

Mitigating Conflicts in Traditional Real Estate Brokerage:

Conventional wisdom might suggest office and industrial occupants possess a competitive advantage in today's real estate market. After all, corporate consolidation, relocation and downsizing have left vacant thousands of rentable square feet in both multi-tenant and owner-occupied buildings. Consequently, vacancy rates remain high throughout most of Northeast Ohio and most of the U.S. with no immediate end in sight.

Despite this, businesses seeking to relocate, expand or merely renew a lease still face a significant *disadvantage* due to serious conflicts of interest between occupants and their tenant and buyer representatives. These conflicts emanate from the traditional real estate brokerage compensation model that was specifically established to maximize property owner profits.

Prior to the last 15 to 20 years, brokers were only legally permitted to represent property owners (i.e., sellers or landlords). Accordingly, they were paid on a contingent basis to motivate the quick closing of a transaction and hence accelerate a property owner's revenue generation. Further, commissions, based on the total consideration of the deal, encourage negotiation of the highest rental rate or sale price, the most square footage or acreage and the longest lease term – usually in direct conflict to the occupant's objectives. Commissions also discourage brokers from pursuing valuable tenant options, such as termination rights, which often result in the deferral of portions of the commission. While such commissions clearly align the interests of the owner and its listing agent, it is the occupant who often disproportionately overpays for limited service with reason to question its agent's advocacy.

Real estate brokerage laws in Ohio and most other jurisdictions have changed since the 1980s to permit brokers to serve as agents of buyers and tenants in an effort to reduce the confusing practice of co-brokerage (in which listing and procuring brokers are both agents of the owner). Yet *compensation practices have generally not adapted to this change*. Brokers are still typically paid by owners based on terms of a deal, even when "representing" the other side of the table.

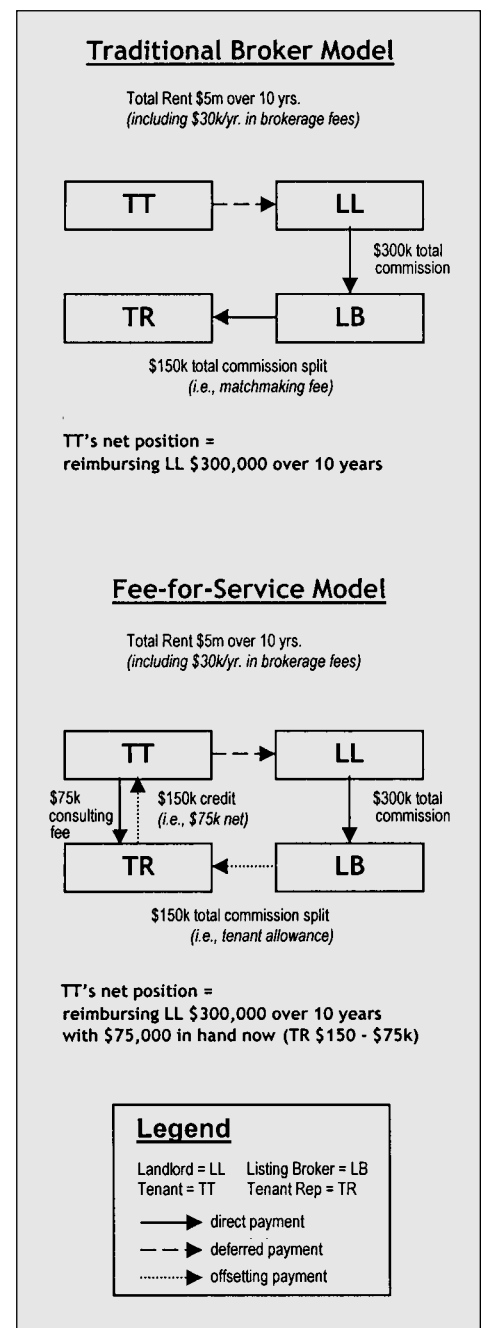
How Fee-for-Service Approaches Can Level the Playing Field

To add insult to the occupant's injury, the risk/reward scenario inherent in commissioned business models promotes further imbalance. For example, it is not uncommon for a broker to work on 10 assignments in which two or three ultimately result in brokerage fees. To compensate for time invested in all 10 clients, the occupant whose deal closes may pay three to five times the value of the service provided. Diverging even farther from a fee-for-service concept, a 5,000 square-foot transaction involves nearly the same amount of time and effort as a 50,000 square-foot requirement. Yet the latter generates 10 times the buyer/tenant rep commission of the former. Conflicts do not merely exist at the brokerage firm level. Most real estate agents are independent contractors who are personally paid by the brokerage on a contingent basis. The ultimate conflict of interest exists in your direct contact's wallet.

The result: Occupants significantly overpay (typically as part of the purchase price or rent) and, notwithstanding this high cost of service, can legitimately question whether their "representative" delivered comprehensive services aimed at achieving their best interests.

The Fee-for-Service Value Proposition

Corporate executives, directors and shareholders have a right to know precisely how their dollars are spent and the value received in return. Accordingly, the time has come for occupants to receive real estate representation from advisors who align their interests through compensation structures and provide zealous advocacy for their clients, much like the well-established expectations of the legal field. Today, corporate real estate consultants fill this need with more comprehensive services that may include strategic planning and development consulting; site selection and economic incentive procurement; and real estate outsourcing and transaction implementation. Alternatives to traditional brokers should be sought to engage equally qualified transactional



capabilities and experience but remain free from conflicts of interest.

