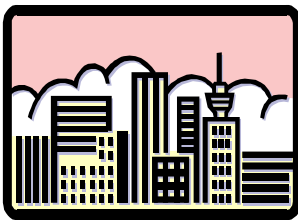


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US FEDERAL ASSET MANAGEMENT
GUIDELINES FOR
REAL PROPERTY

Special

The extract from the Guidelines of the General Services Administration (GSA Bulletin D-240 Public Buildings And Space) - pp12-16 of this issue - contain some interesting prescriptions. In many ways they are similar to prescriptions that have been advocated in Australia and New Zealand over the past 10-15 years but they have some interesting new wrinkles, such as the "clearinghouse" for surplus space.

Answers to Your Questions

If you, like me, are interested in how successfully these guidelines have been implemented send me your specific questions and I will try to find the answers for you. . Email me on penny@amqi.com by March 30th to have your questions included in our follow up issue.

Changes

Those of you who are observant would have noticed a subtle change in the SAM format in this issue. SAM is now designed to print on North American sized paper as well as A4, making reading easier for our American and Canadian subscribers.

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Strategic Asset Management

Selecting the Right Tool for the Job: Two Discount Rates for the Choice of a New Asset

Are Current Discount Rates Overstated?

In the last issue we looked at the question of the appropriate discount rate for the maintain/replace decision for a core infrastructure asset. We looked at three major issues: the hurdle rate, the risk level and whether the rate used should be real or nominal.

The same three issues are also relevant in choosing the appropriate rate to evaluate a new project. *And logic and experience suggest that the hurdle rate for new asset acquisition like the discount rate applied to the maintenance/renewal decision is – in many cases - likely to be overstated.*

Real or nominal?

The real cost of capital is given by the formula

$$1 + r = (1 + n) / (1 + i)$$

where r is the real cost of capital,
n is the nominal cost of capital, and
i is the inflation rate

For example, if the nominal cost of capital is 0.20 (20%) p.a. and the inflation rate is 0.10 (10%) p.a., then

$$1 + r = (1 + 0.20) / (1 + 0.10) = 1.091$$

So that the real cost of capital is 0.091 (9.1%) p.a.

“Using the nominal rate when the cash flows have been projected without allowing for future inflation is a great way to reject a desirable project”.

Choice of hurdle rate

The choice of the hurdle rate is perhaps the most contentious of the three issues.

The hurdle rate should represent an opportunity rate – the rate that the funds required for the project could earn in alternative employment. It is important to identify clearly the reasoning on which your hurdle rate is based and to test the realism of the assumptions that underlie it. (And not to simply accept the first figure that comes to hand!)

Hurdle Rate Should Not Be the Accounting Rate of Return

Suppose, for example, that the hurdle rate is based on the agency's accounting rate of return – its accounting profit divided by the book value of its assets.

1. The first point to note about such a rate is that it is a nominal rate: gains from inflation are automatically included in conventional accounting profit.
2. The second point is it represents an average yield from the company's past investments. This will almost certainly overstate the true opportunity cost. (see example below)

Consider just four projects as in the table below. (Each has an investment cost of \$1,000 just to keep the maths simple.)

With a hurdle rate of 6% rate 3 projects would be selected, projects a, b, and c. Project d would be rejected.

	\$	RoR
Project a	1000	10%
Project b	1000	8%
Project c	1000	6%
Project d	1000	4%

Project c is the marginal project at 6% equal to the hurdle rate, BUT the average of the three successful projects is 8%.

So we can see that the average return cannot be the hurdle rate

- 3. Even in the absence of inflation the book value of assets employed almost invariably understates their actual value because depreciation is based on conservatively estimated economic lives. *Underestimation of asset values leads of course to overestimation of accounting rates of return*

All of which leads to the realisation that:

“Accounting Rate of Profit Overstates Opportunity Cost”

(I still find valuers, especially in the big valuation firms, equating market rate of return with the discount rate. Perhaps because they have the skills to calculate market rate of returns with complicated and expensive market formulae! But a market rate of return is one tool and a discount rate is another. They do two separate jobs. Again, one size does not fit all!)

Solution: For the discount rate use the Cost of Capital or Return on Alternative Investment

The sensible way to proceed is to set the hurdle rate at the level of the agency’s cost of capital or the rate of return that the agency can reasonably expect to earn from alternative investments.

