

# Real Estate: A Financial Tool to Address the Ongoing Fiscal Crisis Facing Not-for-Profit Organizations and Municipal Entities

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## About the Author



*Christopher Larson is an Associate Vice President with Equis Corporation. His background and expertise is in providing business consulting, financial and strategic services to healthcare companies. With more than 14 years experience in the fields of healthcare and finance, he has provided management and corporate development expertise for both healthcare product and service providers. He has performed a full range of activities ranging from product development to Interim Executive postings. Chris Larson holds an M.S. in Health Administration from Cardinal Stritch College and is a Professional of the Academy for Healthcare Management (PAHM) and a licensed real estate broker.*

The current economic climate makes it advantageous to examine real assets for cost savings strategies. Like corporations, not-for profit organizations can no longer afford to overlook one of its largest expenses, real estate.

## I. Introduction

Like most corporations, not-for-profits, municipalities, and similar organizations are feeling the impact of poor economic conditions. An unusual convergence of factors including depressed stock markets, decreased corporate profits and decreased government allocations are placing undue fiscal pressures on the not-for-profit world. In fact, says Jon Pratt, Executive Director of the Minnesota Council of Nonprofits, "This could be a brutal test of the resiliency of the nonprofit sector... I think we are clearly going to do less with less" <sup>1</sup>

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The severity of the predicament not only challenges the ability of not-for-profit entities to deliver on their respective missions, but it also poses a very real threat to the longer term viability of such entities. In response to this crisis, both 501(c)(3) and municipal organizations would be well advised to step back and explore financing options and strategies that have long been overlooked or remain relatively undiscovered. By adopting the more progressive strategies of their most innovative for-profit

counterparts, these entities will be better positioned to address the existing and potentially prolonged fiscal crisis. For many organizations, leveraging real estate can be a central factor in this approach and should be explored as a powerful and largely untapped tool.

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Many not-for-profits believe that they are hamstrung by their tax-exempt status. In reality, these organizations have unique opportunities to develop and implement real estate strategies that dovetail with their missions. At the same time, these real estate strategies can help secure an organization's long-term legacy. In the current budgetary climate, most organizations need to rally all available potential advantages.

## II. The Bad News: A Severe Fiscal Crisis

It is widely observed that fundraising success generally mirrors the economy's success. At the moment, the economy is not doing well at all. "All the major sources of revenue are down at the same time following 10 years of steady growth," says Pratt, "We are seeing a retrenchment. The big question is how big and how long." <sup>2</sup>

It is no surprise, then, that 501(C)(3) organizations, particularly those who count on gifts as a source of funding, are dealing with severe fiscal constraints. According to the American Association of Fund Raising Counsel's (AAFRC) Trust for Philanthropy, corporate

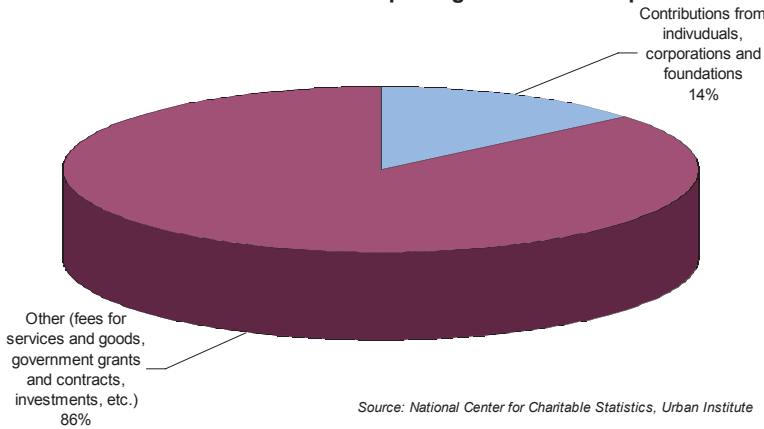
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<sup>1</sup> Minneapolis StarTribune

<sup>2</sup> St. Paul Pioneer Press

giving fell an estimated 12.1% (a decrease of 14.5% when adjusted for inflation) during 2001 as compared to the previous year. <sup>3</sup>

