



## THE IRISH COMMERCIAL PROPERTY MARKET - OUTLOOK 2012

By Marie Hunt, Executive Director, CBRE, Ireland

### OVERVIEW

Over the course of the last three years we have been reminded on many occasions that 'markets don't like uncertainty'. This is also true of the real estate market. The uncertainty that prevailed last year, particularly around the Government's proposals with regard to reforming rent review provisions in existing business leases proved to be a major impediment to performance and the volume of transactional activity in the investment sector of the commercial property market in Ireland. Although a number of good investment properties were offered for sale towards the end of the year, transaction volumes in 2011 were negligible. The volume of sales activity in the development land and hotel & licensed sectors of the Irish market in 2011 was also disappointingly low and was not helped by the scarcity of debt. The only sectors that performed relatively well in 2011 were the occupier sectors, with letting activity fuelled to a large extent by the fact that rents had declined more than 50% from peak levels and tenants were controlling negotiations.

The performance of the real estate sector in Ireland in 2012 will again be largely influenced by a combination of economic, financial and political considerations. Although there is no doubt that the ongoing Eurozone debt crisis, financial issues and market volatility will continue to dominate over the course of the next 12 months, local economic, financial and political decisions will be the primary drivers of pricing and transaction volumes in the domestic real estate sector in 2012. With the uncertainty that prevailed last year now alleviated following announcements made in Budget 2012 and domestic economic prospects showing some tentative signs of improvement, we expect the commercial property market to stabilise over the course of 2012 and begin to emerge from the most significant correction it has ever experienced. The road to recovery will however be a long one and values will only stabilise once there is sufficient transactional evidence available to provide clarity on pricing. The real estate sector now has to adapt to a scenario where debt funding is going to remain severely constrained.

In the short term, the real estate sector across Europe will be overshadowed by Eurozone default concerns and a continued scarcity of debt to facilitate transactional activity, re-financing or development. Although Ireland is ahead of the curve in many respects in terms of implementing austerity and getting its economy back to growth, recovery will nonetheless be gradual. We expect to see a notable increase in the number of transactions in the investment, development land and hotel and licensed sectors of the market in 2012 as banks and NAMA kick-start disposal strategies. Although yields for prime properties are expected to strengthen this year, weaker than expected economic conditions, scarcity of funding and the fact that demand will be primarily focussed on prime assets could see further deterioration in yields for secondary properties over the course of 2012. Overseas investors are likely to be the most dominant purchasers of prime assets in the investment sector of the Irish real estate sector this year.

In the occupier sectors, we expect to see modest increases in rents for prime properties over the medium term but rental growth is unlikely to materialise in any sector in 2012. In

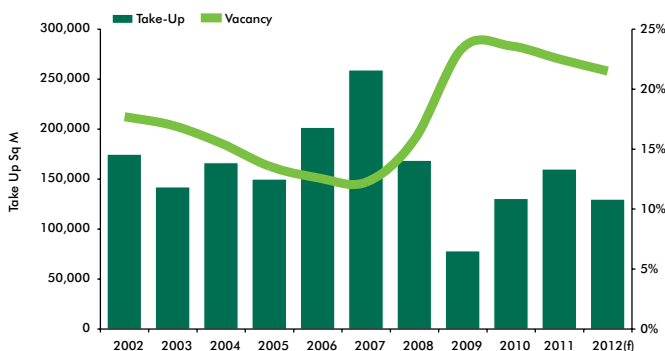
fact, while rents for prime properties are expected to stabilise this year, rents on secondary properties, both in terms of location and specification, will more than likely continue to deteriorate over the course of the next 12 months. With occupier sentiment across all markets deteriorating in response to a weaker economic outlook, it is expected that some multinational occupiers will delay or put strategic location decisions on hold in 2012. The volume of take-up in all sectors is therefore likely to decline compared to the year just gone. Another concern is that Ireland's financial services industry - a large driver of demand for office property - could be at a disadvantage if an EU financial transactions tax is implemented, particularly if the UK do not impose it. New development will only occur where pre-lettings have been secured at rental levels that are higher than those currently prevailing.

