MKC
ASSET MANAGEMENT, INC.

Fixed "CAMs"

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AN IDEA WHOSE TIME HAS COME??

A few years ago an article in *Shopping Centers Today* discussed a shift in the retail real estate industry from the traditional "variable common area maintenance expense charge methodology" (where tenants are billed up front for their share of a property's expenses, and then at the end of the year their landlord determines whether those tenants paid too much or too little based on the "actual building expenses" incurred) to one of "fixed" charges (where the tenants' monthly charges are pre-determined and no actual year-end reconciliation is performed or needed). Is this a good idea, and would this be a good idea for office and industrial properties?

I believe that this is a *great* idea for all types of commercial properties for a variety of reasons. But first, some background …

In the Beginning …

Historically, the purpose of the common area maintenance expense charges (now also known as the *Operating Expense Escalations or CAM/OE Escalations*) was for the tenants of a building to only share in the *cost-of-living type of increases* of the building's common area operating expenses over the amount that existed when the tenant first occupied space in the building (note that the tenants were typically already directly paying for the expenses associated with their own premises). Such "expenses" were originally intended to be only the normal, ongoing maintenance costs and not any "expenditures" that were "investment or ownership related". All this actually had its origins long, long ago (i.e., in feudal times) in a land far, far away where tenants initially paid only (base) rent for their rented space. Years (centuries) later their landlords subsequently discovered that they weren't making as much money as they thought they should have made because their expenses for maintaining their property at the same levels as they had previously maintained it had increased (due to what later would be called "cost-of-living / inflationary" causes), but the rent payments they were receiving from their tenants weren't similarly increasing to the degree that covered the expense increases. Hence, the landlords' profits were being eroded, and they had to come up with a way to change the situation that would still also be acceptable to their tenants. Thus, the concept of tenants sharing in the maintenance expenses of a property/building evolved.

The Evolution …

Originally, the concept was simple, and both parties found it fair and reasonable – as the general maintenance expenses of a property/building increased, the tenants would reimburse their landlord for their fair share. Over time, however, the concept became more and more complicated and convoluted. In the 1990's, it got to the point, because of inaccurate calculations and billings, that heavily negotiated, multi-page operating expense escalation lease language became commonplace and began to detail what specific expenditures could and couldn't be escalated to the tenants, how the actual escalation calculations were to be done, what kind of tenant review/audit process could be done before legal action could begin, etc. The actual escalation procedures are now at times so *complicated* for a property/building with many tenants that only a few people in the commercial real estate industry actually fully understand how, and have the patience, to do the escalation process *correctly*, although many claim they can. Worse yet, many are asked to do the work with little or no specific training in the correct expense escalation procedures. As a result, expense escalation calculation *inaccuracies* are prevalent and commonplace, charging *abuses* are frequent, and tenants are generally *overcharged*, most of the time by mistake, but sometimes on purpose – all of which reflects very poorly on the property's/building's landlord in particular and the commercial real estate industry in general. In the end, both the tenant and landlord parties generally lose, with some landlords even finding out that certain tenants will refuse to occupy space in their buildings because of real and/or perceived problems with these additional rent (over)charges. In general, the process is needlessly broken, as is demonstrated by the fact that a viable new business sector has successfully emerged and thrived – the feared *operating cost escalation / lease auditors*. Additionally, for landlords, this broken process also diverts high level and valuable resources from other far more important and profitable aspects of their investments – that of enhancing their properties' values and addressing "customer" (i.e., tenant) facility needs.

So What's The Problem? …

While certain high-quality property management firms can perform the current "variable escalations" right – which means applying the appropriate attention to the process and spending the (enormous amount of) time to do it right and in accordance with the extensive provisions of each specific lease for each tenant in the property/building – most other property management firms look simply to "push a button" and have the numbers crunched by the computer. Having personally done well over 400 separate sets of annual escalations in my career, I can vouch that there is no way the "button approach" is fair, reasonable, or anywhere near accurate. Both the landlords and their tenants are negatively impacted as a result, including the creation of such problems as:

For the landlords / property management firms:

- ☐ Very time-consuming to calculate – To do the process right can take from 20 to 100 or more hours for a single property/building to produce correct billings depending on the number of tenants and the complexity of each of their leases.

