A Benchmark for Property Management Cost that Features Appropriate Management Specifications

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1. Property Management Costs Lack Transparency

Currently, the real estate investment market is growing rapidly as money flows into JREITs and private real estate funds. Meanwhile, office rents have been unable to pull out of a long-term slump. Despite the economic recovery, supply and demand conditions in the office leasing market suggest that prospects for significant rent increases in the near term are dim.

Thus to improve cash flow, real estate investors have focused on cost reduction, and particularly for recurring costs in office property management.

This is because property management costs comprise a significant portion of a cost structure that includes taxes, repair, insurance premiums, and depreciation, leaving investors with considerable discretion to boost performance. In addition, large cost cutting opportunities exist because property management is often automatically relegated to affiliated companies, whose cost structure and management operations have largely been neglected.

Thus in many cases where ownership changes to third parties due to securitization, the new owners decide to install a new property management system through competitive bidding.

However, many investors still remain unaware of standards for appropriate management cost based on appropriate management specifications (which describe service categories and service frequency and grade, including personnel allocation).

Ordinarily, property management costs can be decreased by revising multilevel outsourcing contracts or improving efficiency at the management company. However, costs can also be slashed by ignoring appropriate specifications and settling for a substandard quality level.

Among securitized properties, there have been cases where property management costs were slashed drastically below reasonable levels to enhance the apparent performance of properties. However, investors need to be aware that such practices pose a significant risk of damaging the property's asset value by driving away tenants and accelerating building degradation.

In reality, a large portion of property management costs lack transparency for several reasons, thus resembling a black box for investors unfamiliar with the properties.

First, a detailed description of management costs (itemized by management specification or category) is not provided to investors. Even the relatively advanced disclosure practices of JREITs reveal only the total property management cost (referred to variously as property management cost, management operation cost, outsourcing cost, outsourcing management cost, etc.).

Second, management cost categories are not defined or standardized. In fact, information provided by property management companies to investors, asset managers, and loan officers contain arbitrary category names and distinctions, making it difficult to compare different properties.

Third, management cost calculations are not disclosed. To understand cost calculations, we would need explicit information on management specifications and unit cost by category. However, these specifications are usually unstated, as are explanations of categories and unit costs.

For these reasons, when investors and asset managers seek to reduce the cost of property management, they often resort to a competitive bidding process and choose the management company with the lowest total cost bid. Or, when instructing the current property management company to cut costs, they often forego a detailed analysis and assessment of management specifications and categories, and instead instruct the management company to cut costs across the board. However, these sweeping approaches greatly risk impairing the quality of property management. Needless to say, property management companies must also do their best to cut costs and improve efficiency.

2. Methods for Evaluating Property Management Cost

Below we examine several ways that investors and asset managers determine appropriate management costs when making investment decisions.

1. Outsourcing to Specialists

One method is to hire competent property managers or consultants familiar with property management, and have them propose appropriate management specifications and costs based on a property analysis.

However, due to time and cost considerations, this method is not suited to investors in securitized products, particularly investors in debt products and loan officers, or to investors who must appraise a large number of properties.

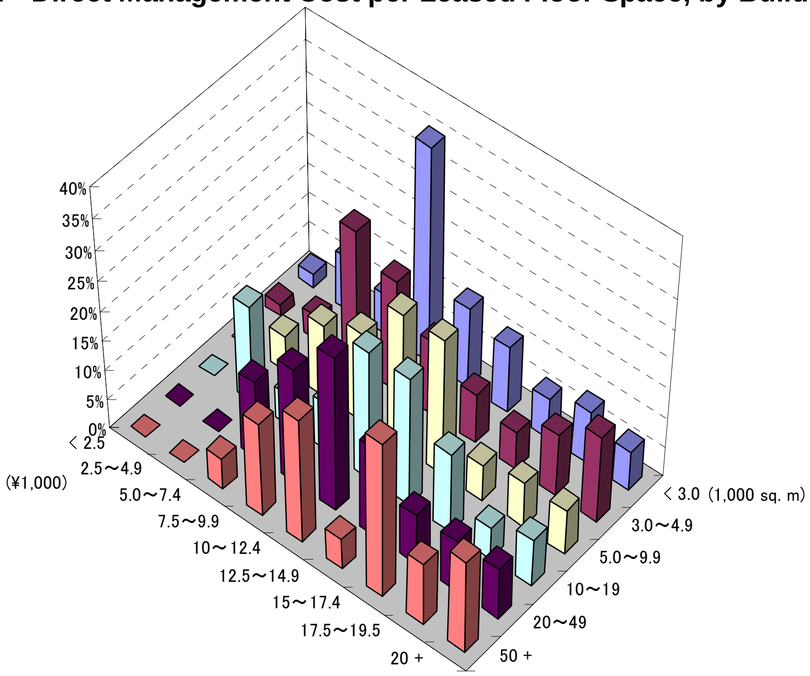
In such cases, the following two alternative methods are often adopted: management cost per unit floor space, and ratio of management cost to rent income.

