CFO

Space Race

The weak real estate market offers CFOs a great opportunity. Here's how to maximize it.

Russ Banham, CFO Magazine
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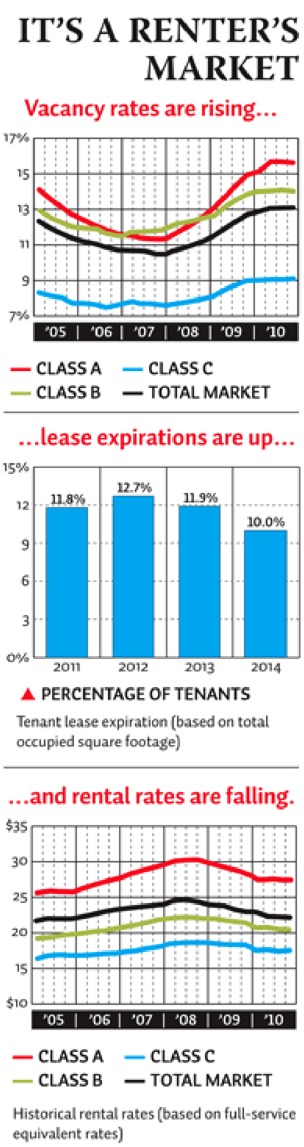
Many companies will move or expand into new facilities in 2011, particularly if the economy picks up steam. Fortunately for them — and for companies that simply want a better deal on their current space — the weak commercial real estate market presents opportunities for significant savings. With vacancies still at near-historic levels, landlords are offering 20% to 30% reductions on longer-term leases.

But cheap leases aren't the only way to save money on real estate



these days. Some companies are auditing their current leases and finding that they are paying more than they should. Others are winning site improvements from landlords anxious to keep them as tenants. And still others are employing creative ways to reduce power, water, heat, and other utility costs, pushing annual expenses down by tens of thousands of dollars.

There is also the obvious attraction of buying instead of owning, especially given rock-bottom price tags and interest rates. Far more intriguing to companies, however, are the opportunities presented by sale-leaseback arrangements. These deals have flowered in the last few years, although proposed changes to lease-accounting rules may take the bloom off the rose for some.

Finance chiefs who have recently negotiated leases have come away smiling. Cosmo Alberico, executive vice president and CFO of Odyssey Logistics and Technology, recently renegotiated the lease on the company's Danbury, Connecticut, headquarters building, locking in a five-year deal at a 27% savings. An eight-year-old logistics and transportation services provider, Odyssey wanted to stay put rather than incur the expense and headaches of moving to another location, says Alberico.

The privately held company renegotiated its lease not through its real estate broker but directly with its landlord, an arrangement that suited both parties. "He knew he'd save the 5% annual broker's commission, and I knew that he didn't want to risk losing us as a tenant," says Alberico. But the CFO didn't go behind the broker's back: in fact, he asked the broker to compile data on other leases for comparable space, which it did free of charge. (The broker was happy to comply: Odyssey is growing and sees a bigger physical footprint in its future, portending more business for the broker.)

The lease data gave Alberico the upper hand with the landlord. "I had leverage to get a great deal, well below market rate," he says.

Odyssey's experience is writ large across the landscape, says Marisa Manley, president of Commercial Tenant Real Estate, a New York–based real estate advisory firm. "We're seeing an average 30% in savings in terms of lower face [that is, contract] rents, greater cash contributions by building owners to build out a tenant's space, and just better deals, such as the ability to expand into additional space without having to pay for it today," she reports. "We just worked on a lease where the landlord charged $50 a square foot and was willing to finance $10 per square foot for the tenant. That's the kind of leverage tenants have today."

The Window Is Wide Open, for Now

Those conditions are not expected to change for the next 12 to 18 months, says Manley. According to her research, the average U.S. vacancy rate is 15% in large urban areas and between 13% and 17% in suburban areas, even surpassing 20% in some suburban markets. A 10% vacancy rate is customarily regarded as equilibrium, offering equal bargaining power between landlords and tenants.

High vacancy rates aren't the only factor giving current and prospective tenants the upper hand. Other considerations include commercial real estate availability — space that will become vacant within the next 12 months — and "shadow space," an industry term for space under lease that isn't being used.

