

RETAIL CENTER EXPENSE GUIDE

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INTRODUCTION

This operating expense guide provides general guidelines as to the likely expenses that would be incurred in operation of common retail centers in Southern California. Ideally, it should be used as an adjunct to consideration of actual prevailing and historical expenses of a given retail property.

In addition to expense guidelines, this guide provides insight as to various methods of treating operating expenses as a result of cumulative knowledge gleaned from the appraisal of retail centers, augmented by insight from periodic interviews of buyers, sellers, and property managers active in the retail sector of the Southern California real estate market.

Operating Expenses Defined

Briefly stated, *operating expenses* are the periodic expenditures necessary to maintain property and to continue the production of income. Unlike for accounting purposes, for valuation purposes, expenses do not include debt service payments and peripheral items not specifically needed for continued operation of the property. While expenses can be categorized as fixed and variable, it is not a necessity in the expense estimation process. Rather, categorization with respect to simple expense types is more market oriented with respect to the Southern California retail market—for example, real estate taxes, insurance, etc.. Depending upon the lease types associated properties under appraisal; it is often helpful to categorize expenses with respect to reimbursable and non-reimbursable status.

Basic Applicability Of Guideline

This guideline is basically targeted toward providing operating expense information applicable for common retail centers in Southern California in the size range of 10,000 to 50,000 square feet of gross leasable area. This size range primarily encompasses typical convenience centers, small specialty centers, and so-called strip retail centers. Typically, this category of center is not anchored, although mid-size name-recognition tenancy may sometimes exist (also, it may consist of satellite retail space associated with an anchor under separate ownership).

Physical Characteristics Of Centers Surveyed

The majority of centers used for expense data extraction consisted of common wood frame and concrete block construction and were built from 1960 to 2006. The overwhelming majority of centers were single story.

Basic Study Procedures

Operating statements of retail centers were compiled and analyzed, grouping expenses into six main categories. These included Insurance, Common Area Maintenance, Building Repairs and Maintenance, Property Management, General Administration, and Reserves (aka replacements).

Due to the impact of Proposition 13 in California, real estate taxes were not included in the analysis, although a presentation regarding treatment of same is provided herein. The guidelines presented herein are primarily based on observed minimums and maximums for each of the categories, tempered by judgment. Surveyed centers with atypical expense characteristics were purged from the analysis (such as centers in very poor condition, centers undergoing renovation during the survey year, etc.).

The expense categories used herein are representative of the most common basic categories in the regional retail market. However, the categories are sometimes combined in market practice based on individual management styles. For example, Property Management could be grouped with General Administration, and sometimes Building Repairs and Maintenance are commingled with Common Area Maintenance.

It should be recognized that the term *Common Area Maintenance* has a specific and general meaning. Technically, the term relates to the expenses specifically relating to the common areas (as indicated elsewhere herein). However, the abbreviated term *CAM* is often used in the market in conjunction with rental quotes. When used in this context by market participants, the so-called *CAM* charge typically includes the pro rata charge for not only common area maintenance, but also real estate taxes, insurance, etc.(basically, other expenses that are obligations of the tenants as stipulated in leases and enforceable in the market.

Expense Estimation Methodologies-Retail Centers

Two basic methods of estimating operating expenses for retail centers exist. The appropriate method or methods to use depend upon the lease types impacting the center, local trends, and judgment of the analyst/appraiser. One method relates to essentially a short-cut technique that addresses the expenses likely to accrue solely to a landlord under triple net leases. It is used in conjunction with an estimate of Potential Gross Rental Income arising from triple net rents (that is, income exclusive of reimbursements) and typically consists of rule-of-thumb percentages applicable to effective gross income. The benefit of this technique is that it eliminates much of the potential error associated with developing a per-category type expense estimate. The basic logic of this method is that under triple net leases, ultimately the tenants will pay for most of the expenses associated with ownership. Many buyers of retail centers utilize this method of estimating expenses. However, one of the dangers of this method is that it assumes that tenants will be able to pay reimbursements for operating costs regardless of their amount (for example, a change in tax liability resulting from a sale could alter reimbursement liability to a prohibitive level).

The second method involves a per-category estimate of basic expenses likely to be incurred in operation of a retail center. This guideline relates to implementation of the second method.

