Commercial Property Newsletter

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Irish Commercial Property Commentary

Summary

- **Irish commercial property returned -2.4% in 2010.**
- **Capital values were down -11% but rental income of c. 8% led to slightly negative returns.**
- **There is cause for hope in 2011 but continuing rental weakness is a big risk.**

This time last year we believed there would be a significant rise in investment transactions in the Irish market which would help us gain a better view of where the market was. We were partly right, as investment transactions increased by €150m to €242m; however this was still a low level and was not driven by NAMA sales as expected.

There are signs that things are stirring in the market and 2011 could be an interesting year. Believe it or not, 2010 saw a new office letting every second day in Dublin, with 130,000 square metres let to the likes of the Central Bank, AOL, Google, Betfair and Facebook well ahead of the forecasts for the year. These companies are taking advantage of flexible lease terms and low rent levels.

2010 also featured foreign investors dipping their toes in the Irish market. These long term opportunistic investors are being driven to Ireland in search of higher yields as the UK and other prime European markets experienced contracting yields during 2010. We expect to see more foreign investors emerging in 2011 but it may be in the second half of the year as foreign investors are still reeling from the IMF bailout.

There are still significant risks overhanging the market. Vacancy rates in the Dublin office market are stubbornly high at 23%. The good news is no more new space will be added in 2011 so this rate may begin to drop. The bad news is any job cuts in the public sector and financial industry won't help this rate, and even if it falls, vacancy is still at such a high level that rents will not be rising any time soon.

In the retail market, while a significant number of operators continue to enter administration, there has been an encouraging level of activity in prime areas with Disney, Pandora and Cult entering the Dublin market in 2010. However, the gap between prime and secondary assets is very large in terms of occupier interest, and this disparity will continue to be an important trend in 2011. Investors in high quality well located assets will almost certainly be better placed than investors exposed to lower quality properties.

In summary, it is not difficult to envisage 2011 as something of a turning point for the Irish commercial property market. Income returns of 8%+ certainly provide a buffer from the last of the capital value falls which hopefully will end at some stage this year.

Further rental declines are likely in the first half of the year in both office and retail markets but stabilisation may occur in the second half of the year. From thereon, it is hard to see any significant uplifts in property values in the short to medium term, so asset management initiatives will be key. Returns will be driven by the aforementioned high income levels. All in all, a softly softly approach is advised when looking at the Irish commercial property market, but it should not be altogether forgotten about as a potentially good investment during 2011.

UK Commercial Property Commentary

Summary

- **UK property achieved total returns of 14.5% in 2010.**
- **Investors were attracted to the UK in 2010 on the back of good pricing and a weak sterling.**
- **The pace of growth declined significantly in H2 2010; we expect this to continue in 2011.**

While property returns were impressive in the UK in 2010, there can be no doubting that these were driven by pricing revaluations which took place in the first half of the year and the pace of growth has significantly slowed.

The slowdown in the pace in growth is explained by the reducing speed of the swift reversal in yields which drove returns in early 2010. At the beginning of 2011, prime West End yields were 4% and prime City yields were 5.35%. With rising inflation causing bond yields to edge up in the UK, the risk premium of property over bonds is narrowing and further yield compression is unlikely.

The slowdown in the pace of growth in the commercial property market can be attributed to weakening investor sentiment and uncertainties around rent levels, which are very closely linked to the health of the overall economy. Demand is largely for well located assets with very good tenants as investors look for alternative income sources to the low yield provided by UK government bonds.

Outside London there has been, and there will continue to be, considerable differences in the performance of various cities and regions. Cities such as Liverpool which are heavily reliant on public sector employment may suffer from government spending and employment cutbacks.

Another feature of the market in 2011 will be more distressed selling by banks as borrowers break covenants. These type of sales have been mooted for the last two years but have not materialized to the extent that was expected. However as the market has now risen and is generally considered to be hitting something of a plateau, banks will likely finally look to reduce their property exposure through sales. NAMA will add to this trend, as UK disposals will be seen as a quicker way of recouping value than Irish sales.

