Savills Research – Q1 2023

MARKET IN MINUTES
Savills Research

Ireland Investment Market

Macro view • Investment flows • Sectoral analysis

€933m
worth of transactions took place in Q1

34%
United States buyers had the highest market share

25 bps
increase in most prime yields quarter-on-quarter

60%
rise in debt costs year-on-year

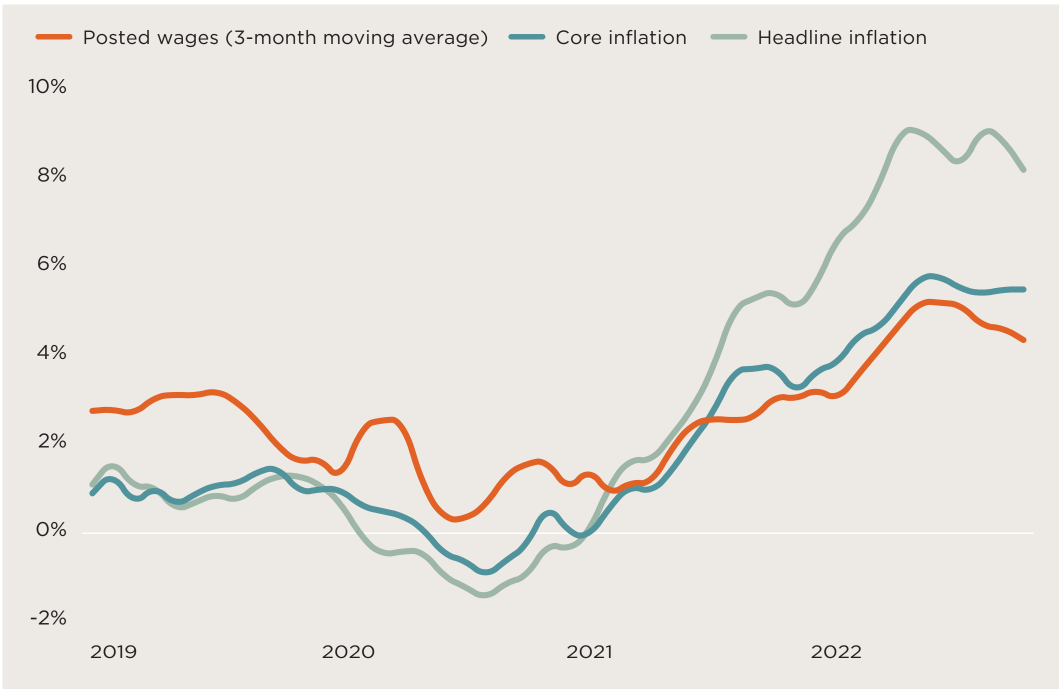
Macro view

Challenged investment market despite relatively resilient Q1 investment volumes.

The macro environment continued to offer a mixed picture in the opening quarter of the year, reflecting differences between a strong real economy and a more uncertain financial one. Overall, the domestic economic picture is stronger than expected with Modified Domestic Demand now forecast by the Central Bank of Ireland to be 3.1% in 2023, up from 2.3% in Q4. The current unemployment rate of 4.3% remains at levels generally considered full-employment, and down from the 5.0% recorded 12 months ago. The strong economy is also being mirrored in the country's falling debt burden, with debt to GNI* expected to be just 75% by the end of 2023. This compares with a ratio over 100% just two years ago, representing an extraordinary turnaround on the nearly 160% witnessed ten years ago. This reduction in the debt burden is significant in the context of the rising interest rate environment, which will raise future borrowing costs as debt matures (although Ireland's weighted average maturity of 10 years mitigates this rate risk). Debt is expected to continue to decline in the coming years, with debt-to-GNI* forecast to reach 65% by 2025, and thus close to the target rate of 60% mandated by the Euro convergence criteria. Contrast this with the 10-year bond rates for countries such as Greece, Italy and Portugal who had debt-to-GDP ratios of 171%, 144% and 114% respectively at year-end 2022[1].

> **Debt is expected to continue to decline in the coming years, with debt-to-GNI* forecast to reach 65% by 2025, and thus close to the target rate of 60% mandated by the Euro convergence criteria.**

Figure 1: Advertised wages versus inflation, Ireland



Source: Indeed.com, Central Bank of Ireland

[1]Eurostat

"While rate rises may hurt the economy in the short-term, they are needed to preserve its longer term health."

