International Real Estate Conference '99

Co-sponsors: Pacific Rim Real Estate Society (PRRES)
Asian Real Estate Society (AsRES)

Kuala Lumpur, 26 - 30 January 1999

CONTROL OF OUTGOINGS (BUILDING CHARGES) IN COMMERCIAL BUILDINGS.

Peter C. Wills.
and
Colin Dominy

University of Western Sydney, Hawkesbury.
Blacktown Campus, Quakers Hill. Australia
Phone: +61-2-9852-4218. Facsimile: +61-2-9852-4185. E-mail: p.wills@uws.edu.au

Keywords: Control of building charges. Commercial Building Outgoings. Management of building fees. Property management practice. Government charges. Statutory building charges. Insurance charges. Fixed building charges. Operating expenses. Building allowances/charges. Recoverable and non-recoverable building charges.

Introduction.

After analysing outgoings the next step to manage or control them. As stated in our paper presented last year on ‘Analysing Outgoings’ (building charges) the overall objective is to increase the value of the asset, and one way to achieve this, is by being proactive with property management procedures. The same break-up, or grouping of outgoings will be used to indicate ways of possibly controlling expenditure. Statutory charges, Insurances, Operating Expenses, Other Expenses, and Allowances will be investigated in that order. What must be kept in mind is that as well as trying to cut costs, the role of the property manager is to maintain full occupancy. If drastic cost cutting occurs and tenants become dissatisfied, then vacancies will climb. This results in a quick drop in income, while outgoings probably remain the same. Outcome, one very unhappy building owner ! One way of helping to control outgoings, is to know immediately where problems areas occur. Kaplan, in 1976, (pp34-36) made the following statement:

> "Our attitude toward a landlord-tenant relationship is quite straightforward: constant, open two-way communication. We also encourage a return flow of information detailing problem areas and complaints. Many potential troublesome problems can also be short-circuited by early communication. Extending this communication program to its logical conclusion, we are now beginning to create and distribute a monthly newsletter to tenants."

Things haven't really changed today. If tenants, and owners are aware of what is going on, then problems areas may cease to be problem areas. A satisfied tenant will hopefully remain in occupation.

Statutorv Charges. (Government Charges)

This grouping consists of Council Rates, Water Rates and Land Tax, and can account for up to 35% of outgoing expenditure. Most property managers and owners may think that, as these are Government charges, they can't be reduced. In the BOMA Journal of February 1996, interesting comment was made that, " there is a growing compliance problem in areas such as occupational health and safety, accompanied by a plethora of payments which have to be made for various inspections and certificates". Are these statutory charges and can they be recovered from the tenant ? To try and achieve this recovery, owners are now placing all encompassing recovery clauses in leases to cover this contingency. It appears many Local Government authorities are trying to recreate the bureaucracy of old. If you can't raise the rates, (enough), create a department, carry out unnecessary inspections and then charge a ridiculous fee for it ! Council rates, Land Tax and now to a lesser extent Water Rate charges, are based on the Valuer General's (the Government valuer) figures. The calculation of council rates (Local Government rates/taxes) is related to the land vale of the property, (this differs from country to country, and it can be based on the unimproved land value, improved value, assessed annual rental value), and a rate in the dollar is struck by the council. Each local council is empowered under the Local Government Act to assess and charge the owners of land, within the council's boundaries, a council rate. Rates are considered a charge on land, and therefore take precedence over other charges. Council rates on commercial premises seemed to have increased greatly over recent years. (Without little increase in services). There seems to be perception amongst local government authorities that if you own investment property, you must be wealthy, therefore you can afford to pay any rate they impose. What they do not consider, or seem to forget is, that the consumer, or tenant ends up, one way or another, paying those high rates. The property owner, to maintain a reasonable return, is left with no other option than to pass the council rates, or at least

