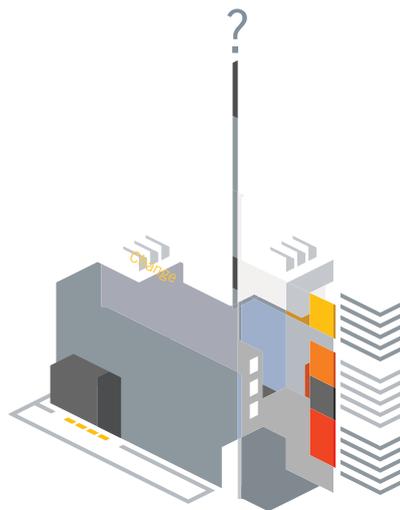




2nd Year MBA Student Project Report 2009

Service Charges in Commercial Property



Fixing UK commercial service charges -
has the credit crunch helped?

Summary Report **09**



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INTRODUCTION

Commercial service charges are the common costs of maintaining and operating multi-let commercial buildings. As set out in the lease, the landlord is responsible for providing the services and carrying out the works, typically through a managing agent, and the tenant is responsible for paying the bill. This relationship can produce conflicts of interest between the principal parties. Tenants are concerned about high costs and value for money services.

In June 2006 the RICS published a Code of Practice (the Code) in the form of a guidance note to regularise the management of service provisions in commercial buildings and reduce disputes. This came into force on 1st April 2007 and has brought about positive change. Issues, however, still remain.

In 2008 Property Solutions commissioned research entitled "Options for Change", which was carried out by two London Business School MBA students. The study's key message was to "Enforce the Code".

Since then the industry has received the twin shocks of the credit crunch and the resulting economic downturn. It is unclear what longer term effects these shocks will have on the industry and on service charges.

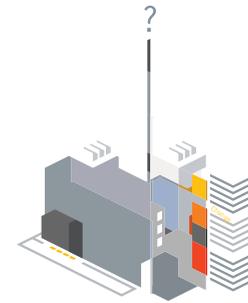
London Business School MBA students Saleem Jin and Svetlana Tsourikova have undertaken this research project, into the effects of the credit crunch on service charges, for their MBA.

The objective of this project was to carry out a macro-economic analysis of the effects of the credit crunch and resulting economic downturn on commercial multi-let office property with a focus on service charges and determine how the effects of the financial crisis are impacting different stakeholder groups. The project sought to identify options to minimise the impact of the downturn and in addition to identify and suggest ways to remove/reduce conflicts of interest, improving value for money and reducing disputes.

DATA GATHERING

We carried out both primary and secondary research over a six month period. The primary research consisted of interviews with 33 industry stakeholders (50% more than last year's "Options for Change" study) including landlords, tenants, agents, RICS, OPD/IPD, media and consultants, many of whom also took part in last year's study. Comments in quotation marks throughout this report are from those interviews. Secondary research included the RICS Code, 2008 Loughborough Report, RICS information papers on sinking funds & tenant alterations and attendance at a 2009 RICS service charge roadshow.

"[Service charges are] very poorly administered. Costs are higher than they need to be because no rigour is implemented in procurement of services... Communications and transparency are also very poor in regards to policy of service charges and preparation of budgets."



