Irish Investment Market Review

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part of the UGL
global network

Investment Market Review
Economic Background

While the economic backdrop in Ireland remains challenging, indications would suggest that the worst has passed for the Irish economy.

The Irish economy has now exited recession and remains on course to achieve modest growth in line with forecasts of less than 1% for 2012 and further expansion of GDP in 2013. The recovery remains two-tiered with strong growth in the export sector offsetting sluggish domestic demand. While domestic demand remains a drag on GDP, the latter part of 2012 saw gradual signs of stabilisation in activity in the domestic economy.

The Exchequer outturn for 2012 highlights the continued improvement in the public finances. Figures released by the Department of Finance reveal that the Exchequer deficit fell to €14.9 billion in 2012; approximately €10 billion lower than the same period in 2011. Tax revenue grew strongly in 2012, outperforming expectations as tax revenue rose to €36.6 billion; an increase of €2.6 billion or 7.7% on 2011 revenues. Exchequer expenditure in 2012 was in line with targets despite overspends in health and social protection. These latest figures mark a positive development and are likely to further boost international investor sentiment towards Ireland.

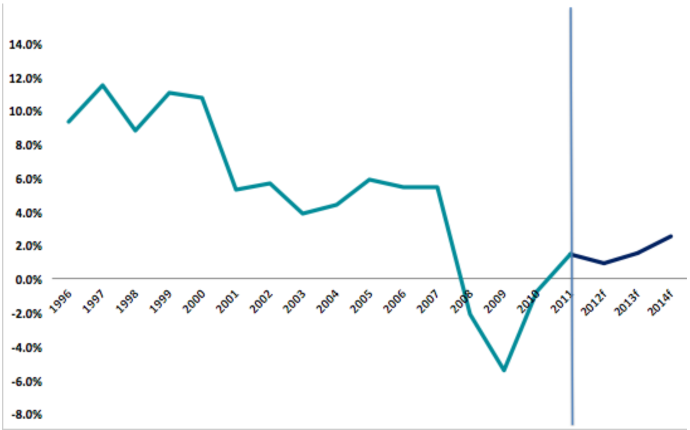
> **"The worst has passed for the Irish economy"**

Ireland has successfully concluded the eight review of the EU/IMF "Programme of Fiscal Consolidation". Ireland's committed policy implementation has continued with the 2012 deficit on track to come within target. Budget 2013 has introduced measures to enable Ireland to meet its 7.5% deficit target for 2013, and the government remains committed to bringing the deficit below 3% by 2015.

In line with Ireland's adherence to the EU/IMF programme targets and policy announcements at a European level, 2012 witnessed a significant decline in Irish Government bond yields. At the end of 2012 the yield on Ireland's benchmark 2020 bond stood at 4.43%, a significant improvement when compared with 8.26% at end 2011. Furthermore, the rate of decline in yields on shorter maturities was even more pronounced. While Ireland's return to the private markets in autumn is tentative, the National Treasury Management Agency (NTMA) has made considerable progress in its phased return over the past year. Furthermore, the financial markets perception of Ireland was boosted by a €2.5 billion syndicate bond sale in January of this year from predominantly international investors.

Figure 1

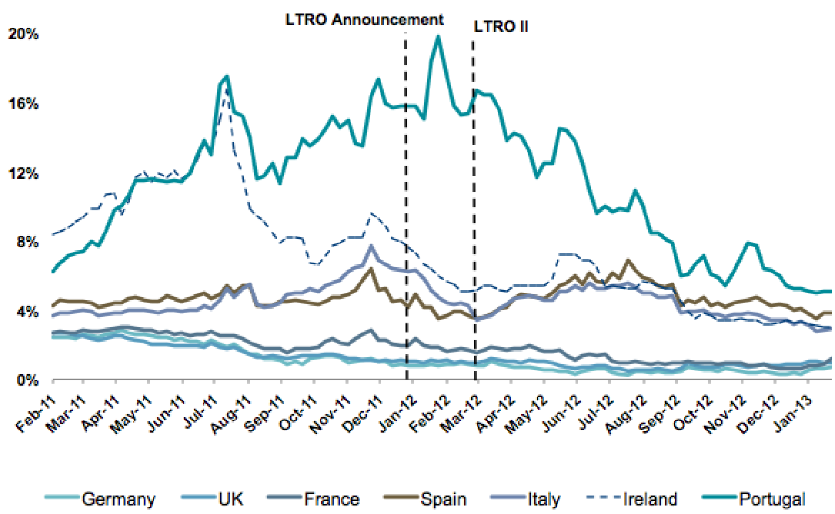
Gross Domestic Product (Annual %)



Source: CSO/Department of Finance

Figure 2

5 Year Government Bond Yields (%)



Source: Bloomberg

Irish Investment Volume

2012 proved to be somewhat of a turning point for the investment property market with the volume of transactions reaching a five-year high in 2012.

