THE IMPORTANCE OF CORPORATE REAL ESTATE MANAGEMENT IN OVERALL CORPORATE STRATEGIES

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CREM Whitepaper

In the early 90s, one of the leading topics in Europe's real estate business was corporate real estate management (CREM). This new wave of professional enthusiasm with Anglo-Saxon origin was embraced by both scientists and industry. Corporations established real estate departments and enabled their administrative property or land departments to do more than simply execute tasks. However, soon afterward CREM became silent again, and only with the arrival of the financial crisis in 2008 did CREM become a part of public awareness.

Most commonly, CREM is defined as the "value and success-oriented acquisition, handling and disposal of properties under use or possession of corporations."[1] Thus, the focus is on the property assets of companies with a core business in anything but the acquisition, erection, management or disposal of real estate – non-property companies.

The fact that properties are not part of the core business but are seen as operational resources or fixed capital to accomplish core business goals leads to a few specifics among corporations with regard to the handling and management of their used or owned properties. This has to be considered, although there are many parallels in the traditional (institutional) real estate industry with regard to structure and allocation of responsibilities (see Figure 1).

Contrary to property companies, whose core business and corporate strategy have a real estate focus, are real estate-related strategies within non-property companies clearly subordinated toward the overall corporate strategy. In short: The core business defines how to deal with its real estate, not the other way around. This is the critical challenge corporate real estate

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Figure 1: Taxonomy of Real Estate Management

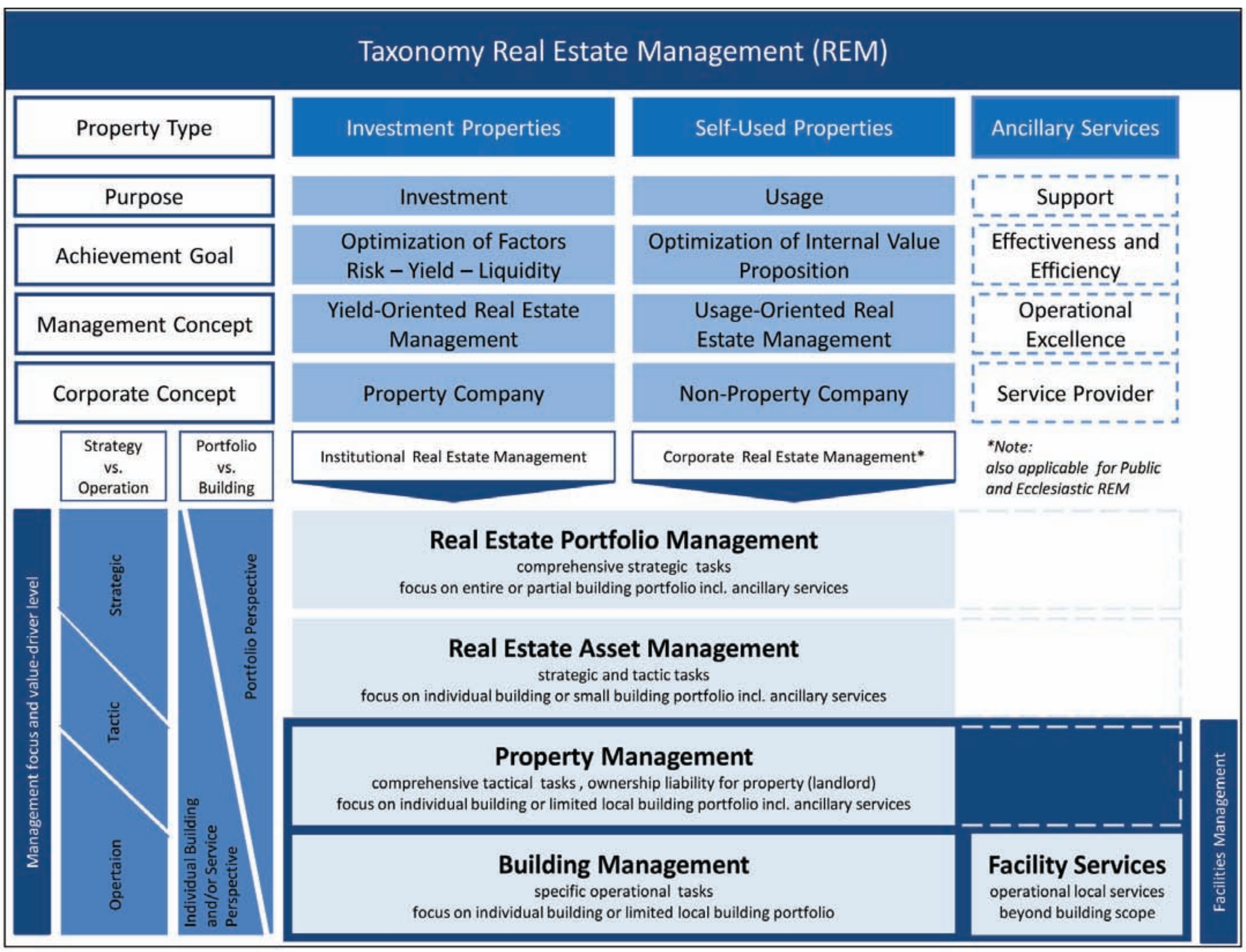

Figure 2: Main production and headquarter site of BASF Group, Ludwigshafen/Germany[3]

