The commercial real estate industry is nearly all the way back. According to CBRE’s Global Investor Intentions Survey 2015, investors poured $835 billion into real estate during 2014, a figure that could approach $1 trillion in 2015. Not since 2005-2007 has the institutional appetite for real estate been so strong, and real estate is taking a far larger slice of the overall investment pie now than it did in those years.

In the United States, office market fundamentals are also nearing pre-recession levels. As BOMA International President and Chief Operating Officer Henry Chamberlain reported during his annual State of the Industry address in June at the 2015 BOMA International Conference & Expo, office vacancy is expected to dip below 15 percent by year’s end, a point not reached since 2008. These figures have industry experts wondering whether the market may be approaching its peak for this cycle.

Abundant capital and improving occupancy together have contributed to elevated property values and an environment conducive to rising operating expenses. And, as BOMA’s 2015 Office Experience Exchange Report® (or Office EER) shows, this is exactly what occurred in 2014.

For nearly a century, the Office EER has provided the commercial real estate industry with reliable data on income and operating expenses at office buildings across the United States and Canada. The 2015 edition offers data collected from more than 5,300 buildings representing 275 markets. (This year also saw the launch of the brand new Industrial EER for industrial properties. See “Big Differences at Big Boxes” sidebar on page 33.)

This annual look at operating expense trends analyzes a special subset of more than 2,000 U.S. private-sector buildings representing more than 300 million rentable square feet. Buildings in this subset supplied data for both the 2014 Office EER and the 2015 Office EER (which report on income and expenses incurred in 2013 and 2014, respectively). These buildings also meet certain occupancy and measurement requirements, which add to the degree of confidence that measured changes in income and expenses reflect actual market conditions.

THE BIG PICTURE: A RISING TIDE

The good news for commercial real estate is that total rental income for private-sector office buildings in the United States rose by an average of $1.43 per square foot (psf) in 2014, an increase of 5.3 percent. Unfortunately, expenses rose at an even higher rate: As illustrated in “Figure 1,” total operating expenses increased by 6.1 percent (or $0.49 psf), on average. (Note: For the Office EER, calculations are performed based on office rentable square feet.) The overall increase similarly impacted buildings regardless of whether they were located in downtown or suburban areas, though downtown buildings still tend to cost more to operate—an average of $0.80 psf.

Figure 1: Average total operating expense per office rentable square foot by U.S. private-sector building type (Avg. $ per office rentable sq. ft.)

<table>
<thead>
<tr>
<th>Building Type</th>
<th>2014 Total OPEX</th>
<th>% Change from 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. PRIVATE SECTOR</td>
<td>$7.06</td>
<td>6.1%</td>
</tr>
<tr>
<td>DOWNTOWN</td>
<td>$4.56</td>
<td>6.8%</td>
</tr>
<tr>
<td>SUBURBAN</td>
<td>$7.36</td>
<td>5.6%</td>
</tr>
<tr>
<td>GEN. MULTIPLE</td>
<td>$7.06</td>
<td>6.8%</td>
</tr>
<tr>
<td>MEDICAL</td>
<td>$0.12</td>
<td>3.3%</td>
</tr>
<tr>
<td>CORPORATE</td>
<td>$0.42</td>
<td>1.1%</td>
</tr>
</tbody>
</table>
Among the property types included in the Office EER database, operating expenses rose most for general multitenant buildings, which reported an average increase of 6.8 percent, or $0.54 psf. Medical office buildings saw a smaller increase of 3.7 percent ($0.30 psf). Corporate facilities were best able to control expenses, reporting an average increase of only 1.1 percent ($0.09 psf).

**INCREASE DRIVERS: LARGEST EXPENSES**

As has typically been the case, utility and repair/maintenance expenses were the two largest operating expense categories in 2014. As such, they drove most of the overall increase, especially since very little change occurred in the third-largest category, administrative expenses.

“Figure 2” displays the change per square foot for each major operating expense category for all U.S. private-sector buildings in the two-year Office EER sample. Average reported utility expenses rose $0.17 psf, an increase of 7.9 percent. Repair and maintenance expenses increased $0.12 psf, or 6.2 percent. Together, these increases account for approximately 60 percent of the total average increase in operating expenses reported during 2014.

