CUSHMAN & WAKEFIELD

CUSHMAN & WAKEFIELD
RESEARCH SPOTLIGHT

How Inflation is Impacting CRE Occupiers

June 2022

Inflation has recently emerged as a hot topic in real estate, and for good reason. Most measures of inflation are at multidecade highs, as a strong economic recovery paired with pandemic-related supply disruptions have kindled a surge in the costs of labor, materials, energy and other inputs companies need to operate their businesses. More recently, the war in Ukraine has exacerbated price pressures globally. Because supply chains remain bottlenecked and the geopolitical outlook is highly uncertain, this phenomenon is not likely to resolve itself soon. Central banks around the world are intervening by raising interest rates, but the knock-on effects could result in slower economic growth and more subdued commercial real estate (CRE) leasing demand for certain property types over the next several years.

In addition to the overarching macroeconomic implications, CRE stakeholders face unique challenges in an inflationary environment. Land developers struggle with materials shortages and project delays, not to mention rising land values. Asset managers incur volatile operating and maintenance costs. Investors face an uncertain pricing and financing environment. **But what about CRE occupiers?** While they're certainly not immune to inflation, the implications are not easy to generalize.

In this report, which is focused on inflationary pressures in the U.S., we break down the key considerations that tenants should have in mind when evaluating if and how to fine-tune their leasing strategies. Key takeaways include the following:

- A large imbalance between labor supply and demand has led to shortages across sectors, and wage growth is responding. Harder hit sectors like accommodations, food services, retail and wholesale trade—where labor is about half of all operating expenses—are all recording the fastest wage growth rates in the economy.

- Input and operational costs range from materials to costs of energy, transportation, storage and supporting services. Inflation in the supply chain is much more acute than that for services or consumer prices, reflecting special dynamics of the pandemic recovery. Goods prices are rising at more than three times the rate of services prices as a result.

- Real estate costs are largely driven by market conditions—that is, rent growth is a function of local fundamentals and vacancy conditions and less so of national or even local inflation. This creates both opportunities and challenges for occupiers, depending upon the property types they lease.

- However, real estate costs associated with buildouts have risen significantly and labor shortages are compounding challenges for occupiers. Planning further in advance is more important than ever.

LABOR COSTS

Labor costs are typically the largest expense for businesses, ranging anywhere from about 30% for transportation firms, to 50% for retail and warehousing firms, to more than 60% for many office-using businesses such as accounting, legal, medical and professional services, depending on the occupation mix (see table to the right). In December 2021, the average U.S. hourly compensation was $40.35, about 70% of which represents wages and salaries with the remaining 30% of costs attributable to employee benefits. Hourly compensation varies dramatically by industry, geographic region, firm size and other factors. For example, the average hourly compensation rate for management and business professionals was $64.12 in December 2021, whereas for retail sales occupations, it was just $19.44. Compensation for all occupations ranges from a high of $44.63 in the Pacific states to a low of $31.01 in the central part of the South. Labor costs have always been a key consideration for location strategies, but labor costs are only one piece of the puzzle that includes labor availability, proximity to customers, infrastructure and other strategic priorities.

U.S. Labor as a Share of Total Operating Expenses

Industry	Labor % OpEx
Wholesale	54.3%
Retail	52.2%
Restaurants	51.6%
Warehousing	51.1%
Office	49.6%
Transportation	31.6%
Manufacturing	21.2%

Source: U.S. Census Bureau, Cushman & Wakefield Research

The labor market changed rapidly during the pandemic and is still not fully healed. Despite the economy adding 21.2 million jobs since the peak lockdown period in April 2020, the total number of people employed remains about 820,000 shy of the pre-COVID level and even further below where the prior trend suggests employment would be, absent the pandemic. The incomplete recovery thus far has not been for lack of hiring demand, but rather supply. In May 2022, 1.8 million people reported that they had been unable to work because their employer closed or lost business due to the pandemic, and another 455,000 were prevented from looking for work because of the virus. These numbers are significant but do not tell the full story, since other disruptions may still be keeping people from returning to work—difficulty finding child and eldercare, for example. These hindrances are expected to abate as the virus becomes less disruptive, especially as many families have likely exhausted stimulus funds and as enticing job opportunities bring people back to the workforce. Still, labor supply will remain a defining feature of the present recovery and expansion as some groups—like early retirees—may simply never return.

