



In the Time of COVID: Controlling Operating Costs

How owners, asset managers and property managers can account for the disruption in their value propositions

MAJOR ISSUES ADDRESSED IN THIS PAPER

- How the coronavirus pandemic impacts budgeting
- Engaging tenants in cost-cutting strategies
- Maintaining sustainable practices in under-utilized facilities
- Technology's role in projecting and controlling operational costs

INTRODUCTION

For owners, asset managers and property managers, the perennial valuation challenge intensified in 2020. Facing off against the coronavirus pandemic has raised new hurdles to enhancing property values.

Conventional attempts to increase profits and reduce operational costs were met by tenants hunkering down in place — usually at home rather than at the office — while cleaning protocols ramped up and HVAC systems continued to



operate. The long-term ability of owners to keep spaces occupied might be called into question as tenants re-evaluate their needs.

“Owners of commercial real estate are all about the value proposition,” says Mark Dukes, vice president of asset management for Physicians Realty Trust in Atlanta. “The question that’s always before us is how to grow revenue and income while constantly being mindful of the expenses it takes to provide a healthy, successful, desirable environment for tenants and their invitees — in our case, patients. We have the fiduciary responsibility to our shareholders and our tenants to operate our properties well and do what we can to maximize value.”

The balancing act suggested by Dukes’ observation was disrupted in 2020. “The office sector has faced cyclical impacts before, and it has always recovered to pre-recession levels of performance and beyond,” noted Kevin Thorpe, Cushman & Wakefield’s chief economist, in the firm’s August [COVID-19 Impact Report](#).

But today, many office workers have the option to work at home, which Thorpe sees as changing the landscape. “For some businesses, those new dynamics are likely to change the mix of space they lease in the central business district versus the suburbs.”

As a result, the office sector faces a potential reversal of the long-running trend toward higher-density, open floor plans and fewer individual offices. The new challenge is accommodating a workforce that is not only more fluid than ever but also uneasy about densely populated offices.

The mandate to manage costs is undiminished at a time when uncertainty characterizes both tenant needs and the direction of the economy. “The COVID-19 pandemic has globally impacted industries and changed the way many businesses operate,” says Maria Solobay, Pulse product manager for Yardi. The result has been record-setting vacancies, compounded by rent deferrals that threatened huge losses of income.



BUDGETING & COVID-19

This sea-change is severely challenging baseline budget projections for 2021. LBA Realty operations director Michelle German has no plans to base 2021's budgets on 2020's performance. "For those deep-pandemic months, we'll go back to 2019 for a more accurate comparison," she says.

It seems that operations costs should have been lower in 2020 than in previous years. Occupancy in LBA's office portfolio dropped 70-80% during the summer because tenants decided to have employees work at home, German reports. Yet since much of its tenant base meets the definition of an essential business, LBA has continued to operate its buildings. "While we're seeing certain costs go down in some areas, we're also seeing increased costs in other areas due to COVID protocols," she says.

That cost dynamic — the balance between energy costs and overall operational expenses — calls for closer scrutiny. Early in the crisis, the Centers for Disease Control and Prevention issued guidelines for maintaining HVAC systems at performance levels that would reduce the growth and spread of COVID-19 as well as other airborne contaminants. While meeting the CDC's guidelines, German reported, LBA is operating its properties less energy efficiently. "We're flushing the buildings daily, two hours before and after business hours, and increasing the amount of outside air that we're supplying during operating hours," she explained.

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– Michelle German, LBA Realty

The CDC guidance was intended to move as much air as possible, adds Sara Neff, vice president of sustainability at Kilroy Realty Corp. And that makes operating HVAC still more complicated.



“If you have a building that’s 95% vacant,” she says, “building energy use goes down only between 25% and 40% because buildings weren’t meant to be ramped down.” The air systems must continue to perform, even if only one person is on a floor. And for that single employee, occupancy sensors will also click on all lights in the area, chipping away still more at cost controls. However, some of that might be recoverable, depending on the wording of specific leases.

The subtleties of cost control come into play here. On one hand are areas of increased operational focus revolving around COVID, such as stepped-up sanitation protocols, personal protection equipment, signage and marketing.

On the other hand, energy costs won’t necessarily increase; more stringent procedures are offset to some extent by lower occupancy. “Although we don’t have a full picture yet, we anticipate a modest reduction in overall operating expenses,” German says. One factor is that the smaller number of tenants translates into significantly reduced use of supplies. “At this time, our expenses appear flat.”