FINDINGS

IMPACT OF THE FINANCIAL CRISIS ON UK COMMERCIAL PROPERTY

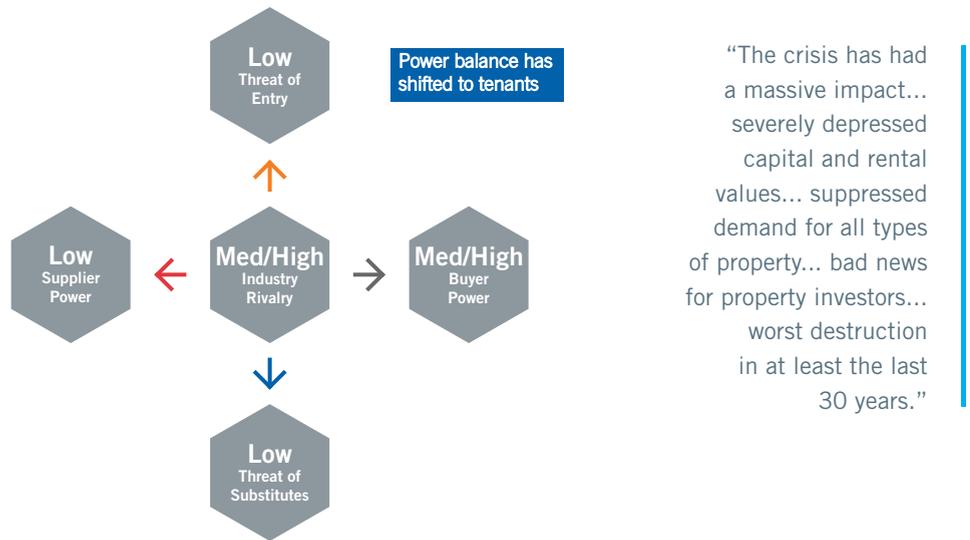
Low interest rates, excessive leverage and the subsequent collapse of the US subprime mortgage market were the key factors that led to the global economic downturn. The UK was hit particularly hard, due to the extensive investment in securitised mortgages by its financial institutions. In late 2008, the British government injected a £500 billion bailout package. Interest rates were slashed from 4.5% to 1.5% by early January 2009 with further cuts imminent. Additional elements of rescue packages for both the banks and the economy were being rolled out at the time of writing.

The total decline in property values has been c.35% since July 2007, according to IPD. Additionally, office rents in London fell by over 27% in 2008, with the figure expected to be 40% by end of autumn 2009, according to Jones Lang LaSalle. Large UK property owners such as British Land have been forced to announce rights issues to secure themselves from further falls in asset values.

The key impact of the financial crisis on services charges and leases has been as follows:

The balance of power has shifted from landlords to tenants: This has occurred due to the reduction in demand and the subsequent oversupply of property in the short term.

Most stakeholders agreed that the balance of power has shifted to the tenants, although, interestingly, the tenants themselves don't feel this as strongly.



“There is no movement in the market because people are hanging on to what they have or selling the odd one... There is no demand anyway.”

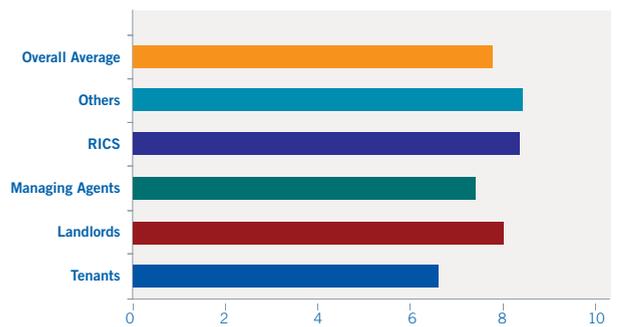


Figure 2: The financial crisis has given more power to the tenants

There is more dialogue between landlords and tenants (particularly in the retail sector):

The downturn has made landlords more proactive in working with tenants to reduce service charges and review lease terms (e.g. allowing monthly payments) to ensure that tenants stay in business.

If tenants fail landlords would not only be left with empty floors but would also be required to pay empty rates on these.

Tenant-landlord disputes have increased: Disputes have been on the rise during the past 12 months, driven by tenant’s requirement to reduce all operating costs.

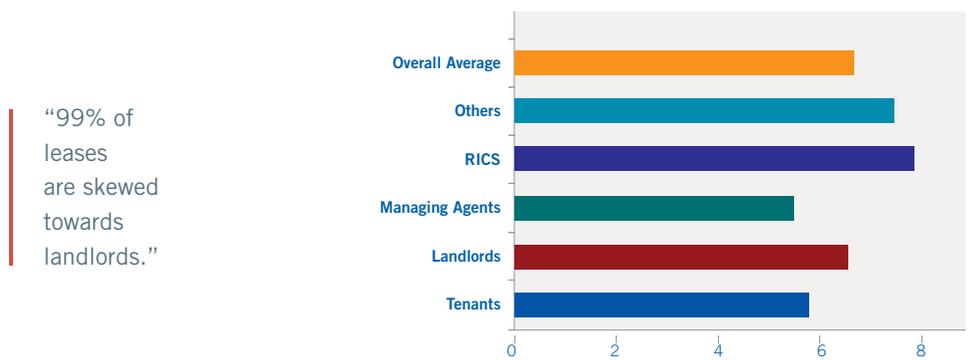


Figure 3: Service charge disputes have been increasing in the last 12 months

Lack of trust: Although communication has improved and there has been a shift of power to tenants, there is still surprisingly very little trust between tenants and their landlords or managing agents.

