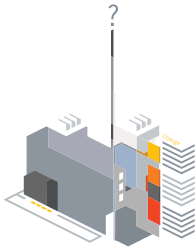


Options for
Change

Summary Report





INTRODUCTION

Commercial property service charges are the common costs of operating and maintaining multi-let office and other commercial buildings. High and uncertain costs, lack of transparency, and poor communication are sources of disputes between landlords and tenants. In England and Wales service charges are increasing above inflation, raising concerns amongst property professionals. Service charges are generally a small percentage of principal rent and are often overlooked. However, if air conditioning or security services fail, such service failure can have significant detrimental effects on the tenant's business.

While the Royal Institution of Chartered Surveyors (RICS) has published a Code of Practice to remove service charges as an area of conflict, its implementation and therefore effectiveness to date has been limited. Moreover, there are no widely accepted industry benchmarks against which to measure service charge costs and compliance with the RICS Code.

London Business School MBA students, Avanti Patel and Joysy John, have undertaken this research project into service charges for their MBA. The objective of the project was to understand the perspective of different industry stakeholder groups and to identify the "Options for Change". These options, if implemented, would result in improvements in the landlord/tenant relationship and better value-for-money service charges.

DATA GATHERING

Over a six month period, we gathered both primary and secondary data to understand the current state of service charges and draw analogies from other industries which faced similar issues. Primary data consisted of 22 interviews with key stakeholders, including the RICS, Landlords, Tenants, Managing Agents, OPD/IPD, Media and Consultants. Secondary research included the RICS Code, studies done by Loughborough University, and various related articles.

INDUSTRY ANALYSIS

The commercial property industry is generally regarded as "highly conservative and resistant to change". Industry analysis (Figure 1) reveals that landlords have enjoyed high profits. In this industry, power resides with the landlords, who own the property and thus are able to set rental levels and strongly influence the actions of other stakeholders. However, as valuations in the commercial property market continue to soften and supply of property exceeds demand, this may change.

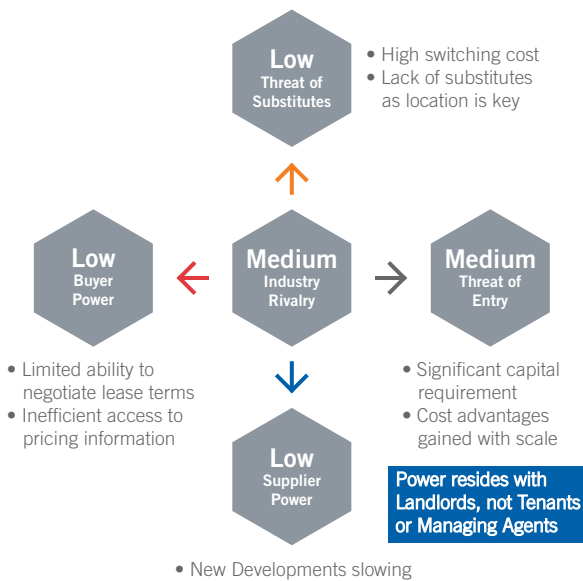


Figure 1: Commercial Property Industry Analysis

STAKEHOLDER ANALYSIS

Based on a detailed stakeholder analysis, we uncovered gaps in power and interest levels of various stakeholders (Figure 2). Conflicts of interest have been increasing as the players in the market have different goals. Landlords are incentivised to enhance the investment value of their property. Tenants want to maximise value for money. Managing agents are stuck in the middle. They are retained by landlords to operate property but also earn a fee indirectly from tenants for administering service charge contracts.