The means by which real estate consultants are compensated generally falls under one of four categories:

- 1. Time and Expenses:** When the scope of services is difficult to estimate (such as the twists and turns involved in negotiation processes), clients pay hourly rates only for the volume and level of service needed.
- 2. Fixed Fees:** When the scope of services can be accurately estimated (such as conducting market surveys or financial analysis), fixed fees buy services for a predetermined scope.
- 3. Fixed Monthly Fees or Retainers:** Corporate clients who possess large portfolios and/or ongoing real estate needs are able to gain direct access to a variety of capabilities as various needs arise through ongoing monthly arrangements.
- 4. Success Fees:** Best used as second-tier compensation, success fees enable clients to structure incentives to achieve stated objectives. These may be economic, such as a percentage of savings based on an agreed-upon threshold (e.g., lease audits), or they may be based on achieving certain deal points, such as renewal and termination options.

Compensation Strategies Based on Program Requirements

The method by which a client chooses to compensate a real estate consultant should depend on the scope of work to be performed. For a typical office relocation engagement, it often makes sense to establish phases and then structure different fee arrangements accordingly. A tenant representation project such as this usually begins with a transaction strategy, or needs analysis, phase. This can be performed under a fixed fee, since time estimates for the associated tasks are fairly straightforward. Likewise, research and surveys lend themselves to fixed fees. However, fixed fee arrangements tend to be overly risky for a consultant when third parties are introduced into the process. Therefore, a time and expense structure makes more sense when entering the negotiation phase of an engagement. At that point, specific lease and occupancy objectives should have been defined during the needs analysis, which then become the basis for structuring success fees that align the objectives of the client and advisor. While different phases or types of projects may drive alternative fee structures, a clear understanding of decision points and their impact on compensation approaches is necessary.

Leveraging the Commission

By retaining an experienced real estate consultant, the client compensates its advisor directly and hope-

fully structures compensation that balances and aligns the interests of both parties. But what happens to the commission due to the procuring broker upon the completion of a transaction?

A real estate commission is either amortized over the term of a lease or built into a purchase or lease price. Ultimately, occupants pay these fees, but do they derive any benefit from that money? The answer is a resounding *yes* – provided they utilize a consultant with transactional capabilities. Such an individual may claim the procuring broker commission (often *exceeding* the consultant's direct fees) and address the best way for their client to benefit from it (e.g., free or reduced rent, tenant improvement and moving allowances or, if appropriate, a credit or rebate against consulting fees.) But do not think of this as discount brokerage since the client receives more than the comfort their advisor is a true advocate. Additionally, the client often taps into a broader set of services and unhindered access to the capabilities of all the advisor's salaried staff.


Selecting A Real Estate Advisor

Whether you are serious about completing a transaction or simply want to explore options in the market, seeking unbiased real estate advice makes good sense. Occupants who commit themselves to completing a transaction are better served by having commission dollars credited to them as opposed to paying a broker several times the value of services provided. Conversely, those who aren't as sure should consider paying a consultant directly to deliver objective advice about the implications of their options. Sometimes, the best course of action is to stay put; however, the inherent nature of contingent compensation provides incentive to a broker to promote a transaction that may not be in the best interests of the client.

Regardless of the outcome, a consultant who offers objective information has provided value to the client. If, for example, a needs analysis is performed, the corresponding data can help direct organizational planning well into the future. If a client pays for market research and then decides not to move, he or she retains important information that can support renewal negotiations or guide future decision making. In all cases, the client receives reliable service commensurate with fees paid.

Before engaging a real estate service provider, ask hard questions and demand specific answers. Below are some broad areas to consider during the selection process:

- **Process Overview:** Get to know the ins and outs of how different real estate transactions affect compensation - how and how much brokers and individual associates are compensated for different properties and roles in a project.

- **Proposed Scope of Services:** Obtain a specific breakdown of what services or phases will be performed, the anticipated work plan, schedule, outcomes and impact on your ultimate goals.
- **Organizational Overview and Team Structure:** Understand how the service provider's organization is structured, who will do the work, who ultimately is accountable for the quality of the work and how team members are compensated individually. Again, the individuals who work on your project especially should have their interests squarely aligned with yours. It's critical to know up-front who will represent you in working with architectural, engineering and construction personnel before and after completion of the transaction. You should feel comfortable that your consultant will help you reach conclusion with every point related to occupying the space. Also, you need to know if the best qualified individuals in the firm will be available to you and whether this impacts your primary contact's compensation.
- **Qualifications:** Always ask for team member biographies, client case studies and references.
- **Fee Structure:** Obtain a detailed itemization of anticipated fees and costs up front. The consultant should clearly articulate the method, amount and timing of compensation. If they are paid a commission, request an hourly work plan to evaluate your costs.
- **Conflicts Disclosure:** Ask about property owners represented by the broker as well as their other buyer/tenant assignments that may compete with you for properties satisfying your needs. 



Michael L. Cantor is a principal with Allegro Realty Advisors, Ltd., in Cleveland. He serves corporate, real estate industry and public sector clients through management and development consulting and portfolio management.