

Real Estate and Inflation



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A risk we have not had to think about for some time is inflation, however, it is now at the forefront of many investors' minds. While it is not an immediate issue, a combination of supportive fiscal and monetary policy, a shift in the focus of central banks in targeting inflation, and further consequences of globalisation could result in unexpected inflation in three to five years' time. Real estate investors already need to be considering the implications of these risks for portfolio construction, in areas such as lease lengths and indexation clauses.

Real estate is traditionally associated with low inflation risk. Investors are therefore often attracted to invest in the sector because it can be used as an effective inflation hedge. In Europe, the basis of their confidence has rested on two core beliefs:

- In most countries, property leases are commonly indexed automatically to growth in inflation (usually Consumer Price Inflation, or CPI)
- Leases have traditionally built-in frequent rent reviews, allowing the rent underpinning the nominal cashflow to grow.

Growing income streams should feed through to capital value appreciation over time, providing additional return for investors. In addition, where leverage has been applied, inflation can help to depreciate the value of the principal amount owed, and in the case of fixed rate debt, the repayments as well.

However, the reality is more nuanced, rendering some forms of real estate more - or less - effective inflation hedges than others, while its effectiveness can vary over time and in different economic conditions. Not all inflation is good for real estate investment, and, given the uncertainty in the medium term as to whether we will see a further prolonged period of low inflation, or a rapid escalation of inflationary pressures, it is important to understand how inflation could affect real estate performance over the next few years.

The Good News - The Contractual Income Inflation Link

Real estate income returns are geared towards capturing inflation in most European markets either through indexation, open market rent reviews (OMRRs), or fixed rental uplifts – written in to lease contracts. Indexation plays a large role in Continental European lease structures across all the main

property sectors while in a UK context, it is limited to speciality segments such as supermarkets, health care properties and some logistics assets.

Typical inflation-linked lease terms across Europe

	Sectors	Benchmark	Review frequency	Hurdle rate	Caps/Collars	Inflation capture
Germany	All	CPI	Monthly	3/5% for Office and Industrial. 10% for Retail	No	Full except for retail which captures c.70%
France	All	Commercial Rents Index (ILC, ILAT) - composite of GDP, CPI, Construction Costs	Annual	No	No - rents can be reviewed at anytime if ERVs have changed by more than 25% since last review	Full
Netherlands	All	CPI	Annual	No	No	Full
Belgium	All	Health Price Index (CPI excluding alcohol, tobacco, fuel)	Annual	No	No - either party can ask the courts to review the rent every 3 years if ERVs have changed by 15%	Full
Luxembourg	All	CPI	Annual	No	No	Full
UK	Specialist	RPI/CPI	Annual	No	Yes - usually 1% to 5%	Full within cap and collar bounds

Source: Fidelity International - 23/11/2020

The nuances of how indexation is applied in each market alters its effectiveness for capturing inflation. For example, the hurdle rates that apply to German leases ensure there is a degree of inflation leakage which cannot be recovered through indexed rent increases. France is a particularly attractive market for inflation hedging due to the special rent index that typically outpaces CPI, delivering an additional 25 bps pa over the last ten years. Coupled with the relatively frequent rent review periods, French indexed leases offer appealing, timely hedging properties.