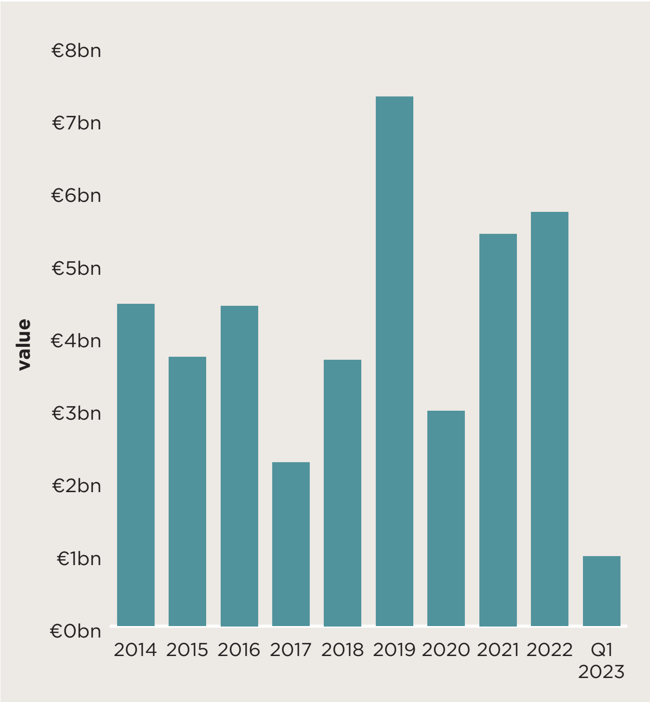
One of the primary influences on Ireland's falling debt profile has been corporation tax receipts continually running ahead of projections. €22.6 billion of corporation tax revenue was generated in 2022, approximately 50% ahead of 2021 receipts – itself a previous record. 2023 is expected to see corporation tax receipts rise further again with €24.0 billion projected, although few will be surprised – based on past performance and in the context of strong Q1 figures – if this threshold is significantly surpassed. It should be noted that the persistence of these outsized corporation tax inflows is very uncertain and cannot be relied upon into the future, and thus should be treated by fiscal policy makers as windfall gains rather than recurring income. In our opinion, they should be used to pay down sovereign debt or invest in infrastructure projects with a positive net present value, rather than being used for recurring government spending.

Against this largely positive backdrop, inflation continues to pose an existential threat to the economy. While the headline rate of European inflation as measured by HICP is falling (7 .0% in April versus a high of 10.6% last October), the core rate remains elevated (5.6% in April versus 5.0% last October). As illustrated in Figure 1, it appears that a close relationship between increases in advertised wages and core inflation has emerged in Ireland. This relationship is problematic as it indicates that inflation expectations are becoming embedded in wage expectations and underscores the need for aggressive rate rises to break this link, even if the headline inflation rate is falling. While rate rises may hurt the economy in the short-term, they are needed to preserve its longer term health.

Investment flows

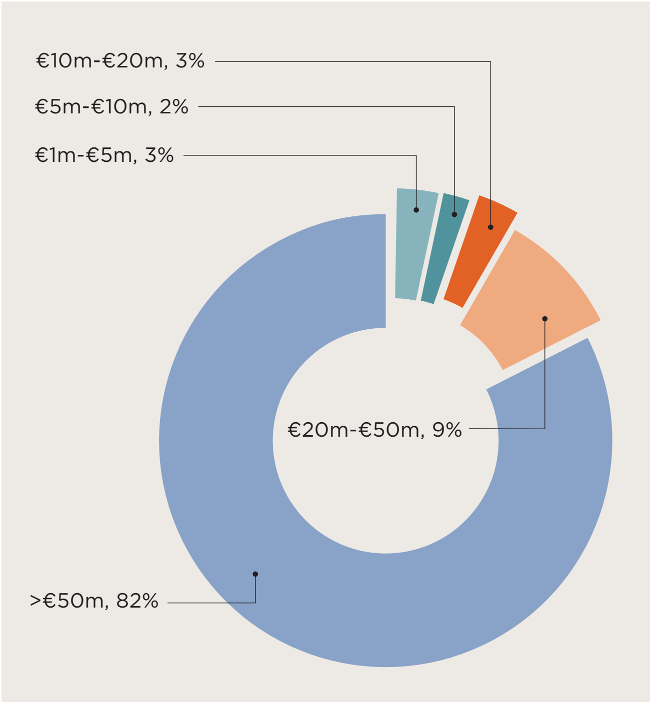
€933.0 million worth of investment transactions took place in Q1, up 10.3% on Q1 last year and 19.4% ahead of the ten-year Q1 average. In total, there were 31 transactions during the quarter, which was 8.8% less than Q1 last year and 36.6% less than the ten-year Q1 average. This dynamic of larger total volumes by value but a lower number of deals reflects an increase in the average deal size to €30.1 million, the largest Q1 on record. The trend towards larger deal sizes reflects both the appreciation in values witnessed over the last decade and the investor demand for investments of scale.