While the year opened to a relatively fragile market, signs of recovery emerged as the year progressed and activity levels gained momentum. The final quarter of the year witnessed a strong uplift in investment volumes which boosted the overall investment asset transactional turnover for 2012 to just over €624 million. This represents a significant increase on the same period in 2011 when volumes were €192 million. One notable deal not included in the €624 million is the sale of the Bank of Ireland premises on Baggot Street which achieved a reported €43 million. The majority of the building is vacant and as such is not an investment but this transaction demonstrates the investor confidence in the Dublin CBD sector.

The recovery in activity levels was long awaited and well received by the market. The turning point for the market began with the property favourable Budget in December 2011. In particular, the reduction in stamp duty from a rate of 6% to 2% coupled with the introduction of considerable Capital Gains Tax incentives aided the market recovery. Furthermore, the removal of the uncertainty concerning retrospective changes to upward only rent reviews that haunted the market in 2011, has had a very significant impact as evidenced by the marked increase in both the value and volume of transactions in 2012.

> **“ The recovery in activity levels was long awaited and well received by the market ”**

The market saw a strong level of both domestic and international buyer activity with many new partnerships marrying sector expertise with equity. Many of these new entrants have put platforms in place and have a strategy to assemble a property portfolio they can actively manage.

While funding remains challenging it has become less of a barrier to activity levels in recent months. The provision of NAMA staple finance on a number of key deals assisted buyers fund acquisitions.

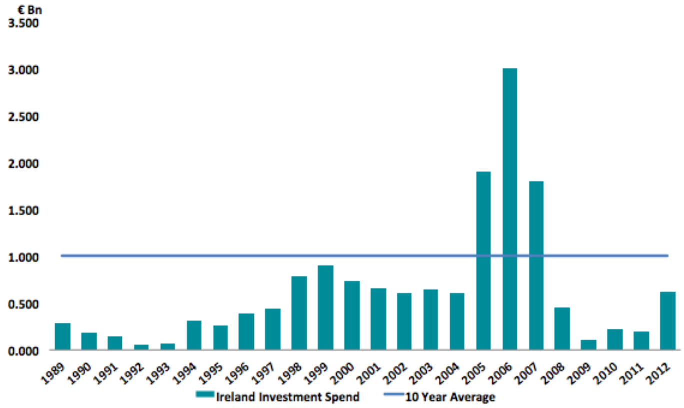
There was a notable increase in buyer demand and formal sales in the market in the second half of 2012 with an expectation that this is set to continue for 2013. Buyers have invested time over the last number of years in researching the market and undertaking due diligence and, as a result, when the right asset came up for sale they were able to move quickly. The controlled release of sales by major funders is creating some liquidity in the market, although demand for prime assets continues to exceed supply.

The investment volume level comprises asset sales and is not inclusive of loan sale activity or figures for trading assets. Loan sales were approximately €750 million and hotel sales approximately €150 million. With these loan sales and all trading assets the total commercial market activity is estimated at approximately €1.5 billion for 2012.

> **“ Highest annual turnover in five years ”**

Figure 3

Irish Investment Market Turnover, €Bn



Source: DTZ Sherry FitzGerald Research

Investment Market Review
Investment by Sector

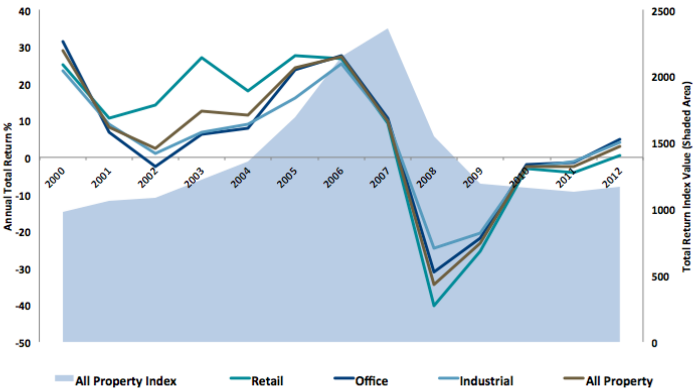
Performance in the Irish investment market is best illustrated with figure 4 which depicts total return in Ireland's commercial property market. Following a boom of epic proportions, the Irish commercial market saw returns fall by an equal magnitude over the last number of years. However, the latest data from the Investment Property Databank (IPD) reveals that 2012 marked the first annual positive return for the Irish market since 2007.

