CFO ROUNDTABLE BRIEFING

NEW RISK MANAGEMENT STRATEGIES FOR CFOS

DISCIPLINED MODELING OF BUSINESS RISK TO REDUCE FIXED COST COMMITMENTS AND IMPROVE BOTTOM LINE RESULTS

JUNE 2008

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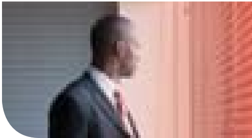
EXECUTIVE SUMMARY

The Capability Maturity Model (CMM)[1] is a conceptual framework that aids in the definition and improvement of an organization's processes. A Risk Management CMM provides a useful roadmap for advancing an organization's management of risk, reaching beyond financial and accounting issues. Smart companies look to incorporate business decisions and variability of outcomes.

Non-financial business risks often have more impact on shareholder value than financial risks. In addition, strategic and operational business variability has a significant impact on the selection and negotiation of real estate assets – a complex task requiring consideration of expansion, contraction and options in lease, purchase, disposition or other real estate negotiations. Cushman & Wakefield VOX methodology provides a disciplined approach to quantifying risk based on the volatility of the business. Quantifying volatility informs and rationalizes mitigation strategies which directly increases shareholder value, lowers financing costs and helps prevent multi-million dollar losses.

INTRODUCTION

Risk management is a traditional area of responsibility for CFOs. While much attention has been paid to managing financial risk, the non-financial business risk in today's environment provides complexity and opportunity. As illustrated in the following chart, strategic and operational business risks often represent the greatest area of variability. The reason is straightforward: executives tend to underestimate the range of business outcomes that can occur and over-extrapolate the future from the past. Inside the organization, managers are often unfamiliar with external technologies and sources of change. Market shifts, competitor actions, business success/failure, operational changes, merger and acquisition integration and expectations about the riskiness of business models, markets and products alter the requirements for real estate.



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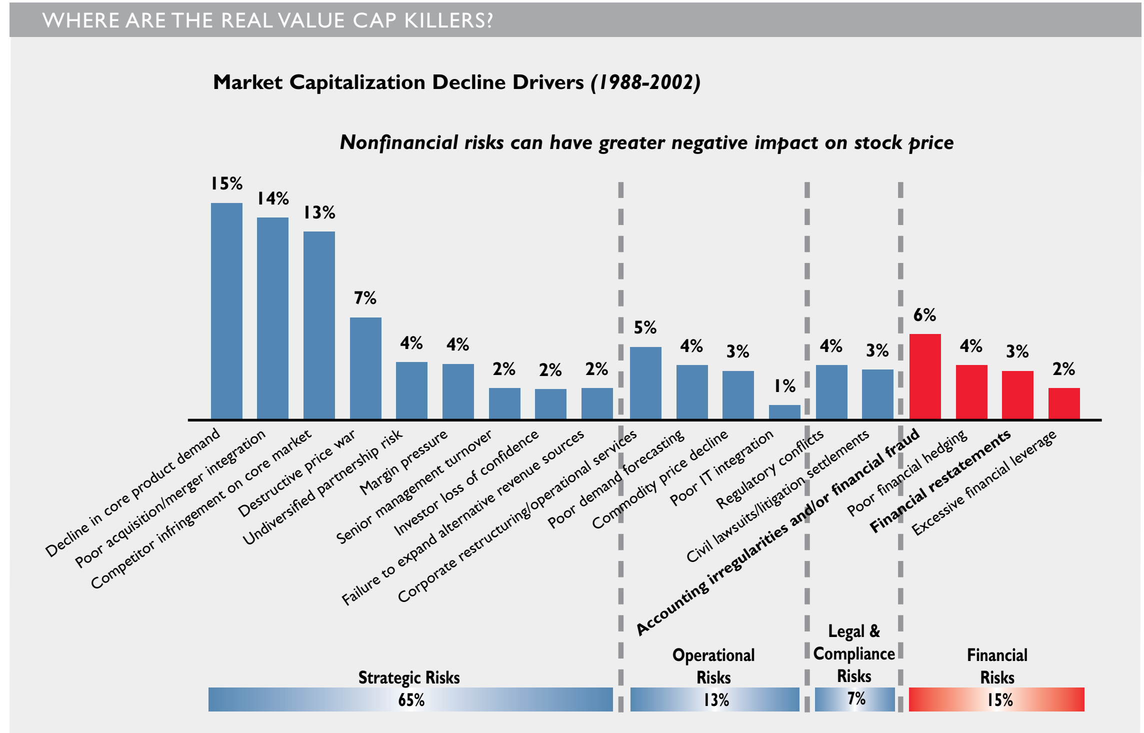
The Unmeasured Threat

The temporary frenzy over Sarbanes-Oxley compliance leaves little room to consider the broad and serious implications of deferring attention from non-financial risks. The penalty for not mitigating these other risk exposures is unclear and therefore conveniently misassessed. Internal auditors should seek to measure and understand this risk.

