly has its advocates. For a young company, leasing its space may be the only real option. If a company cannot resource at least a minimal facility department, leasing may be the only solution. Even some major companies have policies that expansion, at least initially, is accomplished through leasing. Almost all companies lease some property for unexpected new requirements, to meet temporary needs, or for initial expansion. In the current business environment, companies use a balance of owned and leased space to provide them business flexibility.

The other advantages of leasing are the tax deductibility of lease payments, accelerated if not immediate delivery, the opportunity to have state-of-the-art buildings and less risk of obsolescence, a predictable cash flow during the initial term of the lease, the lack of a large initial capital outlay, and maintenance with the lease.

Perhaps the most negative characteristic of leases is the inability to predict and control costs. Even a tightly negotiated lease leaves option year costs contingent on some type of index. At renewal, the company can face substantial increased costs or the option of moving elsewhere.

Sale-Leaseback

A method that combines the features of real estate ownership and leasing is sale-leaseback. If applied correctly, this maximizes the value of the company's real estate assets by reducing occupancy costs while permitting the company to maintain long-term control.

In a sale-leaseback, the corporation sells one or more of its properties to a limited partnership and simultaneously leases back the real estate for long-term use. The typical transaction has three participants: the seller or lessee, the purchaser or lessor, and the lenders. Sale-leasebacks offer many benefits, including:⁴

- Raising funds for 100 percent of the property's value
- Long-term, fixed-rate capital
- Long-term control
- Off-balance-sheet treatment
- Earnings improvements
- Cash flow

The Negotiating Process

When negotiating a lease, an entirely different set of considerations must be made. The extent to which the lessee may be favorably accommodated is strongly affected by both financial considerations and other factors. For example:

- *Size of organization.* Large organizations always ask for and receive more favorable lease terms than smaller organizations. If your size or the nature of your organization makes you a prestigious tenant, strengthen your position during lease negotiation.

- *Stage of building construction.* During the early stages of building construction, a lessee can get the most favorable lease considerations.

- *Part of building occupied.* Generally the highest floors with the best views afford the fewest leasing concessions. Accepting lower-status space offers the greatest opportunity for other concessions.

- *Availability of space in the area.* In overbuilt cities (vacancy rates of 10 percent or more) leasing organizations are much more likely to be accommodating. In cities where the vacancy rate exceeds 15 percent, it is not uncommon to ask for and receive up to one-third of the term of the lease in free rent, in addition to special furnishings and other concessions. It is reasonably common for a lease to be written at "net zero" or just for the lessor's operating expenses under these conditions.

- *Term length.* Most leases for commercial spaces are for five or seven years. The facility manager in search of space should remember that lease terms may be written to accommodate the lessee, and different lengths may be better for the organization. A lease with a term of five years will leave the organization that is growing rapidly with a burden of inflexibility years before the lease expires. It might be better to negotiate an original lease of three years with options to absorb additional space at a fixed rate at the end of the three years. Options to expand into suitable space (which may afford, for example, a better view, more status, or greater accessibility to interfacing departments) are also possible.

- *Operating expenses.* Operating expenses and parking are issues of some importance and may also be negotiated according to the relative strength of the market, position of the lessor, and priorities of the lessee.

The advantage of a lease decision over purchase may depend greatly on specific negotiable items in the agreement. For instance, cash benefits may accrue to the lessee if terms require little or no down payment and balloon payments after one or more years. The organization is then able to apply 100 percent of its income to operating expenses and keep its cash flow liquid.

It is important to negotiate the proper kind of lease (e.g., operating, financial, maintenance, leveraged) and be certain that the IRS recognizes the agreement as a true lease, not a rental-purchase agreement. (The rental-purchase agreement is treated as ownership by the IRS.) It may be an advantage to ensure that the lease does not affect the debt-equity ratio of the organization, since the IRS requires that most bank loans have debt accounted against equity.

It may be advisable to negotiate a varying cash flow. For instance, balloon payments can be scheduled to coincide with cash-rich periods within the fiscal year and avoid periods of cash drought.

In negotiating, understand the position of the lessor. Often the lessor is will-

ing to offer lower rates if he retains investment tax credits and rights to depreciation tax credits. A fluctuating taxable income may affect the lessor's willingness to grant advantageous fixed-rate terms, or he may be willing to offer variable-rate terms that are satisfactory.

Site Selection and Acquisition

Facility managers in companies that acquire and dispose of facilities routinely have a real estate division and financial, legal, architectural, and engineering experts well equipped to handle the acquisition and disposal of real estate. For most facility managers, however, site selection and acquisition can be the initial step on a major capital project that could be the highlight of their career. For that reason, it should be done with care, discretion, and prudent use of expertise to obtain the best deal for the best dollar on the schedule expected.

For the majority of facility managers, site selection and acquisition is so infrequent that it takes on a life of its own. There are always political aspects to site selection, for example. A common saying in the corporate world is that the headquarters relocation will always reduce the CEO's commute. It is not possible to eliminate politics totally, but you can take several steps to make site selection as objective as possible.

