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Industry Leader Profile: Andrew Florance, CEO and Founder of CoStar

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Abstract

[Excerpt] CoStar Group, Inc. was the nation's first independent commercial real estate information research organization, and since its inception in 1987, has taken an industry lacking efficiency of information and revolutionized i t by compiling and maintaining detailed records on hundreds of thousands of different commercial proper ties across the Uni ted States and Uni ted Kingdom. As President and CEO of CoStar, Andrew Florance has directed CoStar's successful expansion from its beginning over twenty year s ago, through its public offering in July 1998, and onto an international service plat form fol lowing i t s expansion covering European market s in the United Kingdom and France. With approximately 1,300 people working for the CoStar worldwide, CoStar serves a client base that includes nearly all of the leading commercial real estate brokerage firms.

Keywords

CoStar, expansion, market analysis; downturn, leadership, restructuring, opportunity, business leader, entrenpenuer, Cornell, real estate

Industry Leader Profile

CEO and Founder of CoStar

Andrew Florance

CoStar Group, Inc. was the nation's first independent commercial real estate information research organization, and since its inception in 1987, has taken an industry lacking efficiency of information and revolutionized it by compiling and maintaining detailed records on hundreds of thousands of different commercial properties across the United States and United Kingdom. As President and CEO of CoStar, Andrew Florance has directed CoStar's successful expansion from its beginning over twenty years ago, through its public offering in July 1998, and onto an international service platform following its expansion covering European markets in the United Kingdom and France. With approximately 1,300 people working for the CoStar worldwide, CoStar serves a client base that includes nearly all of the leading commercial real estate brokerage firms.

Andrew Florance was born in Washington, DC, and graduated from Princeton University with a degree in economics. Prior to CoStar, Florance served as President of Real Estate Infonet, a real estate public records publishing firm that developed the first generation of software products for Federal Filings, a SEC Schedule 13D tracking service, later acquired by Dow Jones. With his proceeds from this sale and family financial support, Florance began his seemingly fantastical quest to inventory within a computer database the entire commercial real estate market in Washington DC - an endeavor which of course eventually evolved into the business of CoStar.

The editors of the Cornell Real Estate Review engaged the 45-year-old entrepreneur to ask him about his inception of CoStar, its relevance in the real estate industry, and what his data-driven career has told him about the current economic crisis.

What inception or insight did you have to see the market niche a company like CoStar couldserve?

At Princeton, I was on a student committee that bought the first four PC's during a transformative time (1980's) when technology was becoming accessible to the masses. With this democratization of technology, as a student I was able to work writing software at night for a number of companies to help pay for school. While a student, I started writing software for a developer in Washington, D.C., creating elaborate 10-year discounted cash flow models for commercial and mixed use developments in Washington. It was an eye-opening experience because I spent hours upon hours building an elaborate model but the data input available for the model - rents, cap rates, per square foot prices – appeared to come from dubious sources and varied widely in terms of accuracy and consistency. Having taken a number of honors physics courses as a student, I looked at that whole experience and thought the process wasn't really very scientific. And I thought, "If one could theoretically quantify and standardize the information for the input data, then people could actually understand these financial models driving deals, and more importantly, they could depend on them to be more accurate."

Starting out in Washington, I attempted to collect and digitize information on real estate. This had to be, in my mind, the most naive moment in history, because – from the inception of trying to find truth in the economics of commercial real estate until today – the amount of brain damage that has occurred is just stunning. Ten thousand people and a billion dollars later, we continue to work on that goal of quantifying information that is not readily obtainable.

What has CoStar's impact been in the real estate industry?

I believe that CoStar has basically changed the way the commercial real estate market works. The commercial real estate market has transformed from a state in which nobody really knew how many buildings there actually were, what the vacancy rate actually was, or what the construction costs or rental rates were. These are now being quantified by CoStar. The market went from being an antiquated, over-the-counter market to being a much more organized market. By completely changing how information flows within the market and between players, I believe we have changed how players within the market communicate with each other.

When CoStar came into the market, things that before had been secret or not readily available were made transparent. Before CoStar, everyone had a chair, and now due to transparency, everyone plays musical chairs. So over the entire twenty-some years we have been doing this, in my experience, our company alternates from being an indispensible utility that people love and a company that people regard with tremendous suspicion and repugnance. Being a 'change agent' can sometimes be a difficult thing.

