



HIGH FIVE

BY PAUL SEIBERT, CMC

Headquarters are not as sexy or as much fun to talk about as the latest in retail branch design, but whether owned or leased they are a necessary—and expensive—cost for every credit union. For most credit unions, headquarters account for half of facility operating costs and have a significant affect on the CU's return-on-assets ratio.

It is surprising that many high-cost headquarters decisions are based on less analysis than that is used to place and construct branches. Today, free-standing retail branches in strong markets cost between \$1.5 million and \$3.5 million, while headquarters facilities for these same credit unions cost \$15 to \$50 million.

A small enhancement like a 10 percent increase in occupancy efficiency or the correct answer to the lease vs. ownership question can mean millions in cost savings over the life of a large credit union headquarters.

For CEOs and boards, the long analysis process that must be undertaken before investing in a headquarters facility can be distilled to five critical questions.

NO. 1: DO WE REALLY NEED A NEW HEADQUARTERS?

The need for a new headquarters is driven by many factors and assumptions. Some of these are critical to future credit union performance. Others are desirable in terms of enhancing community, member and staff perceptions. Or, you may have an old building that cannot be updated at a cost less than new construction. Your building may be in a poor location in terms of staff amenities and safety or in terms of your evolving target markets. Your building may present a poor image that does not positively promote your brand to the community or is not competitive in terms of attracting and retaining the best staff.

The most common reason for building a new facility

Five big questions you should answer before investing in a headquarters facility.

is the need for more space to meet future business demands. But, before pursuing a new building for expansion, the potential to increase occupancy and productivity in the existing building should be analyzed. You may be able to enhance your office space standards to increase occupancy, find wasted space, or improve circulation efficiency and capture 5 percent, 10 percent, or 15 percent in usable space, forestalling the need to relocate for a number of years.

Can this really be done? My early career was accelerated by finding a way for a \$45 billion bank to stall leasing an additional 500,000 square feet for five years. This has worked on a smaller scale for many credit unions.

Whether analyzing the ability of an existing building to meet your needs or the need for a new building, staffing and space projections must be accurate. The typical planning process is to complete 10-year staffing- and support-space projects for each operations department, establish space standards and then multiply the two together. From this, a building size is generated and a "little more" added to accommodate the needs out 15 to 20 years. While a common methodology, its limited grasp of relevant staffing and space drivers and peer analysis can create costly issues in the future.

A more savvy and complete approach to headquarters planning includes applying an efficiency factor to



the calculations. For example, a \$900 million credit union recently defined its 10-year space needs at 85,000 square feet based on 5 to 8 percent member growth per year. Our next steps were to compare staff-to-assets efficiency ratios of credit unions along a similar growth path and with similar levels of products and services, apply an inflation factor, and recalculate the need.

This comparison resulted in a dramatic change—the need for 65,000 square feet rather than 85,000 square feet in 10 years. This was then extended out 20 years, the desired planning period, saving more than 50,000 total square feet. If this credit union only builds to the 10-year need with sufficient property to meet a 20-year

expansion, it will save at least \$3.5 million in construction and significantly more in operating costs just in phase I.

NO. 2: WHICH OCCUPANCY STRATEGY IS BEST?

Building a new headquarters is recognition of a credit union's success. It can present a strong branded community image that enhances market awareness, makes staff more productive and satisfied, and prove to be a profitable real estate investment. While building a new headquarters has significant advantages, the planned



new building may not be sustainable without a detailed assessment of occupancy alternatives. Let's look at some of the most important:

Building a new facility is the obvious answer and is often the right solution—after considering all the growth and risk factors.

Purchase adjacent land and expand. Land in mature markets can be expensive and often there is not sufficient parking at existing buildings to meet current codes and staffing needs. Twenty-year land needs should be purchased at the same time as the 10-year land. For example in 1995 we completed a strategic operations occupancy study for a \$520 million credit union. Our recommendation was to build a 50,000-square-foot building for the CU's 10-year needs and purchase sufficient adjacent land to support its 20-year needs. The board felt we were overestimating the needs.

In 2002, the credit union asked us to relocate the administration offices because they were running out of space. The cost of purchasing adjacent land had risen from \$3.25 to \$19.50 per square foot and only a portion of the original property was available. With our recommendation, the worst-case scenario would have been if the CU did not grow as we projected and the vacant land would not have been needed. Instead, after just seven years, the CU was out of space, separating the operations function, and looking for a new long-term solution. We are now helping them plan a new headquarters.

Leasing property and building a headquarters can seem attractive at first glance as the initial yearly cost is relatively low and capital is retained. Often properties with high market visibility are considered retail and the owners do not want to sell. One of our clients in California inherited a headquarters building on leased property with only five years left on the lease. At the end of five years, the building has no value unless the credit union is willing to pay whatever the landowner wants. If it leaves rather than pays the high rent, the land owner gets the building and reaps the high appreciated value. This is not a win-win.

Sometimes the need for a big operations building on retail land is driven by the assumed need for an on-site main branch. But this preference can be very costly in terms of lease rates or purchase cost. Retail land can often be two to four times higher in rental rates. Members would likely receive substantially greater value from a more convenient smaller branch location on retail land and a highly productive headquarters located on land at one-quarter the cost.

Leasing is a good option in the short term, but a very bad option in the long term unless the lease rate is well below building value, a rarity. When CFOs run the comparative calculations, leasing is typically less expensive for the first six to seven years; then owning becomes the most cost-effective option.

