

Real Estate Review

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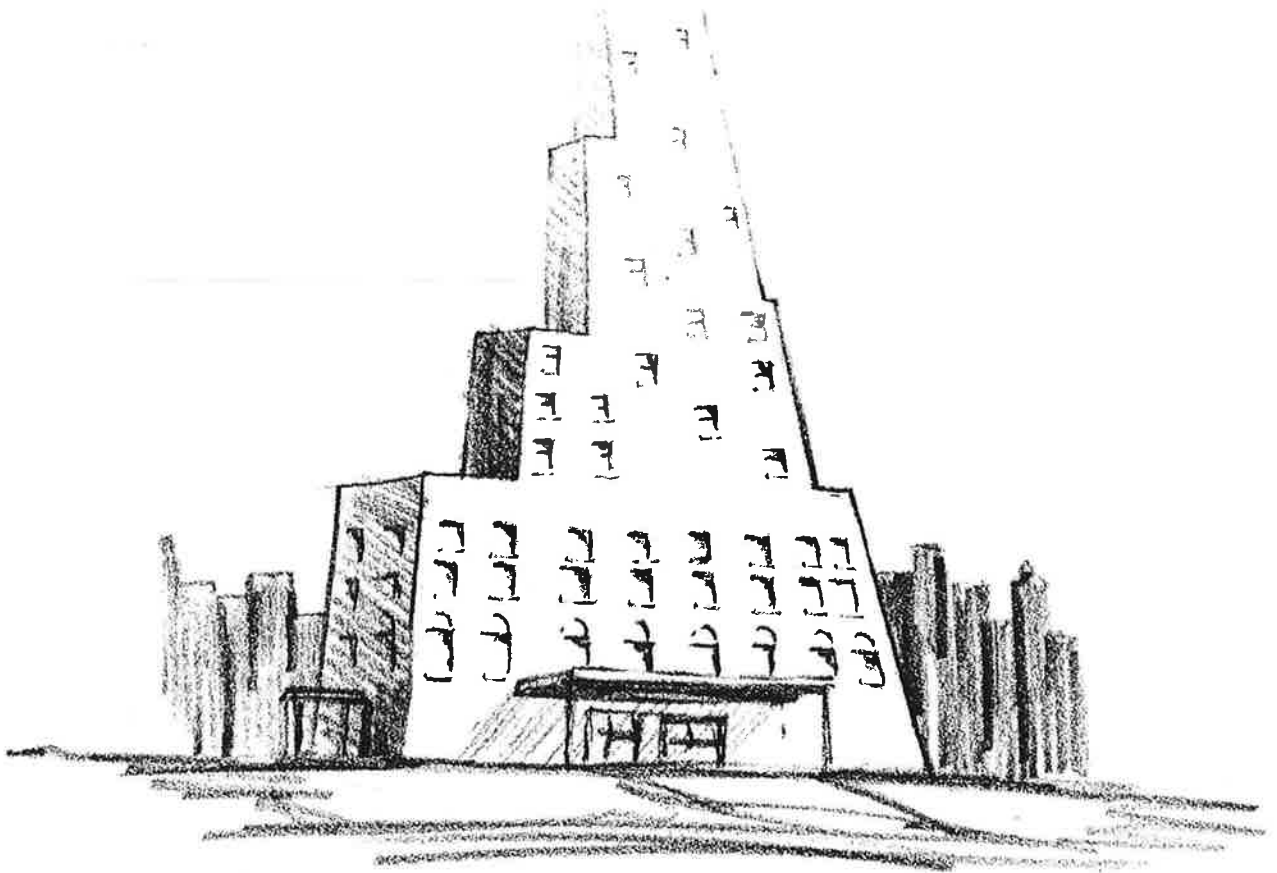
The Real Estate Institute of New York University



Market-driven R/U ratios and other causes of disappearing rentable area.

