Management Services: A Magazine of Planning, Systems, and Controls

Volume 4 | Number 3 Article 8

5-1967

Costly Fixed Attitudes Toward Fixed Assets

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Many companies that keep close control over most cost and profit aspects of their assets neglect completely their investment in real estate and buildings. Yet continuing attention here may offer handsome possibilities for substantial savings —

COSTLY FIXED ATTITUDES TOWARD FIXED ASSETS

by William J. Bolger
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The investment in and costs related to fixed assets deserve continuing close attention. Fixed assets, whether owned or leased, are a necessary ingredient of every business. If the management and control of this necessary ingredient are treated positively and in a constructive and creative manner, these assets can become significant contributors to financial success. Conversely, if fixed assets are regarded with a negative attitude or are unintentionally ignored, hidden and unnecessary costs often result.

Consider the following examples of the unsatisfactory results that apathy can produce:

A well known company owned a plant built in stages from 1880 to 1965. The buildings had been put to hard use, and maintenance had been deferred for a number of years because of divisional operating losses. To stem continuing losses and avoid heavy carrying costs, the plant was sold quickly for one million dollars, more than three times its net book value. The purchaser, a real estate investor, spent $75,000 demolishing the buildings and six months later sold the land for $4,800,000.

An important company had an option to purchase a building in which it leased part of the total space. Under the terms of the option, the option would be canceled if the company failed to approve a lease for space it did not lease in the building. The landlord tendered a lease for approval and in the waiver included the language: "The optionee consents to this lease and cancels its purchase option." The optionee was not compelled to agree but did so indifferently, later stating, "We did not want to be in the real estate business." Postscript: The optionee could have sold the option for $350,000, continued as a tenant, and still avoided being in the real estate business.

Contrast the excellent results

A building tenant who casually agreed to cancellation of a purchase option it had on its building later found it could have sold the option for $350,000.

achieved by companies that regarded a problem as an opportunity:

Offered a settlement to vacate its truck terminal and terminate its lease, a company determined the property's true value through a market analysis. It was able to obtain four times the settlement originally offered. This money was used to construct facilities twice as large with a carrying charge that came to less than the old rental.

Another company timed a purchase, rental, and sale to occur simultaneously and completed structural changes in eleven weeks. This action eliminated a long-term $300,000 annual obligation on a building that had been empty for three years, and the company realized a $500,000 profit on the combined transaction.

These are just a few examples of the experiences of corporations that were "not in the real estate business." The use of quotation marks is deliberate; these words are frequently used to express the antipathy many corporate managers feel toward real estate.

This antipathy is in some ways surprising. Careful examination of the financial statements of most publicly or privately owned companies would show total net book investments in fixed assets, including land, buildings, and machinery, of between 35 per cent and 50 per cent of net worth. (These percentages are before capitalizing on the balance sheet certain leases tantamount to installment purchases, in accordance with the accounting procedure established in Opinion No. 5 of the Accounting Principles Board.) Business has an important investment in real estate.

Necessary evil

Since most managers would prefer not to be in the real estate business, it is logical that they would prefer to own or lease a minimum amount of real estate consistent with operational needs. There are bases for this feeling.

Once the initial investment has been made, land and buildings are not usually regarded as measurable contributors to profits. Ownership of property involves the problems and costs related to an investment. Such investment might involve using cash, the sale of common or preferred stock, the creation of debt, or a combination of these. Leasing, of course, incurs a direct cost payable from each sales dollar. Keeping the property investment to a minimum permits funds to be used profitably elsewhere, thus tending to increase earnings. Furthermore, the managements of organizations not in the real estate business naturally prefer to stress the business they know best and in which they are most qualified.

When antipathy toward being in the real estate business is combined with consideration of the large investments and costs required to house the business, the conclusion that real estate is a "necessary evil" is understandable. As a result, however, the manager who regards property negatively as a necessary evil is unable to think constructively and positively about its profit-making potential.

When real estate is viewed as a necessary evil, an appropriate policy is to keep the investment in and costs related to land and buildings as low as possible. Here, however, many companies fall down. They fail to establish and execute a consistent program for keeping this investment and these costs at

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the optimum level consistent with operating requirements and profit objectives.

All too often, as a result of expansion, acquisitions, broadening of marketing efforts, and other needs at the time, sales offices, laboratories, plants, warehouses, and land for expansion are added year after year. It is easy to overlook such increases in investments and costs when per share earnings are increasing and the total net book value of land, buildings, and machinery is remaining relatively constant or even declining. If business conditions change, the result may be unwise liquidations. A firm policy for maximizing the investment in and costs related to property should be instituted when the economy and the company are prospering.

