Savills Research - Q1 2021

MARKET IN MINUTES
Savills Research

Ireland Investment Market

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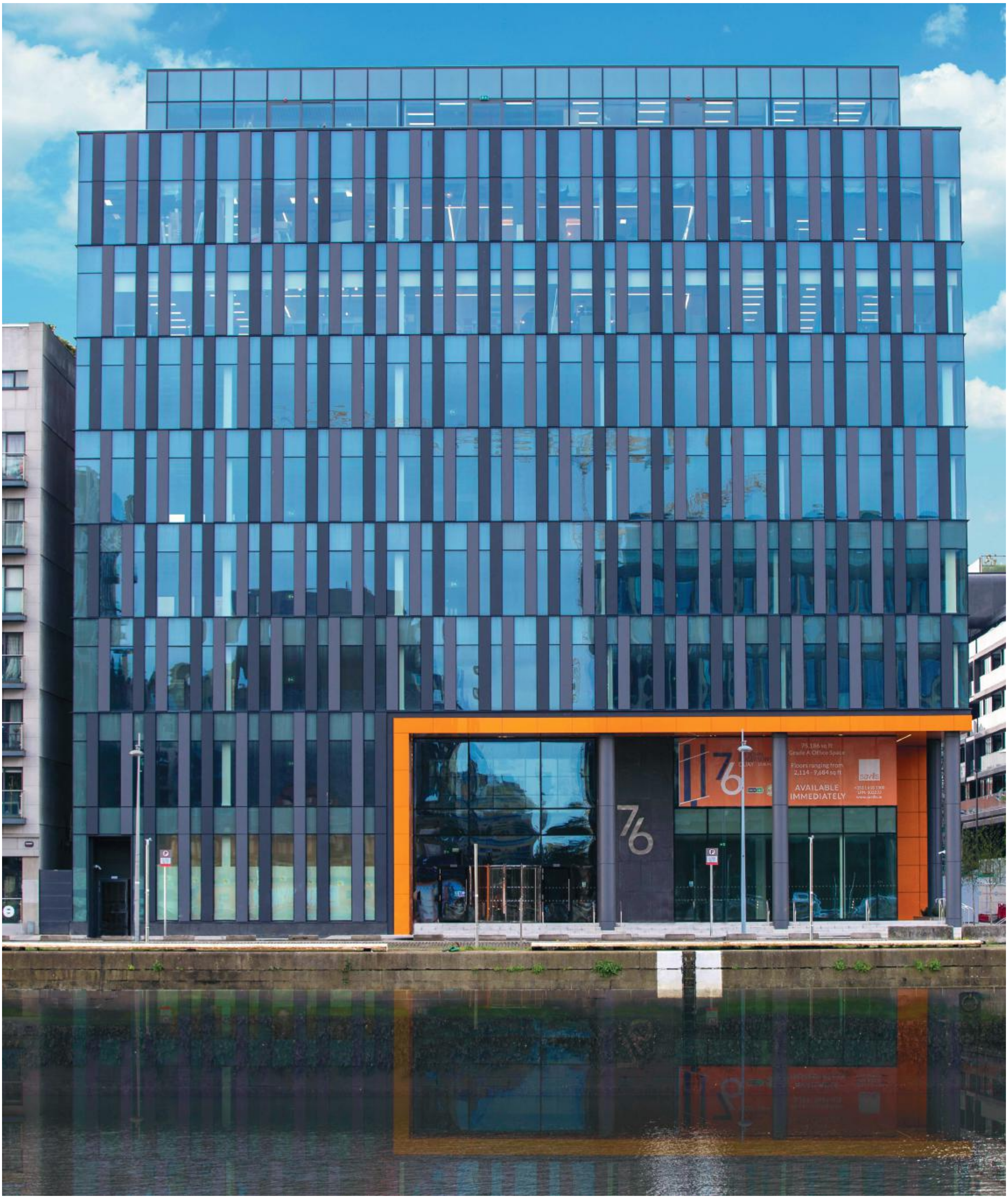
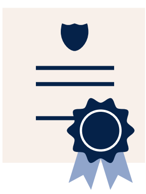


Macro view • Investment flows • Outlook

€1.2bn
transacted in Q1

€713m
transacted on PRS

€392m
spent on offices



ESG
credentials now a critical consideration

Macro view

Attention turns to inflation as the economy opens-up

In our last report, we discussed the prospect of rising inflation as one of the key considerations for investors heading into 2021 due its potential to put upward pressure on property yields. If an opening up of the economy leads to an inflation rebound, we may see the 'lower for longer' view of interest rates being challenged which would put upward pressure on property yields. Concerns regarding inflation accelerated in Q1, pushing the yield on Irish ten-year Government bonds to positive territory for the first time since July 2020.