Owners Need Rentable Area Management Programs

Barry G. Lynch



THOSE WHO WANT to finance, sell, or rent office properties are constantly searching for credibility. Lenders and others can be fairly confident about the financial claims of borrowers, because they can insist that a mortgagor submit a letter from a certified public accountant that “attests” to the mortgagor’s financial assertions. The CPA’s attestation—a written conclusion concerning the relevance, reliability, and accuracy of

the financial statements and their underlying assumptions—reinforces the treatment under current tax law of real estate as a long-term investment rather than a tax shelter.

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However, one element of assertion concerning a property often escapes thorough examination: the area of the building. Assertions about rentable area (used in determining the value of the building by the income and capitalized value methods) and assertions about gross area (used to determine replacement value) are often not documented thoroughly. Often, they fail the reliability, relevance, and accuracy tests that the accountant applies to financial assertions. This is especially unfortunate in the case of rentable area, because that measure exerts a double impact on financial performance: It affects both operating income and appreciation.

The process of determining a building's real rentable area is like hunting an elusive buck. The hunter spends considerable effort tracking it down; he catches a glimpse of it; finally the prey walks into the clearing. The kill takes place (the building is 100 percent leased); the hunter sizes up the trophy (the landlord adds up the square footage of the leased area). But suddenly, the landlord is forced to confront an unpleasant reality: He has not brought down an eight-point buck, but rather a four-pointer with branches tangled in its antlers (the total of leased space is less than the pro forma rentable area, and the landlord cannot pinpoint the reason).

RENTABLE AREA MANAGEMENT PROGRAMS

Rentable area is elusive; unwatched, it tends to shrink. Moreover, the problems of managing rentable area are considerable. The manager must understand the uncertainties engendered by the three-dimensional aspect of architecture as well as the square-footage accounting problem. Retroactive building code changes, unforeseen leasing conditions, and modifications to building systems all can disrupt the pro forma estimates of a project's area. However, a rentable area management program is an important asset management tool that can be used to plan and control square footage throughout the project's life. A rentable area management program is not the same thing as a square footage accounting program. The one seeks to control the process by which changes in square footage are imposed upon the building space; the other merely reports historic square-footage transactions.

Rentable Area/Usable Area Calculation

Commercial properties in New York City may be valued (using the income method) by ap-

praisers who can choose among different rentable/usable (R/U) ratios. The Building Owners and Managers Association Standard (American National Standards Institute Z65.1-1980)¹ may produce a rentable area slightly less than the building's gross area. However, the Real Estate Board of New York's Standard,² for example, may yield a rentable area that even exceeds the size of the building. Either method may be used in drawing up a space lease.

The concept of rentable area has evolved in response to developers' needs to recover the full cost of their buildings. Although tenants occupy only "carpetable" space, developers must provide tenants with support areas like corridors, lobbies, mechanical rooms, toilet rooms, and janitor closets. It seems logical that the tenant should pay rent for its pro rata share of these service areas. Various organizations have developed generally accepted standards for the calculation of rentable area. Generally, these definitions use the following formula:

$$\text{Rentable area} = \text{usable area} \times \text{R/U ratio}$$

where

$$R = \text{rentable area and } U = \text{usable area.}$$

¹ "BOMA Experience Exchange Report", Building Owners and Managers Association International, Appendix D, 1989 (yearly publication). BOMA is at 1250 I St., N.W., Suite 200, Washington, D.C. 20005.

BOMA defines office rentable area as all space enclosed by the dominant interior surfaces of the exterior building closure (usually walls, windows) exclusive of vertical penetrations (elevators, stairs, shafts, etc.) and their surrounding fire-rated enclosures. BOMA provides for allocating common area to tenants only on the floors where the common area is located. For example, under BOMA, the common area designated as the building lobby would be prorated exclusively to tenants on the first floor.

The Designation ANSI Z65.1-1980 signifies that BOMA has been approved by the American National Standards Institute (ANSI).

² "Standard Method of Floor Measurement for Office Buildings," *Real Estate Board of New York Diary and Manual* (appendix to the yearly publication). The Real Estate Board of New York is at 12 E. 41st Street, New York, New York 10017.

