

# CHALLENGING REIT PROPERTY MANAGEMENT ORTHODOXY

REITs Should Re-Examine External Property Management

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“I THINK IT SHOULD BE REQUIRED READING FOR EVERY TOP-LEVEL REIT EXECUTIVE...”

## INTRODUCTION

BY RALPH BLOCK

Your assessment is very well done, and closely reasoned. I think it should be required reading for every top-level REIT executive for the reasons summarized below.

And I also believe that value-creation is best done when the REIT makes intelligent and incisive decisions with respect to corporate strategies and management, including: balance sheet management, e.g. taking on and/or refinancing debt, reducing debt, issuing equity, etc.; portfolio management, i.e. allocating capital into the most productive and profitable properties and regions; and developing and implementing overall business strategies, e.g. individual, portfolio and public-to-public acquisitions; property sales; development and redevelopment; etc.

This puts individual (and even regional) specific property management on a lower plane of importance, in my opinion. I have never been convinced that much value can be created, over time, via day-to-day management of discrete properties. Property types, of course, are important here – in self-storage, for example, and probably in the apartment sector also, local property management is probably quite important to a REIT's overall value as a company – and perhaps malls also. But office, industrial and the typical strip center, probably not.

Outsourcing is a growing trend in Corporate America, and every corporate executive needs to ask whether outsourcing in a particular area makes sense and is cost-efficient. I see no conceptual reason why individual (or even regional) property management cannot best be outsourced, depending upon the needs and specific peculiarities of the property type and the REIT's business – and even when a REIT calls itself (and is regarded by investors as) a growing and flexible public company rather than a collection of properties.

Your argument that investors/analysts have unthinkingly lumped specific/regional property management into the same box as more important public REIT responsibilities, such as having an “internally-managed” and “internally-advised” structure, is persuasive, and this old mind-set should

be re-examined. The fact that most smart investors loathe externally advised REITs shouldn't have much relevance to the wisdom of internal property management.

The existence of large and well-run property management companies such as CBRE should be a game-changer for some REITs in some property types. Perhaps it might have made sense for every REIT to micro-manage its owned properties 15 years ago, when the alternative was small, local and inefficient property management companies, but today is different; the functions, responsibilities and capacities of large and sophisticated service companies such as CBRE should not be ignored because of prior executive, investor and analyst mindsets.

Bottom line, I think you are very much on the right track in your analysis, and believe that every public REIT owes it to itself and its shareholders to re-examine the property management function to determine whether outsourcing to a large, capable and efficient service company such as CBRE will save money and allow more efficient resource allocation into areas where the REIT can create the most value for its shareholders.

- Ralph Block

# AUTHOR'S NOTE—STUDY METHODOLOGY

CBRE commissioned this study to obtain an objective analysis of the benefits to REITs of expanding external property management services. My first reaction when meeting with the senior CBRE team was, "Are you kidding? Internal property management is core to the modern REIT structure and serves them well, while external management goes against everything investors and REITs believe about their model's advantages." While this was the starting salvo in our relationship, the fact remains that CBRE funded this paper, warranting skepticism in recognition of the hired-gun element.

As an analyst, I had promoted internalizing property management, made conference presentations advocating vertically integrated REIT strategies, and taught a generation of Johns Hopkins MSRE students that REITs are real companies – that they create value through management. How credible would a paper be that promotes outsourcing property management? And could CBRE even make a convincing case that outsourcing property

management can make operating and financial sense? I doubted it.

As CBRE's executives described the problem, the task seemed even more daunting. The company's property services business has lost fee revenues to the REITs industry's growth. REITs are consolidating high-quality real estate, much of which was formerly run by external managers like CBRE. As the world's largest property management company, CBRE is increasingly vulnerable to the REIT internalization model, even though it believed that some REITs' property management internalization decisions are for the wrong reasons.

Specifically, CBRE found that REITs internalizing property management often blame the decision on investors and analysts saying, "What kind of REIT are you if you don't manage your own properties?"—a group that formerly included this writer. While other reasons for internalized property management also come up, the recurring theme is an investor/analyst "requirement" for vertical

integration. However, when examined fully, the stated reasons for internalized property management crumble into an old Greek-chorus orthodoxy about what constitutes a "real" REIT, based on perception more than attribute analysis.

We agreed to the following project ground rules: First, the conclusions are mine, reached independently. Second, CBRE provided open access to the organization, and under a confidentiality agreement, to the numbers underlying its business model. Third, I had access to the same internal tools, software, management manuals and online systems that CBRE uses to run properties. Fourth, CBRE staff participated in unsupervised interviews and conversations about how they operate. Lastly, CBRE developed a financial analysis, included in this report, showing before-and-after property management economics. Having reviewed the methodology, I conclude that in many cases, REITs can increase NOI and FFO under the external property management model.

# AUTHOR'S NOTE—STUDY METHODOLOGY

My prior REIT-centric views changed in key respects after meeting with CBRE's property services team, visiting with regional and national property management executives and participating in their employee training. Here is the short conclusion: Externalizing REIT property management is an option that can be both functionally and financially superior to internal property management. Many REITs never fully vetted the internalization decision, and it is worth re-examining the premise. The property services technology and financial premise has changed since many REITs established their operating platform. There is evidence that national property management companies with significant infrastructure create value for their clients, in many cases

adding portfolio flexibility, efficiency and risk reduction benefits that are unavailable through internal management.

My deep dive inside CBRE showed some surprising benefits to the external management model – positive elements that can only exist with professionally independent management focused on one task – property management. I conclude that the decision should be property-specific and geographically justified—that external property management is a legitimate alternative and a better answer in some circumstances. REIT boards and management teams owe themselves a property-specific analysis that quantifies and justifies the decisions they have

made or will make about managing their properties.

Readers should remain skeptical, but think about the how, what and why of property services objectively and separately for each property – perform a qualitative and quantitative analysis before AND AFTER making the internalization vs. external property management decision. I believe that objective answers to the questions and findings raised in this analysis will surprise and challenge REIT executives, analysts and investors.

*-David Fick*

# REAL ESTATE “MANAGEMENT” DEFINED



How REITs are organized and managed is a frequently discussed topic that often causes misunderstandings because of confused and overlapping terms. Recent media commentary on the issues surrounding the successful hostile takeover at Commonwealth REIT served to further confound investors.