Vice President
Corporate Audit
Fortune 100
Health Care Company

STRATEGIC RISKS GREATLY IMPACT MARKET CAPITALIZATION

WHERE ARE THE REAL VALUE CAP KILLERS?



Source: CFO Executive Board Research; Audit Director Roundtable Research

By their nature, business and operational risks are distributed widely throughout organizations. As a result, some companies are now pursuing facilitated and distributed risk management exercises with line managers. The critical task is making sure all individuals with knowledge of business and operational risks contribute to processes that collect and assess risk information. Risk mitigation is either centralized or decentralized – yet another complex decision.

Business risks are often managed via multiple, separate business procedures and business units; e.g., formal risk management process, scenario analysis, forecasting and budgeting, business planning, product planning, competitive analysis, enterprise modeling, capital budget modeling, new product development funnels, and mergers and acquisition activities. Additionally, risks are typically perceived as tangential to the business process. As a result, they go unassessed and unmanaged. It's important to have a process for encouraging assessment and centralized reporting of key, cumulative risks.

Scenario analysis is an increasingly popular tool for evaluating risk. Well-managed companies use scenario analysis and risk mapping to think through the impact of various futures and the consequences of alternative strategies. They also typically use outside expertise to frame possible futures and extend their understanding of risk.

CFO ROUNDTABLE BRIEFING

RISK AND REAL ESTATE DECISIONS

Directly or indirectly, most new business initiatives end up affecting a real estate portfolio. The risk profile of your organization's business portfolio should influence the real estate investment and leasing decisions. Real estate assets can be selected for different degrees of commitment with varying options on expansion, contraction, conversion to ownership and sale leaseback. Given the volatility of the current financial markets, understanding the complexities of ownership versus leasing is critical. Uncertainties in today's economy and financial markets have also made companies reluctant to increase fixed cost commitments, making flexible or lower level obligations more attractive.

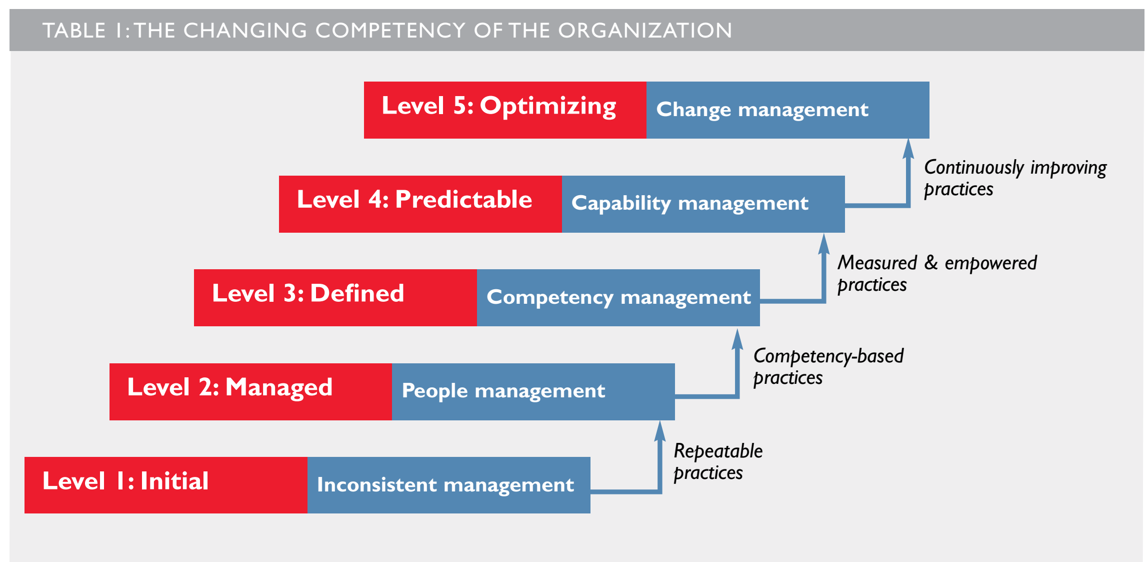
Some companies consider "disposable strategies" and/or disposable business models where high levels of uncertainty about a market, technology or location demand a low commitment real estate strategy. Instead of negotiating standard five or ten-year leases, companies are opting for shorter term commitments. Low penalties for cancellation, leasing rather than ownership, options to buy, negative rent escalation clauses and selection of easily sublet locations are all practical ways of reducing real estate risk.