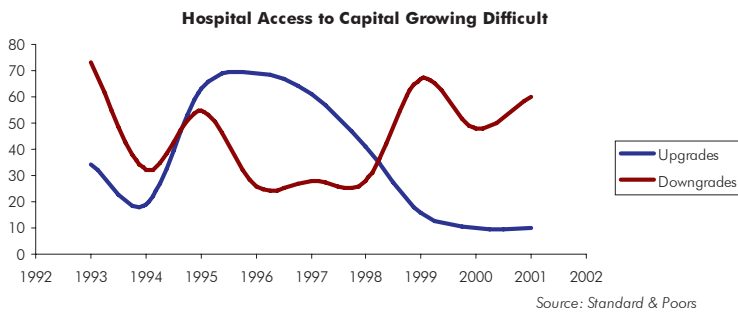
Sources of Revenue for Reporting Charitable Nonprofits



Adding to this burden, endowment income has been slashed by three straight years of equity market losses. The S&P 500 has fallen approximately 40% from its early 2000 mark, while the NASDAQ composite is off by more than 70%. This has had a profound impact on endowments and foundations, particularly for those with aggressive allocations in equities.

According to research from The Foundation Center, an organization dedicated to supporting and improving philanthropy, foundations reported that their assets lost approximately 10% of their value in 2002, following from a 4% decline in 2001. Even more ominous is the expectation that "ongoing instability in the economy and stock market suggest that foundation giving will decline in 2003." <sup>4</sup> This situation impacts the educational sector most seriously, since it relies heavily on endowments to sustain and support growth.

Private gifts to higher education have also waned.



According to an Annual Survey by RAND's Council for Aid to Education, "contributions to colleges and universities in the United States dropped slightly during 2002 - the first decline in giving to higher education in more than 15 years." <sup>5</sup>

Federal, state and local budgets, another major traditional source of funding, are also in jeopardy. Budget shortfalls at all levels of government are resulting in the reduction or complete elimination of subsidies across the country. In addition, the Balanced Budget Act of 1997 continues to threaten the long-term financial stability of not-for-profit hospitals, many of which have seen their credit ratings deteriorate rapidly as Medicare reimbursements have been scaled back as a result of the Act.

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**In the Denver/Boulder metropolitan area, 88% predict a rise in their client population over the next five years, while 60% predict their current facilities will not meet the anticipated need.** <sup>3</sup>

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Hospitals are likewise feeling the economic squeeze. Healthcare financial difficulties are to a large degree cumulative, resulting from a chronic lack of capital reserves that's set to snowball under current economic conditions. With the average age of a hospital's physical plant increasing 18% since 1990, these organizations will need to modernize their facilities and accommodate new technology, which requires significant capital. <sup>6</sup>

Further exacerbating the situation is the demand side of the equation. If charitable gift figures tend to fall with the health of the economy, the demand for the services tends to rise at the same time. For example, in Illinois, 62% of the 153 non-profits polled saw an increase in demand for their services over the past year. <sup>7</sup> And in the Denver/Boulder metropolitan area, 88% predict a rise in their client population over the next five years, while 60% predict their current facilities will not meet the anticipated need. <sup>8</sup>

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**Real estate strategies such as restructuring leases, sale-leasebacks, outsourcing, workplace redesigns can be an untapped and powerful tool to help not-for-profit and municipal organizations overcome their budgetary challenges.**

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<sup>3</sup> American Association of Fund Raising Counsel's (AAFRC) Trust for Philanthropy

<sup>4</sup> The Foundation Center

<sup>5</sup> RAND survey

<sup>6</sup> The Future of Not-for-Profit Healthcare Capital Financing, Healthcare Finance Forum, June 2002.

<sup>7</sup> A Portrait of the Nonprofit Sector in Illinois, by Linda Lampkin and Stanley Waringo (Illinois: Donors Forum of Chicago and The Urban Institute Center on Nonprofits and Philanthropy, May 2003. See [www.donorsforum.org](http://www.donorsforum.org) and [www.urban.org](http://www.urban.org).