Management roles at REITs (and most property portfolios) include four major categories:

- Corporate (executive) management
- Portfolio management
- Asset management
- Property management

Each management function involves specific activities and responsibilities, but all of these can be performed either by “internal” staff on the REIT’s payroll, or contracted out to “external” service providers. To be clear, this paper, and the related analysis, focuses on the last of these four categories – and is specifically NOT about the internal versus external advisor issue, and is not about where the REIT’s C-Suite, portfolio management and asset management functions should reside.

## EXTERNALLY MANAGED/ADVISED VS. INTERNALLY MANAGED REITS

It is clear that the investment community and the successful REIT models have demonstrated that the internally advised model works best, and that the internal executive functions should include corporate structure, balance sheet management, portfolio strategy and management, and asset management. This study is about the service BELOW the executive and investment management functions – solely at the property level.

The earliest REITs were externally advised/managed in every respect – by law they had no employees. The 1960s through 1980s-era REITs were essentially mutual funds of commercial real

estate properties, run by external advisors who were paid fees that included advisory, portfolio, financing, acquisition, disposition and asset management services. These external advisors hired property management firms, usually mom-and-pop local operations, to run the physical assets and handle tenant interactions.

Commencing with the 1986 tax act and the modern REIT era, REITs became “real” companies with internal employees, and the advised REIT model fell out of favor, for good reason. The best REIT management teams behaved as operating entities that created value – they were no longer passive property owners. The primary industry group for REITs, the National Association of Real Estate Investment Trusts (NAREIT) picked up the thesis and promoted the new public REITs as living, breathing entities that investors can evaluate and own like any other public company.

Although REITs tend to be driven by investor demands, many non-REIT institutional investors employ outsourced property management.

This is in large part driven by institutional investor demands for integration benefits that are not easily quantified or proven. The asset management level which is where the REIT adds value is almost never externalized. Non-traded REITs always use third-party property managers. This may be in large part because they do not have external demands from investors or analysts to be vertically integrated.

The confusion comes in here – about a dozen REITs did not adopt the internally advised corporate management model (also called internally-managed). Instead, they continue to contract with an advisor to provide executive

management services and staffing for fee(s). Most analysts and industry experts look at that model with some disdain, as it incorporates a potentially conflicted structure. The REIT’s external advisor is incented to grow the portfolio to increase its fees. Meanwhile, the advisor’s executives who run the REIT for fees typically own little or no stock in the REIT. Externally managed REITs therefore are run by people who are most aligned with the advisor’s interests and not always the REIT shareholder’s interests.

As a group, externally managed REITs have underperformed their internally managed brethren. When we refer to an externally-advised or managed REIT in this instance, we are speaking about those few remaining REITs that have no staff, and instead purchase the required executive, organizational and corporate accounting services of an external advisor, a fee that is usually computed as a percentage of the REIT’s total owned assets. To refer back to the four categories above, these underperforming REITs have outsourced all four categories.

This question of internally managed vs. externally managed REIT management/advisory structures is NOT this paper’s topic. This paper is about the bottom-most level of real estate management, at the property level, where tenant contact occurs and the physical property is maintained and managed—think of the building manager with his/her name embroidered on his/her jacket, and his/her direct supervisor, plus property-level lease administration and accounting.

The fee-based property management business specifically excludes asset management, portfolio management, and corporate management functions and responsibility.

# REAL ESTATE “MANAGEMENT” DEFINED

**Corporate (executive) Management** is that which determines whether a REIT is internally or externally advised and managed in the company executive suite. This is usually distinguished by whether the REIT executives own stock in the REIT and are paid standard executive compensation packages on the REIT’s own payroll, or whether the REIT has no executive payroll, but instead pays fees to an advisor for all executive and corporate management services. Corporate Management is not the subject of this paper other than to define it separately from other management roles.

Portfolio management is the process for setting overall real estate strategy. Portfolio management includes determining where to focus investments geographically, what asset classes to own, property size targets, capitalization strategy, and supervision and execution of those decisions, including performing property acquisition and disposition transactions. Portfolio management positions the company, and usually happens inside the REIT’s board and executive suite, with support from asset management. Portfolio Management is also not the subject of this paper other than to define it as above property management.

**Asset management** is the REIT’s property-level decision-making process – note the distinction between making decisions and executing or delegating those decisions. Asset Managers focus on individual property-level operating and capital budget options, and individual property strategies and tenancing decisions, and tenant relationship building. The function generally includes the long and short-term buy-hold-sell analyses for individual properties, to ensure they meet the REIT’s overall portfolio objectives. This includes calculating, reviewing, and forecasting property value changes over time, usually

supported by asset management analysts. Asset management usually includes supervising and monitoring the property level management processes, such as ensuring that the property manager is obtaining all required property insurance, accounting for new leases or tenant lease renewals appropriately, maintaining the physical property adequately, etc.

Where external leasing and/or property managers are employed, asset managers also determine which property management and leasing companies to hire or renew, and they evaluate whether the current providers or internal staff are maximizing property value. Put simply, the asset manager’s job is to ensure that each property’s value is maximized over its holding life cycle. Asset management does pretty much the same job whether property management is external or internal and is a subject of this paper only in the respect that it directly interfaces with and controls the property management function.

**Property management**, classically speaking, is the services and employees who directly interface with the property and its occupants and service providers. Examples of the old-school property manager’s job include hiring cleaning services, trash collectors, landscapers, painters, collecting rents and replacing light bulbs. That version of property management also includes some specific offsite work, generally limited to tenant billing and collections, lease management (but not leasing per se), common area maintenance, accounting and property-level general ledger. The property manager supports and provides data for annual operating and capital budget requests, but does not make actual budgetary or tenant leasing decisions, which are generally reserved for more senior asset management, portfolio management and corporate executive staff.

Today’s professional property manager is not recognizable compared to the old model from the 1980s and 1990s. With the addition of technology and training, the property manager has become accountable for the overall tenant experience – adding value to the property through incorporating best practices in property management – working to improve NOI and asset value.

Put simply, property management is a service for which an external or internal property management group is paid a fee that is usually a percentage of tenant revenue collections. Depending on property type and size, these fees can vary from less than 1%, to 5% of cash collections. Property management is this paper’s primary topic – specifically the third-party property management model for office, industrial, and shopping center retail space.

Property management services for apartments, self-storage, lodging or health care (except medical office buildings) are outside of this paper’s scope. Senior living and hotel REITs generally must outsource property operations due to revenue tests in the REIT enabling legislation, which require the majority (75%) of a REIT’s income to come from rents or interest on mortgages. They also benefit from flag-branding and therefore lease their properties to operating tenants like Hyatt or Sunrise, who run the hotels and senior living operations. Similarly, some real estate business models require branding and include key property-level operating models, so are clearly best run in a vertical model – self-storage and apartments are in this category and are therefore excluded from this analysis.

