REAL ESTATE

How Inflation and Rising Interest Rates Impact Commercial Real Estate

Discussion

August 10, 2022

Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with William Pattison, Head of Real Estate Research to discuss the impact that the high inflation and rising interest rates is having on Commercial Real Estate.

Guy: **Commercial real estate is an interesting asset class with unique characteristics, particularly in today's high inflation environment with growth now beginning to slow due to sharply rising interest rates. I am glad that you can help me make sense of the opposing crosscurrents. On the one hand commercial real estate investments are viewed as an inflation hedge as values typically rise at the rate of inflation rise. On the other hand, values are affected by changes in cap rates, supply and demand, and inputs such as commodities, labor costs, and financing availability. How does it all shake out?**

William: As you inferred, there are many variables that can influence commercial real estate valuations, and it's worth considering each of them separately. I also slightly cringe when referencing the commercial real estate market as a whole, as this combines sectors with strong tailwinds like warehouses against sectors facing headwinds like office. That said, I don't want to dodge your question so will say we are expecting real estate prices as measured by NCREIF to be up about 7% in 2022, and around 4% in 2023.[1]

MetLife Investment Management

Guy: **Ha ha, thanks for that, but perhaps we should also go through the components. Let's start with inflation. Is commercial real estate really a good inflation hedge?**

William: We believe that it is. Our research, using NCREIF data, suggests that from 1978-2021 the unlevered total rate of return from real estate is historically close to the cap rate plus the inflation rate. For investors who think high inflation will last through 2023 or 2024, we think an especially strong case could be made for real estate investments today, as values generally expand with inflation.

Guy: **Let's start with the premise of returns equaling the cap rate plus inflation because that is where it gets confusing for me. Both cap rates and inflation have risen this year which suggests that investors can expect a higher total rate of return going forward. That also makes sense because interest rates are higher, and spreads are wider, but does this mean that, like most fixed income bond, existing positions are underwater?**

William: Similar to a bond, real estate valuations can be influenced by the present-value effect from interest rates. In practice, however, increases in interest rates has often corresponded with rising inflation, which puts upward pressure on real estate rents and property values. This increase in property income, or potential income, has been helping to offset the spring and summer 2022 rise in interest rates. Now that the market consensus view seems to be shifting towards inflation being "transitory", as opposed to remaining high over the next several years, we think real estate price appreciation will be approximately flat during the remainder of the year.

Guy: **As you mentioned earlier, the pandemic has caused changes to consumer behavior and to work habits. Could you provide an example?**

William: The height of the pandemic certainly saw its own set of challenges when malls, offices and hotels were temporarily empty. But as we've emerged into the post-pandemic world, there has been noticeable shifts in the landscape.

In the office sector, the trend toward remote work has impacted some industries, and geographic locations, more than others. The geographic difference in return-to-office is particularly contributing to a dispersion in investor views of the sector, with some investors thinking the office sector is completely dead and others thinking now is one of the best buying opportunities they've ever seen.

Outside of office, the rise in e-commerce growth drove demand for warehouses, while remote working drove demand for housing (both single-family and apartment). Today's post-pandemic environment is producing some of the best returns investors in these property types have ever experienced, with track records going back to the 1970s.[2]

Guy: **Geo-political tensions, inflation and wage pressures have also shifted the real estate landscape. How else are you assessing opportunities and property types today from those factors?**

William: MIM has a long history of ground-up real estate investing, and we are finding many attractive opportunities today. That said, certainty around labor and construction costs has declined, and it's something we are putting more focus on when evaluating new projects. During the pandemic we've run into issues as small as not receiving a shipment of metal washers to install a roof, and as large as a plumbing company reneging on a large work contract. Thankfully, the downside from these delays has been relatively minimal from an IRR/return standpoint.

More broadly, price and behavior shifts have spilled into funding costs throughout the capital structure. Financial market conditions and the economic environment has also led to bank balance sheet constraints. Looking forward, bank appetite for real estate loans might be further impacted by Federal Reserve stress tests. That gap in capital availability could provide upside potential for non-bank mortgage investors.

Endnotes

[1] NCREIF

[2] NCREIF Property Index 1977-2022

Disclaimer

This material is intended solely for Institutional Investors, Qualified Investors and Professional Investors. This analysis is not intended for distribution with Retail Investors.

This document has been prepared by MetLife Investment Management ("MIM")[1] solely for informational purposes and does not constitute a recommendation regarding any investments or the provision of any investment advice, or constitute or form part of any advertisement of, offer for sale or subscription of, solicitation or invitation of any offer or recommendation to purchase or subscribe for any securities or investment advisory services. The views expressed herein are solely those of MIM and do not necessarily reflect, nor are they necessarily consistent with, the views held by, or the forecasts utilized by, the entities within the MetLife enterprise that provide insurance products, annuities and employee benefit programs. The information and opinions presented or contained in this document are provided as of the date it was written. It should be understood that subsequent developments may materially affect the information contained in this document, which none of MIM, its affiliates, advisors or representatives are under an obligation to update, revise or affirm. It is not MIM's intention to provide, and you may not rely on this document as providing, a recommendation with respect to any particular investment strategy or investment. Affiliates of MIM may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives) of any company mentioned herein. This document may contain forward-looking statements, as well as predictions, projections and forecasts of the economy or economic trends of the markets, which are not necessarily indicative of the future. Any or all forward-looking statements, as well as those included in any other material discussed at the presentation, may turn out to be wrong.

