What goes up must come down? Impact of inflation on real estate

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Inflation presents challenges for real estate sector

Real estate lease structures rarely protect investors when inflation rises above 5 per cent, which presents a challenge in the current environment of rapidly rising prices.

Rent escalators vary across sectors such as retail, office, industrial and healthcare, but typically protect against low to moderate inflation, Jennifer Johnstone-Kaiser, Principal Consultant, Frontier Advisors said.

“There's nothing beyond 5 per cent that we're aware of within the industry currently and in fact, anecdotally our managers are reporting tenants are pushing back, so 5 per cent is a little bit difficult in today's environment. They have a preference for fixed increases… they don't have any tolerance for variability in their expenses.”

For example, one-third of the office sector is protected by annual reviews of CPI plus 1.25 per cent and two-thirds of the sector is protected by annual rent reviews between 3 to 5 per cent.

Inflation around the world has surged after unprecedented fiscal and monetary support in the wake of the COVID-19 pandemic, which has been exacerbated by supply chain issues and a tight labour market. US inflation hit a 40-year high of 8.6 per cent in May while the RBA expects Australian inflation to peak at 6 per cent this year.

Johnstone-Kaiser said asset owners should understand cyclical versus structural changes within real estate relative to the fund’s objectives and assess current exposures. She stressed it’s not all negative for the asset class as some sectors pass through inflation to tenants and consumers and shorter leases are better at capturing rapid rises.

Asset owners should also identify weak points across their portfolio by sector, geography and revenue as well as prioritise new investments that tap into long-term demand such as needs-based real estate, to cope with inflation.

Real Investment Analytics Director and Founder, Dr Anthony de Francesco, said the most challenging environment for commercial property would be elevated inflation and potentially lower economic growth (which could create stagflation). Meanwhile, higher interest rates could dampen capital growth.

“We could have a period where we've got elevated inflation and we've got lower effective rents, because we're going into a lower growth profile, which means the demand for space might be lower than average.”

Invesco Real Estate Managing Director – Portfolio Manager, Michelle Foss said historical periods of US rising rates had resulted in declining cap rates six out of seven times.

“Rising rates don't necessarily portend an increase in cap rates.”

She also recommended investors lean into investments with robust demand growth, such as those benefiting from changing demographics and technology and lease expiration schedules that can capture near-term rent rises.

“Single family rentals, multifamily, self-storage – those are all one-year leases so you can capture that mark-to-market relatively quickly,” she said.

de Francesco said valuers were currently being cautious and waiting to see whether inflation was transitory.

“Let's say that the inflation story becomes more real in the sense that inflation exceeds 5 per cent and creeps further up, and we see the RBA jacking rates further up, I think you will see a lot of movement, not just within commercial property.”