The Problem of Inflation in Lease Negotiations

by Max J. Derbes, Jr., C.R.E.

One of the most perplexing problems in lease negotiations is agreement on the provisions relating to inflation protection for the lessor. Because of the recent acceleration in the rate of loss of the dollar's purchasing power, this problem has been aggravated. To what extent will recent inflationary trends cause radical changes in the economics of leasing?

The basic purpose of any lease is assurance of occupancy for a given period to the tenant while at the same time assuring the lessor a steady income for the same period. This gives stability of occupancy and real estate costs to the tenant and makes outlays for moving costs, tenant improvements, business planning, and so forth, more predictable. The lessor's benefits include a reduction in management burdens, a predictable income, and better security for obtaining a long-term loan. On new projects, the lease often is the difference between a feasible and a non-feasible venture; that is, there would be no facility without the financing made possible by the lease.

Prior to the current rates of inflation, lessors were willing to settle for modest rent increases periodically (say each five years at the expiration of the primary term for each option period). In bygone years, some owners were even willing to accept options at reduced rates after the original term during which the mortgage was paid off.

Experience has shown, however, that the fixed rent step-up periodically during the base term or for the option periods more often than not did not cover the loss in the purchasing power of the dollar which the lessor suffered. Regardless of how significant the increases in rent appeared at the time of the original negotiations, much of this benefit was wiped out by inflation. Therefore, in recent years, numerous systems have been devised to overcome this lessor disadvantage. Each of these has advantages and objections from the standpoint of lessor and lessee. No system has been devised which is a universal solution applicable to all cases.

One obvious economic fact of life makes the universal solution an impossibility: that is, the *difference* between the future rental value of any parcel of real estate and the future relative purchasing power of the dollar. If this were not

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so, then wouldn't it be possible to tie all future rents to the overall purchasing price of the dollar?

While rent levels generally tend to follow other inflation phenomena, they generally move within the range of their own special economics. Recent items in the news continually underline the variations in the movement of prices among various commodities and services. Of particular note in the recent inflationary period has been the lag of rent levels behind other economic indicators. Furthermore, the fair economic rent of any one parcel of real estate moves to a degree independently of real estate rent trends in general because of very localized conditions, particularly neighborhood influences.

In theory at least, the rents due to the owner in the future should not exceed the property's individual rent capabilities during the lease term. This may work two ways. If the property is in a rapidly growing area, then the fair rent ten years after the beginning of the lease may increase by many times the overall inflationary indicator generally or even the real estate rent indicators. However, if the area is declining, then the fair rent ten years hence may be the same or less than that charged at the offset.

There is another subtle effect on a particular property; that is, to what extent did the lessee's good influence on the property and its neighborhood enhance the rent potential 10 or 20 years after the original date? Should the lessee be charged for his contribution to this theoretically fair rent as the lease term progresses?

Furthermore, the negotiation strength of the parties at the outset will depend upon the estimated future benefits of the property at the time of the negotiations, the recent history of the property's productivity, and the subjective financial strength of the parties. These will tend to influence not only future protections against the shrinking purchasing power of the dollar, but even the primary term rent considerations.

If a particular property enjoys a bright outlook with limited or non-existent competition, then the lessor can push for maximum inflationary protections. If the track record recently is very good or, for proposed properties, the track history of similar properties shows success, then the lessor is in a favorable bargaining position. Lastly, if the lessor does not need long-term minimum rents to assure favorable financing, his position is improved.

Because of these many variables, there is no one lease agreement which can be applied to all situations. All possible means of protection should be considered in light of the financial condition of the parties and the property's potential.

LIMITATION OF LEASE TERM

When the lessor does not need a long-term lease in order to obtain long-term financing, he has the surest protection that fixed rents will not reduce the future purchasing power of the rental income. Often, the financial strength of the owner-lessor will be such that he can obtain long-term financing based primarily upon his financial strength rather than the strength of the tenant. Or, the owner may own the property outright with no mortgage.

The type of property and the cost and trouble to the lessee of moving will influence just how short such a lease term can be. For the residential apartment, for instance, the cost of moving is at a minimum and competitive units can be easily found; therefore, the lease term is normally one or two years. The small retailer will have fixture and decorating expenses and probably will insist on from two to five years minimum. Relocation costs will force the small industrialist to require a three to five-year minimum with options, if possible. Users of larger facilities, both retail and industrial, will usually not settle for less than 10 to 20 years, including primary term and options.

The short-term lease is not advisable for any type of specialty building because of the risk to the lessor. Specialty restaurants, service stations, auto dealerships, and so forth, represent such a risk unless they are older, successful, and have a bright future.