1. Establish a confidentiality policy and restrict access to those having a need to know, including administrative personnel.
2. Ensure that in-house personnel are objective and have broad-based knowledge of the company's requirements. Often a consultant is needed for focus and to do the legwork and analysis.
3. The criteria for selection must be credible and truly the most important factors. They must be developed within the corporation, and used to judge all sites. This is a substantial effort, and a consultant can be used here well.
4. The acquisition team should identify those individuals and groups who will be winners or losers in the various options or who will try to influence the decision. An internal relations campaign should be launched both to strengthen the voice of supporters and to minimize the detractors. Make sure everyone supports what the team decides because it is best for the company.

Given the importance of site selection, internal politics are inevitable. Fortunately in large firms, site selection is almost routine, thus less politically charged.⁵

Site Selection Team

The first task in selecting a site is to put together a team or committee to determine who the decision maker is and to set the criteria for selection. But if the decision is political, or if the chief executive officer (CEO) or chairman has predetermined the location, admit it up front and do not waste time on a search. That

sounds simple, but when the matter isn't viewed realistically, there's often much wasted time and energy.

In either case, prepare detailed cost comparisons for all sites or locations. Be sure that no single individual or department analyzes all the information, so that you obtain an adequate range of options and negate personal bias. It may be the final responsibility of one individual or department to propose the site or property; however, the team should offer its combined expertise.

Whether the team is all in-house personnel or includes an outside consultant depends on your personnel and their familiarity with the local market. A consultant is often used because most companies acquire sites so seldom that the staff cannot provide adequate advice, and large companies that operate internationally are not versed in local market conditions.

The consultant to use is a matter of personal preference. A new type of consultant—the relocation adviser—has emerged in all major U.S. cities to provide a technical and fee alternative to brokers. But your relationship with the consultant is more important than the type of consultant hired, particularly since brokers' fees can be negotiated. Also, it is not unusual for a company to augment the site selection team with an architect, a builder, legal counsel, and a financial analyst.

Decision Making

The factors or decision matrix used to organize the decision making may be simple or complex. Typical factors are given in Exhibit 7-2. However, each acquisition is unique and depends on the type of facility to be located and the work to be performed there. The more sophisticated decision models weigh factors according to their predetermined importance.

Undoubtedly cost is a factor in site selection, so the cost factors must be quantified. Typical cost factors are presented in Exhibit 7-3. Most facility managers prefer a rule of thumb approach to solving problems whenever possible. But facility managers with strong mathematical backgrounds might prefer to use mathematical modeling. *Facilities Locations, Models and Methods*, by Robert F. Love, James G. Morris, and George O. Wesolosky, discusses mathematical modeling for facility location.

The list of sites to be considered can be generated by the consultant, based on confidential general criteria set by the company. If no consultant is used, ascertain site availability from in-house data or a local guide to locations, available in most localities without charge and without unnecessarily exciting the real estate market.

The site search and evaluation should be as confidential as possible, but relocation searches are about as hush-hush as the Super Bowl and often take on characteristics of that event. Despite these limiting aspects of the process, the company and the facility manager must ensure that the final decision is credible, transparent, equitable, and comprehensive.

Acquisition

The line between site selection and acquisition is a fuzzy one. The acquisition process starts when the requirements and criteria for the site have been devel-

Exhibit 7-2. Major factors in location searches.

Access to Markets/Distribution Centers

- Cost of serving markets
- Trends in sales by areas
- Ability to penetrate local market by plant presence

Access to Supplies/Resources

- Cost of transporting supplies
- Trends in supplier by area

Community/Government Aspects

- Ambience
- Cost of living
- Cooperation with established local industry
- Community pride (appearance, activity, citizen views)
- Housing (availability, pricing)
- Schools, cultural and recreation programs
- Colleges, graduate programs
- Churches, civic groups

Competitive Considerations

- Location of competitors
- Likely reaction to this new site

Environmental Considerations

Interaction With the Remainder of the Corporation

- Is this supposed to be a satellite plant?
- Supplied by or supplier to other company plants?
- Extent of engineering/management assistance from headquarters

Labor

- Prevailing wage rates
- Extent and militancy of unions in the area
- Productivity
- Availability
- Skill levels available

Site Itself

- Area of site—layout of structure
- Price of site structures
- Construction/remodeling costs—insurance
- Condition

Taxes and Financing

- State income tax
- Local property and income taxes
- Unemployment and workman's compensation premiums
- Tax incentive/concessions
- Industrial/pollution control revenue bonds

(continues)

Exhibit 7-2. (continued)

Transportation

Trucking services

Rail services

Air freight services

Utilities/Services

Availability, quality, price of water, sewage, electric, and natural gas services

Quality of roads, police, fire, medical, and similar services

Source: Bruce N. Wardrep, "Factors Which Play Major Roles in Location Decision," in McKinley Conway and Linda L. Liston, eds., *Facility Planning Technology* (Norcross, Ga.: Conway Data, 1987), p. 322.

oped. Acquisition without a real estate professional, particularly one familiar with the local area and its political jurisdiction, is not recommended. If a real estate professional is not on staff, then hire a consultant because acquisition can be a snake pit without one. The seller will always know the property better than you. Consequently, try to learn as much about the site as possible. Don't overlook critical sources of information. Exhibit 7-4 is a listing of possible sources. The time spent finding this information translates into a firmer position during acquisition and can help avoid embarrassment.

If time and finances permit, use a team composed of yourself; an operations person; structural, mechanical, and electrical engineers; a communications specialist; and a security, fire, and life safety expert to prepare a property assessment. This assessment will focus on hard costs for the final acquisition decision and highlight factors that might block acquisition.

