Irish property - back to basics

Frank O'Neill considers how investors shall assess property investment in a changed investment climate and the impact of the new market realities on the relationship between landlords and tenants.

The Irish commercial property world has changed fundamentally. Whilst change was not totally unexpected, the extent and rapidity of the recent events has left market observers shell-shocked. The commonly held perception that property values only increase has been exposed as a fallacy. The performance of Irish commercial property in recent years has defied basic rational analysis. This period is over and unlikely to return, it's back to basics.

Property values have fallen dramatically. The three fundamental reasons for this fall are:

- Firstly, the yield compression which the Irish property market experienced over the last number of years and which drove values up has been reversed. (I commented in some detail on the dramatic impact on values of yield compression and its reversal in the October 2008 issue of FINANCE).
- Secondly, occupational demand has faltered putting market rental levels under severe downward pressure, and
- Thirdly, the international financial crisis – 'the credit crunch' – has meant that finance is not available for purchasers.

The traditionally investor friendly model of Irish commercial property investment is changing rapidly. The once prevalent long FRI (full repairing and insuring) lease with upward only rent reviews, no breaks, limited rights of alienation (assignment and sub-letting) and backed up by the comfort of a blue chip tenant has become a rare bird and may be heading for extinction.

Market pressures have resulted in a serious imbalance arising between supply and demand for commercial property occupational space. Development projects which were based on decisions to commence which were taken in the very different market circumstances of 2006 and 2007 are now complete or nearing completion, bringing new space onto the market. The economic downturn has curbed expansion plans of occupiers and resulted in accommodation being brought back to the market as a result of business contraction and failure. In virtually all sectors supply has increased and demand has dramatically decreased.

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In the halcyon days of the Celtic Tiger with easily available banking finance, pent-up demand for a limited supply of investments in conjunction with a booming economy which offered investors a real prospect of rental growth, investors were satisfied with historically low yields on the premise that values would continue to increase due to the continuation of this positive paradigm. However, the assumptions implicit in these investments have proved to be invalid.

The average length of leases has fallen and will fall further as tenants insist on terms that give them the flexibility that the rapidly changing business environment necessitates. Five year or shorter leases shall become the norm. The ability to opt out of statutory rights of renewal shall remove the legal hazard to the value of the investment that shorter tenancies extended beyond 5 years would have caused in the past. The traditional landlord cushions of long break notice periods, penalties for exercising breaks and mercilessly enforced comprehensive repairing obligations will become the exception.

The traditional adversarial approach of landlords to landlord tenant relationships will change to one of building a positive relationship with the tenant to encourage them to stay in the property beyond the termination of their short lease. Landlords marketing and customer focus will need to change from its current front end emphasis (get the lease signed!) to the entirety of the tenant's term of occupation – this will need a major change in attitude and approach.

Landlords will have to take a proactive approach to improve the amenity of their properties to their tenants and keep the non-rent costs of occupation – service charges, insurance etc. - to a minimum consistent with the provision of a good quality service.

Funders will need to develop the ability to assess property without the traditional comforts of long FRI lease terms and blue-chip tenants. This will be a challenge. Irish property management and property funding will move relentlessly toward the US and European models. Income streams will be less certain and landlords will incur significant irrecoverable costs. Analysis of property investment opportunities shall become more focused on the property's ability to attract and maintain tenants and the quality of its management and less a matter of financial engineering. More judgement will be required. Funders will need to look beyond the building survey, the valuation report, the tenant's accounts and the solicitor's title and lease report – and the PII cover of their authors. These important diligence steps will need to be supplemented with an assessment of the relevant market - current and future occupational demand - and critically the competence of the investor's property management abilities/structures.

While this may be a shock to some traditional Irish and UK focused investors and their funders it should not be a problem to others as investors and funders from Europe and the US are

well used to nine year leases with three or five year breaks.

