

Institutionalization of Corporate Real Estate: *What It Means*

There is a run on corporate real estate in the world of REITs and other institutional investors, which is mostly good news for companies selling their facilities.

by MARK AREND

Two schools of thought are emerging in the wake of the rampant transfer of ownership of corporate real estate assets to institutions. First, institutional ownership will *erode* tenant service levels, because institutions are more interested in return on investment than in tenant services. Second, institutional ownership will *enhance* tenant services, because it is in the institution's best interest to keep satisfied tenants in the building.

Reality lies somewhere between the two theories. What's clear is that many corporations are shedding non-strategic assets from their balance sheets. For example, many are selling and leasing back properties in the hope of devoting more financial resources to such strategic functions as research and development.

Institutional buyers of corporate real estate range from pension funds with relatively healthy appetites for risk to real estate investment trusts (REITs) that must keep acquiring properties to reward shareholders. How much corporate real estate is landing in the hands of institutional owners is very hard to pinpoint, but REIT activity is less elusive.

REITs now own, by conservative estimates, about US\$250 billion of cor-

porate real estate assets. Ten years ago, they owned under \$2.5 billion worth. Investment funds and other institutional investors own more than \$100 billion in commercial property, a figure likely to increase dramatically as real estate becomes a less "alternative" asset class in the minds of investors.

Nevertheless, while the REIT phenomenon cannot be dismissed in today's market, it should not be over-emphasized in the grand scheme of things, insists Will McIntosh, managing director of Prudential Real Estate Investors, Parsippany, N.J. "Our data indicate that the public market penetration is greatest in the regional mall and hotel property types," he says, citing research his group released in July 1998. "We estimate that 28.6 percent of all regional markets are owned by public REITs, and 17.5 percent of hotel rooms are owned by publicly traded hotel companies, which besides REITs could include a real estate operating company."

McIntosh's group has been tracking for three years — current research covers 1995, 1996 and 1997 — public and private market activity and what it means to real estate investors.

"The acquisitions of office buildings by publicly traded companies certainly

accelerated in 1997," he relates. "A lot of that was driven by the surge in initial public offerings [IPOs], and existing companies with active acquisition programs, but the penetration driven by these IPOs was particularly exceptional. We tracked a total of nine private conversions to public REITs," McIntosh reports, including Equity Office Properties Trust, Boston Properties and several others. Existing public REITs acquired about 800 properties — 158 million sq. ft. (14.7 million sq. m.) of space in 1997.

"In no sector has the public market share increased by four points in any year we have measured," McIntosh points out. "The sectors with the highest penetration added the most in 1997, as opposed to 1996 and 1995, which may imply that the trend to increasing ownership feeds on itself, to some extent. Some argue that the pattern of increase in public market ownership follows an S curve, where the increase doesn't occur very fast and then it picks up speed pretty quickly as the industry gains growth momentum. This begs the question: Will this growth continue?"

As the public market gets bigger, McIntosh argues, it becomes more attractive to institutional investors,

because the market is better capitalized, which precipitates more liquidity and, ergo, transparency — the dual Holy Grails of institutional investors. “It becomes easier to get into and out of the market without *moving* the market,” he explains. “The reason we’re tracking this so closely is because we invest in real estate publicly and privately,” to the tune of \$400 million all told, “which is not an insignificant amount of money to have invested in the market. Going forward, we think the public market will continue to grow and capture a larger percentage of the overall commercial real estate market.”

Are Sellers Back-Seat Drivers?

Still, regardless of the buyer, in few instances does the person who decides to purchase a property actually manage it. Property management arms of real estate service organizations or similar units in the REITs handle the building and tenant services tasks. But who’s in the driver’s seat?

Does the corporation now renting a facility or floors in a building have the same or comparable power to alter work space or obtain additional HVAC equipment as it did when it owned the building? Or does the property manager, acting on behalf of the owner, pull rank on the lessee and decide such changes are not in the long-term interest of the property from a valuation perspective?

By most accounts, U.S. property owners and managers go out of their way to accommodate tenants, whether or not the tenant used to own the building. A spirit of customer service pervades most of the commercial real estate market, and owners of property seeking only to “make a killing” on their real estate investment are few and far between.

Nevertheless, it is important to be sensitive to shifts in the balance of power and to keep alive a sense of competition when it comes to securing real estate from owners, institutional or otherwise.

