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Net Lease Real Estate Vs Inflation and Interest Rates

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What is in Store for Net Lease Real Estate Investing?

In recent months, interest rates have risen, inflation has spiked, and the economic outlook has clouded. Naturally real estate investors, including those investing in net lease commercial properties, may wonder what is in store for net lease real estate investments. Herein, the relationships between net lease real estate performance and interest rates and inflation are examined.

In summary, since the mid-2000s, the relationships between interest rate moves and inflation levels and returns on net lease property investment have been moderate. To date, historically, net lease real estate investing has been driven predominantly by long term economic drivers and thoughtful underwriting and less so by short to intermediate term shifts in interest rates and inflation. Admittedly, high inflation has been rare since the late 1980s and the current rate increase cycle/trend is likely not yet concluded. However, early indications of moderating inflation are apparent, and the absolute levels of interest rates are not threatening to investment. Further, it is likely that cap rates/initial investment returns will increase, if yields remain higher, and prospective investment spreads can be maintained.

Setting the Framework

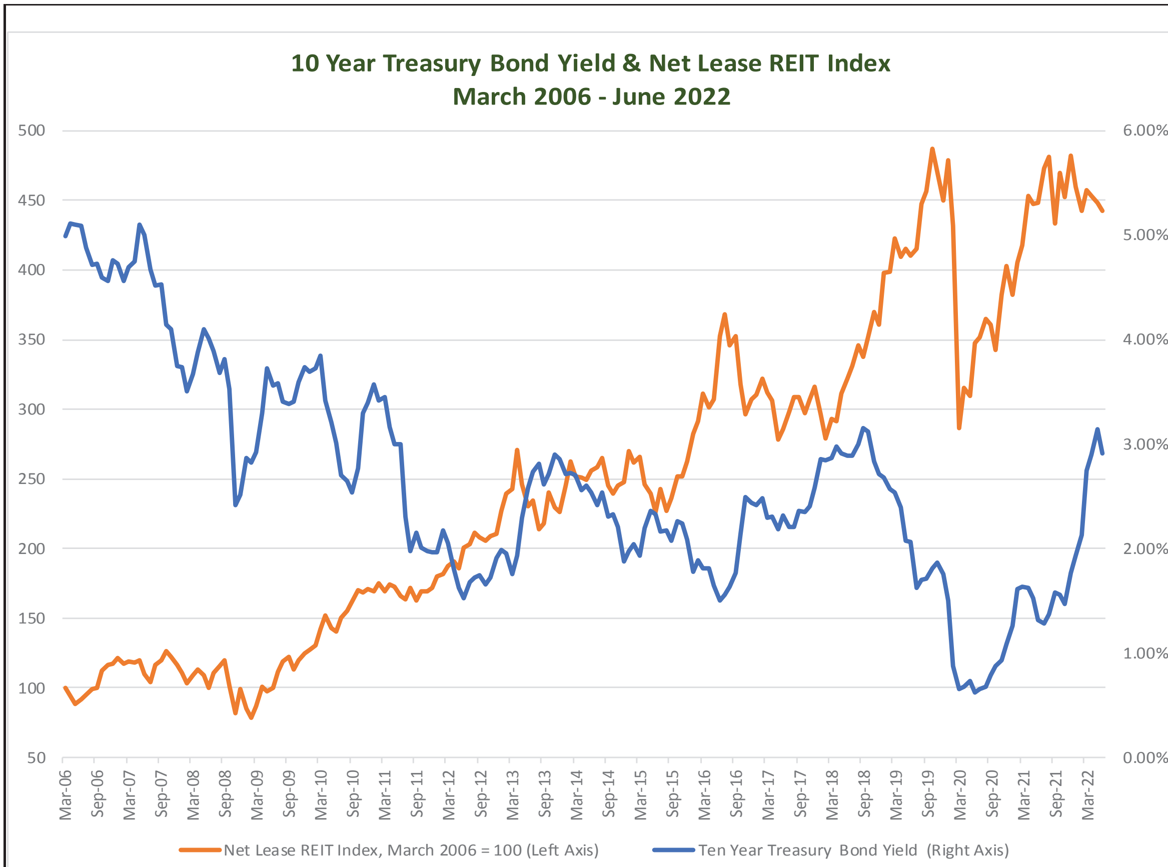
The evaluation of the relationships between net lease real estate performance and inflation and interest rates herein is estimated using public net lease REIT performance data. Reliable, comparable private net lease portfolio performance data is elusive. Meanwhile, verifiable, public net lease REIT index data is available from March 2006 forward and pricing/return activity is 'real time.'

Herein, inflation is measured by the consumer price index (CPI) data from the US Bureau of Labor Statistics. Ten-year Treasury bond rate data from Federal Reserve is used for the interest rate proxy. The net lease REIT performance data comes from the National Association of Real Estate Investment Trusts (NAREIT) and Bloomberg.