The rational investor coming to the market will have a very different view of his or her return requirements than heretofore. Property investment will need to get back to basics. What are the basics? In essence the return (income) that a property should generate needs to provide sufficient income to provide for all of the following:

- **Financing -** the servicing and amortising of borrowings – the cost of borrowings will be more expensive than in the recent past and the funder will need to see how and when he is getting his money back.
- **Management -** the cost of ongoing management of the property and the ad hoc events that will arise as leases terminate, tenants exercise break clauses, and go out of business – in the changed tenant's market these events will be more frequent.
- **Irrecoverable Costs -** the increasing level of unrecoverable costs that will arise as tenants exercise their negotiating muscle and extract concessions from landlords forcing them to incur costs that previously would have been recovered under FRI type arrangements.
- **Void Periods -** the likely cost of the increased probability of void periods when the property or parts of a multi-let property are not let and are incurring costs rather than generating income,
- **Reletting Costs -** the likely cost of any monetary or rent-free incentives that may be needed to be given to a new tenant to acquire the property, or to an existing tenant to stay, along with the associated agency and legal fees.
- **Obsolescence** - the costs of refurbishment and replacement of the property asset as it ages – this is a key issue which I will return to below, and is to a large extent dependant on the nature of the specific asset invested in.
- **Return on Capital -** lastly and perhaps most importantly, after all of the above the property must also provide the investor with an after tax return on capital commensurate with the risks of the investment.

The issue of the replacement, refurbishment of obsolete property assets is significant. However across the spectrum of property sectors this varies greatly. At one extreme we have the standard shop (non shopping centre retail unit) in a prime location – i.e. unit in Grafton Street – with virtually no obsolescence. Over decades an investor will spend little or nothing as the tenant will invariably assume responsibility for both the fit-out out and upkeep of the property and it will relet quickly if empty. At the other extreme we have an industrial unit which after 20 years will be obsolete. If we consider a building with a 20 year life cycle, this would mean that the investor would need to provide for 5% of the replacement/refurbishment in each year to ensure that he has sufficient fund accumulated to finance the replacement/refurbishment at the end of the building's useful life. The alternative to replacement/refurbishment is the prospect of a much reduced rental income as a building moves down the property quality hierarchy from prime to secondary and lastly tertiary with negative consequences on its income producing ability.

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In the new world of Irish investment property a rational investor will need to take all of the above factors into account and demand a yield which is sufficient to ensure that all of the above needs are addressed. Higher yields mean lower values.

What are the other consequences?

The consequences in my view are that an investor who has rationally assessed the risks associated with property will need to ensure that in addition to an appropriate yield that his/her property portfolio is sufficiently diversified to protect him against the increased specific risks in a changed marketplace. Going forward in a world of greater risk, the model of an individual amateur (in the true sense of the word) investor acquiring one property as a pension will be inappropriate. Similarly the single property syndicate route may not be attractive. Investment in a single property that may become empty and absorb rather than generate cash is not an attractive prospect for a pensioner. Investors should in my view consider other vehicles for investment in property – property funds, US style REITs, or property companies. A super high net worth individual who can afford to invest in a range of property may be able to achieve sufficient diversity within his/her portfolio and engage professional management.

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The rational property investor in the new world of commercial property will recognise the need to invest in a well diversified professionally managed portfolio. The profile of the investment property owning community shall change. Historically the ownership of commercial property was concentrated in the hands of institutions, property companies and a small number of very wealthy private investors. The fragmentation of commercial property ownership to much broader group of investors that occurred over the recent years was driven by the easy availability of finance based to large extent on the attractiveness of the traditional FRI arrangement to funders. For the reasons outlined above this model is under threat and consequently I believe that the profile of the property ownership shall gravitate back towards the historical model with fewer but larger and more sophisticated professionally managed investors.

The notion of a trophy property will fade – vanity shall be replaced by common sense. A property's attractiveness shall be determined by the adequacy of its expected return over the anticipated investment holding period. A prestige address or a cutting edge architectural design shall only be of relevance insofar that it is perceived to assist in the generation of income or reduction of costs. As I said at the outset it's back to basics.

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