

Common Area Maintenance Reconciliation - Art or Science?

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Lease Types:

► NET LEASES:

- Industrial (True) NNN specifies that tenant is directly responsible for all Common Area Maintenance (CAM), Tax and Insurance Expenses.
 - If Landlord performs any services at all, they will be billed back to Tenant.
- NNN (Triple Net) lease terms stipulate landlord is responsible for maintenance of the property, payment of property taxes and insurance. Tenant reimburses the landlord for all maintenance costs, including property tax payments and insurance premiums. Generally, the landlord is only responsible for common area maintenance, not responsible for any maintenance within the tenant space.

► GROSS LEASES

- GROSS lease specifies the landlord is responsible for all maintenance, property tax and insurance payments. Tenant do not reimburse the landlord for operating expenses.
 - Landlord is generally responsible for maintenance within tenant suites for building systems and janitorial.

Lease Types:

- ▶ **MODIFIED GROSS**
- ▶ Tenant pays base rent at the lease inception, but pays base plus a proportional share of other costs associated with the property in consecutive years.
 - ▶ Landlord is generally responsible for maintenance within tenant suites for building systems, janitorial.
- ▶ **MODIFIED GROSS WITH STIPULATED BASE**
 - ▶ Stipulated Base amount is a designated number, stated in whole dollars, which offsets future years' costs. It may or may not reflect actual operating expenditures at the time of lease negotiation. Often referred to as base year or base stop.

LEASE TYPES

► MODIFIED GROSS - BASE YEAR

- Base Year provisions limit the tenant's reimbursement of future years' operating expenses to the extent those expenses typically exceed operating expenditures for the year in which the tenant's lease commences. Very common in office leases.
- There are varying methods for establishing a base year:
 - Established per a budget
 - Established per actual for the year lease commences (determined by year end reconciliation)
 - Established per a future year (determined by the year end reconciliation for the year Landlord and Tenant agree upon).

LEASE TYPES

- ▶ MODIFIED GROSS -EXPENSE STOP
 - ▶ Expense Stop is an amount stated in dollars per square foot on an annual or monthly basis. Tenant pays exceeding the stop amount. Not necessarily based on actual expenses. Not very common anymore.
- ▶ MODIFIED GROSS-EXPENSE CAPS
 - ▶ Expense Caps are an artificial ceiling created to limit the amount the tenant may pay in operating expenses. This cap is used to control the amount of expense increase from year to year.
 - ▶ We will discuss this more later in this class.

BENCHMARKING

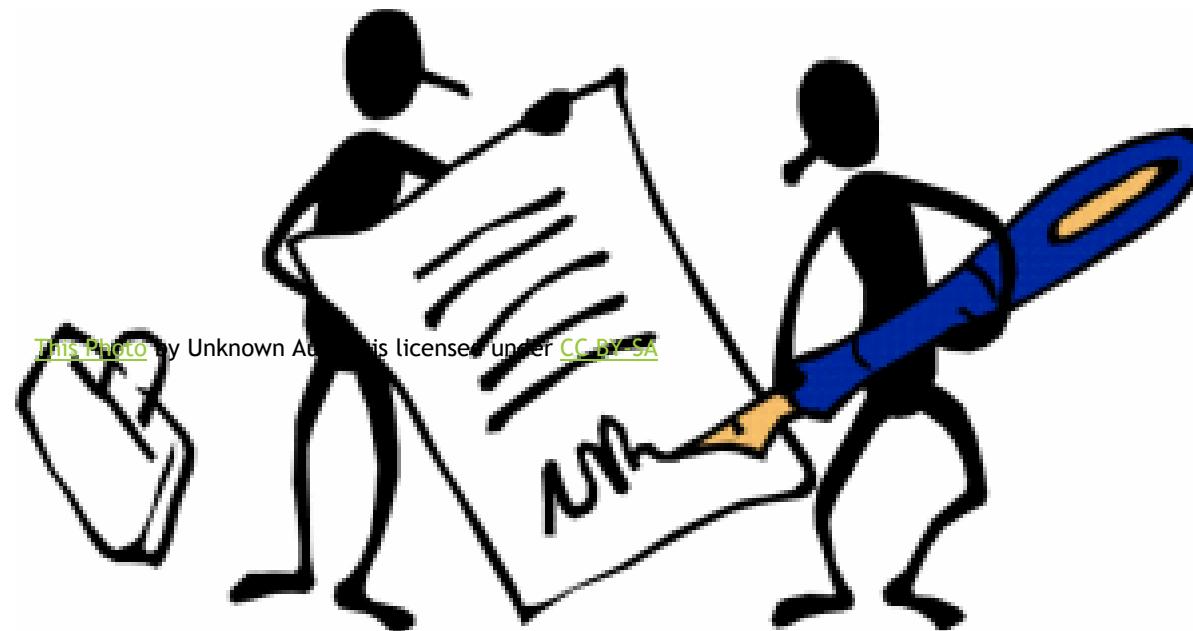
- ▶ BOMA Experience Exchange Report (EER)
 - ▶ Office
 - ▶ Industrial
 - ▶ Retail currently being developed
 - ▶ www.boma.org
- ▶ Need your participation!

