

Ninja Expense Reduction Techniques

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It seems like everyone is looking for ways to reduce expenses these days. A McKinsey & Company survey of 1,820 chief executive officers conducted in February found that the top priority of 74% was to reduce operating costs. There is a real danger, however, in reducing expenses without an eye on long-term profitability. For example, there may be a temptation to postpone necessary replacement and maintenance of building components, but this will lead to higher costs in the long-run. Here are three ways to reduce costs without jeopardizing the viability of your property.

1. Appeal Your Property Taxes

Property taxes are typically the largest expense associated with real estate. Depending on what state a property is located in, the property assessment determines either all or most of the amount of property taxes. Property taxes operate somewhat differently in each state, but the fundamental principles are similar throughout the country. For the purposes of this article, we'll focus on the Pennsylvania property tax system.

Some states levy property taxes on machinery and equipment, but Pennsylvania only levies them on real estate. Property taxes in Pennsylvania consist of county, municipality, and school district taxes. Each of these entities creates a budget for their fiscal year. In the process, they decide the amount of revenues they will receive from property taxes. They then divide the total budgeted property tax revenues by the sum of assessed values of all of the real estate, except tax-exempt properties, within their jurisdiction. This yields the tax rate and is expressed in a millage, meaning dollars of taxes per \$1,000 of assessed value. Each taxing entity then multiplies the millage by one tenth of a percent of the assessed value of every property in order to compute the property taxes owed.

For example, the 2009 Chester County budget includes \$145,288,007 of revenue from property taxes. The total assessed value of all of the real estate in the county is \$36,635,119,073. Dividing the total assessed value by \$1,000 yields \$36,635,119. Dividing the budget of \$145,288,007 by \$36,635,119 gives us the millage of 3.965.



Table 1: Property Tax Calculation

	Millage	Property Taxes
County	3.965	\$ 39,650
Township	3.000	30,000
School	10.000	<u>100,000</u>
Total		\$ 169,650

If a Chester County property has an assessed value of \$10 million, the millage is applied to \$10,000. If it is located in a township with a millage of 3.000 and a school district with a millage of 10.000, the total property taxes are \$169,650, as illustrated in Table 1.

This brings us to the first consideration in deciding whether to appeal your property taxes. With real estate values falling, we can expect many tax appeals this year. If you do not appeal your taxes but your neighboring property owners do,

your property taxes will go up *even if* the budgets of your taxing entities do not.

The Common Level Ratio Factor

You might be saying, however, that your assessed value is already well below your opinion of the market value of your property, so there's no point in appealing your taxes. Nothing could be further from the truth.

It has been many years since most counties conducted a countywide reassessment. In order to account for changes in market values since the last assessment, the State Tax Equalization Board (STEB) conducts a ratio study every year. This involves comparing the sales price of each property that sold in a county to its assessed value. The result is the common level ratio factor (or equalization rate in many other states). In order to arrive at the assessor's opinion of the market value of your property, you have to multiply your assessment by the common level ratio factor.

For example, the most recent common level ratio factor for Chester County was 1.93, meaning that the assessor thinks that our property assessed for \$10 million is actually worth \$19.3 million.

Because of the current level ratio factor, it is probably worth appealing your taxes even if you don't think that the value of your property has decreased. The net change of all properties that sold in your county determines the current level ratio factor and if this has declined, it will drive up the current level ratio factor, resulting in a higher assessor's opinion of market value.

STEB publishes the common level ratio factors in June, and property tax appeals in most Pennsylvania counties run from May 1 through August 1 each year. You won't know exactly what you are appealing until the ratios are published but there's not much time after that to file an appeal, particularly if you want to complete the process in time to enjoy the summer. For this reason, it's important to file the appeal as soon as the ratios are published. We expect the publication of the 2009 ratios to occur on June 13. If you subscribe to the CapStruc Valuation Movers and Shakers, we'll send you the common level ratio factors as soon as they are published.

Questions and Concerns

There are several common questions and concerns that people typically have about tax appeals. Can they raise my assessment? Will a tax appeal affect other issues related to the value of my property? Will I receive bad publicity when people find out that I'm appealing my taxes?

The county can raise your assessment but won't if you properly prepare for the appeal. You'll need a taxpayer representative and an appraiser. Your representative can be someone from your company, an attorney, or a professional familiar with property tax representation. If you engage a state-certified appraiser, he or she is prohibited by law from releasing the appraisal conclusions without your permission. This means that you'll have a 50 to 100-page report supporting a value conclusion before you have to decide whether you want to go ahead with the appeal. In my 20- years of appraisal experience, I've never been involved in a tax appeal where the assessment was raised. Your appraiser should also have experience with appraisals for tax appeals, as these differ somewhat from appraisals for other uses.

