RETAIL CENTER EXPENSE GUIDE 2014

INTRODUCTION

This operating expense guide provides general guidelines as to the likely expenses that would be expected to be incurred in the operation of common retail centers in Southern California, as well as specialty centers and frontage-style retail centers such as the unique center pictured above. It should be used as an adjunct to consideration of prevailing and historical expenses for a specific retail center. As indicated elsewhere herein, guidelines provided herein are based on the observation of actual expenses incurred at numerous retail centers in Southern California based on income and expense information provided by property owners. In addition to expense guidelines, this guide provides insight as to various methods of estimating operating expenses as a result of cumulative knowledge gleaned from the appraisal of retail centers, augmented by periodic interviews with market participants (property owners and managers) in the retail center sector of the Southern California real estate market. The guide is basically applicable to centers ranging in size from 5,000 to 50,000 square feet.

OPERATING EXPENSES DEFINED

Briefly stated, *operating expenses* are the periodic expenditures necessary to maintain property and to continue the production of optimal income. While expenses can be categorized as *fixed* and *variable*, it is not a necessity in the expense estimation process. Rather, categorization with respect to simple expense types is more market-oriented with respect to the Southern California retail center market—for example, real estate taxes, insurance, common area maintenance, etc.. However, depending upon lease types associated with a property; it is often helpful to categorize expenses with respect to *reimbursable* and *non-reimbursable* status. For properties with leases dictating

reimbursements for various expenses (such as net leases and so-called triple net leases, aka NNN), *Potential Gross Income* consists of base rental income *and if applicable depending on lease types*, reimbursement income and, as such, can require iterative circular math in the treatment of income and expenses.

BASIC APPLICABILITY OF EXPENSE GUIDE

This guide is basically targeted toward providing operating expense guidelines applicable for common small- to mid-size one-story retail centers in the range of 5,000 to 50,000 square feet. This size range primarily encompasses typical convenience retail centers, small specialty retail centers, and so-called strip retail centers (also known as frontage-style retail centers as the centers are set toward or at the sidewalk—at the street frontage). Typically, centers in the referenced size range are not anchored, although mid-size name-recognition tenancy may sometimes exist (also, expenses apply to satellite retail space associated with an anchor under separate ownership). The majority of centers used for expense data extraction consisted of common wood frame and concrete block construction and were built from 1965 to 2013.

RESEARCH AND STUDY PROCEDURES

Operating statements of retail centers were compiled and analyzed, grouping expenses into six main categories. These included Insurance, Common Area Maintenance, Building Repairs and Maintenance, Property Management, General Administration, and Reserves (aka Replacements). Due to the impact of Proposition 13 in California, real estate taxes were not included in the expense extraction process and analysis. Proposition 13 in California dictates establishment of new tax liability upon sale (with the exception of some leasehold situations). As such, an analysis of tax liability of comparable properties does not serve as a reliable indication of tax liability for a property to prospective buyers. Although real estate taxes were not considered in the analysis, insight as to the estimation of same is provided herein. When estimating *Market Value*, tax liability for valuation purposes should be based on an hypothetical sale as of the valuation date in keeping with the definition of *Market Value* which states that:

> "…implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer …".

The guidelines presented herein are primarily based on observed ranges for each of the categories, tempered by my judgment. Expense information for centers with atypical expense characteristics were purged from the analysis (such as centers in very poor condition, centers undergoing renovation during the data extraction/reporting year, etc.). The expense information analyzed was from the year 2013. Most of the centers were located in the Counties of Los Angeles, Orange, Riverside, and San Bernardino.

The expense categories used herein are representative of the most common basic categories observed in the regional retail market. However, the categories are sometimes combined in market practice based on individual management styles. For example, Property Management could be grouped with General Administration, and sometimes Building Maintenance and Repairs are commingled with Common Area Maintenance.

It should be recognized that the term *Common Area Maintenance* has a specific and general meaning. Technically, the term relates to the expenses specifically relating to the common areas (as indicated elsewhere herein). However, the abbreviated term CAM is often used in the market in conjunction with rental quotes and, when used in this context by market participants, the so-called *CAM charge* typically includes the pro rata charge for not only the specific common area maintenance, but also real estate taxes, insurance, etc. (basically, other expenses that are obligations of the tenants as stipulated in leases and enforceable in the market).