Sample Base Year Calculation

▶ Total Operating Expenses	\$10,000
▶ Total Insurance	\$ 5,000
▶ Total Real Estate Taxes	\$ <u>20,000</u>
▶ Total Expenses	\$ 35,000
▶ Less Base Year Expenses	\$ <u>30,000</u>
▶ Difference over Base Year	\$ 5,000
x Pro Rata %	<u>10%</u>
Total	\$ 500

THE FIRST STEP TO THE CAM RECONCILIATION: KNOW YOUR LEASE

- ▶ Landlords and Tenants spend a lot of time during negotiations discussing expense reimbursements. It is our job to make sure the landlord gets as much as allowed per the final executed lease.



OPERATING EXPENSES

- ▶ Operating Expenses are determined annually on a cash or accrual basis by taking into account all property expenses for operational, maintenance and repairs, management fees, parking and insurance.
- ▶ Costs Associated with managing, operating, maintaining and repairing:
 - ❑ Air Conditioning
 - ❑ Electricity
 - ❑ Steam
 - ❑ Heating
 - ❑ Mechanical
 - ❑ Ventilation
 - ❑ Elevator
 - ❑ Security



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OPERATING EXPENSES

- ▶ Management expenses are fees, charges and other costs of managing the building. Some examples are:
 - ❑ Management Fees
 - ❑ Telephone Service
 - ❑ Onsite Management Office Space - fair market rent
 - ❑ Consulting, legal and audit fees (cannot be tenant specific)
 - ❑ Wages, salaries and other labor costs of personnel directly engaged in the management or operation of the building.



OPERATING EXPENSES

- ▶ Insurance and Fee Expense
 - Insurance Expenses
 - Business license and similar fees and taxes related to the building
 - Fees imposed by a government authority
 - Costs of complying with any government laws, codes, regulations or ordinances
 - BOMA Dues

REAL ESTATE TAXES

► Property Taxes, Assessments and Services

- ❑ This category includes cost for consultants to appeal taxes, personal property tax
Tax Appeals save both tenants and landlords money
- ❑ Accrual versus Cash entries - make sure you look at prior year CAM reconciliation to see if the taxes were for the property tax year or the cash paid in that year
- ❑ Handling Tax Refunds

CAPITAL EXPENSES

- ▶ Capital Expenses can be included as an operating expense, if it is considered a “cost saving improvement”
 - ▶ Items to Note:
 - ▶ Although large repairs can typically be passed back to tenants, tenants often object to increases in their Operating Expenses due to what they consider to be major repairs, such as sprinkler installation, replacement of HVAC equipment or elevator renovation
 - ▶ Tenants have an option to review and audit the expenses
 - ▶ Leases are usually very specific about the recovery of capital expenses. If leases are vague, it is client's decision whether to capitalize the expense or to recover as an operating expense
 - ▶ Consider what the market will handle and stay competitive with your peer groups when determining if a capital expense should be recovered.