The highest rating given by any tenant was 5/10. This seems to be a long-term issue and is allied to a perception of unfairness.

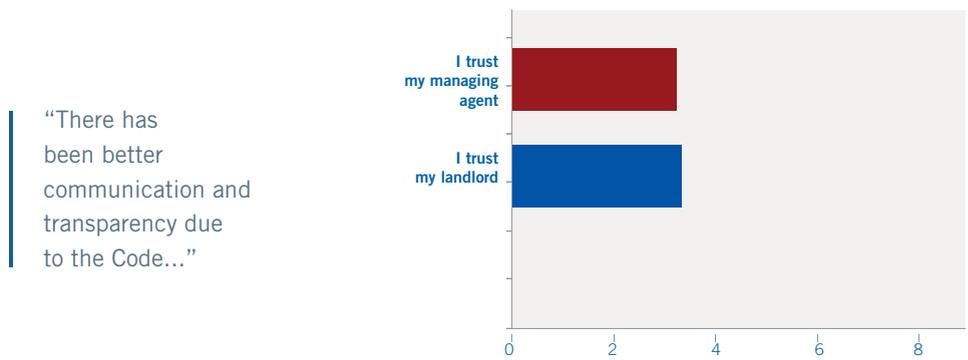


Figure 4: Do I trust my managing agent and landlord?

This view is supported by the UK Occupier Satisfaction Index 2009 which showed no improvement in service charge satisfaction and that **“Occupiers want property suppliers to place greater emphasis on reducing costs and to consult with them more.”**

IMPACT OF THE CRISIS ON SERVICE CHARGE ISSUES

Since the “Options for Change” study, carried out by London Business School students in 2008, we have observed the following additional key changes:

There is better awareness of the Code and there are some signs of better adherence: Most of the interviewees felt that more people are aware of the Code and there is a trend towards better Code-adherence, at least with the larger landlords and managing agents. However, very few leases if any are actually referring to the Code and it is left to the landlords’ discretion whether or not to follow the Code. The Code is still perceived to have no teeth and tenants still feel that they are not getting value for money.

Service charges have moved up the priority schedule of occupiers: This is because tenants are trying to cut costs wherever possible. Some people estimate that c. 25% extra time is being spent on the scrutiny of service charges.

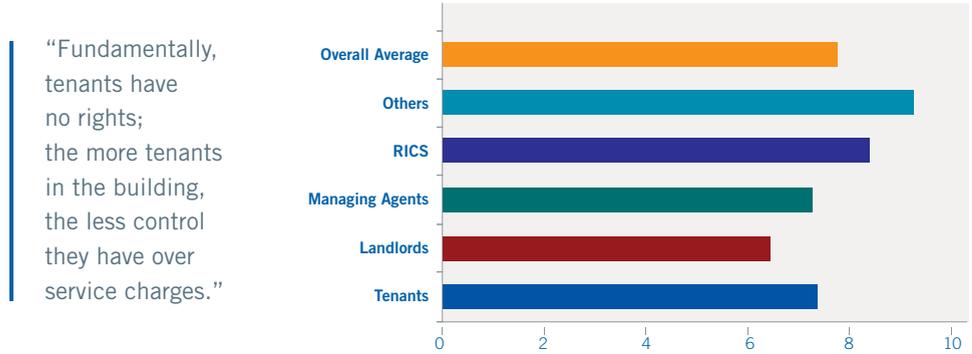


Figure 5: Have service charges become more important to my firm over the past 12 months?

However, there are misperceptions about the resolution of disputes, with landlords and their managing agents nearly twice as likely to believe that disputes are being adequately resolved.



Figure 6: Are disputes adequately resolved?

The key issues that still remain: The key issues that still remain with service charges are highlighted below. Although many are new findings, they are consistent with the findings of the previous study.

Code related issues: Very few [if any] leases include a landlord’s compliance with the Code covenant. Additionally, the Code has no teeth; it is up to individuals to decide to follow it and to what extent to follow it. Finally, not all industry stakeholders are members of RICS. These factors combined result in insufficient adherence to the Code.



Figure 7: Does the RICS Code of Practice adequately address service charge issues?

