

2009 will not be remembered as a vintage year by property investors. Capital and rental values dropped precipitously across all sectors of the Irish property market against the backdrop of the worst economic contraction since the 1930s. The lack of market liquidity was exacerbated as the market awaited the outcome of the government's creation of the National Asset Management Agency. The Irish economy experienced a sharp slowdown as the impact of rising unemployment and falling disposable income hit consumer spending. The consequent impact on retailers and retail property in particular throughout the year, has been considerable. Although the Irish economy continued to suffer more than most of its Eurozone counterparts, there have been initial signs of stabilisation and opportunistic buyers for commercial property have started to emerge.

Other Western European property markets have not experienced as significant a slump and there have been signs of improvement in the third-quarter, with a clear investor preference for prime assets evident. The Eurozone economy showed signs of growth in the third-quarter, following five straight quarterly contractions. The UK market has been particularly buoyant in the second-half of the year with yields for prime assets being driven down by strong demand, primarily from foreign investors.

## IRELAND

The ongoing uncertainty in the Irish commercial property market was highlighted by a further fall in returns in the third-quarter. The IPD/SCS All Property Quarterly Return was -6.7%, 60 basis points worse than in the second-quarter. With a further quarterly decline of 9%, capital values have now fallen over 50% from the September 2007 peak. Offices replaced retail as the worst performing market sector in the third-quarter with a total return of -6.8%, as market values fell by -8.7%. Illustrating the magnitude of the decline, prime office returns have fallen over 35% in the year to September 2009. The retail sector was the only one to experience a deceleration in the pace of negative returns, generating a total return of -6.5%, a reasonable improvement on the -8.3% recorded in the previous quarter.



The investment market remains weak, with transactional activity low despite the completion of the sale of the Tommy Hilfiger store on Grafton Street in September to a leading German fund for a reported yield of 6.5%. However, agents continue to report interest for prime property assets from both overseas and local purchasers attracted by yields at historical highs. The number of properties that are currently being openly marketed may be initial evidence of a perception that the rise in yields may be stabilising. The scarcity of finance is not helping competition in the market place. Investors remain risk adverse - a point demonstrated by the reported

collapse of the sale of the McDonalds unit on Grafton Street following the recent introduction of legislation banning upwards-only rent reviews by Minister for Justice.

Overall tenant demand remains weak and the misfortunes of the EP Mooney and Budget Travel brands will do little for confidence. It is of little surprise that existing occupiers have adopted a very cost-based focus. New occupiers are taking advantage of high vacancy rates, across all sectors, to secure significant incentives from landlords.

The industrial sector; a barometer on the economic frontline, has seen take-up fall over 50% from peak levels although there are signs that this is beginning to improve, albeit at much weaker rents.

Retail rental values have continued to decline, and the premier shopping streets also continue to bear the brunt. As sales volumes weaken, retail rents are increasingly being set at a base rent plus a percentage of the tenant's turnover. Jack Wills and Cult have become the latest fashion entrants to the market to take advantage of the weak market and locate off Grafton Street, having taken the former Berry Bros & Rudd, and Habitat premises respectively.

Office rents have seen similar declines with particularly weak demand for suburban offices where vacancy rates are over 30%. The prime CBD office rent is now in the region of €400 per sq.m

### Irish Commercial Property Yields...

Prime Yields	2004	2005	2006	2007	Dec-2008	Dec-2009
<b>Offices</b>						
City Centre	5.25%	4.25%	Sub 4%	4.00%	6.00%	7.50%
Suburban	6.25%	5.25%	5.00%	5.00%	6.75%	8.50%
<b>Retail</b>						
Grafton Street	3.20%	3.00%	2.65%	2.50%	5.00%	6.25%
Henry Street	3.20%	3.00%	2.65%	2.65%	5.00%	6.25%
<b>Industrial</b>						
Dublin	6.50%	6.25%	5.75%	5.75%	6.75%	9.00%

from a peak of €650 per sq.m. The overall dublin vacancy rate is over 20% and there is sufficient on-stream Grade A stock to absorb current levels of demand.

As economic pressures continue there is increasing evidence that players in the property sector are becoming increasingly litigious in the hope that the courts will afford them some respite in the current environment.

## United Kingdom

The UK commercial property investment market is performing admirably given the well-documented economic woes that have beset the country. Buoyed by strong capital growth, values in November rose by the largest monthly figure in 15 years. The annual total return to the end of November was -1.4%, according to the IPD monthly index. Total returns for 2009 are now projected to be slightly positive as capital values continue to rise, despite weak occupational markets. In the current conditions this represents a strong and somewhat unexpected outcome.



Investment demand strengthened in recent months as investors chased a higher income return and an attractive yield premium over alternative assets. The sustained weakness of the Sterling pound remains a significant attraction for overseas investors. It is estimated that foreign capital accounted for about 80% of total investment in the central London office market in the year to the middle of November.

Institutions have now re-emerged as net purchasers and most property companies and Real Estate Investment Trusts (REITS), now trading at premiums to NAV, are no longer sellers. The anticipated large sell-off by banks has not materialised, lending conditions have improved and the number of banks lending in the market has increased.

### UK Commercial Property Yields...

Prime Yields	2004	2005	2006	2007	Dec-2008	Dec-2009
<b>Offices</b>						
London West End	5.25%	4.00%	3.50%	4.75%	5.25%	5.00%
London City	5.75%	4.85%	4.35%	5.25%	6.50%	6.00%
Major Provincial Cities	6.00%	5.35%	4.50%	5.50%	6.50%	6.00%
<b>Retail</b>						
Prime High Street	4.50%	4.00%	4.00%	4.75%	6.00%	5.25%
<b>Industrial</b>						
Prime Distribution	6.25%	5.65%	5.00%	5.75%	7.50%	6.50%

While the economy has not recovered from recession as quickly as its American and European counterparts, demand has proved more resilient than expected. Yields have fallen lately as sentiment towards higher risk assets has improved.