Inflation expectations

are in unchartered territory due to unique pandemic circumstances

Much of the concerns regarding inflation are emanating from the United States, which saw the Federal Reserve revise its 2021 inflation forecast to 2.4% in Q1, up from 1.8% in Q4. In Europe, the ECB maintains that inflation will remain muted for some time to come, with CPI expected to rise by 0.9% this year and only rising to 1.7% in five years time. In short, the ECB expects inflation to remain below their target of 1.9% for the medium-term at least.

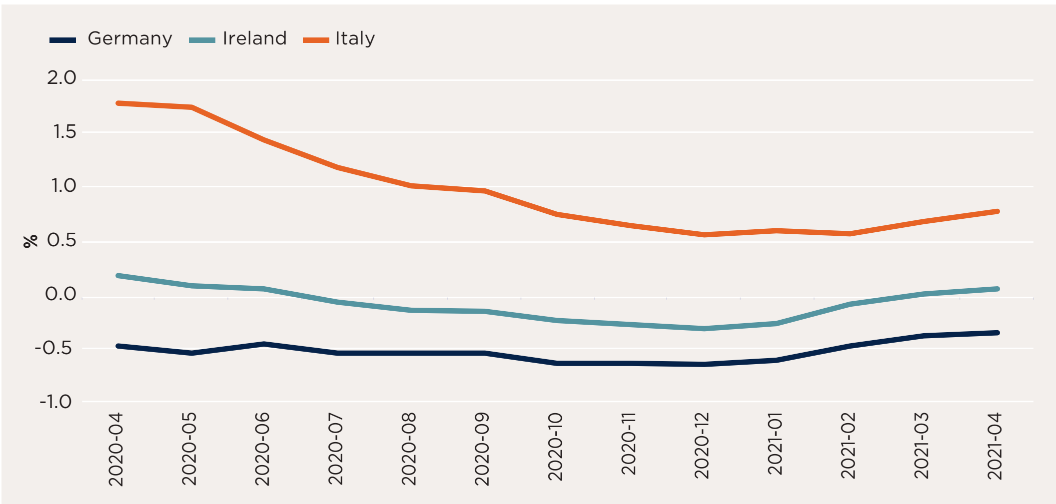
What is perhaps lying behind the market nervousness is that, historically, reliably forecasting inflation has proved notoriously elusive. Given this chequered history, investors are placing a large degree of uncertainty around forecasts and giving greater weight to the empirical data as it comes out. Given the corrosive effect inflation has on wealth, some investors are positioning their portfolios for higher inflation out of caution.

For real estate investors looking for protection against inflation, the below are some considerations to bear in mind:

- CPI linked rent reviews for office and industrial sectors are attractive while per cent of nominal turnover models work well for retail investors
- FRI leases are also preferable to those with exposure to operational cost inflation exposure such as in the PRS and hotel sectors
- However, PRS and hotels have the advantage of more frequent resetting of income to market rents – yearly and daily respectively – than FRI leases which are generally five yearly, so that income can better keep pace with inflation

Overall, real estate is a powerful asset class during times of inflation compared to other risk assets. While sharing the fixed-income quality of predictable cash flows, real estate is superior in an inflationary environment by allowing the re-setting of income to market levels at specified intervals. Equities can also suffer, especially growth stocks with high intangible values and whose cash flows are far off into the future and face being discounted at higher rates. Real estate, in contrast, have cash flows that are generally stable and predictable from an early stage and are tied to a physical asset, helping to mitigate the corrosive effects of inflation on a portfolio.

