Why Owners "Grow" Office Buildings and How Tenants Pay

If you think that some of the office buildings around the country seem to be getting larger over the last decade you would be correct - well sort of. The amazing fact is that while the rentable area for many office buildings increased dramatically, it did not occur as a result of any physical construction to the building.

To illustrate this point P. Stevens Associates (PSA), performed an analysis that tracked office buildings in the Boston/Cambridge, Massachusetts, market that had at least 200,000 rentable square feet in 1997. With a sample size of 51 buildings, from 1997 to 2009, one grew by over 30 percent, three grew between 20 to 30 percent, eight grew between 10 to 20 percent, and nine grew between 5 to10 percent. The overall weighted average was exactly 5 percent. In fact, more than 65 percent of the buildings increased in size, with the largest increase exceeding 200,000 rentable square feet!

How Prevalent Is This?

Although the study covered only the Boston/Cambridge markets, PSA has spoken to brokers around the country and found that this "growing" phenomenon happens elsewhere as well. In fact, brokers tell PSA that the harder the times get for real estate owners the more prevalent this concept becomes.

Why Do Buildings Grow?

Buildings can increase in size over time for several reasons. First, if the prior owner of the building had understated the proper rentable area in the building, it would be reasonable and appropriate for the new owner to correct this mistake. Second, there may have actually been physical construction to the building that added new rentable square footage. Third, it is also possible that the owner simply added phantom rentable square feet to the building in order to increase the building's value. In this case the increase is not justified by any industry measurement standard such as the Building Owners and Managers Association (BOMA) measurement method. Many owners will manipulate the measurement in an effort to generate addition rentable square footage, which increases the building's income and the resulting value. Remember, rentable square footage can mean something totally different to an owner than it does to a tenant especially if an industry-accepted measurement method like BOMA is not used. If a tenant is willing to lease space in a building without doing the proper due diligence to determine the accuracy of rentable square footage, then the blame falls on the tenant and their consultants. The owner is trying to create value, and the tenant is allowing the owner to do so at the tenant's own expense.

What Is the Biggest Risk?

The single largest financial risk to a tenant is to pay base rent based on an inflated rentable square footage that is unsupported by an accepted industry measurement method. If the actual building add-on factor for a particular tenant's premises is 15 percent, then why should the tenant pay base rent based on an add-on factor of, say, 18 percent, 21 percent, or more? If the proper add-on factor for the building is 15 percent, but the owner has re-measured the building to create an 18-percent add-on factor, the tenant will be paying an additional 2.6 percent in base rent. If the building is re-measured to create a 21-percent add-on factor, the tenant will be paying an additional 5.2 percent in rent.

What Is The Solution?

What should tenants do to protect themselves from paying for rentable square feet that do not exist? The easiest way to avoid this problem is to insist that the tenant's rentable square footage be determined by an accepted industry measurement method, such as BOMA, and then **verify the calculation**. Although this may require hiring an architect to verify the owner's computations, this expense is extremely low if calculated over the length of the entire lease term. If an owner refuses the tenant's request to have the space measured by BOMA, then the tenant can reasonably conclude that the measurements are inaccurate and that it will be paying for space that doesn't exist. Owners often provide for this "phantom space" by inserting language in the lease stating that the rentable square footage is simply an amount that is "agreed upon."

Other Financial Consequences

Another direct consequence to a tenant is that an increase in rentable area of a building results in an immediate increase in real estate taxes. When the local tax assessor determines the value of a building, one key figure that they use is the rentable square footage, a number provided by the owner. If the rentable area increases over a period of time, the assessed property value will also increase as a direct result of this change. Therefore, a 10-percent increase in a building's rentable square footage results in the assessment being 10 percent greater and thus the taxes being 10 percent greater. If the building's rentable area increases during the term of a tenant's lease, then the tenant pays for increased taxes that are due solely to the owner's desire to increase the size of that particular building in order to create value.

What Does this Mean for Tenants?

What does this mean to a tenant from a financial perspective? Besides impacting the tenant's base rent there are also financial implications regarding real estate taxes and operating expenses. Concerning real estate taxes PSA analyzed the property assessments for the Boston buildings that are generally considered Class A. For fiscal year 2008, the analysis included 46 properties. The actual real estate tax expense per square foot for these properties ranged from $5.81 to $11.45, with the weighted average being $8.96. Therefore, if an owner were to increase the rentable square footage by 10 percent in one of these buildings, it would cost tenants in that building between $0.58 and $1.14 per rentable square foot in additional real estate tax escalations annually. The only clear winners in this scenario are the owner and the city.

When this concept of growing a building is applied to operating expenses, the result is similar to that for real estate taxes, but with one key difference. We saw that increasing the building's square footage actually increased the taxes. Although an owner may "grow" the building's area, this should not increase any operating expenses, other than management fees, which are typically paid as a percentage of gross building revenues. However, "growing" a building affects the amount that the owner is reimbursed from the tenants as a whole. If the rentable square feet in a building has increased over time, and if the owner has calculated each tenant's pro-rata share based on the square footage of the building at the time of the each lease commencement, then the total of the pro-rata shares in the building will actually exceed 100 percent! It's all smoke and mirrors, but as they say, "It's good work if you can get it."

The question really becomes, why should the tenant continue to pay its original pro-rata share when, based on the current building square footage, the tenant's pro-rata share has actually decreased? The simple answer is, it shouldn't. The equitable thing to do would be to adjust the tenant's pro-rata share based on the then-current square feet in the building.

Tenant's Protection

How can tenants protect themselves from paying for these real estate tax increases and also pay only their true pro-rata share of the operating expenses? The answer: Make sure the tenant has the proper language in its lease. Language such as the following would protect the tenant:

"The Tenant's pro-rata share shall be a quotient equal to the Tenant's Rentable Square Feet over the Building's Rentable Square Feet. If the rentable square feet in the Building increases or decreases during the Tenant's lease term the Tenant's pro-rata percentage shall be adjusted accordingly based on the new denominator."