
SHAREHOLDER VALUE'S BLACK HOLE . . . CORPORATE REAL ESTATE

by Richard A. Hanson, CRE

Like matter sucked into the grip of a cosmic black hole, never again to see the light of day, corporate capital tied up in real estate never realizes its earning potential and ultimate value to shareholders.

Corporate America could be losing \$153 billion per year and not even know it. Such is the impact of real estate ownership on the potential earning capability of a corporation when, effectively, a sizable portion of its assets disappear from an active role in creating capital growth and investment benefit. This requires serious consideration of the relative effects of real estate ownership on the financial performance and operations of a corporation.

Given the hyper-competitive nature of business and the investment returns demanded by shareholders, real estate investments generally fall short of the productivity, liquidity, and investment objectives of corporations. In short, corporations can better serve themselves and their shareholders by rethinking how real estate serves their needs. This point is demonstrated in this article through an analysis of key financial data of a hypothetical company. As additional support, alternative real estate ownership structures are presented that allow corporations to use and, in most instances, control real estate without investing substantial portions of their precious capital in this asset class.

WHO OWNS CORPORATE REAL ESTATE?

This often-overlooked asset ties up a major portion of corporate capital. In fact, according to *Forbes*, corporations own \$1.7 trillion, or 43.1 percent of all commercial real estate in the United States (Figure 1). This is a startlingly high figure considering that 33 percent of such corporate-owned real estate is held for investment purposes,

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according to a 1990 report completed by Arthur Andersen/IREM.

In effect, that \$1.7 trillion represents capital that corporations could deploy more productively. Alternative uses could include repaying debt, buying back corporate stock, or investing in the company's core business.

ACCEPTABLE RATES OF RETURN

To be competitive, a company must return a market rate acceptable to its investors. These returns need to take into consideration the returns delivered by all companies competing for investor dollars. The S&P 500 provides an objective and diverse baseline to evaluate any corporate investment. This index has generated an average annual return of 24.1 percent over the past five years and 19.2 percent over the past 10 years.¹ Therefore, if a company is competing for equity investments it must strive for competitive returns in excess of 19 percent on invested capital. Historic investment performance data indicates that each dollar invested in real estate creates a gap between the expected equity return

and the return expected by real estate investors, a condition investors term 'negative arbitrage.'

An analysis of returns required by real estate investors allows a more precise determination of the amount of that negative arbitrage. Over the past 10 years, expected real estate spreads have averaged 500 basis points over 10-year Treasuries (*Figure 2*).