I've also never seen a tax appeal appraisal become an issue in any other valuation issues. The Pennsylvania definition of market value is different from any other value definition, so it would not be appropriate to use appraisals for property tax appeals for any other use.

The publicity concern is a legitimate one for some companies. If your property contributes a substantial amount to the property tax base, a tax appeal might cause you to be seen as less of a corporate citizen. You'll have to ask yourself, however, how much it's worth to be seen as a good corporate citizen. Is it really better for the community if they lose hundreds of jobs because you move your operation to a community with lower taxes? Only you can decide.

Whatever your situation, it is imperative that you consider appealing the taxes on any Pennsylvania property that you own within the next three months.

2. Get an Energy Audit

Energy costs are typically the second highest expense associated with real estate. Energy experts predict that electric rates will increase 20-30% after rate caps expire in the PECO (2011) and PPL (2010) territories. In one scenario, PECO has stated that they will base electric rates (after rate cap terminations) on based *current usage and demand*. So, now is the time to start thinking of how you can reduce your facility's energy consumption.

Things You Can Do to Prepare

Benchmark your facility:

Find out how your facility compares with other similar facilities and determine where you stand with the Energy Star ranking. This can be self-performed using the EPA's Energy Star website. In most cases, if your facility uses more than \$2.00/SF of energy costs, then you are a candidate for energy savings! Older buildings, those that use fuel oil or electricity for heating, or incandescent lighting are the best candidates for the next steps.

Become aware and understand the charges your utility bills:

- Are they accurate?
- Are you paying taxes when you are exempt?
- What's your demand charge vs. usage?
- Can you shift electricity usage to other time periods?
- How does your facility compare with other similar facilities?

In most cases, this can be done by consulting firms on a contingency basis.

Audit your facility to identify wasteful or inefficient equipment:

Retain an energy audit firm to review your specific facilities equipment and recommend energy savings opportunities that could reduce your current power demand and consumption. They should recommend projects with simple payback periods that could help you decide to implement. Several state and federal organizations will audit a facility for free to eligible parties. Another alternative is to take advantage of auditing firms that offer a Shared Savings Plan. Shared Savings is a method to offset the upfront cost of an energy audit and project implementation by paying for this cost using money saved on your utility bills for a specified period of time. This could mean no capital investment for your company.

In some instances, you can realize 5 to 10% in energy savings by simply by doing things differently, provided that management and employees are committed to implementing these measures.

Implement energy savings projects:

Once the energy audit identifies energy savings projects that pass your financial metrics, it's important to implement the equipment replacements properly. Specifying the equipment, bidding and retaining contractors and overseeing the installation are all necessary if you want the project to meet its projected energy savings.

Research grants, low-cost loans or other funding sources for energy efficient equipment upgrades:

Currently, there are grants and low-interest loans available from the government and utilities that will help finance your energy savings projects, if you qualify. Research the available funding and take advantage of it as much as you can. Your competition is doing it!

Verify energy savings achieved as a result of project implementation.

Once your energy savings projects are implemented, have the auditing firm or a third party engineering firm verify that your energy bills have been reduced to what was projected. If savings do not meet the projected, then investigate as to why.

How to go about it

Most facility owners or managers simply don't have the time to commit to the process. One option is to hire a full time energy manager. As an alternative, consider retaining an experienced energy management firm on an outsourced basis to assist you through the process.

3. Perform a Lease Audit

If you lease a property, you might pay property taxes and energy expenses, either directly or through common area maintenance charges. Whether or not you are paying these expenses, there's a third expense reduction technique.

Landlords and tenants typically negotiate leases over an extended period. The lease then goes to property accountants and lease administrators, who were not parties to the negotiations, to administer over the term of the lease. With the added burden of having to do the same thing for a portfolio of dozens or hundreds of leases, all with potentially differing language, formats and terms, property accountants and lease administrators often resort to automating the process. Truly accurate accounting, however, really requires highly individualized analysis on a lease-by-lease basis. The result is that errors occur in a high

percentage of landlord operating expense escalations, and the errors can result in overcharges that are quite substantial, ranging from a few pennies to several dollars per square foot. With changes in ownership, turnover in management, and reductions in personnel, the risk of errors and overcharges only grows.

