

Preserving Value

Actions That Managers Should Take in Turbulent Times

Part 2 of 3



BuildingEngines
Optimizing Property Performance



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About Building Engines

Building Engines is a web-based suite of integrated modules that provides owners and managers of any property type with a comprehensive solution for improving operations and workflow management.

Building Engines helps companies increase occupant satisfaction, manage assets more efficiently, and limit exposure to risk and liability while reducing costs and enhancing management visibility into operations.

Advanced Technology. Superior Support. A Flexible Fit

Executive Summary

This white paper is designed for property owners & managers and is part of a series that focuses on the challenges and opportunities created by the current economic crisis. It outlines the actions that owners must consider and presents specific strategies, methodologies and systems for surviving and thriving in the real estate downturn.

Simply put, the contraction of the U.S. economy heralds a dismal performance for commercial real estate in the coming quarters. The current climate of declining GDP and plummeting consumer spending, when viewed in conjunction with commercial real estate's traditional lag behind the national economy, means rough times for the industry in 2009 and 2010. Fortunately, that same lag provides owners and managers with the time to prepare for and to benefit from the coming industry sea change.

To successfully adjust during the coming months, building managers need to capture building activity data to assess how their buildings are performing and identify which performance influencing factors can be optimized to create efficiencies and generate revenue.

The challenging conditions that real estate managers face today require that they question their assumptions and embrace the tools and techniques necessary to stabilize, strengthen and then grow property NOI.

The following table summarizes the effect of improved operations management on a property and illustrates how proactive real estate managers can generate significant value.

Effect
on
Cash
Flow

(\$ per SF)	Before	After
Effective Rent	\$36.00	\$36.05
Expenses	\$10.03	\$9.83
NOI	\$25.97	\$26.56
Capital Items	\$11.50	\$10.85
Net Cash Flow	\$14.47	\$15.70

*Numbers for a typical 500,000 SF Class A Building

An increase in cash flow of \$1.24 per SF over a 500,000 SF building for five years will result in over \$3.1 MM in additional cash to its owners. The \$0.59 per SF increase in NOI will result in an increase in value of \$6.50 - \$8.50 per SF, or \$3.3 - \$4.2 MM in total building value, depending on market cap rates.

Introduction

This white paper will identify both the challenges the current economic climate presents and the key levers that building owners can use to preserve and then to increase asset value in the face of this challenge, focusing on those activities that are likely to have the greatest positive impact. This paper will also note less obvious, but still significant, operating improvements that drive building performance and it will suggest ways to pursue these within a property portfolio.

The Current Economic Climate

From 2003 until late 2007, the United States experienced unprecedented growth in real estate investment in virtually all sectors and markets.

Growth was fueled by a dramatic increase in available capital that drove up other asset valuations (e.g. housing, commodities) and that created an industry-wide epidemic of over investment, which drove down cap rates and sent valuations soaring.

By early 2007, valuations appeared unworldly and unsustainable - later that year, both observations came true. As institutional investors became skittish about the underlying credit quality of the massive amounts of asset-backed securities they owned, the value of those securities plummeted, lenders weakened and credit dried up.

As credit disappeared, the value of all classes of commercial real estate stalled in their upward march and began to deteriorate.

Credit is the modern economy's lubricant. Without it, the economic engine seizes. The commercial real estate industry is bracing for the effects of the downturn, and the possibility of a full-blown global recession.

