

PROPERTY MANAGEMENT STRATEGIES
FOR INSTITUTIONAL INVESTORS IN THE '90S

by

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ABSTRACT

Institutional owners of real estate are paying increasingly more attention to property management as a means of improving their return on investment. They are closely examining both the organization of their property management effort and its implementation. In many cases they are devising radically new structures to manage property involving a combination of in house resources and external providers. Most owners appear to want property managers to bring new levels of professionalism to their day to day operations.

Owners see value in sweeping reorganization of their property management activities to capture economies of scale and reduced fees. Some accord property management a strategic status and have created in-house property management capability. Some owners are seeking to add to the value of property management by broad application of the principles of service quality enhancement. These owners put mechanisms in place to empower their frontline property managers. Others exhibit the desire to improve property management performance through relatively tight control and standardization. Still other owners appear to believe that active management of property managers is best left to the property management firms themselves.

This thesis describes property management strategies at three large insurance companies using an analytic framework taken from literature on vertical integration and quality management. The data was analyzed to identify how the insurance companies, and institutional owners of real estate generally, are organizing and implementing their property management function, and what rationales they have for their strategies.

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CHAPTER ONE - Institutions and Property Management - Structure of the Study

Introduction

Real estate is an integral component of most investment portfolios held by large financial institutions. Despite the comparatively poor performance of real estate vis a vis other investments in the past few years, there is widespread belief that the diversification benefits of having real estate in a broad based portfolio will still be evident over time. While some institutions have recently reduced their allocation, my research indicates that many will continue to hold about 10% of their assets in real estate when their portfolios are stabilized. Along with this show of faith, however, have come much more rigorous expectations for the management of real estate investments. Investment advisors have identified effective property management as one critical component of maximizing the value of real estate holdings.

Many different kinds of owner/clients retain property management services. This study focuses on the needs of large financial institutions such as insurance companies, pension funds, and mutual funds. In many cases these entities are new to the challenges of property management, having been reluctantly transformed from lenders into owners in the fallout of the recent real estate recession. These companies are actively interested in the question of how to structure their property management effort effectively not only because it makes good financial sense, but also because they are new to the game. Many of the firms, whose portfolios were swollen in the early part of this decade with foreclosed properties, found themselves in business relationships with many more provider firms than they could easily manage. They seek a sound property management strategy that is also easy to administer.

A later section details some of the prevailing business conditions that focus attention on property management practices. Many institutional owners, as a result of examining their practices more closely, are confronting a fundamental dilemma: should they have an internal property management capability or hire the service from outside providers? Once they settle on whether or not to maintain in-house property management, they ask further, "what kind of organization for this work should be developed?", and "how should the property management plan be implemented?"

The purpose of this study is to explore some of the organizational strategies employed by large institutional owners of real estate for maximizing investment value from the property management effort. Generally speaking, the owners may create a property management division or subsidiary, hire out the work on a regional basis to national providers, or adopt an intensely local strategy, seeking out the best providers at work in each place where they have an investment. The strategies are rarely "pure" in the sense that owner involvement is entirely absent from out-tasking strategies, or that in-house management systems are not in some way supplemented with outside providers. The study will examine the various reasons real estate owners and advisors may have for selecting one form of property management over another. The study also looks at different ways owners are searching for value beyond cost savings from the property manager's effort.

Section 1 - Commercial Property Constituencies

One can think of commercial property as having two sets of customers - tenants and investors. In this paradigm the property manager is the entity that the tenant/customer sees as most accountable for its satisfaction. With respect to the investor, the property manager is the principal generator of information about the performance of the asset. Although the investor's primary dealings are with the portfolio manager, it is the data from the property managers upon which the portfolio manager must rely, both for its investment decision making and for providing aggregated performance reports to investors.

Many commercial real estate portfolios are structured with three layers of management - portfolio management, asset management, and property management. As noted, the portfolio manager's allegiance is to the owner/investor. The portfolio manager's responsibility is to extract adequate returns from a mix of investments, buying and selling properties to maintain the presumed optimal asset allocation. The asset manager's role is to champion the performance of a specific asset or assets as long as they have a place within the established portfolio strategy. The asset manager develops a business plan for each property in its purview, and directs the property manager in its execution of the plan. The property manager must operate the building efficiently and be responsive to the tenants needs while carrying out a strategy developed by, and receiving its compensation from, the asset manager. If the asset manager's plans for the property and the tenants needs are not in accord, as might be the case in the months preceding a sale, the property manager can find itself in a difficult position.

One can see how all the three "constituencies" - the owner, the asset, and the tenant/customers - are well served if the efforts of the three management layers, though sometimes in opposition to each other, are in rough equilibrium. If a good balance exists, tenants are happy, occupancy is high, revenues strong, expenses low, the asset's performance dependably good, and the portfolio's returns will exceed targets. This is a good construct to keep in mind when issues such as incentive alignments and conflict of interest surface in examining property management strategies.

Section 2 - the Business Context

An inevitable consequence of events of the past decade, in which many real estate investments not only failed to keep pace with stocks and bonds but actually lost value, is that investors want to see measurable performance improvements in the near term. Although the cyclic behavior of real estate investments is anticipated and accepted by most investors, consistent underperformance is not. Years such as 1990, when stocks were down and real estate failed to perform as an effective hedge, were particularly frustrating to investors in real property. Real estate investment management activities are thus subjected not only to increased scrutiny, but also to demands that demonstrable performance improvements be made very quickly.

Until quite recently, real estate professionals paid comparatively little attention to property management. They regarded it primarily as a custodial function, visible only when things went wrong. Buildings were to be kept clean, parking lots plowed, rent collected. That property management enjoys elevated stature today is a function of the increasingly tight margins real estate investors have to work with. No cost driver can be glossed over in the asset manager's strategy. The impetus to extract value from property management is clearly motivated by the bottom line, but it has many distinct components.

Property Management As A Source Of Value To Investors

In the current business environment, fundamental changes have taken place in the way real estate investment managers are compensated for their work. Most significantly, investors evaluate portfolio and asset management fees against those they would pay to have their money placed in stocks and bonds. Real estate is a management intensive investment and, until recently, high management fees were justifiable. The work is still there, but if the investment returns on real estate cannot exceed those on other forms of investment, then it is

no surprise that intense downward pressure on fees exists. Where once portfolio management fees were exclusively volume and transaction based, it is now not uncommon to hear of plans aligning some part of management compensation with the performance of the portfolio. To the extent that this kind of incentive alignment is applicable at the portfolio management level it can readily be seen that cost effective property management must be a first order concern. If portfolio managers have truly strong incentives to enhance the performance of their holdings, they will be vigilant for every opportunity to build asset value by directing their property managers in strategies such as reducing operating costs, repositioning their buildings in changing markets, and optimizing leasing structures.

Moreover, it seems likely that this state of affairs is not cyclic. Intense competition and the distinct improbability of real estate ever again being viewed as a fail-safe investment will ensure that highly effective property management will be of paramount concern for the foreseeable future.

Property Management as a Source of Value to Real Estate Service Providers

Due in large part to the wave of foreclosures in the late eighties and early nineties, a much greater percentage of commercial real estate is now in the hands of institutional owners than ever before. Having provided more stock than can be absorbed in the near term, developers are out of business or curtailing their activity. While many of the institutions have pursued strategies calling for partial divestment of their real estate in the early nineties, the volume of buying and selling is much smaller than it was in the mid eighties. At present, many institutions have comparatively little money allocated in their budgets for real estate acquisitions. Beyond tactical selling to meet portfolio allocation targets, the well capitalized institutions have little incentive to sell real estate, particularly at prices which are still commonly below replacement cost. Those that wish to sell often find little demand and a scarcity of acceptable assets to buy to maintain their allocation. The institutions are waiting for demand for space to rebound. Foreign investment, though reviving in some markets, is still far from levels of a decade ago.

The institutions have thus become holders of real estate of last resort. Business expansion into new space, with the exception of certain industries like financial services, has been tentative in the past few years. Transaction activity, both from leasing and sales, is down, and with it, an important source of income to many players in the real estate industry. In this climate, the revenue potential of property management services gets intensified attention.

Property managers, not surprisingly, are fashioning arguments for why their fees should be higher. They cite the value their efforts can add, and how it is multiplied by the effect of capitalization rates in valuation models. One manager used the following simple illustration: If he could improve annual bottom line performance of a property by one million dollars, he would have increased the value of that property by ten million, at a 10% cap rate. He contended that, at fees of 2 to 3% on revenues collected, he would have meager incentive to aggressively pursue the necessary actions to net the higher net income. He argued that bonus incentives in the \$100,000 to \$500,000 range were more likely to produce results than a \$20,000 to \$30,000 fee enhancement. (Sheridan, 1995)

Supply Forces

A logical consequence of the growing interest in property management is a dramatic increase in firms providing property management services. Real estate firms, primarily the development and some of the brokerage companies, whose specialties are not now in demand, have repositioned themselves. They offer an enlarged menu of services, often including property management.

Some people interviewed for this study claim that the nature of the service offered is influenced by the core capability of the provider firm. They argue, for example, that the cultures of development and brokerage firms are distinct enough to be reflected in the way each kind of company approaches property management. Brokerage firms, so the theory goes, would manage in a way that consistently defers to the deal. Developer-managers, with long experience as operators of their own properties, would emphasize the orderly long term management of the asset over an attractive tenant's demanding lease terms. Managers who have contributed to creating value through the development process would provide a great deal of entrepreneurial motivation with regard to property management. This kind of thinking suggests that along with the growing number of providers comes a broader array of management styles to choose from.

But restraints on supply are also evident in today's market. Anecdotal evidence suggests that significant consolidation has begun to place in the real estate services industry. Strong local providers are being purchased by regional and national firms; major national and regional players are merging.

Changes In Ownership Of Commercial Real Estate

Institutions bring their own corporate culture, organizational structures, and policies to the ownership of real estate. Where owner-developers are most often comparatively small companies with lean organizational structures, institutional owners, such as the major life companies and pension funds which are the subject of this study, may be large, multidimensional businesses. The owner-developers structure themselves to act quickly; the institutions, with their fiduciary responsibilities always in the forefront, to act with great accountability. The effect of these structural differences on property management is that the institutions demand more service, typically manifested in detailed and varied reporting requirements and heavily scrutinized budget processes, than owner-developers have typically been willing to settle for.

Both because they have heightened interest in property management as a source of value, and because of their fiduciary role, advisors to institutions are demanding ever increasing professionalization of the property management function. When large institutions own real estate the stakeholders are many, diverse, and geographically dispersed. Accountability is multivalent - the beneficiaries, investment committees, accountants, boards of directors, as well as the asset and portfolio managers - need to know how their investment is performing. The internal reporting requirements are infinitely more complex than they are for a local developer, and they depend completely on accurate, timely, and usefully presented information from the property manager.

Institutions are not simply content to demand greater competence from their service providers; they wish to exert more direct control themselves. At one time property managers negotiated and signed leases at their own discretion, as long as they operated within the owner's set parameters. Today it is increasingly common for institutional owners, or their advisors, to insist on reviewing and approving each lease, and sometimes on participating in the negotiations.

Institutional ownership of real estate promises to increase opportunities for the property managers who can perform to exacting standards. This "good news" scenario is tempered somewhat by the possible consequences of the growing importance of public ownership of real estate. Conventional wisdom holds that the most successful REITs will be those that structure themselves as full service real estate operating companies. To the extent that this model becomes prevalent, there will be fewer opportunities for fee for service managers.

Presently, publicly owned real estate is a small fraction of all commercial real estate, but if that fraction grows as anticipated, the supply and demand dynamics of property management will likely change.

Public ownership of commercial real estate again brings up the comparison between real estate and stocks and bonds as investment vehicles. Real estate requires hands-on treatment at every phase in the investment cycle - acquisition, operation, and disposition. In this way real estate compares distinctly unfavorably with assets like stocks and bonds that need little tending by their portfolio managers. Public market scrutiny is thus certain to put considerable pressure on the management structures of REITs to be lean and efficient. Institution owned investment real estate, even if it is in the private realm, cannot buck this trend for long and remain competitive. Property managers for institutions will have to do their part to contribute to the productivity of the total management effort.

Section 3 - Strategies For Property Management

The real estate portfolios of the major institutions are typically large and diversified by region and property type. Broad expertise is required to manage the properties in these portfolios. This section briefly describes the currently dominant property management models in the market today, and why owners may or may not elect to choose each one. Chapter 2 of this study presents a review of current literature on subjects which pertain to the fundamental choice institutions must make between managing their property themselves or having others do it. If owners make the decision to have a separate entity do the work, they then must choose what kind of provider they want. They have a full spectrum of options to choose from, ranging from full service national firms to local specialists. It is not uncommon for owners today to have property managers of all descriptions managing portions of their portfolios.

Property Management By an In-House Entity or Subsidiary

Certain institutions may find it advantageous to have their own property management capability. With this strategy, the benefits of simplified reporting, standardization, and, depending on the size of the institution, economies of scale can be realized. Having an in-house capability may yield more reliable service over the long term than continuously purchasing the service. Benchmarking can be undertaken, and the results used to structure internal incentive programs in the absence of competitive pressure to retain the assignment.

However, if the investor has only a few properties in a given area it may be impractical to set up a property management function there; already existing regional players could take on the work more efficiently. Market specific knowledge would take time to acquire. Without competition innovative property management techniques might go undiscovered.

Property Management By External, Locally Strong Firms

In this model, portfolio managers select property management firms with strong reputations in the markets in which the investment properties are located. Theoretically, these firms would be best able to identify and retain the most appropriate local services, to understand competitive forces within the market, and to be familiar with existing and prospective tenants. As each firm would contribute a body of knowledge about property management strategies and techniques there would be rich opportunities to exchange information about best practices.

Such firms are unlikely, however, to be immediately conversant with the corporate practices and information systems of the institution that hires them. The portfolio and asset managers face a shake-out period with each new property manager hired, and the prospect of managing multiple entities under dissimilar contractual agreements. Some of the firms with the best local reputations may be purely local firms, without the technical resources and management sophistication of larger firms. With this kind of atomistic approach to property management it may be difficult to make meaningful comparisons between the quality of service provided by the provider firms.

Property Management By External National or Regional Firms On A Regional Basis

In this model national fee management firms would be retained on at least a regional basis to operate the buildings in the portfolio. Portfolio managers may find this model attractive because it promises standardized operating and reporting procedures over many properties. The property management firms may be able to win pricing concessions from subcontractors and vendors due to economies of scale. Benchmarking can be readily used to set conditions for the renewal of the engagement.

Clients of national and regional fee management firms often complain that their full potential is rarely realized. Despite standardized practices some of the firm's offices are

inevitably stronger than others. The inconsistencies are often attributable to differences in the quality of personnel, which can result in local market reputations being strong in some places, weak in others.

Property Management By External Networked Providers

"Federated" associations of property managers exist in which strong local and regional firms band together under a loose administrative structure which facilitates information sharing. The network of provider firms offers sole source responsibility by allowing the client firm to choose a "quarterback" from among them. This is usually a firm with whom the client has a prior relationship and which has demonstrated superior capability in the particular services the client wants. The quarterback firm may select provider firms for the client in the other markets in which the client owns property. The quarterback firm is not obliged to choose all these firms only from the network members, but rather will seek out firms with the particular strengths the client has specified. In theory, the integrity and credibility of the network concept is upheld if clients perceive the quarterback firm taking its charge seriously enough to breach the network in selecting some members of its team.

The promoted advantage of the network system is that clients can enjoy single point responsibility without giving up strong local representation. Such an arrangement does not, however, offer the same economies of scale and standardization that single large firms do. The networked providers counter that remaining fairly autonomous allows them to be nimble and pro-active in their respective markets, an advantage which they regard as more valuable.

Section 4 - Property Management - the Emerging Picture

Today, institutional owners view property management as a vitally important function and not a commodity service. Many owners see value in a systematic review of how property management is delivered, and are willing to undertake significant reorganization of this work. Attempts to capture significant near term cost savings are behind some aspects of the contemplated reorganizations. Institutions are trying to simplify property management and achieve economies of scale by either vertically integrating or doing business with regional and national providers. Smaller, local property management firms may be left out in the cold.

Still other owners, perhaps with an initial reorganization effort behind them, are now devoting their attention to developing and putting in place property management procedures that will add value over time. More and more owners will address these aspects of property management service as time goes by. They will develop organizational strategies to facilitate continuous improvement in the property management function. No matter where they are in this continuum from cost reduction to quality enhancement, most owners are in agreement that they must, in one way or another, actively manage their property managers to extract maximum value from them.

The research and analysis in the remainder of this study first refines then tests these views. To determine whether the views can be substantiated, I will concentrate much of the research in this study on the owners of real estate, and their perception of how value is created through property management.

This picture of current developments in property management has two dimensions - organization and implementation. Consideration of how the property management entity is organized necessarily addresses the questions of how integrated the manager is with the client company, how the manager is selected, what services it is asked to perform, and what trade-offs are implicit in these choices. To examine how a property manager implements its duties one must address each of the major functions the property manager performs - operating the building; providing accounting, reporting, and budgeting services; and dealing with tenants.

Section 5 - The Study Methodology

As stated earlier, the purpose of this study is to describe strategies of property management in use by institutions today, to suggest reasons why each strategy makes sense, and to illustrate some of the ways the various strategies are implemented. The study does not aspire to determine which strategy is best. Limitations of time and other resources preclude such an analysis. Even if the resources were present, the difficulty of measuring the cost and benefits of each property management strategy and assembling reliable data would be a formidable obstacle to overcome.

I discuss leasing in the context of the client firms' attitude about whether it makes more sense to combine responsibility for operations and leasing or leave them separate. This

study does not cover, except in a tangential way, the implementation (marketing, negotiations, etc.) of a leasing program.

The Research

In the course of this study I have performed three kinds of research:

Literature Review: While property management receives some attention in the trade press, I found it useful to review general management literature as well. Theories on vertical integration, outsourcing, customer satisfaction, customer retention, service quality, and strategic alliances, and the use of information technology are all applicable to this work.

Background Questionnaires: Data on current property management practices is, of course, absolutely essential to the study. To obtain a fairly broad impression of contemporary practices, I circulated a questionnaire (Appendix) to several client and service provider firms. From 22 questionnaires distributed I received 11 replies. Client firms among the respondents included national insurance companies, pension fund advisors, and mutual fund companies. Provider firms among the respondents included national and regional and local (a network member) companies.

In Depth On Site Interviews and Document Reviews: I obtained the cooperation of three major institutional holders of commercial real estate for in depth profiles of their property management practices. In each case, I made site visits; conducted numerous interviews with regional directors and asset managers; and examined documentation such as property management procedures manuals, standard contracts, property manager performance evaluations, and internal reports on various initiatives to improve the property management effort. In performing the on site research I ascertained, to the extent possible, the degree to which each firm felt that its property management program in general, and its specific components, were meeting its expectations.

