

**COSTS
 AND SERVICE CHARGES
 IN OFFICE PROPERTIES
 2011-2016**

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Knight Frank is part of the Knight Frank Group, the leading international real estate advisory. We have more than 26 years' of experience on the real estate market in Poland. We manage a portfolio of over 80 office and office-retail properties with a total area of 1.4m sq m, as well as a portfolio of industrial and warehouse properties. We have chosen 38 A/A+ class and B/B+ properties located in Warsaw, Poznan, Cracow, Tricity and Lodz as the subject of the costs and service charges analysis. The analysis encompasses the years 2011-2016.

Office and retail space leasing in commercial properties is linked to the necessity of carrying the costs for the owner which include: rent, service charges (often referred to as additional rent) and media expenses. The amount of the rent and service charges as well as the method of reconciling media expenses are usually regulated by the lease agreement. The service charges and media expenses carried by the tenant cover all operating costs of the owner to maintain the property. Additional costs such as costs borne to complete and finance a project, modernize or renovate in order to maintain or raise the property standard, costs of acquiring new tenants and arranging the space to their needs, administrative costs or costs resulting from individual tenants' requests are costs of the owner.

SERVICE CHARGES

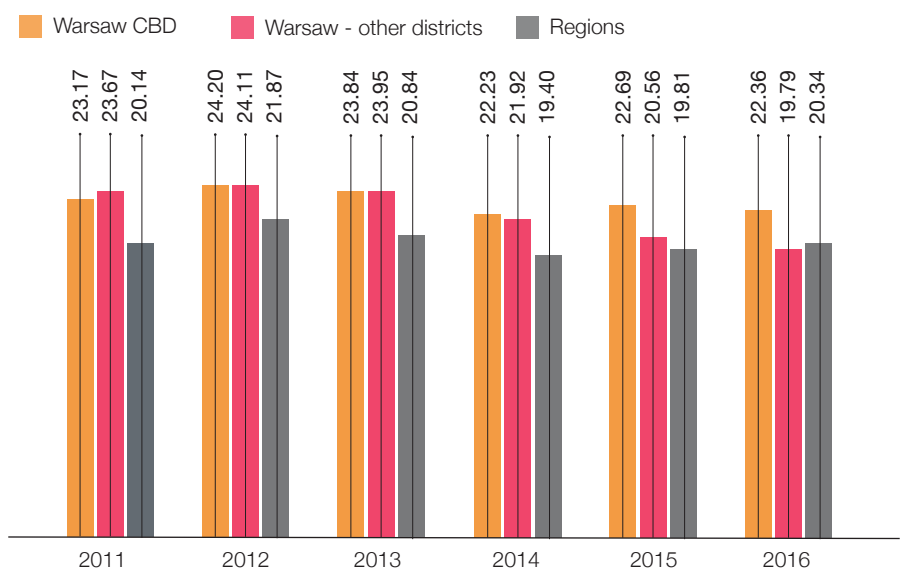
Service charges include costs carried by the owner for the ongoing maintenance of the property. The lease agreement usually defines the costs which may be covered via service charges. The list, however, is rarely closed. The amount of the service charges calculated per square metre of the leasable area depends on many factors. These include i.a. the technical advancement grade of the property, its geographical location, the lease area, the land ownership form and many others.

1.

INFLUENCE OF THE PROPERTY LOCATION ON THE AMOUNT OF SERVICE CHARGES

Regardless of the property's location within the city, service charges in Warsaw are significantly higher than in regional cities. The difference results mainly from the land ownership form. In regional cities the land ownership law prevails, while in Warsaw only some 1/3 of the owners disposes proper ownership law. The annual charge for perpetual usufruct is a key factor which raises the service charges.

Chart 1. Average amount of service charges in the years 2011-2016 (PLN/sq m/month) depending on property location

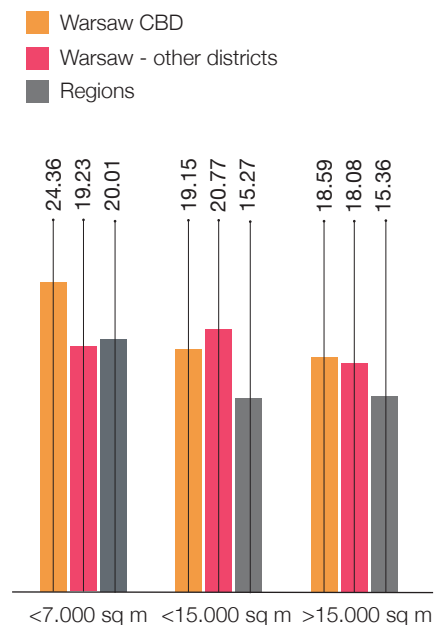


2.

INFLUENCE OF THE BUILDING SIZE ON THE AMOUNT OF SERVICE CHARGES

An important element influencing the amount of service charges is the building size and, what follows, the size of the leasable area through which the operating costs are divided. In Warsaw's Central Business District properties with an area below 7,000 sq m have to pay a high annual charge for perpetual usufruct. On the other hand, medium-sized properties located outside the Central Business District have higher operating costs due to parking spaces with additional security and free-standing properties which raise the property tax.

Chart 2. 2 Average level of service charges in relation to office building size (PLN/sq m/month)



3.