One of the best practical discussions of real estate strategies is the HOK consulting report, *Exit Strategies*. An exit strategy is a methodology for explicitly ad-

Exhibit 7-3. Quantifiable location factors.

- Site and preparation costs
- Construction (renovation) costs
- Equipment costs
- Labor and fringe benefit costs
- Start-up costs (e.g., training)
- Working capital requirements (e.g., inventories)
- Freight (in and/or out) expense
- Property taxes
- Workman's compensation premiums
- Unemployment compensation premiums
- Relocation expenses
- Revenue forecast

Source: Bruce N. Wardrep, "Factors Which Play Major Roles in Location Decision," in McKinley Conway and Linda L. Liston, eds., *Facility Planning Technology* (Norcross, Ga.: Conway Data, 1987), p. 322.

Exhibit 7-4. Sources of site information.

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- Federal and State Agencies
 - U.S. Geological Survey maps
 - Army Corps of Engineers' or state floodplain studies
 - Soil conservation maps
 - Regional land planning studies
 - Environmental protection requirements
 - City and County Authorities
 - City and county records
 - Zoning ordinances and maps
 - Property tax assessment records
 - Planning abstracts or surveys
 - Documents of Public Record
 - Mortgage history
 - Liens or other financial encumbrances
 - Long-term leases
 - Easements, covenants, equitable servitudes
 - Reversionary and remainder interests, rights of entry, power of termination (rare)
 - Other Local Informational Sources
 - Previous or comparable sales
 - Accessibility consideration; rights-of-way and availability of required modes of transportation
 - Site-Specific Data
 - Building permits
 - Building blueprints and specifications
 - Interviews
 - Planning consultants or other counselors
 - Real estate appraisers
 - Economic development agencies
 - Present and prior owner
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Source: Bruce N. Wardrep, "Factors Which Play Major Roles in Location Decision," in McKinley Conway and Linda L. Liston, eds., *Facility Planning Technology* (Norcross, Ga.: Conway Data, 1987), p. 322.

dressings factors that affect real estate risk and for accommodating the many changes that confront facility managers every day. Here are some of the considerations for exit strategies:⁶

- You have fewer options when downsizing. Downsizing companies should concentrate on leasing versus buying.
- A rapidly growing company should refrain from owning real estate until it has the cash that can be diverted to building ownership. Once cash is committed to bricks and mortar, it becomes nonliquid.
- High-volatility companies need to spend the most time in planning their real estate strategy and any individual real estate action.

- Alternative work strategies may assist or alleviate the impacts of exit strategies. Some of these alternative work strategies have implementation costs.
- The facility manager can provide the most value by giving good advice on controllable risk. A market-based partner may help in reaching good decisions.
- Before building or leasing, particularly the former, evaluate the market attractiveness for future sale, lease, or sublease. This is particularly important when considering building or renovating unique facilities with substantial mechanical or electrical infrastructure. Single-purpose facilities can be very difficult to dispose of.
- International acquisitions emphasize the need for thoughtful exit strategies.
- We can't always change our mind later; our decisions to build are, in fact, cast in stone.
- Orderly acquisition and disposition tends to be the most cost-effective.
- When negotiating a lease, ask for all of the rights that you can get that won't cost anything to obtain.
- Early lease renewals can result in more favorable rates.
- Facility managers should prepare multiple scenarios for business units so that their managers can choose among options. Never underestimate the time for decision making. Cost estimates need to consider both this deliberation time and that, once a decision is made, implementation will take time, particularly if leases have not expired.
- Never neglect the impact of business interruption.
- Downsizing often frees up small pockets of space. That space often can't be marketed until consolidated. There is a cost to that consolidation.
- Make sure that costs for an acquisition are in line with other speculative space in the area.
- Don't tailor the building for one tenant; plan it so that it can be used by multiple tenants.

The company counsel and a real estate professional can guide you around the potential pitfalls in negotiating the sale and closure. With their guidance approach the acquisition with three rules in mind:

1. Create the time envelope for the acquisition process and control it.
2. Negotiate with the principal owner.
3. Maximize leverage with the initial offer.⁷

The process of selecting a new site or property is only one phase of the strategic process of managing assets of the organization. You can attempt to influence top management to include relevant facility data in the formal decision making by offering specific information that significantly skews the financial projects, derived from your site-selection process.

The site and property selection process, when combined with the strategic planning process, offers greater visibility and credibility to the facility manager within the company than most other functions do. Therefore, upper management

will tend to judge the facility manager disproportionately on the quality of the site selection process.

Notes

1. Joseph Horowitz, "A Facility Manager Looks at Office Leases," *IFMA Conference Proceedings* (Houston: IFMA, 1988), pp. 125–138.
2. Bruce N. Wardrep, "GAAP Considerations of Lease versus Purchase Analysis," in McKinley Conway and Linda L. Liston, eds., *Facility Planning Technology* (Norcross, Ga.: Conway Data, 1987), p. 266.
3. Heidi Lord Butler, notes from IFMA "Facility Accounting" seminar, Seattle, November 1989.
4. John E. Jamerson, Michael J. Leahy, Peter M. Bradley, and Andrea D. Terzi, "The Sale-Leaseback, in *Facility Planning Technology*, p. 176.
5. Based on Charles F. Harding, "Company Politics in Plant Locations," in *Facility Planning Technology*, p. 354.
6. *Exit Strategies* (St. Louis: HOK Consulting, 1996), pp. 2–19.
7. H. Basil Hallquist, "The Fundamentals of Acquiring Corporate Real Estate," in *Facility Planning Technology*, p. 202.

