



BOMA•Kingsley REPORT

Practical Industry Intelligence for Commercial Real Estate

DEFERRED MAINTENANCE AND CAPITAL IMPROVEMENTS | Spring 2011

Preparing for Recovery Strategies for Deferred Maintenance and Capital Improvements

By Lindsay Tiffany

Increase income, decrease expenses. This has been the mantra for many over the past few years amidst soaring vacancy rates and plummeting asset values. As employment reports grow more optimistic and lending activity picks up, property professionals are now concerned with how to best position their assets for success once the market recovers.

Management companies and building owners are grappling with the question of asset value preservation in different ways, especially when it comes to deferred maintenance and capital improvements. Some are performing improvements that will attract tenants and pay back in the long-term. Others are focused on balancing deferred maintenance with cost constraints. Many are facing a backlog of deferred maintenance, first because of the buy-and-flip cycle in the boom years mid-decade, followed closely by the market downturn. So what's the winning strategy?

Meeting Tenants' Needs

One thing everyone is focusing on is tenant retention. "Preparing for the turnaround is about keeping the income you have in place now and making sure that you are leading the market—beating the market—to increase your occupancy," comments Joe Markling, managing director, Asset Services and Strategic Accounts Group, CB Richard Ellis. "If people wait too long for the market to recover, they are going to miss that revenue stream."

Measuring tenant satisfaction, both formally through surveys and informally through face-to-face interaction with tenants, is critical. It can also help property professionals prioritize what capital improvements to make. Notes Ginny Carita, vice president of property management, Advance Realty: "If you understand what your tenants' issues are, you can determine what type of capital improvements you might need to make. A lot of times when we're looking at capital improvements, we're also looking at ways to reduce operating expenses so it's a win-win for both tenant and owner."

Anticipating what prospective tenants are looking for is another important aspect to take into

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consideration when approaching capital improvements and deferred maintenance. “With everybody scrambling for the same pool of potential tenants, you have to understand your tenants’ needs and either meet these needs with your current facility or upgrade,” says Larry Schoen, P.E., president and principal engineer, Schoen Engineering.

Existing buildings that were built more than 15 years ago face an even greater challenge. “The latest waves of development have set new standards for what a good asset is. One of the challenges that a lot of owners face is how to prepare their assets to match or at least approach, in class and in expectations, those buildings that have newer floor plans, newer mechanical systems and are greener,” says Chris Hipps, managing director, Transwestern. “Owners and managers need to develop a five-year capital plan that reflects potential changes in the market from a demand perspective in order to prepare their asset for the future.”

Prioritizing Where to Spend

With a limited budget and, in many cases, a number of pressing issues, property professionals must make tough choices about what to invest in

and what to put off. Dovetailing with the tenant retention theme, many say addressing the improvements that tenants see day-to-day go to the top of the list—areas like lobbies, common areas and parking garages. Things that tenants don’t see, like the roof, can be patched up for a year or two until more capital is freed up, as long as it does not affect tenants.

Enlisting building engineers and thinking creatively are two strategies that have worked for Carita. “The engineers are really the ones on the ground and we bring them into the discussion right from the beginning,” explains Carita, who recalls one instance where building engineers came up with a creative solution that helped avoid craning an HVAC unit into a 26-story building. Instead of replacing the entire unit, the engineers suggested using the HVAC unit’s existing framework and just replacing the individual parts, which saved money and avoided downtime.

Investing in technology has also proven to be a successful strategy for Advance. In one building, the company reduced security staff by installing turnstiles to the elevator banks, a glass curtain wall from the main lobby to concourse and additional card access readers, as well as implementing a delivery and tenant/guest visitor check-in

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system. The payback for this work was one year and one month and they were able to amortize the cost of the capital back into the operating expenses.

For portfolio managers, having a portfolio capital plan helps prioritize what improvements and maintenance to fund. “You do a triage—we call it a ‘capital triage’—where, just like with a hospital, we ask the question what do we absolutely have to do to maintain safety and occupancy? What do we need to do to be more efficient? What do we want to do?” says Markling. “Once we answer those questions, we overlay that onto a whole portfolio-wide plan and start moving things around a timeline to deal with the cash implications.”

Enlisting Service Providers

Many are turning to vendors for help. With their technical expertise and depth of knowledge, service providers can often propose solutions that save money and prolong equipment life until a bigger budget for maintenance or capital improvements is available. Because of the deep relationships that develop between vendor and property manager, most vendors are more than willing to be flexible.

