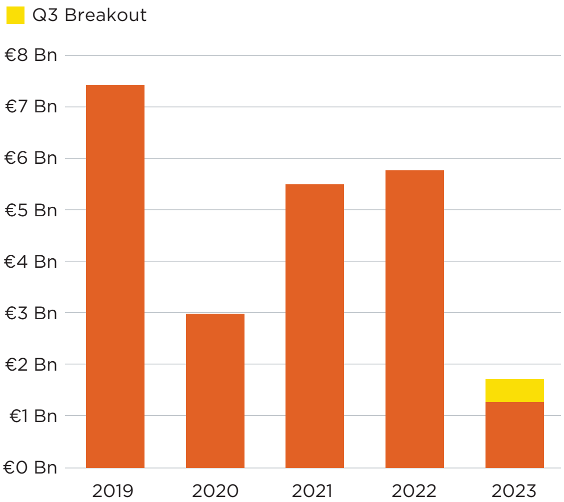
Savills Research – Q3 2023

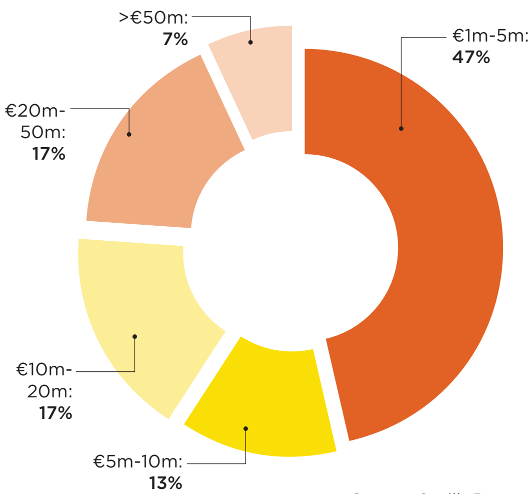
Ireland Investment Market

Figure 1: Investment volumes



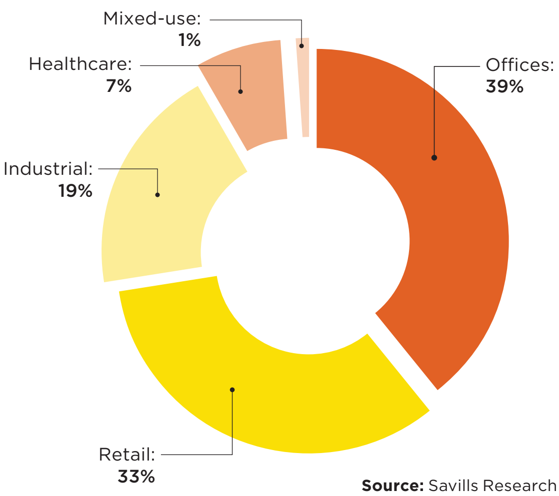
Source: Savills Research

Figure 2: Market share by deal size



Source: Savills Research

Figure 3: Market share by sector



Source: Savills Research

Q3 Ireland investment market

Offices and regional shopping centres dominate deal flow.

€444.1m worth of investments transacted in Q3, which compares with a ten-year quarterly average of €1.1bn. Comparing it with the €1.8bn which transacted in Q3 last year – the highest Q3 on record – demonstrates the slowing down in investment market activity over the past 12 months. In total, 30 deals took place in Q3 (versus a ten-year quarterly average of 55) with an average deal size of €14.8m (versus a ten-year quarterly average of €21.1m).

ANALYSIS

Offices accounted for 39% market share with €175.4m across five deals, all above €10 m in lot size. The largest transaction was the sale of George's Quay House by Henderson Park to French income investor Corum for €81.0m, representing a net initial yield of 6.25%. Corum was also involved in the fourth largest deal of the quarter, acquiring a new office building in Cherrywood with an unexpired term of 12 years from Spear Street Capital for €33.4m, representing a yield of 6.15%. Iroko Zen also made two purchases, illustrating that French SCPI funds continue to be the most active buyers in the Irish market, collectively accounting for over 30% of investment volumes this quarter.

