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Hunt Corp. Commercial Real Estate Q&A: Lease Escalations - by David Hunt

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Q: What is a fair rent increase in a commercial lease? My firm is negotiating a lease on an industrial building, and the landlord is asking for a 4% escalation every year. Is there a standard rent increase for industrial leases?

A: There are no standard or published lease escalations. Escalation terms are essentially whatever two parties can agree upon. An alphabet soup of rent escalators was common in the past, such as CPI (consumer price index) and COLA (cost of living adjustment). Most of these lease escalators have fallen by the wayside, and what is most common today is a simple percentage increase in the rent, usually on the anniversary date of the lease commencement. There are four major areas that are usually covered by escalation clauses in some way: the rent itself, real estate taxes, building insurance, and common area maintenance (commonly known as CAM.)

There are some guidelines that reflect the current negotiating trends in the marketplace. A typical escalation of the base rent today is often a 3% increase in the net rent each year. This can vary however, depending on the term of the lease (longer terms such as 20 years will either have lower annual increases, or the “bumps” will be spaced further apart, e.g. a rental increase every three years.) The financial strength of the tenant or the market demand for the space will also play a role in the ultimate rent escalation. The landlord is attempting to anticipate, and collect rent upon, the rising value of his real estate as well as cover the increasing cost of expenses. The tenant is, obviously, attempting to control costs. This is one reason that open ended lease escalations, such as those based upon a consumer price index, lost favor. They made it impossible for a tenant to cap his rental increase.

There is one clause in almost every lease on Long Island that does allow for an open ended increase. Almost all tenants face either a “tax stop” clause, or a provision in the lease requiring direct payment of the real estate taxes by the tenant. A “tax stop” clause provides that the tenant will pay his proportionate share of real estate tax increases in a lease where the landlord is responsible for the payment of base year real estate taxes. Either way, the tenant is responsible for real estate tax increases, a cost that cannot be predicted with absolute accuracy. Another clause that is usually open-ended is the cost of CAM. On Long Island, for example, snow removal costs can vary dramatically from year to year, so it is not unusual to see a provision that passes along additional CAM cost to the tenant.

As a tenant, you want to make sure that your rental increase is calculated on the net rent (rent without real estate taxes), not the gross rent. If your rent is being quoted as a gross rent that includes real estate taxes, insist upon knowing the actual portion of the rent allocated to the taxes. Your escalation should be based upon the gross rent less this allocation. Otherwise you will effectively have two real estate tax escalations. There should also be a provision that delivers to the tenant a proportionate share of any real estate tax refund received by the landlord.

Your broker should be able to provide you with guidance on recently negotiated deals with this landlord, or landlords of similar properties. A little homework and education will go a long way to making sure that your escalations are reasonable and not above market.

Do you have a question regarding commercial real estate? Email your question to Commercial Real Estate Q & A, at email@huntcorp.com for possible inclusion in a future column.

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