Additionally, credit unions that own headquarters facilities build a substantial asset that can be used as a down payment on the next operations center or sold in an emergency to generate cash. Ownership is often the best option for headquarters and offers more flexibility than a lease. Many credit unions feel this holds true for branches, but the factors surrounding ownership vs. lease decisions are based on retail rationale such as target markets, site opportunities, market evolution and return-on-investment projections.

Sell and leasing back a credit union's facilities has been suggested by real estate executives pursuing credit union business. The rationale is that credit unions are not in the real estate business and could better use their money to spend on expanding their branch network. While I concur that at times a great strategy is to forestall operations projects and lease space to focus resources on aggressively capturing market share through branching, new product development and marketing, selling a headquarters will eventually increase operating costs and reduce ROA.

NO. 3: HOW CAN WE MAXIMIZE THE ROI OF OUR HEADQUARTERS?

Planning a new headquarters involves so much more than just figuring out how much space will be needed and where it should be placed. Every CEO must don two hats: credit union president and real estate investor. The decision to purchase land and invest in up to \$50 million in construction should be more than just an occupancy solution; it should be a savvy real-estate strategy that positions the credit union for short-term accommodation and long-term profit.

Maximizing the ROI is accomplished by understanding leasing market opportunities. This understanding then results in a recommendation to build to 20-year needs and lease vacant space, or build the 10-year needs and then expand later or sell the vacant land. In a strong lease market, building to 20 years can provide significant long-term occupancy savings through lease income. The down side is that substantially more capital is needed up front.

"Recycling" a building has many advantages. For one, the cost savings can be significant. For example, one of our clients recently purchased a 100,000-square-foot facility for about \$45 per square foot. The building needed a new exterior skin, HVAC units, interior changes and some site



work adding about \$45 per square foot. When done, the building will cost \$90 per square foot compared to new construction cost of \$155 per square foot.

Be warned, not every deal works out so well. A few years ago a California credit union bought an existing building for about three quarters of what it would cost for new construction. The architect estimated \$1 million would be sufficient for the improvements. After purchase and a full evaluation, it was discovered that more like \$3 million to \$4 million would be required. When the work was done, the credit union had an old building that cost more than a new building. The lesson here is: Do not purchase land or a building without first completing a full due diligence and building survey process by an unbiased industry expert.

NO. 4: HOW CAN WE LIMIT OUR RISK?

Planning mistakes are a risk that grows over time. The solution is to hire savvy experts that have helped financial institutions through the same process many times and clearly understand the credit union industry. This includes engaging a highly experienced commercial Realtor while remaining aware of their motivations and relationships.

It is fairly easy for a CEO to remain safe through the land purchase and building planning and design phase. This is the fun part for the board and staff. Mistakes or poor planning start to surface as construction starts. Most CEOs do not build large facilities regularly and may not have a sophisticated understanding of construction, regulations, subcontracting, liability, relevant laws or unions. A CEO is wise to work with a strong architect and builder or highly regarded construction management/design-build firm.

The negative effects of change are often unforeseen, but can be mitigated by testing both best- and worst-case business scenarios against specific real estate strategies and what steps you will take to solve future issues. What if you merge with a \$150 million credit union and need to consolidate all operations staff into one facility? What if you do not grow as expected? What if the leasing market collapses? What if zoning changes on your vacant property or the local government claims eminent domain? What if you are merged into another credit union?

NO. 5: HOW WILL OUR HEADQUARTERS NEED TO EVOLVE?

We have seen significant headquarters evolution over the past 10 years, and the next 10 years will likely be the same. Let's look at a few possibilities.

Every headquarters facility will exhibit some level of "green" and most will be LEED® certified. All facilities

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we have under design include some level of green as requested by the boards of directors.

Because they do not have the advantages of scale, small credit unions will need to reduce operating costs to survive in the future. One way to create these facility economies is to form a credit union service organization with other credit unions to consolidate operations, human resources, call centers, marketing and even management. These operations centers could serve local credit unions and credit unions across the nation. An alternative could be a large credit union offering its own capabilities to smaller credit unions while accelerating its own economies of scale (and possibly picking up a few mergers as well).

Virtual operations functions have been talked about for many years. Such functions as regional management, marketing and call centers can be remote or even in people's homes. While companies in Silicon Valley keep testing the ideas, the social side of generating productivity and creativity, cultural development, management and liability will continue to keep most people commuting to work for at least the next 10 to 15 years. While "virtual work" for most credit unions is a long way away, I think a disaster preparedness plan is prudent. Our office is developing a plan to continue our service to clients and employment of our staff in the event of a flu pandemic requiring staff to stay at home for extended periods.

Workstations will continue to evolve to solve the continuing challenges of privacy and sound control, wiring and cabling. Soon cabling will be replaced with secure wireless operations and a full day's electrical needs will be provided through a battery pack, which will substantially reduce installation costs and free up organizations for change.

While headquarters facilities are often not the sexiest side of a credit union's real-estate portfolio, they are a key component of success. CEOs must be certain their real estate decisions are guided by well-conceived strategic growth, business and occupancy plans, and trusted advisors, and include the flexibility to take advantage of the unforeseen, create a high return in terms of staff productivity, positive brand image, financial gain, and position their CU to thrive well into the future.

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