There is a general feeling that the RICS represents landlords more than it does tenants. Tenants feel that the RICS doesn’t represent their interests and the Code doesn’t adequately resolve service charge related issues.

There is a perception that not everyone understands the Code. Our interview findings were that most stakeholders said that they understood the Code. However, they feel that other people in the industry don’t understand it.

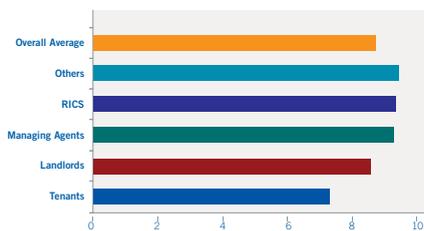


Figure 8: Do I understand the RICS Code?

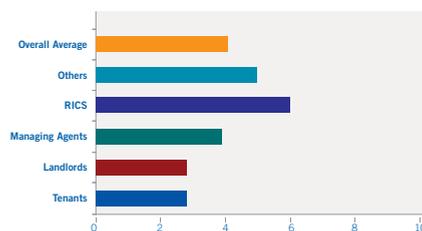


Figure 9: Does everyone understand the RICS Code?

Once again, this shows a level of mistrust but also indicates that there are a lot of stakeholders out there who don’t understand the Code. If they don’t understand the Code then it would be much harder for them to actually adhere to it, which may explain the existence of the large number of service charge disputes in the industry.

“There appears to be more compliance – more cautious eyes”

The broken nature of the industry: A fundamental issue with service charges is that tenants bear an inappropriate burden of financial risk. Landlords invest in properties because they choose to take on commercial property risk. However, tenants are not in the property business, but end up taking both the risk of their own industry and that of commercial property.

In recent times lease lengths have shortened and the use of sinking funds and depreciation charges has been reduced or eliminated. When major work needs to be done (e.g. replacing a lift) a short-lease tenant might get hit with a very large and unanticipated bill. If the tenant is prudent enough to negotiate this upfront, the landlord ends up footing the bill and with an unpredictable cost, which may or may not be 'priced' into the investment valuation.

Landlord/managing agent issues: There is a perception amongst many occupiers that service charges don't provide value for money; there is insufficient transparency/communication; and there is lack of trust towards landlords and managing agents. Additionally, fund-based landlords are not as actively involved with tenants as direct property owners and most serious issues appear to occur in these situations. Finally, Managing agents are not incentivised or measured to perform better so they don't have any motivation to do well.

"From an industry point of view, service charges are on the high side... Service charges are high because there is this thing that you can charge what you like..."

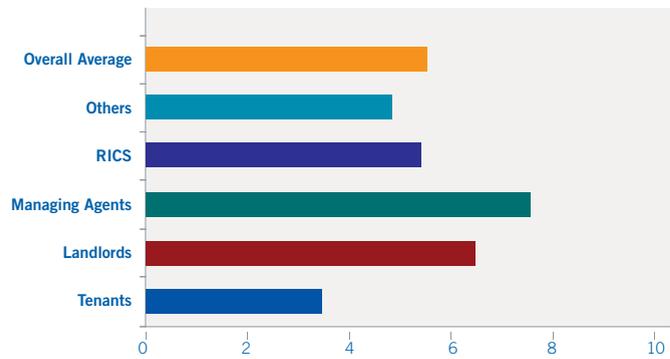


Figure 10: Do service charges provide value for money?

Tenant issues: Many tenants are not sufficiently educated in service charges and don't seek professional advice early enough. Additionally, there is little or no leadership among office tenants to give them a common voice and fight for their rights. Finally, service charges are not a priority for tenants in good times so they sign leases without sufficient negotiation and face problems later.

Benchmarking: Most interviewees complained that the current benchmarks (Loughborough and OSCAR) are a good concept but not granular enough to cater for different services included (e.g. air-conditioning) and locations/ types/sizes of properties.

"I am wary of legislation but the government could take the lease Code and translate it to 10 recommendations and make it legislation... not nit picking detail."

Legislation is not seen as the best solution: Most stakeholders were generally not supportive of legislation because they felt that this could actually worsen the situation and complicate things far more than they need to be.

