

An Investigation into the Credit Tenant Characteristics of Department of Defense Contractors

Abstract. *In the next few years, it is anticipated that the Department of Defense (DoD) and other government agencies will begin to outsource their civilian workforce to private contractors. The real estate and facility management sectors are prime areas for this privatization strategy. Current regulations favor DoD contractors that are tenants rather than owners. This will create a high credit lease opportunity for real estate investors. This study explores the impact of the privatization trend toward creating high quality office and industrial investments for the real estate marketplace. Given the government contract bias toward renting, a new group of credit tenants may appear. A hypothetical DoD tenant is used to explore the implications of the new regulations on the real estate market. This study posits that large office and industrial park complexes will be positively affected and properties in the right location to attract the new credit tenants that have been awarded privatization contracts will become more valuable, especially to the institutional investor.*

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Introduction

In the next few years, it is anticipated that the Department of Defense (DoD) and other government agencies will begin to outsource their civilian workforce to private contractors. The real estate and facility management sectors are prime areas for this privatization strategy. This follows closely the trend of the last decade where large corporations have moved to outsourcing the real estate function. In addition, the current political environment has resulted in increasing defense budgets that will also grow the demand for space by defense contractors. This study posits that large office and industrial park complexes will be positively affected by these two trends. Properties in the right location to attract these new credit tenants with long-term occupancies that have been awarded these privatization contracts will become more valuable, especially to the institutional investor.

Current regulations favor DoD contractors that are tenants rather than owners of their real estate. This will create a high credit lease opportunity for real estate investors. This study focuses on the existing role of real estate in the federal government but more importantly will explore the impact of the privatization trend toward creating high quality office and industrial investments for the real estate marketplace, particularly the product starved institutional investor. Given a government contract, companies will be forced to rent. Government outsourcing will also initiate a new level of

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credit tenant that could provide much more stable income and returns to the institutional investor.

A case study approach is offered here to explore the new streamlined Federal Acquisition Regulations (FAR). In future work we plan to explore the potential lease terms and the likely geographical location for recipients of the federal contracts. This knowledge can be used by real estate investors when making investment decisions.

Where Have All the Credit Tenants Gone?

With the recent collapse of the stock market, coupled with the poor economic conditions and fraudulent financial activities of some household names, owners of office properties need to think twice about how they classify their credit tenants. Typical strategies such as using rating agencies and analyzing company financial statements do not work if ratings can be changed over night and the audited financial statements turn out to be fabricated. Exhibit 1 details the twelve largest bankruptcies that were declared in 2001/2002. Their combined asset value before bankruptcy was estimated at close to \$400 billion and these companies employed over half a million employees. Not all of them will completely close down but even using a conservative estimate of 50% of the employees being laid off and 250 square feet of space per employee, these twelve companies alone could conceivably empty 75 million square feet of office space. Not only have these companies laid-off employees but they have created legal and financial nightmares for their landlords.

Office space is the number one allocation of institutional investors. According to the National Council of Real Estate Investment Fiduciaries (NCREIF), 40% of the NCREIF Property Index was allocated to the office sector in 2002 (NCREIF, 2002). In 2002, the office sector clearly underperformed most of the other property sectors and many of the “trophy buildings” held by institutional investors are plagued with credit tenant problems. In addition, with the flight of capital from traditional stock and bond investments to real estate investments (particularly the high

quality, trophy assets), there is a surplus of cash that is seeking good quality real estate with low-risk tenants. Given the recovering economy and the military situation in Iraq, the DoD is one of the few industries that are in a growth phase right now. Indeed, the federal government is moving toward outsourcing the majority of their contracts. Therefore, defense contractors are likely to become a major source of the credit tenancy in the future.

The next section explores the hypothetical case of a defense contractor located in Southern California. A brief description of the company and its real estate needs are followed by an example of how the recently enacted FAR impact the real estate decisions of the defense contractor. This is followed by a brief exploration of the other potential real estate opportunities that might exist for companies contracting with the DoD.

The Case of a Southern California Real Estate Defense Contractor

The FAR with respect to DoD contractors have been streamlined and made uniform across the wide scope of other government agencies and departments. This study is interested in the role of real estate costs to the government contractors. The typical DoD contractor chooses to rent rather than own since it is clear that the real estate cost is “ordinary and necessary” for the conduct of the contractor’s business. No other presumption of reasonableness can be attached to facts surrounding the decision to purchase real estate associated with a government contract. The burden of proof is on the contractor to establish that the cost of purchase is reasonable (arenet.gov, Contract Cost Principles and Procedures, 31.201-3).

