

Getting to the Point...
Communicating Effectively in the
Commercial Real Estate Market

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AGENDA

- **What drives competitiveness, profitability and value in commercial real estate (CRE)?**
- **“Who pays” & “who benefits” in CRE-style RCx?**
- **Messaging that motivates CRE players**
- **Approaches for calculating & presenting RCx benefits**
- **Fine-tuning messages for the CRE decision-making chain**

What drives competitiveness, profitability and value in CRE?

- CRE investors seek both current income *and* equity appreciation over time
- Lowering landlord's share of operating expenses boosts Net Operating Income (NOI)
- Higher NOI supports higher asset value

What drives competitiveness, profitability and value in CRE? (cont'd)

- Be sure to consider both current income *and* equity appreciation when calculating CRE returns over time
- Project proposals must transcend Simple Payback Period (SPP) when expressing returns
 - Internal Rate of Return (IRR)
 - Modified Internal Rate of Return (MIRR)
 - Net Present Value

EE \Rightarrow NOI \Rightarrow Asset Value

- **Appraisal Methods**
 - Cost approach
 - Market comparison approach
 - Income approach
- **Efficiency can boost NOI and appraisal**

Capitalization Rate

- A special discount rate used in the “income approach” to appraisal
- The rate of return an investor would expect to receive if the income-producing property were purchased with all cash

$$\frac{\text{Net operating income}}{\text{Capitalization rate}} = \text{Asset value}$$

Could a “greener” building command a lower cap rate (which would support a higher sales price)?

Owner's View of Lower OpEx

Before-Tax Cash Flow

- potential gross income**
- **vacancy and bad debt allowance**
- + **miscellaneous income**
- = **effective gross income**
- **operating expenses**
- + **operating expense reimbursements**
- **cap ex reserve for replacements**
- = **net operating income**
- **debt service (interest + princ. amort.)**
- = **before-tax cash flow from operations**

Income Approach to Appraisal

$$\frac{\text{net operating income}}{\text{capitalization rate}} = \text{asset value}$$

In this example, a \$1.00/SF upgrade with ~3-year simple payback period supports \$3.50/SF in higher asset value.

$$\frac{\$0.35 \text{ SF/year}}{10\%} = \$3.50/\text{SF}$$

Who pays and who benefits?

- Leasing types (“gross” vs. “net” vs. “fixed-base”)
- Difference between “Cap Ex” and “Op Ex”
- Is RCx classified as “Cap Ex” or “Op Ex”?
- Could the cost of RCx be passed through to tenants?
- And what long-term benefits boost Landlord’s returns?

“When you purchase an income-producing property, you *get* the ‘sticks and bricks’...but what you’re *buying* is a box of leases.”

What kind of lease did you say it was?

“Fixed-Base”

“Net”

“Rent Inclusion”

“Gross”

“Electric Rent Inclusion Factor”

“Plus Electric”

“Net of Electric”

“Full Service”

“Plus Electric & Cleaning”

“Plus Utilities & Char”

“Porter’s Wage”

“Plus Lights & Plugs”

“Industrial Gross”

“Triple Net” (“NNN”)

“Double Net” (“NN”)

“Tenant Electric”

“Plus All Utilities”

