

CHICAGO MIDWEST

CoreNet Global Summit
1-3 May 2011

Money Talks: How Corporate Language Drives Corporate Real Estate Strategy

Facilitators:

Richard Podos, *Lance LLC*

Jane Mather, Ph.D., *Critical Core*



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MONEY TALKS - AGENDA

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- **Money Talks** – Are we using the right language?
- **Session Motivation**
 - FASB lease accounting changes
 - Are we making the right financial decisions for our organizations?
- **SPP and Optimizing Capital Task Force**
- **Topics**
 - Trends
 - NPV analysis - discount rates, taxes and residual values
 - Financial criteria, performance measures
 - Non-financial considerations

\$\$

\$15 - \$25 million
difference in return
on \$100 million
investment

PANELIST



End Users

Stan Gibson, Wells Fargo

Luigi Sciabarrasi, Symantec Corp

CRE Finance

Gerald Levin, Mesirow Financial

Kyle Gore, CGA Capital

Advisors

Bob Cook, Grubb & Ellis

Kevin Haverty, CresaPartners

Russ Howell, Jones Lang LaSalle

Academic / Technology

Michael Hammerslag, Lucernex LseMod, previously NYU

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Thanks to our sponsors.

**SPP Community
Optimizing Capital Task Force
Financial Doctrine Survey**

SPP Community



Thanks also to all Optimizing Capital Task Force members that contributed as part of our monthly conference calls.

SPP Background



- **Strategy and Portfolio Planning (SPP) Community**
 - Gather, share and advance best practices
 - Research task forces
- **Optimizing Capital Research Task Force**
 - Capital Market Impact
 - FASB / IASB Lease Accounting Changes
 - Financial Doctrine
 - Long-Term Project – Just Beginning

Concerns and Stories

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- What leads to shareholder value?
 - Cash flow
 - Real decisions – which product, which property
 - Financial structuring decisions
 - Financial stability
 - Current cash vs future cash
 - Risks

Concerns and Stories



- Poor decisions reduce shareholder value
 - Capital deployed in wrong ways - Are there better uses for capital - invest in new product, invest in property, buy back shares?
 - Losing \$15-\$25 million on a \$100 million decision
- Why?
 - Wrong discount rates, optimistic residual values, no tax implications
 - Financial languages – Cash flow, GAAP / IFRS accounting values - not used appropriately
 - Performance measures with wrong incentives
 - Believe can time market
- Stories from our panelists?
- How important is it for you to understand these issues to gain respect from C-Suite?