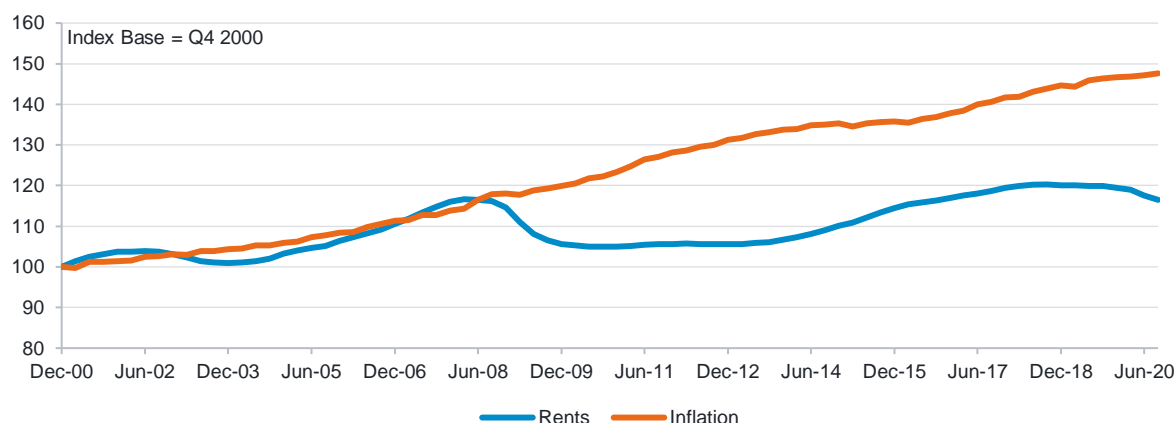
Despite some of the limitations in how indexation can be applied, the mechanism is adequate for insulating investors against inflation risk in most circumstances. The time lag effects of capturing inflation will depend on the average time to an 'open market' review of the properties in a portfolio but over the medium to long term, indexation is a valuable tool for hedging inflation risk through real estate.

Open Market Rent Reviews

Outside of the traditional hedging offered by inflation linked leases, OMRRs can also provide similar benefits. OMRRs, the most common UK lease type, are upwards-only which ensures rents do not decline for the duration of the lease. This affords protection against the downside risk of deflation that is not provided as standard in continental European markets. OMRRs do not usually contain a cap on rent increases and usually have no hurdle rates for increases to become applicable. As a result, the OMRR structure can capture low and high inflation rates efficiently.

Strong correlation between general inflation, and rents is a key requirement for the inflation hedging benefits of OMRRs to hold true, and as can be seen below, rental values do tend to move with general inflation in the economy.

Although UK rents and inflation decoupled during the GFC, they remain highly correlated ($r = 0.74$)



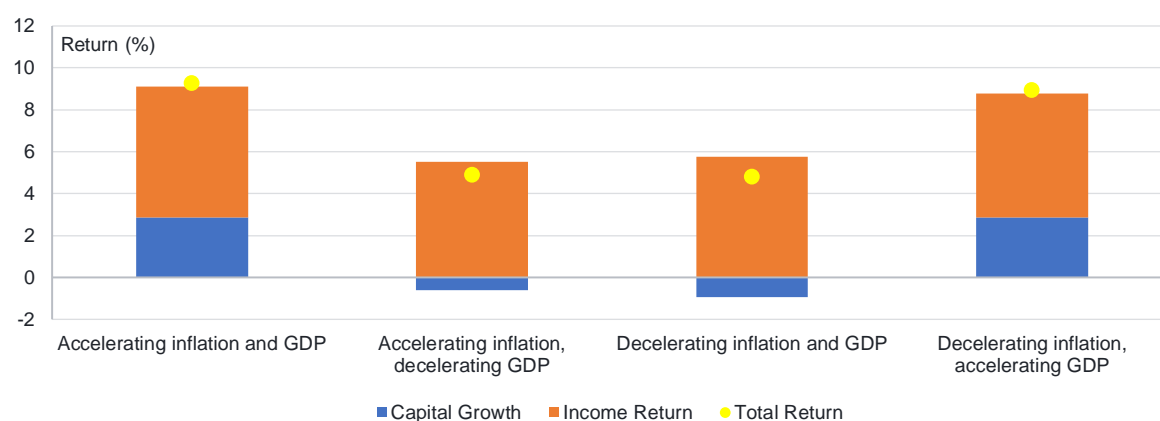
Source: ONS, MSCI - 30/09/20

Fixed rental uplifts provide a partial hedge against inflation given that rents will increase by a defined amount for the duration of the term. However fixed uplifts do not account for the current inflation rate, or trends in market rental values which may lead to incomplete inflation capture, or significant overrenting.

