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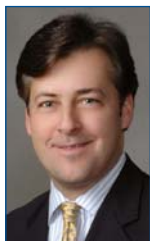
Interview with Real Foundations



On today's episode of The REIT Report[®], we're going to focus on a topic that's generated a lot of discussion in both business and political forums over the past few years. And that's outsourcing.



Joining us today are (from top to bottom) Chris Shaida, David Stanford and Jim Vincent from Real Foundations. Chris is CEO of Real Foundations, while David is co-founder and executive managing director, and Jim is managing director and leads the firm's institutional capital markets practice. Gentlemen, welcome to The REIT Report.



ANATOLE PEVNEV, co-host: Chris, can you take a moment and tell us about Real Foundations?

CHRIS SHaida: Real Foundations is a management consultancy that has a pretty straightforward mission. We're in the business of helping real estate companies run better. We've been around for about six years. The three founders were big-five consulting partners and have worked in the real estate space for the past 20 years. Currently, we've got about 150 professionals in offices in New York, Dallas, Newport Beach, California, Chicago, Denver; and we just opened an office in London. And we're delighted to be here today to participate in this conversation about what we think is an exciting new capability for the REIT market.

PEVNEV: Terrific; well, we've got a lot of questions to get through here, so I'll get right to it. Gentlemen, can you start off by giving us a quick history of how outsourcing has changed the past few years?

JIM VINCENT: Before we get started on some of the trends, I thought we'd get grounded a little more on some of the core terms and differences here. So outsourcing is principally the un-bundling of different integrated processes and then purchasing back the services to leverage lower costs and superior capabilities. And what is different today is the word offshoring. Offshoring is typically locating those business processes in offshore locations, and the primary drivers behind that are the differences in the wage levels and availability of skilled labor across the borders.

And so generally people throw around the name outsourcing, use that term very interchangeably with offshoring, and we'd like to make a distinction with that, because it differs upon the location and who has control of that work process. And so if you look at it from that perspective, outsourcing, at its core, has been around a very long time. There's nothing really new. What is attracting the attention of the media and business today is really the offshoring of those business processes to India.

From a trend-line perspective, outsourcing really started with the IT outsourcing in the late 1990s with the Y2K challenges. And as the business has evolved, it's migrated into various parts of business process outsourcing. In the BPO market (business processing outsourcing) market, the services that started off, typically

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very low-end, less complex, administrative and task-oriented type of work—that could include data entry, transaction processing and even document imaging and management. And it's evolved upstream to a little bit more complex work and interaction with customers.

Typically in the call center environment, we've seen the gradual shift to the outsourcing of whole business functions, which could include finance accounts; and HR is an example. And some of the more recent trends—we've actually seen some of those BPO providers move further upstream, up the value curve, to more complex and analytical work, and that's a new trend known as knowledge process outsourcing.

PEVNEV: OK, well, now that we've got our terms straight between outsourcing and offshoring, where do these offshore jobs go? I mean is it India, China, Russia? What countries are getting the majority of this now?

VINCENT: Typically India and Ireland have traditionally been the largest market for offshore BPO, and the primary reasons for that, certainly out of the U.S. base, is that people are looking for English-speaking workers, typically college-educated. Other English speaking countries would include Canada, Israel, Singapore, Philippines and Malaysia. There are a number of other countries such as Mexico, Hungary, China and Russia that are emerging in this field, but for the U.S. customer base, it's actually, again, back to the simple tasks because of the language barriers and some questions over the quality of the labor supply. And their relative experience in outsourcing compared to some of the more-established countries.

Today, we see some of the up-and-coming areas to watch would be Israel and Eastern Europe attracting more attention in the near term for U.S. customers.

MATT BECHARD, co-host: And how do you factor in cultural and work-ethic factors in foreign countries in regard to offshoring?

VINCENT: Typically the BPO provider is most focused on the care and feeding of the employees. And that could include the daily transportation, meals, et cetera.

In India, that's part of the culture in addition to the normal factors, the motivation and retention of the associates. I think some of the U.S. companies think about and consider building out their own operations overseas, it's some of these challenges about the management, administration and cultural and legal differences that frankly push them to a decision to not go into and operate a facility themselves but to rely upon the third-party BPO providers.