EXPENSE ESTIMATION METHODOLOGIES

Two basic methods of estimating operating expenses for retail centers exist. The appropriate method or methods to use depend upon the lease types impacting the center, local trends, and judgment of the analyst/appraiser. One method is a Simplified Procedure and the other is an elaborate Per Category Procedure.

Simplified Procedure

This method relates to essentially a short-cut technique that addresses the expenses likely to accrue solely to a landlord under triple net leases. It is used in conjunction with an estimate of *Potential Gross Rental Income* arising from triple net rents (that is, base rental, exclusive of reimbursements) and typically consists of rule-of-thumb percentages applicable to effective gross income. The benefit of this technique is that it eliminates much of the potential error associated with developing a *per-category* type expense estimate. The basic logic of this method is that under triple net leases, ultimately the tenants will pay for most of the expenses associated with ownership—the operative word being *most*. Even with triple net leases, property owners are likely to incur some expenses. Many buyers of retail centers utilize this method of estimating expenses. However, one of the dangers of this method is that it assumes that tenants will be able to pay reimbursements for operating costs regardless of their amount (for example, a change in tax liability resulting from a sale could alter reimbursement liability to a prohibitive level).

For this procedure, it has been my observation that percentages are commonly used by buyers and generally include a management fee in the range of 5% to 6%, sometimes provision for reserves at 1% (or alternatively, a reserves figure of around $0.10 to $0.15 per square foot of gross leasable area can be used) and a *Due To Vacancy* provision of about 1% (percentages are applicable to effective gross income). The Due To Vacancy expense is to compensate for periods of vacancy during which some expenses will not be reimbursed. For single tenant retail property, a lower management fee is generally anticipated, such as 2% to 3% (depending on the financial wherewithal of the tenant).

Per-Category Procedure

As the name implies, this method involves developing a *per-category* estimate of basic expenses likely to be incurred in operation of a retail center. Other than brief comments made in the preceding section (and insight regarding use of the short cut method elsewhere herein), this guideline basically relates to implementation of the *per-category* method of estimating expenses.

APPLICATION OF GUIDELINES

The application of most expense guidelines presented herein relate to a *per-square-foot* annual basis. Unless otherwise indicated, such expenses are based on gross leasable area (often nearly the same as gross building area for retail centers), which is defined as follows:

> "The total floor area designed for the occupancy and exclusive use of tenants, including basements and mezzanines, and measured from the center of interior partitioning to outside wall surfaces..." (The Dictionary of Real Estate Appraisal, Third Edition, Appraisal Institute).

Note: In Southern California, mezzanine space is rather uncommon as are basements and same are typically not considered gross leasable area.

In some cases expenses are suggested as a percentage of effective gross income. And, in situations where gross building area significantly exceeds gross leasable area, insurance expense is best estimated based on the former (unless the excess size is associated with functional issues that would not likely be incorporated into replacement of the center in the event of a catastrophe).

EXPENSE GUIDELINES-PER CATEGORY METHODOLOGY

Real Estate Taxes

As indicated previously herein, Proposition 13 in California stipulates that a transfer of fee/leased fee title triggers establishment of a new tax base. Real estate tax liability for a new owner will be re-established upon title transfer, likely reflecting a basis on sale/purchase price, but not necessarily. As such, tax liability for valuation purposes must be based on an hypothetical sale as of the valuation date in keeping with the definition of Market Value.

Estimation of tax liability is commonly done by one of two methods. One method involves loading and unloading the capitalization rate with the tax rate. The other method consists of an iterative, circular-mathematics process, using computer spreadsheet software, with the tax rate, direct assessments, the other estimated expenses, and implied value in order to discern tax liability to a new owner.

