KNOWLEDGE EXCHANGE

Best Practices in Strategy and Portfolio Planning

Authored by Richard Holberton, EMEA Research Director, CBRE

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FOREWORD

The Knowledge Exchange events, held by CoreNet Global UK Chapter, are a unique opportunity for CRE professionals to discuss and debate the trends that are impacting our industry.

Strategy and Portfolio Planning is increasingly being seen as an area in which there is much potential to provide value to businesses. However, with little consensus on the mechanics and measurement of this evolving discipline, the resulting debate was fascinating and thought-provoking.

The unique insights are those which I hope you can all draw value from. As always, this wouldn't have been possible without engagement and commitment from all of our attendees. We are especially grateful to our speakers Neil Austin at Royal Bank of Scotland and Irene Masterson at Shell, and facilitator Andrew Hallissey at CBRE.

Lastly I would like to thank our planning committee who organised such a fantastic event and CBRE for their continued sponsorship.

Steve Probert
President, CoreNet UK Chapter

INTRODUCTION

The importance of high-quality Strategy and Portfolio Planning (S&PP) in corporate real estate (CRE) has been thrown in to sharp relief over the past decade. The practice of S&PP has only really been established since the mid-1990s and has since evolved as a function of significant changes in the corporate environment.

The contribution of real estate to corporate costs has long been recognised (often third behind labour and IT) as has the fact that CRE represents a very large concentration of capital for most firms. Despite this, the rate of external change affecting many corporates has exceeded the ability of CRE activities to keep pace. This, in many cases, has resulted in piecemeal tactical processes being overwhelmed by industry events and changes in the business cycle. Until recently, the absence of rigorous approaches in this area has resulted in many unintended and unrecorded, but substantial, bets on real estate exposure and large losses that have had to be written off.

It is perhaps not surprising in this context that the early adopters of S&PP, and some of the more successful, have included companies operating in particularly complex or fast-moving environments. This includes, for instance, those with very broad geographic coverage, facing major corporate decisions such as relocations or network consolidation; those in industries that may be expanding or contracting very rapidly; or those facing major internal change such as an acquisition or change in business model.

While there is now a broad acceptance of the importance of the discipline as a “steward” of corporate real estate, there is as yet little firm consensus on the mechanics of how to do it, its optimal position within corporate structures and how best to focus effort to ensure (and measure) effectiveness. This seminar was designed to explore these issues and challenges, to identify pointers and obstacles in moving towards best practice, and to develop thinking around success factors, key metrics and risks associated with S&PP activity.

AIMS AND CHALLENGES

As the name implies, S&PP introduces a level of “big picture” analytical discipline at the level of the whole portfolio allows specific decisions or course of action to be assessed in this light. There may be certain situations or catalyst events where S&PP is considered to be most relevant or effective, such as integration of an acquisition target or introduction of new service lines. However, the long term nature of real estate as a factor of production, introduces a requirement for ongoing longer term planning. Moreover, the level of economic uncertainty currently affecting the market argues for a more coherent approach to portfolio planning.

In general terms, S&PP aims are to integrate real estate decision-making at portfolio level more closely with broader business aims by translating real estate issues into data and decisions relevant to business unit leaders. In this respect the S&PP function sits between business strategy, and asset management or operations functions that are more focussed on individual properties. Specifically, the three core objectives are to:

- **Enable core business objectives**
  As an effective “factor of production”, S&PP should satisfy business needs and enhance speed to market.
- **Minimize cost or maximise value-add**
  Achieve through beneficial impacts on cash flow, present value of capital projects, revenues or the corporate balance sheet.
- **Mitigate risks**
  Avoid surpluses or shortages of space relative to business requirements and provide a portfolio-level hedge against property market swings.