To protect the anonymity of my sources I have presented the data obtained from the on site interviews and the questionnaires without attribution or using pseudonyms.

The Analysis

The first and third sections of Chapter 2 present a discussion of vertical integration and quality enhancement based on a review of pertinent management literature. The literature includes commentary pertaining to manufacturing and service businesses in fields other than real estate, and, within the real estate industry, to sectors other than institution owned. It is about performance optimization strategies for both selecting an organization and enhancing the value of its operations. The synthesis of this material, therefore, is a picture of the kind of thinking that might go into structuring any kind of business process which would have the best prospects of creating value.

The second and fourth sections of Chapter 2 more explicitly tie the literature review to a consideration of property management for institutions. Section two presents an analytic framework, using concepts distilled from the discussion on vertical integration, for examining the decisions institutions make about organizing their property management effort. Section four identifies the principal components of a quality enhancement program and illustrates how they might be applied to property management operations. Through these two conceptual frameworks - one for examining the initial organization of the property management activity and one for examining what implementation strategies firms adopt to enhance the value of the property management effort - I hope to present views of contemporary property management practice. Through this analysis I will try to substantiate the thesis that institutional owners of real estate recognize that they must actively manage the property management effort, that they believe that in many instances they can realize dramatic cost reductions by fundamental organizational change, and that they are beginning to look now to the way their properties are managed on a day to day basis for a more sustainable way of creating value.

The three company profiles are presented in Chapter 3.

In Chapter 4, I examine the three profiles through the analytic frameworks developed in Chapter 2. Since the three profiles are being reviewed against the same frameworks the analysis will permit the reader to readily perceive both major differences and minor variations in emphasis among them. I then analyze the data from the profiles to see if the arguments about property management made in the introduction to this chapter are sustainable.

CHAPTER TWO - The Analytic Framework

Section 1 - Vertical Integration - Literature Review

One fundamental choice the institutional owners of real estate have to make with respect to property management is whether to build the capability within the organization or to contract for it from outside providers. This choice is felt by many to have potentially profound influence over both the cost and the quality of the service provided.

Vertical integration is the term used by business theorists to refer to the strategy of combining complementary yet distinct functional activities under one management umbrella. Vertical integration, and its opposite number, outsourcing, are subjects covered extensively in the general business literature. Much of the literature is about manufacturing processes and service industries other than real estate. Nonetheless, a review of this work yields a valuable framework for thinking about whether or not to integrate property management into the general management structure for investment real estate. When the choice is made to hire an outside provider, the arguments for and against having an in house capability are still useful to consider while the decision is made about what kind of outside provider to select.

Financial institutions have a fiduciary duty to their clients: their policyholders, shareholders, beneficiaries and depositors. Some proponents of vertical integration in industry hold that the best way to discharge this duty is to exert maximum control over all phases of the business. They identify accountability as the most important reason for adopting this policy. A truly accountable business is one which offers its services in a reliable and timely way, and offers swift and satisfactory recourse when things go wrong. Customers of businesses whose performance exceeds the market average in these respects perceive them as highly accountable. As a bonus of sorts, a firm that can fulfill, and perhaps even exceed, the level of good management required of a fiduciary is felt to have a source of advantage with respect to its competitors (Akerberg, 1989). Only vertically integrated businesses can be fully accountable.

Even the staunchest proponents of vertical integration concede that economies of scale are necessary to justify the expense of maintaining full service capability across many markets. This simple argument is rooted in economic and accounting logic. The vertically integrated

function is a fixed cost to the company, whereas fee based services can be contracted for on an as needed basis, and easily scaled to the task at hand.

The decision not to carry an in house capability is usually based first on cost considerations (Martinsons, 1993). The company cannot achieve economies of scale everywhere it operates and opts to subcontract some of its processes or services. This course is very appealing to company policy makers who can anticipate expense reductions in a wide array of company activities as a consequence. Costs can be reduced or avoided in recruitment, supervision, benefits, equipment obsolescence, payroll, purchasing, and hiring temps. While the cost of these activities, and of the space required to perform them, will be embedded in the outside service provider's fee, the client company pays only on an incremental basis (Friedman, 1991). This is a particularly salient point with respect to cyclical businesses subject to unpredictable cycles where the function in question may be needed at some times and not at others.

What if the business enjoys critical mass at every location? Are there still compelling arguments for contracting out certain functions when it appears that the client firm can plausibly run them efficiently? Advocates of hiring out the services in question cite specialization as one reason. Specialization, when, for example, it takes the form of local market knowledge, may be demonstrably more important than economies of scale. The make vs. buy analysis thus changes from a consideration of how the client firm's resources can be most efficiently utilized, to examining the particular value enhancement the provider firm claims to offer. Typically, the provider firm will assert that because it specializes in a certain function, its labor resources will be more skilled and thus more efficient in that activity. The provider firm may also claim scale efficiencies of its own. It will make the argument that because it operates in many markets for many clients it can obtain supplies and services at lower costs from its vendors (Lacity, 1993). Outside providers may simply have a fundamentally lower cost structure - lower wages and overhead, or stronger performance incentives. (Venkatesan, 1992)

Provider arguments such as these are persuasive, but large client firms clearly have the potential to exercise their own purchasing power and to develop specialists within their own ranks. They may put in place broadscope purchasing programs for the kinds of capital equipment that are standard at many of their locations. They may train or hire their own specialists. Repeatedly going to the market for services is itself a time consuming and costly process. In time, the in house specialists may be even more valuable than those

employed on a fee basis. The in house specialists will grow within the company, becoming familiar with its culture and service philosophy. They will always be available. The threat of an external provider's highly competent and valued employee being promoted away from direct client service to a management or marketing role within her own organization is very real.

For many theorists, the decision about whether or not to carry a function in house is grounded not just in near term cost analysis but also in tactical considerations. Any business operating in a competitive environment will have a strategy to establish and sustain an advantage over its competitors. The theorists contend that firms should themselves provide the services that they are good at and that have strategic significance. In the language of manufacturing, they should keep the proprietary parts, those that confer a competitive advantage, in house, and buy from others the components that are easily commodified. These firms will want to keep secret certain techniques and procedures. They will be more than usually concerned that they not be exposed to conflicts of interest which may lead to breaches of confidentiality.

How do firms decide what products or services are strategic? Might there be good reasons to outsource even strategic goods and services? Venkatesan offers three test to use in determining whether or not an activity is strategic:

- 1) Does it "have a high impact on what customers perceive as the most important product attributes (including cost, of course)?"
- 2) Does it "require highly specialized design and manufacturing skills and specialized physical assets - and for which there are very few, if any, capable independent suppliers?"
- 3) Does it involve "technology that is relatively fluid and in which there is a significant likelihood of gaining a clear technological lead."

Venkatesan acknowledges that even strategic activities may be purchased outside the company, but under strict conditions. The capabilities of the outside provider, both to design and deliver the service, must be carefully weighed against the client firm's own competencies and shown to be clearly superior. If the firm has no existing capability in a certain function, then the costs that would be incurred to "catch up" with outside providers must be assessed as significant. If a certain function is regarded as strategic, and if the firm, based on the foregoing analysis, decides to engage an outside supplier anyway, then Venkatesan counsels that it should generate at least the "architectural knowledge"

underpinning the function. It should supply performance specifications for the function to its provider firm, in this way preserving its competitive position. In theory, this would assure existing and would-be clients of the company that the aspects of its service they most valued would consistently be delivered, whoever the provider firm was.

In its most evolved form contracting with an outside provider can take the form of a strategic alliance. This implies a long term relationship where the partners integrate their strategic efforts; freely share information on best practices, much of it learned from third parties; jointly market their services; pool technology; and compensate their staffs based on meeting mutually determined performance goals. The hallmarks of such an arrangement are longevity and a good deal of functional integration. In a way, the strategic alliance is a hybrid of the vertically integrated solution and hiring out, with what its advocates hope are the best attributes of each.

The potential benefits of the strategic alliance are the efficiency that should come from streamlining the working relationship over time, the knowledge sharing, and the joint incentive that should exist to continually improve the alliance. A common criticism of vertical integration, that the in house function cannot be fired and suffers motivation shortfall as a result, is addressed with an alliance. Friedman notes that strategic partnering "offers companies the opportunity to obtain stable pricing, eliminating the need to shop around while worrying about distribution and consistency of quality. Once you zero in on partners, educate them regarding your environment, and have them suggest ways to cut costs at your end. That's where you save."

Contracting for important services, whether strategic or not, carries several perils. Recalling an earlier part of this discussion, one can think of these generally as the risks of reduced accountability. First and foremost, deciding not to have an in house capability means not having it at any time in the business cycle. A current buyers' market for certain services may not persist. The attractive cost structures of outside providers may melt away over time. If contracts with the provider firms are short term, as is the rule, suppliers can raise prices when they begin to feel truly needed. Without a viable in house capability, or a long term relationship, the client firm will be vulnerable to a suddenly hostile market.

A major risk in a long term relationship with a service provider is that it will have some, but not all, of the characteristics of a strategic alliance, and be mistaken as such by the client firm. Outside providers are unlikely to be true strategic partners if, for example,

performance incentives are not scrupulously aligned. In this case, the loose contract language which permits the strategic alliance its flexibility may be exploited as the provider roots out sources of additional fee revenue.

Having enumerated the risks and disadvantages of relying on outside providers, the literature (Lacity, 1993) does not neglect the matter of proper management of the relationship once the decision has been made to use them anyway. Some commonly encountered recommendations are:

- Have a formal grading system for suppliers to enable rigorous, informed comparison of service quality.
- Allow the provider to fully exploit its economies of scale by bundling multiple engagements together where possible
- Have a good contract, carefully specifying baseline performance, service levels, cost structures, penalties for nonperformance. This often means discarding the supplier's standard contract.
- Establish or retain in-house a core staff of specialists - engineers, lawyers, accountants etc.- to set standards for and to assist the provider firms, and to advise the in-house personnel on the quality of the provider firms' work and recommendations.
- Build in adjustment provisions if the business changes significantly - i.e. sale of assets, or a major acquisition.
- Specify the account manager - choosing the right person can overcome omission of many of the other items.
- Specify termination clauses and the notification period required of both parties to terminate.

Section 2 - Vertical Integration Theory and Property Management

The theory of vertical integration suggests that its value as a strategy depends on what combination of business conditions exists at the time the decision to vertically integrate or not is being made. The following is a synopsis of the conditions, with property management specific illustrations.

Reasons to Vertically Integrate:

- Demonstrating accountability confers competitive advantage: Greater accountability at all levels is a hallmark of institutional ownership. Property management's actions must increasingly be both verifiable and justifiable. At least two major national real estate advisory companies use only in house property management personnel (questionnaire results). These companies believe that only with in house personnel at each property can a high degree of accountability be assured. They actively market themselves as differentiated from the competition by virtue of having in house property management.

The effectiveness of the property management strategy can be compromised if it has imbedded within it potential conflicts of interest. Many firms which market property management services also provide asset and portfolio management - they are themselves vertically integrated. In cases where property managers in a common locale report both to portfolio managers in their own company and to outside clients it would seem that the latter group would have cause for concern. Coveted tenants, attractive repositioning opportunities, favored subcontractors could gravitate towards the properties with the fully integrated management structure. Despite the fact that the questionnaire circulated to clients of property management firms did not list conflicts as one of the considerations for choosing a manager, one respondent felt strongly enough about the matter to pencil in "free of conflicts" as a necessary qualification.

When property managers are part of a full service real estate company, confidentiality issues can arise. Accountability is blurred. One interviewee offered this illustration: A fee manager may learn its institutional client's hurdle rate for new property purchases. If the fee manager is part of a competing entity targeting properties in the same market, its information may enable its colleagues in acquisitions to successfully underbid the institution.

Many vertically integrated advisory firms have a temptation, perhaps even a strategic mandate, to expand their fee base. When property management is carried out by their own colleagues, portfolio managers could be tempted to call for marginally productive property management services if, rather than having to pay for them, they represented additional income.

- Property management is perceived as a strategic function: As noted in the first chapter of this study, the institutions must be responsive to both investors and tenants. Property management is very visible to tenants, completely invisible to investors; thus, application of Venkatesan's first test (does the service have a high impact on what customer's perceive as the most important product attributes?) to property management yields ambiguous results. This condition is closely allied with the first. Firms who feel they can sell in house property management as a source of competitive advantage are likely also to think of it strategically. They are likely to engage in thinking of ways to continuously improve this function, just as strategists do with all products that are not viewed as simple commodities.
- Supply (and quality) of property management services vacillates: At present, competition for property management engagements among qualified providers is healthy, but as noted, a significant reduction in their number - largely due to the disappearance of mid-size firms - is currently being observed. In house capability guards against the time when there may not be enough fee managers active in a given area to assure spirited bidding and top flight service execution.
- In-house providers are familiar with client expectations: Property managers and asset managers can be neighbors in the same office suite. The modes of communication, quality standards, culture and business strategies of the client could be ingrained in the provider. Compatibility between the accounting and data systems of the hiring entity and the provider is vital. This fact alone may justify carrying property management in-house, engaging in a long term preferred provider relationship, or hiring national or regional firms with capabilities in many accounting and data systems. Some smaller fee managers may simply lack the capacity to fulfill all client's needs and will not even be considered for the job. Some may be able to do it, but will judge that the anticipated profit margin is too slim to be worth the trouble.
- Expectations are difficult to pin down in contract terms, particularly in dynamic markets: Inevitably, some aspect of the scope of services the outside provider is meant to deliver will be a point of controversy during the engagement. As noted earlier, the potential ramifications of a lack of clarity in the terms are much more grave the longer the contract length. In theory, an in-house provider can always be told what to do.

- There are inevitable "extra" costs to hiring a service provider. Service providers typically include a profit in setting their fees. All things equal, the hiring firm would like to keep this money in its own coffers. The process of identifying and retaining property managers can be arduous and time consuming. There are substantial costs associated with such a process, especially if it has a scrupulously followed sequence of steps which could include an RFI, RFP, and multiple interviews. Selection processes can require significant cash outlays from both the service provider and the client firm. The process, particularly if it is elaborate, can have the unwanted effect of scaring off competent property management candidates, who feel the engagement not worth the prospecting costs. Winning firms willing to run the selection gauntlet may well price their service with a compensating premium.

Reasons not to Vertically Integrate

- Critical mass / economies of scale are missing: At each site the vertically integrated company has placed a staff there should be enough space to manage, tenants to respond to, capital projects to oversee, etc. to warrant its existence. If there aren't, it may be impossible to extract maximum productivity from the in-house property management division. Having the in-house capability may not be justified when its return on investment is calculated. Similarly, economies of scope are vital determinants in the make vs. buy decision. Outside providers may be able to price themselves beneath an in-house manager if there are enough synergies in the elements of the engagement (such as a "package" of leasing, marketing and strategic repositioning duties) to enable them to drive down costs. Out-tasking may even be desirable in the opposite circumstance, if the owner keeps the menu of services so simple that it is easily commodified.
- Business cycles are pronounced and/or unpredictable: In portfolios when there is active buying and selling both the scale and scope of the property management commissions may change frequently and dramatically. Different capabilities are required for properties that are on the sell list than for long term investments. Selling some of the properties in a region may cause economies of scale to drop below threshold levels for justifying the in-house function.
- Certain assets require specialized skills, knowledge and equipment: Operation and leasing for retail and hotel properties are typically more demanding than for other forms of commercial property. It would be commensurably more difficult to develop an in

house management capability for these property types. Owners often regard local market knowledge possessed by an outside provider as a valuable form of specialization. (Access to information through new technologies may permit national property management firms to neutralize the historic advantage local firms have had in knowledge of their particular market's idiosyncrasies. But these new technologies come at a price, heavy investment in new capital and training, that may protect the local player's cost advantage somewhat.) New, networked data management systems and customized accounting packages promise to speed the aggregation of data from individual properties into a form susceptible to analysis at the portfolio level. To the extent that these systems permit flexibility as well as rapid response, portfolio managers can also offer investors report formats tailored to their individual specifications. This capability is extraordinarily important to portfolio managers who need to respond to investor demands for timely performance data.

An important issue in determining where to place the property management function is whether or not the property management and leasing functions will be combined. The case to be made for separating the functions is that both are specialized skills, not necessarily equally resident in real estate service companies; that leasing remains an intensely local enterprise while operations competency has become more exportable; and that the compensation structures for the two activities must of necessity be different. Advocates of combining the functions cite the coordination benefits of formulating a strategic plan for the asset with one agent instead of two; and the information synergies inherent in combining the firm with tenant and market knowledge with the firm most familiar with the physical asset.

- Property management is not perceived as a strategic function: Based on Venkatesan's second and third tests it would be difficult to claim that property management is a strategic undertaking. As previously noted, there are many "independent suppliers" of property management services. While technological innovations are continuously expanding the realm of capabilities property managers must possess to be competitive, once they appear they typically are rapidly disseminated throughout the industry. No examples of firms outperforming their competitors for a sustained period because of a closely held technological advantage come to mind.
- Providers' cost structures are favorable: Outside property managers may simply give inferior benefits, contribute less to pension plans, and pay lower salaries than

institutions customarily do. A property management firm looking to expand market share may offer attractive price concessions, particularly if the foothold gained with the institutional owner carries with it the possibility of further work with that owner, expanded scope of services, and market penetration in new geographic areas.

The questionnaire responses revealed an interesting divergence in perception between the client and provider firms on this question. Client firms tended to rate cost of services about in the middle of the list of selection criteria for property managers, while the providers saw it as a key determinant. In follow up interviews, many clients ventured the opinion that provider fees were so "compressed" by competition that it would be difficult for any one firm to differentiate itself on the basis of cost.

- Start-up costs for the capability are prohibitive: Developing an in-house property management capability imposes substantial costs in hiring, training, and equipping the new staff.
- Opportunities for learning are enhanced by association with a different entity. A kind of corporate cross-pollination takes place in which best practices are shared.

Conclusive evidence that vertical integration or hiring out property management is the better course of action is hard to come by. In 1993 Ernst and Young and the International Association of Corporate Real Estate Executives sponsored a study which sought to determine if costs were lowered and/or quality enhanced when corporate real estate departments retained third party providers for their property management functions. Survey respondents replied that 50% of the time costs were lowered, and 46% of the time quality improved (Evans). This is hardly a ringing endorsement of outsourcing, and, in any case, it is not clear that data from corporate real estate is reliably generalizable to institutional portfolios.

