Commercial Property Newsletter

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Irish Commercial Property Commentary

Summary

- **Sales of distressed properties are expected to increase, giving a clearer view on the overall markets condition**
- **The fallout of the government debt crisis in Europe continued to negatively impact Ireland's economic outlook**
- **Positive economic news: the manufacturing and services sectors have began expanding again**

There was some brighter news to go with the usual glumness for Irish commercial property in Q1 2010. The first three months of the year saw the largest take-up in office space since Q4 2008 as Kerry Foods and rating agency Dun & Bradstreet signed leases for large office premises. There was also activity in the Dublin retail market with Disney looking for a spot on Grafton Street and Kiehl's, a high end beauty products retailer, taking space on Wicklow Street.

Of Europe's twenty largest cities, Dublin now has the highest office yield. However, there is still a large shadow of vacant space looming over the market and this will place further downward pressure on rents. Vacancy rates in office space are very high compared to other European cities, while prime retail streets are seeing vacancies rise as the Irish consumer continues to decrease spending. Rents have already fallen 40-50% in commercial property from their peak levels so any further declines are not expected to be as severe.

A recent Royal Institute of Chartered Surveyors global report indicated that Ireland and the US are expected to have the largest increase in the number of distressed properties coming to the market in the coming months. Perhaps surprisingly, the number of distressed properties that have emerged in the market to date has been much lower than expected. This is due to a combination of NAMA and property lenders providing flexibility around loan conditions in order to avoid fire sales. If there is an increase in distress sales as suggested by the RICS survey, these sales may help to give a truer reflection of the exact state of the market at present. The lack of completed deals in the past eighteen months has lead to uncertainty around the true extend of the falls.

One sale which reportedly did complete was the purchase of AIB's Grafton Street branch by a British investor for €28m, a yield of around 6%.

There have been other developments in the market which may prove interesting to watch in the coming months. Green Property, an Irish investment and development company, is launching a €900m joint venture with private equity firm TPG Capital, with a view to investing in UK and Irish property. It remains to be seen how much of this will be allocated to Irish property. Additionally, Green is in the process of taking over an Anglo Irish Bank Irish property fund. The value of this deal will give a good reflection of property values in the market as a whole.

The economic news in Ireland has been mixed of late. The good news is that we are officially out of recession, mainly thanks to strong sales from multi-nationals. The bad news is that unemployment continues to rise and a record 444,490 people are now on the dole. Measures taken by the IMF and the EU have stabilised the government debt markets but a lot of uncertainty remains. All in all, the recovery is definitely taking place, but it remains tentative at the moment.

Irish Life Property Fund Information

- **Vacancy rate: 7.55%**
- **Average lease life across all properties: 11.7 years**
- **Current yield: 7.79% (as of 30/06/2010)**

Property in Focus

Block 1, Eastpoint Business Park, Dublin 3

Acquired in 2005, this property is leased to Oracle Manufacturing Europe Limited, under a 20-year lease from 1997.

Tenant: Oracle Manufacturing Europe Limited. The tenant has a strong presence in Eastpoint Business Park (with occupancy in 4 buildings). Oracle Manufacturing Europe Limited is a subsidiary of Oracle Corporation, a multinational computer technology corporation that specialises in developing and marketing software products, particularly database management systems. The company has a market value of $125 billion.

Building: This is a modern 3-story reinforced concrete structure, constructed in 1997, with 60 car spaces. It is fit out is to a good standard and is mostly open plan.

Location: The property is located in Eastpoint Business Park, which is located less than 2km north of the city centre. It is convenient to Dublin Airport (15 minutes via the port tunnel), and it is also located close to both the DART line and the East Link Bridge. Eastpoint Business Park accommodates many technology firms. Sun Microsystems, Cisco Systems, Eircom and Yahoo all have a presence in the Business Park.

Sub-market: Eastpoint is a submarket in itself and was developed in the late 1990's on what was formerly a landfill site. There are approximately 31 buildings in the Business Park, where Irish Life has other holdings. The area benefits principally from proximity to the city centre, the Docklands, the IFSC and also strong transport linkage.

UK Commercial Property Commentary

Summary

- **The pace in valuation increases has slowed as the market "pauses for breath".**
- **Vacancy rates have fallen in London office markets, but regional markets remain vulnerable due to over-supply.**
- **There are mixed signals from the economy, with 2010 GDP downgrades by the Bank of England coupled with some positive economic data.**

UK commercial property capital values continued to rise in the second quarter of 2010. Capital values have now increased for the past ten months but the pace of growth is slowing. Values have increased around 5.5% in the first half of the year. According to the Association of Real Estate Funds, UK institutional property funds raised a record €3.6 billion in Q4 2009. This momentum has not been carried forward into the first half of 2010, which suggests the brakes may be applied to the market momentum of late. Another reason for the market cooling slightly is the recent strength of sterling and increased investor interest in European markets.