As households, businesses and banks continue a process of de-leveraging, the key feature of the commercial real estate market in 2012 will be a focus on preserving and seeking to potentially enhance the value of assets through intensive asset management.

## THE OFFICE MARKET

In spite of the economic backdrop, the office sector in Dublin performed well in 2011, fuelled by domestic and international occupiers taking advantage of the ability to negotiate relatively attractive deals. Indeed, take-up close to the ten year annual average level of 160,000 square metres was achieved in the capital last year. It seems likely that continued global financial instability will impact on occupier demand over the course of the next 12 months leading to some strategic leasing decisions being put on hold. As a result, we expect annual take-up in the Dublin office market to decline somewhat in 2012, with take-up of approximately 130,000 square metres likely to be achieved in the capital this year.

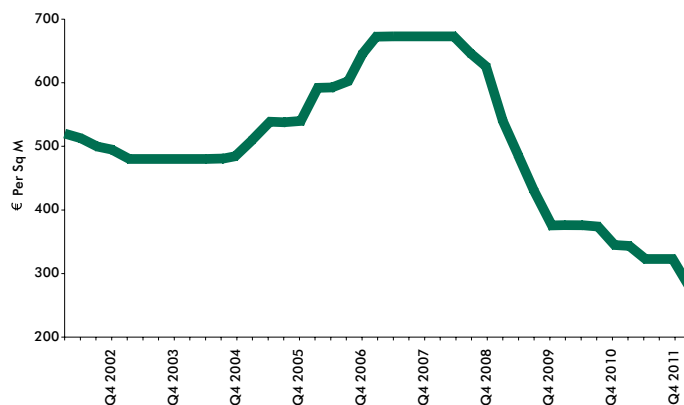
### Dublin Office Take-Up vs. Vacancy 2002 - 2012(f)



We will continue to see new corporate announcements as a result of Ireland's improved competitive position and the retention of the attractive 12.5% rate of corporate tax. An increasing number of occupiers will take advantage of upcoming break clauses and lease expiries to initiate negotiations with their landlords or seek alternative accommodation. We expect to see continued polarisation between rents for prime and secondary office buildings reflecting the relative scarcity of prime buildings (particularly in the city centre) and the abundance of poorer quality second-hand accommodation in the market.

Despite the underlying levels of vacancy in the office sector, the scarcity of modern Grade A buildings in the Central Business District coupled with the complete lack of new development in the pipeline will ultimately force rents for prime buildings gradually upwards. However, a number of good office buildings are due to come back on the market to let in 2012 and this will alleviate pressure to some extent. Rental growth is therefore unlikely to materialise in the Dublin office sector in 2012.

### Prime Dublin Office Rents 2002 - 2012(f)



In fact, we expect that prime headline rents will come under further slight downward pressure in 2012 before ultimately stabilising at approximately €296 per square metre during the course of the year.

The key focus for landlords and source of most activity in all sectors of the occupier markets over the next 12 months will be on retaining existing tenants and where possible coming to agreements with them to extend their existing lease commitments in order to preserve income streams. As was the case last year, the majority of transactions in 2012 will comprise lettings of 10 years or less although concessions such as rent free periods may harden somewhat for prime accommodation as the year progresses. While tenants will increasingly demand shorter lease terms, landlords are likely to accept lower headline rents in exchange for the certainty of longer lease terms considering the implications for funding terms.

