

Briefing Note

Ireland's economy & property market

Q2 2012

The Irish economy grew by 0.7% in 2011, the first year of growth since 2007. GDP growth of 0.5-1% is forecast for 2012. Investment market turnover is expected to be considerably higher this year as more prime stock comes to the market.

Economic Overview

Following three consecutive years of negative economic growth the Irish economy grew by 0.7% in 2011 as measured by Gross Domestic Product (GDP). Gross National Product (GNP) declined by 2.2% as a result of high net outflows. 2011 recorded the first annual growth in the economy since 2007 which is good news.

The pace of growth was particularly strong in the first half of 2011 but slowed in the second half as concerns about the Eurozone impacted overall activity (technically pushing the economy into recession in Q3 and Q4 as growth rates were negative).

Due to the small open nature of the Irish economy, there is a high interdependency between its performance and that of its main trading blocs—namely, the Eurozone, the UK and the US. This is clearly evident from the slowdown that was recorded in the second half of 2011. GDP is forecast to increase by between 0.5% (EU/IMF) and 1% (Irish government) this year and by possibly 2% in 2013. Aside from external demand, key factors supporting the recovery are the 12.5% corporation tax rate, the government's commitment to addressing the public finances and an educated workforce. These factors support the export sector in particular which is driving the gradual recovery in economic output.

A very significant increase in competitiveness is also supporting a recovery and Ireland continues to attract foreign direct investment with Google, Facebook, LinkedIn and PayPal in expansion mode. Unemployment while set to remain high, is expected to fall from 14% this year to 13.7% in 2013.

Inflation

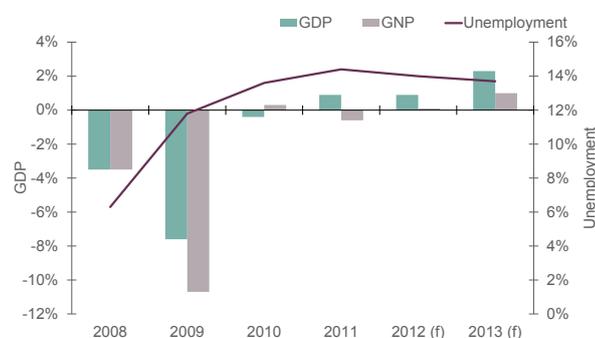
There is expected to be little in terms of domestic factors that will put upward pressure on prices in 2012. This is and will be cancelled out by the impact of higher energy prices on many input (such as transport costs etc.) prices for businesses. Consumer Price Index (CPI) inflation was 2.2% in 2011 while the Harmonized Index of Consumer Prices (HICP) which is used to compare Irish with other EU member states inflation rates, averaged 1.1%.

Consumer Confidence

Consumer confidence/sentiment remains fragile and somewhat volatile.

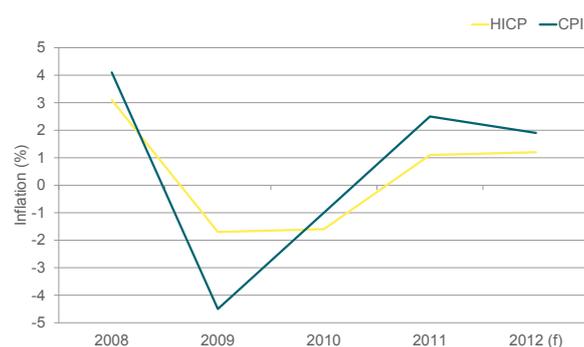
Consumers are concerned about the impact of the measures that were announced in Budget 2012. While there was no increase in direct income tax, there were additional indirect taxation measures announced, which combined will put pressure on disposable incomes in 2012.

GRAPH 1
% Change in GNP, GDP & unemployment



Graph source: ESRI, Central Bank, Department of Finance

GRAPH 2
% Change in CPI & HICP



Graph source: CSO

“The Irish economy is proving flexible in terms of its ability to adjust to rapidly changing external factors and this bodes well for what is expected to be a considerable period of recovery.” Joan Henry, Director of Research, Savills Research

➔ Concerns about the impact of these measures coupled with further potential austerity measures in 2013 and 2014 are expected to weigh on consumer sentiment in 2012.

Retail Sales

2011 was a very challenging year for the consumer and this is clearly evidenced in the retail sales data. Reduced disposable incomes and the effects of price increases in fuel, mortgages and other essential services have had a negative impact on sales, both volumes and values.

