

# Briefing Note

## The Irish recovery and hopes for Spain

April 2013

The creation of NAMA in Ireland three years ago has clearly helped the credibility of the government and property market with investors. This paper examines how NAMA has helped to turnaround the Irish property cycle, and looks ahead to see whether Spain's newly created equivalent (SAREB) will have the same effect on that market.

### From depression to hope

■ The subprime mortgage crisis in 2007 has found both the Irish and Spanish economies overheated, overweight in the construction sector and less competitive.

■ Between the end of the 90's and the time of the downturn both economies had experienced strong growth rates, a significant fall in unemployment and a strong demand for residential and commercial property driven by economic expansion, and ease of finance.

■ Property value rises had been significant in both markets and this trend was supporting further speculation in the construction sector.

■ After the global financial crisis both economies and their banking systems were left exposed to the effects of the property bubble burst. As a result banks in both countries have been facing large losses and have required government support. Besides, austerity measures have been demanded by the EU to bring finances under control,

leading to slow economic growth. After that point, the two countries followed a different path through the crisis. The key difference has been the speed in which the two nations have responded to the property market bubble burst.

■ The creation of NAMA in 2009 offered the best prospects for improving the external perception of Ireland. The correction in the economy and the property market has been significant but last year a turning point was reached with some signs of improvement evident.

■ In Spain the SAREB structure that was created last year, has injected liquidity in the market and has improved transparency raising hopes that the turning point for Spain may also be close.

■ The economic challenges in the Eurozone persist, therefore investors either focus on risk averse or distressed opportunities. However as investor psychology moves from depression to hope, some new opportunities can emerge.



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“The measures Ireland has taken to deal with the crisis have begun to pay dividends, allowing for renewed confidence. Spain is challenged, but following this lead” Eri Mitsostergiou, Savills European Research

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## NAMA vs SAREB

### Facts and figures

	SAREB	NAMA
Date of formation	November 2012	December 2009
Amount of loans transferred	€50bn	€77bn
Average discount rate applied	45.6% for developer loans 63.1% for foreclosed properties	56%
Banks whose loans were transferred	Bankia, Novagalicia, Cataluna Caixa, Banco de Valencia; Caja 3, CEISS, BMN, Liberbank	AlB, Anglo, Bank of Ireland, EBS, INBS
Public participation	45%	49%
Private participation	14 domestic banks, two foreign banks, one private company, 10 insurers	Irish Life Investment Managers, New Ireland Assurance, Allied Irish Banks
Exit period	15 years	11 years

➔ **Ireland - the impact of the crisis**

The impact of the crisis on the real economy of Ireland has been significant. Real GDP, has shrunk by 7% over the past five years and the unemployment rate has increased from 4% in 2001 to just below 15%.

The Irish property market, which had begun to lose momentum already in the second half of 2007 was further negatively affected by falling domestic demand and weakening consumer confidence. House prices began to decline in late-2007 and they are now 50% below their peak. The commercial property market, has also experienced a dramatic correction. From an investment turnover of over €3bn in 2007 it dropped to less than €20m in 2011 and prime yields moved out from below 4% to 8.5% over the same period.

With falling property prices, banks began to suffer huge losses on their loans. At the same time, they began to experience deposit outflows, and there were fears about their ability to access funding from the wholesale money markets.

**Dealing with the problem**

In 2009, Ireland has made some progress in dealing with the legacy of the property bust by creating the National Asset Management Agency, or NAMA, which used bonds to buy commercial real estate loans from the banks. Moreover, the government attempted to support the banking system through guarantees of banks

liabilities and the recapitalisation programme of its three major banks. Nevertheless, the large costs of these measures led to an acute deterioration in the government's fiscal position.

In November 2010, the government negotiated a financial assistance package with the EU and the IMF totalling €85bn to support the economy and the public and to keep vital public services running. Over the past two years progress has been made in the consolidation of the banking and fiscal sector of the country and the structural reforms in combination with the flexible nature of the economy have allowed for a considerable adjustment in competitiveness.

**The road to recovery**

Ireland enters what is expected to be its third consecutive year of growth, and there is greater sense of renewed confidence, which marks a turning point for the economy and the financial markets. Although the economy has grown by only 0.9% in 2012, this follows a 1.4% rise in 2011 and appears on track to return to a sustainable growth path in the medium term. The debt agency issues 10-year government bonds for the first time since the bailout, undershooting its budget deficit target by almost 1% of GDP.

The recovery in Ireland's competitive position is also supporting export growth, which comprises an important factor for the performance of the economy. Besides, multinational firms that use Ireland as a low-tax base are

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 "We expect investment turnover to reach €1bn in 2013 supported by the return of investors and higher supply of quality assets." Angus Potterton, Managing Director, Savills Ireland  
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investing once more, especially from Financial, Information Communication Technology and Pharmaceutical sectors (eg Facebook, Dell, Google).