The precise form of activity may vary widely depending on the mix of objectives, and type of organisation. Hence the various levers available to achieve these goals, such as changes to location, function and financial structure will be deployed differently. It follows that there is great variation in the range of information required to deliver effective S&PP, but it is clear that the process works best when it is backed by good information. Generally, this will come under three headings:

- **Supply**
  Including area occupied, allocation among different user types, lease or ownership terms, built capacity, density, and lease expiry profile
- **Demand**
  Current and projected staffing by location, business unit and type of labour
- **Cost**
  Such as rents, value of owned facilities, depreciation

Even when supported by sufficient high-quality data, the multiple, and sometimes conflicting, demands of S&PP initiatives present a number of common challenges. The tension between the need for operational flexibility on the one hand, and cost reduction on the other, is particularly prominent. It is often a stated objective to ensure short-term and flexible occupancy strategies that allow the firm to remain agile in the face of rapid change. At the same time, however, since occupational costs are inversely correlated to length of term, the aim of reducing occupancy costs usually means committing to long-term leases or ownership.

Other challenges are external in origin, and these may be grouped under four principal headings.

EXTERNAL UNCERTAINTY

Issues relating to economic change, policy settings, regulation and competitive conditions as well as industry-specific issues such as input cost changes and shorter product life-cycles.

DIFFERENT GROWTH STRATEGIES

Particularly in large multi-location and multi-service businesses, different imperatives requiring very different CRE strategies may co-exist at the same time. For instance, separate parts of a business may, at a given time, be undergoing rapid growth, cost reduction, consolidation or rationalisation such as precipitated by a merger or acquisition, or repositioning of corporate assets in the wake of major structural change. Whereas for large firms, in the banking and finance sector for instance, it is quite likely that more than one of the trends will be in train at any given point, making very different demands in the area of S&PP.

INDUSTRY VOLATILITY

Shifts in growth and profitability across different phases in a business' life cycle can affect planning horizons, performance of different business units and the accuracy of financial forecasts. In turn, all of these may affect real estate space requirements, and indeed the degree of reliance that may be placed on projections of these.

MISMATCH OF EXPECTATIONS

Generally this revolves around the increasing premium being placed by businesses on having the flexibility to respond to very dynamic business environments, against the inherent inflexibility, long lead-times and high renovation costs characteristic of commercial real estate. For example, real estate demand drivers such as headcount are far more volatile than the ability of a real estate portfolio to keep pace. This introduces great long-term space demand uncertainty and perhaps argues for the identification of various "sub-portfolios" with common characteristics to be managed separately.

PRINCIPLES AND BEST PRACTICE

Despite these challenges it is possible to identify elements of principle, process and deliverables that offer pointers towards best practice in this area. As noted the guiding principles:

- Treat corporate real estate as a factor of production rather than a generator of profit;
- Aim to match the duration of property commitments with those of business requirements at portfolio or cluster level; and
- Base any analysis on sound financial management principles with due regard to relevant accounting standards and tax or regulatory frameworks.

The key feature underpinning any planning process based on these principles is a detailed understanding of business drivers, both at industry or company level and in respect of specific business units. In other words a direct alignment of the S&PP function with the needs of the business. Profiling supply and demand with appropriate data generates an assessment of the characteristics and needs of like-kind clusters or sub-portfolios. From here, a range of options and recommendations can be identified which can be shaped into deliverable policies and initiatives, with authority and approval protocols attached. It is crucial throughout this process that clear cost allocations within the business are assigned so that the cost implications of different recommendations are completely transparent.

The range of deliverables will vary but is likely to include annual or rolling plans for like-kind groups of assets, whether geographic concentrations or functionally-similar groupings. Key performance metrics will be established and monitored, and contingencies developed for adverse or unexpected external events.

While it is possible, as described above, to outline the structure of S&PP practice in generic terms, there is a range of conceptual and practical issues involved in applying broad principles in this area, some of them quite fundamental.

LACK OF EVEN A COMMON DEFINITION OF S&PP

There are a variety of reasons for this, including disparate reporting lines, lack of data, and absence of commonality of approach. However, an equally strong view is that a clearer common understanding would be beneficial, with the onus firmly on CRE teams pro-actively to develop the necessary tools and terms of reference.

