BOMA·Kingsley REPORT
Practical Industry Intelligence for Commercial Real Estate
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Market Analysis

2010 *Experience Exchange Report* Indicates Tight Management Needed for Today's Demanding Market

By Phil Mobley

As BOMA International reported on July 13, the 2010 *Experience Exchange Report*® (*EER*) revealed a $0.09 (1.1 percent) decrease in total operating expenses at U.S. private-sector buildings during 2009. Owners of buildings participating in the *EER* thus enjoyed a total contribution of more than $62 million to net operating income (NOI), or about $15,000 per private-sector building—a critical amount given today's environment of tough competition for occupancy and limited capital availability.

Of course, aggregate trends are one thing; understanding where and how they occur is a far more interesting (and, ultimately, far more rewarding) exercise. A building's location—both its market and its situation within that market (downtown vs. suburban)—obviously has a profound impact on the cost to own and operate it. Factors from local tax and utility rates to labor costs to the general economic conditions of a particular submarket can render comparisons to a "national average" practically useless. Also important is the type of building, as certain specialties have very different needs in specific expense categories. And, the context provided by a time trend should never be overlooked.

What follows is an analysis of office building expenses for the year 2009 based on the 2010 *EER*. While the *EER* contains information from over 4,200 office buildings across the United States and Canada, this analysis will focus on a specific subset of those buildings—those in the United States for which data was submitted in both 2009 and 2010, whose total rentable area did not change by more than 10 percent and whose occupancy did not change by more than 15 percent. This two-year "same building analysis" is akin to retailers' "same store" analysis and allows for a fairer "apples-to-apples" comparison of expense information by netting out the potential impact of volatile occupancy, changes in building size and changes in the overall composition of the buildings that contribute to the *EER* year over year. The two-year, same-building analysis comprises 1,600 buildings and 350 million square feet. It also provides a truer time trend comparison, as it represents literal year-over-year changes in the operating expenses and incomes from the same buildings in each year.

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Building Type Analysis

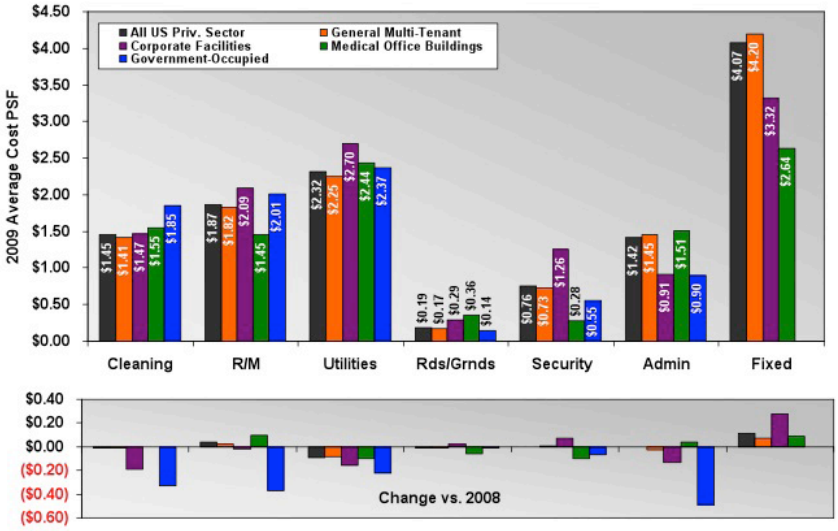
About 75 percent of the buildings in the sample are general, multi-tenanted office buildings. This stands to reason, as they are by far the most common buildings in the marketplace. The 2010 data set is robust enough to examine three other types of buildings: corporate facilities (typically owned and/or occupied by a single tenant), medical office buildings and buildings used primarily by government agencies. The chart "Major Category Expenses by Building Type" displays the average cost per square foot (psf) for each of the building types listed above across the seven largest expense categories (note that government buildings are excluded from the examination of fixed expenses, which are largely driven by real estate taxes, from which most government buildings are exempt).

