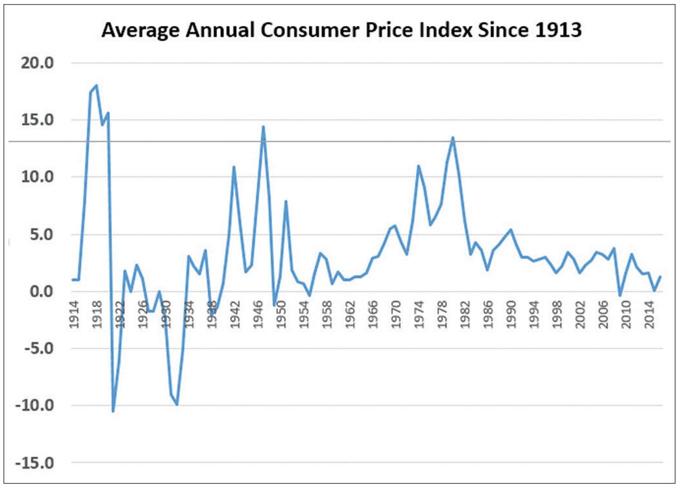
THE 3 MOST COMMON ~~MISTAKES~~ IN LEASE RENEWAL CONTRACTS

By Robert Hand, SIOR

Whether you rent space in Class A office towers, industrial parks, or retail centers, your lease should have language that not only ties rent to the Consumer Price Index but details exactly how that index is determined.

Even small mistakes can be very costly unless your lease language is clear on every detail, ranging from what time periods are used in the calculation to whether the adjustment is applied on a compounded basis. This article discusses the three most common mistakes in lease agreements and how to prevent them.



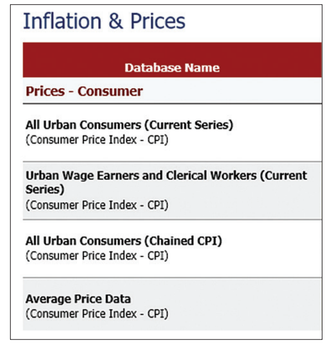
The history of linking rent payments to inflation became standard practice in the days of 1970's high inflation, when the OPEC oil embargo caused oil prices to skyrocket. When combined with the wage-price spiral, the result was an overnight jump in inflation from 3.2% in 1972 to 11% in 1974, causing landlords to realize that rental income did not retain its purchasing power. Today it is common practice for leases to include CPI language to protect landlords, but the problem is that there is more than one Consumer Price Index and there are different ways to calculate each. Even sophisticated landlords need experts to advise them.

Make Your Lease Clear on How Rent is Adjusted

Here is an example of the lease language used by $2.6 billion market cap Regus in 3,000 locations:

> 8.7- If this agreement is for a term of more than 12 months, the Provider will increase the monthly office fee on each anniversary of the start date. This increase will be by the local Consumer Price Index or such other broadly equivalent index where a consumer price index is not available locally.

The Regus lease leaves lots of room for dispute, because the Consumer Price Index has 4 ways of being calculated. The CPI index is produced by the Bureau of Labor Statistics, under the United States Department of Labor and found at the website https://www.bls.gov/data. These are the four types of Consumer Price Indices:



1. All Urban Consumers (Current) – Consists of all urban households in Metropolitan Statistical Areas (MSAs) and in urban places of 2,500 inhabitants or more. Nonfarm consumers living in rural areas within MSAs are included, but the index excludes rural nonmetropolitan consumers and the military and the institutional population.

2. Urban Wage Earners and Clerical Workers (Current) – Consists of clerical workers, sales workers, protective and other service workers, laborers, or construction workers. More than one-half of the consumer income has to be earned from these occupations, and at least one of the members must be employed for 37 weeks or more in an eligible occupation.

3. All Urban Consumers (Chained) – The urban consumer population is deemed by many as a better representative measure of the general public because 90% of the country's population lives in urban areas. Using chained CPI means the rate at which Social Security benefits tick up would be slower, because it reflects substitutions consumers would make in response to rising prices of certain items. It utilizes a basket of goods and services that are measured changes from month to month; much like a daisy chain. If the cost of a certain form of transportation goes up, people might switch to another kind and this kind of "substitution" is part of what is factored into chained CPI.

4. Average Price Data – Calculated for specific items such as, household fuel, motor fuel, and food items. Average prices are best used to measure the price level in a particular month, not to measure price change over time.

The most common CPI Index is the All Urban Consumers Index, but it has two methods used to calculate the numbers: one uses a base period 1982-1984 as 100), and the other method uses a base period of 1967 as 100. Most leases make the mistake of not being clear about which index is used. In addition, the data can be seasonally adjusted or not seasonally adjusted (which is released faster).

Here is lease language for a medical property that makes the CPI data source very clear:

> Consumer Price Index: It is further understood and agreed by and between Lessor and Lessee that, commencing with the first day of the second year of lease, the monthly rental as set forth above will be adjusted upwards at the beginning of the second lease year, and every year thereafter until expiration or termination of the lease using the all urban consumers (CPI-U) United States City Average, All Items, (1967=100) published by the Bureau of Labor Statistics, United States Department of Labor (referred to as "Consumer Price Index").

