

The length of time a building can keep its tenants affects profits as much if not more than construction costs, market share, rent levels, or other competitive factors. Owners and managers need to learn to focus on occupancy rather than vacancy.

Managing Property For Zero Defections

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Hardly a manufacturing industry was untouched in the 1980s by the revolution of zero defects. Manufacturing without defects rather than inspecting for defects at the end of the line or repairing defective products later proved to have enormous advantages for production costs, marketing, customer satisfaction, and brand loyalty.

Service industries are now jumping on the bandwagon, enthusiastically committing themselves to “customer service” and “customer satisfaction.” But often they find commitment alone does not suffice to bring results. Service companies are learning a lesson manufacturers also had to learn: unless you measure it, quality cannot improve.

For service companies, quality is best measured by the number of customers who come back. The goal is zero defections, or keeping every customer that the company can profitably service.

Does a zero defections strategy relate to real estate? Most practitioners continue to view real estate as a product, which it is in a narrow sense. Leaking roofs, faulty HVAC systems, and flaws in parking lots definitely decrease profits, so achieving zero defects in construction is desirable.

But in the broader sense, supplying occupants with physical space is a service activity that assists the occupants with their business or living needs. Structures, suggests Paul Zane Pilzer in “The Real Estate Business and Technological Obsolescence” (*Real Estate Review*, Fall 1989), should be thought of as merely the tools of the occupants, while the firms that produce, own, or manage real estate can be described as:

- assisting in the distribution of goods and services (in the case of shopping centers and warehouses);

- assisting in the creation and marketing of ideas and the processing of information about products (in the case of office buildings); or
- providing facilities for sleeping and living (in the case of hotels and housing).

Real estate is no different from the car rental business, whose customers contract not for a product but for a service: transportation.

As a service industry, real estate can use the powerful yet simple tool of managing for zero defections to achieve enormous economic benefits. As in all service industries, customer (tenant) defections significantly affect the bottom line. Quite simply, the longer a tenant stays, the greater the overall profits; and the longer a real estate company can continue doing business with a particular customer, although not necessarily in the same physical space, the greater its profits.

The Economics of Zero Defections

We illustrate the economics of zero defections with a hypothetical five-year old, 100,000-square-foot, Class A office building that is 80 percent occupied (80,000 square feet). It cost \$8 million to develop, financed with a 30-year \$6.4 million mortgage at 10.5 percent and \$1.6 million in cash equity.

Subject to space availability, new tenants are attracted at the rate of 12,000 square feet per year. Year 1 rents are \$18 per square foot fixed for a four-year lease term; leases or renewals commencing after year 1 are based on a 4 percent annual increase to the rental rate, with fixed rates for their four-year terms.

Operating expenses are as follows: general costs at \$500,000 in year 1, increasing at 6 percent per year; \$8 per square foot for renewal refinishing, in-

creasing at 5 percent per year; \$15 per square foot for new tenant remodeling, also increasing at 5 percent per year; and 6 percent for broker and/or management commissions for new leases and 2 percent for renewals.

Assuming the original 80,000 square feet of occupied space comes up for lease renewals at 20,000 square feet per year, using the absorption, rent, and expense assumptions listed above, and varying only the annual tenant retention rates for leases that come up for renewal, we find that increases in the retention rate have a dramatic impact on profitability (see Figures 1 and 2).

At 50 percent retention, for example, the building does not begin to achieve a positive cash flow until year 4, but at 70 percent, it nets \$60,700 in year 2. In year 2, the building starts making money with a 60 percent retention rate and each 10 percentage points increase in the retention rate yields an additional \$50,000 or so. In year 3, the corresponding return for each 10 percentage point jump in the retention rate is about \$92,000. In four years of operation, a 60 percent retention rate yields \$176,000 in net cash flow while a 90 percent rate yields \$899,000.