**Property investment**

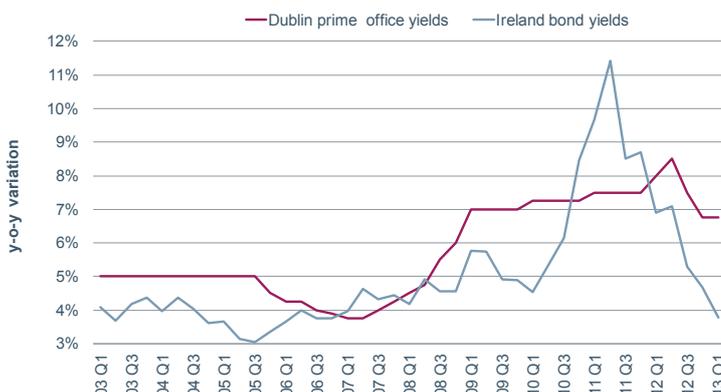
The property market has also shown signs of recovery, particularly last year. Irish home prices have stopped falling in Q2 2012 and increased by about 3.5% on average on a quarterly basis.

In the commercial market 2011 was the low point in terms of value and volume of turnover. Market participants entered 2012 with renewed confidence following the government's structural package for the commercial property sector in Budget 2012, which eliminated the possibility of legislation in relation to commercial rent reviews and which also boosted the sector with reduced stamp duty levels and capital gains tax relief for investors who acquire property in 2012 and 2013 and hold the assets for seven years.

Overall, the prompt response of the Irish government to the property bubble burst, has set the grounds for the road to recovery. The increased supply of prime assets put on the market, created an active market after a period of stagnation. As 2012 progressed, the level of turnover increased ending the year at just over €576m for the country. A further €350m of deals have been completed in the first quarter, confirming the return of investor interest. Three deals over €50m accounted for 50% of total turnover. Almost 90% of the deals were completed in Dublin and office deals accounted for approx. 68% of the total value of turnover.

The private equity investor type dominated, with private Irish investors accounting for 45% of the total. Increased interest from international and domestic investors is also apparent since the end of last year.

GRAPH 1 **Prime office yields vs long term interest rates** Prime asset pricing could harden in 2013



Graph source: Savills, Oxford Economics

## Spain - following Ireland's steps?

It is widely acknowledged that from an economic point of view Spain is experiencing similar conditions to Ireland three years ago. Since the beginning of the crisis in 2007-2008 the economy has been caught in a deepening recession caused by the contraction of the domestic sector. Economic output has lost 6% of its value and GDP growth is expected to contract by 1.6% in 2013 (Oxford Economics). Unemployment has climbed up to 26% from 8.6% in 2007.

The repercussions have been severe for the property market as well. Widespread unemployment resulted in many citizens being unable to meet their mortgage requirements. House prices have dropped by 29% since their peak in 2008 and they continue to edge downwards.

Commercial investment volumes have dropped from almost €10bn in 2007 to about €2.2bn in 2012. Prime yields, are at least 200 bp above their peak levels with prime CBD office yields in the region of 6.0% and prime shopping centre yields at 6.75% (Q1 2013).

## Dealing with the problem

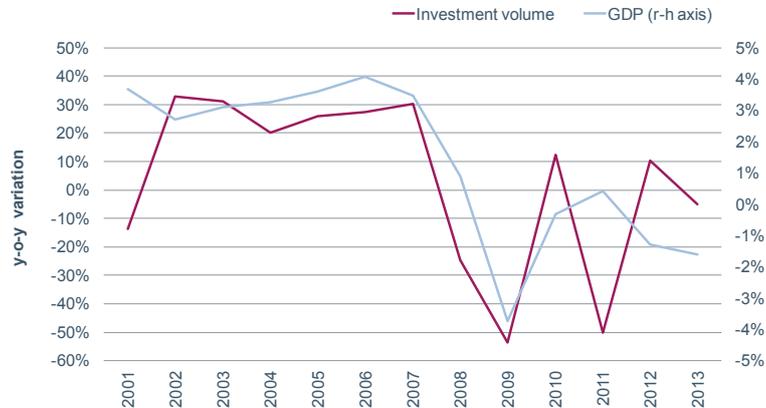
The government tried to deal with the problem by nationalising some of the most problematic banks and introducing the Guindos law, which forces the banks to increase their volume of real estate asset provision. The enforcement of this law, confirmed that many banks had a significant liquidity issue.