As implied in the first procedure, all expenses except real estate taxes are deducted from effective gross income in order to develop a *temporary* net income figure (although Direct/Special Assessments associated with real estate taxes should be deducted as well). The temporary net income figure is capitalized by loading the selected capitalization rate with the tax rate (that is, adding the tax rate to the selected capitalization rate). For example if the selected capitalization rate is 6.5% and the tax rate is 1.0547, the income would initially be capitalized at 7.6% (that is, 0.076, or .07555). The tax rate is then applied to the resulting value indication to glean tax liability. The analysis is then recalculated using the implied tax liability and the initially selected cap rate (6.5% in the foregoing example). It is important to make sure the Special/Direct Assessments, if any, are also deducted along with the other expenses prior to the load procedure. Direct/Special Assessments for a property can be determined by contacting the appropriate governing agency, or can be roughly estimated based on a recent tax bill or roughly deduced by observing the disparity between taxes charged vs base taxes due relative to the tax rate. The tax rate area and tax rate can be obtained from government records (web sites and in person) and via many subscription sources. In my judgment, this is a rather primitive method of estimating tax liability and fails to make use of modern technology. However, if conducted properly it is a reliable procedure.

In the second procedure, which I prefer, spreadsheet software is used. With iteration set on, an income/expense analysis is developed with all expenses entered into the analysis on a per-category basis, except that the cell for real estate taxes is set to calculate as a percentage of the implied value cell, plus direct/special assessments (or the latter can be treated in a separate cell if preferred). Thus, taxes are automatically calculated. Ideally, *precision as displayed* should be used in the spreadsheet software.

Insurance

This expense category basically covers common property (fire, theft, wind damage, etc.) and liability coverage. The easiest method to estimate this expense is based on premium cost *per square foot* of gross building area (while alternative methods exist, such as using composite rates in conjunction with replacement cost, it requires peripheral calculations and estimates that can contribute to errors).

Observed insurance expenses on the compiled expense comparables were in the broad range of roughly $0.30 to $0.50 per square foot of gross building area, per year, although the majority of properties had expenses in the vicinity of $0.35 to $0.45 per square foot. Older-vintage buildings typically exhibited the highest expenses per square foot. Retail centers that had sprinklers for fire protection generally exhibited expenses toward the low end of the observed range.

Other basic forms of insurance that can accrue to a landlord, for which reimbursement is sometimes invoked, consist of earthquake, flood, and rent insurance. My survey revealed occasional inclusion of these forms of insurance, although rarely the latter. Earthquake insurance often resulted in nearly double the insurance expense per–square-foot, depending upon the property's location. Such insurance should be based on actual expense information and/or a specific investigation as to cost and need, augmented by judgment. The same is true of flood insurance. Rental insurance is not considered a typical operating expense and would be a highly questionable item in terms of enforcing tenant reimbursement (I have only observed this implemented with respect to trophy properties during robust market conditions).

With respect to mandatory flood insurance, this depends upon the flood zone in which a property is located. Flood zones are land areas identified by the Federal Emergency Management Agency (FEMA). Each flood zone describes the land area in terms of its risk of flooding. Flood Zones B, C, and X are areas outside the 1% annual chance of floodplain, sheet flow flooding, etc., and insurance is not required. Mandatory purchase of flood insurance applies to all A zones. Zone D is an area of undetermined status/risk. Additional information can be obtained from FEMA at www.fema.gov and www.floodsmart.gov. A good source for flood information is RiskMeter.com.

Common Area Maintenance

This expense category basically includes supplies/materials, landscape, trash removal, sweeping, security (if needed), lighting, repairs, electricity, water/sewer, and miscellaneous other services/items.

Observed CAM expenses on the sampling of centers ranged from roughly $1.10 to $2.85 per square foot of gross leasable area, per year. This range excludes atypical locations such as the L A Fashion district and affluent areas such as Beverly Hills, Century City, prominent beach districts, etc.. Significant influencing factors include the extent of landscaping, condition and age of common areas, and whether security is needed/provided. Observed landscaping expense on the centers was often in the vicinity of $0.35 to $.042 per square foot, per year, representing a significant portion of the CAM. Security expense was observed in the range of $0.35 to nearly $0.60 per square foot, per

year, but is not common (usually incurred with centers located in market-perceived high crime areas). The lowest common area maintenance fees are typically associated with frontage-style retail centers that have no (or nominal) parking and nominal landscaping. These are often in older downtown areas—particularly in small cities.