If defections exceed new tenant absorption, the economics become even worse. In our example, at a low 30 percent retention rate, new tenant absorption (at 12,000 square feet per year) fails to compensate for defections, with the following results:

	Year 1	Year 2	Year 3	Year 4
Square Feet Occupied	78,000	74,000	70,000	66,000
Net Annual Cash Deficit	-\$259,990	-\$362,443	-\$455,294	-\$538,199

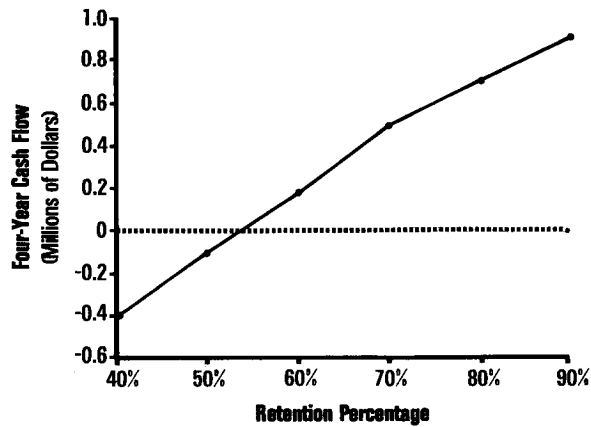
Reducing defections provides economic benefits to real estate firms in other ways as well. Long-term tenants build up confidence in the company's service, and are often willing to pay a premium to continue to use it. Loyal tenants make a lot of referrals over the years, and referrals are a landlord's most effective form of advertising.

Focusing on Occupancy, Not Vacancy

If improved tenant relations can affect profits so dramatically, why don't more real estate firms focus on preventing tenant defections? At least three reasons come to mind.

First, most companies do not understand the economics of zero defections. Service improvements that result in higher rates of retention generate more return than investments in securing new tenants. The cost of refurbishing for an existing tenant falls far short of the commissions and remodeling costs involved in getting new tenants. An existing tenant continues paying rent, whereas a new tenant does not start rent payments until the remodeling is complete. In a nearly full building, the op-

FIGURE 1: TENANT RETENTION AND FOUR-YEAR NET CASH FLOW

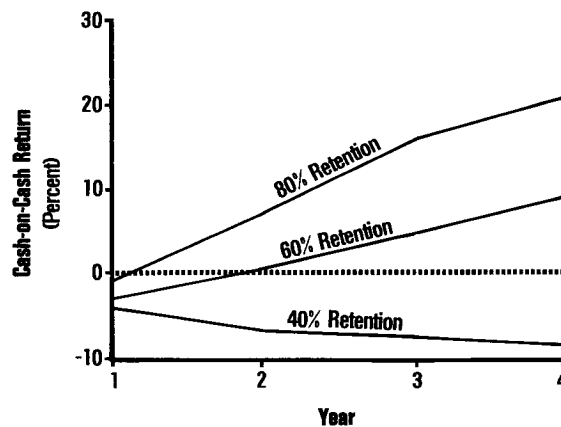


portunity cost of remodeling down time becomes significant. Retaining a tenant can produce savings equal to well more than half a year's rent.

Second, the landlord-tenant contractual arrangement encourages landlord neglect. For most commercial real estate, long-term leases are the rule. The tenant is held captive during the term of the lease no matter how bad the service delivered, short of the roof caving in or the utilities being cut off. Usually the landlord courts the tenant only shortly before renewal time, at which point the damage from previous bad service may be irreparable. If owners and managers called lessees *customers* instead of *tenants*, perhaps they would start thinking and acting differently.

In situations involving short-term or no contracts with the customer, real estate companies understand the importance of zero defections and make a concerted effort to provide continuous, high-quality service. Many apartment complexes fit into this category. Their commitment to customer service has produced a proliferation of value-added fitness centers and other physical amenities as well as management-organized social activities, outings, and entertainment. "Renter-tainment" is the term one major newspaper recently coined to describe such customer services.

