What Every Leader Should Know About Real Estate

by Mahlon Apgar, IV

LOOK AROUND YOU. If you're on land, you are in real estate. It is ubiquitous and indispensable. For most businesses, it is the largest or second-largest asset on the books; yet, because it is everywhere, real estate is easy to take for granted. And because it affects everyone – customers, employees, investors, regulators, neighbors – real estate is not easy to manage. My aim in this article is to distill real estate maxims that will help board members, executives, and others meet this challenge.

Business real estate is not merely an operating necessity; it's a strategic resource. But it rarely captures senior management's attention. In many organizations, real estate remains a reactive, second-order staff function, focused on discrete projects and deals rather than on the company's broader strategic issues. Location and layout choices are made within business units, driven by short-term needs, and based on conventional wisdom. Proximity to headquarters can take precedence over customers' and employees' preferences. The five maxims discussed below – intended not for real estate specialists but for the leaders who guide them – highlight the issues that senior managers need to understand.

1 Manage the Portfolio

A company's portfolio of real estate holdings should be more valuable to the enterprise than the sum of its individual sites. To ensure this, executives need a high-level view of their real estate situation, which they won't get from the site-by-site analysis that is generally the focus of internal staffs and systems. Executives need a "snapshot" of the company's footprint: the locations, the land and building types, the utilization and condition of major facilities, the lease terms and operating costs, and the financial and environmental risks. Leaders also need a dynamic, moving picture of where corporate strategy is driving their real estate holdings and of how the footprint could change depending on the route they take. When they compare the snapshot – tables, maps, and photos – with the "movie," made up of robust scenarios of a company's known and potential needs, the analysis will probably reveal some misalignments. The company may have too much space in one location and too little in another, or the wrong kind of space in certain areas. The analysis will also show which leases are expiring and when, their amounts and costs over time, and how the locations and sequence of expirations could complicate, or even block, future actions.

Pfizer When Pfizer began overhauling its sprawling collection of real estate in 2006, leaders discovered that nearly 15% of each research dollar was going to facilities depreciation and site-operating costs. The process of real estate rationalization cut that figure in half.

Armed with these insights, a leader can take advantage of portfolio opportunities that a site-by-site analysis will not reveal. For example, offices that do not need to be downtown can be relocated to less costly (though not necessarily distant) submarkets. Redundant facilities can be sold, subleased, or vacated.

The portfolio approach is especially important when a company is going through a major change, such as a merger, an acquisition, or a divestment. Rationalizing an organization's real estate – that is, matching space and facilities (supply) to strategic and operational needs (demand) – can be as important as rationalizing the workforce. The process of equating supply and demand, physically, financially, and operationally, often involves relocations, closures, and dispositions. WPP Group, the global advertising and communications giant, captured a $100 million windfall by promptly selling the Tokyo building of J. Walter Thompson after acquiring the agency. And when divestments loom, real estate is often the most visible and valuable asset – witness Bear Stearns, whose Wall Street building was its principal asset when the firm collapsed.

Portfolio analysis can also inform leaders about a property's costs and uses over time. The total costs of operating and maintaining a facility during its useful life (typically around 50 years) can be many times the original costs of building or renovating it. Taking a portfolio view allows for better planning of maintenance spending and of the timing of building subleases and sales. By comprehending this life cycle holistically, leaders can anticipate – and possibly avert – project-level actions that compromise portfolio-wide gains. For example, a business unit might lease additional space to accommodate growth or a reorganization, unaware that another unit has vacant space in a nearby building the company owns; or an executive might make expensive headquarters alterations while more junior managers are pursuing cost reductions.

Caveat: Beware the shadow portfolio. As companies strive to reduce costs through outsourcing, they should keep in mind their indirect responsibility for facilities that house outsourced functions. Workers at those sites may not be company employees, but their productivity depends heavily on the location and configuration of facilities. In addition, companies can be subject to stakeholder activism and even legal action if workplace health and safety standards aren't met. Companies that have outsourced a significant portion of their functions – Citigroup and Nike, for example – have found themselves with substantial de facto portfolios that must be managed as adroitly as the real estate they hold directly.

IDEA IN BRIEF

- **Real estate is the largest or second-largest asset on the books for most companies, yet senior managers rarely pay attention to it. They should follow these principles:**
- **Think of real estate holdings as a portfolio, not a set of discrete properties.**
- **Pay a little extra for a lease or a purchase if it buys flexibility.**
- **Collect data to assess the portfolio's performance.**
- **Work with real estate service providers that offer expertise and efficiency.**
- **Embrace sustainability; it's here to stay.**

2 Build In Flexibility

The nimble organization ensures that it has maximum flexibility throughout its real estate holdings – even if that means paying more up front in some instances. Flexibility can be financial (leasing instead of owning), physical (designing modular space), and organizational (redistributing work).

