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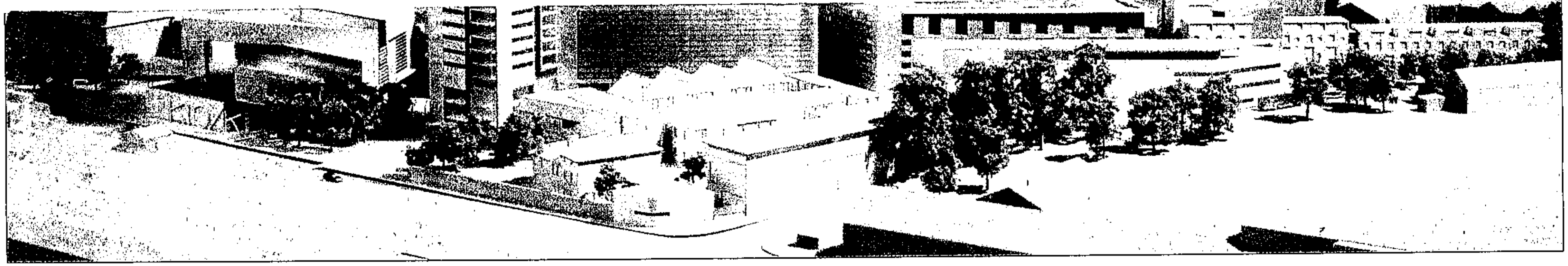
It's back to the norm after the big bonanza



A 32-storey tower – reaching to 140.55 metres – planned for a site in Kilmainham, Dublin 8. 'There will be no crash in property values while the economy continues to prosper and interest rates continue more or less at current levels'

The 10 years since 1994 have been spectacular in terms of growth and rising values for the property industry, but what will the next decade hold? Bill Nowlan investigates

Will the spectacular growth in property values continue or will we settle down to a new norm in values at prevailing rental and value levels and at the current yield spectrum?

The past 10 years in property in Ireland have been spectacular. Multi-millionaires have been created due to four simple factors.

Firstly, rents have risen by a factor of nearly three. Secondly, investment yields have fallen by 2-3 per cent. Thirdly, more urban development land was demanded than the system could supply. Fourthly, the building industry was not able to respond to the huge increase in demand. These factors have given rise to a fivefold increases in values across all property classes.

The rental rise was because of the scarcity of commercial space. Yields have fallen because of factors emanating from the US, the low inflationary environment and due to the expectation of further rises in property values.

In the remainder of this article I would like to examine the fundamental factors that will influence the property market in the next decade to see if I can find out some clues about property values over that period.

Firstly, over the last decade the building industry has transformed itself in Ireland. It is now seven times bigger than it was in 1994 with an annual turnover of €23 billion. It is responsible for 20 per cent of GNP and has built 80,000 housing units this year, as well as huge amounts of infrastructure and commercial space. In 1994, it employed 95,000 people; today that figure exceeds 200,000. While the order books of the industry are full, construction prices are not rising significantly – a little above the rate of inflation. If a developer wants a new building, he can procure it without too much delay at a predictable cost.

This brings me to the second possible constraint in the property supply chain which was a major factor in driving up property values. The demand for extra development land for housing and commercial development with services has made holders of zoned and serviced land into one of the wealthiest classes in the country. There is no shortage of land – we only have a shortage of services, including planning permission.

In regard to services, in the mid-1990s there was a backlog of local authority schemes for new sewage and water treatment works. There was no surplus capacity in the system when the Celtic Tiger arrived. While designs for such plants were often prepared, they were lying in county engineers top drawers gathering dust. There was no money from government to lay pipes or build treatment works.

Over the past decade, that money has been forthcoming and been applied to huge amounts of infrastructure, such as the €200 million Ringsend water works. Throughout the country similar schemes are in place – or being put into place – and the plans are being prepared for further long term investment in piped infrastructure. Consequently, the scarcity of developable land is unlikely to be a factor in the mid-term future unless the Government's infrastructure programme is stopped or delayed and this does not seem likely.

Regarding planning permissions, it takes longer to wind one's way through the planning process than it takes to construct the subject buildings. In my experience, this factor holds true: To build a 9,290 sq m (100,000 sq ft) office building to completion takes about two years. To secure planning permission takes at least three years and is often longer.

However, there is hope. Planning authorities have been improving their systems and the process is getting faster. Secondly, there is a surplus of planning permissions as a result of permissions that came through over the past two years but were not acted on.

A third factor is that planning applications have been getting larger and the permissions granted are for very large chunks of space. A big scheme in 1994 was for 9,290 sq m (100,000 sq ft) or 100 houses, today it has to be for 92,903 sq m (1 million sq ft) or several thousand houses to be classified as "big".