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BENCHMARKING THE BASICS

Nevertheless, tracking all COVID-related expenses is wise. That is the approach Physicians Realty takes at the 270 medical buildings it owns and operates in 38 states. “Benchmarking typically starts with setting a business plan for the coming year and looking at multi-year comparisons,” says Dukes, chair-elect of BOMA and an international fellow at the organization. In 2020, he explains, Physicians Realty created a cost code through its Yardi program that tagged expenses related to COVID-19. But given the heightened need for sanitary protocols in healthcare facilities, the increased scope of services may become the norm in future years, precluding the need to track incremental expenses.

Given the nature of the REIT’s tenants, deep cleaning was always a core service. The pandemic increased the frequency of cleaning and added new protocols for signage and social distancing. “I expect our stakeholders will want these long-term,” Dukes says. “We’ll budget 2021 with COVID expenditures separately, but I have the feeling many of those expenses will become the norm and be baked into future budgets.”

“If we’re successful in keeping everybody safe and doing so without a significant increase in expenses, it reflects positively on our commitment.”

– Mark Dukes, Physicians Realty Trust

For cleaning costs alone, he estimated the 2020 increase at a “very rough” 20-25%. Moreover, savings can’t be expected from reduced supply use with properties at full occupancy. Dukes doesn’t expect much pushback from Physicians Realty’s savvy tenant base, which recognizes that increase as a cost of doing business and ensuring sanitation and public safety.

“For us, job one is the safety of all of our clients and their patients,” he explains. “I’m hoping not to have unhappy customers when they see their annual reconciliation statement. Our tenants have responded favorably to recent surveys about how well we’ve cleaned, communicated and responded. We hope they know we did all we could to control expenses.”



NAVIGATING UNKNOWN'S

The unknowns of cost control are clearly greater for portfolio managers who endured larger holes in occupancy. Cost predictions for 2021 remain difficult, given the unpredictable nature of the pandemic. Practitioners who advanced the dual causes of tenant safety and cost control well before COVID found themselves ahead of the game. “Kilroy has always been a proponent of such measures as increased outside air, guidance for which we get largely from requirements to maintain our LEED certifications,” says Neff.

She notes that the U.S. Green Building Council’s LEED program encourages a 30% increase in outside air for all new construction. “Fortunately, we were already in compliance, and we intend to keep it that way,” she says. A landlord that hasn’t aligned itself with LEED might now face the prospect of evolving processes.

A manager’s ability to control costs — typically a basic exercise — becomes far more difficult amid changing protocols and often unclear regulatory guidance, as the pandemic has demonstrated. “Staying on top of all the guidance is challenging for our industry,” Neff says. “That said, I think the general position in the industry right now is that it’s better to be taking proactive action as opposed to stepping back.”

Maintenance, repair, operations and utility charges typically ran to 60% of all controllable costs prior to the pandemic. Property managers could find, hidden in those numbers, the wiggle room to maintain asset value when the economy hits a rough patch, as it did in 2020, and when increasing revenues is difficult.

The most recent **BOMA International research** available sheds light on the specifics of pre-pandemic MRO costs. In 2019, while the industry could still speculate on how long the record-breaking upcycle would last, total operational and fixed costs tallied \$14.13 per square foot against rental income of \$33.33, according to reports from 3,000-plus office buildings.





COST-REDUCTION COLLABORATORS

No matter the year or state of the market, controlling expenses and tenant engagement is part of the building-value scenario. Tenants may bring their own expectations for building performance, especially as it pertains to sustainability. As they join forces and collaborate on measures to keep costs down, tenants and landlords alike benefit.

“Together we can impact change,” German says. “We underwrite each property individually, and each has its own budget and strategy.” Even though each asset has a specific plan, LBA focuses on finding portfolio-wide opportunities, such as technology solutions and economies of scale.

But property-level performance is, to a great extent, dependent on the type of lease. LBA’s portfolio is bifurcated between office and industrial; the latter is typically triple-net leased. “On the office side, it’s in our control to reduce utility expenses,” she says. “On the industrial side, we can make recommendations and share our preferred network of vendors and suppliers. But it’s up to the tenant, ultimately.”

Of course, tenants’ expectations are not necessarily aligned with those of their prospective landlords. Neff mentions tenants that have asked for both more energy efficiency and increased ventilation at the same time. Tradeoffs and compromise become the watchwords in those cases, and fortunately, “most of those questions are hammered out at the lease stage,” she says.

Neff adds that those sustainability expectations ran the risk of getting lost in the immediacy of developing a workable COVID-response approach. Yet long-term strategies for sustainability and COVID control are not mutually exclusive. Making both workable is a matter of maintaining one’s focus and remaining proactive in the commitment to sustainability.