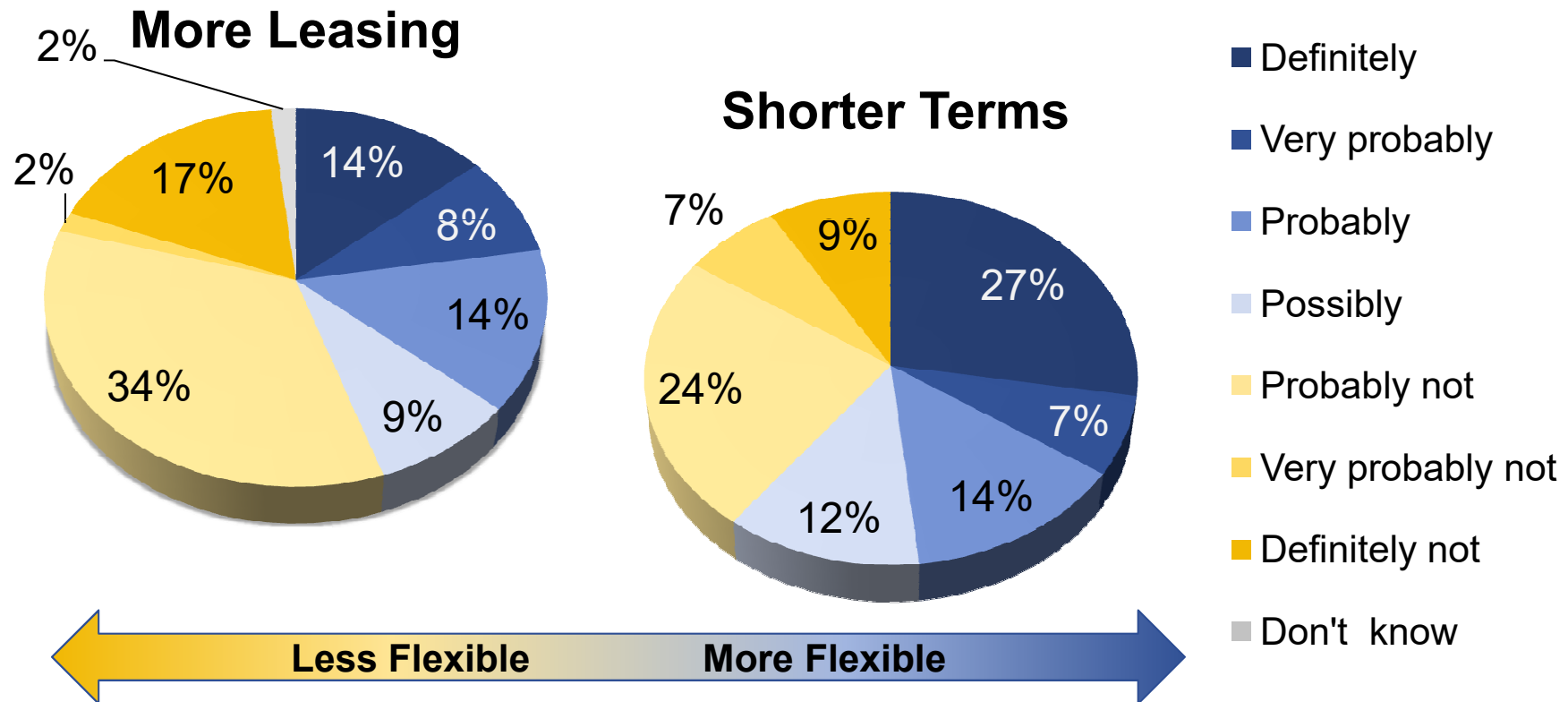
Trends – Survey Results



- Survey Caveats
 - Small sample – 58 people responded, 45 completed all questions
 - End users or service providers who worked on behalf of end user
 - Biased sample?
- Good baseline to start discussion

Trends – Survey Results

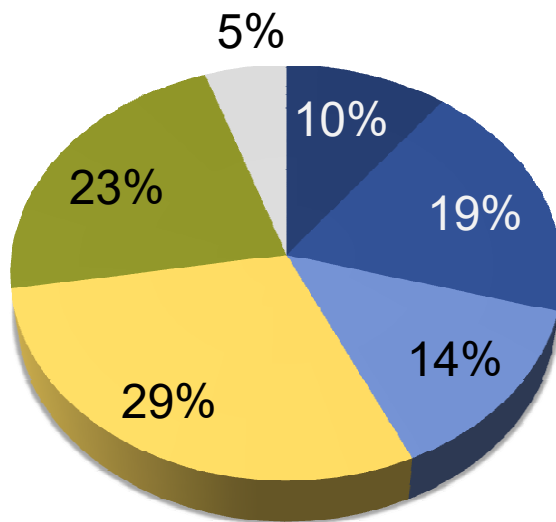
Without consideration of the upcoming proposed lease accounting changes, **our organization is moving towards,**



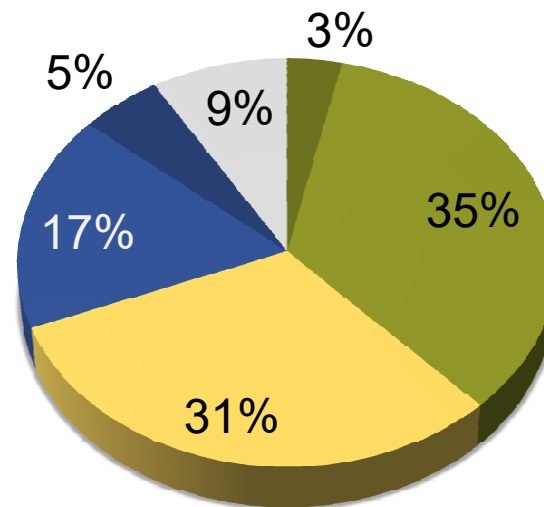
Trends – Survey Results

Our organization believes that **capitalizing all leases on the balance sheet** would lead to. . .

