Q3 IRISH INVESTMENT MARKET 2023

BNP PARIBAS REAL ESTATE

Q3 2023 KEY TRENDS

CONTINUED SLUGGISH ACTIVITY
with just €444m traded in Q3

30 TRANSACTIONS
almost half the 10 year quarterly average of 56

ONLY TWO €50M DEALS
well below long term trend

RETAIL (33.3%) AND LOGISTICS (19.5%) SHARES ELEVATED
Investors locking-in to demographic growth

NO RESIDENTIAL DEALS
for first time since Q3 2015

GERMAN CAPITAL
waiting in the wings

LOGISTICS AND RETAIL YIELDS
move out by 25bp to 5% and 5.25% respectively

TRADING TO REMAIN SUBDUED FOR REMAINDER OF YEAR
as price discovery process continues

MARKET ACTIVITY

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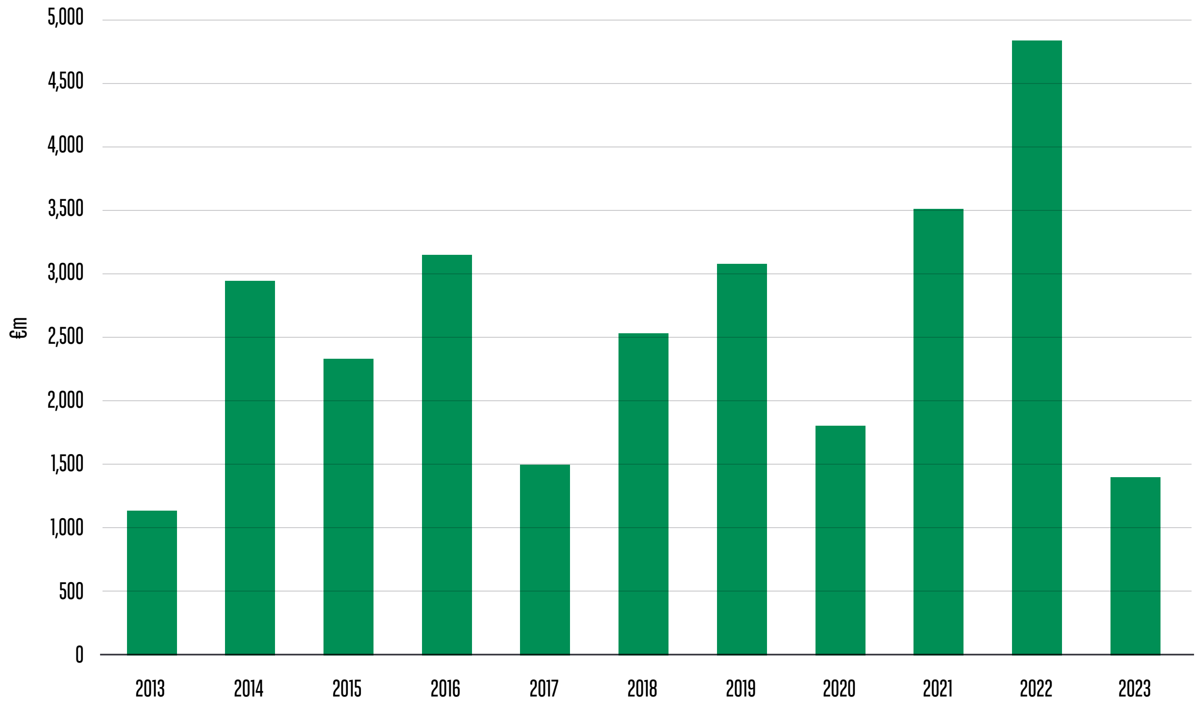
The investment market remains stuck in the mud with just €444.1m of income-producing property assets changing hands between July and September. This represents a 75% decline YY. Admittedly, last year's comparison quarter included the €500m sale of the Salesforce HQ. However, the number of transactions is down by one-third and, with just €1.4bn traded this year, we have to go all the way back to 2013 for a weaker opening nine months. Soberingly, this includes the peak Covid period in 2020.

