

# REAL ESTATE

## CPI ESCALATIONS:

# The evolution of an index

Consumer price indexed rental rate escalations became popular in the early 80's out of necessity. During the Jimmy Carter administration the inflation rate rocketed resulting in the purchasing power of a dollar dropping. Normal, market-based rental rate step-ups common in most leases at that time generally failed to provide an actual constant dollar value increase over the term of a lease. Many property owners suffered actual inflation adjusted dollar value decreases in cash flow.

Quickly, the CPI index increase became an

by  
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accepted part of most leasing transactions. Typically, tenants resisted the addition of this clause to their lease for it created an unpredictable rental obligation. Larger tenants, with more negotiating leverage, generally negotiated floors and ceilings which would bracket their escalation liabilities or agreed upon a formula which permitted a percentage of the CPI increase to be passed thru to become additional base rent.

The rationale for this arrangement went something like this: While a property owner's expenses may rise with the inflation rate, so does the value of its property. Likewise, while a

corporation can pass thru to its customers a portion of the inflation rate in higher prices, it is generally not possible to pass through 100% of such escalations.

This evolution of the CPI escalation clause resulted in the following 2 examples which were widely used: (Illustration of standard CPI clause with two choices of limiting clauses.)

a) The term "Price Index" shall mean the "Consumer Price Index" published by the Bureau of labor statistics of the United States Department of Labor, All Items, New York, NY - Northeastern, NJ for urban consumers.

b) The term "Base Price Index" shall mean the Price Index for each year prior to the attained year commencing upon the 2nd anniversary of the lease term.

c) The term "Current Price Index" shall mean the Price Index for the first month of each lease year's anniversary.

If the Current Price Index for any lease year shall be greater than the Base Price Index, the base rent shall be increased by an amount equal to product obtained by multiplying (i) the percentage difference between the Current Price Index and the Base Price Index by (ii) the fixed rent (such increase hereinafter referred to as the "Cost of Living Adjustment"). However, in no event shall Owner have any obligation to Tenant hereunder if the Current Price Index for any lease year is less than the Base Price Index or,

1. In no event shall an annual escalation exceed 50% of the CPI increase as aforementioned computed ...or:

2. In no event shall an annual escalation as aforementioned computed be less than 1% or greater than 4%.

Then came the 1990's, the decade of reduced inflation expectations. Led by credit tenants, many leases only had provisions for CPI escalations; not for reasonable market level expectable base rental increases. Soon, awareness rippled through the real estate ownership community that CPI escalations alone were not keeping up with market value increases. Something had to be done, and for those with negotiating leverage the answer was to change the CPI formula!

The modifications required only a modest change in the definition for the base year. The new base year remains as the commencement month of the lease. The above, standard formula was altered and quickly gained in popularity among landlords, not tenants.

By maintaining the base year of the index as the commencing year of the lease, this clause allowed for "double compounding". This formula did not apply one year's escalation in the CPI against the already inflation adjusted rent, but rather, applied each year the total accumulated inflation index from the commencement of the lease term.

Assuming a 2% annual increase in the CPI, the first year of escalation would be a benign 2%, however, the 5th year's escalation would be 16.5% and the 10th year's escalation would be 84.1%....!

The following illustrates the impact this clause would have over a ten year term on a commencing base annual rent of \$100,000.00 for a 5,000 sq. ft. commercial property.

Escalation clauses like this one, which were intended to keep a rental rate current with inflation and market increases was a significant cause of the most current trend of having no CPI escalation. While tenants reacted negatively to the onerous rent increases, landlords began to dislike it as well, for such large annual increases became uncollectible, requiring evictions or lease renegotiations.

Led once again by credit tenants who required rent rate predictability, coupled with a benign inflation environment, a fixed, annual, or semi-annual increase became the norm. Predicated on relative negotiating leverage, increases generally ranged from 2% - 4% per year, or 5% - 6% every 3-5 years.

Generals and landlords typically share the common trait of planning to fight the last war. With a current guns and butter national economic policy, a ballooning deficit, and oil reserves dropping as prices increase, the last war in fact may be our next one.

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YEAR	BASE PRICE INDEX	CURRENT PRICE INDEX	% INCREASE	ADJUSTED BASE RENTAL	RENT PSF
1	157.7			\$100,000.00	\$20.00
2	157.7	160.854	2.0000%	\$102,000.00	\$20.40
3	157.7	162.854	3.2682%	\$105,333.60	\$21.07
4	157.7	164.854	4.5365%	\$110,112.01	\$22.02
5	157.7	166.854	5.8047%	\$116,503.68	\$23.30
6	157.7	168.854	7.0729%	\$124,743.89	\$24.95
7	157.7	170.854	8.3412%	\$135,148.97	\$27.03
8	157.7	172.854	9.6094%	\$148,135.96	\$29.63
9	157.7	174.854	10.8776%	\$164,249.62	\$32.85
10	157.7	176.854	12.1458%	\$184,199.13	\$36.84

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