<sup>8</sup> Technical Development Corporation Denver/Boulder survey

Table 1. Example Tactics that Can Be Implemented to Benefit from Real Estate Strategies.

Who	What	Why
Healthcare Organizations	Monetize major owned real estate assets	501(c)3 Status provides opportunity to sell and lease back only the portion of major facilities that is needed
	Sell and lease back major Medical Office Buildings	Stark Regulations encourage outsourcing to avoid conflicts or liability
	Outsource facilities management	Free up capital and focus on core activities
State and Municipal Organizations	Redesign inefficient workplace formats	Restacking can improve efficiencies and optimize space utilization
	Monetize owned real estate assets	Generate capital for deferred maintenance and asset preservation projects
Educational Institutions	Sell and lease back major facilities	Larger organizations with established credit might find a sale-leaseback advantageous
	Utilize "green" construction alternatives	Creates more flexible and efficient learning environments at a reduced cost
Traditional Not-for-Profit Entities	Review all leases for restructure opportunities	In most US markets, rental rates have dropped and landlords are being more competitive
	Consider sharing space with other NFP organizations	Can offset larger rent obligation, and be considered an "in-kind" donation

Moreover, over half the organizations surveyed in Denver that have searched for new facilities over the past two years did not find suitable space. So not only are these organizations faced with budgetary issues, but increasing service demand means they also need to identify and secure expanded physical space and facilities. Clearly these are critical issues.

### III. The Good News: Who Stands to Benefit?

Still, there is some hidden good news. Real estate strategies, largely overlooked in any sector during good economic times, can be an untapped and powerful tool to help not-for-profit and municipal organizations overcome their budgetary challenges. The key, it appears, is for these organizations to recognize that their unique circumstances, missions and bylaws as 501(C)(3) organizations, do not preclude them from employing creative real estate or related financial tactics. In fact, their status might present them with unique opportunities.

### The Healthcare Sector

Of the various not-for-profit sectors, healthcare has been one of the earliest to adopt innovative real estate strategies. A developing healthcare crisis that is driving up costs and forcing providers to compete for patients and "profitable" procedures has compelled the large health systems into action. As a result, health systems have implemented strategies such as monetizing their owned medical office buildings and outsourcing facilities management to third party managers.

Outsourcing is an especially helpful tactic in avoiding potential conflicts with regard to Stark Regulations. Mismanagement of facilities and failure to implement market rents at hospital-owned facilities has exposed hospitals to potential Medicare fraud and abuse charges. Such violations, even if unwitting, have become common throughout the industry. Organizations with limited landlord experience should also consider the possibility of outsourcing their facility management functions in

order to free up capital and focus on core activities. While the healthcare arena has realized the need to investigate creative financing strategies, the potential for these strategies remains significantly unrealized.

### State and Municipal Organizations

Municipal organizations, some of the largest real estate users in cities, frequently overlook a significant opportunity in the form of their real estate assets. Cities, counties and state organizations are some of the largest tenants and owners of real estate in the country. Although laws vary with regard to ownership and use of such facilities depending on location, there are numerous creative alternatives through which these organizations can utilize their assets as a way to address budgetary demands. The presumption that facilities need to be self-owned and managed often perpetuates the inefficient use of these assets. With many states and cities falling on hard economic times, real estate is beginning to be viewed as more of a cost savings opportunity than it has in the past.

