



# Commercial Property Newsletter

September 2010

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# Irish Commercial Property Commentary

## Summary

- ◆ **Irish commercial property has now fallen almost 60% since its peak.**
- ◆ **It is likely that the market is nearing its bottom as yields begin to look attractive.**
- ◆ **Distressed sales have not really happened as expected but there are indications NAMA and the banks are closer to making sales.**
- ◆ **The fragile economy means rent levels are the big threat to the market.**

The Irish commercial property market has fallen by close to 60% from its peak in 2007. This is the largest decline that the Irish market has experienced since records began in the late 1970s – and probably the biggest the market has ever experienced. While the short-term outlook still remains challenging for the Irish commercial property market, we believe that the longer-term outlook for the commercial property market is beginning to look attractive.

One way of assessing the value of Irish commercial property is to compare prime property yields with government bond yields. Government bonds would be considered a much safer investment than commercial property and you would expect property to have a higher yield than government bonds. The spread between property and bonds (prime office yield minus 10 year Irish government bond yield) stands at approximately 1.20%, which is close to historically high levels. Furthermore, when we factor in that Irish government bonds are themselves trading at significant yield spreads over German government bonds, it only serves to underscore the potential value in Irish commercial property.

In terms of market news, there is a very large amount of vacant space in offices, retail and industrial sites throughout the country. However the amount of enquiries from tenants seeking space has increased. Google recently leased a large portion of office space in East Point Business Park in Dublin and Ebay, Yahoo, ESB, the Central Bank and other large operators are said to be actively looking for space. The majority of new lettings look like they will be in the office sector, as the retail sector continues to suffer from stagnant retail sales. Tesco and TX Maxx both recently announced expansion plans which are good news for the retail sector.

There were no major investment transactions of note in the past two months but with yields stabilising it is likely that NAMA and the banks will begin to offload properties and this will help give a true picture of where the market is heading.

The main threat to the market comes from concerns about the ability of tenants to pay rent, particularly in the retail sector. Rents have already fallen quite considerably over the last number of years and based on these much lower rents, and the long-term future for rents is largely dependent on the state of the economy. As we are all aware, things are difficult from that perspective but are improving. Unemployment rates are stabilising, albeit at a very high rate of 14%. GDP growth is expected to be slightly positive in 2010 and it can be hoped that a strong reviving German economy will help drive the euro zone forward and benefit the key Irish exports sector. On the downside, retail sales have weakened after a good second quarter in 2010 and there is still a lot of uncertainty surrounding the banking sector and the impact of NAMA.

# 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 values rose by only 0.21% in July. While marginally positive, this was the fourth month in row the index showed a decline on the previous month. In the past twelve months capital values have now risen by 15.4% and the ‘all property’ yield has fallen 1.4% from 7.9% to 6.50%, below the long run average of 6.8%. This suggests the pace of growth in the market may now slow as investors look to other markets and asset classes for income.

In economic news, the Bank of England revised its economic growth forecasts for 2011 and 2012 lower, attributing the downgrade to tight credit conditions, lower confidence and the austerity measures that were put in place by the government in June. Despite this, recent economic data that has been released has generally been stronger than forecast and is fuelling expectations that Q3 GDP growth could be ahead of expectations. For example, retail sales were stronger than expected; manufacturing levels are up and the government’s budget deficit fell.

A weaker than expected UK economy could impact the commercial property markets in two ways. On the one hand it will stifle interest from international investors, especially as yields are now stabilising. On the other

hand it may mean that interest rates are kept very low and property yields will look attractive to income seeking investors, which would serve to drive demand. The likelihood is that there will be an element of truth in both sides of the coin and demand will stabilise in the coming months as the market settles into a period of more normal growth.

With regard to office markets, the government looking to cut public sector expenditure will inevitably lead to some job cuts. This will particularly hit some of the UK’s regional cities which have a large public sector presence. On the plus side, the London City and Canary Wharf markets are now experiencing growth and the regional markets tend to follow these markets with a lag. However, given the weak outlook for the employment and high vacancy rates, the pace of recovery in regional office rents is likely to be very modest.