In office markets, vacancy rates have fallen in London as tenant demand from financial services has increased and there are limited amounts of new space being delivered. As a result, rents on second-hand space should benefit but rental growth is not expected for 12-24 months. Outside of London, the story on offices remains bleak, with over-supply in a number of the larger regional centers still being an issue.

Retail is benefiting from a reduction in new development. This has not yet led to rental increases, but it has forced retail tenants to make decisions about taking up space in existing developments. However, retailers are beginning to feel the effects of Britain moving to a savings culture, as opposed to a spending culture, a change in culture which may be amplified by the effects of the UK's tough emergency budget.

From an economic perspective, all the recent talk has surrounded the emergency budget. The budget provided the first signal the new government will tackle the large fiscal deficit and the cuits necessary to achieve this may dampen the UK economy in the short term. Stubbornly high inflation levels have also lead to concerns the UK will have to begin raising interest rates sooner than anticipated, However the Bank of England have continued to express their belief that inflation is being driven by one off factors such as higher oil prices. There has been positive economic news from rising manufacturing levels, falling jobless numbers and increasing wages.

Overall the demand for property and increasing values seems to suggest the market was undervalued at its lows in 2009. The slowing of the markets growth rate in April and May is welcomed as there are many headwinds facing the market and the economy. Looking ahead, the recovery of the UK economy will remain the key issue, and the picture is hazy on this front at the moment.

Irish Life UK Property Fund Information

- **Vacancy Rate versus IPD index: 7.14% v 10.3% IPD**
- **Average lease life across all properties: 7 Years**
- **Current yield: 6.36%**
- **Is the fund fully or partially currency hedged: Fully Hedged**

Property in Focus

Omega House, Bradbourne Drive, Tilbrook, Milton Keynes

Tenant: Ideal Bathrooms Ltd

Lease: the property is let in its entirety to Ideal Bathrooms Ltd until 2025. However, there is an option to exit the lease by the tenant in March 2015, subject to 9 months notice.

Brief Description: The premises comprise a modern warehouse with ancillary office accommodation with a yard to the rear. There are approximately 60 car parking spaces

Breaking News: With less than five years to the tenants break option, the key to improving the properties value will be to improve the security over the length of future rental income. We have engaged the services of CBRE to open discussions with Ideal Bathrooms Ltd in order to negotiate the removal of the break option. If achieved, the certainty of a further 15 years income will have a significant impact on the property's value.

European Commercial Property Commentary

Summary

- **The first quarter of 2010 was positive for European commercial property, with values increasing in most markets.**
- **Investment volumes are being restricted by the huge amounts of property exposure already held by European banks.**
- **Europe's main economies of France and Germany continue to improve but the outlook for some peripheral countries remains weak.**

Market conditions continued to brighten in the first quarter of 2010. With very few exceptions, property yields fell across Europe, leading to increasing values. Given the low returns on cash deposits, and the recovery and uncertainty in global equity markets, investor interest in European property is growing. The flow of money into property is being fuelled by improving financing conditions. According to Jones Lang LaSalle, property Investment in Europe in the first quarter of 2010 totaled €5.4bn – more than double the volume of the previous year. The core European markets of the UK, France, Germany, Italy and Spain continue to be the main focus for investors, accounting for more than 80% of total transactions across Europe.

Given rental value declines are easing in some markets and have ceased completely in others, investors are becoming increasingly confident and have already proved willing buyers of prime properties at prices only moderately higher than long term averages. Focus has remained on properties with secure income and long leases.

With €970bn of commercial property debt outstanding in Europe at the end of 2009, there is a concern that banks may look to reduce their exposure to property which may have an adverse impact on property valuations. Additionally, given this large exposure to property, banks will be less willing to lend to the property sector, and this may serve to dampen the investment market.

From an economic viewpoint, the leading indicators in the euro zone increased by more than expected in the past four months, mostly due to a stronger performance in the core regions of France and Germany, but there are tentative signs these leading indicators are retreating from recent highs. However, the recovery remains in tact in the region. The German Bundesbank recently upgrading its growth forecasts for the German economy. The region is likely to benefit further from the weaker Euro that has been seen since the start of the year. However the outlook for the peripheral economies remains weak, particularly given the severe fiscal adjustment that will have to take place in Greece, Spain and Portugal.

July 2010 – Stephen Cass, Investment Analyst

Sources: Irish Life, ILIM

Other Sources: Bloomberg, Capital Economics, CSO, CBRE, DTZ, ESRI, IPD, Jones Lang LaSalle, Knight Frank, Prudential Research