CHRIS SHaida: Just a further comment on the work ethic. I've spent some time in India, specifically looking at providers. And it's our point-of-view that the offshoring isn't just a lower cost of labor. There are also opportunities to actually improve productivity and the quality of the labor being performed.

Quite often, you have access to better-educated workers than you would get in the U.S. for these jobs. The status of the jobs is often much higher within the Indian culture.

To give you an example, you're REIT guys, you know about the nasty business that is lease abstracting. We, in one way or another participated in that. Worked on projects where it was going on for the past 20 years. And I've never seen a happy room of lease abstractors in the U.S. It is work that isn't tremendously well-respected. I was in India and in the midst of 60 people doing lease abstracts, who were very proud of the work they were doing, and felt that this was high-status work in their local economy. They had to be able to read English; they had to be able to interpret. These were all folks with undergraduate degrees, and half of them had graduate degrees and CPA equivalents there.

So there's an interesting thing to investigate for those interested in offshoring. It's not just a labor-savings play; there can well be a productivity improvement and quality-of-work play, because of the different value that this kind of work has in

that culture.

BECHARD: And related to that, how are employees, specifically in India, motivated to do their jobs? Is there any concern about turnover issues?

SHAIDA: Well there are big concerns about that, because, as this is growing very rapidly, there is a fair amount of poaching from one BPO provider to another. So I think these are generally thought of as high-quality jobs. They are in clean, well-lighted places, very recognizable office spaces, and they're viewed as being long-term jobs.

There can be some issues to work through over the next five years in terms of the growth of this market in India in particular as this market matures, and there'll be some wage pressure, and there'll be turnover pressure.

Right now, the successful providers are providing a home and a sense of well-being in the jobs they're providing. A big thing to look at is the ability of any potential service provider to attract and retain folks.

DAVID. STANFORD: Back to the turnover issue. We've seen some pretty high turnover rates in our work. The investigations we've been making on behalf of our clients. And many of the BPO providers that we talk to are focused heavily on mitigating this with career path development, personnel training and diversity of work assignments.

It sort of goes into what Chris said about the status of these jobs and this kind of thought-provoking job in India, which we think has an advantage for any specialty provider that's focused on the real estate market. To be able to manage that turnover a little bit more precisely.

The other thing we're seeing is some firms that are expanding geographically and opting for site locations in smaller markets. We still have great access to intellectual property and trained people but are sort of less directly competing with the very, very large BPO providers to manage that turnover. PEVNEV: OK. Well, clearly, motivated

employees are an important part of the success of any enterprise, but how about the political issues? I mean, outsourcing, more specifically offshoring, became a minor issue in the last presidential election. And is this potentially a political or public relations issue for companies that decide that they want to outsource some of their functions offshore?

SHAIDA: I think that generally it is, though practically speaking in the real estate world; the size is so small compared to more recognizable targets in the Fortune 100, where the numbers dwarf what would be there in a real estate firm.

A large financial institution with thousands of people offshore or a retail operation with back office operations with, you know, 500, 600, 700 people offshore. I think we'll continue to see that percolate in the process. I think that the real estate companies are sort of, in one degree, removed and two levels down, because we're talking about 10, 20, 30 people. It is hard for us to see this becoming a big public perception issue for a particular reason.

BECHARD: And what about the body shop mentality of outsourcing, specifically the use of offshoring as a means of labor cost arbitrage?

STANFORD: The body shop approach portraying the labor arbitrage is really a short-term tactic. We've seen some occasional bloodbaths that companies are taking approaching that. So generally, task-oriented project work, which is manually intensive and also has a high degree of consistency and repeatability. We've seen, specifically in the real estate market, some of that kind of project work, with valuation modeling, lease abstraction, assignments that have been outsourced and offshored successfully.

But, you know, when you stop with the body shop, when you're starting to get into the recurring, day-to-day business processes, thinking of it only as cost or labor arbitrage can really hurt, because you have to wrap around the labor arbitrage a very defined process, quality control

and mentality of a operating company.

And that starts to, really in our mind, separate the service providers and what they can provide. We've seen basically two camps emerging. Those that are project- or assignment-oriented, task-oriented providers, and those that are more full-service, providing day-to-day and long-term work for the REIT industry.

