

# Market rentals do not necessarily follow escalation-rate path

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In an inflation environment, the purpose of contractual rental escalation rates is to obviate the need to renegotiate the contractual rental once a year or so. In a hyper-inflation environment, this "or so" could be monthly, of course. Instead, the periodic in-lease rental escalation is an attempt by the parties to the lease to forecast the growth path of market rentals over the duration of the lease. Hence the market escalation rate on rentals is at any one time nothing but a forecast by the market of the probable growth rate of market rentals over the duration of the lease.

With the above as a background, it is, therefore, not surprising that many property practitioners blandly assume that the market rental growth rate over the duration of the lease will be equal to the market escalation rate at inception of the lease. Quite often, market escalation rates are even compared with the inflation rate. The purpose of this article is to examine these two propositions.

In the accompanying set of graphs we take a look at how accurate the market has been in the past in making its forecasts. The graphs compare the movement over time of

- escalating rentals (as per market escalation rates at lease entry) and
- market rentals.

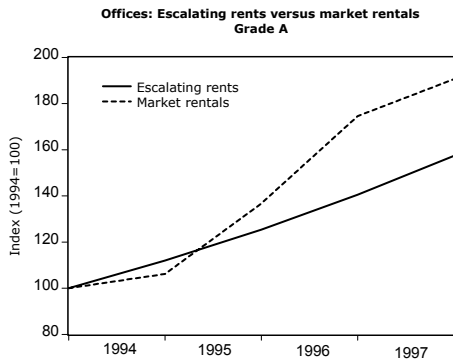
The comparisons are done for grade-A offices in the Sandton CBD as well as prime industrial property on the Central Witwatersrand. We chose to do the analysis on four-year leases for the periods 1994-1997, 1995-1998, 1996 -1999, 1997-2000 and 1998-2001. We chose four years because that is halfway between the typical lease duration of three or five years.

In this article we differentiate between an *escalation* rate and *escalating* rentals (as in leases) and *growth* in market rentals. Thus we reserve the American word *escalation* for contractual in-lease rental adjustments. Put differently, market rentals do not *escalate*, but they *grow*. We urge readers similarly to make this distinction in order to prevent confusion.

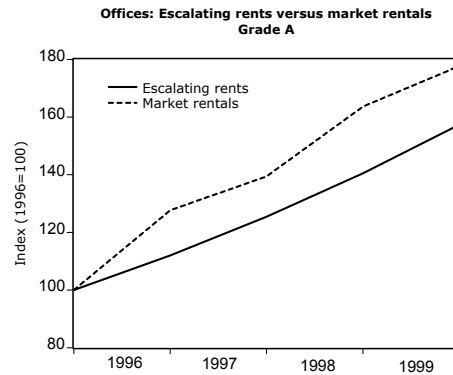
Readers should note that when **comparing indices**, one is looking at the levels relative to the base dates (which in the accompanying graphs have been set at 1994, 1995, 1996, 1997 and 1998 respectively) and not at the actual values recorded.

In the booming office market of the time, market rentals grew faster than the escalating rentals of leases signed for the periods 1994-1997, 1995-1998 and 1996-1999. Then market rentals started to decelerate, and in the period 1997-2000, the escalating rentals and market rent-

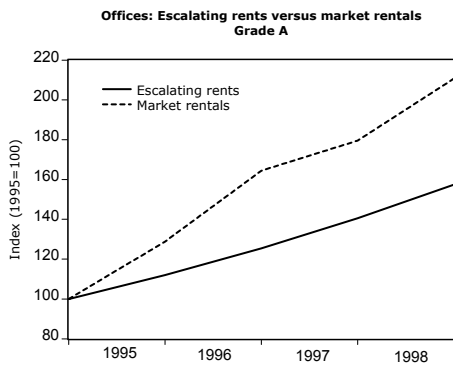
als performed on a par, whilst in the lease period 1998-2001, the escalating rentals grew faster than market rentals, but only because of the collapse of market rentals in 2001. The downturn in market rentals in 2001 was of course the result of the cyclical oversupply of office space.