€444.1m
OF ASSETS TRADING IN **Q3**

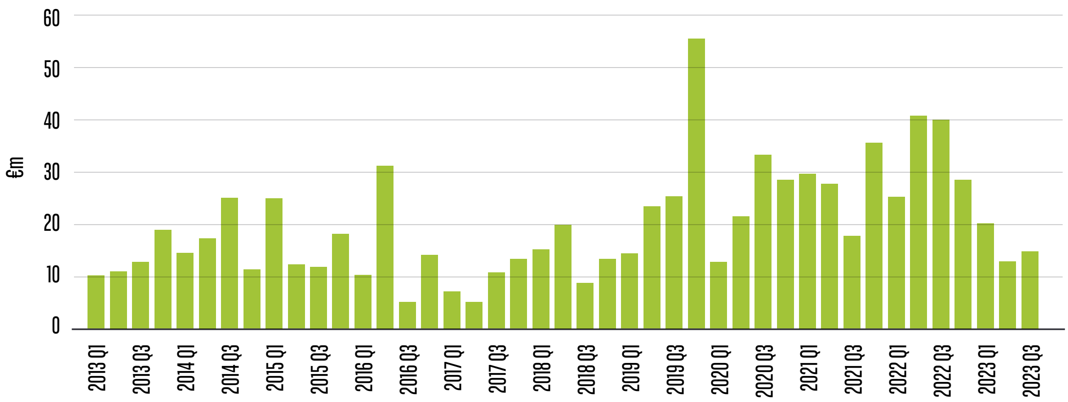
FIGURE 1: INVESTMENT MARKET TURNOVER (Q1-Q3)



Source: BNPPRE

The reasons for this pullback are well rehearsed. Slowing economic growth, persistent inflation, tech sector turbulence, elevated political uncertainty and structural challenges to the business models of office and some forms of retail leasing, are all impacting occupational markets. This has become priced into void risk and rental growth expectations. Simultaneously, rising interest rates have reduced the amount of debt capital that is available to finance larger property transactions, while higher bond rates mean that real estate investments must reprice to compete. Some adjustment has already occurred with capital values down by 13.5% in the year to Q3 according to MSCI data. However, with just 87 transactions done this year, with some details remaining confidential, and with the remaining activity spread thinly across multiple sub-sectors and locations, vendors and buyers are operating in an evidential vacuum. This leads to hesitation on all sides and, as a result, bid-offer spreads are often just too wide for deals to happen. This is particularly true for the core assets that are traditionally purchased by institutional investors.

FIGURE 2: AVERAGE DEAL SIZE



Source: BNPPRE

As illustrated in Figure 2, the average deal size has more than halved from €35.2m in 2022 to €16.1m so far in 2023. This is being driven by three factors; the continued decline in property values noted above, a shift in the buyer profile, and a sectoral shift in the assets being traded.

