Insight

Inflation Borrowers face interest rate risk as central banks tackle the rising cost of living

Surging inflation has elevated interest rate risk in Europe's real estate financing market to its highest level since the global financial crisis. More than a decade of ultra-loose monetary policy could begin to unwind over the course of the year, as central banks seek to tame inflation by increasing rates and reducing balance sheets through quantitative tapering, ***writes James Wallace***.

The long-anticipated shift from massive policy stimulus over the past two years to monetary tightening presents opportunities and risks for lenders and leveraged real estate investors to navigate.

The pandemic was the catalyst for the inflationary surge. On the demand side, covid stimulus boosted consumption power, while factors including labour market constraints and disrupted supply chains impacted the supply side. While demand-side pressures are subsiding, due in part to the removal of stimulus, supply-side pressures are more persistent.

In the UK, inflation reached a 30-year high of 5.5 percent in January, leading to a February rate rise by the Bank of England. The Bank predicts inflation will peak at 7.25 percent in April, more than triple its 2 percent target. In the eurozone, inflation also surprised to the upside, at 5.1 percent in January, a record high for the bloc.

The inflationary environment presents mixed fortunes across property lending markets. It may benefit lenders of floating rate debt. However, these advantages will be unequal, says Laurence Richardson, director in the debt advisory division of consultancy Colliers.

"Credit fund managers that raised private capital in the last couple of years may become marginally more competitive relative to traditional senior banks as the former's target returns will have been benchmarked in a lower interest rate environment," he says. "By comparison, a senior lending bank will essentially need to borrow money in the wholesale market and pass through the prevailing reference rate."

7.25%

The Bank of England's prediction for peak inflation in April 2022

Lending market competition will counter upward pressure on pricing, Richardson adds. "On the supply side, the weight of that capital will keep a lid on lenders' ability to run away with margins."

Rahim Bavandi, executive director of real estate debt at Empira Group, a real estate manager active in German-speaking Europe, says the case for non-bank debt providers, like Empira, could strengthen. "Should interest rates rise, financing conditions offered by banks will likely become more expensive – and thus make alternative debt solutions even more attractive by comparison."

Interest coverage

Mark Bladon, head of Investec Real Estate, the property arm of UK and South Africa-headquartered bank Investec, foresees two impacts of rising rates across the real estate lending market. "Interest coverage ratios in investment loans will come under stress. Many ICRs in recent years were set at 1.5, based on low rates. A rise could mean borrowers having to cure shortfalls.

Bank of England: raised rates in February

"In the development finance market, where interest is often rolled up and paid at the end of the loan term, developers may find the interest roll-up facilities taken out with their banks, and based on historic rates predictions, are no longer sufficient to cover the eventual interest cost."

The prospect of rising rates means borrowers will need to manage the implications of debt becoming more expensive to service, as well as potential problems rising costs could have on refinancing maturing loans. Such risks, in the worst-case scenario, can lead to solvency concerns. Higher base rates are also likely to drive demand for fixed-rate loans and interest rate hedging products.

However, Barkha Mehmedagic, global head of institutional sales and group treasury at Germany-based manager Commerz Real, believes the inflationary environment will have a limited impact on the company's borrowings. She says the European Central Bank will be cautious about the timing of rate rises to avoid damaging fragile Southern European economies. She adds that Commerz Real's inflation-adjusted leases will provide some protection.

"If interest rates were to rise to levels we haven't seen for many years, financing costs could go up with an impact on the profitability of our business," she says. "However, we do not expect a rapid rise, and we don't foresee our financing costs increasing significantly."

Mixed fortunes

Walter Boettcher, head of research and economics at Colliers, believes the impact of inflation on real estate investment activity will be varied, and short-term. He does not think higher borrowing costs will cause concern for many owners of commercial property: "Equity is already here for prime assets, and while these equity investors use leverage, they are not 'over-leveraged', hence many of the concerns [around rising debt costs] may not be a key driver in their decision-making."

However, he expects the situation to be different in the secondary real estate market. "For secondary assets with leverage, especially those that present challenges in repositioning for ESG [environmental, social and governance] compliance, the story is very different, especially when refinancing becomes an issue. This differential – between prime and secondary assets – will be a dynamic to watch, with distress and opportunity rising in equal measure."

Some in the industry argue it is possible monetary tightening may prove more muted than expected due to the supply-side nature of the inflationary pressure. Central banks' QT programmes may do the heavy lifting and prevent the need for significant rate rises.

"Our view – and one shared by a lot of borrowers I speak to – is that markets have run slightly ahead in terms of expectations for the speed and severity of future rate rises," Colliers' Richardson says. "The interest rate trajectory is not clear cut at all. Many sponsors are minded presently to take out a floating rate loan and buy a cap product to provide some degree of protection against a scenario where rates were to rise beyond a strike rate which would cause real solvency and liquidity issues." ■