



Klein Commercial

Business Strategy

and

Real Estate Decisions

Why a Strategic Approach to Real Estate?

Real estate is a significant cost to business. It is also fairly permanent and visible. For a large part of the real estate public, the emphasis is on the "deal," not how real estate will improve the business. For this reason, a strategic approach will give the real estate user new tools to improve its use of property. Here are a few goals in the strategic use of property:

- Real estate has the potential to be a competitive advantage if the opportunities and business are thoughtfully considered. Strategize to make real estate improve the business.
- As a counter to the deal-driven real estate market, a strategic approach analyzes what is best for the business, not what is best for the developer.
- Real estate is the fount of identity for customers and employees. It is the place of production, creation, and administration.
- Business changes and companies require ever more complex analyses. But real estate tends to be more stable and visible.
- Functionally, properties can be acquired or modified to improve business processes.
- Operationally, real estate is a key component in communication and networking with customers and business allies.
- Develop a strategic mindset throughout the organization.

I learned much of this material from Dr. Martha O'Mara, Ph.D in her book and seminar entitled Strategy and Place. More information can be found at <http://www.strategyandplace.com>. For further interest in advanced real estate topics see the courses at <http://www.centerprise.org>.

3 Types of Real Estate Decisions

Companies face three major types of decisions when planning their real estate future. The three basic categories are **incrementalism**, **standardization**, and **value-based**. A closer look these strategies will put your decisions in a clearer perspective and allow for a fuller understanding of your needs.

Incrementalism

Characterization	Advantages	Disadvantages
Take space when needed; piecemeal	Short forecasting horizon	Hodgepodge of facilities; lacks overall plan
Short term decision making	No need for long term decisions	Conflicting and confusing
Functional space, no amenities	Opportunistic in real estate market	No consistent image
Uncertain or fast changing business conditions	Short and relatively risk-free commitments	No macro saving or operational effectiveness

Standardization

Characterization	Advantages	Disadvantages
Standard policy and specs	Reinforces identity and stability	Difficult to modify when needed
Measured and efficient	More economy to scale	Reinforces existing structures
Certainty in business	Reduced confusion	Stifles creativity and change

Value-based

Characterization	Advantages	Disadvantages
Meaning and future expressed in values and symbols	Reinforces strategy and culture. Defines future	Can be costly
Thoughtful approach merging place and company goals	Adaptive to change	Possibly distracting
Moderate certainty	Better design and workplace	Needs a lot of input

Interview Questions for Key Executives

Person _____

Title _____

Date _____

1. What business are you in? And where do you want to be?

2. What is changing in the business that can be addressed in real estate?

3. What goals do you have for the overall enterprise? In your department?
Personally?

4. What would you like to see in a new facility?

5. What are the problems with the current facilities?

Diagnostic for Strategic Analysis

To enable real estate to work strategically, companies should think of the business strategically. Many companies have full time staffs to examine these issues daily. Much has been written about competitive strategy, most notably, in the works of Michael E. Porter. In this exercise we want to identify "key" strategies that companies wish to follow. We then look at property-specific features to see what will propel the business strategy.

The type of thinking that this framework will encourage should resemble the following:

Customers:

Who are they? Do we need to move closer? More central? Is it easy to make pick-ups? Deliveries? How is access? On the property? To the property? Do we need visibility? What kind of image do we want to project?

Suppliers:

Are we close enough to suppliers? Do we handle materials efficiently? Can we obtain lower prices with another location? Are there other suppliers?

Rivalry:

Who are our competitors? What do they do better? Can real estate make us more competitive? Are rival's buildings more efficient? Do our customers offer employees a better workplace? Can real estate improve our position over rivals? By productivity? Improving workplace? Improving image?

Work Force:

Can we offer employees a better atmosphere? A more productive environment? Can we move to be closer to our employees? To better employees?

You can perform this diagnosis yourself on the following two pages.

Diagnostic for Strategic Assessment

External Strategy	Importance	What's Known	Gap	Anything to change	What works well
Customers					
Suppliers					
Rivalry					
Technology					
Regulation					
Financial					

Diagnostic for Strategic Assessment (page 2)

Internal Strategy	Importance	What's Known	Gap	Anything to change	What works well
Structure					
Work Process					
Demographics					
History					
Culture					
Preferences					

Forecasting for Demand, Growth, or Consolidation

Demand forecasting is one of the trickier analyses because growth is usually not straight-line but occurs dynamically because of a new product or process. Normally, one tries to model future demand by making "best case" estimates. If in doubt it normally pays to take more space than needed because a space shortage can crimp production and the additional marginal costs is small compared to a loss of sales. Additionally, if done right, the extra space can be subleased until needed.