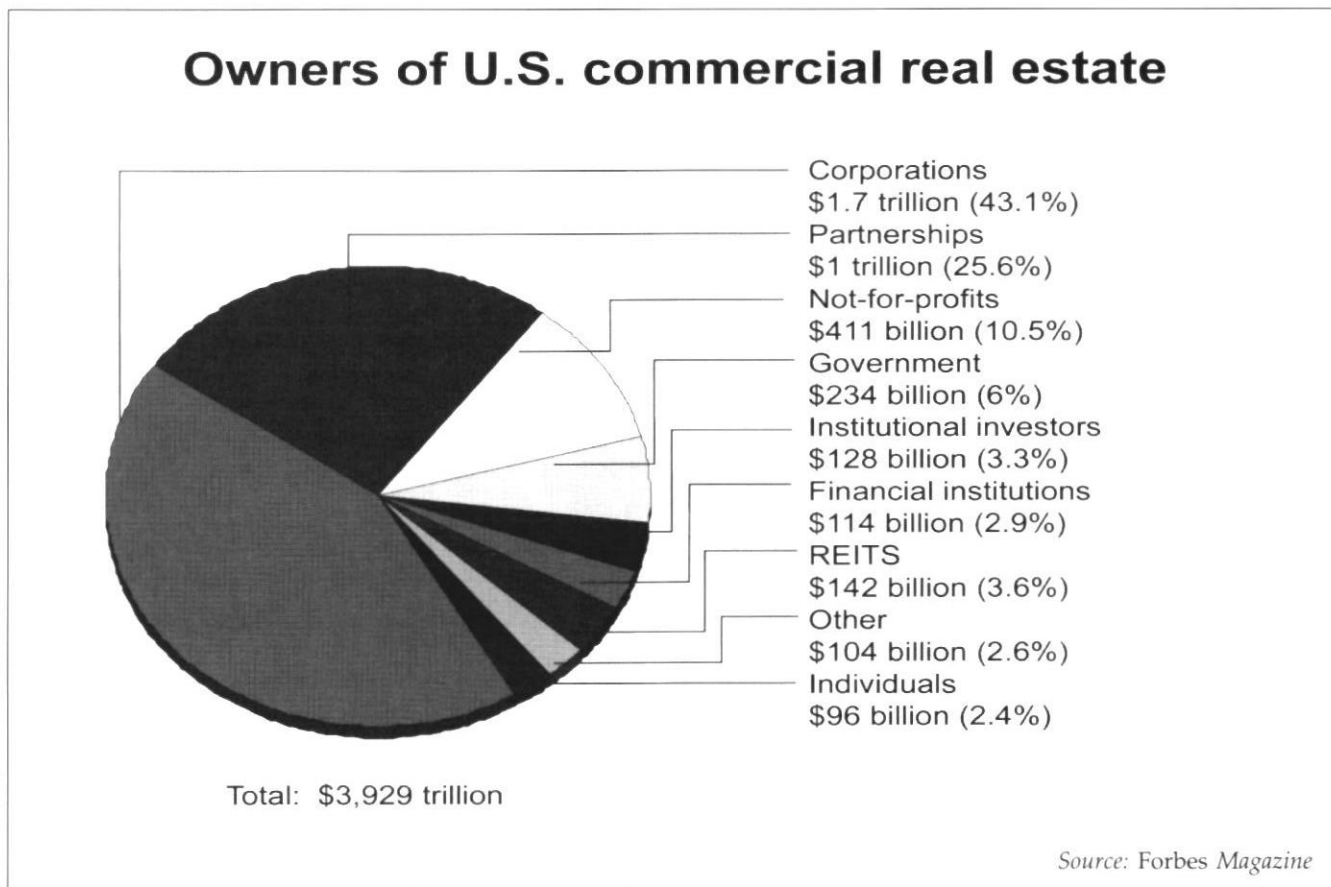
Therefore, if we were to assume that 10-year Treasuries were yielding five percent, the current capitalization rate for the average real estate investor would be 10 percent; thus, the negative arbitrage would be 900 basis points. When applied to the \$1.7 trillion dollars of real estate owned by corporate America, this creates a staggering potential loss of shareholder value.

REAL NUMBERS

Examination of a hypothetical company in two different scenarios will further illustrate this point:

- a. Company buys and owns real estate, or
- b. Company leases real estate

Figure 1



The standard assumptions are as follows (in 000s):

General

Asset cost	\$6,000
Holding period	10 years
Operating income	-0-
Tax rate	40%
Discount rate	10%

Ownership of Asset

Depreciation	
Basis	\$6,000
Depreciable life	40 years
Annual depreciation	\$150
Loan (70% loan to value)	\$4,200
Interest rate	8%
Term	20 years
Annual debt service	\$422
Capital invested in asset	\$1,800

Lease of Asset

Asset basis	\$6,000
Lease constant	9.25 %
Capital invested in asset	-0-
Capital invested in core business	\$1,800
Return on capital invested in core business - (Assume S&P 500 10-year average)	20%

For the purpose of isolating the effect of ownership versus leasing, the discussion does not include such factors as potential company operating income and asset appreciation or depreciation during the 10-year holding period.

Scenario A: Owning

If the asset were purchased, the company would invest \$1.8 million of its capital and borrow \$4.2 million at eight percent interest. The interest expense and depreciation would be deductible. In year one, this would result in an interest expense of \$333,000 and depreciation of \$150,000, for a total deduction of \$483,000. Using a tax benefit of 40 percent, the after-tax cost is \$290,000. Adding back depreciation of \$150,000 and subtracting a principal payment of \$89,000, the negative cash flow is \$228,000. *Exhibit I* calculates this cash flow for each year during the 10-year holding period.