Labor shortages were a common complaint for businesses prior to pandemic and are now ubiquitous. To complicate matters, many people switched jobs, industries or relocated altogether during the past few years, creating mismatches in local job markets that further contributed to labor shortages. The “easy” solution for businesses struggling to hire has been to raise wages and offer more perks, such as one-time bonus payments, remote work flexibility or stronger

Hourly compensation for all occupations ranges from a high of $44.63 in the Pacific states to a low of $31.01 in the central part of the South.

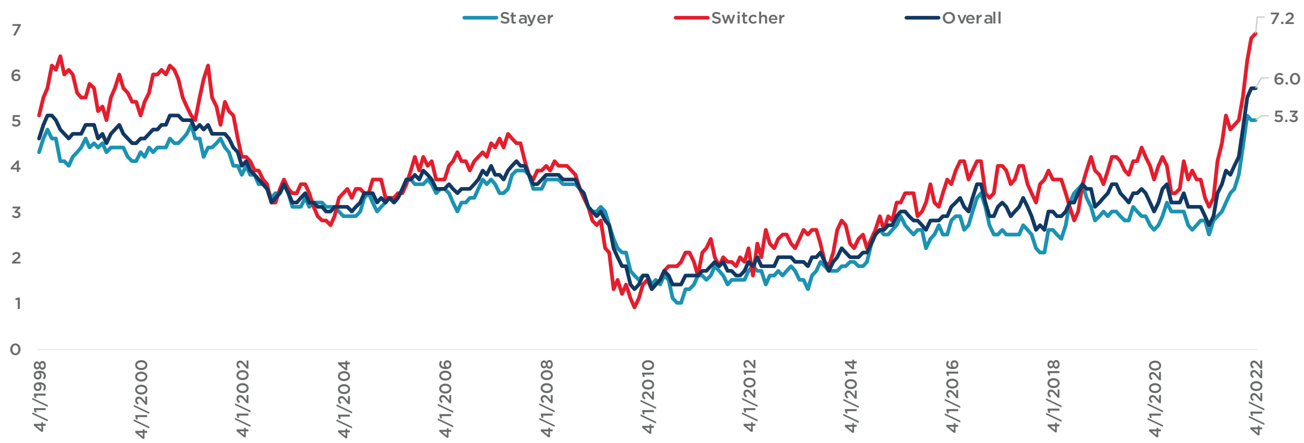
benefits packages. While some firms have had success with these initiatives, they're not a panacea. The more successful long-term solution—and a crucial component in real estate leasing decisions—involves re-optimizing labor force strategies for a post-pandemic workforce, which costs time and money and comes with a healthy dose of uncertainty regarding employee desires.

The result is that labor costs for real estate occupiers are rising more quickly than any time in recent memory, and certainly when compared to the expansion that followed the Great Financial Crisis (GFC). According to the Employment Cost Index (ECI) for the private sector, median wage growth in the first quarter of 2022 rose 6.0% from a year earlier—tied for the fastest rate on record dating back to 1990. Following the 2007 recession, annual wage growth did not exceed 4.0% at any time, so the current environment is an abrupt shift from the previous expansion cycle.

Difficulty hiring workers for new roles is not the only problem—retaining employees is also increasingly challenging given that job-changers in April received a 7.2% year-over-year wage increase compared to 5.3% for people staying in their current roles. It is no surprise that the number of people quitting jobs remains near all-time highs. What's more, losing productive workers can start a vicious cycle of lower employee morale and exacerbate hiring challenges.

Escalating labor costs may not ease as quickly as other forms of inflation, barring a recession. Wages typically are sticky, meaning that growth tends to feed upon itself over an extended period rather than quickly reverting to prior trends. This is especially true in periods of high consumer inflation since workers will demand better pay to offset higher costs of living. Fortunately, so far, we are not seeing signs of a wage-price spiral, but many economists note it's a key risk in the year ahead.

U.S. Wage Growth (Yr/Yr % Chg.)



