

Lessons to Be Learned From the New Real Estate Management Power:

The Department of Defense

As government facilities managers revamp their real estate policies, the value, and perhaps even the importance of privately owned facilities and assets, could take on a whole new luster.

By Mark A. Smith

There has been much discussion among property owners in the private sector about maximizing the value of their real estate assets, but many companies have not seriously addressed the opportunity. Perhaps that might change once the corporate sector understands just how much value can be produced through proactive management of assets. You might be surprised to learn that the so-called “bureaucrats” are about to teach the private sector a big lesson in fiscal responsibility and creativity. In fact, in coming years, the government sector may become our prime example of smart capitalism.

The structural change that has enabled the government to take a new view of its assets is not unlike the opportunities already available to the private sector. The difference is that necessity has met creativity and action in the public sector, whereas these forces are lacking among the private sector.

In fact, recently expanded legislation now allows the U.S. military to take underused real estate assets and actually make deals with private-sector companies using private-sector capital to increase their own asset values. The U.S. Department of Defense (DoD) is already using the new concept, called “enhanced use leasing” (EUL), to look at its facility needs and market opportunities in a new context.

How it Works

The EUL authority is a real estate tool that allows a government agency to lease underused real property to the private sector in return for cash or in-kind consideration. With EUL, an agency can put underused land and buildings to productive use and generate cash and in-kind consideration, which can be used to support other infrastructure and capital needs, such as maintenance and repair of critical facilities. EUL is based on a successful model first employed by the Department of Veterans Affairs (VA) in 1991.

EUL can help a federal agency save money by reducing facility operating costs, generating income for the government from previously underused property, and finally, leveraging private-sector dollars instead of scarce government dollars to support local agency needs. For example, in the Walter Reed Army Medical Center EUL project, the government was able to leverage more than \$60 million of private capital instead of government funds to renovate a previously unusable historic office building. The DoD is also using EUL to renovate the facility in a shorter time frame than if government dollars were used.

Under EUL, agencies such as the DoD and the VA can rent out under-

used assets for cash or in-kind services and keep all in-kind goods or services received or a portion of cash received to support local operations. Without EUL legislation, any proceeds received from leasing out underused assets have to be turned over to the U.S. Department of Treasury.

With EUL, agencies can decrease capital and operating expenses and put the savings to better use supporting agency programs and missions. For example, in June 2001, the U. S. Army signed a lease with a developer that will renovate several buildings at Fort Sam Houston in San Antonio and sublease them. The Army expects to receive \$253 million in revenue during the next 50 years from this project.

Public/Private

An agency can receive cash or services from leasing underused space to a private-sector entity. With this arrangement, the private-sector entity can obtain the use of real estate needed to generate significant value for its enterprise. For example, the Army could lease its underused buildings formerly occupied by Army personnel to a private office developer, in exchange for lease payments (cash) or in-kind contributions, such as building renovations or building another project such as a parking lot.

EUL can also allow for the co-location of industry and academic partners on an agency's real property. Such co-location could benefit the agency, by promoting the exchange of ideas and personal interaction among industry and academic partners and government personnel. An example of this is the Army's 2001 33-year lease with the University of Missouri, which will develop and sublease 62 acres on Fort Leonard Wood, Mo., for a technology park.

By law, the government must receive fair market value in exchange for the real estate asset used in the project. Under EUL, installations are able to keep at least 50 percent of the fair market value of cash proceeds and 100 percent of in-kind (cash used for janitorial, maintenance, security and other

services) fair market value proceeds from EUL transactions. The regulation creates a powerful incentive for the leaders of local installations to use the EUL tool, because now the local installation can retain a significant amount of the revenues generated through EUL.

Thus far the concept has spread to several key government asset owners. The VA DoD, Department of Energy (DoE), Army, Navy, Air Force, Army Corps of Engineers and NASA are all investigating or using the EUL techniques. There is also a bill pending in Congress that would expand EUL to other federal agencies.

The potential of possible activity is also significant. The major user of facilities space in the federal government is DoD, which uses about 1.8 billion square feet of owned space, or 60 percent of the 3 billion square feet owned by the federal government. The agency also owns nearly 24 million acres of land. By DoD's own account, 25 percent of its real estate is underused, and therefore, potentially available for EUL opportunities.

