OUT OF THE ORDINARY

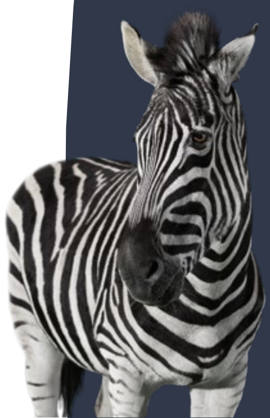
WEEKLY DIGEST | 28 March 2022

Commercial property investment in times of high inflation

Andrew Summers
Head of Collectives & Fund Research

Among the multitude of issues we have been contemplating over recent months is the potential impact of higher inflation and interest rates on the UK commercial property market.

Spoiler alert: Historically UK ‘cyclical’ commercial property hasn’t been a good inflation hedge, and ‘non-cyclical’ exposure can be out of favour when bond yields are rising. To square this circle, we believe that investors should focus on structural growth in the cyclical space, as well as some inflation protection through non-cyclical plays. Ultimately, the sustainability of a building’s rental growth will be a bigger determinant of a building’s value than changes to interest rates or bond yields.



What is cyclical property?

We define cyclical property as properties with tenants whose ability to pay rent is typically determined by the economic cycle, such as offices, retail and leisure. Non-cyclical property is defined as properties with tenants whose ability to pay rent is not determined by the economic cycle. This includes government-backed rental payments from healthcare properties, social housing or care homes where old age care is largely immune to economic cycles. These are relatively defensive assets.

Property investments are by definition, asset-backed, with relatively visible future cash flows. Indeed, in aggregate, commercial property cash flows are generally exceptionally secure, with overall rental levels barely declining during even the most savage of 'normal' recessions. (Covid-19 was an exception due to the specific nature of lockdowns on many sectors).

Occupiers are, on average, tied into leases with about six years remaining and will normally make many other savings in difficult times before vacating their premises. Certainly they will be more likely to cut their dividend before they default on a lease, making rental income more bond-like than equity-like.

Even if prevailing open market rents plummet during a downturn, in a given year, only about one in six leases are actually renewed, creating a smoothing effect that protects aggregate rental income from a well-diversified portfolio. Consequently, in the long term, income comprises up to 80% of the total return from property investing. Our strategic positioning therefore emphasises the stability and growth potential of this asset type. High yields are appropriate if rental levels can be maintained; lower yields are attractive if combined with medium-term rental growth.

How does commercial property fare in periods of high inflation?

Historically, neither capital values nor rental income have kept pace with inflation in the UK. This may come as a surprise, but it reflects a history of long periods of excess supply of different types of commercial property over different periods, as well as excesses of demand.

Furthermore, inflation spikes in the UK have historically been of the "cost-push" rather than "demand-pull" variety, which is more painful for tenants.

There are however, two essential caveats. Firstly, while property returns have not historically kept pace with inflation overall, there are long periods where certain sectors deliver strong returns above inflation and extremely attractive risk-adjusted returns. For example, in the three decades prior to 2010, retail rents kept pace with inflation, but have had a torrid time since (with almost half of all retail units still paying rents in excess of what they would pay if they signed a new lease today).

In contrast, the industrials sector was the only sector that has beaten inflation over the long term and we see good grounds for this to continue given almost two thirds of units are currently paying rents below which they would pay if they signed a new lease today.

Secondly, explicit inflation linkage is a key component of a number of non-cyclical subsectors such as primary healthcare properties, specialist social housing and care homes.

What effect does rising interest rates have?

The impact of rising interest rates on cyclical commercial property is also nuanced. It often depends on whether interest rate rises are 'good' interest rate rises (reflecting strong economic growth which will be supportive of cyclical property) or 'bad' interest rate rises (reflecting policy makers' desire to slow down the economy sufficiently to induce a meaningful reduction in aggregate demand).
In the first scenario, rising interest rates, in line with a strong economy, should have a limited impact on property returns as a strong economic backdrop is accompanied by strong occupier demand for buildings, which in turn leads to rental growth and higher valuations through normal demand/supply mechanisms. Tenants can also afford higher rents.
In the second scenario, the opposite holds true, with policymakers slowing down the economy and triggering the associated change in demand for commercial property space.
Similar, but slightly different, is the impact of the type of inflation. Demand-pull inflation is when demand outstrips supply due to high demand, pushing up prices. This is – initially at least – reflective of good economic conditions and will be favourable for commercial property.

Cost-push inflation is when demand outstrips supply and pushes up prices. This is a relatively bad economic condition and will be bad for tenants, who will suffer from rising costs. This, in turn, will be bad for landlords at lease renewal time. If their existing and prospective tenants are suffering from rising costs, they will be less likely to agree to higher rents.

