

CORPORATE REAL ESTATE**Addressing an Accepted Conflict of Interest: TIME TO CHANGE***by Adnan Tapia*

ABSTRACT

In a post bailout economic environment where topics such as financial reform, regulatory compliance and fiduciary responsibility have received much attention, one key area of potential ongoing conflict of interest has surprisingly received little to no coverage. This paper highlights an area of accepted potential conflict of interest in corporate real estate transactions and proposes a likely solution to address and mitigate such conflict going forward. In doing so, the paper also applies the theory of comparative advantage to further substantiate the rationale and possible benefits of the proposed solution. This paper is targeted towards C-suite level executives and decision makers who are focused on not only maximizing benefits derived from available resources, but also, simultaneously, minimizing non-core recurring fixed expenses without compromising key elements of trust, transparency, control and quality.

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Over the past few years, the US has experienced one of the worst economic downturns since the Great Depression. In this fast, ever evolving, super-competitive global business environment, the pain and impact from such and other future downturns will probably be felt over a longer recovery period.

As the powers that be try to rectify and rejuvenate the financial system and simultaneously tackle some of the more complex regulatory and governance issues, one area that seems to have been overlooked and has so far received little to no scrutiny is the potential for conflict of interest that can arise from the current real estate brokerage model, specifically, the Tenant Representation business.

This white paper aims to highlight this conflict of interest and proposes a possible solution to address and mitigate such risk going forward. The paper also applies the theory of comparative advantage to further substantiate the rationale and possible benefits of the proposed solution. The hope is that after reading this paper, owners of businesses and key executives at organizations that recognize real estate as a critical resource will choose to think differently, and maybe, consider the alternative presented in this white paper.

CURRENT REAL ESTATE BROKERAGE MODEL (“CREBM”)

In the current environment, with organizations seeking to reduce operating expenses via strategies that involve restructuring, consolidation of assets, relocation and reduction of space, one can presume that tenants potentially have substantial leverage over owners of real estate when making real estate decisions. However, as most organizations choose to work with real estate brokers to help them navigate through several of the above listed options, it is important to draw attention to an area of potential conflict of interest that stems from CREBM.

Landlord Perspective:

The brokerage fee or commission based CREBM is designed to maximize price, regardless of sale or lease. When an owner (“Landlord”) seeks the services of a broker (“Landlord Broker” or “Listing Broker”) to lease or sell a property, the aim of the Landlord Broker is simply to lease or sell at the highest price with the best terms possible for the Landlord. A Landlord Broker’s commission or compensation is therefore directly proportional to the total consideration achieved by the Landlord. Hence, there is complete alignment of interest on the Landlord side of the equation.

Tenant Perspective:

Consider an organization that seeks to lease real estate (“Tenant”) and uses the services of a broker (“Tenant Broker”, “Tenant Representative” or “Tenant Rep”) to assist with the assignment. The goal of the Tenant is to pay the lowest achievable rent. However, in most cases, the Tenant Rep who technically is an advisor to the Tenant is not paid by the Tenant, but is usually paid by the Landlord. The Tenant Rep typically splits the total commission, which is calculated as a percent of total consideration, with the Landlord Broker. This arrangement allows the real estate brokerage fee or commission to be amortized over the lease term or factored into the sale price. However, herein lies the potential for conflict of interest.

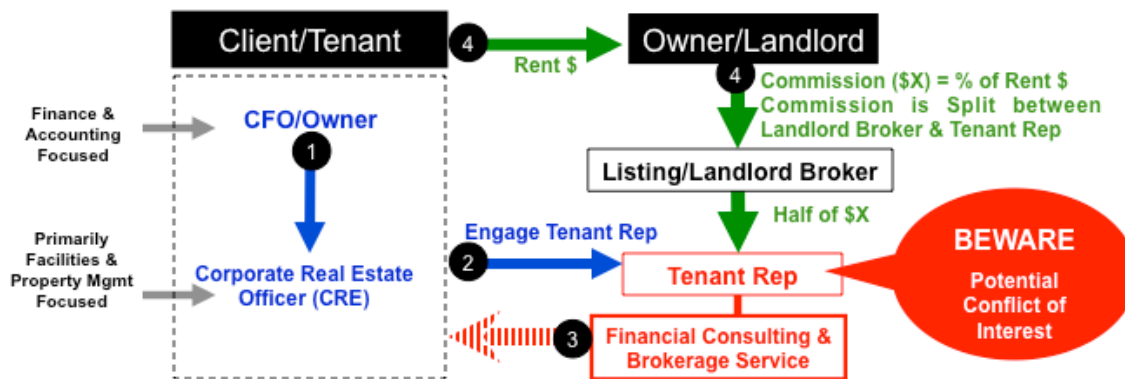
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Although the Tenant Rep's fiduciary responsibility lies with the Tenant, the Tenant Rep's compensation not only is paid by the opposite party (i.e., the Landlord), but also to make things worse is directly proportional to the total consideration paid by the Tenant (i.e., Tenant Rep's client) to the Landlord. The relationship between the various stakeholders is shown in the schematic below.