The cumulative negative cash flow over the 10-year period is \$2,492,000. At the end of the 10-year holding period, the asset is sold for \$6 million. The remaining book value is \$4.5 million, resulting in a gain of \$1.5 million. Applying a tax rate of 40 percent creates a tax of \$600,000. The remaining mortgage is \$2,698,000, resulting in cash on sale of \$3,302,000. Thus, the cash less the tax results in cash

Figure 2

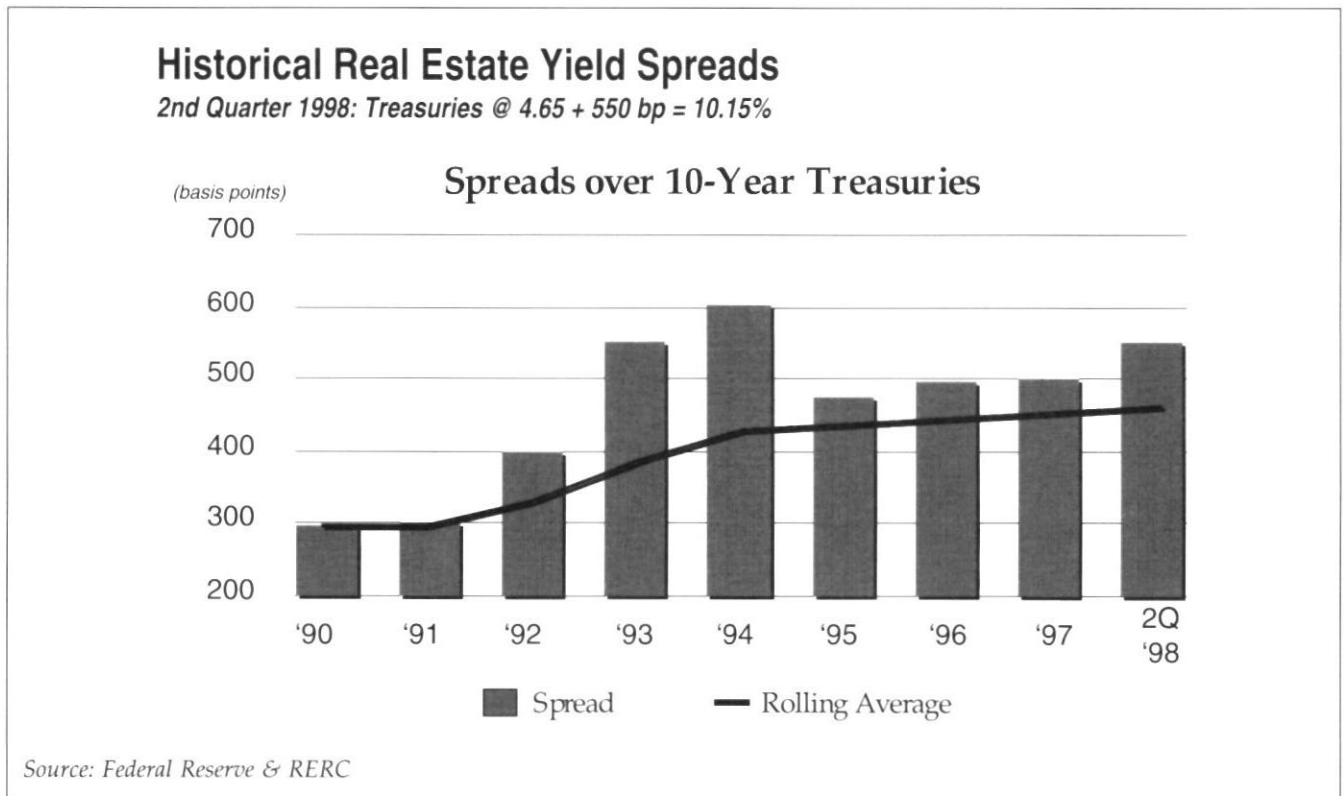


EXHIBIT I

OWN AND SELL AT END OF HOLDING PERIOD

	1	2	3	4	5	6	7	8	9	10	
Operating income	0	0	0	0	0	0	0	0	0	0	
Interest payment	(333)	(317)	(309)	(299)	(289)	(278)	(266)	(254)	(240)	(225)	
Depreciation	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	
Taxable income	(533)	(517)	(509)	(499)	(489)	(478)	(466)	(454)	(440)	(425)	
Income tax	213	207	204	200	196	191	187	181	176	170	
After tax operating income	(\$2,886)	(320)	(310)	(300)	(294)	(287)	(280)	(272)	(264)	(255)	
Operating income	0	0	0	0	0	0	0	0	0	0	
Debt service	(422)	(422)	(422)	(422)	(422)	(422)	(422)	(422)	(422)	(422)	
Income tax	213	207	204	200	196	191	187	181	176	170	
After tax operating cash flow	(\$2,292)	(208)	(215)	(218)	(226)	(230)	(235)	(240)	(246)	(252)	
NPV (\$1,497)	(192)	(183)	(172)	(161)	(152)	(143)	(134)	(127)	(120)	(113)	
Net sale price										6,000	
Adjusted basis										(4,000)	
Taxable gain on sale										2,000	
Capital gains tax										(800)	
Sale proceeds										6,000	
Remaining balance on mortgage										(2,698)	
Sale proceeds										3,302	
Capital gains tax										(800)	
Cash available for reinvestment \$2,502										2,502	
Cash reinvested										0	
Income from reinvestment	0	0	0	0	0	0	0	0	0	0	
Income tax on reinvested income	0	0	0	0	0	0	0	0	0	0	
After tax income from reinvest	\$2,502	0	0	0	0	0	0	0	0	2,502	
NPV \$1,127	0	0	0	0	0	0	0	0	0	1,127	
TOTAL AFTER TAX CASH FLO	\$210	(208)	(215)	(218)	(222)	(226)	(230)	(235)	(240)	(246)	2,250
TOTAL NET PRESENT VALUE	(370)										

EXHIBIT II

LEASE

	1	2	3	4	5	6	7	8	9	10
Operating income	0	0	0	0	0	0	0	0	0	0
Rent x	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)
Before tax operating cash flow	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)
Income tax	222	222	222	222	222	222	222	222	222	222
After tax operating income	(\$3,330)	(333)	(333)	(333)	(333)	(333)	(333)	(333)	(333)	(333)
Operating income	0	0	0	0	0	0	0	0	0	0
Rent	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)	(555)
Income tax	222	222	222	222	222	222	222	222	222	222
After tax operating cash flow	(\$3,330)	(333)	(333)	(333)	(333)	(333)	(333)	(333)	(333)	(333)
NPV (\$2,205)	(307)	(284)	(262)	(242)	(224)	(206)	(191)	(176)	(162)	(150)