Even if the results had been more conclusive, and corporate real estate was regarded as a fair proxy for institutional real estate, writers on the topic of outsourcing caution policy makers to carefully examine the data. They note, for example, that price and performance improvements that come with hiring outside help may be dependent on the development of new technologies that would have been equally available to the owner/investor. Often the efficiencies achieved by outside providers could have been duplicated in-house with proper motivation and backing from management. Ironically, in-house services can cost more

because they suffer from the perception that they are "free", a perception that could be mitigated with charge-back and request prioritization systems. It also has been suggested that property management accounts often are accepted at low profit margins so that other services that generate a substantial profit level, such as leasing, tenant improvement, construction/supervision, and disposition fees, may be provided. (Ackerberg, 1989)

Most experts on vertical integration and outsourcing seem to feel that the decision of which course to adopt should be subjected to constant reevaluation. Market forces are dynamic, so this important choice should not be made once and forgotten. Ackerberg suggests that a bottom up approach be taken. He says that examination of the special characteristics of the assets themselves should provide the first clue which way to go. This is the only way to determine if specialization matters, if economies of scale are present, and so on. Changes in the portfolio should dictate changes in property management strategy. Property management policy should not be developed in the corporate board room based on sound principles alone.

As noted earlier, determining the appropriate organization for the property management function involves more than just the choice between having an in-house capability or hiring an outside provider. There is more than one strategy for organizing the service when it is obtained outside of the organization, and hybrid forms are very likely to exist. Respondents to the questionnaire described some hybrid property management strategies currently in use. One advisory firm, with a total of 4 billion under management, used national firms, an in-house subsidiary, and a partner firm in roughly equal percentages. Most of the respondents used local firms to some extent, but none used them for more than 20% of their property management needs. Three of the firms had a small - less than 10% of the total - in house property management capability, suggesting a response to some special characteristic of the investment portfolio such as a particular asset type or geographic concentration.

Early in crafting a property management strategy the owner must confront "second order" considerations, such as whether the leasing and management functions are combined, and the extent of its concern with potential conflicts of interest. The analytic framework derived from the discussion of vertical integration is useful in considering these issues as well. The following table presents what I view to be the principal choices an owner must make, with rationales for each expressed in terms of the discussion on vertical integration.

Organization of Property Management Effort

Core Strategy

Rationale - Anticipated Value Creation

Vertical Integration	Creates competitive advantage by maximizing accountability. Reduces expenses by retaining profits, avoiding bidding costs. May be able to develop superior capabilities in house. Offers greater administrative efficiency. Permits capitalizing on owner's economies of scale. Avoids risk of conflicts.
Affiliated local firms	Exploits specialization of providers, particularly local knowledge. Permits maximum flexibility with respect to business cycles. Promotes shared learning. Avoids costs of developing own capability. Exposes process to market discipline
National and unaffiliated regional firms on a regional basis	Suppliers cost structures may be favorable. Exploits specialization of providers. Exploits providers economies of scale. Avoid costs of developing own capability. Promotes shared learning. Exposes process to market discipline
Worked local firms	Same as for unaffiliated local firms, but offers point of coordination, some economies of scale, access to more specialization
Worked regional firms on a national basis	Same as for national and unaffiliated regional firms, but offers point of coordination, some economies of scale, access to more specialization

Using

Hard leasing and operations to separate firms	Exploits specialization of providers.
Combine leasing and operations	Offers administrative efficiency. Promotes shared learning

Role of Provider Firm

Main full service real estate firm	Can exploit provider's economies of scale if firm is large. Exploit economies of scope
Main firms that specialize in property management	Maximizes accountability by eliminating risk of conflict of interest. Exploits specialization of providers

Section 3 - Quality Enhancement - Literature Review

An underlying assumption of this study is that the cost implications of the foregoing discussion on vertical integration are the one uppermost in the minds of policy makers for institutional holders of real estate today. In the past few years, dramatic, but "one time" cost reductions have been realized by many companies through consolidating providers, both creating and disbanding in-house property management entities, and forming advantageous alliances with highly capable fee managers. Some of my interviewees speculated that property management base fees have now been ratcheted down as far as they will go. One proposition of this study is that interest in property management techniques which promise sustainable, if not dramatic, value enhancement is just beginning to emerge. How can property management performance be improved for the same fees? Can tenant retention rates be improved? Can the utility of data collected at the property be enhanced? Questions like this go to the quality, not the cost, of the service being purchased.

The business literature holds that once a company markets its product or service successfully customer retention becomes a principal focus. Numerous studies have shown that the costs of attracting new customers, or mollifying disaffected ones, greatly exceed the costs of keeping existing customers satisfied. Businesses grow and prosper largely as a result of having loyal customers. Customers remain loyal as long as they are satisfied that they are getting value for what they are paying. Service businesses are more likely to deliver value when they have employees who feel adequately supported by the policies and resources of the company for which they work. (Heskett, 1994) Maximizing quality is tantamount to finding a "better way of producing goods and services, a way that eliminates waste, gives employees pride in their work, and keeps the customers coming back for more." (Dobyns, 1991) Improving the quality of the process of delivering a good or service should both improve productivity and reduce costs (Dobyns, 1991, George, 1994) Businesses can improve the quality of their products if they adopt certain policies, attitudes, and systems - a so called "quality program." The principal components of a quality program, and their rationales, follow: (Creech, 1994)

Prequalification, Education and Training: A commitment to improving the quality of a business process requires that a company provide its staff with training, evaluation and education. At a minimum, employees need to know company goals, policies and procedures. Staff need to be kept abreast of developments in their various disciplines. More sophisticated training programs will provide employees with skill in team formation

and management, responding to customers, and structured problem solving techniques. Screening processes should be used to select new hires, and to assemble project teams. (Heskett, 1994)

Open, Omnidirectional Communication: Communication is vitally important to service quality improvement. Information must flow freely if frontline personnel are to be able to act autonomously. Timely, complete and accurate responses to customers' requests for information are key to customer retention. Similarly, data from customers and frontline personnel must flow back to company strategists in an equally timely and complete manner.

Compensation Linked to Performance: Theorists on quality enhancement differ significantly on one aspect of quality improvement programs. Some feel that a compensation system that explicitly recognizes improved performance and goals achieved is necessary. These compensation systems would reward employees not only for individual improvement, but particularly for their contributions to team and firm-wide performance. Other theorists, including some pioneers in the quality movement, feel that linking compensation too closely to specific performance indicators and benchmarks would be enormously difficult to do and not necessarily value enhancing. They see such compensation system as constraining, potentially draining a quality improvement system of much of its flexibility and dynamism. (Heskett, 1994; Lacity, 1993; Segal, 1992, Dobyns, 1991)

Full Participation, Teamwork, Frontline Empowerment: Much of the literature about quality emphasizes the importance of "frontline" personnel. Today, frontline staff must have not just the ability to "fix what's broke", but also "people" skills, competence with computer systems, financial and management skills, negotiating prowess, and political acumen. Most service providers find it essential to have some fundamental grasp of their customers' businesses. This combination of attributes is necessary to add value to their customers' endeavors, which is the surest way to obtain and maintain service engagements. Capable frontline staff can act autonomously, thereby showing themselves, and their company, to be responsive to customer's needs. As a corollary to the emphasis on frontline personnel, the theorists state that quality conscious firms should deliver service not through a rigid hierarchy but via a decentralized structure. They will encourage team formation and dissolution as specific issues need to be addressed. Staff people will not necessarily have a "job", but expertise and character traits that are portable within the organization. (Heskett, 1994, Kinlaw, 1992, Brown, 1994)

Measurement, Feedback, Benchmarking: Many aspects of service quality, unlike the quality of a manufacturing process, are notoriously difficult to measure and compare. The most easily measured service initiatives, such as efforts to reduce operating expenses, are the ones that are likely to be fully exploited in the early going. Institutional owners must measure service intangibles - the customers' impressions of the service provider's reliability, responsiveness, competence, courtesy, and so on - to monitor all aspects of its provider's performance, both against its own prior period efforts and against the competition. The measurement systems themselves are an aspect of a quality enhancement program, in that they serve both to identify which service areas are most important to customers and to set performance benchmarks. The design of a truly illuminating measurement system is challenging task; the best indicators of service quality capture service cost and value enhancement together (e.g. number of quality inspections vs. cost of planning, travel, and reporting results). (Lacity, 1993, Kinlaw, 1992)

Continuous Improvement, Long Term Perspective: Service quality improvement requires several kinds of commitment. It requires strong, visible, yet not prescriptive, commitment to improvement on the part of company leadership. Leaders should encourage and coach their firms to improve, without mandating the implementation methods. The commitment should be long term. While goal setting is an important component of quality improvement programs, theorists argue that the programs only work when continuous improvement is stressed, when new and more challenging goals are constantly being identified. Commitment to improvement should be universally shared. Performance improvement programs routinely fail when quality conscious people or divisions within an organization come in contact with colleagues who do not share the mandate. (Dobyns, 1991)

Customer Focus, Market Knowledge: Customer expectations and perceptions determine customer satisfaction. It is the gap between expectation and perceptions of service that determines how satisfied (or dissatisfied) a customer is. Expectations are rooted in standards set by the industry sector, and often by the locality, under consideration. Having the narrowest gap between expectations and perceptions relative to one's competition in the sector is a measurement of service excellence. (Easton, 1993; Kinlaw, 1992) Theorists on customer retention often make the point that an accurate reading of customer satisfaction levels does not come without probing inquiry. For every squeaky wheel there are many who suffer in silence. There is a difference between "satisfied" customers, who find service

adequate, and loyal customers who respond to what they perceive as superior service. (Jones, 1995)

Section 4 - Quality Enhancement Theory and Property Management.

Earlier in this study the concept of the property manager' de facto duty to the property's tenants was introduced. Even though the property manager is hired by the owner of the property, and performs certain functions, such as accounting and reporting, strictly on the owner's behalf, it's day to day dealings are with the tenants. The asset has its champion in the asset manager, the owner in the portfolio manager. If all three managers vigorously represent their constituencies there will inevitably be conflict, but the outcome should be better than if any one of the interests is ignored or subverted. One way to think of the quality of the property manager's performance is to think of it from the tenant's perspective. The extent to which tenants needs are being met should be a good gauge of the quality of the property manager's service. Some theorists believe that in satisfying the tenant/customer the owner of the property will inevitably be satisfied as well. (Rategan, 1992)

Tenant retention is arguably the property manager's most important job. Tenant improvement costs for renewing tenants are estimated by one of this study's interviewee's to run about a third as much as those for new tenants. Satisfied, retained tenants mean lower marketing costs and the need for fewer inducements such as free rent. In the management of commercial property for institutions the property manager is on the frontline. The property manager must have the technical and general business skills mentioned in the previous section, plus industry specific capabilities such as broad knowledge in such areas as environmental policy, zoning, access and life safety codes, taxation, utility rate setting, and the local real estate market. Like any service provider, the property manager must have a good grasp of each of its tenant/customer's businesses. This is especially true when one considers that property manager, as the provider of the physical setting for its customers' work, is positioned to add value on a daily basis and to a degree not enjoyed by the customers' other suppliers.

The literature has many proposals for initiatives that service providers, and, by extension, property managers, can take to improve the quality of their service (Ackerberg, 1989, Rategan 1992). Some common themes weave through these suggestions. Almost all are directly tied to customer (tenant) perceptions and involve entire management systems, as

distinct from isolated operational improvements (e.g. an improved card access system) that might be contemplated.

Some of these initiatives, adapted for property management, follow. They are included as illustrations of measures institutional owners might take, or instruct their property managers to take, to improve performance. Many are already in use by property management firms across the country. They can be categorized according to the key components of any quality program:

Prequalification, Education and Training

- Invest in training and education programs to enhance skills in communication, negotiation, relationship management, as well as keeping staff current in technical matters. The benefits of technological proficiency need not be limited to the reporting function. If frontline members of the property manager's staff are properly trained and enabled to treat the information generated about the asset as real time feedback, they may be able to adopt mid course corrections in the way they manage the property, thereby improving results. A beneficial byproduct for firms with training programs is that staff turnover is often reduced. (Segal, 1992)
- Provide manuals stating institutional owner's expectations for operations, accounting, and tenant relations. The content of these manuals should be appropriately prescriptive - highly so where standardization is important, such as in accounting and reporting requirements, less so where the property manager's good judgment can add value.

Open, Omnidirectional Communication

- Invest in technology. Make it available to frontline personnel. Investigate purchasing common equipment across a portfolio of properties. Network the properties, regional and central offices together.
- Enhance communication through all available means including periodic meetings of all property managers, newsletters, and networks.

- Listen for customers expressing their needs. Is the new tenant with the startup business more concerned about building image than were any of the existing, long term tenants? Do the shopping center tenants want measured feedback from their recent promotions?

Compensation Linked to Performance

- Introduce performance based compensation at every staffing level.
- Institute competitions among provider teams for quality based cash prizes.
- Make sure that the quality is not quiet. Tenant recognition of the effort is essential.

Full Participation, Teamwork, Decentralization, Frontline Empowerment

- Include all vendors in a common, integrated compensation plan. Performance standards should be set with tenant and frontline personnel input. (Segal, 1992)
- Make sure that subcontractor and vendor contracts require performance to the same quality standards that the property manager has set for itself.
- Introduce performance based fees, with no stipulations about staffing levels or methods, which would permit the property manager and its outside vendors to control how they meet the performance standards.

Measurement, Feedback, And Benchmarking

- Monitor service performance by distinct categories. This may have the effect of increasing the likelihood of good quality performance across categories, rather than permitting the property manager to achieve adequate performance overall by offsetting weaknesses in unfamiliar tasks with superior performance in areas in which it specializes.
- Determine correlation between quality measurements at property level and financial performance of overall portfolio.

- Audit property management compliance with the institutional client's own systems and performance criteria. Also use tenant satisfaction surveys, which should be designed by independent companies, not affiliated with the asset and portfolio managers. The two kinds of survey together should provide a balanced and complete picture of the manager's performance. Survey questions might elicit tenant perception, related to expectations, of such things as staff response time, workmen attitude, elevator waiting time, etc.
- Frequently (perhaps monthly) monitor variances in budgets, rental payment delinquencies, maintenance, service calls, tenant retention.
- Send owner's representatives to review operations in the field;..
- Give the property managers opportunities to review the asset managers and the management systems they use. (Spoerri, 1992)
- Benchmark against the competition and local and national standards. Specified baseline performance standards in the contracts.

Customer Focus, Market Knowledge

- Invest in recruiting and screening procedures for new frontline hires. Hire people who are "asset attuned", able to collaborate with asset managers in strategic, "big picture" planning for the property. Stress customer service orientation .
- Hire managers with, or encourage them to develop, a presence in the market, familiarity with local agencies, civic institutions, local leaders.

Continuous Improvement, Long Term Perspective

- Continually set new goals, include performance targets in contracts.
- Look for opportunities to broadly disseminate effective policies and procedures across all three major property management functions.

Section 5 - Property Management - What We Should Look For

I have presented this brief review of the literature on vertical integration and quality enhancement as a framework with which to analyze the data from the field work conducted for this study. With this framework we can:

- delineate what kind of arrangement for property management the subject firm has put in place.
- understand the firm's rationale for its selection.
- illuminate some of the firm's experiences with implementation of the current property management strategy.
- determine how successful the firm feels its strategy has been to date.
- determine how the firm expects to further refine its strategy.

I sketched a picture at the beginning of this study of what I expected to find when I inquired into how major institutional owners of real estate approach property management. In the next chapter I present 3 case studies of property management programs in effect in 1996.

In the section in this chapter on quality enhancement I listed the 7 principal categories of a service quality program, and gave examples of possible initiatives in each category that a property manager might pursue to enhance tenant retention. In presenting this material, I sought to establish a context for determining the emphasis that the owners in the study placed on enhancing the value of their property management service, and to determine the extent of their involvement in the actual implementation of the quality enhancements. In analyzing the cases I will look to see what methods of value enhancement the firms actually employ.

CHAPTER THREE - The Case Studies

Case Study 1 - TJLI and Cupola Management

The Institutional Owner and the Portfolio

In 1996, the Thomas Jefferson Life Insurance Company (TJL) had 11.2 billion dollars of commercial real estate equity under management for its general account, in properties distributed throughout the United States. 75% of the properties were office buildings; residential, industrial, hotel, and retail properties were represented in the portfolio in single digit percentages. 60% of the office buildings were in the business districts of large urban centers, the rest in the suburbs. Among the downtown buildings were many "trophy" high rise structures.

TJL had been reducing its equity portfolio for some time, and more sales were planned, but in 1997 it intended to begin acquiring property for the first time in the decade. The size of the portfolio was to be stabilized at between 10 and 11 billion dollars. TJL also planned to reduce the portfolio's heavy weighting towards office buildings in the near future.

In 1994 the company had made significant changes in the organization of its real estate management efforts. Motivated by a desire to improve the operation of its real estate holdings it created a new centralized property management department called Cupola. Prior to the creation of Cupola, all real estate management activities had been had been handled by a single department, Jefferson Real Estate (JRE). After the creation of Cupola, JRE retained portfolio and asset management functions, while Cupola took over the oversight of property management. The creation of Cupola as a separate entity from JRE, with a parallel reporting line to TJL's head of investments, signaled the new importance that senior management attached to effective property management.

Cupola's mandate was to lower costs at the properties and to deliver "better management." To oversee the majority of the commercial property, Cupola had nine regional directors, each assisted by an analyst. The regional directors reported to two managing directors, one for the eastern and one for the western halves of the country. A centralized support services group provided resources to all the regional directors. Cupola's department head, and the

Cupola Support Services Group were located in the same city as TJL's corporate headquarters, along with most of the senior JRE staff.

Together with retaining portfolio and asset management functions, JRE continued to control lease negotiations and dealt with any litigation involving tenants. JRE provided all the strategic planning for the assets, making the selling and repositioning decisions. In addition, it performed property valuations and marketed the buildings. Cupola was principally responsible for controlling property operating expenses and capital budgeting. It hired and monitored property managers. Litigation involving the property manager, and the contractors and vendors that it hired, was Cupola's responsibility. On a per property basis, Cupola's staffing was leaner than JRE's. One regional director for Cupola, for example, might have in his or her purview properties overseen by several asset managers.

Setting The Property Management Strategy

Cupola's first major initiative was to undertake a dramatic consolidation of its external property managers. In its first year it reduced the number from 71 to 22. The remaining firms were national and regional providers selected on the basis of their perceived relative strength in each of Cupola's nine regions. In addition to the reputation and track record, Cupola managers cited operational expertise, range of services provided, and fee structure as the most important determinants of which property management firms were retained within the consolidated management structure. Many of Cupola's managers and directors cited human as well as organizational attributes as being of crucial importance. They were particularly likely to be favorably impressed by firms staffed with people with both technical and managerial expertise, with people who could strategize and innovate as well as execute.

By reducing the number of fee managers, Cupola accomplished many things. Recognizing that the property managers whose services were retained would have larger portfolios from which they could enjoy economies of scale, Cupola negotiated more favorable management fees. Beyond this most visible cost cutting benefit, Cupola felt that having fewer providers would mean that all phases of property management could be standardized and streamlined. Communications between the properties and regional offices were facilitated. With fewer sources of information, the aggregation of accounting and reporting data was made quicker and more reliable. Cupola established consistent tenant relations policies. It found that it could more readily evaluate performance of its property managers with fewer of them to monitor.

