MARKET RESEARCH

European Listed Real Estate

Special Report:

Inflation and short-term impact on listed property companies

FTSE EPRA Nareit Global Real Estate Index Series

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Key takeaways

- Global inflation has increased significantly during the last couple of years, mainly due to supply disruptions coupled with recovering demand, as well as rising commodity and housing prices. The main central banks in Europe expect inflation to peak at some point this year and gradually return to pre-pandemic levels by late 2022/early 2023, once supply limitations and base effects have eased.

- The current inflationary pressure is likely to be temporary and its short-term impact should represent a positive driver for the listed real estate industry in Europe.

- Inflation plays a key role in influencing lease contracts, maintenance costs, development expenses and property valuations among others. Therefore, property companies see changes in both revenues and expenses when inflation rises. In the case of European listed real estate companies, there is evidence of a strong and positive correlation between corporate profits and inflation as well as shareholders' returns and inflation.

- Rental practices in Europe facilitate the integration of inflation dynamics into the companies' revenues and support rental growth. Property yields are currently stable and display a spread against government bond yields above the historical average, therefore providing stability for future property valuations.

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I. Introduction

Inflation is a strong market driver that influences the performance of several asset classes around the world, and listed real estate (LRE) is not an exception. Inflation plays a key role in impacting lease contracts, maintenance costs, development expenses and property valuations among others. Property companies face changes on both operational revenues and expenses when inflation rises, therefore it is necessary to have a closer look at the way these variables interact, in order to understand the final effect on LRE companies.

Since the beginning of 2021, inflation measured by the Consumer Price Index (CPI) has increased globally, both in advanced and emerging countries, driven by supply disruptions coupled with recovering demand, as well as rising commodity and housing prices (IMF, 2021). In the Eurozone, inflation reached a record level (5.1%) in January 2022, after years of low inflation (Fig.1.a). This can be explained by three main reasons: a quick reopening of the economy as pandemic restrictions were lifted, higher energy prices and the so-called 'base effect' (ECB, 2021).

Although headline inflation in the Eurozone peaked in January 2022, it is expected to decrease rapidly in the second half of the year. There is a consensus we are witnessing a transitory surge in prices as the global economy 'normalises' and higher prices linked to supply shortages will reverse over time. There remain some risks related to a slowdown in economic growth, potential increases in interest rates, geopolitical tensions in Europe and higher energy prices. Moreover, due to the large uncertainty around the pandemic, the recovery might be patchy; it may take longer to repair the disruptions to supply chains, while energy prices may also continue to rise due to the green transition. However, inflation expectations are projected to remain within the target rate over the medium to long-term (ECB, 2021; IMF, 2021). The ECB maintains that it is too early to act, and it needs to wait for a clearer vision before considering a policy tightening. It is highlighted that higher interest rates will not solve the underlying reasons currently pushing up prices, but monetary policy can ensure that prices do not permanently rise. Based on the ECB forecast, headline inflation is anticipated to exhibit a short-lived increase in the Euro area, and it is expected to return to the ECB's target of 2% in the medium-term (Fig.1.b).

Fig.1.a Eurozone Inflation (annual rate of change, %)

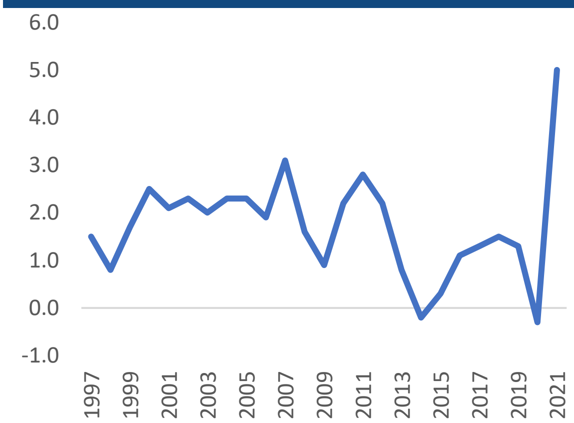
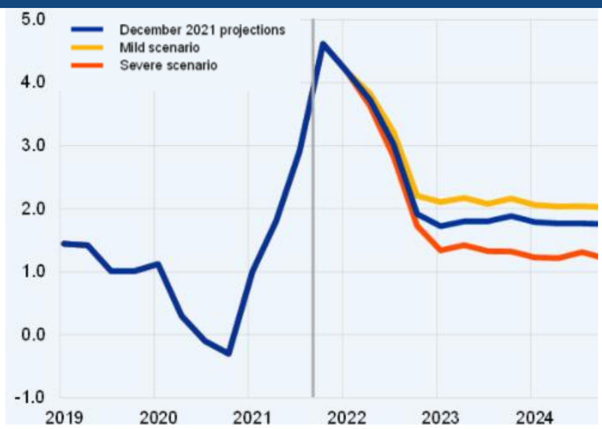


