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# Can Low Inflation Affect Commercial Real Estate's Risk?



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Long-run commercial real estate values are determined by supply-and-demand conditions within a particular market area. In markets where increased demand for space relative to supply exists (or is expected), rental rates increase. During inflationary periods, however, rental rates also may increase because of specific commercial lease clauses linking rental rates to the inflation rate or escalator clauses requiring the tenant to pay periodic rent increases.

Over time, increased rental rates from either source will be capitalized into higher real estate values. During recent years, therefore, commercial property values have gone up, both from the increased demand for space and from inflation.

The effect of a sustained period with little or no inflation on commercial real estate's net operating income (NOI) and value was considered in the last issue of *Tierra Grande*. The article shows that many leases provide commercial real estate owners with rising NOI during inflationary periods.

If the effect of supply and demand on rental rates is set aside, however, these same lease terms produce a much smaller increase in NOI during little or no inflation. With

little or no inflation anticipated, real estate analysts are unlikely to forecast property value increases unless they expect an increased demand for space. Thus, if the Federal Reserve's Board of Governors' effort to control inflation is successful for a sustained period, commercial real estate value could be affected negatively.

Another possible effect of a smaller increase in NOI during a sustained period of little or no inflation is an increase in *financial risk*, i.e., the risk that the property will produce inadequate income to meet debt service requirements. The reasons for this increased risk and how it can be avoided are the focus of this "Instructor's Notebook." Unless otherwise qualified, the statements in this article assume real estate analysts expect a sustained period of little or no inflation.

## Inflationary Expectations

Typically, when a commercial property is financed with a mortgage loan, the loan is repaid in equal payments over the life of the loan. To estimate the amount of the payment that can be repaid from the first year's NOI, the lender requires a minimum debt coverage ratio to add a **margin of safety**, i.e., the excess of NOI over the mortgage payment. For example, if the lender requires a debt coverage ratio of 1.25, the annual NOI must be 1.25 times the annual mortgage payment. The NOI can decline by 20 percent before the borrower's ability to make the payment is jeopardized.

During recent years, real estate analysts usually have projected increased NOI for the life of a loan, with a fixed mortgage payment as shown in the example.

Year	NOI if growth rate is 3%	Mortgage Payment	Debt Coverage Ratio
1	\$60,000	\$48,000	1.25 x
2	61,800	48,000	1.29
3	63,654	48,000	1.33
4	65,564	48,000	1.37
5	67,531	48,000	1.41

The expected NOI increase results from the expected control of operating expense increases with triple net leases or leases with expense stops and expectations of increasing rental rates. In turn, increasing rental rates reflect the expectation that demand for space will exceed the supply of space and/or because of particular lease clauses link rental rate increases to expected inflation or escalator clauses. Over time, the margin of safety and the debt coverage ratio increase, and, thus, financial risk decreases.

**W**hen the property is sold or refinanced, the safety margin will likely be reduced temporarily as the new mortgage payment is increased to the maximum amount the NOI will support. If NOI continues to increase, however, in time the margin of safety and the debt coverage ratio will improve, and financial risk again will decrease.

This expectation of an increased margin of safety over time is analogous to the expectations of many single-family homebuyers in the past. Many homebuyers arranged the largest loan the family's income could support. Sometimes, the large payment was a burden. The family's income was expected to increase, however, while the mortgage payment remained fixed (although property taxes and homeowner's insurance would increase).

As the family's income increased, the mortgage payment was more easily managed; in effect, the family's margin of safety increased along with their income. In other words, a much larger decrease in family income could be sustained before defaulting on the mortgage. The family's increased income could result from increased wages and salary, cost-of-living increases or both.

Thus, increased income improves the margin of safety and reduces the risk of default for owners and lenders of both commercial property and single-family homes. How does sustained little or no expected inflation change these previously expected outcomes?

### Limited Inflationary Expectations

If a family's principal expectation of increased income is from cost-of-living increases rather than from higher wages and salary, the family's safety margin on their mortgage loan increases slowly during a noninflationary period. This lengthens the time that the mortgage payment is a burden. To reduce the burden, the family could choose a less expensive home and arrange a smaller loan so that the initial mortgage payment requires a smaller proportion of family income. Lower interest rates would likely be available; if so, the family's mortgage payments can be reduced. The commercial property owner's decision is more complex, however.

If a commercial property's income is expected to increase slowly during a period when little or no inflation is expected, the property's margin of safety increases slowly as well, all other things being equal. Unlike the single-family homebuyer, however, the commercial property owner neither constructs a smaller or less expensive building nor arranges a reduced loan to have an increased margin of safety.

Constructing a smaller or less expensive building than required for the market will likely result in unleased space. The probability of a property developer asking for a smaller loan is small, if not zero. In fact, the developer will likely take advantage of lower interest rates, if available. This increases the amount borrowed and keeps the mortgage payment at the maximum amount agreeable to the lender. As previously noted, any decrease in the margin of safety brought about by the property's future refinancing or sale should be temporary.

The following example shows that the impact of real estate analysts' expectation of little or no inflation is the projection of smaller increases in the margin of safety during the holding period for newly financed properties.

Year	NOI if growth rate is 1%	Mortgage Payment	Debt coverage Ratio
1	\$60,000	\$48,000	1.25 x
2	60,600	48,000	1.26
3	61,206	48,000	1.28
4	61,818	48,000	1.29
5	62,436	48,000	1.30

There may be a much more important factor to consider, however. Once a commercial property is completed, it must compete for tenants from that location throughout its economic life. If, at the time the property is completed, there is sufficient demand by tenants for the property, the property should generate sufficient NOI to meet debt service and provide a margin of safety.

However, competition from newer, better located properties in the market may take tenants from older properties. To keep current tenants and attract new tenants, the owners of older properties may need to reduce rental rates. Competition from superior properties may take place regardless of inflation, but the consequences of that competition to the owner of the older center may be more severe during noninflationary periods.

During such a period, the aging center must compete to maintain net operating income; lease clauses that link rental rate increases to inflation or escalator clauses are little help. If the center cannot

compete with the newer, more competitive properties, then the owner is forced to reduce rental rates. This action translates into a reduced NOI, margin of safety and debt coverage ratio. Such circumstances increase financial risk and risk of default.

### Maintaining a Competitive Edge

To avoid this increased risk of default, both commercial property owners and lenders must be more concerned with

**“Both commercial property owners and lenders must be more concerned with the supply of and demand for commercial space . . .”**

the supply of and demand for commercial space within particular market areas. Specifically, much greater attention should be paid to competitive conditions within the market. Is additional space needed within the market? If so, what can be done to maintain a new property's competitive edge so that new competition will be dissuaded from entering the market in the future? Is the site under consideration a suitable site for the long-term? Such sites allow the owner to demand escalator clauses from tenants even in the absence of inflationary expectations.

Commercial property lenders should require and owners should accept more rigorous underwriting standards. Properties that can not command leases containing escalator clauses should provide a larger initial debt coverage ratio so that as the property ages it can withstand rental rate reductions that result from newer, better located properties. ☐

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