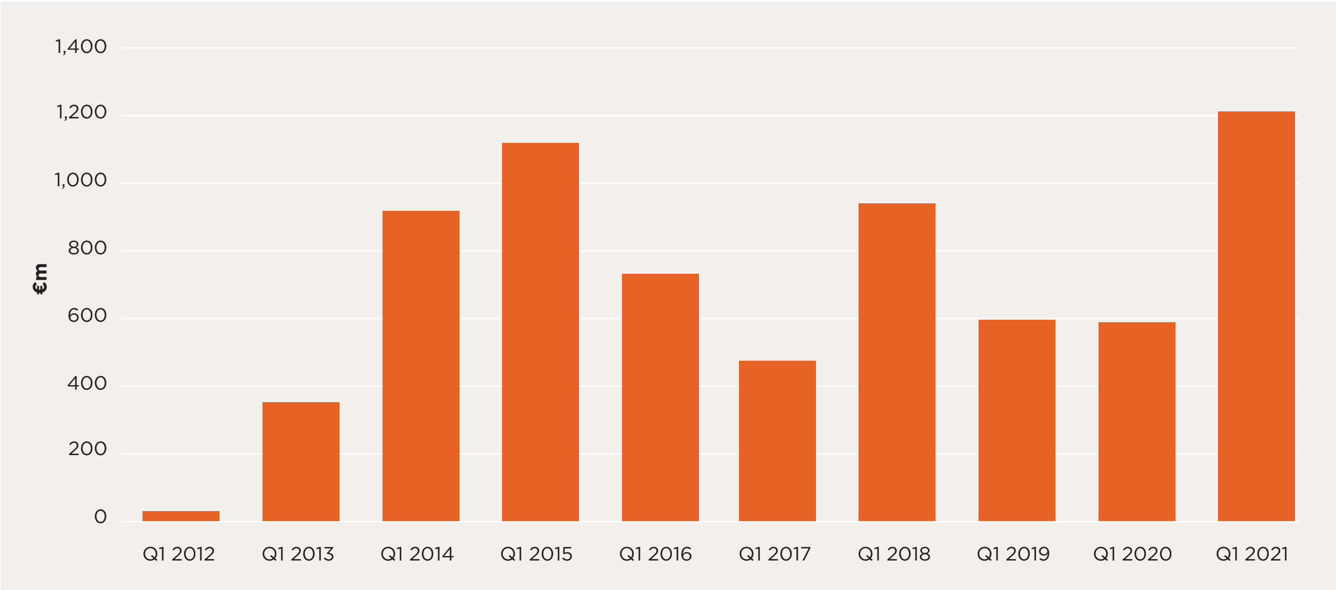
Figure 1: 10-year bond yields



Source: Eurostat

Investment flows

Figure 2: Historical Q1 investment volumes



Source: CSO

Ireland continued to attract large volumes of capital into its real estate market in the first quarter of the year. In total, €1.2bn transacted in Q1 which was double what transacted during the same period last year and the highest in the last ten years, illustrating that the real estate investment market continues to perform well despite the continued restrictions in place.