Figure 2: Investment volumes



Source: Savills Research

Figure 3: Volumes by deal size



Source: Savills Research

Greenogue Logistics Park

The largest deal of the quarter was the acquisition of the Valley Healthcare platform by KKR through its subsidiary company John Laing for €300.0 million. The platform was established in 2017 and is a sub-fund of the state-backed 'Irish Investment Fund' ICAV, a fund launched in 2012 by Irish life Investment Managers and AMP Capital Advisors with backing from the sovereign Ireland Strategic Investment Fund, targeting IRR's of 12% -15%. The Valley Healthcare platform consists of 20 operational primary care centres – which are operated and managed by the HSE - assembled through a combination of acquisitions and development projects. Each site has inflation-linked leases for periods of 25 years with five-year extension options. The sale comprised a further 10 development sites with agreements for leases in place with the HSE.

The deal reflects a number of investment themes prevailing in the current market. Firstly, the assets are in a secular trending sector, backed by long-term tailwinds and shielded from the volatility of the economic cycle – a favourable characteristic at a time when the perception of recessionary risk is elevated. Secondly, the income stream is backed by a state entity, further enhancing the covenant credit quality during this time of economic uncertainty. Thirdly, the assets are inflation-linked, allowing the acquirer to protect the value of their cashflows in an inflationary macro environment. Finally, the large lot size is catering to the demand from private equity funds that have large quantum of capital raised that needs to be deployed in an efficient manner at scale. The assembled portfolio allows them deploy capital at scale while also diversifying their risk across a number of properties and locations throughout Ireland. This will allow them to manage concentration risk and maintain liquidity through the cycle.

The second largest deal of the quarter also involved KKR, this time on the sell side as it disposed, along with its joint venture partner Palm Capital, of Greenogue Logistics Park to Ingka Investments for €110.0 million. Greenogue Logistics Park consists of 450,000 sq ft spread across three units, and the deal marks a successful exit for the investors who speculatively delivered the units late last year.

€300m

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Blackrock Business Park

The third largest deal was the sale by Angelo Gordon and their local partner Carysfort Capital of Opus, a prime PRS scheme located in Dublin's south docklands at 6 Hanover Quay. The joint venture fully stabilised the development following their agreement to forward purchase the scheme in 2018 from Cairn Homes. The 120 unit scheme was purchased by Pontegadea Investments, the family office of Zara founder Amancio Ortega. Excluding the minor associated commercial element of the deal, the yield on the residential component is estimated to be 4.25%. While it marks their first acquisition in Ireland, they have been scoping opportunities in Ireland for some time, having held extensive consideration of the Meta-leased Fibonacci Square in Ballsbridge. The private rented sector was also behind the fourth largest deal of the quarter and also involved a new market entrant, as M&G acquired Eglington Place, Donnybrook, for €99.5 million, representing a yield of 4.1% and an average price of €672,000 per unit. The 148 unit scheme will sit within M&G's newly launched European Living Fund, a vehicle largely funded by Dutch pension fund administrator MN, who are investing on behalf of Dutch pension funds PMT and PME. MN are contributing €400 million while clients of an internal M&G fund seeking exposure to alternatives is contributing the remaining €178 million of the €578 million fund. Due for completion in Q2 and targeting a BREEAM 'very good' certification, the scheme's green credentials were a critical factor in the acquisition process for M&G.