For example, there is COVID-related guidance on operating ventilation systems. But Neff raises a question: “Will we always need ventilation to be set at higher levels? A set-it-and-forget-it approach to extremely high ventilation levels is unlikely to be a good strategy in the long term.”



REAL-TIME CONSIDERATIONS

Managing controllable costs is always a major part of building valuation; in light of COVID-19's unpredictable long-term impact on office occupancy, cost control becomes that much more critical. The pandemic has created "an unexpected urgency for having an energy strategy," says Solobay. Given the persistence of the crisis, that urgency is unlikely to diminish anytime soon.

When property owners, cities and states reopen and set guidelines for interaction, office capacity will continue to be strictly watched. Solobay notes that more flexibility and agility will be needed to effectively manage loads and schedules at commercial properties.

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– Maria Solobay, Yardi

That means keeping a closer eye on energy consumption will be key to identifying opportunities and quantifying savings. Having access to utility invoices is the first step in this exercise, Solobay says, "but without real-time demand and consumption data, you're unable to benefit from more granular insights."

Shoring up that gap between usage and insights demands reliable data, she explains, allowing users to quantify the impact of simple energy-saving measures. Those steps can include raising setpoints or modifying operating schedules hourly or daily, rather than waiting until next month's utility invoice. "To that extent, we recommend applying this visibility across your portfolio first, then using the data to identify which buildings would benefit from a more intensive fault-detection or building-optimization solution," Solobay says.



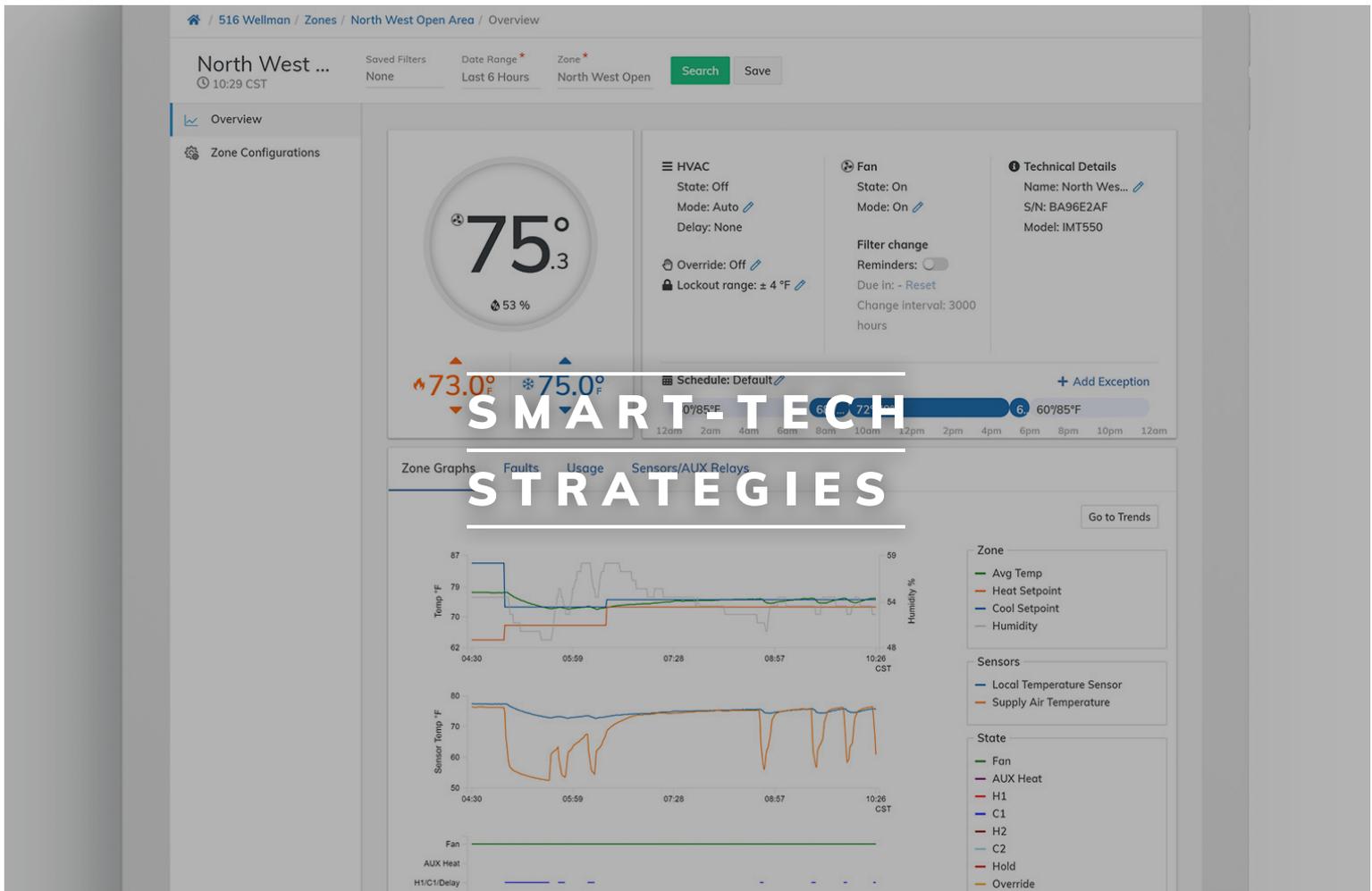
Solobay outlines five primary drivers of asset management investment in a comprehensive energy strategy anchored by a robust and integrated technology platform:

