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Market makes the second big switch in a decade

After the disruption of the boom years, the commercial property market is finally finding its way back to reality, writes **FRANK O'NEILL**

The Irish property world is going through convulsions. There are many casualties, among them the owners and managers of investment properties. As a consequence of either voluntary or forced sales, the ownership and management of property is changing, I call this the big switch.

The profile of the ownership and management of prime Irish investment property historically was the domain of three types of owners – property companies, institutions and high net-worth individuals/families. This profile changed dramatically in the last decade but it is changing again – the big switch has started and it will accelerate.

The principal determinant of the traditional ownership profile was access to finance – property investment is capital intensive. The traditional owners had access to capital, their own and bank funding. They operated at a scale that enabled them to employ expert asset managers and to create diversified portfolios of sufficient size to manage the specific risks (depreciation, physical obsolesce, tenant failure, lease termination, location deterioration, etc) of individual properties.

Portfolio theory tells us that an investor needs a minimum of 10 properties to counteract these specific risks. The traditional investors sought and invariably obtained an appropriate return to reflect these risks, provide a steady income and allow geared investors to pay interest and amortise their borrowings. The prime property world was small but the market functioned well.

A consequences of the tsunami of cheap finance that washed over us from the millennium until the credit crunch in 2007 was the transformation of the profile of property ownership. Banks provided funding to a vast array of non-professional property investors, and the ultra-competitive nature of lending market meant that the amount of equity required by borrowers was increasingly reduced. Our property bubble followed the classical asset price bubble model – starting with a period of rising values which attracted debt financing which accelerated the rise in values and this repeated itself until we reached the stage that the availability of debt alone fuelled further rises. Yields fell to unsustainably low levels – no longer offering an appropriate return to meet the needs of rational investors and not commensurate with the inherent risks and costs of property.

The traditional investors faded away. Property companies had already vanished from the Irish publicly quoted sector in the 1980s, a victim of the tax inefficiency of corporate property ownership structures, whereby rents are subjected to both corporation tax and income tax on dividends. The institutions withdrew from a market which was no longer rational. Traditional high net-worth individuals and families shunned the high-profile scramble for trophy assets at values that defied logic.

What had been a small, rational and professional market became totally fragmented and dominated by highly geared new investors and transaction-fee orientated promoters whose core competence was not property. During this period, the quality of the asset management of Irish property declined dramatically. The new investors did not have the benefit of a carefully constructed, diversified portfolio. A generation of property professionals switched their focus to lucrative deal making. Asset management was neglected.

We are now in a different place. Values have plummeted and lending is scarce and expensive. The banks want their money back. The vast majority of the geared investors have lost most, if not all, of their equity and are in default. Those that are not yet in default face extremely unpalatable loan-facility renewal negotiations. The banks' shopping list of lower loan-to-value ratios (LTVs) and faster loan amortisation offer investors the chilling prospect of cash calls, full cash sweeps and a tax bill on the profit rents.

Nama, the biggest lender of them all, has a well-publicised business plan which is predicated on the repayment of all its loans in a 10-year period, at the end of which, it will close up shop. This is to be achieved in three phases: Loan Acquisition – the transfer of €74.2 billion of the Nama banks' property loans to Nama; Debtor Engagement – the assessment by Nama of the borrowers capacity and competence to manage the assets and repay their loans; Loan Repayment – the implementation of the business plans of borrowers whose business plans were approved or enforcement (i.e. appointment of a receiver) over the assets of those whose business plans were not approved or who are deemed uncooperative.

Nama is two years into its grand project and is entering the third phase. We are starting to see the properties of compliant borrowers being sold with Nama approval and receivers appointed over the assets of the non-complaint. To date, some €5 billion of asset sales have been approved.

The other lenders in the market place are in essence "doing a Nama" themselves, albeit in a less public way and free from the rigidity of public procurement procedures. New structures and teams are quietly being put in place to manage the orderly work-out of their distressed property lending. Either by voluntary or receiver sales, the ownership and management of the vast majority of properties will change. This big switch is very big and is happening.

As a consequence, the profile of our prime property investment ownership will again be transformed. The new ownership and management profile of these prime properties will increasingly resemble the traditional, pre-boom profile but with subtle differences, the main players will be real-estate investment trusts (REITs), the modern incarnation of a property company, Qualifying Investor Funds (QIFs), institutions (mostly but not entirely foreign) and high net-worth individuals/families.

For REITs to play their part, enabling legislation will be required to eliminate the double tax inefficiency of corporate ownership.

The big switch will also see the return to the primacy of asset management. Irish prime property assets will return to effectively regulated, rationally constructed and well-managed portfolios and this will help us to avoid the boom-bust excesses of the past. Property values will fluctuate but it’s unlikely we will see the utter devastation of prime property investors equity again.

The coming years will be difficult but a much improved property industry will emerge.

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