Financial. Companies that prize flexibility tend to own less and lease more. Pfizer, for example, traditionally owned most of its facilities to ensure control and believed that owning was less costly over time than leasing. However, as industry changes led the company to dispose of facilities rather than undertake expensive retrofits, Pfizer found that divesting specialized R&D facilities was exceptionally difficult. The company plans to examine leasing and flexible-use options when it needs new R&D space in the future.

Lease terms themselves offer a way to maximize flexibility. Shorter terms, with more frequent and earlier termination dates, expansion and exit clauses, and renewal options, can help a company adapt to changing circumstances. Coordinating the end dates of leases, subleases, and exit clauses in adjacent spaces also allows organizations to shift or disband operations. Savvy managers negotiate leases as they do equipment purchases: They establish a base price and define an array of options for which the company is willing to pay a premium, depending on the flexibility it needs – for example, exit rights after one year (instead of the typical five) for a unit that is up for sale or modular options on new space for a fast-growing start-up. Corporate real estate managers can make intelligent decisions about how much to pay when they understand the variability of business needs. In volatile times, up-front costs may be low relative to the hidden operational costs of having too little or too much space, or the wrong type of space in the wrong place.

Physical. The simplest form of physical flexibility is space that is easy to subdivide or sublease. In buildings that offer such space, companies can take advantage of less-expensive long-term leases while adapting to changing circumstances by subleasing some of their space to others.

Entire buildings can be designed for flexibility. For instance, modular buildings can be quickly erected and converted from one use to another. "Shrink-wrapped" facilities, designed from the inside out, can be smaller because they do not have the pockets of surplus space that typically exist inside a one-size-fits-all box. This reduced footprint increases the number of potential uses on a parcel of land. In China, short-lived "disposable factories" offer flexibility in land use and capital deployment. The disposable building is not always suitable – both employee comfort and environmental impacts must be considered. But such structures are one-fourth the cost of a permanent plant, take only one-sixth of the time to build, are simple to operate and maintain, and can be quickly and inexpensively dismantled.

More-permanent buildings can be designed with future uses in mind, making it easier for organizations to trade a costly, complex, or obsolete use for a new, more marketable one. These fungible designs have simple, generic common areas, standardized space modules, movable walls, and accessible electric and HVAC infrastructure, all of which make the space easy to reconfigure when anticipated uses or operating expenses change. Building in flexibility at the beginning is an order of magnitude cheaper than tearing down walls to create new configurations.

Organizational. Companies can maintain their real estate flexibility if they are willing to consider alternative workplace arrangements for employees. Working from home is the most obvious example of an alternative workplace. Indeed, "telecommuting" has been in our lexicon for years, but it was limited until recently to select senior employees and workers in self-directed functions. (See "The Alternative Workplace," HBR May–June 1998.) Today, however, some companies routinely offer telecommuting options to many kinds of employees and, as a result, are finding opportunities to decrease their real estate costs and increase employee satisfaction.

In this article, *the real estate business* includes the industries and professions that design, finance, develop, construct, market, and manage land, infrastructure, and buildings. In contrast, *business real estate* refers to an organization's workplaces. The choice of locations, properties, and financing methods can help or hinder a company's strategy, raise or lower its costs, and promote or impede its productivity.

3 Cultivate Intelligence

It is no surprise that leaders not trained in real estate strategy may rely on instinct or casual chatter when making real estate decisions – nor is it a surprise when those decisions fail. Leaders need *real estate intelligence:* accurate data, synthesized into relevant information, interpreted in the context of corporate and competitive realities. This kind of intelligence allows them to understand trade-offs and to connect real estate decisions to corporate strategy. The foundation of real estate intelligence is a database that includes square footage, occupancy costs, uses, capital values, utilization levels, and other relevant information, arrayed by line of business, function, and location. The data warehouse for a typical portfolio can be voluminous, with 50 or more unique fields for each of hundreds or thousands of properties. The quality and effectiveness of the database increase with scale. So, leaders need a dashboard that focuses only on fundamentals and synthesizes the key issues.