Cupola elected to continue working with a select group of third party providers, rather than develop its own in-house capability, partly out of recognition of the difficulty of creating the function, and partly in an effort to exploit the advantages of the dynamic and competitive market for fee management services. Staffing its 440 buildings with newly hired personnel would have been a daunting task. Startup and marketing costs (if third party business was solicited) of such a venture would have been significant. Furthermore, Cupola saw advantages to working with outsiders. Rebidding the service annually would keep the fees disciplined by the market. Information on best practices would flow from outside fee managers to Cupola, and through them to other fee managers, assuring constant updating of management techniques and policies. Many Cupola directors felt it would be easier to demand continuous performance improvements, and if necessary, to terminate the relationship, with outside providers.

Cupola's decision to keep certain of its property managers and let others go was made independently of the consideration of who would lease the buildings. When the major part of the consolidation work was completed, most of the properties were managed and represented by different entities. Many JRE managers voiced the opinion that leasing was still an intensely local enterprise, while the other aspects of property management - operations, reporting, and tenant relations - could be imported. They believed that when it was necessary to find a tenant, only brokers deeply familiar with local market conditions and, of most importance, local prospective tenants, would do. By contrast, they felt that strong property managers could quickly become familiar with local government regulations, taxing policies, utility pricing, vendors and consultants, etc., as needed. Out of town property managers could avail themselves of databases of national organizations such as BOMA and IREM in the search for competent local contractors. At the same time, none of the managers felt that leasing and property management should be separated as a matter of policy. That it usually was came as a natural outgrowth of selecting the best firms for the respective tasks.

Many of Cupola's service providers were full service real estate firms. This meant that they offered asset and portfolio management services themselves, in some cases on properties in which they had an ownership interest. In general, Cupola directors were not sufficiently concerned about the potential conflicts of interest that this posed to be willing to exclude such providers from consideration. One director noted that the full service firms posed little threat when they provided property management services in localities where their other

functions were not active. Others said they would be concerned only when the fee manager was also advising on competing retail properties for pension fund advisors. Their prevailing attitude was that they should capitalize on the superior performance they felt they could get from firms that coincidentally provided the other management services, while being vigilant for any manifestations of conflict.

Building Operations

Although it hired outside fee managers, Cupola remained extremely influential in the way building operations were actually carried out. In order to support the regional directors Cupola strategists formed the Support Services Group to improve the coordination and standardization among properties they wished to achieve. Much of the Support Services Group's early work, conducted at the direction of the regional directors, dwelt on formulating standard policies and practices for all aspects of building operations. Support Services Group staff created national purchasing programs to take advantage of TJJ's clout in the marketplace, as well as to further the standardization effort. The Support Services Group's other nominal function was to provide additional resources to Cupola's regional directors in their dealings with the property managers. As property managers proposed capital improvement programs, or sought approval for hiring a subcontractor, Support services staff could assess both the proposal and its justification. With the approval of the regional directors, Support Services Group staff could also, on occasion, be available to the external property managers for questions and discussion.

In practice, property management for TJJ's holdings was a team effort between Cupola and the fee managers. Cupola issued guidelines, packaged the purchasing opportunities derived from TJJ's economies of scale, and provided advice and consent on capital improvement proposals (bidding was now required for all but the most minor expenditures on goods and services). Support from Cupola to building operations came in several forms including assistance on construction issues, maintenance management programs, environmental policy, compliance with ADA, equipment purchasing, and sophisticated electrical and communications systems. Cupola encouraged the property managers, for their part, to develop their own purchasing advantages, and to deviate from the guidelines when better solutions presented themselves.

The rationale for Cupola's active role, particularly in purchasing, was persuasive. In its own words Cupola enjoyed "substantial purchasing power due to volume pricing." One

program, with a national overnight delivery service, shaved nearly 50% off "street" prices. But there were other, ancillary advantages to a national purchasing program. The list of goods and services thus purchased constituted a de facto catalogue of pre approved items from which the property manager could select, shortening the owner's review and acceptance period. The equipment items on the list were standardized across properties, increasing the chances that replacement parts for one property might be found in storage nearby at another. No costly bidding would be required when one of the purchase program items was used.

Among the list of pre - approved systems were four maintenance management programs. Cupola had not insisted that only these four be employed, and, as a consequence, many more were in use in mid 1996. While some Cupola staff bemoaned the failure to standardize this important maintenance technology, they encouraged the property managers who utilized any of the available systems to continue doing so because of the very real benefits they conferred. Even the least sophisticated computerized "tickler" systems enabled the managers to anticipate and track scheduled maintenance better than antiquated card systems. Nevertheless, the real promise of this technology lay in the future. Cupola staff could envision systems which doubled as inventory control and which could be fully integrated with accounting systems.

Cupola supported property managers in their efforts to craft asset specific value creation strategies. With recent deregulation in the utility industry, attractive opportunities to exchange commitments to purchase energy from utilities for certain concessions were often available at TJJL owned properties. These concessions might take the form of financing for, or outright purchase of, capital equipment by the utility. Cupola and the property managers jointly pursued other value creation strategies, such as exploiting unused rooftop space for fee paying communications equipment.

Sometimes property managers would initiate schemes that were of dubious merit, which highlighted Cupola's mandate to act as watchdog. A director cited an example involving a property management company overseeing an office park partially owned by another life company. The manager had devised an elaborate landscaping scheme and proposed it to Cupola. The landscaping was clearly designed to entice tenants to vacant buildings in the park owned by the other company. Cupola disallowed the proposal, since the incremental gain to TJJL would have been minimal.

Reporting, Accounting, Data Collection, Communications

Cupola required its property managers to make monthly operating reports. These documents served a dual purpose. They aided the manager in operating the property on a day to day basis, and enabled Cupola to monitor the effectiveness of the property manager in meeting the objectives set out in the budget and the annual business plan. The reports covered financial and operating activity, including detailed analysis of variances in both the income and expense accounts.

Most of the reporting was done using Accuedger, a popular accounting software package in the real estate industry. Accuedger was designed to be easily customized to accord with firm specific accounting protocols. It permitted data aggregation at many different levels of detail, and offered completely flexible sorting capabilities. As a result, Cupola and JRE could obtain very focused information - such as a list of properties at which a particular tenant was in arrears more than two months - at any time they wanted. To ensure the fastest possible information transfer, and that the data at any given location was continuously updated, almost all the properties, regional directors, and the main offices of Cupola were networked together.

TJL's budget process for its commercial property was lengthy and complicated. Property managers began producing the annual budgets for each asset at the beginning of the previous year, in order to allow enough time for thorough review and comment by both Cupola and JRE. There was a built in step in the process, usually in the middle of the year, called "re-projection," which allowed the property managers to adjust their initial budgets to the actual experience of the intervening few months. One of Cupola's early initiatives was to demand more backup from its property managers on both budget and operating matters. While Cupola's directors and the financial staff on its Support Services team could not cut steps from the budget process, they were able, at least, to standardize the new backup requirements across properties.

During this period Cupola was building a property management database. This was to capture information about the financial performance of the various properties, but also data about building operations, tenants' profiles, descriptive information about the properties, and market data. Cupola's Support Services staff cited a number of applications for the database, either then in effect or contemplated for the near future. One such application was an energy management program where data on energy use by property, and oil and gas rates

by locality, could be entered on a monthly basis, permitting energy purchasing strategies customized by region to be explored. Cupola anticipated that it would be asking its property managers to supply more and more information from the field as it developed the database.

Cupola required another key document from its property managers, the monthly Asset Optimization Report. This report helped both the property manager and Cupola document their cost saving efforts. The AORs recorded everything from major rebidding of service contracts to small dollar savings in building supplies purchases. The system permitted TJL not only to put a specific measurement to the effectiveness of its property management cost savings effort, but also to see how the benefits were allocated between itself and its tenants. In this way, Cupola could demonstrate the value created by its efforts to both its constituencies, the tenants and TJL senior management, with hard numbers.

As it had with building operations, the Cupola Support Services Group supported the simplification of the property manager's reporting and communication function in various ways. It arranged for a bulk purchase of personal computers to standardize hardware at the various sites. It insisted that a standard word processing, spreadsheet and database application be used at each site. From time to time Cupola's regional directors asked Support Services staff to audit the property manager's books in the field.

Tenant Relations

In reflecting on the attributes of an ideal property manager, one JRE manager noted the importance of having a good communicator in the critical role of dealing directly with tenants. Problems were inevitable, the manager noted, despite the best efforts of highly trained technicians, and once they happened, the value of a good "explainer" exceeded that of the good technician. Having realized impressive early gains from the consolidation effort, Cupola was now embarking on improving its tenant relations and retention programs. Communication with the tenants was at the heart of these initiatives.

Cupola urged each property manager to adopt a quality improvement program for each property. One hallmark of the program was a focus on customers, defined in the property management guidelines as both the tenants and the owner. The guidelines further suggested that the property managers "identify the key characteristics of quality expressed by these customers", and identify "the processes that affect the key characteristics of quality."

Cupola expected the property managers, once they had identified the key processes, to seek ways to continuously improve them.

Cupola extended considerable latitude to the property managers in their dealings with tenants. It urged property managers to conduct tenant satisfaction surveys as a means of "identifying and closing quality gaps." Cupola's property management guidelines suggested that both face to face and written surveys be used to gauge tenants' views about the quality of the service they were receiving. The face to face "surveys" could be performed in the guise of daily check up visits. In that way valuable information about tenant attitudes could be obtained while at the same time demonstrating attentiveness.

Some of Cupola's preferred property managers already had carefully developed tenant satisfaction surveys which they used on all their properties, regardless of their client. At least one of these companies had third party agencies administer the survey, to assure objective responses. In the summer of 1996 Cupola was busy, with a consultant, developing its own survey. This survey would supplement the semi-annual visits to property sites to meet directly with the tenants, usually without the property managers present, that Cupola already was making.

While Cupola and its property managers were moving aggressively to hear their tenants, it was not yet clear how the results of the surveys were to be analyzed and acted upon. As noted, the database was a living, evolving tool. Tenant survey data on such measures as service request response time were ideal candidates for inclusion in the database, but formalized incorporation of survey data and the observation of evolving trends would take more time. In the interim, Cupola had found it difficult to determine appropriate benchmarks for many of the "characteristics of quality." While national organizations such as BOMA and IREM could provide some benchmarking data, Cupola staff were not sure that they were reliable or necessarily applicable to TJL's scale of operations.

Cupola had not linked compensation to tenant satisfaction in any quantifiable way. There were, for example, no bonus opportunities tied to improvement in tenant satisfaction ratings. Some of Cupola's property managers maintained their own incentive programs. They would hold competitions for best customer service among the buildings in their portfolios, and include as eligible participants vendors and subcontractors as well as their own staff. In the current market for property management services; however, most Cupola managers felt that the property managers derived enough incentive to perform well from their desire to

retain the engagement. Similarly, contacts with the fee managers carried no specific performance hurdles that the managers were obliged to meet or exceed. The mandate for continuous improvement carried in the Quality Improvement Program was not given a quantified form.

Results of the Property Management Program

In its first year of operations Cupola was able to claim cost reductions from the previous year of over 22 million dollars. A good portion of this was attributable to the consolidation effort. By offering them larger "territories", Cupola was able to negotiate lower management fees with the remaining property managers. Contract rebidding for services such as cleaning, aided by the new economies of scale enjoyed by the managers, was another key contributor to the savings. Cupola ascertained that almost exactly half of these savings went directly to tenants in the form of reductions in operating expenses for which they would have been responsible by the terms of the lease. Due in part to the novelty of the system, performance data on some of its other elements - such as tenant retention - were not available.

In February of 1996, Cupola held a "Superior Performance in Management" roundtable at its corporate offices. Many of the preferred property managers attended and spoke candidly about their reactions to the new property management strategy. Most of the outside providers cited TJJ's lengthy budget process and confusion about lines of reporting - were they to respond ultimately to Cupola or JRE? - as their principal reservations. On the whole, however, the managers seemed enthusiastic about the prospect of continuing to work within, and help develop, the new system.

Most Cupola staff also seemed enthusiastic about the new property management program. While acknowledging communication difficulties with JRE, and uncertainty between the two groups about roles and responsibilities, in the early going, they felt that rapid improvement was being made in these areas. Many felt that they could observe tangible progress in the qualitative goals of the program - standardization, simplification, increased accountability. On the negative side of the ledger, some managers cited problems in absorbing and capitalizing on all of the data being generated. Despite the efforts to standardize and clarify there were still inconsistencies in industry nomenclature. The exact components of certain measures, such as absorption rate, were not reliably codified.

More significantly, one Cupola director conceded, the major cost cutting initiatives had probably been identified and mined of most of their potential. As a practical matter, even with annual reviews, he did not expect that there would be much turnover in property management firms in the near future. While subjecting the managers to market discipline was important to hold down fees, so was tenants' perception of continuity. It was not clear how comparably large annual savings could be delivered on a regular basis. For these reasons, the director felt that Cupola might shift its emphasis in the future to revenue enhancement strategies. The rooftop management program was a manifestation of this already in effect. The director felt that full implementation of tenant retention measures - both the policies themselves and the performance measurement systems used to assess them - could be another fruitful avenue to pursue.

Case Study 2 - FGLI and Pediment Real Estate Advisers

The Institutional Owner and the Portfolio

In 1996, Pediment Real Estate Advisers, Inc. (Pediment), a wholly owned subsidiary of the Federated Guaranty Life Insurance Company, managed 2 billion dollars of equity real estate for its parent company. Pediment was formed in 1994 to bring concentrated real estate expertise to the management of FGLI's real estate investments. Pediment's choice of an identity distinct from its parent company was a meaningful one. In addition to serving FGLI, it wanted to develop independent business on its own merits, and to be perceived by potential clients without preconceptions.

In the summer of 1996 Pediment was attempting to attract capital from pension funds for a new real estate investment portfolio. The parent company had recently merged with another insurance company which also had a significant position in investment real estate. Near term strategy called for divesting the bulk of the second company's portfolio, and for making new acquisitions. Equity real estate currently represented about 4% of FGLI's general account. Pediment executives felt that over time that number might rise to 6%. In the normal course of business, Pediment sold about 10% of its portfolio each year as part of rebalancing activity.

Pediment managed investments distributed throughout the country with a preponderance in the southeast. 31% of the properties were hotels, 34% office buildings, most located in the suburbs, 18% retail, 10% residential and 7% industrial. Senior Pediment executives characterized the portfolio as of above average quality, and, due to early recognition of the real estate cycle by the parent company prior to Pediment's creation, accurately valued.

Pediment prided itself on being a decentralized organization. It had an essentially flat structure, with autonomous acquisition, asset management, legal, engineering and disposition expertise. All of these capabilities were represented at each of the 4 regional offices, which were located where Pediment wished to establish market presence. Except in rare instances, all decision making on individual properties rested with the regional offices. Necessarily centralized functions such as general administration, investment research and long range planning took place at a headquarters location.

Pediment leadership had ambitious goals for its performance. It wanted the returns of FGLI's portfolio to consistently rank in the top quartile of the NCREIF index. The firm's executives believed that actively managing its portfolio was the key to obtaining these results. It planned to follow a "rotational" strategy, buying and selling different asset types and moving in and out of geographic areas as economic conditions dictated. In some instances it would reposition a property, and sell it when it could fully capture its new worth. In a more general sense, Pediment executives felt that it had to be, in the words of one director, "extremely flexible, always ready to react and change course." Pediment wanted to have the nimbleness of an independent advisory firm. Recently the company had been successfully competing with such firms by conducting speedier acquisition and due diligence processes.

Setting The Property Management Strategy

Pediment directors were adamantly opposed to the concept of having an in-house property management capability. In the past, FGLI had operated a subsidiary property management company which proved to be costly and inefficient. One director illustrated the in-house property management company's cost disadvantage by observing that FGLI extended its defined benefit pension coverage to all its employees, and that it staffed its properties with full time rather than spot workers. It simply could not compete with companies able to hire workers with less generous benefits on an as needed basis. The firm's cost inefficiencies escalated with the larger buildings in FGLI's portfolio. Since closing down the subsidiary FGLI no longer possessed property management capability. Moreover, in the opinion of Pediment's directors, the advisory company had a fiduciary duty to consistently go to the market to seek the best property management service at the best price. As one director put it, "How could you ever prove to your investors that your internal property management firm is the most cost effective? Could you fire the firm if it wasn't?"

As a result of FGLI loan foreclosures, Pediment inherited a roster of management firms. Some were national operations, but the majority were local and regional players. Pediment wanted to consolidate the number of its providers, citing the economies of scale and scope, and the expected improvements in operational efficiency and reporting accuracy to be gained. Through consolidation Pediment would become a more important client in the eyes of the remaining external providers. Not only could it anticipate being able to negotiate lower fees, but it expected also to receive greater attentiveness and better quality staff. Pediment felt that some of the inherited fee management firms were simply too small to be

able to work effectively in this new environment. In foreclosures, Pediment replaced former owner/managers, judging that the risks of dealing with a potentially demoralized entity far outweighed the possible advantages to be gained from its familiarity with the property and the tenants in place.

Pediment's regional directors viewed the ideal degree to which the consolidation should occur differently. The manager of the largest regional portfolio felt that working with only 1 or 2 property management firms by asset type within each of his principal sub regions (states and clusters of cities) could simplify administrative activities and heighten performance. By contrast, a second regional manager noted that, contrary to marketing representations, the quality of individual offices in regional and national property management firms could be very uneven. Further, he had often encountered active rivalries between the local offices of large property management companies. His preferred strategy was to work with a single property manager in each major city where his properties were concentrated.

According to one Pediment director, eligible candidates for a property management assignment must be able to work for a competitive fee, have a pre-existing presence in the region, adequate technological capability, engineering and maintenance expertise, a good track record, an established quality program, and highly qualified staff and management. A viable candidate needed a sophisticated, well staffed MIS department in place. Most of the Pediment directors cited the importance of choosing specialized property managers for certain asset types in the portfolio, such as flex space, service, and R&D properties. One noted that for retail properties he found it effective not only to hire retail specialists, but firms with prior relationships with his principal tenants.

Pediment sought lasting relationships with its providers. Whenever replacements were required, Pediment looked first at firms with which it was already working. Pediment was concerned about potential conflict of interest and breaches of confidentiality, and, where it could, carefully avoided hiring property managers affiliated with competing asset management firms. It typically hired property management firms to provide "core" services, preferring to make separate arrangements, when necessary, for specialized work such as environmental analysis and remediation, master planning, and large capital improvements.

In Pediment's flat, decentralized organization, asset managers had a good deal of autonomy, and were regarded, and expected to think, much like CEO's of their own small businesses.