Because general multi-tenanted buildings comprise most of the sample, their expense profile very closely resembles that of the "typical" U.S. private-sector building. Still, it is notable that, for the past two years, these buildings have spent about 11-percent less on roads and grounds. Similarly, government buildings have spent about 25-percent less than private-sector buildings in this category. Why might this be? One theory is that medical and corporate buildings likely have different parking requirements. Or, perhaps they tend to be located on more campus-like settings, which require more maintenance. For government buildings, the likely explanation is that they are overwhelmingly located in downtown locations, which tend not to require the same level of roads and grounds maintenance. Though this is a relatively small category, the impact of a penny or two across thousands of square feet can be very significant.

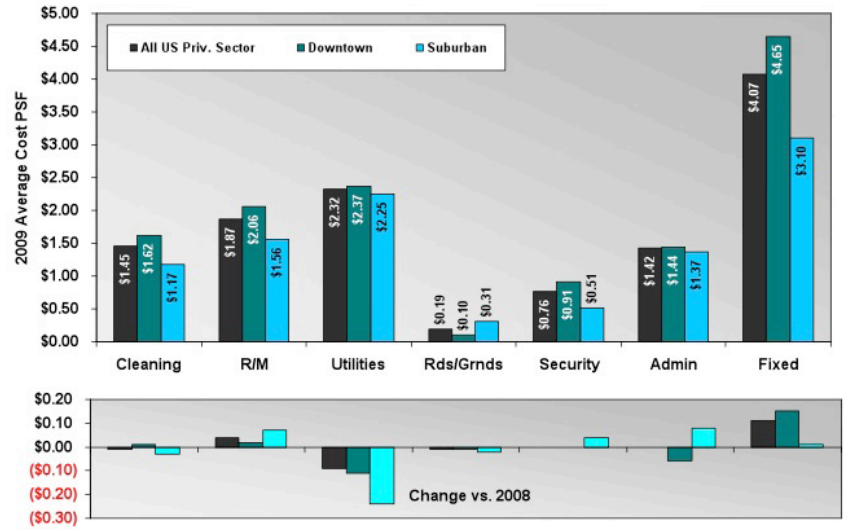
More significant, however, is the impact of utilities expenses. With the typical building spending 10 to 12 times as much on utilities as on roads and grounds, variances here bear very close monitoring. Importantly, this is the one expense category that saw reductions across all property types during 2009. General multi-tenanted buildings trimmed $0.08 psf from their utility bills, while corporate facilities doubled that savings ($0.16 psf) and government buildings almost tripled ($0.22 psf) it. Even medical buildings, which often have very rigid requirements for temperature control and redundant building operating systems, managed to reduce utility costs by $0.10 psf. Whether from falling rates, better weather or more efficient usage, building managers across the board were generally able to squeeze cost out of their operations in the utilities category in 2009. (For more on the energy aspect of utility costs, see the sidebar "Focus on Energy Efficiency is Here to Stay.")

Trending in the opposite direction in 2009 were fixed expenses. While medical and corporate buildings have 20- to 40-percent lower fixed expenses than general multi-tenanted buildings (likely

Major Category Expenses by Building Type



Major Category Expenses by Location in Market



due to tax exemptions and incentives for many such buildings), they saw greater increases. Fixed expenses climbed over nine percent ($0.28 psf) at corporate facilities and nearly four percent ($0.09 psf) at medical buildings, compared to less than two percent ($0.07 psf) at general multi-tenanted buildings.

Government buildings and, to a lesser extent, corporate facilities led the charge in driving down expenses in the other categories. Government buildings cut administrative expenses by 36 percent ($0.49 psf) and cleaning by 15 percent ($0.33 psf), while corporate facilities dropped them by 13 percent ($0.13 psf) and 11 percent ($0.19 psf), respectively. Government buildings also saved another 16 percent ($0.37 psf) on repairs and maintenance and 12 percent ($0.07) on security in 2009. A strong market position in contract negotiations may have contributed to these savings.

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Five Reasons to Benchmark

Industry Practitioners Discuss the Benefits of Benchmarking

By Laura Horsley

1. Fine-Tuning Building Operations.

Comparing building income and expenses to comparable buildings and market peers through tools like the *Experience Exchange Report (EER)* helps property professionals track key asset performance indicators—energy, repairs/maintenance, cleaning costs—to identify ways to trim expenses and bolster net operating income.