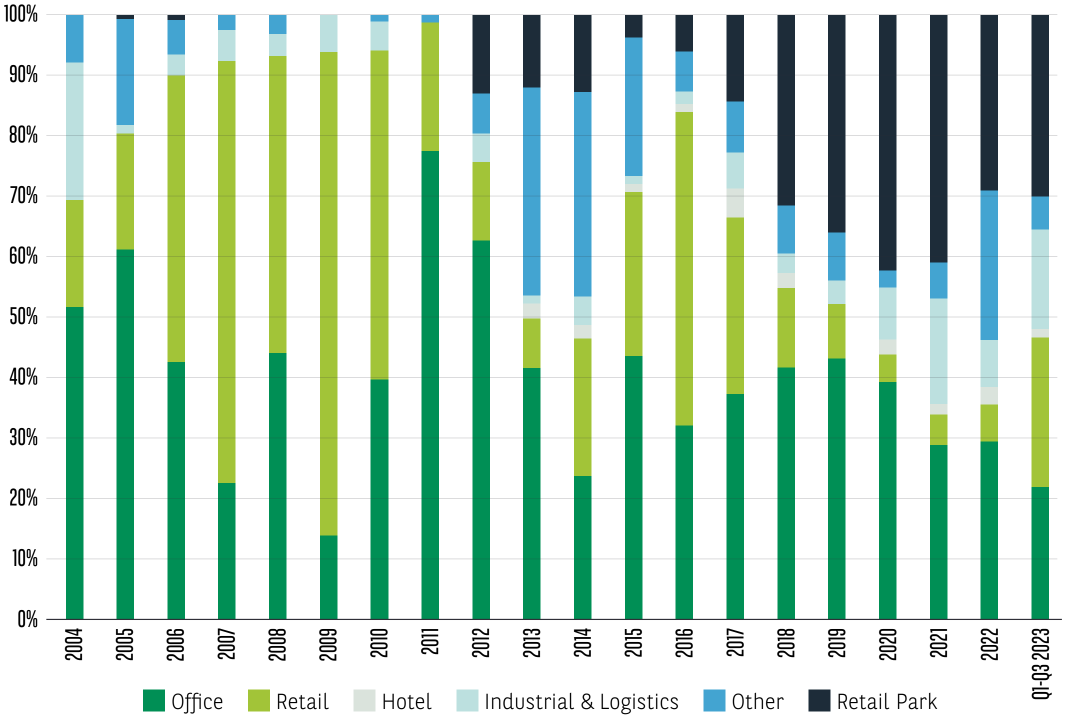
TURNOVER BY BUYER TYPE

With higher costs of capital impacting on leverage, smaller equity funded deals have come to the fore. Private Irish investors with the local knowledge to seek-out value have been the most active, accounting for 44% of the deals done this year. French SCPIs, which have a similar funding model to REITS, have also been active. These buyers are typically seeking smaller assets in the €5m-€15m price bracket, with stable rental income and attractive yield profiles. Once these criteria are met, however, they tend to be agnostic between sectors and locations. Illustrating this, Iroko Zen has been the busiest SCPI in Ireland this year with seven investments scattered across retail parks, neighbourhood shops, convenience stores, suburban offices and logistics facilities. The average price point has been €7.13m, with yields ranging from 6.25% – 8.44%.

TURNOVER BY SECTOR

There has also been a marked shift in the type of product being traded. Offices accounted for two-fifths of total investment turnover between 2004 and 2019. Since then, however, their share of the market has steadily tapered-off and now stands at just 22% YTD. Strikingly, no prime new-build office properties have traded in Dublin since the Salesforce tower was purchased over a year ago.

FIGURE 3: SHARE OF INVESTMENT TURNOVER BY SECTOR



Source: BNPPRE

The contraction in office trading reflects several factors. Occupational vacancy has risen due a coincidence of strong supply flows and weaker absorption. The latter derives from a slowdown in Tech leasing, the impact of remote working, and increased sub-letting.[1] Rising vacancy is negatively impacting office sales in two ways. Firstly, it narrows the buyer pool as some funds are precluded from investing in assets that are not fully-let. Secondly, it requires investors to price for increased void risk and the possibility of weaker rental growth, particularly given uncertainty around the future of remote working. As outlined above, vendors' expectations are not yet aligned with the discounts buyers are seeking to apply, leading to stasis in the market.

Compounding this headwind is the scarcity of opportunities to purchase the modern low-carbon office investments that are favoured by institutional buyers. Fewer than 15% of BER certificates issued in respect of Dublin office buildings are A or B ratings and, in many cases, the owners of these buildings are unwilling to sell. While the emergence of energy efficient new-builds will eventually relieve this bottleneck, these buildings are taking longer to let-up under current market conditions, and therefore they are slow to become available as investments.

While the downward trend in offices continues, the medium-term trends in retail and residential investment seem to be reversing. After years of contracting investment in retail property, spending on shops has surged this year. Retail accounted for €148m of the Q3 spend (33%) and one-quarter of the capital deployed since the start of this year.