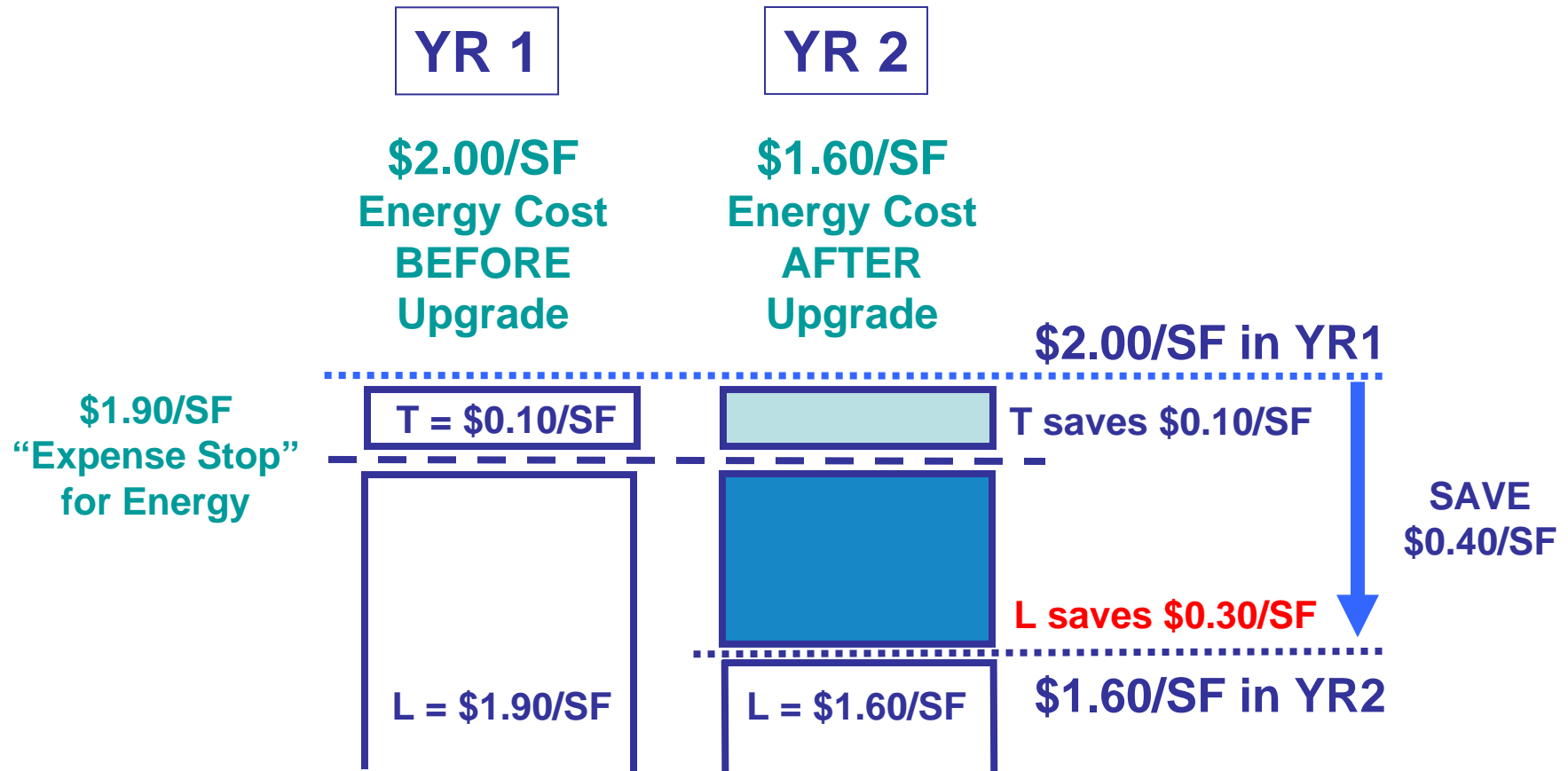
“Hybrid”

“Modified Gross”

Leasing Basics

- **Gross lease**
- **Net lease**
- **Fixed-base lease**
- **Regional variations**
- **“The devil is in the details”**

The "Fixed-base" Lease



“My leases are “net” ...
....Why should I care?”

- **EE supports higher base rents**
 - “Occupancy Cost” = “Base Rent” + “T’s share of Op Ex”
- **Improve your building with other people’s money**
 - Cost recovery uses otherwise wasted utility dollars
- **Lower Op Ex >> Lower base years for new leases**
- **Lower Op Ex >> Lower unreimbursed “Common Area Maintenance” or “CAM”**
- **Lower Op Ex >> Better tenant attraction/retention**

Is RCx classified as “Cap Ex” or “Op Ex”?

