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The vulture funds that mopped up distressed assets during the bust are faced with a choice: cash out or double up on the Irish economy

Naomi Powell

The roar of activity in the Irish property market is about to get a lot quieter. Though that's not because the appetite for Irish offices, hotels and other assets shows any sign of abating. The private equity firms that were first to pick through the rubble of Ireland's collapsed property market have now been joined by a wave of institutional investors, all engaged in a fierce hunt for deals that drove transactions to a record €1.4 billion in the first few months of 2015.

But many of this year's most interesting trades are less likely to happen in headline-grabbing Nama auctions than in quiet, off-market deals, as private equity players look to lock in significant gains on early bets in order to put the money to work elsewhere – either in other countries or new investments within Ireland.

There has already been a notable increase in so-called "secondary trades", as long-term investors seeking stable assets and reliable income buy property from private equity players, said Marie Hunt, head of research at CBRE Ireland.

"You have the deleveraging that was very evident last year continuing, and you're still seeing portfolios coming into the market and being traded," said Hunt. "But, in addition to that, you're now seeing the emergence of secondary trading, where those who bought portfolios three or four years ago are carving them up and selling assets, in most cases individually."

Indeed, while noting that there are still opportunities within Nama and the banks, Hibernia Reit recently highlighted private equity funds as a potential source of assets.

These funds, "active over [the] last 36 months in Ireland, have become increasingly active in other EU markets

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and some are exploring opportunities to exit Irish assets, particularly where project management expertise is required", it stated in its November interim report.

Kevin McGillicuddy, head of Brehon Capital Partners, sees a similar trend on the horizon.

"I think plenty of investors who were unable to be competitive with the first wave of portfolio sales are now looking at the recycling of assets as their way to participate," he said in an email. "These bidding processes are a bit less frenetic and frothy, and will provide greater entry to a more diverse group of investors."

Discretion is the watchword

While not all private equity funds are pitching 'for sale' signs yet, the dramatic rebound in the market suggests that many stand to make significant gains. Commercial property values that fell 60 per cent after the market crash, rebounded by 31 per cent last year. The office market posted the biggest gains, rising nearly 36 per cent, according to the IPD/SCSI property index.

"Is private equity that invested in here two years ago looking to sell? The answer to that is yes, because they've made big profits," said Jonathan Hillyer, director at property agent HWBC.

While secondary trades may soon become a more important part of the market, that doesn't mean we'll hear much about them.

"By the end of this year, I don't think there's any doubt that this market will start showing signs of settling down," said Hillyer. "You'll see more off-market deals, you'll see more discreet trading, more one-to-one deals, as opposed to the bank process of first bids, second bids, which everyone hates, but is a necessary evil.

"That's perfectly in line with a market that's gone through a very strong growth phase and is now beginning to sort of level out a little bit. You're going to see people taking a bird in a hand if someone goes in with a good offer, rather than going to the market and testing it."

For many in the rapidly moving Irish market, the question is not if, but when, to sell. The steady stream of foreign firms looking to establish operations in Dublin pushed office leasing to a seven-year high in 2014. But with no new office projects completed since 2010, those firms are facing a severely depleted supply in the most sought-after locations.

Office vacancy rates in Dublin's city centre now stand at 9.13 per cent and as low as 1.78 per cent for top quality stock in Dublin 2 and 4, according to CBRE. Most of that demand is being driven from technology, social media and financial services firms.

Spiking rents

With little space to be had, rents have spiked from €35 a square foot in 2013 to €47.50 per square foot, and may well climb to €55 by mid-year, according to Hunt of CBRE.

Billionaire businessman Denis O'Brien's development on St Stephen's Green has already pitched even further with a pre-letting of €60 per square foot, though it is not expected to be completed for another 12 to 18 months.

Capital values in the office sector – the likely selling price for a building – are expected to rise another 20 per cent in 2015 before slowing to 6.5 per cent growth in 2016, according to London-based Capital Economics.

"Certainly, this is the year when you'd be looking to exit, but maybe not for a few months," said Stephen Brown, a property economist with the firm. "The pure goldrush is over, but that doesn't mean Dublin is a bad investment. Based on our forecast, it's still going to outperform a lot of other economies."

Those who remain active in the market will be working with narrowing yields and new competition from a crop of institutional players who can access capital at lower costs. And the European Central Bank's quantitative easing strategy is expected to drive even more competition into Irish property markets, by driving down bond yields already at record lows and prompting investors to seek higher returns elsewhere.

"I think, this year, you'll see the institutions being increasingly busy and featuring more prominently," said Hillyer. "That's just natural and, in the end, the exit strategy for most of these private equity firms was institutional money because they have a lower cost of capital."

Credit Suisse, which previously bought La Touche House near the IFSC, recently picked up a six-storey office block at One Grand Parade. And German institutional investors have also been particularly active in the Irish market, with Union Investment, a division of Germany's DZ Bank Group, paying €232 million for two major office blocks at Grand Canal Square that are occupied by Facebook.

It all marks a major shift in the investment landscape from what greeted the first firms to arrive after the crash. With a banking sector in crisis and a potential exit from the EU on the cards, Ireland was initially put into the same risk category as Greece, Portugal and Spain. At one point, yields in Dublin were above what they were in Lisbon, and in line with Spain and Greece, said Brown of Capital Economics. Rents and capital values collapsed, prompting traditional institutional investors to retreat.