Net Lease Real Estate & Interest Rates

From the mid-2000s to the present, the direction of interest rates has been generally one of a declining yield curve. The cumulative experiences of the 1999/2000 'tech wreck', the 2008/2009 'Great Financial Crisis,' and 2020's Covid triggered turmoil have led to sustained accommodative fiscal and monetary policies alongside far more transparency from the Federal Reserve. The well-known, sustained decline, in the trajectory of interest rates, dating back to the early 1980s, has remained in place. Of course, the Federal Reserve obviously pivoted in recent months in light of 'unforeseen' levels of inflation.

How have the 10-year Treasury bond yield and public net lease REIT performance interacted at a high level over the past 15 years? As depicted below, the ten-year Treasury bond yield declined, rather consistently from March 2006 through Spring 2012 and the public net lease REIT index rose steadily- an instinctive expected outcome. In contrast, from April 2012 through late 2018, the yield on the ten-year see-sawed upward yet the public net lease REIT index generally moved higher. Then, the Federal Reserve pivoted again to accommodative policy and rates plunged, beginning in late 2018 and accelerated to a 62-bps trough at the 'Covid' nadir in summer 2020. However, the net lease REITs spiked and plunged during this span. Finally, from the summer of 2020 onward, the net lease REITs have risen again yet the yield of the 10-year Treasury has climbed. In short, the relationship between interest rates (10-year Treasury bond) and return (net lease REIT index level) has been erratic and inconsistent.



Source: Federal Reserve, National Association of Real Estate Investment Trusts, Bloomberg

Admittedly, the above analysis is somewhat crude. However, interest rates have bounced around a good bit over the past decade and a half. Meanwhile, net lease assets, as proxied by the public net lease REIT index have marched higher. Interest rate movements reflect a myriad of constantly shifting economic and policy influences while net lease real estate investment is typically a longer horizon decision less susceptible to shorter term factors.

It is worth noting that after a poor performance start in early 2022, as the 10-year yield began to rise/ Federal Reserve policy pivot, the net lease REITs rebounded to nearly a 2% positive total return as of July 31, 2022, while the broader equity REIT sector had declined 12.6% on a total return basis as of the end of July.

The table below affords a bit more context relating changes in the 10-year Treasury yield and the performance of the net lease REIT index. Since March 2006, there have been 184 rolling one-year periods. As reflected in the table, the yield on the 10-year rose 65 times on a rolling one-year basis. During those 65 periods of rising rates, the net lease REIT index generated positive returns 52 times, or 80% of the time. Interestingly, the yield on the 10-year declined 119 times out of the 184 total rolling periods and the net lease REIT index generated positive returns 81 times, or a lesser 68% of the occurrences. By math, the net lease REIT index declined during only 28% of the 184 occurrences - whether the 10-year yield had increased or decreased.

Rolling 1-Year Change (Increase or Decrease) in 10-Year Treasury Yield vs.
Rolling 1-Year Change (Positive or Negative Return) in Net Lease REIT Index
March 2006 - June 2022

	10-Year Yield Increased	10-Year Yield Decreased	Total
Net Lease REIT Index Positive Return	52/65 Occurences, 80%	81/119 Occurences, 68%	133/184 Occurences, 72%
Net Lease REIT Index Negative Return	13/65 Occurences, 20%	38/119 Occurences, 32%	51/184 Occurences, 28%

Source: Federal Reserve; National Association of Real Estate Investment Trusts (NAREIT); Bloomberg

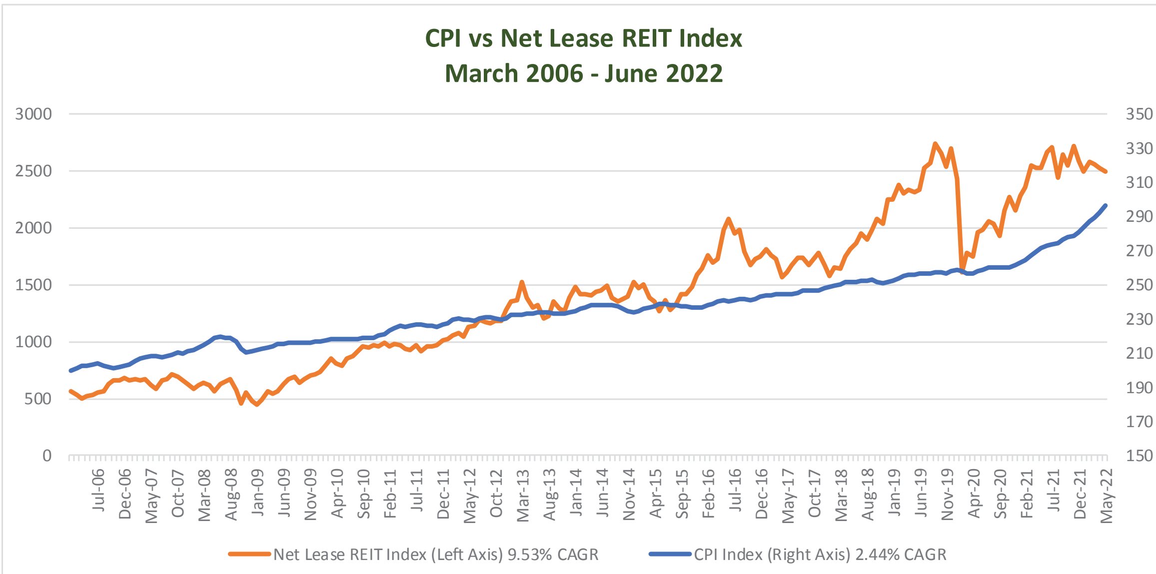
Net Lease Real Estate Performance & Interest Rates Prospectively