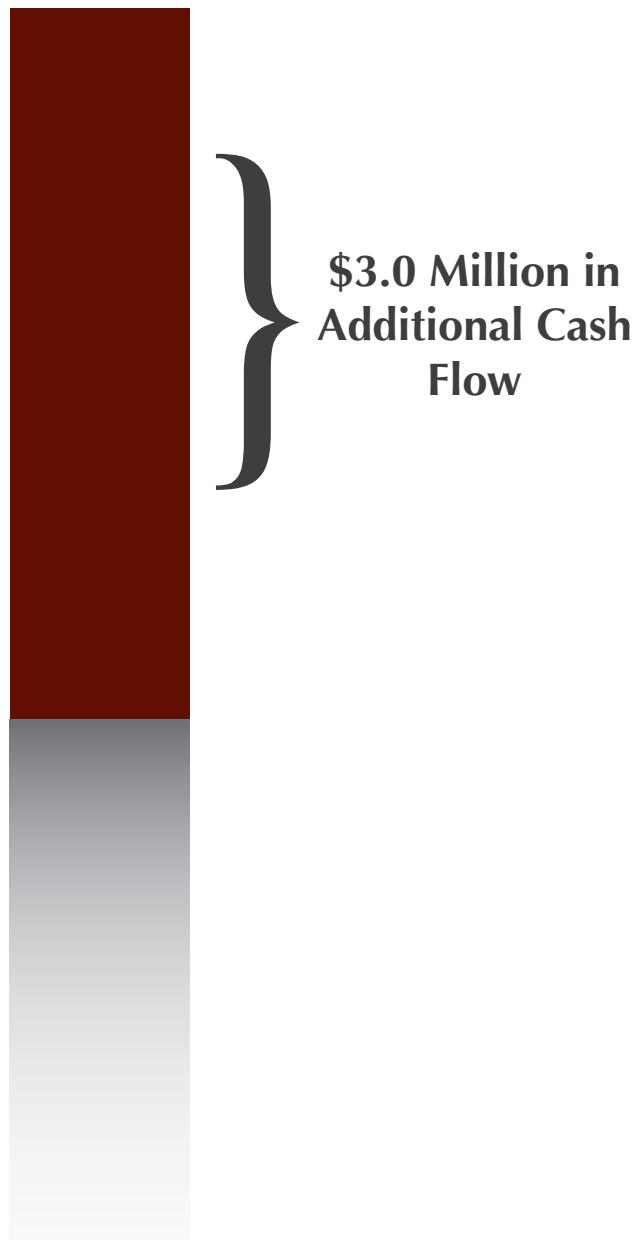
Owners will face a challenging operating environment for several quarters, likely encompassing 2009 and 2010. Successful owners and managers through this period will look inward for relief, and refocus their operations to first survive and then to prosper.



Levers That Drive Down Cost

This white paper will focus on five areas of potential major cost savings:

1. Measure and improve their current performance to reduce churn,
2. Deliver current and prospective clients timely and meaningful information,
3. Generate additional revenue streams,
4. Increase billable service collection,
5. Reduce operating expenses, and
6. Minimizing capital outlays.



Improved Tenant Service (Customer Service)

Tenant service – otherwise known as customer service – is the first and most important lever that commercial real estate owners have at their disposal to improve building performance.

When the market is hot and vacancy rates are low, less emphasis is placed on customer service. However, improving tenant service through real time, multi-channel communication, rapid response to requests and world class maintenance, can have a significant impact on lease renewal rates, and tenant churn.

Reduced churn increases effective rents by reducing downtime and also reducing money spent on tenant improvements and leasing commissions. The results of improved tenant service can be dramatic, as our financial model, whose assumptions are summarized below, illustrates.

“Tenant retention is a critical means for capturing revenue through improved operations management – made easier through effective operations management systems,”

- Managing Director of a National, Third Party Management Firm

Modeling a typical 500,000 SF class A multi tenant office building with 20% of its leases rolling every year, and testing for the effect of reducing tenant churn by 10% (2% of total space inventory) through improved customer service, the property could generate an additional \$0.83 per SF in cash flow annually (\$0.33 in additional effective rent + \$0.50 in reduced TIs and commissions), resulting in approximately \$3.0 MM in additional cash flow over a five year term.

Levers That Affect Value

Aggressive Web Based Marketing

It is difficult to imagine how, just a few years ago, we worked efficiently without the Internet. It is also difficult to imagine how the real estate industry will thrive if it does not aggressively leverage the power of the Web to the same extent as other sectors have. Giving a property a strong Web presence, with detailed information about amenities, location and available space, is essential to ensuring that it gets maximum exposure in the market. A broker's marketing program is not enough – you need to make information about your properties available through as many channels as possible – including the tenants currently in your building!