Source: Federal Reserve Bank of Atlanta

Even as people return to work full-time following the pandemic disruptions, we may continue to experience labor market inefficiencies stemming from lower international migration. Migration into the U.S. understandably came to a halt during the pandemic but had been on a downward path for several years prior to 2020. It's difficult to predict how this trend will play out, but a ramp-up to the 2015-2016 peak—a period when the U.S. added more than one million net foreign residents—is unlikely to happen quickly. It is estimated that the U.S. has about two million fewer foreign-born workers as a result of reduced immigration.

Additionally, domestic mobility could impact labor markets as the ability for workers to move becomes more difficult due to rapidly rising home purchase and rental prices, and rising mortgage rates, which lock homeowners into historically low rates (over 90% of mortgages have an interest rate below the prevailing 30-year fixed-rate mortgage rate). That trend would be a reversal of the housing market boom of 2020-2021 when favorable homebuying conditions encouraged more relocation between metropolitan areas and regions.

Finally, the evolving role of remote work will play a role in labor costs and availability, with uncertain implications for occupiers over the long term. This is not solely a question for office-users; retail and industrial occupiers will need to consider how the changing nature of where people spend time impacts their labor pool.

INPUT PRICES & OPERATIONAL COSTS

In addition to universal labor concerns, businesses are concurrently contending with widespread inflation in the costs of producing goods and providing services to their customers. These costs range widely between industries, and even at the company level, depending on the specifics of the operation. For example, furniture manufacturers are more highly exposed to volatile lumber prices than grocery chains, which are more sensitive to food and storage costs. Given the range of these costs and range of impacts, it makes sense to dive deeper into the types of input costs that are rising fastest as well as the extended outlook.

Energy

Consumers are feeling pinched from higher gas prices, but the bigger pain point for CRE occupiers stems more so from the downstream impacts on input, utility and transportation costs (more on transportation below). Higher operating costs—such as electricity, heating and cooling—are a given across all property sectors, but only some tenants are responsible for those expenses depending on their lease agreement. In the U.S., the consumer price index (CPI) for electricity rose 11.0% over the previous 12 months ending in April. For natural gas utilities, the CPI increased 22.7% over that same period. These increases pale in comparison to those for retail gasoline and heating oil costs, which rose 43.6% and 80.5%, respectively. Occupiers still relying on heating oil, as opposed to natural gas or clean energy, will suffer disproportionately as a result.

The good news is that with the Northern Hemisphere heating season winding down, prices will have a chance to ease as they typically do after a spike. The bad news is that the broader energy outlook is highly uncertain as the pandemic drags on and new geopolitical risks emerge. Since early 2020, just before the COVID-19 pandemic, market prices for crude oil have roughly doubled to north of $100 per barrel and natural gas prices have tripled. Like other prices, demand for energy ramped up quickly once pandemic lockdowns eased. Supply has been slower to recover, leading to higher trading prices. Oil prices peaked in October 2021 at over $80 per barrel (for WTI) before heading towards $70 by year-end. However, Russia's invasion of Ukraine in February 2022 significantly disrupted global energy markets given Russia's position as a leading energy exporter, primarily to its neighbors in Europe and Asia. The U.S. is also subject to global price movements more generally and is currently recording oil prices hovering in the $100 to $120 range. The geopolitical outlook is difficult to predict and can change quickly, but the risks for even higher energy prices cannot be discounted. For example, a widespread European embargo of Russian oil would have more severe impacts on global energy prices. As such, energy-intensive occupiers should be monitoring the situation.

Although some occupiers were pursuing real estate strategies that supported broader, longer-term ESG missions before the recent inflationary conditions and Russia-Ukraine conflict, companies may put more emphasis on becoming greener and more energy-resilient sooner. Seeking out locations or assets with more accessible renewable energy and high energy efficiency ratings is an advisable strategy given the current climate. Some companies will be able to leverage city- and state-offered incentives for solar technology or emissions reductions. For many occupiers, periods of higher energy costs may not redefine ESG strategies or lease negotiations. But for some, it may. Lastly, energy-intensive occupiers are likely to lean further on hedging (via futures, options, swaps, etc.) to help mitigate financial risks associated with price fluctuations.

Energy price volatility may accelerate the urgency for firms moving toward clean energy use and ESG initiatives.