- **Does a commissioning project directly pertain to an expense-reducing capital project?**
- **If so, is Cap Ex project being “passed through” to the Tenant(s)?**
 - BOMA standard lease clause
 - “Side agreements”
 - Limitations to recoveries
- **Can you “capitalize” RCx expenses along with other A&E costs?**
- **Verify savings first, then calculate savings allocation to justify recoveries**

“Cap Ex” or “Op Ex”? (cont'd)

- **Is RCx being performed on existing building systems?**
 - Addressing tenant complaints about comfort or cost
 - Owner recognizes that he/she would get most/all savings, or wants to lower base years for new leases
 - Could RCx expense be “passed-through” as an operating expense?
 - Owner may stage RCx across multiple years to minimize impact on the “base year” for new leases
- **What if “Op-Ex-style” commissioning uncovers potential for an EE-related capital project?**

What long-term benefits boost the Landlord's return?

- **Improved tenant retention/attraction**
- **Higher base rental rates**
- **Lower base years for new leases**
- **Cap rate compression**

How much is it worth to retain a tenant?*

- **Assume replacement tenant already identified as follows:**
 - Monthly rent of \$2.35/SF for 20,000 square feet
 - 5-year lease, 6 months of free rent
 - Tenant improvement allowance of \$35 per usable square foot
- **What renewal rental rate would be financially equivalent?**
\$1.23 per square foot
- **If you add a 4% leasing commission to the new tenant?**
\$1.15 per square foot
- **If you add a “dark period” for locating the new tenant?**
\$0.95 per square foot

* Excerpted from “Tenant Retention in the '90s”, Richard C. Mallory and Anton N. Natsis, *Skylines Magazine*, 1992

What messages motivate CRE players?

- **Knowing leases & implications for RCx-related cost/savings**
- **Properly positioned, RCx works in many leasing situations**
 - Many net and fixed-base leases have Cost Recovery for investments that reduce operating expenses
 - If not, intelligently drafted lease amendments may help
- **Properly calculated RCx returns can be compelling**
 - Be sure include all costs (and recoveries) and all benefits
- **RCx can create value in today's capital-constrained CRE world**
 - CRE-centric messaging grabs attention of "hard-to-reach" and distracted decision-makers

Modeling approaches to consider

- **Some situations require little if any modeling**
 - Gross leases
 - Net leases
 - Fixed-base leases where escalations exceed estimated savings
- **The other end of the spectrum:**
 - **Detailed “discounted cash flow” (DCF) modeling**
 - Multiple runs of Argus or similar DCF analysis
- **Most situations can be modeled effectively using...**
 - Simplified Excel-based template (demonstrated later)
 - NOI Builder[®] or similar modeling tool
- **Allocate costs/savings by tenant, ECM and time period**

Financial Analysis Template Demo

- **Cash inflows**
 - Rent (less vacancy and bad debt amounts)
 - Rebates, tenant cost recoveries, other
 - Proceeds upon property sale or refinance
- **Cash outflows**
 - Operating expenses, less Op Ex reimbursements from tenants

Financial Analysis Template Demo (cont'd)

- **Variables that influence profitability and asset value**
 - Vacancy rate (expressed as % of Potential Gross Income)
 - Base rent inflation rate
 - Cap Ex reserve rate (expressed as % of Potential Gross Income)
 - Discount rate (% reflects risk of receiving cash flows)
 - Cap rate (% relates NOI to Asset Value)

The importance of “persistence”

- **Owner’s share of savings affects NOI**
- **Increases in rental income affect NOI**
- **Increases in NOI affect appraisal**
- *However, how persistent are these increases?*
- **Increases in tenant retention/attraction due to improved comfort generally lead to “persistent” NOI benefits**

Working as a team

**The more 3rd-parties involved,
the greater the potential for
miscommunication and/or
suboptimal decision-making!**

- **Portfolio manager**
- **Asset manager**
- **Property manager**
- **Chief engineer**
- **Building engineer**
- **Vendors & service providers**

Additional Resources

A Retrocommissioning Guide for Building Owners (2007)

Developed by Portland Energy Conservation, Inc. with funding from the U.S. Environmental Protection Agency's ENERGY STAR® Program

For copies of ***Upgrading Tenant Spaces*** and other works on applying energy efficiency to commercial real estate including the ***Retrocommissioning Guide for Building Owners*** referenced above, please email me at mjewell@realwinwin.com

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