However, the pace of decline in both the volume and value of retail sales slowed in the latter part of 2011 – boosted by pre-Christmas shoppers availing of sales and also by shoppers' front loading purchases in advance of an increase in the VAT rate from 21% to 23% which took effect on January 1st 2012. Department store sales followed the same trend.

February data was disappointing and showed a 1.9% annual drop in the volume of sales and a 1.8% drop in the value of sales, reflecting overall consumer caution. Excluding motors, the decline in sales volumes and values was more pronounced.

Public Finances

Under the EU/IMF Programme, the government must reduce the deficit to 3% of GDP over the coming years and indeed under the new EU Fiscal Compact (which needs to be ratified by a referendum in Ireland) the deficit must be reduced over an agreed period to 0.5% of GDP.

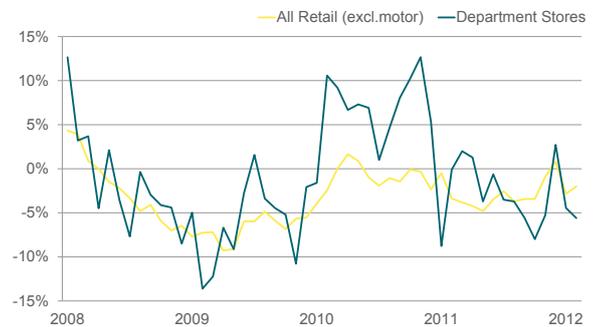
The government has implemented a series of austerity budgets which have reduced the deficit from 14.2% of GDP at the end of 2008 to 9.4% at the end of 2011 (excluding effects of recapitalisation of banks). The target is to reduce the deficit to 8.6% by 2012.

International market reaction to the government's budgetary measures has been positive. Ten-year bond yields are now below 7%.

In summary a gradual recovery in the Irish economy remains dependent on the external environment – this is the norm for a small open economy facing tough economic conditions on both domestic and external fronts. To date the Irish economy has proved flexible in terms of its ability to adjust to rapidly changing external factors and this does bode well for what is expected to be a considerable period of recovery.

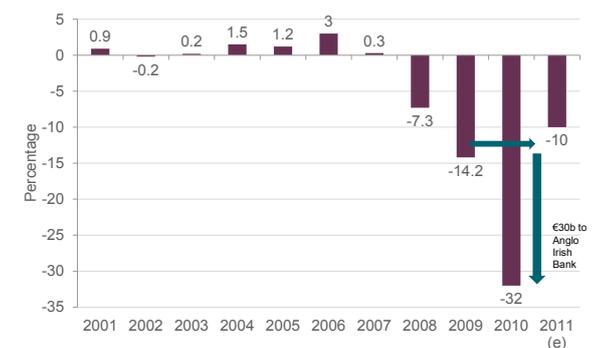
“Consumers are concerned about the impact of the measures announced in Budget 2012.” Joan Henry, Director of Research, Savills Ireland

GRAPH 3 % Change in retail sales



Graph source: CSO, Savills

GRAPH 4 Government balance as a % of GDP



Graph source: CSO, Savills

NOTE: Government balances went from surpluses in the 2003-2008 period to deficit of 7.3% in 2009. 2010 – deficit of €49 billion (-32% GDP, included approx. €30bn note to Anglo Irish Bank (now merged into the IBRC)

Commercial Property

In 2011, IPD data shows that Irish property returned -2.4% year-on-year, the fourth consecutive negative annual total return. The decline came from 10% year on year income return and -11.4% capital growth.

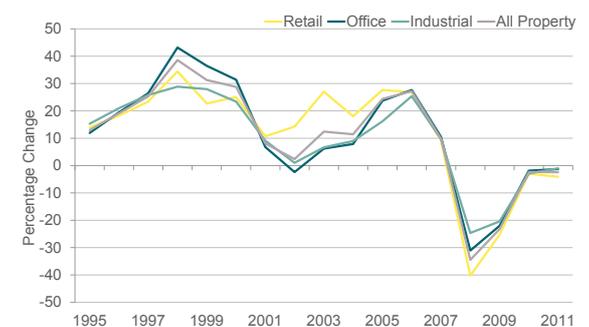
Continued falls in capital values were driven by a combination of a decline in rental values and an expansion in yields.