Risk

It is not uncommon to encounter hurdle rates that clearly exceed both the cost of capital and the alternative investment yield.

Such high hurdle rates are sometimes defended as being necessary to protect the agency against excessive optimism in the estimation of project cash flows, or against unforeseen reductions in earnings prospect. In other words, it is claimed that the high hurdle rate represents a way of allowing for the risk and uncertainty inherent in the cash flow forecasts.

The result is that, far from being ‘conservative’, the agency runs the risk of missing out on desirable projects, delaying the replacement of obsolete or worn-out equipment, and failing to adopt new technology, thus weakening its competitive position and ability to meet the needs of the market.

Note: A similar thing happens when government ‘capital charges’ are set at a rate clearly in excess of borrowing rates. When the Commonwealth Treasury announced a 12% capital charge, agencies presenting at the Public Accounts Committee inquiry promptly said that, in that case, they would get rid of all their assets and lease them back from the private sector since that would cost only about 8%. This is a sound decision from the agency’s viewpoint, but if the real cost of capital to the Commonwealth is less than 8% (which is likely) then it and the taxpayers of Australia are making serious losses with the rate set this high.

What is the alternative?

Choose a rate that reflects your borrowing rate if borrowing is involved (taking into account that if you borrow more than your future cash flows will support, your credit rating will fall and your future borrowing rates will increase) or your next best investment opportunity (commonly taken as the risk free government bond rate) if you are using reserves.

(But note that as both of these are nominal rates you will need to adjust them downwards if your analysis and cash flows is being carried out in current dollar terms.)

The more you understand risk, the more you can manage it. Increasing the discount rate to take account of risk is too blunt an instrument, risk is best managed by working through scenarios on the cash flows which we will look at in the next issue.

“Risk is like a swing door, push too hard to avoid the risk of loss from doing a project and you increase the risk of not doing”



GOVERNMENTWIDE FEDERAL REAL PROPERTY ASSET MANAGEMENT PRINCIPLES

1. Use what you have first.
2. Buy only what you need.
3. Use industry-like instruments of agreement.
4. Re-investment is essential.
5. Income/expenses comparable to the market.
6. Maximize use among agencies.
7. Timely disposal.
8. Retain proceeds from disposal and outleasing.
9. Professional training.

PRINCIPLE #1 USE WHAT YOU HAVE FIRST

Real property assets under the custody and control of the Federal Government should be considered first when accommodating Federal agency mission requirements.

EXAMPLE

Federal agency program missions generally require real property assets to support them. This can be reflected in the need for office, warehouse, laboratory or other improved or unimproved real property. To meet these mission needs Federal agencies should first review their current real property inventories to determine whether they have the space on hand to satisfy new mission requirements.

If there is insufficient space to satisfy a new program need, agencies should then look to the inventory of other Federal agencies to determine if they have either unneeded or underutilized space. In this way the entire inventory of Federally-controlled space can be screened first before looking outside the Government to satisfy agency space needs.

To assist Federal agencies in satisfying these space requirements, GSA has established and implemented a Real Property Information Clearinghouse.

The clearinghouse is an electronically connected network of building and facility information and data, organizational structures, policies and procedures that is shared by and benefits real property professionals. The clearinghouse routes users to this information and data, which is made available by Federal Government agencies and commercial realty firms. The clearinghouse allows users to perform queries, print information and download files.

PRINCIPLE #2 BUY ONLY WHAT YOU NEED

The amount of interest in Federal real property assets should be the minimum necessary to effectively support a Federal agency's mission.



Interest in Federal real property can have various meanings such as the type of ownership interest (leased or owned), the term of the interest if leased, the interest in terms of the capital improvements to the real property, or the amount of space, to name a few.

The interest in the asset equates to the amount of time the space is leased, the amount of money expended to build or modernize the property, or the

amount of space that the Government has acquired -- the more of any of these, the more interest the Government has in the real property asset.

EXAMPLE:

If an agency has a requirement to conduct a study that will last a limited period of time, such as a few years, the space requirement will likely be for leased space, as the purchase and/or construction of a new facility would go far beyond the mission requirement of the agency.

However, if an agency's headquarters occupies a Federal building that has outlived its useful economic life, and the need for a consolidated headquarters still exists, then the construction of a new building may be called for.