The moderate economic outlook suggests that retail rental values will continue to struggle. High unemployment, rising taxes and the prospect of renewed falls in house prices could lead to consumer spending falling despite holding up reasonably well in the first half of 2010. With demand for retail space at a low level and incentives to lease space to tenants rising in the short term we expect rental values to remain under pressure.

## Irish Life UK Property Fund Information

- ◆ **No. of Direct Holdings: 19**
- ◆ **Vacancy Rate versus IPD index: 7.24% v 10.2% IPD**
- ◆ **Average lease life across all properties: 7 Years**
- ◆ **Current yield: 6.18%**
- ◆ **Is the fund fully or partially currency hedged: Fully Hedged**

### Property in Focus



25/27 Petty Cury, Cambridge

**Location:** Cambridge is considered one of the premier retail centers in the UK due to its large affluent population. As such it is in high demand from retail occupiers seeking representation in the City.

**Tenant:** Nationwide Building Society is considered one of the strongest financial institutions in the UK and was largely unaffected by the banking crisis. The Building Society did not require any Government intervention during the past two years. Global Finance magazine recently ranked Nationwide Building Society among the world's 50 safest banks.

**Lease:** The property is leased in its entirety to Nationwide Building Society for 14 years nine months from January 2004. The next rent review is in October 2013 and due to the flexibility of the property can be reviewed on the basis of an individual retail premises or two separate premises.

**Brief Description:** The 7,097 square foot property contains two retail units with ancillary offices, storage and staff facilities at basement, first and second floors.

Nationwide occupy the ground, first and second floors of 26/27 Petty Cury with the ground floor and basement of 25 Petty Cury occupied on a sub-lease to Faith Footwear Ltd.



# European Commercial Property Commentary

## Summary

- ♦ **Europe's economic recovery has been impressive in the past few months, led by a resurgent Germany.**
- ♦ **Investment volumes are increasing.**
- ♦ **Yields are declining but not at a very fast pace, leading to moderate capital growth.**

The vast majority of European economies have now exited recession with Germany leading the way (Germany recorded export driven growth of 2.2% in Q2, the fastest in over twenty years). France also recorded an increasing rate of growth in Q2 although Spain continued to struggle returning growth of a mere 0.2%.

Of roughly 50 European cities tracked by property agent CB Richard Ellis, 16 experienced falling yields in Q2 2010 while only four experienced rising yields, showing that the general trend in Europe is positive. Rental growth was largely negligible across the continent, which is a good sign as it looks like the worst of the declines in rent are over and areas such as Paris and Stockholm experienced growth.

The level of investment activity across Europe is also on the increase. According to DTZ Research, transaction volumes of €41 billion are up 85% in the first half of 2010 compared to the first half of 2009. Interestingly retail has been the most sought after asset, as well-let shopping centers' are seen as being a safer asset by defensive lenders.

Europe's office markets are generally seeing a good increase in the amount of new lettings. This is almost exclusively limited to prime offices as tenants look to relocate to good quality locations at discounted rents. Rental growth or no growth was experienced in the core

European markets of France, Germany and Western Europe, while Southern European markets such as Portugal and parts of Spain continued to experience falls in rent.

In the retail market, consumer and retail confidence indicators have improved and there appears to be enough stabilisation for retail tenants to begin looking at expansion plans. Due to the capital intensive nature of developing shopping centres', there is limited space due for delivery in many markets up to 2011 as the effects of the 2008 recession are felt. The supply of retail property is limited in many markets when compared to the forecasted future demand and this will be positive for rental growth in cities such as Paris, Milan, Munich and Stockholm. On the flipside, markets such as Barcelona, Berlin and Dublin face oversupply and this will put downward pressure on rent levels.

Overall valuations now look reasonable in Europe and the improving economy is very positive. However economic forecasts are for moderate growth and the health of property markets is highly correlated with economic growth in the long run. As such, moderate growth can be expected in the core European markets, provided there isn't very large capital growth in the coming months as that would likely lead to falls in future and a bumpy investment ride.

*September 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*

**Warning: The value of your investment may go down as well as up. Investments may be affected by changes in currency exchange rates. Past performance is not a reliable guide to future performance.**