Leads to More Ownership and Less Leasing



Leads to Shorter Leases



- Strongly agree
- Generally agree
- Neither agree nor disagree
- Expect no change
- Generally disagree
- Strongly disagree
- Don't know

Less Flexible

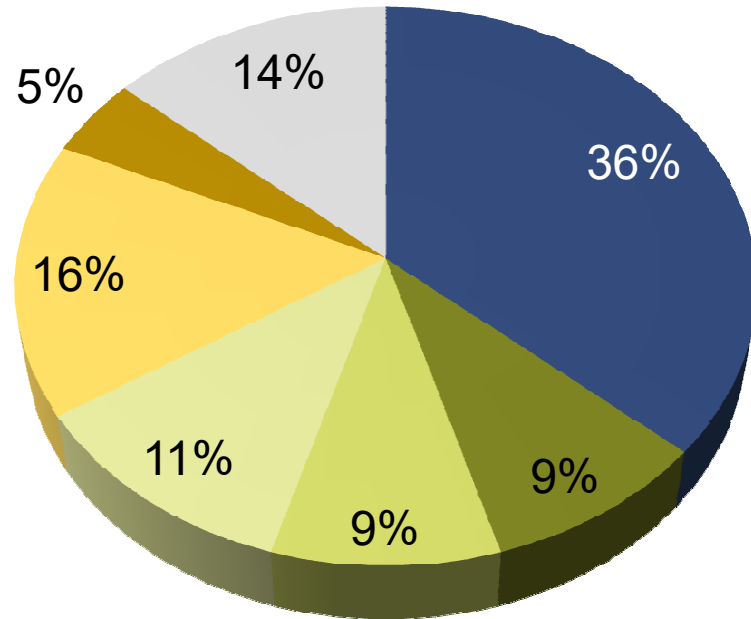
More Flexible

Next Topics

- Basic financial NPV
 - Discount rates
 - Before and after tax
 - Residual value
- Cash flow vs accounting and performance measurement
- Impact of reporting structure on approach
- Non-financial reasons to own

Discount Rates

In your organization's Net Present Value (NPV) or IRR analysis, which methodology of discount rate or hurdle rate do you use?



- Weighted average cost of capital (WACC)
- Different discount rates to reflect risk
- Corporate debt rate - depends on term
- Corporate debt rate - short-term
- Return on equity
- Hurdle rate different than these
- Other - not my responsibility

Review – Time Value of Money

Net Present Value (NPV) Analysis for Investment in Business

- A dollar today is worth more than a dollar tomorrow because if I had it today I could invest it and receive more tomorrow
- Discount future cash flows at a rate equal to the risk of the investment

Investment in Business - Returns WACC													
Risk equals business risk													
Values in millions			Time										
			0	1	2	3	4	5	6	7	.....	14	15
Investment			-100.00										
Annual return	10.6%			10.63	10.63	10.63	10.63	10.63	10.63	10.63	.....	10.63	10.63
Residual													100.00
Total CF				10.63	10.63	10.63	10.63	10.63	10.63	10.63	.....	10.63	110.63
Adjustment factor				0.90	0.82	0.74	0.67	0.60	0.55	0.49	.....	0.24	0.22
Discounted cash flow				9.60	8.68	7.85	7.09	6.41	5.80	5.24	.....	2.58	24.33
NPV	10.6%	100.00											

After-Tax Weighted Average Cost of Capital (WACC)

$$\begin{aligned}
 &= \left(\frac{\text{Debt share}}{\text{of firm value}} * \text{Cost of debt} * (1 - \text{Tax rate}) \right) + \left(\frac{\text{Equity share}}{\text{of firm value}} * \text{Cost of equity} \right) \\
 &= 50\% * 5\% * (1 - 35\%) + 50\% * 18\% \\
 &= 10.6\%
 \end{aligned}$$

Note: WACC will vary depending on company. Calculations are designed to illustrate the concepts for a sample firm with debt/equity ratio = 1 and AA debt rating. For a bank with strong debt rating and with a much higher share of debt, the WACC would be much lower, closer to 4% in today's market.

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15 –year analysis, property size – 400,000 rsf

- **Lease**

- Cap rate (first year) – 7%
- Lease escalation – 2%
- Net rent (first year) - \$17.50 / rsf
- **Total rent (first year) - \$7 million**

After-Tax Analysis, With 0% Appreciation

[illegible]

Review – Basic Financials

Impact of Discount Rates on Lease vs Own Decision

After-Tax Costs Alternative Discount Rates	Own	Lease	Strategy
Weighted Average Cost of Capital = 10.6%	\$74.7 m	\$37.1m	Lease
Debt Rate After-Tax = 3.25% = (1-35%) * 5%	\$36.1 m	\$60.8 m	Own
Return on Equity = 18%	\$88.5 m	\$25.2 m	Lease

What is risk of lease or own activity?