In staffing each region with legal, financial, engineering and management expertise, Pediment believed it had laid the proper groundwork for constructing fluid teams for asset management. Even though the asset managers were nominally in charge of the buildings, when issues came up requiring a certain expertise, any member of these teams could take the leadership role.

After the consolidation, single external property managers often reported to several of Pediment's asset managers in a particular region. Piedmont's regional directors could intervene if inconsistent expectations became too great an issue. Pediment's directors believed that maintaining a clear distinction between the roles of the asset and property managers was critical. Both had a fiduciary duty to their constituencies. Senior executives felt that it was important for the property managers to act as the voice of the tenant/customers. They expected the fee managers to think proactively about the property, about tenant retention, about "turnaround" strategies, but insisted on the asset manager's ultimate authority for capital budgeting, lease approvals, and periodic hold, sell analysis.

Pediment believed that leasing and the operational functions of property management (tenant relations, building operations, and accounting/reporting) were complementary activities and should be provided by the same entity. It viewed close teamwork between leasing and operations personnel as essential, and, if performance should suffer, wanted to have a common locus of responsibility. One regional director negotiated lower fees of about 50 basis points when purchasing the combined services. Another Pediment director observed, however, that more and more property owners were placing building representation on salary. They sought marketing expertise from their property managers rather than deal making skill. Due to intense competition, property management fees were significantly reduced from prior years anyway. He felt that even if there were commission opportunities to offer property managers, there would be little room to negotiate the fees down further.

Pediment wanted both to establish long term relationships with its providers and to subject them to some degree of market discipline. Like most clients of property management services, it typically signed one year contracts with escape clauses for either party after a minimal notice period. Pediment did not, however, insist that its providers engage formally in an automatic competitive rebidding process at the termination of each contract. Instead, its managers reviewed the terms of the agreement against their own collective market knowledge to keep fee and performance expectations in line.

Building Operations

Pediment exerted very little formal control over its property managers' handling of day to day building operations, except in the areas of reporting, accounting, and risk management. While it required that a specific software package be used for accounting, it did not insist on governing the property managers' selection of maintenance management software. For properties in earthquake prone states Pediment performed elaborate seismic modeling studies and instructed its property managers if remedial work was required. Similarly, Pediment engineers kept up to date on OSHA and ADA regulations. Asset managers made "check up" visits to their properties two to four times a year.

Of course, many of Pediment's fee managers provided their own guidelines and training programs for field work. One provider held monthly seminars and workshops attended by all the property management sub-disciplines - engineering, financial, managerial. Their intent was to "cross-fertilize", to share insights across disciplines and across assignments. This same firm also kept extensive trend data on its buildings in order to improve its benchmarking capabilities. The guidelines covered such topics as crisis communication, accounts receivable management, preventive maintenance, the due diligence process, community relations, and environmental regulations.

Pediment selected fee managers who could critically appraise and improve upon current staffing structures and procedures at its buildings. Pediment wanted these fresh approaches to be comprehensive - aspiring property managers had to have capabilities in all aspects of the property in question. Shortly after being retained to manage a mixed use project, one manager benchmarked the project against other properties in its portfolio, and quickly developed a new staffing plan to reduce the number of on site personnel and improve their productivity. Since the complex was entirely powered with electricity, the manager negotiated an utility agreement in which the project would receive yearly rebates on its power bills in return for installing more energy efficient equipment. The new manager assumed the parking facility management, with its own staff, and consulted with Pediment on the name and graphic identification package of the project.

Pediment's directors placed high value on the contribution property managers could make via repositioning strategies, particularly in working with tenants. While such initiatives were often vital components of increasing the appeal of under-occupied buildings, they were also

important as a means of boosting income from fully leased but "static" properties. In one instance, an external provider helped turned around a strip center by convincing some tenants, including the municipal library, to move to other properties it managed, permitting the center's anchor tenant to expand. Pediment valued this kind of resourceful thinking, which extended beyond simply servicing the needs of the tenants in place. Once Pediment launched a repositioning strategy it frequently issued RFPs to its current property manager and to several other firms soliciting ideas from many sources about such aspects of the plan as what the components of the work should be, how it should be staged, and what it might cost.

The mixed use project cited earlier combined office and retail space, a hotel, and parking in one structure in the center of the city. Most of its components were successful, but the retail shops and associated food court had fallen out of favor with local consumers. The sluggish performance of the retail threatened the appeal of the entire property as an investment. Pediment installed a new property manager based on its demonstrated ability to plot creative turnaround strategies. The manager responded with a process for renewal that ensured that several solutions, beyond adjusting the tenant mix to the current trends, were explored. Pediment and its management team approached their task with open minds, willing to consider dramatic changes, such as retrofitting the entire space for another use, and to invite community input. Ultimately, the team picked a solution which relied less on extensive and costly structural reconfiguration than an imaginative relocation and exchange of tenants, including non-retail uses such as bank back-office functions and a branch of a college. At this writing Pediment's asset managers are happy with the results, and feel they have benefited from their property manager's strategic planning skill.

The fee structures for Pediment's property managers were conventional, but some of its directors were thinking about new ways of aligning compensation with performance. Pass through expenses could be significant, particularly in retail properties. In one case, a regional director considered structuring his fee managers' compensation to create incentives for them to be more diligent in the identification, justification, and collection of these expenses. Property managers who were compensated solely on the basis of a percentage of base rent had no incentive to aggressively pursue these payments. The director believed that, as a general rule, broadening the compensation base to include pass throughs and most other non-rent revenues while lowering the percentage of total revenue received in fee by the property manager would result in increased net income to the owners. In theory, property

managers would accept the lower percentage in return for the opportunity to achieve a net increase in their compensation by adopting more aggressive collection practices.

Pediment executives had also considered unbundling some of its fee managers' services in order to set up independent compensation schedules for them. It saw this as a first step towards making possible a more fine grained system of incentives and performance measurements than it currently used. In some instances, where Pediment negotiated property management staff salaries separately from the base management fee, a de facto version of such a system already existed. Like many owners, Pediment already compensated property managers who supervised significant capital improvement projects on top of their base fee.

With respect to building operations, Pediment evaluated its property managers primarily on their ability to realize expense savings from prior years, their effectiveness in pursuing collectibles, and, in general, their success in executing the year's strategic plan for the asset. In addition, Pediment looked for demonstrations that the provider firm's market knowledge continued to pay dividends in contributing to and executing the strategy for the assets it managed.

Reporting, Accounting, Data Collection, Communications

In most of its regions Pediment had built its accounting and reporting functions around one software program. Pediment did not require property management firms to have prior experience with the program, although most of the firms on the consolidated list already did. Pediment provided no training of its own, preferring that its property managers learn directly from the software company's own training team. One Pediment executive acknowledged that placing high expectations on the data management capabilities of the property management firms, while providing no centralized support of this function within its own organization, virtually assured that the property managers it hired would have to be comparatively large firms.

Pediment fully exploited the software's flexibility in presenting data. It collected information on a property by property basis, but packaged it for review by the client according to FGLI's lines of business. Pediment required its property managers to file monthly accounting reports which detailed income and expenses, and variances from the annual budget plan. Property managers transmitted accounting data simultaneously to their

asset managers in the regions and to Pediment's central offices by modem. Pediment, in turn, provided fund performance information, including variances from budget, on a quarterly basis to Federated Guaranty.

Pediment's property managers regularly produced three kinds of reports, and periodically updated activities such as capital improvement projects. In addition to accounting data, the regular reports tracked leasing activity on a quarterly basis, and market data as conditions in the marketplace evolved. Some Pediment asset managers met face to face on a quarterly basis with their property managers to go over the accounting data in detail, and "recast" budget projections afterwards if warranted. The leasing report captured data about rental activity including which prospects had been shown the property, what kind of space the prospects were looking for, rent terms discussed, tenant retention, new leases for review (this was felt to be of too much importance for property managers to control alone), square feet available, and sq. ft. shown. Pediment looked to the market report for information on competing properties in the region and general trends.

Pediment's managers attached great strategic importance to obtaining, packaging, and controlling information in a "seamless" way. They believed that the attractiveness of real estate as an investment suffered in comparison with stocks and bonds in part because information about real estate was so difficult to manage. While some investors had been successful precisely because information was unevenly distributed and of variable quality, Pediment felt that investors who could consistently rely on good market and property information, presented in a standardized yet flexible format, would have a sustained advantage.

Pediment conceded that its own systems did not yet yield seamless data. A good deal of the information Pediment wanted its property managers to provide was necessarily returned in narrative form and could not be suitably presented using the accounting software, which was essentially a customized spreadsheet application. Accounting, or "backward looking," data, was captured and analyzed in one software package, and cash flow projections, or "forward looking" data, in another. Many of Pediment's property managers reported to their own home offices using systems and formats quite different from Pediment's, which could threaten the timeliness of their reporting to Pediment. While Pediment managers valued the fee managers local knowledge and required their market reports, they had also learned to be skeptical of the accuracy of the information thus obtained. They regularly purchased market data from outside vendors specializing in this work, and through their in-house

research facility, produced their own annual market reports. Thus, despite having networked offices, standardized reporting formats, and powerful software, Pediment was still far from having a completely unified system.

The budget and strategic planning process for Pediment properties typically extended from August to the end of the year. Property managers routinely contributed to the strategic plan. Many property managers - usually the vertically integrated ones - also marketed valuation services and sensitivity analyses, but Pediment preferred to do this critical work itself. Pediment evaluated its property managers' reporting performance at year end on the basis of its timeliness, completeness, and accuracy. Pediment managers observed generally that their property managers were quite accurate in their reporting, but that reports often lacked critical data and were not always received on time.

Tenant Relations / Tenant Retention

Pediment had well established incentive compensation programs with its hotel properties, but had only begun to consider them for other asset types. Its hotel operating companies could as much as double their base fees if they were successful in reaching certain negotiated targets. Rather than being pegged to annual occupancy rates, the targets reflected the investment performance of the hotels - annual returns and valuation - in order to capture the net effect of revenues and expenses. For its other asset types, Pediment contemplated a bonus tied to tenant retention percentages and, for buildings about to be sold, increases in net operating income.

Some of the regional directors felt that in typical markets tenant retention rates above 50% indicated that the property managers were doing an adequate job. They viewed the added value of formal tenant satisfaction surveys with some skepticism, based on a belief that they were often not thoughtfully filled out and that most tenants made their feeling known in any case. Property managers stayed on top of their own tenants' accounts receivable and rollover statistics, but Pediment didn't feel it was possible to have them benchmark this data against the results of other property managers in the same market. This information was too jealously guarded by competing firms. When tenants did leave a property, Pediment's managers expected its property managers to conduct an informal "exit survey", so that Pediment would know why they left. Sometimes, to provide property managers with extra incentive to retain tenants, Pediment would pay them half of a typical leasing commission when tenants "re-upped."

Pediment relied heavily on its periodic site visits to determine how well property managers interacted with tenants. One director said that it was a "big red flag" if the property manager and the tenants seemed to be "distant" during the building walk through. One of its retail property managers shared Pediment's belief that tenant retention was key to investment performances, and committed itself to understanding its tenants' businesses, even to the point of offering "image" and visual merchandising consulting to them. This management company, which was located nearly 100 miles away from one of its properties, bolstered its efforts through local third party representation, and conducted its own biannual tenant satisfaction surveys.

Property Management Results / Initiatives for the Future

In its short existence, Pediment had not quantified the savings proceeding from the reduction in providers. It assessed a manager's success primarily on the previous years "financials" and leasing activity, adjusted for market cycles. Pediment did not keep other "scorecards", and relied heavily on the impressions of individual asset managers to determine whether the service was adequate or not. There were no concrete plans to standardize new initiatives connected with compensation and incentives.

One director noted that he considered property management to be a commodity, largely because the highly competitive environment ensured that innovations developed by one property management company were quickly copied by others. Companies offered a range of similar services that were not easily differentiable, except on the basis of price. Despite the company's policy to keep asset and property management distinct, the director said that he hoped at least some property management firms would upgrade their staffs in the future to be able to offer asset managers stronger analytic support and assistance in strategic planning. He felt that firms that could do this would enjoy a competitive advantage over their peers.

Case Study 3 - JMLI, Finial Real Estate, & Triangle Management

The Institutional Owner and the Portfolio

Finial Real Estate Advisors was a wholly owned subsidiary of the James Madison Life Insurance Company (JMLI). In 1996 it managed over 17 billion dollars in real estate equity. Of that total, approximately 5 billion dollars were for James Madison's general account, 9 billion for domestic pension funds, and 3 billion for foreign investors. It had over 1000 properties in its portfolio. By area, approximately 30% of its holdings were in retail, 42% in offices, 23% in land and industrial, and 6% in hotels. Finial's assets were located throughout the United States, with slightly higher than average concentrations in the Northeast and Northwest.

Finial considered itself a generalist in the real estate industry, active in all facets of real estate advisory. It was a decentralized company, operating 14 full service regional offices, where it offered investors, among other capabilities, expertise in acquisitions, asset management, dispositions, research, and financing.

Finial: Setting The Property Management Strategy

In 1988 Finial created a subsidiary firm, Triangle Management, to offer property management services. The decision to do this grew out of frustration with the quality of these services typically available on the market, compounded by a desire to retain the fees and profits being paid to others. Finial also wanted to be assured of receiving priority service from its property management providers, and to bring a measure of standardization to its operations.

One regional director for Finial observed that having in house property management conferred advantages in more situations than had been anticipated when Triangle was originally formed. During the late eighties and early nineties, when many borrowers from its parent company were in financial distress, Finial found that it could negotiate favorable workout terms in part because it had a highly capable property management firm on board. Finial's borrowers could not argue that, as able property managers, they were essential partners in the deal, when Finial was convinced it could do the job just as well.

At the same time, Finial was not obliged to use Triangle for all its needs, and selected its property managers from Triangle and other qualified firms based on an even handed assessment of all the competitors' strengths and weaknesses. Still, as one asset manager put it, "Triangle is good for our type of owner." Triangle, like Finial, had a large, broadly diversified portfolio. In many cases the firms traded personnel back and forth, which had the effect of enhancing their familiarity with each other's policies, procedures, and expectations.

When Finial selected Triangle for property management duties it generally did not include brokerage responsibility beyond renewal listings. Finial wanted to be able to give its clients exposure to the market which it felt it sometimes could not get from its own subsidiary. In cases where Finial hired an external provider for a full menu of property management duties it often did so primarily in order to get this strong local representation.

Asset managers at Finial emphasized the desirability of selecting property managers on the basis of their suitability for the current asset strategy. They expressed readiness to switch managers when changing strategies, even if the manager in question had successfully executed a prior plan. When contemplating a repositioning, Finial looked for managers with redevelopment and leasing skills, and for familiarity with local politicians and regulatory agencies. If a particular firm was not strong in the day to day operations of the property, once repositioned, Finial would not hesitate to replace it. While acknowledging the virtues of consolidating property management providers across a portfolio of properties, one Finial asset manager indicated that he would contemplate hiring separate managers for each property if that achieved the best alignment of management capability with asset strategy.

Triangle's Organization and Strategy

By 1996 Triangle had evolved into two separate firms, Triangle Retail and Triangle Management and Leasing. Both were leaders in their respective fields. Triangle Retail was one of the country's ten largest managers and developers of regional shopping centers. Triangle Management and Leasing (hereafter "Triangle") was one of the top three property managers for all other forms of commercial real estate, managing more than 120 million square feet in the United States and abroad. Because of the extent of its business volume and geographic coverage - it was active in all regions of the country - Triangle brought its own economies of scale to its engagements.

Triangle enjoyed considerable autonomy from Finial. From its inception it marketed its services to potential clients other than its parent company with such success that by 1996 only 30% of its business came from Finial. Triangle managed approximately one half of the property in Madison Life's general account. Despite its distinct name and operational independence, Triangle executives recognized that perceived conflicts of interest would prevent them from selling to Madison Life's competitors, and even to many of Finial's. In recent years Triangle had begun to successfully develop business with the corporate real estate departments of some of the country's major manufacturers and service companies.

Triangle tried to co-market its operational and leasing capabilities. It argued that combining the two facilitated communications and improved strategic planning for the asset. A particularly critical time with potential for conflicting agendas between separate brokers and property managers occurred when new tenants were being courted. Triangle felt that it could make the case that the possible excesses of the commission-driven broker could be mitigated if that broker had to "answer to" his or her colleagues in operations.

One of Triangle's selling points to potential clients was its "incentivized" compensation program. Many of its employees received a base salary plus a "variable" which depended on good performance, such as reducing expenses or boosting occupancy, in their area of responsibility. High level property management staff received bonuses directly tied to the investment performance - measured by NOI in some instances - of the asset or portfolio of assets. Triangle felt that this kind of close alignment of incentives with the interests of the building owner differentiated it from other property management providers. Finial was, of course, familiar with these incentive programs, and thought highly enough of them to look for them in the proposals of external providers seeking engagements.

Triangle executives characterized their firm as decentralized and entrepreneurial. They believed that value was added at the properties where the customers were. As a matter of principle, they kept Triangle's headquarters operation lean, dedicated only to articulating the company philosophy and disseminating expectations for quality and consistency to the regional offices. Decentralization was also a necessary response to changing economic conditions; fees slashed by competition would not support multi-layered hierarchies. Property managers in the field retained all decision making responsibility for their properties, managed their own accounting, and were not subject to centralized review of proposed expenditures for capital equipment and services (they would, of course, review

significant items with their counterpart asset managers). Delegation to and empowerment of frontline personnel were key ingredients of Triangle's management philosophy.

Triangle did have a support services group located at its corporate headquarters. It researched and developed ways for Triangle to further differentiate itself from other management companies, and provided marketing support. Triangle staffed this group with specialists - one or two per discipline - in finance, information services, administration and real estate law. Many of the initiatives developed by Triangle's central support group relied heavily on technology and would impact all the operational aspects of property management. Triangle was looking for ways to make its reporting systems cheaper, better and faster. It had devised automated methods to track service visits, and had put in place elaborate measurement systems for gauging customer satisfaction.

Beyond exploiting technology on behalf of operations, Triangle also wanted to improve the quality of its staff. Like many observers of the real estate industry, Triangle's senior executives believed that property managers needed to be more "value oriented", able not just to implement cost savings, but capable of ascertaining whether these cost savings ultimately yielded value to the tenants and investors. While not claiming to have devised the definitive profile of the ideal property manager, human resources specialists at Triangle headquarters had adopted a testing program to generate motivation profiles for job applicants in all the property management subdisciplines. One Triangle director said that the ideal lead property manager would possess skills in sales, numbers and engineering. If a composite couldn't be found, he said that he would value the persuasive skills of the salesperson above the others. A person with these skills could organize and direct a team where others contributed the accounting and engineering skills, and deal effectively with asset managers.

