CMBS Special Topics

Inflation-Resistant Leases: Rent Steps Offer Some Revenue Protection, though Not Much

Track Step-Up Leasing Provisions as Inflationary Pressures Mount

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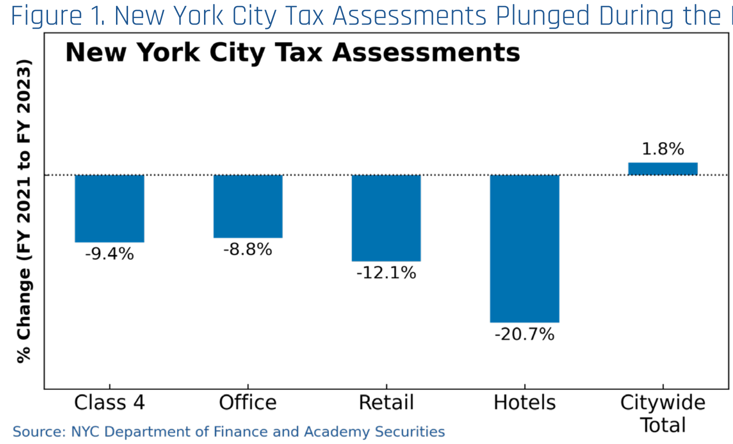
Inflationary pressures on landlords' cost structures should sharpen the focus on rent steps or "step up leasing" across CMBS properties. Contractually negotiated rent increases could shield property NOIs to some extent from rising expenses. Rent increase provisions may include fixed annual increases, resets to market, or inflation-driven adjustments (e.g. CPI lookbacks). Separately, leases can also feature reimbursements of operating expense pass-through charges – another inflation-protection measure.

Anecdotal disclosure of fixed rent steps in deal documents suggests the contractual increases could offer only limited protection from elevated inflation. US CPI rose 8.3% YOY in April, according to the BLS. In contrast, office lease annual steps appear to hover around 2-3%, according to a few writeups of office properties in recent deals that disclosed the precise steps. For example, the lease of Novo Nordisk HQ ($210.6 million, across five 2021- and 2022-vintage conduit deals) features 2.0% annual rent steps in the 731K sf suburban office in Plainsboro, NJ. Detailed office lease comps in the Novo writeup show that other large Northern New Jersey suburban office leases also include rent steps in the 2% range. Office landlords explicitly note in recent financial disclosures that rents may not increase frequently enough to fully cover inflation.

Still, even amid recent high inflation levels, several large property expense items may not see much of an impact. Property taxes is a case in point. Some property tax assessments plunged during the pandemic, leading to much lower tax bills for landlords. For example, in New York City, FY 2022/23 tax assessments for commercial properties (so-called "class 4") are still 9.4% lower compared to FY 2020/2021 (Figure 1). Hotels assessments are nearly 21% below pre-pandemic levels. Property taxes many times represent the largest expense item for properties.

Figure 1. New York City Tax Assessments Plunged During the Pandemic



Source: NYC Department of Finance and Academy Securities

Greater Disclosure of Early Termination Options, Not so Much Rent Steps

Contractual rent steps in combination with other revenue-protection provisions could better position properties to address expense pressures. Asset writeups may increasingly disclose such provisions, with direct underwriting implications. Interestingly, we observed greater disclosures of tenant termination options in recent months. Early termination options grew in importance during the pandemic as office tenants re-assess their future space needs. Deal documents usually mentioned early termination provisions in passing or in table footnotes. But recent writeups of large properties, such as the $830 million Old Chicago Post Office (in JPMCC 2022-OPO and BMARK 2022-B32), more clearly lay out tenants' termination options in easily accessible tables.

Until asset writeups more explicitly disclose rent steps, investors can track steps via cash flow analysis line items such as straight-line rent averaging credit or base rent footnotes (Figure 2). Straight-line averaging can add rent steps credit for investment-grade tenants. For example, the gross potential rent of the $1.0 billion 601 Lexington Avenue (BXP 2021-601L and seven 2022-vintage conduit deals) includes $6.7 million rent average benefit for three tenants, or 4% of the overall underwritten rental income. In turn, in Greenwich Office Park ($94 million, BMARK 2021-B31) $351.9K rent steps revenue is built into the overall $13.9 million underwritten base rent. This suggests about 2.5% rent steps in the 343.2K sf suburban office complex in Greenwich, CT.

Figure 2. Rent Steps Cashflows on Large Recently Originated Office Loans

Loan	Deal	Loan Balance ($MM)	Base Rent	Rent Steps	Location	Maturity
601 Lexington Avenue	BXP 2021-601L, BANK 2022-BNK40, BANK 2022-BNK41, BMARK 2022-B32, BMARK 2022-B33, BMARK 2022-B34, BMARK 2022-B35, MSC 2022-L8	2,765.0	$145,905,931	$128,513	New York, NY	January 2032
The Summit	SUMIT 2022-BVUE	525.0	$32,704,127	$735,068	Bellevue, WA	February 2029
1888 Century Park East	BBCMS 2022-C14, BBCMS 2022-C15, BBCMS 2022-C16	200.0	$28,447,410	$797,606	Los Angeles, CA	December 2031
Greenwich Office Park	BMARK 2021-B31	94.0	$13,954,241	$351,867	Greenwich, CT	December 2031
200 West Jackson	BMARK 2022-B33, BMARK 2022-B35	86.0	$9,626,672	$93,467	Chicago, IL	February 2032

Source: MCIA and Academy Securities

Ground Lease Inflation Protection

CPI-driven rent adjustments are particularly prevalent in recent ground leases. For example, 97% of the portfolio of one of the ground lease-focused REITs includes some form of inflation-linked protection. A typical CPI lookback provision would kick in every 10 years to increase rents if inflation has exceeded 2% during the previous decade. Still, the provision may also cap the inflation adjustment in the 3.0-3.5% range.

Interestingly, several of the large outstanding CMBS leased fee loans do not appear to include inflation-linked adjustments on their associated ground leases, according to deal documents. Examples include 625 Madison Avenue ($194.8 million, COMM 2014-CR14 and CR15) and 530 Seventh Avenue Fee (BANK 2021-BN32). Older ground leases typically did not include CPI lookbacks, according to market participants. Rather, ground leases included fixed periodic resets or fair market value ("FMV") resets, which linked the rent adjustments to the land value. Such FMV resets hobbled quite a few ground lessees, such as in the Chrysler Building or the Lever House (390 Park Avenue). As a result, newer ground leases typically do not include FMV resets.

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