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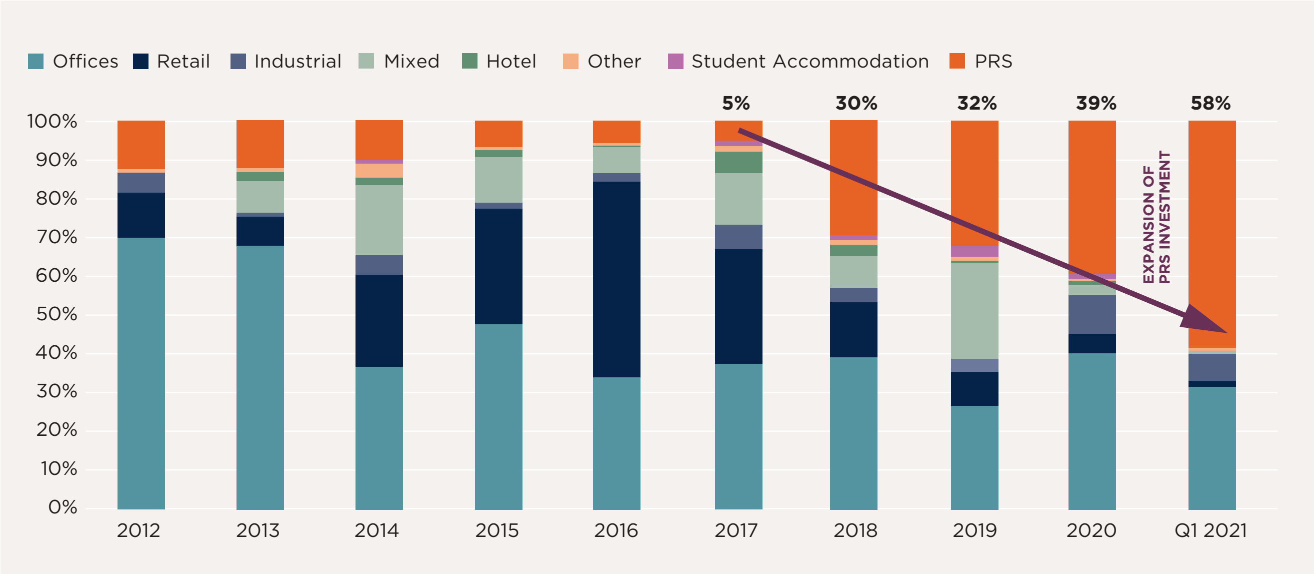
PRS market

Figure 3: Historical breakdown of investment spend



Source: Savills Research

The PRS market accounted for the largest share of investment spend by sector, comprising 58% of transactions while the office market accounted for 32% and the remaining sectors accounted for the balance. We expect that the share of investment spend accounted for by PRS will decrease as the year progresses due to large transactions in other sectors upcoming in the pipeline.

There was one large-scale PRS transaction in Q1 – accounting for €450 million of the €713 million of capital allocated to the sector – consisting of an off-market portfolio comprising a mixture of standing stock, forward commitment and forward funding. The majority of units transacted in Q1 were undertaken on a forward commit basis, accounting for 70% of units transacted while yields remained stable at 3.6%.

€450m

off-market transaction was the biggest deal of the quarter

Figure 4: PRS prime yield

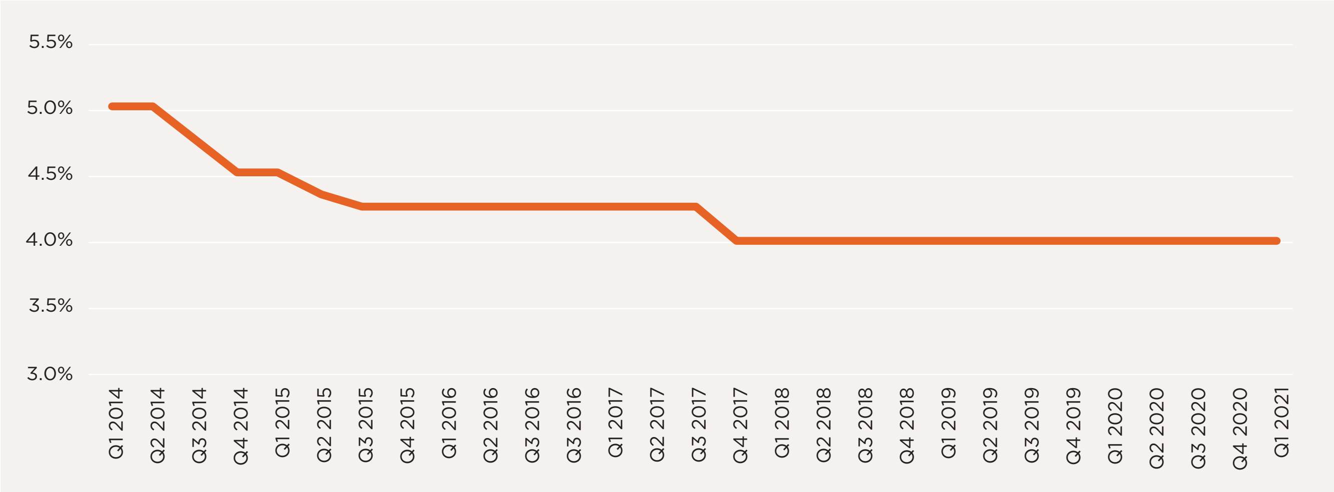
Source: Savills Research

Figure 5: PRS units transacted – forward purchase versus standing stock

Source: Savills Research

Office market

Figure 6: Prime office yield



Source: Savills Research

Demand for office assets remains strong, with the €392 million transacting 7% ahead of the €366 million that transacted in Q1 last year, giving a strong indication of investor assurance in the future of the office. By far the largest transaction was Project Tolka, which traded for approximately €300 million and consisted of a portfolio of office assets in Dublin 2 and 4.

