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# THE IMPORTANCE OF REAL ESTATE PORTFOLIO OPTIMIZATION IN M&A TRANSACTIONS

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# EXECUTIVE SUMMARY

Mergers and acquisitions (M&A) are complex undertakings that require meticulous planning and execution. While financial, operational, and strategic considerations often take center stage, the real estate portfolio, a substantial asset and expense, is frequently overlooked. This whitepaper underscores the critical role of real estate portfolio optimization in M&A transactions. By strategically evaluating, aligning, and transforming real estate assets, companies can unlock significant value, mitigate risks, and enhance overall transaction success.

## INTRODUCTION

Real estate is a fundamental component of most businesses, representing a substantial portion of assets, liabilities, and operational costs. In the context of M&A, the real estate portfolio can be a hidden opportunity or a significant challenge. By proactively addressing real estate issues, companies can improve deal valuation, drive economic efficiencies (e.g., reduce cost of capital), streamline integration and achieve long-term operational efficiency.

## THE ROLE OF REAL ESTATE IN M&A

### Asset Valuation:

Real estate often represents a significant portion of a company's asset base. Accurate valuation is essential for determining deal value and allocation of purchase price.

### Financial Opportunities:

Real estate offers financial opportunities through monetization, cost containment, and consolidation.

### Operational Efficiency:

Real estate directly impacts operational costs, productivity, and employee satisfaction. Optimizing the portfolio can lead to significant cost savings and improved business performance.

### Risk Management:

Real estate-related risks, such as environmental liabilities, lease obligations, and property condition issues, can impact deal terms and post-merger integration.

### Strategic Alignment:

The real estate portfolio should align with the combined company's strategic objectives, ensuring optimal utilization of space and resources.


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# IMMEDIATE VALUE CREATION

In M&A real estate often represents a significant portion of a company's assets — yet it's frequently undervalued or misunderstood during the transaction process. Properly assessing both owned and leased real estate is crucial to unlocking value, optimizing financial outcomes, and ensuring the success of the deal.

# USING REAL ESTATE FOR VALUE CREATION IN M&A

In the realm of mergers and acquisitions (M&A), understanding the full spectrum of a target company's assets is crucial for a successful transaction. Among these assets, real estate, whether owned or leased, often represents a significant and complex component, as well as a meaningful portion of a company's balance sheet.

By conducting a comprehensive portfolio analysis during the assessment or diligence phase, companies can proactively address real estate issues, leading to improved deal valuation, streamlined integration, and enhanced long-term operational efficiency. This process also reveals significant financial opportunities, including monetization, cost containment, and consolidation.

## Valuation Multiples and Arbitrage Opportunity:

Real estate assets often have different valuation multiples compared to business operations. For instance, valuations for industrial businesses may range from 5x to 12x EBITDA, depending on various factors, while industrial real estate assets can command multiples of 10x to 20x EBITDA, influenced by location and market conditions. In many M&A scenarios, there is an opportunity to leverage this difference by selling the real estate assets at a higher multiple than the business itself, with such transactions often executed alongside the business acquisition. In this buy-side scenario, the buyer benefits from the multiple arbitrage and can replace higher-cost equity with the capital raised from the real estate, which immediately reduces capital costs, decreases leverage, and enhances future cash flows due to the long-term nature of real estate or lease financing.

Additionally, for M&A investors with shorter investment horizons, a sale-leaseback can mitigate enterprise value risk and improve IRRs by capturing the value of the real estate in the near term.

# UNDERSTANDING VALUE IN OWNED REAL ESTATE

## Asset Valuation:

Understanding the market value of the target's owned properties is essential as it will impact the Company's financial statements moving forward. Often, M&A buyers will solely focus on the balance sheet impacts and overlook the impacts to the Income Statement (e.g., depreciation, tax, operating expenses) and Cash Flow Statement (e.g., Capex). Properly assessing the value will assist in aligning financial incentives and outcomes of the acquisition.