Real property asset managers should be cognizant of these requirements, the importance of not exceeding them, and the need to match mission needs with the most appropriate real property interest so that taxpayer dollars are spent in the most economical and cost-effective manner.

**PRINCIPLE #3
USE INDUSTRY-LIKE INSTRUMENTS OF
AGREEMENT**

Real property assets of the Federal Government should be utilized among agencies with the use of instruments of agreement that follow the best practices of the industry.

In order to best utilize the Federal Government's real property assets, the agencies that use them must work together toward a common purpose to ensure that the assets are utilized to the maximum limit of their useful economic life while still satisfying the mission requirement of the occupying agency.

In order to do this, agencies must work together by comparing space needs, sharing information on space that others may use, and being willing to release space when it is no longer needed, rather than holding onto it for a need that is likely never to materialize. To assist in this

effort, agencies need to use instruments of agreement that follow the best practices of industry.

EXAMPLE:

A common example of an instrument of agreement that is used between real estate entities is an occupancy agreement, which is an agreement defining the relationship between a landlord and tenant. An occupancy agreement will define the terms and conditions set forth between the parties, and will describe their duties and responsibilities. Such agreements are useful because they are written documents that reflect the understanding of each of the parties, and hold them together for a joint purpose and for a specific period of time.

Since an occupancy agreement may not be a legally binding contract, both parties to the agreement are exposed to risk. However, there must be a responsibility on all parties to adhere to the terms of the agreement, thus achieving more businesslike practices and higher levels of performance among agencies.

**PRINCIPLE #4
REINVESTMENT IS ESSENTIAL**

Reinvestment in a real property asset is essential to maintain its fair market value, its ability to benefit from advancements in business practices and technologies, and to support the Federal mission and enhance employee productivity.



EXAMPLE:

If it is determined that the continued use of a real property asset is needed, the task of the asset manager begins with assessing the physical status of the real property, whether owned or leased. Engineering reports determine what the condition of a property is and what improvements, either capital or otherwise,

must be made to bring the property up to industry standards. Technological innovations may have been developed that could bring employee productivity and morale to a higher level as well.

Besides assessing the physical status of the property, the real property asset manager must also determine when reinvestment should occur. Determining the cost of funds is harder when the asset is Federal real property, as these costs are more difficult to define than in private industry where the manager goes to his/her lender and gets the best rate he/she can obtain. The cost of funds, as well as the timing of their disbursement, must be calculated by the asset manager in order to obtain the lowest cost for capital improvements.

**PRINCIPLE #5
INCOME/EXPENSES COMPARABLE TO THE MARKET**

Any income realized by a real property asset during its useful life should approximate that generated by a comparable commercial property; while any expense by such an asset during its life cycle should approximate that incurred by a comparable commercial property.

EXAMPLE:

When the Government leases space in the market it incurs rental expenses that should approximate the rent for similar commercial space. For example, when GSA leases space to house a Federal tenant, the rent it pays should be at commercial market rates. Similarly, when GSA houses either a Federal or an out-lease tenant, the rental expense to GSA that the tenant incurs should approximate what it would pay to a private landlord in the commercial market. The expenses associated with the utilization of real property should also be approximate to the commercial market. The Government should pay commercial rates for services and supplies required for the day-to-day operation and maintenance of real property assets.

**PRINCIPLE #6
MAXIMIZE USE AMONG AGENCIES**

The maximum utility of a real property asset can be realized if it is continuously transferred among agencies having mission needs while it is under the control of the Federal Government.

EXAMPLE:

The GSA is a large holder of Federal Government real property. Whenever GSA has property that has been declared excess by one of its customer agencies, it screens it and makes every attempt to backfill the space with another agency before finding it surplus to the needs of the Government. Depending on the needs of GSA's customer agencies, if a property is suitable it will be utilized as quickly as possible.

Federal property that is under the custody and control of other agencies should be dealt with in the same manner. The only way that this can occur, however, is to have communication that will link agencies to one another, as well as establishing an atmosphere of collaboration among the family of Governmentwide agencies that have their own real property authority. At the present time, GSA's Office of Real Property is establishing a real property information clearinghouse which will include excess property for use by all Federal agencies. It is hoped that this database will assist agencies in achieving the maximum utilization of their real property assets, especially in these times of diminished resources.