8

Lease Administration and Property Management

Pulse Points

- *A company with multiple facilities requires careful lease management.*
- *The facility manager needs to be familiar with the principles of property management.*
- *When real estate development is the organization's goal, the facility manager should be part of the corporate development team.*
- *Properties should be disposed of when they are no longer of value to the organization.*
- *Development projects that are designed specifically for investment or resale purposes may severely inhibit the flexibility of the facility to respond to the productivity support needs of the workforce.*
- *Public sector facility managers must be politically astute in disposing of major public facilities.*

Regardless of a company's preference, at some time it almost inevitably is a lessor. For that reason, it is desirable to have at least a rudimentary knowledge of lease administration. And since many corporations choose purchase over leasing, it behooves facility managers to understand property management, including when to develop and when to dispose of real estate.

Lease Administration

When a company or agency, for whatever reason, decides to become a lessor, certain changes in management and attitude are necessary. Someone must be in charge of administering the lease (lease management) and in meeting tenant needs and ensuring they comply with the lease (property management). Additionally, at least part of the facilities department must reorient itself from a tenant

to a landlord perspective, while taking on both different types of legal and financial obligations.

The joint BOMA-BOMI* document entitled "Leasing Concepts" is a guide to leasing from the lessor's point of view, presenting a "know your enemy" strategy. Another approach is Michael Stack's "Lease Negotiations," available from IFMA. My personal favorite is *Managing Corporate Real Estate* by Robert Kevin Brown, Paul D. Lapidus, and Edmond P. Rondeau.

The Corporate Owner as Landlord

I have two disturbing observations on corporate real estate and lease management. First, too many large companies fragment their real estate management function from operations and maintenance (the same companies mistakenly separate design and construction also). The result is disjointed, suboptimal management of facilities. Second, too many companies turn the management of leases over to unqualified people, often as a secondary assignment. Real estate transactions are highly complex and require specialized financial, legal, and market knowledge. When there is no real estate professional on staff, get a partner to help. A knowledgeable professional is a hedge against a bad deal with long-term consequences.

In general, corporate owners are not good landlords unless they maintain a real estate staff, either in-house or a consultant. This is perhaps even truer in the public sector. There certainly are marvelous success stories of universities' financing their expansion by leveraging their endowment in the real estate market, particularly if some of the endowment consisted of real estate.¹ That is commendable, but the portfolio must be managed toward a set objective, the organization must be willing to accept a new level of liability, and the function must be properly resourced.

In Chapter 7, I discussed strategies for determining the proper mix of owned and leased facilities. In general, companies are using leasing much more extensively than in the past because leases provide the flexibility needed until rapid, short-term growth can be consolidated into assured cash flow or during periods of downsizing.

For most public agencies and corporations, the better policy is to own or lease only that space required for planned growth—that is, three years if planning is for three years, five years for five-year planning. There are some who disagree however. Alfred Behrens of Volkswagen, one of the first companies to manage real estate for other than corporate needs, states, "By the nature of our . . . industry we are also in the real estate business, and we might just as well make the best of it."² However, since facility management is already a daunting prospect, we recommend only those challenges of your own choosing.

Organization and Documentation

In medium and large companies, a small staff office is assigned the responsibility of lease administration. This staff reports directly to the facility manager (see Ex-

*BOMI is the Building Owners and Managers Institute; BOMA, the Building Owners and Managers Association.

hibits 2-2 and 2-3). Since leased space is often a short-term solution for space problems, this same staff often is also charged with strategic planning. If the company cannot spare an individual exclusively for lease administration, then this function is best given to the individual with planning responsibility. Because it requires contact with people outside the company, one individual should be the lease manager. In its most recent survey, the International Facility Management Association (IFMA) found that over 70 percent of facility managers serve in the role of lessee, fewer than 30 percent as lessor.³ But whoever is responsible for leasing operations must rely on counsel—either a staff attorney or outside counsel specializing in lease law.

You need a systematic method of organizing the company's leases. Once the number of leases reaches the double digits, move to a computer-based system.

Your automated system should provide pertinent information (options, termination dates, lease increases, etc.) at the time when it should be acted on. Ed Rondeau, director of consulting, Johnson Controls, lists the following benefits of a tracking system:⁴

1. Saves time.
2. Identifies opportunities to reduce real estate expenses.
3. Increases accuracy and reduces records duplication.
4. Provides reports and real estate analyses.
5. Efficiently transfers correct information to appropriate levels of the corporation.
6. Aids real estate strategy formulation.

The Lease Agreement

The lessor writes the lease and thus controls the leasing situation. Assuming that you have competent legal counsel, there should be few problems, but some areas require special attention if you are the lessor:

- With office technology increasingly entering the workplace, the lease should address how the cost of substantial electrical and HVAC (heating, ventilation, and air-conditioning systems) load increases will be handled. A major user, for example, could force the landlord to install a new electrical riser.
- The lease should specify proper installation and apportioning of costs for supplemental HVAC.
- The lease should certify that the space is free of PCBs, asbestos, lead in the drinking water, and common air pollutants.
- The agreement should be clear about special-purpose space, which varies substantially from common use, of the facilities. An example could be file rooms (high floor loads) and computer rooms (high HVAC, fire safety, and electrical loads).
- There must be adequate access and egress for material and debris, particularly for facilities that do not have freight elevators or loading docks.