2. Cost per Unit Floor Space

When using a management cost per unit floor space basis, cost levels of specific properties are usually checked against average cost data per leasable floor space compiled by the Tokyo Building Association. This unit data is also convenient for comparison with the *kyoeki-hi* (a service fee tenants pay ostensibly to cover management cost), which is also expressed on a per-leased-space basis.

However, since the data used to calculate average costs is itself widely dispersed, whether the average cost represents an appropriate standard is questionable (Figure 1).

Figure 1 Direct Management Cost per Leased Floor Space, by Building Size

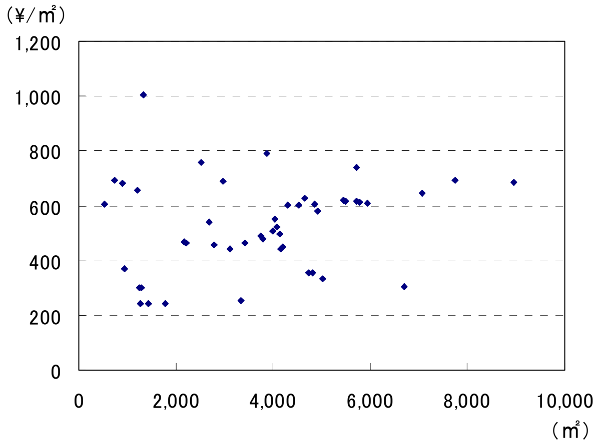


Notes: Direct management cost includes security, sanitation & cleaning, electrical & other equipment (elevators, lighting, power distribution, air conditioning & heating, ventilation, plumbing), and other. This closely parallels our definition of management cost, except for differences in categories and our exclusion of lighting and air conditioning & heating.
Source: Compiled from Tokyo Building Association, *Summary of the Property Management Survey (FY 2003).*

In the Tokyo Building Association data, for example, the annual direct management cost per square meter for large buildings (effective floor space of at least 50,000 square meters) ranges from 5,000-7,500 yen (417-625 yen per month) to as much as 20,000 yen or more (1,667 yen per month). Similar large variances are observed for other building sizes.

Our own data also indicates that management costs per leasable floor space are widely dispersed. Our regression analysis of smaller buildings (less than 10,000 square meters of leasable floor space) produced a low coefficient of determination below 0.1, meaning that building size and management cost are not correlated at a statistically significant level (Figure 2).

Figure 2　Management Cost per Leasable Floor Space, by Building Size



Source: NLI Research Institute

The large variances in management cost can be attributed to the different specifications and costs among property management companies, as well as to the fact that appropriate management costs vary widely depending on building structure and facilities.

3.　Cost/Rent Ratio

Though often used in real estate appraisal, this method is unsuitable for our purposes unless the assumption holds that management cost is equivalent to the *kyoeki-hi* (common service fee), which in turn must be a fixed percentage of rent.

In reality, however, management cost comprises only a part of the *kyoeki-hi*. Moreover, a recent trend has been for the *kyoeki-hi* to be absorbed into and made indistinguishable from rent.

But a bigger problem is that regional disparities in rent are considerably larger than in management cost. This is quite evident, for example, if we simply compare buildings of the same size and management specifications in central Tokyo—management costs are the same, while rents are not.

