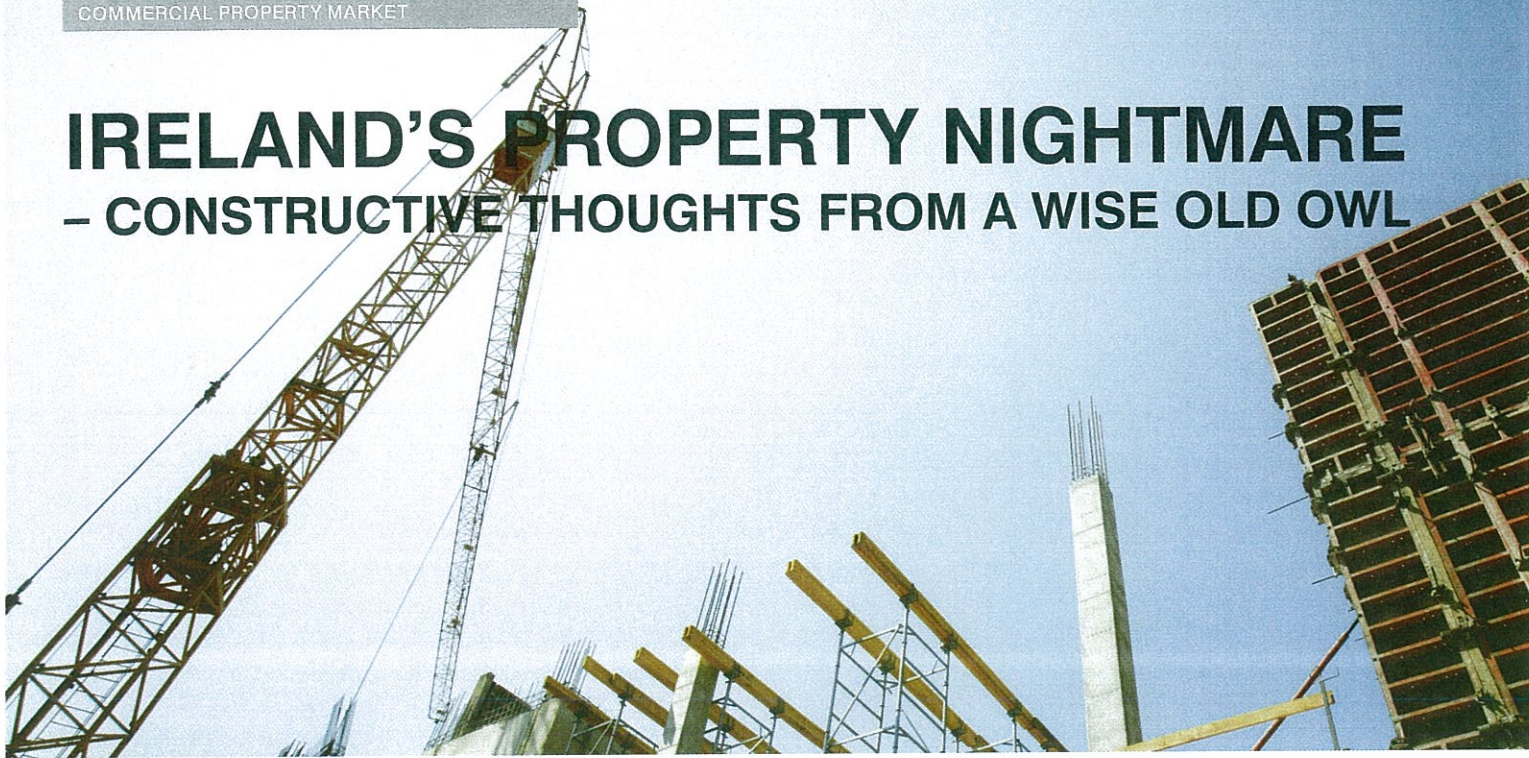


IRELAND'S PROPERTY NIGHTMARE

– CONSTRUCTIVE THOUGHTS FROM A WISE OLD OWL



“The setting-up of a Real Estate Investment Trust (REIT) would prove to be a win-win situation for both potential investors and NAMA”