- The lease must specify the use of tenant material handling devices inside the facilities.

IFMA has studied but has still not approved the best boilerplate lease for facility managers as lessees. Until such time, the following should be of particular concern when you enter into a lease as the lessee:

- Escalation clauses
- The building standard or “work letter”
- Tenant allowance and their applicability against extra work
- Signage
- Approval of tenant’s extra work
- Access by lessee’s contractor
- Weekend HVAC
- Division of costs for:
 - Operations
 - Major building alteration
 - Landlord repairs
 - Building services
- Subleases
- Appurtenances (parking, toilets, storage space, etc.)
- Rules
- Renewal options

Leasing can be mystifying, frustrating, and worrisome because it is fraught with legalism and seemingly biased toward the landlord. Nevertheless, if you are willing to learn the basics of lease negotiations, you will more effectively employ your counsel, broker, or consultant.

Trends in Lease Management

The nature of work is changing, and the real estate market shifts constantly. So you need to be aware of developments in lease management and anticipate changes. For example, tenants are seeking different kinds of buildings. This has produced the following trends.⁵

- Companies seek flexible buildings capable of housing research, laboratories, office space, warehousing, and support space—all in an attractive setting with increased amenities.
- Lessors are shifting as much risk as possible to tenants.
- Tenants are becoming more sophisticated in stating their requirements and in selecting buildings to fit their needs.
- More tenants are considering becoming developers and/or owners.

It has been said that capital costs come and go but rent is forever. However, the financial impact (cost or income) is only one aspect of lease administration.

Equally important are issues of liability and legalities. This is an area requiring both expertise and management. Whether you function as a lessor, a lessee, or both, you must bring those skills to the table.

Property Management

Property management is managing a facility to maximize profit. There is no negative connotation to the word *profit*. In fact, several large property management companies could give management lessons to facility managers. With a certain type and class of property, customer-oriented property management makes good business sense. Nevertheless, the bottom line is maximizing profit from those properties. Since many corporate facility managers also serve as property managers, it is worthwhile to discuss good property management. While there are many similarities, the facility manager should keep in mind the basic difference between himself and the property manager. The approach to a common problem may, in fact, be quite different.

Organization and Documentation

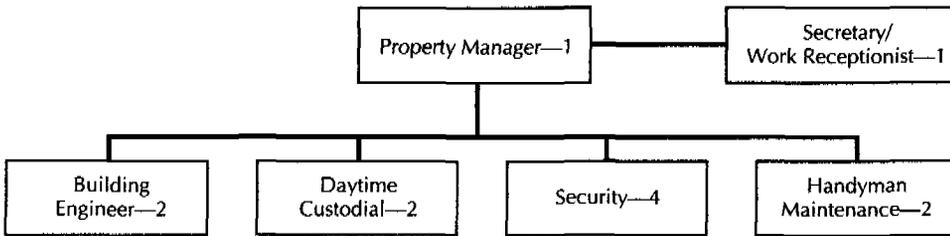
Normally the on-premises property management staff is smaller than for a corporate facility manager. Service and response are spelled out in the lease. Services over and above that are provided only if specially funded and in good time. This is because building services are primarily contracted out, with instantaneous reaction only for emergencies or life-threatening situations. Exhibit 8-1 represents a typical property management organization of a midtown, midrise office building.

The property manager is an exceptionally important individual to the tenants. Increasingly, it is the custom not to have a resident manager and, in some cases, not even an engineer or handyman on the premises. The property is serviced on an as-needed basis by on-call or roving personnel, with one manager managing four or five properties.

Certainly there is a break-even point for the size property that justifies a resident property manager. However, the following benefits to the tenants accrue when a property manager is resident:

1. Rules and regulations are enforced, and violations are discovered before they become serious.
2. Contractual services are performed to a higher standard.
3. Small problems are solved before they become crises.
4. There is less physical abuse of the facility.
5. Tenants have a visible presence for complaints, suggestions, and praise.

All of these result in a better-run building and a happier tenant. That should be reflected in higher renewals and the ability to charge top dollar for well-run space. I am extremely reluctant to rent in properties that do not have a resident manager, particularly office space.

Exhibit 8-1. On-premises property management organization.

Other contracted services (not on premises)

- Alterations
- Electrical
- Communications
- Custodial
- Window washing
- Pest and rodent control
- Signage
- Plants and grounds
- Elevator maintenance
- Supplemental plant engineering and plumbing
- Elevator maintenance

All (or any part of these) services could be provided by a property management firm. The handling of communications is dependent upon who owns the switch.

The same arguments for a managerial-level person on-site apply to a resident engineer or handyman. There is no greater insurance policy. A flood because no one knew where to find the shut-off valve, or the closest handyman was thirty minutes away when the main broke, will more than offset several years salary saved for an on-site handyman. However, it is important that this technical person have a sense of proprietorship in the building and be customer oriented. A lead engineer, skilled in the building's systems and in customer service, can serve the building and the tenants well.

