NAVIGATING A HIGH INFLATION ENVIRONMENT

What's Next for Owners, Investors and Occupiers in Singapore

April 2022

INFLATION REACHES MULTI-YEAR HIGHS

Inflation across the world has surged and reached multi-year highs, driven by a confluence of demand and cost factors. Stronger consumer demand and business activities amidst an emergence from Covid-19 lockdowns and government stimulus are driving demand for good while higher energy prices and supply chain disruptions, have increased the cost of production, leading to vendors increasing prices.

Given Singapore's small open economy and dependence on energy and food imports, inflation in the city-state has picked up. The country's overall inflation grew to 5.4% yoy in March 2022, a decade high. While headline inflation was primarily driven by higher private transport costs, core-inflation, which excludes private transport and accommodation, rose to a decade-high as well, rising by 2.9% yoy in March 2022.

Singapore's headline inflation forecast for the whole of this year is expected to come in between 4.5% and 5.5% while core-inflation is projected to average 2.5%-3.5%, according to authorities forecast.

SINGAPORE MONTHLY INFLATION, SEASONALLY ADJUSTED (2000-2022YTD)

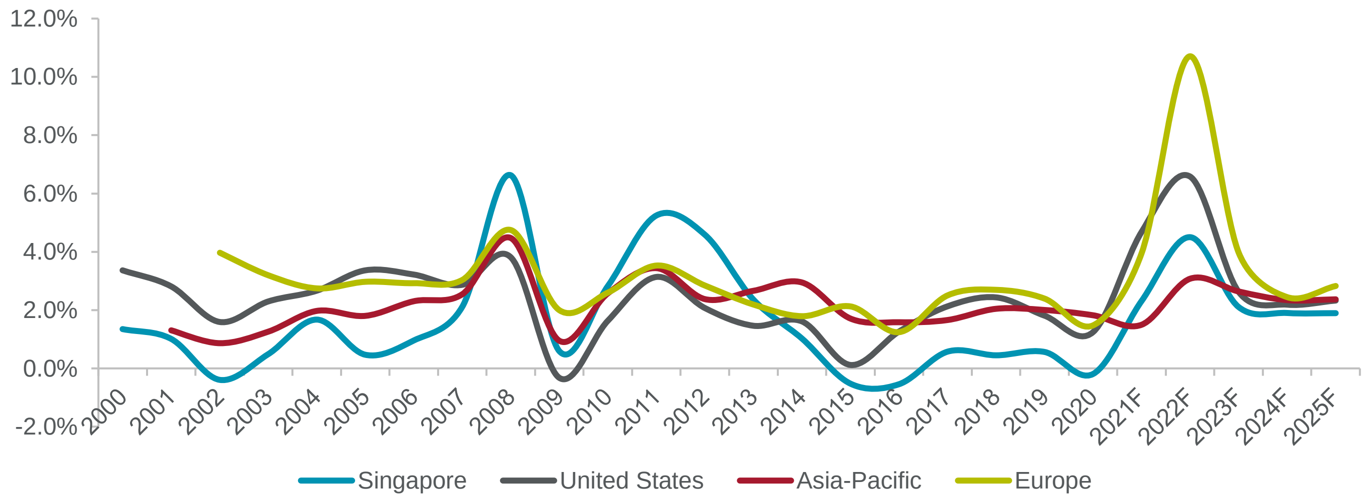
Source: Department of Statistics (Singapore), Cushman & Wakefield Research

Although inflation in Singapore has gone up, it remains relatively muted as compared to that in the US and Europe. Nonetheless, high inflation in US would precipitate a rise in US interest rates that would inevitably propel Singapore's interest rates higher due to its open economy.

Indeed, the MAS has taken a more aggressive approach to tighten its monetary policy and increase its inflation forecast, given shocks to global commodity prices and supply chains that are adding to domestic cost pressures. A tightened monetary policy is expected to lead to a rise in interest rates.