Building Operations

Finial, Triangle's parent company, did not insist on standardized operating procedures for its property managers, and had not created guidelines for them except in areas where there were potential liability issues. Finial provided its property managers with uniform guidance on environmental and life safety strategies, but valued local knowledge. Finial expected its property managers to inform them when state or local law, or simply political exigencies, required a tailored response.

Some of Finial's asset managers speculated that operating expenses in many of their properties had been reduced as far as they could go. They saw greater potential for adding value in improving the product they could offer their user base. To them, this belief only underscored the importance of retaining property managers with superior knowledge of the local market. Locally attuned players could make informed assessments of the real worth of strategies such as adding parking, upgrading lobbies, changing tenant mix, or providing amenities such as limousine services.

Triangle ran a national purchasing program for standard building equipment, supplies, and services. It used the negotiated prices to set a bar and encouraged individual property managers to make better deals if they could. The preferred provider's price carried no condition of exclusivity. Although Triangle pursued this strategy, at least one Triangle manager remained unconvinced that national purchasing automatically produced lowest unit cost opportunities. Since Triangle courted corporate real estate work it had often been asked to demonstrate how it could outperform existing in-house corporate real estate units. Determining if Triangle enjoyed purchasing advantages over the in-house unit for similar lists of equipment and supplies was usually an integral part of making this case. In making this comparison, the manager often found that the best price did not go to the entity with the clearest scale advantages

The Performance Measurement System: A core philosophy at Triangle was that processes could only be effectively managed if they were measured. In three years Triangle had created and refined an elaborate measurement system to track performance data at its properties. It aggregated this data and returned it to the field, repackaged to enable the user to better spot trends and make comparisons. Triangle wished to put as much information as possible in the hands of its frontline personnel, in as useful a format as possible. The system designers created a vehicle for delivering data to the field which in volume, accuracy, and turnaround speed far surpassed what even senior managers had access to just a few years before.

Selecting Data to Measure: In crafting the system the designers had to determine what kinds of data would be of most use in the field. They solicited input from the property managers on this issue, and quickly came to realize that a "supply side" approach to determining the roster of items to track might be productive. They argued that rather than simply choosing what to measure based on conventional notions of which operations merited the most attention, it might also be valuable to see what kind of data they were

already getting, and to what better use it might be put. Property managers all over the country were submitting monthly management reports, but these varied considerably in the range of items covered and depth of detail. Triangle decided to take an inclusive approach, coming up with a "data screen" that incorporated measurement categories from properties throughout its organization. At this writing the system measured 86 separate items.

Triangle strategists formalized and standardized the data screen and included it in a procedures manual. The data collected fed four distinct information systems - work order, accounting, preventive maintenance, and management reports - and illuminated seven functions which were critical determinants of financial performance: marketing and leasing, maintenance and engineering, customer service, administration, accounting and reporting, project management, and human resources. Examples of some of the individual items measured were security, parking income, elevators, janitorial services, energy use, preventive maintenance, unscheduled maintenance, quality of the management staff and services, engineering and administrative staff overtime, leasing percentages, and callbacks. The performance measurement system recorded data in these categories in fine detail. It measured elevator performance, for example, according to door action, entrapments, lights and buttons, noise, speed and response time, leveling and shut downs.

Presentation of the Data: Conceptual work on the data system had only just begun with the selection of data categories. System designers next had to think about how the data could be most effectively organized and presented. They needed to confront fundamental questions of how the data should be aggregated. They decided, for example, that information from properties of varying sizes could be combined, but that attempting to merge data from different building types would not be illuminating. Triangle directors were surprised, yet gratified, to discover that only a handful of the measurements were region specific. The system's architects felt that presenting the data in spreadsheet form alone would almost guarantee that it would not be fully exploited. They decided to associate graphs with the data in order to make the reports easier to use, and hence more likely to be used, and to make trends over time easier to apprehend.

The system's designers decided to present much of their numeric data in ratio form. This was a useful way to ensure that data about an item was always placed in context with the appropriate baseline so that performance could be meaningfully evaluated. The ratios defined how performance would be assessed across all of Triangle's properties, permitting benchmarking. To illustrate, marketing and leasing personnel could use two ratios: the

prospect ratio and the renewal ratio. The prospect ratio was square feet needed by prospects divided by square feet of available space, and the renewal ratio, tenant square feet renewed divided by the total square feet of expiring leases and early renewals.

Obtaining the Data: In designing its tracking system Triangle had to decide where to acquire the data. Logic dictated that obtaining data from its own properties would be easier, and more reliable, than getting it from others. Given the number of properties it managed and its broad geographic coverage, Triangle could consider its own operations a statistically valid sample for this purpose. Triangle's benchmarking would thus be self referential, but, in the opinion of Triangle executives, valuable nonetheless. Like many other property managers Triangle cited the difficulty of obtaining reliable information from competitors, although it noted that in certain parts of the country consensus had developed among local players that sharing information was more beneficial in the long run than hoarding it. In these locations, often under the auspices of BOMA or IREM chapters, a kind of local benchmarking did take place.

At each property Triangle designated the receptionist's desk as the principal locus of data input. As tenants made requests for service, the receptionist would enter them directly into the data system, and would duly note the arrival and departure of the service personnel. An add-on module to Triangle's accounting software, along with the use of bar code technology, allowed property managers to track scheduled and unscheduled maintenance on all pieces of equipment. With initiatives such as this Triangle sought to make the data recording process as effortless and accurate as possible. Triangle officials reported that many of the maintenance workers, now routinely equipped with bar code scanners, were delighted not to have to write anymore and to be catapulted into the "computer age." As a result, one Triangle executive suspected that a much lower percentage of service visits were going unreported.

System Technology: System designers discovered that the relational database in the integrated package of business applications already used at most of its properties by Triangle was ideally suited to its purposes. They found that they could "open up" the firm's accounting software so that accounting and leasing information could be swept into the master database and the results distributed to any regional office or property overnight. One Triangle executive asserted that there were little or no incremental hardware or software costs to setting up the data system. The system was PC based, and in its earliest incarnations did not even require state of the art microprocessors. As Triangle upgraded it

with new features, faster computers were required, but in many instances Triangle was pleased to find that the building owners would purchase the new equipment. Many of the 84 items tracked were not applicable to all the properties Triangle managed, and Triangle made sure that the system in its core form was cost effective even for small properties.

System Applications: Triangle emphasized that it developed the system first and foremost for its managers in the field. Senior Triangle officials wanted these field staff to have first crack at the enhanced data in order to learn about their own work processes and to discover where there was room for improvement. They recognized that the field managers could worry that the information would be misconstrued by asset managers, and delayed production of regional comparison graphs until the system had been in effect for a year and a half, so that reliable national averages could be established.

The system's proponents thought that the system was an ideal vehicle for continuous improvement. In their view a system of measurement enabled property managers first to frame a goal, then to mark their progress towards it. They also noted a less lofty motivation: requiring the property managers to produce the measurements ensured that they would do the work. Triangle inspection teams visited the properties twice annually to verify that the managers were using the system of performance indicators properly.

The system made available accurate, highly calibrated information on a wide variety of programs and processes. Triangle's support center maintained a database of leasing terms in effect nationwide. This information provided valuable backup to lease negotiators, particularly when dealing with a potential tenant who was already in a Triangle property in another part of the country. Through the addition of the work order module to the accounting software, it was now possible not just to record what maintenance personnel did in a day, but also exactly what proportion of the day was spent productively and what was "down" time. The "supply side" approach to data, which captured data that might have seemed optional to many managers, began to pay dividends. Security system measurements turned up a distressingly high monthly number of false alarms in Triangle buildings which lead to investigations unearthing potentially serious problems with the wiring of life safety systems. A nuisance which might otherwise have been tolerated, when recorded and observed over time, instead became a red flag, prompting necessary corrective action.

Reporting, Accounting, Data Collection, Communications

As noted, creation of the enhanced database system involved adaptation of Triangle's existing accounting system. The significant expansion of measurements tracked included several new accounting items, many of them requested by Finial. The implementation process for the refined accounting and reporting system followed much the same sequence as it had for the building operations segment. Use of the system uncovered hidden problems, then it enabled what Triangle executives termed "defect correction" to occur. For example, shortly after putting the system into effect, Triangle discovered that the interpretation of escalation clauses in leases was a wide open affair, with as many as 20 different variants currently in use. It quickly moved to standardize this important accounting measure, through offering system-wide training to its property managers in the intricacies of lease contract language.

Triangle managers used their system's capability to produce refined measurements to improve the timeliness of rent receipts. Triangle had followed the industry norm, checking for missing payments at 30 and 90 days past due dates. It decided to begin checking earlier, at 10 days past due. It found dismaying delinquency levels at this earlier date, and began to issue reminders much sooner to the late paying tenants. In 2 years since instituting this new measure paid up rates at 10 days increased 40%. As an unexpected bonus, paid up rates at 30 and 90 days also increased. Triangle's cash flow looked better, and it saved on some of the "compliance assurance" costs it would have otherwise incurred. From this, Triangle executives concluded that their "early warning" system had imposed a rewarding discipline on managers and tenants alike at the correct point in the process.

One Triangle director said that the new measurement system was not reinforced with an incentive program for the property managers, noting that he preferred "friendly competition" between properties. Although Triangle had the incentives alluded to earlier for certain broad measures such as improvements in NOI, this particular director was leery of having too many spot incentives. In his experience he had found many highly regarded property management staff who had excelled at the measured procedures that carried cash "rewards", but had neglected everything else. Sometimes incentives were too strong. In one case, where another company had offered its managers bonuses on a quarterly basis for keeping "arrears" down, the policy had engendered such an ambitious response that it created a tenant relations fiasco. Triangle had managed to get its 10 day late list in better shape without a cash incentive.

All property managers were required to use Finial's own proprietary software for financial reporting. The providers also had to be networked to both its regional and headquarters offices. For its part, Triangle made monthly reports to Finial, including a summary of operating results, accounts receivable and payable, rent rolls, lease expirations and marketing activity, budget variances, and subsidiary information such as real estate tax payments and descriptions of any litigation involving the properties.

Property managers who worked at properties in Madison's general account had to begin supplying budget data to Finial asset managers in January of the preceding year. They were thus engaged in budgeting as well as monthly accounting activities simultaneously for much of the year. Madison's size, the complexity of its investment holdings in vehicles other than real estate, and its status as a public company made a multi-stage budgeting process inevitable. This meant that the property manager, as the originator of the pertinent real estate information, had to get started early and exposed the budget to necessary revisions as the year wore on. This was particularly true with certain assets, such as hotels, where asset managers felt that beginning year projections were simply too speculative to be useful for long.

Tenant Relations / Tenant Retention

Triangle's quality management program established customer focus as the first priority. Many of the tenets of the program were oriented towards ensuring that the personnel in constant touch with tenants were up to the task. Property managers who "managed by fact" using the data provided them could break down a process and assess the value contribution of each part. As a result, they would give better service. If Triangle provided its employees with continuous education and assessment, urged them to take responsibility as individuals, encouraged them to form teams to solve problems, and used its diagnostic skills to put the right people in the right places, then tenants, and owners, would benefit.

Triangle did run a continuous series of training courses for its employees. Most of the courses were in building operations - preventive maintenance, energy management, building systems, environmental and code compliance, etc. - and many, not surprisingly, were in the use of the performance measurement system itself. Triangle issued periodic tenant satisfaction surveys in which both its staff and its service were evaluated. Triangle also submitted itself for evaluation by the owners, its own employees, and third party brokers.

Significant points of evaluation in the owner survey were renewal percentage and "positioning in the market", the item that many of Finial's managers had highlighted as most important to them.

Triangle's property management procedures manual contained a standardized tenant satisfaction survey to be distributed annually. Once again, the building's receptionist served as the point of entry for the data. One distinctive feature of Triangle's survey process was that its data measurement system permitted full text comment entries. In keeping with the "more is more" philosophy of data management, Triangle did not condense tenant comments or blur them with an inflexible numbered box format. Triangle officials performed trend analysis on the comments, just as they did on more easily quantified items, such as equipment maintenance procedures.

Results of the Property Management Program / Future Plans

Triangle's performance measurement system had been in effect for about three years, but the firm had not yet formally assessed its contribution to investor value. Triangle executives were happy with the system as a means of detecting defects in their operations. They felt that in the three years the system had enabled frontline managers to move from average performance to above average, and that the system would prove to be a durable analytical tool, one that would point the way to further operational improvements for several more years. One of the executives said that he wished in the near future to change the emphasis from rooting out problems to using the system to substantiate good procedures and practices, and to disseminate them throughout the organization.

For the most part, the system worked as intended. One manager noted accuracy problems with some of the data, mostly at secondary and tertiary levels. He and his colleagues had found flaws in leasing data from time to time, citing incorrect lease expiration dates as one significant problem. Triangle was considering offering data from elements of the system to its customers, but recognized the need for better validity checking first. Despite the occasional glitches, a national consulting firm had recognized the system with its annual "Best Practices" award for technology implementation.

Triangle's recent involvement with corporate real estate work promised to reinvigorate its thinking about property management. Corporate management structures and real estate portfolios were, of course, significantly different from those of institutional investors. In

response, Triangle upgraded its performance measurement system substantially, consolidating its data entry procedures and, it hoped, improving efficiency. Corporate work, which often involved complicated sale / leaseback arrangements, demanded new financial sophistication of Triangle. It expected that developing these new capabilities would only help it in its core business with institutional investors.

CHAPTER FOUR - Analysis and Conclusions

Introduction

I argued in the first chapter that institutional owners of real estate are first preoccupied with structuring the organization of their property management function in order to produce significant near term cost savings. Once these savings are captured, they then turn their attention to enhancing the value of day to day property management operations.

In this chapter I present my observations about the three cases in terms of the analytic framework developed in Chapter 2. I will discuss the organizational choices the firms have made, and the rationales for their choices, in terms of the theory of vertical integration. I will discuss the efforts the companies are making to enhance the value of their property managers' services in the context of the theory of service quality.

Choosing the Organizational Strategy: Owners of investment real estate can elect to vertically integrate their property function or not. If they choose not to vertically integrate they can hire the service exclusively from local firms or from regional and national firms on a regional basis. Networks of local and regional providers also exist which purport to offer their clients some of the advantages of both local expertise and big company scale. Thus, the five general models for organizing property management are:

- Vertical integration
- Unaffiliated local firms
- National and unaffiliated regional firms on a regional basis
- Networked local firms
- National and networked regional firms on a regional basis.

In Chapter 2 I presented the criteria which, according to business literature, most companies use to evaluate the decision of whether or not to vertically integrate. They are: accountability, the strategic nature of the function, supply and demand, familiarity with client expectations, cost, scale and scope of business activity, specialization, and opportunity for shared learning. I maintained that if a company chooses not to vertically integrate, these criteria would also be useful in selecting from among the remaining options. A company will weight the importance of these criteria differently, and will develop rationales for their

organizational strategy accordingly. On the next page there is a matrix indicating my analysis of both the organizational choices which the three companies in the cases made, and which criteria they judged to be significant in making the choice.

	TJLI Cupola	FGLI Pediment	JMLI Finial Triangle
Organization of Property Management Strategy			
<u>Vertical integration</u>	<u>No</u>	<u>No</u>	<u>Yes</u>
<u>Unaffiliated local firms</u>	<u>Yes (via JRE)</u>	<u>Yes</u>	<u>Yes</u>
<u>National and unaffiliated regional firms on a regional basis</u>	<u>Yes</u>	<u>Yes</u>	<u>No</u>
<u>Networked local firms</u>	<u>No</u>	<u>No</u>	<u>No</u>
<u>National and networked regional firms on a regional basis</u>	<u>No</u>	<u>No</u>	<u>No</u>

Criteria For Choice Cited by Institutional Owner

<u>Accountability</u>	<u>No</u>	<u>No</u>	<u>Yes</u>
<u>Property management deemed strategic</u>	<u>No</u>	<u>No</u>	<u>Yes</u>
Supply and demand			
<u>Provider supply uncertain</u>	<u>No</u>	<u>No</u>	<u>Yes</u>
<u>Owner demand uncertain</u>	<u>Yes</u>	<u>Yes</u>	<u>No</u>
<u>Familiarity with client expectations</u>	<u>No</u>	<u>No</u>	<u>Yes</u>
<u>Contract Complexity</u>	<u>No</u>	<u>No</u>	<u>No</u>
Costs			
<u>Costs of hiring external provider</u>	<u>No</u>	<u>No</u>	<u>No</u>
<u>Start-up costs for in-house capability</u>	<u>Yes</u>	<u>No</u>	<u>No</u>
<u>External providers' cost structures</u>	<u>No</u>	<u>Yes</u>	<u>Sometimes</u>
<u>Economies of scale / scope</u>	<u>No</u>	<u>No</u>	<u>No</u>
<u>Specialized skills, knowledge, equipment</u>	<u>Yes</u>	<u>Yes</u>	<u>Yes</u>
<u>Opportunities for shared learning</u>	<u>Yes</u>	<u>Yes</u>	<u>Yes</u>

Enhancing the Value of Operations: In the real estate industry tenant retention is the measure of customer loyalty. The tenants are the principal customers of the owners of investment real estate. The owners expect property managers to act as their agents in seeing that tenants are satisfied and want to stay. Because tenants will often have options to move elsewhere, property managers must in many cases be able to add value to their properties to keep them. Owners of investment real estate expect their property managers to perform certain services on their behalf that do not impact tenant retention, mainly accounting and reporting. The owners will want to obtain more and more value from these services as well.

Theorists on quality hold that value can be enhanced in any enterprise by performing the work with the following attitudes and systems in place.

- prequalification, education and training
- open, omnidirectional communication
- compensation linked to performance
- full participation, teamwork, decentralization, frontline empowerment
- measurement, feedback, and benchmarking
- customer focus, market knowledge
- continuous improvement, long term perspective

In theory, property managers can set up these systems and imbue their operations with these attitudes to increase productivity and reduce costs. In this chapter I will analyze the data from the cases to see if they have done so, and what value they expect to create thereby.

On the next three pages I present matrices, one for each case study firm, which summarize practices of the firms which are in keeping with these seven attributes of a quality program. I list these practices in terms of the three main functions of a property manager - building operations, tenant retention/ tenant relations and accounting/reporting.