Compounded or Added Together?

Year	CPI	Rent Annually
0	3.00%	$ 100,000
1	3.00%	$ 103,000
2	3.00%	$ 106,090
3	3.00%	$ 109,273
4	3.00%	$ 112,551
5	3.00%	$ 115,927

Always compound. When adjusting for the CPI, it makes a difference if you add the inflation rate for each year rather than multiply the rate by the previous year. Assume a 5 year lease renewal where the CPI was 3% each year for the previous 5 years. Some landlords multiply 5 years times 3% to get 15% for the increase. For a large property with rent income of $100,000 annually, the adjusted rent would be $115,000; however, if the lease is written correctly, the CPI is compounded, meaning each new year is applied toward the previous year's CPI, resulting in rent income of $115,927. Your lease should spell out compounding as the method.

How CPI Adjustments Affect Market Value

Year	Annual
2007	2.8
2008	3.8
2009	-0.4
2010	1.6
2011	3.2
2012	2.1
2013	1.5
2014	1.6
2015	0.1
2016	1.3

Our economy today is driven by a different wage/price spiral which causes low inflation. This helps borrowers but hurts landlords and savers. One solution is to build in a fixed rate adjustment in addition to a CPI adjustment because the challenge for landlords is that the CPI since 2012 has averaged 1.3%. The CPI doesn't keep up with 3% average annual medical care increases.

Year	Rent, Assume 1.3% CPI	Rent, 3% Fixed Annual	Rent Variance	Added Market Value 8% Cap
0	$ 100,000	$ 100,000		
1	$ 101,300	$ 103,000	$ 1,700	$ 21,250
2	$ 102,617	$ 106,090	$ 3,473	$ 43,414
3	$ 103,951	$ 109,273	$ 5,322	$ 66,522
4	$ 105,302	$ 112,551	$ 7,249	$ 90,607
5	$ 106,671	$ 115,927	$ 9,256	$ 115,702
6	$ 108,058	$ 119,405	$ 11,347	$ 141,841
7	$ 109,463	$ 122,987	$ 13,525	$ 169,059
8	$ 110,886	$ 126,677	$ 15,791	$ 197,391
9	$ 112,327	$ 130,477	$ 18,150	$ 226,876
10	$ 113,787	$ 134,392	$ 20,604	$ 257,552
11	$ 115,267	$ 138,423	$ 23,157	$ 289,458
12	$ 116,765	$ 142,576	$ 25,811	$ 322,636
13	$ 118,283	$ 146,853	$ 28,570	$ 357,128
14	$ 119,821	$ 151,259	$ 31,438	$ 392,977
15	$ 121,378	$ 155,797	$ 34,418	$ 430,228
16	$ 122,956	$ 160,471	$ 37,514	$ 468,928
17	$ 124,555	$ 165,285	$ 40,730	$ 509,124
18	$ 126,174	$ 170,243	$ 44,069	$ 550,866
19	$ 127,814	$ 175,351	$ 47,536	$ 594,204
20	$ 129,476	$ 180,611	$ 51,135	$ 639,190
21	$ 131,159	$ 186,029	$ 54,870	$ 685,880
22	$ 132,864	$ 191,610	$ 58,746	$ 734,327
23	$ 134,591	$ 197,359	$ 62,767	$ 784,591
24	$ 136,341	$ 203,279	$ 66,938	$ 836,729
25	$ 138,114	$ 209,378	$ 71,264	$ 890,804
26	$ 139,909	$ 215,659	$ 75,750	$ 946,877
27	$ 141,728	$ 222,129	$ 80,401	$ 1,005,014
28	$ 143,570	$ 228,793	$ 85,223	$ 1,065,281
29	$ 145,437	$ 235,657	$ 90,220	$ 1,127,749
30	$ 147,327	$ 242,726	$ 95,399	$ 1,192,486
			$ 1,212,376	

One alternative is to include lease language stating the rent adjusts based on the CPI or a fixed rate, whichever is higher. The 30 year table shows how, during an extended period of low inflation, this strategy can dramatically increase the market value. This lease would include language with adjustments based on the CPI, which we assume in this scenario will continue at the average 1.3% annual rate, compared to a fixed rate of 3%. The result, assuming current rent income of $100,000, would be to increase rent by $95,399 in year 30, which at an 8% cap rate adds $1,192,486 more market value to the property.

Summary

In conclusion, make sure your lease language details how your rent is adjusted. You can design your table data at the Bureau of labor website, https://www.bls.gov/data/, and their phone number is shown on the data release. If you call the number on the press release, the analyst who produced the CPI report will answer any questions. If your property is in outlier data cities such as Detroit, Houston or New Orleans, you can even produce a local Consumer Price Index. Remember to always compound your adjustment rate, and protect your client when the CPI is not a proper index to retain purchasing power by using a fixed rate alternative. ▽

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