

Gross-ups and COVID: Alpha Office Escalations solves complicated calculation issues

BY BRANDI SMITH

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Larry Mayerhofer

With news of a potential vaccine on the horizon, the thought of returning to “life as normal” seems more possible than ever. However, the pandemic may have changed some of our behavior permanently, specifically impacting how we think about the safety of our work environment.

“For the first time in my life, I find myself unconsciously counting to twenty every time I wash my hands, which I now do more often than ever before,” said Bill Brownfield, Counselor of Real Estate (CRE), Certified Commercial Investment Member (CCIM) and co-author of *The Escalation Handbook for Office Buildings* with Larry Mayerhofer, CPA. “Extrapolate that behavioral change out to include many millions of office employees and you can quickly conclude that some, probably a lot, will want to work in offices that have an office version of the proverbial Good Housekeeping Seal of Approval.”

As a result, Brownfield said many office owners and managers are executing new and/or expanded operational protocols designed to improve air quality and safety so tenants will feel comfortable when they return.

“Most of their operational adjustments have been implemented by now and are becoming normal daily routines for cleaning, security and social distancing,” Brownfield said. “Some have made capital investments in HVAC upgrades, touchless technologies, UV lighting and other preventive strategies.”

In many cases, those operating expenses can be allocated on a pro-rata basis to a property’s tenants, along with their base rent, via escalations. But because leases so often vary, calculating the appropriate share for each tenant accurately can be a challenge.

“We know that owners and property staff care deeply about doing the right thing. But the scope of responsibilities for property managers and accountants has expanded so much over the past two decades that they have little time for deep dives. They’re pedaling as fast as they can, so they need new tools to

automate and speed up work processes,” said Brownfield.

That’s where Alpha Office Escalations (AOE) can be a lifesaver. Brownfield, after literally writing the book on escalations, teamed up with Mayerhofer, a Certified Public Accountant with more than 30 years of real estate accounting experience in the Chicago market, to develop the software specifically for commercial property managers and accountants.

“We believe that AOE is one of those timely tools that will save time, improve accuracy, eliminate redundant processes and build trust with each tenant,” Brownfield said. “When done accurately, escalation invoices do their part to build and maintain trust. At AOE our goal is ‘Happy Gross Ups’ for each tenant and landlord.”

Expense recoveries are extremely important and can range from 10 percent to 50 percent of a building’s total revenue (depending on the lease structure used for each tenant), according to Brownfield. As an example, a base-year lease can generate 10 percent to 20 percent of a building’s revenue (depending on the maturity of each lease term). A net lease, though, can generate 40 percent to 50 percent.

“What’s surprising is how few owners and managers look at recoveries from that perspective,” Brownfield said. “Don’t get me wrong, they know it’s important, but they often don’t know how much of the building’s operating expenses they are subsidizing. If they did, they’d probably focus more on absolute accuracy and compliance with each individual lease.”

So how do you get started to deal with COVID-19’s impact on 2020’s operating expenses? First, Brownfield and Mayerhofer recommend setting up a Chart of Accounts category for unique or COVID-related expenses, so they can be isolated and dealt with at the end of the year.

“Depending on circumstances and market conditions, a property owner can then choose to either absorb those costs or to pass them through to the tenants, collectively as CAM charges or individually as above-standard rebills,” said Brownfield.

The AOE team also suggests that the prior years’ methodology for grossing up variable expenses be consistently applied for 2020’s expenses.

“If the methodology is correct, and if COVID-related expenses are excluded, the total grossed-up operating expenses should be very close to 2019’s, since inflation is modest,” Brownfield said. “However, if grossing up blows up the variable expenses too much (due to such historically low occupancy), then it is likely that the prior methodology is flawed, in which case it should be analyzed and improved.”

Brownfield and Mayerhofer encourage a stress-test of the methodology at various levels of occupancy. If that doesn’t work, it needs to be repaired.

It’s a complicated process, especially because every lease gets abstracted for key provisions, but most abstract forms don’t collect all of the necessary economic factors used to create accurate invoices.

“Our AOE software duplicates the methodology used in our Handbook and our

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abstract (we call it a Tenant Profile in our system) is flexible enough to capture all of the strange and wonderful lease clauses,” said Brownfield.

At a recent fall training seminar for AOE clients, most of whom are office property managers and property accountants, multi-tenant building occupancies ranged from 10 percent to 75 percent, varying by market, building and tenant type. That spectrum means that calculating escalations accurately is more valuable than ever as buildings make improvements to lure tenants back in.

“Office buildings compete on several levels. Location and rental rates to some extent, but also on service and trust. The best way to keep an existing tenant is to have exceptional, responsive service and a trustworthy relationship,” Brownfield said. “If those two happen, rent will take care of itself, because service and trust will carry the day, even during COVID-type events.”

To learn more about Alpha Office Escalations, visit <https://www.alphaofficeonline.com/>.

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