Capital Costs and Large Repairs

How to Amortize

- If it is to be based on energy savings: divide total cost by energy savings per year = # of years to amortize
- If considered a repair, so amortizing cost over useful life (or other reasonable length of time) with no interest, divide by # of years = amount to be amortized per year
- If adding interest, treat like a loan - use an amortization worksheet

AMORTIZATION WORKSHEET

TOTAL COSTS	\$ 125,000.00	PRINCIPAL	INTEREST	TOTAL PYMT	AMOUNT DUE	Lease Month
TOTAL COSTS	\$ 125,000.00					
# OF MONTHS	60					
PERCENTAGE RATE	7.000%					
PAYMENT NUMBER						
1		(\$1,745.98)	(\$729.17)	(\$2,475.15)	123,254.02	1 1/1/2019
2		(\$1,756.17)	(\$718.98)	(\$2,475.15)	121,497.85	2 2/1/2019
3		(\$1,766.41)	(\$708.74)	(\$2,475.15)	119,731.44	3 3/1/2019
4		(\$1,776.72)	(\$698.43)	(\$2,475.15)	117,954.72	4 4/1/2019
5		(\$1,787.08)	(\$688.07)	(\$2,475.15)	116,167.64	5 5/1/2019
6		(\$1,797.51)	(\$677.64)	(\$2,475.15)	114,370.13	6 6/1/2019
7		(\$1,807.99)	(\$667.16)	(\$2,475.15)	112,562.14	7 7/1/2019
8		(\$1,818.54)	(\$656.61)	(\$2,475.15)	110,743.61	8 8/1/2019
9		(\$1,829.15)	(\$646.00)	(\$2,475.15)	108,914.46	9 9/1/2019
10		(\$1,839.82)	(\$635.33)	(\$2,475.15)	107,074.65	10 10/1/2019
11		(\$1,850.55)	(\$624.60)	(\$2,475.15)	105,224.10	11 11/1/2019
12		(\$1,861.34)	(\$613.81)	(\$2,475.15)	103,362.75	12 12/1/2019
13		(\$1,872.20)	(\$602.95)	(\$2,475.15)	101,490.55	13 1/1/2020
14		(\$1,883.12)	(\$592.03)	(\$2,475.15)	99,607.43	14 2/1/2020
15		(\$1,894.11)	(\$581.04)	(\$2,475.15)	97,713.33	15 3/1/2020
16		(\$1,905.10)	(\$570.00)	(\$2,475.15)	95,820.47	16 4/1/2020

(\$29,701.80)



GROSSING UP EXPENSES

- ▶ Lease provisions allowing for gross up are usually stated in a percentage (%), example-gross expenses up to 95%
- ▶ The ability to gross up may depend on the actual average occupancy of the property of the coverage year
- ▶ If average occupancy is at 95% then the expenses are already considered to be grossed up

GROSSING UP EXPENSES

Variable & Fixed Expenses

- ▶ Variable Expenses are those directly affected by occupancy and may include:
 - ▶ Utilities (fixed and variable components)
 - ▶ Cleaning Contract / Supplies
 - ▶ Management Fees
- ▶ Non Variable Expenses are those not directly affected by occupancy and may include:
 - ▶ Real Estate Taxes
 - ▶ Insurance
 - ▶ Maintenance and repairs not affected by occupancy (review though, as some that you don't think of can be affected by occupancy – day porter hours, part time engineers, vacancy credits on elevator contracts)

GROSSING UP EXPENSES

Gross Up Examples

- ▶ In 2019, 100,000 square foot building, 50% occupied by one tenant, 50% vacant
 - ▶ Actual Electricity in 2019 = \$10,000
 - ▶ Tenant pays 50% of \$10,000 or \$5,000, LL does not recover balance
 - ▶ 100% Gross Up of Electricity of \$10,000 in 2019 to = \$20,000
 - ▶ Tenant pays 50% of \$20,000 or \$10,000, LL recovers full amount
 - ▶ In 2020, another tenant takes the other 50% of vacant space. No gross up since building is 100% occupied
 - ▶ Actual Electricity in 2020 = \$24,000
 - ▶ Each Tenant pays 50%, or \$12,000, LL recovers full amount