Other significant transactions included the purchase by Fine Grain Property of Waterside, Citywest from joint venture partners IPUT and Davy for €65.5 million. Elsewhere, Woodberry Capital acquired a property on Grafton Street, giving a net initial yield of 7.0% and an estimated equivalent return of just under 5.0%. Kennedy Wilson were active on both sides of the market in Q1. They purchased three industrial units for €14.8 million from an undisclosed seller and sold Blackrock Business Park to French fund Remake for €13.0 million.

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Opus, 6 Hanover Quay

Unit 5 and 6A, Galway Retail Park

Looking at geographical spread, 57% of deals took place in Dublin with 43% taking place nationwide. Outside of Dublin, the most significant sales – aside from the Valley Healthcare deal – were the purchase of Douglas Village Shopping Centre in Cork by Urban Green Private from the Love Family/Deutsche Bank for €23.0 million and the sale of Fairgreen Shopping Centre by CarVal to Lava Capital for €20.0 million.

Looking at market share by sector, residential investment accounted for the largest market share at 36%, with the two aforementioned PRS deals at Opus and Eglington Place the most significant deals in this category. The second largest category was 'Other', which was largely driven by the Valley Healthcare deal. Industrial, offices and retail made-up the remainder, accounting for 13%, 10% and 7% market share respectively.

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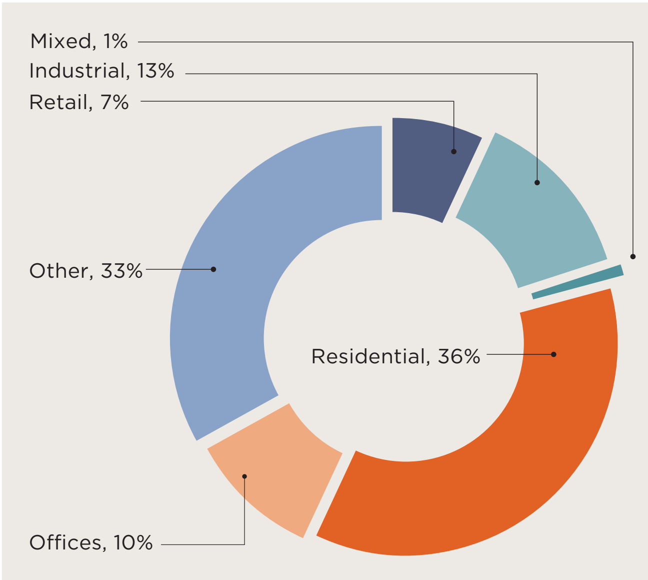
Figure 4: Market share by sector



Source: Savills Research

Table 1: Top five deals

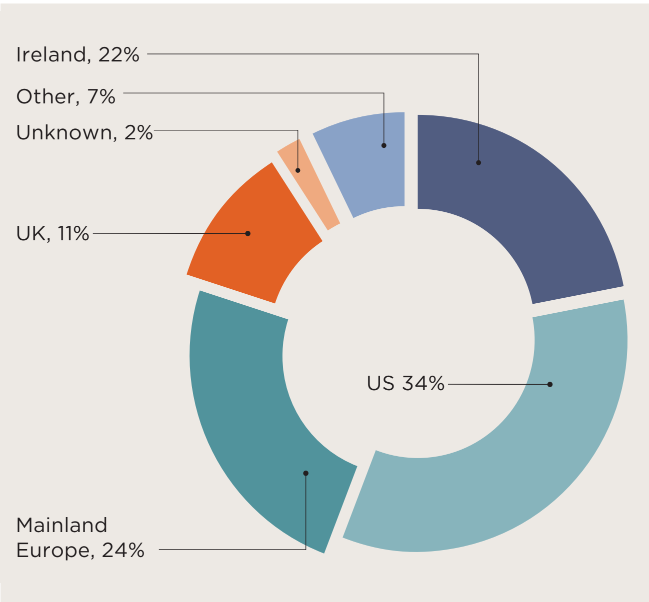
Property	Price	Sector	Vendor	Buyer
Valley Healthcare Portfolio, country-wide	€300.0m	Health Care	Irish Infrastructure Fund/AMP Capital	John Laing/KKR
Buildings 1A, 1B and 2, Greenogue Logistics Park, Co. Dublin	€110.0m	Industrial and Logistics	Palm Capital/KKR	Ingka Investments
Opus, 6 Hanover Quay, Dublin 2	€101.0m	PRS	Angelo Gordan/ Carysfort Capital	Pontegadea Investments
Eglington Place, Dublin 4	€99.5m	PRS	Richmond Homes	M&G
Lisieux Hall, Murphystown Road, Dublin 18	€92.0m	Social Housing	Fitzwilliam Real Estate	Respond