The Real Estate Board of New York provides definitions of gross and usable area, and recommends that they be used in fully disclosing how rentable area is calculated. The definition of rentable area is left to the discretion of the owner. Gross area can include mechanical penthouses and freestanding power plants. BOMA does not include these areas in the gross area. Gross area is measured to the window (where present) as opposed to the dominant exterior wall surface under the BOMA Standard. Tenant space is measured to the corridor side of hallways; BOMA measures to the tenant side.

Many owners in New York City prorate to the tenants their equitable shares of mechanical penthouses, mechanical floors, and full-floor building lobbies. Because office buildings in New York city vary so greatly in age, structural condition, and location, determination of rentable area by the owner is often a key ingredient in determining a building's economic success.

But what is the appropriate R/U ratio? Usable area and gross area are physical concepts linked to the characteristics of the building. In contrast, rentable area is a financial concept driven by market forces.

The issue of R/U ratios has become important, not only because the ratios are a benchmark of the mark-up of usable to rentable space but also because today's competitive market effectively places a cap on acceptable ratios.

The fact that R/U ratios may be adjusted in response to market pressure may ultimately cause a property owner real problems. Building owner R.V. Winkle sold his property to XYZ Corporation. Winkle had never been aware of the importance of controlling the building's rentable area, and XYZ's research revealed a striking discrepancy. A leading architectural firm documented the size of the building as 312,000 square feet. But adding up the rentable area of all the leases in Winkle's 100 percent rented building produced only 287,000 square feet. Investigation of the building's history showed that the 312,000-square-foot total was associated with a multi-tenant R/U ratio of 1.25. The 287,000-square-foot total was the result of a number of deals, in which the leasing agents had cut the multi-tenant R/U ratio to the then current market rate of 1.15. The zeal and priorities of the leasing team, which wanted to lease the space quickly, had reduced the property value at the time of sale.

The term "multi-tenant R/U ratio" implies that any building has different single-tenant and multi-tenant ratios. The reason is obvious: Multiple tenants on a floor need corridor space and other common facilities that are part of a single tenant's interior space. In our hypothetical example, XYZ was able to turn its knowledge of the relationship between various R/U ratios to its advantage.

Lease rollover time was imminent. A study of the physical and square footage characteristics of the building showed XYZ that the floor plate was well suited for single floor users, and that it would be more efficient than the existing arrangement of multiple tenants on each floor. Indeed, the building's actual single-tenant R/U ratio was only 1.04, while the market rate was 1.08. That meant that new full-floor leases at the market R/U ratio rate of 1.08 could recover some of the rentable area lost under the multi-tenant leases based on a 1.15 R/U ratio. The new full-floor tenants would absorb more common area charges than was warranted by the space that they occupied. The key to successful implementation of this strategy

was a program that gave XYZ airtight documentation of rentable area allotments, and that coordinated definitions and management control procedures with the language in the lease agreement.

The importance of a proactive plan was demonstrated in a study of a recently built one-million-square-foot office building. Analysis of key areas during construction showed that for every one inch change in window placement, 12,000 rentable square feet would be lost or gained. A difference of 12,000 square feet in 1 million is perhaps minor, but such changes may result from nearly every design change. The composition of an architectural team may turn over several times during the course of the project. Furthermore, the design architect usually specifies a generic window system and relies on the contractor shop's drawings for the actual details of installation. The project or site architect who checks the contractor's drawings is focusing on potential leakage or liability, rather than on the owner's need for rentable space. Presto! The result can be loss of rentable area that might go undetected until a shrewd tenant brings a rent abatement suit against the unsuspecting owner.

An Actual Case

Exhibit 1 demonstrates how actual income drops below pro forma income when a developer of a multi-tenant building had to accept an R/U ratio that produced fewer rentable square feet than he had expected. (The numbers were taken from an actual building and have been slightly altered to protect the source.) The numbers reflect the first year income loss and do not address the ultimate loss upon sale that will occur if the R/U ratio is not adjusted.

THE LOSS OF RENTABLE AREA

There are many reasons other than artificially low R/U ratios that cause the loss of rentable area. The following three are most common:

- Creation of excessive corridor space when tenancies change on multi-tenant floors;
- Calculation errors during leasing;
- Deals cut by overzealous leasing agents.

