

Lease Audits for Fun and Profit

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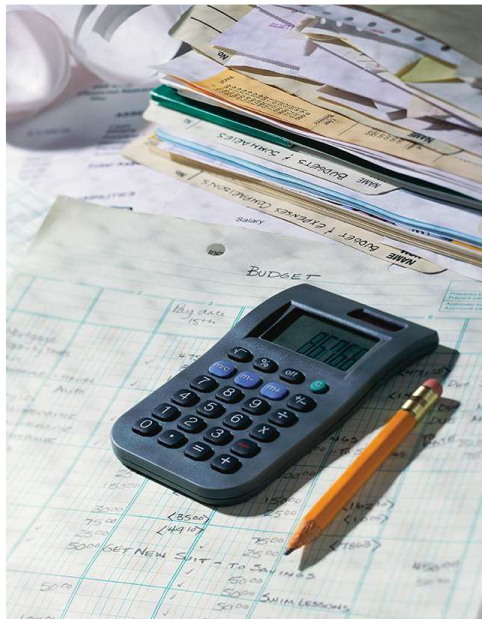
Believe it or not, corporate tenants often spend more time and money matching up purchase orders and paying for bottled water than they spend making sure that their rent expense (most likely the second highest company expense after personnel) is correct.

A lease audit is an invaluable tool that identifies billing errors that are, unfortunately, all too common in commercial real estate leases. Here are a couple of examples of how a recent audit that our firm conducted saved the tenant significant sums of money:

A tenant leased 200,000 square feet of space in a 1,200,000 square foot office building. The office building was part of a 3,000,000 square foot mixed use complex that included retail stores, a hotel, a supermarket, and a parking garage. The tenant had recently seen a large increase in operating expenses and real estate taxes. Being concerned about the accuracy of these expenses, the tenant engaged our firm to verify the landlord's records.

Audit Findings

The audit revealed that the landlord had made several errors. First, real estate taxes, which should have been charged to the parking garage, were charged to the office building. The reason? If real estate taxes are charged to the parking garage, the landlord would not be reimbursed, whereas when they are charged to the office building, the tenants in the building reimburse the landlord.



Second, the property was managed by an affiliate of the landlord. The lease stated that if a management fee was paid to an affiliate of the landlord it could not exceed the amount that would be paid to a third-party property manager. In spite of this limitation, the landlord/manager charged a management fee, approximately twice the market rate being paid to third-party managers.

Third, the lease stated that no expenses for personnel above the level of property manager would be charged to the office building. The landlord had hired an on-site general manager to oversee the operations of this mixed use complex in addition to managing additional properties owned by the

landlord in another city. The compensation paid to the general manager was well beyond the amount that would be paid to a property manager for this specific complex.

Savings to Tenant

As a result of our audit, the landlord agreed to three financial concessions: 1) eliminate real estate taxes associated with the parking garage, 2) reduce the management fee from

three percent to one and one-half percent, and 3) adjust the payroll expense to reflect the proper cost that would be incurred for a property manager. The audit resulted in savings to the tenant of \$801,000 over a two-year period.

When an audit uncovers major errors that would require reimbursement, the landlord often becomes creative in how it justifies the overbilling. In another recent audit, the lease stated that if the landlord used an affiliate to manage the property, the affiliate could not be paid more than what a third-party would be paid. The landlord had charged the tenant a management fee of three percent, whereas third-party managers were being paid one percent in the local market.

The landlord responded to our audit with this comment: "The San Francisco commercial real estate market is dominated by REITs. It is well established in the local market that REITs charge higher management fees than full-service firms since the fee is a source of profitability for each property management assignment. Even a cursory evaluation of REIT fees typically charged for Class A office buildings would show that the three percent fee is within the range charged by most other REITs operating in Greater San Francisco. Your argument of a third-party fee in the range of one percent is not practical. This fee is comparable; it is not possible to demonstrate that it is inappropriately so."

Landlord Accountability

Obviously the landlord didn't care about what the lease permitted, only about its internal financial goals. However, as a result of this audit, our firm negotiated a decrease in the management fee to one and one-half percent, saving the tenant \$425,000 over the lease term.

So, what strategy should a tenant generally pursue with a landlord? The same one that President Reagan used on nuclear disarmament with the Soviets: "Trust, but verify."

Our firm, like ITRA Global affiliates, only represents tenants, not landlords, so we have no conflicts of interest and can help tenants with verification. We can also work closely with ITRA offices to help advocate the client's best interests, starting with the draft lease and continuing with a no-cost annual review of tenant expenses to determine if an audit would be advisable.

Conclusion

Our team can help tenants deal with overbilling and contract disputes in three key ways. First, we assist a tenant during the lease negotiation process to ensure that the tenant is protected with the best possible lease language regarding operating expenses, real estate taxes, and audit rights. No tenant is too small to ask for and receive the help of our company.

Second, we believe that a base year audit is the most important tool that a tenant can use to identify and contain costs. We make sure that the base year expenses are correct, verify that the lease accurately documents the methods used by the landlord when calculating these expenses, and ensure that expenses for future years are determined using the same methods.

Third, our firm also performs a future year audit to make sure that the tenant is only being charged for the expenses permitted by the lease and in concert with how the base year expenses were determined.

Together, P. Stevens Associates, Inc. and ITRA Global can minimize real estate expenditures and enhance the bottom line of any corporate tenant.

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