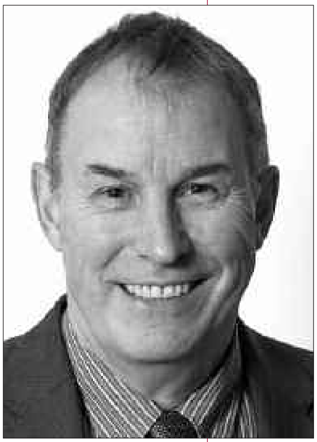
Commercial property and inflation – hedge or just a picket fence?



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Because business property is such an important factor of production its performance is closely linked to the overall performance of the nation's economy. Anything that has implications for the economy will have implications for commercial property, both in respect of the occupier (rental) and investment markets. This dual susceptibility has been amply demonstrated over the last year or so where a double whammy of poorer economic performance and the lack of available credit has significantly affected the performance of both the investment and more recently the occupier markets.

It can be argued that ultimately most of the risk associated with property derives from changes in the macro-economic variables; inflation, interest rates and economic activity. In this regard, we currently live in uncertain times. The world is in the grip of the worst recession for over 60 years and within the last year we have moved from a period of relative high cost-push inflation to almost zero inflation, with the prospect of deflation this year. Although we believe that the outlook for inflation over the next two years looks fairly benign[1] there is an increasing risk that inflation will rise significantly if the current quantitative easing in the economy is not reversed sufficiently quickly when the economy begins to recover.

Historically, investment in commercial property has been perceived by some as a hedge against inflation. Given the current economic climate, therefore, it seems opportune to re-examine this premise and how resilient property might be as an asset class in these uncertain times.

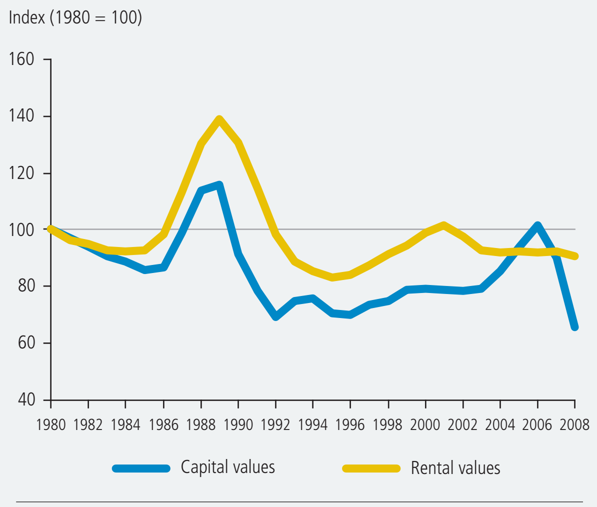
Inflation and property

Profitability outcomes in property investment depend on a number of factors but important amongst these is inflation. Put simply, inflation is the phenomenon of generally rising prices of goods and services or alternatively the fall in the purchasing power of money.

There are two measures of inflation used in the UK – the consumer price index (CPI) and the retail price index (RPI). The RPI is the older and more familiar measure of inflation. It is used for the indexation of various incomes and prices and the up rating of pensions, benefits and index-linked gilts. The CPI is the main measure of consumer price inflation and it forms the basis for the government's inflation target. It excludes a number of items included in the RPI, mainly relating to housing costs, e.g. council tax, mortgage interest payments and depreciation. The RPI gives a consistent series back to 1947 and is generally used as an indicator when considering rent uplifts for commercial property. I have used the RPI as the measure of inflation in my considerations in this analysis.

Inflation has eroded both commercial property capital and rental values over the years. Figure 1 shows changes in all-property rental and capital values since 1980. These have been indexed in real terms (1980 = 100). There are a number of important observations that can be made. In the first instance clearly both rents and capital values are below what they were in real terms in 1980 and have been for most of the period covered. In the case of capital values, it is also interesting to note that despite the recent capital bubble that effectively peaked in mid-2006, capital values at the peak only just reached the levels seen in 1980.