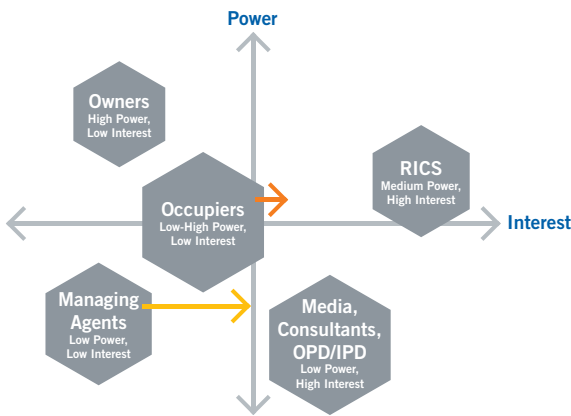


Figure 2: Stakeholder Analysis

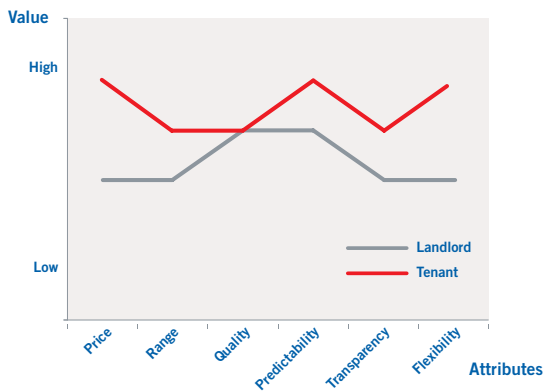


Figure 3: Value Curve for Commercial Property Service Charges

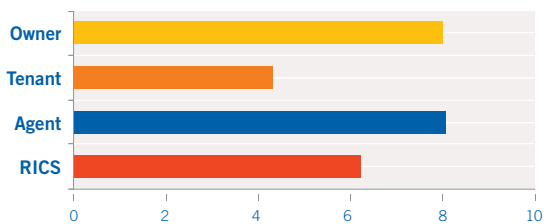
Agents are thus conflicted in their duty of care to tenants and landlords. Those agents who operate on a percentage fee basis have no incentive to seek value-for-money service charges since such an achievement directly reduces their fee income.

Until recently, tenants typically did not prioritise service charges as they are a small component of the rent and their businesses had limited resources to monitor these costs. We found that owners and managing agents were not very interested in service charges. They perceived service charges as “not for gain/not for profit” and a “boring part of commercial property.” Some of the agents and landlords do not even see any conflict of interest as they feel that they are operating as per the requirements of the lease. Based on our analysis of the current value curve (Figure 3), tenants want flexibility with lease terms and predictability of service charge costs. However, landlords and managing agents are less inclined to provide this. We suggest that a new value curve needs to be created to meet the unsatisfied needs of the tenant.

FINDINGS

Given the dynamics of the commercial property industry, structural inertia will be difficult to overcome and ingrained mental models will be hard to change. Our interviews show that while many stakeholders viewed the Code as comprehensive, adoption of the Code was actually quite low. Many stated that this was due to the fact that the Code was voluntary. The larger landlords may see the long-term value in adopting the Code, as it strengthens their reputation, but the smaller, independent landlords will have less incentive to look beyond short-term financials. 80% of all stakeholders interviewed agree that service charges are important, but differ widely in their perception of “value-for-money” (Figure 4).

Service Charge Provides Value-for-Money



Service Charge Disputes Adequately Resolved

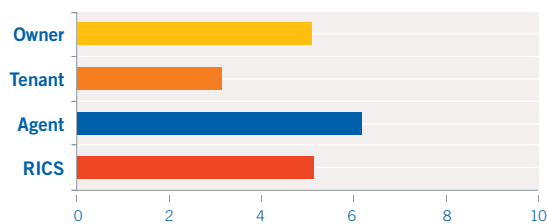


Figure 4: Perception of Service Charges

Option for Change is Legislation

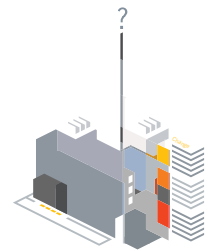
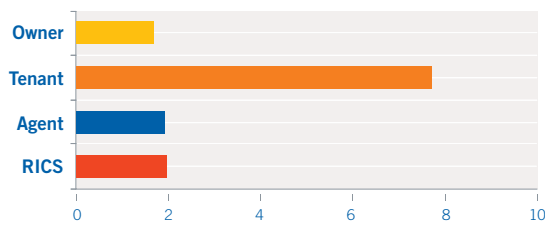


Figure 5: Legislation as an Option

In addition, stakeholders had mixed views on the viability of legislation (Figure 5). 45% of stakeholders who were interviewed felt that legislation was not the best option for enforcing the tenets set out in the Code. Views on legislation were largely as expected - 22% of stakeholders, largely tenants, felt legislation would be more effective. While those in favour of legislation acknowledged that it would increase administrative costs for all parties, they felt strongly that without enforcement of the Code and severe penalties for non-compliance, landlords would not be motivated to change their practices.

About a dozen different options were identified through interviews with stakeholders (Figure 6).

