Effects Of Corporate Real On Company Values

By Mauricio Rodriguez PhD and C.F. Sirmans

Regardless of industry, companies need real estate to function. Typically, real estate accounts for 25 percent to 40 percent of corporate assets, and occupancy costs range from 40 percent to 50 percent of net income. Given these large investments, it is not surprising that studies find decisions related to real estate have a significant impact on company values as reflected by changes in their stock prices. Recent attention has focused on corporate real estate assets. The evidence indicates that real estate owned by corporations is not being managed efficiently.

Research shows that only 40 percent of U.S. firms evaluate the performance of their real estate on a regular basis. Only 20 percent of U.S. firms are reported to manage real estate for a profit. Arthur Andersen & Co. reports senior managers do not view corporate real estate as making a significant contribution to competitive advantage, and they believe there is no need to link strategic real estate planning and business planning. These survey results imply that senior corporate managers do not believe real estate decisions significantly impact company value. As a result, relatively little attention has been given to this substantial corporate resource.

Academics have conducted research studies investigating the impact real estate decisions have on firm values. How do academics measure a decision's effect on shareholder wealth? Typically, "event study" methodology is employed in such studies. Event study methodology was introduced in 1969 by Eugene Fama, Lawrence Fisher, Michael Jensen and Richard Roll. Since then, the methodology has been expanded and refined. The basic ideas underlying event study methodology are as follows. First, a model is used to forecast the expected return a company would have if no "event" (corporate real estate decision) took place. Often, a simple model based on capital asset pricing theory is used to develop forecasts. Next, "unexpected" returns are calculated by comparing actual returns to the expected returns. Unexpected returns are commonly known as "abnormal returns" or "prediction error." Unexpected returns can be calculated for one-day or multiple-day intervals. Lastly, unexpected returns are grouped for companies that experienced similar decisions and statistics are computed to help determine if the decisions had a significant impact on firm values. This helps researchers determine if an unexpected return is associated with a real estate decision or if there is a high probability that such a return would occur regardless of the decision.

The results from event studies provide useful insights. It is important for managers making real estate decisions to see how company values changed when compared to similar decisions by other managers. Real estate related decisions can enhance or diminish shareholder wealth. For example, research shows a significant 1.23 percent one-day increase in the value of firms that sold real estate assets. Similarly, a 1.46 percent return is found for international firms selling real estate. When REITS sell real estate, they experience an average 2.89 percent return. Negative wealth effects from real estate related decisions also can occur. For example, research shows a significantly negative 1.28 percent one-day market reaction to relocation decisions prompted by managerial self-interest.

Key Factor

How can real estate be managed to maximize shareholder wealth? The first and most important step for improved management of corporate real estate is for top managers to acknowledge the importance of real estate for their companies' livelihood and to incorporate real estate decisions as part of the overall corporate strategy. Real estate related decisions should complement the overall direction of a firm. For example, a high-growth company may benefit from flexible short-term leasing arrangements that allow for increases in space.

It is important for companies to evaluate the overall environmental, legal and financial risks associated with real estate. For example, a company should evaluate how its cost of capital may be affected by commitments to own vast amounts of real estate. Large firms may find their lower cost

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of capital consists of selling common shares or bonds backed by the strength of their balance sheet. Smaller firms may find their lower cost of capital to be traditional real estate financing backed primarily by the real estate being financed.

Related to the cost of capital is a company's capital structure. Can real estate decisions influence how much debt or equity a firm uses? Decisions to purchase, lease and sell real estate can each impact a company's capital structure and value. Leasing can be a substitute to debt financing. Leasing decisions have been well received by the market. Research shows lessee firms experience a .85 percent unexpected return on the day leasing decisions are announced. Unexpected returns have not often been reported for most corporations making new debt issues. However, REITs making new debt security offerings experience positive unexpected returns. These research results support the use of leasing over debt by real estate mangers in non-real estate companies. However, decisions should be made in light of the impact on a company's overall cost of capital and capital structure.

Several organizational options are available to corporate real estate managers. The management of corporate real estate may be centralized or decentralized. Real estate holdings may be spun off as a separate entity. Using a REIT for real estate ownership may become more viable in the next few years. These decisions should be made within the context of the overall corporate strategy. Announcements that some of these initiatives will be undertaken can increase company values since they inform stockholders that efforts are being made to manage corporate real estate more efficiently. Specifically, research shows firms experience a positive 5.7 percent unexpected return when they decide to spin-off real estate operations and a positive 2.14 percent unexpected return on the days surrounding decisions to form a corporate real estate unit (CREU). In both cases, company values increased when efforts were initiated to improve the management of real estate holdings.

Once managers have made a commitment to improve the management of their corporate real estate, an inventory is often necessary. It is surprising that large commitments have been made to real estate assets, yet often companies do not have detailed information on what they own. It is useful to store the information in a geographic information system (GIS) that will facilitate further analysis, periodic report generation and monitoring of real estate performance. A GIS can be used to analyze how company profits will be affected by doing business in alternative geographic locations. Transportation costs can be more easily analyzed within a GIS. Also, the potential impact agglomeration economies may have on sales revenues can be modeled in a GIS.

Analysis of Holdings Critical

An analysis of the value of real estate holdings is critical. Balance sheet accounts (book value) for real estate purchased in the past do not reflect any market changes. These accounts often appear to have minimal values due to depreciation deductions even though the market value of the real estate may be substantial. Documentation of the market value of real estate provides managers with the ability to analyze whether real estate assets are generating an acceptable yield. The simple release of real estate values may elicit a positive market reaction since it brings attention to these important assets and allows investors to update their estimates of corporate real estate holdings.