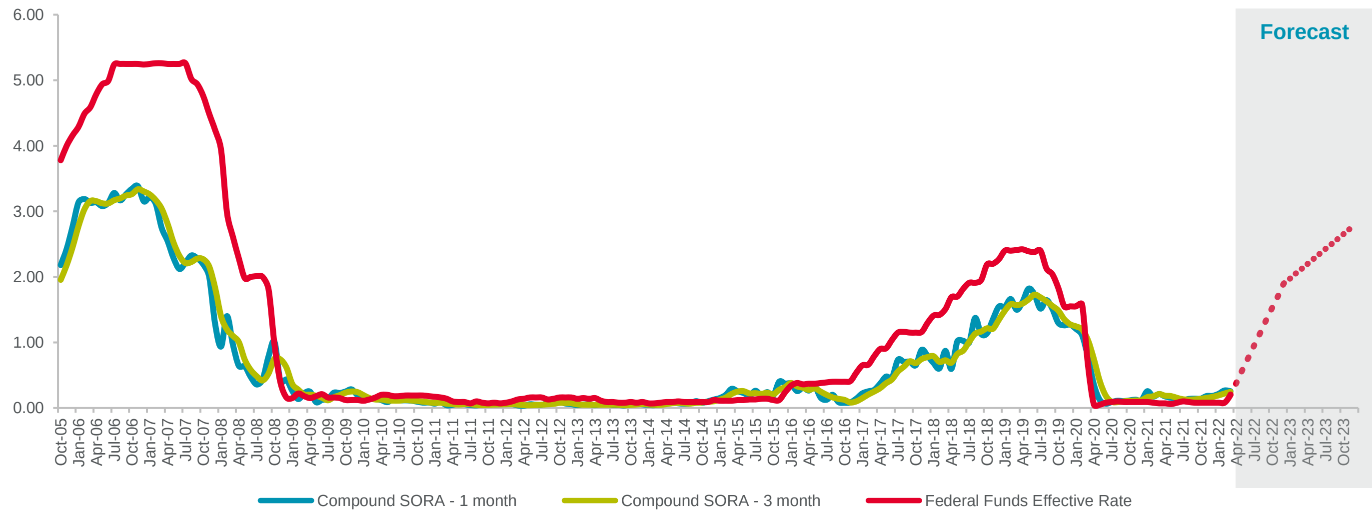
Rising interest rates would put upward pressure on property cap rates and financing costs as investors demand a higher rate of return.

ANNUAL INFLATION FOR US, EUROPE, APAC, SINGAPORE (2000-2025F)



Source: Moody's Analytics, Cushman & Wakefield Research

US AND SINGAPORE INTEREST RATES (2005-2023F)



Source: MAS, FRED, Cushman & Wakefield Research

HIGHER FOR LONGER

Amidst a high inflationary environment that may persist, how should investors position themselves and which assets are poised to outperform?

Generally, real estate is seen as a good inflation hedge as landlords can increase rents in tandem with economic growth. However, rising inflation due to higher cost pressures such as energy and manpower costs, would be unfavorable as higher operating costs may erode building profits.

Landlords may be able to pass on some costs by raising property service charge. Property service charge covers building management fees, maintenance fees, security services, insurance, air-conditioning during normal operating hours and so forth.

However, tenants would be sensitive to a higher property service charge as it increases their overall occupancy cost.

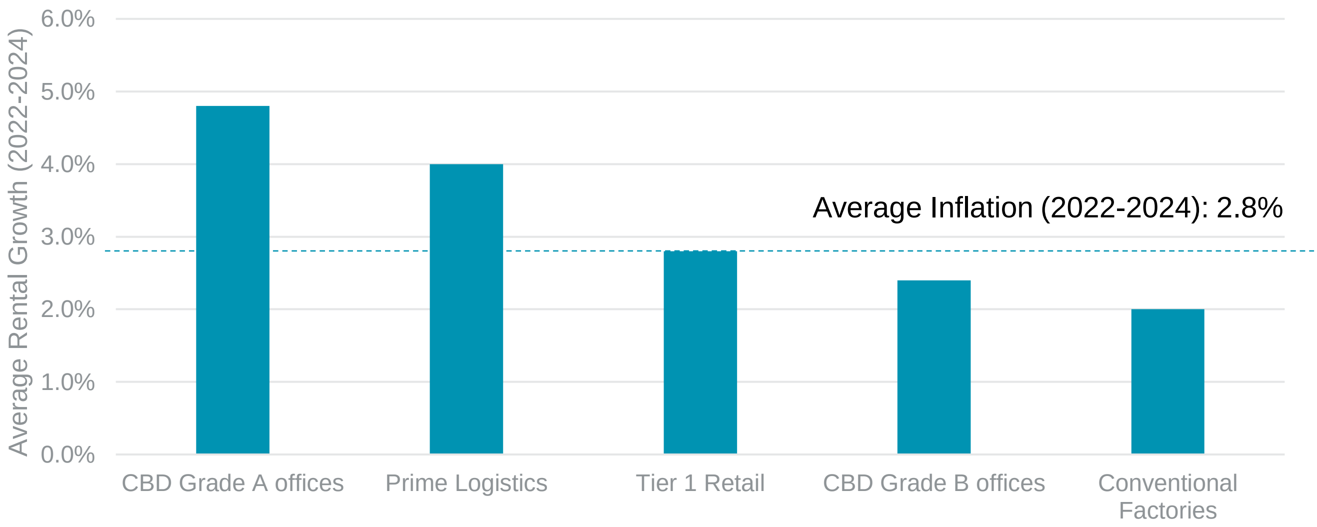
Anecdotally, many landlords have kept their property service charges unchanged over the last few years. This may be due to operational challenges for large multi-tenanted buildings.