The most astute property owners build an identity around each asset and then market it. The most impactful component of value to a tenant – other than location and price per square foot – is the service provided in their building. The best way to illustrate and advertise those services is to tell a story about building amenities and services, all through a sophisticated, interactive building website with both public facing (for prospective tenants) and private facing (for existing tenants) components that provide easy access to what tenants need.

Regarding the public facing pages, making as much information about your property as possible available online to brokers and to prospective buyers – even information traditionally regarded as confidential (e.g. lease offer rates, vacancies, TI packages) is key to attracting tenants and operating effectively through the downturn. Potential tenants search the web for accurate, verifiable information about properties. Hiding information about your building will miss such sales opportunities and make your property less competitive.

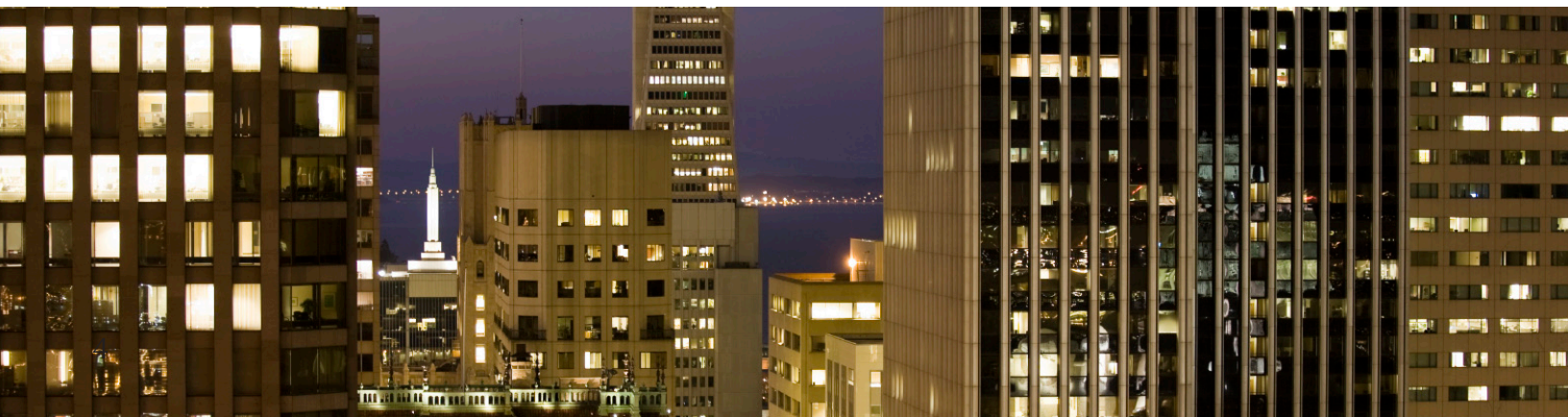
Regarding the private facing pages, there is no greater way to give your tenants a sense of control (and satisfaction) than by giving them clean, clear access to building services via the web. More traditional owners and managers will often say: “My tenants want to interact with people because this is a people business. I don't want to depersonalize things in my buildings, with a lot of technology.” In fact, real time, multi-channel communication tools (like an interactive web site), complement the role of the human face of property management and improve tenant satisfaction – also allowing managers to focus on higher value.

With the right tools in place, an owner can actually downsize staff and increase customer service by offering tenants multiple channels to access information about the building.

Additional Revenue Sources

Property owners have only just begun to identify and respond to their tenant's unmet needs. If you think of your tenants as customers and then begin to think of the services they would like to have provided to them, you may uncover additional revenue opportunities.

In our financial model, we conservatively assumed that the building could generate an additional \$5,000 in revenue annually from leasing revenues/commissions from services such as in-building wireless, dry cleaning delivery, car wash, car detailing and other personal services. The final figure could be much larger.



Levers That Affect Value

Additional Bill Backs

During the last five years, as valuations got a little frothy, it was easy to lose track of exactly what costs are recoverable under the terms of each tenant's lease. Accurately tracking lease terms, making term and condition information easily accessible by building staff and ensuring that when billable services are provided that they actually generate an invoice are all essential to capturing money that is contractually owed. The industry average in lost billable revenues approaches 10% of total non-tax expenses. Even if billable services are not actually billed for and then collected, this potential revenue represents an important lever for the leasing agent who can use unbilled services charges as evidence of broad service excellence when the tenant's lease comes up for renewal.