Fig. 1.b. Alternative scenarios for HCPI inflation in the euro area



Source: Eurostat (2022)

Note: Euro area (EA) coverage: EA11-1999, EA12-2001, EA13-2007, EA15-2008, EA16-2009, EA17-2011, EA18-2014, EA19-2015

Uncertainties remain around issues such as inflation persisting at a higher rate for a more prolonged period of time, and the duration of higher inflationary pressures. The key question is how investors can position themselves in an inflationary environment. Inflation also has an impact on real estate from the point of view of mortgages, rents, asset prices, transaction costs and more. In the next section, we will have a closer look at the role of inflation on real estate dynamics, mainly in terms of property rental, capital value growth, companies' profits and shareholders' returns, with a specific focus on listed property companies.

Projections for the euro area (annual percentage change)	2021	2022	2023	2024
Real GDP	5.1	4.2	2.9	1.6
HICP inflation	2.6	3.2	1.8	1.8
10-year government bond yields	0.1	0.3	0.4	0.6

Source: ECB (December 2021)

II. Inflation and real estate markets

Real estate markets are widely regarded as providing a hedge against inflation, since an inflationary environment leads to higher rents and higher asset prices. Most of the long-term leases have CPI-linked rent escalations, which offer income protection and higher revenues, and are also correlated to higher property values. This assumption is linked to strong economic growth conditions (*demand-pull inflation*), but it is hard to foresee the impact of the current 'transitory' inflation environment (*cost-push inflation*). Its impact also depends on the sector, geography, and lease agreements, and it is evident that certain properties are better positioned against rising prices than others (Savills, 2021; Schroders, 2021). There are other relevant factors, such as supply and demand balance in the markets, cost of debt, yields and construction costs.

A. MARKET RENTAL PRACTICES

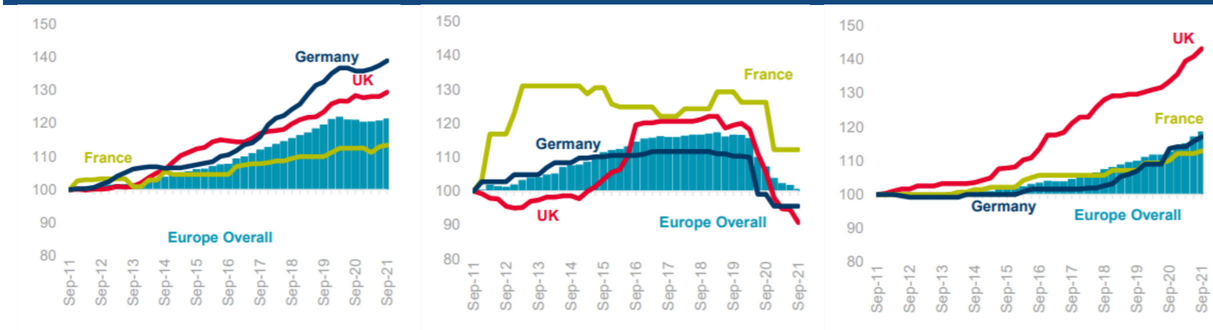
One of the major implications of inflation on property markets is to guarantee rental income, since many leases are tied to inflation. As a general market practice in Europe, rental escalation is based on CPI-linked indexation, so it reflects an automatic CPI adjustment. Lease agreements have an annual CPI-linked indexation or 5-year rental review – mostly for the UK, where leases are subject to market review to evaluate between inflation-adjusted rents and actual market rent growth. Therefore, lease structures (indexation, review period, lease period) might have implications for both landlords and tenants.