Figure 1: Change in capital and rental values in real terms



Source: IPD

Both rents and capital value really only 'beat' inflation over the period from 1986 to late 1992. This was a period characterised initially by rising economic output (the period 1987-88 experienced the highest rate of economic growth over the whole of the 28-year period covered by Figure 1) and relatively low inflation. However, by 1989 the UK economy was beginning to move into recession and inflation began to rise. Figure 2 illustrates how during this period rental growth declined rapidly and entered a period of negative real growth from 1990 until rents finally recovered in 1996. Figure 2 also shows that rental value growth had effectively been negative for a period of 10 years from 1975 – a period characterised by high inflation effectively resulting from two oil crises and low economic growth in the UK.

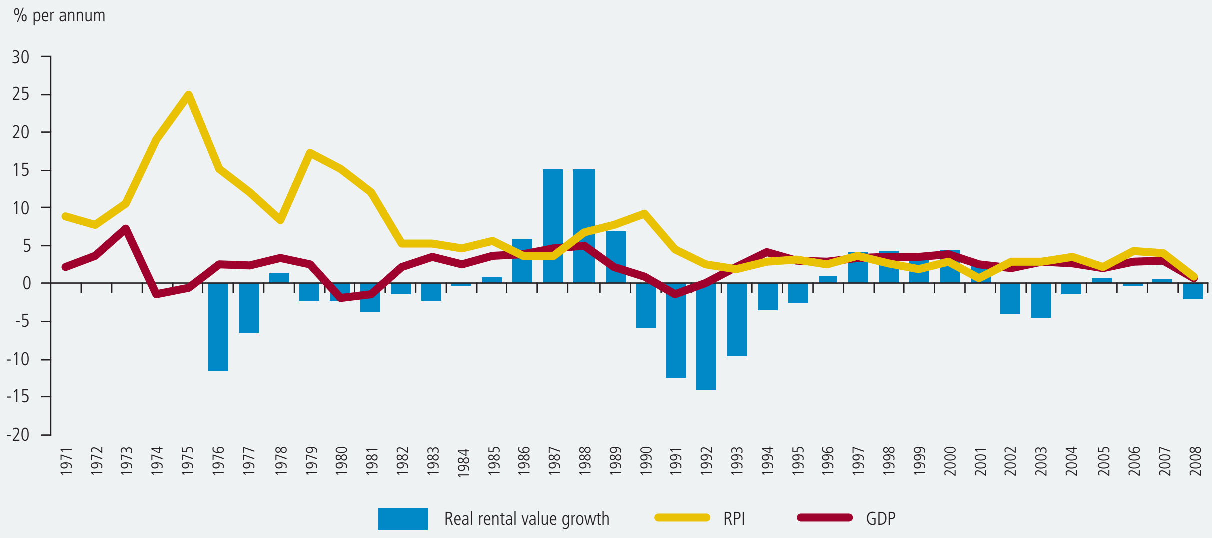
But is there any direct link between inflation and capital values, total returns and rental growth? A more detailed analysis suggests that over the period 1976 to the end of 2008 there was a weak correlation for all three factors, the strongest being for rental growth[2] (see Figure 3). Interestingly, this is not the case for capital values and total returns if the period of very high inflation in the early 1970s is included. In this case the correlation coefficients reduce to 0.13 and 0.09 respectively.

One other aspect of inflation that ought to be mentioned here is that relating to construction costs. The dominance of construction costs in total development costs and the close link

1 We are forecasting that UK CPI inflation will rise to 1.75% by the end of 2010 and to around 4 % by the end of 2011.

2 In this context, we can estimate the degree of correlation between different factors by estimating correlation coefficients (r) in the range -1 to +1. The closer r is to +1 or -1 the more closely the two variables are related - either positively (when one gets larger so does the other) or negatively (when one gets larger the other gets smaller). If r is close to 0 there is no relationship between the variables.

Figure 2: Rental growth in real terms 1971-2008



Source: IPD, Datastream and ONS

between construction costs and the rate of inflation would suggest that the value of new commercial property ought to generally keep pace with inflation in the long run.