Net sale price	6,000									
Adjusted basis	(6,000)									
Taxable gain on sale	0									
Capital gains tax	0									
Sale proceeds	6,000									
Remaining balance on mortgage	(4,200)									
Sale proceeds	1,800									
Capital gains tax	0									
Cash available for reinvestment \$1,800	1,800									
Cash reinvested	(1,800)									1,800
Income from reinvestment	360	360	360	360	360	360	360	360	360	360
Income tax on reinvested income	(144)	(144)	(144)	(144)	(144)	(144)	(144)	(144)	(144)	(144)
After tax income from reinvest	\$3,960	216	216	216	216	216	216	216	216	2,016
NPV \$2,241	199	184	170	157	145	134	124	114	105	908
TOTAL AFTER TAX CASH FLO	\$630	(117)	(117)	(117)	(117)	(117)	(117)	(117)	(117)	1,683
TOTAL NET PRESENT VALUE	36									

available for reinvestment of \$3,202,000. Subtracting the cumulative negative cash flow from the positive proceeds of sale results in total after-tax cash flow of \$210,000. The net present value, using an 8 percent discount rate, is a negative \$413,000.

Scenario B: Leasing

If, instead of purchasing the asset, the company were to lease the asset, there would be no capital investment. The lease payment would be 9.25 percent of \$6 million, or \$555,000 per year, all of which is deductible. Using a tax benefit of 40 percent, the after-tax cost is \$333,000. The negative cash flow is also \$333,000 per year. *Exhibit II* calculates this cash flow for each year at the end of the 10-year holding period. The cumulative negative cash flow over the 10-year holding period is \$3,330,000.

The \$1.8 million not invested in the asset is reinvested in the core business of the company at a 20 percent pre-tax return, resulting in \$360,000 per year of additional operating income. The tax at 40 percent is \$144,000, resulting in an after-tax return of \$216,000 per year. Thus, the annual negative cash flow is reduced to \$117,000. In year 10, in order to make the analysis consistent with the sale of the asset in *Exhibit I*, the \$1.8 million is returned. The after-tax cash flow is \$630,000. The net present value, using an eight percent discount rate, is a positive \$36,000.

NET RESULT

Leasing results in an after-tax benefit *three times greater* than the purchase of the asset. On a net present value basis, this difference is \$449,000 — a negative \$413,000 on the ownership basis versus a positive \$36,000 on the lease basis. This is accomplished by the ability to reinvest the \$1.8 million equity in the core business instead of in the asset. In order for the purchase option to accomplish the same result, the asset would have to be sold in year 10 for \$15,068,000 instead of \$6 million.