Quality Enhancements: TJLI - Cupola

Quality Initiative	Service Aspect		
	Building Operations	Tenant Retention Tenant Relations	Accounting, Reporting
Prequalification, Education, Training	multi disciplined support, field guidelines	field guidelines	MIS support, field guidelines
Open, Omnidirectional Communication	standardize business software; properties, central office networked, preferred maint. mgmt. systems		standardized accounting formats, reduced number of PMs, exploit flexibility fo software
Compensation Linked to Performance	some PMs organize quality competitions among properties		
Full Participation, Teamwork, Frontline Empowerment	guidelines not prescriptive; some PM quality programs include subs, vendors; PMs encouraged to have mgmt skill		
Measurement, Feedback, Benchmarking	energy consump measured, database begun, looking into merging maint., inventory control, accounting syst.s	encouraged PMs to use tenant satisfaction survey, t.s.s. addressed in guidelines, planning own survey	detailed monthly reporting, item by item cost savings reports, allocate savings separately to tenants, TJLI
Customer Focus, Market Knowledge	encouraged PM familiarity with vendors, agencies, rate structures	guidelines require PMs identify customer expectation of quality	
Continuous Improvement, Long Term Perspective	sought long term relationship with provider, held PM workshops, used national purchasing as targets to be exceeded		

Quality Enhancements: FGLI - Pediment

Quality Initiative	Service Aspect		
	Building Operations	Tenant Retention Tenant Relations	Accounting, Reporting
Prequalification, Education, Training	some engineering, legal support		some accounting support, field guidelines
Open, Omnidirectional Communication			standardized accounting software; property managers, central office networked
Compensation Linked to Performance	some bonuses linked to escalation capture, NOI improvement. Fee disaggregation under study	sometimes paid partial "commissions" for tenants retained	
Full Participation, Teamwork, Frontline Empowerment	fluid teams, PMs encouraged to think proactively, capitalize on tenant, market knowledge		PMs participate in budget, business plans
Measurement, Feedback, Benchmarking	no central system. Some PMs hold workshops, keep trend data, benchmark		accounting, leasing reports monthly; market reports, quarterly adjustments to budget projections
Customer Focus, Market Knowledge	values PMs with local contacts. conducts extensive market research	PMs held exit interviews, offered extra services	tailored reporting formats by clients' lines of business
Continuous Improvement, Long Term Perspective	sought long term relationship with provider, encouraged PMs to generate repositioning strategies		

Quality Enhancements: JMLI - Finial - Triangle

Quality Initiative	Service Aspect		
	Building Operations	Tenant Retention Tenant Relations	Accounting, Reporting
Prequalification, Education, Training	multi disciplined support, field guidelines, screening, training	multi disciplined support, field guidelines, screening, training	multi disciplined support, field guidelines, screening, training
Open, Omnidirectional Communication	integrated accounting / performance measurement; properties, central office networked		integrated accounting / performance measurement; properties, central office networked
Compensation Linked to Performance	some bonuses linked to NOI improvement		
Full Participation, Teamwork, Frontline Empowerment	PMs autonomous, generate repositioning strategies. Perf. Meas. system primarily for field use	performance measurement system primarily for field use	PMs autonomous, no centralized Triangle review of reports
Measurement, Feedback, Benchmarking	perf. meas. system tracks trends, national benchmarking, broker evaluations	perf meas system tracks trends, national benchmarking, client evaluations	accounting, leasing, market reports monthly, refined accounts receivables policy
Customer Focus, Market Knowledge	values PMs with local contacts	tenant satisfaction survey	
Continuous Improvement, Long Term Perspective	sought long term relationship with provider	perf. meas. system to spot trends, set goals over long term	

Section 1 - TJLI and Cupola Management

Choosing the Organizational Strategy: The centerpiece of TJL's property management organizational strategy was to create an in-house group, Cupola, to select and direct external property managers in all activities except leasing. It gave this group the double mandate of lowering costs and improving the performance of property management. Cupola's first initiative was to dramatically consolidate the roster of property managers already working for TJLI. It chose regional and national firms almost exclusively for this work. While the consolidation was in process, and after it was completed, Cupola systematically worked to enhance the value of property management operations.

In TJLI's organization, JRE managed the leasing component of property management. Some of its providers were local firms. JRE was willing to forego a degree of simplification and standardization and the other advantages of "going regional" for the presumed benefits of local representation. Taken together, Cupola and JRE managed property management for TJLI using firms from every category of external providers. They thus adopted a hybrid version of two of the general property management models.

TJLI chose not to vertically integrate for many reasons. It felt it could control the quality of the services it obtained from outside providers, and was not concerned about conflict of interest issues. It did not think of property management as a strategic function. It was concerned about the organizational shake-up required to start a new capability, and uncertain enough about sustaining owner demand in all the markets where it would have to establish a presence as a property manager. It wanted to obtain specialized knowledge and capabilities, and it wanted to be exposed to, and learn from, the experience of other entities. While TJLI was large enough to enjoy economies of scale by itself, it wanted its external providers to contribute pricing advantages of their own based on their size and market coverage.

TJLI's organizational strategy had both centralized and decentralized elements (see diagram, end of this section). The Support Group constituted the centralized function, issuing guidelines and standards (albeit with input from the regions), and serving as a common resource to Cupola's regional directors. Questions and issues from the field were directed to the Support Group and shared among its staff, and could quickly be grouped into the collective knowledge of the company. By contrast, Cupola located its regional directors throughout the country. These directors had decision making authority in their regions, with recourse to the Support Group for advice. External fee managers reported to Cupola

regional directors. Thus, technical expertise was centralized, while authority was decentralized.

TJLI chose its organization because it felt that leasing and operations were functionally differentiated enough to warrant two management entities. It believed that leasing was a local operation and required certain specialized skills. It believed that property management operations, on the other hand, could be "imported" and that economies of scale, simplification and standardization were more compelling criteria for the selection of these providers.

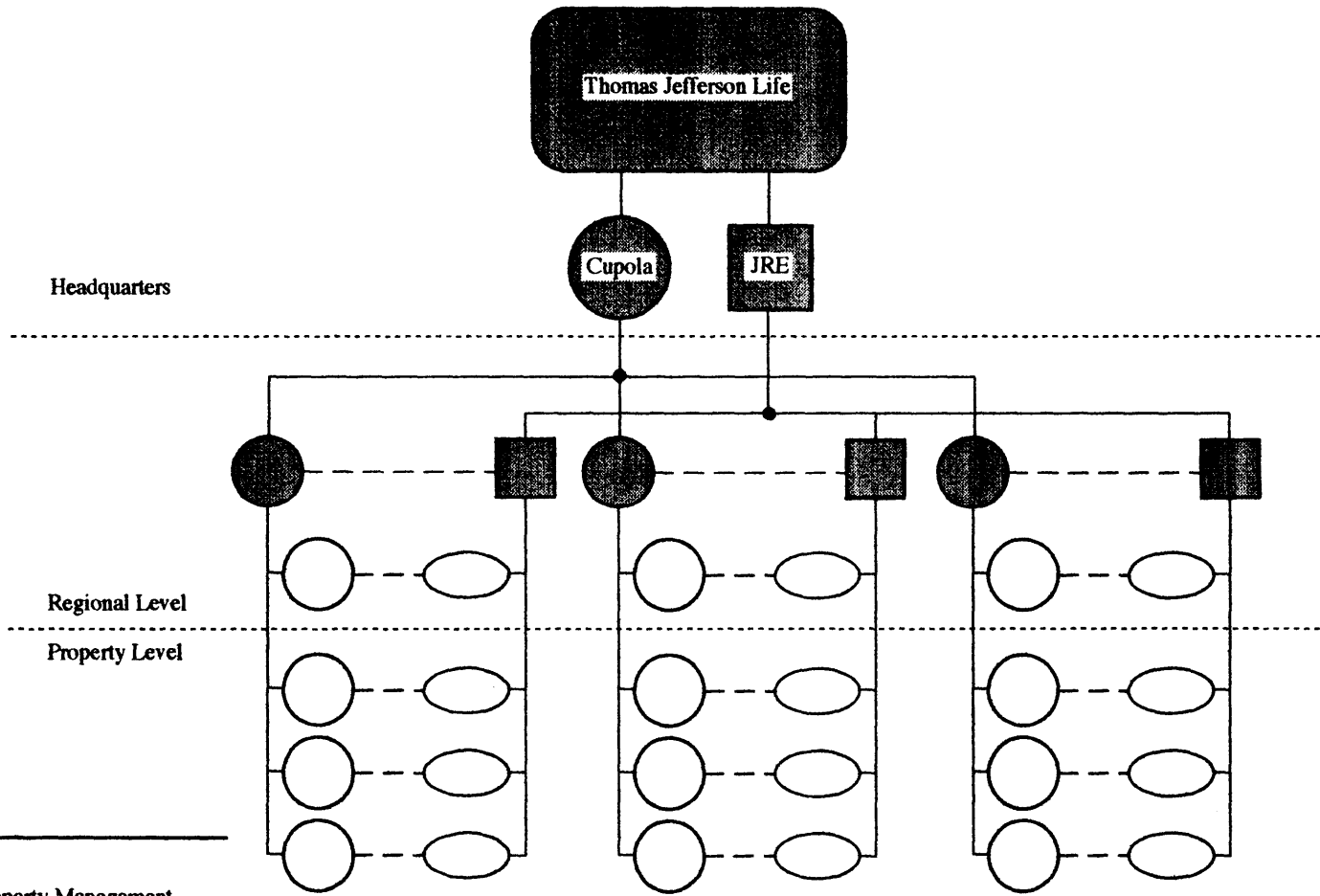
Enhancing the Value of Operations: Cupola networked the property managers (sometimes the properties themselves) and the regional offices together to enhance communication. This was important because Cupola's management structure was quite dispersed, yet its various elements needed to be in contact. Regional directors and the support services were in separate places. Cupola and JRE both had regional directors, again in different locations, who would often be managing different entities for the operations and representation of their properties. It was very important that all these parties keep informed of each other's activities.

Cupola believed that it could improve the performance of its property managers through generating data about its properties. Cupola was in the process of identifying general data and performance measurements it wanted to collect, but had not completed design of a system for codifying it and determining who would benefit most from it. Cupola was developing a tenant satisfaction survey of its own to obtain standardized, unbiased view of what tenants across their portfolio thought of their property management service.

Cupola did not believe in structuring its property management contracts with incentives tied to performance. It felt such incentives were often counterproductive and that they were not needed in the present economic climate when property managers would be adequately motivated simply by their desire to retain the engagement. Cupola did document the value added (cost saved) of every initiative undertaken by its property managers, and determined how much should be allocated to the tenant and how much to the owner. This data could be used to apprise both groups of Cupola's customers how much they benefited from Cupola's work.

Certain of Cupola's policies enhanced their control over external property managers at the possible cost of diminishing their flexibility. Property managers could not contract for materials or services above a certain dollar amount without approval from regional directors. Cupola provided detailed guidelines for almost all of their property managers' duties, and the expertise and oversight of its Support Services Group. The guidelines provided what Cupola thought of as a lower bound on service quality, and Cupola did encourage its property managers to take the initiative to do better.

Case 1 Analysis Summary: Cupola had measured the results in cost savings of its consolidation policy, and was happy with the results. Although it had decided not to vertically integrate, it had still formed a fairly elaborate internal management structure largely to assure the accountability of the property management function. It had embarked on enhancing the value of its property management operations in the field, but had not completed all of its planned initiatives. Its internal structure was geared towards monitoring and controlling property management.



KEY

Internal

- Property Management
- Asset Management (leasing only)

External

- Property Management
- ◌ Leasing Agents

solid lines indicate primary report, dashed lines working relationships
 diagram is schematic and does not indicate the exact number of offices at each level

Section 2 - FGLI and Pediment

Choosing the Organizational Strategy: Pediment's core organizational strategy was to decentralize its own management functions as much as possible, and to hire external property managers who were strongest in their markets whether they were local, regional or national operations. It did not have any dedicated internal property management function. Instead it established teams in each region charged with all aspects of real estate investment management, among them selecting and directing property managers. These teams had little input from a central source except in accounting matters. Consistent with its determination to remain nimble, Pediment kept the teams lean and hired consultants and property managers who could bring innovative thinking about their role to the assignment. (see diagram, end of this section)

At the time this is written Pediment was undertaking a consolidation of its property management providers. It intended to create economies of scale, simplify reporting, and engender greater responsiveness from its providers with the consolidation.

Pediment solicited third party business. Its institutional "parent" created it to manage the properties in its general accounts, but also made it a profit center, able to work for others and to develop its own investment products. Conscious attempts were made to give Pediment an identity distinct from its parent. Its decentralized structure and autonomy allowed Pediment to get close to its independent customer bases.

Pediment's principal reasons for hiring external providers were that it did not feel it could provide property management itself in a cost effective manner, and that it wanted the best specialized skills and knowledge the market could offer. Its investment strategy called for it to move in and out of markets and it did not want to create and dismantle management structures accordingly. Its perception of its fiduciary role also contributed to the determination of its organizational strategy. Pediment believed that it could not vertically integrate the property management function because it felt obliged to "expose" it to market discipline periodically, and that this could not be done convincingly with an in house entity. Pediment believed that it had to keep property management free of conflicts of interest, and so restricted its list of eligible firms in certain markets.

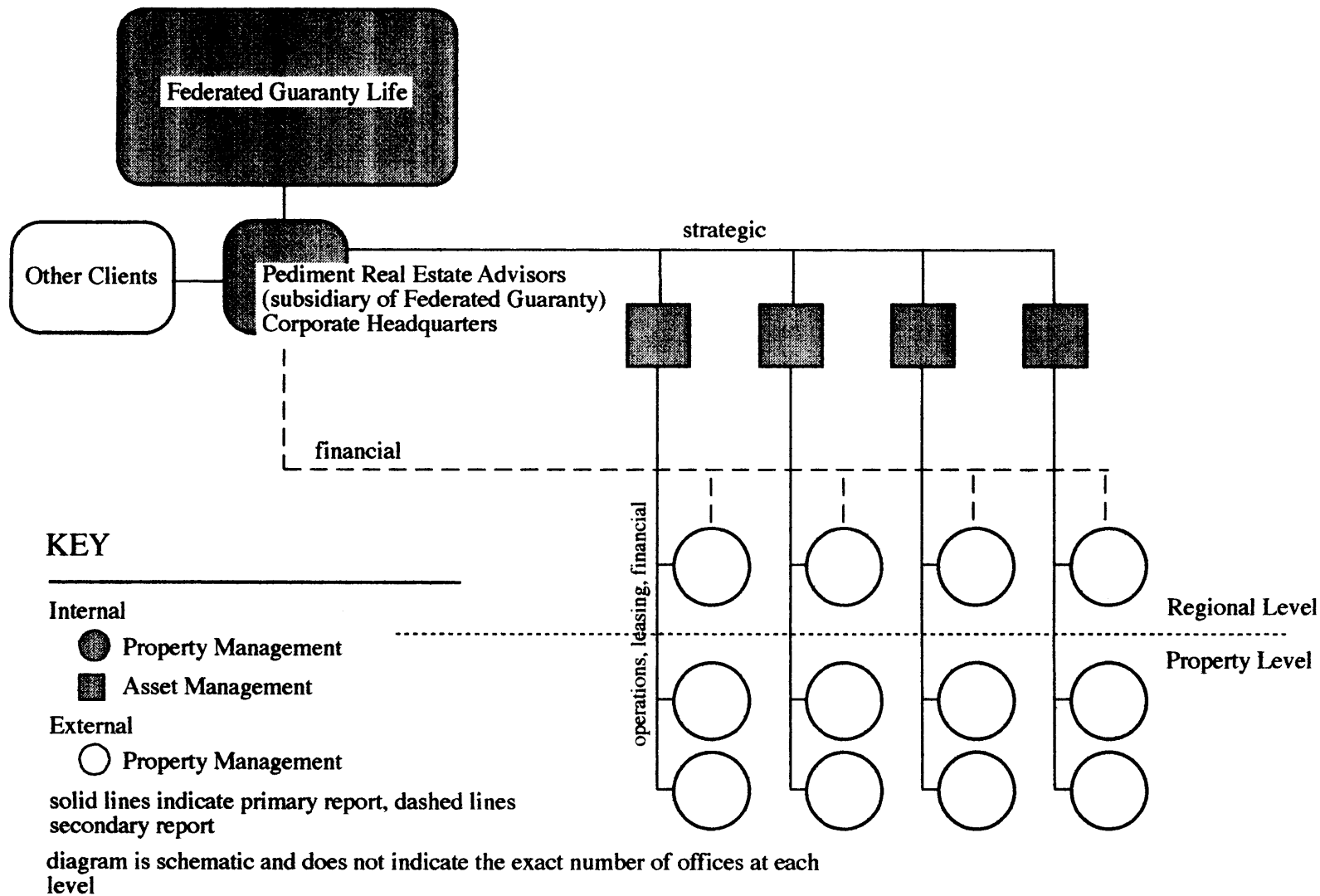
Enhancing the Value of Operations: Pediment's asset managers worked closely with its property managers to ensure good performance, but Pediment had made comparatively few

formal initiatives to improve the quality of their operations. Pediment did smooth communications by networking its property managers and both its regional and headquarters offices, and standardizing accounting software. It had established some compensation programs linked to performance and was contemplating more. Although it did not maintain a central database on performance measurements, a number of its providers did, benchmarking against their own portfolios. To complement its insistence that its property managers maintain a customer focus, Pediment performed in depth market studies annually, and with each investment "event." Pediment's decentralized and lean organization necessarily gave the property managers considerable autonomy.

The lack of a central "clearinghouse" for anything but market and financial data meant that information on good practices in building operations and tenant relations might not get circulated throughout Pediment's organization. Information came in various forms from the field and could not be readily integrated.

Pediment hired property managers who could think proactively about the assets and could be responsive to tenants. It particularly looked for demonstrated skill in value enhancing repositioning programs, and for managers who could make important contributions to annual budgets and business plans. Still, some directors at Pediment considered good property management a commodity in adequate supply in the current buyer's market. They were not inclined to build programs to enhance the value of property management, particularly when many of the external managers demonstrated that they would do it themselves.

Case 2 Summary: Pediment was a very new organization. It had begun a consolidation of property managers for which it had high hopes, but as yet no hard numbers with which to evaluate the success of its strategy. It did look to property managers to add value in performing their duties, but left quality initiatives largely up to them. It placed great emphasis on the competitive advantage of integrated information processing, what it called "seamless information", but had not yet found the system technology to support this ideal.



Section 3 - JMLI, Finial and Triangle

Choosing the Organizational Strategy: Finial Real estate Advisors had its own property management subsidiary, Triangle Management. Finial and Triangle had nearly parallel structures (see diagram, end of this section). Both were essentially decentralized, having autonomous full service offices in most regions of the country. Both had a headquarters office which, in Triangle's case, performed a formal processing function for data coming to and from the properties, as well as developing guidelines, setting hiring practices, and marketing for the whole company. Triangle's headquarters office stayed out of the direct report line between the field offices and the asset managers, even when Finial hired external property managers. Finial and Triangle both solicited third party business.

Finial emphasized integrating the property management function with asset and portfolio management as a means of ensuring clear communication between parties and consistent quality. It regarded property management as a strategic function, using Venkatesan's three tests. Finial and Triangle together clearly believed 1) that property management was important to both customer groups, owners and tenants 2) that it was a specialized skill, as witnessed by their training and employee screening programs, and 3) that creative use of technology could play a significant role. Finial explicitly mentioned the benefits of having a property manager with an "insider's" perspective on its culture and policies. It did not believe that the market was adequately supplied with competent property managers. It cited the significance of recapturing revenues and profits that would otherwise be earned by external providers. Given these beliefs, Finial's decision to create an in-house capability is not surprising.