Figure 3: Correlation coefficients (1976-2008)

	Inflation
Nominal	
Property total returns	0.30
Rental value growth	0.39
Capital value growth	0.34

Source: IPD

Figure 4: Annualised rates of returns for asset classes against inflation (1970-2008)

	Rate of return %	Rate of inflation %
Nominal		
UK Equities	12.4	
UK Bonds	10.4	
UK All-property	11.0	
Inflation		6.5

Source: IPD

A close long-term link between development cost and market value can only exist for modern or modernised property whereas any individual property's value must decline through obsolescence and this is reflected in the index of capital values in Figure 1. Furthermore, ceteris parabus, the link requires a generally stable or rising demand for floor space. Where there is falling demand there can be no link with development cost and inflation cannot provide a support to values except in the very long run.

Commercial property as a hedge

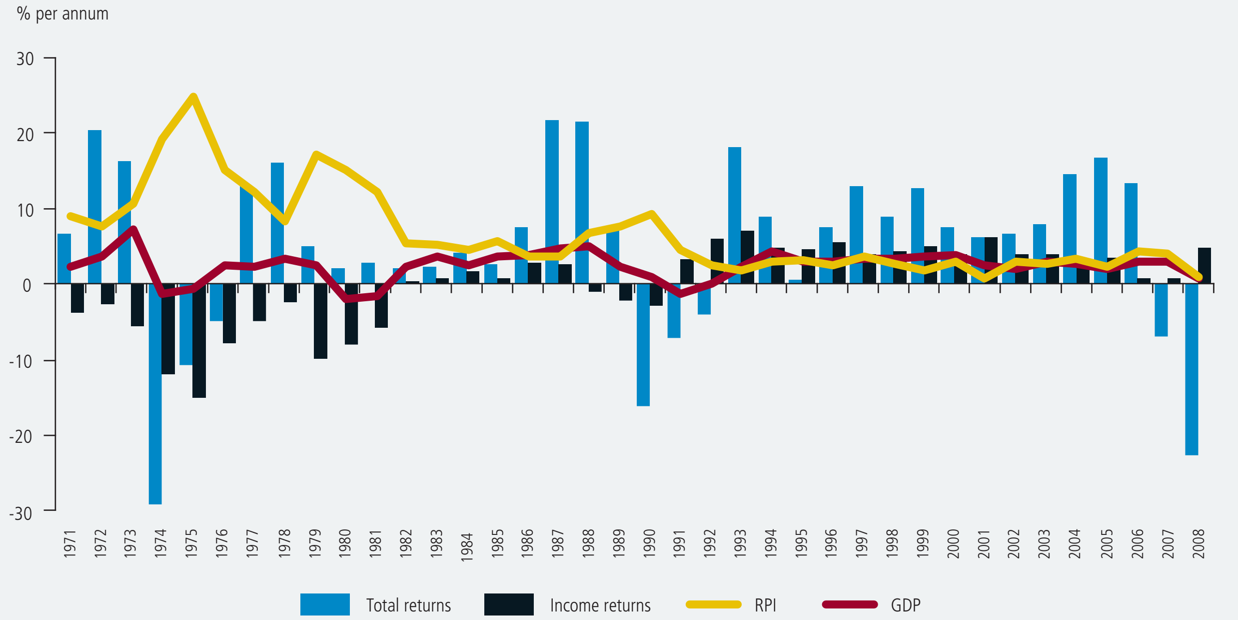
An inflation hedge is an asset that loses little value in periods of rising prices – it holds its value and its purchasing power during inflation, including hyper-inflation. An investor expecting inflation will buy this asset to hedge against inflation.

Historically investment in property has been perceived as providing such a hedge and this process has been going on much longer than might be expected. The institutions appear to have made a direct investment in land as early as 1852, using the value of the land for this purpose. In relative terms, however, all asset classes are affected by changes in inflation and it is also true to say that all investment classes in the long run outperform inflation (see Figure 4).

However, clearly there will be times when returns are below the rate of inflation and real returns are negative. In this context, we should be aware of the sometimes illusory nature of returns by recognising both the potential impact of inflation and the extent of it.