# THE CASE FOR INTERNALIZED PROPERTY MANAGEMENT: POINT-COUNTERPOINT



The REIT industry is now dominated by internally advised companies that also internally perform much or all of their own executive, portfolio, and asset management functions. Property management functions are performed by a mix of internal and external business models, but are dominated by internal property management. REITs that still use external property managers often come under pressure from analysts and investors to internalize. This evolved in the 1990s as an element of marketing REITs to investors. REIT management teams, analysts, investment bankers, and NAREIT promoted the view that REITs add value through good management at all levels, beyond what occurs in a passively managed real estate portfolio. Whether this is correct or not, it sounds right, seems logical and remains in the REIT marketing and capital raising toolbox.

Most analysts who were around during the REIT industry's explosive growth in the 1990s, including this paper's writer, had checklists of criteria for what elements make a "good" REIT, and what specific characteristics are required to recommend the REIT's shares to investors. Many of us had a check-the-box approach to this analysis, and some analysts still employ a bright-line approach. Simplifying to make the point, they ask, "Internally advised? Check. Unclassified board? Check. Good property markets? Check. Investment grade balance sheet? Check. Internal property management? Check." And so on. Analysts and institutional investors in REITs often believe (or at least promote) the following about internal property management, supported by enthusiastic management assertions and the industry's overall programmatic story:

## BRAND VALUE

REITs run their properties better than the competition and therefore have brand value that can translate into higher relative rents, better tenant retention and growing property values. Putting the REIT's name on employee uniforms and executing a business plan under a consistent corporate flag reinforces tenant relationships.

## COUNTERPOINT

This hasn't been proven through independent study, but is a logical claim made without much basis. Some property management companies are willing to private-label their property staff, keeping the owner's name in front of tenants. While REITs often don't test their brand value proposition, the largest external property managers use tools (like CBRE's Key Performance Indicators) to prove their management operations are effective.

A comparison of rents at a privately owned property vs. a REIT should logically show higher rents with no occupancy loss. However, investors tend to focus more on occupancy than rent levels, sometimes at the price of overall NOI growth. Brand value? Meh.

## PRICING POWER

Tenants in REIT-owned properties often pay more and expect an unsurpassed occupancy experience compared to competitive properties. Property-level staff who deal with tenants represent the owner, and should look and feel like part of the REIT's organization. REITs generally have higher occupancy than their markets overall, making this case.

## COUNTERPOINT

This is statistically not provable. Other factors also lead to higher average occupancies, including the fact that REITs self-select the top properties in most markets, and have capital access that allows them to meet any market rent price point, thereby enhancing tenant acquisition and retention. However, it is a good story and most REITs stick to it.

# THE CASE FOR INTERNALIZED PROPERTY MANAGEMENT: POINT-COUNTERPOINT

## CONTROL

Property employees who work directly for the REIT are more easily managed and will work harder to represent the REIT's interests than staff who are employed and answerable to an independent third-party property management company. Property management staff employed directly at the REIT level can cross-train and move between properties, promoting a uniform corporate operating culture.

### COUNTERPOINT

Again, great theory. However, many property employees are primarily loyal to their property. Building managers often work for several successive owners. A third-party property manager provides a consistent culture and approach across the country and globe.

## PRICE OF OWNERSHIP

REIT employees work solely for the REIT, but third-party property management staff have multiple bosses – the property service company and the owner (the REIT). This can lead to financial and operating conflicts. Some REIT executives believe that direct staffing translates into better job satisfaction, happier employees, and superior results for tenants and the REIT's financial statements.

### COUNTERPOINT

This is a persuasive argument, especially for REIT executives who believe they make a difference in motivating people. However, some external management proponents believe that property managers can be more motivated to perform for a customer – after all, an owner can more easily fire a third-party service provider than its own employee. Employees of a third-party manager have a larger, focused organization to support their career growth and upward mobility.

## ENTREPRENEURSHIP

Employees who work directly for the REIT are more likely to take ownership of the property and deal with tenants and outside contractors in an entrepreneurial manner. A REIT's property employees can be financially incented to enhance property value – bonuses and stock awards can align the employee directly with the REIT's objectives, a goal that is harder to accomplish using salaried and hourly employees working under a property management company fee cap.

### COUNTERPOINT

How many property management staff really are entrepreneurial? If so, wouldn't they be doing something else? A truly entrepreneurial property manager is likely to find more advancement opportunities inside an international management company than at most REITs. Third-party managers provide alternatives to move into leasing, development, capital markets and a wide geography of locations.



# THE CASE FOR INTERNALIZED PROPERTY MANAGEMENT: POINT-COUNTERPOINT

## EFFICIENCY

A single property manager can efficiently handle multiple small properties from one location, rather than staffing small-format properties individually. Compared to small, local property management companies, many REITs have enough size to enhance revenues and reduce costs through corporate purchase deals, such as grouped insurance and landscaping contracts, power redistribution programs, and centralized deals for supplies and equipment.

### COUNTERPOINT

A third-party property manager can exceed whatever a REIT accomplishes in scale and purchasing power, based on even larger scale.

## PROFITABILITY

Property management companies must be making SOME profit in property management or they would not be in the business. A REIT should be able to capture that profit by performing its own property management functions.

### COUNTERPOINT

Few REITs, perhaps only a handful, are large enough to have enough scale to build a full property management infrastructure comparable to a large-scale worldwide external fee manager. Smaller REITs actually lose efficiency and therefore margin due to excess capacity at some level, or inability to spread costs across enough square feet. For example, a REIT may employ a senior lease administration executive for its 20 or 30 million total square feet, while an external property manager might spread that same skill and resource cost across 100 million square feet.

If a REIT has less than 10 million square feet in a given market, CBRE's models demonstrate that an external manager usually can be more efficient.

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A logical conclusion from the positive factors listed above is that everyone in the process will do better, be happier and make more money through internalized property management. There is some merit to both sides of the argument, and marketing, investor and analyst optics have historically been enough to create internal management functions, but it isn't as simple as it first appears.

# THE CASE FOR EXTERNAL PROPERTY MANAGEMENT



Evaluating internal versus external property management alternatives involves qualitative factors that are difficult to measure numerically. However, property service providers outline a consistent logic, backed up by real world experience for a case that is compelling enough that REIT executives should seriously consider whether it applies to them. While the decision remains a judgment call, and anecdotes support both approaches, solid data and analytics support the external property management model for many properties.

