Reprinted from the issue of April 26th, 2004

BANKER & TRADESMAN

THE REAL ESTATE, BANKING AND COMMERCIAL WEEKLY FOR MASSACHUSETTS *ESTABLISHED 1872*

Street's Earnings Expectations Influence Real Estate Decisions

By Richard M. Bradbury

The Securities and Exchange Commission and the Financial Accounting Standards Board have spent thousands upon thousands of man hours working to create financial reporting standards that make financial statements easier to read for the average investor. These organizations have put such rules in place with the hope that they will help prevent financial disasters, such as those seen with Enron and Parmalat.

But what happens when these rules create a conflict between sound business decisions and Wall Street's reaction to those decisions?

One reporting standard that may cause this effect is Financial Accounting Standard 146, which provides companies with a clear calculation for accounting for the disposal of excess office space. Generally speaking, the standard provides for taking a one-time write-off related to the sublease or abandonment of vacated space under an operating type lease. The calculation in simple terms asks users to subtract the potential sublease revenue from the remaining lease liability and to take that difference as a one-time charge as an expense on the income statement. Depending on the size and cost of the current space, this charge is often in the tens to hundreds of millions of dollars.

Falling to the Bottom Line

To take it another step, this charge adversely affects a company's earnings per share by an amount equal to the write-off, divided by the total shares issued and outstanding in the period taken. For example if a company takes a $10 million dollar charge related to the disposal of vacant space and they have 100,000,000 shares outstanding, earnings per share is negatively impacted to the tune of $.10 per share.

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Five years ago every man, woman and – for that matter – child with an extra $500 fancied themselves as the next Peter Lynch, hoping to earn millions off of the potential revenues generated from the Internet. People found themselves investing in jargon like "eyeballs" and "sticky" applications that could monetize users and generate extraordinary profits. As the profits did not materialize and investor capital ran dry, some companies shut their doors while others tightened their belts and started the drive towards profitability.

In the period that ensued, firms found themselves cutting costs by eliminating staff and in turn reducing office space throughout their portfolios. Wall Street encouraged companies to face the music by making these changes and taking the one-time charges necessary to clean up their finances. Many companies took advantage of this window of opportunity and not a day would go by during earnings season where investors could not read about one-time charges related to restructurings.

The good news for investors is that after an extended period of falling profits – if there were any profits at all – and employee layoffs, we are now in the middle of an economic expansion. In this expansion the markets are again rising, but this time, investors are more disciplined and focused again on the "fundamentals," such as profitability and positive cash flow. As ecstatic as we all are to see an economy in recovery, corporate finance departments across America are encountering not just a challenge to return to profitability, but the expectation that the company will meet growth expectations and projected earnings estimates.

Therein we find the challenge. It is no secret that commercial real estate often lags the overall financial markets in its recoveries. Although locally we have seen some signs of a real estate recovery in our suburban Massachusetts markets, there still exists millions of square feet of vacant sublease space throughout the region. This is relevant because as both corporate real estate and finance managers grapple with eliminating this excess space, the window for taking miscellaneous charges related to restructuring has all but closed.

Those companies that did not previously take charges for underutilized space must now focus a keen eye on how their real estate reduction decisions will affect the profits expected in a growing economy.

The accounting rules put in place to protect investors are now causing companies to think twice about making what were previously considered prudent operational decisions. The following is an example: Public company X has two 100,000-square-foot pieces of vacant space, one in Downtown Boston and the other in Westborough, each with five years of term remaining on their respective lease. Both offices are vacant and are equivalent in size, but the current rental liability in the space Downtown is $60 per square foot, while the rent in Westborough is $30 per square foot. Let's also assume that this company has 100,000,000 shares of common stock issued and outstanding. Market experts will tell you that a potential sublease in a Class A building Downtown could take place for around $35 per square foot while the same deal in Boston's western suburbs will probably earn about $17 per square foot.

If the company had to choose between deals, one might expect the obvious choice would be to take the deal that creates the best cash flow. After all, $3.5 million in sublease revenues beats $1.7 million any day. However, that would not take into account the write-off. While doing a deal Downtown makes more sense from a cash flow perspective, it leads to a one-time charge of approximately $12.5 million or $.13 per share, while the deal in Westborough would reduce earnings in the period by only $6.5 million or $.07 per share.

This might be an extreme example, but the fact of the matter is that companies are now becoming ultra-sensitive to achieving the earnings projections they have provided to Wall Street. A real estate transaction that makes sense from an operations or even a cash flow perspective may now cause more harm than good to shareholder value.

Real estate has always been recognized as a major expense on any organization's income statement. Current financial reporting though has created a rift between companies who try to manage their operations efficiently and the investors who determine their ultimate market value. ■

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