(CRE) managers have to tackle since CREM was "invented" as a profession. However, a simple top-down-approach between core business and CREM doesn't seem as appropriate as an interrelation between clearly defined prerequisites of the core business and their professional and realistic reflection with the reality of the real estate market.

Why Should It Be Like That?

A closer look at the balance sheets of European corporations proves that these enterprises still retain a fairly high ratio of real estate assets (five to 20 percent of fixed assets). A counter-check with their real estate departments still derives a high ownership ratio within their property portfolio (only a slight decrease from 75 to 68 percent between 2000 and 2010[2]). However, once detailed questions are asked with regard to real estate or workplace-related costs - which require significant transparency toward processes, property portfolio and cost structures - responses would be marginal because of the very heterogeneous maturity of the respective CRE organizations.

One of the reasons for this is that many corporations still perceive the alignment between corporate strategy and CRE strategy as a one-way road with the CRE department deemed the executor of operational directives. The result is lack of transparency, an excessive portfolio of surplus sites, inefficiently utilized space and high property-related costs. It is, unfortunately, a fact

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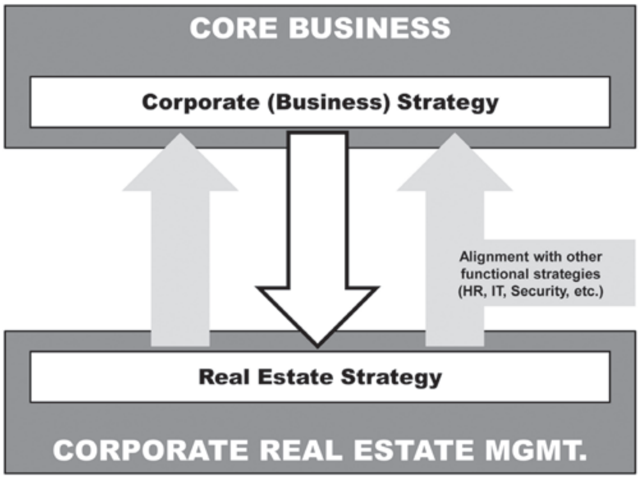
that this lack of transparency impedes companies from knowing the value in their assets.

The inflexible, immobile condition of property makes it highly essential to convert the internal corporate one-way road of command into two-way-traffic. Today's dynamic and demanding business environment requires flexibility, speed and a high ROI – all prerequisites for which properties of the traditional real estate market are not commonly known. Institutional investors consider real property in their portfolios a way to stabilize and safeguard other riskier investments. Therefore, it seems logical and economically reasonable to seek a vice-versa alignment between a corporation's overall strategy and its real estate goals with regard to success factors and a corporation's prerequisites

Figure 3: Interdependencies between business and corporate real estate management



A typical way to measure success is through **deriving profitability indicators** from success factors whereby profitability can be **understood** as the capability to cover **business-related expenses** (cost) through **respective income** (revenue)

and feasibility in a real estate market. Contradictions within the respective value proposition can be shown especially in quantitative performance indicators like yield or productivity or qualitative indicators like flexibility – meaning timely availability and marketability – as well as user or customer satisfaction.

In a purely economic view, the sum of all (economic) targets within an enterprise is defined as the target concept, which can be categorized into:

- Performance targets (procurement, inventory, production, sales)
- Financial targets (liquidity, investment, financing)
- Success targets (turnover, earnings, profitability)

Financial targets and performance targets are basic economic objectives and focus on the methodology of management and operation within a company. Success targets are rather formal economic objectives to visualize the aspired commercial goals as a result of pursuing fulfillment of those basic economic objectives.

A typical way to measure success is through deriving profitability indicators from success factors whereby profitability can be understood as the capability to cover business-related expenses (cost) through respective income (revenue). Yields are being commonly used as a term to describe profitability. With regard to non-property-companies, prevailing market yields for real estate are typically well behind yields of most corporations' core businesses. Depending on the type and the risk profile of the respective property, yields between 4.5 and eight percent are common for traditional central European real estate investments. The yields expected from a non-property-company's core business often starts only at or above this threshold – sometimes even well above.

Such factors for success with regard to an achievable yield for holding a piece of property are, however, related to the view of a real estate investor. It has to be questioned whether such perspective could be shared by a corporate investor at all as his/her view is defined predominantly from its usage. The usage itself is derived from an existing demand that, in the first place, is defined by specific operational needs of the respective corporation's core business. In the end, those will be the selection of the property's site location, its physical requirements as well as its respective commercial and legal aspects.