What are your expansion plans to grow CoStar and in which markets do you see the most potential?

We always try to lead a step further and then backfill when there is less competitive pressure. From 1995 to 2002, there was about $500 million of investment going to direct competitors, such as Dow Jones, McGraw-Hill, Thompson, GE, Goldman Sachs; all of whom were pouring very significant investments into trying to recreate what CoStar was doing. A lot of our decisions regarding where to expand next were based on trying to move fast enough so the competition could not catch up with us. Hence we moved into the United Kingdom and France. Our biggest investment right now is in the United Kingdom.

Before expanding in Europe, we thought the obvious next place to go was Canada, but we decided it would be more valuable for us to take a bigger challenge and try to work abroad. We thought that if we succeed in those two markets, it would be easier to later return to Canada, especially if we were the dominant player in the UK, France and the US.

What are some of the challenges of inventorying property in foreign markets?

The first time you take an incremental step like going from the US to the UK it forces you to reinvent all of your processes. For example, when we went from being a Washington, D.C. company to operating in New York, we had to change our business model to be much more flexible and modify our data models to reframe how the commercial real estate market in NYC operated. Similarly, going in to the UK, we have been wrestling with, but making a lot of progress on, breaking the data models down to the local country level while creating a flexible global model. The goal is to be able to seamlessly query a company's properties around the world, and be able to view these properties from your cultural perspective. This means we have to interpret and understand each country's business rules, linguistics, currency exchange, business operations, and other issues. We are at the tail end of this two-year process, and once we complete it, we believe we will be able to grow much more quickly.

How would you describe CoStar's business culture? And does it vary from each different country?

I think it is a fairly intense business culture. We are extremely competitive, which is necessary when you are a change agent type business. Once people realize there is an opportunity for a completely new business segment, we draw a lot of competitors. So we are always in this competitive and driven environment. We are constantly trying to be intellectual about what we're doing and with the responsibility of generating industry metrics. We are always trying to keep the bar high with how we provide our business products to our thousands of clients. So it is a blend between a very fast paced and intellectually aggressive group with a huge research function and operation.

Prior to our financial crisis, did your data draw attention to any impending market issues?

I believe the reversion to the mean is all powerful in real estate. We are reverting to the mean at the speed of light right now. On the commercial side, this was a train wreck you could clearly see coming since 2006. As a company, we started becoming less aggressive three years ago after looking at the amount of construction activity and the compression of cap rates. We even had to change our quality control checks on our software to allow a lower property cap rate to be entered; we saw this low go from a historic minimum of 3.5% to 1.5%. To us at CoStar, that was an indicator of future market problems. After having tracked commercial sales over twenty- five years, during which a 5% minimum cap rate had always worked as your error check, it seemed that a transaction that required a 1.5% cap rate was an indicator of market misalignment. And it was.

As someone who has made his career mining and analyzing data, what is your perspective on the current financial crisis?

The market is moving so quickly, that some of the traditional measures are somewhat inadequate to judge where we are. Vacancy rates for commercial real estate no longer accurately track what is happening. I believe you have to look at the availability rate, and you have to look forward at the product that's coming down the pipeline, not just that which is already being delivered today. Another key measure in commercial real estate has been absorption, but absorption isn't effective in measuring or reflecting what's happening at the real speed of change. Again, you have to look at forward availabilities. Income is eroding in properties, and rental rates are coming down at unprecedented rates. I believe we already have enough notice of future availabilities to see what the vacancy rates will be next year. In many cities, we expect vacancy rates are going to be above 20%, at the same time we expect rental rates to drop 50%. We also see an unprecedented amount of physically vacant space that is currently leased by companies. Companies seem to be trying to avoid subletting this space to avoid flushing the sublet through their income statement while keeping the lease obligation on their balance sheet. And so, there is a hidden vacancy rate out there. Hence we expect the leasing picture in the next two years will be grim, on par with the debacle in the late 80's and early 90's or worse.

What does the data tell you about the resetting of property values?

