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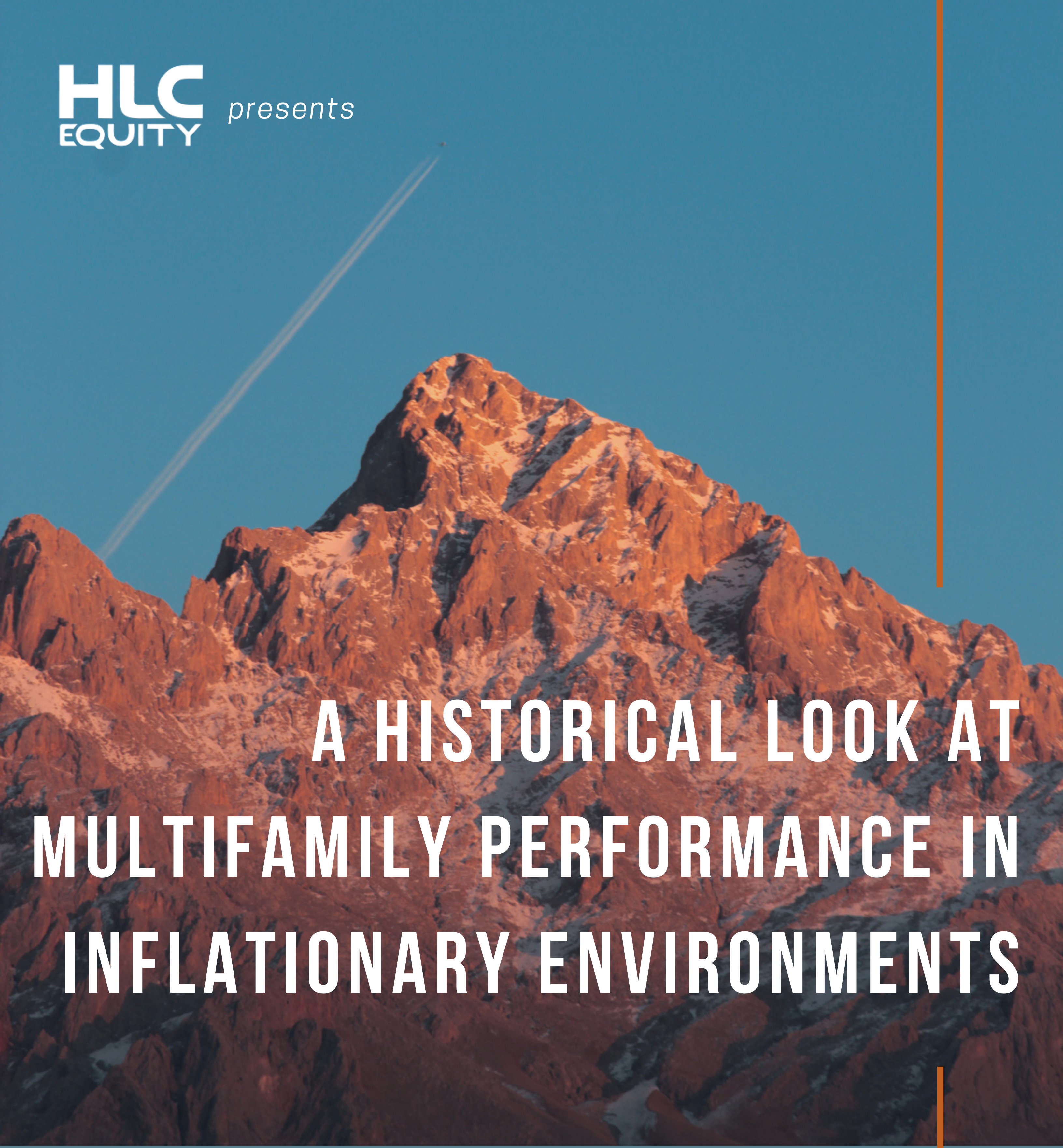


A HISTORICAL LOOK AT MULTIFAMILY PERFORMANCE IN INFLATIONARY ENVIRONMENTS

ECONOMIC OUTLOOK SERIES: WHITEPAPER

Over the past 12 months, the pace of inflation has accelerated faster than any other year-over-year period since the Reagan Administration. In March 2022, consumer prices had shot up a staggering 8.5 percent compared to the year prior – with no signs of slowing down.

