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Real estate: risk or opportunity?

Real estate risk is not generally top of the Boardroom agenda, which is somewhat surprising given that real estate is generally the second largest cost after payroll and may constitute a significant percentage of the average financial services companies' investment portfolio. By failing to consider real estate at the strategic level, financial services organizations are missing out on the opportunity to manage real estate risk, reduce costs, free up cash for the business and align the real estate base with corporate strategy.

The slowing world economy, combined with ever intensifying competition in global financial services, means the smart money is on organizations that prioritize the need to manage real estate risk and related costs including energy, telecommunications, procurement, and insurance.

Managing occupancy costs

Occupancy costs, including rental costs and operating expenses, can have a significant impact on an organization's bottom line. Companies often believe that the best strategy to reduce such costs is simply to downsize headquarters and other operating locations as well as to relocate to less costly hub areas. These options are obvious, but all the alternatives should be considered before implementing new occupancy strategies.

An organization's space needs will vary greatly over time as a result of activities such as mergers or downsizing. Changes in the demographics of the labor base, increased reliance on temporary or contract labor, or new methods of working including increased reliance on teleworkers, mobile workers and others with variable space requirements will also place demands on the organization. The real estate management team needs to understand where the board is taking the company if they are to provide flexible, appropriate and cost effective real estate solutions. Switched on management teams are already analyzing their space utilization and developing their own productivity metrics in order to determine the performance of owned or leased facilities. By analyzing the key indicators of performance, such teams can better determine whether they are operating consistently within the organization and compare metrics against similar institutions as well as industry leaders.

Of course, operating costs will vary by facility type and industry function. The Building Owners and Managers Association (BOMA) has issued annual Experience Exchange Reports based on survey results from more than 100 North American cities. Recent years' surveys have identified production/processing facilities as the facility type with the highest operating costs per rentable square foot, exceeding the costs for headquarter

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facilities, back-office and administrative operations, and computer operations/data services. However, from industry function analyses, it is apparent that facilities utilized for financial industry functions have higher operating expense costs than many other industries including healthcare, manufacturing and wholesale/retail.

DTZ Debenham Tie Leung (DTZ) completed a Global Office Occupancy Costs Survey in 2002[1], which analyzed space utilization standards and occupancy costs per worker covering 86 business districts in 40 countries worldwide. DTZ Research reported that the typical space utilization standard per office worker averaged 185 square feet. The North American standard was 231 square feet while Western Europe reported 181 square feet. Conversely, the survey indicated that occupancy costs per worker were highest in Western Europe at US$ 7,670 per annum. North America reported in at US$ 7,570 per annum.

Monitoring such metrics can help promote consistency in real estate utilization throughout the organization. Brand consistency matters not just on the High Street, but also within the back office functions where employees will be quick to make comparisons between locations. Morale and performance will be affected in locations less geared to providing staff with a good working environment.

'Pass-through' costs also represent an opportunity for cost management. Performance of lease reviews relative to financial and non-financial covenants such as common area maintenance charges, real estate tax assessments and property management performance thresholds will assist management to identify overcharges and contractual non-compliance. As a result of recent events in the United States, many tenants may find that pass-through costs have increased significantly as a result of increased security and insurance costs. There is much debate as to who should bear such increased costs, the landlord or the tenant, as well as how such costs should be allocated to the tenant pool. Organizations should aggressively manage their contractual rights relative to such costs.

Whatever strategy management may choose to control occupancy costs, alternatives should be continuously re-evaluated to help to ensure that competitive advantage is not compromised.

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Energy risks

Recent years have demonstrated the effects that volatile energy prices have on businesses and communities. During 2001 and 2002, real estate owners, operators and tenants in California were forced to operate through rolling blackouts and other reduced energy programs while at the same time facing demands for increased energy charges. More recently, several states in the Northeast United States as well as European countries including France, Germany and Italy have battled blackouts and output cuts due to utility grid failures and other energy crises.

This situation is not expected to improve, and as such represents an opportunity for the real estate management team which is prepared to enter into rate plans with the electricity provider when such plans are available, and to renegotiate and match these plans with changing business strategies, such as downsizing efforts and related consumption patterns.