Changes in utility and repair/maintenance expenses were far from uniform across building types and locations (see “Figures 3 and 4”). Suburban buildings reported a 12.6 percent increase in utility expenses over 2013, an average of $0.26 psf. In both absolute and percentage terms, this is nearly twice the increase in utility expense during 2014, though they both tend to spend more in this category on an absolute basis.

A disparity between downtown and suburban properties also is evident in the repair/maintenance category, though the difference is striking in the absolute rather than in the degree of change from 2013. On average, downtown buildings spent $0.53 more in repairs and maintenance than their suburban counterparts in 2014, a difference that actually narrowed slightly during the year because the rate of increase was nearly three percentage points higher at suburban buildings.

In terms of year-over-year change, the strongest observable contrast in the repairs and maintenance category is based on building function rather than location. General multitenant buildings saw an increase of 8.5 percent ($0.17 psf), while medical office buildings were essentially flat with their average increase of 1.7 percent representing only $0.03 psf on an already relatively low base. Corporate facilities, however, experienced a decrease of 4.7 percent, or $0.10 psf, a significant reason for the slower growth in total operating expenses for these buildings.

**MARKET MOVERS: BIG VARIATIONS IN MAJOR CITIES**

Utility and repair/maintenance expenses moved dramatically differently in major markets, in some cases, even trending opposite each other within the same market. “Figures 5 and 6” display the average cost per square foot reported for 2014 on the vertical axis and the percentage change from 2013 on the horizontal axis for the two expense categories, respectively.
Buildings in New York City reported by far the highest average expense per square foot in both categories for 2014. The New York average expense of $4.39 psf is 87 percent higher than the national average of $2.35 among private-sector buildings, and its $3.81 psf average repair/maintenance expense is 81 percent higher than the national average of $2.11. Yet, these same buildings reported relatively little change in both categories: A 2.0 percent (amounting to $0.08 psf) increase in utility expense and a 0.8 percent decrease (-$0.03 psf) in repair/maintenance expenses. Most markets saw far greater movement.

Denver, for example, observed a huge average increase of 33.6 percent ($0.61 psf) in utility expense. Atlanta’s utility expense increase was also very large, exceeding 25 percent and $0.50 psf. These two markets reported opposite trends in repair/maintenance expenses, however. As it did with utility expense, Atlanta experienced one of the nation’s largest increases in repair/maintenance expenses: 19.0 percent, or $0.24 psf. Denver, on the other hand, enjoyed a 3.4 percent (-$0.06 psf) decrease.

This savings mitigated Denver’s overall average increase in operating expenses, bringing it closely in line with the national average. By contrast, Atlanta, with its double-barreled increase in both utility and repair/maintenance expenses, was one of the nation’s leaders in the rate of increase in total operating expenses—though still, it must be noted, one of the least expensive markets in the absolute.

A trio of markets (Dallas, Houston and Philadelphia) bear mention more for their similar expense trends than for their differences. Each of these three markets reported expenses per square foot below the national average in both the utility and repair/maintenance categories. Furthermore, each experienced either a decrease from 2013 or a minimal rate of increase also below the national average. As a result, the three markets stand out together for having relatively low total operating expenses with restrained growth rates.

As a final note on market trends, one market in each category is a proximate bellwether for the nation as a whole. In the utility category, the Virginia suburbs of Washington, D.C. reported an average expense of $2.18 psf, slightly below the national average of $2.35. This market also observed an increase of 9.1 percent, or $0.18 psf, similar to the overall 7.9 percent ($0.17 psf) rise.

Suburban Chicago best reflects national trends in the repair/maintenance category. The market’s $2.17 psf average for 2014 is very close to the national figure of $2.11. Its increase of 8.7 percent ($0.17 psf) is slightly higher than the overall increase of 6.2 percent ($0.12 psf), but no other market more closely mirrors the national trend.