Given the extent to which the landlord controls the operating expenses and related record-keeping, what can a commercial tenant do to ensure that it is being properly charged for building operating costs, in accordance with the lease agreement, accounting standards and industry customs? One thing that is becoming increasingly commonplace is the lease audit. A recent survey by Deloitte confirms this point:

“Lease audits and reviews have become fairly common among lease administration organizations. Nearly three quarters of executives from corporate tenants said they perform lease audits and another 12% said they were planning to do so. Of this group, 74% reported they relied on vendors to perform at least some portion of that work. When it came to the benefits from lease audits, 85% of executives at corporate tenants said their lease audits had resulted in cost reduction, with 41% citing significant savings.”

How to know if a lease audit is necessary:

Given that fees for lease audits are typically a percentage of savings, there is relatively low risk in performing one. You don't pay a fee if you don't recover any money. However, how can you determine if your lease warrants an audit? There are a number of warning signs, any number and combination of which suggest an increased likelihood that overcharges exist.

- Changes in ownership, management and/or personnel
- New Construction
- Unusual fluctuations in, or changes to, expense categories
- Changes to building/project (additions, reconfigurations, demolitions)
- Significant change to tenant mix
- Sudden increase/decrease in occupancy level
- Sloppy building operations/unresponsive ownership/management
- Many uniquely negotiated lease provisions (caps, exclusions, etc.)

Be sure to follow the lease provisions very closely.

Assuming your lease permits an audit, it is crucial that you follow the lease audit provisions very closely. (A brief discussion of what to negotiate into the operating expense clause is included below.) For example, if the lease requires you to dispute the statement within 30 days of receipt, you will need to send a letter to the landlord stating that you dispute it. Simply stating that you wish to conduct an audit without a letter of dispute could be inadequate. Similarly, failure to issue a report, submit to arbitration, and even notify all parties, as required by the respective clauses, could result in you unknowingly waiving your rights to recover any overcharges.

Who should perform the audit?

Just as you would hire a brain surgeon, not your family physician, to perform delicate, life-saving brain surgery, you should hire someone to perform the lease audit who has sufficient experience and expertise. Lease auditing is a highly specialized function incorporating property management, accounting, auditing,

legal and negotiating skills. In-house staffs, such as internal auditors, typically do not have the specific real estate knowledge that is critical to understanding the many complicated issues that could arise.

The lease audit starts before you sign the lease:

If you fail to negotiate aggressively the operating expense clauses before you execute the lease, you will undoubtedly pay throughout the lease term more than you otherwise should. It is important to address clearly the definitions of pro-rata share, base years and amounts, inclusions and exclusions, cap limitations, allocations, and the descriptions of the mechanics and timing of the calculations. The lease should also require that the landlord keep its records using accrual basis accounting in accordance with Generally Accepted Accounting Principles (GAAP) consistently applied. Of equal importance is to properly address your audit rights to ensure that you have a fair chance to verify what the landlord is charging. You'll achieve this by negotiating and defining the four W's:

Who may conduct the audit? You should have the right to engage any reasonable professional, working under any reasonable fee arrangement to which you and the auditor agree. While the marketplace dictates that lease auditing is typically a contingency fee-based service, many landlords will attempt to insert lease language that precludes contingency fees and requires a CPA to perform the audit. There is no valid reason for either of these restrictions.

When must you conduct the audit? The lease should define a reasonable period in which to conduct the audit, produce a report, and negotiate a settlement. A reasonable period in which to conduct the audit and produce a report is a minimum of three months, preferably six months. A deadline to settle any claims, with the option to submit to litigation or arbitration, will force the landlord to be responsive. However, be careful that the wording does not require submission to arbitration by a certain date, failing which the claim is waived. Instead, the lease should provide that either party *may* submit to arbitration after the passage of a certain amount of time.

What may be audited? The lease should state that all landlord's books and records pertaining to the operating statement must be available for review and copying. Copying is important because it facilitates the report writing process, as well as future settlement discussions.

Where will the audit occur? The lease should stipulate that the audit will be performed at the building. Otherwise, you could be required to travel cross-country to accomplish the task. Moreover, in the case of a mid-year building sale, you could be visiting the offices of the former and current landlords to gain access to the complete year's records.

Increasingly commonplace in the real estate industry, lease audits are a low-risk mechanism by which to verify that you are paying only for what you agreed when you signed your lease. Paying close attention to the provisions contained in the lease, a qualified specialist should perform the lease audit. With many possible indicators that a lease audit is needed, a lease audit can yield significant recoveries of past overcharges. Paying proper attention to the operating expense and lease audit provisions when negotiating the lease can also yield significant savings during the lease term and ensure that you have the ability to conduct lease audits whenever you deem necessary.

Property tax appeals, energy audits, and lease audits are three powerful ways to reduce expenses. Become a modern-day expense cutting ninja and use these on all the properties for which you are responsible.

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