The demand driven contraction in prime yields is now beginning to be replicated among secondary yields. Whilst the main focus remains on prime assets, as the scarcity of prime product continues to drive values higher, investors are showing increased flexibility in lease length, covenant or location criteria. The IPD All Property Yield at the end of November was 7.4%.

The pace of rental decline is slowing across all sectors. In the office sector, tenant incentives appear to have peaked at around 30% of income, and rents in the City of London seem to be stabilising, having fallen to £42 per square foot - a level that evokes comparisons with 1987. The overall vacancy rate in Central London has fallen to 7.2% amid improving take-up and a diminishing development pipeline. Rental growth is expected to return in 2010.

In the retail sector, the fall in rents has slowed in recent months in comparison to the early part of the year. Whilst rents and lease terms have continued to weaken outside London, signs of stabilisation emerged in the capital as retail sales statistics showed increasingly resilient trends. Retail sales rose 3.4% in October on a year-on-year basis, the fastest annual rate since May 2008. Consumer sentiment has improved as the pace of unemployment slowed and as house prices started to rise in recent months. However, the recession has continued to claim casualties on the high street, with Borders among the recent victims.

Tenant demand remained weak in the industrial sector, particularly for large warehouses. Take-up is expected to be down 35% year-on-year from 2008 and prime industrial rents have continued to fall, although, in line with the broad trend, the pace of decline is slowing.

## EUROPE

Despite the continued fragility of the financial markets, some confidence and risk appetite appears to have returned to the European property markets. With investors back in the market, there was a notable improvement in some key cities in the third-quarter. The pick-up in activity has been underpinned by increasing evidence that the French and German economies, in particular, have emerged from recession with two consecutive quarters of expansion. Leading indicators such as purchasing manager indices, alongside business sentiment surveys have revealed improvements that detail a recovery, albeit fragile.



Outside Germany which has seen very strong investment demand, the key beneficiaries were London and Paris with investment volumes up 83% and 59% respectively on the second-quarter, according to BNP Paribas research. There has been a strong rise in cross-border investment in Europe, and investors are doing larger deals as credit conditions improve. There was a substantial quarterly increase in investment volumes in Amsterdam, as cross border capital returned to what is perceived to be a stabilising market.

It has been estimated that turnover in the investment market grew by almost 40% in the third-quarter, compared to the previous three-month period.

As has been the case in most parts of the world, demand has been most focussed at the prime end of the property market, where there is a limited supply of stock available for sale.

On a relative basis, European markets have outperformed the UK. The IPD All European Pooled Property Fund Index delivered a return of -12.8% for the 12 months to end June 2009 and a six-month return of -1%.

Prime office yields have continued their trend of stabilisation and the bottom of the cycle, with regards to yield decline, appears to have been reached. Paris, like London is seeing strong yield compression.

Occupier markets have continued to lag, and rents have continued to fall, albeit at a slower pace in recent months. Prime rents are showing signs of stabilisation. According to Jones Lang LaSalle (JLL), gross take-up of office space remained stable at around 2.2 million sq m across 24 European office markets. On average, prime office rents have fallen 16% over the last 12 months and European office demand is nearly 30% below the 5-year average. The CBRE EU-15 Office Rental Index fell 1.3% in the third-quarter. The RICS European Q3 Commercial Property Survey shows that while occupiers' rental expectations have stabilised, inducements have continued to increase.

## Outlook

The Central Bank of Ireland recently upgraded its economic forecasts for 2010, predicting a contraction of 2.3%, compared to a previous forecast of -2.7%. In early November, the European Commission predicted the Irish economy will shrink by 1.5% in 2010, while growth predictions among forecasters suggest an expansion of about 4% in 2011. The continuing weakness of the economy presents a sizeable headwind to the domestic property market. However, the correction in valuations appears to be close to the bottom of the cycle and would suggest limited downside. In the retail sector, overseas retailers are reportedly looking to take advantage of falling rents to establish a foothold in prime locations. As seen with the sale of the Tommy Hilfiger store, investors are also being tempted by emerging value. The AIB sale and lease back on Grafton Street attracted considerable interest from a range of purchasers when placed on the market. While office vacancy rates have been rising, there is evidence to suggest that firms which held off relocation plans are now looking seriously at their space requirements once again. Legislation to establish the National Asset Management Agency (NAMA) was finally enacted in late November and the actions it takes should provide clarity on market valuations and may put a floor under valuations. It is most unlikely that NAMA will launch a 'fire sale' of properties at a time when bank liquidity remains relatively tight.

The speed with which UK property prices have started to recover as a result of global investment demand marks it out as an efficient and therefore attractive market. While other markets are still drifting lower, prices for prime UK property have strengthened in recent months. Property is now yielding a healthy premium over low-risk asset classes and there is scope for long-term capital value gains. However, rental values are likely to remain under some pressure, particularly as European economies still face considerable headwinds. Although economic forecasts have been upgraded recently, corporate and consumer spending is not expected to grow notably in the near term. The advanced nature of the correction in the UK suggests that the worst has passed for UK property and Paris and other markets will follow as the global economy improves. Values should improve as markets correct and robust returns are forecast outside Ireland for 2010 and beyond as interest rates and inflation are expected to remain low.