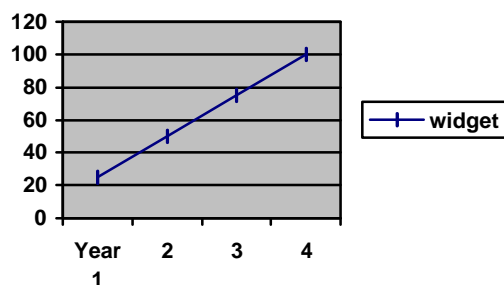
A. Overall Strategic Context - What direction is the company heading?

- Growth Management
 - Under control with incremental growth
 - Out of control growth without strategy
- Consolidation and Disposition
- Migration to lower cost position
- Repositioning

Types of Forecasting Stages:

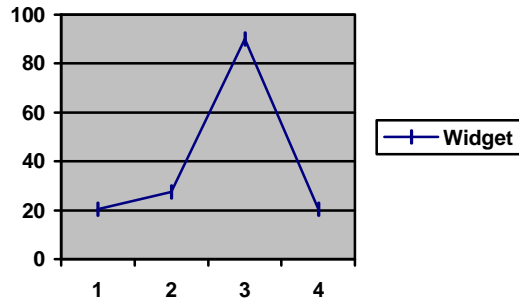
Direct Translation

- Headcount to square feet
- Widgets and product to square feet
- Historical growth and metrics needed
- Straight line charting



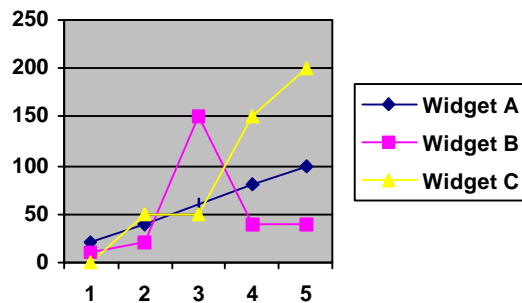
Extrapolation from Business Indicators

- Non-linear relationships
- Partially subjective
- Sudden growth through new product or invention
- Metrics



Bull and Bear Scenarios

- Risks of multiple outcomes
- Modeling and wave analysis
- Minimum and maximum analysis



Build in flexibility

- Land banking, optioning, space banking
- Note space under the curves

Real Estate Metrics

Demand Forecasting and Financial Measurement

Metrics are an important means to diagnose current and future real estate issues. Metrics are used for the following purposes:

- **Economy Measures:** These ratios measure the relation of real estate's contribution to the economy of the business. Such measurements as real estate to sales, profit, or overhead show the overall costs of the real estate strategy.
- **Efficiency Measures:** Efficiency measurements show if the company is making the best use of its resources. These ratios show efficient use of capital, the use of the property, and how effective the building is to its productive mission.
- **Effectiveness Measures:** This measurement shows how productive real estate is to the company's production goals. The reliability, suitability and functionality of the property can be judged with these ratios.
- **Efficacy Measures:** Efficacy measures if the company is receiving desired results from its property. It measures how relevant property is to the company mission by examining real estate returns, profitability, and satisfaction.

In addition, these measurements are frequently used for forecasting and gauging the use of property. Companies can also judge company performance by examining these ratios or other ones that may be more pertinent to the enterprise.

Real Estate Metrics Demand Forecasting and Financial Measurement

Economy Measures

Real Estate Costs/Gross Profit (measures contribution)	Real Estate Costs/(sales income-direct costs)
Real Estate Costs/sales	Real estate costs/sales ratio
Real Estate Costs/ Overhead	Real estate costs/SG&A
Real estate costs/headcount	Real estate costs/headcount
Real estate cost/total amount of business output	Real estate costs/total amount of output
Unproductive Cost Ratio	Cost of vacant space/real estate costs

Efficiency Measures

Real estate capital ratio	Real estate capital investment/total capital investment
Office capacity ratio	Occupied useable area/gross building area
Density	Total bldg area/headcount
Vacancy ratio	vacant area/gross area
Area per unit or primary business output	Total Bldg area/total output

Effectiveness Measures

Facility Reliability	Minutes of critical facility downtime
Facility Reliability	Minutes of downtime/gross area of buildings
Facility nuisance	No. of unscheduled maintenance calls
Responsiveness	Number of tasks completed in time/total number of tasks
Workplace functionality	Gross area with current serviceability/total gross area
Backlog maintenance ratio	Value of backlog maintenance tasks/gross area

Efficacy Measures

Return on real estate assets	Profit before interest and tax/real estate asset value
Earning per unit area	After tax profit/net area of real estate
Sales per unit area	Sales/net area of real estate
Customer satisfaction	% users and distribution results from satisfaction surveys
Facility appropriateness	% users occupying appropriate class of facility

Specialty Measures - Distribution

Truck Trips/Gross Building Area

Truck Trips/Gross Building Area

Truck Waiting

Average time of waiting to load at docks

Number of cubic feet of storage

(Square foot x height)-(area of aisles+staging)

Warehouse effectiveness

Weight or cubic storage/square foot

Warehouse cost effectiveness

Weight or cubic storage/real estate costs

Speed of warehouse

Truck waiting/gross building area

Speed of warehouse

Time at dock/gross building area

Speed of warehouse (forklift)

Average time to load a truck or make a run

Financial Management and Negotiation of Real Estate

Lease Analysis

Generally, the analysis of leases is fairly straightforward using a net present value analysis. This will compare several alternatives with different cash flows. The highest and lowest price alternatives can be easily judged.