Leases with a fixed-rental escalation offer landlords and investors a secure earning income, however a sharp increase in inflation or a sustained period of unexpected inflation might pose a risk of potential income loss. Meanwhile, leases with rental reviews offer repricing opportunities, depending on the review period and the gap between actual rental growth and inflation movement within this period.

Lease agreements tend to be long-term, particularly for commercial properties such as retail and office, and long-term fixed rental payment leases give certainty for the landlord to secure their cash flow. On the other hand, shorter-term leases – mostly common for residential properties – are based on current price levels, reflecting actual inflation, but this benefit can be offset by potential occupancy losses, especially under oversupply market conditions.

It is reported that prime European logistic assets' rents grew on average by 5.2% over the past twelve months, their fastest year-on-year rate in over two decades and are expected to further increase in the short-term. Although COVID-19 alongside the debated impact of working from home put pressure on the office market, it did recover in 2021, and the prime office market in particular saw a relatively higher rental growth. As one of the hardest hit sectors, retail experienced higher rental losses due to the pandemic restrictions and there is a shift towards turnover-based rental agreements. Although the sector saw rental decrease, a stabilisation is expected in the short-term (Fig.2).

Fig.2.a. Office (Q311=100) b. Retail-High Street c. Logistics



Source: Cushman & Wakefield (2021): DNA of Real Estate 2021Q3

According to a recent report by Savills, Europe provides the best inflation hedge when compared to North America and Asia, due to the widespread use of indexation. Focusing on sector differences, the industrial sector stands out given the underlying favourable supply and demand dynamics, but also some prime office (Amsterdam, Paris, Madrid) and retail (Amsterdam, Madrid, Milan, London) locations look attractive in terms of better inflation protection. Apart from the prime commercial sectors, the residential sector can also provide a good protection against inflation risk since CPI-indexation, short lease lengths (often 1-2 years) and multiple tenants provide rental adjustments opportunities. Leased hotels can also typically provide a strong inflation hedge through very long lease terms (up to 25 years) which are traditionally index-linked to inflation (Savills, 2021).

B. PROPERTY VALUES AND VALUATION

Property values are of course associated with rents and yields which reflect investors' expectations for potential future rental income, therefore risk and inflation expectations are included. Under current conditions, demand across different asset classes varies: high for logistics, self-storage and residential, mild for office and lower for retail, with yields expected to be compressed for the high demand asset classes. Property yields look stable, with a slight yield compression in certain sectors like logistics and an increase in the retail sector (Cushman & Wakefield, 2021).

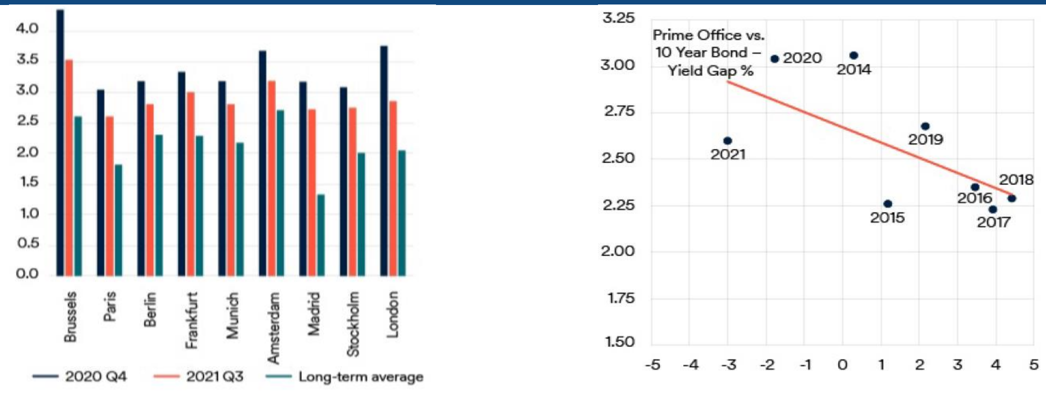
Market Indicators (European average, %)

