About Real Property

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ABOUT REAL PROPERTY...’

The purpose of this paper is to provide some contextual and definitional background to contemporary real property assets and their management

Introduction

Try to think for a moment about real property assets in a reasoned and analytical way — and removed as much as possible from our own personal experience with it, our own taste, preferences and social conditioning, professional backgrounds etc. Try to think about it in its various forms and in a truly clinical way — the way that a computer scientist might work through algorithms or a pathologist might work through samples looking for common themes, issues, problems etc.

It is a difficult ask and something, of course, that we seldom, if ever, do. It is not that real property (or, to use the vernacular, 'the built environment') is not important or not worthy of such attention. In fact, the reverse is true. Look out of your window and the main things you see outside are real property — land and buildings. They contain our lives, our businesses and economic activity, and our civilisations. It is the store of about 40% of all our wealth. Its source, the development, building and construction industry, is the second largest in the world, exceeded only by agriculture. Real property is the basis of collateral and under-writes most major financial arrangements. These assets are traditionally a source of wealth, power, prestige and enjoyment. They are the subject of statutory control, disputes and even wars. In recent world events, they have even been seen in a new light — that being vulnerable and stationary physical and economic targets in international disputes.

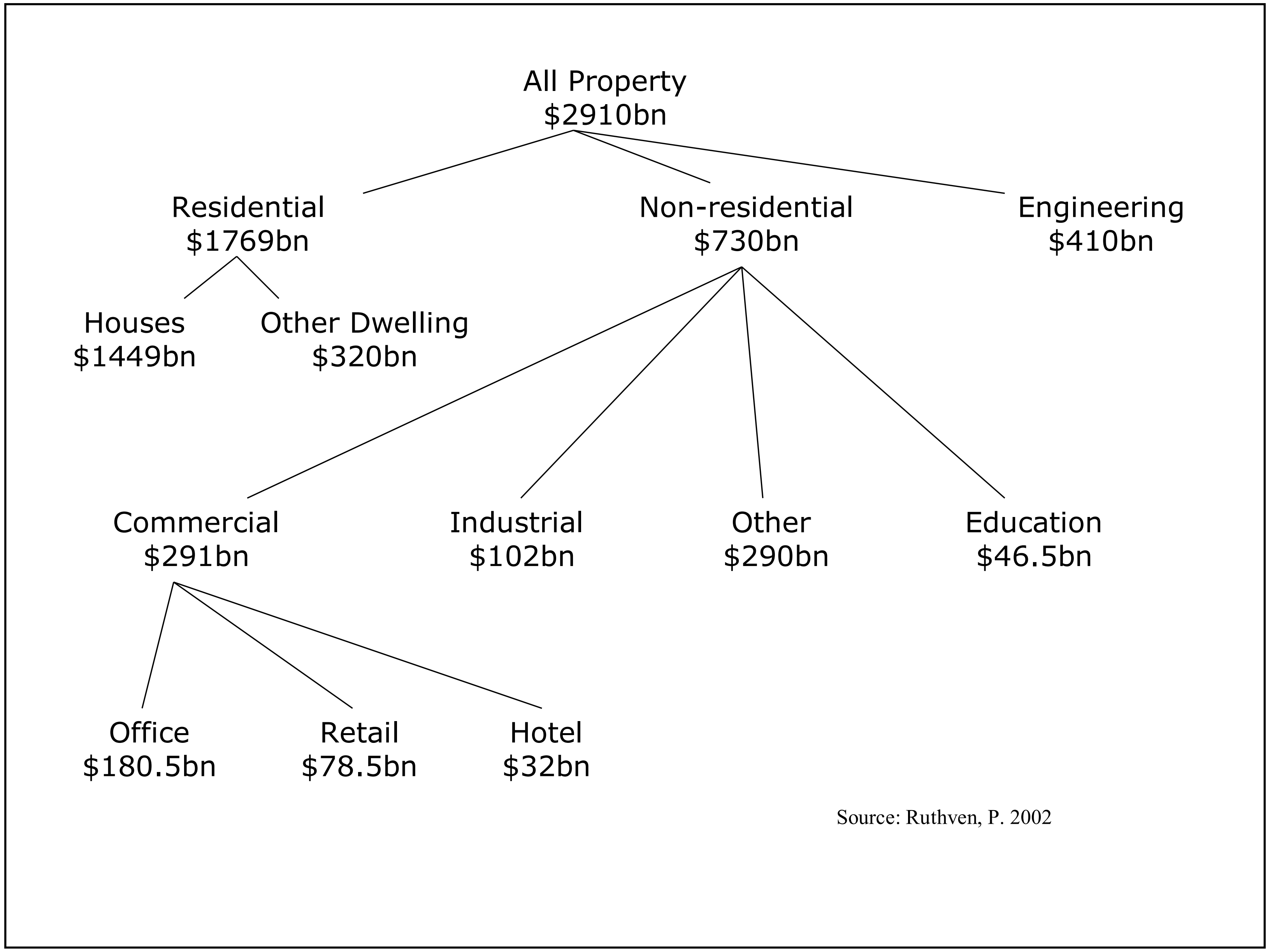
The built environment surrounds us, looms over us and persists beyond us. Winston Churchill observed that *'We shape our buildings and afterwards our buildings shape us'*.

