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Industry Insights

Q3 2021

WHO PAYS FOR CAM?

Common area maintenance charges are so often a lost opportunity for building owners for two very different reasons. In both cases, tens of thousands of dollars are left on the table. It is time owners are fully informed on both counts.(1)

"We use NNN leases, so the maintenance costs don't matter"

We hear it often. Unfortunately for the owners saying it, this comment is accurate in first order effects but not in second order effects, costing them valuable dollars.

It is a matter of time horizons. Tenants on NNN leases *do* pay for all maintenance in the course of a year, once reconciliations are completed. But what happens on a longer time horizon? New tenants expecting NNN leases negotiate base rents but often also ask for trailing one to three years of operating expenses too. Why? Whether it is base rent or CAM charges, the tenants want to know what their *all-in* rent burden will be. A lease in which they pay $1.50/sf of base rent and $1.00/sf CAM estimates is no different to them than a lease with $2.00/sf of base rent and $0.50 of CAM estimates; they pay $2.50/sf either way. But it is different to the owner! The owner keeps $1.50/sf in the former and $2.00/sf in the latter because less of the tenant's overall payment is spent on maintenance. This is where the second order effect over longer timelines fails: higher maintenance costs are paid for at new leases or renewals in the hidden form of lower base rent. The leasing market is a zero-sum game; owners are competing against comparable properties down the street for tenants and the market supports, in the short-term, a fixed *total* rent burden. Who pays for CAM? In the short term, tenants. Over longer horizons, owners.

Just as you cannot buy homeowners insurance when your house is already on fire, you cannot expect tenants to believe maintenance costs will decrease when your three-year track record does not bear witness to your narrative. It is important for owners to be aggressive about managing costs *as soon as possible*. This does not mean reducing care for the building; it means being prudent and intentional with expenses. If the market supports $2.50/sf, the less that goes to paying landscaping, electricity, street sweeping, HVAC repairs, etc., the more that is left for ownership. (See also our Q3 2020 Industry Insight on tenant retention and why it is important to manage costs and keep tenants happy, even if they pay in the short term.) Managing CAM expenses is integral to satisfied owners and tenants.

(1) See our Q2 2021 Industry Insights for a more fundamental review of CAM

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The market for CAM is efficient…yet behavioral

Does using NNN, base year, or gross leases matter? Unsurprisingly, the answer is nuanced and mostly boils down to opportunity cost and behavioral changes driven by first order expense implications. Base year leases are generally superior to gross leases because it adds a nudge, however small, aligning owner and tenant interests, especially regarding utility usage. Gross lease tenants pay no CAM and have no incentive, for example, to conserve water, electricity, or trash. Base year tenants know increased usage will increase their CAM costs. However base year leases struggle most when, e.g., only one tenant is a large user of electricity (say, a medical tenant in an otherwise office building). In that scenario, the other tenants bear the burden of the high usage tenant, and it is recommended that the lease for the medical tenant specifies electricity usage is sub-metered and billed back for excess use(2).

Similarly, base year and NNN leases should be the same with the expectation that the base rent on the base year lease is higher by the base year CAM. Putting numbers to the wordiness, a property with $0.50/sf in monthly CAM could expect $2.00/sf on a NNN lease and $2.50/sf on a base year lease. In both scenarios, the tenant pays $2.50/sf in year one, $2.57/sf all-in in year two, etc. The difference between using a base year or NNN lease again comes down to the expectation of decreasing costs. On a base year lease, effective management that drives down costs to $0.40/sf increases the owner's profit by $0.10/sf. If that same improvement occurs on a NNN lease, the tenant is the beneficiary of the decreased costs. This matches the conclusion on the previous page: NNN tenants bear the cost / (benefit) of CAM increases / (decreases) in the short term, while building owners see that decrease / (improvement) in the long term. Efficient rent should normalize NNN vs base year leases but owners with costs to cut should prefer base year leases!

This takes us to the other lost opportunity for owners in CAM. Many, especially owner-managers, do not charge it! We hear it all the time: "it's too much effort for the money". (1) Are you sure? Especially for older leases, the amount over base year can be significant! It is an owner's prerogative to waive CAM charges but wouldn't it be better to know what you are missing? (2) This is one of the many ways property management should add value. When management is all you do, CAM is a core skill and one that is very accretive to ownership!

(2) Lots of nuance here! To be covered elsewhere.

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A frivolous story of inefficient markets

Consider this page an appendix for those *dying* to go down the rabbit hole of thought. It is best to start with a story:

It is common (or, was, circa 2014) for Marine officers and senior enlisted to buy a car while on a six-month deployment to Okinawa and resell the car to someone on the next deploying unit. There are several notable behavioral implications. (1) Does the car *ever* get maintenance? No! Why bother when you own the car for six months? Kick the can down the road to the next owner. In retrospect, yikes! Dangerous! (2) Once every two years, the cars needed a special inspection that cost about $500. Of note, many of these cars were only being bought and sold for $500, so the inspection costs as much as the car itself. It was common knowledge that one shouldn't buy a car that would need the inspection in the six months of ownership. Taking it a step further, one shouldn't buy a car that would need an inspection in the *next* six month cycle either, because after your ownership there would be no buyers who would want it during *their* ownership. But...something odd happens. The thought process isn't carried out ad infinitum. The *correct* thought process is to imagine a car owned forever and include all future inspections (and maintenance!) as part of the current price (discounted for the time-value of money, of course). Instead, junior officers happily bought cars with expirations over twelve months out. Why? It is still a mystery. But pure logic breaks down and "eh, I'll figure it out" overrides. There is always a greater fool to sell the cars to.

I know what you are thinking. "I bet this applies to purchasing buildings." Yes! For professional real estate investors in the state of California, it is common knowledge that it is better to have base year or NNN leases than gross leases, particularly for long-held assets. CA Prop 13 often leads to a large step-up in tax basis at sale. For base year or NNN leases, tenants pay the increase in taxes and bear the cost after sale. Conversely, on a gross lease, the new owner pays the increase in tax basis and discounts the purchase price by the increased tax expense divided by the cap rate. Thus, the current owner should ensure no tenants are on gross leases leading up to sale in order to maximize sale price. But in an efficient market, the tenants price that in! Savvy tenants should carve out tax increases due to sale or negotiate lower base rent knowing CAM will increase. This may not be possible with asymmetric sale information. It's all a game of markets, efficiency, and behavioral adaptations...or not!

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