(Example follows)

Sale vs. Lease Analysis

This analysis also uses net present value analysis to compare cash flows between buying and leasing. Predicting the future value of the real estate asset is a wild card so it is best done under a best and worst case scenario.

Generally, if there is a high degree uncertainty in the business, leasing is preferred because this will reduce exposure to a real estate "bet." Long term certainty in the business reduces the "bet" because of the buildings continual use and amortization.

(Example follows)

Cost of Capital

The cost of capital is intrinsic to the Net Present Value Analysis. Companies will differ in their view of the cost of capital. Different scenarios tend to moderate the uncertainty. What is your cost of capital for real estate projects?

- Corporate borrowing rate - 6.5%
- Mortgage rate - 8.5%
- Rate for new product investment - 20%
- Blended rate?

One answer is to compare the cost of the real estate to other properties on the market. Secondly, does the property provide more utility than others on the market do?

Lease Comparison using NPV
50,000 Square foot warehouse
10% cost of capital

Year	1	2	3	4	5	NPV	
Building A	\$ 350,000	\$ 350,000	\$ 400,000	\$ 400,000	\$ 425,000	\$1,445,061	Class A move-in condition
Building B	\$ 450,000	\$ 250,000	\$ 250,000	\$ 250,000	\$ 250,000	\$1,129,515	Requires \$200,000 intial fix-up
Building C	\$ 250,000	\$ 250,000	\$ 300,000	\$ 300,000	\$ 300,000	\$1,050,459	Class B move-in condition



**Lease Comparison using NPV - Pre-Tax
50,000 Square foot warehouse
10% cost of capital**

Lease for 10 years

Year	1	2	3	4	5	6	7	8	9	10	Total	NPV
	300000	300000	325000	325000	350000	350000	375000	375000	400000	400000	3500000	\$2,092,937.10

Purchase with 10 year hold and sale

Year	1	2	3	4	5	6	7	8	9	10	Total	NPV
	1,000,000	250,000	250,000	250,000	250,000	250,000	250,000	250,000	250,000	-1,300,000	1,700,000	\$1,620,367.86

Sale Notes

Purchase at \$60.00 psf or \$3,000,000. 25 % down in 1st year. Sell at \$3,800,000 including closing costs
 \$750,000 down; Payments \$250,000 per year; Very little amortization, but appreciation of \$800,000 after selling expense
 Year 1 calculation includes down of 750k and 250k of mortgage expense
 Year 10 calculation = (Original down of 750k + 800k in profit - 250k of mortgage expense

**Asset Level Analysis
Basic Portfolio and New Property Items**

Owned Real Estate	Leased Real Estate
Asset Cost (Book and Market)	Lease rate, escalations
Operating expenses	Operating expenses
T.I.'s including special systems	T.I.'s including special systems
Cost to cure obsolescence	Cost/value of options
Tax benefits	Tax benefit
Transaction costs	Transaction costs
Terminal value and cost	

Location Decisions

Headquarters Decision

Pick Up and Go	Major Repositioning Strong vision, Critical factors
New Horizons	Achieve lower costs Different labor component
Consolidate to Beachhead	Scale economies Human resource economies Macro cost savings
Green Acres	Control over surroundings, expansion land
New Urbanites	Cosmopolitan, urban amenities and talent
Recommitment	Location retains attraction, Part of local fabric, Local success

Major Facility Decision

Additional Building Nearby

- Retain workforce and location preference
- High fixed costs that can't be shifted
- Lack of other alternatives
- More expensive to manage

Merge multiple facilities in one nearby

- Retain workforce and location preference
- Cost savings by consolidation, scale economics
- Upgrade operation, equipment and facility
- Recommitment to area

Relocate entire operation to new area

- Business restructuring or repositioning
- Achieve lower costs
- Control surroundings (green acres)

Why Companies Move

- Growth
- Schools
- Cost of Housing
- Workforce
- Strategic Location
- Lower Prices

Clusters

- Go where the competition is
- Logical for similar companies to make similar location decisions
- Lower transaction costs
- Greater mass leads to lower cost of inputs and ideas

Relationship Management and Interpersonal Skills

Technically aside, any implementation requires personal and management skills to affect policies. When moving the company, one can expect challenges. These are just a few issues to expect:

- Tensions are created with new moves
- Differing management and organizational objectives
- What's best for the business
- Often takes time
- Build information database, think objectively
- Outsourcing requires more control and good relationships