However, as inflation continues to trend higher, landlords would attempt to raise rents but the ability to raise rents in tandem with inflation would differ across property segments.

As such, in a high inflation environment, investors may consider two key factors.

1. **MARKET PRICING POWER:** Property segments that enjoy strong demand-supply fundamentals would have a higher pricing power and be more able to increase gross rents in tandem with inflation. On the other hand, property segments that face a challenging market environment could see building profitability erode as operating costs increase with rental growth falling behind inflation. Pricing power is determined by examining the projected rental growth forecast versus inflation of the property segment over the next 3 years.

RENT AND HEADLINE INFLATION FORECAST (2022F-2024F)



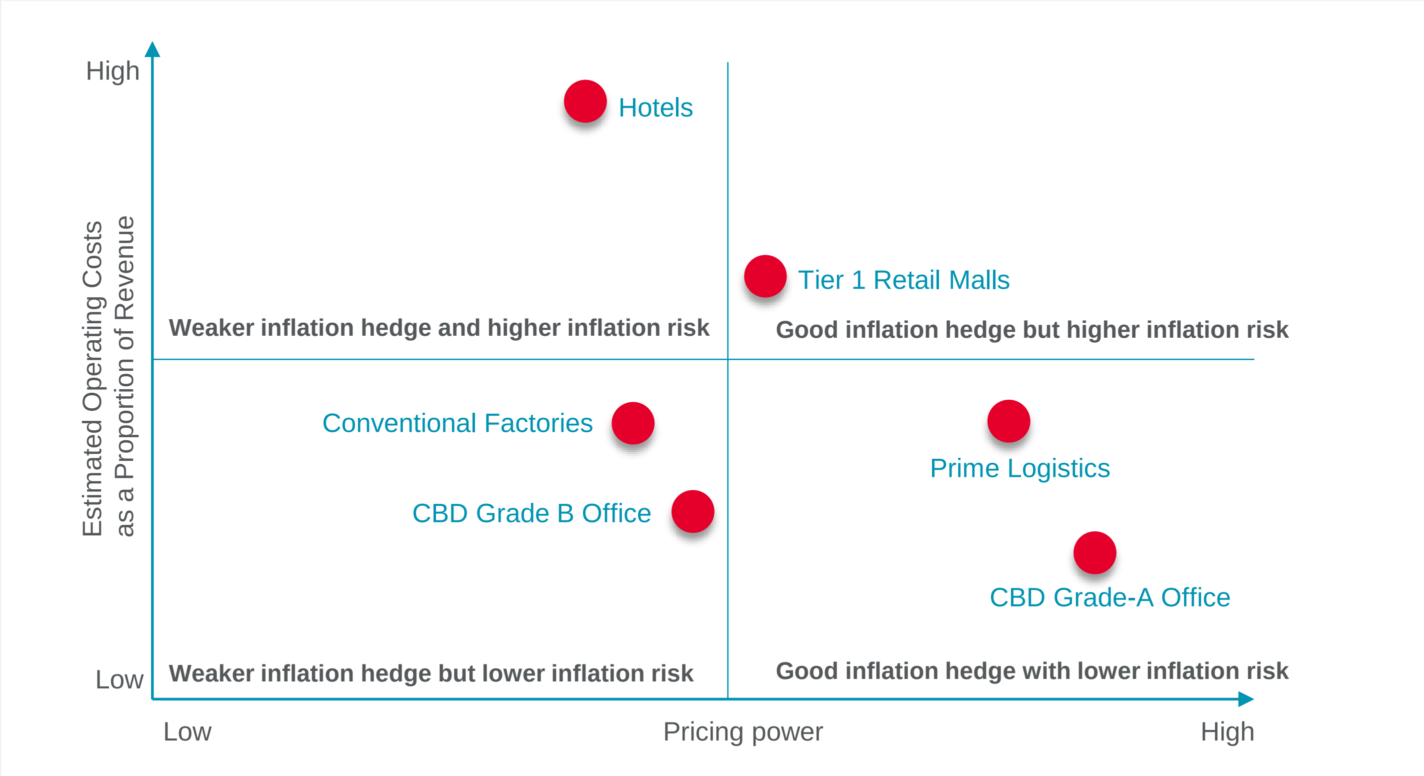
Source: Moody's Analytics, Cushman & Wakefield Research