"In hindsight, that seems crazy, because Ireland obviously has had a really strong recovery," said Brown. "But that's how it was, and it created a great opportunity."

Ireland had a well-educated workforce and its low corporate tax rate made it uniquely attractive to North American companies looking for a European footprint. Without the advantage of the current European Stability Mechanism, Ireland was forced "to get its house in order", imposing painful austerity measures and other decisions in order to regain the faith of the markets, Brown added.

So, even though property yields rose to the same level and rents collapsed to the same extent as in Greece and Portugal and Spain, "there was much more reason to see why they should rebound", he said.

"The upside in Ireland did look, and still looks to be, much better than in Portugal, Greece or anywhere like that. You can see why these companies came into Dublin . . . from historical data, you can see that you don't get many opportunities like that."

Wall of cash

The introduction of real estate investment trusts in 2013 marked a significant turning point, in which, "all of a sudden, a wall of cash started coming for Ireland", said Hillyer.

Prime office buildings that were bought for €400 a square foot at the bottom of the market corrected quickly to €600 a square foot, and continued to climb. Though they remain below peak levels, "chances are you would have made a significant return if you bought at the beginning", Hillyer said.

Private equity funds, which earn large-scale profits by investing ahead of the recovery curve, enjoyed yields

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of 7.5 to 8 per cent on prime office assets between 2008 and 2012. Today, those yields have contracted to 4.75 per cent, and the field of competitors has thickened.

"We're still forecasting double-digit returns in most of the sectors," said Brown. "The problem is, there's so much more competition. It's on everyone's radars now, so there's not the same level of assets that can be snapped up at really cheap prices. You're looking at value-added opportunities, rather than opportunistic things.

"Whereas, if you are of the opinion that Portugal and Italy are the next countries to move from being in the doldrums to looking like they'll grow, that's where the opportunistic opportunities are now. You've got less competition, and you can get in there quickly."

Spain was cited in several investor surveys last year as a target market for new investment. This year, eyes are most definitely turning to Italy, said Tom Leahy, director of European market analysis at London-based Real Capital Analytics.

"In Ireland, if you look at the sources of stock in the market, the IBRC is running down and Nama has done a good job of offloading lots of its stock," he said.

As Ireland's loan sale market slows down, said Leahy, more investors will look to Sareb, the bad bank established to sell off property assets from Spain's distressed banks. Attention will also be focused on Italian banks that were among the worst performers on the European Central Bank's stress tests and are expected to offload more property, he said. "Italy pops up a lot as an opportunity, and not just for private equity."

Others say many investors who began their European investments in Ireland have already examined other markets and found themselves back at square one.

Rewards for risks

"The challenge with Europe, in general at the minute: is where else do you go?" said Hunt of CBRE. "Some investors see that pricing in Ireland has knocked ahead so significantly that it's no longer at the level it was when they came three years ago. They start looking at Spain, Portugal and Italy, but find deleveraging hasn't happened to the same degree.

"You can wait a long time for a Sareb to start selling portfolios at the same pace Nama is selling them, for example. There's just a scarcity of product right across Europe at the minute. And unless you're going somewhere like central Europe, the returns aren't that much better in these markets."

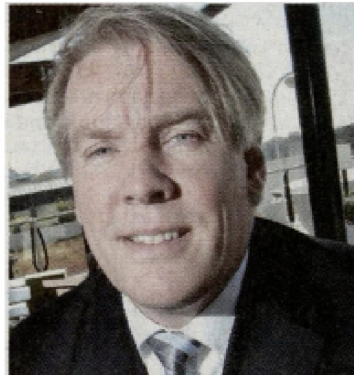
Ireland's strengthening economy and improving consumer confidence also added to its appeal compared to other markets, Hunt said.

In its latest assessment, the International Monetary Fund said it expects the Irish economy to grown by 3.9 per cent this year and 3.3 per cent in 2016. Unemployment is also expected to decline at a quicker pace, falling to 9.8 per cent this year.

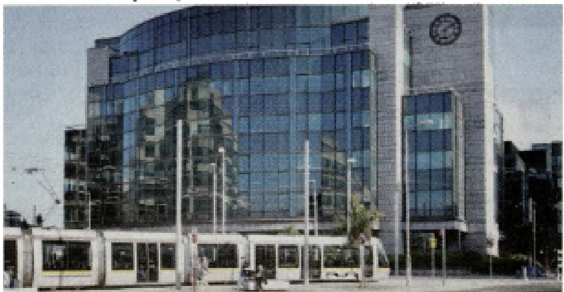
Rather than leave Ireland, Hunt expects investors to retool their strategies, looking beyond the Dublin office market at provincial properties, development opportunities and the retail sector.

Indeed, there is no "one size fits all" approach to private equity investors that have invested in the Irish market over the past four years, said McGillicuddy of Brehon Capital.

"Some will want to be rewarded for the risk that they took coming into the property market at its depths," he said, "and others may be quite happy to hold onto the investments given the attractive income and the basis for which the investment was acquired."



Grand Canal Square, Dublin 2



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