CREM can under such circumstances only provide a real estate-related optimization within the framework given by the core business. Thus, a comparison with the traditional view of institutional real estate investment makes sense only upon full marketability of the respective property with regard to its asset type and site location. The marketability is, however, defined by its potential usability for third parties, which is not applicable for the vast majority of corporate properties. Manufacturing enterprises are for many logical reasons required to locating and further develop only at the edge of or far away from urban settlements.

In case changing market conditions require a reallocation of production capacities, existing sites and facilities thereon might become underutilized. Under such circumstances there are only very limited alternative ways of use for these facilities, for example, a conversion of standardized production or storage buildings. If reasonably well located, such facilities can be marketed for alternative use, perhaps taking into account a certain discount on their value or potential rental fee because of existing user-specific features in the facility's structure, fit-out, connection or current usage.

Such challenges for the marketability of corporate property are easily understandable for production and logistic facilities. However, they might also be applicable to other property types, e. g. office or administrative buildings. For example, it has to be questioned why office facilities are being built within industrial production sites or at the periphery of urban developments and not in downtown areas or in administrative clusters. Such buildings cannot be reintroduced to the real estate market in the event vacancies might arise. Thus, such buildings - although fairly market-common by property type – are in this case non-marketable special properties that are too risky for external financing. As a result, such properties become a significant burden and liability for the core business. The situation even worsens once business declines and vacancies arise that cannot be absorbed through letting to other users. The remaining business activities therefore have to cover the vacancy cost – another commercial liability on top of a perhaps already struggling business.

This situation clearly describes where the added value for an alignment between corporate and real estate strategies lies. The re-

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flection of real estate-specific know-how in core business processes and decisions will lead to long-term cost advantages if sites and facilities are selected, located and designed not only according to the immediate needs of the requesting business but also according to the realities of the local real estate market. Only marketable facilities can provide the flexibility needed by a dynamic business with regard to its site location and avoid the sizable collection of surplus or inactive sites, which, in the end, tie up resources and capital that should be allocated to business development.

To make it right from the very beginning, this means not only the aforementioned optimization during a facility's operation but also a long-term real estate view of the core business requirements during site selection through reflection of local real estate market specifics and the application of marketable building or fit-out standards for manufacturing or storage facilities.

Here it makes sense to elaborate also on the time-related aspects. Land itself has in principle an unlimited life span. However, many external changes occur over time. As a result, many property requirements also change within a certain period of time, e.g., forms of usage, needs, legislation, etc. Markets are cyclical. Additionally, real estate projects and developments require time for planning, decision-making, approvals and construction.

It is a challenge for a corporation that the feasibility study for an investment project is driven predominantly by requirements of its core business, especially in regard to all timing-related aspects: market cycle, investment timing, investment horizon, etc. Unfortunately, market cycles of core businesses and real estate correlate not in a way that is attractive for overall investment. In an international environment, investment decisions are being pushed often at times when real estate markets are also overheated - either through availability of suitable land or construction capacities. Depending on local property market conditions, it might be worthwhile to select for economic purposes from owned investments or financial or operating leases.

Another qualitative indicator for success is user satisfaction and, directly related to it, the quantitative indicator of user productivity. A study of the Germany-based **University of Darmstadt**, **Institute for Real Estate Business Administration and Construction Management**, determined that because of the application of different work space concepts, productivity deviations of up to 20 percent were seen.[4] However, to achieve substantial productivity increases, substantial changes toward space utilization concepts have to be made, and significant intervention into operational work flows, corporate structures, traditional understandings of hierarchies, HR concepts and availability of IT tools is eventually required.

Here there becomes more need for alignment between real estate and overall corporate requirements. However, only a professional CRE organization and a proactive operating core business will recognize this as a positive overlap of common interests and will be able to successfully solve the tasks that will arise. Internal corporate stakeholders and core business and supporting functions have common goals. These require a holistic, comprehensive approach with other functional departments such as HR and IT and their individual functional strategies (see Figure 3). **CoreNet Global**'s "Corporate Real Estate 2020" initiative therefore came to the logical conclusion that an increased fusion of topics dedicated to CRE, personnel or information technologies was necessary because of new ways of collaboration in our work environment.[5]

Based on that, it can be concluded that despite the natural right of the core business to define the overall direction of a non-property company, an alignment between corporate strategy and individual strategies of support functions (including CRE) is not only beneficial but essential for economically efficient management of the corporation's asset "real estate" and to provide a sound basis for the overall commercial success of a corporation. Only along this path is there a chance for a corporation to adapt to a highly dynamic business environment, to achieve further productivity increases and – as one of the ultimate goals – to generate ambitious returns.

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