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Recovery is just around the corner

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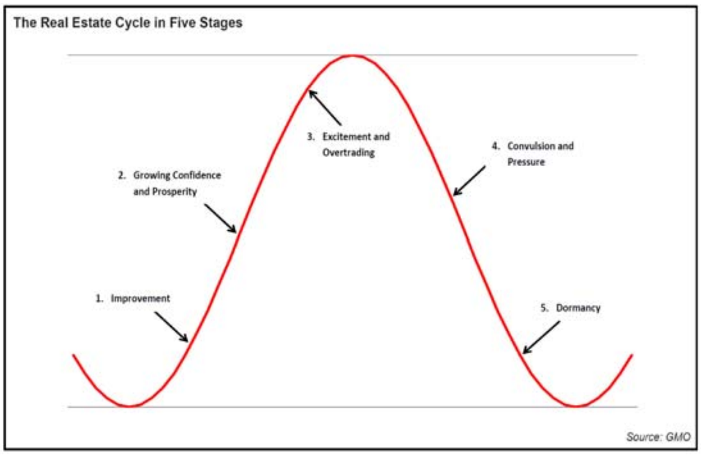
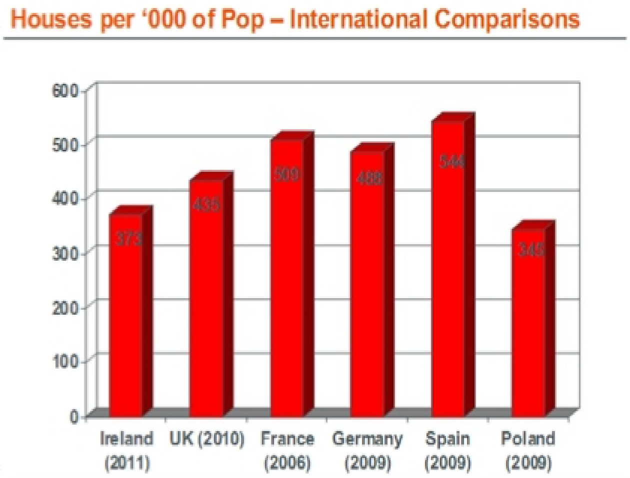
When the funding impasse is resolved there will be a 40 to 60 per cent recovery in prices for quality commercial property in Dublin





'Prospetity ends in a crisis. The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born, not an infant, but a giant." So wrote AC Pigou in *Industrial Fluctuations* (1927).

Back in 2004 I wrote several articles in these pages stating that the Irish property market was overheating and that a downward adjustment would happen soon. My phrase then was "trees do not grow to the sky".

While my diagnosis was correct my timing was wrong. My assertion was based, among other things, on my analysis of property cycles (see graph, above). The 1996 cycle should have been about to turn in 2004 but the peak was delayed a further three years and made worse by the banking bubble in Ireland, as was the case in the US and Europe.

We are now at or close to the bottom of that cycle and a keepsake in the current doom and gloom is the old saying: "Even the deepest ocean has a bottom."

Predicting property markets is not all that difficult – property cycles have been around for millennia – the hard bit is judging the timing. That timing is driven by economic, monetary, demographic and political factors.

My analysis of the current cycle envisages an inevitable scarcity emerging in the locations where people want to live and work. Most of the oversupply is either of poor quality or in the wrong locations.

If you want an apartment close to Dublin's IFSC or a modern office building in the same location then having an oversupply of flats or offices in Carrick-on-Shannon is not much help. Likewise, if you want a three-bed semi in Clontarf or Clonskeagh for your growing family then an oversupply of two-bed apartments in Sandyford is not much good.

What is critical is the realisation that there is not one big market but rather many sub-markets.

The inevitable recovery in demand and prices will be focused on locations that the market selects and not what the politicians, commentators or other observers want. Listen to the market – not what people say about the market.

The big drivers of recovery in this nascent cycle will be population growth, affordability and funding. Population change is of huge importance. Looking at Dublin, the recent census reported that the capital's population grew by 140,000 in the five years from 2006 to 2011 – a growth rate of almost 30,000 a year.

Population growth becomes a driver of demand for property. More people translates into demand for more bedrooms, more schools and more workplaces.

To spell it out, 140,000 extra people now live in Dublin than 2006 and a further 140,000 will by 2016. This will eventually give a demand for between 60,000 and 120,000 extra homes and, if the CSO predictions are right, then we will have a need for more than double that again by 2026.

Ireland already has one of the lowest housing levels per 100 population.

It has been argued that the alleged oversupply of Celtic Tiger output will meet this demand. Not true. The same census study shows that while the dwelling vacancy rate in Longford is 21.8 per cent and in Sligo is 22.2 per cent, the vacancy rate in Dublin averages about 7 per cent and 5 per cent in Dún Laoghaire. At 7 per cent this is only slightly above the normal "churn" rate for empty dwellings in a normal property market.

So much for expected population growth giving rise to demand – it's real and it's happening. A survey by Savills this autumn showed that the number of vacant homes in Dublin fell from 11,000 in March 2010 to 5,400 currently – most of the take-up was in lettings rather than sales.

What about prices and economics? Well, most property prices have fallen by over 60 per cent. A 60 per cent price decline puts property prices back to the 1990s. Prices up to 2002/2003 were affordable – the problem then was that supply could not keep up with demand.

So we are at the point where house prices are now affordable. What is lacking is confidence and funding. When confidence and funding do return, as inevitably they will (recessions do not go on forever), there will be a huge scarcity of dwellings in Dublin and prices will rapidly rise. In this context the issue is how high prices will rise, not if they will rise.

Price is the balance point between supply, demand and the availability of funding. It is also reflected in the ability of the supply chain to adjust to demand and the cost of labour and material, etc.

Costs are now substantially higher than prevailing prices and this will inevitably drive prices up in the long term. The cost of building new offices requires that rents have to almost double to restart that part of the development industry and similar factors apply in most of the residential markets.

Due to infrastructure bottlenecks and planning delays in the period after 2002 the supply chain in Dublin failed. Consequently house prices more than doubled (and land prices went into the stratosphere) and the unsatisfied demand spread to Kinnegad, Gorey and elsewhere in an unplanned way.

This is all history, but a history that is very likely to repeat itself because little is being done to anticipate this almost inevitable scenario in Dublin. The growth in Dublin's population is real but the failure to meaningfully plan and install appropriate infrastructure is also real. Installing threshold arterial water services is a five to 10-year undertaking – not to mention cancelled transport links.

But the recovery in values will not be uniform. Much of the new commercial space developed in the suburbs and the provinces was built in the wrong locations by incompetent developers, arising from bad planning decisions and often incompetent builders. Much of this is the commercial equivalent to ghost estates.

So looking at the property value cycle, where are we now? We are at the bottom in some markets and still slipping in others. Dublin city centre offices are at the beginning of a recovery phase with the prospect of likely yield compression as are inner urban residential rents and these markets will probably show a 10 to 15 per cent gain in 2012.

Good Dublin residential property is close to the bottom but a recovery will be patchy until funding returns.

When the funding impasse is resolved my prediction is for a 40 to 60 per cent recovery for Dublin house prices but only in those areas and of those building types that are in demand. A similar increase is in store for good commercial property. Bear in mind that a 60 per cent rise in prices is the same as a 30 per cent fall and will only bring us back to 2004 levels.

As to timing, I got the analysis right but the timing wrong in 2004 by three years but I don't expect to have to wait three years to be proven right this time.

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