Source: Savills Research

Investor nationality and type

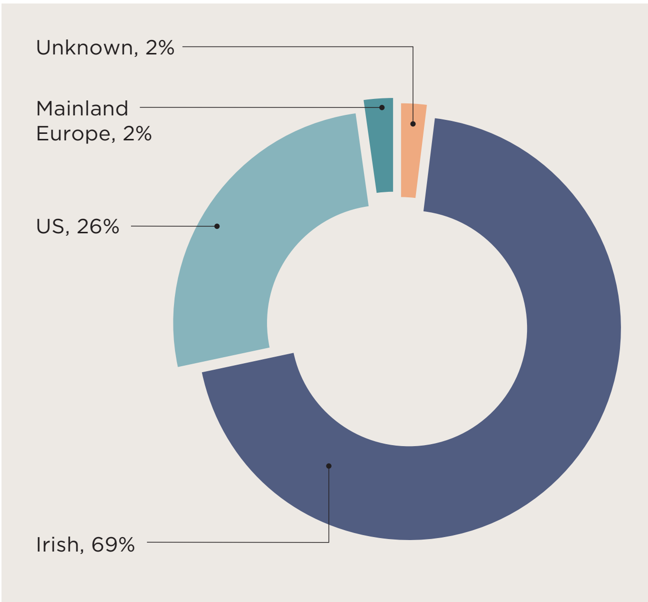
Purchasers from the United States accounted for the largest share of buyers active in the market in Q1, with their 34% market share ahead of Europe (24%), Ireland (22%) and the UK (11%). 'Other' accounted for 7% with 2% unknown. In terms of sellers, the market was dominated by Irish participants with 69% market share, followed by the United States with 26%. European vendors accounted for 2% with a further 2% unknown. Turning to the type of capital active, 40% of buyers were private equity firms, followed by the 'Other' category at 26%, 18% were private individuals and 14% institutional buyers. Ikea's investment arm, Ingka Investments, purchase of Greenogue Logistics Park was the driver of the high share of the 'Other' category. Looking at the breakdown of vendors, the 'Other' category accounted for the highest share of sellers at 32%, followed by private equity (23%), property companies (15%) and institutional capital (13%). The high share of the 'Other' category was driven by the Irish Infrastructure Fund's sale of the Valley Healthcare portfolio, which consisted of sovereign and private sources of capital.