Application of Guideline Information

The application of most expense guidelines herein relate to a per-square-foot annual basis. Unless otherwise indicated, such expenses are based on gross leasable area, which is defined as follows:

“The total floor area designed for the occupancy and exclusive use of tenants, including basements and mezzanines, and measured from the center of interior partitioning to outside wall surfaces...” (The Dictionary of Real Estate Appraisal, Third Edition, Appraisal Institute).

Application of the guidelines is set forth in each expense category section.

EXPENSE GUIDELINES

Real Estate Taxes

As previously indicated, real estate taxes were not included in the survey analysis due to Proposition 13 in California. Proposition 13 basically limits real estate tax liability to 1% of value, plus bonded indebtedness, subject to a maximum annual increase of 2%. By definition, Market Value assumes a title transfer as of the valuation date. A transfer of fee/leased fee title triggers establishment of a new tax base. Due to the proposition, prevailing assessments and tax liability of a property *usually* cannot be considered a reliable indication of future tax liability to a prospective buyer (other than implication of an effective tax rate). Real estate tax liability for a new fee/leased fee owner will be re-established upon title transfer (likely reflecting a basis on sale/purchase price, but not necessarily, as the Assessor may assess the property at market value). Tax liability for valuation purposes of fee/leased fee estates should be based on an hypothetical sale. This should be done by applying the appropriate tax rate to the implied value via circular mathematics (using spreadsheet software) or via *loading* the overall capitalization rate for application to net income without deduction for base taxes. In addition, Direct (Special) Assessments should be accounted for in each method as needed.

An exception to the foregoing is the valuation of leasehold estates (i.e. ground leasehold retail center). In most counties in Southern California, transfers of leasehold estates with remaining terms in excess of a stated period (typically thirty-five years) trigger reassessment. This should be confirmed with the appropriate government agency. It is important to realize that, if the sale triggers a tax change, taxes are generally based on the fee simple estate. As such, it is generally necessary to conduct a separate analysis of the hypothetical fee simple value of the property in order to glean tax liability to a new owner. For leasehold estates with less than a stated period remaining (typically thirty- five years), the prevailing tax liability can serve as implication of tax liability, subject to judgment. However, it should be recognized that if the leased fee estate is sold, taxes will be altered at that time. As such, since the leasehold owner has no control over the sale of the underlying leased fee estate, some appraisers consider it prudent to implement a change in taxes in the valuation procedure. This is supported by verification of leasehold purchases with buyers.

In some states, tax liability is based upon an analysis of the tax liability for similar properties at the property under appraisalment.

Insurance

This expense category typically provides for common property (fire, theft, etc.) and liability coverage. Observed insurance expenses on the surveyed centers ranged from roughly \$0.35 to \$0.55 per square foot of gross building area, per year (note, not gross leasable area). If gross and gross leasable area of a retail center are nearly the same, use of either size for the estimate should be reasonably accurate. Most of the centers in my expense sampling had an insurance expense in the range of \$0.35 to \$0.45 per square foot, per year. Most recently, this expense category has been rising and is rumored to continue to rise. Subject to judgment and consideration of actual historical expenses, an expense in the vicinity of \$0.35 to \$0.40 per square foot, per year, is generally reliable.

Other basic forms of insurance that can accrue to a landlord, for which reimbursement is sometimes invoked, consist of earthquake, flood, and rent insurance. My survey revealed occasional inclusion of these forms of insurance, although rarely the latter. Earthquake insurance often resulted in nearly double the insurance expense, depending upon the property's location. Such insurance should be based on actual expense information, a specific investigation as to cost and need, augmented by judgment. The same is true of flood insurance. Rental insurance is not considered a typical operating expense and would be a questionable item in terms of enforcing tenant reimbursement.

Common Area Maintenance

This expense category includes supplies/materials, landscape, trash removal, sweeping, security (if needed), lighting, repairs, electricity, water/sewer, and miscellaneous other services/items.

Observed CAM expenses on the sampling of centers ranged from roughly \$0.85 to \$1.75 per square foot of gross leasable area, per year. This range excludes atypical locations such as the L A Fashion district and affluent areas such as Beverly Hills, Century City, beach districts, etc.. Significant influencing factors included the extent of landscaping, condition and age of common areas, and whether security was needed. Observed landscaping expense on the centers was often in the vicinity of \$0.30 per square foot, per year, representing a significant portion of the CAM. Security expense was observed from \$0.30 to \$0.60 per square foot, per year, but was not common among the centers (usually, in market-perceived high crime areas). The lowest CAM fee is typically associated with frontage-style retail centers that have no or nominal parking and nominal landscaping.

