
BUILDING MEASUREMENT STANDARDS AND REAL ESTATE SECURITIES

The absence of a single standard creates new liabilities for the securities industry.

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The securities markets have never offered so much exposure to the risks associated with investments in commercial real estate. Most of the investors in real estate securities are likely to be relative amateurs in the real estate industry. Few of these investors realize that one basic element of lease information that is essential to the “arithmetic” of real estate valuation and underwriting, the computation of the rentable square feet on a property, is calculated by various differing standards, with results that are rarely audited for accuracy.

Investors must realize that “rentable square footage” is an imprecise term of art in commercial real estate parlance, almost an industry “fudge factor.” Even when all the information in the financial statements, cash flow schedules, and other data disclosed in a prospectus to solicit investment have been fully audited, that information may contain misrepresentations (both intentional and unintentional), *because the rentable square footage fig-*

ures on which the information is based are rarely audited.

This situation creates the potential for devastating securities litigation, which could arise because of the ambiguous, inconsistent and often casual trade usage associated with reported square footage.

THE ISSUE

The re-emergence of equity and mortgage real estate investment trusts (REITs) in the 1990s and the rapid expansion of commercial mortgage backed securities (CMBS) markets since the late 1980s brought a dramatic surge of Wall Street capital into direct and indirect forms of commercial real estate investment.

These investments are subject to all the risks inherent in commercial real estate assets as well as to market risks. Prudent investors in public REITs and CMBS should expect and require consistent credit and cash flow analyses. It is difficult to produce such analyses because the underlying commercial real estate assets are far from standardized, varying significantly by property type, market, transaction and ownership structure. Because truly consistent and standardized historical performance information is generally not available, val-

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uations and credit ratings are largely driven by generalizations about the underlying properties and short-term performance analyses. The securities markets are not accustomed to such inconsistency in analytical methodologies.

There is no better illustration of the fundamental lack of consistency and standardization in real estate underwriting than the lack of consistency in the definition of the “rentable square foot,” the term that identifies the amount of space that is subject to the lease. When this figure is multiplied by a rental figure (dollars per square foot) the product is the amount of rent that a tenant must pay. In a typical multi-tenanted commercial or retail property, rentable square footage also determines each tenant’s prorated share of taxes, insurance costs, maintenance expenses, and the like.

The buyer and seller of an income-producing rental property start to establish its total net operating income (NOI) by multiplying the rentable square footage for each lease by the rent rate and summing the products of all the leases to determine gross revenues. They deduct operating expenses, reserves and a vacancy allowance from these gross revenues to calculate NOI (and, of course, the discount NOI) which can then be discounted by a certain capitalization rate to yield the value of the property. Thus, buyers and sellers of real estate make certain assumptions about rentable square footage when they determine its price.

Similarly, lenders rely on rentable square footage in the calculations they need to underwrite mortgage loans and incorporate rentable square footage amounts into their calculations of ratios of “debt service coverage” and “loan to value.” Securities rating agencies regularly scrutinize these and other ratios when they size and rate each tranche of a CMBS issue.

Today, new groups of investors of all levels of sophistication — from the Wall Street buyer of CMBS to the lay person contemplating the purchase of shares in a public REIT — implicitly rely on the rentable square footage figures set forth in prospectuses and other disclosure documents when they make investment decisions.

As indicated, although the importance of rentable square footage is great, its definition and the actual methodologies used to calculate it vary greatly. Not only do definitions vary by geographic region, but different levels of sophistication of own-

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ers and developers lead to the use of differing measurement methodologies. Perception can vary greatly from reality, and the dollar implications in terms of the value of real estate can be profound.

In some rented buildings, leases may refer to a specific square footage measurement standard. However, in actuality, the owners, tenants, and brokers may ignore the standard and estimate the amount of rentable square footage subject to the lease, usually on

the basis of unverified historical information, possibly in order to produce a rental based on rough market notions of supply and demand.