the increases in them, onto the tenant. The tenant, to maintain their profit level, must pass this onto the consumer/customer/client.
The other tax that is directly related to the land value figure is that of land tax. (Again this will vary from country to country). For example, in New South Wales, for the owner/s of land as at midnight, on the 31st December each year, is liable for such tax. This tax, which goes directly to the State Revenue Office, in most cases is quite unjust. It is rarely adjusted for increases in value, i.e. it is not indexed, and again the end user appears to meet the cost. How can the property manager control or decrease this area of expenditure ? As the rate is assessed on the land value figure, provided by the Valuer General's figure, careful consideration should be given to appealing the figure placed on the property. Experience has shown the authors, that many Valuer General's assessments are in error.
Objections on various grounds can be made against the Valuer General's assessment. (See the explanation brochure enclosed with your next assessment). The most common ground for objection is that the figure placed on the land is too high. This is only worth appealing if you can support your objection with good evidence. Most times a recommendation may have to be made to the owner that a registered valuer be consulted to investigate the feasibility of objecting. The property manager may also have an obligation to supply tenants with a copy of the Valuer General's assessment, especially if the tenant has any liability for the rates or Land Tax. The final thought when trying to reduce or control council rates and land tax, is the cost benefit approach. The question to be asked is, 'is the cost involved in obtaining a valuation and possibly taking proceedings through the Land & Environment Court, offset by the savings in rates etc. ?' With a large discrepancy, (which can occur) or with medium to large premises, and with savings over a number of years, the effort may well be worthwhile.
Water rates are now shifting to a user pays basis. How can this equitably met, partly by the owner (if necessary) and by the tenants, especially where individual water meters do not exist ?. This is particularly the case with the majority of multi-tenant buildings in Australia. Again a cost benefit analysis could be undertaken to establish the feasibility of installing water meters to each floor, (Usually each floor has a separate control cock/tap). This may help in establishing a water usage pattern. It must be remembered that some businesses do use a large volume of water, and careful consideration should be given to this when drawing up a lease (e.g. Laundromat, printing, food shops etc.). Thought must be given to this area when a building is being planned, refurbished or retrofitted. To immediately manage water consumption, the property manager can become pro-active. Active steps can be taken such as; carrying out a regular inspection of all water apparatus. At night when the building is shutdown (supposedly) take a master water meter reading, then one or two hours later take a second reading. This may give some indication that pipes are leaking, or apparatus is left on, wasting water. Of course this should be carried out floor by floor, if possible. To carry this out and save water, all automatic flushing systems should be shut off. If there is not a mechanism in place to carry this out, there should be one installed as soon as possible. With modern technology, it will be possible soon, to monitor all water consumption in an office or retail building, by electronic on line digital read outs, supplied from micro-processor flow meters located in the water pipes.

Insurances
Adequate insurance are of concern to every property owner and manager. Investigations and research has shown that problems with insurance (with property), fall into three main areas:

- Under insurance. Where the owner has either purposely under-insured the premises, to save money on the premium, but carrying part of the risk themselves (subject to average clause), or they have not realised that replacement costs have risen dramatically.
- Over insurance. This can occur where the cost is met by the tenant, and the owner/property manager does not worry about the accuracy of cover.
- Wrong policies used, or cover not taken for certain areas of possible liability. Types of policy would include, Fire insurance (building), workers' compensation, machinery breakdown (including fusion of electric motors, public liability, burglary/theft, plate glass, impact, loss of rent, etc.

How can the property manager or owner save expenditure in this area ? The first step is to check on the adequacy of the insurance, both in respect to the sum insured and the policy coverage. To confirm the sum insured, a valuation, from a registered valuer should be obtained. The services of an insurance broker should also be used to obtain the best possible premium for the cover required and suggestions of the types policies and extensions. This area should be reviewed on an annual basis. There is a great deal of competition amongst insurers.

Operating Expenses
As could be seen in our paper presented last year, operating expenses covers, air conditioning, energy users, (fuel/gas/ electricity), fire protection, security, lifts and repairs and maintenance.
Many of the above items listed above are carried out under contract, and this is perhaps the area where greatest savings can be made. Re-negotiation of contracts on an annual, or two yearly basis must be carried by the property manager, if they wish to remain pro-active. It may be possible to obtain a cheaper job, but will the service be as good ? If a reduction in the service leads to tenant dissatisfaction, a higher vacancy rate will occur. It must be remembered here, that the main disadvantage in using any long term contracts, is that if your income falls, you could still have high operating expenses. Energy users are an area that should come under immediate scrutiny. It is now common practice to have an energy audit of a building on a regular basis. Research has indicated that savings of up to 20% on energy can be obtained. Repairs and maintenance are often overlooked or under-estimated by property owners. To maintain rental levels, and maximise occupancy, it is essential that adequate allowance be made for such repairs and maintenance. It is in this area that the facilities managers come into their own. The use of planned preventative maintenance programs (pro-active management techniques), as well as a calendar or diary system, an hours run system and life cycle costing can greatly enhance the return on a property.
Specific planned repairs and maintenance can be contracted on a regular basis, allowing for medium and long term planning of expenditure. This of course, is related back to the goals and objectives of the owner.