## Sale-Leaseback Transactions:

These transactions allow companies to unlock capital held in real estate while retaining operational control of the property. Additionally, sale-leasebacks can be structured with short or long-term leases to align with the operational life cycle of the facility. These funding alternatives are often used in M&A to raise equity for the acquisition or executed post-close to improve liquidity and cash flow or pay down debt. For many borrowers who cannot access 12+ year fixed rate financing, sale-leaseback provides a compelling solution for long-duration capital, with lower annual costs when compared to conventional financing alternatives.

## Surplus Assets:

During the assessment phase, a company may identify redundant properties within its own portfolio or the target's footprint. These surplus assets can be leveraged for significant cash generation and cost reduction. Additionally, the acquirer might find that the target owns properties in prime markets where the intrinsic value of the real estate surpasses its operational value to the company. In such cases, these high-value properties can be sold at top market prices, while the company consolidates or relocates operations to lower-cost locations.

# LEASED REAL ESTATE

## Lease Obligations and Flexibility:

Leased properties offer flexibility, enabling companies to scale operations according to market conditions. While evaluating current lease terms, including duration, renewal options, and termination clauses is crucial, its equally as important to understand broader market dynamics and future projections. A comprehensive assessment of key markets and facilities can allow you to plan for future state, proforma costs, and financial statement impacts. Focusing on key factors such as labor trends, population growth, construction trends, incentives and infrastructure can lead to predictable outcomes for future lease cost and support the broader growth strategy. Implementing a forward-looking strategic plan during the due diligence stage can uncover value creation and cost savings opportunities.

## Accounting:

Changes in accounting standards (FASB) over the last decade now place a greater amount of lease liabilities on balance sheet. Gathering a thorough understanding of long-term lease obligations will be critical as, for industries with heavy real estate concentration, excessive lease liabilities can impact a company's creditworthiness and debt capacity.


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# CONSOLIDATION OPPORTUNITIES

As companies merge, aligning their real estate strategies with the combined entity's goals is critical for realizing cost savings, optimizing operations, and enhancing overall value. From evaluating redundancies to leveraging market conditions and maximizing credit advantages, thoughtful real estate planning can unlock substantial financial and operational benefits in the M&A process.

## Operational Efficiency:

M&A transactions often result in overlapping real estate assets. Carefully evaluating redundancies during the due diligence phase can not only unveil cost savings opportunities by scaling footprint but improve operational efficiency through location and site selection analysis. Additionally, due to the right-sizing many companies have completed since the start of the pandemic in 2020, the average size of leases signed is approximately 11.0 percent smaller compared to pre-pandemic leases. As a result, companies can focus on efficiently using space that meets current and future needs. Employee occupancy has been consistently between 60 to 65 percent of pre-pandemic levels for the past 24 months (2022 – 2024). Consequently, companies can negotiate better lease terms that meet existing needs, particularly for companies that effectively leverage synergies that take place with many M&A transactions. Further, because many leases that were signed in the pre-Covid era (prior to the start of 2020) are beginning to roll, thoughtful lease negotiations for renewals and new leases can take advantage of soft market conditions to find spaces that not only meet space needs but include the types of amenities and locations that will help to encourage employees back to the office and boost attraction and retention of talent. These strategies can reduce real estate footprints through effective space utilization strategies, leading to operational savings.