CREBM – A Broken System



Listed below are a few potential drawbacks of CREBM from a Tenant's Perspective:

- Model is designed to maximize Landlord profits
- Tenant organizations face serious conflict of interest
- Fees contingent to transactions drive desire to close quickly
- "Do Nothing" rarely a good option for a Tenant Rep, because Tenant Rep does not get paid under that scenario
- Tenant Rep compensation based on total consideration paid by Tenant to Landlord may encourage larger and/or longer rental obligations and higher sales prices – the **exact opposite** of what a Tenant or purchaser seeks
- Conflict of fiduciary responsibility versus flow of funds
- Tenant Rep may be deterred from pursuing valuable tenant options such as termination rights, which often defer part of the Tenant Rep commission
- Risk-return imbalance – Tenant Rep typically work on multiple assignments all of which may not materialize, therefore, a Tenant whose transaction closes may end up overpaying in exchange for limited service
- Increase in size of transaction results in a disproportionate increase in the ratio of Tenant Rep fees to incremental time invested by Tenant Rep

COMPARATIVE ADVANTAGE IN CORPORATE REAL ESTATE

In economics, the theory of **comparative advantage** refers to the ability of a party to produce a particular good or service at a lower opportunity cost than another party. Therefore, it is the ability to produce a good or service with the **highest relative efficiency** given all other goods that can be produced.

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So what has this got to do with corporate real estate?

The theory of comparative advantage can be applied to the corporate real estate function within an organization. An organization may be able to justify, both from an economic and business perspective, the farming-out of all or a portion of its non-core corporate real estate function. The term “non-core” implies that real estate is not a core business of the organization, but rather a resource for conducting business resulting in a related non-core expense. By aligning with a qualified external real estate consultant (“REC”), an organization can potentially redirect greater resources to and focus on its core operations.

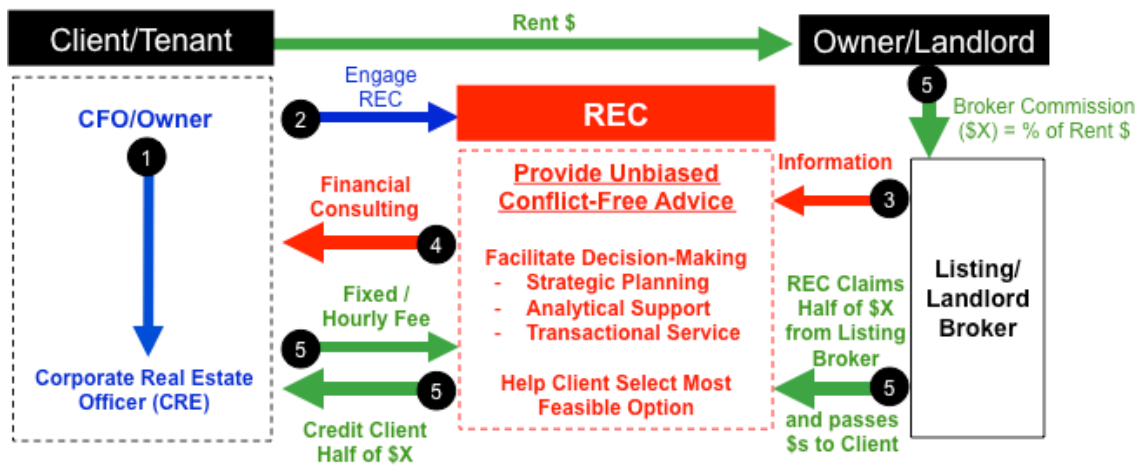
As defined under the theory of comparative advantage, working with a REC may be a better option given that a REC may be able to perform certain real estate functions at a lower opportunity cost compared to an organization that chooses to perform the functions internally. Therefore, a transfer of certain functions related to an organization’s corporate real estate duties to a REC might allow an organization to not only reduce its fixed recurring non-core real estate expense, but also better control its ongoing real estate expense. For example, by working with a REC, an organization can potentially convert a sizeable portion of its full-time employee related fixed expense to a variable expense that may be incurred on a project-by-project basis.

Corporate real estate needs be an integral piece of an organization’s overall business strategy and it is important that corporate real estate teams, whether external or internal, work closely and as an extension of the C-Suite.

SOLUTION

Here is one possible solution that can help organizations that use real estate as a resource for conducting their business (i) better manage and potentially reduce their non-core expense and (ii) mitigate conflict of interest described under CREBM.

New Proposed Model – A Better Way Forward



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Work with a Qualified Real Estate Consultant (REC) and apply the general guidelines outlined below:

- **Compensate REC based on hourly rate, fixed fee or monthly retainer**
- **Ensure that REC has a brokerage license so that share of brokerage fees or commission that would have otherwise been paid by a Landlord to a Tenant Rep under CREBM can be credited or reimbursed by REC to the hiring organization**
- **Break-up project into well-defined parts so that performance of REC can be measured and tracked allowing an organization to control risk and expense with greater flexibility**



Adnan Tapia is a Principal at Ploutus Advisors, LLC in Los Angeles, California. He has worked in the US and India on over 16.0 million square feet or \$2.5 billion worth of real estate transactions across several property types and product life cycles and advises clients on matters of corporate real estate, real estate investments, development, portfolio management and real estate private equity.

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