Selecting a lease index

by John Selling, CPM®

The IPD appears to be the most accurate index equitable to both parties: providing some protection for owners against rising prices and eliminating wide swings in rates that could anger tenants.

John Selling, CPM,® is a former IREM regional vice president and is also a member of the National Association of Realtors® and the National Association of Corporate Real Estate Executives.

During the spiraling inflation of the late 1960s and early 1970s, many property managers adopted some form of a rent escalation clause as a way to offset rising operating costs and preserve an acceptable profit level for their commercial property owners. Today, escalation clauses are widespread, but there is still controversy over what form of escalation increase best serves the interests of both the owner and the tenant.

Escalations tied to increases in operating expenses, the wages of maintenance personnel, and even the cost of electricity have all been adopted with varying degrees of success by managers. However, one of the most widely used forms of escalation clause, especially for commercial and retail properties, is an index escalation clause.

An index escalation clause allows for an adjustment in rental rate in an amount related to the annual change of a particular cost-of-living index. The general purpose of such an adjustment is to ensure that neither the tenant nor the owner gains or loses significantly from inflation. In a sense, the index lease imposes a condition of price stability on both parties and enables the manager to correct for the redistribution effects of inflation.

Selecting an index

If the property manager determines that a lease escalation clause tied to an index is the best way to insure a steady cash flow for the owner, the next question is "What index is the most appropriate to use for lease indexing?"

The three common indices used for calculating lease index escalations are: the Consumer Price Index (CPI), the Producer Price Index (PPI), and the Implicit Price Deflator (IPD).

The most widely used of these three is the Consumer Price Index, created by the Bureau of Labor Statistics of the Department of Labor. The CPI essentially measures the purchasing power of consumer dollars to procure goods and services, by comparing the cost of a "market basket" of specific items to the cost of the same items in a predesignated base year.

Because the CPI is calculated using the costs of services as well as products, it tends to rise and fall much faster than the producer price index, which is based only on the cost of commodities. And because the prices of services tend to rise faster than prices overall and to respond more explosively to swings in inflation than do other cost factors, the CPI tends to fluctuate widely.

Thus, tenants whose rents are tied to the CPI may experience either large and sudden or small and inadequate increases in rent. This creates potential problems for the manager who must enforce the escalations and maximize profitability.

More stable than the CPI is the Implicit Price Deflator index (IPD), compiled by the National Income and Wealth Division of the Department of Commerce. The IPD is a weighted average of the price indices used in the deflation of the gross national product (GNP). For each period, the IPD uses as weights the composition of constant-dollar output for that period.

In computing price increases, it takes into account the ratio of the value of current dollars to the value of constant dollars for a predetermined date. Any changes in the implicit price deflator reflect both changes in price and changes in the composition of output.

The IPD index is not widely used among real estate practitioners, and as a result is not well understood. Its inclusion in a lease may require some interpretation for owners and tenants. However, the IPD may be both more accurate for use in lease escalation and ultimately more palatable to tenants.

The IPD tends to be a more accurate reflection of actual dollar increases in operating expenses than the CPI because it is a deflator index.

The increases indicated in the IPD index are determined after deflating — that is, counterbalancing — the effects of inflation on current market values of the groups of final products and services that the federal government uses for its

computation. Thus, the stability of the IPD index provides some protection for owners against rising prices. At the same time, it eliminates wide swings in rates that could anger tenants.

Limiting factors, however, prevent the IPD from serving as a totally accurate indication of price increases. Some of these factors are:

- A number of major capital goods and some soft goods and services are not priced at all, so that some major areas of increase may not be shown.
- Some of the prices are list prices rather than transaction prices.
- The available price indices used to compute the IPD are not always corrected for changes in product quality, with the result that some quality changes may be erroneously tallied as price changes.
- Some indices are derived from unit values rather than from price observation. Because unit values are usually computed from heterogeneous mixes of products, the unit values may be changed over time and variations in the product mix may be read as changes in prices.
- Construction costs are almost nonexistent as a cost in most indices.