While the future is never known with certainty, it is worth considering the following. Rising interest rates are typically a function of a growing economy. In turn, a growing economy typically drives demand for high quality commercial real estate, including net leased properties. At present, the Federal Reserve is principally combatting high inflation. Meanwhile, key economic indicators such as unemployment, factory utilization and corporate profits remain strong. In turn, commercial real estate fundamentals remain solid as well- rising rents, high occupancy levels, and controlled quantities of new supply.

Any and all of this could change, and the odds of a recession have risen. However, the intermediate to long term outlook for space demand remains sound. Net lease real estate investment is an intermediate to long term proposition.

Net Lease Real Estate & Inflation

As depicted in the chart below, CPI has been modest from March 2006 to the present- a 2.4% CAGR. The 2.4% compound rate includes the spike in CPI in recent quarters. Meanwhile, the public net lease REITs exhibited a 9.5% annualized total return over that span. Thus, net lease real estate, as embodied by the public net lease REIT cohort, has performed well historically and total returns have comfortably exceeded CPI- i.e. appealing positive real returns.



Source: US Bureau of Labor Statistics; National Association of Real Estate Investment Trusts (NAREIT); Bloomberg

Admittedly, the above chart does not 'tell the whole story.' The public net lease REITs have exhibited considerable shorter-term volatility as captured in the chart below. The orange line is the rolling one-year total return for the net lease REIT index since March 2006. Meanwhile, the blue line is the rolling one-year CPI change. The average one year rolling total return for the net lease REIT index is an appealing 12% (yellow horizontal line) contrasted with the rolling one-year average CPI change of 2.2% (grey horizontal line). However, REIT index returns have been notably more volatile than the CPI change/trajectory.

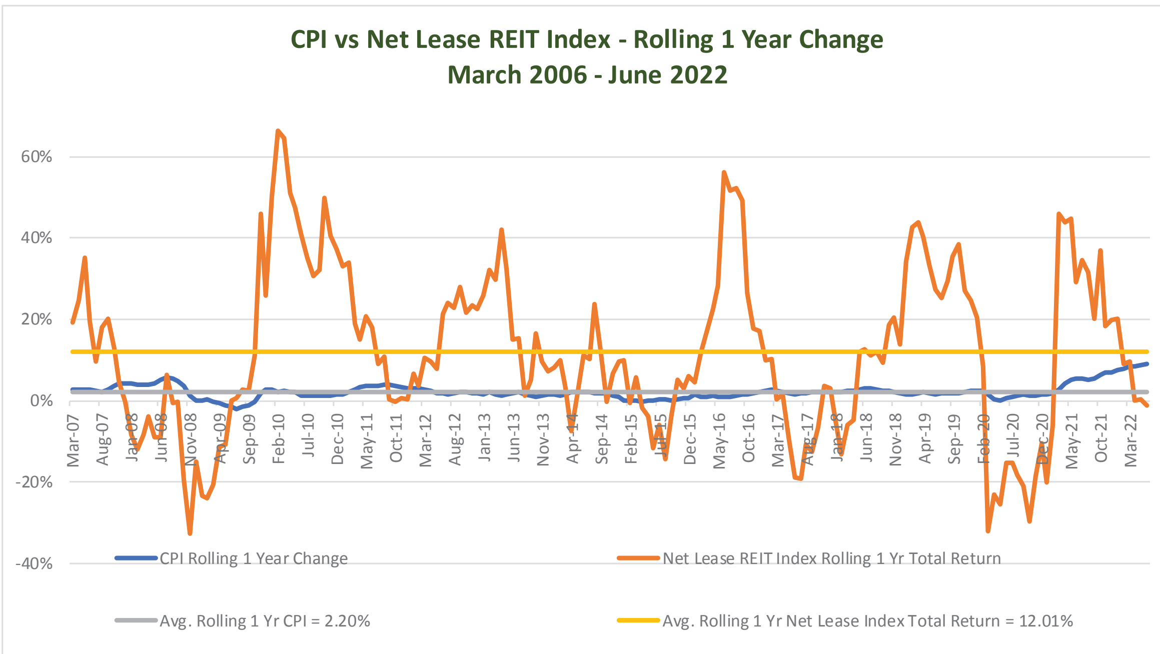
The linkage between CPI and net lease REIT returns is not strong. While not presented, the correlation between the change in CPI and the forward total return for the net lease REIT index is low. The correlation is quite low as well when the REIT index returns are compared to lagged CPI change, on a three- or six-month basis. The assumption was that a spike in inflation may lead to weak forward three or six month returns for the net lease REITs.

