

Commercial

Pump Up the Bottom Line

With rents falling, tighter spending is the only way to grow a building's NOI.

By Mariwyn Evans

Want to boost the value of your client's building? Two words: Cut expenses. "During economic upturns, owners forget to watch their nickels and then have to play catch up in the downturns. The best time to run a tight property is all the time," says Nick Nicholas, CCIM, CRE®, president of Nicholas Co. in Dallas.

Lowering expenses increases net operating income, which translates into a higher value. Cutting costs can also be a way to pocket more rental income, says Geoff Kreuzer, SIOR, president of Colliers Bennett & Kahnweiler Inc., in Denver. "Most triple-net industrial tenants look at the gross rent number to occupy space, so you'll be able to charge a slightly higher rent if your expenses are lower."

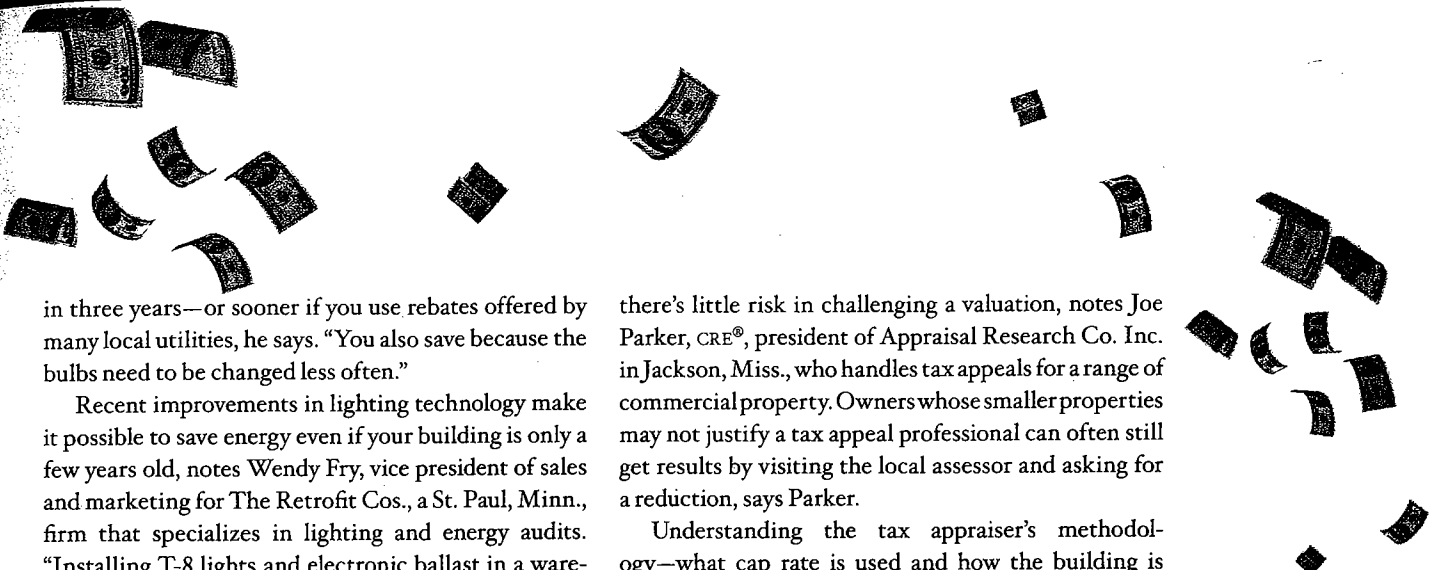
What are the best ways to better your building's bottom line? Start with the biggest ticket items—utilities, property taxes, and cleaning costs. Depending on location, building size, and market, utilities represent between 22 percent and 25 percent of operating expenses for commercial properties, according to the Institute of Real Estate Management's Income and Expense Analysis reports. Close behind are property taxes at nearly 24 percent and janitorial costs at approximately 15 percent, says Nick Schwendeman, CPM®, senior vice president of asset management at The Webb Cos. in Lexington, Ky.

Here are tips for tackling major expenses.

Rein in Utility Costs

Many commercial managers start their quest for energy savings by benchmarking current energy consumption with the help of the Environmental Protection Agency's Energy Star Portfolio Manager program (www.energystar.gov). This free online tool lets you track and compare your properties' energy and water consumption with similar buildings and chart improvements.