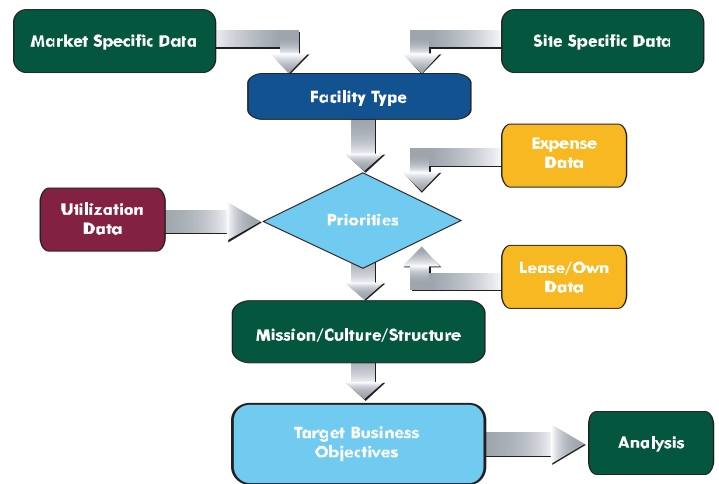
**An enterprise-wide real estate asset analysis is one of the best approaches that can help sort through the myriad parameters that are unique to any organization.**

### The Education Sector- Public and Private

School districts, in effect a large subset of municipalities, have unique facilities requirements. Schools are in an excellent position to benefit from the strategic use of their assets. Even private universities, some of which have strong endowments and a very low cost basis in long-term property holdings, frequently fail to fully leverage the value of their facilities. These inherent yet untapped assets are potentially lucrative financial sources that can be used to position the institution for growth and academic excellence in the future. Again, with government entities nationwide facing massive deficits and cutting funding, schools and universities are seeking out any and all opportunities to generate cash and/or cut costs.

### Traditional Not-for-Profit Entities

Finally, traditional social service providers are also in a position to benefit by developing a strategic real estate plan. Foundations, religious groups, arts and entertainment organizations all have traditionally viewed their real estate strictly as a liability that consumes fiscal and human resources. These groups can better utilize their assets to deliver on their mission.



## IV. An Asset Analysis Approach

Given that the need is dire and the opportunity exists, what exactly should a municipality or not-for-profit organization do to determine how they can leverage their facilities and real estate to meet the overall needs of the organization?

An enterprise-wide real estate asset analysis is one of the best approaches that can help sort through the myriad parameters that are unique to any organization. This modeling exercise is a comprehensive process that, regardless of the organization and its mission, must take into account three overarching considerations:

1. *Specific real estate and facility issues* – for example, a healthcare organization that seeks satellite clinic locations must consider the future stability of any co-located or jointly-owned medical office buildings.
2. *Broad financial and economic parameters* – When interest rates are low, landlord attitudes to granting concessions can be more lenient.
3. *Organizational structure, mission, culture and governing laws* – an organization that serves the needs of inner city youths in a major metropolitan area will be allowed different operating parameters than a school district or an arts organization.

**A modeling exercise must take into account specific real estate and facility issues, broad financial and economic parameters, organizational structure, mission, culture and governing laws.**

*Real estate considerations.* The first step in developing any real estate strategy aimed at best utilization of assets is a portfolio analysis. Such an analysis should include: an inventory of owned and leased assets, a productivity/

utilization analysis, valuations of owned properties, operating and capital budgets for the entire portfolio, lease-term analysis, an assessment of market conditions, and other factors. The entire process must also take into consideration the organization's strategic plan, current business plan, and future facilities needs. The goal of the analysis is to develop an understanding of the organization's real estate state-of-affairs, as well as the current and anticipated costs associated with its ideal facilities situation.

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**A multi-tiered modeling exercise that accounts for all these aspects can yield specific recommendations and help the not-for-profit entity realize maximum benefits from its real estate assets.**

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Even if a portfolio analysis reveals minor opportunities to release capital, it can still be helpful in setting future performance indicators and for establishing accountability in situations where no formal real estate inventory has been conducted previously. However, it is more likely that significant opportunities to release capital or reduce expenses will be discovered in this process.

**Financial and budgetary considerations.** As the real estate portfolio is analyzed, each organization must also consider its broader fiscal position. Financial and budgetary considerations are critical to creating an overall strategy that helps the organization raise capital, fund new projects, lower debt burdens and enhance cash flow to otherwise achieve its mission goals. Short and long-term budget projections, pro formas for fundraising efforts, balance sheet and income statement analysis, non-real estate asset allocations, current and expected rates of return analysis, interest rates and existing capital market conditions, and many other factors can be integral to a more detailed analysis. Without such an analysis, any real estate strategy will fall short of its desired goals of contributing to the overall health of the organization.

