PUBLISHED ON SEEKINGALPHA.COM, APRIL 20, 2012

SHOULD OPERATING COMPANIES INVEST IN COMMERCIAL REAL ESTATE?

Many public companies have substantial sums invested in commercial real estate that it owns and uses in its business. The real estate can be a headquarters office building, industrial warehouse property, retail store site or restaurant building. Dillard's and Sears, two department store operators, own many of their own stores. Cracker Barrel, Bob Evans Farms and Ruby Tuesday, three restaurant chains, also own a large number of their restaurant buildings and sites. Zynga, the online game maker that went public in December 2011, recently agreed to acquire their headquarters building in San Francisco's South of Market Neighborhood for $228 million. Google, a technology company, bought its 2.9 million square foot New York headquarters building in 2011 for $1.9 billion.

Commercial real estate is considered a capital intensive asset and includes four main property types, office buildings, retail centers, industrial warehouses and apartment buildings. Each type of property (except apartments) is subject to a lease contract that typically has a base rent, additional rent for the property operating costs like real estate taxes and maintenance, a term of 3-10 years and options for renewal. The base rental rate varies depending on the location and age of the building, lease terms and credit of the tenant.

Does it make economic and investment sense for a public operating company to sink large amounts of capital in its own real estate? Should an operating company own or lease its real estate? From a return on capital perspective, the answer is no. A public company should not tie up capital in commercial real estate whether it's used for office, industrial or retail purposes. Companies with large real estate holdings should sell the assets or do sale/leasebacks unless the assets are of strategic investment value. Some companies do need to own real estate for strategic and marketing purposes. Examples are a retailer buying a building on Fifth Ave. in New York or Rodeo Dr. in Beverly Hills, CA for a new, high profile store location to advertise its business or a company buying a suburban office building for a national headquarters. In most other cases, the capital tied up in real estate should be reinvested into the company's core business where the rate of return is greater than in a real estate investment.

The expected return from investing in an operating business is higher than a real estate investment. This is because of risk. Operating business investments are riskier due to the volatility of the business, EBITDA (earnings before interest, taxes, depreciation and amortization) or cash flow, profits and competition. Commercial real estate investment is less risk because properties are encumbered by leases, as stated above, which can deliver a more reliable and steady income stream and the ability of the lease income and asset to be leveraged.

Two proxies for operating company investment returns are the returns from private equity and venture capital investments. A Pepperdine University Private Capital Market Study in November 2011, stated that the expected return for private equity investments in 2011 was 25% and for venture capital, 28%. The expected return from investing in commercial real estate can be viewed through data provided by the National Council of Real Estate Investment Fiduciaries, (NCREIF), and a nonprofit provider of institutional real estate investment data. NCREIF provides a quarterly property index which is a time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes on an unlevered basis. The NCREIF unlevered average annual return for the last thirty years was 8% and the comparable levered return with 60% debt is 14%.

Therefore, if the expected return in private equity at 25%-28% is greater than the 14% in commercial real estate, then companies should dispose of their real estate and reinvest the proceeds in their business. Operating companies should be able to increase their investor return by selling real estate assets and redeploying that capital into their core business. As an example, a hypothetical operating company, ABC Digital, manufactures circuit boards and disc drives has delivered an average annual return of 22% since going public in 2000. It owns a headquarters office building bought for $60 million with a book value of $50 million and a market value of $100 million. If the building is sold for $100 million the net proceeds after a 35% tax rate are $82.5 million. If the company has a weighted average cost of capital of 12%, but can earn a 22% return (the company's historical return on equity) on reinvesting the $82.5 million in its business, the company will add $18.1 million in value annually to its shareholders. This will result in a higher stock price and enterprise value. The value of a company is the present value of its cash flows discounted at its weighted average cost of capital. The incremental cash flows generated from the above investment will increase this intrinsic value. If ABC Digital decided to keep the real estate, it would have a slightly higher net income because the deprecation would be less than a comparable rent, however, it would not have the capital to reinvest and earn the incremental 22% return.

The capital companies have tied up in real estate is not earning a return other than the amount of rent being saved by owning the property. However, this amount is very small compared to the lost capital investment. Today, many public companies are evaluating their return on capital and asset utilization in a difficult economy. One way to increase these returns is to dispose of non-strategic real estate assets and reinvest that capital in the business operation to generate organic growth. Companies that reinvest this real estate capital into their core business can earn a much higher return on equity, which will result in a higher stock price and market value.

Author: Joseph Ori

President

Paramount Capital Corporation

jori@paramountcapitalcorp.com