An Bord Pleanála has been speeding up the appeal process and hopes to have it down to a maximum of 18 weeks in the next 12 months.

Now, let's look at demand for new buildings over the next decade. The demand for new housing is estimated to peak over the next year or so as we can't continue to find buyers for new homes at rates 20 times higher per capita than the UK, which produced 160,000 houses last year and is now experiencing a downturn. There may be some scarcity in Dublin but a correction will happen sooner rather than later. If the economy stays buoyant and interest rates low, it will be a soft landing for developers and house owners.

With regard to demand on the commercial front, there is an oversupply of office space in Dublin with vacancy rates over 17 per cent. There is a patchy market in industrial space with vacancy levels of 13 per cent. The days of space occupiers pleading with developers to give them somewhere to store their goods are long gone. The boot is on the other foot with the space user calling the tune.

The only market still in real scarcity is retail. Retail rents are rising as shopkeepers compete with each other for available pitches. New shopping floor space is coming on stream but the time lag for such schemes is very long.

Just look how long Dundrum Town Centre is taking to build and then add on the planning and land assembly time. I suggest that a period of 10 years would be a good guess for most large schemes and at least half that for simple neighbourhood schemes.

Retail schemes are very location-sensitive and need to be accessible to the markets. Grafton Street, Henry Street and Patrick Street in Cork are irreplaceable in terms of accessibility. That is why rents have multiplied by 10 in the past decade and why rents are likely to grow there. But then the prices in these shops have to reflect these rents and, possibly, the consumer might get tired of these prices in due course. Various retail schemes are on the drawing board and are underway, but I doubt whether they will led to an oversupply of retail space.

Now to interest rates and yields. According to the Investment Property Databank, the yield spectrum for top quality investments has moved from 7.5 per cent to just 4.5 per cent over the past 10 years. If nothing else had happened in that period, such as rents increasing, this would have resulted in a doubling of property values.

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Will yields stabilise or continue to fall? I don't know, but I find them at levels that make my toes curl with concern that the next move must be upwards.

Davy Stockbrokers in a recent article by Robbie Kelleher noted that the yields on property were now very demanding when compared with Irish equities. Indeed, the positive gearing effect from bank borrowing has almost disappeared. Bank borrowers are now relying almost 100 per cent on capital gain to make their borrowings worthwhile whereas there was a 2-3 per cent net gain in the past due to the differential between borrowing rates and rental income.

If interest rates do eventually rise, this will impact on property prices – probably in a negative way.

My final issue is that of the relationship between building cost and the property value spectrum. This ratio is important in establishing the capacity of property value to be driven up or down by the under or oversupply of new buildings coming on stream.

By way of example, take one square foot of offices in central Dublin – the current value of that would be about €600 per sq ft (a building of 50,000 sq ft would have a value of say €30m). Currently, the cost of providing that square foot new would be about €300, or half the value. The difference between the two is represented by the site value and/or the developer's profit.

Put another way, one would be holding fire insurance cover on that 50,000 sq ft building of say €15m and not €30m as you don't insure the site. To show how things have changed I would note that in 1995, when I acquired Lansdowne House for £9m (around €10.8 m), on the day we bought it the insured value was £13m (around €15.6m).

The point I am making is that there is no fundamental construction cost driver supporting current property values in Dublin as there was 10 years ago.

Neither is there a shortage of land either in the cities or suburbs. There are a lot of developers with land banks very willing and able to build at current property prices and take a very satisfactory profit. In economic terms, the supply side is now quite elastic at current price levels whereas 10 years ago it was quite inelastic.

My conclusion to the scenario set out above is as follows. Firstly, that there will be no crash in property values while the economy continues to prosper and interest rates continue more or less at current levels.

Secondly, the huge imbalance between supply and demand that existed for most of the past 10 years has now gone. It was this imbalance that has forced up property values in Ireland, as properties were effectively auctioned off to the highest bidder. The supply chain of the development industry is working very well and in a competitive environment.

Thirdly, property values will not rise significantly on a general basis for quite a few years other than in the retail sector. It would not surprise me if Dublin office rental levels in 2014 are the same as today. There may be a gradual rise at more or less the rate of inflation.

Fourthly, one factor to be borne in mind is that there are probably too many property developers chasing any emerging opportunities. There will probably be some attrition in the sector as over-ambitious and over-borrowed schemes come into focus.

Finally, there will be some winners and some losers and lots of special situations. I would expect that the old adage of location, location, location, will be applied by the wise to their advantage but the great property bonanza that made many into multi-millionaires is over.

From here on, it will be hard work to make big money out of property. But there will be money to be made by the smart, the lucky and the hard workers. It's called normality.

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