Subject to judgment and consideration of actual historical expenses, an expense in the vicinity of $1.30 to $2.60 per square foot, per year, would be a reliable forecast as to this expense category (generally around $1.75 to $2.25 PSF). An expense at or arguably below $1.00 per square foot could be supported for frontage-style development (aka street retail). And, for high-end centers with exotic design characteristics and significant landscaping/sweeping needs, an expense of $2.75 to perhaps $3.00 per square foot would be supported.

Building Repairs/Maintenance

This expense category includes building maintenance oriented supplies and materials, and maintenance pertaining to electrical, plumbing, painting, and the roof. Observed expenses for this category were rather erratic, being in the broad range of roughly $0.25 to $0.75 per square foot of gross leasable area, per year. After close examination of the operating statements, eliminating atypical expenditures, most centers demonstrated building repairs and maintenance expenses in the vicinity of $0.35 to $0.50 per square foot, per year—the variance largely being due to project age, condition, and management style.

Combined Option: (this is often a preferred method)

Common Area Maintenance/Building Repairs & Maintenance

Many of the owners of centers for which data was obtained reported a combined expense for Common Area Maintenance and Building Repairs/Maintenance. The typical range for the expenses combined was observed at roughly $1.35 to $3.10 per square foot, per year, but typically in the vicinity of $1.60 to $2.85 per square foot. For high profile locations such as Beverly Hills, Century City, Santa Monica, Newport Beach, Laguna Beach, La Jolla, etc. it is not unusual to see a combined expense for this category at $3.50 to nearly $6.00 per square foot, per year.

For common locations and typical retail centers, a reasonable rule-of-thumb for combined Common Area Maintenance/Building Repairs and Maintenance is $1.55 to $2.85 per square foot, per year. For centers in particularly active areas of Los Angeles, such as such as Culver City, Koreatown, Mid-Wilshire area, Beverly Hills, West Hollywood, and West Los Angeles.

Property Management

This expense category relates to the fee for overall property management (rent collection, orchestration of repairs/maintenance, tenant/customer service, etc.). Observed expenses for this category were generally in the range of 3% to 6% of effective gross income—typically around 4% to 5%. This range was echoed by periodic consultation with various management companies. In a few instances—usually with the smaller centers and often with single tenant retail—properties were self-managed. It is my contention that a management fee should be implemented in valuation and loan debt service analyses as the preponderance of property owners invoke use of a management company. Even under self-management, time is being expended by the owner in lieu of management fees and as an old adage states “time is money.”

Subject to judgment and consideration of actual historical expenses, a management expense in the vicinity of 4% to 5% of effective gross income is reasonably appropriate for most common retail centers operating at stabilized occupancy. For properties judged to have more intense management needs, a rate closer to 5.5% would be dictated, while a rate at around 3% could be supported for centers requiring less management. A management fee of 2% to 3% tends to be supported for single tenant retail. Significant influencing factors include the number of tenants in a center and the overall condition of the center. With a name-recognized credit tenant occupying a large percentage of the space, lower management intensity would be anticipated. A center with numerous small local tenants associated with frequent turnovers would be expected to be management intensive.

General Administration

This category includes professional services (such as legal, advertising, and miscellaneous related items). Of the surveyed retail centers, observed expenses for this category ranged from nothing/$0.00 to $0.25 per square foot of gross leasable area, per year. The primary sub-category comprising this category consists of legal costs, typically pertaining to evictions. Few of the surveyed centers evidenced any significant advertising expense.

Subject to judgment and consideration of actual historical expenses, an expense in the vicinity of $0.00 to $0.25 per square foot, per year, is generally a reliable forecast as to this expense category. Where tenancy is well-established and long-term and/or reflects a high percentage of credit status tenancy, this expense is not warranted. As a general comment, I don't see many prospective buyers implement this expense in their purchase decision-making.

Replacement Reserves/Allowance

This category basically provides for accumulation of funds for replacement of so-called short-lived items. It has been my observation that many managers/owners prefer to treat replacement of items on an as-they-arise basis and do not truly set aside a portion of the income stream. Few of the surveyed centers evidenced owners having a reserve expense. As such, this expense category tends to be more appraisal-oriented than actually invoked by market participants. In reality, most expense reports merely show sporadic capital expenditures for replacement items. Nevertheless, the preceding expense categories do not provide for periodic replacement of items which is bound to occur during normal property ownership. As such, a replacement reserves/allowance category is logically supported to compensate for same. A variety of methods can be implemented for this category, ranging from using a simple percentage of effective gross income—typically 0.5% to 1.0%—to an elaborate estimate of likely costs to be incurred on the average per year. Often an expense in the range of $0.10 to $0.15 per square foot, per year, is used/supported.