COMPONENTS OF SERVICE CHARGES

Service charges consist of the following cost groups:

- MEDIA CONSUMPTION
- FACILITY MANAGEMENT
- PROPERTY MANAGEMENT
- SECURITY AND RECEPTION
- COMMON AREAS CLEANING
- INSURANCE
- TAXES AND PERPETUAL USUFRUCT
- OTHER SERVICES.

In the years 2011-2016 in Warsaw and regional cities the share of particular cost groups was formed as follows:

Chart 3. Service charges – average share of particular cost groups (in the years 2011-2016)

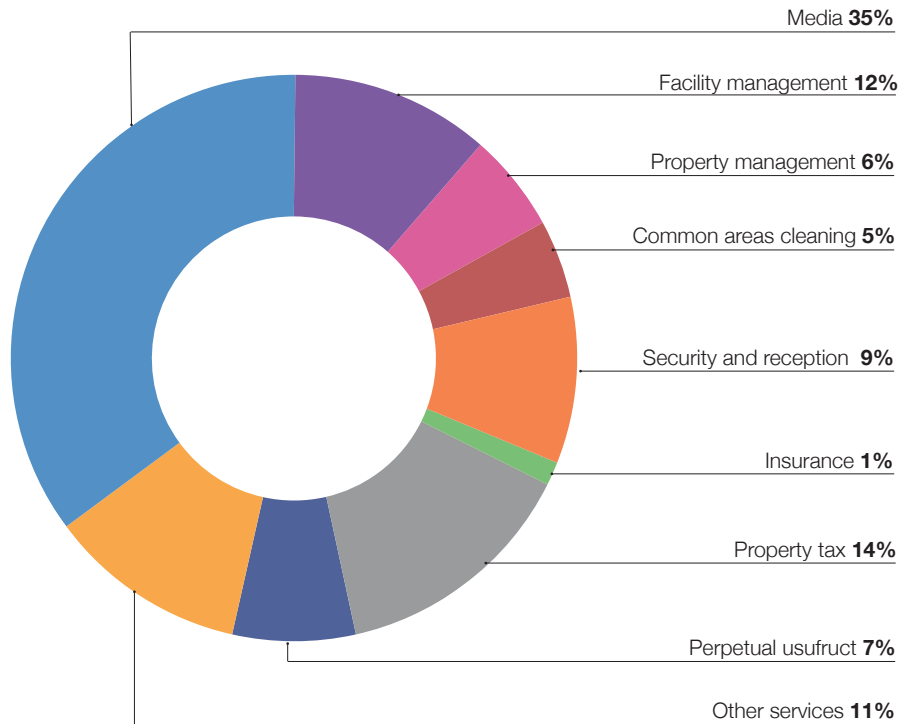
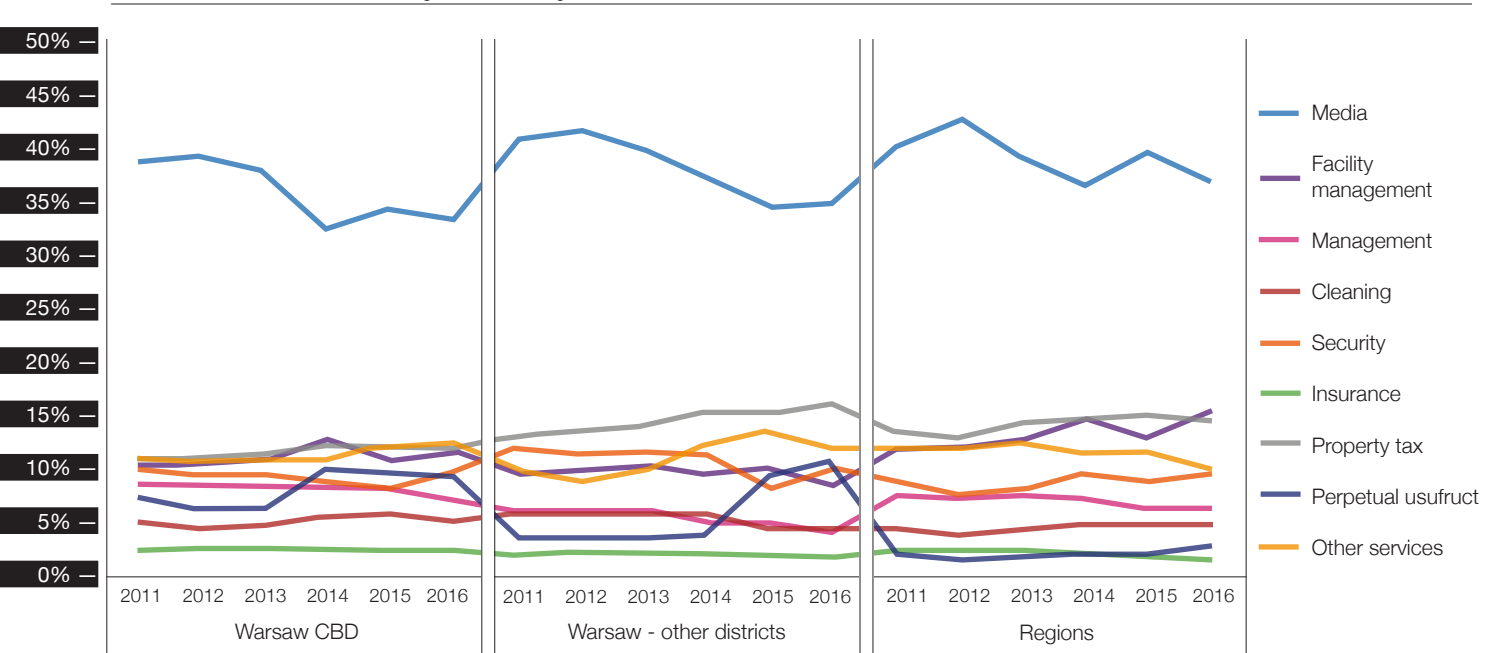


Chart 4. Share of particular cost segments according to type in years and location



4.

