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COMPETITIVE STRATEGY AND REAL ESTATE DEVELOPMENT

REMARKS TO THE 1989 HARVARD BUSINESS SCHOOL REAL ESTATE SYMPOSIUM[1]

The real estate industry is an industry in which many of you will have to make some choices about how you will compete in the future. Past modes of behavior probably will not carry you through the next decade. The questions are how do you think about the question of strategy for your business and how do you do that in a constructive way.

In looking at any industry, whether it is real estate or whether it is making widgets, there are two basic questions that each of you has to answer if you are going to develop an effective strategy.

The first question has to do with what's going on in the industry itself. Industries differ dramatically in their profit potential and their profit potential changes over time. You have to understand this because there is something about the game in which you are playing that is going to determine how successful you are going to be. There are some games that are good to play in and some games that are not good games to play in.

When I talk about the word industry, there is going to be a tendency for the people in this room to think of real estate. But that's not what I mean. Real estate isn't an industry. It's a whole sector of the economy. It is composed of many distinct businesses, each of which is an industry. So developing shopping malls, putting up prime downtown commercial space, and brokerage are all industries. Each of these industries has a different economic logic. Each of them is different in terms of its fundamental attractiveness. You've got to understand how attractive the industries are in which you are competing and you have to understand how they are likely to change over time. Hopefully, your job is not only to compete in a way that is going to improve your position but also that will make your industry better.

The second basic question in strategy has to do with your position within the industry. No matter where you are operating, you are going to have to decide exactly how your company is going to compete and how you are going to position your company to be a superior performer.

What we see from looking at every industry is that, no matter how attractive or unattractive an industry is, some companies do a lot better than others, year in and year out, because they have found exactly the right position. One of the most profitable companies in the United States in the last decade has been a steel company. It's in a lousy industry but it's in just the right position.

[1] This presentation was delivered to a group of leading real estate executives who convened at Harvard Business School in December 1989. The presentation's analysis of the emerging changes in real estate proved to correspond well with actual events, and the same principles remain important today. In the current real estate downturn, these principles are especially timely. June 2002.

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These two questions are the fundamental questions in strategy. How can you understand your industry and your competitive environment, and how can you understand how to position your company within that environment?

Basically in any industry, there are five forces of competition. The first is rivalry amongst competitors. This takes many forms. One of which is the threat of substitute products or services. In your business, this might be some type of totally new retail space, some new location for office space or rehab instead of new construction.

The second is the threat of new entrants into the industry. This is always a threat whenever there is something profitable going on. If they do enter, they are going to erode the profitability of that segment.

The third and fourth forces are the bargaining power of the suppliers, from whom you are purchasing critical inputs, and the bargaining power of the buyer to whom you are trying to sell.

I would like to focus principally on the development side of the business for the following reasons. A critical portion of the strategy for those of you involved on the financial side is to understand what is going on on the development side, because that is the side of the business that will be generating the projects that you will be investing in. Others of you are in brokerage or other areas of the business, but once again, I think that the development business is driving a lot of the economics that is facing these other businesses within the real estate sector.

In development, it's useful to think of two buyers: the tenant and the financial buyer. Often, the financial buyer is considered to be a supplier but I think that it is more useful to think of them as a buyer.

The question in the real estate development industry is what has been the nature of the industry historically and how has it been changing? I think it has been pretty clear in the past that, with the exception of some seismic tremors, it has been a relatively attractive industry. It was an industry, at least from my perspective, that was such that if you were in the game and you were reasonably professional, you could make money. In fact, you could make what some people would call unbelievable amounts of money.

Now why is that? I think the historical success of this industry really begins on the demand side. We had a number of forces that made for a very favorable buyer environment.