Positive program

A shift from negative attitudes to a positive program can lead to dramatic improvements in earnings and freeing up of capital. Such a program is outlined in the remainder of this article.

The investment and costs related to land and buildings should be reviewed frequently. This review necessitates preparation of a full inventory of land and buildings, either owned or leased, and a full breakdown of the investment and cost, including depreciation, rent, taxes, insurance, and maintenance. Photographs (including aerials if possible), plot plans, surveys, and complete descriptions of improvements should be part of the resulting portfolio.

This material should be reviewed periodically by key staff and line personnel. Such a review will serve as a reminder of the need for action and change as operational and financial needs change. Comparisons of maintenance, tax, and other costs per square foot of similar facilities will suggest the need for appropriate programs. For example, high taxes may reveal discriminatory tax treatment or may reflect changes that make the property more desirable for a higher economic use.

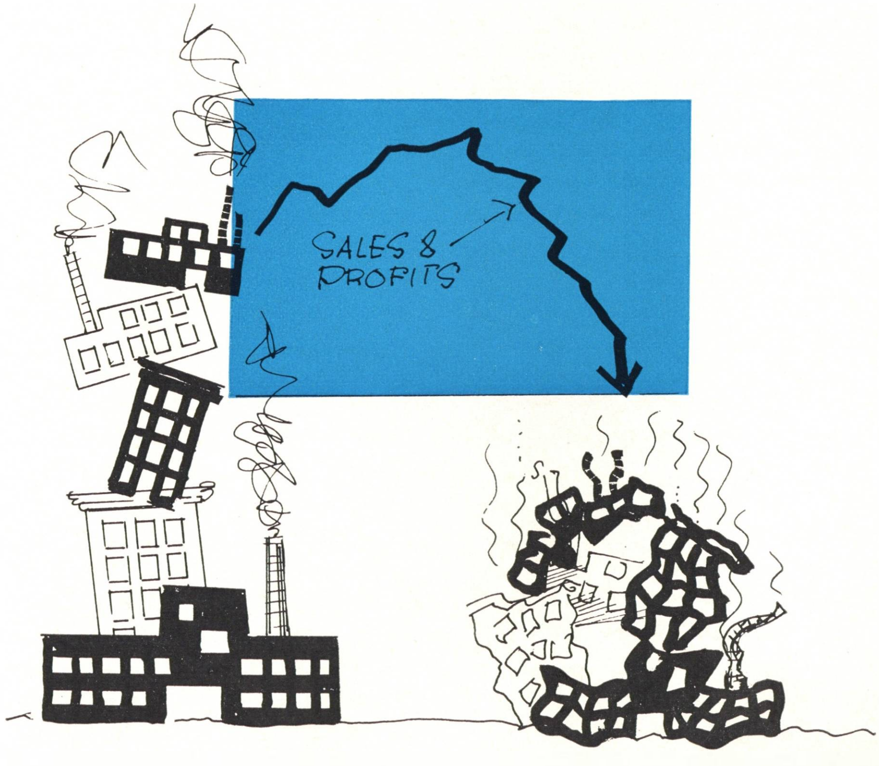
In analyzing a company's fixed asset position, the manager should keep in mind that real estate decisions are different from other business decisions because the "product" is different and the market is different. Each property should be analyzed as a separate business that is required to earn a satisfactory return on the investment. The amount for which a plant can be leased to provide fair value for both owner and renter should be determined, without reference to the fact that the company either leases or owns a particular plant or warehouse. Even though the question of lease vs. ownership may have been considered at the time of a property's acquisition, the decision should be reviewed periodically. If a property is leased, at what price might there be an advantage in purchasing it? The answer in terms of current conditions will not necessarily be the same as those reached earlier.

For example, in 1955 a well known company entered into a fifteen-year lease for a distribution branch in a Western city. The length of the lease was based on the company's experience that growth had necessitated relocating facilities after fourteen or fifteen years.