SERVICE CHARGES ANALYSIS DIVIDED BY GROUPS

MEDIA

The group includes consumption costs of electricity, heating, gas, water usage and drainage and sewage costs.

Media consumption costs form the bulk of the service charges. It is a custom to separate them from the operating costs and invoice tenants individually. Since the buyers were given freedom in choosing their electricity and gas providers, owners, property managers and tenants negotiate buying electricity by using the scale effect. The cost of electricity depends on the portfolio size, negotiation strength and stock market price on the day of the agreement execution with the provider.

Chart 5. Average media consumption costs in the years 2011-2016 (PLN/sq. m/month)

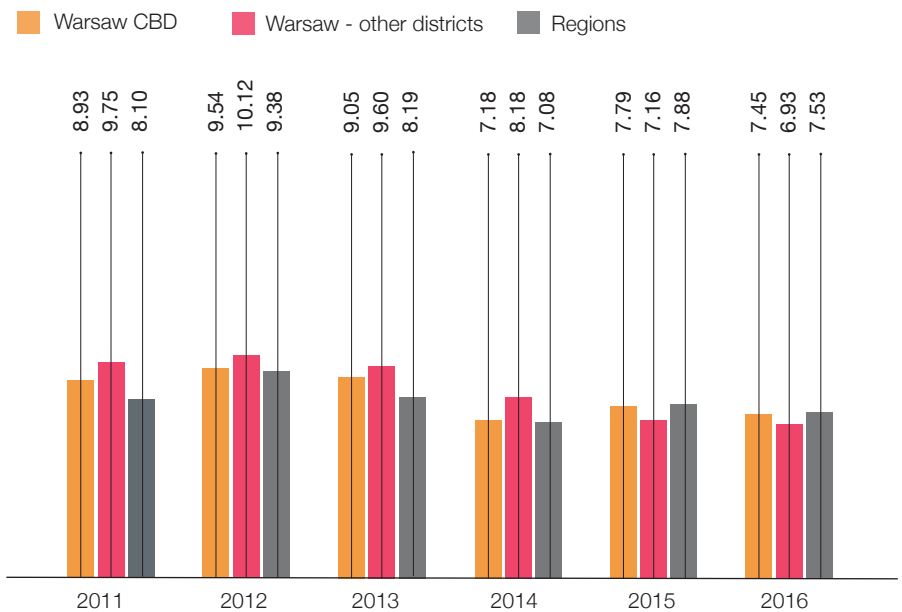
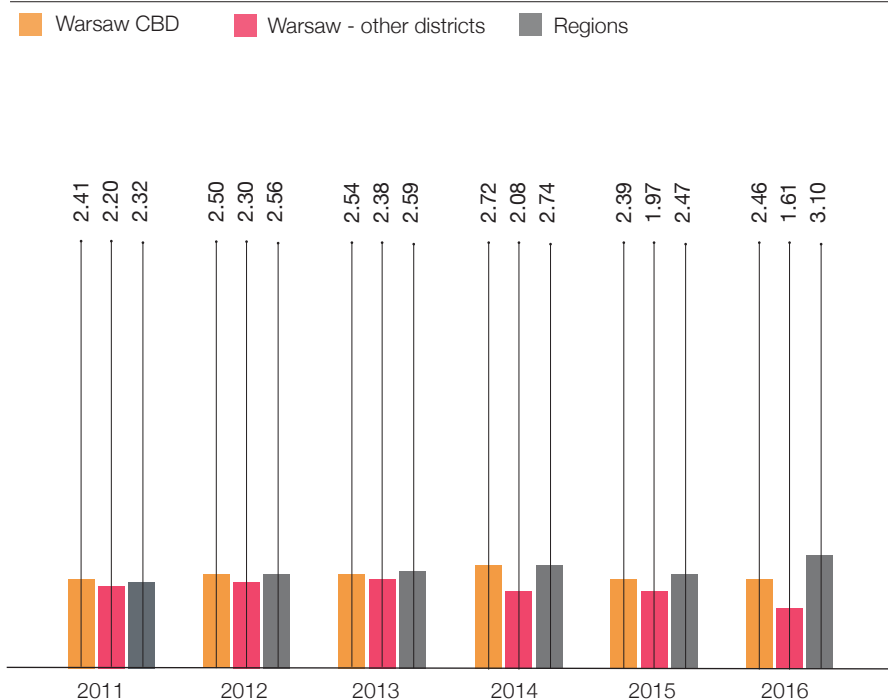


Chart 6. Average technical service (FM) costs in the years 2011-2016 (PLN/sq. m/month)



FACILITY MANAGEMENT

This group includes facility management (permanent facility management team onsite and/or mobile service), technical installations and elevator maintenance. Technical maintenance of all installations is usually handed over to a single company, excluding elevator and escalator maintenance, which is commissioned to specialized entities.