Since profit maximization is the *raison d'être* for leasing a building, it is important that leases be systematically controlled. A proper lease management system has four characteristics:⁶

1. It is a real property database.
2. It is an action-reporting system.
3. It is a management-reporting mechanism.
4. It is a tool for real estate planning.

Services

Property managers should be interested in how their services are being rendered and how they are perceived by the tenants. There are many inexpensive ways to gain this knowledge—for example, by:

- Monitoring work requests for timeliness and completeness—by trade and by building location
- Quizzing the work receptionist or having him keep statistics or conduct short surveys
- Following up all or a percentage of service requests for satisfaction, with phone calls or with a brief questionnaire
- Having a tenant advisory council meeting, perhaps quarterly

It is extremely important that once this information is gathered, you take action and communicate your response back to the tenants.

Trends in Property Management

The changes in lessor-lessee relationships that were noted for lease management earlier in this chapter apply to property management as well. It is recommended that facility managers who also serve as property managers keep current with these trends and anticipate change.

Property Development

I admit a certain ambivalence toward facility managers' becoming property developers. Some argue that it shows how far facility managers have come; others say that the facility manager already has enough on his plate without taking on another major task; yet others are concerned that even before facility management is defined, it is merging into property management, where there's a different philosophy. The considerations are similar to those regarding ownership or leasing of property: Stay out of the development business but also realize that some of your colleagues will become developers by default. So if development is to be done, it deserves to be done well. And by "doing well," I mean that the shareholders receive a competitive return on their investment.

The Development Process

The process of development usually connotes a transition of function and improvement of a property. In Chapter 7 I urged the facility management department to work closely with finance, counsel, and top management in the lease versus purchase decision. I also suggested developing a comprehensive real-property database. Those suggestions are even more appropriate when considering property development.

The major difference between developmental activities and site selection or acquisition is that site selection is part of a process, the results of which are concerned with greater productivity. Development implies that improvement of a property will return a profit outside the organization. In other words, in site selection the facility manager offers advice that can optimize profits from internal activities; in development, the advice is tempered with considerations affecting the

future leasing and resale of the property. The significant criteria for maximizing internal activities were considered in the previous section. Here, I focus on the factors affecting return on investment as it relates to property acquisition and improvement planning for the leasing and eventual resale of the property. As implied in a quote from Alfred Behrens earlier in this chapter, a site selected to meet a corporate need may well offer opportunities for development as well.

Development Constraints and Considerations

A facility manager may be able to control most of the factors related to internal activities, but a developer develops sites to meet the needs of potential clients as well.

In property selection, attempt to persuade top management to consider properties in terms of employee and vendor access, or for their transportation capabilities. Investment properties may be better suited at locations that will service other clients. A facility manager is concerned that stacking plans (how departments relate to each other in a multifloor building) are consistent with communications needs and work flow. That same building, viewed as an investment property, should be developed according to the needs of potential clients.

A dynamic organization planning a building program may wish to construct a number of buildings that afford a panoramic vista. But when vistas are not available, lakes, rivers, or fountains can be constructed instead; this makes the total site desirable to others and promotes further development.

When developed for a particular company, the architecture for a building is integrated, and access to amenities is universal. However, when a building is constructed for outside clients, the architecture may be varied, and each will demand amenities not to be shared by others. Heterogeneous architecture presents considerable problems with regard to grounds keeping, traffic control, security, and features such as walking paths, jogging trails, food service, and emergency preparedness.

One concern of great interest to investors is the potential for efficient expansion. By their nature, some investment properties may not have the flexibility to respond to certain renters' specific needs. For example, an urban site, despite a favorable location, may not be appealing to a think tank desiring tranquility and a scenic view for its headquarters.

Among the factors inhibiting development flexibility are the following:

- Specific state regulations, zoning, or community demands
- Limited access to major streets
- Limited air rights
- Wildlife preserves and permanent open space
- Quiet zones
- Limits on land reclamation
- Inadequate public transportation
- Limited-capacity sewage and waste disposal
- Limited water and power access

- Historic preservation covenants
- Public housing dictums
- Public amenities dictums

If a facility manager becomes a developer, he must be equally concerned about his ability to dispose of the property to meet company business plans. Many of the factors listed above are equally applicable in a disposal scenario. Two other considerations are the extent that there might be regulatory time bombs on the property (e.g., submerged, leaking tanks or contaminated waste) or that the facilities are so uniquely engineered or so closely identified with a single company that no other organization wants to occupy them. Both factors can be deal breakers and make properties difficult, if not impossible, to sell.

The Development Team

From the facility manager's perspective, there is little to recommend the acquisition of a property for investment purposes. There are few advantages and many potential headaches. Nonetheless, the property may be acquired. The chief financial officer (CFO) will have a major interest in the development project, but it is the facility manager who must control the development team.

Although each development project is a unique challenge, the makeup of the team is fairly standard:

1. The facility manager
2. A land-use consultant
3. A concept designer
4. Counsel with local land-use expertise
5. An internal client representative (if one is involved)

The sole purpose of this team is to develop a project that will best meet company needs within available resources. They must sell the project to the necessary board or other decision-making body.

Your CFO can assist in determining what an adequate return is. The primary determinant is the cost of capital. However, the question then becomes one of choosing among potential investments. John Dues, of Mead Land Services, suggests the following:⁷

1. Manage the allocation of capital or cash resources to business units selectively.
2. Ascertain or confirm the long-term viability of each investment in its business.
3. Determine the overall performance objectives of the units.
4. Facilitate identifying critical threats and opportunities facing the business units.
5. Provide a baseline for measurement and control of performance during the planning horizon.