- Stable – lease payment is like a debt payment
- Risk of business – WACC
- Opportunity cost of investment – at equity rate or other hurdle similar to new investments

Discount Rates - AFP

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AFP – Association for Financial Professionals



2011 AFP
Current Trends in Estimating
and Applying the Cost of Capital
Report of Survey Results

Variations in Cost of Capital Used

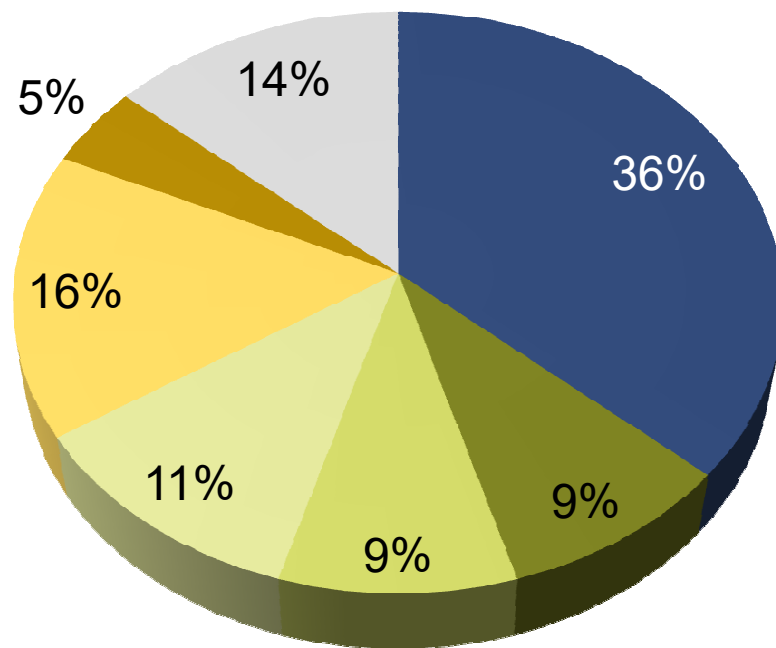
A small majority of organizations use their calculated cost of capital as the standard hurdle rate for evaluating a project or investment (53 percent). However, large organizations and those that are publicly traded are more apt to use a rate above the calculated cost of capital as their standard hurdle rate than are small organizations and private ones.

Method for Determining the Hurdle Rate in Evaluating a Project or Investment (Percent Distribution)

	All	Under \$1 Billion Revenue	Over \$1 Billion Revenue	Privately Held	Publicly Traded
Organization uses the calculated cost of capital as the standard hurdle rate	53%	70%	45%	60%	48%
Organization uses a standard hurdle rate above the calculated cost of capital	47	30	55	40	52

Discount Rates

In your organization's net present value (NPV) or IRR analysis, which methodology of discount rate or hurdle rate do you use?

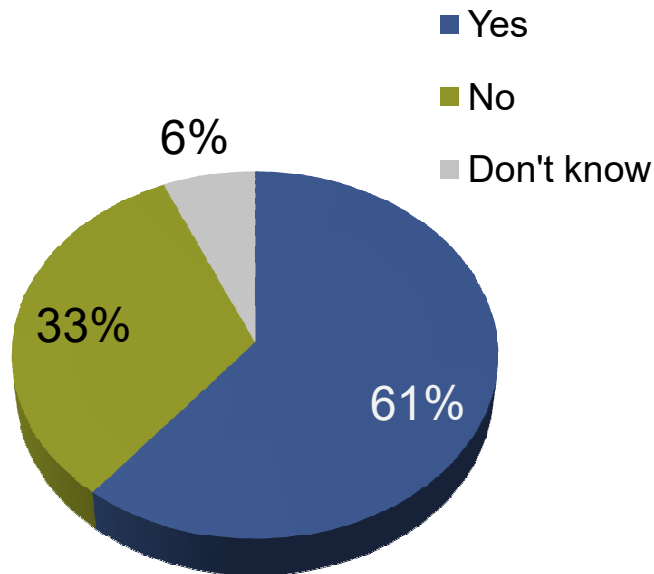


- Weighted average cost of capital (WACC)
- Different discount rates to reflect risk
- Corporate debt rate - depends on term
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- Return on equity
- Hurdle rate different than these
- Other - not my responsibility