The amount of facility managements costs per square metre of leasable area in the Central Business District remains on a comparable level. On the other hand, in regional cities the lack of qualified facility managers can still be felt, resulting in the constant growth of facility management costs.

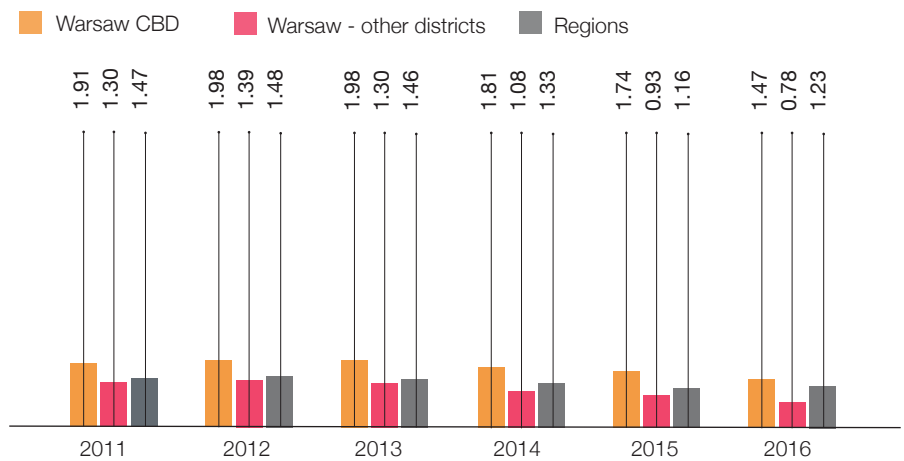
PROPERTY MANAGEMENT

Property management in Poland is a term far wider than in Western European countries. In Poland, property management includes all ongoing activities necessary for the efficient and safe functioning of the property and the reconciliation and rent & service charges collection. All services related to property management are usually handed over to a single entity.

Property management does not include bookkeeping services of the special purpose company.

The monthly charge for property management is usually defined as a set percentage of the invoiced rent income, excluding the provided discounts. The decrease in rents and the rise of vacancy ratio result in the lowering of property management costs per square metre of leasable space.

Chart 7. Average monthly property management in office buildings in the years 2011-2016 (PLN/sq m/month)



COMMON AREAS CLEANING

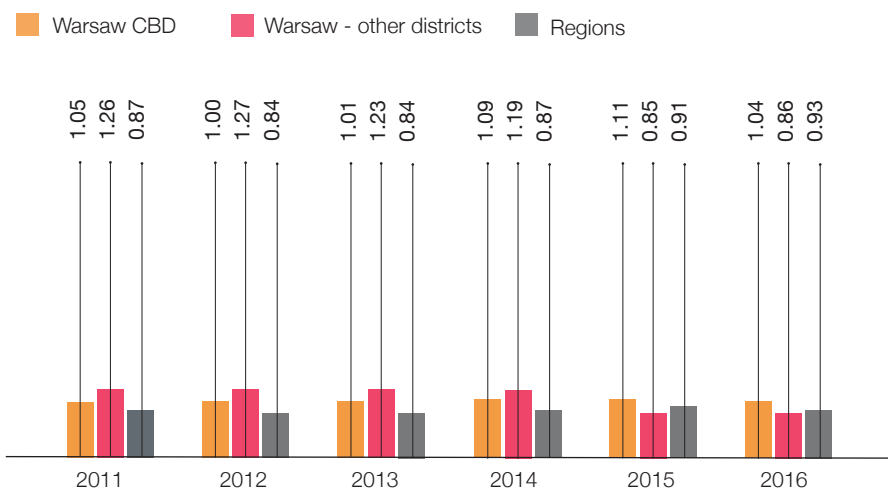
Common areas cleaning includes the cleaning of common areas accessible inside the property including the car park and maintaining the area around the property. The costs also include buying the necessary cleaning materials.

In modern office properties common areas (excl. car parks) amount from 3% to 7% of the total building area, which significantly influences the amount of cleaning costs.

The cleaning cost calculated per square metre of the property largely depends on the building structure and division of lease

modules – the more divided the lease structure is, the higher the costs. A major element is also the total size of the area around the building and car parks as well as additional cleaning areas i.e. the common driveway.

Chart 8. Average common areas cleaning costs of office properties in the years 2011-2016 (PLN/sq m/month)



SECURITY AND RECEPTION

The services include reception services, open usually during office working hours, the constant presence of security staff and mobile intervention patrols. The security headcount onsite depends on the property size and its plan. Usually during evening hours, there are two security employees present. Due to safety reasons, security services are handed over to one specialized and licensed provider.

Due to their high costs, security services are supported by CCTV, tripods/entry gates, magnetic cards and sensors.