	Office	High Street Retail	Logistics
Rental Growth (y-o-y)	0.3	-6.1	5.2
Outlook	↗	→	↗
Yields	4.16	4.35	4.56
Outlook	↘	↗	↘

Source: Cushman & Wakefield (2021): DNA of Real Estate 2021Q3

Another relevant factor is supply shortage, mainly due to a slowdown in construction activities during the pandemic and a later hike in construction costs limiting new supply delivery. The shortage is expected to put a premium on existing, high-quality properties, which might cause value increase in certain properties in prime locations. Property values are also correlated to risk-free interest rates (10-year government bond yields) since risk-free rates are usually a very important variable in the property valuation process. If government bond yields rise, temporary price volatility in the short-term can be expected. However, it might be just temporary and there is still room for bond yields to rise further before real estate yields follow suit (BNP Paribas Exane, 2022; Schroders, 2021). The gap between bond yields and prime office yields in Europe's major cities are still above the long-term average which suggests real estate remains an attractive asset class (Fig.3).

Fig.3.a. Prime office yields vs 10-yr bond yields **b. Paris office yield gap and expected rental growth**

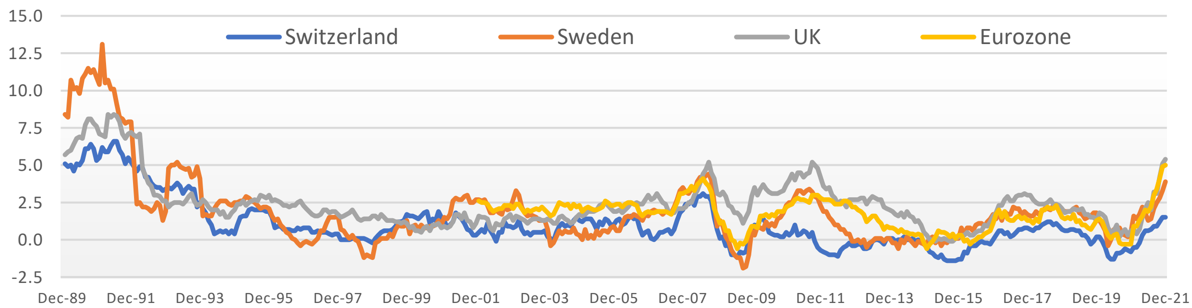


Source : Schroders (2021).

III. Short-term inflation and listed real estate dynamics

This section will concentrate on the impact that inflation traditionally has on listed property companies in the short-term (1-5 years). We will mainly focus on the four major European currencies (EUR, GBP, SEK and CHF) and their own inflation and capital markets. Despite having similar dynamics in the last 30 years (20 years for the EUR), inflation in these four economies shows different characteristics and impacts the LRE industry in varying ways. The UK displays the most volatile inflation (Std.Dev of 1.25%) and Switzerland the most stable one (Std.Dev of 0.79%). Using the European indexes in the FTSE EPRA Nareit series as the main benchmark for the LRE industry on the continent, we will now look at the property companies' performance in terms of corporate profits, dividends and shareholders' total return.