Additionally, some companies are utilizing executive office suites and sublets to test locations before committing long-term. Distributed office strategies (including a hub and spoke model) may increase the efficiency of servicing a market. They can also lower real estate costs and liabilities and attract employees by reducing commute times. Telecommuting and home offices can also be linked with VoIP technology to provide professional communication capabilities at remote locations.

Adhering to standard policies for real estate in risky and uncertain markets would be a mistake. The acquisition of real estate assets for one purpose that may be reused for other purposes also provides flexibility.

RISK MANAGEMENT CAPABILITIES MATURITY MODEL

TABLE 1: THE CHANGING COMPETENCY OF THE ORGANIZATION



Source: SEI: People Capabilities Maturity Model

A CMM describes stages of organizational competence. Great organizations strive to better their capabilities through continuous improvement. CMM can be used to frame the requirements for building risk management capabilities – it is a roadmap for progress.

TABLE 2: THE FIVE STAGES OF CMM AND IMPACT ON REAL ESTATE

Stage	Stage 1 Initial	Stage 2 Managed	Stage 3 Defined	Stage 4 Quantitatively Managed	Stage 5 Optimized
Characteristics	Risk is an unmanaged process.	Some basic processes in place. Compliance focused. Reactive in nature.	Basic processes extended and pushed down through organization. Performance focused. Proactive.	Strategically focused. Sophisticated modeling and scenario analysis embedded in some processes.	Risk is a managed and optimized process. Strategic and innovation capabilities high.
Activities and Analysis	Ad hoc risk management. There are likely gaps in coverage, reporting and involvement.	Pareto risk management addresses the 20% of risk that appears to be most important. No cross functional or SBU coordination and integration. Centralized reporting incomplete. Overlap and gaps in mitigation.	Effort, budgets and quantification of risk addressed throughout organization. High quality centralized reporting and monitoring. Early attempts at integrating capital, business and innovation risks and options.	Proactive modeling and scenario analysis done on limited basis. Experience with adjusting models limited and accuracy of models limited. External risk analysis is input into the risk management process. Systematic linkage of decisions and risk across functional areas.	Sophisticated organization with formal processes, modeling, scenario analysis, competent staff, well balanced incentive systems, good board of directors' access and credibility. Focus on process improvement.
Real estate issues	Poor linkage between real estate decisions and risk profile.	Limited linkage between real estate portfolio and business strategy.	Integrated central reporting of real estate exposure and contracts.	Real estate strategy and capital impact modeled. Portfolio tied to capital and business strategy.	Real estate as a source of competitive advantage.

Source: Alistair Davidson, Cushman & Wakefield

REAL ESTATE RISK MANAGEMENT AND MITIGATION

Companies seeking to advance their real estate management capabilities; i.e., advance to stages three, four and five of the Capabilities Maturity Model, find it essential to formally model their real estate portfolio. VOX is a proprietary methodology developed by Cushman & Wakefield, based on best practices in real estate acquisition, leasing and disposition. By mapping a company's organic business cycle and then determining its volatility within the cycle, Cushman & Wakefield professionals are able to develop an optimal portfolio of real estate alternatives that enable flexibility (liquidity), which is often very limited during down cycles.

The VOX methodology is particularly valuable for companies with medium to large real estate portfolios. Organizations with 500,000-2 million square feet find that volatility in their business exposes them to $2-20 million of real estate risk in any given year. Avoiding an earnings hit is obviously valuable. Mitigating such risks can prevent a drop in shareholder value, reduce the risk of becoming a take-over target and prevent loan covenants from defaulting. Highly leveraged companies who actively manage their real estate risk may also reduce the bankruptcy risk component in their cost of capital, thereby lowering their cost of borrowing or raising equity.

CUSHMAN & WAKEFIELD VOX METHODOLOGY

A typical time horizon for VOX is ten years. The VOX methodology has five stages:

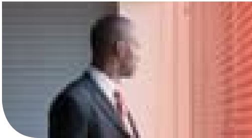
1. Identify drivers. Determine the key drivers of real estate demand for the organization. In most cases, the drivers fall into three categories: people, customers and inventory/manufacturing processes. The detailed drivers will vary across different companies and industries. In most cases, multiple drivers are used to correlate with real estate usage. For Kaiser Permanente, a particularly important driver might be subscribers. Alternatively, a consulting organization might focus on the number of professionals and associated revenue-per-consultant derived. For other industries, there may be a relationship with revenues and some combination of additional factors.

