FIX, INFLATE *or* RESET TO MARKET

FACED WITH SURGING INFLATION, COMMERCIAL PROPERTY OWNERS ARE TAKING A HARD LOOK AT HOW TO RECOUP COSTS THROUGH RENT STRUCTURES.

WITH THE COUNTRY'S INTEREST rates hitting a 30-year high, commercial landlords and tenants have been forced into something of a tussle over rent structures in a bid to balance rising costs.

The most common rent review mechanism for new leases in both office space and industrial property over the past two to three years has been fixed growth, of typically around 2.5 to three percent annually, with market reviews mid-way through the lease term, or at renewal.

However, with the recent Consumer Price Index (CPI) inflation figures hovering around 6.9 percent, well outside the Reserve Bank of New Zealand's (RBNZ) target band of one to three percent, there is an emerging trend for landlords to push for faster rental growth via higher fixed rates or CPI indexing to keep pace with inflation.

In the opposite corner, tenants are more in favour of the certainty offered by fixed-growth rent structures to help them predict and manage costs and ride out the economy's current volatilities.

The good news is that the rent challenges are not black and white, and according to Bayleys' commercial experts there is room for negotiation and flexibility on both sides.

CHANGES TO OFFICE LEASING

Bayleys' national director office leasing Steve Rendall says until about six months ago, before inflation became a material issue, the hybrid model of fixed growth structures with periodic market reviews was working well for both tenants and landlords because of the stability and transparency it offered.

"THE IDEAL BASIC PRINCIPLE OF ANY LEASE AGREEMENT IS THAT TENANTS SHOULD BE PAYING A MARKET-BASED RENT, AND THE LANDLORD SHOULDN'T BE OVER-RECOVERING, OR UNDER-RECOVERING."

STEVE RENDALL, BAYLEYS' NATIONAL DIRECTOR OFFICE LEASING

Bayleys' Insights, Data and Consulting team analysed rental data over the past six years under three scenarios from the same starting rent: fixed annual growth at 3.0 percent per annum; inflation-indexed based on CPI + 0.5 percent per annum; and Auckland CBD prime office benchmark rent for reference (where annual market rent reviews would be unusual).

That analysis found the preference for a hybrid rent mechanism, of fixed growth with periodic market reviews has tracked the market benchmark well.

The data showed that the scenario of fixed rent growth of three percent achieved overall higher rent than the CPI-indexed scenario and it would likely take a further 12-24 months of heightened inflation to balance things to similar outcomes.

"The ideal basic principle of any lease agreement is that tenants should be paying a market-based rent, and the landlord shouldn't be over-recovering, or under-recovering," Rendall says.

"Because the process by which you reset rents to the market can be quite cumbersome, landlords have typically added in some degree of fixed growth to lease agreements so they can offset moderate inflation expectations, with market-based reviews every three years or so."

It's a system that does depend on both sides having a confident view of what inflation looks like over the term of the rental agreements.

"Inflation was low for long enough that those adjustments of two or three percent looked like pretty safe bets for a fair, fixed rent uplift. Now that inflation has run away on us completely, those fixed reviews suddenly seem like a bad idea because if you only have a two or three percent rent uplift the landlord is under-recovering relative to what the true rent should be," Rendall says.

"THERE ARE SOME GREAT OPPORTUNITIES IN THE FRINGE FOR OCCUPANTS SEEKING HIGH-QUALITY BUILDINGS THAT WILL PROVIDE EXCELLENT OUTCOMES FOR OCCUPANTS."

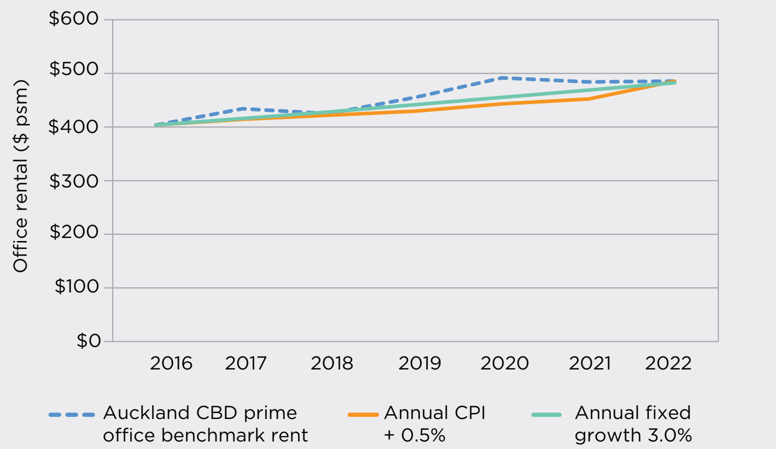
STEVE RENDALL, BAYLEYS' NATIONAL DIRECTOR OFFICE LEASING

Now landlords in premium office locations where demand is high are looking at new rental agreements that include a CPI adjustment plus growth.