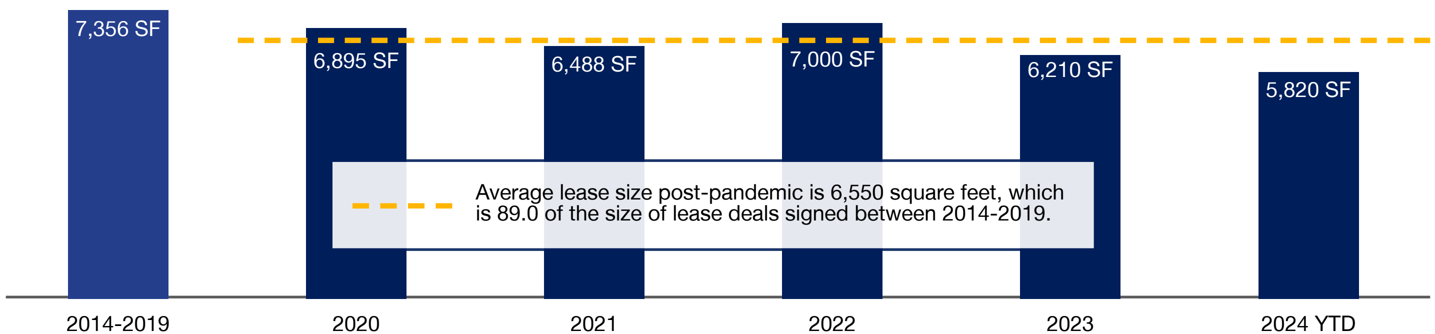
## Enhanced Operational Synergies:

Combining operations in optimized locations can enhance synergies and streamline processes. These impacts can be increasingly profound for businesses operating in manufacturing and distribution, where access to labor and efficient transport networks are critical.

## Credit Enhancement:

If the acquirer is a higher credit entity than the target, the acquirer may step in to existing lease negotiations to provide credit enhancement. Depending on the difference in credit quality between the two entities, the savings benefits enabled by credit enhancement can be substantial, and include reduced or no security deposits, higher tenant improvement funds, lower lease rate and escalations. In this instance, any credit enhancement could be effectuated upon closing of the M&A transaction, but prior to signing a new lease agreement.

Average Lease Size of Transactions (Square Feet): Pre-Covid vs. Post-Covid




Source: CoStar, Cresa, data is through Q2 2024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## CHALLENGES IN REAL ESTATE PORTFOLIO OPTIMIZATION

### Data Availability and Quality:
Inconsistencies and incomplete data can hinder effective analysis and decision-making.

### Complexity of Real Estate Transactions:
Real estate transactions involve multiple stakeholders, legal complexities, and long timelines.

### Integration Challenges:
Combining disparate real estate portfolios can lead to operational inefficiencies and increased costs.

### Short-Term Focus:
The pressure to complete the deal quickly often overshadows the long-term benefits of real estate optimization.

## KEY STEPS TO REAL ESTATE PORTFOLIO OPTIMIZATION

### Comprehensive Assessment:
Conduct a thorough evaluation of both companies' real estate portfolios, including property types, locations, lease terms, occupancy rates, and condition.

### Strategic Alignment:
Define the combined company's real estate needs based on its strategic goals and operational requirements.

### Portfolio Optimization Analysis:
Identify opportunities for consolidation, relocation, subleasing, disposition, or new acquisitions.

### Financial Analysis:
Evaluate the financial implications of different optimization scenarios, including cost savings, revenue generation, and capital expenditures.

### Risk Assessment:
Identify and mitigate potential real estate-related risks, such as environmental liabilities, lease obligations, and property condition issues.

### Integration Planning:
Develop a detailed integration plan for the real estate portfolio, including timelines, responsibilities, and communication strategies.

### Technology Implementation:
Leverage real estate information systems and analytics tools to support decision-making and optimize portfolio management.

## CONCLUSION

Conducting a real estate portfolio optimization analysis during the assessment or diligence phase of an M&A transaction is not just beneficial; it is essential. By understanding the full scope of the target's owned and leased real estate, companies can identify monetization opportunities, ensure proper financial statement impacts, achieve operational and cost synergies, and unlock significant value. Moreover, creating a strategic plan around the target's real estate portfolio can reduce integration risk and create near term and long-term value for the combined entities, benefiting partners and shareholders.

### About the Authors

Blake Lacher and George Mack are leaders with Cresa Capital Strategies, specializing in providing real estate and capital markets solutions for occupiers across North America. With over 30 years of experience, Blake advises clients on complex financial structures and strategies to meet operational and regulatory goals. George brings a corporate finance approach to real estate, leveraging his background in private credit to develop innovative capital solutions. Together, they guide clients through large-scale, critical transactions, helping them achieve better financial outcomes through tailored real estate strategies.

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