Chart 9. Average security costs in the years 2011-2016 (PLN/sq m/month)

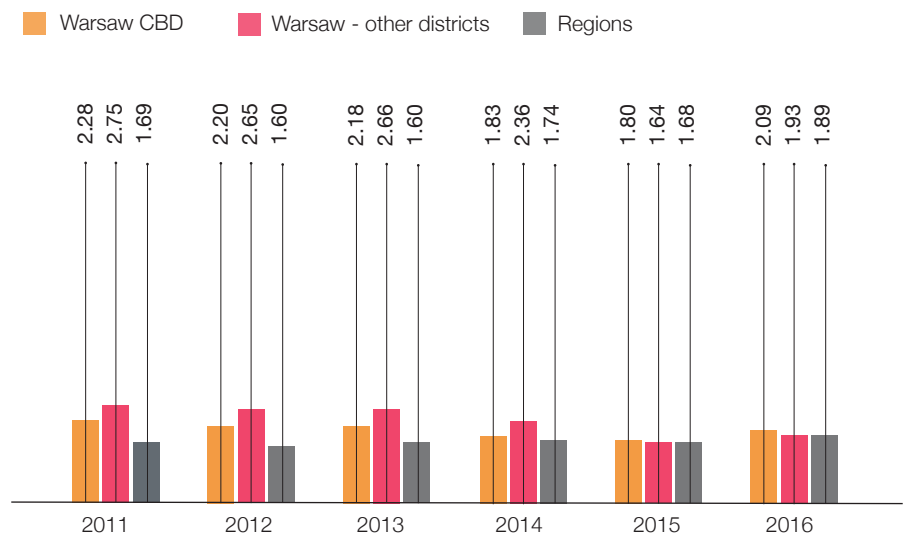
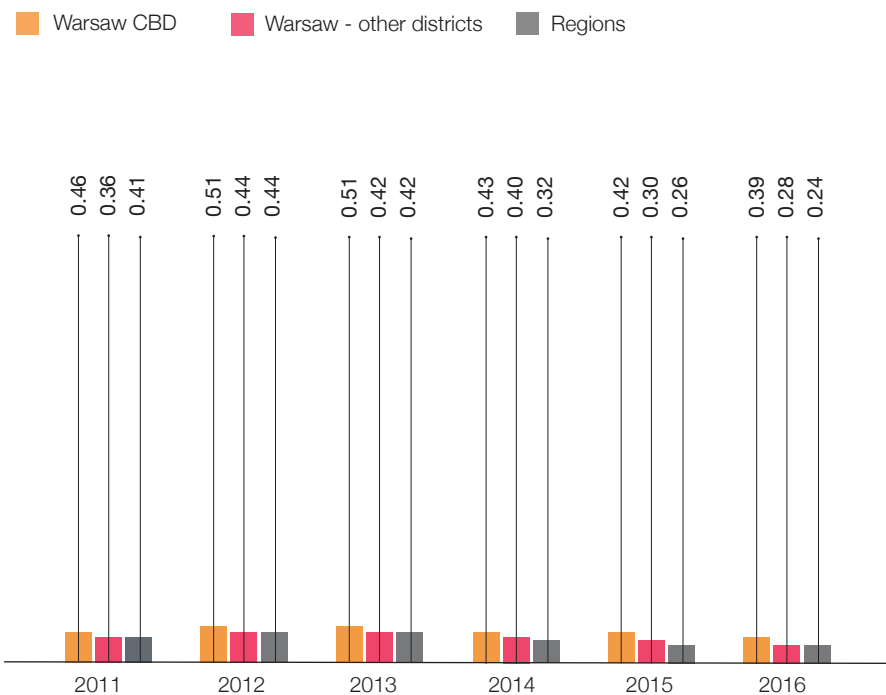


Chart 10. Average insurance costs in the years 2011-2016 (PLN/sq m /month)



INSURANCE

Insurance costs include annual charges for property insurance in full scope and property liability insurance. The lease agreement defines, if the insurance also covers property insurance from loss of rent and terrorist attack.

Property insurance is negotiated directly by the property owner or the property manager. What decides about the amount of the

insurance cost is i.a. defining the franchise level for particular events. Negotiation options for the charge amounts depend on the portfolio size of the owner or the property manager.

CHARGES AND TAXES

This cost group includes the property tax, the lane occupation fee in order to place the building overhang and annual fees resulting from perpetual usufruct.

PROPERTY TAX

Land, structures or parts thereof related to conducting business activity and edifices are subject to taxation. Basing on the provided data and rates published by regional governments, the owner calculates the amount of the tax due in each calendar year and submits a declaration.

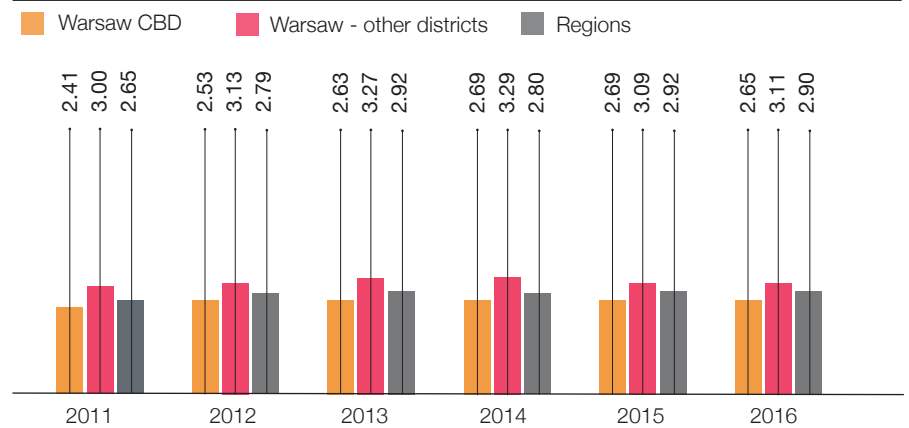
The Ministry of Finance publishes the maximum rates for particular tax components, while counties publish the rates applicable in their borders.