- ☐ Costly to calculate – Since "time is money", to do the process correctly would eat significantly into the monthly management fee. Additionally, the time that it takes to answer tenant questions about the billings would erode the management fee profits even further. An alternative, of course, would be to outsource the escalation calculations, but this can cost anywhere from $3,000 to in one case we're aware of Deloitte & Touché charged $50,000 for one year's escalations for one property.

- ☐ Costly to defend – Because most property management firms do it wrong and overcharge their tenants, when (i.e., if) tenants complain, there is a significant amount of time and resources required to re-focus on the expense escalations that were done months earlier, and to get back up to speed to be able to attempt to justify why the calculations were done the way they were. To deal with those tenants that chose to take the review to the next level (i.e., the "audit"), both executive and legal time become heavily involved, both with their associated "costs".

- ☐ Creation of the attitude that there is little reason/ incentive to control costs – Because of the mistaken belief that "the tenants will pay for all costs anyway", many management firms and landlords aren't motivated to operate a property efficiently and cost effectively. Unfortunately, property/building values and cash flow take a negative hit under this line of thinking because there is always a portion of the costs that the landlords have to absorb even with "grossing up" because no multi-tenant property/building is always 100% leased.

- ☐ Negative perception in the market – Landlords and their buildings that overcharge their tenants are known in the market and have a certain stigma associated with them, and they aren't as successful in leasing to high credit tenants as those who don't.

For the tenants:

- ☐ Time-consuming to review – Because most tenant real estate department personnel don't understand operating expense escalations, they either spend no time (which has its own negative consequences) or too much time trying to understand the billing they just received. Even if they are versed in this process, they still have to spend a significant amount of time to justify their "okay to pay" approval stamp. If they can't initially agree with the billings, then their amount of time rises exponentially as they begin questioning their landlords' property management firms' billings.

- ☐ Costly – The initial cost of reviewing a landlord's billing is either staff time being spent on this "non-core" business matter or on their professional consultants' review of the escalation billings. Audits, of course, can also become part of the process, and their cost is typically a minimum of $5,000 per year audited up to tens of thousands of dollars, not to mention the enormous legal fees and court costs resulting from formal legal action. For those tenants who fail to review and/or audit the billed charges, their costs are the higher occupancy costs that they really shouldn't be paying.

So What Can One Do? …

The "Fixed CAM" is probably the best thing yet in reducing *everyone's* overall time, involvement, and costs, while still protecting the landlords' investments and return, and also protecting the tenants' bottom line and ability to remain credit tenants in their buildings of choice.

The basic premise of the "Fixed CAM" concept is that the building expense type of charges would be *fixed* for annual periods, yet stepped up over time to model the expected inflationary pressures faced by landlords in operating their properties/buildings, and no annual reconciliations would ever be required since these are all pre-determined and agreed-to payments (just like Base Rent is). Note that it is still important to not just fold the CAM type of charges into the Base Rent amounts, which would result in the normal "Full Service Gross" rental payment, because it's important for all parties to continually realize that a certain separate payment is in fact associated with the expenses of the property/building. Otherwise, this fact will be "lost" over time, and "variable CAMs" will come back into existence once the current set of real estate professionals disappear from the scene.

"Fixed CAMs" provide the following benefits:

For the landlords:

- ☐ Actual, known and scheduled income will offset budgeted and actual expenses associated with their building(s) versus the unknown (actually phantom) levels of expense recoveries that aren't in fact determined (if they actually exist at all) until a few months after the subject calendar year has completed.
- ☐ Property valuations will be more accurate.
- ☐ Property cost efficiency and control would become more important and focused on, thus positively affecting valuation.
- ☐ No time-wasting billing disputes will exist with the tenants.
- ☐ Leases would be easier, and cheaper, to negotiate because time spent by staff and legal counsel to negotiate the leases would be reduced and shifted to other important priorities.
- ☐ Legal fees wouldn't be wasted trying to defend incorrect CAM billings, and the saved money would instead go to the bottom line or to improve the property in order to derive even higher base rents and therefore value.
- ☐ The "lease auditing companies and industry" would never visit the "Fixed CAM" converts and would instead be forced to focus on just the non-converts.