And the investment community is taking note.

During periods of inflation, cash is no longer considered a “safe” investment. Cash, whether held in a checking, savings or high-yield account, will generally earn less than one percent annually, well below the rate of inflation. In other words, anyone who is sitting on cash is losing money as the inflation rate rises.

Instead, even the most conservative investors will turn elsewhere in search of yield. Among their options, an alternative investment like commercial real estate shows significant promise.

In this article, we look at how inflation impacts commercial real estate generally, and multifamily investments more specifically. As shown, direct investments in multifamily real estate have historically outperformed both the stock market and other CRE product types.

A BRIEF PRIMER ON INFLATION

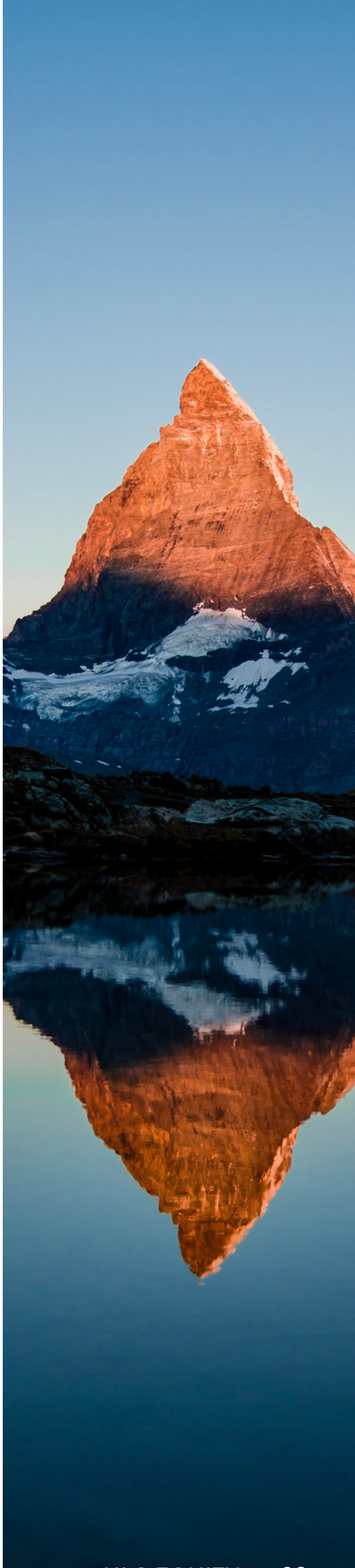
Inflation refers to a general rise in prices for all goods and services, across all sectors. As inflation rises, consumers' purchasing power decreases. For example, whereas it may have cost $2.25 for a gallon of gas last year, an uptick in inflation can cause that same gallon of gas to cost $4.00 or more this year.

There are two primary causes of inflation.

The first is referred to as "demand-pull" inflation. With demand-pull inflation, the demand for goods and services exceeds the economy's ability to produce them. Therefore, goods end up in short supply, which puts upwards pressure on prices.

The second type of inflation is called "cost-push" inflation, which is when the raw costs for certain goods or services increases and therefore, the final cost for those products or services increases as well. For example, the rising cost of certain foods has put pressure on restauranteurs trying to hold prices steady. Meanwhile, finding reliable, qualified labor has become more challenging. In response, many restaurants are paying new employees more per hour than ever before. This combination of factors – higher food costs and higher labor costs – has all but forced restaurants to raise their menu prices.

Since the end of the Great Recession, the inflation rate has hovered around 1-3 percent per year – that is, until now. As of March 2022, the inflation rate had risen 8.5% year-over-year, causing many investors to be on edge. Here's why.



AS THE COST FOR BUILDING MATERIALS AND LABOR INCREASES, CONSTRUCTION BECOMES COST-PROHIBITIVE.

According to the National Association of Home Builders (NAHB), building material costs soared 26.1% between June 2020 and June 2021 – the highest percentage cost increase ever recorded in an NAHB survey. The previous record was just 6.1%, a record that was set back in 2017. At the same time, the construction worker shortage has reached "crisis levels" with an estimated 740,000 new construction workers needed each year for the next three years to keep pace with demand. This dual shortage—of both raw materials and skilled labor—causes construction costs to rise.