A higher tax rate for properties located outside of the Central Business District results from properties located on larger plots – external car parks, pavements, ramps, streetlights, trafo stations etc. Such properties are not present in the centre

of Warsaw, due to the maximum property density on the plot.

Charges for lane occupation in order to place a building overhang are placed upon the submission of the landlord. The appropriate office defines the applicable rate.

Chart 10. Average property tax costs in the years 2011-2016 (PLN/sq. m/month)



ANNUAL PERPETUAL USUFRUCT CHARGE

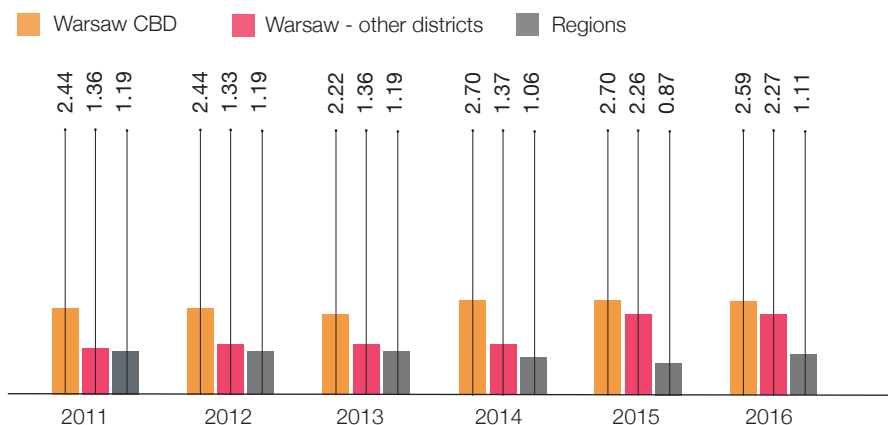
Perpetual usufruct law is a form of managing land used in the Central European countries. Within the property portfolio under Knight Frank's management, some 60% of owners in Warsaw use this law. In regional cities, the number amounts to only ca. 40%.

The amount of the annual charge is 3% (for land used for commercial purposes) of the land's worth as defined by the plot owner, which in this case is the National Treasury or a regional government unit (community, council, voivodship).

In Poland, it is common practice to include the annual perpetual usufruct charge in the operating expenses.

The land's worth is subject to a periodical update, not more often than every 3 years. The cost is excluded when the owner is also the legal owner of the land.

Chart 11. Average annual perpetual usufruct charge in the years 2011-2016 (PLN/sq. m/month)

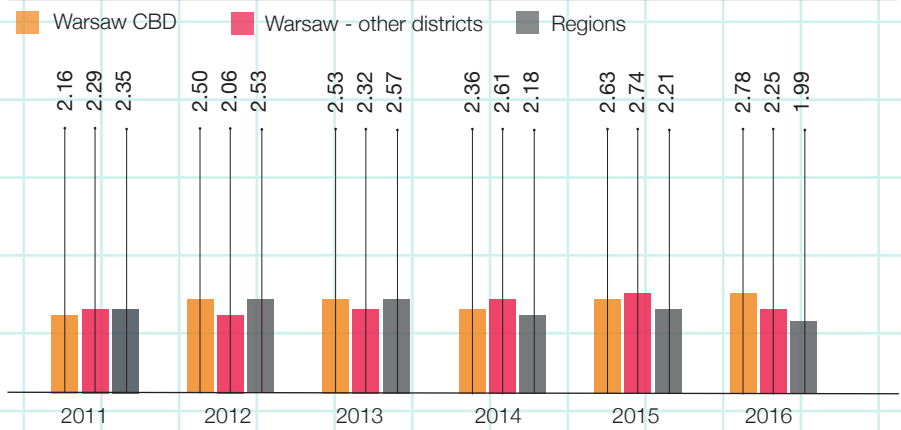


OTHER COSTS

This is the most varied costs group as it depends on the property and service agreements. It includes cost such as: repairs and ongoing refurbishments, spare parts, chosen system maintenance, technical control office inspections, annual and 5 years construction reviews, carpet rentals, pest control, seasonal decoration, green area maintenance etc.

The above costs are often unequally distributed in time (5-years inspections) and difficult to estimate beforehand (snow removal). They are also very hard to compare.

Chart 12. Average property tax costs in the years 2011-2016 (PLN/sq m/month)



5.

SERVICE CHARGES VS OPERATING COSTS

Lease agreements usually oblige tenants to carry all operating costs. The form in which the costs are carried is defined by the lease agreement.

Depending on how the lease agreement is constructed, the tenant pays for:

- Service charges
- Media consumption

Lease agreements also include a list of operating costs covered by the service charges. The list is usually open and includes all ongoing property maintenance costs. Media are excluded from the list.