According to IPD, total return for 2012 stood at 3.1%, boosted by strong income returns of 10.1%. Income yields are very competitive at present, thus attracting the attention of international investors. Capital values on the other hand continued to decline during 2012, albeit at a much reduced rate. Capital values fell by 6.4% during the twelve month period; while remaining in negative territory it compares favourably to a reduction of 11.4% in 2011. IPD's index shows a cumulative decline in capital values of 67% since the September 2007 peak.

> **"The office sector was the strongest performing sector in 2012"**

Figure 4

Irish Commercial Market - Total Return (Annual %)



Source: IPD

Office Sector

During 2012 investor demand was drawn towards a few key sectors specifically Dublin Central Business District (CBD) offices and block residential investments. Investments sold in these sectors have been much sought after by both international and domestic investors.

The office sector was the strongest performing sector in 2012 according to the latest IPD figures which show a total return of 4.9% for 2012. Office capital values have fallen a long way; however the rate of decline eased to -5.4% during 2012. This followed a notable reduction in the rate of decline during the year with just a 0.9% fall recorded during the final quarter of the year. Income yields were also very competitive, with office assets offering 10.9%. The office sector accounted for the largest share of investment transactions in 2012, comprising 67% of the market by lot size. In particular, the Dublin CBD office sector dominated much of the activity.

“Office sales accounted for 67% of the annual investment volume”

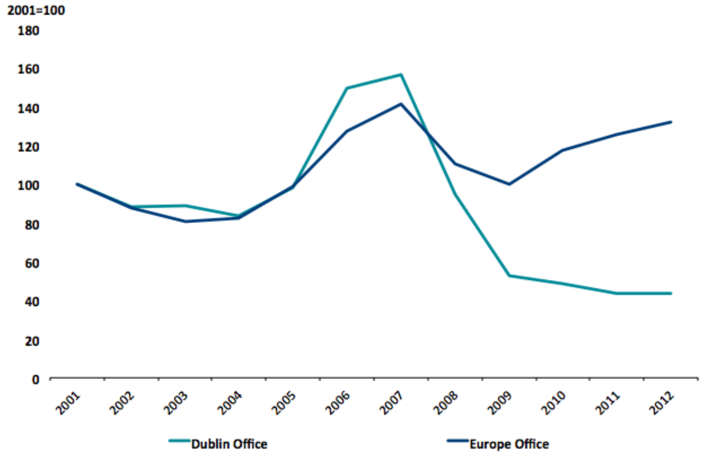
The demand for this sector is driven by the market fundamentals and expectation of both rental growth and capital appreciation. The Dublin office market has witnessed changing dynamics in occupier trends, more specifically; the stock of grade A space and in particular newer A1 space continues to diminish due to increased activity and has not been replenished. Furthermore, 2012 witnessed strong demand from foreign direct companies; however the ability to attract major FDI projects could potentially be impacted by the limited supply of modern office buildings with large floor plates. As supply levels in the CBD recede, prime rents are unlikely to increase immediately. However, the incentives available on existing new grade A space are showing signs of tightening and lease flexibility beginning to diminish. That said, 2013 could see some isolated cases of rental inflation, however this will not be an indicator of a wider trend in the market.

There is a new confidence among investors which is borne out by the interest in acquiring good quality well positioned vacant office buildings for refurbishment. Vacancy and short income in these properties is being viewed as providing an opportunity. Along with pricing, buyers have to demonstrate their track record and ability to execute the deal in relatively tight time scales; this is likely to become a key factor for vendors in 2013. The competition has resulted in price levels exceeding expectations for prime, fit for purpose assets as supply remains limited. As a result the yield range between prime and secondary assets has widened. There is limited demand for secondary stock which requires funding.

There are many tenants also emerging in this sector and considering a move away from leasing to owning their own headquarters building. This may be an interesting sector to watch in 2013.