Figure 5 plots real total returns and real income returns from 1971 and compares them with RPI inflation and GDP growth over the same period. What is clear from the chart is that real

Figure 5: Real income and total returns



Source: IPD, Datastream and ONS

income and total returns were negative during the periods of very high inflation in the 1970s, brought about by the unexpected[3] inflation caused by two oil crises. They were also negative during the period of rising inflation in the early 1990s – a period characterised by falling economic output and in the context of commercial property a period of oversupply.

On the definition of a hedge given earlier then, property fails but as I have noted in the long run returns do beat inflation. As an asset class it cannot cope with high unexpected inflation and is not correlated in a strongly positive way with this macro-economic variable. It is a hedge but perhaps a poor one. Despite this, historically property continued to be viewed as a hedge because of its long-term returns and as such suitable for matching the long-term, inflation-linked liabilities of life and pension funds.

As far as institutions and pension funds are concerned this is not now perhaps the main reason for investing in property. The case for investing in property as a hedge against inflation has declined as inflation has declined and this has been further undermined by the introduction of index-linked gilts. These can be used to match longer term inflation linked liabilities at a lower risk and without the disadvantages of high management risk. There are other reasons for continuing to invest in property.

So why property?

Commercial property continues to have considerable attractions as an investment and fund managers continue invest in the sector for a number of reasons, including:

- It provides a secure and stable cashflow;
- It is a particularly good diversifier for portfolios dominated by equities and bonds;
- Total returns are less volatile than either equities or gilts; and
- It performs well relative to other investment categories.

In particular, commercial property is a good diversification investment for portfolios dominated by equities and bonds because of the low to medium positive correlation of total returns between these main asset classes. Over the period 1970 to the end of 2008 the correlation coefficient between total returns from property and equities was around 0.3 and between property and gilts around 0.02 – see Figure 6. So for a significant period of time property has been a very good diversifier and there is no reason to think that this will change in the future. This is partly because of the tendency of returns from gilts and equities to lead the economic cycle and property to lag, both in real and nominal terms.

Figure 6: Asset correlation 1970-2008 nominal and (real)

Asset correlations	Direct Property	UK Equities	Gilts
Direct Property	1.00 (1.0)	0.29 (0.2)	0.02 (0.1)
UK Equities		1.00 (1.0)	0.59 (0.5)
Gilts		0.59 (0.5)	1.00 (1.0)

Source: IPD

3 Unexpected in the sense that these were external shocks to the system and really not part of longer term economic cycles that might be expected.

It is also worth remembering that property investments are rights over land and buildings and as a consequence are tangible and durable assets. In circumstances less extreme than bankruptcy, a company in difficulty will stop paying dividends before it stops paying rent. Rent is a contractual obligation like interest on debt, dividends are not.

Rental growth from commercial property tends to lag economic activity and importantly inflation. In one sense this is not helpful since the effect of lengthy rent review periods is to cause a delay before rental growth is converted to higher investment income. In a similar sense, property can suffer in the short to medium term in periods of high inflation but importantly gain in periods of low inflation when properties can become over rented and property can produce higher than expected income yields. I believe that this will be the case in the UK short to medium term where the balance of expectation is for a period of low to medium rates of inflation with income and total returns being positive from 2010 (see Figure 7).

In summary, while property may not be the complete hedge against inflation thought previously, it can provide some protection against expected inflation. More significantly, however, it still offers considerable benefits when held as part of a well-balanced portfolio. It has defensive attributes, a stable and competitive income, the potential for capital gains and a low correlation with other asset classes. Quality properties and active management skills will be the key drivers of performance and for those prepared to ride out the short-term downturn, investing in commercial property will again provide the long-term benefits that have characterised the asset class in the past.

Figure 7: Forecasts of property returns and RPI (April 2009)

	Total returns %	Income returns %	RPI (average) %
2009	-15.1	7.1	-1.5
2010	7.6	9.1	2.1
2011	11.0	9.2	4.2
2012	12.3	8.9	3.0
2013	11.5	8.5	2.5

Source: SWIP