Other Expenses
The two main areas covered by other expenses are management and cleaning/cleaning supplies. Management is a strange beast in both analysing property performance and investigating investment reports. In analysing property performance, management can vary from 2% to 5%. When investigating property or investment reports management was not even mentioned (0%) or so low as to be laughable, (1/2%). This is an expense that must be adequately allowed for when analysing and controlling outgoings. The size of the income, the complexity of the premises and the amount of work the owner wishes the property manager to undertake will determine the fee. The quickest way to assess the validity of the fee, is to take the gross income, deduct the vacancy allowance, then calculate the percentage of management to that income. Research has shown that if the management fee does not fall between 2 and 4%, depending on the size of the income, then proper allowance needs to be made. Unfortunately today, many property management departments are forced to undersell their expertise by other sections of the real estate firms. The leasing or selling department may be keen to obtain the leasing and/or selling rights, and to 'get in on the ground floor', they force an under-cutting of the management fee. This may be acceptable if the property management staff receive a proportion of the leasing or selling fees, in recompense. (The bottom line is 'money' !). Cleaning is perhaps one area where an annual review of performance and costs needs to be maintained. Many property managers know cheaper cleaning can always be found, but tenant satisfaction must be given consideration, and to this end a definite minimum standard of performance must be contracted.

Allowances
An allowance should be made for vacancies in any investment report or performance analysis. This is more than often completely disregarded by most parties. It can be the most telling item in the performance analysis of a building that has been operating for a number of years. The tenants are the ones who have to live with the premises, if it does not perform, then they will soon vacate. As well as looking at the vacancy rate, the turnover rate will also become apparent. Any non-recoverables should also be detailed. These items are not covered in lease provisions, they are not capital expenditure items, but are allowable deductions in operating buildings. They can also be covered in sundry items, or the contingency allowance.

One area that not been mentioned is that of depreciation. Speak to any accountant and they will tell you that there must be depreciation somewhere ! If depreciation, on that particular premises, is an allowable deduction, then by all means it can be shown, (on the balance sheet), but not in the outgoings. Depreciation is immediately taken into account by the rents obtained, and the expenditure on repairs and maintenance.

Conclusion
What does this tell us ? Property management is usually under-rated by the property industry. It is often felt that the glamour selling and leasing areas are much more important, they are at least more high profile, however the quality, value adding process of pro-active property management can greatly enhance the value of a premises. To achieve this competent analysis and control of outgoings is one of the tools available. As owners and tenants become more aware of the types of property

performance analysis that can be carried out, they will look to properly constructed outgoing spreadsheets, comparing data to industry benchmarks and to previous years figures. Three recent case studies revealed that outgoings could be decreased (that's right, decreased) by up to 20%, over a period of three years, (From 27% of gross income down to 22%, approx.), by careful analysis, management and planning. The value of the property was increased and tenant satisfaction rose dramatically. The value adding process of pro-active property management in the area of outgoings is a reality.

Bibliography.

Davis, F.A. & Wills P.C.	Real Estate Management, Petfran Publications, Sydney. 1996.
Fiddman, R.A.	Real Estate Asset Management: The Key to Performance. Pension World, USA, 1980, pp 14-16
Haddad, G.L.	The Evolving Role of the Real Estate Property Manager. Commercial Investment Real Estate Journal, USA, 1988 pp 20-21
Kaplan, W.B.	"The Property Manager's Role in Acquisition", Journal of Property Management, USA 1976, pp 33-36
Pupilli, S	Energy Management Opportunities for the Building Sector. BOMAQ, Sydney, 1985.
Shenkel, Prof. W.M.	Computer Accounting Records for Real Estate Management, Unibeam, Vol XI, 1983, pp 62-67.