What are some of these? First, we have a tremendous shift going on from an industrial economy to a service economy. Tremendous demand for office space was created. We had an explosion in the demand for retail space over the last twenty years. New retail concepts were being spun out at an ever-increasing rate. We had demographic shifts in the population. Changes in where people will want to work and where they will want to shop. This created tremendous demand for new buildings with new features. We had significant improvements in the product: the HVAC, the amenities, the layout, the elevators. A lot of the aspects of the quality of the product have improved dramatically over the past twenty years. What this did is that it made the option of using the old space much less attractive. Many

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tenants looked at what they could get in a new project and compared it with what they could get in their current building, which was hard to heat and cool and awkward to work in, and they chose new construction. Tenants were out looking for space and, historically, they were not very sophisticated buyers. The deals that they cut left you plenty of margin.

How about the financial buyers? Again, historically, a very attractive set of forces were at work. The first of two fundamental forces was the move to institutional ownership. A vast pool of capital was being directed at real estate just as it has been directed at LBOs. Now where it is going to be directed at is an interesting question. The second force is the role of the dollar and of the United States as a place to invest money. Not only do we have U.S. institutions but we also have a lot of foreign institutions wanting to invest in U.S. real estate. Real estate has become an attractive alternative.

Financial buyers wanted deals. They were anxious to get deals and there weren't enough good deals to invest in so, historically, they were willing to cut pretty good deals for you. Entry barriers into the industry were low, except in some segments, but that really didn't matter because you had such an explosion on the demand side that the industry could absorb lots of new competitors and still do okay. In particular, the companies that were professional and had a little bit of real expertise did alright. There have always been lots of companies in the industry and so there has always been an active situation of rivalry. But again there was plenty of room. Yes, there would be seismic tremors and overbuilding in one city or one product type for a while, but the broad upsurge in demand over a long period of time allowed a lot of companies to prosper. If you had professional management skills, you were in the cat bird seat. It's one of those industries were the potential for truly high rates of return was present.

Now what has been happening to the industry over the last decade? Entry barriers have been low and a lot of new competitors have come in. Some of that competition has come from financial buyers who have backward integrated into the industry. The Prudential comes to mind as an example. These new competitors have gotten the capital to build a lot of new projects. This heightening of competition has combined with a slowing on the demand side to lead to overcapacity. You all know that. But this overcapacity and the active competition have also triggered some shifts in the nature of competition.

There is the emergence of development for a fee. Income builders versus investment builders. We see all kinds of modifications in the nature of contracts, the structure of deals, and the way in which deals are cut. This is a reflection of the rising competition in the industry. People are agreeing to things that they never had to agree to in the past. Part of the problem is that, historically, some of the financial buyers were not very sophisticated and they were willing to finance competitors that were doing dumb things. And this industry has a real dumb competitor problem. Not just because they do uneconomic projects that lead to overcapacity but also because they change practices. They change the rules and start doing things like development for a fee. No one used to do that before and it starts you down a line of competitive development that is destructive.

Now this is bad enough but what is more disturbing is what has been happening on the buyer side. On the tenant side, we not only have fewer tenants but we also have fewer

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large tenants who can come in and essentially guarantee that your project is going to be successful. They have more clout. They know that they have clout. They are exercising that clout. They are cutting better deals. They are bargaining away your profitability in the process. The brokers who are really in between you and the tenants have grown and consolidated. They have always been there but their role as a bargaining force against you has accentuated the structural problems.

On the financial buyer side, you have the growth of the advisors as the intermediary between the providers of capital and the actual developers. These advisers are out there to bargain down your rate of return. That's their job. They have had a big influence on the industry. I think it's fair to say that the financial buyers have become a lot more sophisticated. They saw what kind of money was being made in the industry and they saw the economic potential of the industry. They asked for more participation. They have become more powerful. Some of them are getting into the development business.

On the supplier side, we have land becoming relatively scarce, and again we have advisers on this side helping the land owners to get more of the profit out of each transaction.

So what I think you've had in the real estate development industry is fundamental, structural change. This is not a cyclical change. Every one of these forces has shifted in a fundamental way. It's just like what is happening in investment banking right now. Yes, if for some reason there was a broad upsurge in demand, the industry would be profitable. But it will never be as profitable as it was before. There are more competitors out there. The tenants are smarter and they are more powerful. The financial buyers are smarter and more powerful. The suppliers are more powerful. These people know better what they are doing and they are capturing more of the rents. We also have rehab as a viable substitute.