The objection to the short-term lease from the lessee's standpoint is that he is at the mercy of the owner at the end of the short term. The lessee will usually push for some options to guarantee his continued occupancy. Many of the means of constructing these options to provide inflation protection for the lessor are listed below.

One seemingly harmless method is the right of first refusal with no rent stipulated. From the viewpoint of the lessor, the difficulty with the right of first refusal is that other prospective tenants who become aware of such a clause will not even consider the location seriously unless it is truly prime. This is particularly true in the case of properties requiring complex analysis before leasing. Much time and expense go into the prospective new tenant's considerations and these are for naught if the original tenant meets his offer. On the other hand, the right of first refusal makes the original lessee and the owner more amenable to reasonable negotiations toward the end of the short-term lease.

Long-term leases afford protection to the lessor-owner only if the tenant is a strong credit risk; otherwise, it is a one way street in favor of the lessee. Nonetheless, it may assist in financing over a long term.

The objection to the short-term lease from the standpoint of the owner is that this does not guarantee rental income at the expiration of the lease. Many owners have been lulled into short-term leases with the proposition that the facility would still be desirable to the tenant at the expiration of the three to five or ten-year term only to find that their lessee outgrew the facility or for other reasons moved out. Add to the owner's exposure (besides the potential risk of a vacant building) the added burden of management and the exposure of fixed expenses with no income. Thus, the short-term lease as a means of inflation protection for the lessor is not the answer for all owner-lessors.

INCREASED EXPENSE PROTECTIONS

Where the lessor is responsible for some or all of the expenses of the real estate during the term of the lease or options, numerous means of protection are available. The most obvious is to require that all expenses above a base period or a stated amount be paid by the lessee. However, such a provision puts the

lessee at the mercy of the owner, creates a problem with regard to agreement on the criteria of the base period and, in cases of multiple occupancy, involves an allocation problem.

A not-too-subtle result of passing on the average expenses to the tenant is the ill-will caused and the bad reputation which such a situation can give to the owner-lessor or manager. The end result is that the tenants go hunting for other space at the end of their primary term.

The most obvious way to avoid strained relations is to have the lessee pay his own expenses directly. In the single occupancy building, the "net, net, net" lease is the ultimate answer with the lessee obligated to carry a sufficient amount of insurance, maintain the property, pay the taxes, and so forth. With such an arrangement, the owner should allow the lessee the right of appeal to the taxing authority.

In many cases, particularly buildings with multiple occupancy, it is not possible for the tenants to pay all the expenses directly. Nonetheless, in these cases the structure should be so designed that the tenant pays whatever is logical, such as separate utility meters, separate air conditioning and heating when possible, and even separate interior maintenance.

In cases requiring prorated increased costs, the lease should clearly provide means for figuring the proration and the lessee should be given an opportunity to participate in major decisions with regard to tax appeals, types of cleaning services, and other major costs which the tenant must bear pro rata. Even though the costs to the tenant might be the same in the final outcome, there is at least a minimum of hard feelings. This has become an important aspect of lessor-lessee relationships with the tremendous utility and tax increases of recent years.

In order to assure good ownership management, some lease arrangements provide that the lessee shall bear less than the total amount of the increased cost. For instance, if the *ad valorem* taxes do increase, then the owner must bear 10%, 20%, or 25% of this increase with the rest paid by the tenant. Some tenants are willing to pay a higher base rent in order to get such a clause to assure that the owner will be motivated to hold taxes to a minimum.

FIXED STEP-UPS IN RENTS

The original means of protection against increased expenses for the lessor (to some extent, a compensation for inflation) was the fixed step-up in rents. Both were more closely predictable prior to this decade because the rate of inflation and expense escalations were considerably less than they are now.

As a matter of custom, such step-ups were generally not on a per annum basis, but rather every five or ten years. The basic idea was that the lessor covered added expenses and inflation for a few years and was thereby motivated to hold them within reason. The lessee was given the advantage of a locked-in rental for this time period (say five years at a time) so that he could budget. This was also used as a sign-up motivation for the lessee. He was more amenable to a step-up five years in the future than to one the next year.