Karrie McCampbell, senior vice president of the Central Region with Transwestern in Dallas, uses the *EER* to catch and analyze anomalies that crop up in expense line items. "You can compare a building to the *EER* market data to see if anything seems out of whack," says McCampbell. "If something does come up, you can then delve in to see if there is a legitimate reason or if there is a problem you need to investigate."

2. Budgets and Trending.

Benchmarking data allows users to examine trends and forecast the impact on revenue and expenses.

Prior year *EER* reports are available and allow users to track performance year-over-year within a given market or nationally. Come budget season, *EER* users can import data tables in both PDF and Excel formats to create reports and presentations.

"With the new trending in the *EER*, you can see what the increases are and whether expenses are trending up or down," says McCampbell. "We use it when presenting our budget to the building owner. We can show him/her that our expense budget is in line with, or lower than the *EER* market average (taking inflation into consideration)."

Brenna Walraven, managing director of national property management with USAA Real Estate Company, has been benchmarking with the *EER* for more than 20 years and uses it as a management tool to help indicate where improvements need to be made. "We use the *EER* as an indicator of how we might budget and where. For instance, if $2 per square foot for energy costs is the going rate in a particular market and our building is at $2.50, then we know right away that there is a problem. We might decide to budget more for energy-efficiency retrofits or other activities to address being well above market."

3. Acquisitions and Development.

Benchmarking is also an important tool for property acquisition and development. Explains Walraven, "We use the *EER* in the underwriting of assets. So, if we are looking at acquiring a property or portfolio of properties, we use it as a benchmark to confirm whether a given asset is above or below the benchmark and whether we have opportunities to improve our deal or ways to ensure performance post-closing."

Mark S. Johnson, CPM, senior vice president and national property management executive with DASCO, logs into his *EER* to help forecast operating expenses for medical office buildings. "The *EER* serves two main purposes for me when evaluating new opportunities for DASCO," says Johnson. "The first is to forecast future operating expenses for new developments. The second is to benchmark the performance of potential acquisitions as I look for expense reduction opportunities to help grow NOI and, ultimately, increase the property value. For me, the *EER* is a crystal ball."

4. Rebid Service Contracts.

Knowing whether a building is in line with the cleaning, security and other expenses relative to a market can help property professionals rebid and negotiate lower costs for products and services. Remarks Walraven, "What a manager can do is look at his/her cleaning costs and say, 'Here's what we're paying, but wait a minute, the market is three percent or five percent better.' That can be used as a tool to put pressure on suppliers to do better and improve."

5. Educate Stakeholders.

Property managers are not the only ones who rely on benchmarking. Owners, tenants, occupants, brokers and tenant rep brokers can all benefit from the data. Owners rely on the information when analyzing and eventually signing off on budgets, and tenant and clients want to know that they are not paying above the market.

Explains McCampbell, "It's very helpful for brokers because they talk a lot about operating expenses, and when they are comparing one building with another, the client will usually ask about current operating expenses. They like to compare it to the market to see if they are too high or too low."