Now what does this mean? One view is that we should turn off the projector and go home because we are in a tough competitive environment and things are not going to be as good as they used to be. Well, it doesn't quite mean that because this is an enormously fragmented industry. It is an immense industry. Even if the average profitability has gone down somewhat, which I believe it has, there is an enormous amount of room above the average and there are also an enormous number of companies that are candidates to be below-average competitors.

What this does say is that it isn't enough to simply be in the game anymore. Simply being out there doing a good job isn't going to lead to your being rich and famous. You are going to have to find a way to deal with these forces in a way that will give your company an advantage, a real sustained advantage in the marketplace. This is a transition that many industries have gone through.

You are gong to have to have a strategy. Historically, many real estate firms didn't have a strategy. They just did deals; they were relatively opportunistic. Whatever deal that came along with good numbers, they did. They could always make a case for why they should do a particular type of deal even though they had never done a similar one before. I think that way of thinking about your company and about how you are going to compete will

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not be sufficient in the future. If you are simply coming to deals as just another development company, the average profits will probably be much less attractive.

How should you position yourself? If you accept this notion that the industry is getting less attractive, has become less attractive, and that it is permanent and not just an overcapacity problem that will go away in a couple of years, then how should you deal with that? How is your company going to be a superior performer?

In every industry there is a distribution of profits. Whatever the industry average profits are, there are some companies that outperform the average and there are some that underperform it. So what is it that will allow you to outperform your industry? The answer to that question, at least in generic terms, is very simple. And that is to have a sustainable competitive advantage. Very few real estate firms have thought in these terms. People didn't think in terms of competitive advantages that they could sustain. They thought in much more opportunistic terms. But I maintain that if you are to be successful in the future, you are going to have to think this way about your company and about what you should be doing.

How do you do that? In terms of competitive advantage, we believe from our research that competitive advantage comes in two flavors. And only two. One is lower cost. You are able to finance and develop a project and deliver it at a lower cost which allows you to get a higher margin at prevailing price levels. The other advantage is what we like to call differentiation. Differentiation is the ability to have some unique skills or resources that allow you to command a premium price. So the idea here is that if you are skilled in design or in creating new conceptions of projects that you could get higher revenue per square foot or better utilization of the land. Again, providing that you can keep your costs in line, this differentiation will lead to superior performance. These are the two simple-minded routes to superior performance.

There is one other critical issue in your industry and that is the question of scope. In any business, when you pursue competitive advantage, you have to decide what part of the business you are going to have the competitive advantage in. Some companies have a broad scope and they try to build many different types of projects. Other companies can and do choose a narrow scope. They specialize in one particular type of project, in one particular geographic location or one particular type of tenant.

Any company must make a choice about these two variables. What's the essential kind of advantage that you are going to seek? Are you really seeking lower costs because you are going to be more efficient? Or are you going to try and differentiate yourself? You may spend a lot of extra money trying to do that. What array of products, tenants, and geography types are you going to serve?

If you take an average industry, like the airline industry, you can see companies making choices. American Airlines serves the whole United States. They serve business and pleasure travel. They have frequent flier programs and they give you a meal. They have downtown ticket offices. They have a broad range of services. What they are trying to do is to be "something special in the air". That is their whole concept: to be a differentiated airline with superior service.

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Continental is trying desperately to be the overall cost leader. They also fly all over the United States, they give you a meal, they have frequent flier programs, and downtown ticket offices. They offer all the services that any other airline does but they are trying to be the low cost deliverer of those services through imaginative labor relation policies. They also do it in a lot of other smart ways like the type of meals that they serve and the way that they flow their planes over the United States. Without all of the Eastern problems, I think that Continental would be quite a force in the industry because they really do have a very clear, articulated strategy.

