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Coming to terms with changes in the property landscape

A combination of small changes has transformed the fundamentals of the property industry during the downturn

Summer is here and the property industry appears to be emerging from a long period of hibernation, but during that long four-year property winter, a number of changes have quietly altered some key fundamentals.

It is a combination of small changes: the shortening of lease commitments; upward and downward rent reviews; a change in tenants attitudes to accommodation, with the insistence by tenants on break clauses; new landlord and tenant law; the internationalisation of the market; public access to information on new lettings; high energy costs; new banking rules; the greening of the industry; new accountancy rules; new Vat complexity and Vat paid on rents not on some obscure calculation of capital value.

International model

We have hardly noticed these changes creeping up as we focused on survival. We are like the proverbial frog being gradually boiled to death in slowly heating water rather than jumping out if plunged in to the same hot water.

The holy grail of property investment was, in the old days, the letting of the entire building on a full repairing and insuring lease to a strong covenant for a 25-year term with upward rent reviews. Such new leases are now history, or exceptional, in this new paradigm. New tenants will just not sign 25-year commitments – or in many cases not even 10-year commitments.

Ireland has come in line with practices in the rest of the world particularly Europe, which has a standard three, six, nine-year lease break options (France and Belgium) or straight five-year term (Holland and Germany) or five and 10-year contracts (the US). Irish property law has moved to an international model: commercial leases and landlord and tenant law used to have a strong pro-tenant bias – now, as a result of modern legislation, straight arms- length contracts, usually without renewal rights, are the norm.

The result of all this requires a fundamental change in both the approach to managing buildings and the characteristics of property investment.

The first issue is the reliability of the cash flow, the second is the bankability of modern property investments, the third is the valuation impact of a less predictable income, the fourth is property management practices and the fifth is refurbishment/obsolescence conundrum.

It is not the end of the world because the European and American systems do work, and investors and developers do make money out of property but by a different set of rules. We have to learn the following new rules:

1 Your tenant is your customer and not a cash machine committed to giving you a guaranteed cash flow. Treat him or her badly and he will leave your building: treat him or her well and he may renew and indeed in due course take more space. In Europe tenants stay with landlords who look after them.
2 The single let building is no longer automatically a better investment than multi-let buildings. The logic for this is simple: if one tenant departs in a five tenant building then 80 per cent of the rent continues to flow. This also gives an opportunity for another tenant in the building to expand and for the landlord to upgrade the vacant space and to keep his building competitive in the market place.
3 Real estate is a business that requires active management. No more can the approach be to find a good tenant, sign him or her up and head off to the sunshine. Tenants in multi-let buildings expect service – all day every day. The concierge, greeting tenants' visitors, is greeting your clients also; the boiler that does not come on some morning is your problem.
4 The banking/funding issue. The days of the 75 per cent LTV with 10 to 15-year loans are over. A 50 per cent LTV loan will be the norm repayable over five or seven years. However, it is impracticable to finance long-term property ownership on the basis of a five-year loan – and much more equity will be required. Development finance will be scarce and probably only available for prelet buildings constructed by experienced developers with strong balance sheets.
5 The valuation base position will be a vacant building because with five-year breaks and upward and downward reviews the vacancy/cash flow risk will be high. There will be a premium to this base for multi-tenanted well-managed buildings that have demonstrated their capacity to stay fully let. Valuers will also have much higher regard to the state of repair of a building, linked to fewer bonus points for covenant quality.
6 Refurbishment of buildings will be more focused and programmed. In the old days of 25-year leases, a landlord could afford to refurbish a building to an "as new" condition before reletting. It is totally impracticable to fully refurbish a building every five or 10 years.

Active management

So, if we in Ireland think that life in property in the future is going to be like the past, then dream on. Our world has metamorphosed during the four- year property winter. Property ownership is a business with customers; the days of property being a sinecure are ending as the old FRI leases expire. The new way of property has arrived which is short leases, multi-tenanting, active management, uneven valuations and on-going refurbishment.

The good news is that it will work if managed properly; there is no macro change. There will still be the same volume of tenants paying the same rents (probably higher) as heretofore and the same volume of old buildings – but not new ones. However, there will be more competition amongst landlords for those tenants, which is probably good news for agents. Property performance, although more volatile, will not significantly change in the long term and property will still be a good investment, giving high dividend yields and capital growth but with more individual volatility. For the traditional non-institutional investor in property this news is bad as his or her risks in owning one or two properties increase significantly. But for the institutional investor, who will have seen all this coming and probably experienced it in his international portfolio, it is not such a huge change. For the small investor, it should persuade him or her to participate in multi-property portfolios through REITs or through other well managed vehicles.

However this all raises the following questions:
Is it temporary – will all go away when normality returns? I think not.
What will be the impact on rents and yields – if any?
How will the bankers go about funding property?
How will it impact new development?
Consideration of these questions will form another article.

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