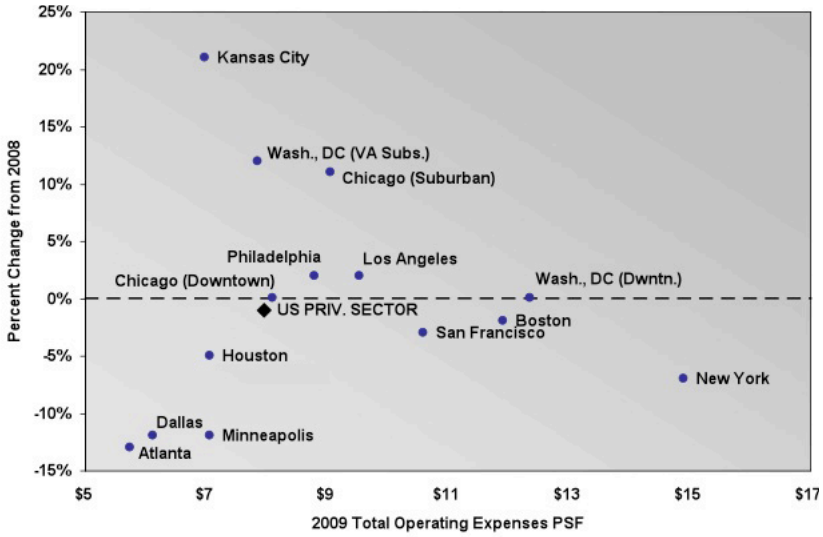
Downtown vs. Suburban

Including fixed expenses, private-sector buildings in suburban locations typically spent about $2.84 psf less than their downtown counterparts in 2009, a difference of 22 percent. (As will be explained below, this gap is six-percent wider than in 2008). While roads and grounds expenses were over 200-percent more in 2009 (still a $0.02 psf decrease over 2008), security expenses were lower by 44 percent and fixed expenses by 33 percent. Cleaning (28 percent) and repairs and maintenance (24 percent) expenses were also lower at suburban buildings.

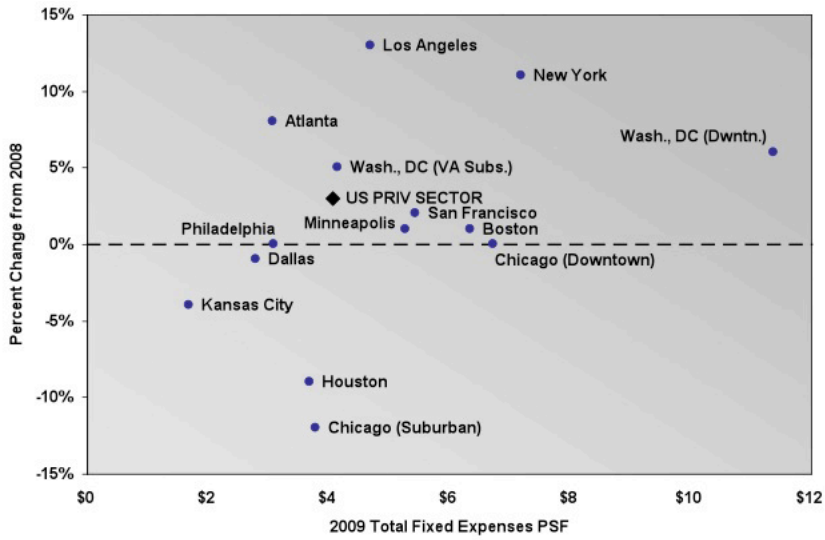
Interestingly, utility expenses were very similar for downtown and suburban buildings, primarily because they decreased more than twice as much at suburban locations than at downtown. Further contributing to the widening gap in operating and ownership costs between downtown and suburban locations was a $0.15 psf increase in fixed expenses at downtown buildings, compared to a negligible increase at suburban sites.

One quirky finding in this analysis is the opposing trend in administrative expenses. At suburban buildings, these expenses increased $0.08 psf in 2009, while they declined $0.06 psf at downtown locations. Administrative expenses are still higher in the absolute at downtown buildings ($1.44 psf vs. $1.37 psf), but this has brought them closer in line.

Trends in Operating Expenses • Selected Markets



Trends in Fixed Expenses • Selected Markets



Market-Level Analysis

Perhaps the most relevant factor impacting expenses is the market in which a building resides. The trends charts on this page display 2009 expenses and the change since 2008 for private-sector buildings in a few selected markets. The first chart depicts total operating expenses, while the second shows total fixed expenses. To illustrate that different locations within the same market can have an impact, two markets have been split: Chicago (downtown vs. suburban) and Washington, D.C. (downtown vs. the Virginia suburbs). Some secondary markets are also included for the sake of comparison.

It may not be surprising that New York had the highest total operating expenses among these markets in 2009, as New York perennially is one of the most expensive markets in which to own and operate an office building. However, New York buildings did experience a seven-percent decrease vs. 2008. Atlanta, Dallas and Minneapolis, already with relatively low operating expenses, saw double-digit decreases.

Operating expenses in Kansas City went against the national trend, going up by nearly 21 percent. This was largely driven by tremendous increases in utility (15 percent) and administrative (25 percent) expenses. Also bucking the trend were suburban portions of Chicago and Washington, D.C. While their downtown brethren saw no appreciable change in operating expenses, suburban Chicago and Washington, D.C. experienced increases of 11 percent and 12 percent, respectively.