However, total returns on a quarterly basis showed an increase of 2.8% between Q3 and Q4 2011.

Performance was boosted by a 0.2% increase in capital growth, the first increase since 2007. Income return quarter on quarter was strong at +2.8%.

Rental values continue to decline. Changes to the stamp duty rate (now 6% to 2% on transactions) along with clarification that will be no retrospective changes to the rent review legislation have had positive impact on the market.

GRAPH 5 Total annual returns by sector



Graph source: CSO, Savills

➔ **Investment Property**

Activity in the Irish investment market has been stagnant now for virtually four years. 2011 looks to have been the worst year in this cycle with total investment turnover only €25m for the year as a whole.

Market conditions have improved significantly due in large part to the government's package for the property market announced in the December budget, including:

- Reduction in stamp duty from 6% to 2%
- Capital Gains Tax (CGT) relief for investors who acquire commercial assets up to year end 2012 and hold for 7 years
- No change to existing upward only rent review contracts.

Apart from the significance of these individual measures, international investors see the budget package as a commitment from Government to get the property market moving again. This coupled with other factors, such as historically high initial yields are making commercial property investment in Ireland more attractive.

Since the budget there have been three significant deals of scale agreed. The three assets, varying in lot size from €27m to €43m and all of which would be regarded as prime, are agreed with institutional investors and are the most significant transactions in the last four years. Overall, there is now price transparency for prime assets, (by location, length of income and quality of covenant).

The increased demand from core/core plus, private equity and opportunity investors is expected to be matched by an increased amount of stock coming to the market.

The secondary market is more difficult but if the length of income and quality of covenant is strong enough, investors will look at the product, more as a financial play.

In general the outlook for the investment market in 2012 is positive, although this needs to be measured against the low base of 2010/2011.

There is over €100m currently deal agreed and with more stock coming to the market turnover could reach €500m this year.

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 Director, Investments,
 Savills Ireland

Occupier Markets

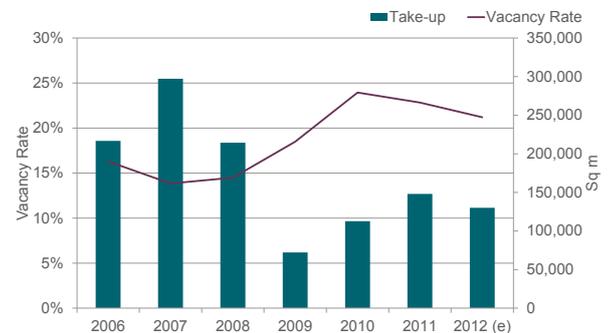
Dublin Office Market

2011 saw the strongest level of office take-up in the Dublin market since the slowdown in economic activity in 2008. Take-up for the year as a whole came in just under our forecast of 150,000 sq m, with 148,000 sq m of space occupied. This level of take-up is just over twice that achieved in 2009 which was the low point in terms of letting activity. Take-up in the office market in 2011 was 25% higher than in 2010.

The level of interest in the Dublin market from international telecoms, media and technology companies increased in 2011 and is a reflection of the very significant improvement in competitiveness that has taken place in the Irish economy. Part of this improvement has come from the significant reduction in office rents, particularly for prime space. These factors, along with a highly skilled workforce with English as the main business language will continue to make Ireland and Dublin in particular a very attractive location for US multinationals.

A trend that dominated activity for the year as a whole was occupier preference for space in Dublin's prime locations (namely Dublin 2 & 4). 56% of the total take-up in 2011 was in these two locations, compared to 52% in 2010. Dublin 4 in particular experienced a doubling in the amount of space occupied in 2011 compared to 2010. 32% of the annual take-up was in Dublin 4. Google's purchase and occupation of just under 20,000 sq m of space (Montevetro building), accounted for 40% of that total. Removing the effect of that deal, Dublin 4 still accounted for 19% of the total annual take-up in 2011. The second largest deal of the year was also in Dublin 4 - the occupancy by

GRAPH 6 **Dublin office vacancy rate & take-up**



Graph source: Savills

Paddy Power of just over 11,000 sq m of office space in Belfield office complex.

Dublin 2 accounted for 24% of total annual take-up, with take-up stronger in the second half of the year. There were 25 deals completed in the first half of 2011 in Dublin 2 and 40 in the second half. While the average size of the space being taken up in Dublin 2 remains relatively small (eg. averaging 500 sq m in Q4) demand for space remains strong and consistent (considered to be 25,000 sq m per quarter or above). This been the case now for six consecutive quarters.