Regional shopping centres accounted for 25% of volumes, driving retail's total share of the market to 33%. Davy was another notable buyer in Q3, acquiring two high-yielding shopping centre investments: the nationwide Hexagon Portfolio for €74.0m and Marshes Shopping Centre in Dundalk for €29.0m. Primary Health Properties PLC purchased a long leased enhanced community care centre in Cork for €31.4m, it was the fifth-largest deal of the quarter. There were also several off-market industrial portfolio trades, driving the sector's market share to 19%. Finally, it is worth noting that Q3 saw the largest deals take place (YTD) in the office, retail and healthcare sub-sectors while during this period no residential assets were recorded. This is the first time in an 8-year period where no living sector assets have traded, with this last occurring in Q3 2015.

Table 1: Top five transactions

Property	Location	Sector	Vendor	Buyer	Price	Approx. NIY
George's Quay House	Dublin 2	Offices	Henderson Park Capital	Corum	€81.0m	6.2%
Hexagon Portfolio	Ireland	Retail	Receiver (KPMG)	Davy	€74.0m	11.0%
Off Market Industrial Portfolio	Dublin	Industrial	P&C	P&C	€41.0m	P&C
Building F1, The Campus	Dublin 18	Offices	Spear Street Capital	Corum	€33.4m	6.2%
1 Westfield Ballincollig	Cork	Healthcare	O'Flynn Group	Primary Health Properties PLC	€31.4m	5.3%

Source: Savills Research

YIELDS

Yields continued to push out in Q3, with most sectors witnessing yield expansion during the quarter. All prime sectors saw a 25 basis points (bps) movement outward during the quarter except for Grafton Street, which remained stable at 5.25%. We are seeing good liquidity for Grafton Street assets, driven by strong demand from high-net-worth individuals looking for a trophy asset. Secondary shopping centres moved out by 50 bps – the largest change of any sector – with yields at this level attracting value buyers. Looking at year-on-year changes, the increase in secondary CBD offices of 150 bps was the most of any sector. The next largest were secondary industrial, secondary shopping centres and prime retail warehousing, all of which saw yields expand by 100 bps over the past year. As discussed in our macro section, Government bonds saw renewed yield expansion in Q3, suggesting that property values will continue to come under pressure in the coming quarters.

Table 2: Yields

Sector	Q3	Q/Q	Y/Y
Offices - Prime CBD	4.75%	25 bps	60 bps
Offices - Secondary CBD	7.00%	25 bps	150 bps
Industrial - Prime	4.75%	25 bps	75 bps
Industrial - Secondary	6.25%	25 bps	100 bps
PRS - Prime	4.50%	25 bps	70 bps
PRS - Secondary	6.25%	25 bps	125 bps
Shopping Centres - Prime	6.75%	25 bps	90 bps
Shopping Centres - Secondary	10.50%	50 bps	100 bps
Warehouse Retail - Prime	6.25%	25 bps	100 bps
Warehouse Retail - Secondary	9.75%	-	75 bps
High Street - Prime (Grafton)	5.25%	-	75 bps
High Street - Secondary	8.00%	25 bps	75 bps