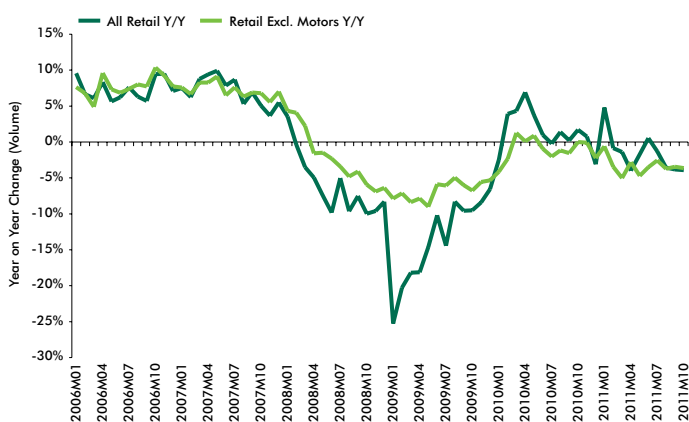
The Government is to undertake an extensive review of their property holdings this year, which will inevitably lead to some consolidation. The banking and insurance industries are also likely to bring some office accommodation back onto the market in the capital over the course of the year.

We believe that there will be no new office development commenced in the capital in 2012, unless a pre-letting agreement is secured. With the availability of bank funding unlikely to improve to any degree over the course of the year, tenants will focus their attention on good quality fitted space as opposed to office accommodation that they have to fit-out or refurbish. The quality of available accommodation will therefore continue to deteriorate over the course of the next 12 months. Any reduction in the high level of vacancy in the Dublin office market in 2012 will be marginal as a result of weak net absorption being achieved.

## THE RETAIL MARKET

Despite very challenging conditions in the retail sector of the Irish economy in 2011, a range of new entrants opened new stores in the jurisdiction while a large number of existing retailers, both Irish and overseas operators, pursued aggressive expansion and relocation strategies. This activity was fuelled to a large extent by retail tenants taking advantage of the ability to secure premises in good locations and retail schemes and negotiate favourable lease terms including shorter leases and rents that were at least 50% lower than peak levels. Discount retailers were particularly aggressive, taking the opportunity to increase their market share.

### Consumer Spending 2006 - 2011



Source: CSO

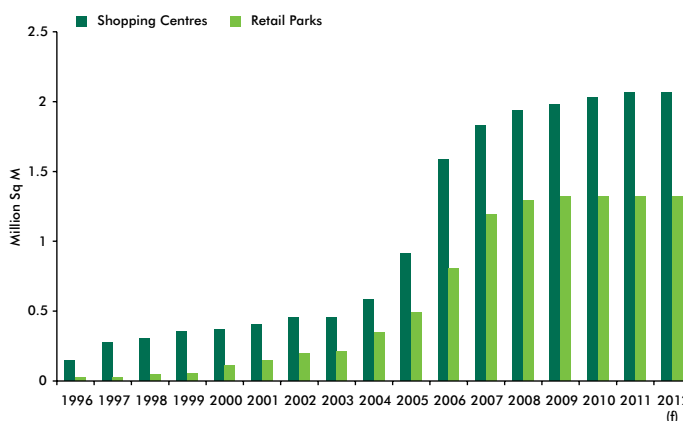
Retailers have endured three very difficult years in the Irish retail market particularly those reliant on discretionary spending. With economic prospects now showing tentative signs of recovery, we believe that most Irish retailers will see their turnover and cost base stabilising in 2012. Despite this, consumer confidence remains fragile with little expectation of a meaningful recovery in consumer demand or Irish retail sales activity in 2012. The 2% increase in the standard rate of VAT in December's Budget has further exacerbated the situation. Therefore, even though retailers are encouraged by improving economic prospects domestically and can see opportunities, they are likely to adopt a cautious approach to expansion and relocation in 2012. The Government's decision not to proceed with retrospective lease reform will cause some retailers to re-assess their options. Nevertheless, we expect to see healthy levels of letting activity continuing to be achieved from a property perspective, particularly in good retail schemes and sought-after locations around the country.