Fig. 4. Historical Inflation

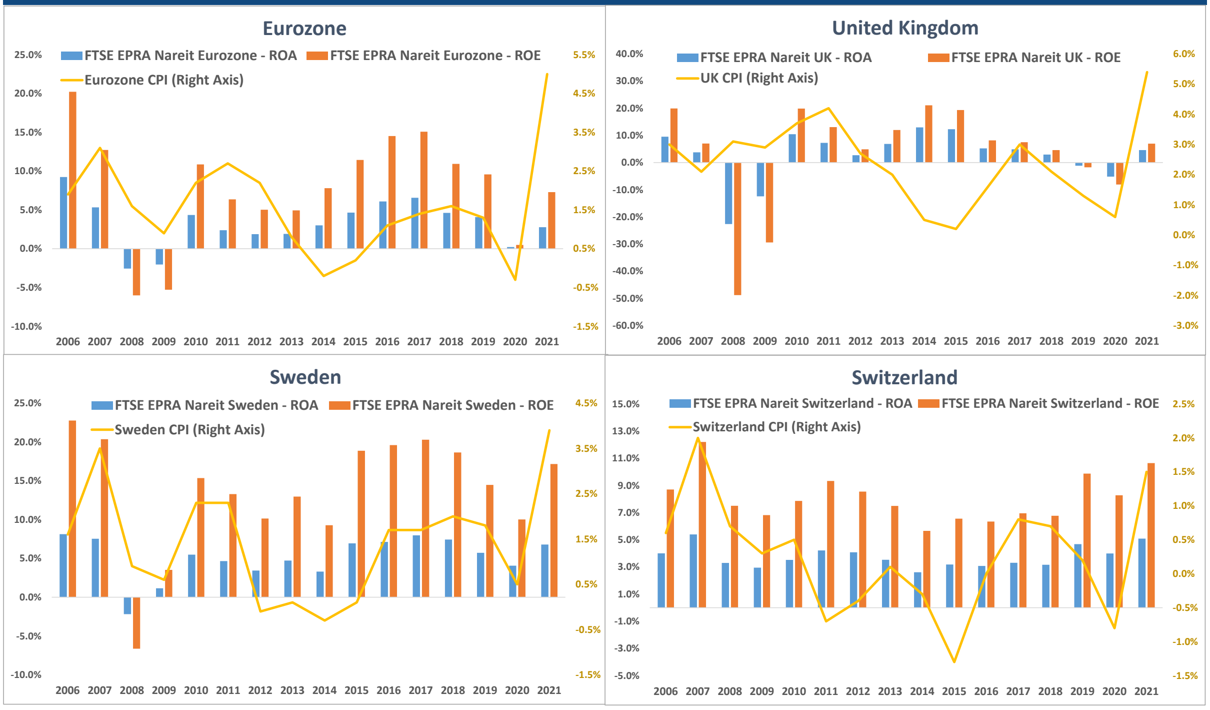


Source: Bloomberg & EPRA

A. CORPORATE PROFITS

At first glance, inflation seems to have a significant impact on the historical earnings for property companies in Europe. In countries like Sweden and Switzerland, the correlation between return on equity (ROE) and return on assets (ROA) against the annual inflation showed an average of 0.47 between 2006 and 2021 and remained quite stable across the years, thus supporting the ideas presented above. In the Eurozone, the same correlation was 0.15, which is still quite significant given the large number of economies in the region with different sizes and fundamentals. However, this correlation showed a much higher average between 2006 and 2012 (0.56) than between 2013 and 2021 (0.14), mainly as a result of a prolonged period of low inflation and strong corporate profits in countries like Germany, France and Belgium. This was particularly marked for companies in the residential, industrial and office sectors. Finally, in the case of the UK, this correlation was also positive and significant during the period 2006-2012 (0.2) but decreased and even turned negative in the period 2013-2021 (-0.12) given a moderate reduction in the companies' earnings in parallel with an increase in the inflation, mainly due to a combination of several factors like Brexit, GBP's volatility, the rise of e-commerce and the COVID-19 pandemic.

