Landlord Audits

Our experience is that landlords routinely over bill tenants in ways that cannot be detected by the best desktop review of invoices. Landlords often fail to test and/or report co-tenancy and conditional payment formulas you may have diligently negotiated. Additionally, they typically use a universal definition of GLA when calculating the tenant's pro rata portion of common area expense, irrespective of negotiated inclusions. REIT Industry practice is to bill standardized charges and settle when audited. We estimate that leading retailers have negotiated over $200 million in settlements in recent years.

What are landlord audits?

Every tenant, typically, has a right under its lease agreement to insure they have been billed **according to the terms of their lease**. A landlord audit is no different than the normal due diligence any fiscally responsible person would do before s/he paid a large bill.

Who does landlord audits?

The three largest regional mall specialty tenants – Gap, Limited Brands and Footlocker—all do landlords audits on a regular basis, as do many smaller retailers. All the large players supplement their internal resources with external specialists.

What kind of recoveries can we expect?

We estimate recoveries from all retailers in the last four years exceed $200 million. Recoveries are highly dependent on the strength of your lease language; however, almost every lease has a calculation or definition that is difficult for the landlord to accurately bill.

That seems like a big number. Why do landlords bill incorrectly?

Landlords have multiple properties with hundreds of leases per location, all individually negotiated, and all with differing formulas and definitions of allowable pro rata charges, co-participation thresholds and co-tenancy definitions. It would be an enormous task to accurately customize each invoice to the specific terms of each lease. Consequently, most landlords have standardized billing procedures to allocate expenses to all tenants, and settle when audited.

Additionally, any money expenses or capital improvements that can be recovered from tenants directly benefit the landlords, so they naturally take an aggressive approach on classifying expenses. Landlords often have the right to earn a 15% "administrative" fee on certain pass through expenses, which provides an additional strong incentive to take the most aggressive approach, and little incentive to control costs.

Finally, landlords are increasingly taking the position that they can create profits on certain pass through expenses, such as trash and utilities that tenants feel they have negotiated as strict pass through items.

501 W. Schrock, Suite 201 Westerville, OH 43081 Tel: (614) 212-5180 Fax: (614) 212-5181

How does Asset Strategies Group perform audits?

We have a proven audit approach that begins with a detailed abstracting of each lease under review. We focus on the financial terms of the lease and provide to our clients an interim work document: a detailed financial abstract to help your accounts payable group perform more effectively. We visit each mall under audit and document the visit with pictures and write-ups. Finally, we obtain needed documentation from the landlord and compile a bulletproof audit fact book that clearly outlines the basis for your claim.

Lease Abstracting and Data Analysis

ASG abstracts each lease using our proprietary template. The abstracting process details the co-tenancy, pro-ration, co-participation and allowable expense language on a lease-by-lease basis and produces checklists for landlord document requests and mall visits. Each abstract is double-checked for accuracy and a summary table is produced to give us an overall view of the client's lease portfolio. We assemble the abstracts into a notebook and give them to the client for use in their desktop audit process.

Landlord Document Review

At this stage of the audit, the client notifies the landlord that ASG will represent them in the audit process and, subsequently, ASG arranges with the landlord to obtain documents and/or do onsite document reviews. During the inevitable downtime between our request and securing the documents, ASG visits each mall under audit and completes a checklist. The principal purpose of these visits is to assess the condition of each mall, tenancy levels, and to answer any mall specific questions raised in the abstracting process or requested by the client. ASG will include these mall reports as part of our final work product.

Claim Book Preparation

Once the necessary landlord documents are secured and the mall visits are completed, ASG follows its internally developed audit program to prepare work papers for each lease and audit area (CAM, real estate tax, merchants, utilities) for a two-year period (the results of which are extrapolated to the full extent of the statute of limitations for the state in which the mall is located). The differences identified through the audit are linked to a master table for sorting and subtotaling by year, lease, audit category, etc. Once the draft claim book is internally reviewed, we meet with the client for approval. After incorporating client-requested changes, we prepare a final claim book for presentation to the landlord.

Claim Presentation

The client mails the approved claim book to the landlord along with a cover letter. Typically, the landlord will discount the claim, in part or in whole, and a meeting is set up to discuss the claim at the landlord's offices. ASG travels with client management to convince the landlord of the claim's merit. There will be agreement on very few points but a claim range will be established for use in the negotiation process.

Settlement Negotiation

The settlement part of the process, while usually less contentious than presenting the claim, can still be volatile. However, because it is in the best interest of both the client and the landlord to settle the claim without litigation, there is opportunity to produce "win-win" settlements. Prior to any settlement negotiation, it's important for the client to know a) the minimum desired settlement value and b) how the value can best be achieved (portfolio moves, reduction of future charges, cash, etc.). Using our experience in such negotiations, ASG can provide coaching to the client and, if desired, accompany the client to the settlement negotiations.

What does it cost?

Asset Strategies Group charges a fixed fee per lease which amounts to, for the average sized mall store, about fifty cents per square foot. Assuming you have a scheduled process of auditing a landlord every five years, the expense, on an annual basis, is around ten cents per foot

What are the benefits?

The number one benefit of a landlord audit is to recover economic value, including cash, from landlords. Using a negotiating process recommended by the Asset Strategies Group, tenants can use the audit claim to gain leverage in current and future real estate deals.

Are there other benefits to an audit?

Working with Asset Strategies Group provides several additional benefits that would make the process worthwhile even if there were not substantial financial recoveries. These include:

- A lease professional will review your lease language and recommend best practice changes or clarifications which will strengthen your position as you negotiate new leases with the same landlord.
- A lease abstract is produced for each location that is specifically designed for a payables process. Using this abstract will enable payables personnel to improve their efficiency in reviewing validity of the yearend adjustments every landlord creates.
- The fact you have a professional group auditing bills on a regular schedule puts your landlords on notice to take more care with your charges.
- Satisfaction of internal and external audit concerns that this major expense category is being properly monitored.

Should I be concerned by the Landlords reaction? We need their cooperation to achieve our real estate objectives.

The first reaction of landlords is to threaten to hold key deals hostage. Since these landlords are being audited by all the major retailers (and settling claims), this failed tactic rarely works, especially if you are using a responsible third party audit group. It is important to manage the audit process as a financial due diligence process, not something tied to the deal making function. Just as the landlords exercise fiduciary responsibility by auditing sales, retailers do so by auditing occupancy charges.

That said, once a claim is sent to a landlord, it is often productive to involve the deal function in a strategic settlement process that includes broader portfolio issues. A strong audit claim enhances your leverage in negotiating with a landlord.

Okay, I’m interested. What do I do now?

Contact us and we’ll arrange a meeting to discuss more specifics and help you formulate an overall portfolio audit strategy.