orangegroup

Increasing tenant profitability through real estate

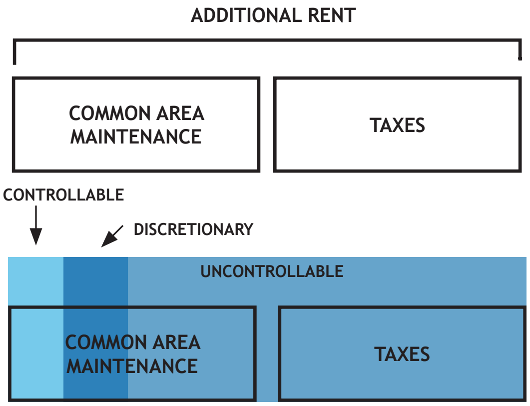
EXPERT ADVICE:
A summary of additional rent
see page 3

ANALYSIS SUMMARY:
"CAP" on common area maintenance costs
see page 4

OPERATING COSTS: AN INSIDE LOOK

TIPS, TRICKS AND COMMON MISTAKES

A closer look into what operating costs you should be aware of.



The Orange Group negotiates real estate for some of the world's leading brands from Starbucks Coffee Company to Whole Foods Market. What can you expect in a negotiation?

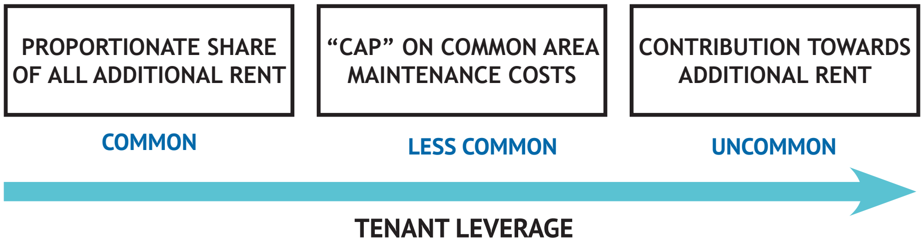
Additional Rent (often also referred to as Additionals, Operating Costs or Chargebacks) is typically comprised of Common Area Maintenance (C.A.M.) and Property Taxes.

Often there are intense negotiations surrounding both the amount and content of Additional Rent. We will endeavor to break down both into a straight forward explanation and analysis.

Additional Rent can be further broken into two separate categories: **Controllables** (those costs which are under a Landlord's control) and **Uncontrollables** (those that are not). As with most things there is also some grey area where costs are "somewhat" controllable, however most Additional Rent costs fall into the "Uncontrollable" category.

Given that controllable costs generally amount to only a fraction of total Additional Rent costs, many tenants don't place sufficient emphasis on negotiating the "Additional Rent" clause. However, one should still be aware of the elements.

There are 3 general methodologies for paying Additional Rent:



YOUR ABILITY AS A TENANT TO HAVE AN IMPACT ON ADDITIONAL RENT IS ALMOST SOLELY DERIVED FROM LEVERAGE AND GENERALLY ONLY APPLICABLE TO CONTROLLABLE COSTS.