The fact that they are all pervasive to us and with so many attributes — ranging from economic and financial through personal, community, governmental and political — that we do not stop to think or analytically consider how the functionality, value and other characteristics come about, are influenced and evolve, and how the property sector relates and integrates to the balance of the economy and community.

When we start dissecting this sector, we start to become aware of a wide range of idiosyncrasies, sometimes contradictions, within its ownership and management — a vibrant mixture of applied economics, management theory, tastes and preferences, legal and financial parameters, physical issues, the influence of a range of professionals who, in one way or another, produce, manage or otherwise influence the asset. Critically, all of this has a time dimension and the words 'real estate' and 'building' should perhaps not be seen as nouns at all but rather as verbs — actions rather than statements as the property provides those outcomes required by owners and occupants

A large proportion of the real property asset base lies in business-related sectors (eg commercial, industrial, retail, tourism/hospitality, rural, mining etc). (In value terms, about one-third of all investments per annum on fixed assets is expended on these areas — another third is expended on residential and the final third [approximately] is spent on all other forms [eg roads, bridges and other infrastructure].) The total Australian built environment has been estimated to have a value of some three billion dollars. Figure one illustrates the value of the various categories of property in Australia.

Figure One; The Built Environment



The non-residential sector represents about a quarter of the total investment in built environment and is the basis of all business related premises. The commercial sector, in effect, provides a platform for Australian business. The digitisation, globalisation and breakdown of corporate structures and changed work environments over the past decade continue to have major impacts on the demand for and definition of those assets. Whilst new assets will (hopefully) respond to those changes and build in the design flexibility to adapt to future changes, existing assets must be managed smart' to accommodate those changes. In some cases, this will be very difficult. In most, however, sound client intelligence, innovative management and targeted upgrades will protect functionality and value.

If we take the matter of personal tastes, preferences and prejudices aside for one moment, we can, through all the complexity, identify some underlying rules and principles that underpin the sector. And, whilst there are variations on the theme, they are the underlying economic principles that guide all markets in a capitalist economy. Once we understand these. we then can apply suitable management approaches and systems that will optimise returns, properly manage risk, and provide the effective and efficient workplace of the future.

The risk is that we never take the necessary effort/journey to build on fundamental research, to analyse true cause and effect and therefore come up with robust conclusions and (most important of all) predictions.

Again, our familiarity with physical property (at a fairly basic level) tempts us into great leaps to simplistic, unfounded generalisations and conclusions — the 'I bought a house and I live in it so I know what property is about' approach.

There is a great quote that encapsulates the problem: 'For every complex problem there is a simple solution that is invariably wrong.' (H L Mencken)

WHAT'S DIFFERENT ABOUT REAL PROPERTY ASSETS?

Real Property is acquired and held for a wide range of physical, economic, political and social reasons. These include:

- the basic human need for shelter; privacy and security, both for residential and business purposes.

- the generation of income (eg. combined with other economic factors of production to supply goods for profit or establishing terminable interest to produce rental income for the owner) - ie. micro-economic reasons (using property as an offensive or defensive asset). Property investment by ever growing pension funds has significantly changed the Australian property market over the past couple of decades

- the accumulation of capital (ie. capital gain) through development and/or speculation - ie. micro-economic reasons. Property has long been regarded as a stable investment providing a hedge against inflation.

