

LOGISTICS FIRMS REMAIN HUNGRY FOR SPACE

COVID-19 has created opportunities and challenges as logistics providers continue to strive for last-mile efficiencies.

ROOM FOR RECOVERY

The hospitality sector was devastated in 2020, but vaccinations, industrywide efforts, and returning demand are reasons for hope.

A FUTURE FOR INFRASTRUCTURE

With potential bipartisan support for infrastructure, could 2021 be the year for a breakthrough in Washington, D.C.?

SURVIVING VOLATILITY

The pandemic turned the world upside down, so CRE professionals will need creative options when renegotiating leases.

COMMERCIAL INVESTMENT

SPRING 2021

REAL ESTATE

Back to the Office?

As offices reopen, the COVID-19 workplace must emphasize flexibility, safety, and collaboration.



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FAILING TO PLAN

Commercial real estate should be a profit generator whenever possible, which may require creative thinking.

Not to put too fine a point on it, but profit is the ultimate goal in commercial real estate transactions. All aspects of the industry, including donation, acquisition, disposition, build-to-suit, development, redevelopment, restructuring, lease buyout, sale-leaseback, M&A, investment, various accounting procedures, and so on, are designed to make commercial real estate into a profit center.

Taking this into account, why would an organization have to justify real estate as a cost center instead of a profit center? These costs — sooner or later — will create financial challenges that contribute to an organization going out of business.

This concept is rather simple, but a straightforward case study can help add depth and perspective.

SKYROCKETING COST CENTER

In 2008, Apple had a store in the Third Street Promenade in Santa Monica, Calif. — one block from a 17,750-sf building occupied by a Borders bookstore. The Borders property sold in August 2010 for \$24.8 million, was redeveloped to 10,352 sf, and then leased to Apple on an NNN lease. The building was sold again in July 2012 for \$58 million and once more in July 2014 for \$100 million.

Here are some basic facts: Apple was well acquainted with the location and the desirability of this property. From 2008 to 2014, the property was resold four times, all while Apple leased the property on an NNN basis. The property is currently assessed at just over \$112 million with a tax rate of 1.179 percent, which works out to \$1.32 million.

- What did Apple fail to do? In this case, Apple failed to conceptualize the

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following: value, planning, strategizing, modeling, and intangible assets, and, most of all, they found themselves fighting the wrong battle.

- What could have been done differently? Apple could have strategized to shift the store from a cost center to a profit center, but they actually passed on this opportunity multiple times.
- Is this the only case where Apple failed to plan? How about the spaceship headquarters? This is a much bigger

discussion. The bigger the case, the bigger the variance. And they're not alone in missing out on this opportunity.

How could Apple have capitalized on the commercial property's additional value? Every organization carefully crafts a business plan for the core business, yet they fall short when it comes to the strategy for optimizing the intangible asset premium in the real estate.

One of the most valuable yet often overlooked premiums by any organization in the U.S. is the intangible asset of goodwill related to real estate. This goodwill premium mostly is collected by investors rather than organizational stakeholders, as seen in the Apple example. The value skyrocketed because of the Apple brand name. Unfortunately, how to leverage an organization's goodwill asset through strategic real estate planning is not a course taught by any financial school, leaving industry professionals to rely on their creative thinking skills.

Apple and other organizations can capitalize on their goodwill premium through a dynamic real estate strategic plan — one carefully coordinated with the core business milestones.

In this situation, Apple could have strategized to shift the store from a cost center to a profit center. This route is very similar to those of other major companies like Pan Am, Macy's, Sears, and JCPenney, which have all fallen from top American brands to bankruptcy. But before going further, mistakes like this aren't specific to one company or one market. It's a common practice to use commercial real estate as a cost center rather than a profit center. No single actor can be blamed for this trend because it's standard practice in the corporate real estate world.

PLANNING VS. STRATEGIZING

Successful planning involves a set of steps. Follow them and you'll achieve what you want; fail and you won't reach your goal. Strategizing, meanwhile, requires a more holistic approach to the situation — it requires knowledge, thinking outside the box, creativity, and innovation. When someone on the battlefield identifies a certain spot as a strategic position, for example, it means they have examined the location, analyzed it, observed its strengths and weaknesses, and identified important aspects that others couldn't.

- Approaches are mismatched — for example, specialized finance assigned to accounting or corporate tax assigned to real estate and vice versa.
- There is a lack of applicability.
- Improper classification takes place.

RIGHTING CLASSIFICATIONS

Improper asset classification can lead to many negative consequences — from fighting the wrong battle to turning capabilities into liabilities and not tapping into the power of an intangible asset. For example, Apple's biggest

No matter if you lease or buy, you're paying for the property you occupy. Now, the question is: If there's one thing that could prevent an organization such as Apple from shifting its real estate from cost center to profit center, what would it be?

The short answer is that people often limit themselves to choosing between leasing and owning, despite more than three dozen value-add options available for a commercial property. Both leasing and owning an asset are still considered a cost center.



Apple failed to take advantage of the increasing worth of its real estate in Santa Monica, Calif.

Looking at the Apple case, the company planned for its real estate to be a cost center. It wasn't seen in a strategic light — one that aims to monetize both tangible and intangible assets. The goal is to collect that goodwill premium for the stakeholder's benefit and not leave it on the table for other investors.

Along those lines, no matter what market a business is in, companies need to have a proper strategy to ensure financial sustainability. Financial sustainability is unachievable when:

- Strategizing falls short, as it did in the Apple case.
- Some of the available options remain unknown; what if the best strategic solution is the option the company isn't even aware of?

asset is not the iPhone or any other physical product — it's the intangible of its brand recognition. Apple certainly knows that, but the company failed to strategize for optimizing this asset in this instance. The intangible asset in this case became a liability instead of a capability, thus stacking up the cost center.

In addition to the cause cited in the Apple case, cost centers can quickly snowball due to inadequate strategizing in other areas as well.

- Why would a publicly traded company assign the real estate matter to HR?
- The REIT is managed by someone who has no experience in the commercial real estate industry or any related industry.
- A publicly traded REIT does not have a real estate department, and so the transactions are handled by an accountant.

Take, for example, the spaceship headquarters at an assumed value of \$6 billion with utilization of less than 5 percent since its inception. What is the translation of cost per person for this property?

Which of the value-added options could be appropriate to apply — is it leasing, owning, planning, strategizing, or restructuring real estate with a creative thinking? The real estate portfolio of any organization can either make or break it. The opportunity lies in carefully looking at proper strategizing before rather than after the fact.

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