"Updating lighting in office and industrial properties is a no-brainer for lower expenses," says Kreuzer. Switching to T-5 fluorescent bulbs in an industrial or office property can have a payback



in three years—or sooner if you use rebates offered by many local utilities, he says. “You also save because the bulbs need to be changed less often.”

Recent improvements in lighting technology make it possible to save energy even if your building is only a few years old, notes Wendy Fry, vice president of sales and marketing for The Retrofit Cos., a St. Paul, Minn., firm that specializes in lighting and energy audits. “Installing T-8 lights and electronic ballast in a warehouse that operates 24 hours a day can pay for itself in six months,” she says. Changing out exterior lights to induction fixtures is another way to reduce electricity consumption, often lowering exterior lighting costs by as much as 50 percent, she says.

“Automatic motion sensors on lights are a small thing, but they can add up to savings without affecting the quality of the tenant experience,” says Jim Cantrell, CPM®, principal with Cantrell, Harris & Associates in San Francisco. The sensors work particularly well in areas like file rooms that are used infrequently.

HVAC is the other big energy user in most buildings, and energy savings are often possible without major upgrades. Optimizing HVAC start times to coincide with occupancy can also cut waste and wear. So is turning temperatures way down in unoccupied space. “We keep vacant warehouse space at 45 degrees in the winter, just enough to keep the sprinklers in good shape,” says Lynn Reich, CCIM, SIOR, executive vice president of Colliers Bennett & Kahnweiler in Chicago.

Green practices—in the form of recycling—also lower waste hauling costs, notes Jo Anne Corbitt, CPM®, director of property management with The Mathews Cos. in Nashville, Tenn. She instituted a white-paper recycling program that gives every worker two bins—one for recyclable paper and one for personal trash. “My garbage removal costs have dropped by a third,” she says.

Challenge Tax Valuations

Another big budget item that deserves regular scrutiny is property taxes. Too often, owners simply compare their current tax bill with last year’s. If it’s less, they let it go, says Bob Herman, managing director and national leader of the property tax services practice at Duff & Phelps, an independent financial advisory and investment banking firm. That can be a costly mistake, particularly in a market with falling values and rising vacancies.

And since many companies that specialize in property tax appeals work for a percentage of the savings,

there’s little risk in challenging a valuation, notes Joe Parker, CRE®, president of Appraisal Research Co. Inc. in Jackson, Miss., who handles tax appeals for a range of commercial property. Owners whose smaller properties may not justify a tax appeal professional can often still get results by visiting the local assessor and asking for a reduction, says Parker.

Understanding the tax appraiser’s methodology—what cap rate is used and how the building is classified—is essential in planning any tax appeal. David Zimmer, SIOR, of Zimmer Real Estate Services LC/ONCOR International in Kansas City, Mo., suggests visiting the assessor’s Web site and meeting informally with an assessor to get more details. Being aware of how different types of land are assessed can also pay off, he notes. For example, business park owners in his market have been able to lower taxes on undeveloped parcels by planting a harvestable crop, such as wheat, and getting the acreage taxed as agricultural land until they’re ready to rezone for development.

Control Cleaning Costs

Lowering janitorial costs can also increase your bottom line, so long as you don’t try to save at the expense of building quality and tenant satisfaction, says Cantrell. A key first step is to rebid cleaning contracts or apply pressure on current vendors to lower costs. But careful monitoring of cleaning charges can also pay. “Property owners need to tell vendors the square footage that is being cleaned, not the other way around,” says Schwendeman. You also need to be prompt about notifying janitorial staff when a space becomes vacant so that your bill reflects credits for space that isn’t cleaned, says Cantrell.