2. **PROPERTY OPERATING COSTS:** Operating costs for various properties and segments differ due to their varying operating requirements and energy consumption. For example, retail malls tend to have higher operating costs and energy requirements than office buildings due to their higher lux levels required and a wide tenant mix. Properties that have higher operating costs versus their revenue may face higher risk exposure to rising costs. However, there could be exceptions in each property segment, especially energy efficient buildings or buildings that have mitigated rising costs with contracts.

   To proximate operating costs, we have used the proportion of service charge to gross rents. This excludes other costs such as vacancy costs, property tax, marketing fees and other capital expenditure.

   Based on market pricing power and operating costs, we have classified several property types into a four-quadrant matrix with their ability to raise rents in tandem or higher than inflation mapped against their estimated operating costs relative to total revenue. Notably, being able to increase rents has a greater impact on rents given that base rents take up a large proportion of property revenue.

OPERATING COST AND PRICING POWER MATRIX



Source: Cushman & Wakefield Research
Note:
1. Property segments are positioned not to scale
2. Operating costs exclude property tax, marketing fees and other capital expenditure
3. Prime logistics and conventional factories refer to multi-tenanted properties. Prime logistics are primarily ambient warehouses
4. Tier 1 Retail malls are defined as well located retail malls with a good tenant mix and high levels of footfalls.
5. Hotels do not charge service charge; their operating costs is proxied based on their estimated gross operating profit

GOOD INFLATION HEDGE WITH LIMITED RISKS

Prime Logistics

CBD Grade A Offices

Prime logistics and CBD Grade A offices are best placed to navigate the inflationary environment ahead, given their limited supply and strong demand and relatively lower operating costs.

The current vacancy rates for prime logistics and CBD Grade A offices are tight at below 5%.

Prime logistics and CBD Grade A offices gross rents are poised to increase by over 4% annually over the next three years, outpacing the expected Singapore's annual inflation of 2.8% in the same period.

GOOD INFLATION HEDGE WITH HIGHER RISKS

Tier 1 Retail Malls

Tier 1 retail spaces are poised to see higher demand due to economic reopening, easing of safe management measures and limited supply. However, retail trades such as F&B - a key source of retail demand, already face higher operating costs due to higher energy and food costs and would be resistant to rent escalations.

Also, according to the code of conduct for retail premises, property service charge can be increased but gross rent payable by the tenant during the lease term should remain unchanged. As such, it is important that operation costs are managed well for retail malls.

WEAKER INFLATION HEDGE WITH LIMITED RISKS

CBD Grade B Offices

Conventional Factories

CBD Grade B offices and conventional factories rents are poised to grow amidst the economic recovery. However, the anticipated increase in rents may lag inflation. The current flight to quality and hybrid work have led to lower structural demand for CBD Grade B offices. For conventional factories, higher new supply in 2022 due to construction delays in prior growth may limit rental growth.

Nonetheless, their relatively low proportion of operating cost to gross rents would limit inflation risks.

WEAKER INFLATION HEDGE WITH HIGHER RISKS

Hotels

Hotels may face higher risks, given their higher operating costs and weaker market conditions. While border restrictions have eased, Singapore's tourism and business travel may only recover to pre-covid levels after 2022. Nonetheless, hotels that manage their operations and energy consumption efficiently could perform.

WHAT'S NEXT

INVESTING IN RESILENCE

Asset performance will bifurcate. Assets such as prime logistics and offices, which have rental growths poised to outperform inflation and lower operating costs, are expected to be more resilient in a world of higher inflation driven by higher production costs and recovering demand.