- the provision of community services or requirements and the compliance with political objectives - ie. macro-economic and political reasons (public-owned assets, community requirements, including social buildings, schools hospitals, roads and bridges. Although even this sector is rapidly changing with securitisation of highways, airports and tunnels.

- the holding of real property, in part, for social and status reasons. The Australian attitude to housing and home ownership provide an example, as do the iconic public buildings such as the opera house and Canberra parliament.

In every case, however, real property holdings are live and dynamic assets. Their physical and spatial nature and the ever-changing political, social, commercial and legal environment means that real property assets require constant, detailed management.

This involves much more than just the obvious physical maintenance and includes continual monitoring and modification to ensure optimum performance and return. It also involves the programmed review of overall strategies and composition of portfolios, the acquisition, disposal or refurbishment of assets to deliver optimum functionality for all stakeholders.

Most capital assets (eg. cash, share portfolios, gold, bonds, futures, debentures etc) are available in units of comparatively small capital value. They do not physically deteriorate or change over time. Physical holding of such assets involves little more than providing adequate security, although their market value will fluctuate constantly with the ebb and flow of trading. Even when a strategic change is to be made regarding these types of assets, the decision will (whilst requiring skill and acumen) normally be clear cut and final. For example, the decision will typically be whether:

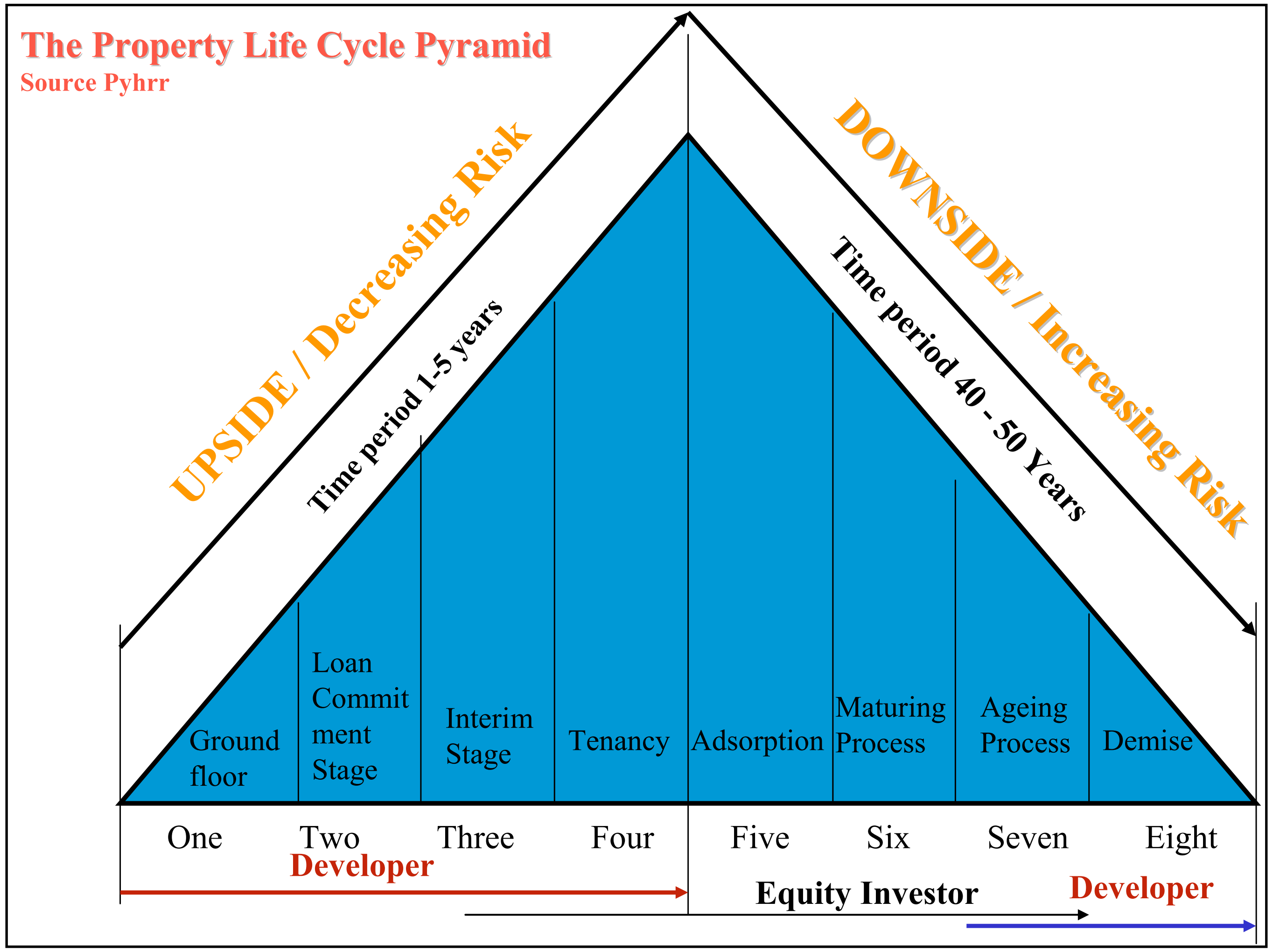
- to buy more of the asset and in what quantity:
- to continue to hold the asset in its present form and quantity: or
- to sale of all or part of the asset.