Although for the most part, rents will remain under pressure throughout 2012, we expect to see prime retail rents stabilising this year. The fact that there is no new retail supply due to come on stream in 2012 will make it difficult for some retailers to access the specific locations they want. As a result, rents for prime locations will stabilise as the year progresses. In contrast, the value of secondary and provincial retail properties, which are more prone to tenant defaults and higher levels of vacancy, could deteriorate further in 2012, particularly if NAMA, banks and receivers accelerate the disposal of distressed assets. Many landlords will have to focus their attention on encouraging existing retailers to remain in their schemes and in many cases, where they have not already done so, this will mean negotiating more flexible lease terms and rebasing rents. Shorter leases and performance/turnover related rental arrangements will continue to be a feature of the market. It remains to be seen what impact the recent changes to the cap on the size of retail premises will have on the Irish retail sector over the course of the next 12 months and if it will improve competition in the retail sector as envisaged.

A key challenge for retailers over the course of the next few years will be to leverage their multi-channel operations as retailing patterns increasingly shift to other channels such as e-commerce and m-commerce. Irish retailers have a lot of work to do in this regard.

No new retail accommodation is due for completion in 2012, although subject to some specific issues being clarified some new supply could be released to the market this year.

### Irish Shopping Centre & Retail Park Stock 1996 - 2012(f)

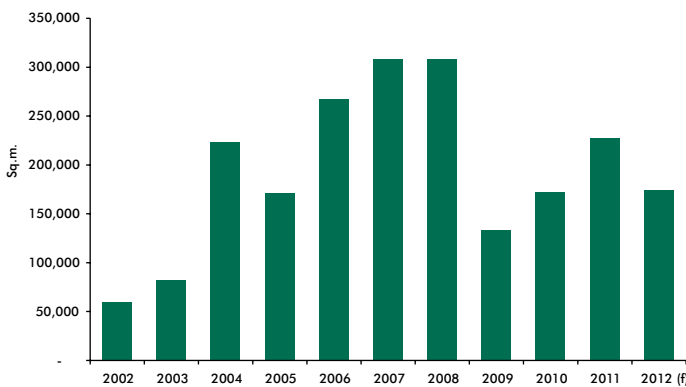


## THE INDUSTRIAL MARKET

Although take-up in the industrial sector held up well in 2011, most of this activity emanated from occupiers focussed on cutting operational costs and taking advantage of the ability to negotiate short-term lettings on attractive terms. There were a number of large transactions negotiated although some industrial occupiers were reluctant to make large-scale strategic decisions in light of prevailing economic uncertainty.

Following the trend of the last number of years, most of the transactional activity in the sector in 2011 comprised lettings due to the lack of funding to facilitate sales. With no significant improvement in bank funding anticipated in 2012, we anticipate that lettings will again make up the lion's share of transactions in the industrial sector this year. We also anticipate that the majority of transactions will comprise relatively short-term agreements. The exception to this will be for new facilities being developed on a design and build basis where a longer lease term will be required to secure debt funding.

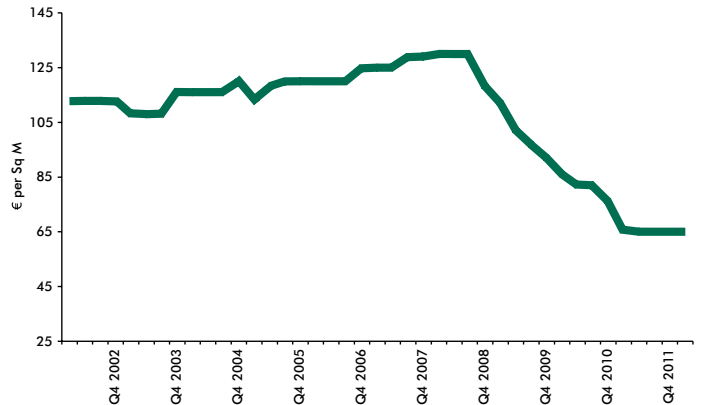
### Dublin Industrial Take-Up 2002-2012(f)



We expect that take-up of approximately 175,000m<sup>2</sup> will be achieved in the Dublin industrial market in 2012.

