How Management Fees Can Cost You Dearly

by Darrell Nevin

The management fee that your landlord charges you is another great mystery in our continuing exploration of the gray areas of real estate pass-through costs. It represents a fairly substantial portion of overall operating expenses and therefore should be carefully scrutinized and clearly defined before you sign a lease document.

Most commercial landlords (or their management company) pay themselves a fee for managing your property based on a percentage of the gross income the property generates. In full-service office buildings, the management fee can be between 3.5% and 6% of gross revenues. Some Landlords apply that percentage to just rental income; others include recovery income as well, such as expense pass-throughs, service work income, after-hours electric usage, etc. Retail leases typically charge 15% of common area maintenance costs (commonly referred to as CAM) and call it an administrative fee.

During the recession of the early 90’s, some Landlords in full-service buildings and single story office parks started charging both a management fee on total revenues and an administrative fee on their operating expenses! The two fees together could amount to between 25% and 40% of your overall expense pass-throughs! Without clearly defining what the management fee is based on, your Landlord is free to apply it to whatever income they want. Here’s how that can hurt you.

Suppose you are a 5,000 square foot tenant in a 100,000 s.f. full-service building. You signed your lease when the market was very favorable to tenants in the early 90’s. The building was 40% vacant at the time and the rent and expenses seemed much lower than other Landlords were quoting. On top of that, you got lots of free rent to sweeten the deal. Rejoice! Rejoice! But now just 4 years later, the building is full and your expense pass throughs are increasing 10-15% each year. You’re now paying almost $1,000 more each month in rent for your expense pass-throughs. What happened? Lots of things.

First, the operating expense base assigned to your lease was not “grossed up” to reflect a full building. Or if it was, it may not have been grossed up in all occupancy-sensitive areas. The management fee assigned to your base year when the building was 40% vacant should have been grossed up to reflect full occupancy. How much is that costing you now for your little 5% of the building? If we assume the entire 40,000 s.f. was leased for $15/s.f., generating $600,000 additional income on rent alone, a 3.5% management fee would add $21,000 to the overall expenses of the building. Your 5% share of that increase is now costing you $1,050 each year for the remainder of your lease term! If you fail to have the Landlord ”gross-up” other expenses, such as utilities and cleaning costs, that figure could easily double. But that’s fodder for another episode.

Here are other scenarios where a management fee can burn holes in your budget. Let’s say a very large tenant wants out of their lease and agrees to pay the Landlord a percentage of the rent owed for the remainder of their term. Instead of recording the usual $50,000 in annual rent from this tenant, the Landlord actually receives $150,000 this year for the buyout of the remaining 5 years on the lease. Do you end up paying your management fee on their good fortune? You betcha! What if the Landlord has the further good fortune of quickly leasing that space to another tenant? Are you going to pay a management fee on this double rent scenario as well? Absolutely! What is 5% of the management fee on $150,000 in extra revenue? How about adding another $262.50 to your pass through bill for this year!

What to do to prevent this from happening?

1. Try to restrict your Landlord’s management fee to a percentage of your rental payments, not a pro rata share of everybody else’s. While you were out
celebrating the great deal you got, you ended up with a lease that has you paying the management fee as a percentage of everyone else’s bad deal. This is especially true if there are retail spaces in the ground floor of your building, whose rents could easily be double what you are paying per square foot for your office space. Years ago it was too complicated for Landlord’s to add the management fees individually to each tenant’s pass throughs. Now, with the ubiquity of desktop computing system software, it is not an unreasonable request nor difficult task.

2. Be sure your Landlord grosses up your expense base year to reflect a fully occupied building. All occupancy-sensitive categories should be grossed up. The formula to do so is different for each line-item category. Management fees should be grossed up for vacant space based on market rents in the area or the average rent in the building. Janitorial costs should be grossed up based on square footage, whereas utilities should be grossed up based on watts per square foot of anticipated power consumption. Consult your local BOMA office for industry-wide standards for doing so before you sign a lease.

3. Restrict what your Landlord can define as gross revenue. If the Landlord sub-meters electric usage for a particular tenant (which is becoming more and more common these days), be certain your lease restricts them from counting that as revenue when it is actually an off-set from the electric expense of the building. Same, too, for charges they collect for extra HVAC usage or a repair done in your space. Those invoices usually have fees attached already anyway. If they are not deducted from overall income at the end of the year, you’ll be paying a fee on top of a fee, not to mention a fee on revenues that are actually expenses. Most property accountants view income as income and expenses as expenses. I can’t tell you how common it is that you get charged your management fee on those off-sets to expenses, or how often they just plain forget to deduct that recovery income from the expense line before sending you your bill at the end of the fiscal year. Even their auditors often overlook this fact or don’t know to look for it in the first place.

4. If you can’t get your management fee restricted to just the rent from your space, then exclude all extraneous potential income sources from the Landlord’s calculation of your management fee. Things change over time, so if they start to charge for parking, or they decide to lease space on the roof of the building for satellite or antenna installations, these should be excluded from the definition of gross income. If it wasn’t in your base when you signed the lease, you should restrict it from being added later in your term, or have them increase your base accordingly. Same too for windfalls from lease buyouts or holdover rents that artificially increase their income from a particular space by as much as 150%-200% if a tenant refuses to leave their space at the end of their lease term. You should not be penalized one penny for that unfortunate situation.

As you can see from these brief examples the computation of the management fee can be quite complex. Be sure a qualified real estate professional is reviewing your charges regularly. Negotiating settlements for overcharges can be tricky if your lease does not clearly define what the Landlord can and cannot charge you a management fee for. As part of any settlement, require that the Landlord change the language in your lease so that you are properly protected from such overcharges in the future. And if you are thinking about renewing your lease, or moving to a new location, this type of protectionist language should be mandatory before a final agreement is reached. You probably won’t get everything you ask for, but the requests will surely make for lively negotiations!
Some Landlord's will assure you that they would never do such things, yet refuse to put it in their lease document. Tell them that you need it in the lease to protect you from some other Landlord they might sell out to during the course of your tenancy. If you can’t force the issue, settle for a side letter agreement. Leasing reps and site managers have far more leeway with side letters than they do with the actual lease, because of the strict oversight from their boss and/or corporate attorney. Side letters can be just as effective in protecting your interests and pocketbook, if you can get them.

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