IRISH REITs – GETTING READY TO GO

REITs are coming to Ireland. The Irish Government's Finance Bill 2013 includes the draft provisions for REITs which it has recognised as an important element of the toolkit for the recovery of the property market. This is a key milestone on the road to the establishment of a REITs industry in Ireland according to Frank O'Neill

Figure 1

IRISH REITS FORUM MEMBERS	
W K Nowlan & Associates	Property Asset Managers
NCB / Investec	Corporate Finance
KPMG	Accountants & Tax Advisors
William Fry	Law firm
A & L Goodbody	Law firm
Byrne Wallace	Law Firm
Eversheds	Law firm
Goodbody	Stockbrokers
Irish Life	Investment Managers
Irish Stock Exchange	Stock Exchange
IPUT Property	Unit Trust
Matheson	Law Firm

It is the culmination of both two years' concerted effort and over 20 years' history. Let me explain: 20 years ago the Irish property industry campaigned to persuade the Government of the day to bring in the necessary legislation. It failed. Two years ago, in very different circumstances, battle was re-joined and this important victory achieved.

These two campaigns, while chronologically remote, do however have a common thread; my colleague Bill Nowlan, an ex-Chairman of both the Society of Chartered Surveyors and the European Society of Chartered Surveyors. 20 years ago he was the Property Director of Irish Life Assurance Company (then the biggest investor in Irish property) and led the campaign to bring REITs to Ireland. Now Managing Director of WK Nowlan & Associates, a specialist asset management consultancy practice which he founded in 1995, Nowlan has brought together a voluntary industry body, the REITs Forum, (Figure 1) which has worked assiduously for the introduction of REITs in Ireland.

But to tell the story of the Irish REITs journey we must first look at the history of the Irish commercial property market over the last 30 years, during which time it has gone through several normal cycles and one cataclysm in 2008.

Pre-bubble

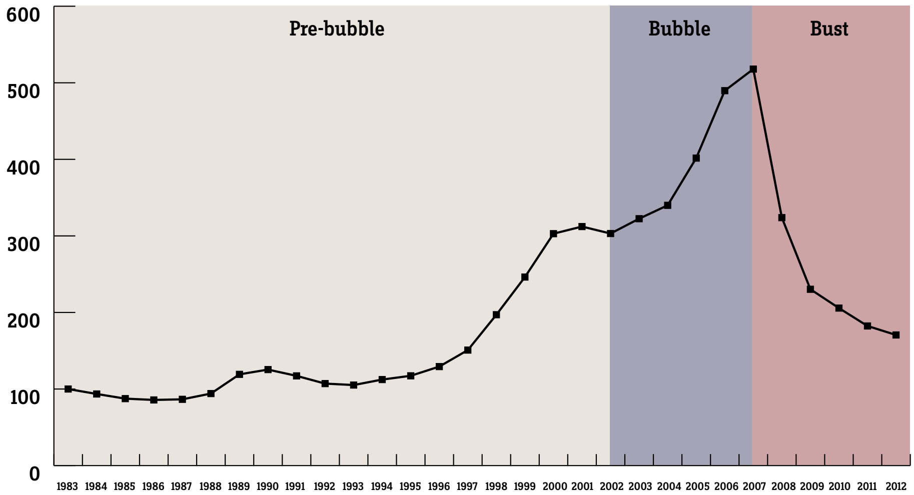
Prior to 2002 the prime Irish commercial property market was insular with a small number of players, consisting overwhelmingly of domestic institutions and private investors. The double tax disadvantage of non-REIT corporate property ownership had put paid to the small Irish property listed sector and our currency, the Punt, posed a significant currency risk to overseas investors.

The institutions (pension and life assurance companies) were 100% equity investors and the private investors were professional seasoned property specialists with deep pockets and a careful conservative approach to gearing. Finance was scarce and prime property investment was only for those who had substantial equity.

While dominated by domestic players, there were occasional forays into the Irish market by international players, notably, our nearest neighbours, the British, who invested on an on-going basis, frequently with a local partner, and the Swedes who during their ill-fated bout of property mania in the 1990s entered the market with a swagger and departed with a whimper.

The principal implications of this investor profile were that the scale

Figure 2 - IPD All Property Capital Value Index



of investment lot size and market exit routes were very limited. The size of the domestic investors' portfolios were not of sufficient scale that they could, while adhering to prudential constraints, invest more than EUR 30 million in a single development or investment project (see panel, bottom right). It was an illiquid market dominated by the locals. These were significant deterrents for international investors.

However, this market worked reasonably well and did not suffer any major convulsions beyond the normal cyclical patterns common to economies and the property world. The IPD All Property Capital Value index for the 19 years from its commencement in 1983 until 2002 increased at a rate equivalent to 6% year on year (Figure 2). All that was to change.