With no new speculative industrial accommodation due for completion for the foreseeable future, the quantum of quality accommodation along the highly sought after N81/N7 and N2 corridors in Dublin will continue to decrease as the year progresses. The overhang of industrial accommodation along the N3 corridor will take longer to erode, which will continue to impact on rental values along this route.

### Prime Dublin Industrial Rents 2002-2012(f)



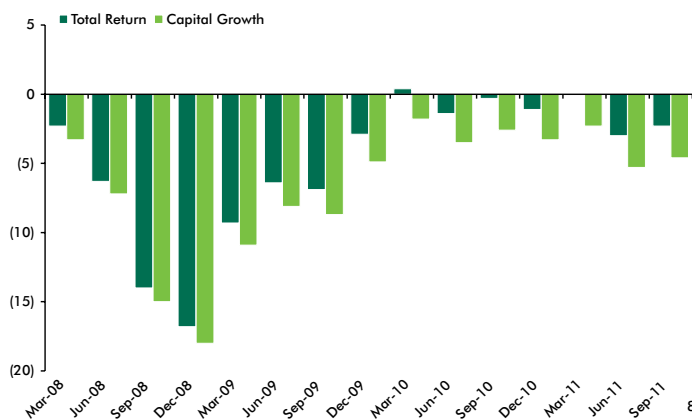
Having experienced a decline of more than 50% from peak, we believe that rents for prime industrial buildings will ultimately stabilise at between €60 and €65 per square metre in 2012. We do not envisage any development commencing in the Dublin industrial market in 2012 unless a pre-letting agreement is secured. The gap between rents for prime and secondary buildings will continue to widen over the course of 2012 and a scarcity of modern accommodation will ultimately see rental values for prime buildings hardening despite the relatively low cost of secondary accommodation. Although demand will certainly be affected by global and to a lesser extent domestic economic concerns, we expect that there will be a number of acquisition requirements in 2012 driven by large multinational pharmaceutical companies and data centre operators that are not as directly exposed to the economic situation.

We do not envisage a significant improvement in demand for industrial sites until such time as there is a meaningful improvement in demand from industrial end users.

## THE INVESTMENT MARKET

Although the occupier sectors held up well last year, the investment sector of the Irish commercial property market was stalled by uncertainty in 2011. Uncertainty around Government plans to implement radical retrospective reform of rent review provisions in business leases meant that transactional activity was effectively put on hold for the year and values continued to drift downwards as a result. By year-end, commercial property values in the Irish market had declined by as much as 65% from peak levels.

### Quarterly Irish Capital Value & Total Returns Q3 2008 – Q3 2011



Source: IPD

The Government have now confirmed that they will not be proceeding with rent review reform. This coupled with a reduction in stamp duty for commercial property from 6% to 2% along with a waiver on capital gains tax for properties purchased before the end of 2013 and held for seven years should stimulate transactional activity and help stabilise values in 2012.

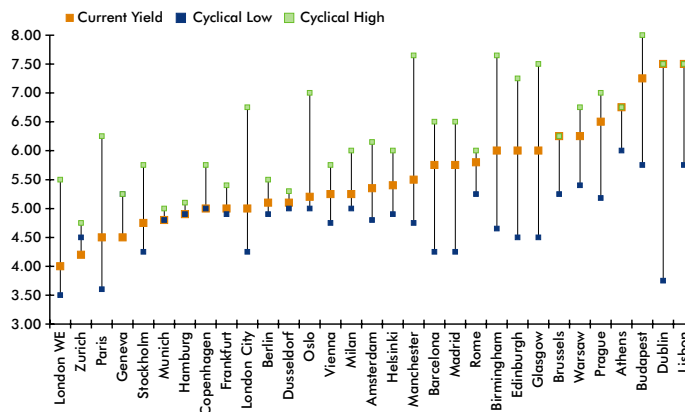
With some prime assets going under offer in recent months, pricing levels are now being established. We believe that there will be an increase in the number of investment properties being offered for sale over the course of 2012, as banks, receivers and NAMA implement disposal strategies. The bulk of demand for prime investment properties will emanate from overseas investors whereas domestic investors will be the dominant purchasers of smaller investment properties and provincial assets.