- By controlling operating costs that are not fixed, managers can begin to benchmark performance and find and address anomalies.
- Through the automation of accounts payable functions, managers not only reduce manual effort and keying mistakes, they can also reduce the potential for missed deadlines and the duplication of payments.
- There is a clear correlation between improved AP performance and overall tenant experience, realized in reduced complaints and a higher, positive profile among potential occupants. The nuances of leases, incorporating the varying expectations of tenant stakeholders, also point to the desirability of more automation in systems controls and more accurate data.
- That degree of landlord/tenant collaboration speaks not only to physical and fiscal comfort but to investor expectation. A fully automated cost-control system provides the potential for increased rent, says Solobay, as well as fewer concessions and increased market valuation.
- The control such systems can bring, especially to sustainability programs, also dovetails with investor Environmental, Social and Corporate Governance (ESG) criteria, as a part of investors' decision-making processes.

"It becomes very important from a compliance standpoint to be able to quantify and defend the spend you make," says Dukes, "because the goal of owners of real estate is to balance that spend with our mandate to keep people safe."

"There are a lot of moving parts here," says Kilroy's Sara Neff, "but portfolio benchmarking is critically important for investor disclosure." The applications the REIT has in place provide constant monitoring of its buildings' overall spend — and tracking them in increments as granular as 15-minute cycles. On that basis, Kilroy can determine "how much energy a building is consuming, and we can identify if the asset has a start problem or issues with setpoints," she says.

Energy use is tracked in dollars and cents, she adds, which speaks more clearly than data expressed in kilowatt-hours ever could. That detail of expression is critically important, as well, because it leads to staff buy-in. But never lose sight of the fact that software is a tool, Neff advises: "Software without engagement by the building engineering team is worse than useless; it's often counterproductive."



SMART TECH STRATEGIES

When the pandemic hit, LBA was in the midst of a smart-building rollout for its office properties, and the need for integrated systems and staff buy-in was not lost on stakeholders. With the help of Yardi, LBA split its office properties into a multiphase implementation.

The first phase consists of real-time metering, fault detection and diagnostics; the second phase emphasizes energy efficiency through automation and the optimization of equipment, such as HVAC, together with energy intelligence. “This allows us to make our office buildings smarter, thus reducing our spend,” German says.

But much of that initiative is not purely software-based, necessitating the need for a hands-on look at master contracts, “diving into them and analyzing if they should be rebid,” she says. “For our smart building program, we also look at where we need to make any capital improvements or modifications.” She explains that some buildings, including those that do not require upgrades, will start in phase one and after a couple of months enter phase two.

Prior to COVID, German reports, the firm’s results for the three buildings that entered the second phase saw significant energy reductions and cost savings. For obvious reasons, 2020 “was a little different because of the unexpectedly low occupancy. Additional thought and analytics will need to come into play.”

Tech systems can be further enabled by managers creatively enrolling in various utility programs, Neff notes. One technique Kilroy employs is enrolling in dynamic pricing, which varies electric rates by the time of day. To take advantage of lower prices, Kilroy can then shift properties’ energy load through such measures as onsite battery storage and demand response programs.



The approach isn't perfect, but, she adds, "we do this better than most of our competition by predicting and then controlling that spend. We do this before it's required, so the penalties are less than they would be, and we can operate our buildings in response to peak demand times."

Clearly, asset managers were charting new terrain in 2020 and continue to do so to achieve the perennial goal of increasing portfolio value. A decisive factor in that struggle is the implementation of a robust and integrated software platform. But that alone will not suffice. Enhanced value is a study in engagement of all stakeholders: ownership, management, staff and tenants.

As Dukes puts it: "If we're successful in keeping everybody safe, and doing so without a significant increase in expenses, it reflects positively on our commitment not just to lease space but to partner with our stakeholders to ensure they are all successful."

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