€300m

sale of project Tolka was the largest office transaction of Q1

Specifically, it comprised of interests in 28-29 Sir John Rogerson's Quay and also One and Two Burlington Plaza. The next largest transaction of Q1 was the purchase of 76 Sir John Rogerson's Quay by AM Alpha from TIO for €95 million, with the relatively good value it represents on a capital value (€1,026 per sq ft) basis reflective of the fact that it was 70% vacant at the time of sale. The willingness of international capital to take-on office leasing risk during a time when the majority of staff are working at home is a vote of confidence in the office market. Experienced institutional investors active in the area clearly believe that the office will remain a cornerstone of the knowledge economy going forward. The trend is also borne from necessity, with most stabilised income assets having been acquired by long-term holders over the last decade resulting in a lack of these opportunities for sale. This means that investors are turning their attention to the speculatively built office stock that was delivered in 2020 but yet to be leased-up. More importantly, however, it reflects the increasing requirement for Environmental, Social, and Corporate Governance (ESG) credentials within portfolios, a trend that has substantially accelerated over the last twelve months.

Office investment outlook – reasons for an upside

Fundamentally, the prospects for an office investment market rely on the long-term health of its underlying tenant base. In this respect, Dublin has good reason to be optimistic as we emerge from the pandemic. The grounds for optimism lie primarily in the Dublin market's exposure to tech, which has accounted for just over half of take-up over the last five years. Dublin is perhaps unique globally in such having such a concentration of tech companies across the spectrum from small cap to mega-cap companies, especially when one takes accounts of the relative size of Dublin compared to other, much larger, global cities.

Prior to the pandemic, this exposure to tech was commonly held to be a source of risk for the office market. Specifically, many held the view that tech stock valuations were too high and would undergo a sharp downward correction in the event of an economic shock. Like the dotcom bubble, this would feed through into occupational real estate markets, like Dublin, that had a high exposure to the sector.

However, we have seen that the FAAMG firms[1] were not only resilient during the pandemic period, but doubled their market capitalisation from approximately $4bn to $8bn over the past year. Their robust cash heavy balance sheets combined with solid growth prospects (and unique structural forces accelerated by the pandemic favourable to tech) means they prospered during the pandemic. Such was their performance, they have transformed into quasi safe haven instruments for investors. As a result of this empirical evidence, their performance during the downturn should increase demand for these real estate covenants available in the Dublin market while also providing a tailwind to occupational markets – both office and PRS – going forward.

> **“Tech performance during the downturn should increase demand for these real estate covenants available in the Dublin market while also providing a tailwind to occupational markets going forward.”**

[1] Facebook, Amazon, Apple, Microsoft, Google

ESG – now of critical importance

In Q1, the Irish Government approved the 'Climate Action and Low Carbon Development Bill' which commits to cut carbon emissions by 51% by 2030 and reach net zero carbon by no later than 2050. The introduction of legislation by Ireland is part of a global effort to become carbon neutral by 2050, with the EU and UK also signing up to this goal while the Biden Presidency has signalled that the US must join other nations in achieving this target also.