We expect to see more sales of residential investment portfolios over the course of 2012 as banks and NAMA continue their process of deleveraging. There is significant demand for well-located and well-designed residential schemes from international and local buyers.

In addition to selling individual investment assets, we believe that NAMA and banks will also begin selling portfolios of Irish assets over the course of the next 12 months, most likely by way of loan disposals. We believe that in the absence of an improvement in the availability of debt finance, NAMA and other entities will become more prevalent in the provision of vendor finance for prime properties.

We anticipate that the decline in capital values that has characterised the market for the last three years will come to an end in 2012 and we will see a small positive total return being achieved in the Irish market for the first time since 2008 as pricing for prime assets stabilises. However, there is likely to be a lot of secondary property being offered for sale over the course of the next 12 months, for which funding will prove very difficult to source. With the market for secondary properties limited to a small pool of domestic cash buyers and economic conditions still proving challenging, it is inevitable that yields for non-prime properties will continue to soften despite values for prime properties strengthening somewhat.

### Prime Office Yields (Peak to Trough) Q3 2011

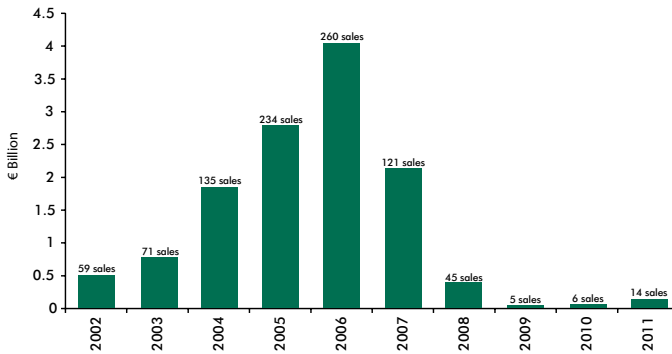


Income return is now the most critical component of investment performance. Capital growth won't be a feature of the market in the short term with income being the primary driver of value. Shorter leases are now commonplace in the occupier markets and this will obviously have an impact for cash flow, value and risk. The level of over-renting in key occupier markets along with the generous incentives forming part of letting transactions will make initial yield a meaningless measure of long-term performance.

## THE DEVELOPMENT LAND MARKET

Although negotiations proved very protracted, a number of development land sales were completed over the last 12 months. Excluding agricultural land sales, we believe that 14 transactions totalling approximately €28.5 million were transacted in the development land market in 2011. This compares with over 260 transactions totalling over €4 billion at the peak of the market.

### Value of Development Land Sales in Ireland 2002 - 2012(f)



We expect to see a notable increase in the volume of sites coming to the market in 2012, led for the most part by NAMA, banks and receivers accelerating the pace at which they dispose of property assets.

With an improvement in the availability of bank funding for development land unlikely to materialise any time soon and no speculative development being undertaken, demand for sites will be limited to cash buyers. We expect that demand and pricing will be strongest for small infill sites in urban locations. Outside of Dublin, the reality is that agricultural land values will prevail for the most part. In many instances this will represent a decline of up to 90% from peak values. However, this is all purchasers are willing to pay in the current environment.

The prospect of a meaningful recovery in land values in the medium to long term is limited and we believe this reality will encourage many borrowers and banks to cut their losses and offer sites for sale over the course of the next 12 months. The optimum scenario is for sites to be brought to the market on a phased basis rather than a flood of distressed sites being offered for sale, which would further impact on pricing and the saleability of development sites.