2. Determine asset classes. Classify the types of real estate exposures into different groups. For most companies, three categories are useful: headquarters and administration, special purpose and field offices.

3. Calculate net position. Looking over a ten-year period, identify the asset status of each location. Assets will be owned, leased, leased with a "hard" right to terminate in a given time period, or expiring in a given time period. Understanding the lease schedule allows restructuring of costs and risks in the same way that a portfolio of bonds or financial instruments can be optimized.

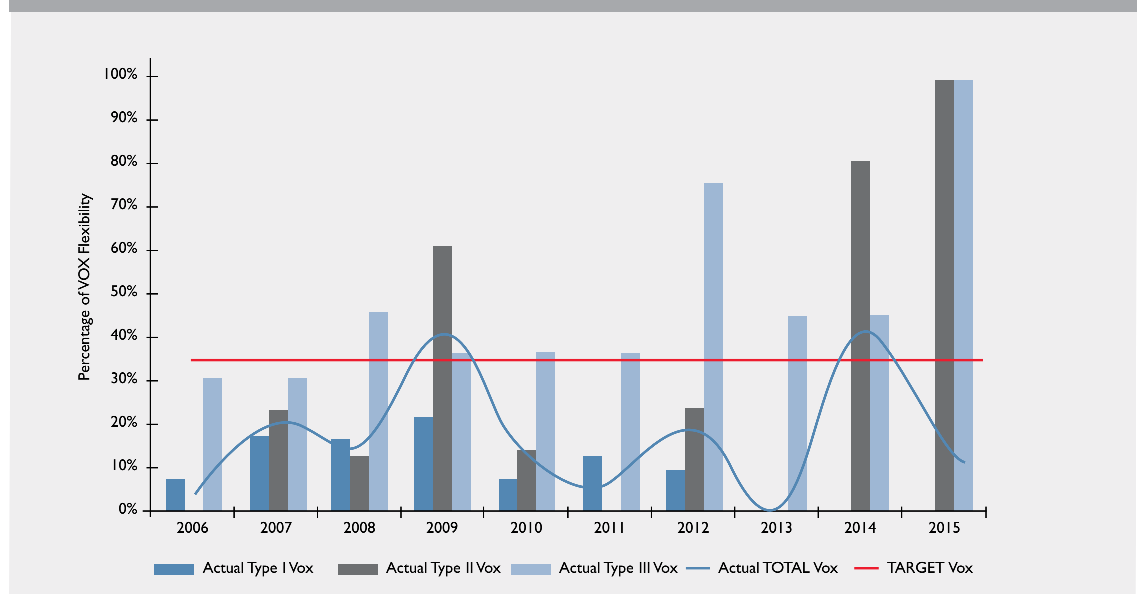
4. Measure and project volatility. Using historical and projected data, quantify the amount of volatility in the business model using the "Identified Drivers" that are highly correlated to real estate demand by real estate class, location and time period. This projection results in a VOX coefficient that identifies the ideal real estate flexibility/liquidity (measured in occupancy cost dollars and square footage) that needs to be shed to optimize for the current business environment (when a downturn occurs).

5. Identify and execute risk mitigation strategies. Once volatility has been quantified, Cushman & Wakefield professionals working alongside an organization's C-Suite develop appropriate mitigation strategies. Some can be performed immediately. Some will take time. Mitigation steps can include:



a. *Avoiding large or multiple lease obligations that expire at the same time.* An innovative and attractive strategy for many organizations, particularly those in downtown high-rise buildings, is to spread the expiration and renewal dates of different floors over multiple periods. This spreading of risk can change the consequences of a major downturn from a company-killing event to one of minor financial pain.
b. *Building in hard lease termination rights* in exchange for paying a premium lease to the landlord. Think of this approach as insurance.
c. *Creating options for disposition and reduction in leasing cost* by obtaining a right to purchase the building. There is often more flexibility in financial structuring when a building is owned. Cushman & Wakefield recently helped a client exercise their option to purchase and, simultaneously, executed a sale leaseback. Because of a very low capitalization rate, this strategy lowered the client's occupancy costs by $3 million over a ten-year period.
d. *Spinning off or selling non-core operations* in the event that a downturn occurs.
e. *Using technology to reduce the overall requirement for space.* Distributed VoIP PBXs, video conferencing and high speed data lines make distributed operations easy to coordinate and manage.
f. *Reorganizing the location of activities* to change the impact of fluctuations in capacity utilization. Queuing theory can be used to affect economics. In the same way that a single line for five bank tellers distributes customers more evenly than five queues, a move to centralized services or technologically distributed but linked operations can change the economics of downturns.
g. *Incorporating flexibility into workplace portfolio and location-specific workplace design.* With this approach, consider: network of locations, operating across virtual and physical space, alliances/shared and hired space, and landscaping space for varied functions.

