CommercialProperty

MarketOutlook

Yields to remain low for a very long time

A rapid rise in property values or rents is not going to happen, writes Bill Nowlan

In last week's article I pointed out that office and industrial rental values have been static for the past three years or longer. Indeed, several Dublin office buildings with which I have been involved are passing their first five-year rent review without securing any rent increases.

Retail rents are the exception to this flat rental environment as the consumer boom has exceed the capacity of the development industry to supply new retail accommodation. But oversupply is on the horizon and the capacity of retails to pay some of the current very high rents must be questionable.

I think investors buying shops off 2 per cent and 3 per cent yields will be just as disappointed in the long term as those buying offices off 4 per cent yields.

This plateauing of rental values has been hidden by the compression of investment yield resulting in good capital appreciation in spite of static rentals. However, this reduction in yields can't go on forever and may have gone too far already.

Why is this happening in a booming economy? One's natural instinct is that everything is booming, new buildings are being constructed everywhere and the increases in property values must continue. We see villages, towns and cities expanding across the island. A flat property market is just not logical. Or is it?

Thus, the property market is not flat or dead, it is humming away nicely. Why is Nowlan so negative? It is only the price in the form of rentals that is flat. As I reminded you last week, property is a commodity and subject to the laws of supply and demand.

Back in the 1990s during the early phase of the Irish economic boom, it was a commodity in very short supply and rentals rose correspondingly (very often doubling and in many cases tripling). But now it is a commodity that is no longer in short supply at current prevailing rental prices.

A comparison with oil is appropriate here. We all know that oil was trading at about $25 a barrel for a long time in the 1990s. Suddenly there was a shortage of oil as a result of the Middle East situation and prices went up to the $50 range. Supply increase and demand reduced at the new price level. We now have a new oil price plateau and the likelihood is that it will stay that way.

Property in Ireland, except in niche situations, is in the same position as oil, the new price levels have induced huge volumes of development producing a supply level in excess of demand.

There are plenty of suppliers (developers) willing and able to build at prevailing prices (rental levels) and there is no shortage of land, concrete, manpower or money. The planning authorities have overcome the shortages of services and the planning bottlenecks that caused some of the scarcity are fast disappearing.

I know the old adage about land being in short supply and not making any more of it but bear in mind that the land area of Paris is smaller than the land area taken up by Dublin with a population eight times its size. There is enough land zoned and serviced in most urban areas to cope with most foreseeable situations of population and economic growth.

Another factor is that the building industry has got very good at what it does and, consequently, the period between ordering on a new building and getting the keys is often less than a year. The long delays between selecting a site and getting occupation of a new building are becoming a thing of the past due to the emergence of some very professional builders and developers.

If you are a tenant, or indeed an owner-occupier, in need of a new building then you will get one – generally at prevailing market rental or price levels. So if the perfect building required by you is not already built, then a developer will have it for you in short shift.

For those interested in the detail of urban economics, the construction cost of a new building today generally represents less that 50 per cent of the value of the building so that there is little or no construction cost inflation applying to the development equation as happened in the 1980s. This is a critical factor to bear in mind.

Thus with this scenario I believe – in spite of a booming economy, a booming demand for floor space – that in the offices and industrial end of the business, we can look forward to small or nominal increases in rents or capital values for a very long time – probably in excess of 10 years.

Normality returns to the market place! It has done so in such circumstances hundreds of times before – and not only in Ireland but across the world.

For example, in many parts of the UK where the economy has been doing well, many rents are still at the levels that were prevalent 10 or 15 years ago but there are areas – like the West End of London – where rents have gone up significantly due to scarcity.

Also the retail sector has done well there. Capital values have gone up in the UK also as a result of yield compression but not as much as in Ireland. But what is happening in the UK is for another article.

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So what for the next 10 years. Firstly, development activity will go on but there will be intense competition between developers for tenants and for owner-occupiers.

Secondly, the art and craft of estate management will be rediscovered. This is an art which is not well-known to the new breed of property professions as it tends to involve a lot of hard work, attention to detail and produce results slowly. No high commissions and champagne here!

But in my scenario you will have to woo customers – not treat them in an arrogant way as you could do a couple of years ago.

The big imponderable for the future is bank interest rates. Pain will be slight and tolerable for investors buying at current yield levels if yields remain low and the future holds mere disappointment. If interest rates increase the pain will hurt a lot more. If interest rates increase by more that 2 per cent, the pain will be intense.

Several Irish investors are bidding for Hambleden House, a recently upgraded office block at Pembroke Street in Dublin 2, which is currently being sold by Scottish Provident. However, the building may be sold as part of a larger UK portfolio which is on the market. The Dublin office block has a floor area of 3,716sq m (40,000sq ft) and is producing a rent of €1.25 million from a range of tenants. It is likely to make around €20 million, which would represent a yield of 5 per cent

Thus, in conclusion, it will gradually dawn on all those Irish property investors holding ordinary properties acquired at low yields that their initial yield is all there is going to be for a very long time. At the same time they will be watching their lease getting shorter, their building requiring maintenance and bank interest rates possibly going up.

Tenants are customers. These are customers who up to about two years ago have been through a rough time with property owners and will show them no mercy as the boot goes onto the other foot. Investors will have to treat their tenants like guests.

I know that I have said similar things before in my articles and I have apparently been wrong. Wrong not because of my reading of the fundamentals of supply and demand (my forecasts about rental growth have been spot on!) but wrong about the propensity of Irish investors to ignore reality and to keep competing with each other for property at yields that I believe to be unreal.

In conclusion, I am not forecasting a collapse of the property development industry. What I am forecasting are disappointed investors who will be servicing debt out of other resources and for a very long time. A rapid rise in property values or rents is not going to happen.

Property, except in some special niche situation, is a commodity just like coffee beans, oil or lumber. We have had our one-off adjustment and it won't be repeated in my life time. I will be putting my future pension contributions into other markets.

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