The property decision is by necessity much more complex and time consuming. On all of these levels, size of portfolio units, need for management and decision- making processes, each real property portfolio is both unique and complex and demands much more complex management. The rapidly changing contemporary economic, business and social environment reinforces this requirement.

Individual real property assets are each of considerable capital value and are normally acquired as part of medium to long term strategies. A typical high-rise office building sells for $400 or $500 million and will on average take a year or more to sell. Consequently, the buy-or-sell decisions are less frequent and of greater importance and consequence than, say, the day-to-day finessing (buying or selling) that occurs with a share portfolio.

Property is a wasting asset. That is it is exposed to continuous depreciation and obsolescence - in a physical, utility and income-producing sense. Property management is a continual process of monitoring and manipulating to effectively defend against these threats, in the short, medium and long term and to seek out new opportunities. Property assets therefore require continuous capital investment in management, maintenance and refurbishment just to retain their original asset value. It should be noted that the land element is not subject to this continuing capital expenditure other than in terms of land taxes. It is the built improvements that require the ongoing expenditure.

It needs to be recognised as well that each property asset is unique and has its own life and life cycle:



Stages (2) Design and commitment stage and (3) the construction phase tend to attract the bulk of attention, professional input and effort. On the face of it, these are the areas where the major decisions are made and where major capital funds are committed or secured or expended over a short period of time. They are areas of often intense activity by owners, financiers, valuers/analysts, architects, engineers, builders etc.

These "high points" of concentrated activity, whilst clearly important, give a skewed view of the true life cycle and overall economic performance of property assets.

Many of the faults in an asset are, for example, set at the pre-design phase. Further, it is important to realise that the initial acquisition phase typically only amounts to about 15% of the total cost of the asset during its whole life which include inter alia recurrent costs of operation and maintenance together with capital expenditure on upgrades and refurbishments. It should also be noted that the total lifecycle costs of a building will only amount to one twentieth of the costs of staffing and using the asset or its life, any efficiency measures for the occupiers cost will thus significantly influence the costs in use.

Note also that the “stages” identified in the simple analysis above are clearly related. Design and construction, quality and functionality, for example, affect the operational costs and overall capital value. Likewise, astute management whilst holding the asset also maximises long term net income and, thereby, capital value and extends life cycle.

During the extended period, too, the whole business environment (ie business structures, tenant and occupant demand, technology, statutes etc) will change and challenge the functionality and therefore the value of the asset. The greatest danger to large, fixed assets is obsolescence — the reduction, for physical, technical, locational, legal or other reasons, in functionality and demand. Obsolescence is to property as inflation is to currency — it restricts and potentially destroys the fundamentals that secure value.

Management, in this context, requires an incremental approach — continual readjustment / re-alignment to changing demands and market conditions to help these fixed assets (which, by definition can have difficulties accommodating major change) evolve to meet these changes.

