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Wednesday, Feb 25, 2015

Latest boom is a different kind of beast

The commercial property upswing is part of a cycle, but differs from last time

Second phase city: Dublin is at the second phase of a typical property cycle when prices rise to the level that new development is viable

Bill Nowlan

The commercial property industry is in rude health, with more than €4 billion of investment transactions and 40 per cent growth in values in 2014. Just as the market fell like a stone, it is now rising like a rocket – or is it a phoenix?

That market is now of a different nature to that of a decade ago: different drivers, different financing, different players.

It's important to remember that demand for commercial property is a derived demand reflecting activity in the wider economy. Property markets operate within a national economic and urban context (in our case, primarily Dublin). Those markets are cyclical because that economy is cyclical.

Lastly, the development industry generally lags behind the main economy and takes two to three years to grind into motion. Conversely, it can take a similar period to wind down. So every property cycle has three phases to its life.

Rapid demand rise

The first is the rapid growth in demand as the economy expands, leading to higher prices (rents) for extra accommodation. With no new supply, competition drives up prices for the available stock.

The second phase begins when prices rise to the level that new development is viable and construction of new buildings gets under way. This can be a slow process due both to the cumbersome regulatory process and the actual time it takes to build. During this mobilising period, prices will continue to be bid up because of continuing shortages of stock. Dublin is now at the beginning of this phase in the cycle.

The third phase, still a long way off in Dublin, is when new accommodation is being produced in large volumes and demand is less than supply. This oversupply often happens just as the economy tops out. In the last property cycle of 1996- 2007, this oversupply began to emerge around 2003-2004. This was the key signal of the impending correction.

Against this background, it is worth looking at the “players” in the current Dublin market. Broadly, they fall into five categories. The first are institutional investors simply looking for a reliable income from a secure and appreciating asset. The collapse in bond yields has diverted these to property, and international money is roaming the safe economies in search of extra margin. On the Dublin market currently, they are both local (including pension funds) and overseas investors, many of them German.

The second category of operators are the speculators who are expert at reading the world’s property cycles and acquiring property in the early stages of the recovery cycle, but intend selling before the market matures. Call them the hedge or private equity funds.

The third category includes traditional property companies, both public and private. They know they will be around through the whole cycle and will have to hold and manage their Irish assets during the down cycle. These are mainly the traditional developers, more recently joined by real estate investment trusts (REITs).

They have a deep understanding of their operating environment and the imperative of securing long-term income, but who can take risks in the earlier part of the cycle. They seek to add value to the assets entrusted to them and pay regular dividends to their investors.

The fourth set of players are investors who recognise the long-term characteristics of property as a store for wealth. These can be high-net-worth individuals or syndicates put together by experts with long-term asset management strategies – as well as the occasional gouger who convinces clients to invest in dubious projects. And, yes, such syndicators are still around. One would have thought that the punters would have learned, but apparently they have not!

The final category are the madman property speculators who will always be with us and who always believe they have a unique insight, and hence pay prices for assets that are usually too high but sometimes come off.

Notably absent from this cast of characters are banks. What differentiates this property cycle from the last is that it is being driven mainly by equity funding rather than borrowing. Equity investors are generally much more careful with their money than lenders are with depositor's funds. Banks will retain a lesser role as support for developers but the lessons of banking over-exuberance have been learned – for now, at least.

A different boom

In summary, the property industry currently rising from the ashes is a very different creature from the one that was consumed in the flames along with our banks, much of our construction industry and many private individuals. The fundamental difference between this cycle and the last one is that it is an equity-fuelled one and not a borrowing binge.

The strategy of some of the new players is to make an early exit. Many more will remain for the long haul. How that new industry will look as the cycle evolves is relatively predictable but the subject for another day.

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