Wise leaders pay more attention to internal measures of facilities' costs, productivity, and utilization than to fluctuations in the real estate market. Four ratios link real estate to business economics:

- occupancy cost per person and per unit
- occupancy cost as a percentage of revenues and/or expenses

- utilization of building space and land, per person and per unit
- asset performance (measured by return on total investment)

Leaders should also insist on periodic reporting of those internal ratios across business units, markets, submarkets, and building types. Benchmarking peers and competitors is no less important, but those data are hard to capture and it may be difficult to find strictly comparable properties in competitors' portfolios.

Real estate deal makers are known for quick back-of-the-envelope analysis. The typical business leader may not be as facile but can use many tools, such as space budgeting, lease decision analysis, and employee location mapping (see the exhibit "Assess Your Real Estate Performance"). What used to take weeks of effort with occupancy cost formulas and P&L impact analysis can now be done in days or even hours with models that permit real-time iterations as assumptions or goals change.

4 Team with Professionals

The most efficient organizations often do the least to operate their business real estate. Instead, they team with firms offering the full range of facilities functions and services. Such partnerships succeed if both parties agree on two conditions. First, the organization must be willing to share some control over its properties. Successful precedents in other central functions, such as IT, may pave the way for this arrangement. Second, the real estate firm must agree not to focus solely on transactions but to work toward long-term goals such as strategic advantage, occupancy-cost reduction, and employee satisfaction.

Service partnerships. An industry of service providers has emerged in recent years, led by global, billion-dollar firms such as CB Richard Ellis, Colliers, and Jones Lang LaSalle. These providers manage the entire value chain, from short-term leases to multiyear development projects, making it possible for companies to outsource most or all of their property management. They have made great headway in professionalizing real estate services. Their brokers, traditionally paid on commission, have morphed into salaried "relationship executives" who are awarded bonuses not only for closings but also for client satisfaction.

Organizations benefit from the firms' expertise, focus, and efficiencies, and from their willingness to provide certain essential services at low or no cost. The service firms, which used to be whipsawed by episodic revenues and boom-bust cycles, benefit from the more predictable fees they receive through multiyear contracts.

Lease partnerships. In some instances, a leasing relationship between landlord and tenant can evolve into a partnership. Landlords invest substantial time and money in finding tenants, and tenants effectively underwrite their landlords' financing. Given that interdependence, smart landlords aspire to teamwork with their tenants, and smart tenants seek landlords with a long-term interest in their success. In a "performance lease," for example, a retailer's rent is based partly on its revenues. This arrangement presses the landlord to create an environment for customers and employees that promotes the retailer's success.

Development partnerships. A business that wants to create value from its real estate generally partners with a developer, who repositions the land and buildings through "entitlements" (such as zoning and building permits), a localized regulatory process that can take years and cost millions for large projects. When those entitlements have been obtained, the value of the land is some multiple of its cost, but this additional value is usually locked up while the site is under development. As infrastructure is added, both financial and market risks may decrease, as long as the project is aligned with demand. Through this process, the developer's cash flow is the key to its survival. The business partner must be patient and vigilant in order to

Limited Brands

Real estate intelligence (built from carefully collected data) helped Limited Brands realize that it should negotiate with retail mall developers on the basis of all its stores (3,000-plus) and brands (seven) rather than one store or brand at a time. Because retail lease terms are based partly on store performance and brand leadership, Limited could gain an advantage by showing national developers the number of Limited Brands stores in their properties (in one case, more than 400), how the portfolio performed as a whole, and how that performance compared with industry and competitor benchmarks. As a result, Limited was able to secure favorable lease terms and excellent locations.

preserve the project's economics during this costly and time-consuming process. Once assets are leased, their value depends on the user's commitments and the real estate capital and leasing markets.

Canary Wharf, the massive urban center in east London, exemplifies how businesses can benefit from partners' expertise. Creating this project depended on a shrewd, visionary developer, substantial public infrastructure, the engagement of key service providers, and early commitments by iconic companies. Although major tenants were attracted by the opportunity to consolidate geographically dispersed business units, the developer went further, proposing buildings that would increase the efficiencies of collocated units, provide layout flexibility and room for growth, and offer generous terms in return for long-term commitments. The developer's skills and thoroughness were critical in persuading companies to relocate; indeed, the Canary Wharf team often understood the companies' needs as well as the companies themselves did.

Caveat: Beware the "insider" deal. Companies that develop their own real estate rarely achieve results comparable to those of independent entrepreneurs and professionals. In part, that's because real estate development is not a core competence for most companies. In addition, internal real estate groups are subject to organizational pressures that outsiders can escape. One way to ensure sound real estate decisions is to prohibit the company's finance arm – even one that is a successful business function – from underwriting its own corporate facilities. This keeps business units from requesting uneconomical price breaks from the corporate real estate function, and corporate real estate from pressuring business units to take space they don't need.

