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Low inflation could trigger drop in commercial property values

Deflation would change the rules for commercial landlords **Ray Sparvell**

by **Larry Schlesinger**

Investors in shops, strata offices or warehouses, could lose hundreds of thousands of dollars in value if, in a low inflation or deflationary environment, they continue to link rent increases to the CPI.

"Commercial property investors need to think carefully about the type of rental agreement they enter into with their tenants," The Secret Agent's Paul Osborne said.

"With many older leases still operating on a CPI basis, we may start to see leases that produce rent decreases for tenants annually and erode the value of some buildings, especially where long leases and terms have been secured by tenants," he said.

The Secret Agent, a Melbourne buyers agent, has modelled the impact of CPI linked rent increases against fixed increases after consumer prices fell by a surprise 0.2 per cent in the March quarter, the first quarterly deflationary reading since the global financial crisis.

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Impact on value of CPI v fixed rent increases ($)

	Property A CPI -0.40%	Property B Fixed +3.50%
Rent per annum	100,000	100,000
Year 1	99,600	103,500
Year 2	99,202	107,123
Year 3	98,805	110,872
Year 4	98,410	114,752
Year 5	98,016	118,769
Buy @ 3.5% yield	2,800,455	3,393,389
Difference		592,934

SOURCE: THE SECRET AGENT

Impact on value of CPI v fixed rent increases

For a small tenanted commercial property of about $3 million, and earning $100,000 a year in rental income, the potential decline in value was almost 17 per cent in a deflationary environment if rent was CPI-linked, compared with rent increased by a fixed 3.5 per cent a year.

The Secret Agent modelling is purely hypothetical, but devaluation would also play out if there was a persistent period of low inflation.

Fred Nucara, director of Melbourne commercial agents Beller, said, "This type of scenario has been on the cards for years, but nobody wants to listen."

"As property agents we have never encouraged CPI as a benchmark [for rent increases] over time because inflation has been going down to very low levels over the last three to four years.

"It's quite concerning for property owners that have rent increases linked to CPI because it's very difficult to change a lease mid-term. Of course it's to the advantage of some tenants.

"When we negotiate for landlords we try to get tenants to commit to fixed increased of 3-4 per cent over a four or five year period," Nucara said.

Dean Venturato, a director at commercial property specialists Burgess Rawson, said the preferred option for buyers was combination of fixed price and CPI for example "3 per cent or CPI, which ever is the great" so landlords had the "best of both worlds".

"The least preferred are market reviews, because there is quite a lot of uncertainty and it's quite a process to go through. A market catch up every five-10 years is OK though."