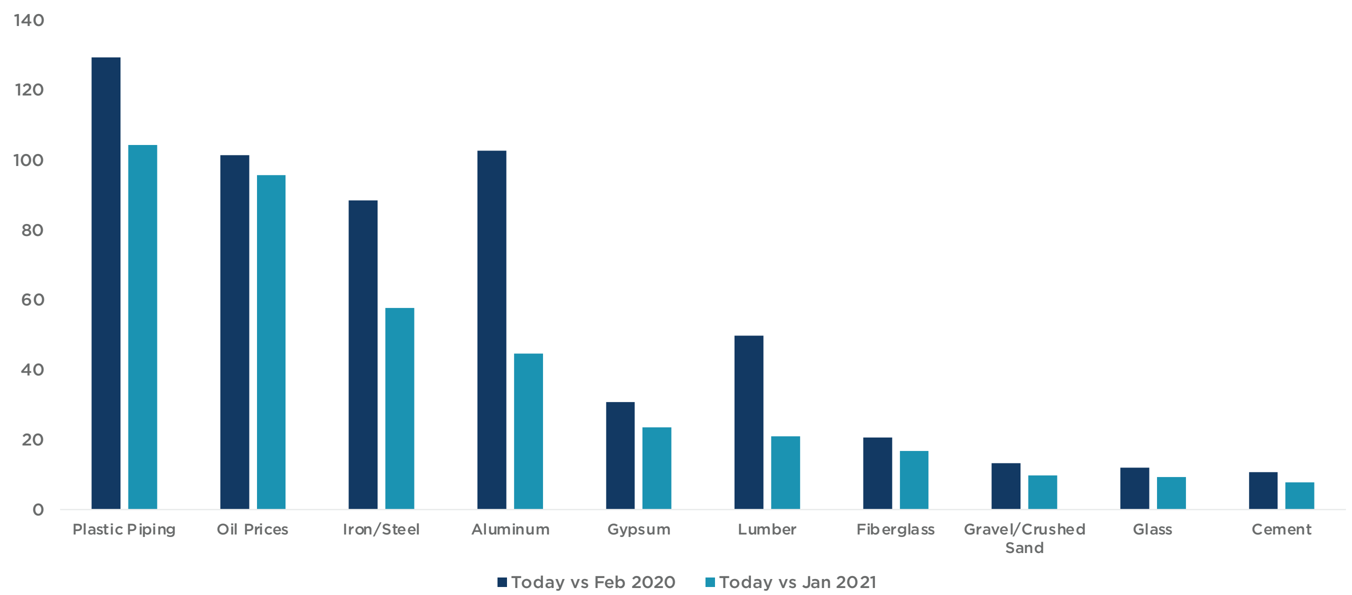
Transportation

Rising production costs stemming from materials and energy are significant on their own, but price pressures on the transport services throughout the supply chain are adding to the total costs of distributing products in a timely manner. The cost pressures come from both overseas and domestic sources. As a net importer of most consumer goods, the U.S. faces tremendous strain due to the supply chain logjam that emerged as economies began to reopen in 2021. Suppliers and transporters were slower to ramp back up and are still struggling with excess demand amid ongoing COVID-19 lockdowns in Asia. Moreover, once goods arrive at U.S. ports, ships are experiencing lengthy dwell times due to the surge in imports amid strong retail and online spending. Freight prices have skyrocketed as a result. As of April, the PPI for deep sea freight increased 24.7% from a year earlier, and the PPI for trucking freight transportation surged 32.5% from a year ago—roughly triple the highest rate experienced over the last decade. While port dwell times have eased in recent months, there is concern that renewed COVID-19 lockdowns in China will exert further upward pressure on overseas shipping costs. The outlook for trucking rates is brighter, with tender rates having already turned the corner amid a ramp-up in fleet sizes. Despite this welcome news, the overall supply chain is likely to remain challenging for some time, and certain real estate occupiers will incur the brunt of higher transportation costs and product delays. Upcoming negotiations between unionized West Coast port workers and their employers are yet another source of uncertainty for companies relying on timely delivery of products and materials. As a result of all these issues, many logistics occupiers are investing significant effort in exploring East Coast port-adjacent site options as a means of diversifying import-related risks.