"Landlords – and their lenders – will generally want rent review mechanisms that provide a degree of hedging against high inflation and high-interest rates, while tenants generally seek the opposite to avoid a big jump in rents," he says.

Many tenants are inevitably pushing back on that to try and negotiate for just CPI or a slower growth rate. Others, says Rendall, may still be able to get landlords to agree on a fixed-growth rate lease mechanism, but that rate will be higher than it was six months ago; often around four percent.

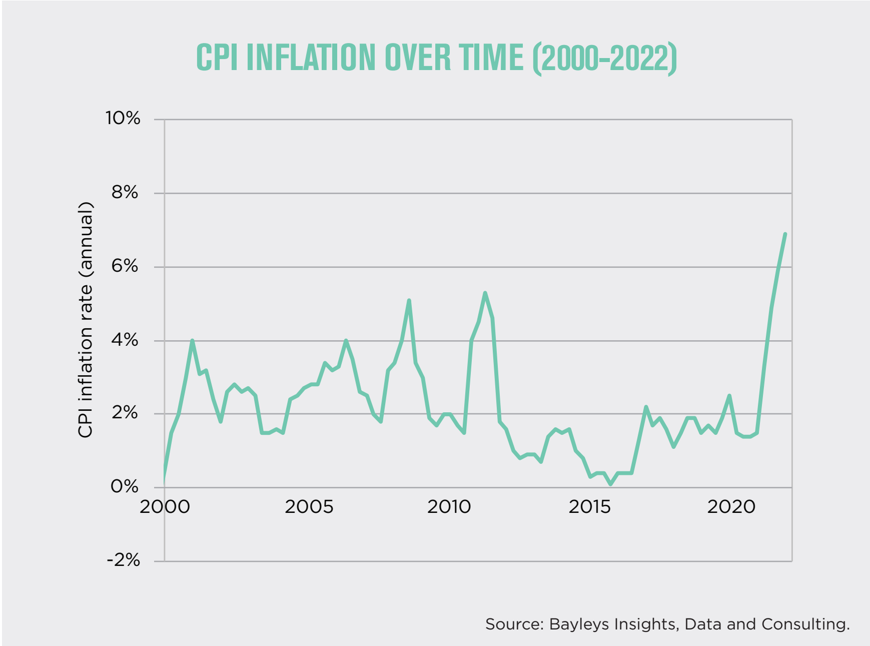
COMPARING RENTAL SCENARIOS OVER TIME – AUCKLAND CBD OFFICE



Source: Bayleys Insights, Data and Consulting.

"WHAT WE HAVE SEEN IS AN UPLIFT IN FIXED RENT REVIEWS TO HELP KEEP UP WITH INFLATION, WHICH WILL LEVEL OUT AT SOME POINT."

SCOTT CAMPBELL,
BAYLEYS' NATIONAL DIRECTOR
INDUSTRIAL AND LOGISTICS



Tenants' other source of push-back against CPI-based mechanisms may lie in the increasingly two-tier nature of office leasing.

While a flight to quality is leading to high demand for premium, often new-build space, giving landlords more heft in their lease negotiations, demand for secondary office space is lower, giving tenants more buying power in the lease agreements.

"On the other hand, in some of the fringe locations more profoundly affected by disruption over the past two years (like mid-town in Auckland's CBD, or the University precincts) or in poorer quality B and C-grade buildings, we have higher vacancy rates, and we're not seeing the same growth."

Rendall says a compromise move for tenants wanting to keep greater control over rising rental costs without sacrificing the quality of their workspace, is to look at premium properties in good fringe locations.

"There are some great opportunities in the fringe for occupants seeking high-quality buildings that will provide excellent outcomes for occupants."

Pressures on rental structures and rising costs aren't purely about keeping pace with CPI-based inflation. Rendall says the well-documented sharp increase in the cost of building is another factor.

"To build a new office building right now, given the price of construction, you're going to want to be able to achieve a rent that two or three years ago would look really optimistic," he says.

With face rents required to make a new building cost-effective often sitting well above $700 per square metre, that is having a flow-on effect by pulling up other premium rents, he says.

REGIONAL VARIATION

Most metropolitan office leasing markets around the country are facing the same challenges related to inflation which have landlords considering CPI adjustment mechanisms as a solution.

That said, market conditions do vary between regions which will impact how much tenants can expect to pay, says Rendall.