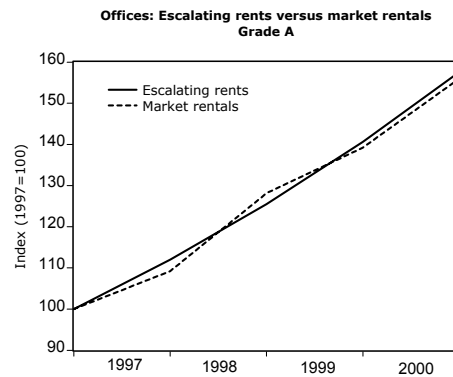
Source: Rode's Database



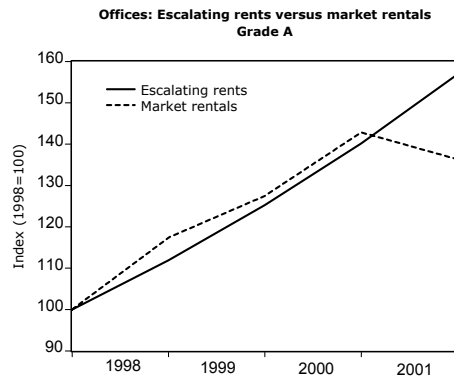
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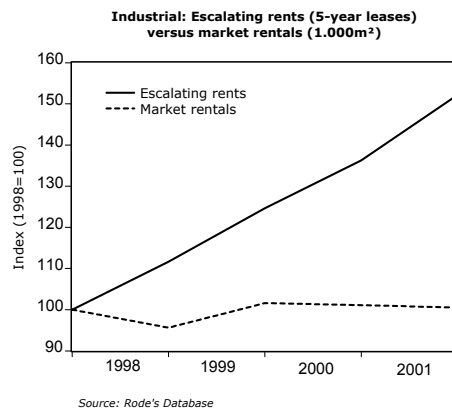
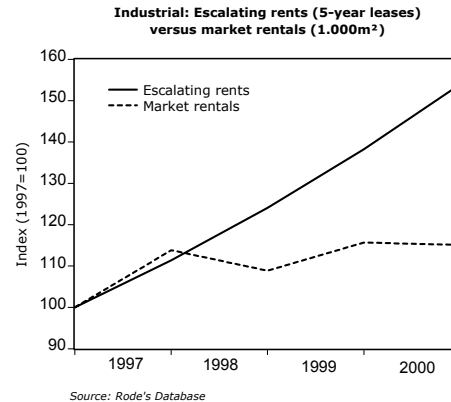
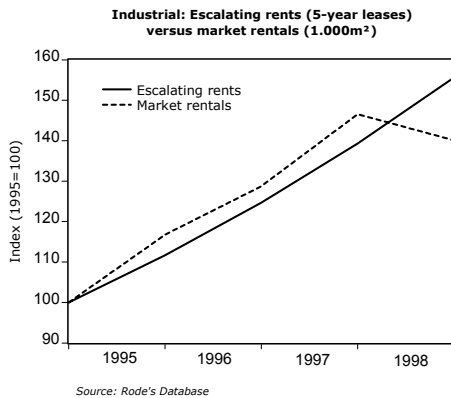
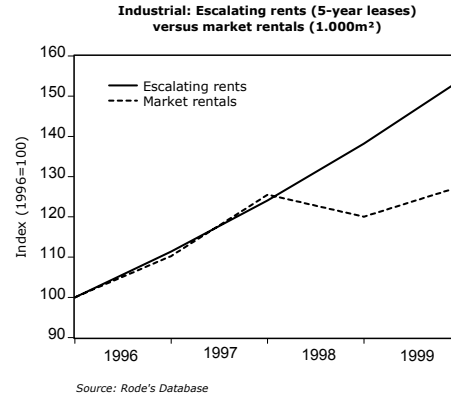
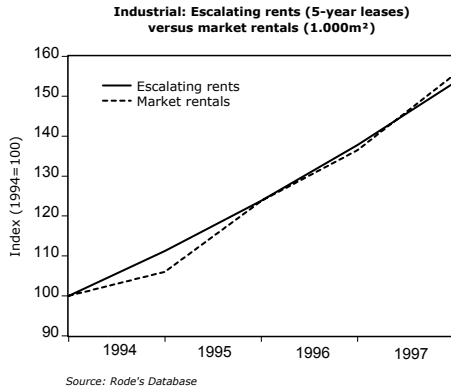
Source: Rode's Database



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In the industrial market, the escalating rentals and the trend in market rentals followed a similar path during the lease period 1994-1997. However, leases with inception dates 1995 to 1998 were negotiated at escalation rates higher than the subsequent market-rental growth

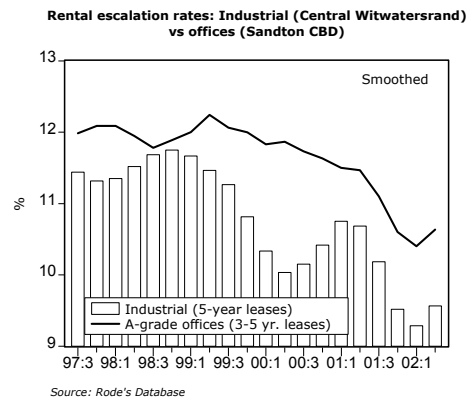
achieved, thus benefiting the landlords who had lease contracts with entry dates during this period. For instance, new leases were signed in 1998 at an average escalation rate of 11,6%, whilst industrial market rentals showed no growth over the subsequent four-year period.



