Irish Times Weds 30 Nov '05

MarketAnalysis

Strong returns in 2005 likely to moderate in 2006

I do not expect any serious threat to existing values but I do expect relatively mundane income and capital performance for a long time to come, writes **Bill Nowlan**

Controversy rages as to whether or not house prices will rise or fall over the medium term.

On the one hand you have got the *Economist* magazine and some experts in OECD saying that current Irish house price levels are too high and will fall by up to 20 per cent. On the other, you have local auctioneers, bankers and economists saying house prices are fair today and they will rise in 2006 – notwithstanding an expected increase in ECB interest rates. The Central Bank has a crick in its neck trying to look in both directions.

But what about commercial property? Looking back over the 10 years since 1995 on the extraordinary performance of the office, industrial and retail market, capital values increased more than threefold.

This growth was driven by three things: huge demand for extra accommodation by business driven by the emergence of the Celtic Tiger and the roaring economy; the scarcity of accommodation in the period up to 2001 while the construction industry tooled up to meet the new level of demand; the fall in interest rates.

In the period 1995/2001 the scarcity of floor space for booming business led to an intense bidding war for any available accommodation. In this environment the office and industrial rents doubled and vacancy levels in Dublin city and suburbs moved from 14 per cent to 2 per cent.

However, the almost trebling of the size of the construction and development industry in the past eight years has led to the production of vast amounts of new houses, offices, hotels, roads and shopping centres in Dublin and throughout the country. This production level was initially in catch up mode but is now probably at a higher level than the economy currently needs.

The fall in interest rates, which only really kicked in after the millennium and 9/11, took up the momentum when rental levels stabilised and this factor has been the main driver of property values for the past four years.

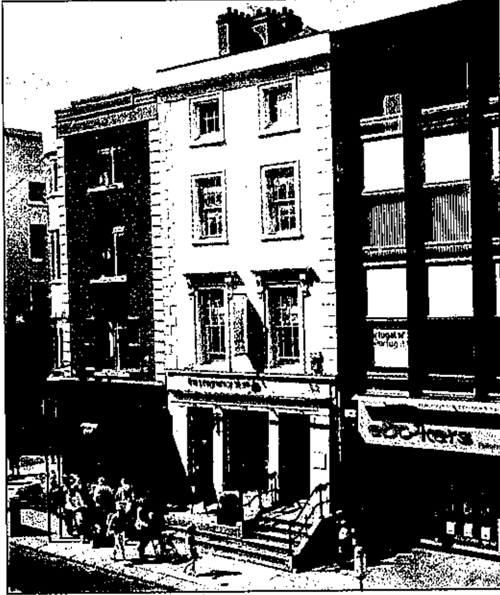
The issue now facing the Irish commercial property market is that all these factors are gradually going into reverse. The scarcity of floor space in the period up to 2001 has truly gone and there is an oversupply of office and industrial accommodation. Currently up to 15 per cent of buildings are vacant in both sectors.

In the retail sector, the supply of new space has been significantly slower in emerging than in the office/industrial sectors but the development machine is about to produce an oversupply there too.

Turning now to rental values. On the office/industrial front the scarcity of accommodation and the bidding war for any available supply up to 2001 resulted in the doubling of rental values.

In the period between 1995 and 2001 the IPD index of office rental values moved from 129 to 290, a factor of 2.25. But since 2001 the rental spectrum has been almost static, if not falling, as will be seen from rental value table opposite which comes from the revered and respected IPD database.

This shows that office rents have been almost static if not falling over the past five years. This is not surprising with the high vacancy rate as shown in the office vacancy table opposite. In a normal market the vacancy level would be at about 7 per cent and at this level you would see some gradual rental increase but above the 7 per cent level, rents will fall or remain static as has happened in Dublin over the past four years.



