



OPERATIONS: MAXIMIZING YOUR REAL ESTATE ASSETS

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There's a good chance that your company has some unwanted real estate in its portfolio. It could be an old storage warehouse that hasn't been used since your operations group consolidated its operations. Or it might be some property your company bought for a future requirement that it doesn't need any longer. Whatever it is, it's sitting on your books—unused and maybe even costing your company a hefty tax bill every year.

Real estate rationalization gives companies an opportunity to evaluate the interrelationship of their operations and real estate assets. (See the sidebar, "Elements of a Real Estate Rationalization.") The purpose is to take a snapshot, indicating inefficiencies and underutilized facilities that can be consolidated or tapped to improve internal cash flow. Generating cash from real estate rationalization and improved productivity is becoming a business imperative.

Real estate portfolio strategies often need updating. Moreover, they often are developed without input from the operations teams. Consequently, some real estate is frequently underutilized, poorly located, and may also be functionally obsolete (with low ceiling heights, inefficient layouts, too much or too little office and storage space, etc.), which is why the optimization analysis yields such valuable information.

Consolidate or Repurpose?

For some companies, consolidating or selling select real estate assets is a solution. For example, headquarters buildings that are underutilized provide an opportunity to implement such workplace strategies as hoteling, where employees who do not have a workspace assigned to them are "booked" on an as-needed basis. If the company allows some employees to work remotely, it can allocate nominal space, if any, to them, thereby reducing costs. This is one reason that average square feet per employee at headquarters buildings has gone from 250 square feet per person in 2005 (according to MIT's Sloan School of

Management) to as low as 100-150 square feet per person in 2009.

Also, moving the corporate headquarters to lower-cost space is an option: Leases can be renegotiated and owned properties can be sold in a sale-leaseback transaction to generate cash internally.

Closing or consolidating properties can have downsides for customers, field-service staff, and public relations. A rationalization analysis, however, will prioritize and align sites with customer needs. In this way, a company closing its properties to consolidate or relocate to a location closer to its customers or employees also has the additional benefit of improving customer service, reducing fuel costs, and increasing employee productivity.

Repurposing company-owned real estate to maximize its value is part of the rationalization process as well. Repurposing involves a rationalization evaluation and a highest- and best-use analysis for the property. In a recent case, a Northeastern based company owned a piece of land zoned for light industrial (li) located within blocks of a retail load center, comprising a Best Buy, Macy's, and Target stores. Strategically, retail was a better use for this property than its current li zoning. Larger retailers typically are on the look-out for desirable retail locations and can pay cash for them. If the company can get a zoning change, sale of the land for retail use would maximize its value at monetization—industrial land and buildings usually have a much lower market value than a potential retail site.

In another example, a Midwest electric utility owned a service center from the early 1900s that, in its run-down condition, was a significant drain on the company's cash resources. The property, however, was located within two blocks of an urban university with good access to transportation. Since there often is a shortage of affordable, convenient, modern student housing in urban

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markets, it may be more cost-effective for a developer to buy and convert a distressed building than to tear down and build from the ground up. Distressed properties allow the investor to maximize the investment's return, and the predictable demand for student housing maximizes the property's value at sale.

Other Factors

There are certain risks associated with any disposition or sale, including the cost of legal fees associated with a zoning change (if required), the decision that the property will never be needed for the business, an investor tying up the property to obtain financing, to name a few. A company should consider many factors in its rationalization study.

Monetization. Repurposing can maximize the property's value at monetization, which is often the owner's objective. Sometimes companies list their asset for a sales price assuming pricing for current use or book value and don't consider its highest and best use when alternative uses could double or triple the proceeds from the sale. These opportunities apply to almost all types of real estate—other than a million-square-foot office tower that would likely not make sense to redevelop for an alternative use.

Timing. In the current market, selling a property typically takes 18-24 months to close, or longer if a zoning change is required. Cost/benefit decision modeling will help quantify potential benefits or downsides, including comparing the carry costs (such as taxes, operating expenses, and maintenance costs) of selling in a down market to the sales price that would be secured in an improved market.

Shareholder benefit. Shareholders will see significant benefit from real estate portfolio optimization as companies uncover hidden opportunities to reduce costs and unlock capital. Shareholders would benefit from improved operating efficiencies and reduced capital expenditures, as well as lower operating and maintenance costs by consolidating or relocating to lower-cost properties and realignment with the company's business. In addition, book value often obscures market value, with the latter being as much as five times the former—depending on how long the property has been owned and its current and potential use.

Weighing 1031 Exchanges

Section 1031 of title 26 of the United States Tax Code allows tax payments to be deferred indefinitely through continuous qualified real estate sale and purchase transactions as long as the sale complies with Internal Revenue Service (irs) rules. Moreover, a buyer can purchase multiple properties and still qualify. For example, a company can sell a \$10 million waterfront lot and buy an \$8 million parcel of undeveloped land and a \$2 million commercial building as the combined replacement property and defer all federal capital gains tax liability.