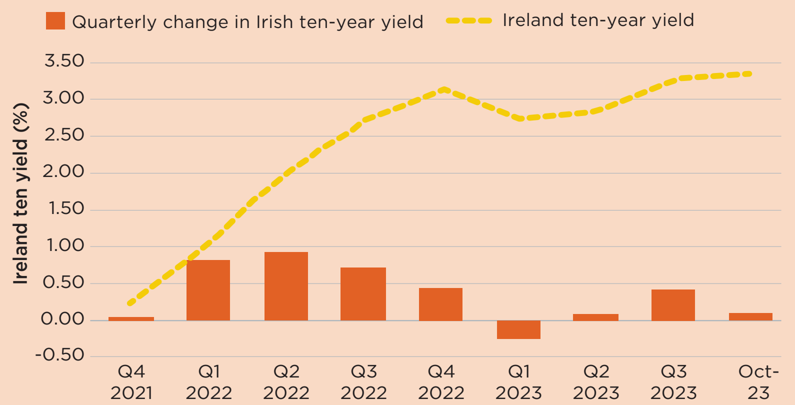
Source: Savills Research

Macro view – Outlook for bond yields

The Irish ten-year bond yield resumed its outward movement in Q3, moving by 43 basis points (bps), which represented the largest quarterly expansion since Q4 2022. The trend continued into October, with yields increasing by a further ten bps between the end of Q3 and the 20th of October. This recent reacceleration of the ten-year yield reflects the triumph of the 'higher for longer' narrative as the consensus viewpoint in capital markets. Prior to this, there was an expectation that central banks would pivot to rate cuts in the not-too-distant future, with lower inflation or a weaker economy being the catalyst for such a turning point. However, both inflation and the macro-economic picture have proven more resilient than envisaged, thus cementing the 'higher for longer' viewpoint.

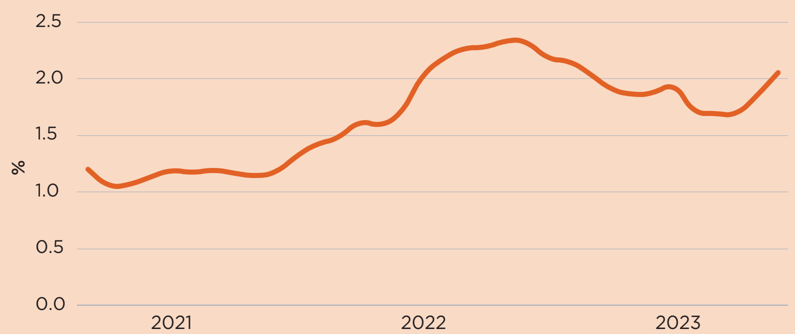
While Irish government yields are rising, they are performing better than their international counterparts. Specifically, concerns about a number of governments' fiscal sustainability is a risk factor that increasingly came into view in Q3. In the United States, the issuance of new bonds by the government to shore up a larger-than-expected budgetary deficit is affecting the supply-demand dynamic in the secondary bond market, putting further upward pressure on treasury yields. In Europe, sovereign yields have also come under pressure as concerns about Italy's debt sustainability have reemerged.