The internalization case seemed clear when I was in the investor/analyst world. Now that I am freed from the burden of market-driven optics and conventional investor thinking, the internalization benefits are hazier, and some advantages of external management are clearer. While there isn't one answer, external property management can be effective - investors and property owners should consider the following case for external management:

- Cost savings
- Portfolio management flexibility
- Central purchasing and contracting
- Career management
- Property-level risk management
- Training uniformity and compliance
- Reduced technology costs
- Back office efficiency
- External managers perform their work in accordance with industry standards
- Quality managers prove it

## COST SAVINGS

Perhaps most surprising is my conclusion that many REITs incorrectly believe that they save money through internalizing property management. CBRE's analysis shows that the regional breakpoint where they begin to see marginal profitability from third-party office

OUR REVIEW OF CBRE'S INTERNAL PROFIT MODEL SUPPORTS THE MATHEMATICAL CONCLUSION THAT UNLESS A REIT OWNS A SUBSTANTIAL PORTFOLIO IN ANY ONE MARKET, IT CAN USUALLY SAVE MONEY THROUGH OUTSOURCING PROPERTY SERVICES IN THAT LOCATION.

property management contracts is about 10 million square feet. While CBRE has some property management offices that manage fewer than 10 million square feet, those offices don't break even, and generally exist to support other revenue opportunities, such as leasing assignments.

The sweet spot in the external property management model starts at about 10 million square feet. CBRE believes that it can sustain 15% margins above the 10 million foot break even point. Almost no REITs have this much space in any one market. Our review of CBRE's internal profit model supports the mathematical conclusion that unless a REIT owns a substantial portfolio in any one market, it can usually save money through outsourcing property services in that location. Other factors may still mandate internalization, but saving money that way is nearly impossible.

## PORTFOLIO MANAGEMENT FLEXIBILITY

REITs exist as a function of real estate investment capital flows and the related cost of capital. Top-tier REITs can access all forms of capital – public and private equity and public and private debt. To justify the public company costs and limitations, REITs must establish a top-down portfolio and balance sheet strategy that is logical and transparent to investors, presumably leading to a lower cost of capital compared to other property investment formats.

Reduced capital costs are the key factor in REIT success, and come from a combination

of portfolio strategy and balance sheet management. Telling the story in a convincing way is also critical – but the story must be real. That story for many REITs includes internal management skills – “We are better at running our properties than anyone.” Investors buy the story, and demand the same of other REITs. But at what price? Is it really worth lost portfolio flexibility tradeoff?

Investors understand that a solid portfolio strategy is desirable, preferring top-tier properties, management and capital structures. Investors value an executive team's ability to identify new strategies as markets shift. For example, some office REITs have a development focus and/or buy properties in secondary and suburban markets, while others focus on only trophy properties in one or more specific cities.

The common factor is that almost every REIT has shifted its property focus strategically over time – even those exclusive to a single market have gradually moved away from their legacy “IPO” portfolios to new, often higher-quality acquisitions and portfolios. An example is SL Green's decision about a decade ago to move from their original IPO's mid-town Manhattan “Side-Street” B-building focus, to an upscale A-building mid-town Manhattan “Avenue” focus. While SLG did not move its geography at all, its portfolio was turned upside down in a few short years – the side-street buildings were sold, with the capital redeployed into Avenue trophies. Likewise, most suburban office REITs entered new markets in the early 2000s, and have since

# THE CASE FOR EXTERNAL PROPERTY MANAGEMENT

A REIT WITH EXTERNALLY MANAGED ASSETS HAS MORE FLEXIBILITY TO MOVE CAPITAL BETWEEN PROPERTY TYPES AND GEOGRAPHIC LOCATIONS, WITHOUT CONSIDERING WHERE ITS EMPLOYEES ARE LOCATED.

exited or refocused some of those markets, while adding new geographies. This reflects the REIT industry's increased maturity, lessons learned and the fact that good managements constantly re-evaluate strategy, reacting to changing physical supply and demand circumstances. How does this relate to property management-level business models?

Outsourced property management enhances flexibility as REIT portfolios and capital ebb and flow over time - matching personnel with local portfolio size, while avoiding transitional human resource issues. A REIT with externally managed assets has more flexibility to move capital between property types and geographic locations, without considering where its employees are located.

## CENTRAL PURCHASING AND CONTRACTING

External property management can improve property-level performance through central contract and purchasing controls that do not exist at most REITs. Property management service companies can have enough scale to source services and supplier contracts that are simply unavailable to the average REIT. A large property manager such as **CBRE, which has approximately 800 million square feet under management in the U.S.**, far more than any REIT, can scope property and equipment service contracts that allow its comparatively massive property base to run individual properties at a high quality level despite lower cost, contributing to better tenant relations and retention.

We reviewed many examples of cost savings that are not available to the average REIT with an internalized property management model.

CBRE estimates that its procurements systems save an **average of 7.7% on products, and 5% to 25% on contract services**. One factor that promotes cost savings is a policy to re-bid contracts every 36 months or more frequently to meet ownership requirements. This discipline is systematized at CBRE and is a routine matter that has concrete results for operations, but is a process that most REITs either do not perform, or do more sporadically. In some respects, it can help for the third-party manager to be the "tough guy" with vendors and service providers, buffering the property owner and simplifying transitions.

For example, CBRE maintains an exclusive price schedule for all products sold in the Staples and Office Depot commercial catalogs (two examples of hundreds of vendors with CBRE-negotiated price schedules). CBRE has a proprietary online system that property staff must use to purchase supplies. The system shows pricing for similar goods from all contract suppliers, allowing cross-shopping and quantity selection that is unavailable anywhere else. The savings are passed directly to the property - translating into reduced tenant common area maintenance costs or enhanced net operating income, or both. Contractual price arrangements go far beyond supplies, and include service providers like Otis Elevator, Trane and Waste Management. Whether a property is in a small or large market, these contracts come with national pricing power that REITs generally cannot obtain anywhere.

## CAREER MANAGEMENT

Internal REIT property management career paths are typically capped, while external property managers can offer clear advancement paths for property employees. Few REIT C-suites include senior executives who grew up in property operations, most likely because property management is the least sexy part of the real estate world - almost an afterthought in a swashbuckling development and deal-making environment. Most senior REIT executives come from the finance, development, law and leasing professions.