Fig. 5. Inflation vs Corporate Profits

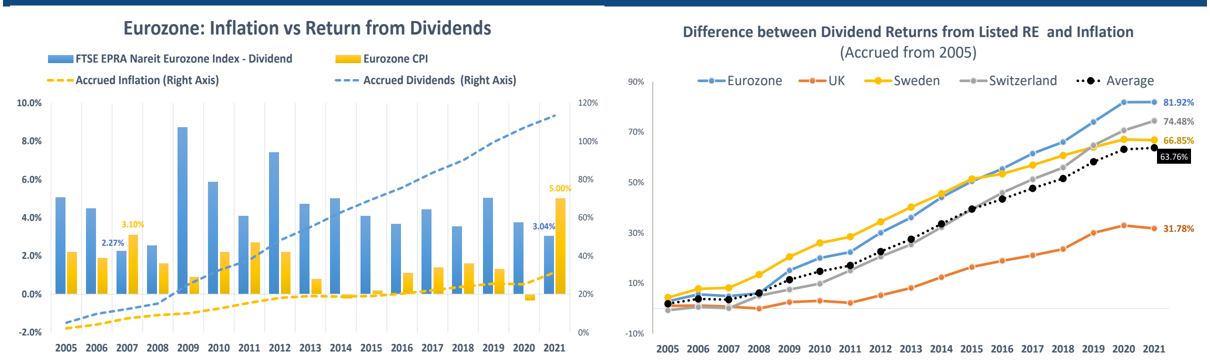


Source: EPRA & Bloomberg. All the figures are denominated in local currency.

B. DIVIDENDS

From a shareholder's perspective, dividends from listed real estate companies can be seen as a highly efficient mechanism for inflation hedging. In the Eurozone, during the last 17 years, the returns from dividends were always above annual inflation, except for 2007 and 2021 which were clearly influenced by strong global crises (GFC and COVID-19). A similar story was observed in Sweden with only one year of inflation above the dividend return (2021), Switzerland with two years (2005 and 2007) and the UK with four years (2007, 2008, 2011 and 2021). On average, returns from dividends in the European listed real estate industry are 2.47% higher than the annual inflation. Given this significant difference between dividends and inflation, investors with a long-term horizon have received an average real return from dividends of 63.76% (3.13% annualised) between 2005 and 2021, which is higher than the simple annual average (2.47%) given the compounding effect, again supporting the idea of real estate viewed as a good investment for hedging inflation.

Fig. 6. Inflation vs Return from Dividends



Source: EPRA

Source: EPRA

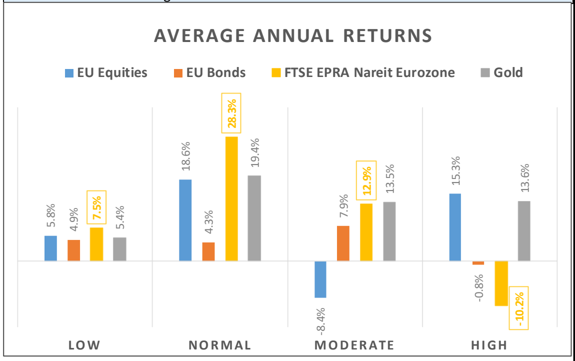
C. TOTAL RETURNS UNDER INFLATION CYCLES

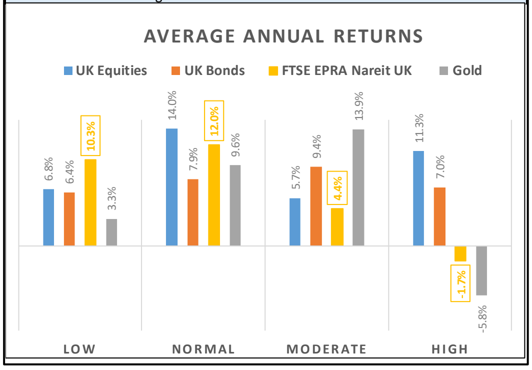
Looking at the total returns from real estate shares under different inflation cycles, we can observe a strong performance compared to other assets classes during the last 20 years in the Eurozone and 32 years in the UK. In the first case, listed real estate always outperformed general equity and bonds under low, normal and moderate inflation cycles. Similar evidence for the UK shows a higher or similar return than general equities under the same scenarios. However, under high inflation cycles (above 3.06% for the Eurozone and 5.04% for the UK[1]) listed real estate underperformed general equity and bonds in both regions, the result of a combination of a strong demand pressure on inflation and low returns in real estate in anticipation of an economic contraction, such as the case of 1990-1991 in the UK and 2007 both in the Eurozone and the UK.