In some markets, the rents landlords will need to achieve for a deal to pencil out become unattainable. This stalls the construction pipeline, which bodes well for existing property owners (who benefit from less competition), but can hurt those who were intending to do development and/or significant value-add projects.

AS INTEREST RATES RISE, PRICES FOR COMMERCIAL REAL ESTATE TEND TO COME DOWN.

During recessionary periods, the Federal Reserve Bank typically lowers interest rates. This makes it more affordable to finance commercial real estate, in turn, allowing investors to spend more per property. The opposite is true during inflationary times. As inflation rises, the Federal Reserve Bank typically increases interest rates – as they are now doing. A commercial loan that cost 3.85% last year is at least 50 to 75 basis points higher this year. Rising interest rates tend to have a chilling effect on the values of commercial real estate.

PROPERTIES WITH FIXED-RATE DEBT TEND TO OUTPERFORM THOSE WITH FLOATING-RATE DEBT.

As noted above, interest rates tend to rise as inflation escalates. Commercial real estate owners who have fixed, long-term debt on their properties will generally fare better than those with adjustable, floating-rate debt. For example, someone who finances a property with 3.75% fixed-rate interest is generally less concerned about inflation than someone whose interest rate can adjust periodically up or down. If the rate of inflation is 6.5%, someone with fixed-rate debt below that level will benefit from their in-place interest rate, especially if they can increase rents at the same time. It is important to note that some real estate investors combine floating rate debt with an interest rate cap. This essentially allows investors to utilize the benefits of floating rate debt (better leverage, lower rates, and better terms), while mitigating the risk against fluctuating interest rates by capping how high the rate can go.

RISING INFLATION WILL CAUSE SOME INVESTORS TO RETREAT.

With costs (particularly the cost of debt) rising, many investors will retreat to the sidelines. How this impacts multifamily real estate remains to be seen. On one hand, there remains limited inventory, pent-up demand, and many investors ready to deploy capital into multifamily real estate. On the other hand, some investors will decide that now is not the right time to invest given price escalations. This could have some cooling effect on the market, at least in the short term, but given the sector's strong underlying fundamentals, others will view this as an opportune time to grow their portfolios.

INFLATION IMPACTS PROPERTY TYPES DIFFERENTLY BASED ON LEASE STRUCTURES.

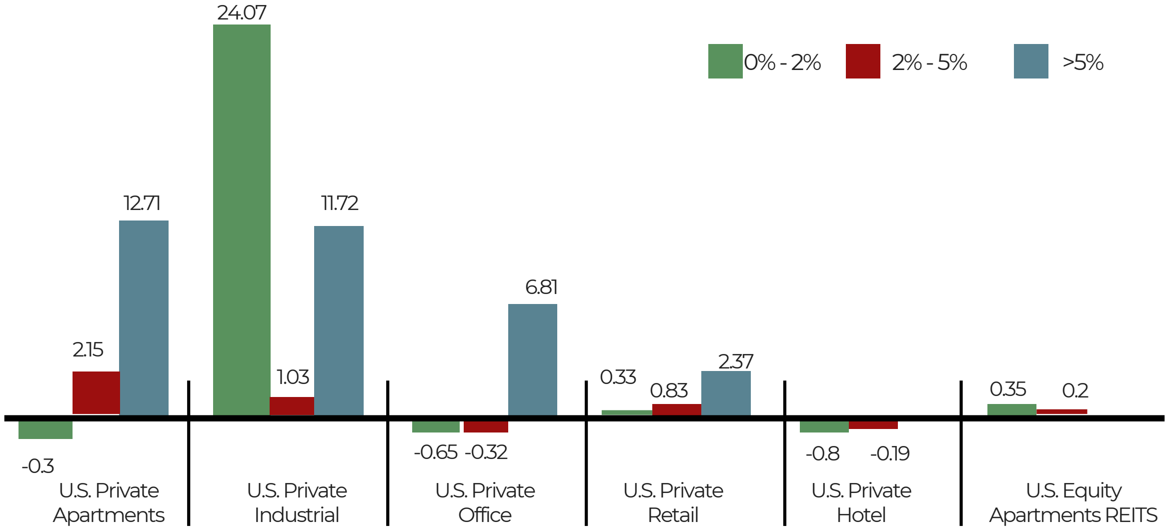
Inflation does not impact all property types equally, as we'll see below. Owners who can increase their rents above and beyond the rate of inflation generally fare well during inflationary periods. This is one reason why multifamily shines during recessionary periods; leases generally turn over on an annual basis and owners can restructure leases each year as inflation goes up or down. Annual rent increases are more difficult at office, retail and industrial properties where leases tend to be longer-term. Most long-term leases will have some built-in escalation, but unless that increase is tied to the Consumer Price Index (CPI), landlords may lose ground relative to rising inflation.