A meaningful improvement in occupier demand, which is not envisaged in the Irish market in 2012, is ultimately required to kick-start demand for development land. In the residential sector, the market is still pre-occupied with absorbing excess supply although we expect to see some residential development occurring in Dublin in 2012. Clearing the overhang outside of core cities will prove challenging due to the mismatch between where properties are located and where demand is focussed. In the commercial property sector, no new development is envisaged in any sector for the foreseeable future unless a pre-letting is agreed.

As 2012 progresses, we expect that there will be a growing realisation that density is not a primary driver of value in the current market, due to the fact that in many cases, demand from end users and those funding land purchase is for lower density product.

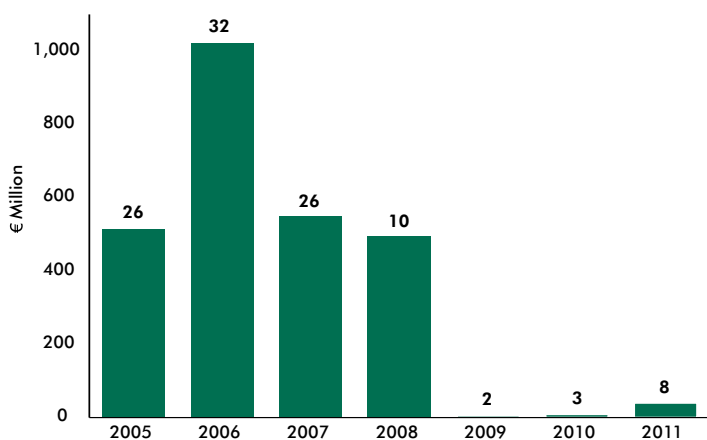
Over the course of the next 12 months, more local authorities will publish their development plan core strategies, which will inevitably lead to more phasing of development sites and in some cases the rezoning of land parcels around the country.

## THE HOTELS & LICENSED MARKET

Following two years in which virtually no hotels were sold in the Irish market, a number of hotels were sold during 2011. A number of small provincial hotels sold during the last 12 months, primarily to local cash buyers but what was most encouraging was the very strong international appetite for the prime Dublin hotels that sold during the year, including the Four Seasons.

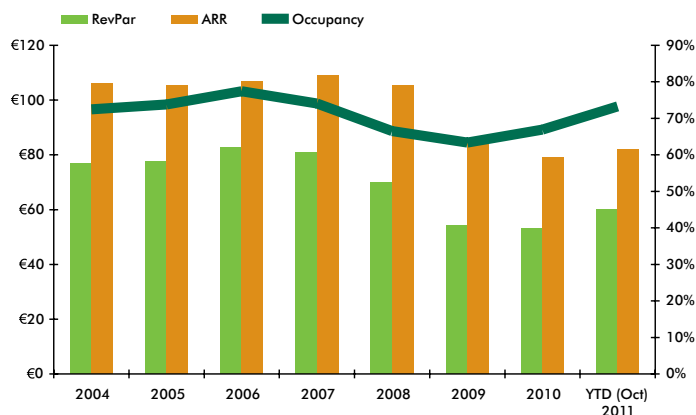
The receivership trend continued in 2011 with approximately 65 hotels in receivership by year end. Many of these hotels continued to trade, regardless of their profitability or obvious long-term potential to become profitable.

### Value of Irish Hotel Transactions 2005-2011



There was a noticeable improvement in tourist activity, particularly in the Dublin market last year. In fact, there have now been 15 consecutive months of positive Revpar for Dublin hotels which is having a noticeable impact on EBITDA, particularly for hotels that have cut their operating costs.