In our financial model, we have conservatively assumed that the building operator is able to increase recoveries equal to 1% of operating costs, or \$0.05 per SF.

Reducing Operating Expenses

We dwell in some detail on this topic in the paper titled "Operating Well" in this series. Suffice it to say that, by increasing focus on the following operational factors the building team can lower expenses significantly:

1. Improved Energy Management
2. More Effective Preventive Maintenance
3. Improved Staffing Management
4. Reduced Risk and Liability
5. Increasing Billable Revenue

In our financial model, these improvements result in an expense reduction of \$0.20 per SF annually, or about 2% of total operating costs.

Reduced Capital Outlays

It is no secret that an effective preventive maintenance program yields tremendous dividends. Jones Lang LaSalle ran a comprehensive long term study on the efficacy of PM programs and found an average ROI of 545%, partially through extending the useful life of assets.

The difficulty for maintenance teams has always been finding a system that is easy to implement and easy to use. Legacy systems tend to be either very complicated and difficult to use as well as very expensive to purchase, to configure and to maintain (CMMS tools designed for manufacturing and repurposed for real estate fall into this category). Many are simple, PC based programs that have limited functionality, poor web access, and end up holding key information in a "silo" that managers cannot always access. The best solution provides universal access to key information and data on a cross functional basis – integrating all facets of a building maintenance manager's responsibilities.

In our financial model, we have assumed that the building's capital base of \$100.00 per SF is amortized over 33 years, so that \$3.00 in capital is required annually to replace it. Additionally, we have assumed that a more effective maintenance program will reduce this outlay by 5% or \$0.15 per SF annually.

Financial Model

The following is a summary of a financial model of a typical 500,000 SF, multi-tenant, Class A office building that illustrates how improved management can affect cash flow and value. The assumptions driving this model are described in the balance of the paper and are based on industry standards.

Benefits from Improved Operations

	Before	After	Difference
.....			
Revenue			
Effective Rent	\$36.00	\$36.33	\$0.33
Add'l Services	NA	\$0.01	\$0.01
Bill Backs	NA	\$0.05	\$0.05
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Total Revenue	\$36.00	\$36.39	\$0.39
.....			
Operating Exp.	\$10.03	\$9.83	(\$0.20)
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NOI	\$25.97	\$26.22	\$0.25
Tls, Commisions	\$8.50	\$8.00	(\$0.50)
Capital Costs	\$3.00	\$2.85	(\$0.15)
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Net Cash Flow	\$14.47	\$15.71	\$1.24

An increase in cash flow of \$1.24 per SF over 500,000 SF building for five years will result in over \$3.1 MM in additional cash to its owners. The \$0.59 per SF increase in NOI will result in an increase in value of \$6.50 - \$8.50 per SF, or \$3.3 - \$4.2 MM in total building value, depending on market cap rates.

How You Get There

Improved communications, more accurate data tracking and more consistent processes are critical to improving tenant service and building operations. Using a Web Based Operations Management system (WBOM) will enable the building owner to take advantage of the web and enables tenants, managers and vendors to communicate in real time through a variety of channels. It will also enable the management team to set up consistent work flows and procedures, track and store key documents and standardize request and maintenance procedures, all resulting in greater efficiency.

With a WBOM Solution, an organization will:

- Retain current tenants by providing world class services, increasing customer satisfaction and making your site “sticky” and more competitive. This will reduce vacancy rates and churn – thus raising effective rents,
- Aggressively market its buildings using the web by making information accessible to potential tenants through a powerful channel – the Internet – that has become indispensable,
- Increase additional revenue by identifying and providing tenants the “extras” that they desire,
- Increase revenue by tracking and collecting on all billable services,
- Lower operating expenses by driving down energy, maintenance and insurance costs,
- Reduce potential loss, risk and actual liability with more responsive data gathering tools coupled with better notification and event management procedures, and
- Reduce capital expenditures by implementing a proven preventive maintenance program.

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