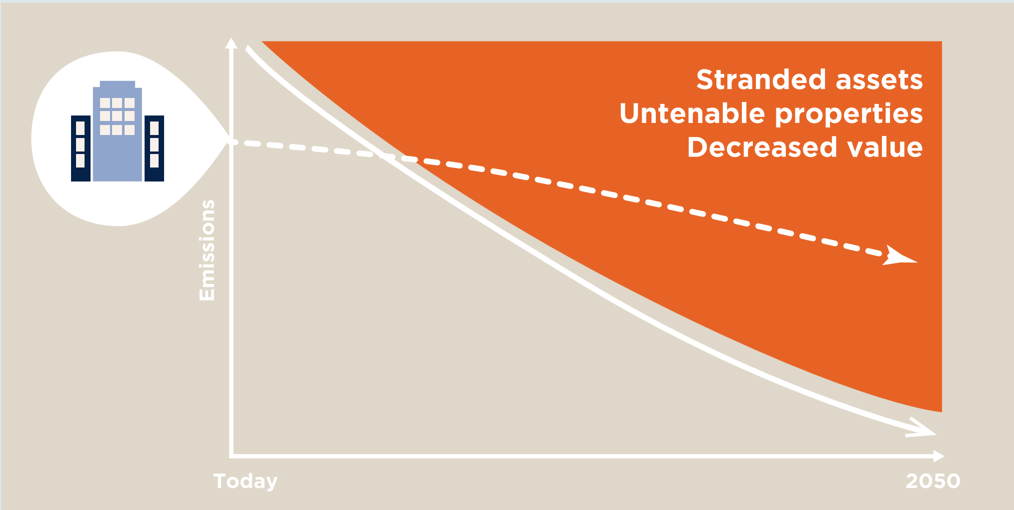
40%

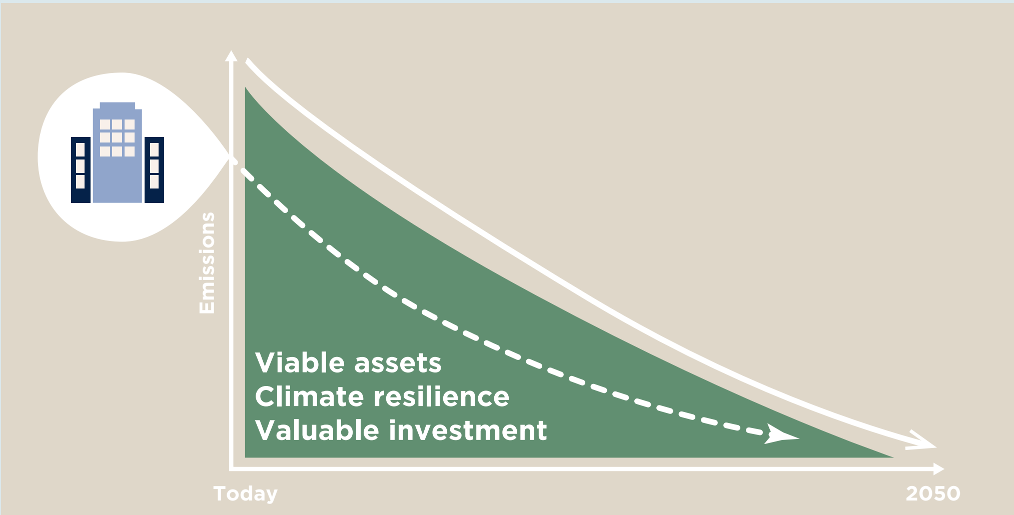
real estate's contribution to global carbon emissions

Real estate is at the core of these objectives, given that it accounts for 40% of all global carbon emissions so that new buildings must operate at net zero by 2030 and 100% must operate at this level by 2050 if this target is to be achieved.

It is within his context, that Environmental, Social, and Corporate Governance (ESG) considerations have risen to the top tier of real estate investment criteria over the last 12 months. While previously it was seen as a desirable extra, it is now deemed essential in terms of protecting the value of portfolios over the longer-term.

As illustrated below, buildings that do not meet ESG criteria risk becoming untenable properties and thus stranded assets, while those that are climate-friendly will continue to remain as viable assets and thus retain their value. The global nature of real estate ownership means that it will transcend borders and cover the full gamut of real estate strategies. The importance ESG investing will encompasses equity, debt and development exposures, meaning changes will be heralded across all facets of the real estate life cycle. The premium for ESG credentials assets is taking primacy and out-weighing other considerations. While yield spreads between prime and secondary stock tend to widen during times of uncertainty, the rise of ESG will compound this effect in the context of the pandemic.