Because property management companies are in the building services business as their main focus, they offer a broader career path for property and accounting staff to rise through the ranks - there are simply more available levels for advancement. Property services companies can sometimes offer ambitious and capable employees higher compensation targets than REITs can afford because the property-focused staff pyramid rises higher where property services is the only business focus. Employees are motivated when they can see concrete training and career development results and mentors as aspirational examples. Some management companies can also offer flexible work environments and teaming that are more difficult for REITs to execute in markets with relatively small footprints.

REIT executives will protest that they value and provide strong support for their property-level

# THE CASE FOR EXTERNAL PROPERTY MANAGEMENT

THE SCALE OF A LARGE SPECIALIZED MANAGEMENT COMPANY MAKES IT POSSIBLE TO SPREAD TRAINING DEVELOPMENT AND PROGRAMMATIC COSTS FOR A FRACTION OF WHAT SIMILAR FUNCTIONALITY WOULD COST A REIT ON A PER-FOOT BASIS.

staff. This is certainly true to a point, but the fact is that generally speaking, the career upside potential for external property management employees is higher than for most REIT's internal property managers.

## PROPERTY-LEVEL RISK MANAGEMENT

CBRE employs full time risk management and insurance procurement experts who specialize in reducing property liability and related costs. Only the largest REITs can staff this area.

CBRE outlined many examples of preempted legal disputes, reduced property and liability insurance costs, and risk-reduction systems and procedures that are used throughout the organization. For example, CBRE audits and compensates or penalizes property staff for ensuring tenant compliance with insurance certificates and environmental reviews, among other objective factors.

While lease administration is a seemingly mundane function, something as simple as obtaining tenant estoppels during property refinancing is a major project at some REITs, but is a routine event that is pre-trained and anticipated at CBRE.

## TRAINING UNIFORMITY AND COMPLIANCE

I was surprised to find that CBRE has a deep and specific compliance monitoring and compensation-linked program that rewards property staff for completing some fairly mundane tasks that can exist only at a professional property manager, and likely nowhere else. For example, CBRE has an extensive menu of both classroom and online training courses for property management staff and executives. The training is required and has specific completion date parameters.

All property management staff are provided new and reinforcement training several times per year. **CBRE offers about 500 training programs, including 150 specific property management courses, and claims 30,035 hours of property management training last year alone.**

Examples of internally developed courses include:

- New Hire Orientation
- Real Estate Finance
- Real Estate Accounting
- Customer Service
- Building Systems
- Technical Services
- Operations Training
- Master Connections Training (by MCA for clients like Ritz Carlton)
- Legal and Risk Management
- Project Management
- Sustainability
- HR Training
- Mentor Training

The company has a central computerized software function that documents training compliance, something that is generally not done at REITs. CBRE maintains 74 global standards for its property operations business, all of which are trained and monitored for compliance. CBRE backs this up with unannounced onsite peer and supervisor inspections that verify compliance with an extensive list of management metrics, performing about 150 internal property site audits annually.

The vast majority of REITs do not have the time or resources to develop such training systems and compliance tools – they cannot be cost-justified with 30 or 50 million feet under management. The scale of a large specialized management company makes it possible to spread training development and programmatic costs for a fraction of what similar functionality would cost a REIT on a per-foot basis. Looking objectively at the training and compliance functions alone, it may be fair to say that they come “free” in the external property management fee – a value-add that isn't available any other way.

Some REITs do use BOMA, ULI and IREM training programs for property manager certification or accreditation, plus internal training resources. However, based on our interviews, few have the resources or programmatic continuity to make staff development part of the corporate soul like it is at CBRE. A sample property management training calendar is on the next page.

## REDUCED TECHNOLOGY

Most REITs expend significant resources on internal IT systems. Hardware and software transitions are a continual process, complicated by onsite and home office communications and shared resources across multiple software platforms. Modern large-scale REITs often have Chief Information Officers and sophisticated IT environments that are subjected to annual audit. This is costly, and escalates for wide property geographies.

# THE CASE FOR EXTERNAL PROPERTY MANAGEMENT

Property management companies see IT as their core service tool – almost everything they do revolves around, or is documented in, central command and control systems that are focused on tenant service and property and lease accounting. The largest property management companies own and maintain a full complement of the latest industry-standard software packages, and can integrate with the property owner's accounting systems almost for free, because the costs are spread across many tens of millions of square feet, rather than being focused in a single REIT that may have a complete free-standing system for only 20 or 30 million square feet.

CBRE believes it can reduce a REIT's technology investment through external management. Similar to employing external payroll processing, a standard practice for many companies, external property-level IT deployment allows a REIT to focus on its investment and portfolio management business, while the external manager maintains the latest in property management technology and software. CBRE's annual \$115 million IT budget includes about \$15 million for technology in the property management and accounting services division, far more than any REIT can sustain – yet each client gains access to the entire underlying infrastructure. For example, CBRE has a proprietary web-based building management system called Axis Portal that is available to all third-party management clients. Some external users, including TIAA-CREF, Morgan Stanley, Invesco and MetLife, who sometimes manage their own properties, **purchase licensed access to this system.**

CBRE'S ANNUAL \$90 MILLION IT BUDGET INCLUDES ABOUT \$15 MILLION FOR TECHNOLOGY IN THE PROPERTY MANAGEMENT AND ACCOUNTING SERVICES DIVISION, FAR MORE THAN ANY REITS CAN SUSTAIN—YET EACH CLIENT GAINS ACCESS TO THE ENTIRE UNDERLYING INFRASTRUCTURE.

ASSET SERVICES CALENDAR				
MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
	1	2	3	4
		VARIANCE REPORTING & ANALYSIS WEB CONFERENCE		
		BOMA BEEP 1 WEB CONFERENCE		
7	8	9	10	11
MASTERING THE POSITIVE ALTERNATIVE DETROIT		MASTERING THE POSITIVE ALTERNATIVE NY/NJ		MASTERING THE POSITIVE ALTERNATIVE WASHINGTON D.C.
		RISK MGMT ROUNDTABLE WEB CONFERENCE		MASTERING THE POSITIVE ALTERNATIVE ATLANTA
		BOMA BEEP 2 WEB CONFERENCE		
14	15	16	17	18
MASTERING THE POSITIVE ALTERNATIVE PITTSBURGH		MASTERING THE POSITIVE ALTERNATIVE CHARLOTTE		TIME MANAGEMENT IN THE WORKPLACE HAWAII
ACTION BASED EMAIL WEB CONFERENCE		BOMA BEEP 3 WEB CONFERENCE		P2P MONTHLY ENHANCEMENT AND Q&A CALL
	FINANCIAL MASTERY ATLANTA			
21	22	23	24	25
	ACTION BASED EMAIL II WEB CONFERENCE		BOMA BEEP 4 WEB CONFERENCE	
	P2P MONTHLY ENHANCEMENT AND Q&A CALL			
SERVICE CONTRACT BASICS WEB CONFERENCE			IN-BUILDING WIRELESS NETWORKS AND CELLULAR COVERAGE WEBINAR	
28	29	30		
		VARIANCE REPORTING & ANALYSIS WEB CONFERENCE		
THE POSITIVE ALTERNATIVE WEB CONFERENCE				

# THE CASE FOR EXTERNAL PROPERTY MANAGEMENT

CBRE TARGETS TO SAVE ABOUT TWO TIMES THE GROSS MANAGEMENT FEES ON THE AVERAGE PROPERTY THAT IT MANAGES.