Figure 5

Dublin Office Capital Values



Source: DTZ Research

Investment Market Review

Retail Sector

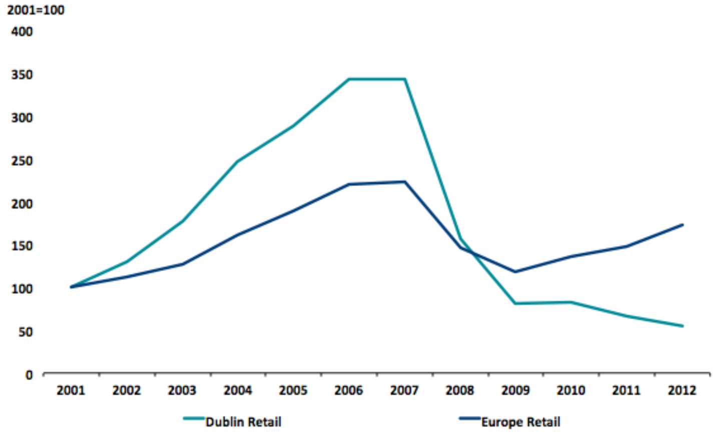
The retail sector, which remains susceptible to adverse economic developments, continued to struggle during 2012 accounting for just 11% of the overall volume of investment transactions. The latest IPD figures reveal that total return weakened during the latter half of 2012 and as a result, registered a return of just 0.5% for the year as a whole. The quarterly income return was steady during the year with 8.8% recorded for the year as a whole. The retail sector suffered the strongest sector decline in capital values falling by 7.6% in 2012. This brings the cumulative decline in capital values to -71% since the peak in December 2007.

Industrial Sector

The appetite for industrial investment was subdued during 2012. The industrial share of the total volume of investment transactions stood at just 5% in 2012. According to the latest IPD, the industrial market delivered a total return of 4% for 2012. However, capital values remained weak declining by 7.2% during the twelve month period. In terms of rental declines, the industrial sector was the worst affected, declining by 5.8% in 2012.

Figure 6

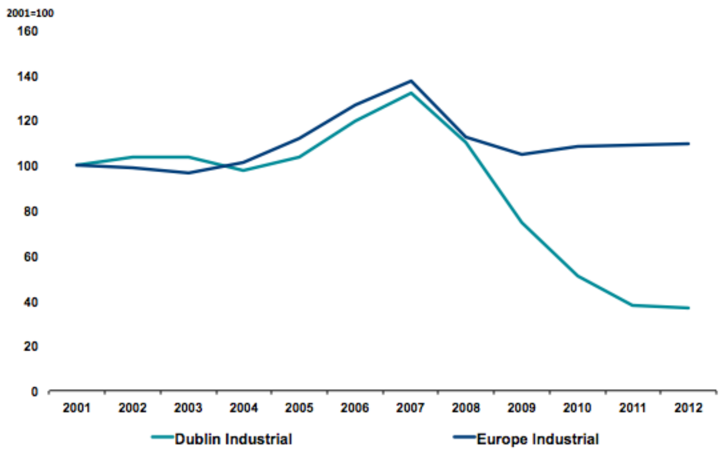
Dublin Retail Capital Values



Source: DTZ Research

Figure 7

Dublin Industrial Capital Values



Source: DTZ Research

Residential Investment Sector

2012 saw an influx of institutional investors seeking residential block investment, specifically focussed in Dublin.

This relatively new 'multi-family investment' sector recorded over €80 million in sales in 2012, encouraged by a significant growth in the number of rented households in the overall rental market from 2006 to 2011. The latest census 2011 figures reveal that a total of 305,377 households were rented from a private landlord, an increase of 110% when compared to 145,317 households in 2006. 2012 also saw a general improvement in rental levels due to a more limited supply.

The most significant deals transacted during the year included The Alliance building at the Gasworks in Dublin 4 for a reported €40 million and Sandford Lodge in Ranelagh for €27 million; both acquired by Kennedy Wilson. Other notable sales included blocks transacted on North Circular Road and in Dublin 3. Furthermore, there was one large portfolio assembled with a large quantum of units in Tallaght, Dublin 3 and in Cork with a guide price of €75 million which as yet has not transacted.