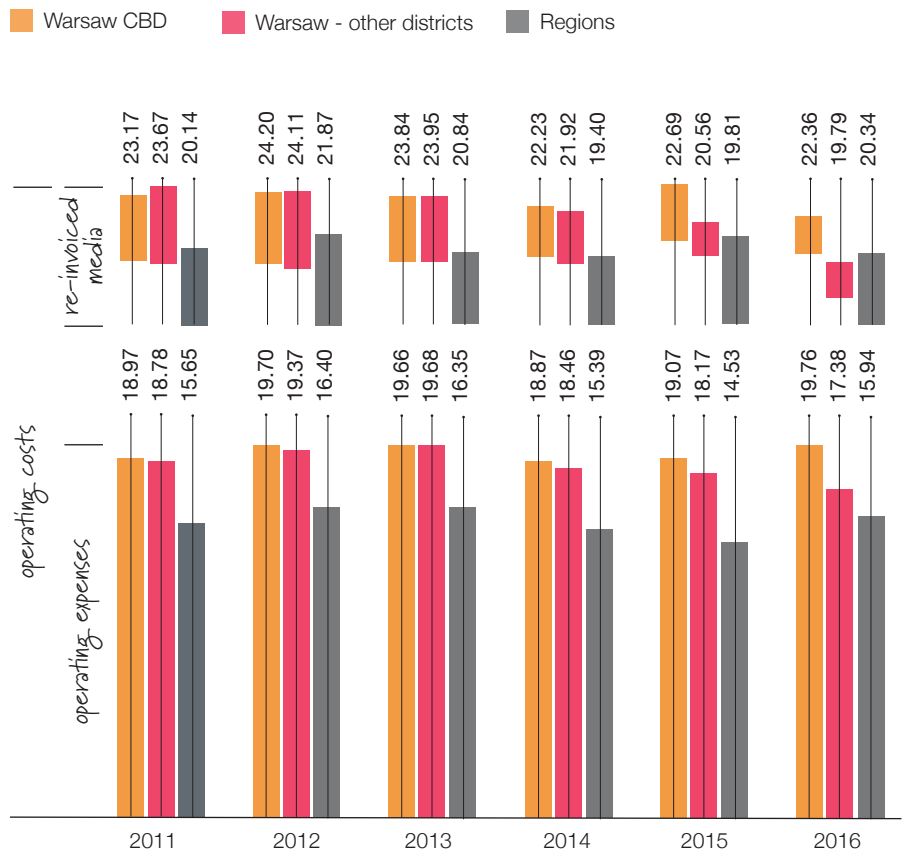
The media consumption costs are divided between the tenants in full or in part according to the rules set out in the lease agreement. Invoicing is based on direct consumption measured by individual meters or by an algorithm based on the relation between the occupied space, room dimensions and devices installed on the premises. Particular lease agreement clauses allow to exclude even up to 100% of media consumption costs from service charges. It is an important element which shapes the final cost. Lease agreements allow tenants to control how much they pay. The most frequently used clause is the right to audit – after the ending of the fiscal year – the correctness of the reconciliation and legitimacy of the carried service charges.

Another frequently used clause is to limit the raising of service charges which depend on the owner to a given percent on a year-to-year basis.

Table 1. Level of service charges in the years 2011-2016 (PLN/sq m/month)

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|--------------------------|-------|-------|-------|-------|-------|-------|
| Warsaw CBD | 18.97 | 19.70 | 19.66 | 18.87 | 19.07 | 19.76 |
| Warsaw - other districts | 18.78 | 19.37 | 19.68 | 18.46 | 18.17 | 17.38 |
| Regions | 15.65 | 16.40 | 16.35 | 15.39 | 14.53 | 15.94 |

Chart 13. Average monthly amount of costs and service charges in the years 2011-2016 (PLN/sq m/month)



MARKET TRENDS

Changes in employment

Within the last two years, legal regulations regarding remunerations has been changed twice. In 2016, the obligation to deduct social insurance from remuneration was broadened and now includes commission contracts. In January 2017, the minimum salary was raised and the minimum hourly wage was raised to PLN 13. This resulted in the increase of security costs which rely most on employing staff – in 2016 the cost rose by 13% in relation to 2015; since January 2017 the costs increased from 20% to 40%. The same can be observed in cleaning, where the human element is key. In 2016, cleaning costs rose by ca. 2% (outside of the Central Business District), while in 2017 the increase amounted to 5% to 15%. The above changes resulted in the costs, especially security, becoming major components of operating costs. With such high increases ahead, owners had to undertake steps to replace staff with technological solutions such as barriers, revolving doors or CCTV systems.

The fall of the unemployment rate and the introduction of the '500+' programme resulted in the outflow of low-qualified Polish employees from cleaning and security services providers. Polish speaking employees of Eastern Europe origin are being hired in their place.



Property tax correctness audit

In the last few years, property tax remained on a stable level or rose only slightly. Local governments are consciously limiting the right to impose maximum rates in favour of greater community office and city activity in auditing the correctness of how taxes are calculated (property taxes in particular). Offices audit the correctness of the usable area, the completeness of the structures adherent to the property and the calculation of their worth. Owners not able to produce the base for the tax calculation are subject to heavy fines.



Office property marketing

Not only shopping centres prepare marketing budgets. Since two years we are observing significant marketing activity of owners and property managers aimed at attracting the attention of companies looking for an office and making the building stand out on the property market. Seasonal décor and gifts for tenants, flowers, sweets or fruit on various occasions are the most frequent activities. Amongst the more often held actions are occasional events, fairs, summer picnics with food trucks to spice up the lunch offer or even community sports watching. Environmentally-friendly initiatives

and charity is also on the rise. They contribute to the image of both the owner and the participating tenants.

