RETAIL CENTER Operating Expense Guide 2023

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INTRODUCTION

This operating expense guide provides general guidelines as to the likely expenses that would be expected to be incurred in the operation of common retail centers in Southern California (such as so-called strip centers), as well as specialty centers and frontage-style retail centers. It can also be used relative to mixed-use centers with a retail component, such as the center pictured above. It should be used as an adjunct to consideration of prevailing and historical expenses for a specific retail center. As indicated elsewhere herein, guidelines provided herein are based on the observation of actual expenses incurred at numerous retail centers in Southern California based on income and expense information provided by property owners. In addition to expense guidelines, this guide provides insight as to various methods of estimating operating expenses as a result of cumulative knowledge gleaned from the appraisal of retail centers, augmented by periodic interviews with market participants (property owners and managers) in the retail sector of the Southern California real estate market. The guide is basically applicable to centers ranging in size from 5,000 to 50,000 square feet.

OPERATING EXPENSES DEFINED

Briefly stated, ***operating expenses*** are the periodic expenditures necessary to maintain property and to continue the production of optimal income. While expenses can be categorized as ***fixed*** and ***variable***, it is not a necessity in the expense estimation process. Rather, categorization with respect to simple expense types is more market-oriented with respect to the Southern California retail center market—for example, real estate taxes, insurance, common area maintenance, etc.. However, depending upon lease types associated with a property; it is often helpful to categorize expenses with respect to ***reimbursable*** and ***non-reimbursable*** status. For properties with leases dictating reimbursements for various expenses (such as net leases and so-called triple net leases, aka NNN), Potential Gross Income consists of base rental income and reimbursement income and, as such, can require iterative circular math in the treatment of income and expenses.

BASIC APPLICABILITY OF EXPENSE GUIDE

This guide is basically targeted toward providing operating expense guidelines applicable for common small- to mid-size one-story retail centers in the range of 5,000 to 50,000 square feet. This size range primarily encompasses typical convenience retail centers, strip centers, small specialty retail centers, and frontage-style retail centers. Typically, centers in the referenced size range are not anchored, although mid-size name-recognized tenancy may sometimes exist (also, some centers within this size range may consist of satellite retail space associated with an anchor under separate ownership). The guide may also be helpful relative to larger centers, or mixed-use properties with a retail component. However, the majority of centers used for expense data extraction consisted of common one-story wood frame or concrete block construction and were built from 1960 to 2015 (with a small number of older and newer centers in the data set).

RESEARCH AND STUDY PROCEDURES

Operating statements of retail centers were compiled and analyzed, grouping expenses into six main categories. These included Insurance, Common Area Maintenance, Building Repairs and Maintenance, Property Management, General Administration, and Reserves (aka Replacements). Due to the impact of Proposition 13 in California, real estate taxes were not included in the expense extraction process and analysis. Proposition 13 in California dictates establishment of new tax liability upon sale (with the exception of some leasehold situations). As such, an analysis of tax liability of comparable properties does not serve as a reliable indication of tax liability to a prospective buyer. Although real estate taxes were not considered in the analysis, insight as to the estimation of same is provided herein. When estimating Market Value, tax liability for valuation purposes should be based on an hypothetical sale as of the valuation date in keeping with the definition of ***Market Value*** which states that:

> *"… implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer … ".*

The guidelines presented herein are primarily based on observed ranges for each of the categories, tempered by my judgment. Expense information for centers with atypical expense characteristics were purged from the analysis (such as centers in very poor condition, centers undergoing renovation during the data extraction/reporting year, etc.). The expense information analyzed was from the years 2021 and 2022. Most of the centers were located in Los Angeles and Orange Counties, with a minority in Riverside, San Bernardino, and San Diego Counties.

The expense categories used herein are representative of the most common basic categories observed in the regional retail market. However, the categories are sometimes combined in market practice based on individual management styles. For example, Property Management could be grouped with General Administration, and sometimes Building Maintenance and Repairs are commingled with Common Area Maintenance.