Figure 5: Market share by buyer nationality



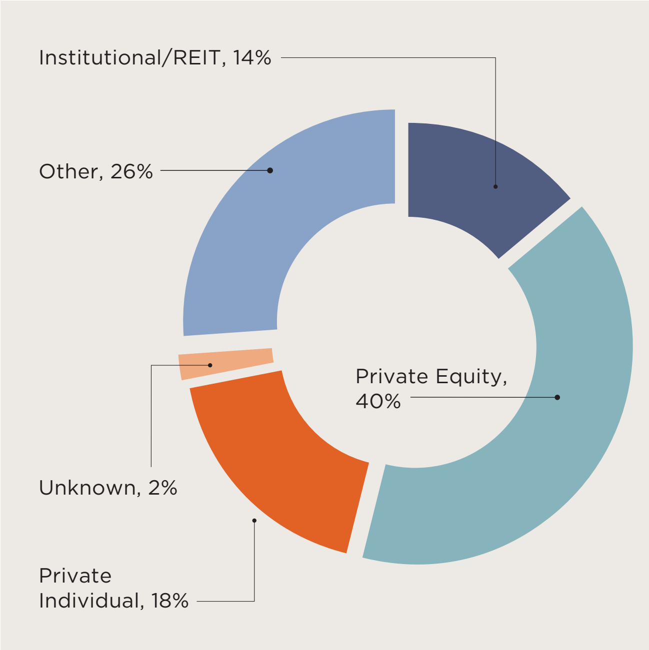
Source: Savills Research

Figure 6: Market share by seller nationality



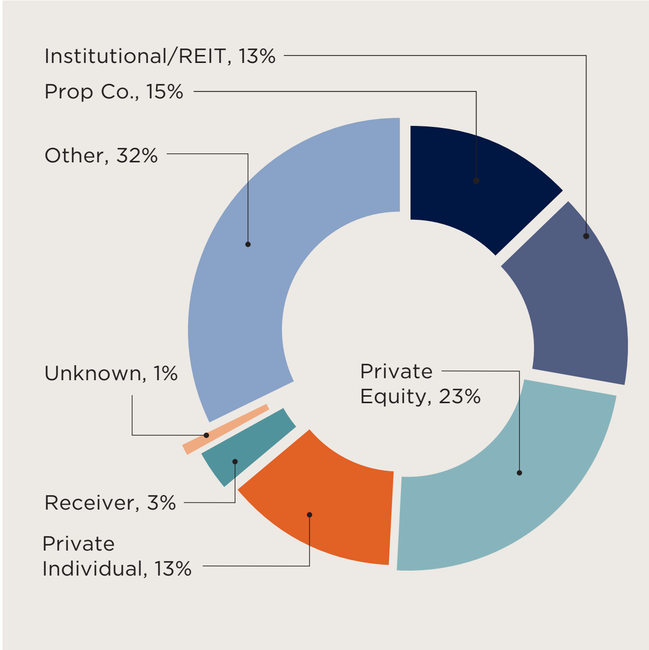
Source: Savills Research

Figure 7: Market share by buyer type



Source: Savills Research

Figure 8: Market share by seller type



Source: Savills Research

> **The high share of the 'Other' category in sellers was driven by the Irish Infrastructure Fund's sale of the Valley portfolio, which consisted of sovereign and private sources of capital.**

Douglas Village Shopping Centre, Cork

Investment yields

Investment yields continued to soften in Q1 as the market adjusted to the dynamic created by elevated debt costs and higher bond yields. Almost all of the property segments pushed out by at least 25 bps on a quarterly basis, except for prime retail which pushed out by 15 bps. Prime PRS moved from 4.00% to 4.25%, while both the offices and industrial and logistics sectors moved from 4.25% to 4.50%. Prime shopping centres and secondary office yields pushed out further, going from 6.00% to 6.50%. In terms of secondary yields, these have been pushed out the most in the offices sector, reflecting the heightened challenges these assets face in an environment where occupiers are hyper-focused on top quality stock with ESG credentials.

Table 2: Investment yields

Sector	Q1 2023	Q/Q Change
Offices - prime CBD yield	4.50%	0.25% ▲
Offices - secondary CBD yield	6.50%	0.50% ▲
Industrial and logistics - prime yield	4.50%	0.25% ▲
Industrial and logistics - secondary yield	6.00%	0.25% ▲
Shopping centres - prime yield	6.50%	0.50% ▲
Shopping centres - secondary yield	10.00%	0.00% ◀▶
Warehouse retail - prime yield	5.75%	0.25% ▲
Warehouse retail - secondary yield	9.75%	0.00% ◀▶
High street - prime yield	4.90%	0.20% ▲
High street - secondary yield	7.75%	0.25% ▲
PRS - prime yield	4.25%	0.25% ▲
PRS - secondary yield	5.75%	0.25% ▲