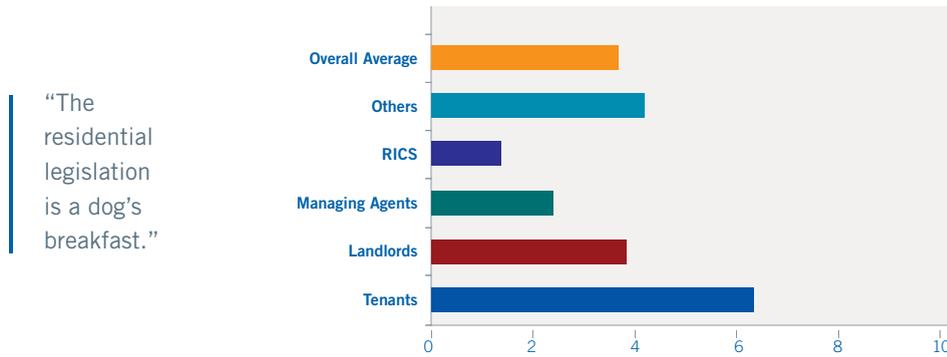


Figure 11: Is legislation the best option for change?

Our interview results showed that tenants were slightly more in favour of legislation as compared to the rest of the stakeholders.

“It would be hard to define universally acceptable legislation... What would the penalties be? ... Impact on business community? The party that tries this may have a negative impact on votes... However, it could work if done properly.”

“Legislation is heavy handed, doesn’t fit all situations and is not the right thing.”

“I will change my job if the government legislates service charges”

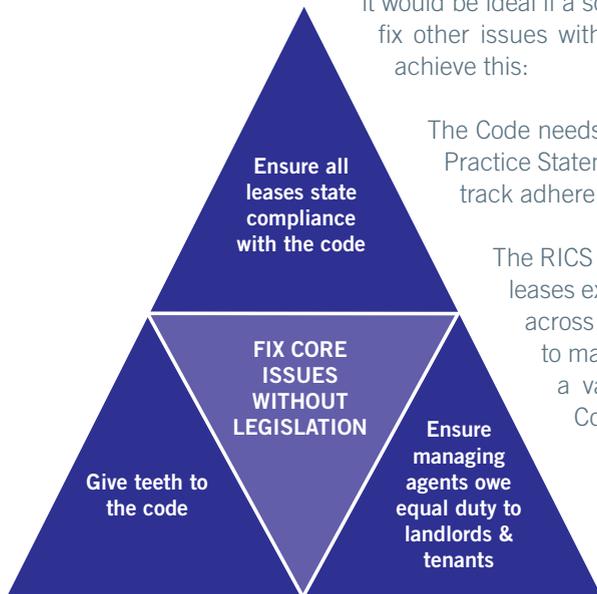
“Managing agents take commission on insurance... this should be shared with the tenant... sometimes landlords get involved and take part of the service charge fee! It is in issues like this that legislation could be beneficial.”

RECOMMENDATIONS

These recommendations flow from the work done by the students this year as well as the results of the macro study on the credit crunch.

CODE RELATED ISSUES:

A 3-pronged approach by the RICS: As most stakeholders are not in favour of legislation, it would be ideal if a solution could be found to achieve better Code adherence and fix other issues without the need for legislation. A 3-pronged approach could achieve this:



The Code needs to be given teeth by promoting it from a Guidance Note to a Practice Statement (like the Red Book for valuations). The RICS should also track adherence and carry out random member compliance audits.

The RICS should link with the Law Society to ensure that all commercial leases explicitly confirm compliance with the Code. This would ensure across the market compliance, over time. But, the RICS then needs to mandate that Red Book valuations should not negatively impact a valuation because a lease contains a compliance with the Code covenant.

The RICS should mandate that managing agents owe an equal duty of care to both landlord and tenant and that managing agents should only be appointed after the agreement of principal tenants.

THE BROKEN NATURE OF THE INDUSTRY:

All inclusive rent option: With the decreased usage of sinking funds and depreciation charges it is imperative that another system is in place to cater for large capital expenditures. An all-inclusive rent option can be ideal for tenants who want to avoid risk and have better certainty on costs. Landlords are far better placed to take the risk; they have better information, resources and experience to price this risk into all-inclusive rents.

LANDLORD/MANAGING AGENT ISSUES:

Improved processes & performance: Landlords should have more and better communication with tenants. They also need to understand the consequence of shorter leases and the advantages of providing better value for money and flexibility; the key benefit is better tenant retention, which in turn leads to lower costs and ultimately higher profits. Many landlords fail to realise the big pluses to the value of their investments of maximising tenant satisfaction/retention.

