

Chapter 5: Hurdle and leaseback escalation rates

Escalation rates not all that unrealistic

Most South African investors calculate the value of an income-producing property by using an income-capitalization approach. Even viability studies are usually judged on the basis of what an acceptable initial income yield is. For this reason, there is plenty of relatively reliable information on market capitalization rates or income returns required by investors, especially since *Rode's Report* introduced the regular survey of "cap" rates at the end of 1987.

However, in contrast to what business schools have been teaching us for decades, the hurdle rate is seldom used as an investment criterion when doing viability studies.

In spite of the neglect of hurdle rates, *Rode's Report* started surveying these in 1993. The question we pose to respondents is as follows:

In your opinion, what is presently the minimum expected internal rate of return or hurdle rate (%) at which your organization will acquire the following properties ... assuming a time horizon of 5 years?

Of note is the fact that we elected 5 years as a time horizon because from anecdotal evidence we are pretty sure that this is the typical term that is used by investors and valuers alike — that is, in those few cases where they do discounting or IRR calculations.

*The minimum total return required by potential investors to induce them to invest in property is known as **the hurdle rate** (income yield plus expected capital appreciation). Because it represents the opportunity cost of not being invested in property, it therefore is the correct discount rate to use for valuations and viability studies. One way of measuring the total rate of return on an investment — ex post or ex ante — is the internal rate of return (IRR) method.*

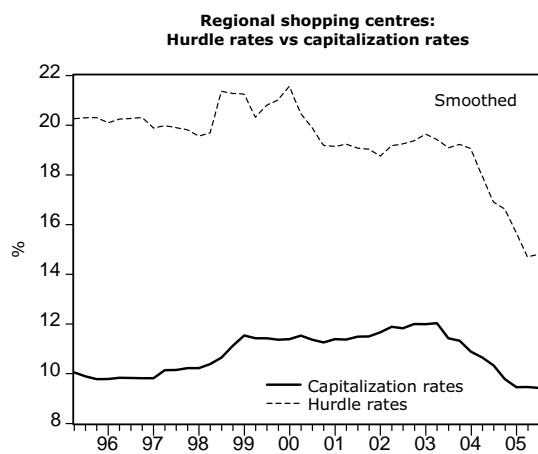
Synonyms for **hurdle rate** are **required total return, cut-off rate** or **cost of capital** (not to be confused with the cost of loan funds). The Afrikaans terms are: *kritieke rentabiliteit* or *drempelkoers*.

Hence, many property-investing professionals out there are not all that certain about hurdle rates (the minimum total return required by their organisations to proceed with an investment). This is a great pity because even when using capitalization as the primary valuation method, a measure of discounting — which requires a discount rate — is still called for most of the time when valuing income-producing properties (remember, the discount rate equals the hurdle rate).

tions.

Note that when we say that viability studies are done with a 5-year investment horizon, we do not wish to imply that investors necessarily plan to sell a property at the end of Year 5.

However, in viability calculations it is problematic to try and forecast rental growth and operating-cost inflation over a period longer than 5 years.



The accompanying graph shows that there is some correlation between hurdle rates and capitalization rates. One would of course expect that hurdle rates would move in synchrony with capitalization rates — provided the recent (early 2000s) drop in capitalization rates was the result of a downward revision in investors' long-term inflation and interest-rate expectations, or a change in investors' risk rating.

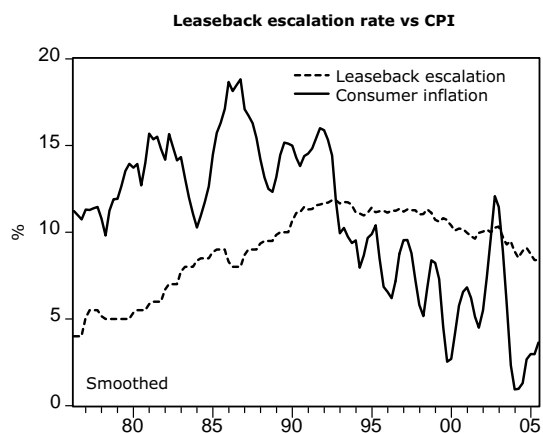
Table 5.1 suggests — based on small samples — that hurdle rates vary from as low as 14% for regional shopping centres to around 16% for office and industrial buildings. Given the current level of capitalization rates of these property types, it would seem that investors expect roughly 5% net-income growth (and hence capital growth, assuming no change in cap rates) on their investments (the hurdle rate less the capitalization rate \approx 5%).

The hurdle rates in **Table 5.1** are based on a small sample of respondents. Hence we advise caution in interpreting the results. For instance, compare this quarter's results with those of previous quarters.

We next deal with leaseback escalation rates.

Leaseback escalation rates

Table 5.2 shows that the average leaseback escalation rate was 8,4% during the second quarter of 2005. The escalation rate is an attempt by the market to forecast market rentals until the expiry of the lease. Hence, an escalation rate of 8% isn't all that high given our bullish view on rental growth over the next few years. The problem is, of course, that many players out there — especially tenants — look upon the escalation rate as compensation for consumer inflation, rather than rental inflation. We must nevertheless bear in mind that leaseback terms are typically 10 years, and that a compounded growth of 8% p.a. over this term is high when consumer inflation is expected to run at, say, 5% p.a. For leases of 3 to 5 years, 8% is — in our opinion — not a bad stab at the future movement of market rentals.



The leaseback escalation rate is a proxy for the property market's expected rental growth rate of an individual property over the next 10 years.

This concludes our section on hurdle and escalation rates. ■

Intuitively one would think that a gross-rental escalation rate (for a given period of lease) is a function of two factors:

- Expected (operating cost) inflation rate
- Expected net rental growth rate

If we remember that

Gross rental (100%) = Net rental (say 75%) + operating costs (say 25%),

one could say that:

- Net rental escalation = function of expected rental growth
- Operating costs escalation = function of expected inflation rate

Finally, if we accept the above weights, we are implicitly saying that the main determinant of escalation rates is *expected rental growth*.

Table 5.1
Hurdle rates assuming a time-horizon of 5 years (%)
Quarter 2005:3

	Buy %			Develop on speculation (%)		
	Mean	SD	n	Mean	SD	n
Office buildings (dec.)						
Johannesburg	16,2	N/A	1	21,2	N/A	1
Sandton CBD	16,2	N/A	1	21,2	N/A	1
Pretoria	16,2	N/A	1	21,2	N/A	1
Durban	16,2	N/A	1	22,6	1,98	2
Cape Town	17,1	1,27	2	20,4	2,83	4
Industrial leasebacks						
Central Witwatersrand	15,6	N/A	1	19,6	N/A	1
Pretoria	15,6	N/A	1	19,6	N/A	1
Durban	15,6	N/A	1	21,8	3,11	2
Cape Town	16,8	1,70	2	19,5	0,50	3
Regional shopping centres						
Witwatersrand	14,1	N/A	1	17,1	N/A	1
Pretoria	14,1	N/A	1	17,1	N/A	1
Durban	14,1	N/A	1	20,1	4,17	2
Cape Town	15,1	1,34	2	17,5	0,45	3

n = Number of respondents; N/A = Not available (fewer than two respondents); SD = See Glossary of terms and abbreviations in Annexure 1.

Table 5.2
Prime industrial leaseback escalation rates
Quarter 2005:3

Mean	SD	n	Change 2005:3 less 2005:2	Broker-contributor codes
8,4	0,6	12	0,2	AU, BZ, EQ, FO, IN, KR, LG, MW, PY, SQ, TH, TS, ZZ