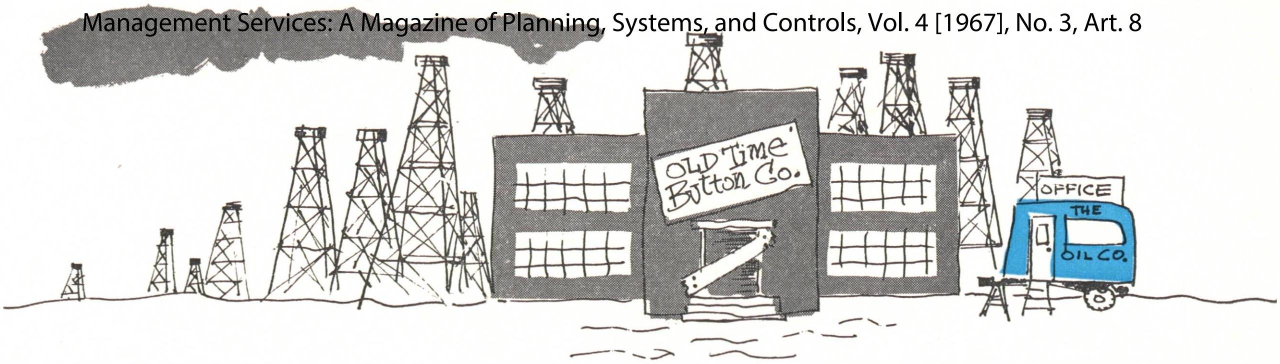
At the tenth year, however, analysis of the lease costs and the business of the Western branch suggested that the location would be advantageous for ten or more additional years. As a result of negotiations with the lessor, management was able to choose between purchase of the property at an attractive price or an immediate reduction of the rental upon execution of a lease extension.

Utilization analysis

Each property should be analyzed in terms of its use to the basic business, the ways in which its utilization may be improved,



Many a company that has blithely added sales offices, laboratories, plants, and warehouse through years of rising sales has been forced to liquidate when business conditions changed radically.



There are many situations where property, while not causing an absolute loss, would be far more valuable put to another use for the company.

and the effect on the business of discontinuing its use. These factors, again, apply whether the property is owned or leased.

Often declining profitability at a given location provokes a decision to close down or relocate an operation. Yet profitability analyses should not be confined to operations that are in trouble. There are many profitable operations that would be even more profitable if they were relocated. With changing conditions, formerly efficient layout and work flow patterns may become inefficient without actually making the operation unprofitable. Many such situations can be corrected by renovation or rearrangement. Sometimes the property would be more valuable for another use and could be sold for enough to replace the facility and improve operations while reducing the capital investment.

Each property should be analyzed both in its present state for its current use and in possible modified states for use by another company or for commercial or residential use.

For example, a well known retailer for many years had occupied a building as its headquarters and principal store under a long-term lease. With ten years remaining on the lease, it obtained from the landlord a settlement payment equal to five years' rent to cancel its lease and move. This arrangement permitted the retailer to move to a better location and a more modern building. The landlord also profited since he converted the building for office use and improved his return.

Total costs of fixed assets should be added up, and regular fixed asset cost and investment budgets should be established for use in conjunction with other key budgets. This is a basic but often neglected procedure.

The well known discipline of a specific budget is just as effective in controlling property costs as in controlling the costs of sales, advertising, production, and other operations. In a review the customary criteria used for all budgets will apply.

Responsibility

The specific responsibility for supervising and controlling the continuing investment in and costs related to fixed assets should be assigned to a key executive whose primary training and orientation are financial. His status in the organization should be high enough to permit him judiciously to cross lines of authority in marketing, finance, and production to assess the priority of needs and to relate such needs to financial objectives. If the size of the company permits it, this executive should be supported by personnel experienced in real estate finance, negotiations, planning, engineering, construction, taxation, and marketing. The objective is to relate the business' fixed asset requirements to the real estate business in order to minimize immediate and longer-term investments and costs.

Take the case of a large freight forwarding company, which needed a new terminal and offices adjacent to a large city. An analysis of operations had showed that profits would be increased by this expansion if total annual rental costs were $2.50 a square foot or less. Operating personnel made tentative arrangements to lease a building to be constructed for the company's use at an annual rent of slightly under $2.50 a square foot.

Analysis by real estate personnel showed that the landlord would obtain an adequate return at about half that rental. Factors analyzed included the value of the land, architectural fees, construction costs, plans and specifications, mortgage financing, and the landlord's projected return on equity and residual value. After correlating these factors, with only slight modifications in the plans and specifications, the real estate personnel succeeded in negotiating a lease for the same term at $1.10 a square foot annually.

Negative attitudes toward fixed assets should be changed to positive and constructive policies. The steps necessary to make this change are simple to establish. Handsome rewards can be attained with management support on policy and the attention of qualified personnel. Fixed assets and the costs related to them deserve much greater attention than they are getting.