To qualify under section 1031, the property (or equipment) must be held for investment or income-producing purposes or used in a taxpayer's trade or business. Stocks, bonds, partnership interests, limited liability, company interests, and personal residences are not eligible for Section 1031 exchanges. Second, the rules also require a swap or purchase of a "like kind" replacement property. Real estate must be replaced with real estate, as opposed to equipment, for example. Third, equity and debt on the replacement property must be "equal to or greater than" the value of the relinquished property. The replacement property must be identified 45 days after the property is transferred, and the owner has 180 days to purchase the replacement property. If the seller does not comply with all the 1031 rules, the capital gains payment will be due at the closing. A 1031 exchange may not be the right way to go for a company if it will rush a decision to purchase a property that may ultimately not meet their needs just to comply with exchange rules.

With the current economic situation, companies should anticipate a lengthy sales process and plan ahead for compliance with the strict 1031 exchange rules. For example, one should assume that it will take 120 to 180 days to get an offer, another 30 days to negotiate, 120-180 days for due diligence contingencies, and 30-45 days for the closing. A conservative timeline also would plan for a deal or two to fall through before the real deal actually closes.

It may be the right time to purchase a more efficient, better designed or located facility, or to dispose of brownfield site. The reality is that if the property sells for less than it had been appraised a few years ago, the purchase price of the new property also will be lower. If shareholders benefit by reducing operating costs,

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increasing productivity, and mitigating tax risk, selling facilities now should not be an overlooked component of the business strategy. If the property has been owned for years, with a low basis or little to no debt, deferring capital gains payments is a way to retain and leverage the asset's appreciated value. Justification of IRS Section 1031 like-kind exchanges may be helpful, but the use of the code section will vary by individual company circumstances. Stakeholders comparing the impact of owned assets would be wise to plan ahead with their tax advisors and determine the best time to sell.

Don't Neglect Brownfields

Brownfields are getting a second look by real estate investors who specialize in investing in distressed properties. With advances in remediation technologies and more flexibility in environmental regulations, a utility might not have to be saddled with the costs associated with maintaining environmentally problematic property assets and can mitigate trailing liabilities.

The change in attitude and activity stems from a focus on risk-based clean-up standards and incentives for brownfield redevelopment. Older statutes and regulations required a complete extraction or remediation of any contaminant. Both financially and technologically, reducing levels to zero were either impractical or impossible for companies attempting to remediate these properties. Moreover, past legislation required excavation and transportation of contaminants off-site, making the remediation effort cumbersome, costly, and risky given the long-term liabilities associated with landfills, and put brownfield redevelopment at a standstill. However, changes to environmental regulations in the 1990s made on-site remediation of brownfields possible and allowed brownfield redevelopers to focus on environmental improvements without the cost of transporting contaminants off-site or bearing the long-term legal risk of landfills.

A number of other factors also have made brownfield redevelopment an attractive prospect. First, at the state and federal level, projects that have a "green" component are getting first priority for approvals. Under the American Recovery and Reinvestment Act of 2009, approximately \$100 million has been earmarked for brownfield remediation and oversight. One example is the Brownfield Revolving Loan Fund Program being administered by the

Environmental Protection Agency, with grants of up to \$200,000 being administered to government agencies and nonprofits with shovel-ready projects that involve a contaminated property that is interfering with redevelopment efforts in the region.

Second, brownfields are an excellent prospect for renewable energy projects, since many renewable energy technologies can co-exist with the remediation effort on the property. This makes it a highly desirable proposition for redevelopment and the project-related tax incentives.

Companies generally come under one of two situations: Either they have already absorbed the cost to remediate a brownfield property or the utility has a brownfield property it wants to sell or remediate. In either situation, there are many considerations. The buyer, who may have a team of brownfield experts and prefer to do the remediation, may be able to bear the remediation costs. Such buyers generally know how to do remediation more cost effectively than a utility. Further, it is possible that no remediation may be required depending on the repurpose or redevelopment planned. For residential purposes, of course, remediation is necessary. However, a manufacturing company that is held to a lower environmental standard may be comfortable buying the property in its current condition.

Buyers will typically require that the company continue to be liable to some degree for the contaminated property. This legacy risk is negotiable, however. The company will need to perform a risk-assessment analysis to determine whether or not sale of the brownfield subjects them to an unacceptable degree of liability. In sum, brownfield dispositions should be carefully evaluated.

Despite the sputtering economy and rising costs, cash-strapped companies are discovering an untapped internal cash source in their real estate. With a strategic approach to real estate portfolio management, unlocking tens of millions of dollars in capital and operating efficiency gains is possible.

Elements of a Real Estate Rationalization

In a recent case, a major Northeastern utility underwent a rationalization of its real estate to discover an anticipated \$64.9 million in savings over a 10-year period. In this particular case, the optimization process began with an

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evaluation of the utility's entire real estate portfolio—both owned and leased assets. Some elements of the engagement included:

- financial and operational analysis;
- physical assessment of the real estate assets;
- determination of how best to support operations;
- space utilization of the corporate headquarter facilities;
- determination of the optimal number and location of customer service offices and field service stations;
- determination of the most effective strategic location for warehousing facilities;
- probable market value of assets for sale; and
- identification of risk.

Based on a five-year projection plan, the company will save nearly 60 percent from capital expenditure and operating and maintenance savings. The annual cost of delaying the initiative would have been \$5.9 million because of the costs associated with carrying excess space and investing too much capital to maintain and operate inefficient facilities. Key operational improvements included a 40-percent reduction in total customer service wait times, 20-percent reduction in total materials management shipments, and an increase in corporate office space utilization from 45 percent to 92 percent through new workplace strategies.

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