### Dublin Hotels Performance 2002 - 2011



Source: STR Global

The controversial airport tax was abolished on July 1st last year and has been helpful in boosting tourism numbers. In addition, the cut in the VAT rate for restaurant meals and hotel accommodation from 13.5% to 9% last Summer has been particularly helpful to this sector. Although there are no new hotels being developed at present, the five star Grand Canal Hotel in Dublin Docklands may commence trading in 2012. Buoyed by the cut in stamp duty and changes to capital gains tax, we expect to see a number of hotel properties traded over the course of the next 12 months. We expect international operators will be the most dominant purchasers of prime Dublin hotels. Many have done detailed due diligence on the Dublin hotel sector in making bids for both the Four Seasons and The Morrison in 2011 and will bid again on other prime assets in the capital if they are offered for sale. Room rates have now stabilised in Dublin but there is still pressure on hotels outside of the capital. With property funding for hotels expected to remain constrained, it is therefore hoped that NAMA, who now own the debt on more than 87 hotel properties in the country, extend vendor finance to the hotel sector to enable transactions to take place.

A further boost in tourist numbers is expected in 2012 and encouragingly, there are a lot of forward bookings. PWC have forecast that occupancy rates will increase by 2.8% in Dublin this year. They forecast that rates will improve by 2.6% and RevPar will increase by 5.5%. 70% of hoteliers expect occupancy to increase in 2012 according to HBC. Nevertheless, although there will be some exceptions, we expect that conditions in the hotel sector outside of Dublin will remain difficult in 2012, considering the economic backdrop. We expect to see some provincial hotels closing for longer during non-peak periods.

It is unfortunate that having invested heavily in improving our national hotel stock over the last decade, that a lack of capital expenditure and scarcity of working capital for repairs and maintenance is now leading to an obvious deterioration in hotel stock in many locations. This is a big issue for elaborate facilities.

Many hotels, particularly those outside of core population centres, are unlikely to be able to trade their way out of difficulty, even over the long term so we expect that NAMA, banks and their receivers will reflect the market reality and put these hotels on the market and accept the pricing that the market offers. Domestic investors will be the most likely buyers of provincial hotel assets if they are competitively priced.

## TOP 10 PREDICTIONS FOR 2012

- Rents for prime buildings will eventually stabilise in 2012 although rents for secondary properties will continue to decline as occupiers continue to take advantage of the ability to negotiate favourable terms and conditions in an oversupplied market. Occupiers will focus attention on renegotiating lease terms in an effort to cut costs and increase efficiencies, whereas landlords will focus on getting tenants to extend lease terms in order to preserve income streams.
- The decline in capital values that has been a feature of the Irish market since 2008 will come to an end over the course of 2012, particularly following measures announced in Budget 2012. However, although yields for prime properties are expected to strengthen as transactional evidence materialises, yields on secondary properties will continue to come under pressure as the year progresses.
- Overall levels of take-up in the occupier sectors of the market are likely to decline somewhat in 2012 as some occupiers delay or postpone strategic location decisions due to economic uncertainty. In the office sector the threat of the implementation of a financial services transaction tax across the EU is worrying, particularly if this tax is not payable in the UK.
- The Government's decision not to proceed with retrospective lease reform will cause some retailers to re-assess their options.
- There will be a notable increase in the volume of transactions in the investment, hotels and development land sectors of the Irish market as banks, receivers and NAMA release more properties to the market. At the prime end of the investment and hotel sectors, overseas investors are likely to be the most dominant players.
- There will be an increase in the disposal of loan portfolios in 2012.
- There will be an increase in the sale of residential investment portfolios over the course of the next 12 months - a new trend for the Irish market.
- There will be no new development activity in the commercial property sector other than where pre-letting agreements are secured and at higher rental values than prevailing at present.
- Despite the lack of speculative development, any decline in the overall level of vacancy in the Dublin office market will be countered by buildings coming back on the market to let as companies consolidate operations.
- A problem which is going to become increasingly obvious in 2012 and beyond is the growing prevalence of functionally obsolete accommodation in all sectors. Without a functioning debt market, this accommodation is set to become increasingly unfit for purpose and eventually won't comply with health and safety and other legislative directives.

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*This years Outlook document is dedicated to the memory of our late friend and colleague Christine O'Reilly (1982 – 2011) who started her surveying career at CBRE in the research department. She is greatly missed.*

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