Finial blunted concern about uncertain owner demand by creating Triangle as a profit center. When Triangle was first established it had regional offices in exactly the same cities as Finial. By 1996 both entities had evolved their operations enough so that each was represented in certain cities without the other. By giving Triangle a mandate to develop third party business, Finial insulated it to some degree from its own business cycles.

Notwithstanding its endorsement of having in-house capability, Finial would not hesitate to use property managers other than Triangle, if competing firms had compelling specialties, particularly local knowledge. In fact, it hired many external providers, making its model of organizational strategy a hybrid of vertical integration and the use of local firms.

In its fiduciary role as an advisor to its parent company Finial would not hire fee managers who worked for, or were associated with, its competitors, citing the perceived conflicts of interest. Triangle did not even bother marketing to Finial's competitors. Finial did not, however, stress the importance of annual rebidding in the market, though it did claim willingness to replace managers, even Triangle, for strategic reasons.

Enhancing the Value of Operations: The centerpiece of Triangle's quality enhancement program was a detailed performance measurement system which was integrated with accounting data and which permitted users to benchmark with Triangle properties nationwide.

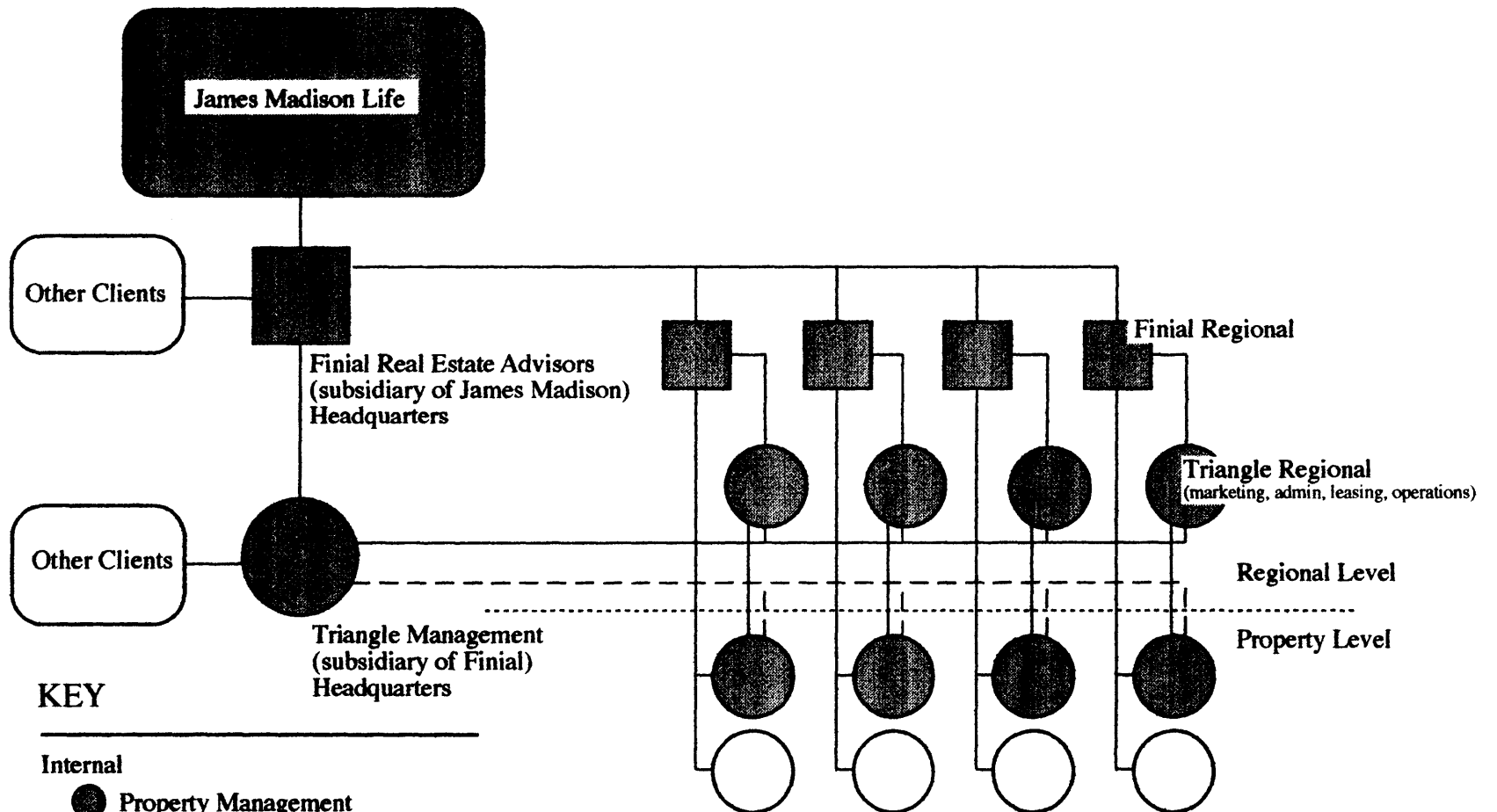
Triangle produced a multi-volume set of guidelines for its on site staff, produced extensive diagnostic materials to ensure that the right people were hired for the right task and team assignments, and conducted numerous function specific training classes. Although the company stressed empowerment, its training was largely technical and did not appear to have a process management component.

Most of Triangle's properties were networked - this was essential for the performance measurement system to work - and it insisted on standardized software for accounting. It had installed a common computer "language." Its proprietary accounting, reporting, and performance measurement system was used universally among its buildings.

A necessary prerequisite of a reward for performance program is a good measurement and trend analysis system. Even though Triangle had such a system it was reluctant, at least through 1996, to use it for determining bonus payments and compensation levels. It cited the potential for "punitive" use of the trend data by management. Triangle preferred to use the system to have underperforming managers attempt corrective action on their own, with trying to equal the national benchmarks as the incentive.

In its handling of its field staff, Triangle endorsed concept of frontline empowerment. Its hiring manual described independent, "able to think on their feet", individuals as ideal property managers. It designed its performance measurement system to put the kind of information into the hands of the property managers that would enable them to act independently.

Case 3 Summary: Finial was happy with its decision to maintain an in-house property management entity. It felt that in the several years of its existence Triangle had demonstrated that it could bid its services at rates competitive with outside providers. In creating Triangle, it had accomplished a de facto consolidation of property managers. Although its quality initiatives were new, Triangle had clear indications of improvements in various individual processes. It claimed that the performance measurement system had been inexpensive to implement. Triangle's headquarters office acted on occasion as a passive conduit, simply packaging information and sending it back to the field to be used however the managers at the properties wished. In other instances it proposed initiatives, such as the revised accounts receivable tracking system mentioned in the case, that eventually became broad policy.



KEY

Internal

● Property Management

■ Asset and Portfolio Management

External

○ Property Management

solid lines indicate primary report, dashed lines secondary report for operations purposes

diagram is schematic and does not indicate the exact number of offices at each level

Section 4 - Conclusions

Most of the theorists on quality and performance enhancement programs cite as their most important component adopting continuous improvement as a corporate aspiration. They feel that the only way to ingrain all the good habits of a quality program is if the expected gains are not perceived as finite. There is dispute among the theorists about whether setting any kind of performance improvement goal is wise (Dobyns 181), but all agree that if goals are set, meeting them is no reason to scrap the program. Instead, the continuously improving company seeks new goals.

All three firms in the study exist as responses to great changes in the real estate industry. In some sense, Triangle was created to cushion the blow of the real estate recession, Cupola and Pediment to deal with its fallout. For much of their existence, Cupola and Pediment have been preoccupied with consolidating their property managers. Cupola has documented the success of its effort in fee savings; Pediment is confident that it will have similar results. Finial, with Triangle long established as its de facto consolidation strategy, did not feel compelled to further pare down its roster of managers. There appear to be no more dramatic gains to be had from tinkering with the property management organization chart. All of the firms expressed satisfaction with their property management strategies at this level.

All of the firms are now looking beyond their initial organizational restructuring to determine where property management strategies can continue to enhance value. Cupola continues to look for cost savings, to effectively control property management through standardization and oversight. More than the other firms, it is attempting to define its "architectural knowledge" in order to guarantee the performance of its outside providers. Pediment's approach is to run a lean, decentralized operation, emphasize property management's role in crafting successful repositioning strategies, and create the "seamless" information system. Finial via Triangle has put in place a performance enhancement structure which has most of the elements of the classic quality program, stressing empowerment of frontline personnel. Triangle executives explicitly connected their performance measurement system with continuous improvement, suggesting that it could be a vehicle both for finding problems to correct and good practices to disseminate for years to come.

Executives at the three companies conceded that their systems have shortcomings, internal contradictions, and unproved aspects. Cupola's organizational structure has created some confusion in lines of reporting and requires extra diligence to coordinate leasing and operations functions. It is currently emphasizing oversight and control of property management activities, but does not want to constrain frontline flexibility and creativity. Pediment is still attempting to achieve seamless information processing, at the regional level and between the regional offices of its highly decentralized operation. Pediment clearly values the strategic contributions the property managers can make in some areas, such as repositioning, but considers many other property management services as commodities. The Triangle measurement system is self referential, affording the firm little opportunity to learn from other organizations. Triangle wanted to explore ways of sharing its performance measurement system with its customers, yet without distorting its fundamental purpose of enabling frontline personnel to take control of improving their own work. It was still experiencing some problems with data validity. All three of the companies say that annual rebidding of the fee management contracts, or at least checking them in the market place, is a fiduciary duty, but want at the same time to forge lasting relationships with their providers.

None of the three firms' executives have evaluated their systems on a cost benefit basis. In Triangle's case the question is whether the costs of setting up the performance measurement system, which it claims were minimal, have been adequately compensated by tenants perceiving improved service and opting to renew more readily or being willing to pay higher rent. In a larger context, has Finial's investment in Triangle yielded adequate returns in the fees and profits no longer paid to outsiders, and in increased third party business? Cupola's directors would need to evaluate the improved efficiencies they are generating from their property managers against the costs of a comparatively elaborate in house management layer. Pediment's investment in the property management function is very slight, confined primarily to the reporting function. It might wish to benchmark against other companies to see if the costs of its network and accounting software, and the time spent in the reporting function by its property managers and asset managers, are offset by comparably detailed, versatile and timely data reaching the portfolio managers and their clients.

As a result of this study, the picture I drew of property management for institutional clients needs some alteration. The actuality of institutional property management appears to be more complex and varied. Institutional owners have different views about the strategic nature of property management and organize the function in different ways.

The basic premise that institutional owners are turning their attention to property management in unprecedented ways appears to be true. However, many do not see property management as a source of competitive advantage. When a company standardizes a service or product it turns it into a commodity. Some institutional owners are clearly taking this approach. They appear to be organizing their property management effort not so much to be innovative as reliable. The data from the questionnaires and the cases clearly show a clientele looking for basic operational competence well ahead of strategic capabilities and quality initiatives. On the other hand, none of the firms questioned put low cost fees at or near the top of reasons to select a property manager. Property management, from the viewpoint of the owner, is too important, and not yet standardized enough, to be purchased on the basis of cost alone.

I stated in my initial argument that local unaffiliated firms would not have much of a role to play in the future in institution owned real estate. Although many unaffiliated local firms did lose their engagements in this process, some remained on the rosters of the three firms because of their unique market knowledge. The clear message was that standardization and simplification often took a back seat to what a firm could contribute in familiarity with local prospects, agencies, and procedures.

Another ray of hope for the unaffiliated small and mid-size firm comes, surprisingly, in the area of technology. All three case study firms cited recent gains in productivity deriving from new accounting software and networking. Two of the firms, Pediment and Cupola, cited the high cost of such systems as likely impediments for local firms, unless they were quite large, to continue to do much work with institutional owners. Pediment and Cupola were both looking for further advancements in computer systems that would integrate more kinds of data. Triangle maintained, however, that it had been able to integrate disparate data systems using existing hardware and software systems and networked desktop computers without appreciable incremental cost. It may be that technology, seen by some as presenting an imposing cost hurdle, may in fact enable some local players to get back in the game.

Institutional owners and their advisors have organized to realize significant one time expense reductions in property management service. The consolidations are evidence of this. But the follow on premise that the owners will create internal structures to perpetuate value enhancing change in the property management effort is not so easily substantiated. It appears that some owners are content to "know what they like" when it comes to property management, and to leave the business of performance enhancement to the property

management firms themselves. These firms create organizational structures oriented towards the asset managers, and only tangentially affect what property managers do. They do not actively manage property management.

Some owners clearly do regard property management as strategic and a source of competitive advantage. For them, the study suggests that there is at least one appropriate structure to explore. It has a number of components. It is vertically integrated at least to the extent that the "architectural knowledge" - core principles and performance expectations - can be generated in-house. It has some centralized component for information processing and dissemination. It has a decentralized aspect to support frontline empowerment and customer orientation. It has dynamic evaluation systems in place to measure progress.

There is no hard evidence that any of these property management strategies is the right one; there is no perfect organizational structure for administering property management. Institutional owners should be prepared to adopt the approach that best suits their overall corporate business objectives, and which best confronts conditions they face in the economy.

In another thesis it would be interesting to revisit these firms when Pediment and Cupola are a few years older to see if Finial just has different business priorities in choosing to vertically integrate, or if it is evolutionally ahead of the others. None of the firms studied in depth, and none of the questionnaire respondents, selected the network model for property management. Research on whether or not this intriguing approach is a viable one for institutional clients would be valuable. Another fruitful piece of research would be to redo the thesis at a point in the economic cycle, if it should ever come, when property managers are the scarce resource. A more robust version of this thesis would expand the range of firms studied in depth to include a purely vertically integrated company. A good companion to it would be one structured from the property managers' point of view.

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APPENDIX

***Request for Information
from Clients of Property Management Services
(Institutions and Advisory Firms)***

Note: In this questionnaire, "portfolio" is defined as the collective sum of the investment real estate, held for your company and/or third party beneficiaries, that your firm owns or advises upon.

Please write your name and the name of your company in the space below. This is for the author's purposes only, to help organize data. No attributions will be made in the published product.

-
1. Please describe the investor(s) in your portfolio. Check all that apply.
- Insurance Co.
 - Pension Fund
 - Shareholders (REIT, mutual fund)
 - Other (please specify)

-
2. Please indicate the approximate % of each property type in your portfolio. Note: if percentages are not readily available, check the property types that apply.

Office CBD	___%
Office Suburban	___%
Residential	___%
Industrial	___%
Hotel	___%
Retail	___%
Other (please specify)	___%

-
3. Please briefly describe the geographic distribution (% / region) of the properties in your portfolio. Indicate any areas of particular concentration.
-
-
-

4. What is the current market valuation of the portfolio? What % of your entire investment portfolio (real estate plus everything else) does this represent?
-

5. What is the approximate size (sf, number of units, etc.) of your portfolio?
-

6. Please indicate the approximate % of each method of property management that you employ for this portfolio. If percentages are not readily available, check the methods that apply.

In house property management _____%

Subsidiary _____%

Outside provider - national firm _____%

Outside provider - regional firm _____%

Outside provider - local firm _____%

Outside provider - local or regional firm with network affiliation _____%

Other (please specify. e.g. various national firms on a region by region basis)

7. Please indicate in order of importance (1 = most important, 2 = next most important, ...) the basis on which you select your property management service provider.

Cost of the service _____

Geographic coverage _____

Compatible technology _____

Specialized technology _____

Operational Expertise (e.g. engineering, maintenance) _____

Leasing expertise _____

Range of services provided _____

Specialty (e.g. in building type) _____

Track record _____

Senior level account manager _____

Quality program _____

Other (please specify) _____

8. Describe the management structure for this portfolio provided by your firm. Check all that apply

___ Portfolio manager

___ Asset manager

___ Property manager

___ Other (please specify)

9. Describe the services provided by the property manager of this portfolio. Check all that apply.

- Building operations / facilities management
 - Leasing / transactions
 - Lease administration
 - Real estate project development
 - Construction and project management
 - Interior space planning and design
 - Environmental services
 - Master planning
 - Strategic planning and consulting
 - Business support services (e.g. company mail, copier center, shipping/receiving)
 - Other services (please specify)
-

10. Please indicate which measures you use to evaluate the performance of your property managers. Check all that apply.

- Tenant retention
 - Tenant mix optimization
 - Expense cost reduction
 - Enhancement of service quality (reduction in service calls, response time, etc.)
 - Customer satisfaction surveys
 - Management fees, costs, and overhead
 - Accuracy, flexibility, and speed of accounting / reporting
 - Other measures (please specify)
-
-

11. Please describe briefly the type and frequency of reports that are routinely required from your property managers.

12. If you contract for outside property management services, what is the typical length of engagement?

13. Please list your principal provider(s) of property management services.

***Request for Information
from Providers of Property Management Services
to Institutional Clients and Advisors***

Note: In this questionnaire, "portfolio" is defined as the collective sum of the investment real estate held by institutions (such as insurance companies, real estate mutual fund management companies and pension funds and their advisors) that your firm services. This questionnaire does not address the other types of clients you may have, such as corporate real estate divisions.

Please write your name and the name of your company in the space below. This is for the author's purposes only, to help organize data. No attributions will be made in the published product.

-
1. Please describe the investor(s) in the portfolio. Check all that apply.
- Insurance Co.
 - Pension Fund
 - Shareholders (REIT, mutual fund)
 - Other (please specify)

-
2. Please indicate the approximate % of each property type in the portfolio. Note: if percentages are not readily available, check the property types that apply.

Office CBD	___%
Office Suburban	___%
Residential	___%
Industrial	___%
Hotel	___%
Retail	___%
Other (please specify)	___%

-
3. Please briefly describe the geographic distribution (% / region) of the properties in the portfolio. Indicate any areas of particular concentration.

4. What is the current market valuation of the portfolio?

5. What is the approximate size (sf, number of units, etc.) of the portfolio?

6. Which of the following best describes the type of property manager you consider your firm to be?

- In house property management _____%
- Subsidiary _____%
- Outside provider - national firm _____%
- Outside provider - regional firm _____%
- Outside provider - local firm _____%
- Outside provider - network member _____%

7. Please indicate in order of importance (1 = most important, 2 = next most important, ...) the basis on which your services are typically selected.

- Cost of the service _____
- Geographic coverage _____
- Compatible technology _____
- Specialized technology _____
- Quality program _____
- Operational Expertise (e.g. engineering, maintenance) _____
- Leasing expertise _____
- Range of services provided _____
- Specialty (e.g. in building type) _____
- Track record _____
- Senior level account manager _____
- Other (please specify) _____