Another way to gauge the result is to compare the benefit with the asset. In this example, the asset cost \$6 million and the incremental after tax cash flow benefit of the lease is \$420,000 (\$630,000 less \$210,000). On both a marginal and annual basis, this is a seven percent after-tax return on this single asset.

By all accounts, the lease far outperforms the purchase in this situation.

ADDRESSING THE ARGUMENTS

Typically, there are three major arguments made

against the sale of real estate: 1). tax on the sale; 2). loss of control over assets; and 3). loss of residual value.

The *tax on the sale* of real estate can be a hurdle. However, a company should always make a decision based on the best economics and not let the tax tail “wag-the-dog,” so to speak. In fact, this argument is nullified in that if the property is appreciating in value, there should be enough cash proceeds to pay the tax liability. If the asset is not appreciating in value, then the property should be sold to avoid further decline in value.

The *loss of control over assets* is not a sound argument to keep real estate. Leases can be written that protect the tenant on all major aspects of the use of the property. In addition, options to renew the lease after its original lease term and options to purchase at fair market value at the end of the lease give the tenant long-term protection.

Finally, with regard to *loss of residual value*, we must remember that most companies are not in the real estate business. The investor in the average company is looking for returns (we have assumed a 20 percent return) based upon the company’s ability to succeed in its core business; therefore, management should employ its capital to achieve that result. As previously stated, there are certain businesses in which real estate is critical to its core business and should be retained. However, these examples are few and far between. Considering that the present value of one dollar received in 10 years discounted at 20 percent is only 16 cents, this further demonstrates how critical it is to employ capital in a way that achieves earnings immediately — not in the future when real estate is finally sold. Real estate is a very cyclical business and the past several years indicate the difficulty of timing real estate ownership with real estate occupancy requirements. As shown in the example, the asset would have to be sold at 250 percent of its cost in order to achieve the same after-tax result.

TRADITIONAL INVESTORS ARE BACK

If corporations should not own this real estate, who should? . . . The answer is, those who have made real estate investment their core competency. Operating with different investment criteria — 10 percent, not 20 percent — they are better suited to achieve acceptable investor results. Real estate has long been considered as a hedge against inflation. In addition, most portfolio managers are attempting to diversify their investments, expressing concern

over the volatility of the stock market and the low returns of the bond market. They see real estate as an effective balance of the two; it produces annual cash flow like a bond but also has growth potential like a stock. Since it is less risky than most stocks it can offer a smaller return.

More importantly, a whole new class of real estate investments is now available to investors and portfolio managers. Vehicles such as real estate investment trusts (REITs) and commercial mortgage backed securities (CMBSs) have attracted large amounts of capital to the real estate sector. In fact, it has been estimated that these two classes of investment have poured in excess of \$250 billion into real estate investments in the past five years (Figures 3 and 4). Although interrupted in 1998, this investment flow is not likely to disappear and pension funds, insurance companies, and private investors are very active today.

Size is critical to both investment vehicles; single transactions in excess of \$1 billion are becoming more and more common. Since REITs are required to distribute 95 percent of their funds from opera-

tions (FFO), they can grow only by raising debt and equity funds and using the cash for acquisitions. These acquisitions can be in the form of purchasing other REITs or acquiring additional properties. In either instance, they will continue to be active buyers of real estate.

A question is often asked as to why CMBSs will benefit corporations that own real estate. The quick and easy answer is that they create liquidity and that is what corporations need. More importantly, they bring a whole new discipline to the real estate financial world. They spread the risk by creating multiple layers of investment in real estate debt with different risk characteristics. This creates a greater variety of investors who will invest in real estate and compete for the product. This, in turn, reduces the spread between the debt and similar investments with the same risk profile, thus reducing the overall cost of money to real estate borrowers.