Thus the two methods above have limitations in assessing appropriate management costs, and should instead be regarded more as general guidelines.

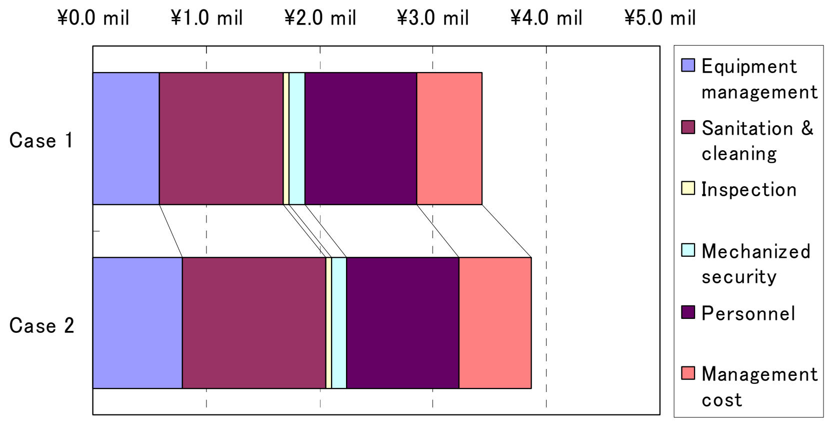
3. A New Benchmark for Management Cost

As a fourth approach, we devised a way to systematize the appraisal method performed by property managers and consultants.

Specifically, after estimating standard management specifications based on building information such as floor space and number of floors, standard costs are calculated based on market prices for each service category, and then totaled. The system was developed jointly by NLI Research Institute and Nissay Information Technology Co. with the collaboration of experts in property management practices.

Our results for management cost per unit floor space reveal that even for buildings of the same size (total floor space of 10,000 square meters), management cost can vary by over 10% depending on factors such as window glass type or air conditioning equipment (Figure 3).

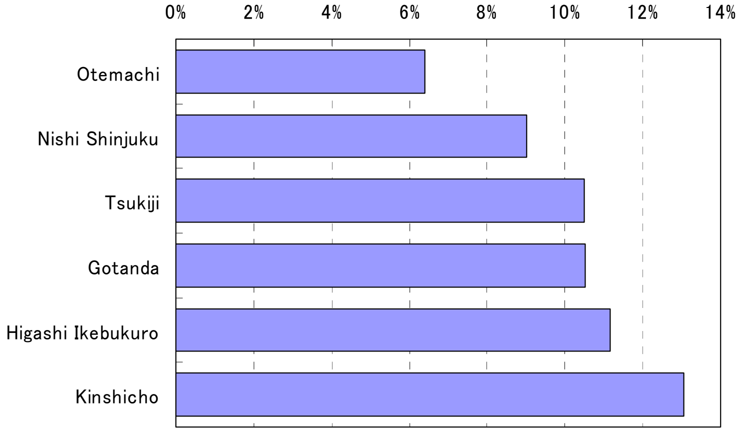
Figure 3 Management Cost of Same-Sized Buildings with Different Facility Specifications



Note: Shows monthly management cost.
Source: NLI Research Institute

Next, we examine how the cost/rent ratio performs under our system. Assuming that management cost is identical in six districts of central Tokyo (under case 2 in Figure 3), we can confirm that large discrepancies arise due to rent level differences by location, making the ratio not very meaningful (Figure 4).

Figure 4 Cost/Rent Ratio for Same-Sized Buildings at Different Locations



Note: For identical buildings with total floor space of 10,000 square meters.
Source: NLI Research Institute

The system is designed to meet the needs of investors with limited knowledge of property management practices. Since costs are calculated from basic information about buildings and facilities, accuracy is somewhat limited, but still sufficient to serve as a convenient benchmark.

For example, if the actual management cost of a building with particular characteristics is well below the benchmark, we can take it as a sign of possible asset deterioration, and approach the property with caution. On the other hand, if the actual value is drastically higher than the benchmark, there may be significant opportunities for cost cutting.

While many improvements are still needed to the system, it represents a new attempt to evaluate appropriate management costs when making investment decisions.