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Credit crunch lets normality bite back

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OPINION&ANALYSIS: Loose credit for too long has left us with too many developers and too many poorly thought through 'developments', says **Bill Nowlan** .

WHAT IF THE credit crunch is normality and what we have been living through for the past six or so years is abnormality?

For most of my 40-year career in the property industry, credit has been hard to obtain. It did not matter if that credit was to buy a car, a house or to carry out a major property development.

Indeed, most consumer items - from white goods up - were bought on "the HP", a term that is almost derogatory with credit so easily available over the past half decade. Sure, I would have been a developer myself if I could have raised the cash and been prepared to take the associated lifestyle risk. Property development looks easy on TV but the reality is a bit different.

For most of those 40 years, for a developer to be taken seriously as a real developer he firstly needed a site with planning permission. To get banking he needed: a valuation of his scheme supported by comparable evidence; realistic development appraisal supported by QS estimates of costs; rent and sales prices supported by actual sales and letting evidence; and experience and substantial equity. By equity I mean cash.

For the past six or seven years many of these conditions seem not to have been required by would-be developers - all that was needed was the phone number of a convenient banker and, hey presto, you were a developer. You could be a TV developer. Also, people acted as if borrowed capital would never have to be repaid.

For professional property people among us, who have survived through the 1970s, 1980s and 1990s, the past few years have been very difficult.

Developments have had very little grounding in detailed analyses, market research or provable numbers. And why should they? Our professional analyses were always too conservative.

No analysis could anticipate prices rising by 20 per cent per annum and yields falling by the same amount in the same period. And it went on and on and on. It was all about the "feel for the market" and not cash flows and rational analysis. It went on so long that people like me were beginning to lose faith in the analytical model.

Of course, those who were in the game of musical chairs that has been a feature of the property industry since 2000, were right to play the game provided one applied the principle of make hay while the sun shines. But all good things come to an end and now, as Warren Buffet says, "we can see those without togs when the tide goes out" and there are certainly some people without swimsuits now.

For those would-be developers, waiting for the credit crunch to be over, is an illusion in the context of all the issues in the Irish property market. The simple fact is that we have too many developers with too many schemes for the size of the country.

We have demonstrated that we have the capacity to build nearly 100,000 houses and the equivalent in commercial and industrial space. We don't, or never will, need this amount of new-built space in any one year ever again.

We may need a little more than half of it and then only in locations that have special characteristics, including being close to the central business districts or well served by public transport and being priced to meet occupiers' capacity to pay out of normal cash income and not rely on capital appreciation to make up for any deficit in cash flow.

Dull old cash flow is now what it is, and will be, all about. This means to the investor that his rental income is sufficient to pay the interest bill with sufficient left over for repairs, depreciation and repayments. To the commercial occupier it means a monthly bill that does not take more than 5 per cent of business turnover. For the home purchaser, a mortgage bill that does not take more than 25 per cent of take-home pay. For developers it means banks that want to see realistic numbers supported by a big chunk of real cash equity.

As to the land speculators, if a plot of land has not got full planning permission, it is not a development - it's a shine in the eye of a greedy landowner and will be treated as such by financiers. A lot of silly money has been lost in land speculation and that truth has not yet come fully home.

These basic facts seem to be coming as a surprise to some people. They think (hope and pray) that this credit crunch is only a short term phenomenon driven by the sub-prime difficulties in the US.

Wrong, wrong, wrong - this is normality or close to it. What has happened in Ireland for the past six or seven years is the abnormality.

Good schemes by strong developers are still getting banking support. Let me spell that out. Good schemes - those with full planning (appropriate to a given market and locations with real demand) and driven by strong developers (those with significant cash equity and a track record) - are still being supported by their bankers.

In summary, the first reality is that many schemes that are now seeking banking do not meet the above criteria. Bankers once again are acting with common sense and are saying "no". Cash is king.

Banking is back to being discerning about development risk and capacity to deliver viable projects. The banking industry is no longer shovelling out money to make individual managers or branches meet sales targets ahead of the guy down the street.

The easy answer is to blame the credit crunch - the truthful answer is that the colour of the financial world has changed and that being a developer requires cash, experience and viable schemes. Cash is, and will be, scarce for a very long time - think in decades and not in months.

The second truth is that we have too many "developers" for the size of the market and the shrinkage process is going to be painful for the second tier of would-be developers.

As in all of life, when the pendulum swings too far in one direction, it equally corrects beyond the mid-point in the opposite direction.

So, to answer my initial question as to what is normality in the development industry, I believe that the pendulum will start slowly to return closer to a mid-point but on the credit-constrained side of the swing and with the bankers having learned one hard lesson which they will remember for at least a decade and maybe two.

What a pity we could not all keep our pendulum in the middle, then life as a banker, investor, developer and professional advisor would be much more manageable.

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