Interestingly, seldom was consideration given to the fact that on a major percentage of his costs (the mortgage payments), the lessor was locked in for the entire period of the mortgage. For instance, let us assume a 75% mortgage, 20 years at 9% interest on a $120,000 building rented for $12,720 per year net. The following results:

Mortgage $90,000 for 20 years at 9%	$ 9,720
Equity $30,000 at 10%	3,000
Total Rent $120,000 x 10.6%	$12,720

Assuming that the inflationary rate is estimated at 10% per annum compounded with rent step-ups each five years, then the rent would need to be adjusted as follows to protect the lessor's return to equity:

Year	Mortgage Constant	Equity	Total Rent Per Annum	Total Rent Percentage Increase over Prior Term	Percentage Increase over Base Period
1 to 5	$9,720	$ 3,000	$12,720	00.0%	00.0%
6 to 10	9,720	4,832	14,552	14.4%	14.4%
11 to 15	9,720	7,781	17,501	20.3%	37.6%
16 to 20	9,720	12,532	22,252	27.1%	74.9%

This schedule of rent step-ups indicates an increase in absolute dollars as return to equity providing for a 10% per annum compounded increase. If the entire rent was adjusted 10% per annum simple or compounded each five-year period, the following would result:

Year	Per Annum Rent Increased 10% per annum simple	% Increase Over Base Rent	% Equity Return	Per Annum Rent Increased 10% per annum compounded	% Increase	% Equity Return
1 to 5	$12,720		10%	$12,720		10%
6 to 10	$19,080	150%	31%	$20,487	161%	36%
11 to 15	$28,620	225%	63%	$32,992	259%	76%
16 to 20	$42,930	337.5%	111%	$53,134	418%	177%

Typically, lessees will not obligate themselves to a known increase in rent equivalent to the amounts above. Yet, on an unmortgaged property the rents would have to be so adjusted to return to the owner-lessor the same purchasing power.

The step-up adjustment in rents is very difficult to calculate for a long-term lease based upon a projection of current trends so long as inflation remains at a high level. One solution is to structure the increase somewhere between equity return increases and the total rent increases. If the property is highly desirable, the rent increase can be higher; if the property is average or marginal, the rent increase should be closer to that represented by protection of the purchasing power of the return on equity investment.

The step-up inflationary protections are arranged at the beginning of the lease based upon predicted trends at that time. What happens if there is deflation? What happens if the productive ability of a particular property falls during the term of the lease? Whenever the real estate broker runs into a lease situation which obviously involves a lease consideration in excess of the fair rental, this can usually be traced back to overoptimism at the time of the original signing.

Cost of Living Increases

The method of adjusting rents periodically or at option periods to the Cost of Living Index[1] was thought to be the answer to lessor protection against inflation. Observe below what the rent increases would be if adjusted to 1) All Items, and 2) Rent (using the same rent for the building illustrated above if rented in 1967):

Year	Index All Items	Rent	Percentage Increase Over Prior Year	Index Rent	Rent	Percentage Increase Over Prior Year
1967		$12,720	0		$12,720	
1968	104.2	$13,250	4.2	102.4	$13,020	2.4
1969	109.8	$13,970	5.4	105.7	$13,450	3.3
1970	116.3	$14,800	5.9	110.1	$14,000	4.1
1971	121.3	$15,430	4.2	115.2	$14,650	4.6
1972	125.3	$15,940	3.3	119.2	$15,160	3.5
1973	133.1	$16,930	6.2	124.3	$15,800	4.2
1974	147.7	$18,790	11.0	130.2	$16,560	4.8
1975[1]	162.3	$20,650	9.9	137.3	$17,460	5.4

[1]July 1975

Many unsuspecting lessees found that prior agreement to the Cost of Living adjustment every five years or so resulted in a fixed rent way above the economic rent applicable to the building. In addition to the many localized conditions applicable to the building and its neighborhood, the cause of the disparity results from the fact that the rent index includes many newer structures built at much more inflated cost than the owner's historic cost. The fixed long-term physical nature of real estate is the primary reason that its index lags behind that of all items. Add to this the slow movement of real estate prices and rents in general.

The aforementioned index figures show that for this seven and one-half year period all items increased at an annual rate of 8.3% while rents increased only 5% per annum. Most significant is that the half of this increase took place in a little over one-third of the total time period, that is, in the last 2.7 years for all items. The same half increase in the rent index took about half the period (i.e., a more even flow for the rent increases).

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1. U.S. Department of Commerce, Bureau of Economic Analysis, "Consumer Prices of All Items of the Joint Economic Committee, Council of Economic Advisers," *Economic Indicators* (Washington, D.C.: U.S. Government Printing Office).

Because of the disparity between the "All Items" index and the "Rent" index, many tenants are finding mandatory rent increases not reasonable. Some intelligent landlords looking to the future have modified the clause after recognizing this inequity. The rent increase indicated for the 7.5 year period is 62.34% for All Items whereas the Rent increase is but 37.26%, so that the inflationary factor for All Items is 67% higher than that for Rent. Obviously, to base a Rent increase on All Items increase is not equitable, particularly if part of the owner's ownership costs is a fixed mortgage payment constant.