Three interrelated conclusions are drawn. First, until recently, the volatility of the rolling CPI change is simply too low, in absolute terms, compared to the volatility of the rolling total returns of the public net lease REITs. Thus, a correlation or relationship is elusive to discern.

Second, the absolute change in the CPI, until late 2021, across the time span presented has been moderate – a trend line that tends to wax and wane gradually by its nature/composition, not plunge and spike like stock prices can.

Third, publicly traded net lease REITs pricing/total returns immediately embody a multitude of capital markets and economic forces. The change in CPI alone does not appear to have been an important driver of public net lease real estate returns historically.

Said another way, historically, net lease real estate investors have profited from 'buy and hold' strategies or have had to be adroit 'traders' to enter and exit the public net lease space at troughs and peaks, respectively. 'Trading' is very hard to accomplish in private/direct net lease real estate investing. As elaborated below, enduring characteristics of net leases themselves and a thoughtful approach to net lease real estate investing can offset inflation risks.



Source: US Bureau of Labor Statistics; National Association of Real Estate Investment Trusts (NAREIT); Bloomberg

Thoughts Regarding Inflation & Net Lease Real Estate Performance Going Forward

As noted in the preceding discussion, for the better part of two decades, until late 2021, inflation has been benign and net lease real estate has performed well. Inflation rates of the past three quarters have surprised many and the jury is out as to its duration and impacts on commercial real estate values in the short to intermediate term.

Assuming the current Federal Reserve actions are successful, and the recent elevated inflation rate moderates, net lease can continue to perform well as certain mitigants have historically preserved the value of net lease real estate properties over time. Meanwhile, representative ten-to-fifteen-year net lease terms tends to bridge short to intermediate term trends in inflation and other factors.

Annual/periodic fixed or CPI linked rent escalators embedded in most net lease real estate asset leases translate to rising property cash flow and act as a mitigant against the impact of inflation. Four Springs intentionally incorporates lease escalations across its portfolio investments.

In addition, Four Springs acquires properties with at or below current market rents. The goal is to avoid owning properties with above market rents at initial lease term expiration. "Buying" rents at inception of an investment, for a higher initial yield, poses the risk of valuation reset/erosion at lease expiration/renewal.

It is also worth noting that, commercial real estate replication costs have grown consistently over time. The Turner Building Cost Index (www.turnerconstruction.com) is a widely followed commercial real estate data series which measures costs in the non-residential construction market in the US. That cost index grew at a CAGR of 3.2% from 2006-2Q22 a faster pace than CPI over the same span which grew at 2.7% CAGR. Higher replication cost translates to a rent pricing umbrella effect. Investors in/developers of newly constructed properties will not proceed unless rents justify the investment economically. Meanwhile, all things equal, tenants tend to stay put/renew at existing locations rather than relocate to a new asset with higher rents. Rising construction labor, land and materials prices continue to dominate the growth in replication costs- with little relief in sight.

Furthermore, astute net lease landlords, like Four Springs, carefully underwrite tenant credit and a property's relevance to the tenant at the onset of an investment. When Four Springs' underwriting concludes a tenant is credit worthy and that the property under evaluation is relevant/core to the tenant's business, value preservation typically results across time. For example, if a Four Springs service retail tenant is capturing higher revenues for its products/services, due to CPI growth, the tenant's business model is preserved to a fair extent. Similarly, if a Four Springs industrial tenant is generating more revenues from the sale of products produced in the Four Springs asset, thanks to inflation, the tenant tends to remain a tenant and property valuation is preserved. Generically, for net lease tenants, occupancy costs are likely rising at lesser rate than the sales/revenues generated at a given property and the tenants are more likely to renew their leases.

In summary, a sustained recession is likely more threatening to net lease real estate valuations, and commercial real estate overall, than inflation risks at present. Sustained economic contraction would pressure the profitability as well as the expansion plans for tenants and space demand would decline. In turn, occupancy and rents would suffer. Fortunately, excess new supply of space does not appear imminent, across most markets and property types. Thus, prospective economic growth/activity is the central factor to monitor.

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