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Wednesday, September 24, 2008

Tighter lending to free up values for fall

After last week's upheavals in the financial markets, banking and its approach to property lending will never be the same again and values will adjust to this reality, writes **Bill Nowlan**

WITH SHOCK and awe I watched the unfolding financial drama over the past 10 days.

One major bank in liquidation, two others in shotgun marriages and one of the biggest insurance companies in the world effectively nationalised by the US government. Reading the Financial Times each day was like reading the chapters in a le Carré thriller.

Freely available banking finance has been the lifeblood of the commercial property bubble. That free availability is over - probably for at least a decade. If we thought we had problems in Irish property before last week, then we have far more now.

Banking and its approach to property lending will never again be like it was. So what will the new world be like?

Credit for property acquisition will be scarce. Credit will be expensive - no more margins of 70 basis points over LIBOR. Expect 2 per cent or 3 per cent over LIBOR.

Banks will have to lend mainly out of their deposit base and not be able to "securitise" loans - this is what gave access to almost unlimited funds.

Loan-to-value ratios will fall probably to around 70 per cent for high quality assets.

Borrowers will have to put up real cash for the difference between what they can borrow and the price of the property.

Bankers will be very selective about who they give their scarce money to - track records of borrowers will be paramount.

Non-recourse financing will be much more difficult to obtain.

Property valuation will be rigorously scrutinised by lenders. We may move to the US model of cashflow-based valuations.

The merchant banking business model as we have known it is dead. And "location, location, location" will regain its meaning.

So what's going to happen to property in Ireland in the next year or so?

First, a stark difference will emerge between actual income-producing quality investment property and the assets held by "commodity" property traders. The price of investment property will adjust relatively quickly to the new financial order. What that price might be, I comment on below.

But the real change will be felt in the realm of the "commodity" property traders. I mean those holding sites or buildings under construction or unlet buildings.

The price of "stock" of unproductive land or unlet/unfinished buildings held by "commodity" property traders will fall to the point where other traders, who have cash, are willing to pick up the pieces and hold them until the recovery.

The commodity traders' choice, if they have a choice, is to either sit out the glut of "work in progress" in the property business or cash in and take a severe financial "haircut". But for those with "commodity" assets, value will continue to seek a bottom - a bottom that will be elusive because those with cash will be slow to commit.

What the banks do and the attitude to their existing clients' holding of that stock of "commodity assets" will determine the depth of the property problem. If they support their clients then the problem will be temporary; if they panic and go for fire sales the problems will be much deeper and more painful.

Second, there has to be a psychological readjustment in the attitude to owning property. As Drummond famously said: "Property has its responsibilities as well as its rights." The responsibility of owning unproductive and overvalued property will gradually dawn on the non-professional investor. The taxi driver will stop boasting about the apartments he owns in Florida, Bulgaria and Malaga, and the financial advisors will take property off their sales pitch.

It will gradually be relearned that property investment is primarily a source of income and that income is dependent on it being located in a market with a real demand. It will be relearned that capital gain is a product of increasing income and not short term interest rate manipulation in Wall Street, Brussels or Washington. The term "yield compression" is one that we will be explaining to our grandchildren.

This relearning will be painful for many so-called "investors" who jumped onto the property bandwagon in the last few years.

They will have to realise that their money has gone forever and they now should check that they don't have a personal liability written in the small print of the bank loan.

Third, prices of investment property have to come back to levels where the income and its characteristics justify the purchase price. Where will that yield spectrum be?

Throughout my 42 years in the property investment business yields have an uncanny habit of hovering in the long term in the range of 4.5 per cent to 6.5 per cent for good retail to 5 per cent to 7 per cent for office and 8 per cent to 10 per cent for industrial. Will they come back there this time around?

Based on what has happened in the UK over the past 12 months, where the property market has been faster to adjust than ours, the answer is possibly "yes". However, the happenings of the past week will make a difference and move things to the higher end of these yield spectrums.

If I could get good quality investments at these price ranges I would be recommending my clients to buy in Ireland today. But, as to buying "work in progress" land or unfinished buildings, I would have difficulty with the price expectations of most vendors who still need to adjust to the new reality.

For those of my clients truly interested in long-term property investment, I have advised not buying in Ireland for several years - but that advice may be about to change.

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This article appears in the print edition of the Irish Times