"Right now in New York City, the availability rate is about 13%," says Manley. "We estimate the shadow space at about 3%. You add all this up, and in the near term the effective vacancy rates are much higher than they appear. And this will continue to compel landlords to cut deals they'd rather not."

"Given the high vacancy rates, the timing is good for CFOs to examine where their companies are in their lease terms," says Ray Milnes, national leader of KPMG's real estate practice. "If they have a 10-year lease and they're in year 6 or 7, the landlord is beginning to feel the stress of the lease expiring and possibly losing the tenant. They know that other landlords are ready to pounce. This gives the tenant the advantage; [the CFO] can say to the landlord, 'We have 3 years left on our lease. We like the space. What can you do for me?'"

Milnes says landlords are working with tenants to extend leases, often at lower rents, and will even provide an allowance to tenants to update or remodel the physical space. "Building owners are doing everything they possibly can to retain existing tenants because they know it is a lot harder to find new tenants than to keep the ones they have," he adds.

Seizing these opportunities now is critical, says Robert Merck, senior managing director and head of New York–based insurer MetLife's real estate investment department. "Now is the time to lock in a long-term lease, because rates in most metropolitan cities are significantly down from their peak," Merck says. "As the economy begins to slowly and steadily improve, vacant space will lease up quickly, since there wasn't as much speculative building prior to the downturn, translating into less overbuilding. The window of opportunity for leasing at attractive terms should remain open for the next 18 months, maybe even two years."

Bill LaFayette, who follows national commercial real estate trends as vice president of economic analysis at the Columbus Chamber of Commerce, says the window may slam shut sooner. "Office space is driven by employment, and the forecasts now for the general economy point to a gradually increasing rate of GDP growth that should be north of 3% by the end of 2011," LaFayette explains. "That is a strong-enough growth rate to drive employment growth. Once that picks up, demand for space will rise and the leverage that tenants now have will slacken."

Beware How Buildings "Grow"

Great leasing deals are not the only ways to cut costs in the soft-as-meringue commercial real estate market. Town Sports International Holdings, a New York–based owner and operator of 160 health clubs along the East Coast, saved $200,000 in 2010 thanks to a thorough audit of its myriad leases. Town Sports leases all but one of its health clubs. "We hired a lease auditor to review all of our leases to see if we were being gouged on the common-area charges, which seemed to rise faster than other property-related expenses across our portfolio," says CFO Dan Gallagher. "We thought something unusual was going on."

There was reason for the skepticism. Paul Stevens, president of P. Stevens Associates, the firm that conducted the audit, determined that the language in Town Sports's many lease contracts made the company vulnerable to additional charges. "Landlords are very creative and will 'grow' the size of their buildings [with] nonrentable space — the common areas like hallways, stairwells, and elevators that all the tenants use," Stevens explains. "We did a study of approximately 200 million square feet of rentable space in Boston and found out that 65% of the 51 buildings we surveyed had grown in size over a 10-year period. The buildings had not changed physically — the owners just measured the square footage differently. We're now paying our fair share of our allocations for common areas," says Gallagher.

In total, Town Sports will likely save more than $750,000 through the end of its leases. To ensure that renters aren't overcharged for common areas, Stevens recommends that leases contain contract language requiring building space to be measured in accordance with ANSI/BOMA Z65.1-1996, a standard published by the Building Owners and Managers Association.

Another CFO, Terry Peterson of Deluxe Corp., has pulled out $10 million in annual expenses from the company's facilities costs. The Shoreview, Minnesota-based provider of business services and printed products such as checks, with $1.3 billion in annual revenues, turned to a commercial real estate firm, Minneapolis-based NorthMarq Real Estate Services, to evaluate its operating costs. "We have several printing plants, which require specific humidity levels to run efficiently," Peterson explains. "We wanted to manage the related utility costs more effectively and decided to outsource this responsibility."

NorthMarq attacked the objective in diverse ways. Remote sensors were attached to buildings to find out if the lights and heat were on when they shouldn't be. Electrical meters on buildings were monitored centrally to determine any electrical anomalies. "We learned that there was something wrong with the electricity in one facility that caused it to spike," Peterson says. "That alone saved us $32,000 in utility costs."

