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COMMERCIAL REAL ESTATE AND INFLATION: IS IT REALLY A GOOD HEDGE?



- ▶ Long income commercial real estate managers have access to a range of solutions to keep pace with inflation
- ▶ CPI or RPI-linked rent reviews ensure a long-term/partial hedge capable of smoothing income progression over time
- ▶ Managers should invest in growth sectors to avoid exposure to risk sectors, such as retail
- ▶ Risk of tenant insolvency is a huge threat to long income portfolio returns, so it's essential to prioritise tenant credit

Written by Rupert Sheldon, Head of Core REIM

It is a long-held belief that real assets generally and commercial real estate more specifically, represent a good hedge against inflation. Well, here we are in inflationary times so let's put that theory to the test and see if this conventional thinking is correct. The answer, as with many complex and multi-layered issues, is that it depends!

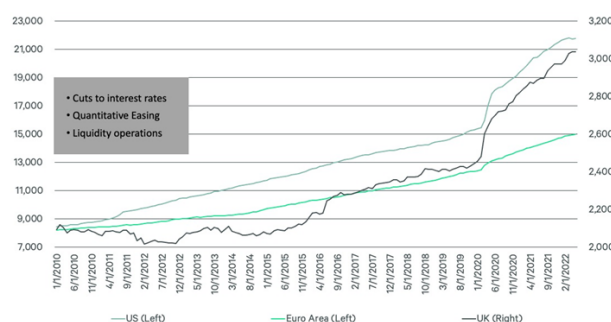
Before looking into the detail, let's consider where we have come from and how we got here, as this offers the key to how commercial real estate can help investors as the market moves through the next, most perilous phase of the economic cycle.

Unprecedented Times

If we go back to 2009 and the height of the GFC, central bankers and governments around the world put the most enormous sticking plaster over a gaping wound to the financial system. Traditional economic medicine would have offered a band-aid in comparison. A second bout of the same treatment was served up on an equally grand scale as governments grappled with the economic fallout and aftermath from Covid-19 through 2020 and 2021. The outcome was a prolonged period of quantitative easing coupled with ultra-low, never seen before, interest rates. With a resultant c.25% increase in the UK's money supply (see chart 1 to the right) this created a sustained period of asset price growth and wealth building providing a foundation stone for today's inflationary forces.

The eventual fallout from this unconventional remedy always had the scope to be painful. Triggered by economic aftereffects from Covid-19, supply chain disruption, war in Ukraine and other multiple factors, resultant spiralling inflation, rising interest rates and bond rate expansion have led global economies to the brink of recession. So, what happens next?

Money Supply (M2), Billions in USD, GBP & EUR



Source: Macrobond, CBRE Research Q2 2022

Bad Inflation

As students of economics know, there is good and bad inflation. The good type or "demand pull" sees increasing demand for goods and services drive real economic or GDP growth. The surfeit of demand over supply creates pricing pressure, but in a growing economy this is supported and sustainable. What we are currently seeing in the UK and other developed economies, is "cost push" or bad inflation, whereby the price of goods and services is going up due to increases in input costs such as energy, labour or materials. When this happens during periods of weak or negative economic growth such as now, the result is stagflation.

Why Is This important?

Economic growth that comes with demand pull inflation leaves businesses more able to manage rising input costs including rent. The opposite is true where cost push drivers are at play and corporate profits are coming under pressure. Increasing insolvency risk and rising vacancy rates typically send rents spiralling in the opposite direction. This is where we are at today so, in such circumstances how do commercial real estate landlords maintain any meaningful pricing power?

Long, Strong & Progressive

When economic conditions are doing their best to erode real returns, long income commercial real estate investment managers do still have a few tricks up their sleeve to keep pace with inflation:

1. **Lease Indexation** – In a standard commercial lease, the landlord will have the opportunity to increase rents every fifth year in line with prevailing rental values in the local market. This is done by having regard to comparable transactions at or around the same time as the relevant rent review date in much the same way as valuing a residential property. However, this may not be much use during times of “bad” inflation or stagflation where increasing corporate hardship and insolvency rates lead to rising vacancy rates and negative rental pressure.

During such times, it pays to hold leases within your portfolio where rent reviews are pegged to either CPI or RPI inflation. This will almost certainly come with collars and caps, thereby providing a guaranteed minimum during times of low inflation and capping the tenant’s exposure during times such as now. However, linking income progression to inflation ensures a long-term hedge/partial hedge capable of smoothing income progression over time and creating greater predictability of cashflows. For long leased funds this helps create a bond proxy, liability matching characteristic which is of particular appeal to mature defined benefit pension schemes.

2. **Invest in Growth Sectors** – Not all property types behave the same. The three principle sectors of the commercial market: retail, industrial and offices, are materially different in their exposure to capital expenditure, lease-up risk and overall rental growth potential. According to Statista, over the 12 month period to Q2 2021 global retail rents fell by 9.6% in nominal terms; during the same period industrial rents grew

by 3.2%. Being invested in the right segment of the market provides an excellent hedge against inflation when the lease structure provides for open market rent reviews enabling this excess rental growth to be captured at rent review.

3. **Don’t Compromise on Tenant Credit** – Now is not the right time in the cycle to be taking tenant credit risk. Over the next few years, income will likely make up between +/- 100% of total returns and should be nurtured carefully to manage risk.

Holding the right assets in the right sectors with the right lease structure will only get you so far. During periods of stagflation, pressure on corporate profits serves to elevate the risk of tenant insolvency and, with that, the prospect for landlords of capital expenditure refurbishing vacant space and potentially long-term rental voids. This can be hugely damaging to total returns and will typically lead to under-performance. Maintaining an aggregate investment grade tenant counter party risk across held portfolios is the best way to defend against this elevated risk.

What Happens Next?

Inflation has been building within global economies for some time with numerous forces coming together more recently to create the perfect seedbed for a persistent and nasty bout. Whilst transient by nature these forces have taken a firm enough hold for us to realise that rising interest rates are here to stay for the foreseeable future.

Resultant stagflation poses huge threats to asset owners through value erosion. However, real estate managers who have aligned their portfolios for the next phase of the cycle will have within their armoury the weapons to fight this unwelcome foe. To this end, a carefully structured long income real estate strategy should continue to offer investors a good hedge against even the bad inflationary forces currently at play.

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