Exhibit 8-2. Forms of development ownership.

	<i>Advantages</i>	<i>Disadvantages</i>
Leasehold control	<ul style="list-style-type: none"> • No building management • Less administrative cost • Minimum front-end investment • Cost expensed immediately for taxes 	<ul style="list-style-type: none"> • Lowest appreciation potential • Generates no leverage
Fee simple	<ul style="list-style-type: none"> • Fullest range of financial options • Considerable tax benefits 	<ul style="list-style-type: none"> • "In-house" management attention needed • Up-front investment high • High administrative costs
Joint venture	<ul style="list-style-type: none"> • "Off-balance sheet" financing • Minimum contribution • Risk minimization • Flexibility 	<ul style="list-style-type: none"> • Can be complicated

Source: Peter Haverkamp and Gary Salton, "Real Estate as a Corporate Reservoir," in McKinley Conway and Linda L. Liston, eds., *Facility Planning Technology* (Norcross, Ga.: Conway Data, 1987), pp. 18–19.

These criteria help the team judge whether an investment fits the strategic planning objectives of the business. If it is compatible, then it is probably a proper investment, and the project can be assessed further, using primarily capital investment evaluation techniques.

The facility manager contributes information to the team effort regarding probable operating expenses, leasing information, engineering and architectural attributes of the project, maintenance programs, and costs for office building or industrial property developments.

By its composition, the development team should have the proper technical, financial, and political expertise to prepare whatever decision-making document is used by the company or agency. When that is done, the necessary groundwork should already be in place to ensure that board approval will be achieved, and the team can disband.

Ownership and Financing

The form of ownership a company chooses for its development project depends on both its financial commitment and development philosophy. The advantages and disadvantages of the three major types of ownership are shown in Exhibit 8-2.

Having chosen an ownership form, the company then often wants to select a development partner. Five criteria are important for selecting that partner:⁸

1. *Integrity.* Choose a firm with which you are comfortable.
2. *Financial strength.* Have the resources to fund the project without constant concern.
3. *Experience.* Have a similar project completed.
4. *Appropriateness to the scope.* Select a firm appropriate to the type of financing you are envisioning.
5. *Familiarity with the location.* Both partners will feel more comfortable if the development partner knows local conditions.

To structure the financing of the development project, the facility manager, in conjunction with the CFO, must be aware of the aspects of real estate that translate into assets and that can be traded for cash. They must both also be aware of the possible objectives of lenders, equity investors, and developers. And they must realize the actual financing means peculiar to real estate, which reconcile the inherent attributes of property with the objectives of money suppliers.⁹

Furthermore, the financial plan for the company should identify the cheapest sources of money, create investment incentives to replace high cash returns, and use devices that defer to the greatest extent the need for cash. Some options that meet these criteria are (1) structuring the development as a tax shelter, (2) using tax-exempt financing, (3) choosing land leaseback, and (4) engaging in joint ventures with institutions.¹⁰ The facility manager will have internal financial and legal advice during the development of the financial plan to support a development project. However, it is necessary at this point to reflect on responsibility. If midway through the project the finances (or any other aspect) goes sour, it is the facility manager who is on the line. For that reason, the facility manager should rightly challenge every aspect of the project development as it proceeds. Internal experts and consultants need to make the facility manager comfortable, or no aspect should proceed.

One last note of caution: Most companies that lost a lot of money in development ventures did not understand the true extent of their risks.¹¹ One of the principal roles of the facility manager is to ensure that company management is aware of not only the opportunities of development, but the downside risk. Admittedly, in the enthusiasm of a major development project, those risks are not popular, but they must be presented.

Successful development requires both a company devoted to that business and also a change of philosophy of the facility manager toward at least a portion of the facilities for which he is responsible. That cannot be done without careful thought and planning and complete commitment.

Property Disposal

Property disposal has become a much more complicated process than when decisions were made simply on market factors like price and location. No one will buy a property without conducting extensive due diligence investigations to ensure that no legal and environmental problems exist. Sometimes the mere whiff

of an environmental problem can scare off a potential buyer, because whoever is holding the environmental problem at the time that it is discovered tends to be liable for the solution to that problem.

A facility manager must be as sensitive to excess real property as to purchase and development. Often, however, timely disposal seems almost an afterthought. And as important as disposal can be, the literature is noticeably silent on this topic. The ultimate horror story in this regard is the company paying rent on a facility it already owned. That facility should obviously have been a candidate for disposal.

How does real estate become excess to the needs of an organization? It can be obsolete. The company can be downsizing or changing products or services. An example can be found in the public sector, where changing demographics have closed many schools. Also, the organization may have relocated.

Leland Smith, a senior vice president at Grubbs and Belli's Commercial Accounts, in his inimitable style, lists the five traditional ways to dispose of excess facilities:¹²

1. Unload this turkey on another operating division as an internal transfer of assets at full book value.
2. Put your widget plant on the market as a widget plant and try to get its full replacement value as a ready-to-operate facility. Hire a broker and tell your boss it is his fault if you can't sell it.
3. Redeploy or auction the equipment, then put the land and buildings on the market as an ideal facility for any conceivable use.
4. Sell it to whoever will take it off your hands and hope to get its depreciated value. Tell your treasurer you've done the company a favor by minimizing the tax consequences of the sale.
5. Donate it to charity, take the tax write-off, and give yourself a plaque for being a good corporate citizen.

