nerej

Containing annual operating expenses yields increased investor returns

September 05, 2008 - Northern New England

Office property investors in Southern New Hampshire are facing challenging times due to rising operating expenses. Although most leases are structured so the landlord can pass common area expense and utility increases to the tenants, there is a ceiling above which the tenants can no longer afford, and which is no longer competitive. We are reminded of this when negotiating leases, regardless of whether structured as triple net or modified gross. Today, tenants are focused on the overall real estate costs, unlike years ago when tenants paid attention to the rate of increase of the base rent component and rarely scrutinized operating costs.

Operating Expense Containment

INEX Properties has done well to keep annual operating expense increases to a minimum - in most cases less than 3% per year. In 2008, most office building managers will be hard-pressed to achieve level budgets due to increases in fuel and related items such as snow removal, parking lot resurfacing/asphalt, and vehicle surcharges by tradesmen. Astute property managers will seek fixed season snow removal contracts; although after last winter's large snowfalls these may be hard to source. Other variable expenses like insurance continue to increase, but at manageable levels.

Electrical consumption is one potential area for savings. Recently, INEX conducted energy audits and determined that light bulb and ballast changes could yield significant savings with a return on investment of less than two years.

Fixed costs such as real estate taxes and water & sewer charges increase annually. Although taxes are considered fixed expenses, a strong property manager will contest rising assessments in an effort to receive abatements. If successful, an abatement yields a cash refund, but equally as important, the reduction in assessment allows future real estate budgets to be pared back; at least for a few years until cities and towns have pushed assessments upward and managers are forced to go through the exercise again.

Base Rent Strategy

Landlords need growth in base rents to create value in their portfolios. Provided buildings can be managed in a way that contains operating expenses, the owner will be able to squeak out nominal increases in the base rent component. Again, tenants more now than ever look at the overall expenses, so increases in base rent can only happen if you manage aggressively.

For the foreseeable future, due to widely-held belief that the economy will experience inflation to some degree, landlords should negotiate annual base rent increases tied to a CPI index. We have already seen upward movement of the CPI - Northeast index that INEX Props. utilizes. Since 2003, this index has experienced an annual rate of increase averaging approximately 3.5%; whereas the prior decade average was 2.75%. Our strategy has been to move away from fixed annual increases of 3% to the CPI index in order to increase base rents and build value. Achieving annual CPI increases is a relatively easy part of the lease negotiation because most tenants are familiar and comfortable with the government-generated CPI index.

Tenant Improvement Impact

In this uncertain economic environment, many tenants desire short term leases as a way to remain flexible and react to changing business conditions. Landlords feel the impact when asked to finance tenant improvements (TI) over a shorter period - the result being higher TI amortization amounts. It is not atypical for office TI to run $25+/- per s/f, which equates to $6 to $9 per s/f if amortized fully over a 3 to 5 year lease term. Landlords must judiciously spend money on TI, so as not to wipe out any gains realized by the aforementioned cost containment and CPI strategies.

Holding Steady

A review of industry reports suggests that Southern New Hampshire office rents over the past five years have increased between 2% to 3% annually, while vacancy has dropped a few percentage points to around 15% (some markets like Nashua are significantly higher at 20%+/-). In order to achieve even these modest gains in the coming years, property managers and owners must employ a combination of strategies - operating expense containment, reasonable tenant improvement allowances and annual CPI increases.

Mark Lacombe, CCIM is the vice president, real estate practice leader at INEX Properties, Manchester, N.H.