All investments involve risks including the potential for loss of principle and past performance does not guarantee similar future results. Property is a specialist sector that may be less liquid and produce more volatile performance than an investment in other investment sectors. The value of capital and income will fluctuate as property values and rental income rise and fall. The valuation of property is generally a matter of the valuers' opinion rather than fact. The amount raised when a property is sold may be less than the valuation. Furthermore, certain investments in mortgages, real estate or non-publicly traded securities and private debt instruments have a limited number of potential purchasers and sellers. This factor may have the effect of limiting the availability of these investments for purchase and may also limit the ability to sell such investments at their fair market value in response to changes in the economy or the financial markets

In the U.S. this document is communicated by MetLife Investment Management, LLC (MIM, LLC), a U.S. Securities Exchange Commission registered investment adviser. MIM, LLC is a subsidiary of MetLife, Inc. and part of MetLife Investment Management. Registration with the SEC does not imply a certain level of skill or that the SEC has endorsed the investment advisor.

This document is being distributed by **MetLife Investment Management Limited ("MIML")**, authorised and regulated by the UK Financial Conduct Authority (FCA reference number 623761), registered address 1 Angel Lane, 8th Floor, London, EC4R 3AB, United Kingdom. This document is approved by MIML as a financial promotion for distribution in the UK. This document is only intended for, and may only be distributed to, investors in the UK and EEA who qualify as a "professional client" as defined under the Markets in Financial Instruments Directive (2014/65/EU), as implemented in the relevant EEA jurisdiction, and the retained EU law version of the same in the UK.

MIMEL: For investors in the EEA, this document is being distributed by MetLife Investment Management Europe Limited ("MIMEL"), authorised and regulated by the Central Bank of Ireland (registered number: C451684), registered address 20 on Hatch, Lower Hatch Street, Dublin 2, Ireland. This document is approved by MIMEL as marketing communications for the purposes of the EU Directive 2014/65/EU on markets in financial instruments ("MiFID II"). Where MIMEL does not have an applicable cross-border licence, this document is only intended for, and may only be distributed on request to, investors in the EEA who qualify as a "professional client" as defined under MiFID II, as implemented in the relevant EEA jurisdiction.

For investors in the Middle East: This document is directed at and intended for institutional investors (as such term is defined in the various jurisdictions) only. The recipient of this document acknowledges that (1) no regulator or governmental authority in the Gulf Cooperation Council ("GCC") or the Middle East has reviewed or approved this document or the substance contained within it, (2) this document is not for general circulation in the GCC or the Middle East and is provided on a confidential basis to the addressee only, (3) MetLife Investment Management is not licensed or regulated by any regulatory or governmental authority in the Middle East or the GCC, and (4) this document does not constitute or form part of any investment advice or solicitation of investment products in the GCC or Middle East or in any jurisdiction in which the provision of investment advice or any solicitation would be unlawful under the securities laws of such jurisdiction (and this document is therefore not construed as such).

For investors in Japan: This document is being distributed by MetLife Asset Management Corp. (Japan) ("MAM"), 1-3 Kioicho, Chiyoda-ku, Tokyo 102-0094, Tokyo Garden Terrace KioiCho Kioi Tower 25F, a registered Financial Instruments Business Operator ("FIBO") under the registration entry Director General of the Kanto Local Finance Bureau (FIBO) No. 2414.

For Investors in Hong Kong S.A.R.: This document is being issued by MetLife Investments Asia Limited ("MIAL"), a part of MIM, and it has not been reviewed by the Securities and Futures Commission of Hong Kong ("SFC"). MIAL is licensed by the Securities and Futures Commission for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.

For investors in Australia: This information is distributed by MIM LLC and is intended for "wholesale clients" as defined in section 761G of the Corporations Act 2001 (Cth) (the Act). MIM LLC exempt from the requirement to hold an Australian financial services license under the Act in respect of the financial services it provides to Australian clients. MIM LLC is regulated by the SEC under US law, which is different from Australian law.

1 MetLife Investment Management ("MIM") is MetLife, Inc.'s institutional management business and the marketing name for subsidiaries of MetLife that provide investment management services to MetLife's general account, separate accounts and/or unaffiliated/third party investors, including: Metropolitan Life Insurance Company, MetLife Investment Management, LLC, MetLife Investment Management Limited, MetLife Investments Limited, MetLife Investments Asia Limited, MetLife Latin America Asesorias e Inversiones Limitada, MetLife Asset Management Corp. (Japan), and MIM I LLC and MetLife Investment Management Europe Limited.

L0822024817[exp0824][All States] L0822024778[exp0724][All States] L0822024865[exp0824][All States] L0822024840[exp0824][All States] L0822024850[exp0824][All States]

MetLife Investment Management