The hypothetical example is a DoD contractor named Maps & Tracks Software, Inc. (MTSI) who leases 200,000 square feet of Class “A” commercial real estate in Southern California. MTSI’s mission is to write top secret software code used by the former Office of Naval Research (ONR). ONR is now also known as Space Warfare Systems (SPAWAR). SPAWAR annually lets billions of dollars in contracts in Southern California to qualified contractors who specialize in tracking naval threats

Exhibit 1
Largest Bankruptcies Declared in 2001/2002

Company Name	Bankruptcy Date	Total Assets Pre-Bankruptcy (\$)	Corporate Location	Total # of Employees
Worldcom Incorporated	7/21/2002	103,914,000,000	Clinton, MS	85,000
Enron Corporation	12/2/2001	63,392,000,000	Houston, TX	20,600
Conseco Incorporated	12/18/2002	61,392,000,000	Indianapolis, IN	12,654
Global Crossing Ltd.	1/28/2002	30,185,000,000	Hamilton HM12 Bermuda	5,000
UAL Corporation	12/9/2002	25,197,000,000	Chicago, IL	84,000
Adelphia Communications	6/25/2002	21,499,000,000	Coudersport, PA	15,735
Pacific Gas and Electric Corporation	4/6/2001	21,470,000,000	San Francisco, CA	18,400
Kmart Corporation	1/22/2002	14,600,000,000	Troy, MI	250,000
FINOVA Group Incorporated	3/7/2001	14,050,000,000	Scottsdale, AZ	497
NTL Incorporated	5/8/2002	13,003,000,000	New York, NY	19,200
Reliance Group Holdings Incorporated	6/12/2001	12,598,000,000	New York, NY	6,050
Federal-Mogul Incorporated	10/1/2001	10,150,000,000	Southfield, MI	49,000
Total		391,450,000,000		566,136

Note: The source is BankruptcyData.com, 2002.

from space using military satellites. In the past, ONR would hire government non-military employees to write code. Today, SPAWAR typically hires private contractors who have lower costs. By law, the contract must go to the most efficient purveyor who has the demonstrated skills and security levels. This initiative is termed the Most Efficient Organization (MEO) (Commercial Activities Panel, 2002). It is possible and normal for MTSI to win a multi-year SPAWAR contract for \$50,000,000 then subsequently share this particular contract with other approved contractors (subcontractors). There are instances where SPAWAR itself could then also be a subcontractor for a piece of their own original contract. SPAWAR may win as a subcontractor yet lose as the prime contractor since they may only have lower direct costs with a certain aspect or component of the program. At this time, it is pertinent to see how real estate ownership versus renting is accounted.

The Application of FAR to the Hypothetical Defense Contractor

MTSI has a ten-year lease at \$1.00 per square foot per month triple net that averages \$200,000 per month. As part of the FAR, this entire expenditure can be picked up by the government as a cost of the project. A brief example follows with respect to the accounting of real estate rent and DoD contractors.

The government has three major areas of accounting classification for this example.

- **Direct Labor** (code writers) and **Direct Travel** (code writers traveling around meeting with War Fighters and Users).
- **Reasonable and Allowable Overhead** (indirect managers, general administration and facilities). A unique overhead position is that of the firm's security officer. This is an employee who may be an accountant or human resource officer 85% of the day and spends 15% of the time dealing with secret and top secret personnel issues. The **Costs of Facilities** (rent) must be at or below the competitive prevailing market conditions. There is no incentive for the contractor to

have a sub standard, inexpensive space since the government will pay up to the prevailing market rate. Thus, the payment of market rent does not affect the bottom line profit as seen below so tenants are free to rent institutional quality space.

- **Reasonable and Allowable Profit** (0%–12%). The proportionate amount of rent will be paid as part of the contract. This \$50 million contract is multi-year and one of several that MTSI has with SPAWAR. In addition, MTSI is a subcontractor for a \$20 million portion of the U.S. Marines Corps C4I effort (command, control, communications, computers and intelligence). In addition, MTSI has a contract with the Central Intelligence Agency that pays \$7.5 million per year for the next three years. Assuming there is no “commercial” work taking place within the confines of the 200,000 square foot facility; it is then very reasonable to assume that the entire real estate cost is proportionately related to these various government contracts. The real estate cost paid by the government itself may be in an above market rental bracket due to the amount of spaced leased and other pass-through expenses (Allen, Rutherford and Warner, 1997).

The ability to fully expense market leases under FAR encourages the use of quality commercial space and discourages the DoD contractor from directly purchasing the space themselves within the same ownership entity. It should be noted, that the FAR do allow smaller, privately controlled contractors to lease space from an ownership entity controlled by the principals of the same DoD contracting firm; effectively the company is leasing from themselves. However, these rare occasions must be disclosed under the expansive audit privileges of the government. Most DoD contractors, however, are not in the real estate business and so they typically choose to pursue their government-focused business and seek real estate professionals to meet their space requirements.