Tax policy changes – pressure mounting

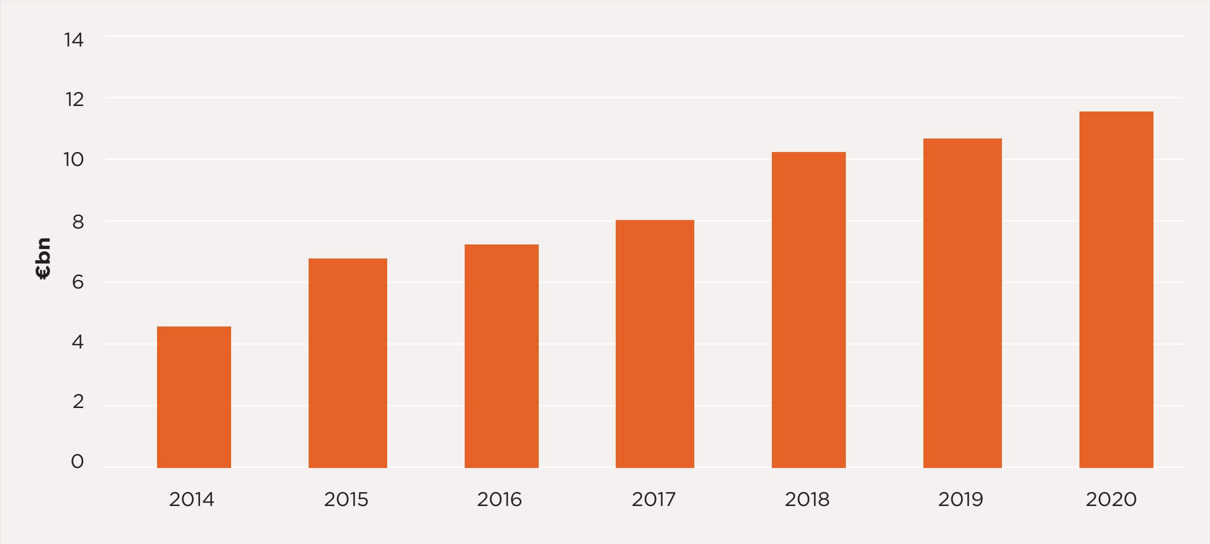
Changes to tax policy changes have risen up the international agenda once again, spurred by OECD proposals as well as President Biden's pronouncement that he will seek to introduce a global minimum tax. The G20 summit due to take place in July has been identified as the deadline for an agreement amid concerns of their impact on Ireland's economic model.

€11.8bn

corporate tax revenues have more than doubled since 2014

The main threat of the proposed measures is to the potential loss of revenue to the public finances. While this has some implications from a fiscal point of view, the over-reliance on corporation tax receipts in the last number of years has been well flagged and is an issue for the government to manage. On this point, it is worth noting that corporation tax receipts are generally conservatively forecast by the Government even if the exchequer has become used to the windfall gains that corporate tax has consistently generated over the last number of years (even if they are not specifically budgeted for). It also points to the crux of the argument being made against Ireland – we can't reliably forecast our corporate taxes here because they are based on globally sourced revenue and have little bearing to the domestic economy and have more than doubled from €4.6bn in 2014 to €11.8bn in 2020, with the top ten companies contributing 51% of the tax take.

Figure 7 : Corporate tax revenue Ireland



Source: Revenue

Impact on property

From a property perspective, the mistake that many make is conflating the preceding issue with the effect it will have on occupiers. The latter is a separate issue entirely. We have seen record levels of office take-up in Dublin over the last number of years despite changes to the tax regime being widely discussed, which is compelling empirical evidence that tax and occupational linkages have decoupled.

Even if the measures are implemented – a feat not to be underestimated – they will affect companies that have brass plate operations with skeleton staff and not the tech companies who come here for all the now familiar competitive advantages Ireland has to offer (English speaking, in EU, closest European country geographically and culturally to the United States, young and growing working age demographic, high education levels, business friendly environment etc.). Talent rather than tax is what drives these companies' location decisions and their commitment to Dublin is evidenced by the large-scale campus-style developments underway in Dublin. The city is now established as a tech cluster of global importance and alterations to tax policy will not change that.

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