Commercial real estate professionals (owners, brokers, and mortgagees) are well aware of the customarily inaccurate nature of the square footage measurements recited in leases, but the investing public (that is now so heavily committing funds to public REITs and CMBS) is not. The investing public can only rely on the valuation figures that prospectuses disclose and it assumes that the rentable square footage numbers that underlie those valuations are accurate. To include misstatements of essential information in disclosure materials is to introduce the concept of *caveat emptor* to the securities market, a characteristic that the Securities Exchange Commission labors to eliminate.

Investors in the burgeoning public REIT investment market are particularly vulnerable. Accustomed to the benevolent protection that the Commission extends over most publicly traded securities, they may assume that the Commission requires the auditing of accuracy of the rentable square footage calculations in solicitation materials. For these reasons, the SEC should take the following steps to protect investors:

- Require the securities industry to adopt a uniform national standard for building measurements and for the calculation of rental square footage, and
- Mandate audit procedures by third party auditors and enforce compliance with the national standard pertaining to all commercial properties for which values are disclosed to potential investors in the prospectus or other disclosure document.

THE CHOICE OF MEASUREMENT AND CALCULATION STANDARDS

Although a variety of national and local standards exist, the only nationally accepted standard for the

calculation of rentable square footage in lease negotiations in the United States is the BOMA/ANSI standard (Z65.1) as revised in 1996. Adoption of this standard by the Commission for securities disclosure purposes would likely meet with the least industry resistance because most major property owners and tenants are already familiar with its methodologies even though they may not use it. It is an indication of the broad acceptance of this standard that the nation's largest tenant, the General Services Administration, recently decided to utilize it in future lease negotiations and abandon using its own national building measurement guidelines for this purpose.

There are two other standards that have gained industry acceptance but are not intended to be used directly for the calculation of rentable square footage. The ASTM/ANSI standard (E 1664-95a) is a method for estimating the "building loss features," that is, the amount of floor area that is rendered unusable for tenant or core business functions by specific physical elements of the building.

The ASTM/IFMA standard (E 1836-96) for facility floor area measurement was created primarily to serve tenants and owner-occupiers who are performing space planning activities and charging core business units for the amount of floor area they occupy. This standard expressly defers to the BOMA/ANSI standard (Z65.1) "for use in lease negotiations with owners of commercial office buildings or related properties."

Currently, typical public REIT disclosure documents rarely mention how rentable square footage figures have been calculated. At best, the standard used is briefly referred to in passing or is buried in a footnote to a table listing the properties comprising a portfolio. The investor is given no assurance that the standard was correctly followed, and the SEC does nothing to give the investor that specific assurance.

In the event that a lease contract expressly invokes a particular (typically local) rentable square footage calculation standard, and that standard has in fact been applied by the parties, then the prospectus or other disclosure document should so state. The SEC could require that square footage figures be adjusted to the BOMA/ANSI (Z65.1) standard for securities disclosure purposes. It would then be incumbent upon the investor to evaluate the significance of the difference for the purpose of valu-

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ing and comparing alternative public REIT or CMBS investments.

IF NOTHING IS DONE

If the commercial real estate market continues to prosper, the issues described in this article will probably not be addressed. As long as securities that are based on, or backed by, interests in commercial real estate continue to generally do well, there will be little incentive for the issuers of those securities, the securities markets themselves, the commercial real estate industry, or frankly the Commission, to be inclined to support new rules which alter the status quo.

During the last cyclical downturn in the commercial real estate industry (1989-1993), the experience of lending institutions that acquired real estate collateral upon default confirmed that square footage measurements were frequently not as large as had been previously represented by borrowers. Suddenly faced with a depressed market, lenders were not only forced to reduce rental rates; they were also left with less square footage to rent or sell.