"In the past, utility bills did not hit the CFO's radar as a significant expense," comments Mark Houge, senior vice president of NorthMarq. "But there are some real dollars in there that can be saved and redeployed into more important things, like technology and growth objectives. The savings on energy is typically between 10% and 30% of the previous three-to-five years' average annual energy costs."

The Sale-Leaseback Surge

Redeployment of capital into strategic growth opportunities helps explain the recent surge in sale-leaseback scenarios. Calkain Cos., a Reston, Virginia-based commercial real estate consultancy and brokerage, estimates that 20% of commercial property sales since 2007 can be attributed to so-called triple-net sale-leasebacks, in which a company sells the building it owns and occupies to an investor, then leases it back on a long-term basis. The "triple-net" refers to the three costs that the owner-turned-tenant agrees to absorb: real estate taxes, operating costs, and insurance.

"By selling the building, a company generates capital for more-effective uses elsewhere, such as paying down debt or for expansion," says David Sobelman, Calkain executive vice president. "Selling the building also moves its book value off of the balance sheet. Buyers of the building, meanwhile, are assured of a monthly rent check from the tenant, assuming its creditworthiness."

There are other perks for buyers. "Generally, the yield on triple-net properties is 50 basis points or more above the equivalent unsecured debt of a company," points out Bob White, founder and president of Real Capital Analytics, a New York–based real estate research firm. "This makes the scenario an effective form of financing. As for sellers, they can often get more proceeds via a sale-leaseback as opposed to issuing other debt."

One such devotee of sale-leasebacks is InSite Real Estate. Over the past few years, the Oak Brook, Illinois-based real estate firm has acquired an 11-million-square-foot portfolio of primarily retail, office, and industrial buildings, most of it through sale-leaseback arrangements. "Our primary target is the middle-market tenant, although we've done deals with very large companies," says Chris Hutter, InSite CFO. "These companies are more interested in using their resources to grow their businesses or acquire a competitor than in tying up their money in real estate assets. We offer them a solution where they can maintain their premises over the long term at a rent they can predict."

KLH Capital, a Tampa-based private-equity firm, has engaged in several sale-leasebacks, buying a company and then shedding its real estate. "When we buy a business, typically we don't want the real estate, which is not a high-return asset and is tying up capital at a low rate of return," says Will Dowden, KLH vice president.

"With low interest rates and impending inflation, there are companies out there looking to buy fixed assets that will hopefully appreciate in value," Dowden adds. "Some private-equity firms have even tapped the value of a target acquisition's real estate to help them raise the capital to acquire the business. If someone can buy a company for 5 or 6 times EBITDA, then sell the real estate and lease it back for a 10^{th} of what they just sold it for, that's an exit at a 10-times multiple. They have now taken an asset that was purchased at 6 times and sold it at 10 times."

All of this would sound even better if it were not for the proposed changes to lease accounting currently on the table. The Financial Accounting Standards Board and the International Accounting Standards Board have both proposed major alterations in lease accounting (see "Taking the 'Ease' Out of 'Lease'?" December 2010). Under the proposals, tenants would be required to place the obligation to pay rent over the entire lease term on their balance sheets as a liability. Right now, only the current rent is booked on the financials, as an expense on the income statement. Many observers predict these changes will be adopted.

If so, those companies seeking to spruce up their balance sheets by eliminating mortgage-debt obligations through a sale-leaseback may change their minds, since a lease liability would effectively treat all leases as a capital lease, which would gum up the balance sheet. "If a company is trying to raise capital, a sale-leaseback would still be a very viable option," says NorthMarq's Houge. "But the proposed changes to the accounting standards will affect other agreements, such as credit agreements requiring a minimum debt coverage ratio, and that could be a problem."

Others predict that future sale-leaseback deals will involve shorter-term leases, in the 3-to-5-year range. "If the rules change, the longer the lease, the greater the liability, so companies may want shorter leases than the typical 10-to-20-year term that makes sale-leasebacks work," says White of Real Capital Analytics. "It comes down to a financial decision: if you can borrow unsecured debt cheaper than what a real estate investor is offering, you may pass."

Dowden of KLH wants the lease-accounting proposals to die a quick death. "Putting all these leases, including equipment and truck leases, on the balance sheet will be extremely adverse to the leveraged-buyout industry," he warns. "Every LBO will go into default. I'm terrified. I've called all of my auditors and told them that they had better be writing position papers on this and to get it turned around now."