Unfortunately, this is typical of the standard approach to property disposal. However, there is another view: The excess property might represent planned excess capacity, obtained at a favorable market rate for future expansion. Surplus real estate is not, in and of itself, good or bad. It is part of the life of a facility, and it deserves to be managed like all real property assets. Most often the problems occur when property becomes excess unexpectedly and it remains excess and becomes a burden, normally financial.

As a general rule, there can be hidden costs in excess property, so only property that has been planned as excess to an organization's need should be retained. There is the old saying, "Hang on to land; it is under all and they are not going to make any more of it." The reciprocal is, "Value is generated by earning power." Vacant, nonproductive land is not a liquid asset; at current interest rates, and considering the cost of management and taxes, land must double in value every four to five years to be an outstanding investment.¹³

Methods of Disposal

The best discussion I've seen of disposal options for facility managers with excess property is by Robert E. Baird. He cites the following as alternative disposal methods:¹⁴

1. Sale and partial lease-back
2. Subdivision
3. Raze and redevelop
4. Tax-free exchange
5. Short-term financing
6. Short-term lease with purchase option
7. Donations

An alternative to disposal is adaptive reuse. I have several excellent examples in my own Washington, D.C., neighborhood: An excess school has been converted to administrative space for the school district. A former but inadequate police station is now a full-service, one-stop human services center. For adaptive reuse to work, the company must be comfortable with the function for the new use.

Disposal Process

Disposal of real estate requires the same close coordination as purchase or leasing. Imagine the embarrassment of the facility manager who has just sold the headquarters of a subsidiary in Chicago, only to find that the headquarters for a new service product in another subsidiary will be needed there in six months. Hard as it is to believe, some organizations lack a real-property information system to identify property as excess to their needs. And of three corporate real estate databases that I reviewed, only one had the capability of identifying upcoming excess property or cataloging surplus property.

The facility manager should follow a detailed procedure for shopping around excess property for an appropriate period in all parts of the company. Most public sector agencies have such procedures. Once they are cleared through operations, the facility manager must develop a game plan with the finance department to maximize the profit or minimize the loss. With the plan in hand, he can then go forward with that popular partner, the company counsel, and a broker if one is appropriate. Each potential disposal property should be carefully evaluated, inspected thoroughly, and its features categorized according to potential buyer types and needs.

Each disposal situation requires an understanding of equity in the property. Many times equity exists in the property, but often it may be enhanced by unused or deferred tax deductions or allowances. There may also be taxes that are due at the time of disposal of a property. Potential buyers will be interested in the property's present cash value as well as its capitalization rate. They will also want to know the amortization rate and how much depreciation they can expect, at what rate, and the financial leverage possible.¹⁵

Prospective buyers should also be informed regarding the property valuations and assessments for similar properties in the region.¹⁶ They will ask about any special exemptions or tax relief inherent in the property. For instance, sometimes prior agreements with state or local authorities include tax abatements or special considerations that can be passed on to new owners.

In the Public Sector

One of the more interesting aspects of my public service life was my involvement in military base closures. Several of these facilities were declared in excess of the military's needs or were proposed for new missions or funding cuts. An elaborate bureaucratic system had been agreed upon with Congress, and it included the following for each site:

- A mission analysis
- A financial analysis
- An environmental impact statement to include the impact on the local economy
- An assessment of national historic significance
- A public hearing

The system was so elaborate, the analysis so detailed, and the environment so political that no bases were ever closed if the closure was contested. The analyses were so complex and contained so much subjective data that they could easily be challenged or returned for further analysis. Public-sector facility managers in particular must be politically astute if they plan to dispose of major facilities.

Congress and the president realized these problems were serious and nearly impossible to overcome if politics was to be the principal driver for base closures. Therefore, to determine the bases to be closed to match the 1990s downsizing of the Department of Defense, they established a commission of experts who prepared an impartial list of base closures based on the analyses listed above. Congress then had to pass or not pass the recommended package in toto. Politics was not completely eliminated from this process, but the country was able to close most of the bases necessary.

Notes

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4. Edmond P. Rondeau, "Contel Finds Great Way to Manage Real Estate," *IFMA Journal* (April 1989), 28.

5. Arthur M. Delmhorst, "Why Tenant-Landlord Relations Are Changing," in *Facility Planning Technology*, p. 150.
6. John D. Mac Eachron, "Managing Real Property Assets," in *Facility Planning Technology*, p. 291.
7. John J. Dues, "Real Estate Management and the Corporate Planning Process," in *Facility Planning Technology*, p. 11.
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10. *Ibid.*, pp. 83-84.
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13. H. Basil Hallquist, "The Fundamentals of Acquiring Corporate Real Estate," in *Facility Planning Technology*, p. 203.
14. Robert E. Baird, "More Innovative Approaches for Surplus Properties," in *Facility Planning Technology*, pp. 250-253.
15. Charles F. Floyd, *Real Estate Principles* (Chicago: Longman Financial Services Publishing, 1990), p. 2.
16. *Ibid.*, pp. 271-275.