Southwest Airlines has focused on a particular segment and they are trying to be even lower cost in that segment. The have a no frills concept. This is a good example of focusing on a very narrow segment and building your strategy around that segment. You can often be very low cost in this way.

The only pure example of a focuser and a differentiater, right now, is MGM Grand Air. It's all first class. It's for rock stars, movie producers, and real estate developers. They are targeting a very specific segment and they are trying to get a premium by creating differentiation for that customer.

Now how do we think about some of these choices in your industry? Well, I think that all of you face some choices on whether you are going to compete on cost and being more efficient or compete on differentiation. Now the whole notion of thinking that way is probably foreign to many of you. You don't think of yourself that way. You think of yourself doing a good project that has good numbers. But I think increasingly this notion that at the end of the day you have to think about what the advantage is to your company and how you are going to deliver those superior numbers. Are you going to deliver those superior numbers because of your ability to be efficient or are you going to deliver those superior numbers because of your ability to command higher rents? I think that increasingly is going to be a crucial question.

In many ways, just as important a question is the whole issue of scope. As I said, historically real estate companies have been very undisciplined about scope. They have tended to do lots of different things. Another issue is vertical scope. In your industry there are a whole bunch of vertical stages. There is the pure development function, but then there is also property management, construction management, brokerage, and many others. There is a whole bunch of vertical segments within the industry.

There is a tendency in any highly successful industry over time to vertically integrate. To do more and more of the vertical stages. Why? Because it's a very profitable industry and you want to get more. That is particularly true in a growing business where there is a lot of pressure on capacity and there is never enough capacity. So you tend to integrate in order to ensure that you get the job done right. I would argue that most every one of you ought to

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be thinking today about how to do the opposite. That is about how to deintegrate. How to perform less of these functions than you have in the past.

Why? First of all, the relative attractiveness of each of these things as a business will vary. We can use the same industry structure analysis to look at development, brokerage, property management, and construction management. We can look at each of these separate functions in the industry and we will find that they vary in profitability. Second, it's hard to have a competitive advantage in every thing. It's hard to have a competitive advantage in the pure development business and also have a competitive advantage in the property management business and also have a competitive advantage in construction management and also have a competitive advantage in construction itself.

The key is to avoid giving away the money you make where you really have an advantage in some other activities where you really don't have an advantage. Again, many industries that have gone through boom times have had to learn this lesson. Just because you are good at pulling aluminum out of the ground doesn't mean that you are going to be good at making tin cans. And the same is true here. Just because you are a terrific developer doesn't mean that you are going to be a good construction manager or a good property manager. Your tendency today is to go in the opposite direction because you are hungry for revenue. You want to increase the size of your company and your tendency is going to be to pull and broaden that vertical scope. To do more functions. But that is the wrong instinct, at least from the perspective of other industries that I have studied and from my distant perspective to your industry. So I think the word today in the vertical dimension is narrow. Focus.

Now let's talk about the segments in terms of property types and target customers. Again, we have in your industry many different types of projects and many types of customers. In the retail side we have malls, we have strip centers, power strip center, outlet center. All these kinds of projects. Each of them is a little different. Each of them has somewhat different tenants. On the commercial side there is downtown and there is suburban and there is prime and there is standard. Now, the name of the game going forward as you think about those product types, in my way of thinking, is choice. I think the name of the game going forward is choice. Again, there is a great tendency as I've said earlier for companies in your industry to think that a project is a project. There are generic skills that apply to all of them. But as we go forward you have to have true advantage to be an above-average performer, and the companies that are going to make real money are those that bring something distinctive to doing a shopping center if that is what their thing is. Or that brings something distinctive to doing warehouses or whatever it is that you are good at.

How can you tell what it is that you bring something distinctive to? Your existing portfolio has some powerful lessons in it about your real skills. All of you I think would be well served by doing an historical analysis of where you really succeeded and why. What kinds of projects. Looking for pockets of real skills and expertise. Companies that are simply imitating others don't do well in industries that are fundamentally less attractive. If the industry is great, imitating is profitable. If the industry is less attractive, imitating is usually a way of insuring disaster.