To prevent rentable area from disappearing through the cracks, a rentable area management program must anticipate and control potential problem areas. Such a program must therefore:

- Identify key areas and monitor them during design, construction, and leasing;

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EXHIBIT 1 FIRST-YEAR PERFORMANCE DEFICIT OF A BUILDING LEASING AT AN UNEXPECTEDLY LOW R/U RATIO

<i>Pro Forma Calculation of Rentable Area</i>		<i>Income Comparison</i>		<i>Actual Rentable Area Achieved</i>	
Net gross area	234,000 square feet	Multi-tenant usable		188,000 square feet	
(less) nonrentable	(15,000) square feet	(Trans)market R/U ratio		1.125 square feet	
Rentable area	219,000 square feet	Total rentable area		211,500 square feet	
Efficiency (rentable/net gross)	93.59%				
Average rental rate	\$18 per rentable square foot	Average rental rate		\$18 per rentable square foot	
Gross rent (at 95% occupancy)	\$3,744,900	Gross rent (at 95% occupancy)		\$3,616,650	
		Variance from pro forma		(\$128,250)	
 <i>Expense Analysis</i>					
<i>Pro Forma Calculation of Recoverable (Pass-Through) Expenses</i>		<i>Actual Recoverable (Pass-Through) Expenses</i>			
Pass-through expenses		Pass-through expenses			
(taxes, heating, electricity, etc.)	\$1,232,600	(taxes, heating, electricity, etc.)		\$1,232,600	
Leased area (95% of rentable square feet)	208,050 square feet	Leased area (95% of rentable square feet)		200,925 square feet	
Expense per leased square foot	\$5.92	Expense per leased square foot		\$6.13	
Expense stop (\$ per square foot)	\$6	Expense stop (\$ per square foot)		\$6	
Developer's nonrecoverable pass-through expense	\$0	Developer's nonrecoverable pass-through expense		\$27,050	
 <i>Summary Cash Flow Analysis</i>					
<i>Pro Forma Calculation</i>		<i>Actual After-Tax Cash Flow</i>			
Gross rent:	\$3,744,900	Gross rent:		\$3,616,650	
Gross operating expenses		Gross operating expenses			
Non-pass-through	\$600,000	Non-pass-through		\$600,000	
Nonrecoverable pass-through	\$0	Nonrecoverable pass-through		\$27,050	
Net income	\$3,144,900	Net income		\$2,989,600	
Less interest on mortgage	\$1,150,000	Less debt service		\$1,150,000	
Less depreciation	\$600,000	Less depreciation		\$600,000	
Total taxable income	\$1,394,900	Total taxable income		\$1,239,600	
Less income tax (34%)	\$474,266	Less income tax (34%)		\$421,464	
After-tax income	\$920,634	After-tax income		\$818,136	
After-tax cash flow	\$1,520,634	After-tax cash flow		\$1,418,136	
		Variance from pro forma cash flow		(\$102,498)	

- Develop guidelines for dealing with specific problem areas, such as the corridor extensions that provide exits from multi-tenant floors;
- Clearly set forth the building's square footage parameters, a record of gross, rentable, and usable areas along with R/U ratios and reference standards;
- Establish readily understood conversions that translate building summary statistics into square-footage accounting that leasing personnel can use;
- Coordinate calculation assumptions with lease language; and
- Document variances from pro forma figures at preset leasing milestones and at project closeout.

The increasing sophistication of tenants means owners must document their assertions as to

space with great care. Recently, a facility manager hired a square-footage consultant (an architectural firm) to verify the developer's rentable area calculations. The architect uncovered a discrepancy between the lease language and the owner's method of calculation that resulted in rent cuts totaling thousands of dollars over the term. The developer had calculated usable area by measuring from the concrete faces of the building's core walls, but the lease specified that the area extend only from the drywall surface, several inches from the concrete.

As rent payments rise, tenants are taking keen interest in documenting lease areas. Developers and owners need to provide increasingly sophisticated verification of their calculations. A sound rentable-area management program will not only clearly document owners' area statistics, but also help prevent loss of income and enhance long-term financial performance. ■