Modified Cost of Living Increases

Coincidentally, two counselors came up with the same solution to the use of the rent index as a means of inflationary protection. Both Don Treadwell of Southgate, Michigan and the author of this article settled this lease provision independently at about the same time on different properties by getting both parties to agree to 75% of the difference in the rent index. Both were rent adjustments which would take place every five years. Using the above illustration, the rent adjustment would be as follows:

1967 Base Rent	$12,720	100%
1972 Rent Index	119.2	
Full Increase	$15,162	119.2%
Less 25% x $2,442	610	
Rent Applicable	$14,552	114.4%

The above represents a rent increase of 2.88% per annum average. Of course if the inflationary trends continue to increase, then the average per annum would be a higher percentage.

If the index for all items were used for this period, the total difference would be 25.3% x 75% or a total increase of 18.98% and a per annum average of 3.80%.

The theory behind using either index but adjusting only to the extent of 75% of the total index difference is that the owner should not get compensated for the total difference in the devaluation of the dollar because his cost of owning the real estate dates back to a prior period. The lessor also has "bought insurance" by obtaining mortgage financing at a fixed interest rate (and fixed mortgage constant) covering a large percentage of his investment. The original base rent was, in part, based on the locked-in mortgage costs, so that adjustment of the rent by 100% of the index may not be considered fair.

Appraiser-Counselor Method

Generally speaking, the system of having the rent set by expert appraisers is used for option periods rather than for the base term, or at least not for the base term which is covered by the mortgage. Most clauses which provide for hiring of appraisers indicate that they shall be so selected only after bona fide attempts at negotiations between lessor and lessee. If the parties can agree, then there is no need for outside opinions.

The principal objection to the hiring of expert appraisers is the cost involved. Secondarily, there is the problem of settling the criteria of the valuation. Lastly, appraiser selection is frequently a problem.

Wherein this system is used, the lessor appoints an appraiser who must be recognized as a professional. Frequently such agreements provide that he or she must be an MAI (member, American Institute of Real Estate Appraisers of the National Association of Realtors®) or SREA (Senior Real Estate Analyst, Society of Real Estate Appraisers) or the equivalent; the lessee insists on similar credentials. These individuals may work independently or together. If their conclusions are within a defined range, then the conclusions may be averaged. If further apart, then the two appraisers ordinarily must agree on a third professional appraiser who will have the final word. The total of the three may be averaged or given a weighted average; or the stance of any two of the three may prevail.

One great mistake of the past was to indicate that the appraisers were to set the market value of the property, or that of the land considered as vacant, and have the lease provide for a set percentage established as rent. Often, the percentage was unrealistically low.

Since the value of the property or the land considered as vacant may be suitable to a higher use than that of the lessee, this often worked into a square-circle type of conclusion. The economic rental of the property in its present utilization could be considerably less than that of the land if the improvements were demolished and it was put to its highest and best use.

A lessee objection to the appraiser system has always been that the lessee created the value by his utilization of the property. This is particularly true in many rural situations where competitive sites are readily available for the same service station, shopping center, or drive-in restaurant.

In those situations wherein an appraiser-counselor is selected to establish the rent and terms of the option period, taking into account all aspects of the problem, the end results are often more satisfactory than when he is requested to use as sole criterion the economic rent of the property if vacant and available for rent. This type of real estate expert must trace the history of the relationships between the parties, the productive capacity of the property, the fairness of the various lease clauses, and so forth. He then endeavors to get agreement on changes which are more applicable to the current situation than those originally written into the lease in addition to settlement of the issue of rent. He does not endeavor to restructure the lease arrangement completely, only those aspects which are clearly inequitable.

This type of real estate expert needs not only technical skill, but wisdom. He needs impartiality, and his end result should be logical.

Leases are intended to benefit both parties. Often, changed conditions cause old leases to benefit one or the other party for a portion of the lease term. Inflation could shake the very foundation of the lease principle unless reasonable people structure the written contract to provide protections from unrea-

sonable inequities. When the time comes to settle rent changes, the parties must act reasonably. They can be aided by a CRE (Counselor of Real Estate, American Society of Real Estate Counselors) who recognizes the basic economics of inflation protections as they relate to the present and future productivity of the particular property, and the respective contributions of the lessee and the lessor to that productivity. Such help is advisable when the original lease is constructed, as well as during examination of a lease that provides for adjustments.