
# IS INCOME GROWTH GUARANTEED IN AN INFLATIONARY PERIOD?

**As central banks continue to fight inflation by raising rates, global real estate markets are still in the middle of repricing. While core inflation is showing encouraging signs of easing, we still have little indication of when the tightening cycle will end. As it might be tempting for investors to assume that central banks will pivot quickly and ease their monetary policies, it might be best for them to focus on other drivers to create value. For real estate, when yield declines are unlikely, it is often said that investors need to focus on income and its indexation to boost their return... but is this type of value creation so easy?**

## Key findings

- Rental indexation is not the only factor to play out for income growth
- Active management is key to create value
- Resilient cash flow and growth potential – driven by structural trends – is an attractive strategy for long-term investors.

## BREAKING HISTORICAL ASSET-VALUE GROWTH INTO DRIVERS

Two factors drive the total change in asset value: yield and income. During the past cycle (2010-2021), the decline in yields recorded between 2010 and 2022 drove most of the value creation in European real estate. Indeed, unconventional monetary policies and the level of liquidity available on the market had a significant impact on the demand for real estate assets and on valuations. However, with the rise in global interest rates triggered by the inflationary shock, we are not expecting any major decline in yields in the coming quarters and investors will have to find value elsewhere.

With the current level of inflation, investors often perceive income growth as the solution to increase the value of a building, or at least to limit downward pressure on its price.

## INCOME GROWTH: A COMPLEX VALUE CREATOR

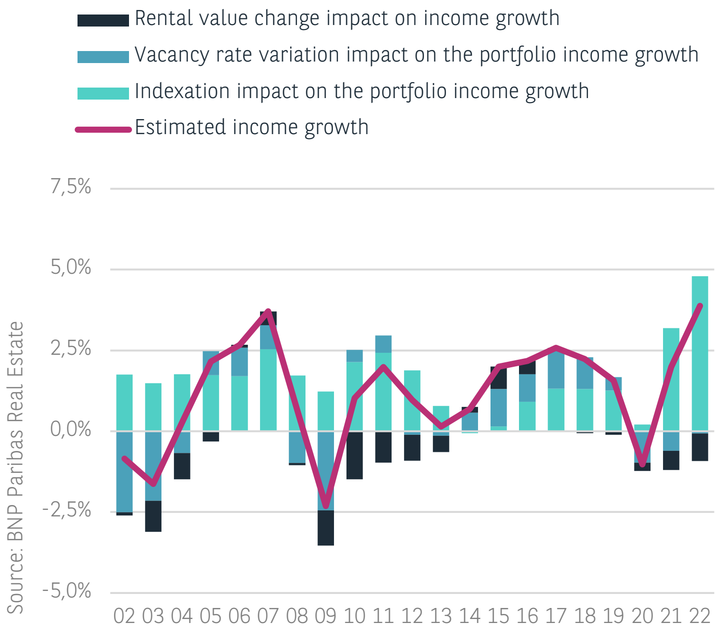
It can be wrong to assume income growth can track inflation thanks to rising market rents and indexation, especially during periods of high inflation. Indeed, this notion is much more complex and other variables might have an impact on income growth. In a real estate portfolio, it is possible to estimate the income growth through three components:

- INDEXATION EFFECT: if there is an indexation clause in the lease, the rent paid by each tenant increases following the rate of inflation each year;
- RENTAL VALUE EFFECT: a portion of the leases in your portfolio will have a break or their term every year and will be renegotiated or renewed at the market rent;
- VACANCY EFFECT: the vacancy of your portfolio is evolving across time and will have an effect on the income.

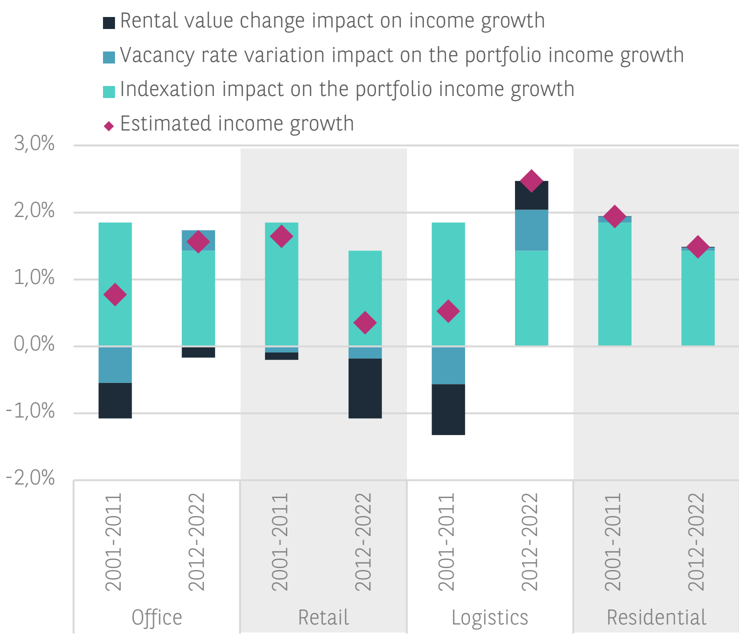

If the rental indexation was mostly positive for the past 20 years, we can see that income growth has been in negative territory during the main economic slowdowns. Both during the financial crisis (2008/2009) and the COVID-19 pandemic (2020), we can see that both vacancy and rental growth have had a negative impact on office income growth. In today's environment, indexation is compensating the increase in vacancy and the decline in rental values. However, slowly declining inflation might drag income growth into negative territory in the coming months, increasing the pressure on prices.

The same results could be derived for the other asset classes. For logistics, income growth was close to zero between 2001 and 2011, mostly due to a negative effect of rental growth and vacancy rate (following a strong increase in supply). Now, with the rise of e-commerce, it is one of the best performing sector regarding income growth, with positive impact of the three factors.

### Estimated income growth for European offices – 2002-2022




### Estimated income growth by asset classes – Average by period




## VALUE CREATION NEEDS ACTIVE ASSET MANAGEMENT, EVEN DURING INFLATIONARY PERIOD

We can also see the benefit of active management on the value of a given asset. During the period of low inflation in Europe (2013-2020), the decrease of vacancy drove up income growth and capital values.

As such, if an investor can reduce the unoccupied space or raise the rental value, the price of the asset should increase. For example, using a proper ESG strategy to improve the energy efficiency of a building should increase both the occupancy and the rental value.

This form of active management is essential, even when inflation is high. In fact, it is more important in this environment, considering the current need to counter rising yields.

# CONTACT


## Benoit Lefebvre

PhD, MRICS

Head of Research

Mobile: +33 6 70 05 75 93

benoit.l.lefebvre@bnpparibas.com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