The Dublin office market vacancy rate has fallen from 23% at the end of 2010 to 21.6% at the end of 2011. It has fallen further to 21.2% at the end of Q1 2012. This reflects a consistent level of demand for space and also the lack of newly built stock coming to the market. The vacancy rates are considerably lower for prime locations with for example the rate in Dublin 2 at just under 6% for Grade A space.

With demand expected to remain steady and completions at zero, we expect the vacancy rate to range between 21-22% in 2012. The rate of completions for office space in the Dublin market is at its lowest annual level since the early 1980s. 12,000 sq m of space has been completed in 2011 (all of which is at Trinity Central in Dublin 2). There is no new space in the pipeline for 2013 and 2014.

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➔ Prime rents had stabilized in 2010 for a number of quarters at close to €350 per sq m/year. The competitive nature of the market saw prime rents drop to between €290-310 per sq m/year at the end of Q1 2012.

We hold the view that prime rents have bottomed out in the current range of €290-310 sq m/year. We expect that there could be some upward pressure on prime rents by the end of 2012/early 2013.

Retail Market : High Street & Shopping Centres

Occupier demand is expected to remain stable in 2012 but will be driven more by value brands rather than higher value brands which had been active in the market in 2010 and 2011. International retailers such as Disney, Pandora, Abercrombie & Fitch, Kiehl's, Hollister and Forever 21 took space in the prime high street and shopping centres of for example Grafton Street and the Dundrum shopping centre in 2010 and 2011 but are expected to take a cautious approach this year and next as both consumer demand and retail sales are expected to remain weak.

Demand will be driven by for example - Bestseller who is expanding with an estimated 30 requirements for 2012. Some of its brands such as Vila and Vero Moda have taken space in Liffey Valley Shopping Centre.

Another key trend in 2012 will be an increased demand from discount stores that have become much more active in the Irish market. UK retailer – the 99c Stores is understood to have in the region of twenty requirements in 2012. Its competing store, UK's Poundland opened in 2011 and is also expected to expand. Adding to this is the expected increase in the number of Euro stores which is the Irish equivalent.

In terms of supply, only one shopping centre opened in Ireland in 2011 – a 17,000 sq m neighbourhood shopping centre scheme at Balbriggan in North County Dublin. The supply pipeline of new shopping centres and retail parks has come to a standstill. The level of vacancy at these centres' is minimal to none on case by case basis.

Rents in 2011 remained under pressure – with prime rents at very competitive levels with potential further downside expected this year. New entrants that are doing deals are negotiating

attractive incentives – such as extended rent free periods. Occupier demand is expected to continue to focus on prime locations, but some further downward pressure on prime rents is possible despite this, given the weakness of consumer demand. Any recovery in rents will be led by demand for prime space. This we do not expect to happen until at least Q1 2013.

Demand for non-prime space is expected to be poor in 2012, keeping downward pressure on rents for secondary and tertiary space. Deals for these types of space are effectively being negotiated almost on a case by case basis, with pressures expected to remain on the downside.

Industrial Market

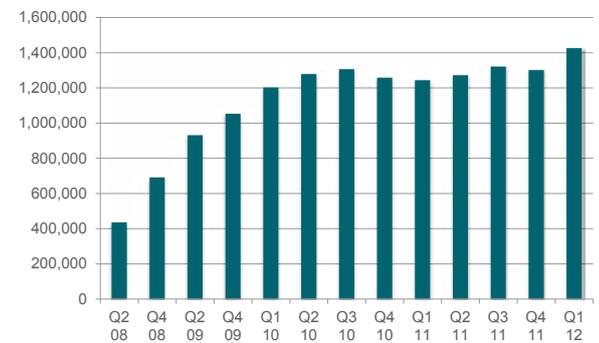
Conditions on the industrial market are challenging. Take-up was less than expected in 2011, vacancy rates are high and rents remain under pressure. A key trend in 2011 was that a significant proportion of industrial properties coming to the market were via receivers and this is expected to continue in 2012. Q1 data shows a sharp increase in the amount of vacant stock on the market.

This reflects the difficulties many companies are experiencing and is resulting in the banks appointing receivers to dispose of properties and mitigate their losses. The debt serving requirements of many businesses which are exposed to the property sector will continue to bring properties to the market for the foreseeable future. This will put upward pressure on the vacancy levels across most locations.