The bubble

The introduction of the euro to Ireland in 2000, with its low interest rate regime combined with the global phenomenon of easy availability of credit, resulted in a vast pool of cheap finance becoming available to acquire property. Led by Ango-Irish Bank the Irish property market enjoyed a spectacular bubble. The IPD capital index for the five years 2003 to 2008 increased by 71%, equivalent to an annual rate of 11.5% year-on-year - almost twice that of the previous 19 years (Figure 2).

The investor profile changed. The traditional institutional investors faded away, withdrawing from a market which was no longer rational. However, the property market stayed in the hands of the locals albeit using foreign capital intermediated by Irish and international banks. The traditional investors were replaced by the advent of the syndicated investors – highly geared clubs of individuals put together by financial engineers. In the early phases of the bubble the syndicates enjoyed spectacular returns as their thin equity CFD-type structure magnified exponentially any increase in asset values.

The bust

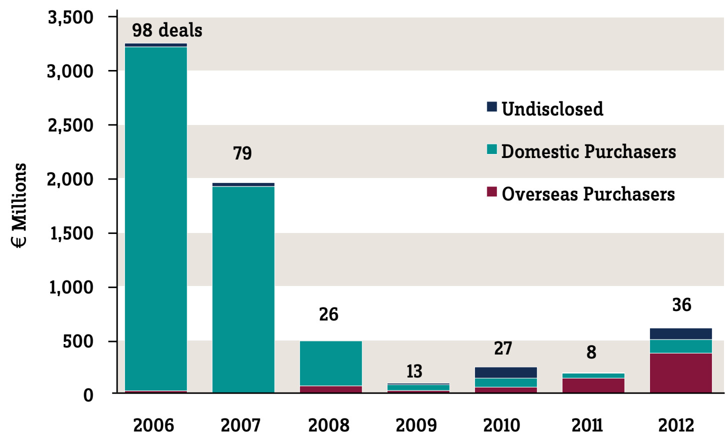
The first tremors that shook the seemingly new paradigm of asset financing appeared in the US sub-prime in 2007 and quickly reverberated in Ireland. The financial engines shifted into reverse thrust. Lending dried up and, if available at all, became very expensive. Asset values plummeted. From 2008 to 2012, the IPD All Property Capital Value index declined by 67% – back to 1998 levels (Figure 2).

The syndicates and others who acquired Irish property assets during the bubble saw their wafer-thin equity, and in turn that of their lenders, evaporate as the CFD-like structure imploded. In 2009 the Irish government set up its bad bank NAMA (National Asset Management Agency) to clean up its domestic banking sector. In 2009, loans with land and development property assets as collateral with a nominal value of EUR 74.2 billion were transferred from the Irish banks to NAMA for the value placed on their collateral of EUR 37 billion. >

WK Nowlan & Associates' Bill Nowlan said at the conference:

"Ireland has had very limed access to International Property equity for decades and had to rely on locally equity for property projects. This came into sharp focus for me when I was in Irish Life Assurance in the 1980s and we had to scale back the size of a major project in Dublin. The scheme had received planning for over 50,000 sqm which would have cost IR£ 50 million but the maximum prudent investment permitted by the Irish Life actuary was IR£ 25 million because no external partner could found to put up the balance of the funding the scheme was halved."

Figure 3 - CBRE Research - Irish Investment Spend 2006-2012



The NAMA figures are daunting and do not include all of the Irish banks' property assets (a significant amount of investment property remains with the Irish banks) or any of the foreign banks' figures.

However the quantum of prime commercial real estate suitable for REITs is only a fraction of these figures, we estimate in the region of EUR 5-10 billion.

Control of Irish prime commercial property now lies overwhelmingly in the hands of the financial institutions – NAMA, the Irish banks and the foreign banks who want to dispose of their property interests at the right price as soon as possible. As Ireland does not have the firepower to acquire them, we need to attract international investors.

The recovery

The recovery has begun. Ireland has, without major civil disorder, weathered three years of austerity and hopefully seen off the threat of the euro collapsing. The very recent deal on the IBRC Promissory Note represents further progress on the road to re-establishing our sovereignty over our economy. International investors have demonstrated in a tangible way – investment in Bank of Ireland and in Irish bonds – their belief in the Ireland recovery story.

The Irish property market has emerged from its moribund stupor. Data from CBRE research indicate that in 2012 investment spend in Ireland amounted to EUR 600 million (71% overseas investors) up from the paltry figures of EUR 188 million, EUR 241 million and EUR 92 million for 2011, 2010 and 2009 respectively, but is still dwarfed by the staggering EUR 3.2 billion in 2006 (99% Irish investors (Figure 3)).

In the last 12 months Dublin has been invaded by international investors – hedge funds, private equity and others – seeking 'product'. Values, albeit from a low base, have increased. Reputedly 14 international investors were each prepared to pay over EUR 100 million for the State Street property (a 16,226 sqm office block and three-acre development site) which was acquired by Kennedy M Wilson for approx. EUR 107 million. This transaction alone would indicate a demand of EUR 1.4 billion of which EUR 1.3 billion remains unsatisfied.