Subject to judgment and consideration of actual historical expenses, an expense in the vicinity of \$1.00 to \$1.75 per square foot, per year, would be a reliable forecast as to this expense category. An expense at or arguably below \$1.00 could be supported for frontage-style development (aka street retail).

Building Repairs/Maintenance

This expense category includes building maintenance oriented supplies and materials, and maintenance pertaining to electrical, plumbing, painting, and the roof. Observed expenses for this category were rather erratic, being in the broad range of roughly \$0.10 to \$0.60 per square foot of gross leasable area, per year. After close examination of the operating statements, eliminating atypical expenditures, most centers demonstrated building repairs and maintenance expenses in the vicinity of \$0.25 to \$0.35 per square foot, per year—the variance largely being due to project age, condition, and management style.

Subject to judgment and consideration of actual historical expenses, an expense in the vicinity of \$0.30 per square foot, per year, is generally a reliable forecast as to this expense category for retail centers built since 1980, while an expense closer to \$0.35 per square foot, per year, is more appropriate for centers built prior thereto (basically 1950s to nearly 1980).

Property Management

This expense category relates to the fee for overall property management (rent collection, orchestration of repairs/maintenance, tenant/customer service, etc.). Observed expenses for this category were generally in the range of 3% to 6% of effective gross income. This range was echoed by periodic consultation with various management companies. In a few instances, usually with the smaller centers, properties were self-managed. It is my contention that a management fee should be implemented in valuation and loan debt service analyses as the preponderance of property owners invoke use of a management company. Even under self-management, time is being expended by the owner in lieu of management fees and as the old adage states, “time is money.”

Subject to judgment and consideration of actual historical expenses, a management expense in the vicinity of 4% to 5% is reasonably appropriate for most common retail centers operating at stabilized occupancy. For properties judged to have more intense management needs, a rate closer to 6% would be dictated, while a rate closer to 3% could be supported for centers requiring

less management. Significant influencing factors include the number of tenants in a center and the overall condition of the center. With a name-recognized credit tenant occupying a large percentage of the space, lower management intensity would be anticipated. A center with numerous small local tenants associated with frequent turnovers would be expected to be management intensive.

General Administration

This category includes professional services (such as legal, advertising, and miscellaneous related items). Of the surveyed retail centers, observed expenses for this category ranged from roughly \$0.10 to \$0.25 per square foot of gross leasable area, per year (excluding some atypical centers). The primary sub-category comprising this category consists of legal costs, typically pertaining to evictions. Few of the surveyed centers evidenced any significant advertising expense.

Subject to judgment and consideration of actual historical expenses, an expense in the vicinity of \$0.15 to \$0.20 per square foot, per year, is generally a reliable forecast as to this expense category. Where tenancy is well-established and long-term and/or reflects a high percentage of credit status tenancy, a much lower figure is supported, and in some cases, this expense is not warranted.

Replacement Reserves/Allowance

This category basically provides for accumulation of funds for replacement of so-called short-lived items. It has been my observation that many managers/owners prefer to treat replacement of items on an as-they-arise basis, and do not truly set aside a portion of the income stream. Few of the surveyed centers evidenced a reserve expense. As such, this expense category tends to be more appraisal-oriented than actually invoked by market participants. Nevertheless, the preceding expense categories do not provide for periodic replacement of items which is bound to occur during normal property ownership. Usually the costs of same end up being reported in the building repairs and maintenance category of operating statements, resulting in periodic hikes in the category. As such, a replacement reserves/allowance category is logically supported to compensate for same. A variety of methods can be implemented for this category, ranging from using a simple percentage of effective gross income—typically 0.5% to 1.0%—to an elaborate estimate of likely costs to be incurred on the average per year. The important factor is to avoid over expensing the property by not deriving the cap rate on a similar

basis (for example, if reserves are implemented on the subject, they should be implemented on the comparables for cap rate derivation purposes).

Comments

It should be recognized that the foregoing guidelines should be recognized as a rule-of-thumb regarding likely expenses that would be incurred in small to mid-size retail centers in Southern California. The information should be considered in conjunction with reported historical expenses for a given retail property as well as prevailing expenses. No liability is assumed by Gregory P. Wingerd or Gregory P. Wingerd & Associates for the accuracy or applicability of the information provided herein.