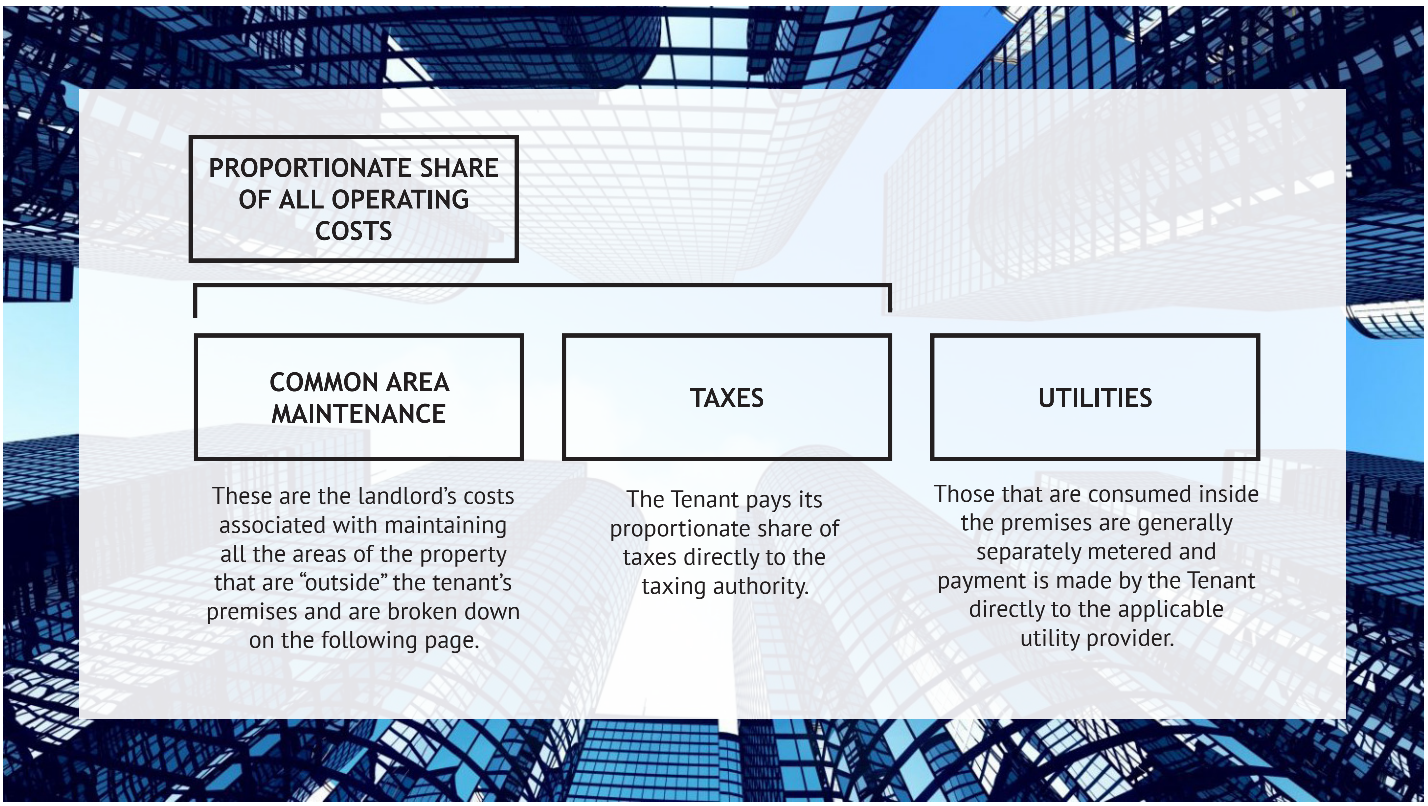
MARKET FACTORS:

- Vacancy, inventory & the economy
- Competition for space
- Desireability of location

TENANT FACTORS:

- Covenant
- Desireability of tenant
- Size of occupied space

LET'S DEAL WITH THE MOST COMMON FIRST - WHERE THE MAJORITY OF TENANTS MERELY AGREE TO PAY THEIR PROPORTIONATE SHARE OF ALL ADDITIONAL RENT WHEN NEGOTIATING AN OFFER TO LEASE. FOLLOWING IS A BREAKDOWN:



PROPORTIONATE SHARE OF ALL OPERATING COSTS

COMMON AREA MAINTENANCE

These are the landlord's costs associated with maintaining all the areas of the property that are "outside" the tenant's premises and are broken down on the following page.

TAXES

The Tenant pays its proportionate share of taxes directly to the taxing authority.