– Bill Nowlan, Managing Partner,
W.K. Nowlan & Associates

Background – Bill Nowlan

Bill Nowlan has experienced a number of cyclical downturns in his long career in property but even he acknowledges the unprecedented nature of the current state of the Irish property market. A former President of the European Institute of Chartered Surveyors, founding Chairman of the Irish Property Managers Association, former property director for Irish Life plc and now advisor to a number of property groups, he is more qualified than most to give a view as to the likely direction of the market from here and to potential solutions to some of the current problems. Outlined below are a summary of his thoughts on Irish commercial property, REITs as a potential solution for NAMA and the shape of development in the short to medium term.

Irish Commercial Property – A return to the old normality

Nama has probably already put a floor to the market prices for quality commercial property.

The first anniversary of Nama has forced me to change my focus from thinking about the present state of the Irish property market to try and picture what the property market will look like when “normality” returns. What will be the route from here to there?

Normality will be a marketplace where houses, offices and shops let and sell in volume and at prices which no one gets excited about and everyone takes for granted. It will be like the mid-1990s, where deals were being done, but took a little time and effort, and rents and prices were stable, only rising gently with inflation (low). Credit was available, but limited.

This normal property market will be a dull place – a dull place that true property professionals feel comfortable to operate in, collecting rents, arranging viewings, organising contracts. No Get-Rich-Quick-Harrys relying on yield compression and ever-rising prices to justify their existence and scoffing at the old hands. Property will not be the subject of chat in the pub or the taxi.

Three things are stopping us getting to this new marketplace:

1. we have a semi-dead economy with little new demand for our big stock of vacant buildings.
2. there is little or no credit available to enable transactions to happen. No bridging loans, no mortgage loans for housing.
3. confidence is missing. Everyone is afraid of paying too much, of grabbing the falling knife.

But the bottom will arrive and it will arrive quietly – it may have arrived in some places.

The most important participant in the Irish market is Nama. It has acquired or is acquiring all its assets based on property valuation levels set as of last November. In recognition of the fact that valuation levels at that date were significantly depressed (being about half what they were at the top of the boom), Nama are paying a small mark-up, averaging about 10 per cent, known as long term economic value.

Nama is now working through the business plans for its clients and these will provide for sales of the underlying property assets over a period of years. In my opinion, it is unlikely that Nama will approve any disposals in these business plans at prices below its buy-in price plus long-term economic value margin. This gives us a major yardstick as to what is a possible floor to the market and Nama in

practical terms may have probably already put a floor to the market prices for commercial assets.

Two things could upset the floor set by Nama in its marketplace, which is mainly the commercial market: first, disposals by non-Nama banks and their receivers could force down values below those of last November; second, if Nama does not have the patience or the capacity to delay disposals by its clients until the market can absorb those sales at their buy-in prices. This will be a hard one to call for the Nama board who will want to start getting money back quickly. On the other hand, its annual cost of funds is low and the ECB is patient.

With this unofficial floor to the market set by Nama, is now a good time to buy? With a yield spectrum of 7 per cent-plus on quality Dublin city buildings and reflecting rents that are below replacement cost, I think there is now good value out there for long-term commercial investors.

Putting my money where my mouth is I have personally transferred a chunk of my (depleted) pension fund into quality Irish property both directly by participating in the purchasing of an individual office building and indirectly by acquiring units in unit-linked property funds. I am advising my risk-tolerant clients to follow suit and some of them are acting on that advice. There is a risk that we may not be quite at the bottom but history shows it is impossible to get timing perfect and one has to take a view. If there is a fall ahead it will not be a big fall and I am quite happy to take that chance with quality Dublin property as time will undoubtedly cure any premature acquisitions.

Real Estate Investment Trusts – Part of the NAMA solution?

The setting-up of a Real Estate Investment Trust (REIT) would prove to be a win-win situation for both potential investors and NAMA. REITs exist and operate in most other developed countries such as North America and the UK. Indeed, Ireland is one of the few countries operating in Europe without a REIT or listed property vehicle. If and when Ireland catches up with the rest of the world it will be making a facility available to investors that is well-trying and tested.