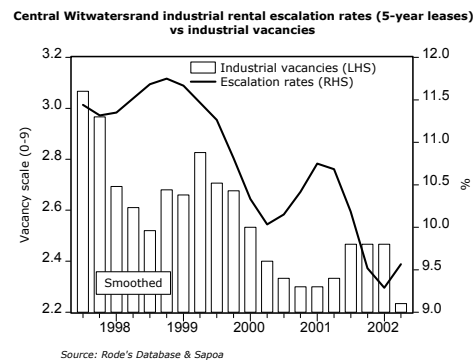
To conclude, the accompanying graphs comparing escalating rents and the movement in market rentals tell us that the market escalation rate is very slow in picking up a change in the direction of market rentals. Put differently, the escalation rate is not a good predictor of the

future movement in market rentals in periods where there is a change in the direction or pace of market-rental growth.

The next graph compares the market escalation rates for office rentals in Sandton CBD with those of industrial space on the Central Witwatersrand. It clearly shows that, over the last few years, escalation rates on office rentals have been higher than those of industrial property. So the market correctly predicted market office rentals to grow faster than those of industrial property.



Comparing industrial rental escalation rates on the Central Witwatersrand with industrial vacancies, we find that there is an inverse relationship. This could imply that, in times of declining vacancies, landlords have more room in negotiating higher escalation rates, whilst, in turn, tenants are able to negotiate lower escalation rates when vacancies are on the increase. However, in the case of offices in Sandton CBD, where vacancies are at a cyclical high, this is seemingly not the case (see graph comparing the market escalation rates of offices with industrial properties). We say "seemingly" in the light of the difficulty of differentiating between a secular trend (inflation's impact) and a cyclical trend (vacancies' influence).



For the record, the predominant approximate market escalation rates at present are as follows:

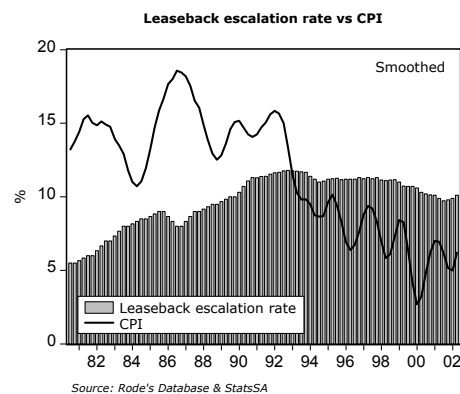
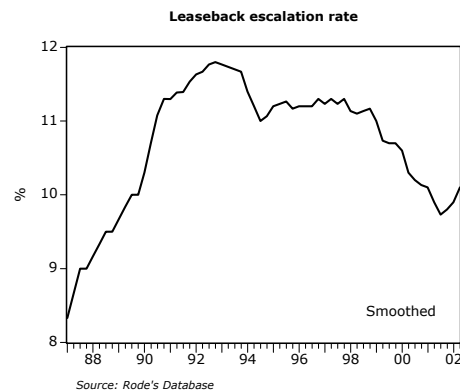
- 10% for (industrial) leasebacks (10-year leases),
- 10% for industrial leases of about 3 to 5 years' duration in good areas, and

- 11% for 3- to 5-year office leases in prime nodes.

In the case of non-leaseback leases, in inferior nodes or areas with low-growth prospects, the escalation rates logically tend to be lower than the above. For evidence of this, see the office and industrial escalation tables in this issue of *RR*.

It is also noteworthy that office escalation rates are higher than those for industrial. This implies that the market is less upbeat about prospects for industrial rentals. This is not surprising, given the disappointingly low growth of industrial market rentals over the past decade (excepting the Cape Peninsula).

The leaseback escalation rate — a proxy for the market's expected rental growth over the next ten years — has been on a secular downtrend since 1992. Indirectly, this is a result of sliding inflation, which in turn will dampen the nominal growth of rentals. However, since the fourth quarter of 2001 this escalation rate has been ticking up again. This is the result of higher short-term inflation pressures following the rand's crash at the end of 2001. Still, this is only seen as a temporary hiccup, and it is expected that the escalation rate will eventually — within the next year or so — continue its secular downward trend, which is in line with lower longer-term inflation expectations.



The accompanying graph portrays the lagged effect consumer inflation has on leaseback escalation rates. Leaseback escalation rates started declining just after 1992, lagging the decline in inflation by five to six years (peak in mid-1986 to peak in the beginning of 1992). The reason for the long lag is that there is no *direct* link between escalation rates and consumer inflation. Rather, the direct link — albeit weak — is between escalation rates and *expected* market rental growth via inflation.

It is nevertheless possible to build a regression model that uses this lagged relationship to explain and forecast market escalation rates. Subscribers to *RR's* sister publication *Rode's SA Property Trends* get the benefit of this forecasting model.

### **In conclusion:**

- It is a fair assumption that escalation rates are largely determined by expectations regarding market rental growth, which in turn is in the long run driven by inflation expectations. Hence the lag with measured inflation is long.
- Using this lag, one can forecast market escalation rates.
- Escalation rates seem to fail completely at calling turning-points in the pace and direction of market rental growth.
- In the shorter term, vacancies and quality of the node or area (and their concomitant growth expectations) may also play a role in determining market escalation rates.

This concludes our analysis of escalation rates. ■