TAKING ADVANTAGE OF CURRENT OPPORTUNITIES

All of this investor attention presents an excellent

Figure 3

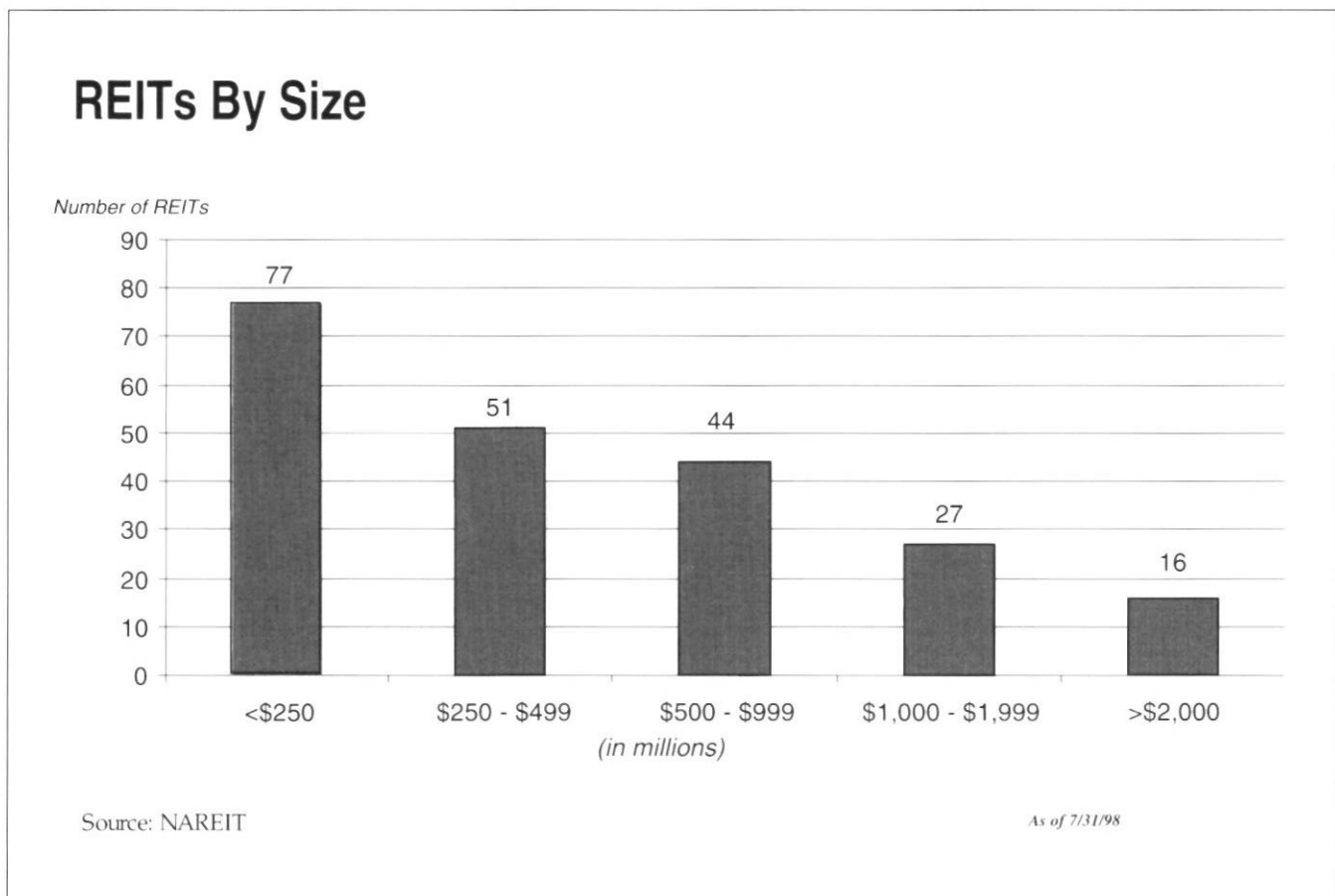
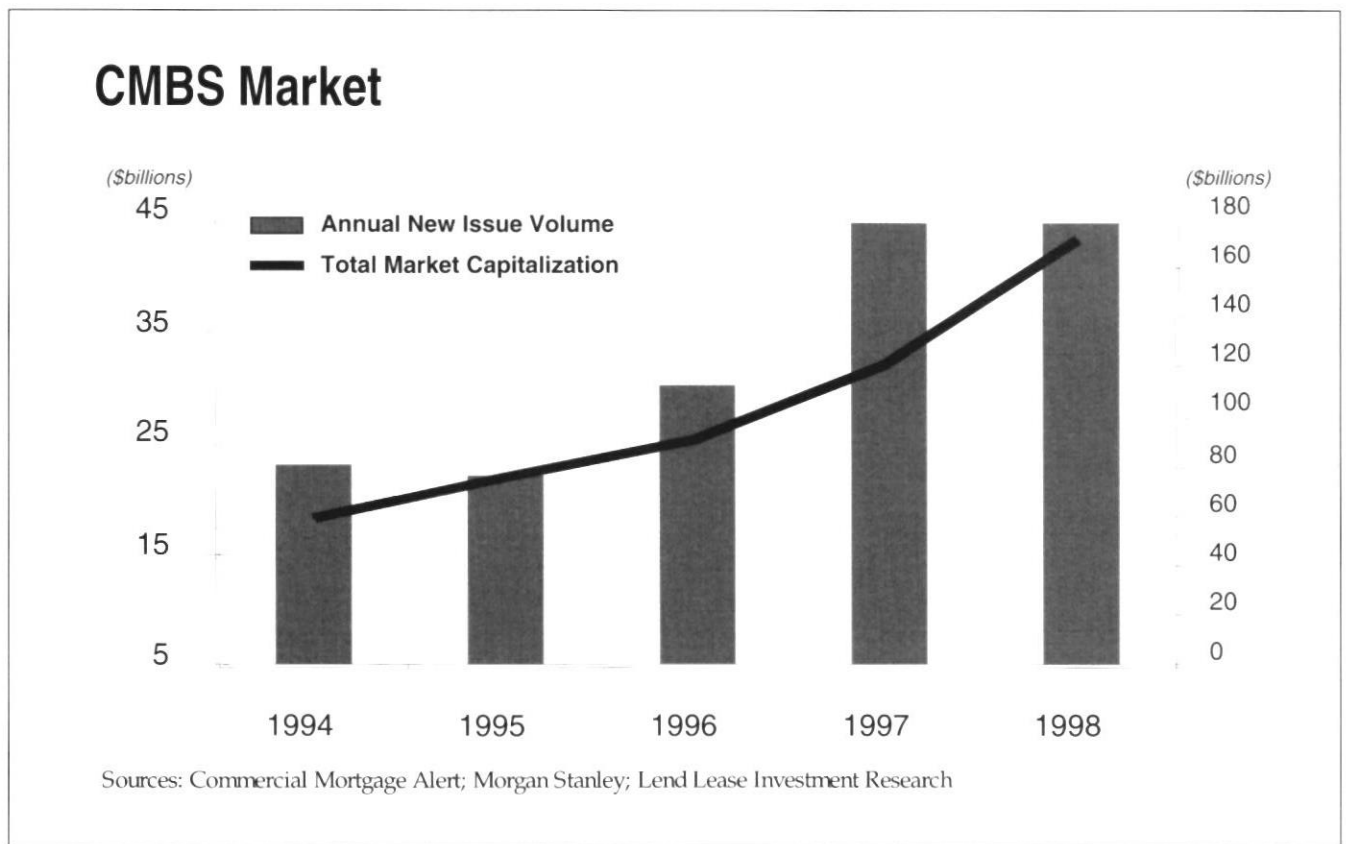