Source: Savills Research


Eglington Place, Donnybrook

Commercial real estate debt market

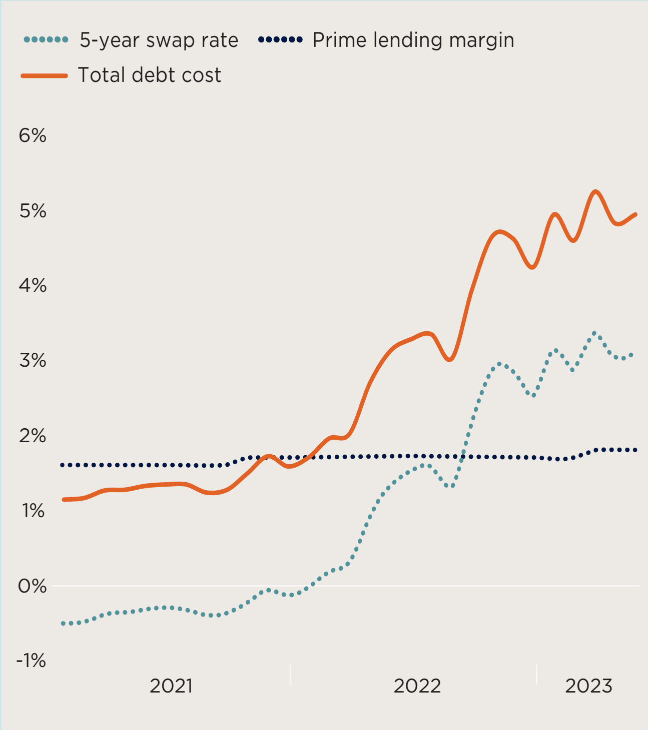
The rising cost of debt is creating challenges for commercial borrowers. For those with investment assets, interest cover ratios (ICR) and debt service covenant ratios (DSCR) are coming under pressure. Some borrowers, who agreed covenant levels in a lower interest rate environment, may need to renegotiate covenants to ensure that sufficient headroom is still available and that covenants are not breached.

Hedging costs have also increased, with many borrowers either required to – or choosing to – acquire interest rate caps at a significant upfront cost which must now be built into any upfront transaction cost analysis. Where borrowers take fixed-rate loans or interest rate swaps, the all-in cost of debt has risen, reducing free cash flows and returns.

It is fair to say that the response from lenders has been mixed. Bank lenders are undoubtedly taking a more risk averse approach to underwriting deals, with LTVs down and covenants tighter. The borrower and their track record in the relevant sector is as important, if not more important, than the underlying assets. On the other side, we see a number of alternative lenders with strong or increased appetite, seeing the dislocation as an opportunity to grow their lending book in Ireland, where the economic fundamentals compare favourably to European peers.

The Irish commercial real estate debt market has changed immeasurably over the last decade. While we have seen the retreat of mainstream banks, such as Ulster Bank and KBC, there is now a much wider choice of debt providers available to borrowers than ever before, highlighting lenders' belief in Ireland as an attractive destination for debt transactions.

Figure 9: Debt costs



Source: Savills Research

Greenogue Logistics Park

Outlook

Despite the relatively strong start to the year as measured by Q1 investment volumes, investor sentiment remains weak. Predictions for a quiet first-half of the year have certainly proved true, as the market continues to adjust to the higher interest rate environment. Asset values have been challenged by rising debt costs and the increase in the opportunity cost of capital. For example, in terms of the latter, government bonds are now a viable alternative for yield hunting investors for the first time in a decade, offering a passing income that rivals real estate (if not the same inflation protection).

The difficult environment has focused the attention of asset managers on shoring up the strength of their balance sheets. The risk of breaching senior debt covenants has required financing gaps to be plugged, which is being achieved via the sale of minority stakes in large assets/portfolios and by additional equity injections where available from sponsors. Property sales are also being undertaken to raise equity, particularly for funds which need to satisfy redemption requests. As a result, we have seen a number of assets on Grafton Street change hands, with the prime nature of the assets ensuring a pool of investor demand even in a market with challenged liquidity. High-net-worth individuals have proved to be active buyers for these assets, as they seek yield in an environment where the value of cash balances is being eroded by inflation. The chance to acquire a trophy asset on Ireland's premier street is also playing into this demand.

