CAPSTAN ADVISORS

Insights

Contracting and Pricing Models

Key considerations in outsourcing real estate and facilities management services are the contracting model and the pricing model selected by the client.

Contracting Models

The two common contracting models in corporate real estate and facilities management outsourcing are the principal and managing agent models.

In a principal model, the service provider is responsible for the work of and payment to sub-contractors, as well as for any breaches of the contract by such sub-contractors. In a managing agent model, the service provider manages contracts with subcontractors on the client's behalf as an agent, but does not take responsibility for the work and payment of those subcontractors.

We use the matrix below to get clients familiar with the pros and cons of these models. The major advantage of the principal model from the client's viewpoint is the transfer of risk to the service provider. And outsourcing parts of contract management and the accounting and administrative tasks that go with it can lead to savings in back office personnel. On the flip side, the client's team loses some control of and visibility into its spend, and the costs saved internally may be offset by provider staff or processing fees charged back.

Contract Model	Pros	Cons
○ Principal	○ Subcontractor risk transferred to service provider ○ Savings in finance or procurement staffing	○ Less visibility into vendor spend for the client ○ Administrative cost to manage contracts is passed through
○ Managing Agent	○ More client control and visibility into sourcing decisions ○ Allows Tier 1 MWBE credits	○ Less ownership of solution and costs by provider ○ May limit economies from provider's vendor network

Managing agent models allow more control of vendor spend by the client, and if diversity spend is an important goal, this model provides Tier 1 credit for that spend. From the provider perspective, there is less risk to absorb, but it may be more difficult to achieve economies of scale in purchasing if the client has a heavy hand in vendor selection.

In the past, providers priced their services under principal model contracts significantly higher than for managing agent roles because of the added risk of taking responsibility for third party performance. But as the service providers grew into larger organizations with bigger balance sheets, they were able to spread that risk (or insure against it) and reduce the cost to their clients. Now most of the facility management contracts we work on are principal agreements, with the focus of negotiations on liability caps and indemnities that quantify the risk assumed.

Transaction brokerage and project management contracts are more likely to be structured as managing agent agreements. Brokerage agreements have historically had the service provider in the position of agent and third-party brokers as subagents. And service providers have tried to avoid direct responsibility for building defect claims that can follow architects or contractors long after a project is completed.

Pricing Models

The terminology used to describe pricing model alternatives and the pros and cons of the models themselves are sources of confusion for some clients. We developed the table on page 3 to outline the key differences among four popular models for facilities management contracts.

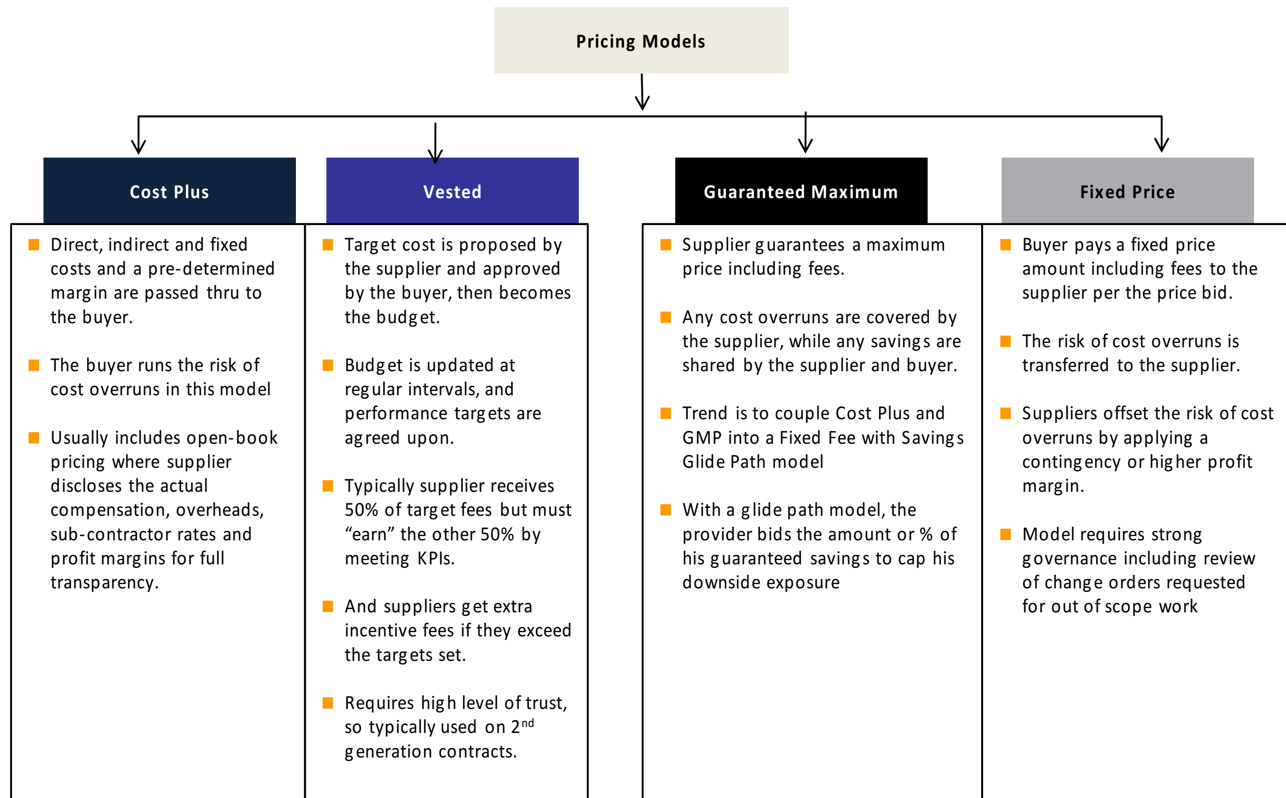
The **Cost Plus Model** on the far left in the chart was the most popular model as the outsourcing business matured in the early 2000s. Service providers passed through to the client the costs of their staff and vendors managed plus mark-ups for overhead and profit. The responsibility for payments to and performance of third party vendors still rested with the client. Budget overruns could be passed through to the client with some offset via the provider's fees at risk against a budget KPI.

The **Fixed Price Model** at the other end of the spectrum has gained in popularity lately as cost sensitive first generation outsourcers such as manufacturing firms have entered the market. Providers bid a fixed prices and deliver the services at that price, funding 100% of budget overruns or pocketing the cost savings achieved. Clients like the budget certainty but often dislike the change orders resulting from changes in the portfolio and/or services over time. Service providers are wary of the risks involved in fixed price agreements, especially if the historic cost baseline is not disclosed during the bid process.

Guaranteed Maximum Price ("GMP") contracts where the provider absorbs budget overruns but shares savings with the client are viewed by some providers as "heads I win, tails I win" for the client. Capstan often recommends modified GMP terms to include shared savings and shared risk for client and provider, with a glide path savings projection over the contract term, % fee at risk and bonus as a % of savings. Management fees are usually bid on a per square foot basis and fixed within a range of portfolio sizes, or passed through as a mark-up on each staff member.

The **Vested Pricing Model** is designed to align the interests of the client and service provider on outcomes that matter to both parties. Because the model is fairly new, and requires a great deal of trust

between client and provider, it has not been widely adopted yet. Where it has been tried, the provider typically charges less than normal fees on a monthly basis, "earns back" the reduction through good performance, and has the opportunity to earn above market fees through excellent performance or achievement of specific goals.



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