GROSSING UP EXPENSES

Gross Up - General

- ▶ If a tenant has other lease provisions in regard to the recovery calculation (Base Years, CAPs, etc), those limitations must also have been grossed up if the current year expense pool is grossed up
- ▶ Grossing up is on a tenant by tenant basis
- ▶ Make sure you can defend your calculations

CAPS

- Caps can be on all expenses, but this is rare
- They are generally on controllable expenses (those expenses that in theory the LL has control over - by bidding services)
- Non-controllable expenses (those over which the LL has very little control) should be defined in the lease, but if they are not, industry standard non-controllables are:
 - Utilities (LL can improve sustainability efforts, but no control over rates set by utility company)
 - Property Taxes (can appeal, but no control over rates set by municipality)
 - Insurance (LL can bid out insurance, maybe reduce exposure, but no control over rates that are affected by factors & events out of LL control)
 - Some leases will list things like governmental mandated wage hikes, management fees, increased security expenses due to global events

CAPS

Handling CAPS - cap over prior year controllables

- ▶ EXAMPLE A

- ▶ Previous year's controllable expenses \$258,000
- ▶ 5% CAP \$270,900
- ▶ Current year's controllable expenses \$263,000
- ▶ In this scenario, you would use the \$263,000 (non CAP) as your controllable expense pool and add your uncontrollable expenses back in for a total expense pool
- ▶ For the next year, on which amount will you place the 5% CAP?

- ▶ EXAMPLE B

- ▶ Previous year's controllable expenses \$237,000
- ▶ 2% CAP \$241,740
- ▶ Current year's controllable expenses \$251,000
- ▶ In this scenario, you would use the \$241,740 (CAP) as your controllable expense pool and add your uncontrollable expenses back in for a total expense pool
- ▶ For the next year, on which amount will you place the 2% CAP?

OWNER RESPONSIBILITY

- ▶ Who is responsible for costs associated with large expenditures such as:
 - ▶ Roof repairs or replacement
 - ▶ Structural repairs
 - ▶ HVAC repairs or replacement
 - ▶ Owner may be responsible for the repair/replacement cost, but those expenses may be allowed to be “passed through” (or charged) to the tenant:

LANDLORD'S OBLIGATIONS. Landlord shall keep in good order, condition and repair the foundations, exterior walls and the exterior roof of the Premises.... Landlord shall maintain the air conditioning units that serve the Premises... **Tenant shall reimburse Landlord for the repairs and maintenance defined in “Operating Costs” in this Lease.**

REVIEW YOUR LEASES to ensure you know how to handle these items.

OWNER RESPONSIBILITY

- ▶ Larger repair costs (i.e., parking lot work, roof work) - amortize over life of the improvement
 - ▶ Amortization - Pros & Cons
 - ▶ Reserves
- ▶ Know your lease!

TENANT RESPONSIBILITY

- ▶ Typically tenants reimburse owners for all expenses related to the property for industrial and retail leases
- ▶ Office leases may also include the ability to include reimbursements for repairs such as light bulb replacements
 - ▶ Remember some owners may be willing to fund large replacement/repair costs and amortize them over the life of the lease (usually includes some interest)
- ▶ Know your lease!

MANAGER RESPONSIBILITY

- ▶ KNOW YOUR LEASES - if you are unsure of the interpretation - ask your boss or your owner.
- ▶ Advise your owners of any poorly written areas of the lease - they may need to change the way their leases are written and will appreciate your suggestions
- ▶ Be consistent - review prior years to see how items were handled and be consistent or be prepared to defend your decisions.
- ▶ Participate in the BOMA EER
- ▶ KNOW YOUR LEASES

SUMMARY COMMENTS

- ▶ KNOW YOUR LEASE!
- ▶ REVIEW THE LEASE - look for who is responsible, what expenses can and can't be included, caps, gross-up, expense stops, audit rights, due dates
- ▶ BE CONSISTENT - check prior calculations for the property and make sure items are handled in a consistent manner.

Thank you!