Hipps has seen vendors’ flexibility firsthand. “We’ve said, ‘We really need to do this, but we can’t afford it right now.’ The vendor will then sit down and work with you,” he says. “It’s about both parties working collaboratively to make a project successful. They have skin in the game and are willing to get the project priced right, designed right and value-engineered so that it takes shape.”

ThyssenKrupp’s Director of Repair Development Stephanie Petkers agrees: “What we’re working towards is a long-term partnership so, if there is something that we can do to help a customer in the short-term, we are more than happy to do that.” Petkers adds that communicating with property managers and tailoring options to meet their needs have been cornerstones of their success throughout the down cycle. “We are taking a more consultative approach

with our customers and are really trying to understand their needs. In cases where capital is tight, we look at how we can make only essential upgrades to the equipment for now and delay the rest until they get it in their budgets.”

One Size Does Not Fit All

Important to note when considering deferred maintenance and capital improvements is that the right strategy depends on the building owner's needs and priorities. A short-term holder of real estate, a REIT and an institutional owner are all going to have a different approach when it comes to deciding what to invest in and what to defer; it's an apples-to-oranges comparison.

Shelby Christensen, senior vice president and national director of property management at Liberty Property Trust, explains that, because her company is a long-term holder of real estate, it does not have deferred maintenance. “We're in it for the long haul so we do not have deferred maintenance from this cycle,” she says. “Instead, we have worked aggressively to control costs and stretch every dollar we do have. We want to maintain a high-performance portfolio because our investors and tenants are judging us on the quality of our real estate.”

Christensen created a strategic plan to decrease the company's two largest operating expenses: electricity and taxes. Liberty appeals real estate taxes as a normal course of business, but this past year it was even more aggressive. Liberty gave each city a goal and was successful in getting more than \$4 million in reductions for the 2010 tax year. As for electricity, Liberty worked with tenants to employ low- and no-cost, energy-efficiency measures and diligently benchmarked energy consumption through ENERGY STAR® Portfolio Manager. Those energy-efficiency efforts have helped Liberty reduce energy consumption by 10 percent since 2008, translating to about \$3.5 million in savings for tenants.

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5 Things You Should Be Doing Right Now ... to Position Your Building for Recovery

By Laura Horsley

Although no one is predicting a rapid recovery for commercial real estate, encouraging signs—such as small dips in vacancy rates, an uptick in GDP and job growth and news of financing opening up and deals getting done—are encouraging. But as the marketplace begins to rise from the depths of the recession, so too do the expectations of tenants and prospective tenants. Will your building meet those expectations?

Here are five things you need to be doing to ensure you keep the competitive edge.

- 1. Make a Good First Impression.** Don't defer maintenance on the important things, but also don't defer maintenance on the obvious things. Lobbies, common areas, parking garages—these are the areas of your building that will make or break that all-important first impression.
- 2. Don't Forget Your Ounce of Prevention.** Be sure to keep up with your preventive maintenance schedule, and, if it's out of date, whip it back into shape. Keeping up with repairs and maintenance on a day-to-day basis can save you from surprise equipment breakdowns and unexpected capital expenditures.
- 3. Be All Ears to Your Engineers.** From the boiler room to the rooftop and everywhere in between, your building engineer knows and understands your building's systems and operations better than anyone. When confronted with capital improvement decisions, repair issues or if you simply need good counsel, call in your in-house expert.
- 4. Keep Harvesting That Low-Hanging Fruit.** Have you changed out your inefficient lighting, added those motion sensors, instituted after-hours and weekend HVAC power downs or reduced landscaping water consumption by replacing sprinklers with soaker hoses? These no- and low-cost green strategies save money, save energy and can give you the green thumbs up with tenants.
- 5. Benchmark, Benchmark, Benchmark.** It may be a cliché, but it's true: You can't manage what you don't measure. Benchmarking your building's performance—energy and water usage, expense and income data—lets you know exactly where you stand in your market and gives you the tools and insight to track and improve performance.

Resources

BOMA's 2010 Preventive Maintenance Guidebook, <http://shop.boma.org>
ENERGY STAR® Portfolio Manager, www.EnergyStar.gov
Experience Exchange Report (EER), www.BomaEER.com

Markling's clients include REITs and institutional owners. "Certainty and consistency of cash flow are what it's all about for REITs. If you really need capital, especially something that affects occupancy, they will give you the capital that you need. You just have to budget for it and then manage the scope and timing because they are very concerned with month-to-month cash flow," he says.