In the event of a future real estate market collapse, property portfolios will again suffer large vacancy rates and reduced cash flows. The combination of reduced rentals (in dollars per square foot) and reduced square footage to rent or sell, will again compound the dollar impact on property owners and REIT or CMBS investors, representing the ultimate devaluation of the "currency" of commercial real estate.

Even with continuing market prosperity, the overstatement of rentable square footage creates concerns for investors in REITs or CMBS. A strong commercial real estate market precipitates increases in average rental rates and, in an environment of increased occupancy costs, many tenants may begin to question the validity of the rentable square footage calculation applied to their leases. The consequences are especially meaningful to tenants in terms of prorated taxes, insurance, common area maintenance and other charges passed through to them under their leases.

Tenants who have successfully challenged their landlords' rentable square footage calculations have gained credits toward both rent and expense pass-throughs, significantly disrupting the cash flow projections of owners, lenders and investors. Of

course, cash flow interruptions imperil the ability of any property to cover debt service and maintain adequate reserves.

As more tenants verify their rentable square footage calculations, it is foreseeable that lease terms may frequently be re-negotiated, resulting in negative adjustments to cash flow projections and the critical ratios of debt service coverage and loan-to-value. Where leases express rent in terms of "dollars per square foot," landlords could face substantial contingent exposure if tenants are able retroactively to calculate the correct rent and expense pass-throughs payable from the beginning of the lease term, based on corrected square footage measurements. Whether a landlord's contingent liability results in either an offset against future rents or an actual out-of-pocket reimbursement of overpaid rent, the risk of mortgage default is enhanced. Both sophisticated and unsophisticated investors can then be expected to question why accurate, verified rentable square footage was not disclosed initially.

Taking the foregoing scenarios to their logical (and not improbable) extremes, REIT and CMBS investors alike will eventually realize that important investment decisions have been made based on casually-determined and typically unconfirmed rentable square footage figures, resulting in a miscalculation of the value of those investments and a misapprehension of their inherent risks. The failure of merely one major REIT could precipitate extensive inquiry into the verification practices used by the Commission with respect to lease data as well as securities litigation and possible class action lawsuits directed towards all parties associated with the issuance of the failed security.

The Commission is in a position to preempt both the devaluation of REIT and CMBS investments and the investor dissatisfaction and litigation likely to ensue therefrom, by immediately undertaking the basic recommendations described in this article. There is international precedent for such action. The French government has adopted regulations that require an independent third party (a "metreur") to verify the floor area

These recommended measures may help defuse a ticking time bomb.

square footage of all residential and commercial buildings sold in France. Japanese law also prescribes a very precise, uniform building measurement standard.

CONCLUSION

The authors contend that the building measurements that underlie the market valuations of all publicly-traded real estate investment trusts and commercial mortgage-backed securities must be calculated and validated at the direction of the Securities and Exchange Commission as agreed to by FASB, in accordance with a single national standard. It is recommended that the Commission adopt the BOMA/ANSI (Z65.1) for this purpose. The Commission should enact rules that incorporate the following requirements.

- Issuers of real estate securities must use a verifiable standard (preferably, BOMA/ANSI Z65.1) to calculate the rentable square footage of all tenanted commercial real estate for which valuation figures are stated in a prospectus or other disclosure document for the purpose of soliciting investment. (In the event that a lease contract actually invokes a different standard, and that standard is used by the parties, the disclosure document should so state, and the actual calculation be verified as well as the deviation from the standard.)
- The issuers of REIT and CMBS investments must cite the specific method used for calculating the rentable square footage in a prospectus or other disclosure document intended to solicit investment.
- All financial calculations, projections and other valuation information contained in a prospectus or other disclosure document should be based on an audited rentable square footage, so that the basis for comparing buildings and portfolios will be equal.
- All square footage measurements, calculations and audits must be performed and validated by disinterested third parties.

The issues described in this article present the securities industry with a new set of liabilities; the foregoing measures will help defuse what may be a ticking time bomb. ■