Materials

Materials usage varies widely by industry and property type, but the cost of virtually all input materials has risen significantly during the recovery. In general, materials costs are going to be more relevant for manufacturers sourcing materials needed to produce and assemble goods to sell to wholesale or retail customers. The PPI for industrial commodities (excluding fuel) increased 13.8% over the 12 months ending in April. Certain products, such as steel, plywood and chemicals, rose by even larger margins. Price spikes for many of these industrial materials have rolled over in recent months as production bottlenecks have eased somewhat. Yet there are pockets of ongoing price pressure in sectors such as agricultural and plastic materials that are being impacted by disruptions related to the war in Ukraine. There is little occupiers can do to skirt materials market prices other than order excess inventory when they find a favorable price. Renegotiating with supply chain vendors to hedge against severe supply chain disruptions may be an option longer term.

U.S. Construction Materials Prices (Total % Chg.)

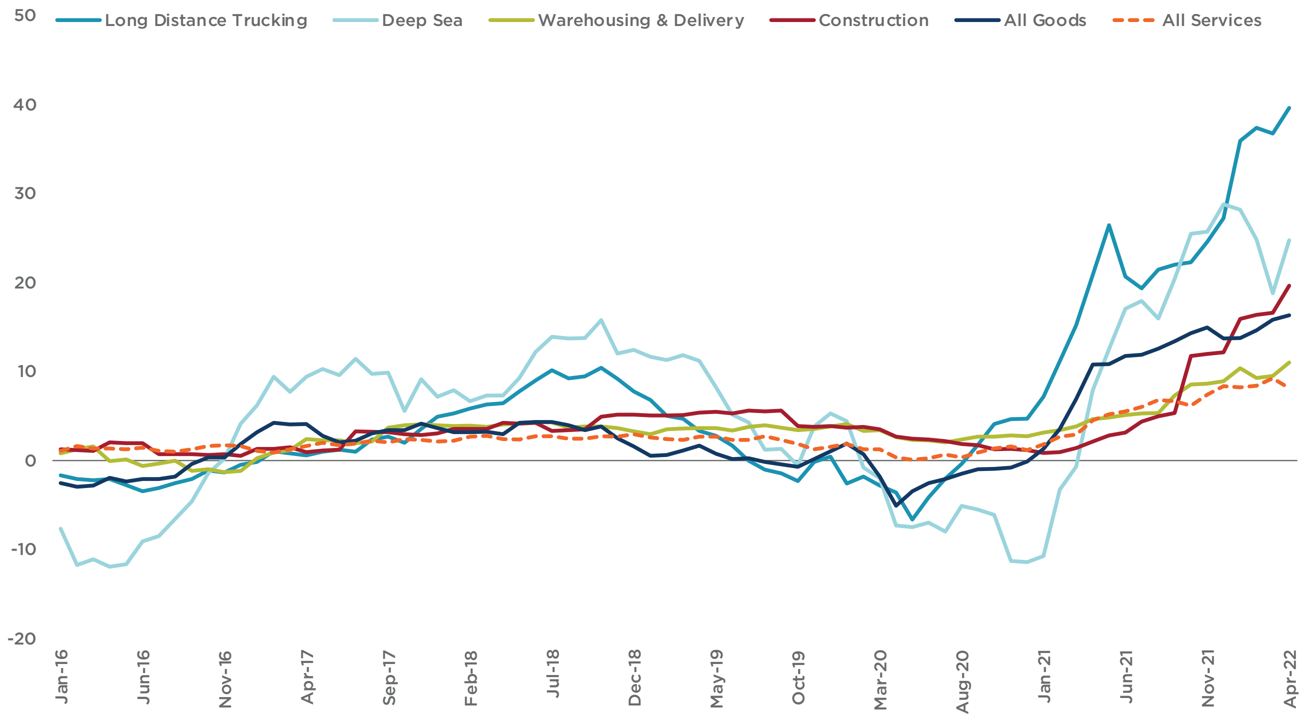


Source: Various

Services

The services side of the global economy is not a major source of inflation for most occupiers outside of rising labor costs. Recent increases in the costs associated with providing financial, legal, healthcare and wireless services, for example, are well within the range we experienced prior to the pandemic. Indeed, the only major shift in pricing here has been in information processing equipment, where prices had been falling for decades only to recently turn mildly positive. Services tend to be relatively insulated from supply chain issues, and in many cases, productivity enhancements such as remote offerings have helped keep costs down. While semiconductor shortages have affected the technology sector, the price impacts for end-users have been muted at an aggregate level. Data storage costs had become more expensive prior to 2020, but there has not been a meaningful increase since then, even with the rapid expansion of streaming and wireless usage in recent years. For restaurant and hospitality operators, costs have gone up since the reopening period of 2021, but this followed sizable declines in operating costs early during the pandemic. Again, this excludes labor costs, which are an outsize expense for service-sector occupiers.

