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The effect of inflation on commercial real estate - by Harold Bordwin

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After years of trying to push inflation to 2% per year, the Fed, joined by the Biden administration, are now trying to address the most recent numbers. The Labor Department said the consumer-price index increased in October by 6.2% from a year ago. That was the fastest 12-month pace since 1990 and the fifth straight month of inflation above 5%. Having claimed that higher inflation is “transitory” resulting from the recovering economy and supply-chain issues, the Fed and the Biden administration may now be changing their tune. There is debate now about which price increases might be short-lived and which might be long-standing. Most recently, the Fed anticipated that inflation would average 4.2% in the final quarter of 2021 before falling to 2.2% in 2022. But markets are uneasy with the fluidity of the situation. As Federal Reserve chairman Jerome Powell recently commented, “Inflation has come in higher than expected...It’s very, very difficult to forecast and not easy to set policy.”

So, how does this all impact the commercial real estate industry, and at which point does the real estate industry conclude that higher inflation is going to be a longer-term issue?

Analysts say weeks, months—maybe even years, so don’t hold your breath for an actual date.

In reality, buyers, sellers, equity investors and lenders are making decisions every day based on their assessments of the market. My firm is a leading real estate brokerage and investment banking firm specializing in special situations (restructurings, bankruptcies, receiverships and Article 9 sales). Inflation is an important consideration along with so many others, including vacancy rate trends, rental rate trends, demographics, traffic patterns, and new construction impacts.

After years of not really thinking about inflation and taking low inflation rates for granted, in real estate circles, the subject is now part of the daily conversation.

In their projections, owners, operators and their capital sources have to be thinking about the impact of inflation on rental rates, operating expenses, CapEx costs, costs of funds – the list goes on. For some owners and investors, it may be time to refinance and lock in long-term low interest rates now, in order to get the benefit of inflation-raising rental income.

Recent studies indicate that real estate is a good hedge against inflation. Property owners can raise rent, generating cash flow, especially those owners who typically rent their properties on a shorter-term basis, like multifamily, hospitality and self-storage. Also benefiting are those with existing properties where construction is anticipated. Because of current market conditions (i.e., rising construction and labor costs and completion delays caused by supply chain disruptions) they are able to maintain or improve their market share because new construction of potentially completing properties is delayed.

That said, predicting the future of inflation and its impact on commercial real estate is not so simple. For instance, those in the real estate industry that may be negatively affected by inflation include: (a) developers faced with the rising costs of construction materials and delays in receipt of building materials (because of supply chain constraints); as well as (b) landlords whose tenants are locked into long-term leases (without inflation adjustments).

To say that we’re living in unprecedented times has become cliché. Nevertheless, the challenges brought on by the COVID-19 pandemic, including the recent rise of inflation is cause for concern. Property owners need to be thinking now about how properly to position their business and their assets for a potentially higher interest rate environment.

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