> **"2012 saw an influx of institutional investors seeking residential block investment, specifically focussed in Dublin"**

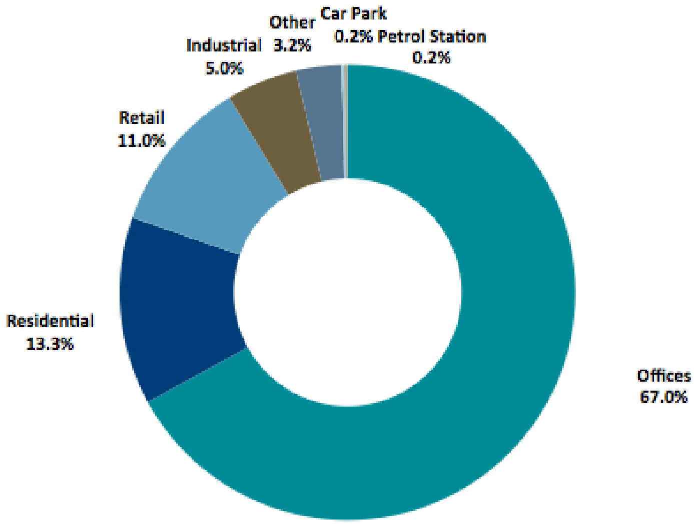
Gross yield ranges have been in the order of 7.5% - 10% but operational costs fluctuate and as a result net yields do vary notably from development to development. Investors are underwriting the investment based on a rent, yield and break-up approach. This is location specific but it can also be impacted by the seven year capital gains tax exemption.

Residential block investments are viewed to be liquid with multiple exit options possible, such as break-up, block sale or in some instances perhaps even REITs.

Interestingly, in addition to the aforementioned US investor Kennedy Wilson, investor appetite has been evident from private domestic, UK, US and Israeli funds.

Figure 8

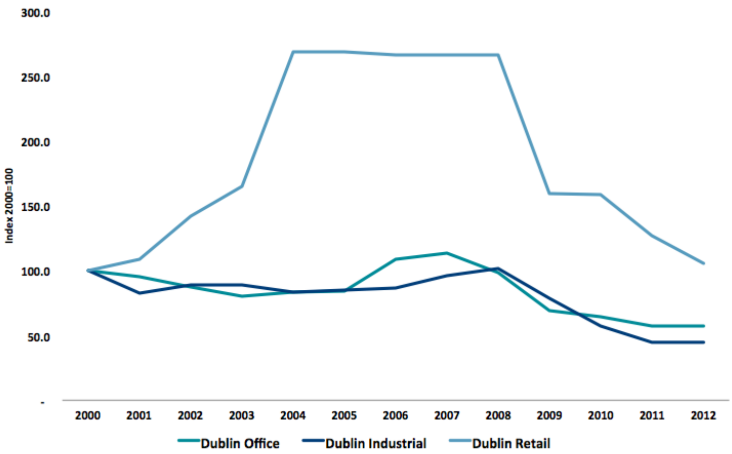
Completed Investment Transactions for 2012: Sector Analysis



Source: DTZ Research

Figure 9

Dublin Prime Rents



Source: DTZ Research

Investment Market Review

Table 1

Table of Notable Deals 2012

Property	Price	Sector	Net Initial Yield	Vendor	Purchaser
One Warrington Place, Dublin 2	€27.4m	Office	7.42%	D2 Private / NAMA	Northwood Capital
Riverside II, Sir John Rogerson's Quay, Dublin 2	€35m	Office	8.74%	Alanis Consortium / Lloyds	AM Alpha
Carrisbrook House and 122 the Mews, Pembroke Road, Ballsbridge, Dublin 4	€16.3m	Office	7.16%	Danske Bank/NIB	Unknown
State Street Building & Site Sir John Rogerson's Quay, Dublin 2	€108m	Office & Site	6.93%	Ulster Bank/ Receiver	Kennedy Wilson
Sandford Lodge, Ranelagh, Dublin 6	€27m	Residential	6.93%	Receivership / Lloyds	Kennedy Wilson
The Alliance, Gasworks, Ringsend, Dublin 4	€40m	Residential	7.90%	Receivership / Ulster Bank	Kennedy Wilson

Source: DTZ Sherry FitzGerald Research

Outlook for the future

Looking to the year ahead, the expectation is that transaction levels will exceed 2012 levels. In particular, loan and portfolio sales are expected to be a growing element of the market with potential for subsequent sub sales.

The yield on 5-year government bonds has fallen from over 16%, at its height in the summer of 2011, to just over 3% in January, which is a positive indicator for investors. This current significant gap between property yields and bond yields is also seen as fundamental value for investors.

The Irish property market now sits firmly in the international capital markets and will be acutely influenced by all of these prevailing conditions. The overall effect of this should lead to a more functioning market with greater activity levels over the long term. The capital gains tax window for investors to December 2013 should see a push from both buyers and sellers to transact before year end. The key for 2013 is to see an increase in supply in response to demand levels which would allow volume to increase further. This should facilitate the attraction of additional funders into the market and help the recovery to a more functioning market.

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