Fig. 7. Asset class comparison under different inflation cycles

Eurozone Inflation Cycle		Average annual total return (2002-2021)			
Average Inflation	Cycle	EU Equities	EU Bonds	FTSE EPRA Nareit Eurozone	Gold
0.8%	Low	5.8%	4.9%	7.5%	5.4%
2.1%	Normal	18.6%	4.3%	28.3%	19.4%
2.5%	Moderate	-8.4%	7.9%	12.9%	13.5%
4.1%	High	15.3%	-0.8%	-10.2%	13.6%

UK Inflation Cycle		Average annual total return (1990-2021)			
Average Inflation	Cycle	UK Equities	UK Bonds	FTSE EPRA Nareit UK	Gold
1.3%	Low	6.8%	6.4%	10.3%	3.3%
2.4%	Normal	14.0%	7.9%	12.0%	9.6%
3.3%	Moderate	5.7%	9.4%	4.4%	13.9%
6.7%	High	11.3%	7.0%	-1.7%	-5.8%

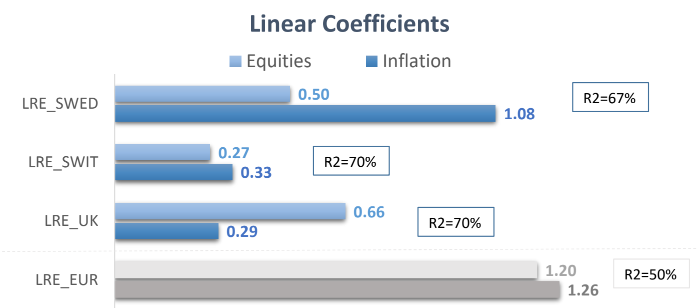




Source: EPRA

Using a time variant econometric model[2] for analysing the impact of inflation on listed real estate total returns and including general equity returns as a control variable, EPRA estimates that a 100 bps increase in the annual inflation has a positive effect of 33 bps in the annual total return from listed real estate in Switzerland, 29 bps in the UK and 108 in Sweden, reflecting a substantial efficiency of listed property companies to react to changes in inflation. In the case of the Eurozone, given the limited history of the currency with very few moderate high inflation cycles, the significant number of countries and drivers involved, as well as the diversity of property sectors, our model seems to be less precise and provides some coefficients that might be biased, therefore it is worth to look into country-specific models to have a more accurate estimation.

Fig. 8. Time variant regressions: LRE vs Inflation and Equities



Source: EPRA. Listed Real Estate is represented by the FTSE EPRA Nareit Indexes.

[1] Moderate and High cycles are defined by the 70th and 90th percentiles respectively, 2.2% and 3.05% for the Eurozone, 2.91% and 5.04% for the UK.
[2] ARIMAX model in 1st differences with LRE returns as dependant variable and Equities and Inflation as independent variables.

D. IMPLICATIONS FOR THE YEAR AHEAD

We have seen from different perspectives the positive effect that inflation generates on listed property companies' profits and returns, with very few exceptions, i.e. specific periods of high inflation from demand pressures in anticipation of economic contractions. Despite the current high inflation environment, the fundamentals behind it are quite different. On the one side, after a deep recession in most of the European economies in 2020, last year was characterised by a clear economic recovery that is forecasted by many analysts and institutions to continue on a more moderate path in 2022 and 2023. On the other side, current inflation levels are not directly associated with strong demand pressures but are mainly attributed to several supply disruptions around the world that have driven up the prices of several commodities like oil, gas, metals and fertilisers, pushing up the inflation in many European countries. At the same time, inflation excluding energy prices remains, in most of the cases, aligned with central banks' targets. This is why the ECB expects the inflation to gradually decrease in 2022 towards levels close to 3%. Meanwhile, the Bank of England sees the inflation peaking at 7.25% around April 2022, before gradually decreasing during the rest of the year. A similar view is shared by the central banks in Sweden and Switzerland, while the IMF expects inflation in advanced economies to return to pre-pandemic levels by mid-2022. Therefore, we are likely to see a moderate inflation cycle in 2022 and 2023 that should represent a positive driver for the corporate profits and returns of the listed real estate industry in Europe.

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