SHAIDA: We think there's a real opportunity for the real estate industry. This is going to sound strange, but it comes from the complexity of the real estate work as contrasted with the more rote work in just the generic Fortune 100 accounts payable processing, for instance—that the complexity of the real estate can actually be a binder and a tracker in elevating the status of this work.

I had lunch with four of the senior lease abstractors in one shop, and they were palpably proud of the work they were doing, and they explicitly contrasted that with work that their friends were doing at other BPO shops: "Oh, that's just mindless work. We're doing work that we have to think in."

So I think as this develops over the next five years in the REIT industry, there's a tremendous opportunity in real estate to take advantage of—as odd as this may sound—the complexity of this work, to build binders with those people performing it.

PEVNEV: What issues do companies need to consider when they're thinking about outsourcing?

VINCENT: It's a pretty complex set of challenges and issues. I think generally at a very high level the way I've seen this done is companies would typically go through an assessment and figure out what are the core competencies or the core functions that they believe are mission-critical to the success of their firm or are proprietary to the firm in some way, and generally those are never outsourced.

That leaves you with a set of different functions and or tasks that they could outsource, and you

have to make a decision in respect to that: whether it makes sense to do so in an offshore location. And generally when you dissect that, you figure out if it is essentially non-core and non-mission critical. Those functions are typically, by and large, outsourced in a material way to proven providers, and you use contracts and oversight of those providers to kind of monitor the performance.

If you get into areas that are either critical or core but you've decided to outsource them to some degree, you take a much more hands-on role in terms of managing and monitoring the supplier in all the metrics that you require and if the supplier measures up to your performance. Usually, you tend to keep people a part of that operation here in the States as a way to benchmark and validate the performance against the third-party provider.

What we actually often find is that companies tend to take sort of a "ready, fire, aim" approach to this. There is a decision to go after a cost-cutting, and they don't really look at it more holistically or in a disciplined fashion, and it comes back to bite them later.

One of the things we do is we work with our clients and help them assess a strategy and look at the suppliers and look at the way the contract control is structured and then manage the performance over time. So it's not a decision to be taken lightly, particularly if you're looking at major functions or key parts of your back office. If it's simply task and project oriented work you can structure a contract and get that done in a matter of days or weeks and be up and running and be very effective.

One other dimension I want to mention in today's shifting economic environment is the use of outsourcing in different operating environments. And what I mean by that is that outsourcing is often looked at as a way to simply reduce unit cost, particularly by leveraging the lower cost labor pool overseas.

But you can also use outsourcing in a high-growth mode to increase your capacity. You might also look at it as variabilizing your cost structure

if you're in a very high profitability mode but low growth or conversely if you're in—you have a low growth mode and low profitability you may be looking at it as a way to reduce total costs.

So, the clients and customer base need to look at it from the perspective of how does it operate in this environment and could it be a part of our strategy to operate and change our business model, and if so, who are the major players or providers that can be a part of that solution?

BECHARD: And from what you guys are seeing in the real estate space, in regards to how they're using offshoring, does it make more sense given the projects and the tasks that they're looking to offshore, to use third-party providers or to do it themselves?

VINCENT: We've actually had clients come to us initially looking at doing captive or building their own facilities and generally when you go through all the economics and the management complexities it's generally not advisable to do that unless you're typically a very large Fortune 500 company and have the scale to do it. The threshold to be thinking about is somewhere between 500 to 1,000 seats to justify a stand-alone captive operation, whether it's India, Ireland or wherever.

As a result, what most of the clients are doing that we're seeing is they're looking for third-party BPO providers that do have certainly the option for capacity, but increasingly they're looking for some dual capacity to have both offshore and onshore presence. And then usually those firms have the domestic presence to maintain the client relationships and for marketing purposes, but they don't always have the U.S. onshore capacity. As the market gets more mature and more established, I think you're going to see a trend toward the larger, third-party providers who have dual capacity and who are more integrated in solving the breadth of the client's needs.

STANFORD: In real estate, people by nature are builders. And there is a tendency in this evaluation to confuse control and execution with a captive.

We do see quite a few of our clients and prospects thinking first about building it themselves. But once you work through a process, you pretty quickly become comfortable with having someone else help you with it, because it is not a core competency of most companies.