It should be recognized that the term ***Common Area Maintenance*** has a specific and general meaning. Technically, the term relates to the expenses specifically relating to the common areas (as indicated elsewhere herein). However, the abbreviated term CAM is often used in the market in conjunction with rental quotes and, when used in this context by market participants, the so-called *CAM charge* typically includes the pro rata charge for not only the specific common area maintenance, but also real estate taxes, insurance, etc. (basically, other expenses that are obligations of the tenants as stipulated in leases and enforceable in the market).

EXPENSE ESTIMATION METHODOLOGIES

Two basic methods of estimating operating expenses for retail centers exist. The appropriate method or methods to use depend upon the lease types impacting the center, local trends, and judgment of the analyst/appraiser. One method is known as the *Per Category Procedure*, which can be applied to any retail center, while the second is a *Simplified Procedure*, which can be used for centers having all triple net tenancy.

Per Category Procedure

As the name implies, this method involves developing a per-category estimate of basic expenses likely to be incurred in operation of a retail center. Other than brief comments made in the following section (and insight regarding use of the short cut method elsewhere herein), this guideline basically relates to implementation of the per-category method of estimating expenses.

Simplified Procedure

This method relates to essentially a short-cut technique that addresses the expenses likely to accrue solely to a landlord under triple net leases. It is used in conjunction with an estimate of Potential Gross Rental Income arising from triple net rents (that is, base rental, exclusive of reimbursement income) and typically consists of rule-of-thumb percentages applicable to effective gross income. The benefit of this technique is that it eliminates much of the potential error associated with developing a per-category type expense estimate. It can thus be particularly helpful in cases where limited actual/historical expense information is available. The basic logic of this method is that under triple net leases, ultimately the tenants will pay for most of the expenses associated with ownership—the operative word being most. Even with triple net leases, property owners are likely to incur some expenses. Many buyers of small retail centers utilize this method of estimating expenses. However, one of the dangers of this method is that it assumes that tenants will be able and willing to pay reimbursements for operating costs regardless of their amount (for example, a change in tax liability resulting from a sale could alter reimbursement liability to a prohibitive level). The reimbursement amount (CAM charge) owners are able to collect in practice can be influenced by local market trends (as an example, if competitive retail centers in a given area are all collecting CAM charges in the range of $0.50 to $0.70 per square foot, per month, a property owner may have difficulty seeking a $1.20 per square foot CAM charge, even if the actual expenses incurred would justify same). Also, in some cases tenants may have leases that specify a fixed monthly reimbursement amount. If any of the foregoing issues are a concern for a given property, use of the more detailed ***Per Category Procedure*** is warranted.

For the ***Simplified Procedure***, it has been my observation that percentages of effective gross income are commonly used by buyers, generally including a management fee in the range of 4% to 5%, sometimes a provision for reserves at 1% (or alternatively, a reserves figure of around $0.15 to $0.25 per square foot of gross leasable area can be used) and a Due To Vacancy provision of 1% to 2% (percentages are applicable to effective gross income). The Due To Vacancy expense is to compensate for periods of vacancy during which some expenses will not be reimbursed. For a single tenant retail property, a lower management fee can be anticipated, such as 2% to 3% (depending on the financial wherewithal of the tenant).

APPLICATION OF EXPENSE GUIDELINES

The application of most expense guidelines presented herein relate to a *per-square-foot* annual basis. Unless otherwise indicated, such expenses are based on gross leasable area (often nearly the same as gross building area for retail centers), which is defined as follows:

> *"The total floor area designed for the occupancy and exclusive use of tenants, including basements and mezzanines, and measured from the center of interior partitioning to outside wall surfaces..." (The Dictionary of Real Estate Appraisal, Fifth Edition, Appraisal Institute).*

Note: In Southern California, mezzanine space is rather uncommon, as are basements, and same are typically not considered in gross leasable area.

In some cases expenses are suggested as a percentage of effective gross income. And, in situations where gross building area significantly exceeds gross leasable area, insurance expense is best estimated based on the former (unless the excess size is associated with functional issues that would not likely be incorporated into replacement of the center in the event of a catastrophe).