For non-cyclical properties, they will be protected from rising inflation by the extent of the inflation linkage in their leases. Many also benefit from fixed uplifts, but these will likely have caps that excessively high inflation levels would breach.

Cyclical commercial property has a greater correlation with GDP growth than inflation. Through the mechanisms described above, this is a material driver of short and medium-term returns. Non-cyclical property will be less defensive in a rising interest rate environment than we have been accustomed to when interest rates have not been on the up.

It is often incorrectly assumed that equities (risk assets) and government bonds (risk-free assets) are negatively correlated. However, During the Covid-19 panic of March 2020, defensive names such as those in healthcare and social housing were more protected than equities (they fell typically half as much as the broader equity market), accompanied by falling government bond yields. We have seen a quite different reaction in more recent market selloffs. While we think that defensive non-cyclical property values will be largely protected from rising bond yields, investor sentiment towards the companies that own them will likely mean they remain unloved if interest rates are seen as being on the rise.

Given the differing nature of inflation, the varying and often competing influences of inflation and interest rates, the best protection against inflation is to invest in assets with pricing power. Buildings with strong structural demand and limited supply will be best placed to offer inflation-busting rental growth as well as rising capital values that might offset any impact of rising interest rates or a slowing economy.

Will sustainability affect commercial property?

Finally, a word on sustainability. It is likely to be a key driver of relative performance in the medium term. Forty percent of all carbon emissions come from the built environment, putting the property sector firmly in policymakers' sights when it comes to transitioning to a lower carbon economy. These regulations include the mandatory disclosure of net zero transition plans and stricter energy efficiency standards. There is now irrefutable evidence that the 'greener' the building, the shorter its average void time.

So how will UK property perform if inflation is persistent and we see meaningful and sustained periods of rising bond yields? Much will depend on the nature of the inflation and bond yield rises. However, in our opinion property will offer a reasonable degree of protection, but not complete protection. As always, invesments must be based on personal circumstances and risk appetites.

Economic Commentary

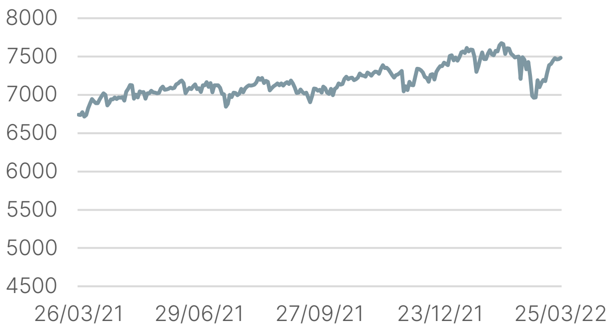
FTSE 100 weekly winners

Rolls-Royce Holdings plc	18.2%
Shell PLC	8.7%
BP p.l.c.	8.7%
Anglo American plc	8.0%
Antofagasta plc	6.6%
Glencore plc	5.6%
Rio Tinto plc	5.4%

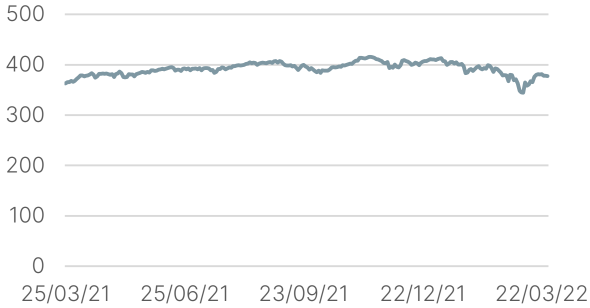
FTSE 100 weekly losers

Kingfisher Plc	-10.3%
Ocado Group PLC	-9.4%
Taylor Wimpey plc	-9.2%
Barratt Developments PLC	-9.1%
Flutter Entertainment Plc	-8.9%
CRH Plc	-8.6%
Weir Group PLC	-8.4%

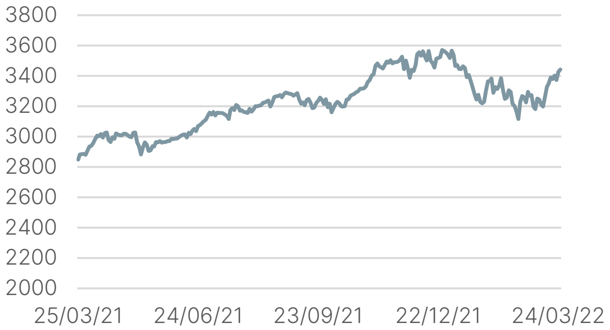
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.