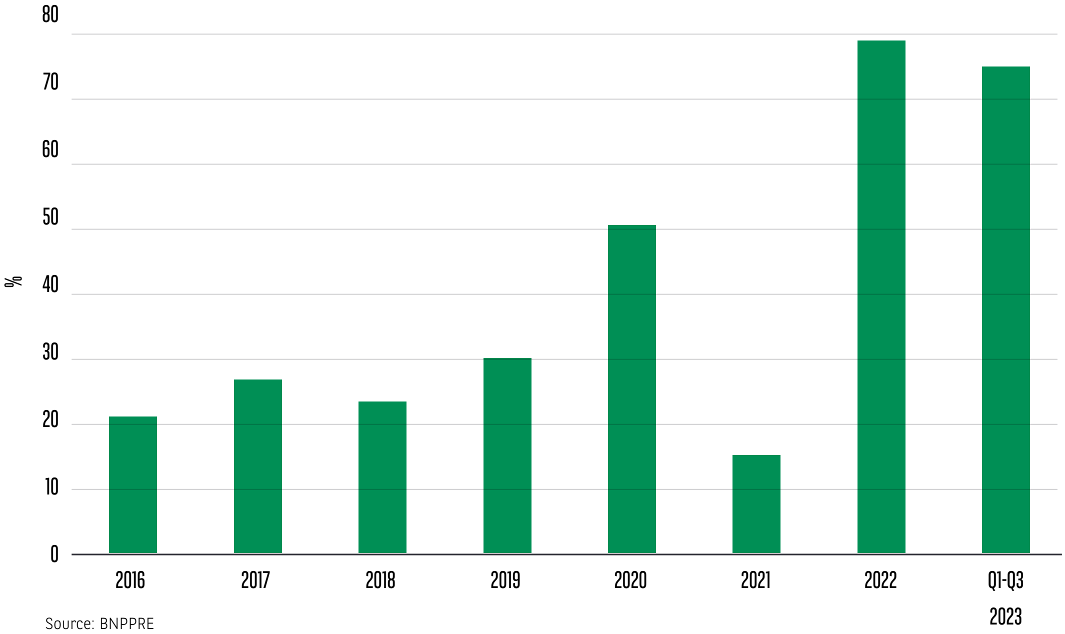
After a long period in which investors struggled to comprehend the implications of e-commerce, a more nuanced and segmented approach has emerged. Investors are now primarily targeting defensive subsectors of retail such as regional shopping centres, grocery stores and retail parks. Moreover, they are willing to seek opportunities outside Dublin where the underlying trade is well underpinned by local demographics. This continued in Q3 with the Hexagon Portfolio, a basket of five regional shopping centres (and Donaghmede Shopping Centre in Dublin), being bought by Davy for €74m. Davy also purchased the Marshes Shopping Centre in Dundalk, which is anchored by Dunnes Stores and Penneys, for €29m. These assets traded at yields of 11% and 10.7% respectively, outlining the value that can be obtained in the sector by selective purchasers.

1. For a detailed discussion of these trends see the latest BNPPRE Dublin Office Market Report BNPPRE Q3 2023 Dublin Office Market Report | BNP Paribas Real Estate Ireland.

Between 2012 and 2021 just 13 units traded on Grafton Street, Dublin's prime shopping thoroughfare. Liquidity was restricted by the limited number of units (Grafton Street is short by international standards), and by the fact that many were held in long-term institutional ownership. However, the institutions increasingly appear to see these assets as 'non-core', and this has opened-up opportunities for private investors to secure a foothold in this ultra-prime location. Five shops on Grafton Street have now been bought since the beginning of last year. The latest is number 83, occupied by Dr. Martens, which was sold by IPUT for €6.1m in Q3. This unit was bought by a private investor at a yield of 5.14%. A further three units are currently on the market while additional opportunities exist on the surrounding streets of College Green, St. Stephens Green and Dawson Street.

There has also been activity on Henry Street, the premier shopping street north of the Liffey. Number 45 and a small unit in the nearby GPO arcade were traded in Q3 for €3.7m and €1.33m respectively, and further opportunities are likely to become available.