A novelty in marketing activities undertaken by the owners is creating common chillout rooms which help the tenants to relax in a friendly atmosphere and promote networking between employees from various offices. Actions aimed at promoting services provided by various tenants have the same goal.



Environmentally-friendly activities and technological solutions

Using modern environmentally-friendly solutions and technologies already during the design phase has become a standard. In existing properties owners and property managers intensify actions aimed at implementing such solutions wherever possible and profitable. Conventional lighting is replaced by LED lighting, various energy-saving sensors are installed. An active waste segregation policy or installing paper waste presses is now common. Tenant trainings in using the property equipment in an environmentally-friendly way, especially the air-conditioning and ventilation, are organised. Properties are ecologically checked and obtain green certificates.

The pro-ecological attitude are prestigious for the owners. In the longer perspective, they also lead to savings in service charges.



SPECIAL

Is information technology and robotics the remedy for increasing employment costs?

Facility management, security and cleaning costs make up to 25% of operating costs. They are a significant component, the amount of which is linked directly to employing staff. The latest changes in law regarding employment (the extension of obligatory social securities to contracts) and the raising of the minimum hourly wage, resulted in significant costs raises already in 2016. The cost then rose once again on January 1st, 2017, after the minimum salary and the minimum hourly wage were raised. This led to searching for solutions how to limit the number of employees by implementing IT and robotics on a larger scale. Expanded CCTV systems and electronic access control have been the standard used in property security for a long time. New technologies such as virtual reception desks and smart security desk systems offering self-service touchpads to the guests help limit the presence of receptionists in buildings, while the mobile accepting of guests by tenants simplifies the work of both the main reception and the tenants.

Entities managing properties are supported by modern helpdesk platforms used for communication between facility managers and tenants. This solution enables to property manager or the general provider to participate in the communication. Thanks to their implementation, the notification service and reporting time can be reduced up to 50%.

Mobile devices equipped with online applications for reports and protocols during technical inspections are yet another example of the use of modern

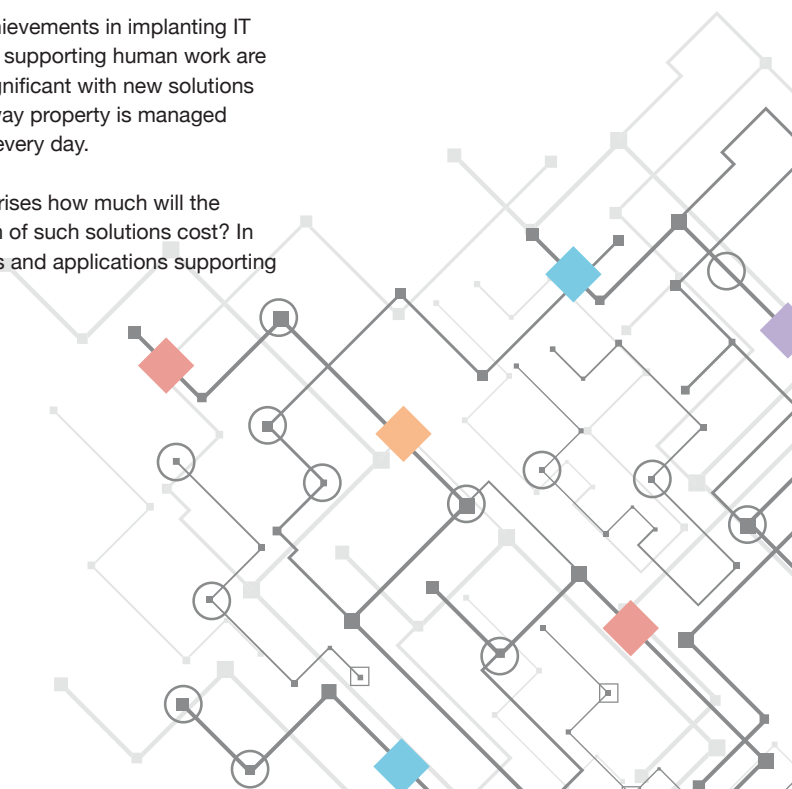
technologies. They can also work in offline mode, when there is no access to wi-fi. These applications resemble reality in virtual form, enabling many entities to perform a simultaneous analysis of the property without the need to actually visit it.

The most interesting technologies which can be implemented in widely understood property management are offered by IoT (Internet of Things). Beacons installed in rooms examine surrounding parameters and the collected data is transmitted via the Internet and processed. This technology may find very wide use: starting from monitoring the performance of facility managers by optimizing their actions to overseeing and providing property security. In the near future these technologies will make the presence of security staff in buildings outside of business hours obsolete, in favour of a patrol system and mobile technical teams.

To sum up, achievements in implanting IT and robotics in supporting human work are increasingly significant with new solutions changing the way property is managed being created every day.

The question arises how much will the implementation of such solutions cost? In case of devices and applications supporting

facility managers and security staff, the cost are included first and foremost in the service charges. For applications supporting property management, the cost is usually carried by the property manager. Nowadays, it is hard for us to imagine an office building without a receptionist, security guard or technician. But that may as change sooner than we expect.





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