Wellington, for example, has extremely low vacancy rates giving landlords a much stronger hand to play in introducing lease structures that meet their goals.

"There aren't a lot of secondary markets outside the CBD in Wellington, so office tenants have far fewer options. I would project a good rental uplift in Wellington over the short to medium term."

By contrast, Christchurch has a higher vacancy rate and a softer rental market.

"They have some big occupants with more space than they need, which they are trying to sublease. But there's also more vacant development land in Christchurch, which makes it a relatively low input cost into new builds. So, even with the costs of construction, it makes new builds a more affordable, viable option," Rendall says.

That greater choice, whether tenants are after new builds or existing stock, gives them a bit more leverage in the terms and mechanisms of new leases, he says.

INDUSTRIAL LEASING

The prevailing rent mechanism for new industrial property leases in the past two to three years has been fixed growth, typically set around 2.75 to three percent per annum.

With most of the country experiencing record-low industrial vacancy rates alongside the surge in inflation, those fixed rates are increasing to between three and 3.5 percent per annum.

Data from Bayleys' Insights, Data and Consulting team also shows landlords are pushing for mid-term market rent reviews, typically with a hard ratchet to guarantee an income level. There is also a trend toward longer lease terms with no rights of renewal, allowing landlords to adjust to the market with a new lease.

Bayleys' national director industrial and logistics Scott Campbell says among astute landlords of industrial property there is less demand to link leases to CPI.

Most of those investing in industrial property are of the view that the current inflation surge will be relatively short and sharp, which means leaping on CPI-based rent mechanisms doesn't make sense.

"Most see it as short-sighted. If you're linking a 10-year lease to CPI, and we fall off a cliff in two years in terms of growth, that's not going to do you any good.

"What we have seen though is an uplift in fixed rent reviews to help keep up with inflation, which will level out at some point."

He adds an upward shift in industrial rents may come in over the next 12 to 24 months with the next round of market reviews, which will take into consideration other market pressures on rent, such as the cost of land and construction.

"From that, we can expect rents to go up by as much as seven to 12 percent," Campbell says, adding that while the figure seems higher it is significantly lower than the recent 30-percent surge in construction costs.

The feeling within the industrial sector is that many tenants will be able to absorb those increases.

Campbell says to date many businesses have largely absorbed those costs suggesting there could be some room to move in occupier rentals.

Regionally, industrial rental capacity remains tight everywhere, says Campbell, with 10 months of lost construction due to COVID-19 lockdowns exacerbating the situation. "Industrial vacancies have never been as tight as they are right now."

While a recession may alter that slightly, he says there is no immediate change in sight. For both investors and tenants that means being primed and ready to grab opportunities as soon as they arise.

ADVICE FOR INVESTORS

Making sense of a turbulent, inflationary market can be tough for commercial investors, says Campbell, and trying to hedge that with the right balance of lease mechanisms can seem like an educated guess at best.

His advice for investors is not to make rash decisions about how to structure or alter rent agreements, and to arm themselves with data, so they're planning for what is happening in the market, rather than what they suspect might happen.

"Long-term strategies will always win," he says, adding that getting advice and insight from those working in the market such as Bayleys can be extremely useful in making sense of market volatilities and how they impact rental returns.

"The world is a funny place, and it can be hard to navigate through all the data to make the best decisions."

In the office investment market, Rendall advises investors to not put disproportionate weight on the risks of inflation and interest rate uplifts.

"If you're buying a building, there is an implicit cost or value in what's been built that is often really hard to replicate in terms of time, cost and risk.

"An existing building has real, substantive concrete value that can be priced today, and often priced very favourably compared to replacement cost. That's really positive for people buying buildings."

The other factor to consider is that while inflation or CPI-based rent mechanisms have been less popular in the previous period of low inflation, they are not an uncommon or new concept for most tenants.

"There are lots of tenants and businesses out there making good money. A good tenant will generally be happy to pay inflation-based rents, or accept inflation-based adjustments."

Rendall agrees that the best way for both investors and tenants to navigate the changing inflationary landscape is by making sure they are informed about trends, market rates and changing dynamics by talking to those who have in-depth knowledge of the market nuances.

"The changes that have been wrought on the economy have happened quite suddenly. And the general consensus in the investment market is that the current inflationary situation is probably likely to last for a shorter rather than longer period of time.

"For good property in a good location, the outlook in the medium term is very, very positive."

"INDUSTRIAL VACANCIES HAVE NEVER BEEN AS TIGHT AS THEY ARE RIGHT NOW."

SCOTT CAMPBELL,
BAYLEYS' NATIONAL DIRECTOR
INDUSTRIAL AND LOGISTICS