A particular point of interest in the FAR documentation is in the area of other payments to landlords. Some high-tech companies have bargained

lower rents in exchange for warrants or stock. This was particularly true in real estate markets where rents spiked in the late 1990s due to the high demand caused by the dot.com companies. While most landlords have been burned in these sorts of transactions, they are also totally unusable for the DoD contractor with potential stock valuation price surges since they cannot be reimbursed for the options. Paying lower rent simply means the government reimburses less and the tenant has given the landlord options that they did not need to grant in the first place.

Another point worth mentioning is that the DoD contractor may also see some commercial application of the work completed (code written) for the government. It is legal, and in fact, encouraged to pursue lawful use of the non-classified code if any commercial activity takes place within the DoD facility. The proportionate amount of overhead used by that activity will not be picked up under the FAR.

Additional Potential Real Estate Opportunities

The DoD, as the clear leader in embracing Office of Management and Budget (OMB) Circular A-76 as quoted in the Commercial Activities Panel, "Improving the Sourcing Decisions of the Government: Final Report" lists the following potential areas for further privatization (Commercial Activities Panel, 2002:20):

- Aircraft maintenance
- Real property maintenance
- Logistic services
- Information and telecommunications
- Acquisition and supply operations
- Computer services
- Education and training services
- Commissary operations, and others

The removal, exchange and conversion of government employees to civilian subcontractors presents a new generation of real estate leasing opportunities. As more employees are shifted away from the

often aging government real estate facilities to privately-owned complexes, the market will require specialized parks and managers that cater to these long term, low risk and high credit tenants.

Exhibit 2 highlights the top ten companies in the United States that were awarded defense contracts in 2000. Just slightly over \$50 billion in contracts was awarded and these top ten companies had close to 40% of the contract dollars. These companies together had over 800,000 employees, which would translate to 240 million square feet of office space if they were all office workers. While this is surely not the case, if they had the U.S. average share of office workers (38%), they would consume over 75 million square feet of space. A prudent institutional investor should examine the geographical location of these companies and target those areas for their future investments.

To examine a local impact, the list of 100 for San Diego-headquartered companies was examined. As detailed in Panel B of Exhibit 2, three companies were identified with close to 50,000 employees. Using an estimate of 250 square feet per employee, this translates (at the same share of office workers) to 4.7 million square feet of space or over 8% of the 56 million square feet of office space reported for San Diego County (*Burnham Outlook 2002*, 2002).

Summary and Areas for Future Research

This study analyzed the requirements of the federal government contractors to lease rather than own space if the contractor is to be reimbursed for their rent expense. The findings show that given the new FAR that contractors for the DoD and other federal government agencies could become the credit tenant of the future. In future research, we hope to analyze the concentration of defense contractors on a geographical basis and examine the markets to see if they are presently "hot" and gain a premium or (as we suspect) few professionals are aware of this accounting requirement and have not implemented an investment strategy that focuses on investing in areas where defense contractors make up a large part of the tenant base.

Exhibit 2
Companies Receiving DoD Contracts (Fiscal Year 2001)

Company Name	2000 Awards (\$) ^a	% of Total Contracts	Corporate Location	Total # of Employees
Panel A: Top U.S. Companies				
Lockheed Martin Corporation	15.1	11.35	Bethesda, MD	125,000
Boeing Company	12.0	9.03	Chicago	165,000
Raytheon Corporation	6.3	4.75	Lexington, MA	77,500
General Dynamics Corporation	4.2	3.14	Falls Church, VA	54,000
Northrop Grumman Corporation	3.1	2.31	Los Angeles, CA	96,800
Litton Industries Incorporated	2.7	2.05	Woodland Hills, CA	31,500
United Technologies Corporation	2.1	1.55	Hartford, CT	155,000
TRW Incorporated	2.0	1.50	Cleveland, OH	93,700
General Electric Company Incorporated	1.6	1.20	Stamford, CT	18,400
Science Applications International Corporation	1.5	1.14	San Diego, CA	41,000
Totals	50.6	38.02		857,900
Panel B: San Diego-Based Companies				
Science Applications International Corporation	1,500,000	1.14	San Diego, CA	41,000
General Atomics	134,232	0.10	San Diego, CA	1,600
Cubic Corporation	183,898	0.13	San Diego, CA	4,500
Totals	1,818,130	1.37		47,100

Note: The source is www.defenselink.mil, 2001.

^aAwards for U.S. companies are in billions; San Diego companies are in thousands.

In the latter case, the location of defense contractors over the next few years could be used as a screen and serve as a leading indicator for investment markets that are relatively safe if they meet the needs of the defense contractors, a credit tenant of the future.

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