Lessons from the Field

A Series of Asset Manager Interviews Conducted by Elaine Magil, TCAM/MRI

Commercial Asset Management in the Affordable Housing Sector
Shadow Morton, Mercy Housing

Shadow Morton is one of very few commercial asset managers working in the affordable housing sector. He oversees Mercy Housing's portfolio of commercial spaces across the country. In this detailed conversation, Shadow shares specific lessons he has learned about the unique challenges of commercial space asset management within the affordable sector.

The conversation has been edited for length and clarity.

EM: Is there anything you've learned from your work as a commercial space asset manager that you want to pass on to others in our sector?

SM: I came from affordable housing AM, so the biggest surprise was the variation in the leases. In affordable housing, there are maybe 1-2 types of leases, depending on the program. In commercial, if you've got 5 spaces you could have 5 different leases. I thought I was going to be so smart and come in and standardize everything: what's this triple-net, gross, modified gross?! I thought I was going to standardize it and just do one lease. Boy was I wrong! The sheer mass of variations makes tracking difficult. We eventually mostly settled on one template for triple-net and one for (modified) gross, and we have two types within that: retail or services business.

Know the variety of kinds of tenants you might end up with. For instance, I enjoy restaurants but I never thought about what it takes to run them. Think about what kinds of equipment they have. Maybe, "OK, you've got these huge hoods and fire protection systems with them - who's responsible for checking it if the tenant vacates?" We never thought about that before, but if those systems aren't certified regularly, you have to remove them. If something falls on us as the owner, we have to be sure our staff knows that.

Office space? Easy as pie. Regular retail is usually pretty easy. The biggest thing you'll have with regular retail is that they tend to be targeted for vandalism a bit more. Restaurants are high impact, and I don't think people realize the extent of that – the world of plumbing is really endless. With restaurants, you have to hydro-jet your sewer laterals far more frequently, which is expensive. You can make physical investments in equipment like grease interceptors and a sump pump to move it along, but those are costly.

We had one instance where the property was paying for a lot of infrastructure maintenance that was supposed to be the tenant's responsibility but no one noticed, or maybe we just didn't fully understand the terms. Until we started managing it, it wasn't happening in line with what was agreed and we took on costs that we shouldn't have.

When you get into commercial AM, make sure you understand the legalese. Have a legal team who knows commercial, who can build you a good lease, and help out if things go bad in the lease or in the relationship. In residential, I never ever thought about the terms because it's all so standard. In commercial, sometimes I'd put terms in the lease and the lawyers would come back and say, "you can't do that!" So, if you're new to commercial, sit down with someone knowledgeable so you understand everything going into the lease. They'll be done one-by-one, not like LIHTC tenants, and they need to get approved one-by-one.

EM: Even just the idea of buildout, right? We don't do that in residential leases at all.

SM: The tenant improvements stuff is complicated, yes. For us, Development deals setting up for the initial tenant, but when the tenant turns over, I oversee it. Buildouts can be really easy, like just new carpet and paint, or it can be really complicated, like installing entire HVAC systems. For instance, we have a veterinary clinic moving in right now and they have a big imaging machine, so we need to be sure that the concrete slab they're pouring will be sufficient for that weight, and we need structural engineers and architects involved. When it's really complicated, we usually have the project manager from Development chip in.

EM: Is there also complexity on things like bookkeeping and administration?

SM: Taxes can be a bit complicated, sure. On triple-net leases you have to track a lot of things, like the tenant's portion of the taxes. If they're a nonprofit that can affect your tax exemption/abatement. If they're not, you've got to carefully calculate their pro rata shares. You might have to quibble a bit about them paying a portion of the building insurance. If there's building-wide janitorial or maintenance for common areas, they'll pay a portion of that. If the utilities for the common areas aren't on a separate meter, you have to calculate pro rata shares of that.

EM: Even just deciding what the right pro rata factor is could be complicated, right? A law office and a restaurant might have the same square footage but very different intensity in terms of their water usage, for instance.

SM: Sure. If they're submetered, their space is fine and you just have to calculate for common areas. But some older buildings won't have submeters. In those cases we have to look to a comparable business or maybe watch the tenant's actual usage for a while to set a baseline. We've learned to sometimes put in the lease that there'll be a re-negotiation on utility use after some number of months. There are other examples, like sometimes we want to say the commercial unit can only access shared cold water and has to install its own in-line hot water, since hot water is much more expensive than cold water and the demand can affect our boilers.

EM: How does asset management work where there's a commercial space in a residential building? Someone else is the asset manager for that property, but then you watch the commercial piece?

SM: There can be a challenge with how hands off an asset manager should be in those cases. I'll ask them, "do you want me to have access to the reserve money as well? If not, and if we don't have a designated commercial reserve, then we'll need to communicate frequently about which of the building's reserve dollars go to what." Property budgets combine residential and commercial portions, and asset managers are responsible for the whole property budget. I'll bring information about the current and anticipated rent levels, when leases expire, plus when annual increases come in and how to calculate them on rent, maintenance (CAM), and taxes. Sometimes I'll ask the property's asset manager, "are you OK with me giving this tenant a rent reduction? Because they're really struggling."

We're seeing a trend with lenders sometimes wanting more assurance and so we're doing things like master leases. But the impact of the commercial space can't be totally cordoned off, because – even if the building assumed $0 of revenue – there will be real utility costs to the building. Plus, there's a single tax bill for the property and I may have a complicated calculation to do in terms of what entity is paying or reimbursing what piece, but the residential asset manager has to get me that bill, and it might not really be on their radar to do so.