However, limited market opportunities and a buyer-seller expectations gap could limit deals. As interest rates continue to rise, investors would be anticipating higher property yields. Although cap rates could remain stable for assets facing a tight supply and strong demand situation. Such assets are more able to achieve a positive inflation-adjusted rental growth as market liquidity remains ample and landlords have strong holding power.

Investors could expand their scope and potential returns by scouting for value-add opportunities in ageing CBD offices or well-located industrial buildings that are ripe for asset enhancement.

Investors should also consider single tenant properties under a triple net-lease structure. These properties would be defensive against cost-push inflation, as the tenant would be paying for operating costs including building maintenance, utilities and so forth.

PRICING REMAINS KEY

While some assets may see risks increase with higher inflation, investors could still achieve strong returns for mispriced assets. If the investment strategy is executed well, weaker assets could deliver healthy returns over time. Also, sitting on cash may not be optimal as inflation would erode purchasing power over time. Barring a sharp deterioration in global economic conditions, the market could see stronger investment sales as liquidity pours into the market.

RISING OBSOLESCENCE RISK TO DRIVE REDEVELOPMENT

An increased focus on sustainability and rising energy prices has sparked a wave of capital expenditure. The flight to quality trend is expected to ensue over the long-term as end-users increasingly consider sustainability factors in their site selection criteria and operating costs increase due to heavier carbon taxes and higher energy prices. As such, ageing and energy inefficient properties may face very high obsolescence risks and building owners will be incentivised to future proof their assets.

As building owners would do more to lower their carbon footprint, we anticipate a stronger drive for asset enhancement or redevelopment across all property segments. A redevelopment project may yield higher gains in energy efficiency than minor asset enhancements due to existing infrastructure limits. Building owners who do not have the will or funds to undergo redevelopment may consider divestment or joint ventures.

For assets with higher levels of operating costs, such as retail and hospitality, investing in sustainability or technology solutions may be key to bring costs lower and reduce obsolescence risks as green demand continues to gain traction. Adoption of smart facilities management would help streamline work processes and operations.

INVESTING IN SUSTAINABILITY

Given rising energy costs, asset owners are advised to invest in sustainability initiatives which would drive operational savings over the long run.

Assets can be enhanced through:

- Building controls
- Fabric improvements (e.g., refit of insulation and windows)
- Efficient building services and installations through capital expenditure (e.g., efficient air handling units, LED lighting)
- On-site (e.g., rooftop solar panels) renewable energy production
- Purchase of off-site environmental certificates (e.g., Renewable Energy Certificates).

The abovementioned approaches have upfront costs but will reduce reliance on increasingly costly energy from the grid. Furthermore, the potential energy savings can be substantial as seen from the difference in top quartile energy use intensity (EUI) versus the average EUI, based on data from BCA. For example, the EUI of the top quartile of large office and retail buildings is about one third lower as compared to the average building EUI.

NATIONAL BUILDING ENERGY BENCHMARKS FOR COMMERCIAL BUILDINGS (2020)

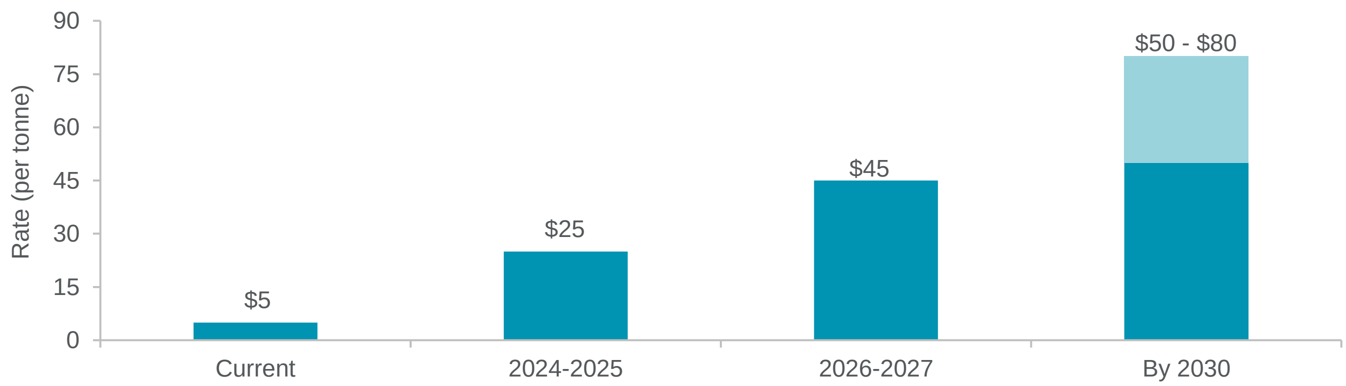
Building Type	Size*	No. of Buildings (in 2020)	Average EUI (kWh/m^2.yr)	EUI of Top 10%	EUI Ranges (kWh/m2.yr)			
					Top Quartile (1% - 25%)	2nd Quartile (26% - 50%)	3rd Quartile (51% - 75%)	Bottom Quartile (76% - 100%)
Office Buildings	Large	151	≤185	≤90	≤124	124 – 163	163 – 211	>211
	Medium	121	≤217	≤75	≤110	110 – 142	142 – 225	>225
Hotels	All	89	≤218	≤160	≤187	187 – 219	219 – 270	>270
Retail Buildings	Large	63	≤312	≤124	≤190	190 – 390	390 – 460	>460
	Medium	43	≤326	≤136	≤216	216 – 294	294 – 434	>434
Mixed Developments	All	31	≤224	≤133	≤170	170 – 199	199 – 289	>289