FIGURE 4: EX. DUBLIN SHARE OF RETAIL INVESTMENT



Source: BNPPRE

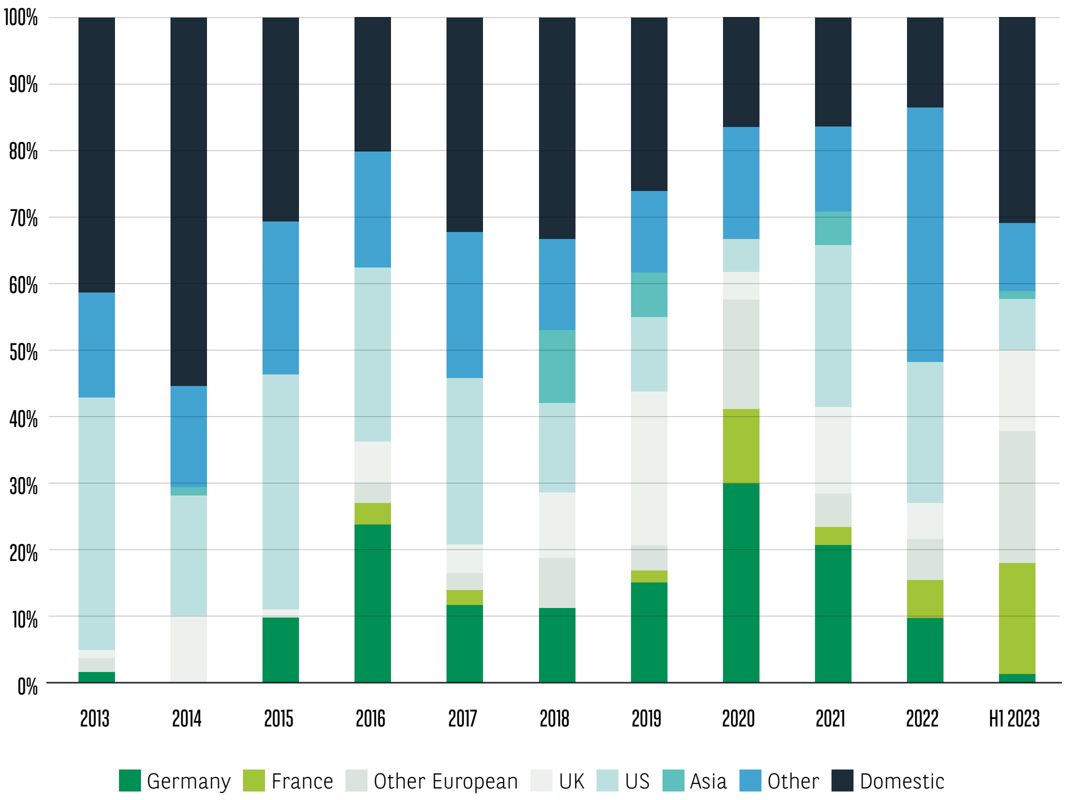
In contrast, there has been an abrupt slowdown in residential investment. As shown in Figure 3, block purchases of income producing residential properties exploded from 4% of turnover in 2015 to over 40% in both 2020 and 2021. The diversified and stable rental streams thrown-off by these assets appealed to institutions such as pension funds and insurance companies which were seeking reliable income to balance their future liabilities. However, with German and Irish 10-year Government bonds now yielding over 2.8% and 3.2% respectively, many of these buyers have concluded that purchasing apartment blocks in Ireland at yields below 4.5% no longer makes sense. Therefore developers are increasingly bypassing the investment market and doing deals directly with State bodies such as local authorities and Approved Housing Bodies. Consequently, Q3 was the first quarter for eight years in which no residential deal was recorded in the statistics.

With the ECB raising base rates twice in Q3, capital is naturally being attracted to the sectors with the strongest occupational markets. Arising from population growth, there is currently robust demand for warehousing space and, although the development pipeline is now delivering new stock, vacancy levels remain below their natural level. As a result, prime logistics rents in Dublin are rising by approximately 9% per annum, and this offers an offset to the drag on total returns from yield decompression. Accordingly, €86.55m of capital was deployed on rent-producing logistics property between July and September, accounting for nearly one-fifth of turnover.

ORIGIN OF CAPITAL

As previously reported, there has been a pronounced shift in the origin of capital flowing into the Irish investment market over the last two years. Most notably, the presence of German investors, which accounted for 30% of the market in 2020, receded steadily through 2021 and 2022 and these buyers have now all-but disappeared. German buyers were responsible for 67 purchases between 2013 and 2022. However, only one asset (€18.25m) has been bought by German capital in 2023, accounting for just 1.3% of YTD spending.

FIGURE 5: INVESTMENT BY ORIGIN OF CAPITAL



Source: BNPPRE

Note: For this exercise 'convenience retail' includes assets such as neighbourhood centres, filling stations and bank branches.

This is all about pricing. The bulk of German capital has come from core institutional investors. As outlined above, the re-pricing of prime assets in Ireland remains a work in progress and, at this time, bid-ask spreads are simply too large for these buyers to bridge. From our conversations with them at MIPIM last spring, and more recently at Expo Real in Munich, German funds remain fully on-board with Ireland's merits as an investment location. But, given current bond yields, they are not prepared to deploy capital until pricing readjusts.