Many countries do not regulate their energy programs while others are in the process of deregulation. In a deregulated location, organizations must be prepared to operate in volatile markets for energy sources such as electricity, natural gas, crude and diesel oils, and propane and heating oils. Unfortunately, many financial services companies don't have the systems or processes necessary to obtain adequate information about their energy usage patterns or threat of exposure, and are therefore unable to manage pricing or other related risks.

Organizations can capitalize on their opportunities by capturing their energy usage patterns, analyzing their risks (e.g. likely movement of market forces) and identifying strategy alternatives. These alternatives could include fixed supply contracts negotiated on a regional or national basis as well as strategic uses of derivative instruments. The benefits of an energy cost management strategy can include stabilized and predictable energy costs as well as cash flow, income and earnings stability.

Telecommunications tips

Telecommunications costs are another example of a critical business function that involves complex networks of services, vendors and user requirements that is ripe for the application of effective containment strategies.

What was once simple voice communication has evolved to encompass multifaceted data and video technologies supported by constantly evolving Internet capabilities. This complex area is further complicated by the inability to measure financial performance of the services used. As strategies in financial services organizations change due to business growth or downturn, operations acquisition or divestiture, telecommunications strategies and management should change in tandem.

> **The events of September 11, 2001, have presented additional hurdles to property owners already challenged with insurance issues**

Even if an organization is not in a period of transition, if it has multiple telecommunications vendor agreements or these agreements are more than a year old, the company may find it worthwhile to review such agreements and relationships to determine satisfaction with current vendors, cost-benefit analyses, levels of service and pricing.

Consider purchasing alternatives

Procurement managers are always looking for more efficient ways to purchase and source goods. Although online real estate-related purchases have evolved slowly, a number of purchasing programs have gained popularity in the last several years. An example would be the use of purchasing cards.

A purchasing card, or P-card, is identical to the look and utilization of a credit card. P-cards are popular where an organization has a high volume of small-dollar invoices. Because the credit card service provider summarizes all of the purchases on the card into one monthly statement, the transaction processing in accounts payable can be significantly reduced. P-cards do have their disadvantages – management must ensure that controls are in place to limit the dollar amount of P-card purchases and types of purchases.

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CEO discussion points

- What metrics have you developed to assess real estate performance?
- Does your real estate portfolio promote or inhibit your ability to innovate in the market?
- Is your real estate strategy consistent throughout the organizations and in line with corporate objectives?

The digital marketplace is another procurement alternative. Financial services organizations can choose to purchase goods and services from procurement companies with cross-industry reach, or look to real estate-specific procurement services companies that are trying to enter the e-procurement marketplace.

Whatever single or hybrid procurement program a company uses, organizations will derive the most cost savings if they restructure their procurement processes and practices to align with their business strategy, improve their purchasing leverage through advanced spend-tracking mechanisms and capitalize on their purchasing power.

Evaluate insurance programs

The events of September 11, 2001, have presented additional hurdles to property owners already challenged with insurance issues. While stakeholders enforce maintenance of terrorism insurance, property owners are discovering that such coverage may no longer be included in their standard policies or be cost-effective. This is of particular concern to organizations that own, or have a significant stake in high profile buildings likely to be the focus of attacks.

In light of the new risk dynamics in the marketplace, companies need to review their insurance programs to determine if the form of coverage and the related costs correspond to their overall business and risk optimization strategies. As an example, although an organization might not wish to self-insure its employee health benefits because of financial or administrative concerns, it may find that establishing a captive insurance company for the purpose of establishing self-insurance for property and casualty claims is the right answer.

When evaluating the balance between insured and uninsured risk or the financial performance of self-insurance programs, determining the effectiveness of risks or claims management and claims processing procedures is important. This is especially critical when considering renewal of third-party administrator contracts. Inaccurate, inconsistent and untimely claims processing is expensive both in terms of finance and employee goodwill. This is also true for missed opportunities to recover from potentially responsible third parties.

Minimize the risk and maximize the value

Very few financial services organizations are really minimizing the risk and maximizing the value in their real estate. Some are beginning to apply effective cost management initiatives that complement business and risk optimization strategies. To be truly effective, however, real estate strategies require an in-depth review of corporate objectives, risk profile, risk tolerance, and long-term corporate business strategy. In this way, the real estate function will support the business going forward and may even anticipate the trends, which will affect real estate use within the organization in the future.

1 Global Office Occupancy Costs 2002, DTZ Debenham Tie Leung International Property Advisors, 2002.

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