OAK INVESTMENT MANAGEMENT GROUP

DECEMBER (1) 2014

Index linked leases in Real Estate

Linking a lease to an inflation index sounds like a sensible way to resolve the problem of a lease getting out of synchronisation with the market rate for a building for a long lease. Unfortunately there is no such silver bullet when it comes to any real estate. This is because nothing in the economy or with economic assets is mechanical. It is not mechanical because there are just too many variables that go into determining the value of a real estate asset.

First, there is the value ascribed to an occupier which might go up or down. Secondly, there is a value ascribed to an area which might get better or worse. Thirdly, there is a value ascribed to a building which might tire at a faster or slower rate. Fourthly, there is the value ascribed to others being able to access the specific or general market in which the real estate asset sits. Fifthly, the capital markets – and amount of money available in the system can increase or decrease dramatically.

An index itself is far from a simple input variable to this mix. Indices are notoriously difficult to define and where an official definition exists, it changes out over time. For example, the once ubiquitous Retail Price Index (RPI) in the UK has been largely discredited and is now being dropped altogether. This is not just political expediency (as some have suggested) it is the very nature of a dynamic and capitalistic economy that a basket of goods changes over time. Like all valuations this is an art not a science.

Intuitively, an index linked lease should be linked both upwards and downwards. Usually, however, in real estate this is not the case. Usually there is an upwards only arrangement whereby the rent only ever goes up never down (although Ireland tried to force through retrospective legislation negating his clause in many contracts without success). This means more likely than not most index linked leases, and certainly in a deflationary environment, are an escalator to nowhere. This is often an investment trap – as it 'flatters' the yield of an investment on the in before it is too late for an unwary investor to notice.

An index is only worth having for a long term lease. As a short lease has its only adjustment of a new lease. French leases often have the structure of a 3 x 3 year lease – which cannot err too far from the market value. Germany usually has an index linked cover but this is usually from a fairly low base. Longer leases are much more prevalent in the UK for commercial real estate or for throughout Europe for bigger e.g. infrastructure projects. Index based links are hugely important for pension funds that need to demonstrate that their rental yield will grow with the economy. Nonetheless, it is important for this mechanism not to surpass the value of the underlying market. If so the victory against inflation will only be pyrrhic.

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