## BACK OFFICE EFFICIENCY

Large property management companies employ thousands of people and therefore have fully-developed and professional Human Resources, Legal, Compliance, Senior Management and Accounting functions dedicated to the property management company. These are spread across a larger property base than can exist at any one REIT (except perhaps the 20 or so REITs in the S&P 500). Scale provides efficiencies in back-office supervision and infrastructure spending through reduced REIT staff and related space and IT costs. **CBRE manages over 32,000 tenants and has over 650 property service accountants for over 3,400 properties (about 564 million square feet). It has 4,500 total property management staff, and 55,000 total employees** worldwide, so executive and systems costs per position are minimal. This scale provides efficiency levels that cannot exist in smaller REIT structures.

## EXTERNAL MANAGERS PERFORM THEIR WORK IN ACCORDANCE WITH INDUSTRY STANDARDS

Lease management and property accounting includes a host of details that can cause honest errors, and resulting loss exposure. Despite good control systems, there are still instances when CBRE indemnifies its customers to correct mistakes caused by CBRE's gross negligence or willful misconduct. A REIT can use external management contracts to reduce operating risk, understanding, however, that industry standards require property owners to retain the risks associated with property ownership. I reviewed real-life examples of limited circumstances where CBRE covered the costs of internal accounting errors, without cost to the owner.

## QUALITY MANAGERS PROVE IT

There are three ways that a large-scale property management company can assure its clients that properties are managed better than would typically happen under self-management:

### Custom At-Risk Fee Arrangements

Management contracts can include performance criteria, and penalties for failure to meet those benchmarks. CBRE often provides management clients with warranties that it will save its management fees in property-level cost savings, or adjust the fees accordingly. CBRE targets to save about two times the gross management fees on the average property that it manages. It calls this process KPI (Key Performance Indicators) and establishes specific property-level objectives and scores to reach fee hurdles. An example of one property's KPI results analysis that we reviewed included the following metrics and objectives for one quarter:

REDUCE ACCOUNTS RECEIVABLE TO 1% OF REVENUES



REDUCE CONTROLLABLE EXPENSES BY 8.2%



MOVE THREE NEW TENANTS INTO THE PROPERTY



REDUCE LANDSCAPING EXPENSE BY 50%



These are concrete, verifiable objectives that are reevaluated every quarter and go to the heart of improved property management quality, and can be tied to fees. How many REITs perform this kind of property-level self-assessment more often than the annual budget review? How many don't do it at all?

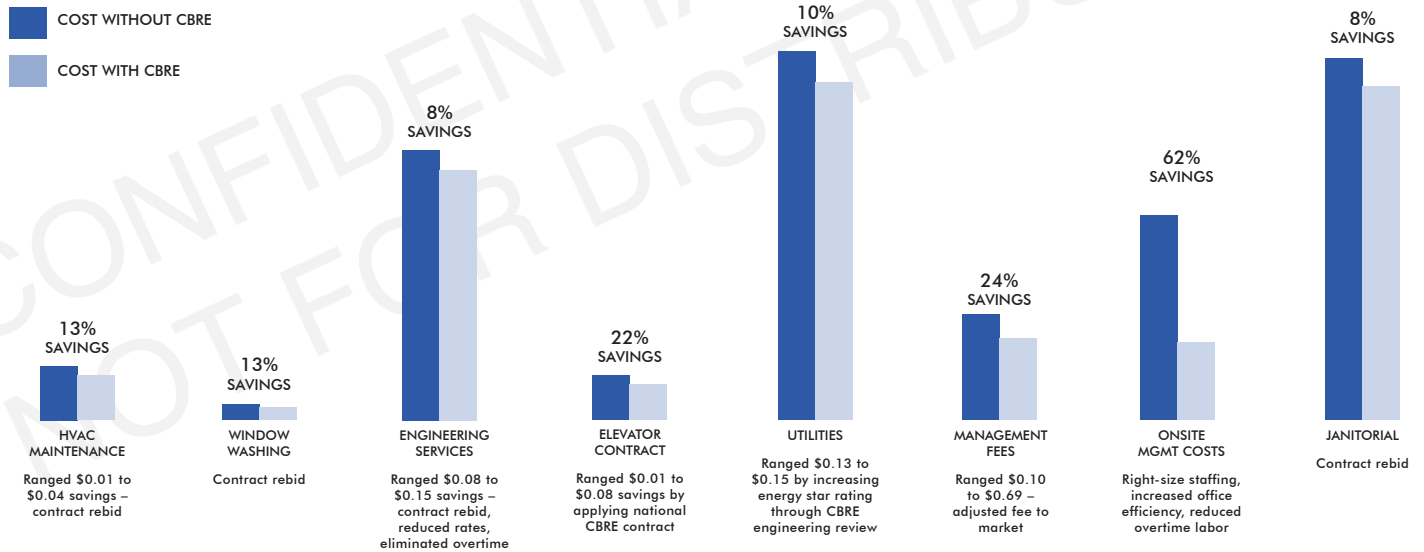
### SSAE 16 Compliance Audits

CBRE undergoes annual compliance audit reports based on the AICPA's Service Organization Control (SOC) framework and standards. The report assesses the company's internal control policies and procedures, testing security, system availability, processing integrity, confidentiality and privacy all related to how it serves clients.

### Annual Tenant & Owner Surveys

CBRE commissions Kingsley to survey owner satisfaction annually, with the option to extend surveys to all tenants as desired by owners.