Taxes and Appreciations

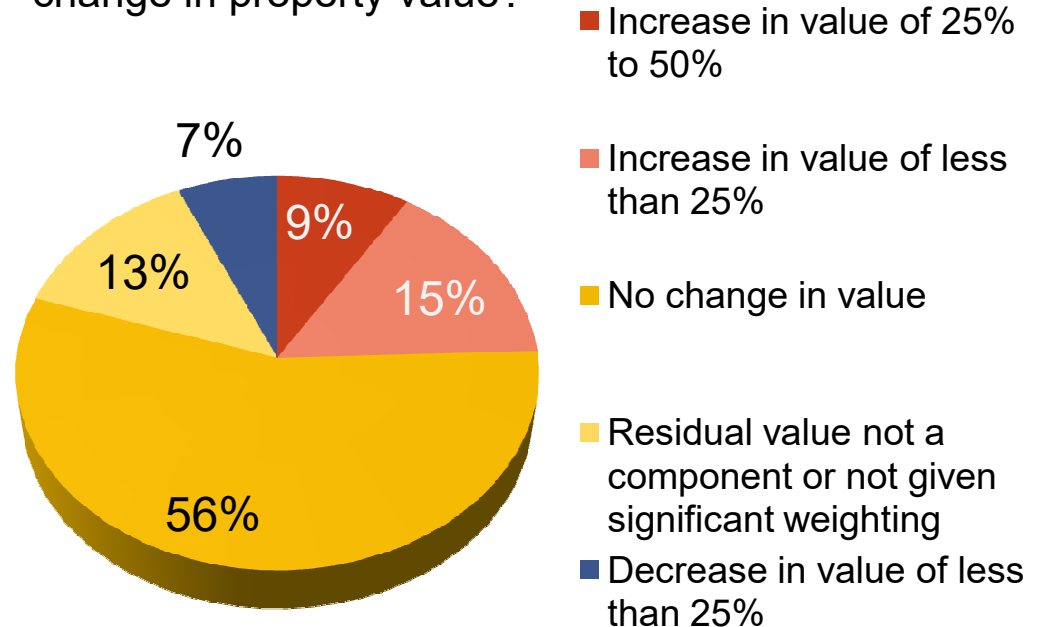
Uses After-Tax Analysis

Does your organization perform it's NPV or similar analysis on an after-tax basis?



Appreciation

In own-versus-lease analysis, which of the following does your organization typically assume in regard to change in property value?