Figure 4



opportunity for corporations. For the first time, real estate can be used to enhance value instead of reduce value.

Securitization of real estate allows corporations to sell their real estate to an established buyer that is becoming very sophisticated in valuation, risk analysis, and delivery of pools of real estate investments to investors. Corporations can take advantage of the franchise value of REITs; because of this ongoing concern value, REITs have lower yield requirements on individual real estate investments. This, in turn, has increased prices for premium properties. Add to this formula the creditworthiness of investment-grade corporations as tenants and a profitable investment situation is created. Suddenly, the sum is worth more than the parts.

Corporations need to take advantage of the current atmosphere that exists on Wall Street. As long as investors continue to believe that diversified portfolios of real estate in the hands of REIT managers reduces risk and creates a sound investment, cash will continue to flow into the real estate sector. This cash will continue to require a return significantly lower than that required by shareholders in the core

business of the company. Corporations must take advantage of the spread created by this new asset class.

Some companies argue that because they have so much cash, additional liquidity appears to be of no value to them. A word of caution to those companies: you were the takeover targets of the 1980s. Then, excess cash was the greatest indicator of a company that should be liquidated. Could real estate become that indicator in the future?

No longer can corporations treat real estate merely as a factor of production or ignore its financial implications. To avoid that 'black hole,' it is essential that real estate today be treated as a managed asset that must compete for scarce capital and deliver a competitive return, ultimately enhancing shareholder value.^{REI}

NOTES

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1. Represents historical stock market returns which may or may not be repeated in the future.