U.S. Producer Inflation
(Yr/Yr % Chg.)



Source: U.S. Bureau of Labor Statistics

REAL ESTATE

The final avenue through which inflation *could* theoretically impact occupiers is via costs for real estate. As we briefly alluded to above, lease types will determine how much exposure to utilities, maintenance and other variable costs occupiers will bear in real-time. Real estate costs account for up to 10% of total operating expenses and so an exploration of inflationary pressures on these expenses is merited.[1]

Escalations

The good news is that real estate costs evolve slowly for most commercial occupiers because lease lengths tend to be five to seven years. Leases typically include a predictable escalation that enables occupiers to plan for future rental cost increases. Although such clauses can be linked to inflation, after decades of inflation stability, many leases have an escalator—a fixed number—based on a historical average of inflation. In those instances,

[1] The accounting treatment for leases is changing, with further guidance between a financial/capital lease which is designated on the balance sheet versus an operating lease, which is designated on the income statement.

occupiers will benefit in the current environment as present inflation far exceeds recent historical patterns. In cases where an index is used, occupiers can expect to absorb more of the recent inflationary environment. Importantly, escalation clauses also appear to be tied to local CRE market conditions more generally. For example, a majority of U.S. office markets representing more than 75% of national inventory report that current office deal escalations have remained more or less flat, despite inflation. This is not true of industrial deals, where vacancy has reached an all-time low of 3.3%.

Buildout Costs

Occupiers who are leasing new space and need to build out the interior will also incur higher costs for materials, construction labor, furnishings and more. The magnitude of these costs will vary by asset type. However, some occupiers will yet again be able to benefit from softer market conditions as landlords will offer tenant improvement (TI) allowances, which subsidize this expense, as part of the negotiation process. When market conditions are weak, occupiers can capitalize on more months of free rent (possibly avoiding paying rent for all or part of the period in which the buildout is occurring) and attain higher TI allowances. Not only will this vary by property type and subtype, but also by class and market as conditions can and often do vary greatly around the country.

For those tenants building out their space, construction materials pricing will be significantly higher than it was pre-pandemic. Broadly speaking, the PPI for construction materials is up 19.6% year-over-year as of April 2022. Compared to February 2020, key materials have recorded whopping price increases: PVC and plastic piping (129.4%), aluminum (102.7%), iron/steel (88.5%), lumber (49.8%), gypsum (30.8%) and fiberglass (13.8%). Many occupiers will not need these materials in their raw form except those pursuing build-to-suit options, as developers are largely bearing the brunt of these cost increases. The PPI indices for furniture, commercial electric lighting and office supplies are up 11.8%, 10.2% and 7.2% year-over-year, respectively.

In Cushman & Wakefield's 2022 Americas Office Fit-Out Cost Guide, we studied both construction delays and costs. The builder sentiment survey illustrates that costs pressures are being felt throughout the industry. Almost all (98%) surveyed contractors indicated their supplier costs increased in the past six months, and 85% of contractors had raised their prices since the middle of last year. Expectations for future costs remain elevated with 96% of respondents expecting their supplier costs to increase further in the next six months. This is particularly true for furniture, fixtures and equipment ("FF&E") expenses.

Base Rent

Probably the most important issue is of course the starting rent itself, the number upon which escalations and concessions are applied. Yet again evidence suggests that market conditions more generally are driving rent patterns versus broader inflation, which should be good news for tenants.

The way in which we can investigate whether inflation drives rents is to do statistical tests for links between measures of inflation and measures of effective rents. One such test is called a "Granger causality test." This test looks at whether one variable (such as inflation) can predict changes in another (such as effective rents) over time. In reality, it is very difficult for statistical tests or models to confirm true causality between different variables, so rather than confirming if inflation *causes* rent growth, it can tell us whether inflation *reliably predicts, or forecasts,* rent growth. If so, we can infer that there may be a more complex causal relationship worth exploring.