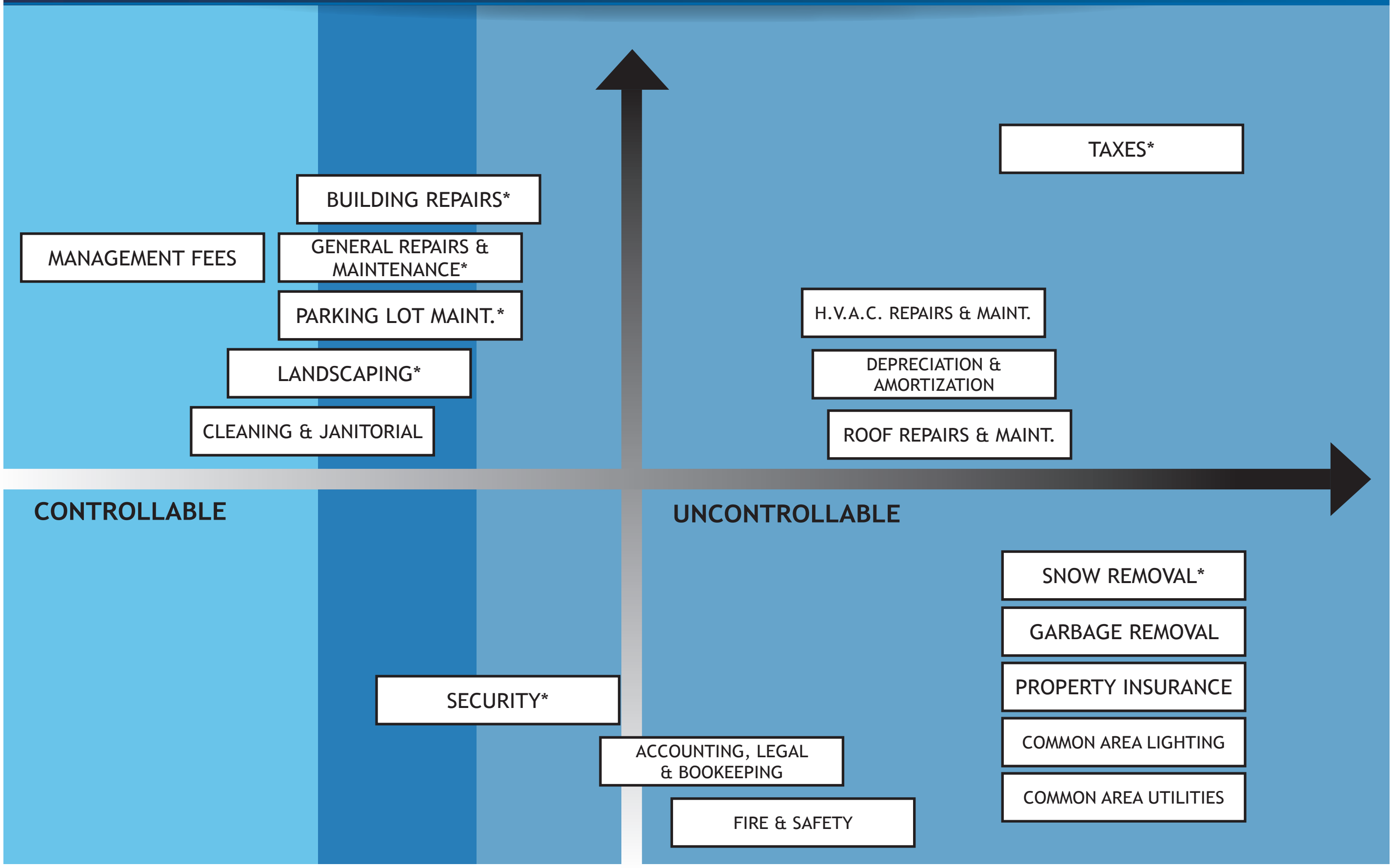
UTILITIES

Those that are consumed inside the premises are generally separately metered and payment is made by the Tenant directly to the applicable utility provider.

Proportionate Share is a simple* calculation where the landlord generally takes the size of the tenant's space as the numerator and the size of all the rest of the leasable space as the denominator to derive the percentage of space the tenant occupies in relation to the property and charges the tenant back their proportionate share of the costs of maintaining, managing and repairing the property.

*Sometimes this calculation is not so simple when a landlord seeks to omit certain tenants and/or areas from the calculation. Smaller tenants should be careful not to agree to disproportionately fund anchor tenants "twice" as smaller tenants typically already pay more base/net rent.

A SUMMARY OF ADDITIONAL RENT



*varies (sometimes significantly) by value and region

OPERATING COST EXCLUSIONS:

When negotiating the Additional Rent clause in your Offer to Lease that is purely based on its proportionate share without a maximum (or "Cap"), it is very important to know what is eligible for the landlord to charge back to the tenant.

The chart above includes some of the most general and commonly acceptable expenses that are recoverable by a landlord from a tenant.

We'll talk about Additional Rent Exclusions (what should not be included in Additional Rent and billed back to a tenant) in our next article.