In simple terms, a REIT is a property rental business quoted on the stock exchange which gets different tax treatment to a normal trading company. This tax treatment avoids the double taxation of rental income and capital gain where property is held through a corporate vehicle. The fundamental difference between a REIT and a normal quoted property company is that a REIT is obliged to invest mainly in rental property and not development or speculative buildings. Secondly, a REIT has to distribute 90% of its income to its shareholders each year and thirdly, it does not pay tax on its profits as would be the case for a normal corporate business.

Advantages of REITs?

The first attribute of a REIT is that it can get the small investor exposed to property of institutional quality. Without REITs, most small investors who want to get into property have to choose between buying individual residential units, investing in property bonds backed by an assurance company, going into syndicates or taking the traditional publicly quoted company route.

Secondly, most indirect vehicles do not pay out virtually all their income to their investors but retain it for re-investment. Thirdly, most traditional property compa-

nies have high gearing, which generally leads to higher risk and share-price volatility. Long-term savers should not be taking on significant leverage in their property portfolios and REITs are restricted as to the amount of leverage they can take on. Generally, it's less than 50% but some take on none. Fourthly, the principal driver behind REITs is to put the investor in the same tax position as if they owned the rental property directly themselves.

In Europe, REITs have been a traditional form of investment for professionals such as doctors and lawyers putting away money for their retirement. They buy units in the fund that in turn buys the property and manages it. REITs are suitable for retired individuals who just want income on a quarterly basis or for the small pension fund that want inflation protection.

Launching a REIT structure in Ireland at the present time would be very propitious. It would help NAMA convert much of its and its clients' overhang of property into digestible assets for small investors, many of whom have deposits in the banks, earning 2% or so. They could earn treble that income rate from good property investment through a REIT. From the investors' viewpoint, it would be a good time to get into a market where values are close to bottom and going only one way in my opinion – up. From the government's viewpoint, there is no downside, its tax take will not change as there is now virtually no investment property held through public companies in Ireland. There should be no loss of stamp duty revenue.

When will building and development resume?

Probably not any time soon, as no developer in his right mind will start a new scheme until the current oversupply of buildings is

used up. The economic viability of most schemes is shot. The fall in sale prices has destroyed viability and the consequence is little or no value in development land and zero or negative profitability. There is a big supply of zoned and serviced land within the system – much with planning permission. This supply is sufficient to meet needs for a long time – possibly for up to a decade – especially outside Dublin. Added to the above, the levy regime that requires developers to pay for all infrastructures at rates ranging from €10,000 to €40,000 per residential unit (and equivalent for commercial) will absorb any significant recovery in land value.

Putting these facts together I see that development will be very much like it was for most of my career in the 1970-2000 era. Builders will build houses and be happy with the building profits they earn from laying blocks and hammering nails, i.e. a 15% mark – up on their costs. Builders will drive white vans and not Porches or helicopters. Land values will stay at a range of zero to 25% of the value of the finished product. The international norm is 25%. There will be few high-density schemes as the market does not want apartments except in special locations such as city centres and traditional flat locations such as Ranelagh and Rathmines in Dublin. In addition, the construction cost of apartments is higher than that of housing and the economics no longer work due to the very big fall in apartment values – which is a much greater fall than in houses. Planners, please take note. Builders will revert to their old methodology of building show houses and then pre-selling them in phases of 10 or 20 units. Only when they are sure that these sales will close will they proceed with opening the show houses again. On the commercial front the pattern will be very much the same. Pre-letting or pre-selling office, retail and industrial

projects will be the aim of professional developers. Banking will only be available where there is a pre-sale or a pre-letting and/or the developer has sufficient collateral and track record to cover a long vacancy. Few developers will have this capacity. Few projects will start speculatively unless bankrolled by someone with deep pockets. This is the way it used to be before madness engulfed our industry. We may be heading back to the days when the institutions and public companies were the main suppliers of development finance. We also may see the publicly quoted development company appearing again.

Finally, a clear understanding of property economics in Merrion Street and the Customs House is badly needed – learning the fundamentals of the industry by blowing up the system is not the way to run an economy. Maybe next time it will be different but I doubt if I will be a player then.

Bill Nowlan