Options Ranked by Stakeholders

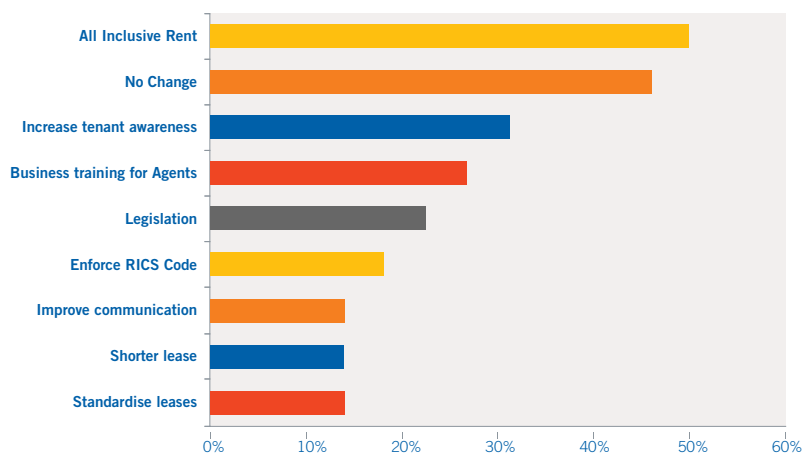


Figure 6: Options for Change selected by % of stakeholders

We mapped the following four criteria against the most popular options as highlighted by interviewees (Figure 7). All inclusive rent and business training for agents are the only two options that meet most of the criteria for evaluating options.

Options	High satisfaction	Improve relationships	Reduce Problems	Lower transaction costs
All-Inclusive Rent	✓		✓	✓
No change	✓			
Legislation			✓	
Increase Tenant Awareness	✓			
Business Training for Agents	✓	✓	✓	✓

Figure 7: Option Evaluation

RECOMMENDATIONS

Change is inevitable in the commercial property industry. To improve transparency and value-for-money and to reduce conflicts of interest, we recommend that industry stakeholders take control of the change process. If the industry as a whole does not move ahead to eliminate the inherent conflicts of interest, then regulators could step in with legislation, which might be a bitter pill to swallow. Based on our stakeholder analysis, drawing from other industries that faced similar conflicts of interest, and the proposals generated from the new value curve, we recommend:

- **Leadership** that gets buy-in from all stakeholders, manages the change process and is accountable for results. This role should be mindful of and act to balance the various conflicts of the interested stakeholders.
- **New offerings** such as more explicit service level agreements (SLAs) and the option of an all-inclusive rent
- **New tools** for property professionals, including business training for managing agents, improved communication between key stakeholders and industry-recognised service cost benchmarks.

Many of the new tools suggested are relatively low cost, simple to implement and achievable within a one to two year timeframe. The new offerings are costlier, more complex and will take longer to implement. However, this should not deter industry stakeholders from building the framework for all-inclusive rental arrangements and SLAs today.

Leadership:

Leadership and measurement against target is critical to managing the change process. Research about implementing change at the organisational level can be applied at the industry level as well. "Large-scale organisational change requires active and visible leadership to help articulate the change and to capture and mobilize the hearts and minds of the people in the organization." (Nadler and Tushman, 1989)

The RICS, seen as an independent and credible body within the industry, is the likely candidate for taking charge of the change process. It has the resources and network of relationships to build working committees to implement new offerings and tools. Its Charter and mission are well-aligned with taking the industry to the next level of excellence.

Measurement against objectives, such as those set out in the Code, needs to occur on a regular basis. This measurement can be done by the RICS or another third-party. If progress is not communicated with a percentage completed figure or some other measurement tool, members are likely to lose momentum or abandon the change process altogether.

We believe successful leadership is not driven by force but by gaining buy-in from all change participants. The RICS could legislate the Code but enforcement will be complex and costly. To build sustainable change, the RICS should bring together stakeholders and give them the skills and tools to reduce conflicts of interest on their own.

The threat of legislation should be a strong enough impetus for industry stakeholders to take action. If this industry decides to turn a blind eye to service charge issues, the Office of Fair Trading is likely to step in with regulation. As in the UK brewing industry example, it is likely that the government will separate building management from investment.

New offerings:

- Implement clearly defined service level agreements (SLA):-
In other service industries such as software and banking there are clearly defined service level agreements. To bring professionalism and transparency into the commercial property industry, landlords should clearly set out an output contract (or SLA) in alignment with their vision for the building. This contract is separate from the lease. The terms of the contract must be specific, measurable and achievable. In multi-let buildings, tenants should only accept the contract if it meets their business requirements or find occupancy elsewhere.

Adherence to the contract should be measured throughout the life of the contract. Tenants should pay an external third-party to conduct this audit rather than having the managing agents police themselves. There should be some incentive scheme for managing agents that exceed the SLA as agreed with the tenant and a penalty

for those that fail to meet the standards set out in the contract. We believe that output contracts are most appropriate for tenants with a need for high service levels due to the increased costs of conducting frequent audits.