Source: BCA
*All: Hotels and Mixed Developments of GFA ≥ 5,000 m2
*Large: Office Buildings and Retail Buildings of GFA ≥ 15,000 m2
*Medium: Office Buildings and Retail Buildings of GFA ≥ 5,000 m2 and <15,000 m2

GREATER IMPETUS FOR SUSTAINABILITY

Energy costs in Singapore are bound to rise due to the increase in carbon tax. Currently, Singapore generates about 95% of its electricity from natural gas. Energy supply diversification will be a long-term endeavor due to limited sources of renewable energy. As such, end-user consumers would inevitably incur higher energy bills. For example, as carbon taxes increase to $25 in 2024, an end-user consumer with a monthly consumption of 3,000 MWh could see higher operating costs of around $24,480 per month due to an increase in carbon tax. As such, it is important to invest early to mitigate rising costs.

LARGE HIKES IN CARBON TAX



Source: Budget 2022

IMPACT ON END-ENERGY CONSUMERS

(Assuming monthly consumption of 3,000 MWh)

Period	Carbon Tax ($/tCO2e)	Carbon Tax (SGD/MWh)	Monthly Consumption (MWh)	Monthly Carbon Tax Payable	Monthly Increase on OPEX due to Carbon Tax (SGD)
2022 & 2023	5	2.04	3,000	$6,120	-
2024 & 2025	25	10.20	3,000	$30,600	$24,480
2026 & 2017	45	18.36	3,000	$55,080	$48,960
By 2030	50	20.40	3,000	$61,200	$55,080
	80	32.64	3,000	$97,920	$91,800

Source: Cushman & Wakefield Report: What Will The Singapore Carbon Tax Cost You?

WHAT'S NEXT FOR OWNERS, INVESTORS AND OCCUPIERS

Investors

- Position portfolio towards assets with strong pricing power such as CBD Grade A offices or new economy assets like prime logistics
- Take on development risks and pursue value-add or opportunistic opportunities to increase returns; joint ventures with developers or construction firms can be considered to mitigate higher development costs.
- Hunt for bargains on underperforming assets with redevelopment or repurposing potential
- Search for single-tenant triple-net lease assets to mitigate increasing property operation costs

Property Owners

- Streamline operation costs with facility management best practices
- Invest in smart facility management and sustainable energy solutions to reduce dependence on grid
- Consider outright sale, redevelopment, asset enhancement, or sale-and-leaseback as obsolescence risks are rising for ageing properties
- Repurpose space to increase rental income

End-users

- Fit out with energy efficient features such as LED lightings and occupancy sensors
- Reduce energy costs by moving to energy-efficient building
- Promote sustainability awareness amongst employees
- Negotiate longer lease terms

SHAUN POH
Executive Director
Head of Capital Markets
Singapore
+65 6232 0882

BRENDA ONG
Executive Director
Head of Logistics & Industrial Services
Singapore
+65 6232 0878

HO CHEE KIT
Senior Director
Contact Center, Corporate & Asset Services
+65 6876 6178

WONG XIAN YANG
Head of Research
Singapore
+65 6232 0885

CUSHMAN & WAKEFIELD

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.