REAL ESTATE ASSET CLASS PERFORMANCE AMID INFLATION

According to a recent in-depth analysis by Berkadia, all U.S. private CRE property types tend to become more favorably sensitive to rising inflation when volatility is higher.

THE STRESS TEST

Here's how different CRE investments tend to perform in different inflation scenarios.



Source: A Better Way to Assess Inflation and Risk in Real Estate (Berkadia)

According to a recent in-depth analysis by Berkadia, all U.S. private CRE property types tend to become more favorably sensitive to rising inflation when volatility is higher.

The chart above shows how different commercial real estate investments perform under different inflation scenarios. The green bar represents inflation rates between 0-2%, the red bar represents inflation of 2-5%, and the blue bar represents scenarios in which inflation is 5% or more. As shown above, privately-owned multifamily apartment buildings tend to perform especially well during periods of high (5%+) inflation. Industrial also performs well, which comes as no surprise given the exponentially high demand for industrial assets in recent years.

Private office and private retail still generate positive returns, but they are not as well-positioned as multifamily or industrial. The outlook for office and retail moving forward remains somewhat unclear. Demand for office is generally low right now, so in the short-term, it may not pose as strong of a hedge against inflation. Meanwhile, retail – which has historically been quite good at delivering short-term inflation protection as retailers are usually quick to incorporate price changes into their business models – may struggle as brick and mortar retailers face growing competition from and/or shift their own businesses more toward e-commerce.

THE HOTEL INDUSTRY FARES THE WORST OF ALL CRE ASSET CLASSES AS INFLATION RISES. WHAT ABOUT MULTIFAMILY?

To benchmark these returns, Berkadia looked at the performance of Apartment REITs under different inflationary scenarios. As the chart shows, privately-owned apartment buildings outperformed all other commercial real estate asset classes during periods of extreme inflation (greater than 5%).

The Berkadia study also looked at the performance of real estate assets in primary and secondary markets. According to the research, secondary apartment markets “exhibit favorable asymmetry in upside and downside exposure” – meaning that gains are amplified in strong markets more than losses are amplified in weak markets.

MULTIFAMILY INVESTMENTS:
A STRONG HEDGE AGAINST INFLATION

Most investors classify an inflation hedge as any asset which beats inflation over the long-run. This is certainly an oversimplification. Using this rationale, many have also come to conclude that stocks are also potent inflation hedges, and by association, they assume that REITs also have powerful inflation-hedging properties.

However, data indicates otherwise.

As shown in the chart above, post-Global Financial Crisis, higher inflation tends to help private CRE returns while hurting REIT and stock returns. Specifically, a 1% rise in inflation implies a 1.20% rise in private CRE excess returns. Over the same period, a 1% rise in inflation caused both REIT and other stock returns to decline.

Compared to apartment REITs, U.S. private apartments offer significantly higher average risk-adjusted returns.

In short, the study “debunked the idea that stock and REIT returns react positively to rising inflation”.

Instead, investors looking for a hedge against inflation will want to consider investing in apartment buildings, which outperform other privately-held real estate asset classes – especially during periods of extreme inflation.

As shown here, commercial real estate can be a tremendous hedge against rising inflation. This is especially true for those considering investing in multifamily or industrial real estate, though all privately-owned real estate will prove to be a worthwhile addition to any investor’s portfolio when compared to more traditional stocks or bonds.

Ready to invest in real estate? Contact us today to learn more about HLC Equity's multifamily platform and our strategy for maximizing value regardless of where we are in any given market cycle.

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ABOUT HLC EQUITY

At the cornerstone of HLC Equity lies a culture that thirsts for impeccable work ethic, innovative entrepreneurship, fundamental analysis, and dedication to the community.
Today HLC Equity is a forward thinking real estate group with over 70+ years of experience in the real estate investment business. HLC Equity has acquired, managed, developed, and repositioned real estate in over 25 states throughout the USA, having owned and managed over 7,000,000 gross square feet of commercial, residential, and development land.

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