For the property management firms:

- ☐ Less time would be spent by staff members on paperwork (e.g., doing the annual reconciliations and defending their numbers to inquiring tenants and auditors), and more time could be spent on actual operational problems and/or improvements to the property so as to enhance its value.
- ☐ No time-wasting billing disputes will exist with the tenants.

For the tenants:

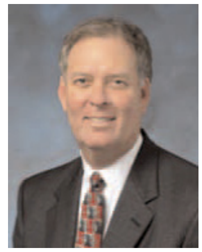
- ☐ Occupancy costs would be known for every year of their lease term.
- ☐ Leases would be easier, and cheaper, to negotiate because time spent by staff and legal counsel to negotiate the leases would be reduced and shifted to other important priorities.
- ☐ No time-wasting billing disputes would exist with their landlords and/or property management firms.
- ☐ No costly accounting audits would have to be performed.
- ☐ No more wasted time would have to be spent on this "non-core" business matter.
- ☐ No more payments would have to be made for the many non-escalatable expenditures typically "passed through by the property management firms" (such as capital expenditures and a landlord's corporate costs, all of which are really the responsibility of the ownership of the property in the process of increasing or maintaining the value of their asset, and not the responsibility of non-ownership entities such as tenants, who don't also get to share in the increased value of the asset due to such expenditures of investment capital).

The primary perceived problems with "Fixed CAM" charges are, of course, "*how can they be calculated*" and "*what if expenses really shoot up; then we eat it*". Well …:

- ☐ "*How can they be calculated*" – They should be calculated just like the normal estimated monthly "grossed up" charges ("impounds") are now being calculated. The main difference here, however, would be that there would be no time-consuming year-end "reconciliation" process, and such a calculation would only be done once (i.e., up front) for the lease negotiations. Of course, the estimated numbers would be negotiated in the lease negotiations, but at least both parties would have the opportunity here to settle on what would seem fair for both, and what both would be willing to live with throughout the lease term. One party (i.e., the landlord's property management firm) won't be able to abuse the process anymore by including anything and everything they want in the annual escalations, frequently much more than what's allowed in and intended by the leases, and then not allowing their "customers" (tenants) to have any insight into the contents of the charges (would even they accept and pay any charge on their own personal VISA bill without demanding proof that it's a viable and permissible charge?).

- "*What if expenses really shoot up; then we eat it*" – Well, maybe, but quite frankly that *usually* happens because of some form of mismanagement (so why should the tenants have to share in that)? And what if expenses do the reverse and actually drop because the property management firm actually operates the property correctly? Typically, good landlords and good property management firms can control costs and have impeccable properties at the same time. At *MKC Asset Management*, we have a property that has been managed by our personnel for over 25 years now, and the average annual increase in escalatable expenses has been *less than 1% per year* despite the facts that the building sold once in that time frame, electrical utility rates have increased by an average of 3%/year as well as by an additional 50% in just 2000/2001 alone due to the "energy crises" at that time, and insurance costs (yes, with earthquake coverage thrown in) have increased. By the way, the property operates really well and is a high-visibility, trophy property constantly being visited by foreign and national dignitaries. The fact is that properties managed by really good property management firms shouldn't have their controllable expenses increase by more than maybe 2% per year overall (which is less than inflation). Stepped "Fixed CAM" charges will then cover these increases and over time the volatility of certain building expenses, and may even provide a cushion (i.e., "profit"). So the choice of a good property management firm is critical in controlling a property's expenses.

The "Fixed CAM" charge concept is a *great* idea and can truly benefit commercial real estate projects. We encourage landlords to begin implementing them.