In economic terms, recent news on the UK has been very disheartening. Firstly, the UK experienced a shock contraction in the economy in the final quarter of 2010 with GDP falling by -0.5%. Secondly, inflation continues to rise, and is currently running at 3.7% and the Bank of England governor Mervyn King recently outlined he believes it could rise to 5% in 2011. This worryingly high level could place upward pressure on UK property yields which would be bad news for property returns.

Irish Life UK Property Fund Information

- **No. of Direct Holdings: 19**
- **No. of Indirect Holdings: 5**
- **Vacancy Rate versus IPD index: 4% v 9.8% IPD**
- **Current yield: 6.26%**
- **Hedging: Fully Hedged**

Property in Focus

Blackfriars House, 379 South Row, Milton Keynes

Location: The property is situated in an established central location in the heart of Milton Keynes. Milton Keynes is situated 55 miles north of London and 70 miles south of Birmingham, adjacent to the M1 motorway.

Tenant: The property is currently vacant.

Lease: n/a

Brief Description: The property comprises a 4 storey office building of traditional construction, built in the 1980's and planned on ground and 3 upper floors. The property is served by a passenger lift to all floors.

The property is a poor state of repair and would require significant refurbishment in order to attract tenant(s).

Asset Management Initiatives: With the Milton Keynes leasing market in a depressed state the prospects for leasing the space (either refurbished or in its current condition) remain remote. For stock specific reasons including significant cost implications for holding the property (empty rates liability and general management expenses) a decision has been made to offer this property for sale.

European Commercial Property Commentary

Summary

- **2011 will be a challenging year for European real estate.**
- **Europe's markets will depend on the balance between investor appetite and the performance of its delicate economy, with inflation a big threat.**

Europe's economy performed surprisingly well in 2010, with GDP growth of c. 1.7% driven by a very strong German economy, which itself grew by c 3.5%. The outlook for 2011 is uncertain for a variety of reasons including concerns over the peripheral economies, slowing global export demand and, from a property perspective, the inevitable unwinding of banks balance sheets by reducing property exposure. The German economy, the engine of growth in 2010, is expected to grow at a slower pace of 2.5% this year, with GDP growth for the euro area forecast at 1.5%.

The threat of inflation in the euro area is not as bad as the inflation currently gripping the UK, but property investors should at least be aware of inflation as a threat to European markets. We have dealt with how inflation matters to commercial property returns in this newsletter in the past but it is worth going over it again. As inflation rises, the yield investors' demand for holding risky assets such as bonds and commercial property, also increases. This is because investors are worried about net retuns i.e. returns after inflation. Inflation is currently running at 2.2% in the euro area, above the ECB's target rate of 2%. High oil and food prices are a factor in this. Strikingly, Germany's import price inflation jumped to 12% in December, hitting its highest level since October 1981. Of all the threats to European commercial property returns in 2011, inflation is the biggest.

That said, there has been plenty of action in the investment market in Europe. Property agent DTZ recently reported that €29.1 billion of real estate changed hands in the fourth quarter of 2010, the highest level of activity in two years. There are significant sums of money looking to invest in 2011 and this number will likely rise again in Q1 2011 as investors appetitie continues to increase.

Another factor which will be important in 2011 is how banks deal with reducing their exposure to property. According to CBRE, European banks have almost €1 trillion of commercial property debt on their books, and over €180 billion of this is due for refinancing in 2011 and 2012. There is no doubt much of this debt will be in breach of loan to value covenants and at least some of this mountain of supply will hit the market by way of distressed sales. It is likely that prime assets will be held by the banks so it is the secondary and peripheral properties and regions that will suffer from any supply flood.

With European commercial property yields now slightly below long term average and a weak-ish economy, European property returns will be driven in 2010 by the income provided by properties. With demand increasing for both office and retail space, this is no bad thing.

January 2011 – 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