- **All-Inclusive Rent:-**
Landlords need to understand customer needs and customise services by offering the option for an all-inclusive rent. By providing greater flexibility through shorter leases and higher certainty of costs via all-inclusive rent, landlords can charge a premium.

Tenants also benefit as they can select the features that best match their needs and in most cases are willing to pay a higher price for better service. An all-inclusive rent is not the panacea for all problems. The additional risk premium built into the all-inclusive rent should be competitive and comparable across similar buildings. The onus is on the tenant to discuss the option of taking on an all-inclusive rent with the landlord. Tenants might want to seek professional advice to compare all-inclusive leases against alternative and traditional leases, and to ensure that they are receiving value-for-money.

New tools:

- **Business Training for Managing Agents:-**
Better training for managing agents is one of the options that will result in higher satisfaction among all key stakeholders, improved working relationships, reduction in the recurrence of disputes and lower transaction costs. By providing business and communication skills as part of the training for surveyors, the RICS can improve transparency and professionalism in the commercial property industry.

As with accountants or bankers and their professional bodies, most managing agents are members of the RICS. As a result, the RICS, in collaboration with other industry stakeholders, should decide the best format for providing additional business training, commit resources and develop a plan for execution. This recommendation has a relatively low cost of implementation, but will drive change over a longer period as more well-trained surveyors join the property management business.

- **Improved communication tools:-**
Improved communication between the landlord, managing agent and tenant (through tenant meetings, customer satisfaction surveys and formal feedback processes) will result in smoother operation of the building and reduce service charge disputes. Effective communication is the key to good management. Managing agents must remember that they are spending the tenant's money and the latter has the right to know that it is being spent effectively, is necessary, and within the terms of the lease.

Budgets and reconciled accounts should include explanations of what is recovered, variance from plan and changes from the previous year. Ideally details of the responsibilities and roles of the on-site staff should also be summarised. Some of the larger managing agents and landlords conduct customer satisfaction surveys to understand how they are perceived by their tenants. This could be another way of improving communication, by openly seeking feedback and identifying ways of improving service.

- **Institute industry-recognised benchmarks:-**
Better benchmarking of service charge costs will benefit all parties, as tenants will have a clearer idea of whether they are getting value-for-money. There are, of course, variances in buildings that need to be explained but benchmarking is key for any industry that wants to improve itself. Even in financial services, where companies might specialise in different products and operate in different regions at varying scale, benchmarking is performed by external consultants to get an estimate of how well the company is performing.

As a regulatory body, the RICS could take the responsibility for sponsoring the benchmarking of service charge costs and also adherence to the RICS Code. Similarly to how financial services firms work with data providers such as Bloomberg and Reuters, firms in the property industry would also be expected to contribute data and pay for benchmarks. Independent institutions with strong credibility in the industry, such as the OPD/IPD, could be a suitable provider of the benchmarks, if the majority of the managing agents and landlords participate. We believe that the OPD/IPD should work with existing benchmark providers such as Jones Lang LaSalle and Loughborough University to share best practice and create a more robust set of benchmarks.



Joysy John

Joysy has over six years' experience in Financial Services gained with JPMorgan Chase in Singapore and New York. Her roles have ranged from application delivery to business analysis and business management. She was the youngest person selected into JPMorgan's Future Leader Development Programme.

Joysy is the President of the Women in Business Club at London Business School and is passionate about developing and empowering women to achieve their business goals. She has also served on the first executive committee for Financial Women's Association in Singapore and was responsible for setting up the mentoring programme for young women.

In 2007, she completed her summer internship at Morgan Stanley's Sales & Trading desk in London. Joysy holds a Computer Engineering with Honours degree from Nanyang Technological University, Singapore and is a Forte Fellow at the MBA programme at London Business School.



Avanti Patel

Before starting her MBA at London Business School, Avanti previously worked as an associate at Grove Street Advisors, a private equity fund of funds, and as a senior analyst at Jefferies Broadview in their London and Boston offices, evaluating technology M&A transactions. During 2007, Avanti worked in London for Ares Management's capital markets group.

At London Business School, Avanti is Portfolio Manager of the Investment Management club and organised a stock investment challenge for 90 students in collaboration with T. Rowe Price. She is also Treasurer of the Women in Business club and Co-President of the Wine and Cheese Club.

Avanti graduated with a B.A. in Economics and Computer Science from Wellesley College and completed a year at the London School of Economics. She is 2006 recipient of the Deutsche Bank Scholarship for Women.

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