MAXIMIZE YOUR ESCALATION INCOME

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Operating expense escalations are often treated like a departmental hot potato by office building executives and owners. Fortunately, property managers can educate owners and other executives about the importance of escalations by explaining that expense recoveries are usually *the second largest income source* for most office buildings, lagging only base rent. Review the four important concepts outlined below to maximize escalation income due from your tenants. The escalation processes you establish should both help you bill tenants *and* help you monitor any leakage that might occur. The content and concepts that follow relate to typical multi-tenant office buildings.

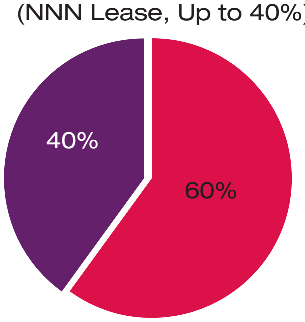
1 ESCALATION INCOME IS 10 TO 50 PERCENT OF REVENUE

With a Base Year lease structure and an average term of five years, escalation income will amount to approximately 10 to 15 percent of gross revenues, depending on local inflation in labor costs, operating costs, property taxes and so on. Base Year leases are designed to shift operational cost increases (inflation) to the tenants receiving those services, so that the landlord's net income agreed to during lease negotiations is preserved. What is your escalation income as a share of total income? If you are billing escalations properly, you might be surprised at how high the percentage is.

With triple net (NNN) leases, the mutual intent is for the tenants to collectively reimburse the landlord for *all* operating expenses and taxes and approved capital expenditures (assuming a fully occupied building), starting at the beginning of each lease term and continuing until each lease expires. Take a look at your property's annual budget and divide the expenses by total income (excluding escalation reimbursements). The product of that calculation is known as the "expense ratio," and expense ratios for stabilized office buildings in most markets are often 40 to 50 percent of total income. That's a huge portion of a building's income and value (see *Figure 1,* below, left).

FIGURE 1

Expense Ratio & Potential Escalation Income
(NNN Lease, Up to 40%)



2 MOST ESCALATION INVOICES HAVE ERRORS

Why? Because the methodology and formulas used for billings are often inconsistent with what the lease requires. Having looked at escalation billings for several thousand buildings over the years, the authors have seen that *most* billings had errors—some small and some large, some which benefited the landlord and others that benefitted the tenants. If you're with a small company, these comments might resonate strongly, because smaller property management and accounting staffs are frequently stuck with homegrown Excel schedules that haven't been tested for years and can have corrupted formulas. But even large national real estate investment trusts (REITs) can and do have problems with errors, because the escalation modules included in popular accounting software packages are not flexible enough to accommodate every type of lease provision. Gross-up methodology, expense caps and combined-versus-separated expenses and property provisions don't always match up well with standard off-the-shelf software capabilities.

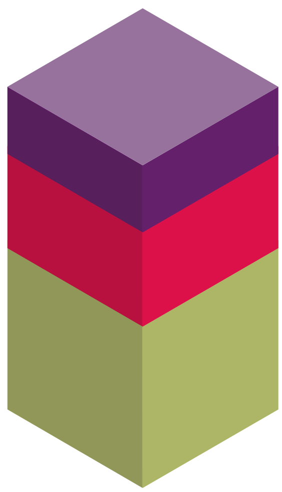
So, what should you do about these problems? Talk to your software provider about making enhancements and improvements. If that doesn't work, look for better software, because it's out there.

3 LANDLORDS NEVER RECOVER 100 PERCENT OF OPERATING EXPENSES

Vacancies, lease expirations, type of lease, rollovers, expense stops and caps will prevent a multi-tenant building's landlord from recovering all escalatable

FIGURE 2

Base Year Components



■ CapEx Amortization
■ Base Year Taxes
■ Base Year Expenses

If the CapEx Amortization expires before tenant leases expire, their Base Years will have been temporarily inflated and future expenses could be below their Base Year amounts, thereby reducing a landlord's recovery of expenses.

operating costs, especially as Base Years get changed for existing tenants. Are there ways to mitigate the leakage? Yes. Stagger lease expirations when appropriate, create a schedule that shows when each lease rolls and then lengthen leases currently under negotiation by several months or a year to push them into less volatile years. Just because most leases are usually three-year or five-year terms doesn't mean that tenants are locked in to those time frames. Think of ways to incentivize them to add time to the lease term.