The European Union provided a line of credit that injected liquidity into the system, which would allow borrowing to start again. One of the conditions imposed by the European partners to accede to the credit line was the creation of an institution to concentrate the toxic assets. In August 2012 the government created the above mentioned entity under the name

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 “SAREB is aiming to restore international confidence in the country's banks and finances. In 2013 the market should attract more investor interest” Jose Navarro, Deputy Managing Director, Savills Spain  
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GRAPH 2

## Spain economy and investment activity Reduction of economic risks will underpin investor demand



Graph source: Savills

of Sociedad de Gestión de Activos (Asset's Management Company), known colloquially as SAREB.

## The road to recovery

The creation of SAREB has been perceived by the local and international investment community as a positive step towards the recovery of the banking sector. By reducing the real-estate risk of the banks, SAREB is aiming to restore international confidence in the country's banks and finances.

Although this finds the economy in a deepening recession and the market activity at its bottom, gradually a turnaround in investor sentiment about the country's outlook is observed. In addition, the arrival of Europe's first tranche of bailout for the financial system should inject capital into the micro economy, which will have an effect on investment and growth in the business environment, resulting in an increase in consumption.

Recent labour market reforms have begun to pay dividends by helping to boost the flexibility and competitiveness of the economy. As a result exports are expanding

and should accelerate strongly in subsequent years helping to offset weakening domestic demand. Expansion of business outside of Spain may mark the beginning of an economic recovery and job creation.

## Property investment

In 2012 the total investment volume amounted to just over €2.1bn, reflecting an increase of 10% over 2011, which was the weakest recorded year in our time series. Almost half of the total figure, relates to three mega individual transactions of some emblematic properties in Madrid. Local investors continue to dominate the market. Offices and retail remain the most sought after assets.

Since the announcement of the creation of SAREB the deleveraging process of the of banks has accelerated. Loan portfolios and distressed assets, particularly residential units are coming onto the market and the response of private local investors is positive. Due to the economic uncertainty private households choose to invest their savings in bricks and mortar and to benefit from the substantial discounts.

Despite the fact that some cross-border investors are interested in the market, the start of 2013 has been slow with only €50m of investment turnover. This can be attributed to the fact that buyer and seller expectations have not converged yet. However a gradual turnaround in investor sentiment could bridge this gap.

## OUTLOOK

### Ireland: 2013 investment volume is expected to rise by more than 70% pa

- The Irish economy has entered a path of recovery, however unpopular austerity measures and a weak labour market will continue to impose a number of challenges, especially on consumer sentiment. Exports are the main driver of growth and they are forecast to grow by 2.3% in 2013. The economy is forecast to expand by just 0.7% in 2013, before entering a more solid expansion trend in 2014 (1.9%).
- A continued increase of economic activity coupled with positive recognition from the financial markets that Ireland is well positioned for continued recovery, offer a good indication that the domestic risks are reduced. These factors should underpin greater investor demand in 2013 and should provide a clearer platform for banks and receivers to offer more prime properties for sale.
- Turnover in Q1 2013 was in the region of €350m and the total investment volume in 2013 is expected to reach €1bn. Institutional investors will be more active with an appetite for larger lot sizes in particular, which nevertheless will be more challenging to finance.
- Transactions in the first quarter of 2013 offer a good indication as to where prime yields are. We believe that prices will continue to strengthen and it is likely that evidence of this will emerge by mid-year as current stock on the market is expected to be quickly absorbed. Prime office assets will continue to attract most attention and will lead the supply. A greater amount of retail transactions is also expected, led by prime high street assets. However, weak consumer confidence will continue to constrain the sector's performance.

### Spain: In 2013 portfolio deals could materialise

- The Spanish economy is expected to go through another year of economic depression as austerity measures and high unemployment will continue to drag on domestic demand. Nevertheless structural reforms on the one hand and the dynamism of exports should help Spain to avoid a more severe recession. GDP growth forecast for 2013 is at -1.6%, while in 2014 our economists (Oxford Economics) expect economic growth to enter a positive path (0.2% and 1.1% in 2015). Nevertheless, there are still some downside risks in relation to the country's fiscal position and the political and economic stability of the Eurozone periphery.
- International investors, particularly the ones that are familiar and present in the market, show confidence in Spain's ability to recover and are scanning the market for the right product. Besides, new entrants in the market such as South American and opportunistic investors are showing interest in the market.
- We believe that in 2013 the Spanish market will bottom out as prime values and rents have dropped between 45% and 55% since their peak in 2007. As demand pricing expectations are finding their equilibrium, there are better prospects for deal activity at the current achievable yield levels. Investment volume in 2013 is expected to be similar to 2012, especially if some portfolio deals materialise. However limited availability of financing particularly for large-scale deals may restrict the market activity.

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