EXPENSE GUIDELINES – PER CATEGORY METHOD

The compiled expense data were grouped into the following categories, which are suggested for use in estimating operating expenses for most common small to mid-size retail centers utilizing the ***Per-Category Procedure***:

Real Estate Taxes
Insurance
Common Area Maintenance
Building Repairs & Maintenance
Combined Common Area Maintenance & Building Repairs/Maintenance
(may be a preferred option for many small retail centers)
Property Management
General Administration/Miscellaneous
Replacement Reserves/Allowance

The above categories are only suggestions, and it is possible for expenses to be broken down into additional categories. For example, **Common Area Maintenance** as defined herein includes costs such as utilities/trash removal, landscaping/site maintenance, and if needed/applicable, security services. Dependent upon center size and the availability of detailed historical operating expense information, it may be reasonable to forecast expenses on a more itemized basis. On such a basis, recent in-project costs are generally the best guideline for likely future costs, particularly for utilities and trash removal (as owners have very little control over expenses in this area) as well as for landscaping/site maintenance (as costs for same can vary substantially dependent on center style/configuration). For small retail centers, it is generally my preference to forecast expenses on a combined basis, with a single expense estimated for **Common Area Maintenance & Building Repairs/Maintenance**. It is recommended that a more detailed operating expense guide be consulted, such as the ***Penner Expense Guidelines***, if seeking to estimate highly itemized costs for a larger-scale shopping center.

Real Estate Taxes

Proposition 13 in California stipulates that a transfer of fee/leased fee title triggers establishment of a new tax base. Real estate tax liability for a new owner will be re-established upon title transfer, likely reflecting a basis on the sale/purchase price, but not necessarily. Tax liability for valuation purposes should be based on an hypothetical sale as of the valuation date in keeping with the definition of Market Value.

Estimation of tax liability is commonly done by one of two methods. One method involves loading and unloading the capitalization rate with the tax rate. The other method consists of an iterative, circular-mathematics process, typically using computer spreadsheet software, with the tax rate, direct assessments, the other estimated expenses, the selected capitalization rate, and resulting implied value in order to discern tax liability to a new owner. Real estate taxes are typically a reimbursable expense under triple net lease terms.

In the first procedure, all expenses except real estate taxes are deducted from effective gross income in order to develop a *temporary* net income figure (although Direct/Special Assessments associated with real estate taxes should be deducted as well). The temporary net income figure is capitalized by loading the selected capitalization rate with the tax rate (that is, adding the tax rate to the selected capitalization rate). For example if the selected capitalization rate is 4.5% and the tax rate is 1.055, the income would be initially capitalized at 5.555% (that is, 0.05555). The tax rate is then applied to the resulting value indication to glean tax liability. The analysis is then recalculated using the implied tax liability and the initially selected cap rate (4.5% in the foregoing sample). It is important to ensure that any Special/Direct Assessments are also deducted along with the other expenses prior to the loading procedure. Special/Direct Assessments for a property can be determined by contacting the appropriate governing agency, examining a recent tax bill, or can be deduced by observing the disparity between taxes charged vs base taxes due relative to the tax rate. The tax rate area and tax rate can be obtained from government records (web sites and in person) and via many subscription sources.

In the second procedure, which is recommended, spreadsheet software is used to calculate real estate tax obligations. With *iteration* set on, an income/expense analysis is developed with all expenses entered into the analysis on a per category basis, except that the cell for real estate taxes is set to calculate as a percentage of the implied value cell, plus special/direct assessments. Thus, taxes are automatically calculated. Ideally, *set precision as displayed* should be set/checked as an option in Excel or other spreadsheet software when utilizing this procedure.

The following insert portrays a sample of one way of developing the expense estimate (in an actual spreadsheet, an = sign would proceed entries in each calculation cell).

Spreadsheet Example Portraying Calculation of Real Estate Taxes

	G	H	I	J	K	L	M
1							
2		Potential Gross Income	208,860				
3		Less Vacancy & Col. Loss	10,443	0.05*I2			
4		Effective Gross Income	198,417	I2-I3			
5		Less Estimated Operating Expenses					
6		Taxes	27,563	(M6*I22)+M7		Tax Rate	0.013049
7		Insurance	4,275			Special/Direct	2743
8		Natural Gas	900				
9		Electricity	1,800				
10		Water & Sewer	6,300				
11		Trash Removal	1,500				
12		Pest Control	720				
13		Maintenance/Repairs	4,500				
14		Interior Painting/Cleaning	1,500				
15		Off-site Management	9,920				
16		On-site Management	5,100				
17		Landscape Maintenance	900				
18		Miscellaneous	1,000				
19		Reserves	4,050				
20		Total	70,028	SUM(I6:I19)			
21		Net Income Expectancy	128,389	I4-I20			
22		Implied Value	1,902,059	I21/0.0675			

Insurance

This expense category basically covers common property (fire, theft, wind damage, etc.) and liability coverage. The easiest method to estimate this expense is based on premium cost per square foot of gross building area (while alternative methods exist, such as using composite rates in conjunction with replacement cost, it requires peripheral calculations and estimates that can contribute to errors).