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Now once again the urge is very strong to go in the other direction. The urge is very strong to find new things to do because you want to fill capacity and because you have a lot of hungry young MBAs that you know are chomping at the bit to get their equity stakes. You want to give them stakes so that they stay with you instead of going and setting up their own company. There is a tendency to proliferate projects and locations. We've learned that doesn't work in most other industries. Again, it works when it's a terrific business where everyone makes money. But it doesn't work in the industry that you are in now.

Now let me make two final comments. The first comment is that there may be a certain number of you in this room that think that everything that I've said is totally inappropriate for your industry for the following reason. And that is that you would argue that this is a transaction or deal business and the whole concept of a strategy doesn't apply in that type of a business. And I think that that is a good question. Is this an industry where it is deal by deal and any notion of strategy that cuts across deals is a dumb idea?

I don't think so. I don't think that's right. Why? Because I think there are really two critical dimensions of success in your business. The first is finding the good deals. Finding those projects, finding those tenants, finding those locations that are going to be economically attractive. The second critical dimension of the business is executing those deals well. So you find the project but then you are able to build it on time and make sure it is nice and deliver it up to expectation. Now you might think that that is an opportunistic process. But it's not. Why do you find good deals? You find them because you have special insight into tenants in that particular area, because you have an unusual knowledge of a particular geographic region, you find them because you understand that particular type of project better than the other guys. Because you have superior market intelligence, because you have superior economic intelligence. Why do you have superior economic intelligence or market intelligence? Because you have a strategy. Because you've done those types of projects before. Because you are systematically pursuing that type of business. Why do you build a project well once you've found one? You build it well because you have the knowledge and resources and expertise that have grown out of a history of doing that kind of project. So it seems to me that even if you look at this as a deal-by-deal basis, the critical determinants of whether a deal is going to be profitable, whether you've found a good one in the first place, and whether you execute on it, are very much driven by whether you have a strategy. Your ability to find good deals and to execute is basically a function of your strategy.

Final comment, I've talked a lot about strategy but I think that in this industry that execution is going to be much much more important than it was in the past. In the past, one percent cost overruns, who cares? Worrying about those numbers down to the last decimal in the past was irrelevant. It didn't matter that much. Going forward, I think that cost control, efficiency, all those things that most people have to do in their industries in order to be really successful, are going to really separate companies in a very fundamental way. Particularly in the area of cost management and cost control. Now one of the major hidden costs in your industry that may not be hidden to you, but it was hidden to me until I thought about it, was the cost of finding all of the deals that you don't do. Most of you are spending enormous amounts of money, if you ever calculate it, sniffing around and doing things and making proposals and drawing up things and then the deal doesn't get built. Dry holes. I think one

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of the critical success factors in the future will be reducing the number of dry holes. How do you do it? By having a strategy, by knowing more about shopping malls. So that you can really do your homework. So that you can really know every site in the United States. So that you can really know every tenant. So that you really know the economics. So that you don't waste your time on stuff that isn't going to get done. You have a strategy. How do you get more and more efficiently managing the costs of doing a deal, of executing a project? Again by having a strategy. You know it may sound boring but building 100 of the same projects is going to allow you to have lower costs.

And you have had the luxury in the past of being utility infielders and running around and doing lots of neat things and being creative and having fun but in the future you are going to have to be that journeyman who doesn't make errors. Who catches that ball and throws it to first base. If you get that down to a science, that's going to allow you to control those costs and be more efficient in execution and set yourself apart from the company that doesn't have the discipline to make choices.

Let me just conclude by saying that strategy is choice. Strategy means saying no to certain kinds of things. Strategy means saying no to certain kinds of deals. Even if they might make some money. Strategy means saying no to certain types of tenants that you are not really interested in. Strategy means making some people unhappy. If you are willing to do anything that looks economic, that's a danger signal. You don't have a strategy and as this industry goes forward, I think your ability to command substantial and sustained returns is going to be substantially lower.

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