At first glance, the data in figures on page 9 would lead us to suspect that there have not been strong links between inflation and rent growth since the mid-1990s (the period for which effective rent growth data are available). For most property types except CBD office, a slightly positive correlation exists between the two, but it does not appear to be that strong. The figures would also suggest that market conditions, as measured by vacancy, could be far more important in driving rent pressure, as indicated by the stronger and tighter negative relationship. These observations are true across office, industrial and retail property markets.

The Granger causality test reaffirms that our suspicions are on point: vacancy rates are predictive of rent growth for all property types, and inflation is not (at both the 1% and 5% significance levels).

Technical jargon aside, for occupiers, what this means is that they should be more focused on broader market conditions when searching for space during periods of high or low inflation. At present, industrial vacancy is at the lowest point on record (3.3%) whereas office vacancy is at 17.5% and is still likely to trend higher as new supply comes to the market. For retail shopping centers, vacancy held up fairly well during the pandemic and is now below pre-pandemic levels by 10 basis points (at 6.3% in Q1 2022 versus 6.4% in Q4 2019). Not surprisingly then, industrial rents are under the most upward pressure, with retail rents growing but at a more subdued pace. Office rents are still declining but likely near their trough. Given the tremendous variation by market and property subtype, occupiers should invest substantial effort in understanding these dynamics as they consider location and potential lease decisions.

Granger Causality Test Results

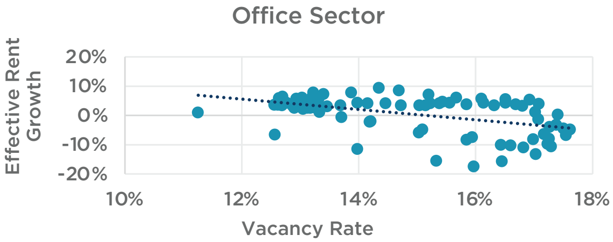
Period: Q1 1995 – Q1 2022

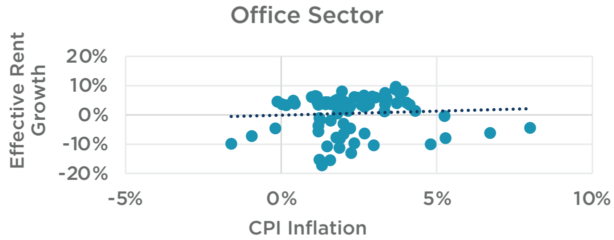
Test	P-Value	“Causal” Link?*
Industrial		
Inflation causes rent growth	0.19	No
Vacancy causes rent growth	0.00	Yes
Retail		
Inflation causes rent growth	0.86	No
Vacancy causes rent growth	0.00	Yes
Total Office		
Inflation causes rent growth	0.14	No
Vacancy causes rent growth	0.00	Yes
CBD Office		
Inflation causes rent growth	0.58	No
Vacancy causes rent growth	0.00	Yes
Suburban Office		
Inflation causes rent growth	0.09	No
Vacancy causes rent growth	0.00	Yes

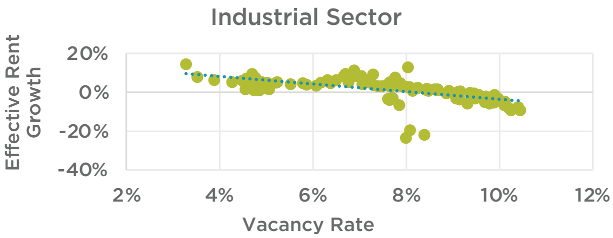
Source: Cushman & Wakefield Research. Note: All times series data were tested for confirmed as stationary. Tests included eight lags. *At the 1% or 5% significance level.