**INTERPRETING THE DATA: POSSIBLE CONCLUSIONS**

What does this year’s Office EER data say about the commercial real estate market in 2015? Though this data alone is not adequate to pinpoint the current moment in the market’s cycle, the fact that expenses rose faster than income suggests that some conclusions are appropriate, particularly in light of other market intelligence.

- First, the observed pattern of steady increases in expenses across all operating categories is consistent with other indicators, such as slow growth in U.S. gross domestic product (GDP), employment and occupancy, showing a maturing economic recovery. The question is whether property values themselves are grounded in such fundamentals or whether they have become decoupled from them due to capital pressures, as happened in the days leading up to the Great Recession.

- Second, with such emphasis and achievement in the area of energy conservation in commercial buildings, it stands to reason that the rise in utility costs measured by the Office EER—which controls for occupancy changes—is driven more by higher rates than greater consumption. This may well be due to demand pressure being generated in other sectors of the economy.

- Third, certain market- and type-specific variations in expense trends can be readily explained. For example, a great many corporations have taken advantage of low capital costs during the recovery to upgrade their space, following the trend to make it more open, flexible and collaborative. It is hardly surprising, then, that corporate facilities would see decreases in their repair/maintenance expenses, as many have relatively new technical and operating infrastructure.

Operating expenses are just one indicator of broader market trends, but they remain the lifeblood of each individual real estate asset’s operations. On balance, it appears that building owners at least relaxed the purse strings in 2014 as the market’s health continued to improve. The onus remains on property managers, however, to be faithful stewards of their operating budgets as costs move steadily upward.

**ABOUT THE AUTHOR:** Phil Mobley is a frequent contributor to BOMA Magazine. From 2009-2013, he served as co-leader for the Experience Exchange Report at Kingsley Associates. He is principal of Koine Communications, and can be reached at phil@koinecommunications.com.
BIG DIFFERENCES AT BIG BOXES
New Industrial EER Reveals Substantial Geographic Variation in Operating Expenses

After providing the office sector the most comprehensive benchmarking data in the industry for nearly 100 years, BOMA International has expanded the Experience Exchange Report® database with the launch of the brand new Industrial EER, the only benchmarking resource in the commercial real estate industry specifically tailored to the industrial sector. The inaugural report includes data from more than 2,800 industrial properties in 85 markets across the United States, representing nearly half a billion square feet of industrial space. While future years’ data promises to reveal important trends in the industrial real estate market, the data found in the 2015 Industrial EER (based on income and expenses in 2014) already contains a number of fascinating insights.

“Figure A” displays the average total operating expense per total gross square foot broken down by (non-exclusive) building use. “Figure B” displays the same data for all buildings, segmented by major industrial real estate market.

Among the initial findings are that, not surprisingly, more specialized uses are associated with higher operating costs at industrial buildings. Basic bulk warehouses report total operating expenses of $1.27 per square foot (psf), $0.13 (9.3 percent) below the average for all buildings of $1.40 psf. On the other end of the specialization spectrum, R&D/lab facilities reported expenses of $2.67 psf, nearly twice the overall average.

Vast differences exist across markets as well. At the high end, buildings in the space-constrained, technology-focused Silicon Valley reported operating expenses of $2.17 psf, nearly three times the $0.77 average for properties in the more spread-out Atlanta market. This is also substantially more than nearby San Francisco/Oakland, where average operating expenses for 2014 came to $1.55 psf. New York City, Houston and Denver joined Silicon Valley in reporting expenses in excess of $2.00 psf.

These big differences across property uses and markets represent new frontiers for benchmarking exploration. With the Industrial EER, industrial property professionals now have the opportunity to examine and mine this new data.

*Actual photo of ice breaking the valve of an auxiliary drain taken in a parking garage during the winter of 2014.

The COLLECTandRAIN® Model 5400A provides a temperature controlled environment for the sprinkler system auxiliary drain so freeze-ups are a thing of the past. This winter stop the cycle of replacing drains and install the only auxiliary drain with superior freeze protection.

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*Actual photo of ice breaking the valve of an auxiliary drain taken in a parking garage during the winter of 2014.