# EXTERNAL PROPERTY MANAGEMENT VALUE PROPOSITION



CBRE analyzed the typical cost/revenue tradeoff between external and internal property management alternatives. The analysis shows significant cost savings for a specific “real” office portfolio converted to external property management. CBRE selected a “trophy” office REIT and analyzed the company’s financial statements and computed before and after scenarios assuming full externalization. The model is presented on the following page and is predicated on managing 115 million square feet. The following operating expense savings were collected as a part of the analysis, but only some of the categories were applied to the analysis based on the likelihood that the savings apply to any asset class or market to make the analysis more representative of an actual externalization scenario.

The analysis assumes that 90% of operating expenses savings are passed through to tenants, based on occupancy and industry averages. The example scenario includes only the Energy

Savings, Engineering Services and Elevator Contract categories because they apply to most properties. CBRE excludes more property-specific savings from Parking, Security, Janitorial, and HVAC Maintenance, but they generally average \$0.08 psf annual savings

The G&A savings assumption includes training, procurement, sustainability and executive time and travel totaling \$0.03 psf that are transferred to the external management contract.

# EXTERNAL PROPERTY MANAGEMENT VALUE PROPOSITION

Consolidated Statements of Comprehensive Income (USD \$)	CURRENT INCOME STATEMENT	INCOME STATEMENT WITH CBRE MANAGEMENT	IMPACT (\$)	IMPACT (%)
	12 Months Ended Dec. 31, 2013	12 Months Ended Dec. 31, 2013	12 Months Ended Dec. 31, 2013	12 Months Ended Dec. 31, 2013
<b>OPERATING REVENUE</b>				
Rental	572,601,250	572,601,250	-	0%
Operating expense reimbursement	234,811,250	206,866,250	(27,945,000)	-12% <b>A</b>
<b>Operating revenue</b>	<b>807,412,500</b>	<b>779,467,500</b>	<b>(27,945,000)</b>	<b>-3%</b>
<b>OPERATING EXPENSE</b>				
Rental property	143,271,250	112,221,250	(31,050,000)	-22% <b>B</b>
Real estate taxes				
	99,897,500	99,897,500	-	0%
General and administrative	93,205,000	86,537,376	(6,667,624)	-7% <b>C</b>
Depreciation and amortization	217,230,000	217,230,000	-	0%
Total operating expenses	553,603,750	515,886,126	(37,717,624)	-7%
<b>Operating income</b>	<b>253,808,750</b>	<b>263,581,374</b>	<b>9,772,624</b>	<b>4%</b>
<b>OTHER INCOME (EXPENSE)</b>				
Interest and other income	12,348,750	12,348,750	-	0%
Interest expense	(158,893,750)	(158,893,750)	-	0%
<b>Total other income (expense)</b>	<b>(146,545,000)</b>	<b>(146,545,000)</b>	<b>-</b>	<b>0%</b>
<b>Income before gain on property dispositions, income taxes and equity in earnings (loss) of unconsolidated joint ventures</b>	<b>107,263,750</b>	<b>117,036,374</b>	<b>9,772,624</b>	<b>9%</b>
Gain on property dispositions	10,845,000	10,845,000	-	0%
Income taxes	(3,498,750)	(3,498,750)	-	0%
Equity in earnings (loss) of unconsolidated joint ventures	7,583,750	7,583,750	-	0%
<b>Income from continuing operations</b>	<b>122,193,750</b>	<b>131,966,374</b>	<b>9,772,624</b>	<b>8%</b>
Discontinued operations (including net gain on property dispositions)	152,298,750	152,298,750	-	0%
<b>Net income</b>	<b>274,492,500</b>	<b>284,265,124</b>	<b>9,772,624</b>	<b>4%</b>
Noncontrolling interest - operating partnership	(816,250)	(816,250)	-	0%
Excess of preferred unit carrying amount over redemption	(1,545,000)	(1,545,000)	-	0%
<b>Net income available to common shareholders</b>	<b>273,676,250</b>	<b>283,448,874</b>	<b>9,772,624</b>	<b>4%</b> <b>D</b>
Weighted Average Shares Outstanding	167,322,500	167,322,500	-	0%
Earnings Per Share	1.64	1.69	0.06	4% <b>E</b>
<b>FFO Analysis</b>				
<b>Net income available to common shareholders</b>	<b>274,492,500</b>	<b>284,265,124</b>	<b>9,772,624</b>	
<b>Adjustments</b>				
Dep and Amort of unconsolidated JV	16,440,000	16,440,000	-	0%
Dep and Amort	252,163,750	252,163,750	-	0%
Gain on Property Dispositions	(118,667,500)	(118,667,500)	-	0%
Noncontrolling interest share in addback for dep and amort and gain on property dispositions	(3,963,750)	(3,963,750)	-	0%
<b>FFO available to common shareholders</b>	<b>420,465,000</b>	<b>430,237,624</b>	<b>9,772,624</b>	<b>2%</b> <b>F</b>

## ASSUMPTIONS / SUMMARY

- A** - This assumes 90% of operating expense savings will be passed through to the tenants. 90% was determined to be appropriate based on example REIT's occupancy of 90% and industry standards.
- B** - Savings included in the analysis are related to Energy Savings (Energy Star rating improvement), Engineering Services, and Elevator Contract. Other savings identified, but not included in the analysis are Parking, Security, Janitorial and HVAC Maintenance. The average annual per square foot savings for these categories is \$0.08.
- C** - Savings include Training, Procurement, Sustainability and Executive Time and Travel.
- D** - Total savings allow for an additional \$9.8M, or 4% of net income, to be available for distribution to shareholders.
- E** - EPS increases by \$.06/share or 4%.
- F** - FFO increases by \$9.8M or 2%.



# CASE STUDIES



We reviewed numerous case studies in which CBRE outlined concrete examples of improved property operations as a result of transitioning to their property management services. Examples included:



## SAVED MILLIONS COMING IN UNDER BUDGET

CAPITAL PROJECT MANAGEMENT TASKS &  
CORPORATE FIT-UP CONSTRUCTION



## SAVED \$3 MILLION BY TRANSITIONING TO CBRE PLATFORM

25 EMPLOYEES  
12 MARKETS  
18 MILLION SQUARE FEET



## SAVED \$1 MILLION ANNUALLY THROUGH OUTSOURCING

ABSORBED 90 EMPLOYEES  
21 CLASS A BUILDINGS  
8 MARKETS



## SAVED \$1 MILLION IN 9 MONTHS

SINGLE OFFICE BUILDING  
NEW ELEVATOR CONTRACTS  
REAL ESTATE TAX APPEALS



## REDUCED ELECTRICITY RATES

NUMEROUS PROPERTIES  
NEGOTIATED KWH PRICING DEALS

# WHAT TO DO?



EQUITY COMMONWEALTH WILL NOW BE INTERNALLY ADVISED AND MANAGED, BUT USE EXTERNAL PROPERTY MANAGEMENT—SHOWING THE WAY FORWARD IN A MATURED REIT INDUSTRY THAT VALUES CAPITAL ALLOCATION AND PORTFOLIO STRATEGY MORE THAN VERTICAL INTEGRATION.