**Governance issues.** Finally, the real estate analysis must be plotted against the issues specific to that not-for-profit organization. What are the potential state and federal laws that might limit which strategies are available to the organization? Do the organization's bylaws preclude certain sale-leasebacks or other tactics? Are there organizational or cultural considerations? Are there unique financing programs available for specific 501(C)(3) organizations? What limitations are there on the use of funds for real estate? Are there any pitfalls that

could jeopardize tax-exempt status? Again, these represent only part of an entire universe of considerations that are often overlooked in considering what financing alternatives are available for each not-for-profit or municipal entity.

On its own or with the help of a real estate advisor, each municipality or not-for-profit needs to build its own unique analysis, and should analyze the full scope of the organization, not merely its real estate assets. A multi-tiered modeling exercise that accounts for all these aspects can yield specific recommendations and help the not-for-profit entity realize maximum benefits from its real estate assets.

## V. Tactics to Explore

Depending on the outcomes of enterprise-specific financial models, there are a number of strategies and specific tactics that not-for-profit organizations can explore:

**Monetizing owned assets** - Sale-leaseback transactions offer numerous potential benefits that include: unlocking an immediate source of capital; strengthening the balance sheet; improving credit ratings; reducing real estate operating risk; and improving focus on core activities. Issues of control, organizational bylaws, buy versus lease analyses, and various other issues need to be considered. A consolidation or disposition strategy could also prove invaluable in situations where facility costs basis is low or local markets have gentrified over time. The potential financial windfall is significant.

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**Regardless of the tactics employed, all real estate specific actions must be aligned with the overall capital allocation strategy and, in all likelihood, will need to be structured in a way that the organization can retain its tax-exempt status.**

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**Lease restructuring** - Monetizing non-owned real estate assets, especially given today's office market conditions in many urban centers, can immediately reduce costs while improving the type and/or locations of an organization's facilities. The rationale is not unlike that for refinancing a home mortgage in the current interest rate environment. One of the most effective tactics is to review the motivations of the organization's landlord. For example, an LLC whose building is for sale will be more concerned about retaining the value of the building by extending its tenant's leases, and therefore will be willing to offer lower rent. A REIT is concerned

about Net Operating Income (NOI) and so will be willing to offer more immediate concessions (such as a larger tenant improvement allowance) in order to retain an existing tenant and keep the NOI stream high.

**Finance alternatives** - Traditional bond issuance remains a powerful tool for raising capital, and it is often employed for new facility development or debt refinancing. However, there are important real estate nuances that need to be viewed in conjunction with the investment banking considerations. This is particularly important for not-for-profit organizations, which have unique alternatives that are not available in the for-profit corporate bond market. Organizations also should consider financial tools available from local government entities such as municipal incentives, Tax Increment Financing and Empowerment Zone programs.

**Workplace integration utilization** - Productivity analysis can identify space usage plans and facility sharing tactics that can yield immediate cost savings. New stacking plans, sharing tactics, or other creative alternatives can yield immediate cost savings. In addition, these tactics can discover increases in operating efficiency and improvements in employee productivity that result in long-term tangential benefits.

**"Green" alternatives** - There are numerous ways to supplement financing for new facilities by implementing environmental and energy-saving designs. These alternatives offer access to additional financing options, and can potentially lower construction and ongoing operating costs. In addition, many states (such as Oregon and New York) offer financial incentives for pursuit of environmental building certifications under the U.S. Green Buildings Council. Private financing options are also available for schools, healthcare facilities and other properties that pursue environmental certifications. Modular, function-specific facilities can also be a way to lower operating costs and enhance flexibility for organizations with dynamic space needs.

These are just a few of the tactics that an overall portfolio analysis approach can identify. Regardless, all real estate-specific action items must be aligned with the overall capital allocation strategy and, in all likelihood, will need to be structured in a way that the organization can retain its tax-exempt status.

## VI. Real World Examples

**Organization:** A major Midwest city that employs thousands of people and holds millions of square feet of office space.