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Next, corporate real estate executives should evaluate if the amount of space they use can be reduced, if the quality or type of space should be changed and if the price being paid for space can be reduced. It is not uncommon to find out that back-office or other activities are carried out in high-priced real estate. If these activities are moved to less costly space, the cost savings can increase the value of the company. Research results show a significant 1.19 percent increase in the value of companies that relocated to reduce costs. Similarly, when companies sell off underutilized real estate, they experience significant increases in firm value. Companies that have exhausted their real estate depreciation allowances may place a lower value on their real estate than companies that can use this tax shield benefit. Under these circumstances, a sale/leaseback arrangement can increase the value of a firm and allow it to stay in the same location. Research on a sample of sale-leaseback decisions from 1975 through 1986 shows a significantly positive .85 percent average unexpected return. The positive unexpected returns appear to result from the overall reduction in the present value of expected taxes induced by the sale-leaseback transactions. More recent work confirms the previous results for seller-lessees prior to the Tax Reform Act of 1986 but shows no significant unexpected returns for firms involved in sale-leasebacks thereafter. Managers should evaluate previous event study results in light of the current and previous economic environments.

Corporate real estate managers face many difficult decisions. Should corporate real estate functions be outsourced or carried out in-house? We have not found any study that measures the effects of outsourcing on stock prices. Are

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there economies of scale for outside providers? Where do benefits from synergies exist? How will location decisions affect overall company costs and revenues? What comparative advantages does a firm have when deciding whether to participate in a real estate joint venture? If the value of the company is to be maximized, it is important to evaluate and understand how decisions related to real estate assets affect company value.

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Editor's note: For a detailed review of the research mentioned in this article, along with relevant citations for further reading, see "Managing Corporate Real Estate: Evidence from the Capital Markets" by Mauricio Rodriguez PhD and C.F. Sirmans in the January 1996 *Journal of Real Estate Literature*, Volume 4, pages 13-33.

Table 1 — Summary of Studies Analyzing Effects of Corporate Real Estate Decisions on Firm Value

Decision	Author(s)	Journal (Year)	Abnormal Return (Interval)	Sample Period and Size	Summary
1. Real Estate Acquisitions	Allen, Rutherford & Springer	*Journal of Real Estate Research* (1993)	.85% (0, 0)	1979-1991 67	Lessee firms experience significant positive abnormal returns.
	Glascock, Davidson & Sirmans	*AREUEA Journal* (1991)	.76% (0, 0)	1971-1986 30	For the total sample of buyers, there are no significant abnormal returns. For a subsample of single purchasers, significant returns are found.
	Elayan & Young	*Journal of Real Estate Finance & Economics* (1994)	1.2% (-1, 0)	1972-1987 70	Overall bidder firms experience excess returns of .6 percent. When the sample is broken down further, non-real estate bidder firms have insignificant excess returns while real estate firms experience positive abnormal returns.
2. Real Estate Joint Ventures	Ravichandran & Sa-Aadu	*AREUEA Journal* (1988)	.76% (-1, 0)	1972-1983 72	The evidence indicates that significant increases in the value of the participating firms occur within a two-day interval. The changes in value vary and appear to be due principally to the amount of information about the local real estate market possessed by the participating firms, and an information signal about the potential financial viability of the proposed project conveyed by the presence of anchor tenants.
	Elayan	*Journal of Real Estate Research* (1993)	1.48% (0, 0)	1972-1989 57	Real estate firms experience positive significant excess returns upon the announcement of a joint venture. Real estate firms earn relatively higher abnormal returns when they joint venture with non-real estate firms.
	He, Myer & Webb	Working paper, Cleveland State University (1993)	1.11% (-1, 0)	1975-1990 53	Domestic real estate joint ventures significantly increase shareholder wealth. International joint ventures experience less positive, insignificant wealth effects.
3. Disposition of Real Estate Assets	Glascock, Davidson & Sirmans	*AREUEA Journal* (1991)	1.23% (-1, -1)	1971-1986 51	The authors find statistically significant positive returns to sellers of realty assets, particularly on the announcement of the sale of real properties.
	Myer, He & Webb	*AREUEA Journal* (1992)	1.46% (-1, 0)	1964-1990 48	Sellers of real estate receive increases in wealth. The wealth gains to sellers were not statistically different for firms selling to U.S. buyers and firms selling to non-U.S. buyers.
4. Sale-Leaseback of Real Estate	Slovin, Suchka & Polonchek	*Journal of Finance* (1990)	.85% (-1, 0)	1975-1986 59	The impact of the announcement of a sale-leaseback of a building is positive. This positive market reaction appears to result from an overall reduction in the present value of expected taxes induced by the transactions.
	Rutherford	*AREUEA Journal* (1990)	1.59% (-1, 0)	1980-1987 41	The evidence suggests that the sale-leaseback of corporate real estate has substantial benefits for seller-lessee common stockholders. Additionally, the SLBs produce an insignificant loss for the corporate purchaser-lessor.
	Alvayay, Rutherford & Smith	*Real Estate Economics* (1995)	Insignificant for intervals post 1986	1987-1989 20	The authors report positive abnormal returns for the seller-lessee prior to the Tax Reform Act of 1986. After the Tax Return Act of 1986, they find that no significant abnormal returns accrue to firms involved in a sale and leaseback of their corporate real estate.
5. Restructuring of Real Estate Assets	Ball, Rutherford & Shaw	*Journal of Real Estate Research* (1993)	2.70% (-1, 0)	1968-1990 40	Spin-offs produce significant abnormal returns. Post-event tracking of spun-off firms and parent firms show no significantly different returns from the market portfolio.
	Rutherford & Nourse	*Journal of Real Estate Research* (1988)	2.14% (-10, 0)	1963-1986 71	Overall, there is a significant impact from the formation of a corporate real estate unit on the stock price of the parent organization. Wealth created varied among the type of units formed.