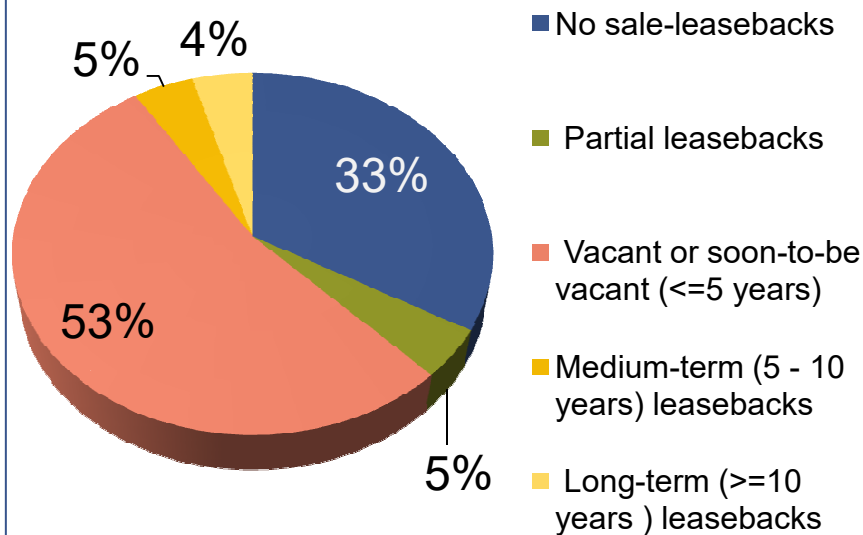


Ownership Outcomes

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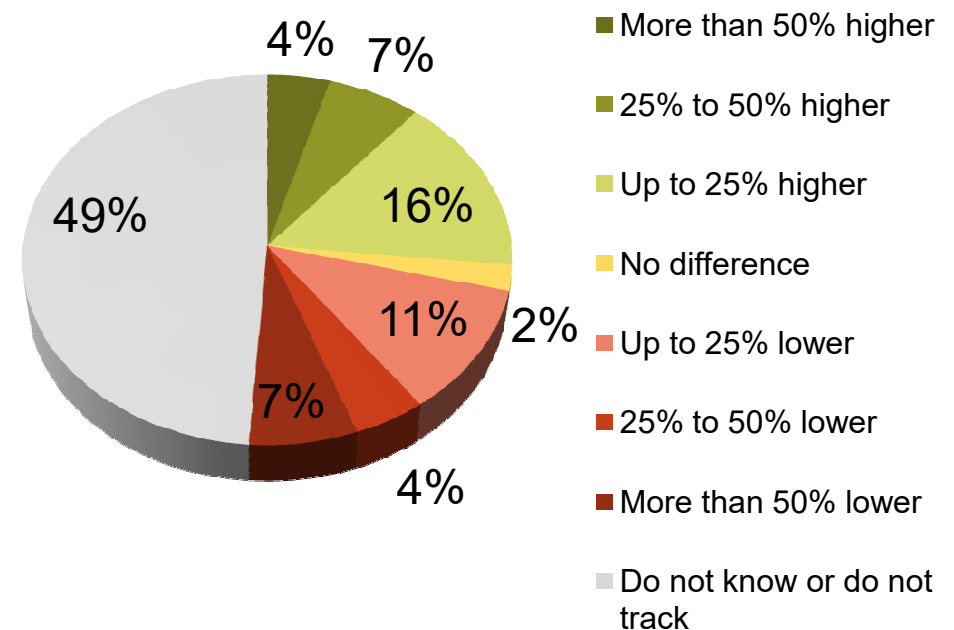
Sale Types

In actual property sales by your organization over the last five to seven years, are the majority:



Actual Appreciation

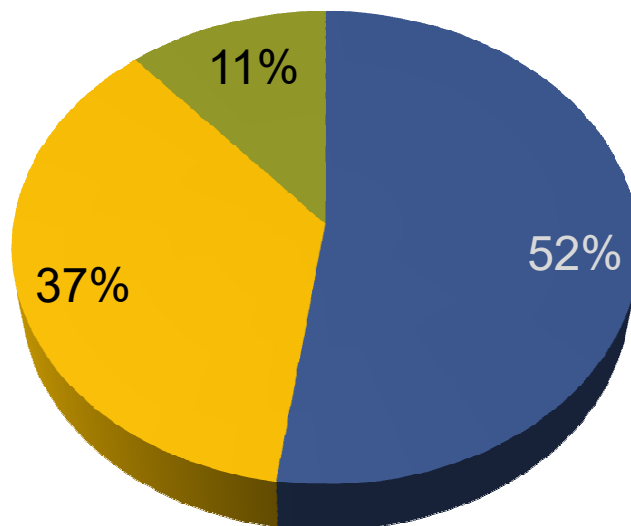
In actual property sales by your organization over the last five to seven years, on average what has been the comparison of (i) original purchase price plus total capital expenditures, if available, to (ii) sale price:



Financial Criteria - Survey

If you could give a weight to the following decision criteria in terms of their importance in the final decision, what would they be? Weights should add to 100%.

