Indexes Commercial Real Estate Investors Should Know

By David V. Tran @ Transmercial.

Consumer Price Index (CPI): It is the measure of inflation as experienced by urban consumers. CPI is more well-known among senior citizens as their Social Security benefit checks are adjusted to the CPI on January to keep pace with inflation. While most commercial real estate leases have fixed annual rent increases, e.g. 2%, some have annual rent increases based on the CPI. Therefore, knowing what CPI is and how to calculate it is an important factor in making a sound investment decision.

The US Department of Labor, Bureau of Labor Statistics collects data about costs of various things from 87 urban areas in the US. The data is published each month and available from the website http://stats.bls.gov. The CPI varies for different regions: Northeast urban, Midwest urban, South urban, West urban, US city average, as well as 14 major metro areas. So, knowing which CPI stated in the lease will enable an investor to correctly calculate the rent increase. For example, the CPI for US city average was 190.9 in Oct 2004 and 199.2 in October 2005. This reflects a 4.3% increase for the above period or in another words, the inflation was 4.3% during that period. So if the rent from October 2004 to September 2005 was $1000/month and the lease has CPI-based rent increase, then the new rent from October 2005 to September 2006 would be $1043 a month or 4.3% higher. The CPI fluctuates from time to time. When there is no inflation, the CPI is zero and thus there is no rent increase. It could also be negative during a deflationary period which in turn will translate to rent reduction for the tenant.

Cost of Living Index (COLI): COLI is a number that indicates the relative cost of living in various cities in the US with 100 being the average. Employers often increase an employee's salary when they relocate the employee to a city with higher COLI. The COLI is weighted according to percent of income spent on groceries (12.49%), housing (29.84%), utilities (9.94%), transportation (10.73%), healthcare (4.07%) and others (32.93%). You could obtain the indexes for various cities from http://www.infoplease.com/business/economy/cost-living-index-us-cities.html. The website www.bankrate.com has a COLI comparison calculator for over 300 US cities which provides the costs of 60 various items in each city. In 2007, the COLI for San Francisco was 169.5 while Dallas was only 91.5. This means you would have had to earn 85% (169.5 minus 91.5 then divide by 91.5) more in San Francisco to maintain the same lifestyle in Dallas. Most of the costs will be higher in San Francisco, e.g. housing is 285% higher (housing index is 278.3 in San Francisco and 72.3 in Dallas), some expenses may be lower, e.g. utilities are 11% cheaper in San Francisco compared to Dallas (utilities index is 88.1 in San Francisco and 98.9 in Dallas).

An investor often reviews demographic data of a city where the property is located and generally prefers to invest in areas that are more affluent. However, looking at data of the Average Household Income (AHI) alone does not give you the whole picture. Let's assume you are an investor in the San Francisco Bay Area and you want to see how the AHI in Plano (Dallas metro) is compared with San Francisco income. You will have a better perspective if you adjust the AHI in Plano to the Cost of Living Index and then compare with the AHI in the San Francisco Bay Area. For example if the AHI is $100K a year in Plano, it would be equivalent to $185,000 in San Francisco. With this adjusted income, you know that Plano is an upper middle class area.