The Hazards of Stagflation

A key issue that real estate investors need to be mindful of with hedging inflation is overrenting - when the contracted rent is above the estimated open market rental value. Overtrenting may arise when accelerating inflation is accompanied by a recession or very weak economic growth, otherwise known as stagflation. If an asset becomes overrented, this position has a negative impact on valuation as the weak economy reduces demand for real estate, and short leases are particularly penalised as valuers increase assumptions about vacancy periods and financial incentives that landlords need to offer to tenants to re-lease space. This value reduction is also a recognition of a likely rebasing of rents to a lower value when a new lease is granted.

Pan-European Property Funds' (MSCI PEPFI) performance under different GDP & inflation conditions (Q2 2004-Q2 2020)



Source: MSCI Q2, Fidelity International - 30/06/20

In light of this, a focus on the underlying quality of the property and land value is important, as it is not sufficient to simply "buy the lease". Management of residual value (essentially, the intrinsic value of the land that the building sits on) drives a significant portion of returns and if you are not discerning, you can be left with assets that have a negative value at the end of the lease!

Which Buildings and Why?

Long-let assets with inflation linked leases would appear to be the most attractive property type given the direct link between rents and inflation. However, given the premium paid by landlords for such leases, careful tenant due diligence is required to ensure that the risk in the cashflow has been properly evaluated. Second to this, real estate with resilient underlying characteristics such as a Central Business District location or access to arterial transport networks provide a further indirect inflation hedge. Asset management can be employed to re-negotiate the leases on these buildings throughout their lifetime, ensuring returns can stay competitive over lengthy investment horizons.

Properties leased with restrictive caps on index linked rental growth may prove challenging over the medium term due to recent developments in monetary policy. Frequently, 1% to 3% 'caps and collars' were agreed in lease contracts, assuming that central banks will hold inflation close to a c.2% target. However, following the Fed's shift towards flexible average inflation targeting (FAIT), many expect the ECB to follow suit which could result in inflation being allowed to exceed the 2% mark for some time. If this materialises, caps set at a level of 3% would simply mean that rents would not keep pace with inflation if the rate of inflation rose to, say, 5%. The consensus of recent years that we were in a 'permanent' low inflation world would, in this instance, would prove costly. Of course, if inflation does remain low for 5-10 years, caps set at 3% will be nothing to worry about. The point is to consider the risk, and ensure that the exposure to such lease terms is as limited as possible.

The impact of non-recoverable costs is another important factor to be considered. These expenses can erode income return in a time of strong inflation, particularly if the inflation rates of goods (effectively captured by CPI) and services (less effectively captured by CPI) diverge significantly. With fully repairing and insuring leases (mainly UK), landlord operating costs are minimal as the tenant pays for maintenance, taxation and insurance. In sectors without these triple net leases, such as the private residential sector or in many European markets, landlords are faced with more non-recoverable costs, which can be a liability in times of inflation. A currency shock could be one scenario where this situation might arise. This is a particularly sensitive issue in Central European markets, where the occupiers receive their sales/profits in local currency but pay their rents in euros.

Portfolios with high development exposure may also be susceptible to inflation risks if rising construction costs cannot be fed through to end users through increasing market rents. The lower the landlord operating costs, the lower the risk!

Conclusion

While real estate is generally accepted (with good reason) to be an effective asset class for hedging against inflation, asset managers need to be proactive rather than passive in order to hedge the risk most effectively. The variation brought about by different lease structures brings the opportunity for active management, astute research and prudent portfolio strategy to deliver an income stream that at the very least keeps pace with inflation in a range of macroeconomic conditions.

An important distinction when factoring this into portfolio allocation decisions is that to ready a real estate portfolio for both expected and unexpected periods of inflation, it takes years, rather than weeks, or months. Unlike a fixed income portfolio manager who can be nimble in their allocation decisions, real estate investors must lay the groundworks for inflation hedging long before inflation expectations may begin to change.

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