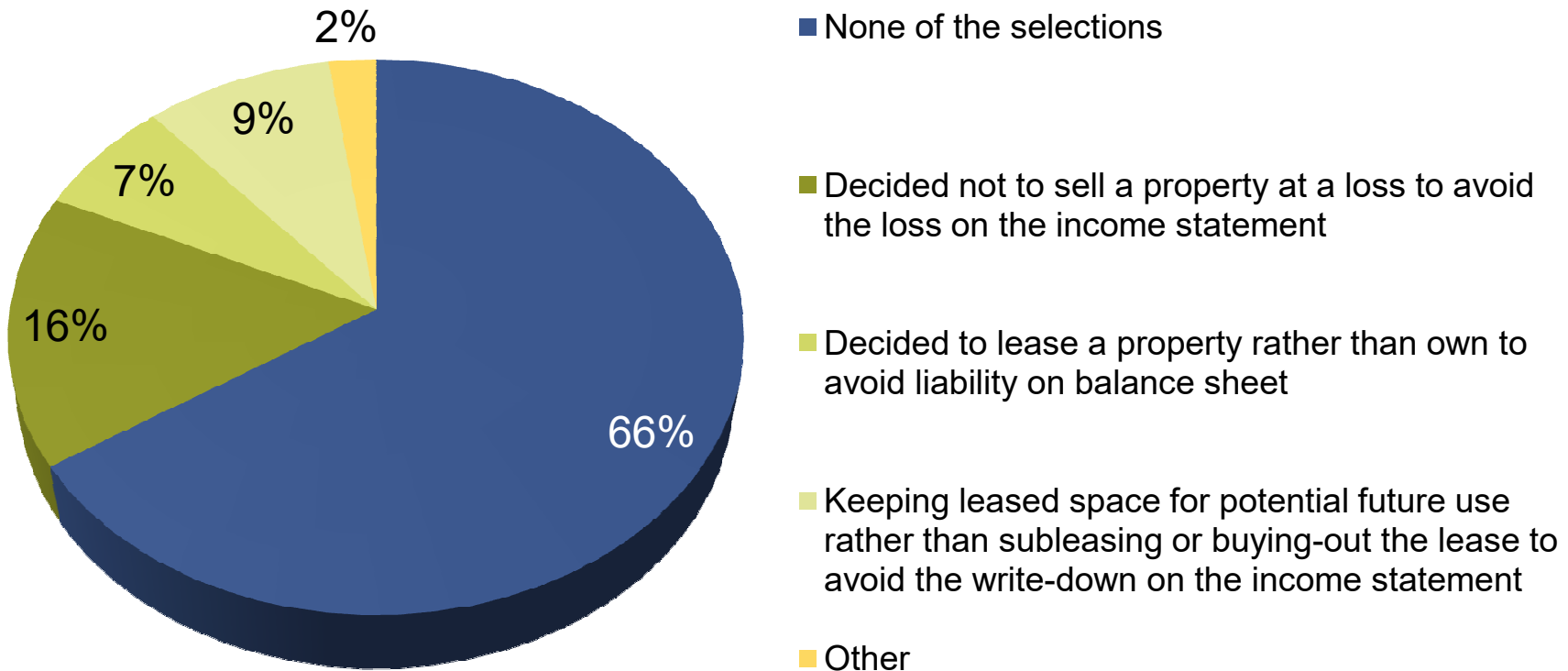
Financial Criteria for Decision Making



- Primarily Cash Flow
NPV, EVA or similar criteria $\geq 70\%$
- Blended
NPV or similar $< 70\%$ and Accounting $< 70\%$
- Primarily Accounting
Accounting – (income statement and balance sheet) $\geq 70\%$

Accounting Impact on Decisions

Which of the following has your organization decided to do based on the accounting impact even though the economic impact might indicate a different decision?



Review – Basic Financials

Occupancy cost targets or compensation based on performance may influence decision makers to own when NPV indicates leasing is more cost effective

- Performance Metrics – Occupancy Cost
(Exclude operating expenses and real estate taxes assuming same)
 - Owned – depreciation
 - Leased - rent
- Income Statement
- Compensation – Earnings per Share

Cost Measure	Own	Lease	Strategy
NPV Analysis WACC after-tax, cost of debt adjusted for tax benefit	\$74.7 m	\$37.1	Lease
Occupancy Cost (P&L) Year 1 – before tax	\$2.3 m	\$7.0 m	Own
Net Income Impact (P&L) Year 1 – after tax	\$1.5 m	\$4.6 m	Own
Depreciation plus WACC for Owned Properties Year 1 – after tax	\$11.9 m	\$4.6 m	Lease

Review – Basic Financials

Alternative Evaluation – Depreciation plus Cost of Capital

By explicitly adding a cost of capital, the true costs of ownership are reflected.

Net Present Value Analysis - Lease vs Own Depreciation with Cost of Capital

Values in millions

	Year	0	1	2	3	4	5	6	7	.....	14	15
Purchase - Depreciation with Cost of Capital												
Invest in property		-100										
Depreciation (acct)	39		-2.31	-2.31	-2.31	-2.31	-2.31	-2.31	-2.31	.....	-2.31	-2.31
Land value	10											
Book value			97.69	95.38	93.08	90.77	88.46	86.15	83.85	.....	67.69	65.38
Cost of capital - after-tax	10.6%		-10.38	-10.13	-9.89	-9.64	-9.40	-9.15	-8.91	.....	-7.19	-6.95
Tax benefit - depr (tax)	35.0%		0.81	0.81	0.81	0.81	0.81	0.81	0.81	.....	0.81	0.81
Total CF - after tax			-11.88	-11.63	-11.39	-11.14	-10.90	-10.65	-10.41	.....	-8.69	-8.45
NPV - WACC	10.6%	-77.89										
Lease												
Rent - escalation	2.0%											
- cap rate	7.0%		-7.00	-7.14	-7.28	-7.43	-7.58	-7.73	-7.88	.....	-9.06	-9.24
Tax benefit lease			2.45	2.50	2.55	2.60	2.65	2.70	2.76	.....	3.17	3.23
Total CF - after tax			-4.55	-4.64	-4.73	-4.83	-4.93	-5.02	-5.12	.....	-5.89	-6.00
NPV - WACC	10.6%	-37.14										
Purchase cost - Lease cost		-40.75	LEASE									

Adding Leases To Balance Sheet



- Primary impact of FASB / IASB lease accounting to be adding leases to balance sheet.
- Changes Debt / Equity Ratio
 - Reflects financial stability – more debt, more risk
 - How often leased to keep liability off of the balance sheet?
 - Will we see shorter leases so that not as much of the lease is on the balance sheet?
 - What were investors and analysts doing already to add leases to the balance sheet?
 - How much are you willing to pay in additional cash flow costs to “manage” your balance sheet?