Observed insurance expenses on the compiled expense comparables were in the broad range of roughly $0.25 to $0.70 per square foot of gross building area, per year, although many properties had expenses in the narrower vicinity of **$0.40 to $0.50 per square foot, per year** (which thus represents a suggested expense range for common small retail centers). Older-vintage buildings typically exhibited the highest expenses per square foot. Retail centers that had sprinklers for fire protection generally exhibited expenses toward the low end of the observed range (an expense in the vicinity of $0.30 to $0.35 per square foot may be justified for such buildings, particularly if historical costs support same). Insurance is traditionally a reimbursable expense under triple net lease terms.

Other basic forms of insurance that can accrue to a landlord, for which reimbursement is sometimes invoked, consist of earthquake, flood, and rent insurance. My survey revealed occasional inclusion of these forms of insurance, although rarely the latter. Earthquake insurance can be expected to result in an increased cost of $0.20 to $0.30 per–square-foot, depending upon the property's location. Ideally such insurance should be based on actual expense information and/or a specific investigation as to cost and need, augmented by judgment. The same is true of flood insurance. Rental insurance is not considered a typical operating expense and would be a highly questionable item in terms of attempting to enforce collection of tenant reimbursements for same (I have only observed this implemented with respect to trophy properties during robust market conditions).

With respect to mandatory flood insurance, this depends upon the flood zone in which a property is located. Flood zones are land areas identified by the Federal Emergency Management Agency (FEMA). Each flood zone describes the land area in terms of its risk of flooding. Flood Zones B, C, and X are areas outside the 1% annual chance of floodplain, sheet flow flooding, etc., and insurance is not required. Mandatory purchase of flood insurance applies to all A zones. Zone D is an area of undetermined status/risk. A particular property's flood zone can be researched utilizing FEMA's free Flood Map Service Center at the following web address:

https://msc.fema.gov/portal/home

Additional general information can be obtained from FEMA at www.floodsmart.gov.

Common Area Maintenance

This expense category basically includes supplies/materials, landscaping, utilities (such as electricity and water/sewer), trash removal, sweeping, security (if needed), lighting, repairs, and miscellaneous other services/items. This category is typically a reimbursable expense under common triple net (NNN) lease terms.

Observed common area maintenance expenses on the sampling of centers ranged broadly from about $1.50 to $3.50 per square foot of gross leasable area, per year. This range excludes atypical locations such as the Los Angeles Fashion district and affluent areas such as Beverly Hills, Century City, prominent beach districts, etc. (wherein costs can run higher). Significant influencing factors include the extent of landscaping, condition and age of common areas, and whether security is needed/provided. For most small retail centers, utilities/trash removal and landscaping are the largest contributors to common area maintenance costs. Security services are not often used by owners of small retail centers in much of southern California, but may be appropriate dependent upon location and actual/prevailing expenses. If needed, the cost for security can be substantial, in the range of $0.60 to $1.20 per square foot of gross leasable area, per year. The lowest common area maintenance expenses are typically associated with frontage-style retail centers that have no landscaping and little or no parking (and for which security is not needed). Such properties are often located in older downtown areas—particularly in small cities.

Subject to judgment and consideration of actual historical expenses, an expense in the vicinity of **$2.00 to $2.75 per square foot, per year**, would be a reliable forecast as to this expense category. An expense closer to $1.50 per square foot can occasionally be supported for frontage-style development (aka street retail). And, for high-end centers with exotic design characteristics and significant landscaping/site cleaning needs, an expense of $3.00 to perhaps $4.00 per square foot can be supported.