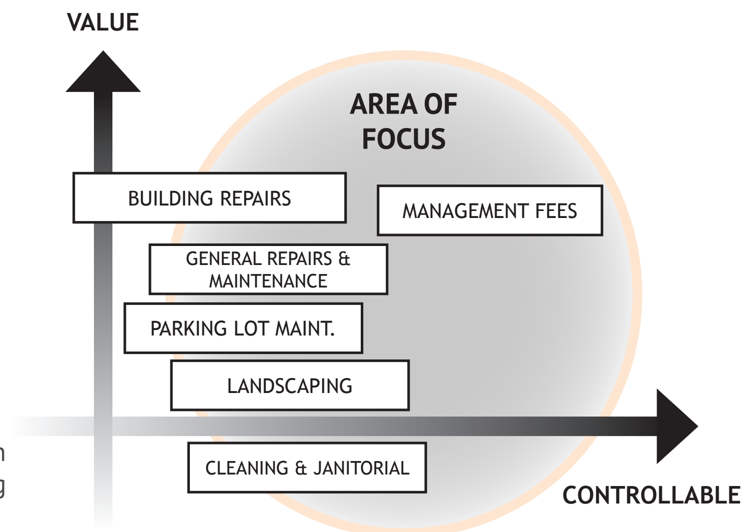
MARKET COMPARABLES ARE A GREAT WAY TO VERIFY WHETHER THE OPERATING COSTS ARE IN-LINE. OPERATING COSTS THAT ARE TOO HIGH (OR TOO LOW) OFTEN SIGNIFY AN UNDERLYING PROBLEM

EXPERT ADVICE

"CAP" ON COMMON AREA MAINTENANCE COSTS

If you do have the leverage to obtain a "Cap" (or maximum amount the landlord can charge for certain elements of Additional Rent), we suggest focusing on the elements that are both controllable and valuable. Generally, a landlord will not agree to take a loss or subsidize a tenant's share of a cost to run a property without re-addressing net rent. Because of this, we generally focus on negotiating the "Controllables". This approach has the best chance of controlling expenses while allowing the landlord sufficient resources to properly maintain the property you occupy.

Since "Uncontrollables" are costs that are beyond a landlord's control (for the purposes of this article we'll assume there is no advantage to them to inflate these costs and manage them well) let's focus on "Controllable" costs and what those numbers should look like. This applies when you (or your real estate consultants) are seeking/negotiating a "Cap" from a landlord. While this amount is often somewhat insignificant to the overall total of Additional Rent (much less total rent), it is important to understand the areas of control.



There is a modest amount of "controllability" to landscaping, repairs, janitorial and parking lot maintenance.

Obviously, some properties are kept in better condition and generally you get what you pay for.

What you should consider is whether you are paying "above market" fees for a property that is poorly maintained and whether the landlord is acting with 'value" in mind. Is garbage regularly cleaned up? Are the windows cleaned? Is graffitti removed promptly? Is the parking lot free of potholes, uneven parts and gravel?

Bear in mind that if you and your fellow tenants pursue "Caps" on Common Area Maintenance, a landlord may be left with an insufficient budget in which to deal with these issues.

GENERAL REPAIR & MAINTENANCE

BUILDING REPAIR & MAINTENANCE

A property requires regular repairs and maintenance much like a vehicle does. Your landlord can choose to defer it to reduce short term costs, but it could wind up costing much more later.

When a quoted per square foot rate for operating cost is "below market" there is a possibility that this is one of the areas which has been compromised. Without some form of "long-term Cap", your costs could increase dramatically in subsequent years in order to fix years of neglect which can fester into more expensive fixes.

This is becoming an increasing concern for many tenants as several large institutional funds have not reinvested in properties in order to support unsustainable shareholder/ unit holder returns.

> ***Know that if a "Cap" is too tight on a landlord, they may start to manage the operating costs instead of the centre so that they don't lose money . This could lead to just as big a problem (or bigger) in the future. Has the landlord undercharged in previous years? Understanding your landlord is important and why research and market consultants play a valuable role. Does the landlord have a good track record? Do they manage their centres well? Are they hands on? Do they have the size to leverage some economies of scale with other properties?***

MANAGEMENT FEES

Ultimately, the area that a landlord has the most control over within Operating Costs is the Management Fees, which is the cost to coordinate all service providers while maintaining the property.

This role is either outsourced or handled internally by a landlord. If the landlord handles this internally, it is often treated as a profit centre – as it would for a property management company (if you can't get a margin from it, then why do it?)

Management Fees across Canada vary considerably and many factors contribute to what constitutes a "fair" Management Fee. These include tenant size, intensity of use and tenant leverage.

A small tenant generally winds up paying a higher rate per square foot than a larger tenant. Let's take the example of a small coffee shop that occupies 1,000 square feet of space (economics outlined on the next page). Their proportionate share of property management will potentially be higher because they do not yield economies of scale from a management and operational perspective and it would take just as much time for the property manager to deal with their daily issues as a 20,000 square foot book store.