CHALLENGES TO THE DEVELOPMENT AND IMPLEMENTATION OF ENTERPRISE-WIDE REAL ESTATE PORTFOLIO PLANS

These include partial understanding of the parent business, lack of integration between different business units themselves, lack of role clarity and the sheer difficulty of keeping up with the pace of change in some businesses.

INTEGRATION BETWEEN THE PROPERTY PLANNING PROCESS AND THE BUSINESS PLANNING CYCLE

Again, it was felt that there is a need for CRE teams to develop an intimate understanding of the business, and establish and retain a position of influence regarding property portfolio planning. Given the pace of business change, it is accepted that this is a position that will need to be constantly “re-sold” by means of clear evidence of effectiveness and value-addition.

Despite these obstacles, there is a clear view that the practice of S&PP has evolved and improved, and will continue to do so. Sometimes this has happened “by accident”. For example, as a by-product of a major corporate event such as a merger that serves as a catalyst for a step change in the rigour and sophistication of S&PP processes. More generally, there is a view that integrated thinking between the business and CRE teams is becoming more common and that the right questions are being asked. This is giving rise to more informed and critical thinking around all aspects of the process. This includes a more discriminating view of available data as opposed to the prior view that "more is better". Service providers have a critical role in this continued evolution, by facilitating the integration of market data and business data (subject to the willingness of the business to share it) and by bridging the language gap between the business and CRE teams. The question of whether service providers are adequately incentivised to perform this role will need to be resolved as often such "soft" advice is regarded as a free add-on.

PRACTICAL POINTERS

Even given the evolving nature of the practice, certain practical pointers can still be provided. These concern:

- the parameters of "own vs. lease" decisions
- demonstration of the value the CRE function creates for the business
- developing a framework work for performance management of the real estate portfolio and key metrics of relevance to the business
- consideration of the key risks for the CRE function and associated measurement methodologies and mitigation strategies

Own vs. lease decisions are fundamental aspects of many S&PP process. In reality they are mostly "short vs. long" investment decisions where the main requirement is to avoid real estate speculation by matching investment duration to expected period of occupancy. At its simplest, this boils down to favouring long-term investments for primary sites within the portfolio and short-term investments for volatile, satellite or uncertain sites. In practice, a long list of factors needs consideration, including assets size, length and certainty of occupancy and market cycle timing. Since part of the underlying rationale is future-proofing or de-risking the portfolio, such decisions need to be based on foreseeable future conditions. Moreover, the consequences of owning assets, in terms of the impact of value fluctuations on business performance and the opportunity cost of owning freeholds, need to be well understood. Even in situations where long-term occupancy is envisaged, buying freehold assets isn't necessarily good use of capital, but paying for unnecessary flexibility isn't either.

IMPORTANCE OF MEASUREMENT

This type of decision is a specific example of the need to understand fully the feedback loops from real estate exposures to the wider business, which for some types of company can be very substantial. It is critical to appreciate the cost and value of real estate positions, where these are likely to trend in the future, and judge accurately the optimal long-term holding approach to sites (and indeed the rationale for holding them at all). The selection of appropriate metrics is fundamental to this.

The list of metrics that best aligns real estate and business agendas is potentially very long, but these can all be categorised under one or other of the headings: cost, control, value and risk (See Figure 1 below). Equally, in any given company it is important to retain flexibility over the choice and relative importance of portfolio metrics. Situations are dynamic and, changes in the external environment as well as shifts in strategic goals both need to be accommodated.

