Lease Audits Can Reveal Hidden Income Potential

With the commercial real estate industry still in an economic tailspin, now is the time for property owners to look at their existing portfolios and monetize any untapped opportunities. In addition, the New Year presents the perfect opportunity for landlords to review lease terms and billing procedures and begin asking the right tough questions — questions that can mean the difference between positive cash flow and money left on the table.

*Landlords cannot afford to forgo revenue at any time. However, revenue opportunities often hide in complex lease terms, elude inexperienced staff, or fall through the cracks due to communication and coordination gaps. In other instances, revenue opportunities may not be negotiated into leases, although they should be. A lease audit may be the solution to lost revenue challenges. It's one of the best ways to find **hidden revenue potential** among existing tenants under current lease terms.*

Missed Opportunities

Consider the following missed revenue opportunities. All of these scenarios translate into significant sums of money left on the table.

Neglecting to Bill Based on Current-Year Estimates: *A major commercial landlord and owner of a class A office building in midtown Manhattan wrote into its leases that tenant escalations could be billed based on current-year estimates. However, it chose not to do so to avoid having to return potential overpayments when expenses were trued-up at year-end. Billing based on current-year estimates would have kept the landlord's cash-flow neutral. Instead, the landlord had to wait 90 days after year-end for the retro billings to be done and more than 120 days to collect them. A typical true-up for this landlord was $1 million (15 months) resulting in a forgone $67,000 per month in cash flow.*

Lenient Rent Collection: *An owner purchased a property and for the first time had a retail tenant (in this case a restaurant). The tenant was required to pay fixed rent plus percentage of sales. A lease audit found that the lease only required the tenant to report sales figures annually within 90 days of the year-end close. However, the tenant hit the* *threshold for additional rent in month six. If percentage rent was required to be paid quarterly, the landlord would have received additional income nine months earlier.*

Lack of Attention to Critical Detail: *A commercial landlord interested in buying a Boston property when market rents were $45 per square foot was performing due diligence on two leases for one tenant, which included step-ups in year 10 based on a certain consumer price index. The leases were almost identical except that one of the leases erroneously added three words to the step-up rent clause: "minus base rent." These three words changed the base rent in year 10 to a maximum of $1.72 psf. It was a simple error that the owner, a sophisticated investor, had overlooked during lease negotiations. Upon discovery of this error during a lease audit, the buyer was able to negotiate a $5 million purchase price reduction to account for the decreased cash flow from the lease.*

Targeting Problems

A lease audit can help find these types of deficiencies and offer recommendations for improvements to billing processes, procedures, and internal controls so that these issues don't reappear in the future. It also can flag other problems, such as those caused by lack of internal coordination among departments. Most commercial leases allow owners to pass through over time their cost of capital expenditures, with interest, if the expenditure results in property cost savings. But realizing this revenue opportunity requires communication and cooperation between the operations department that maintains the property and accounting personnel. For example, if an owner purchased a new energy-efficient heating, ventilation, and air-conditioning system for $1 million — the cost of which can be passed through to tenants over a reasonable period of time (generally not more than 10 years) — yearly cash flow would increase by $100,000 per year before factoring in interest. But to do this, the operations team must calculate and document the cost savings and alert the accounting team. A lease audit can help uncover the communication gap between departments and offer remedial solutions so that revenue doesn't fall through the cracks in the future.

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Steps for the New Year

This year commercial landlords should resolve to give their leases and billing procedures a workout with a detailed lease audit. When conducted by skilled professionals, a lease audit is the best way to make sure that commercial leases will produce the maximum possible revenue during the coming year.

Lease audits are always timely. But the start of the year is a particularly opportune time to get leases in shape. For many landlords and tenants, January 1 begins a new calendar-year cycle for calculating escalations, surveying electricity usage, and reviewing other pass-through costs. Lease adjustments and improved billing practices at the start of the year will translate into more revenue and cash flow throughout the year. A good audit at the start of the year typically will involve these steps.

Review Lease Abstracts. *Make sure that terms are accurate and that all billable items are entered into the billing system correctly. In particular, the review should focus on step-ups, base amounts, free rent periods, escalation calculations, and rent commencement date. Often, a lease will establish a rent commencement date sometime after the space build-out. But too often landlords are not timely in billing rent because the build-out's completion date has not been communicated to accounting. Operations must coordinate with accounting so that billing can start on the effective date. Update escalation calculations and review for rent adjustments that should be made based on changes in consumer price indexes. Gather support for — and calculate — fair-market value rent step-ups that are due.*

Audit Tenants. *If tenants are subject to paying contingent rent such as percentage of sales or subletting profits, ensure that all revenue is being properly reported. For retail tenants, visit the tenant on-site and look at the tenant's reporting systems and operations.*

Do an Electric Survey. *Bring in an energy consultant and quantify electric usage and costs in tenant spaces. Alert accounting to any increases that can be billed.*

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Review Escalation Calculations. *Have an independent party review escalation calculations for accuracy. If costs are expected to rise, are you billing based on current-year estimates rather than prior-year actuals? Consider whether you will be performing any cost-saving capital improvements that should be included in current-year escalation billings and whether any gross-ups should be factored into estimates to get to the occupancy level specified in the lease. With vacancies on the rise, 2015 gross-ups could be significant.*

Review Miscellaneous Billings. *For some properties, miscellaneous building revenue such as net tenant service charges, overtime HVAC, and condenser water can be extensive. Are there procedures in place to ensure these charges are billed on a timely basis? Are all billable items being captured by your current system? Review leases and costs of sales to determine if any increases in HVAC and condenser water rates are allowed and/or necessary due to cost increases.*

Review Internal Controls. *Are you as effective and efficient as possible at getting billings — especially retro billings — out quickly? Can you generate accurate revenue data on the fly so that you immediately know what the property is generating? Improved billing systems lead to better cash flow throughout the year*

Hire Skilled Consultants. *Lease audits are demanding. A good lease audit requires professionals who are aware of finance, accounting, and operational issues, as well as the realities of the marketplace. Landlords would be well-advised to engage skilled consultants to review all current and prospective leases in depth.*