**PRINCIPLE #7
TIMELY DISPOSAL**

A Federal real property asset that has no further mission support use by the Federal Government should be disposed of timely and in a manner that best serves the public interest.



EXAMPLE:

Regardless of the authority that the real property

disposal falls under, however, the asset should be disposed of in the most efficient way possible.

Under certain cases Federally-owned real property can be conveyed to state and local governmental units and non-profit institutions free of cost, and for a variety of public uses such as education, health, park and recreation, and historic monuments. An example of an educational usage would be the conveyance of a former Federal property to a local municipality for the establishment of a high school facility. Although no moneys are generated by such a public benefit transfer, the public interest is served by the means of such a conveyance.

If a property is not being donated through public benefit conveyance, a public sale can be conducted and the property sold to the highest bidder or offeror. As a last resort, if the property is unable to be sold or donated due to age, disrepair or extensive damage, it should be demolished and the land used for another Federal purpose, or disposed of in its own right, while serving the best public interest as well.



PRINCIPLE #8 RETAIN PROCEEDS FROM DISPOSAL AND OUTLEASING

The proceeds gained from the disposal of a Federal real property asset, or from outleasing, should be available for use by the agency having custody, control and use of the asset.

Financial incentives should be put in place in order to encourage real property disposal and the outleasing of unused space.

In the case of agencies covered under the Federal Property and Administrative Services Act of 1949, as amended (the "1949 Act"), there is no incentive to dispose or outlease real property when the proceeds go into another fund out of the agencies' control. Likewise, in the case of some landholding agencies that have their own disposal or outleasing authority, there could be increased incentives put into place as well. (There are individual agency exceptions to where proceeds are deposited).

EXAMPLE:

Before real property under the custody, control and use of agencies covered under the 1949 Act can be disposed of, it must first be declared excess by GSA.

If an agency has a property that is no longer needed, it is declared excess and screened by GSA in order to find an agency that has a need for it. The property is then transferred to that agency and, if monetary proceeds are generated, they are deposited into the General Fund of the Treasury. Only after it is found that the property has no Federal use is it declared surplus to the needs of the Government and then disposed of by GSA. Pursuant to the Federal Property Management Regulations, if monetary proceeds are generated from the disposal of surplus property, they are deposited into the Land and Water Conservation Fund of the Treasury.

In the case of real property not under the custody, control and use of agencies covered under the 1949 Act, the proceeds from disposal do not necessarily go into the Land and Water Conservation Fund or into the Treasury General Fund. In some cases these agencies have the statutory authority to retain some, if not or all, of the net proceeds from the disposal of their real property assets.

In most cases where agencies have the authority to outlease real property under their custody, control and use, they are not authorized to retain the proceeds.

There is an overwhelming need to increase the incentives to dispose of real property above what is currently in place, even at the potential cost of impacting the Land and Water Conservation Fund. Likewise, there can be uses for real property outside of the Government whereby a controlling agency could outlease space to a private sector tenant for a limited period of time. Federal agencies will be more willing to dispose of real property assets, or outlease them, if they know that the proceeds will be retained, rather than placed in a fund that is beyond their control. This is critical in today's changing environment and in times of increasingly short supply of resources.

**PRINCIPLE #9
PROFESSIONAL TRAINING**

Federal employees should be given the training needed to perform their jobs at the highest level of professionalism, and in order to utilize models and other analytical tools for optimizing their real property asset management decisions.

Training is a means to achieve expertise, and so is job rotation and on-the-job learning. Federal personnel involved in real property asset management should be highly trained in a variety of areas. These areas of ex-

pertise are taught in recognized industry courses that specialize in all aspects of real property asset management, such as the courses offered by the Building Owners and Managers Association and other appropriate organizations.

With the proper training and guidance, the agencies of the Federal Government will have employees who are current and competent experts in the real property asset management field, who can discuss real property asset management related issues with anyone, and who can deal with the long range planning and evaluation of assets for the maximum use and benefit to the public.

What is your experience?

How do your guidelines compare? And what has been your experience? Where are the difficulties? What have you been able to overcome and how? What would you like to know about how these guidelines have worked in practice? Please send me your questions and I will see what answers we can find.

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