The Irish REITs story

There are two chapters to the REITs story: the first campaign of the early 1990s and the recent REITs Forum's effort.

The motivation 20 years ago was to address a fundamental structural problem in the Irish investment market – the lack of international investment capital. As discussed above, this deficiency effectively curtailed the scale of Irish property projects and impacted on the attractiveness and liquidity of Irish property investments.

A formidable team of industry participants led by Bill Nowlan came together and a fighting fund

was collected. Representations were made to the key regulatory authorities including the Department of Finance, the Central Bank and the Stock Exchange. They were listened to, but after a series of circular redirections they gave up. The rock the campaign foundered on was never explained but perhaps it was too innovative and too soon; most probably it was because REITs had not yet been introduced in the UK. The campaigners went back full-time to their paid work.

The issue of REITs remained dormant until 2010 when the Irish property market was in a very different and darker place than 20 years before, however, the fundamental issue identified two decades earlier was still a problem – the lack of international investment capital. By this time the REIT regime in the UK was up and running smoothly, and it was clear that REITs could assist in the Irish property market's recovery.

In October 2010, to rekindle interest, Bill Nowlan wrote an article in the *Sunday Tribune.* titled "The government need to do the REIT thing to get the property investment market moving again", it exhorted the then Minister of Finance, the late Brian Lenihan, to introduce REITs.

From this spark the REITs Forum was created. Membership of the Forum was on a totally non-exclusive basis, it was simply made up of the parties who contacted Nowlan after his article was published and volunteered their services to assist. Its members include representatives from all disciplines and stakeholders in the property investment market.

The Forum's first meeting was held in the snows of January 2011. Over the following months it proceeded to compile, disseminate and advocate the compelling case for the introduction of REITs to Ireland. One member, NCB, assembled an extensive body of research on the REITs market globally and on the potential of REITs to help restore stability to the devastated Irish real estate sector. Another, KPMG, researched the tax aspects and opened a dialogue with the Department of Finance. An important development was the introduction by IPUT to the Forum of EPRA. A fruitful collaborative relationship developed, and senior EPRA personnel, Philip Charls, Fraser Hughes and Gareth Lewis, provided the Forum with invaluable technical support and encouragement.

Throughout 2011, a series of presentations were made to the Irish Stock Exchange (which joined the Forum), NAMA, the Department of Finance and the Central Bank. While the interest in REITs by all was >

"I will provide for the establishment of Real Estate Investment Trusts, which allow for investors to finance property investment in a risk-diversified manner. The introduction of REITs may also assist NAMA in deleveraging its portfolio and allow it to bring more sustainable activity to both the commercial and residential property markets. These property measures are also designed to create additional jobs in the property and construction sectors."

Irish Minister of Finance Michael Noonan

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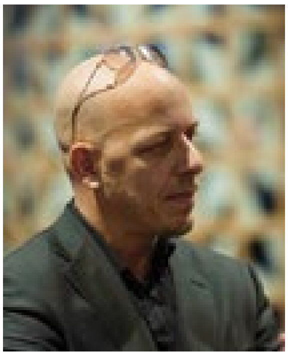

genuine and their responses largely positive, the Forum did not get the traction needed to get the necessary legislative change. The 2012 budget, disappointingly, did not include any reference to REITs.

In 2012, efforts were redoubled and significantly began to make more progress at senior level in the Department of Finance. John Moran, the newly appointed Secretary General of the Department and a lawyer who had worked in banking and finance in New York, understood REITs and recognised the role they could play in revitalising a key sector of the economy and assisting in the deleveraging of the banking industry. The breakthrough came in December 2012, with the inclusion in the Budget of a commitment to introduce the enabling legislation in 2013.

In late January 2013, the Forum held a major invitation-only conference *Introducing Irish REITs* in the iconic Convention Centre Dublin. A top class line-up of local and international speakers including senior representatives of the Department of Finance, EPRA and NAMA addressed an attentive and well-informed capacity audience which comprised delegates from all the key national and international interest groups.

The draft legislation that has now emerged is warmly welcomed by the Forum. It represents the first concrete step towards the establishment of REITs in Ireland. It proposes a regime similar to, but improved on, the recently refined UK model. It conforms to international best-practice with a corporate entity listed on the main Irish or other EU stock exchange with a distribution obligation of 85% of its net rental income. The full details of the proposed legislation, and the recent conference, are also on the REITs Forum's website www.irishreits.ie

Once the Finance Act is in place, the ball will pass to the Irish Stock Exchange to draft the listing rules for REITs. The legislative and regulatory framework will then be in place. After that it's over to the market and there are several possible candidates for an IPO. Irish REITs are getting ready to go!

Frank O'Neill is a Chartered Accountant and a Chartered Surveyor and is the Investment and Finance director of Dublin-based specialist property asset manager WK Nowlan & Associates. He has over 20 years' senior level experience in the Irish property sector and was previously a director of one Ireland's leading private property companies where he had responsibility for the management of an extensive portfolio and the coordination of major development projects.
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