Managing agents need to be more aware that they are spending the tenants' money.

They need to use better processes and systems to ensure timely reconciliation of costs. There needs to be an incentive system to reward good performance of managing agents and penalise bad performance. Landlords and managing agents need to work together and work harder to drive costs down (e.g. through bulk contracts).

TENANT ISSUES:

Leadership & education: An office tenant organisation is needed to fight for tenant rights and give them a common voice. Without such an organisation it is unlikely that tenants will have sufficient individual leverage to change the industry. It is also important to demonstrate a strong potential for economic value generation, to persuade tenants to devote their time and efforts to such an organisation.

Tenants also need to be better educated in treating service charges seriously and need to be made aware of their rights in negotiating lease terms. They also need to seek professional advice early so as to avoid later disputes and disappointments.



BENCHMARKING:

Improved benchmarking: Either existing benchmarks need to be improved or a new benchmark needs to be set up that fulfils the industry needs. RICS is the ideal organisation to either partner with one of the existing benchmarks or set up a new one. We understand the RICS is in fact currently working on such a benchmark.

OPTIONS TO MINIMISE THE IMPACT OF THE ECONOMIC DOWNTURN ARE AS FOLLOWS:

ACTIONS GOVERNMENT IS TAKING:

Reducing interest rates, quantitative easing, bailing out key organisations, etc.

ACTIONS GOVERNMENT COULD TAKE:

Eliminate empty rates: Empty rates are forcing some of the landlords to tear down their buildings as they cannot afford to pay these rates in the current times. They are also driving down property values due to the additional risk and expense shouldered by landlords. The government needs to either temporarily suspend or eliminate these rates.

Relax taxation and subletting restrictions: The government should review tax rules on sinking funds as these regulations are discouraging the usage of such funds which do fulfil a useful function if professionally managed. Additionally, there needs to be softening of sub-letting rules, which can often restrict under-letting by tenants seeking to reduce overheads.

What some retail property owners are doing: By reducing service charges and reviewing payment methods (e.g. quarterly to monthly rents) landlords are helping tenants survive and are thus ensuring their own survival. Office landlords should follow the example set by the retail landlords.

Commercial Service Charge Seminar 26 November 2009 *“Change we can all believe in”*

The findings and recommendations of this research will be presented by the London Business School MBA students and discussed by a panel of eminent speakers at the Commercial Service Charge seminar being hosted by Property Solutions at the IoD, Pall Mall, London on 26 November 2009, alongside other new research from Loughborough & Kingston University Business Schools.



Please join in the debate on how to take these important findings forward by securing your place at the seminar. Contact Property Solutions on **01454 332202** alternatively by email at info@property-solutions.co.uk or go to www.property-solutions.co.uk/servicechargeseminar for further information.

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2nd Year MBA Student Project Report 2009 Biographies



Saleem Jin

Saleem is an Investment Manager with RCH Fund, a start-up fund investing in the real estate of care homes in the UK. He is passionate about real estate and has 5+ years experience in this sector through his current role, residential property investments and consulting projects. He also has extensive experience in team leadership, key account management and project management and has worked with a number of international companies such as Thomson Reuters and Coca-Cola.

Saleem took on high profile leadership roles at London Business School including co-presidency of the Real Estate Club. He also played a key role in helping establish a real estate education programme at the School.

Saleem received an MBA with a distinction from the London Business School. He was also among the top students during his undergraduate studies in New Zealand and received a Senior Prize in Computer Science. He has lived on 4 different continents and speaks 7 languages.

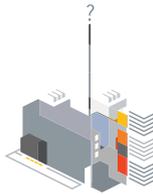


Svetlana Tsourikova

Svetlana has developed a deep interest in commercial real estate investment at the London Business School, where she took a real estate investment course. She interned at Jones Lang LaSalle Capital Markets Division in the summer of 2008.

Svetlana's previous professional roles include JP Morgan and Fidelity Investments in Boston, USA and diplomatic corps in Pretoria, South Africa.

Following her passion for emerging markets, Svetlana co-founded the Emerging Markets Club at the London Business School in 2008. Under her leadership, the Club organised a number of professional networking events. She is also in charge of an emerging markets knowledge database, where various investment opportunities, including real estate, are being evaluated.



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