Customer-Focused Property Management

Consider the situation unfolding in the United Kingdom, where property

owners for generations enjoyed locking their tenants into 25-year leases. As these dinosaurs came up for renewal, they were simply renegotiated at a higher cost. The structure created a chasm between tenant and landlord that is only beginning to be bridged by the emergence of more realistic lease terms and industry players challenging the old guard to reform their ways.

“The UK [real estate] industry has created products for institutional investors — that’s what it’s been about,” says Gordon Edington, group property director at British Airports Authority plc, London. “Therefore, the needs of the occupiers have been secondary. I contend that if you get the needs of the occupiers right, then you’ll have a long-term, sustainable business anyway. You say, ‘Yes,’ to your occupiers if they want short leases, and if they want long leases, it’s ‘Yes,’ within reason, anyway. The point is to operate it as a business, which will cause it to be sustainable in the longer term. It’s not the fact that you have a long-term lease. People are beginning to understand that.”

Such companies as Regus, which provide highly customized real estate and business support services on an outsourcing basis, are helping drive the new way of thinking about lease terms and related matters in the UK, because they compete directly with the landlord community.

“If an owner of property wants to sit back and simply collect an income over a 20-year period, I would question whether or not they, on thinking it through, feel that they should be owners of property,” says Edington, echoing comments he made to a conference of the British Property Federation earlier this year. At that meeting, forces were gathering for a virtual showdown between landlords and corporate tenants frustrated by rigid real estate arrangements. Edington argued that customer-focused property management benefits both parties, which is a lesson that should not be lost on managers globally.

REIT Consolidation Implications

Back in the USA, although corporations remain the largest owners of real estate assets, divestiture of those assets

is ubiquitous. At the same time, institutional players are consolidating, particularly the REITs, which is a trend with ramifications for corporate real estate professionals.

“If you’re a major company with 50 facilities around the country, as is the case with most *Fortune* 100 companies, then you’ll be dealing with fewer owners, and those owners will be better capitalized,” says Joseph Ori, director of the real estate advisory group at BDO Seidman LLP, a Chicago-based accounting and consulting firm.

“They will be more service-oriented,” adds Ori, “and they will increasingly speak the same language. If you as the tenant are IBM and Equity Office is your landlord, you have two fairly big institutions there, both sophisticated, both very large. The owners will have a lot more expertise than an entrepreneurial type or financial guy who simply owns your building and plans to flip it in a couple of years. Those are consolidation benefits.”

Another upside to the institutionalization of corporate real estate ownership is that unlike what’s taking place in the UK, institutions in the USA — or those acting on their behalf — fully appreciate the importance of customer-focused management, Ori observes.

“Today, your tenant is your product, and if you are not managing that building and meeting the objectives and demands of that tenant, he will not stay there,” Ori asserts. “If you have a major corporation as a tenant, you want to bend over backwards. If they want five wings put on a building in two weeks, you put five wings on that building in two weeks. If he wants additional heating or air conditioning late at night, you do it at your cost. It’s a service business, and you have to go the extra mile to service your client.”

Too obvious a point? Not necessarily. The points raised here will become even more concentrated in the coming months. The owner-representative business is likely to become overheated, so stay with organizations with a track record, to better ensure working with people with experience, and organizations that are customer-focused,

analysts advise. At the same time, keep institutional ownership trends in perspective so that real estate asset management plans do not become compromised.

"We expect the public markets to continue to penetrate the commercial real estate market more extensively," says Prudential's McIntosh. "It seems, though, that only a relatively small percentage of the stock of commercial real estate changes hands in any given year, based on our research. If you looked at how much real estate changed hands relative to the size of the commercial real estate market, it wasn't a lot."

That limits the opportunity for market share adjustments, he elaborates. "If you don't have a lot of property

changing hands, how will any market, especially the REIT market, grow rapidly?"

Several factors gave public companies advantages in making acquisitions in 1997 that will not always be present, says McIntosh, including generally high premiums to net asset values at which their shares were traded. "This may mean that 1997's market share gains are unusually large and that public companies may have captured more than a normal share of the available acquisitions in that year. In addition, as development accelerates, which it is in many property types, public companies need to account for at least their share of new development in order to maintain their market share; and many

doubt that that will be the case at least in some property types.

"This suggests that achieving more than a four-percentage-point growth in market share in any year would be an extraordinary event for public companies in any property type," McIntosh continues. "That tells me that if somebody is expecting the REITs to capture 40 or 50 or 60 percent of the real estate market real soon, it probably won't happen. Having a sense of that is important, because it helps you plan your real estate investment strategy and how to plan your business strategy if you're in the real estate business going forward." **SS**