EM: Have you seen any regional differences, since you have properties in several parts of the country?

SM: It's more about municipal variations, not regional. Some cities, even some suburbs, have complicated permitting rules and that affects us because it can take so much time, especially if you need building inspectors, to get everything ready to go. We've had cases where we've had to release someone from their lease after a year because they'd been unable to get all the permitting through. That can be hard on small businesses to navigate. They don't have an army of lawyers and accountants to get them set up. So even if it would be easier on us to lease to big companies, Mercy extends our mission to the commercial space. We want to support those small mom and pops. Some of our spaces are actually businesses run by tenants in our residential units.

EM: Are there things that the Development team can do to make commercial asset management run smoothly?

> ***Insight****: Just as residential leases are way more standardized than commercial, the way that commercial tenants interact with their physical space and the demands they place on that space is also way more varied. And you have to set your contracts up to capture that.*

SM: Over time, we've built up a whole set of how to build things in certain ways and we can just give this set of specs to the commercial developer who's going to find the first tenant and tailor the space to that business. So we attach this whole outline of information to the commercial developer's lease that says: here's what we've done to that cold shell, here's the shaft for your hood, here's space for any conduits you need to run up to the roof, here's a stub-out for the sprinkler system, if it's a post-tension slab we've inserted hangers so they can hang the HVAC rather than have to drill into the building, and so on. We've learned a lot of this stuff from having looked at what we were making and losing money on in the past.

EM: How have you used information systems in your work?

SM: For tracking, SharePoint has been great for making lists and notifications. You can set up workflows and notifications to tell you, for instance, "hey, the insurance is about to expire." Yardi can do some of this as well, though it's not as good for the one-off items. So when a new commercial space is coming on line now, we do one of these *relatively* standardized leases and then set it up in SharePoint, almost like an asset management database, to have it sort of "remind me when this is coming, remind me when that's due." Data tracking is important and the other asset management data systems we have don't always capture what I need. I really encourage people to not scrimp on the data systems piece, don't be penny wise and pound foolish.

EM: Has COVID changed anything?

SM: It's tripled my workload. When COVID hit, I did research and really had to think about whether we want to take a big hit now – quickly writing down leases if people asked, to try to help keep them in business – versus holding rent steady but risking the businesses going under. But then we'd be trying to re-lease a bunch of vacant spaces when all this is over, in an environment where there's fewer people starting businesses and more vacancies everywhere. Even some businesses with subsidized revenue, maybe a contract to provide adult day care services for the City, are struggling as well. So now I'm doing a lot of analysis on, "here's the cost if we do the rent reduction now and keep it there until mid-2021."

We can think then about how the recovery is looking and whether they're ready to have their rent moved back up. All that, versus if we assumed we lost 50% of all our tenants, plus the additional costs we'd have in buildouts for tenants whenever we could turn over those units. I don't think we're in the clear yet, even now. I think the full impact of some of these tenants that have contracts for their funding will hit us next year. We've even had a lot of windows smashed, not associated with protests but vandals – more people are out on the streets and they're starving. So we need to also think about additional costs associated with boarding up windows on some of our properties.

TIP: If you don't have a specialized asset management and you know that your organization doesn't have the skillset for commercial asset management in house, start by finding a vendor for specialized commercial property management. It's not the same as commercial asset management of course, but they know a lot, and there are vendors available for that work.

EM: Any other parting thoughts?

SM: Don't be shy about reaching out! I don't know of a lot of other commercial asset managers in affordable housing, but I reach out to people through our developer partners. We've built up good relationships with commercial management companies. If an affordable housing organization figures out that they really do not have the people power in house to do this commercial space asset management stuff, they should go look at companies that have a commercial management or maintenance arm. Reach out to brokers to get stuff like market comps. Don't reinvent the wheel. Brokers can be very helpful to find experts of various kinds and to get spaces filled. Leasing commercial spaces is a people-person role, it's sales and marketing. That's not my skillset, so I look to brokers. In commercial spaces, you have to go looking for tenants, and that's different from in affordable housing where we have waiting lists. And you have an incentive for those businesses to do well, especially on a triple-net lease.

Also, know that even Mercy, we're really big and we've had commercial space for a long time, but my role didn't exist until 5 years ago. It took us a while to get to a place where it made sense to have a specialist in place. So if you feel like you're too late, it's not too late!

Shadow Morton was a nomadic jack-of-all-trades before joining Mercy Housing Management Group in 1997 as Property/Maintenance Manager. Having experienced homelessness himself in his twenties, he drawn to the company's mission, and now lives it. After additional management and supervisorial roles over the next 10 years in management, Shadow moved into an Asset Management role. In 2015, he took on the task of organizing the Asset Management of Mercy Housing's burgeoning commercial portfolio. A love and respect of history combined with 23 years of affordable housing experience has informed his navigation of the initial Covid-19 shutdowns. Smorton@mercyhousing.org

Mercy Housing, Inc. was born in 1980-81 by the Sisters of Omaha and has grown to become one of the nation's largest affordable housing companies in the U.S. And while Mercy Housing has played a role in creating more than 48,000 homes in the past 40 years, its employees and leadership know that the need for even more housing remains. The people who are the lifeblood of the organization come from all walks of life and are proof that with a common goal of decency, humans can get along and make good things happen.

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