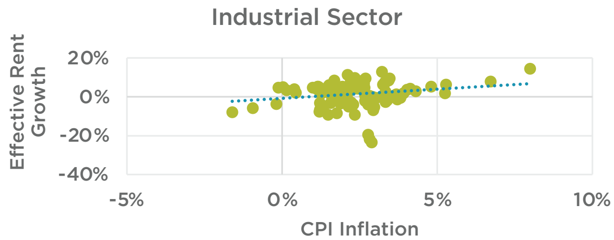
U.S. Property Markets vs. Vacancy and Inflation

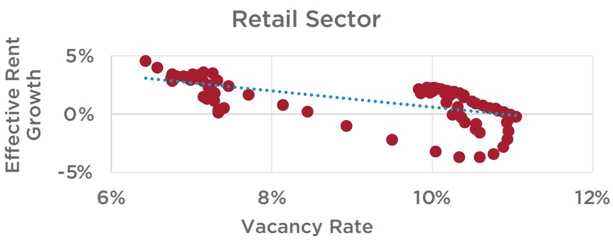
Main Property Types

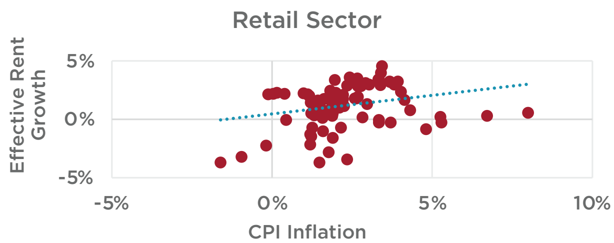






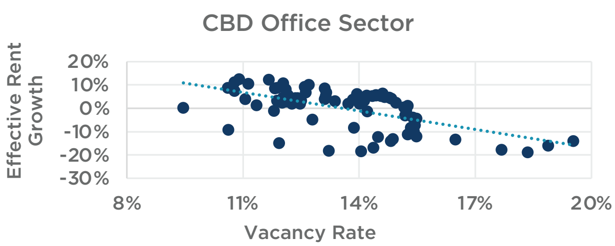


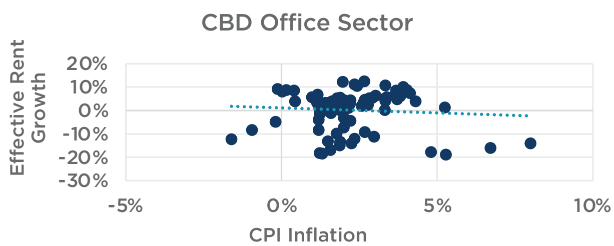


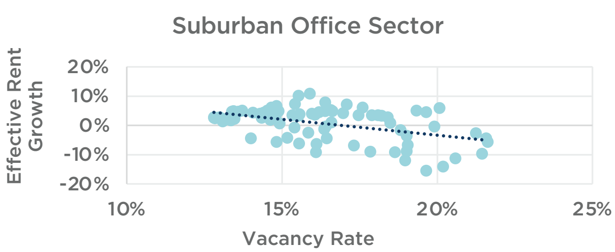


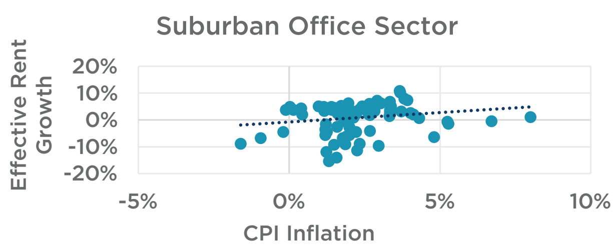
U.S. Property Markets vs. Vacancy and Inflation

Office Types









Source: Cushman & Wakefield Research

Read more on how inflation is impacting occupiers differently by space type—office, industrial-logistics and retail—on our website.

Rebecca Rockey
Economist, Global Head of Economic Analysis & Forecasting
rebecca.rockey@cushwake.com

James Bohnaker
Senior Economist
Global Research
james.bohnaker@cushwake.com

About Cushman & Wakefield

Cushman & Wakefield (NYSE: CWK) is a leading global real estate services firm that delivers exceptional value for real estate occupiers and owners. Cushman & Wakefield is among the largest real estate services firms with approximately 50,000 employees in over 400 offices and approximately 60 countries. In 2021, the firm had revenue of $9.4 billion across core services of property, facilities and project management, leasing, capital markets, and valuation and other services. To learn more, visit www.cushmanwakefield.com or follow @CushWake on Twitter.