Commercial Real Estate in Conditions of Rising Interest Rates and Inflation

As the Federal Reserve winds down its quantitative easing program, commercial real estate investors generally and shopping center owners specifically wonder how they will weather the anticipated interest rate increase. Conventional wisdom is that inflation will increase along with rising interest rates. In this paper, we review the impact of rising interest rates and inflation on real estate, shopping centers in particular.

Anchored necessity based retail shopping centers are a hybrid of two components. The anchor tenant, often a grocery store, occupies 40%-60% of the typical center's leasable area. The rest of the center's income is derived from small shop space. The anchor tenant typically has a very long-term lease (often 25 years or more), small but steady annual rent increases and strong credit, offering rated bond-like investment characteristics for that portion of the income stream. The small shop tenants, on the other hand, are generally of mixed credit quality, have shorter lease terms of three to five years, and larger annual rent increases than the anchor tenant. This component of the income stream is thus rather volatile, and if separated from the anchor component would trade at a relatively high cap rate.

In June 2013, the Federal Reserve signaled that its significant level of quantitative easing would be reduced. The bond market reacted adversely, sending interest rates upward. The REIT market was also negatively impacted. Initially falling swiftly, the REIT market regained its footing and recovered the losses in short order. This move highlighted the long-standing debate about the relationship between real estate pricing, interest rates and inflation.

Interest rates often rise in conjunction with inflation. In one of the seminal pieces of research on the subject, Charles Wurtzebach in his paper "The Impact of Inflation and Vacancy of Real Estate Returns" states: Wurtzebach goes on to conclude that different types of real estate provide differing levels of inflation

> "Real estate more or less compensates the investor for inflation risk (i.e., real estate provides an effective inflation hedge). Furthermore, these studies suggest that when real estate is added to a mixed-asset portfolio, the inflation risk of the expanded portfolio is substantially below that of the original portfolio (ex-real estate). Thus, the benefits of including real estate in a mixed-asset portfolio consist of not only lowering the portfolio's risk/return profile, but also providing a greater degree of inflation protection."

protection. Office and industrial properties provide good protection from expected inflation, while retail properties provide superior protection from unexpected inflation.

Cap rates tend to rise with rising interest rates and fall with falling interest rates, but not in lockstep. In order for property values to remain stable in the face of rising interest rates and consequent increasing cap rates, increased cash flow is needed. The ability of shopping center owners to increase cash flow through rental increases depends on the length of lease terms for tenants in place, near term lease expirations/renewals and current occupancy levels. As shop space leases tend to have shorter terms, rental rates can be increased with each lease expiration to help combat inflationary pressures.

    

Historical research shows that commercial real estate does, indeed, offer inflation protection. Between 1978 and 2011, the correlation between commercial real estate returns and inflation was 0.38, beating every other asset class shown in the table below.

Asset Class	Correlation with Inflation (1978-2011)
NCREIF-NPI Total Return	**0.38**
NCREIF-NPI NOI Growth	0.10
1-yr Treasury Total Return	0.20
10-yr Treasury Total Return	-0.29
S&P 500 Total Return	0.03
NAREIT Total Return	0.09
Corporate Bonds	0.20

Source: "Is Commercial Real Estate an Inflation Hedge", Real Estate Issues, November 2011

The short lease term of the in-line tenants in shopping centers allows for rental rate increases more swiftly than is the case in most other commercial property types. Add in the pass through of operating costs (Common Area Maintenance or "CAM") under the "triple net" terms typical of both anchor and in-line retail leases, and shopping center investments have historically been a superior inflation hedge compared to most other property types. This duality, where the anchor tenant component stabilizes the income stream, while the small shop component provides relatively quick rent adjustments when inflation is occurring has caused retail properties to generate the highest total returns and the lowest volatility of the four primary commercial property sectors - office, retail, industrial and apartments - for the past 30 years, according to NCREIF data.

Conclusion

Historically, easy money and deficit spending have often led to inflation. Since the 2008 recession, however, the weak economy has not permitted general price increases and the Federal Reserve's "easy money" policies have not triggered significant inflation. But as the economy recovers further, there is a general consensus that continued monetary easing will, at some point, result in greater inflation. Moreover, since the Federal Reserve has begun to discuss withdrawing the stimulus in order to avoid such an outcome, interest rates have increased. The Fed's success in properly balancing these conflicting forces remains to be seen. Since real estate has demonstrated that it can provide a hedge against inflation, prudence suggests that investors seriously consider the potential positive effects that commercial real estate, and shopping centers in particular, can have on portfolio performance in a period of increasing inflation and interest rates.

    

About The Inland Real Estate Group of Companies, Inc.

The Inland Retail Property Fund, LP[1] ("IRPF"), sponsored and advised by Inland Institutional Capital Partners Corporation ("ICAP"), will be supported by the Inland[2] integrated operating platform to create an efficient, reliable and unique investment opportunity in institutional real estate for today's investors. IRPF will seek to draw upon Inland's extensive resources, values, and expertise to build and manage its core retail portfolio.

ICAP is part of Inland, headquartered in Oak Brook, Illinois. Inland is one of the largest commercial real estate companies in the nation, representing more than 40 years of expertise and integrity in the industry. Inland is a fully integrated group of companies that is engaged in multiple facets of the real estate industry including property management, leasing, marketing, brokerage, acquisition, disposition, development, redevelopment, renovation, construction, finance, and sponsorship of investment products. Inland affiliates and related parties cumulatively have more than 1,400 employees, own property totaling over 74.6 million square feet located in 49 states,[3] and manage assets of approximately $20.2 billion.[4]

For over 40 years, Inland's primary mission has been to serve its investors. This long tradition of investor focus is manifest in a corporate infrastructure that emphasizes dedication and service to Inland's individual and institutional investors. Its commitment to investor satisfaction is one of the key reasons why Inland has been successful in creating hundreds of real estate ventures and REITs over many decades. As of December 31, 2013, Inland had raised more than $19.7 billion in capital from investment securities sales.

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[1] Additional information regarding the Inland Retail Property Fund, L.P. would be made available to qualified accredited investors upon request.

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[3] Includes all property types, not solely retail.

[4] Statistics as of December 31, 2013.





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