FIGURE 2: TENANT RETENTION AND ANNUAL CASH-ON-CASH RETURN



The lodging industry covets the repeat customer. Companies such as Marriott offer exceptional customer service at all price points within a chain, and thus enjoy high customer retention rates. For hotels, success with customer service comes not only from the lack of captive contracts but also from their view of themselves as being in a service business, not in the real estate business.

And third, the structure of leasing compensation encourages large segments of the real estate industry to put more emphasis on obtaining new tenants. Leasing personnel and managers are wont to value existing tenants less highly than new ones, because commission rates for new leases usually are higher than for renewals and managers often receive fees calculated as a percentage of remodeling costs. These compensation formulas carry over from project development where they are appropriate as incentives to the all-important task of lease-up. However, they are counterproductive for building management. Managers should be most strongly rewarded for the retention of tenants as this represents the property's greatest profit potential.

Managing toward Zero Defections

In the real estate industry, managing that is geared toward zero defections is not hard. Tenants have built-in incentives not to defect, so unless they're pushed out by bad service they will usually stay, often even if they can get a better deal elsewhere and they are somewhat dissatisfied with the current location. Included among these incentives are the uncertainty of dealing with a new landlord, the cost of moving, the disruption of moving, and, for companies with walk-in business, the possible loss of customers.

In service businesses, the quality of customer service is the difference between what the customer expects and what she gets. Deliver less than expected and the service is bad; do what is expected and it is good; exceed expectations and it is superior.

Having usually received minimal levels of service from their landlords, most tenants have low expectations. Accordingly, a level of service that might be perceived as marginal in another industry may be deemed superior by real estate customers, surprising and delighting them. But landlords need to start their customer service programs when the first contact is made with the tenant and consistently administer them. Service improvements late in the game just before the lease is due to expire will have little credibility with tenants.

An owner committed to zero defections must give superior service. The first step is to measure defections continuously. Communicate to the entire organization the importance of achieving zero defections. Prominently display the results of the effort—the declining defections rate and the increasing profitability of the property—to staff, using

charts and graphs to make points clearly. What gets measured gets done.

Good property management is a basic requirement of the effort. Remember that managing toward zero defections is an investment, not a cost. Instead of letting an ordinary budget dictate what can and cannot be afforded, adopt a service delivery, maintenance, and repair program that is superior, and then formulate the budget to deliver that level of services. If keeping windows sparkling requires cleaning them six times a year, do it. The improved retention rate will more than offset incremental maintenance costs.

Superior customer service means thinking about the tenant as more than a legal entity. The people making up the tenant's company will influence strongly the lease renewal decision. Treat them as guests. Most of them spend 40 or more hours a week in the building, or more than 35 percent of their waking hours. Make their workdays more productive and enjoyable—with, for example, flowers in the lobby, good restrooms, an occasional late-day social function, a daycare facility, a driving range or putting green, a concierge.

Few customers complain—less than 4 percent, according to Washington, D.C.-based Technical Assistance Research Program. Tenants expect that their complaints will not be resolved satisfactorily or that the complaints they have are too minor to bother with. But even unvoiced complaints can build resentment to the point of causing defection.

Therefore, it is a good idea to collect information from current tenants as well as from defectors. Feedback from defected tenants tends to be concrete and specific, providing a perspective on the property that is unavailable to insiders. Learn why these tenants left and use that information to make changes that will improve tenant satisfaction.

Question existing tenants as well, probing for problems they perceive in current services and for what new services they would like added. Usually, informal discussions are better than questionnaires, and open-ended questions—"What single service improvement would make this property a better place for your business?"—are best. Follow up on valid suggestions for improvements. The very act of asking tenants for their input will be perceived as superior customer service, and if their suggestions and complaints are followed up with action, tenants, in effect, will become partners in the program to manage toward zero defections. ♦

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