TABLE 3: EXAMPLE SIMPLIFIED VOX REPORT



Source: Dan Harvey, Jim McPhee, Bill Dougherty: Cushman & Wakefield of California, Inc.

The previous chart demonstrates one example of a VOX analysis. The horizontal red line demonstrates the desired amount of flexibility sought in the real estate portfolio. In this simplified example, the organization (in 2006) would optimally like to dispose of 34.5% of its real estate portfolio in a "down market." In a more sophisticated analysis, the risk would vary by year and the red line would not be straight. The undulating blue line represents the current state of the portfolio's flexibility or lack thereof. The difference between the undulating blue line and the red line represents the risk exposure to the organization. (Note: When the blue bar is above the red line, the organization has more flexibility than it needs, most likely due to a major lease renewal.) The vertical bars represent commitments to different classes of real estate assets. Again, the VOX analysis can be utilized for different classes of assets and different geographies.

More advanced risk analysis, using the VOX methodology, can take into account additional sources of risk; i.e., the impact of currency volatility on potential decisions to transfer manufacturing to more attractive locations.

The true advantage of the VOX methodology is that it encourages a *disciplined and integrated review of real estate usage, costs and risk* – a review that is tied to the revenue momentum of the company, its portfolio of business activities and the volatility of business units or products within the portfolio. This type of capability is a stage four CMM capability and the basis for stage five.

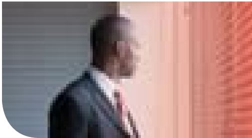
SUMMARY

If the first eight years of the twenty-first century have illustrated anything, it is that the volatility of financial markets is high and the competitive positions of business can change rapidly. Continually evolving reporting requirements dictate that CFOs address traditional areas of financial risk as well as non-financial business risk for existing and emerging organizations. External expertise and superior risk assessment methodologies like VOX can expedite and simplify complex decisions and introduce different perspectives on risk. These new perspectives will alter real estate negotiations and best practices.

REFERENCES:

1. Software Engineering Institute, http://www.sei.cmu.edu/cmm-p/version2/index.html

VOX is a methodology proprietary to Cushman & Wakefield, developed by Dan Harvey, Jim McPhee and Bill Dougherty of Cushman & Wakefield of California, Inc. All rights reserved.



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ABOUT THE CFO ROUNDTABLE PROGRAM

The CFO Roundtable program was created by Cushman & Wakefield professionals John O'Neill and Chris White in partnership with the University of Georgia's Terry College of Business. This is an invitation-only series of quarterly events designed by and for CFOs and other senior finance executives on topics relevant to the CFO community. The program and its events facilitate regionally driven, peer-to-peer discussion that deliver practical value. The interactive format engages attendees and provides new ideas to drive business performance, in addition to building meaningful relationships within the CFO community and participating sponsors.

Following a successful launch in Atlanta in June 2005, the program has expanded nationwide. In association with top-tier business schools, the CFO Roundtable is currently active in seven markets and continuing to grow. It will be established in 14 markets within the next 18 months, reaching an estimated 15,000 CFOs and senior finance executives.

For more information about this briefing and the CFO Roundtable Program, please contact:

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In addition to producing regular reports such as global rankings and local quarterly updates available on a regular basis, Cushman & Wakefield also provides customized studies to meet specific information needs of owners, occupiers and investors.

Cushman & Wakefield is the world's largest privately held commercial real estate services firm. Founded in 1917, it has 221 offices in 58 countries and more than 15,000 employees. The firm represents a diverse customer base ranging from small businesses to Fortune 500 companies. It offers a complete range of services within four primary disciplines: Transaction Services, including tenant and landlord representation in office, industrial and retail real estate; Capital Markets, including property sales, investment management, valuation services, investment banking, debt and equity financing; Client Solutions, including integrated real estate strategies for large corporations and property owners; and Consulting Services, including business and real estate consulting. A recognized leader in global real estate research, the firm publishes a broad array of proprietary reports available on its online Knowledge Center at **www.cushmanwakefield.com**

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