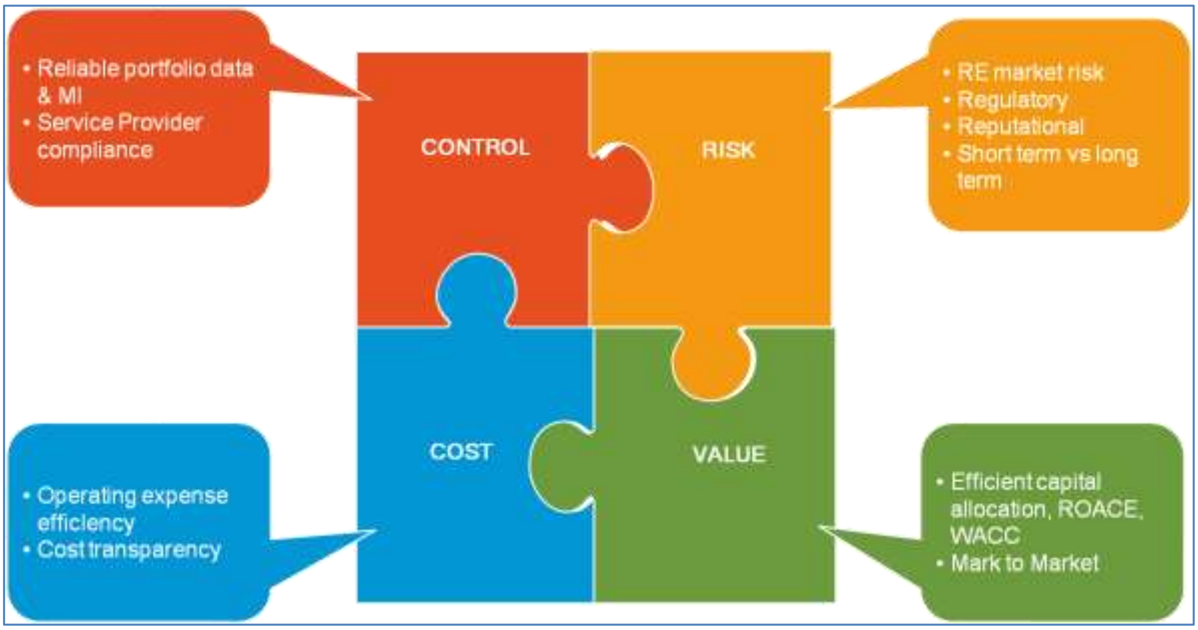

Figure 1: Metrics framework for aligning real estate with business agenda

The consideration of risk in this framework is key and the consequences of underplaying it are severe. Often the default focus is on financial risk which, while clearly important, is not always the full story. Operational or reputational risk for instance, may be equally or more important in some situations. It is important to understand the full range of material risks and the possible impact of worst-case events for each. Not all of this is self-evident at the outset.

CONCLUSION

Clearly the CRE function is pivotal to helping the business to understand real estate related risks, and not just through the right choice of metrics. An “engaged conversation” with the business is central to explaining the value of real estate asset performance to the business. Here a deep understanding of the business is necessary, but not sufficient. It also requires an “engaged conversation” with business stakeholders where language and key themes are informed by the nature and values of the audience; in other words, speaking business language rather than just real estate language. Such conversations need to challenge conventional thinking and ask key “so what?” questions as well as deciding whether more measurement is a help or a hindrance. CRE functions need to get better at communicating their value and impact; some companies, often including smaller ones, have a natural advantage here but there is scope for improvement at all levels. Ensuring that service providers are on the same wavelength and contribute to this process is relevant too.

SUMMARY

Overall, there is acceptance that well-designed and executed S&PP is a business-critical activity that has the potential to add significant value. At the same time, there is little or no established consensus on best practice, choice of data or performance metrics or precisely how to underscore the value of the activity.

While it is still an emergent and evolving activity, it is possible to identify certain traits that characterise effective portfolio planning. The ten traits of best-in-class CRE Portfolio Planning can be summarised as:

1. **Owner of all real estate and facilities occupancy costs**
2. **Accurate data**
3. **Relationship savvy**
4. **Steward for asset class**
5. **Process, policies, and analytics rooted in solid financial doctrine**
6. **Process (rules and tools)**
7. **Learning organisation**
8. **Trusted by business units**
9. **Strongly linked to other support organisations in the corporation (such as IT, M&A, Finance, and HR)**
10. **Able to satisfy clients while maintaining a "bigger picture" viewpoint**

At this stage, some of these are better described as statements of aspiration than of current practice. This means there is plenty of scope for evolution and improvement, and lots to aim for!