Reasons to Own

When would you want to own?

- Bargain price
- Core to business
- Need control

Conclusions



- Corporate “financial language” is important, especially for ownership structure decisions
- Lots of variance in what are right approaches
- Need to identify what is right for your organization
- Optimizing Capital Research Task Force - Further research and discussion on what is appropriate

Question Slides

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Question Summary



	Section	Questions	Panelists
10:45	Intro	Why panel	Richard, Jane
10:55	A – Motivation	A1. Stories from panelists	Russ, all Kevin – blend, extend
		A2. What leads to shareholder value	Russ, all
		A3. Selected examples of “poor” financial decision making Business units different than corporate	Bob
		A4. How important is it for you to understand these issues to gain respect from C-Suite?	Stan, Luigi
11:10		B1. Do you agree with these trends, or do we have a biased sample?	Kevin, Gerry
	B - Trends	B2. Are we surprised that people are still in transition towards more leasing?	Kevin, Gerry
		B3. Accounting proposals – description of changes in proposal	Bob
		B4. Are these survey results – about 20 – 35% say FASB impact - consistent with what you are hearing? Talk about whether appropriate later.	Bob, Kyle, Kevin
		B5. Are there differences by industry? At this point don’t have enough data from the survey to identify industry differences.	Richard Kyle
11:20	Cash flow / NPV analysis		

Question Summary

	Section	Questions	Panelists
11:20	C. NPV Review	C1. Show spreadsheets – review of NPV and WACC Explanation of discount rate should reflect risk of investment	Mike Luigi comment
		C2. Impact of different discount rates on decision-making	Mike
	D. Discount rate	D1. Are these results consistent with the variation that you are seeing? How many in audience use WACC? Variation is not consistent with AFP assumption that everyone uses WACC?	Gerry Kyle Service Provider?
		D2. Which discount rate do you use and why? What is the risk reflected in the location decision?	Luigi Gerry
		D3. Corporate debt may be appropriate if you can borrow money without affecting the investment market's perception of company's financial stability. How big is an investment to have an impact?	Bob Kyle
		D4. For those concerned with alternative uses for capital, is WACC high enough, or should real estate investment do more than break even?	Kyle Luigi Gerry
		D5. How does reporting structure impact decision criteria?	Luigi Treasury
	E. Other aspects of NPV analysis	E1. What other assumptions are important and where do you most often see problems – taxes? residual values?	Gerry Luigi
		E2. What is your experience in seeing what residual value have turned out to be? Is real estate actually is a good store of value? What are the outcomes for different types of property types.	Kyle Luigi

Question Summary

	Section	Questions	Panelists
11:35	F. Cash flow vs accounting	F1. Explanation of NPV to GAAP and performance measures	
		F2. Are these survey results consistent with what you have seen? For weight given to alternative approaches? For actions completed based on accounting impact? M	Luigi – have EPS in compensation Gerry
		F3. Explanation as part of why impact limited - Add additional information to basic accounting values to provide a more accurate representation of profitability and financial risk. Example is adding lease information from footnotes to balance sheet. Analysts multiply by 7. Other examples where D/E already including – covenants, internal reporting.	Kevin – Sony in Japan Kevin – more awareness in the CFO offices
		F4. Is there a difference between different types of companies in extent to which forego cash flow for accounting – younger, manufacturing, technology, size	Luigi – need cash Kevin Bob
		F5. Do you see a difference in who the CRE department reports to in terms of how financial issues are addressed.	Gerry
		F6. We saw using significant use of depreciation + cost of capital or EVA. Are you seeing this much use of these variables? Kevin - cash on cash perspective.	
		F7. FASB – debt covenants definitely have impact – how likely will those be renegotiated. Kevin – more rigor in decision making,	Bob Kyle
		F8. How do you coordinate with accounting groups and accounting firm? How you can coordinate to find the appropriate?	Gerry
11:50	G. Non-financial	G1. When do we really need to buy? Google in NY Luigi – corporate commitment to area, business assumption that need ownership to invest Stan, Kevin – opportunistic landlords	Luigi Stan