Markling stresses the importance of tailoring the capital plan for each type of owner. "The institutions are more value

conscious. They are trying to build occupancy for value creation, not necessarily for cash flow. So they are more apt to look at things like payback," he notes. "I try really hard with my teams to get them to think about the motivations of the people who own the building so that they can package things in a way that works for them."

When it comes down to it, every building is different, as are the goals of its owners and investors; the right strategy really depends on a number of unique variables. For some companies,

a long-term strategy means planned capital expenditures are the norm, as long as cash flow remains consistent. Others may have to defer some maintenance and will focus on critical need and highly visible areas. All are partnering with vendors to lower costs and establish the smartest plans for their asset—and hoping the recovery picks up steam. ^{BOMA}

The BOMA•Kingsley REPORT is written and published in conjunction with Kingsley Associates, www.kingsleyassociates.com.

BOMA•Kingsley Update: Easier Being Green?

By Phil Mobley

In the spring of 2006, our first BOMA•Kingsley REPORT focused on issues of environmental sustainability in the built environment. At the time, green issues were only beginning to impact the industry. In this update, we take a brief look at current views as they relate to building improvements.

Always on the Table

There is a pervasive expectation now that building owners, architects, operators and suppliers be conversant with the latest green options. "Most contractors, architects, engineers and vendors are already including these things in their plans, bids and specs," says Joe Markling, managing director, Asset Services and Strategic Accounts Group with CB Richard Ellis. "It's always on the list, always discussed."

Shelby Christensen, senior vice president and national director of property management at Liberty Property Trust, agrees. "For every capital project we have, we evaluate the green option. And every new tenant is asking about it in the RFP." Green is becoming part of the "normal" operations and tenant retention and recruitment processes.

Indeed, data from the Kingsley IndexSM shows steady interest in green practices among office tenants in the United States. During 2008, the percentage of tenants indicating that green was "important" to them rose from 54 percent in Q1 to 61 percent in Q4. Despite a troubled economy, this figure held steady through Q4 of 2010.

Growing Sophistication and Education

But interest and consideration have not consistently translated into expensive retrofits. Rather, interest has bred increasing scrutiny on and education about green building solutions. Green roofing and the use of alternative fuels are items that can generate a lot of green "points," but at many buildings (especially existing buildings), there is lower-hanging fruit to pick, says Larry Schoen, P.E., president and principal engineer at Schoen Engineering in Baltimore, Md. "The basics—changing to more efficient lighting

and HVAC, turning things off and on more optimally—are still the most cost-effective," says Schoen.

Even less glamorous is what Schoen calls "basic good management": changing filters, fixing leaks and maintaining equipment properly. "You don't get points for that," he explains, "but it's green because you're using fewer resources more efficiently."

Casting building improvements in the green context is a growing trend. Whereas in the past, managers may not have actively communicated about using environmentally friendly cleaners or filters that contain recycled materials, today they can tout the green aspect of everything they do. Tenants thus become more educated and managers get a checkmark for being green.

Sometimes, far from needing to be informed, the tenants themselves are driving green practices. Ginny Carita, vice president, property management at New Jersey-based Advance Realty, notes that tenants now actively approach management to ask about ways they can participate in conservation measures (and the associated cost savings). "They are much more educated now," according to Carita. "It's great that you can get tenants excited about sustainability. It makes it easier to implement green strategies because it often goes to support the tenant's culture."

A Business Case

As green knowledge and technology increases and as more and more building practices fall under the green umbrella, buildings are becoming more sustainable. But it would be inaccurate to suggest that green activity is occurring outside of the cost-benefit context. If anything, the sluggish economy has driven certain green practices precisely because such practices produce a financial payback.

Today's owners and operators are constantly looking at options—and then making the best long-term business decisions for both themselves and their customers. "Am I going to get approval for a green roof today?" asks Advance's Carita. "Probably not. But will it be reevaluated next year and the year after? Absolutely."

"Our job is to justify our actions—financially, sustainably and operationally," says CBRE's Markling. "We have to look at all three." More and more, building stakeholders are finding ways to work together to bring those three aspects into alignment.