In contrast, the share of Irish and French capital has increased. With smaller deals making-up an increased proportion of turnover, it is unsurprising that domestic private buyers with local market knowledge are accounting for a bigger share of the spend. The contrast between the falling German and rising French shares is striking, and is explained by differences in the nature of this capital. As discussed above the French SCPIs are Core+ rather than Core buyers, and their investment objectives are well aligned with the product that is currently available and reasonably priced in the Irish market.

OUTLOOK

So far, 2023 has been the most sluggish year for property investment in a decade as rising bond rates and weakening occupational markets have impacted values. Small markets like Ireland are particularly impacted at moments like this because the scarcity of comparable evidence creates a natural barrier to price discovery and this, in turn, saps confidence and acts as a handbrake on transactions. Reflecting this, commercial property investment in Ireland over the first nine months of this year has fallen more sharply than across the rest of Europe (71% YY compared with 55% across Europe as a whole[2]).

As noted above, the MSCI all-segments capital value index is down 13.5% in the year to September. However, valuation-based metrics characteristically lag the market, and the absence of larger transactions at current valuations suggests that prime yields have further to move by year-end. Beyond that, the future path of monetary policy became clearer at the October meeting of the ECB. The Governing Council kept rates unchanged and sent a clear signal that it believes current rates, if maintained for a sufficient period, would be successful in bringing inflation back to target levels. While it did not rule out further rate increases if necessary, the language used reinforces expectations that we are now at-or-near the top of the monetary cycle, albeit that rates could stay at their current levels for a significant period.

Simultaneous to this peak in the monetary cycle, our view is that key occupational markets (particularly the Dublin office market), are now within touching distance of their cycle lows. This provides a window for agile, well-advised buyers to pick-up cheap assets in the near-term. Meanwhile, although population and economic growth are projected to slow,[3] both are set to remain strong by international standards. This will continue to provide opportunities for value-seeking investors to on-board reliable rental income at attractive yields in sectors such as logistics, grocery, retail park and convenience retail.

TABLE 1: NET INITIAL YIELDS (%), PRIME ASSETS

	Q3 2022	Q3 2023	OUTLOOK
Dublin Office	4.10	5.00	↗
Dublin Logistics	4.50	5.00	↗
Retail (High Street)	4.50	5.25	↗
Dublin Residential (PRS)	4.00	4.50	↗

2. For a perspective on the wider European occupational and investment market see the latest BNPPRE Europe CRE 180 report; Pan-European research | BNP Paribas Real Estate
3. Ireland has been the EU's fastest growing economy for 4 of the last 5 years. The IMF is currently forecasting Ireland's economy to expand by 2% this year (7th in the Euro Area league table) and by a further 3.3% in 2024 (=1st in the league table with Cyprus).

> “The market is stuck-in-the-mud with vendors and investors fearful of making the first move in an evidential vacuum”

JOHN MCCARTNEY
Director,
Head of Research,
BNP Paribas Real Estate Ireland

> “Flexibility and keen market analysis will be the tools that help investors navigate this complex landscape as we move forward into another unpredictable year”

KENNETH ROUSE
Managing Director and
Head of Capital Markets,
BNP Paribas Real Estate Ireland.

GEORGES QUAY
Dublin 2

TOP 10 INVESTMENT DEALS Q3 2023

	BUILDING	LOCATION	SECTOR	PRICE (€M)
1	George's Quay, Dublin 2	Dublin	Office	81.00
2	Hexagon Portfolio	Donegal, Dublin, Galway, Laois, Limerick, Louth,	Retail	74.00
3	Unit D1 Airport Business Park and Units 1a & 1b Rosemount Business Park (Dunnes Stores Logistics Facility)	Dublin	Industrial & Logistics	41.00
4	Building F1, The Campus, Cherrywood	Dublin	Office	33.40
5	1 Westfield Ballincollig Co. Cork	Cork	Other	31.35
6	73-83 Lower Mount Street, Dublin 2	Dublin	Office	31.00
7	Marshes Shopping Centre, Dundalk	Louth	Retail	29.00
8	J5 Plaza, Finglas, Co. Dublin	Dublin	Office	18.10
9	35 Rosemount Business Park, Dublin 15	Dublin	Industrial & Logistics	14.175
10	4 Earlsfort Terrace, Dublin 2	Dublin	Office	11.85

73-83 LOWER MOUNT STREET
Dublin 2

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