IRISHTIMES.com

Wednesday, May 21, 2008

Irish commercial property market paralysed by the banks and vendors

OPINION AND ANALYSIS: The level of real illiquidity being experienced by our market is startling, says **BILL NOWLAN** .

THE TWO MAIN and largely linked disadvantages of commercial property which the stockbroking fraternity love to tout are the high transaction costs and its general illiquidity.

It's difficult to disagree with either point at the moment. Now that the boom years are over and double-digit annual property returns no longer numb the pain of transacting in the Irish market, a stamp duty rate of 9 per cent is simply prehistoric.

It was increased from 6 per cent to 9 per cent in 2003 when things were very different and the rate is now tangibly counter productive both in terms of business promotion and ultimately revenue receipts.

It is an embarrassment on an international stage, most notably relative to our main property investment competitor, the UK, whose rate is 4 per cent and whose market attracts three times more Irish money than the Irish market itself.

However, transaction costs aside, the current level of real illiquidity being experienced by our market is startling.

Whether we acknowledge it or not, the Irish commercial property market is paralysed by banks, commentators and vendors in denial of the fundamental change in the market.

The raw undeniable fact is that "risk" has been reassessed over the past nine months and all assets are being considered afresh in the context of the risk/return premium above cash. Relying on historic reverse yield gaps or indeed positive yield gaps is simply no longer relevant.

Neither is suggesting that we in Ireland are somehow different or that it will all be fine when/if the ECB starts cutting interest rates and banks start lending and reducing their margins when they do.

So let's attempt to lift the lid then. What are today's real prime commercial market yields?

If you asked the majority of commercial property commentators this question last September I would suggest the answer would have been broadly similar, namely: prime retail shops at 2.5 per cent; prime shopping centres at 4 per cent; prime central business district offices at sub 4 per cent; and prime industrial at 5 per cent.

Some commentators are suggesting this is still the case (save for perhaps a 10 to 15 basis point movement). I don't agree, however, as the Irish market is caught in the headlights of denial there is limited transactional evidence to support this view.

I have little doubt that this will change over the coming months but deals which have not transacted in recent months are telling indicators.

Consequently, in the absence of hard evidence, we can only look to our most directly comparable market, the UK, where there is no shortage of evidence, for an indication as to what the reassessed risk premium is for commercial property.

In this regard, I have considered central London retail, prime shopping centres, a combination of West End and mid-town offices and M25 corridor industrial. If we consider the yield levels derived from recent transactional evidence within these sectors in the context of UK five-year money rates (a very relevant rate in the context of UK and Irish review patters) we can deduce a risk premium.

Applying the same proportional discount/premium to the ECB's five-year money rate (currently fluctuating around 4.3-4.5 per cent), the implied prime commercial property yield levels for Ireland can be extrapolated.

On this basis Irish yields would be as follows: prime retail - 3.25 to 3.5 per cent; prime shopping centre - 4.37 per cent; office - 4.37 to 4.5 per cent; and industrial - 5.25 per cent.

In addition, high street locations in secondary towns throughout the UK are trading at a 20 to 30 per cent discount to five-year money which would imply 5.0 to 5.5 per cent yield levels for similar product in Ireland. This is a substantial move for the sub 4 per cent territory being paid for this product this time last year.

Consider Bank of Ireland's provincial sale and leaseback portfolios at 3.9 per cent! If these implied yield levels were accurate the least affected sector would be prime industrial with a less than minus 5 per cent value move followed by prime shopping centres and office.

The hardest hit will be prime and secondary retail. In my opinion, until these adjustments are made UK property is simply better value than its Irish alternative and will continue to deter indigenous investment.

This may be a "ladybird" approach but as "back to property fundamentals" appears to be the by-line for commercial property in 2008, the approach would appear appropriate.

For most diversified institutional portfolios - the majority of which would exclude secondary locations - the implied overall fall in capital values over the last nine months would be around 12 to 15 per cent (not plus 1 per cent as suggested by the major indexes).

If correct, while representing unwelcome news, it is a far cry from the "crash levels" being quietly muted across the land and is consistent with, but less than, the experience of the residential sector.

In addition, it is substantially better than the Irish Stock Exchange whose general index peaked at 10,400 in June 2007 only to fall back almost 40 per cent to around 6,400 today.

In addition, there are a number of Irish shares I will not mention that managed to fall in value by more that 12 per cent in a single day over the past few weeks without major media attention. Given that investors in a certain US bank saw their share price fall from $35 to $5 over the same period, this is not surprising.

It is also important to note that for commercial property holders this is only a "book valuation" issue and for those who invest in property for the long term, which is how property should be considered, the real focus will be the property's rent.

In this regard, property has provided - and is likely to continue to provide - consistent and growing income dividends.

In addition, property offers the opportunity to actively asset manage it to improve and grow that rental income and off-set any negative fluctuations in yield movement.

Finally, while the ECB appears to be fighting the good fight on inflation and avoiding an interest rate reduction, many commentators, myself included, believe they will cave by 25 basis points at the beginning of 2009.

While some of this expectation is beginning to be again priced into long term rates its "actioning" will undoubtedly impact on long term money and should result in positive yield movement taking pressure off those who are concerned about the quarterly "book valuations".

Even if this rate fall does not occur, rate increases look highly unlikely even in the medium term. So long live commercial property in these turbulent times.

Now is a good time to buy at the right price - if your bank will let you. However, banks are going to continue to be apprehensive about lending until a value floor is established.

Bill Nowlan is chairman of WK Nowlan Associates, a management consultancy firm specialising in property asset management

© 2008 The Irish Times

This article appears in the print edition of the Irish Times