Building Repairs & Maintenance

This expense category includes building maintenance oriented supplies and materials, and maintenance pertaining to electrical, plumbing, HVAC, painting, and the roof. Observed expenses for this category were rather erratic, being in the broad range of about $0.50 to nearly $2.00 per square foot of gross leasable area, per year. After close examination of the operating statements, eliminating atypical expenditures, most centers demonstrated building repairs and maintenance expenses in the vicinity of **$0.70 to $1.30 per square foot, per year**—the variance largely being due to project age, condition, and management style. This is traditionally a reimbursable expense

Combined Common Area Maintenance & Building Repairs/Maint.

Some owners of retail centers may not track *Common Area Maintenance* costs and *Building Repairs & Maintenance* costs separately. In cases where only a single expense is reported historically, or where numerous itemized expenses are reported that are difficult to categorize, it may be preferred to estimate a single combined expense to cover Common Area Maintenance plus Building Repairs/Maintenance. The observed range for the expenses combined was roughly $2.00 to $4.50 per square foot, per year, but typically in the narrower vicinity of $2.50 to $3.50 per square foot, per year. Costs can be higher for trophy properties in high profile locations such as Beverly Hills, Century City, Santa Monica, Newport Beach, Laguna Beach, La Jolla, etc.. It is not unusual to see a combined expense for this category at $4.50 to $6.00 per square foot, per year (or rarely even higher).

For common locations and typical retail centers, a reasonable rule-of-thumb for combined Common Area Maintenance/Building Repairs and Maintenance is **$2.50 to $3.50 per square foot, per year**. For centers in particularly active areas of Los Angeles, such as such as Culver City, Koreatown, Mid-Wilshire area, Beverly Hills, West Hollywood, and West Los Angeles, higher expenses could be anticipated.

When examining historical expenses for Building Repairs & Maintenance (or combined Common Area Maintenance/Building Repairs & Maintenance) is it important to distinguish between normal recurring maintenance work and capital improvements or significant one-time work (such as a roof replacement, or parking lot re-paving). It may be appropriate to emphasize a reasonable market expense if the recent historical expenses are judged to be skewed due to inclusion of capital improvements or major one-time repairs.

Property Management

This expense category relates to the fee for overall property management (rent collection, orchestration of repairs/maintenance, tenant/customer service, etc.). Observed expenses for this category were in the range of 2% to 7% of effective gross income, although most commonly in the narrower vicinity of 3.5% to 5.0% of EGI. Consultation with various management companies revealed commonly quoted fees for new clients within a similar range of 4.0% to 4.5% of EGI for multi-tenant retail properties. In a few instances—usually with the smaller centers and often with single tenant retail—properties were self-managed, with no expense reportedly historically. Conversely, I have also observed properties where owners or part owners of a retail center operated their own real estate management company, in some cases collecting an typically high (albeit effectively pocket-to-pocket) management fee. It is my contention that regardless of recent actual in-project practices, a management fee should be implemented in valuation and loan debt service analyses as the preponderance of property owners invoke use of a management company. Even under self-management, time is being expended by the owner in lieu of management fees and as an old adage states, time is money. Forecasting an appropriate market expense is generally preferred over emphasizing historical costs for this category.

For common ***multi-tenant retail centers*** operating at stabilized occupancy a management expense in the vicinity of **4% to 4.5% of effective gross income** is reasonably appropriate, subject to judgment and consideration of actual historical expenses. For properties judged to have more intense management needs, a rate in the range of 5% to 5.5% may be dictated, while for properties in prime areas a rate in the range of 3% to 4% of EGI can be supported, particularly for centers requiring less intensive management. Significant influencing factors include the number of tenants in a center and the overall condition of the center. With a name-recognized credit tenant occupying a large percentage of the space, lower management intensity would be anticipated. A center with numerous small local tenants that experiences frequent turnover would be expected to be more management intensive.

For ***single tenant retail*** properties, a lesser management fee of **2% to 3% of effective gross income** is typically appropriate (particularly if occupied by a credit tenant). Management costs, for both multi-tenant and single tenant properties, are generally not a reimbursable expense under most common triple net lease terms (although in rare cases, I have observed leases for trophy properties in prime locations that included management as a reimbursable expense).