5 Embrace Sustainability

Leaders can no longer ignore this simple fact: In the United States, the construction and operation of residential, commercial, and industrial buildings produce nearly 40% of all carbon emissions that contribute to global warming. Unchecked, the materials and designs used in buildings can harm the environment and employees' health. Companies of all types are beginning to transform the buildings they use in order to reduce emissions, and many leaders are making it clear that environmental concern is not a fad or a PR gimmick; instead, it's both a long-term obligation and an opportunity. As WPP CEO Sir Martin Sorrell said in a personal interview, "Our 'green' approach is not altruism; it's good, responsible business. CEOs ignore [this issue] at their peril."

Notes from the Great Recession

THE ECONOMIC MELTDOWN of 2008 to 2009 vaporized more than $1 trillion in U.S. commercial real estate values. It also accelerated several predictable trends and triggered some not-so-predictable ones.

MONETIZING PROPERTIES Numerous companies have sold properties to raise working capital. The New York Times raised $225 million by selling half its headquarters building to a private investment firm for one-third of the value it might have achieved a year earlier, leasing back what it needs and retaining a buy-back option.

RENEGOTIATING LEASES In return for extending its leases, an industrial conglomerate asked landlords for reduced or free rents, additional tenant improvements, and buyouts or expansion options. More than a third of the landlords were willing to talk (the others held fast to their contracts). The results of this strategy: rent reductions of almost $1 million and much better terms.

REPOSITIONING LOCATIONS Even venerable, image-conscious companies are vacating "trophy" properties in favor of less polished, lower-cost space. In executing this strategy, WPP has collocated business units, increased utilization, upgraded workspaces, and improved energy efficiency, using the occupancy cost savings for other priorities.

MAKING CONTRARIAN MOVES Vornado, one of the largest and savviest public REITs (real estate investment trusts), is planning a $1 billion private equity fund to buy high-quality office buildings at distressed prices. And while Blockbuster, Starbucks, and other icons are decreasing the number of locations, Target is adding 2 million square feet to its U.S. portfolio, Panera Bread is expanding into discounted space, and Dollar General is capturing desirable cut-rate locations for hundreds of new stores.

MIXING USES Companies are seeking properties that mix offices with hotels, apartments, and retail uses. For them, it's a means of providing services and lively workspaces for employees and customers. For the landlord, it's a method of reducing risk, obtaining finance, and offering better value.

HOME-SHORING Hilton Hotels, Jet Blue, and 1-800-Flowers have established virtual call centers in the United States. This large-scale form of work conducted in the home is emerging for three reasons: Costs in India and other offshore locations have increased, communication barriers have frustrated U.S. customers, and rising U.S. unemployment has released qualified professionals into the hourly workforce.

VALUING SUSTAINABILITY Industry wisdom holds that building to green standards is 5% to 10% more costly than conventional construction, so developers defer projects or expect corporate tenants to pay the difference. But recent studies show that green building costs are declining and time to breakeven is shorter, while market values and rents are rising. And the Obama administration's policies are unlocking significant benefits for sustainable projects.

Assess Your Real Estate Performance

Managers can use a simple tool that assesses an organization's real estate portfolio through the evaluation of five factors: amount, price, grade, area, and risk.

The team performing the evaluation should include executives with knowledge of the organization's strategy and real estate and independent experts in analyzing large real estate and facilities portfolios. For complex portfolios, this team may assign greater weight to certain factors for certain facility types. In financial services, for instance, area is more important for branch sales offices and call centers than it is for headquarters offices, which are generally less dependent on customer interface and numerous employees. In a retail enterprise with low operating margins, price will most likely be assigned greater weight because of its high impact on profitability. And in industrial firms with extensive manufacturing and distribution facilities, risk will weigh more heavily.