Two adjoining retail investments at 53 and 54 Dawson Street in Dublin sold in the autumn for record yields. One of them will show an initial return of 1.65 per cent while the other will produce a yield of 2.35 per cent. Number 53 sold at auction for €4.9m while number 54 made €4.5m

In the retail sector, where total sales turnover has almost doubled since 1995, rents have gone up by a factor of 2.4 in the same period (index from 164.8 to 384.1). This is not surprising in a booming economy with a constrained supply of new retail outlets and accounts for retail rents continuing to grow significantly over the past four years while office rents languished.

But there must be some serious doubt, firstly, about the ability of retailers to pay rents which have risen significantly faster than sales turnover (up by a factor of 1.8) and, secondly, where turnover is about to be spread over a greatly increased floor area as a result of the emerging new shopping floor space in new shopping centres and retail parks.

What about the impact on values of a change in interest rates and a fall in purchase yields? In the jargon this is called "yield compression" but, basically, it is the willingness of investors to accept lower returns on a given stream of rental income. In 1995, the yield spectrum was 7.5 per cent for offices; 7.4 per cent for retail and 9.2 per cent for industrial.

Today that spectrum is 5.6 per cent for offices, 3.25 per cent for retail and 6 per cent for industrial (source: IPD). These figures are for a mixed bag of institutional investment and prime yields would be lower.

Dublin Office Vacancy Rates

YEAR	RATE
2001	11.8%
2002	18%
2003	16.85%
2004	15.82%
2005	14.5%

Rental Value Growth

Year	Office	Industrial	Retail
2001	6.6%	3.8%	4.9%
2002	-0.5%	-0.1%	0.93%
2003	-1.6%	-0.7%	8.7%
2004	-1.4%	0%	7.4%
2005	0.3%	0.8%	11.1%

This change in yield spectrum has increased the office rent income multiplier by 4.5 years purchase (yp) (13.3 yp to 17.8yp), the industrial multiplier by 5.7yp (10.9yp to 16.6yp) and the retail by a whopping 17.25yp (13.5yp to 30.75yp).

Thus when you look at industrial/office rents more than doubling and their multiplier increasing by 5yp, it is no wonder such property has done well for investors who got on the bandwagon early enough.

In the case of retail, the rewards have been even more spectacular with rents more than doubling and the multiplier going up by 17.25yp time.

In effect, this means that a retail property with a rental income of €10,000 in 1995 was then worth €135,000 gross, but today that same property is worth €720,000.

So over the past 10 years the scarcity of accommodation forced up rents in the first five or so years and then falling yields took over in forcing up values in the second five years. The combination gave property ownership a golden era.

The question now to be asked for 2006 is what is going to drive future capital growth? Is the golden era at an end? Trees don't grow to the sky!

In my view, rents in the office and industrial sectors will not rise in a situation where there is an existing significant oversupply and where the equivalent of nearly one office landlord in eight has an empty building; and where the development industry is continuing to build new buildings at a very high rate. Just count the cranes on the horizon.

There will be some niche situations where supply is less than demand and rents will rise somewhat. I can see several such situations; one of which is in Dublin 2 but they are the exception and not the rule.

The prospect for further capital appreciation will only arise if the economy performs so well that it absorbs most or all of the supply of new buildings coming onto the market plus the substantial amount of the existing stock of vacant buildings; or there is further yield compression.

My slight concern about further value growth arising from yield compression is that it inherently contains the making of a bubble and it can't go on forever. In an environment of increasing ECB rates, there is a risk of a decompression and yield moving out toward their historic norms but, with a booming economy and a flood of capital seeking property, this is not likely.

In summary, the performance of property investment for the past 10 years was a no-brainer but, in the current circumstances, the chance of further significant capital appreciation is very limited.

I do not expect any serious threat to the existing spectrum of values but I do expect relatively mundane income and capital performance for a long time to come. Don't bet your pension on a repeat of the past 10 years!

● Bill Nowlan is an independent property investment and development consultant. He was formerly property director at Irish Life, is a visiting professor at University of Ulster and advises significant property funds