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Timing is everything in property investment

Income production rather than capital value potential must become the focus on property investment, writes **BILL NOWLAN**

RECENT STATISTICS show that the value of my house, together with most other property, is back to the value it was in 2002 which is just half its 2007 value.

The national average house price today, according to the Permanent TSB/ESRI House Price Index Q1 2010 at €204,830, shows a fall of 34 per cent from its peak value in Q4 2006 (numerically a 33.3 per cent fall equals to a 50 per cent rise).

For Dublin houses, this fall is even greater at nearly 42 per cent from their peak in 2007. Such a fall means that any capital gains made since 2002 have been completely wiped out. As a result, anyone who made a capital gain out of property over the last eight years is offset by someone who has lost an equal amount of money – a zero sum game.

For example, if I had sold my house in 2007 for nearly double the price I paid for it in 2002, I would now be able to buy it back for half that figure.

The same concept applies to all houses, offices blocks, shopping centres, etc, throughout Ireland. So, for the past 10 years property has been a rotten investment of capital and a poor producer of income. Unless, of course, you were lucky enough to buy before 2001 or sell before 2006/7.

This must question the inherent belief that "property is a good long-term investment" which seems an intrinsic part of the Irish psyche.

Have we been fooling ourselves? If we look back at the IPD and TSB statistics for the period before 2000, we can see an interesting argument to say that property might be a good long-term investment – but only if you have to get your timing right. Most investors don't.

By looking at these statistics, we can see the importance of timing plus the role of income. Had I bought property in any of the years between 1986 and 1996, the capital value would have remained almost static up to 1996 but I would have had a high income yield of close to 7 per cent per annum.

All the focus over the period between 2000 and 2010 on capital gain misses a key factor in property investment which is the income side of the equation. When I started in the property business in the 1960s, property was then regarded as being all about income. Capital gain was only a "kicker" to compensate for inflation. Over the past decade the income side of the equation has been downplayed and regarded only as the means to pay interest on borrowing while capital values (supposedly) grew and grew.

The belief being that the leveraged equity would make millionaires out of investors. Those (few) who sold before 2007 fulfilled this dream – but left the purchaser and his bank (plus the taxpayer) with a hole in the bucket.

So property can be a good form of investment but with a key qualification – you have to get your timing right. So what about the next decade. Will we see values recover back to 2007 levels? In my view the answer is yes – eventually, but not for a very, very, long time – say 10 years give or take. The focus on property must change to its income-producing characteristics rather than its capital value potential. History and its statistics tell us why. Let me look at the period from 1996 to 2000.

In 1996 the economy was recovering from a long period of stagnation. Rents had remained almost static for over 10 years, inflation had been pushing up construction costs and it was not viable to build new commercial buildings as values were below cost.

However, new buildings were scarce and were needed to house the emerging service industry. To overcome this problem, the Government introduced double rent tax allowances for selected sites and in particular the IFSC. This effectively gave a subsidy for property development by making the space cheaper to occupy for tenants and allowing rents to rise to levels which made development projects viable. It was a good idea.

It kick-started the development industry which then flowed out beyond the selected designated sites. The economy boomed and rents doubled in that period. Prime office rent in the central business district of Dublin moved from £14 to £28 per square foot.

The interesting thing about that period is that property yields did not change significantly. The average income yield for an institutional property portfolio for that period was close to 7 per cent. The real rot set in about 2002 when values started to be driven by yield compression and not rental growth. Average office portfolio yields fell to 5.2 per cent by the end of 2002 and down to 3.8 per cent in 2007 which was the zenith of the market. It is back to slightly short of 8 per cent today.

One consequence of this artificial rise in property values linked to the availability of money was the speculative-driven growth in the supply of floor space.

By way of example, the vacancy rate (or supply) of Dublin offices rose from just under 5 per cent in 2000 to 14 per cent in 2006. The current office vacancy rate in Dublin is estimated at 23 per cent.

The vacancy rate in a major international metropolitan area would range from 6 to 8 per cent in normal times. We have enough offices in Dublin to take us well into the next economic recovery.

However, every property bust contains the seeds of the next recovery. Due to the fall in values it is not economically viable to build new commercial buildings. Thus, over time, a shortage of space will emerge and sooner – but probably later – we will have the same thing happen as occurred in the period 1996- 2000, a real growth in values driven by fundamentals.

My belief is that property is a safe buy today because we are at, or close to, the bottom. But remember, property investment is primarily about income and long-term inflation protection. Only the very skilled or the very lucky can achieve quick capital gains. A lot of people recently learned this lesson the hard way but will the punter remember? Investing in property is not a zero sum game provided you focus on the income and also get your timing right.

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