As far as space usage is concerned, there are four main types of uses: commercial (such as administrative office space, lab space and medical centers), residential (such as market-rate apartments, hotels, and assisted living facilities), institutional (such as university research centers and childcare centers) and parking garages.

As impressive as those numbers are, in the DoD's 1999 leasing report to Congress, it estimated that EUL could increase DoD revenues \$100 million to \$150 million annually after a five-year rollout period.

Take Home Lessons for the Private Sector

So what are the lessons that the private sector can derive and use from this governmental exercise in asset repositioning? First off is the idea that by being proactive with assets, opportunities surface that can offer significant revenue enhancements. Thus far, private industries seem to insist on considering the importance of their real

ARMS Program Provides Corporations With Unlimited Benefits

The U.S. Army's Armament Retooling & Manufacturing Support (ARMS) program provides a platform to accelerate the growth of both large and small companies by providing commercial space for rent.

The 10 primary facilities in the ARMS program are located at Army ammunition plants throughout the United States. Most of them average 10,000 acres. They feature large industrial parks with existing infrastructure already in place.

Companies can pay to use of these facilities and all of the other investments that have already been made by the government. This includes existing manufacturing equipment and lab equipment. This creates a reduction in capital costs for companies.

Companies sign lease agreements with the management companies of the facilities and not the Army. Pendulum Management Company, LLC assists the Army in managing and marketing some of the properties the Army doesn't need at the moment. The rent offsets the Army's costs in maintenance and operational costs.

"In most cases, there is a company that runs the facilities," says Sid Saunders, managing member of Pendulum Management Company, which is headquartered in Charlestown, Ind., on one of the Army's properties.

"For instance, at Kingsport, Tenn., the plant is managed by British Aerospace. It uses part of the plant to make military items and explosives. In the other part of the plant the company can rent out the extra space to other companies."

Saunders says three of the 10 facilities involved in the ARMS program have business development accelerators. "A company can grow up in a center," he says. "They can use even larger space and the contracts are written so they don't have to break a lease to do so."

Saunders adds that the program is also flexible for operations that need to downsize, or that need to relocate.

"This is a great advantage in doing business with these facilities," he says.

The Army also offers funding to update the facilities. Saunders says among the incentives are funds for building alterations; funds for feasibility studies; and a federally guaranteed loan for those that qualify, for up to \$20 million.

In the past 10 years, more than 110 companies have moved into the facilities, and the Army has invested more than \$250 million in the program, which has leveraged private investment of more than \$200 million.

In terms of industries best suited for the facilities, Saunders says the leading industries include defense contractors, government contractors and recycling businesses. He says the Milan Army Ammunition Plant in Tennessee attracted a British company that manufactures flares. The facility had some of the necessary equipment the company needed on a 25-acre site. He says the Army conducted a \$1.3 million upgrade in pollution control equipment for the company. The company will create 250 jobs.

Saunders says in the recycling arena, Green Tech Panels LLC, located at the Louisiana Army Ammunition Plant in Minden, has received a \$16.5 million loan from the Army. The company expects to employ 70 workers when in full production.

The move-in time frame to these facilities, depending on what needs to be done, can be less than three months, Saunders says. If modifications are less than \$100,000 some facilities can be ready in 30 to 60 days.

By choosing ARMS program facilities companies can leverage and expand their businesses on the back of capital investment by the government.

For complete details on the ARMS program visit www.openterprise.com and www.pendulumsite.com.

estate assets only in the time of a merger or some change in ownership or strategic purpose. This is a lost opportunity that, in a time of limited capital and pressure on management to tighten budgets and operational costs, can no longer be ignored.

Another lesson that emerges is the idea that a strategic investigation into the current scope, condition and use of assets can surface a complete strategic plan to achieve overall cost efficiency and focused property and facilities management programs. Many times, in the vacuum created by high-level management disinterest, company assets

only come into focus when there is a specific problem or challenge to one or more assets.

The private sector has realized that a more global view must be taken of its real estate assets, but the corporate sector is clearly still behind. The challenge is can Corporate America learn a lesson from DoD and other public agencies? ■

Mark A. Smith is global director of Ernst & Young's Real Estate Advisory Service. He is based in New York City. Contact Smith by calling (212) 773-7990 or by e-mailing mark.smith12@ey.com.