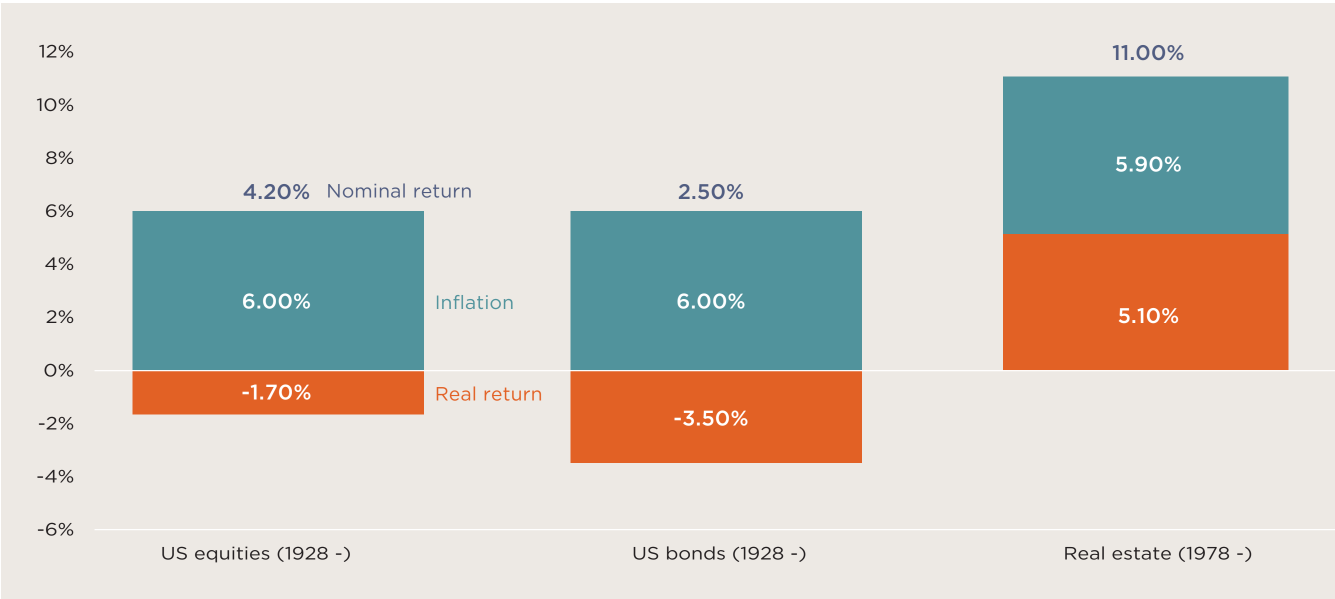
Savills Investment Management estimate that 45% of UK CRE debt will need to be refinanced in the next two years, illustrating the scale of the refinancing required in the market. Asset sales will be inevitable in the cases of non-stabilised assets with upcoming financing events where the holder does not have the ability to plug the funding gap. However, demand for new lending is strong for the right assets, with the debt element of the real estate capital stack an attractive defensive investment in the current environment.

Funding availability is highly thematic and we are seeing the market bifurcate in a way not previously witnessed, leading to a widening in the dispersion of returns opening up between assets. Office investments is at the forefront of this trend, with ESG considerations and demand preferences for CBD locations post covid leading to a concentration of investor demand on a more narrow, focused segment of the market. In recent years, beta-led investment strategies worked as a supportive monetary environment saw asset values rise across the board. In such a context, a rising tide does indeed lift all boats. Contemporaneously, however, investment selection needs to be backed by a detailed thematic story which will underwrite rental growth even in a challenged economic landscape. The industrial and logistics market is an example of a sector which offers such secular opportunities, where long-run demand drivers – such as e-commerce, Brexit, occupier consolidation – offer mitigation against economic cyclicality. The prospects for rental growth are promising, ensuring that rents reprice in-line with general inflation and protecting the value of the cash flow stream. Capital values are also protected by rising replacement costs in an inflationary environment while the rising cost of finance also makes new construction more difficult. The latter acts as a barrier to entry for new supply in an already supply constrained market.

More broadly, inflation protection has always been an attractive feature of real estate. As illustrated in Figure 10, long-run data from the United States analysed by Apollo shows that real estate has returned an average of 11.0% during inflationary periods, compared to 4.2% for equities and 2.5% for bonds. Therefore, while the current market is undoubtedly painful, real estate nevertheless out-performs during these periods over the longer-term.

> **“The industrial and logistics sector is an example of a market which offers such secular opportunities, where long-run demand drivers – such as e-commerce, Brexit, occupier consolidation – offers mitigation against economic cyclicality.”**

Figure 10: Returns by asset class in high inflation environment, United States



Source: Apollo
Note: High inflation environment (defined as years where inflation was above the median level of 2.7% and increased over the year by more than 1%.)

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