In both locations, roads and grounds expenses were up over 2008, possibly due to early winter snowstorms in late 2009. Repairs and maintenance was a key driver in suburban Chicago, increasing $0.39 psf. In the Virginia suburbs of Washington, D.C., repairs and maintenance, utilities and security all increased substantially.

With respect to fixed expenses, New York and downtown Washington, D.C. again led the way with the highest absolute expenses. However, unlike the situation with operating expenses—which were either flat or declining in both markets—fixed expenses increased 11 percent in New York and six percent in downtown Washington, D.C. Los Angeles saw an even greater increase (13 percent), with Atlanta (eight percent) and the Virginia suburbs (five percent) also experiencing substantial increases.

A 12-percent decrease in fixed expenses in suburban Chicago helped to offset the operating expense increase, while a four-percent decrease did the same for Kansas City. Houston (and Dallas, to some extent) was one of the few fortunate markets to see decreases in both operating and fixed expenses.

Making Sense of It All

Given the wealth of data available in the 2010 *EER,* this analysis barely scratches the surface. A multitude of other factors play into the overall cost of owning and operating an office building. The findings presented here are intended not only to inform, but also to provoke further questions and analysis. With real estate transaction activity still very slow and expected not to increase in volume in the coming year, the pressure to drive down expenses as a means for preserving asset value will only increase. Detailed, market-specific operating performance data helps to support and enhance operational efficiency and create competitive advantages.

Access the 2010 *Experience Exchange Report (EER)* by visiting **www.bomaeer.com**.

The *BOMA•Kingsley REPORT* is written and published by BOMA International, **www.boma.org**, and Kingsley Associates, **www.kingsleyassociates.com**.

Focus on Energy Efficiency is Here to Stay

By Lindsay Tiffany

While pressure on operating expenses may ease once the economy recovers, signs indicate that a steadfast focus on energy efficiency will outlast the current market downturn and has become a key element of ongoing operational practice. The 2010 *EER* reveals that overall energy expenses in office buildings continue to decline. While energy costs continue to increase across most markets, the steady decline in utility costs as a portion of total operating expenses suggests that property and asset managers are controlling those costs by controlling consumption. Energy consumption in commercial buildings continues to drop, and though it may be attributed to increased attention on compressing operating expenses due to the economic downturn, many believe the focus on energy efficiency is permanent and will be increasingly important for success in the global marketplace.

According to BOMA's 2010 *Experience Exchange Report (EER),* utilities expenses, consisting largely of electricity costs, decreased significantly in 2009. Analysis of a two-year control sample of private-sector buildings, which contributed data to the *EER* in both 2009 and 2010 and did not have a change in occupancy greater than 15 percent or a change in total rentable area greater than 10 percent, shows that utilities expenses dropped 9.6 percent during 2009 in suburban buildings, from $2.49 per square foot (psf) to $2.25 psf, and dropped 4.4 percent in downtown buildings, from $2.48 psf to $2.37 psf.

Brenna Walraven, managing director of national property management, USAA Real Estate Company, sees the decrease in energy expenses as part of a long-term movement in the industry towards energy efficiency. "With respect to energy, and to a lesser extent water and trash/recycling, the increased focus on compressing utilities expenses is definitely a continuing trend and is part of a permanent shift in our industry to achieve more sustainable and high-performance operations."

In 2009, USAA's portfolio saw decreases in energy expenses similar to those reported in the 2010 *EER*. "Our portfolio saved 7.63 percent in energy relative to overall consumption over the last year," notes Walraven. "I think it is compelling to say that, after a decade-long commitment to energy efficiency, in 2009 we saved the most in consumption than we had in any other year."

Such a move reflects ongoing operating realities. Building owners and managers have very little control over utility rates; rather, their only opportunity to control utility costs is to control consumption. And, investors are taking notice. USAA Real Estate Company recently participated in a study conducted by several large European institutional real estate investors to develop an environmental real estate sustainability score, indicating that energy efficiency plays an important role for global investors when evaluating the performance assets and managers. "Investors look at your sustainability policies and performances but want data; it means that there is an increased focus because you want to show that you are continually making improvements," says Walraven. "Energy efficiency is much more than the plaque on the wall or money saved—it's also very helpful in setting us apart in an institutional investment marketplace."

For resources on energy efficiency and sustainability, visit **www.boma.org/resources/TheGREEN**.