In summary, it is clear that astute management of real property assets held is equally important to the overall success of a property portfolio as judicious acquisition and disposal. A fundamental observation here is that, whilst you hold/own a particular property asset, you can take initiatives, management decisions, in the application of capital improvements, judicious maintenance, and sound tenancy and lease management, that can improve its position, and therefore capital value, compared with other property assets and compared with returns on other asset classes. This is a basic positive (or negative if you manage badly!) difference from other asset types. For example, if you had decided instead of buying the property asset, to buy, say, gold, fine art, shares or some other asset, you would have had very little, if any, actions whilst holding that asset to improve the unit value of that asset.

The “up side” of all of this is that good management can make a great difference to the value and marketability of that particular asset compared both with its direct competitors and other asset types. Indeed in terms of property trusts the quality of manager adds or subtracts from the share price.

Whilst there will be general rules and acceptable practices that will apply in this management activity in practically all cases, it is stressed that the actual application and “strategy settings” will need to be done individually on an asset by asset basis, reflecting the unique physical and commercial characteristics of that specific asset. The very overused, location, location, location tag is very true in that no two properties are identical as at very least the site of each property is unique.

As well as the idiosyncrasies of individual assets, sub-sectors within the property sector will be influenced differently by different market drivers and eventualities the owner-occupied residential sub-sector provides a dramatic example.

The management of the particular asset (Asset Management”) should be seen at three distinct but integrated levels:

- strategic
- management
- operations/facilities

At the strategic level are the overall directions regarding this asset;

- What is our purpose in owning?
- What level of performance is required of it?
- Where is it going?
- How does it fit in with the rest of the corporation/owner and its asset base?
- What is the debt-equity position?
- What is overall risk profile?
- How long is the property to be held?

Property Management, if it is correctly carried out, translates those strategic directions from the owner and organises, controls and administers the asset, its tenants and occupants and those who service the asset so that those strategies are met. Activities might include:

- leasing up and lease management;
- tenancy management;
- financial issues (eg. budgeting, sending and collecting accounts, organising and paying for expenditures, management of cash flow, reporting);

- compliance with statutes;
- organising and managing service/maintenance agreements;
- providing reports and advice to the owner.

The Property Manager is the representative of the owner and, above all, protects the owner's interests. It is essential to note, however, that the "owner's interests", particularly in the medium and long term, will be best served if all of the legitimate stakeholders of the building (eg. Owner, tenant, occupier, community, services providers etc) find the building satisfactory for their specific needs. In an overall sense, therefore, the Property Manager holds a pivotal role in 'making the building work" for all of those stakeholders.

Finally, all of these strategies and management systems have to actually occur in activity at or related to the asset - the day-to-day operations;. maintenance, tenant issues, security, cleaning, building services etc together with facilities management which seeks to optimise building functionality and efficiency.

It is essential to note that, whilst each of these levels of activity, strategic, management and operations, is different and carried out by different groups. There must be a unity of purpose, a holistic approach and philosophy which permeates all levels and all activities. The focus is on what the asset is there to do in an overall sense, and the level of performance required of it. This integrated approach is known as "Strategic Asset Management". There are two distinct streams to strategic asset management, the investment property owner who's purpose of ownership is to provide a return on investment. The second stream is the corporate facilities management stream, in this case the purpose of ownership is to support the occupiers business objective which is not a property investment business. The property in this case must provide an efficient workplace at lowest appropriate cost.

INDUSTRY JARGON / TERMINOLOGY

As the property sector has become more sophisticated over recent years, the professions associated with it (eg engineers, financiers/ accountants, architects, solicitors, valuers, agents, project managers, quantity surveyors etc) have (quite understandably) widened their professional services to net growing interest and demand. This has, in turn, given rise to a range of new names and definitions for services being offered and resulted in confusion even among practitioners and professional institutes.

The principles/approach (as outlined in this paper) are much more important than the industry/colloquial terminology applied (and, in fact, the precise segregation of tasks if probably the antithesis of the contemporary, integrated approach in any case!).Nevertheless, in an attempt to clarify some of the industry terms in common use/services provided, the following general definitions might be put forward:

- **Portfolio Management**

Effectively, the role of the owner either of a group of (real) property assets, or (more commonly) a wider asset portfolio — ie property, shares, cash and exchange dealings, etc.

Decisions tend to be strategic, including portfolio weighting of each asset class, buy/sell, performance, balances, overall risk management and cash flows, longer-term positioning etc. This management level occurs in the investment property context with individuals in large pension funds, insurance companies and property trusts.