SAMPLE RENTAL DEAL

- 1000 square feet
- 10-year term
- $35.00 psf net
- $4.00 C.A.M. (.30 Insurance & .40 Depreciation)
- $4.25 taxes

BASED ON PERCENTAGE OF NET OR GROSS RENT:	3% - 5%
BASED ON PERCENTAGE OF OPERATING COSTS:	10% - 18%
BASED ON PERCENTAGE OF OPERATIONS COSTS NET OF TAXES, INSURANCE & DEPRECIATION:	10% - 15%
BASED ON FLAT FEE PER SQUARE FOOT:	$0.20 - $2.00

We recommend calculating Management Fees based on the last two scenarios as it links the management fee to the amount of work done on a property. The first two scenarios can reward a property manager with a windfall when property taxes rise – thereby magnifying an already unfortunate situation for a tenant.

Based on our coffee shop deal, the following math applies:

SCENERIO A	$1.73 PSF OR $1,730 PER YEAR	*$43.25 GROSS RENT X 4%*
SCENERIO B	$1.16 PSF OR $1,155 PER YEAR	*14% X 8.25 OPERATING COSTS*
SCENERIO C	$0.40 PSF OR $396 PER YEAR	*$4.00 - MINUS INSURANCE AND DEPRECIATION ($0.70) = $3.30 *.12*
SCENERIO D	$0.60 PSF OR $600 PER YEAR	*1000FT^2 X $0.60*

THE CONTRIBUTION TO C.A.M.

Once in a while, a major anchor tenant (depending on their size and leverage) will only agree to pay a contribution towards C.A.M. This simplifies costing as it allows the landlord to spend the money any way they want and elimates the need for an annual reconciliation. The upside for the anchor tenant is certainty of costs while the downside is that the landlord may wind up not having enough funds or resources to sufficiently maintain or repair a property if they agreed to a contribution below the actual costs.

In sum, it is wise to understand what is important and to pick our battles carefully in order to ensure our property is well maintained, while managing real estate expenses / overhead. In our next article, we'll tackle what is appropriate for a landlord to charge back in Operating Costs and what should be reasonably excluded.

So what is a tenant to do? Should tenants attempt to negotiate a Cap and if so, what would be the intent of the Cap?

From what we have just discussed, the interests of both tenants and landlords are served when landlords are reimbursed the routine maintenance costs necessary to maintain a given property to an appropriate standard.

Protecting tenants from high value, uncontrollable capital costs is where a Cap is extremely effective. The most common Cap involves determining a Base Year C.A.M. rate, which is typically the actual C.A.M. costs of the commencement year of the lease. In subsequent years, the landlord is then able to charge the lesser of: 1) the actual C.A.M. rate and 2) the Base Year C.A.M. rate plus a percentage increase, typically between three and five percent. Utilities and insurance costs are often excluded from the Cap.

Applying a Cap in this fashion allows the landlord to recover its routine maintenance costs of the property, while also protecting the tenant from large increases caused by large capital repairs. Capital repairs such as replacement of the roof membrane and the parking lot can often exceed hundreds of thousands. The protection of a Cap will then result in the tenant either paying for these costs over their useful lives and could possibly shelter the tenant from these costs to the extent that the Cap restricts the C.A.M. increases.

TOP SECRET TIP

From a tenant's perspective, a Cap is the most eective way of controlling C.A.M. increases. In situations where market forces shift the negotiating leverage to the landlords' favour, a Cap may not be agreed to. The next best alternative to a Cap is to negotiate the appropriate C.A.M. exclusions. In our next article, we will tackle what is appropriate for a landlord to charge back in C.A.M. and what should be reasonably excluded.

A Little About Us:

We are a specialized Commercial Real Estate firm that provides advisory services for tenants. We focus on companies where location, position and/or rent has a tangible effect on financial performance. Our mission is to help our clients increase profitability through real estate.

We have regional offices in Vancouver, Toronto and Calgary, with partner offices in Edmonton, Winnipeg, Montreal and the Maritimes. Our account executives combine industry leading programs, process and analysis with experience to ensure our clients obtain and maintain great locations at favorable terms.

Please visit our website at **www.orangegroup.ca** or call **Grant Kosowan at 403 209 4291** for more information or to book a presentation.

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