General Administration / Miscellaneous

This category includes professional services (such as legal, accounting, and advertising) as well as other miscellaneous and incidental costs not readily covered by the primary expense categories. For small retail centers, expenses associated with this category tend to be incurred on a sporadic basis. Of the surveyed retail centers, observed expenses for this category ranged from approximately $0.00 to $0.60 per square foot of gross leasable area, per year. The primary sub-category comprising this category consists of legal costs, typically pertaining to evictions. Few of the surveyed centers evidenced any significant advertising expense. This is typically not a reimbursable expense under triple net lease terms.

Subject to judgment and consideration of actual historical expenses, an expense in the vicinity of **$0.15 to $0.30 per square foot, per year**, is generally a reliable forecast as to this expense category. Where tenancy is well-established and long-term and/or reflects a high percentage of credit status tenancy, this expense may not be warranted. In cases where recent historical expenses have regularly substantially exceeded the foregoing range (over a multi-year period), a higher expense of up to $0.50 per square foot, per year may be appropriate.

As a general comment, I rarely see prospective buyers implement this expense in their purchase decision-making, and many brokers omit this expense in marketing packages if no significant costs have been incurred historically.

Replacement Reserves / Allowance

This category basically provides for accumulation of funds for replacement of so-called short-lived items. It has been my observation that many managers/owners of small to mid-size retail centers prefer to treat replacement of items on an as-they-arise basis and do not truly set aside a portion of the income stream. Few of the surveyed centers evidenced owners having a reserves expense. As such, this expense category tends to be more appraisal-oriented than actually invoked by market participants. In reality, most operating statements/historical expense reports will show sporadic capital expenditures for replacement items, rather than a reserves expense. Nevertheless, the preceding expense categories do not provide for periodic replacement of items which is bound to occur during normal property ownership. As such, a replacement reserves/allowance category is logically supported to compensate for same. A variety of methods can be implemented for this category, ranging from using a simple percentage of effective gross income—typically 1.0% for retail properties—to an elaborate estimate of likely costs to be incurred on the average per year. Often an expense in the vicinity of **$0.15 to $0.25 per square foot, per year**, is used/supported.

When examining provided historical expense information, in many cases same will not include any figure for reserves, but may include various replacement costs and capital expenses. Such costs may help to provide an indication of an appropriate reserves expense for a given property, particularly if multiple years of expense information is available (considering the average replacements expenditure over a multi-year period is generally more meaningful than examining replacement expenditures during just the most recent year). In some cases however, reported costs may be more representative of optional upgrades versus replacements, or may be skewed high due to inclusion of a substantial one-time cost (such as a roof replacement, parking lot-repaving, or replacement of all HVAC units at one time).

FINAL COMMENTS

Based on the expense data compiled, total operating costs for small to mid-size retail centers in the greater Los Angeles area can commonly be expected to fall within the range of about **25% to 35% of effective gross income.** The percentage can vary dependent upon center type and location. In some cases, high value properties that have recently sold (with resultant high real estate tax obligations) can have higher than expected costs when considered as a percentage of effective gross income. Centers operating with rents substantially below market or having chronic vacancy issues can be expected to have high expenses as a percentage of effective gross income as well (in some cases up to or even exceeding 40% of effective gross income).

On a per square foot basis, total operating costs were observed to range broadly from approximately $5.00 to nearly $12.00 per square foot, per year, although most centers surveyed had costs in the narrower range of **$6.00 to $9.00 per square foot, per year** (of gross leasable area). Expenses on a per-square foot basis tend to be somewhat correlated with rents (properties generating high rent per square foot will often be found to have high expenses on a per square foot basis as well).

The foregoing guidelines should be recognized as a rule-of-thumb regarding likely expenses that would be incurred in the annual operation of small to mid-size retail centers in Southern California. The information should be considered in conjunction with reported historical expenses for a given property. No liability is assumed by Gregory P. Wingerd, or Gregory P. Wingerd & Associates for the accuracy or applicability of the information provided herein. The cost information used for developing this guide was procured during appraisal assignments and is largely confidential in character. As such, I have typically reported expense data in a rounded manner herein, reflecting observed ranges, rather than presenting individual expense information associated with specific expense comparables. The procedures presented herein do not necessarily reflect those of the Appraisal Institute.

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