- **Asset Management**

This is a generic term encompassing a contemporary, holistic approach to the management of real property assets, life cycles together with the management and support systems to deliver assets that are fit-for-purpose and that remain functional, adaptable and meet the reasonable objectives of all stakeholders throughout their life. This role is more property focussed than portfolio managers dealing with a group of significant assets.

- **Property Management**

Property management is, in effect, the ‘translation of the required objectives set by the asset owner through to the day-to-day operations and functioning of the building. Typically, it will include such aspects as easing and tenancy management, budgeting, cost management, operational management, contract services and reporting to senior management, and the owner.

- **Maintenance or Operations Management**

In most cases, this is a sub-set and operational extension of property management. It refers to the management and organisation of the delivery of building services — including maintenance, operations, cleaning, security, building audits, work contracts and scheduling. Typically this role is filled by technicians with trade knowledge and experience.

- **Corporate Real Estate and Facilities Management**

This refers to the strategic management, technical and operational matters aimed at securing the optimum performance from a particular building asset. It differs from the definitions above in that the property is held for other than investment purposes. The roles are typically identical to those for investment purposes except the management focus is not return on investment but in enabling the business it supports to deliver its products or services in the most efficient and effective way at lowest appropriate cost. It will include such matters as property acquisition and disposal, services, layout. workplace planning, optimisation of expenditures, environmental health etc and overall the creation of effective and efficient workplaces.

SPECIFIC CHARACTERISTICS OF REAL PROPERTY ASSETS

In an economic sense, property markets represent an 'imperfect competition' model. That is to say, there are many buyers and sellers in the marketplace but no-one has market dominance. Consequently, whilst there might be occasional, exceptional circumstances, no-one acts with full knowledge or control and everyone who enters the market to trade is, in fact, a price taker.

The property, commodity is heterogeneous — that is, each commodity unit has unique characteristics which are understood and appreciated by consumers who differentiate between assets by way of the value they are willing to pay for them. Estimating value is a complex process and research shows that a margin of error in the region of 10% is typical.

Other basic characteristics of real property assets which are fundamental to an understanding of property and its management:

Real property assets are:

- fixed’ physical assets - whilst this, traditionally, has been considered as a strength, the fact that banks still want property mortgages almost above all loan collateral provides this is still a mainstream view. Fixed assets will need to be carefully managed to ensure that functionality is maintained in times of rapid changes in demand:

- individual economic units are unique — that is, different from one another through a combination of physical, legal, financial, taxation, equity and equitable interest parameters:

- the asset class is segmented — that is, there are sub-categories, residential, commercial, industrial, public facilities, rural, mining, tourism etc as well as locational differentiation into CBD and fringe, as well as state country and world regional categories.

- income and value are largely derived from use — therefore functionality, adaptability over time, life cycle, and obsolescence are all critical issues;

- property tends to occur and become available in large increments with relatively high capital values for basic units: Therefore, key points of decision making tend to be long-term; capital investment merges with the asset itself and becomes indivisible from it; and the market has reacted to the problem of large increments by the establishment of unit trusts and syndication to reduce entry thresholds;

- except for residential property which tends to be governed by social, cultural and taste issues, real property assets tend to be inputs to other forms of final production. In economic terms it represents the ‘land’ component of economic factors of production;

- considerable and variable legal and statute controls or use impacts exist, including restrictions on tenure , ownership, use, environment, planning and taxation;

- Political sensitivity, the large size and value of assets make them a significant target. Contention between stakeholders leads to political intervention as well as being an easy target for taxation.

- because it is a long-term asset, time parameters are very important and successful property assets, being dynamic in nature, will need to evolve with changing demands over time. Creation of new assets typically take one to two years to complete, this contrasts with the rapidly changing business cycle.

- significant properties typically have a diversity of stakeholders ranging from owners and financiers to managers, tenants, occupants and the general community. All of these have different demands and required outcomes and often have little in common with each other except for property itself;

- there are typically strong paradigms of professional behaviour and decision- making methodologies normally based on historic precedent and professional background;
- cash flows are complex;
- the ability exists, through a number of means, to improve an individual asset compared with other assets in that sub-category;
- structured, strategic and operational management of the 'asset-in-use' is critical to success.