Do the math for your buildings. Calculate the percentage of expenses you actually recover each year, and track it to see if the techniques mentioned above help to increase your recovery percentages.

Finally, avoid creating "Base Year Inflation" that will erode your recoveries (see *Figure 2,* above). A common error made in most office lease documents is to combine approved capital amortizations within a tenant's Base Year and inflate that amount temporarily until the capital expenditures (CapEx) amortization burns off, resulting in no future recoveries by the landlord. This can lead to a massive hidden leakage of expense recoveries. The lease's definition of escalatable capital expenditures should be done in a separate, freestanding section, so that it does not get merged into how Base Years for operating expenses are. A simple workaround is also available: Treat your cost-saving CapEx like your code-required CapEx; and for Base Year leases, only escalate those jobs which are placed in service after lease commencement. This topic is more fully discussed in BOMA International's newly revised publication *The Escalation Handbook for Office Buildings* (available at **store.boma.org**).

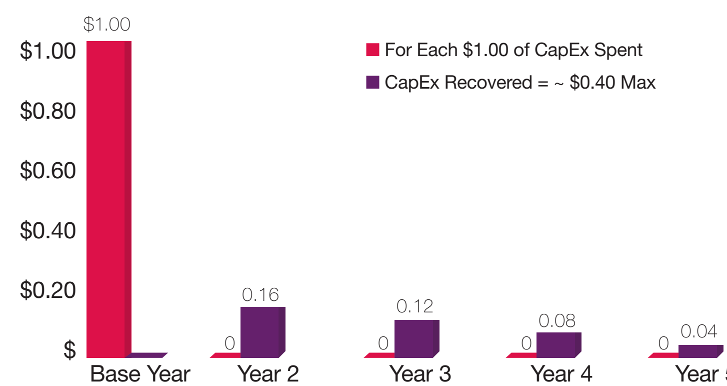
4 LANDLORDS MAKE TWO BIG MISTAKES WITH CAPITAL AMORTIZATIONS

First, landlords often assume they'll recover 100 percent of capital expenditures and don't question if that's true. Landlords generally approve cost-saving capital costs because most leases say this type of capital expenditure is recoverable by amortizing it over a payback period. However, capital amortizations can and do have the same leakage as operating expenses, and for the same reasons. An analysis presented in *The Escalation Handbook for Office Buildings* (Chapter Six, Exhibit 6-3) shows that a hypothetical 100 percent leased building with 20 percent of leases expiring each year *only recovers 40 percent of each dollar spent* on a capital expenditure amortized over five years (see *Figure 3*, below). Such a low recovery should limit capital expenditures considerably.

Second, landlords rarely charge interest on escalatable capital expenditures, even though most leases permit it. Why? Because most property managers and accountants don't pick up on this obscure, minor point found deep in the lease. They miss the opportunity to earn a return on newly invested capital. How much? Over five years, a seven percent rate compounds to 18.8 percent of the original investment.

FIGURE 3

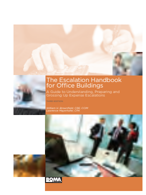
CapEx Recoveries



Tenants benefit when they incentivize landlords to reduce operating costs by agreeing to pay interest on new capital dollars invested. Most cost-saving CapEx jobs are big-ticket items either financed or paid for upfront as a capital investment by the landlord. With a financing charge included, the landlord wins by getting a return on newly invested capital. Once the amortization is complete, the tenant wins due to reduced operating expenses.

Understand these escalation concepts to enhance your building's cash flow. Use the information above to answer two important questions when budgeting and/or reconciling last year's escalation billings:

- What is the percentage of annual total expenses that are actually reimbursed by tenants?
- What is the corresponding leakage that is not reimbursed, and how can I reduce it? B



ABOUT THE AUTHORS: *Brownfield & Mayerhofer, Inc., provides solutions for operating expense escalations and offers consulting, training, software and dispute resolution services. Bill Brownfield and Larry Mayerhofer are the authors of* The Escalation Handbook for Office Buildings *(Third Edition), published by BOMA International and available at* ***store.boma.org****, and ALPHA Office Escalations (AOE) software, available at* ***www.EscalationAdvisors.com****. AOE automatically will calculate and prepare tenant billings for your buildings and determine reimbursement and leakage percentages.*