We're seeing an unprecedented unraveling in the capital markets and a resulting increase in the cost of capital. The cost of borrowing in AAA tranche with commercial real estate has gone from 5% to 10%. Thus no one can logically say, "If I can borrow at 11% then I should be valuing properties at a 4% cap rate." We have a cap rate expansion going on. We have been down at a 5% cap on a US average, and I imagine that we are going to something significantly north of a 9% cap rate in two or three quarters. The price per square foot for Class A office space in the US has dropped 55% in two quarters. That's unprecedented. It took 10 years for Class A office space to appreciate by that amount, and it's lost that in two quarters.

I think the valuation community is looking at this and asking, "Are these prices real?" They want to believe that the current prices are anomalies - low volume prices that only reflect distressed sales. But realistically, at the end of the day, the value is where the buyers are. This sudden 55% drop in value actually puts the market back in line with where it was over the twenty-year average. It is a reversion to the mean. The good news is, in two quarters, we have already fallen pretty close to where I believe the market is going to settle. The bad news is the entire industry is in denial and thinks these are just a couple of distressed sales, when in fact these are likely the new price points.

The secondary problem is you've got hundreds of billions of dollars of debt financed on these values that were dramatically higher than what we expect the market's going to be seeing for a while. And if leases are rolling in those properties that are financed at the highly inflated values between 2004 and 2008, we expect that debt is going to be a problem. I believe the commercial leasing industry is going to be on par with the residential mortgage issue.

What do you see are the global implications?

We are talking about a possible bubble of hundreds of billions of dollars of bad debt that exists throughout the world. I believe it's just a question of when we acknowledge it. If you were a cynical economist, you would say there is one way for government to solve this problem: to inflate the values of the properties back to the value of the underlying debt. And it appears that is exactly the policy we are pursuing globally. I think we definitely have an inflationary environment coming globally. So ironically, at a time when real estate caused the global financial crisis, I believe real estate is going to be the best hedge against what's coming.

Within the global economic environment, do you foresee any future restructuring spawned by the downturn or other forces?

No matter what's happening in the financial system right now, we still have issues other than the economy we have to deal with. Hopefully people will understand that changing is not a bad thing, it actually can be a good thing – that you can do things in a more intelligent way and you can actually make money doing things in a more intelligent way.

A great worldwide transition that I believe has begun is the retooling of our entire global economy around new energy models. Restructuring the basis from "fuels below" to "fuels above" is going to be one of the biggest economic trends. One of the most gratifying things for me was to be able to make the LEED and ENERGY STAR information for commercial property very visible in our CoStar system. This has been extraordinarily successful because we have been able to measure such a significant financial premium for the LEED and ENERGY STAR buildings. And we've been able to make our data available to academic communities so that the significant premiums for developing green have been substantiated by a number of different academics working independently. I think that's a trend that goes beyond just commercial real estate leasing; it is a 20-year trend in everything we do. I believe the value is going to be in re-powering our economy, either by conservation or by generation. We obviously have a long way to go, but it's been fun and exciting to actually see this unfold from the very beginning. And now we have legislative efforts between Washington D.C., New York, and California requiring transparency in real estate. I expect this will have a mega-impact on the real estate community.

Do you think the economic downturn will hinder or help the speed of change to repower the economy?

A productive way for the government to drive stimulus would be to focus on reducing carbon. The current US administration is doing a great job, and I believe they are being about as aggressive as they can be for stimulus in this area. I think the private sectors should be taking greater advantage of this opportunity and embracing that stimulus money to retrofit their buildings.

I have watched the performance of green building lease rates as the market dropped, and the green buildings rents are dropping, however, they are holding the same premium over non-LEED rental rates. The amazing thing, however, is during the worst leasing environment in twenty years, the LEED certified buildings are currently increasing their occupancy. It's an example illustrating how people who are ahead of the curve do better. I think the repowering of industry is the story for the next twenty years, whether you're motivated by a sense of social responsibility or your own pocket book.

Do you see any bright spots of opportunity in this economy?

I believe there is a very good chance that the greatest modern fortunes made in commercial real estate will be those who commence wealth building over the next 12 to 18 months. They are the ones that may see 30% appreciation over the next decade or longer, as we ride up to the next bubble. Sam Zell is an example that comes to mind; he really began acquiring the Equity Office portfolio in earnest in 1992-93. He continued acquiring properties until 2003, and he timed it to the mark and liquidated the portfolio at the peak of the market. So, I expect that the folks who have dry powder now and are acquiring properties are the ones that will amass amazing wealth.