Rather than demanding or paying a premium for internalized property management, investors and analysts should be agnostic, and challenge the decision process. Investors should question whether internal management actually creates value, and at what cost. Likewise REIT managements should re-evaluate the management structure of its properties in each market, within the context of their overall strategy.

I recall attending a property tour in Boston around 2000, put on by one of the largest public office REITs at the time. The tour theme was “Bigger is Better.” The REIT owned several large office towers in a major CBD, and its management walked our group of investors and analysts through their properties, introduced the property managers, and made a professionally-choreographed presentation on their plans to brand the company, cross-pollinate staffing for efficiency, save purchasing costs for things like toilet paper, and improve tenant retention through a king-of-the-world approach, including online service requests and contact management. They also outlined a plan to centralize the region’s management offices and pull staff out of individual buildings. However, as we toured one tower, it became obvious that the local employees were meeting each other for the first time, and some of our guides had never even seen the REIT’s top corporate executives. The staff clearly associated themselves with their building and not the company. While mildly humorous at the time, it was a precursor to an industry obsession with internalization.

This large REIT’s bigger-is-better strategy included other planned features, including

a partnership and ownership interest in a technology start-up, which was created to resell high-speed internet and telecom services to tenants. The partnership included a number of other public office REITs. The effort was essentially stillborn, and ended with huge write-offs and one-time charges all around.

Many analysts and investors now see the 2005-2007 REIT LBO and merger transactions as the end of a grand experiment in size and management technology that did not go as well as they might have liked. Since that time, many LBO successors have successfully outsourced management for the properties that were part of the original plan to dominate and consolidate office property management.

Investors moved on and now generally focus on companies with more targeted portfolio and asset strategies. Some of the most vociferous early proponents of large-scale internal management models now realize that there is a place for professional external property management for generic commodity property types, such as office and industrial space. While the internal scale argument was correct in some respects, the massive-scale operating focus also created an albatross that limited other key corporate objectives, such as portfolio management flexibility.

## LIVE AND LEARN

One of our favorite CEOs, led the bigger is better charge during the last major REIT growth wave, giving equal billing to operational scale and balance sheet structure. After the 2008 implosion, balance sheets became the dominant REIT investment criteria – good balances sheets won the recession’s liquidity battles, and poor balance sheets evaporated along with their management teams. Balance sheet quality, liquidity and cost of capital still dominate the size conversation, with property operations taking a back seat to portfolio strategy.

That same CEO is now focused solely on scale related to capital structures, but not property management. The latest iteration has come full circle, hiring CBRE to externally manage all of its properties. Under this transition, the REIT is going from being externally advised and managed, with internal property management, to the reverse – it will now be internally advised and managed, but use external property management – perhaps showing the way forward in an increasingly matured REIT industry that values capital allocation and portfolio strategy more than vertical integration.

One way for small and mid-cap REITs to gain some operating scale benefits is through external property management, handled by an organization that is far larger than any individual

# WHAT TO DO?

REIT. While not the answer for every portfolio, it is incumbent on REITs and their investors to at least consider alternatives to the old-school internalization orthodoxy.

Rather than reflexively assuming that internal always equals better, analysts might consider tearing up their check-the-box lists and instead ask nuanced questions about how a REIT manages its properties, and why a strategy adds value. Perhaps a newly enlightened investor

constituency will encourage managements to establish best practices, rather than reflexively cow-towing to old perceptions.

One of our favorite REIT CEO colleagues says, “We want our property employees to have (the REIT’s name) tattooed on their forehead.” That may be the right answer in many cases, but let’s examine the evidence. It costs little to run a property-level cost/benefit analysis and challenge the internal vs. external operating

models on a small scale before jumping in with both feet. In the final analysis, property managers can private-label their employees so that the tenants see the REIT as remaining in visible control, with business cards, stationery and uniforms reflecting the REIT name, while potentially adding new controls and efficiencies afforded by large-scale professional external property management.

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## ABOUT THE AUTHOR

David Fick is a member of the professional faculty at the Johns Hopkins University Carey Business School, where he teaches Real Estate Finance, Capital Markets and Investments, and advises graduate thesis students in the Masters in Real Estate program. He is a director at National Retail Properties (NYSE: NNN) and is President of Nandua Oyster Company, an aquaculture business he founded in 2007. Mr. Fick served as Managing Director at Stifel Nicolaus & Company, a successor to Legg Mason Wood Walker. In that position he headed Real Estate Research and was an analyst covering REITs from 1997 until his retirement in 2010. During this period he was also a member of the Legg Mason Real Estate Capital Investment Committee.

Mr. Fick also served as Equity Vice President, Finance with Alex Brown Kleinwort Benson and LaSalle Partners from 1993 to 1995, and as Chief Financial Officer at Mills Corporation and Western Development Corporation from 1991 to 1994. Prior to that, he was a practicing CPA and consultant with a national accounting firm, specializing in the real estate industry. He is also a non-practicing CPA, and is a member of the AICPA, International Council of Shopping Centers, NAREIT and serves on the Virginia Eastern Shorekeeper board and the Virginia Coastal Land Management Council.

## ABOUT RALPH BLOCK

Ralph Block has 40 years experience with Real Estate Investment Trusts (REIT) and has been actively involved with the REIT industry in various professional investment and advisory capacities since 1993. He has been investing in REIT stocks since 1975. Mr. Block is the owner and proprietor of Essential REIT Publishing Co., an independent advisor to and publisher of information for the REIT industry. He is also a Senior REIT Portfolio Manager for Phocas Financial Corporation. From 1993 to August 2003, Mr. Block was the Chief REIT Portfolio Manager at Bay Isle Financial LLC, an Oakland, California-based investment advisory firm, which was affiliated with Janus Capital Group. From 1998 to 2003, he was a Portfolio Manager for the Undiscovered Managers REIT Fund. Mr. Block is the author of two leading books on REIT investing, including “The Essential REIT” and “Investing in REITs”.