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Straight Talking, Bill Nowlan - Seeds of the next property cycle are germinating

All indications are that the market will bottom out in 2010 followed by a slow recovery in values in the years ahead

We all know property values have crashed but the anatomy of that crash has become clear with the recent publication of the Society of Chartered Surveyors/Investment Property Database (SCS/IPD) figures and in particular those for the past two years. This is a database of institutional properties and their valuations from a number of banks and pension funds going back for nearly 30 years.

The first most striking feature is that for the typical institutional property portfolio, values are back at where they were in September 1999. That value would have risen to almost 2.25 times its September 1999 value by December 2007 before crashing back over the past two years. In other words, if it had been possible to invest €1,000 in a typical fund, that €1,000 would have reached a value of €2,250 in 2007 but would be back to being worth only €1,000 today.

The second most striking feature is that if €1,000 had been invested at the height of the boom in September 2007, it would be worth only €447 today. (All figures are without any gearing/borrowing).

So, with hindsight, it is easy to see why many people and the banks have a problem. They would have bought and borrowed right through the build-up of the bubble and few would have got out before the bubble burst in 2008. Much of the buying was done in the period 2003-2006.

Further analysis of the SCS/IPD figures shows that the technical driver of the price bubble was what property professionals call yield compression. This is the process whereby buyers are prepared to pay more and more for the same income. In 2002, the typical yield on an office block would have been about 6.4% but by 2007 this yield had fallen to less than 4.3%. This yield would move the rent multiplier from about 15.6 to 23.3, resulting in a 50% increase in the value of the property. Rents did move upwards but not anything like the same rate – with the exception of retail, where rents rose very significantly.

The third important message from the SCS/IPD figure is that what is bad for capital values is good for the income of acquiring investors. The figures show that income yields fell from just over 6.5% in September 1998 to 3.8% in 2007 but are now back to about 7% and still rising. This is because as yield compression reverses and values fall, then income yield increases.

The fourth striking feature of the IPD figures going back to 1983 is how clearly they depicted the property bubbles over that period. The first up to 1990, the second up until 2001 and our current one just ended (peaking in September 2007).

In reality, the current boom began in the early 1990s, was temporarily interrupted by 9/11 and the dotcom bust and finished in 2007, almost 14 years later.

But if property cycles are normal phenomena, can we use this cyclical pattern to predict when we might get out of the current depressed situation?

I believe we can if we understand the elements of a property cycle. Each property cycle is self-correcting. The normal process is that in recession, rental levels fall to the point that the market accepts the new 'norm'. Then yields rise to levels that are also accepted as the new 'norm'. This norm is set against yields from other forms of investment such as shares, bonds, deposits etc, adjusted of course for the normal property risks and cost factors. As values and rents fall, then new development becomes uneconomical because the cost of new development is more than the value of the finished buildings. This chokes off the new supply of buildings.

At this point, the fall in values generally bottoms out. The property market bumps along the bottom while the economy gradually absorbs the oversupply of built space. Those adjustments have been happening in Ireland for the past two years.

The big question is, are values at the bottom or have they further to fall? This is where I move from being an analyst to being a forecaster.

I believe we are almost at the bottom. Yields have reached a new level where investors are prepared to buy quality property let at market rents. The fall in rentals has slowed down and in some sectors, such as quality offices, is levelling off.

One has to look at what is happening in the real economy. The demand for floor space comes from business. While long-term property investors are patient and usually prepared to invest ahead of a recovery, the issue of their confidence in an economic recovery is critical. We may have reached a valuation floor but this will only hold for as long as investors and businesses believe that there is a real recovery in prospect.

I have to add a second caveat, which is that there is good, bad and ugly property out there as a result of the banking and development excesses. The IPD index has an in-built bias toward institutional or quality property so the messages from this database only apply to good property.

With these caveats, I believe that we will see a further fall of 3% to 5% by year-end before a bottoming out of property values in 2010. However we will see a slight recovery in values in the next few years of about 3% to 5% a year.

But remember, property investment is, or should be, more about income than about capital appreciation and definitely will be for the next few years.

Real property investors, as opposed to property speculators, are focused on income. Reliable income will be the key focus of the new breed of investors. Such investors, many from overseas, are currently watching Ireland and are ready, willing and able to do deals.

The seeds of the next property cycle are in the ground and slowly germinating as the detritus of the last boom are cleared away.

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