Take-up in the Dublin market is likely to be in the region of 125,000-175,000 sq m in 2012 (following total take-up of 141,000 sq m in 2011). Demand last year was driven by the ICT sector - as Ireland has become a hub for data centres and cloud computing operations. Logistics and distribution sectors are also expected to continue to drive requirements for space, but the demand from the motor sector, seen in the latter part of 2011, is expected to be more transitory given the continued weakness of consumer demand and retail sales.

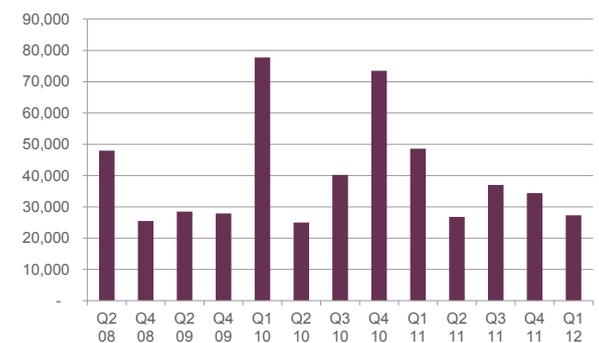
There were 110 open market industrial deals completed last year, a drop of 17% compared to 2010. Sales of industrial units increased throughout the year, with seven sales closing in the

GRAPH 7
Dublin industrial vacancy



Graph source: Savills

GRAPH 8
Dublin industrial take-up



Graph source: Savills

final quarter. Savills analysis of the stock currently available on the market shows that approximately 60% of the space available has been on the market for more than two years. The vacancy level is also dominated by smaller industrial units. This trend has dominated the vacancy breakdown throughout 2011 and is expected to remain the case in 2012 and into 2013. At the current level of quarterly and annual take-up it is difficult to see any significant erosion in the number of smaller units available, for at least 3-5 years.

Prime rents have adjusted considerably as tenants successfully negotiate better deals. Landlords have continued to re-align their expectations in order to attract occupiers with rent free periods and flexible lease terms becoming commonplace in deals to entice or retain tenants.

The gap between prime and secondary rents has narrowed and rents for tertiary premises are now being negotiated on a case by case basis – as low as €10 sq m/year. Void costs is a major issue for landlords who now need to weigh up the opportunity cost of leaving premises empty versus taking nominal rents and covering the annual property management, security and maintenance costs. ■

OUTLOOK

Economy

- Growth of between 0.5 - 1% of GDP is expected in 2012, driven largely by the export sector.
- There has been a significant increase in competitiveness across all sectors of the economy and this expected to continue.
- The consumer and as a result retail sales remain weak and somewhat volatile, but the pace of decline in sales has slowed considerably.
- Inflationary pressures are being driven almost entirely by external factors - rising energy prices in particular.
- To date the Irish economy has proved flexible in terms of its ability to adjust to rapidly changing external factors and this does bode well for what is expected to be a considerable period of recovery.
- A continued gradual recovery in the Irish economy is dependent on the external environment.

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“The outlook for the investment market is positive for 2012, the budget has given renewed momentum to investors who are expected to pursue assets coming to the market over the coming months.” Fergus O' Farrell, Director Investments, Savills Ireland

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OUTLOOK

Property Market

- Budget 2012 was positive for the investment market – eliminating concerns re changes to rent review legislation and reducing stamp duty at point of purchase to 2% from 6%.
- There have been three significant deals agreed in Q4 2011/Q1 2012. The three prime assets are agreed with core investors and will be the most significant transactions in the last four years.
- There has been an increase in stock to the market in Q1. Investment market turnover in 2012 is forecast to reach €500m.
- Occupier markets – in particular the Dublin office market, are performing well.
- Prime office rents have bottomed out in a range of €290-310 per sq m/year.
- Demand for office space remains focused on Dublin’s prime locations of Dublin 2 & 4 where the vacancy rates are low.
- Trends in the retail market continue to highlight a split between prime and secondary.
- Prime high streets and shopping centres have minimal vacancy. Rents have adjusted by 50-60%.
- The industrial market is burdened with a large amount of vacant space – as a result the gap between prime and secondary rents has narrowed considerably.
- There will be no new completions in any commercial sector in 2012 and there are none in the pipeline – this is positive and will erode supply in the short to medium term.

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