	Amount Amount of space in organization's real estate portfolio, categorized by geography, unit, other	**Price** Organization's total occupancy costs, including rents, capital expenses, and maintenance expenses	**Grade** Building class (A, B, C), space type (office, retail, other), and interior standards (lavish, utilitarian, spartan)	**Area** Submarkets (downtown, suburbs) and site locations (primary, secondary)	**Risk** Portfolio's exposure to market, financial, and environmental volatility
Key Ratios	square feet per employee revenue per square foot	cost per square foot cost per employee cost as percentage of revenue (for sales and service facilities) capital cost per square foot	percentage of each building class percentage of each space type percentage of each quality level	percentage of sites in each submarket percentage of primary and secondary locations	market value to book value portfolio value percentage of debt to equity percentage of total capital invested in hazardous sites
Evaluation	Are the organization's uses of space appropriate for the requirements of each category? How does this usage compare with internal and industry benchmarks?	Are the organization's occupancy costs appropriate for its market conditions, profit economics, and functional requirements? How do these costs compare with internal and industry benchmarks?	Are the organization's building and interior standards appropriate for its operating requirements and cost structure? How do these standards compare with internal and industry benchmarks and peer organizations?	Are the organization's facilities located in areas that are suitable for its functions, customers, profit margins, and key success factors? How do these locations compare across the organization's units and with those of industry peers?	Are the portfolio's market, financial, and environmental risks in line with the organization's functions, profit economics, capital structure, and environmental factors? How do these risks compare with internal and industry benchmarks?
Rating	0 1 2	0 1 2	0 1 2	0 1 2	0 1 2

Composite Score ☐

To conduct this assessment, the team considers five factors: amount, price, grade, area, and risk.

Each factor is assigned a rating from 0 (poor) to 2 (excellent). The ratings for each factor are added to develop a composite score on a scale of 0 to 10.

A composite score of 6 or lower typically indicates that management should act quickly to redress problems.

Green buildings may cost more up front, but they deliver high returns over the long term. Consider indicative data: Energy savings in green buildings routinely exceed 20% and reach 50% on hot days. Oxygen-rich air, injected into enclosed space, improves employees' health, increasing productivity. Raised floors cut air-conditioning costs by 70%. Dry toilets save millions of gallons of water. A short-term view will discount or ignore those metrics; a long-term, life-cycle view will embrace them. Former Harvard president and current National Economic Council director Lawrence H. Summers said in a personal interview (before this recession) that Harvard's green lending program, which provided low-interest financing for energy-efficient projects across the university, is "one of the very few investments I know of that had a higher return than the Harvard endowment over the last decade. Many of those projects were paid for in three or four years."

New buildings for Bank of America and Hearst Corporation in New York show the possibilities of green business real estate. Each fits closely to the city's transportation and utility grids, thus shrinking parking requirements, reducing auto emissions, and placing little new strain on water and power systems. Rainfall cools lobby air and waters a planted roof. Heat recovery units, in tandem with the natural gas supply, eliminate energy loss by recapturing and cleaning exhaust. Coated windows provide insulation while maximizing daylight and filtering radiation. Experience shows that designs that let in daylight and give occupants thermal control result in increased productivity. And such features are already increasing building values. Comparable facilities will fast become the new "trophy" buildings of our era.

Until recently, green issues were the province of academics and activists, and the exemplar of excessive regulation when environmental impact statements delayed real estate projects. The swift turnabout in public awareness and private initiatives has been prompted by rapid gains in the intelligence on sustainability. Investors, advisers, and other stakeholders can now glean ready insights and comparative metrics. For example, the voluntary Leadership in Energy and Environmental Design (LEED) building certification, only 11 years old, is becoming a standard for financing and marketing major corporate buildings. And Dow Jones's Sustainability Indexes use economic, social, and governance criteria that focus on long-term shareholder value. These tools, already used by asset managers, aim to set the bar for corporate citizenship.

Green real estate policies and projects generally succeed if they meet four criteria. First, they must be strategic: Leaders need to be able to see how they connect to the business mission. Second, their benefits must be measurable, if not precisely quantifiable. In this new, barely charted realm, even proxy measures such as carbon footprint and sustainability indices can be used to support new directions and pilot projects. Third, the policies must be operational, but they do not necessarily require new programs. If the first two criteria are met, leaders can signal their support for green projects within existing programs. Finally, green initiatives should be aspirational. They count with consumers and rank high on young employees' agendas. But make no mistake: Going green is a hard business issue of cost, competitiveness, and survival. Real estate has significant opportunities to affect the sustainability of our planet. With greater transparency, every organization will be accountable for its environmental footprint, and stakeholders will expect positive results.

Green buildings may cost more up front, but they deliver high returns over the long term.

...

As business enters a new era of more responsive and responsible capitalism, real estate will become even more central to a company's global presence, competitive strategy, and ability to retain top talent. The fact is, real estate is never neutral. It can multiply shareholder value or diminish it; help an organization achieve its mission, implement its strategy, and compete effectively; or hinder its market position, organizational development, and long-term growth. Real estate compels leaders' attention – and their mastery of the issues and principles behind their largest assets.

Mahlon Apgar, IV, *advises leaders of corporations and governments on real estate and is a former partner of The Boston Consulting Group. This is his seventh HBR article.*

Reprint R0911J To order, see page 135.