However, even with these drawbacks, the IPD appears to be the most accurate index equitable to both parties, assuming that the property is reasonably stable and that no dramatic operating changes are anticipated.

Sample calculations

A simple calculation on a lease that contains an escalation clause can demonstrate the differences between the results of using the CPI and the IPD indices.

Assume that you signed a lease for office space which had an initial base rent of $5,000, in January 1980. The lease also included an escalation clause based on either the CPI or the IPD index. Now assume that you wanted to calculate what the rent, including escalation, would be for 1984. (You would use index figures for the preceding year in your calculation.)

Using the CPI index, the calculations would be:

303.5 (CPI for 1983)
−217.4 (CPI for base year 1979)
86.1

86.1 ÷ 217.4 = .396, or 39.6% increase
($5,000 x .396) + $5,000 = $6,980 rent for 1984

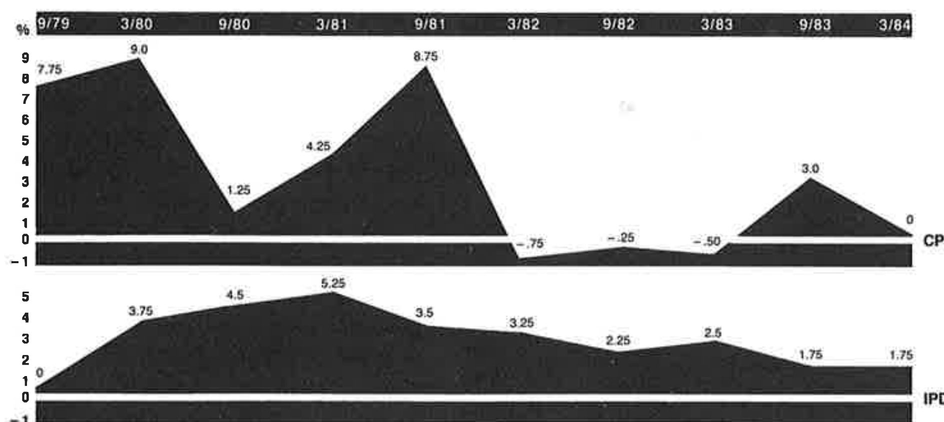
The same calculation using the IPD index would be:

220.5 (IPD for 1983)
−171.9 (IPD for base year 1979)
48.6

48.6 ÷ 171.9 = .282, or 28.2% increase
($5,000 x .282) + $5,000 = $6,410 rent for 1984

Thus, use of the IPD index produces a percentage of increase that more accurately reflects the 18.8 percent increase in operating expenses nationwide for the same period. (Estimates of operating expenses are based on *Income/Expense Analysis: Office Buildings,* 1982 and 1984, Chicago, Illinois, Institute of Real Estate Management.)

A Comparison of the CPI and IPD Indexes, 1979-1984 (Based on Percentages)



Tenants are more likely to accept an increase they believe to be equitable, and the management firm is still able to realize a sound return on the property.

Conclusion

No type of lease indexing will compensate the owner for possible increases in property value arising from increased productivity of that property. Nor will an index lease compensate for shifts in population, buying power, or other economic advantages that rise or fall independently of general price changes.

If these types of changes are anticipated, percentage leases, revaluation leases, and short-term leases must supplement the index lease.

Yet, for property managers interested in using lease indexing as a tool to preserve cash flow from the effects of increasing operating expenses, a lease that is indexed to the Implicit Price Deflator measurement seems to offer the most viable alternative. To quote Dr. William Shenkel, Chairman of the Department of Real Estate and Urban Development at the University of Georgia, Athens: "Because of the specialized character of the consumer price index and the producer price index, the implicit price deflator is recommended for an index lease."

For the information of those property managers interested in using the IPD index for computations, the index is published in the monthly publication *Survey of Current Business* of the U.S. Department of Commerce, Bureau of Economic Analysis. It can also be regularly found in "National Economic Trends," which is published and distributed without charge by the Federal Reserve Bank of St. Louis (P.O. Box 442, St. Louis, MO 63166). This publication further compares quarterly variations for the previous five years.

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