



INVESTMENT REALTY CO. L.C.

THE RAUB REPORT

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Last month, I looked at what inflation is and why it is in our future. So now, what does it mean to you?

What is the Effect of Inflation on Commercial Real Estate?

Property acts as a store of value, like gold and other hard assets. Currencies come and go but real estate and gold go on and on. They have intrinsic value. In contrast, the government can print and spend money faster than anyone can count, inflating the money supply and thus devaluing the dollar. So, when the money supply is inflating, the dollar's value is falling and your property's value is rising in pace with or faster than inflation.

Rent

A second value that property can bring is cash flow from rents. People need a place to live, and businesses need a place to operate; and they will pay to use your property. Properties increase in value as the rents increase. Now commercial leases vary in length. The shortest terms are in apartments and self storage which typically lock in rates for 6 to 12 months before renewing with the possibility of a rate increase. Office and retail leases generally run from 3 to 5 years in length and often include fixed rent increases. Some leases to major companies for large spaces may run ten years with renewal options. During periods of high uncertainty about inflation, like the 1970's, the rent increases are keyed to the Consumer Price Index or C.P.I.

Bottom line – the Landlord wants the ability to raise his rents at the rate of inflation or faster. Landlords want short leases with CPI escalations while Tenants want long term fixed rate leases, so the prudent property owner will negotiate to protect himself from the erosive effects of inflation.

How does Inflation affect your Mortgage?

The value of your mortgage is being paid down by your monthly payments of principle. But inflation helps because your mortgage value is declining in real terms as the value of the dollar declines. You are paying it off with inflating dollars. And the value of the property is going up faster along with the pace of inflation. So your equity, which is a smaller part of your property's value is going up at the rate of inflation while the real value of your mortgage is declining, magnifying the increase in the value of your investment.

Inflation and Interest Rates

Historically, during times of inflation the Federal Reserve has been committed to fighting inflation. They do this by raising interest rates. Remember in the early 1980's when briefly we had 21% interest rates? In the present deflationary environment, interest rates are being kept artificially low to stimulate borrowing. They will rise again, and if inflation really kicks in, then The Fed may substantially raise interest rates to combat inflation. Therefore, the investor may want to consider taking the opportunity to borrow at today's lower interest rate level, as the value of having a lower interest loan will be greater when interest rates move higher due to inflation.

So we can see that Commercial Real Estate can perform well in an inflationary period because 1) property, like gold, is a store of value, 2) rents can be raised to keep up with inflation and 3) and a loan amount declines in real, inflation-adjusted terms, while you pay it back with inflated dollars. I am definitely not saying inflation is a good thing. Inflation is bad! Inflation will hurt companies and their stocks may not go higher in value in an inflationary period. However, commercial real estate investments can be a good place to protect your wealth during inflationary times to come. First deflation, then inflation whiplash. Ouch!

Investment Realty Company is actively pursuing some excellent investment opportunities for our clients. Please call me to see how we can help you.

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