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Michael M. McClune, RPA®, FMA®, is the President and Managing Principal of MKC Asset Management, Inc., a Long Beach-based commercial real estate property management firm. With over 25 years in the commercial real estate industry, and also as the former Chairman of the Board of BOMA of Greater Los Angeles, and Board Member of BOMA Orange County, BOMA California, and BOMA International, he has an in-depth knowledge of commercial real estate industry practices. He frequently consults for various well-known landlord and tenant entities, assisting them in property acquisition due diligence, property management, operating expense escalations, lease abstracting, and lease administration.

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Mickey McClune is the President, Broker, and the Managing Principal of MKC Asset Management, Inc., a Long Beach-based commercial real estate property management firm. As President, Broker, and Managing Principal, Mickey is esponsible for all activities of the firm, including new business acquisition, oversight of all property management activities, and the performance of all of the firm's commercial real estate consulting services. He is an experienced commercial real estate property management, asset management, and leasing specialist with an extensive institutional owner and corporate user background.

Mickey began his career in commercial real estate in the early 1980's with the preeminent national real estate firm, LaSalle Partners (now Jones Lang LaSalle), as its General Manager for all of the office and industrial properties that it had acquired in the Los Angeles and Ventura County areas, and as its Asset Manager for various client portfolios in the Western U.S. While at LaSalle, he was recognized for numerous accomplishments both by the company and the commercial real estate industry. In 1993, he left LaSalle to form his own property management company, New America Asset Management Services, where he was the President and the senior partner of this Long Beach-based commercial real estate property management firm. In late 1997, LaSalle acquired NAAMS and its two million square foot management portfolio, and Mickey then served as LaSalle's Regional Vice President for the Southwestern U.S. In 1999, he joined EPS Solutions, a national corporate services consulting firm, as a Director of Real Estate Services. While at EPS Solutions he assisted property owners with their property acquisition due diligences, their properties' annual Operating Expense Escalations, and with the abstracting of their tenant leases, and he assisted tenants by performing over 50 CAM/OE Escalation Audits for them of their landlords' billed rent charges. In 2001, he again formed another commercial real estate property management firm, MKC Management Services, where he served as CEO and senior partner. Soon thereafter, MKC merged with New York City based Newmark & Company Real Estate and became its California-based Asset Management Group. In mid-2003, Mickey was instrumental in merging Newmark & Company's California-based Asset Management Group's operations into a new start-up entity that then became known as RiverRock Real Estate Group. At RiverRock, Mickey was its Senior Managing Director, where he established all of the firm's property management systems, oversaw selected property management teams, and was responsible for all of the firm's consulting business. In early 2006, Mickey left RiverRock to start MKC Asset Management.

Over the course of his 25+ year career in commercial real estate property management, Mickey has personally managed and leased well over 18 million square feet of commercial office, industrial, and retail space, abstracted over 5,000 leases, performed over 400 annual CAM/OE Escalations for landlords' buildings, saved clients well over $4 million in cash savings, received four (4) "Management Excellence Awards" from LaSalle Partners, was a LaSalle Partners' "Manager of the Year", and was awarded by BOMA of Greater Los Angeles four (4) "Building of the Year Awards" (in "100,000-250,000 SF" and "Over 500,000 SF" categories) and two (2) "Special Achievement Awards" including one for "Overall Design Improvement".

Prior to entering the real estate industry, Mickey was commissioned as an officer in the United States Air Force and spent 11 years in the USAF and private industry with Hughes Aircraft Company specializing in the business management of major aerospace industry programs.

Mickey has a California Real Estate Broker License, and is RPA and FMA certified by the Building Owners and Managers Institute. He is a past Chairman of the Board and past member of the Executive Committee and Board of Directors of BOMA of Greater Los Angeles, has served on BOMA Orange County's and BOMA California's Executive Committees and Boards of Directors, and on BOMA International's Board of Governors and Strategic Planning Task Force. Mickey graduated from the University of Southern California with a Bachelor of Science degree in Civil Engineering and a Master of Business Administration (MBA) degree.