FINAL COMMENTS

The foregoing guidelines should be recognized as a rule-of-thumb regarding likely expenses that would be incurred in small to mid-size retail centers in Southern California. The information should be considered in conjunction with reported historical expenses for a given property. No liability is assumed by Gregory P. Wingerd, or Gregory P. Wingerd & Associates for the accuracy or applicability of the information provided herein. The cost information used for developing this guide was procured during appraisal assignments and is largely confidential in character. The procedures presented herein do not necessarily reflect those of the Appraisal Institute or the National Association of Independent Fee Appraisers.

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Experience

Real estate appraiser and consultant since 1976. Appraisals have included a variety of property types and interests and have been conducted for a variety of uses. Clients include lenders, attorneys, government entities, corporations, and private parties/investors.

Educational Background and Designations Earned

MAI	*Conferred by the Appraisal Institute*
SRA	*Conferred by the Appraisal Institute*
IFAS	*Conferred by National Association of Independent Fee Appraisers*
Th. B.	*Bachelors Degree, New Testament Theology* *United Theological Seminary (Reformed Presbyterian), Anaheim, California*
A. A.	*Associated of Arts Degree, Real Estate* *Orange Coast College, Costa Mesa, California*
Certificate	*Certificate of Achievement in California Real Estate* *Orange Coast College, Costa Mesa, California*
Graduate	*New York Institute Of Photography, New York*

Pertinent Licenses

CGREA	*Certified General Real Estate Appraiser license, State of California*
Broker	*Real Estate Broker license, State of California*

Court Experience

Qualified as an expert witness in Superior Court of California and U. S. Bankruptcy Court.

Property Rights Appraised

Property rights appraised have included fee simple estates, leased fee estates, leasehold estates, sandwich leasehold estates, and various levels of sub-leasehold estates.

Property Types Appraised

Retail centers, shopping centers, single-tenant retail, single-tenant industrial, R&D/flex buildings, multi-tenant industrial buildings, business parks, office buildings, apartment complexes, mobile home parks, restaurants, fast food restaurants, auto-related improvements, religious-oriented buildings (synagogues and churches), auto-related buildings, and single family residences.

Sample Of Past and Current Clients

Attorneys and Law Firms

Rourke & Woodruff
Daneil Spradlin
Buchman, Kass, Morgan & Miller
Cox, Castle & Nicholson
Cooksey, Coleman & Howard
Corbett & Steeeman
Gabriel, Herman & Peretz
Saltzburg, Ray & Berman
Best, Best & Kreiger
McKittrick, Jackson, DeMarco & Peckenpaugh
Morgan, Lewis & Bkius
Rutan & Tucker
Graham & James
Robins, Kaplan, Miller & Ciresi
Lybrand and Anglin
Shafer, Hiskey & Ottolia
J. Peter Gyben
Voegilin, Barton, Kugman & Oetting

Financial Institutions

Bank of America
KeyBank
Chinatrust Bank
Saehan Bank
First Federal Bank
Fidelity Bancorp
Kinetca Federal Cr.
Temecula Valley Bank
Pacific Premier Bank
Broadway Federal Bank
Universal Bank
Wells Fargo Bank
Manufacturers Bank
Provident Bank
Luther Burbank Savings
Independence Bank
Banco Popular
US Bank
East West Bank
Sunwest Bank

Miscellaneous Clients

Aid Association for Lutherans
City of Costa Mesa
Farmers Insurance
Irvine Company
Blue Cross
Burger King Corporation
City of Huntington Beach
Coca Cola Bottling Company

Professional Appraisal Organization Membership

Dual designated member (MAI and SRA) of the Appraisal Institute (formerly American Institute of Real Estate Appraisers) and IFAS with National Association of Independent Fee Appraisers.

Geographical Area Of Coverage

Services provided in the Southern California Counties of Orange, Los Angeles, San Diego, Riverside, and San Bernardino.