PEVNEV: I've got to imagine an issue that a lot of people are going to be concerned about is the security of their information. How do you protect information when a third-party provider is providing services to multiple real estate firms?

VINCENT: This is one of the fundamental concerns a lot of clients have and generally if you look back at what's going on here, these third-party BPO providers basically have built their business model around building repeatable processes and delivering those to multiple clients, usually within a specific industry or function. So that is essentially what you're buying into as part of the value proposition.

It's obviously important for the providers and the clients to dissect the information that's going to be managed by this provider and figure out how confidential and material is that firm at what can be provided at the industry level? So when you're at the point of structuring your contract, you need to pay very close attention to the type of information that's going to be in that shared environment. And if the client or customer feels materially that that is very proprietary or they need dedicated teams, the provider can certainly structure around that and provide those teams, but it's at a higher cost.

I think when the rubber meets the road in terms of paying for that incremental service and segregation of teams and segregation of data, more often than not the clients will in fact step back to the kind of industry practices that the BPO provider is providing and generally rely on shiny walls, segregation of the data, and control the access points, if you will, to the information, whether it's software, hardware, physical access to the building, to control and mitigate that.

STANFORD: In the real estate-specific industry case, we are able to leverage the investments and expertise and experience over the past 10 years. The Fortune 500 companies are figuring this out in offshore locations. This is not something new to these companies to deal with. And they're dealing with large financial service companies that have much higher security practices than most of our clients that we deal with. So we have the added benefit of coming into this as a late adopter, so we can leverage that experience in the market that's already there.

VINCENT: It doesn't stop at just forming the contract. You should preserve the right to have audit and inspection rights. It's essential to do security assessments if you feel like that is material to your firm.

But the bottom line is that the third-party providers create the means for these companies to save money and time, but it's incumbent upon the actual client customer to make sure they're structuring the protection of the intellectual property and capital rights in their statement of work.

BECHARD: We've talked about some of the strategic and security issues involved. What types of social and/or cultural issues do companies need to consider? Both internal, that is inside the company, as well as external, that is in the country where the function is being relocated?

SHAIDA: The first part is that we don't think in real estate somebody is going to say there's a yes or no answer to offshore. And so we're not going to offshore everything. We're going to offshore some piece on a pilot basis and maybe we'll end up with a mosaic of processes that ultimately make—some of which make the most sense to have staff in a traditional way and some of which may be offshored. And once you pull a piece out there's a lot of stress placed on the current operations.

So I've gotten a bunch of processes that have been woven together by habit and practice over a

long period of time. I pull one out that at first appears to be an isolatable process and typically there are a bunch of connectors that are secondary that have to be dealt with once you've pulled that piece out.

Then you think that I've got a bunch of builders down the hall, and that's what they do and that's what their job description says, but I pull them out, and then I remember that, 'Oh yeah, once a quarter, I run down the hall and grab all those folks and have them work on something else in crisis mode.' So there is a whole set of issues related to unbinding some of those processes.

BECHARD: Do you guys find that most companies find that once they do segment something out that then they find out where these bundles lie that they're more likely to then offshore more activities or bring more back?

SHAIDA: There's not a lot coming back. And that initial period of distress ultimately is healthy, because it forces you to more clearly define each of those constituent processes, and that's ultimately a healthy thing for an organization.

VINCENT: Back on the financial services market where this is much more mainstream, and generally as you added on additional work with these different providers you spent the initial time, the ramp-up, getting the quality and kind of the key metrics to acceptable levels.

But more often than not you're layering more and more work and that's part of the allure for the BPO providers, because they get long-term relationships with clients and those contracts frankly become fairly sticky in nature and good duration on them and I think the challenge for the very large firms is you want to manage the operational risk of this, but you don't necessarily offshore 100 percent of your back office literally, but you have some kind of comparable piece here in the U.S. or at least some duality or spread of risk to different suppliers as you get bigger in scale.

PEVNEV: Well, speaking of scale, how easy or difficult is it to scale up outsourced operations?

VINCENT: I think the easiest work to scale up is really that a lot of the project and transaction related work that's been going on in real estate.

Some examples of that would be running Argus, cash flows, trading financials and the commercial and residential servicing world. So those players that are established literally you can be up and running in a day, days or a week or two. Pretty short term; it's part of the regular fabric of the business.

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