**Challenge:** Real estate costs had ballooned throughout the city while decreasing municipal revenues were deepening the budget deficit. The real estate department, responsible for the City's second largest operating cost, needed to decide whether to remain in its 280,000 SF headquarters or relocate.

The city needed to find a point of leverage with its landlord, one of the largest national real estate investment trusts, in order to attain better terms for its lease extension.

**Solution:** A real estate expert was hired to determine a negotiation strategy. The landlord had lost a large percentage of its tenants during the dot-com bust, thereby drastically driving the corporation's national occupancy levels downward. The landlord was very concerned about the negative effects of decreasing occupancy on its stock price so it spearheaded a national initiative to raise occupancy levels. Knowing that the landlord would not want to lose such a high-profile tenant, the real estate expert leveraged this information and negotiated to obtain better lease terms for the city.

**Results:** The city obtained a lease extension for 12 years, with a new, below-market rental rate, which saved them approximately \$450,000 per month. Additionally, significant tenant improvement dollars were obtained. In total, the creative brokerage methods used saved the city \$12 million.

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**"Each not-for-profit organization needs to determine whether it wants to be in the real estate business," Said real estate consultant and former healthcare executive Christopher Larson of Equis. "More importantly, each organization should consider whether they have the human resources and skill set to implement strategies and operate real estate assets efficiently and profitably"**

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**Organization:** A private arts college located in a major urban center.

**Challenge:** A major goal for the school was to increase enrollment, which would, in turn, increase revenues. In order to accommodate new enrollment, the school desperately needed to add dormitory space and

classrooms. With many other projects competing for endowment funds, and a complex governing body, consensus needed to be built. In a large urban setting, properties would be difficult to assemble. The school also needed financing structures that took complete advantage of its 501(c)3 status. A September completion date was also critical to coincide with the advent of the school year.

**Solution:** The school held senior level strategic planning sessions in order to build consensus and further develop its growth plans. The plans were quite comprehensive and strategic in nature, and addressed funding concerns.

The school qualified for a state bond program that facilitated funding for the real estate project at advantageous rates. Since the school is a not-for-profit organization, owning the properties allowed for property tax avoidance.

Financial and facility plans needed to support physical requirements with extreme cost sensitivity. Dynamic and flexible responses to organizational change were also very important.

**Results:** The school was able to win development rights from the city on a unique parcel on which it developed a complex of housing, classrooms, a theater and retail space. A multi-tiered approval process extending to a number of internal bodies within the school was also managed. The project was multi-phased over a period of several years, and involved renovations/conversion of older buildings and new construction.

The school obtained low-interest, state-backed bond financing and avoided real estate taxes altogether because they purchased the properties.

The project had been expected to address plans to increase enrollment, and the school had expected the dormitories to be 70% full after the first year. Instead, as each dormitory was completed, it was at 100% occupancy within the first year. This helped the project pay for itself and allowed the school to fund other projects with the unexpected revenues generated from the dorms. In addition, the project was developed with existing resources in mind so no additional administration staff were required to manage the new buildings.

### About Equis Corp.

Since 1984, Chicago-based Equis Corp. ([www.equiscorp.com](http://www.equiscorp.com)) has been working with not-for-profit, municipal and other organizations, helping them make real estate assets accountable to business revenue, expense and operational goals. As one of the largest full-service real estate firms in the United States Equis focuses exclusively on the business space user. With 25 offices nationwide as well as offices in London, Budapest, Mexico, Brazil, India and Singapore, Equis offers services including portfolio analysis and management, transaction and project management, auditing services and capital sourcing/financial consulting.

Equis serves many not-for-profit, municipal and Fortune 500 clients, and is one of the largest real estate service providers to work with the federal government. Clients include the various not-for-profit organizations across the country, as well as Blue Cross Blue Shield, (U.S.) General Services Administration, The Coca-Cola Company, DaimlerChrysler, Detroit Medical Center, Northwestern University, Juvenile Diabetes Foundation International, Society of Actuaries and Webster University among others.