Find Other Places to Cut

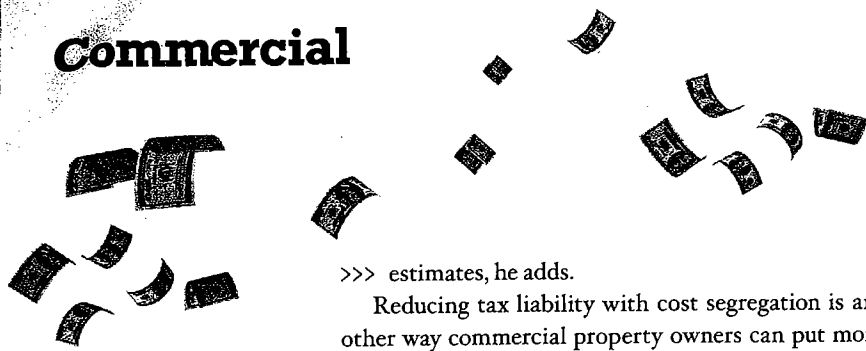
Reining in spending on big budget items may have the greatest benefit for the bottom line, but wise owners and managers shouldn’t stop there. “Insurance costs aren’t as much as energy expenses, but if you pay attention, you can save on premiums,” says Nicholas. One way is to match the insured value to the risk of loss. For example, as much as 30 percent of the value of a property may be the land, which doesn’t need coverage against certain property and casualty perils, like fire, says Nicholas.

Insuring for full replacement cost may also add to premium expenses, especially if the replacement figure is based on insurance industry construction-cost underwriting manuals instead of local contractor >>>

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compare your
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**Finding
obscure
sources of
extra funds
just requires
some
creativity.**

>>> estimates, he adds.

Reducing tax liability with cost segregation is another way commercial property owners can put more money in their pockets. Cost segregation enables owners to accelerate depreciation, and thus maximize cash flows, on portions of a building. Changes in classification can make a big difference since commercial real estate is depreciated over 39 years, while exterior improvements and tenant build-out are usually depreciated over 15 years or less. Existing assets can also benefit from cost segregation thanks to a 'look-back' provision," says Greg Bryant, managing partner with Bedford Cost Segregation in Bedford, N.H. That lets you recalculate depreciation going back as far as 1987 and then take that deduction in the current tax year.

While larger, more complex buildings with lots of secondary decorative features are more likely to generate savings from cost segregation techniques, even buildings with a depreciable basis of less than \$1 million can see savings. Fees for a cost segregation study vary by building size and complexity, but reputable companies will provide an estimate of possible depreciation savings at no cost, says Bryant. "We generally

look for a tax savings of at least 10 times our fee before we encourage a client to use cost segregation."

Look to the Revenue Side

While cutting costs gets most of the attention in current efforts to improve net operating income, it isn't the only option. Raising rents is tough, but finding obscure sources of extra funds just requires some creativity. "Every manager should review the language in leases related to electricity consumption and evaluate the potential for rebills," says Schwendeman. "Make sure your lease spells out standard business days and hours and rates for billing back off-hours use or exceptional consumption." Schwendeman was able to bill back some \$80,000 to two heavy-use tenants in one building during 2009 as well as an additional \$11,500 in overtime HVAC usage.

Perhaps the most important revenue generator in this market is retaining the tenants you have, even if it means reducing rents. "Vacancy means more expensive tenant improvements. Keeping your tenants happy and in place probably has more effect on your bottom line than any cost saving," says Parker. ■



COMMERCIAL NEWS ROUNDUP

Appraisers Are in Demand

Want work in these tough times? Become an appraiser, suggests Chris Lee, president and CEO of CEL & Associates (www.celassociates.com) in Los Angeles. Appraisers

will be needed to evaluate assets taken over by banks and to perform more frequent reappraisals of property for existing or refinanced loans, he says. "Appraisal is a discipline within

commercial real estate that will grow dramatically." Lee made his remarks on the Fourth Quarter 2009 Technology & Intelligence Briefing podcast by NAR's Commercial division. For a link to the recording search for "Appraisal Podcast" at

REALTOR.org/realformag. Lee, whose consulting firm tracks strategic trends in commercial real estate and conducts surveys of tenants and industry compensation, also sees demand for commercial real estate practitioners in the

areas of green retrofits, government service providers, and distressed assets. Industries that are prospering and will need more space to grow include waste management, biotech, education, and health care, he says.

Sales Volume on the Rise

Though difficult economic and commercial market conditions persisted through 2009, NAR's 2010 *Commercial Member Profile* found some hopeful signs. While significantly lower than the 2007 peak, commercial sales improved steadily in each consecutive quarter of 2009. Sales volume nearly doubled to \$19 billion in the fourth quarter, up from \$10 billion in the first.

For the year, sales volume was down 64 percent compared with 2008. One in five commercial members reported no sales. The median dollar volume for those who did was \$407,200. Median gross income for 2009 was \$68,600, a 31 percent decline from 2008.