Figure 4: Ireland ten-year government yield, current versus change per quarter



Source: Investing.com, Savills Research

Figure 5: Spread between Germany and Italy ten-year bond



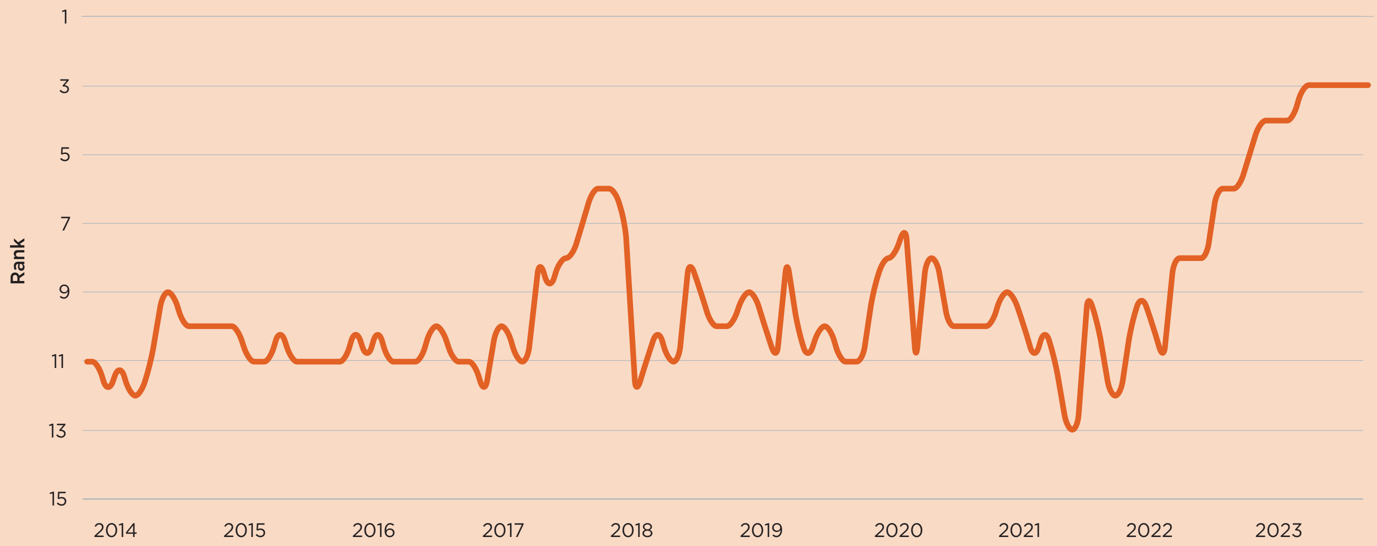
Source: Eurostat. Savills Research

Macro view – Outlook for bond yields continued

With debt costs rising, doubts are being raised once again about the ability of the economy to sustain its debt pile of over 140% GDP. Furthermore, Italy's ruling party recently announced a €24bn budget package, which will increase its deficit for 2024 from a previously projected 3.6% of GDP to 4.3% (and well above the 3% mandated by the EU's Stability and Growth pact). As a result, Italian bond yields have risen to 5%, but more significantly, the spread between Italian and German bonds has widened to over 2%; an early sign of sovereign risk-related stress emerging.

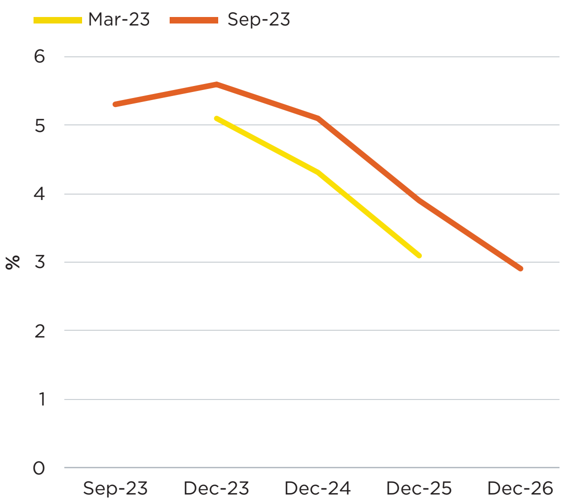
Ireland's projected budget surplus of €9.6bn for 2023, representing 1.8% of GDP, stands in contrast to this uncertain international environment. Thus, while Ireland's ten-year bond rate has moved out as ECB interest rates have increased, they have moved out less strongly relative to other eurozone countries. As a result, Ireland has improved its position relative to its peers and is now firmly established at the heart of core European bond pricing. As illustrated in Figure 6, Ireland now has the third lowest bond yield in Europe, behind only Germany and the Netherlands, and compares with a position of 10th at the start of 2022. Ireland's sovereign strength is a critical advantage in terms of attracting capital flows to its real estate.

Figure 6: Ireland's relative ranking of ten-year yield in eurozone (lowest to highest)



Source: Eurostat, Savills Research

Figure 7: FOMC median interest rate expectation



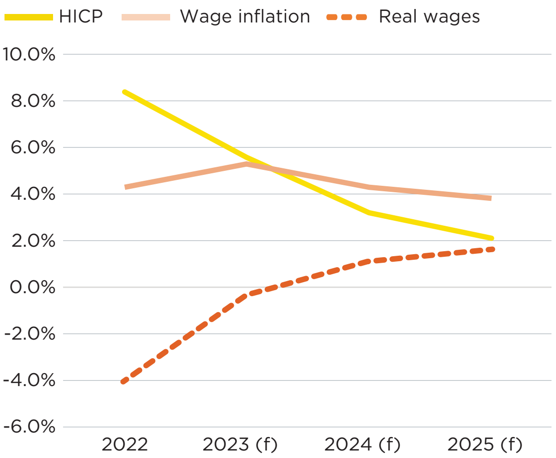
Source: Eurostat, Savills Research

OUTLOOK FOR RATES

Looking ahead, the global outlook is for interest rates to remain elevated. Figure 7 plots the Federal Open Market Committee's median estimate for future interest rates in the United States. It indicates that the federal funds rate is expected to increase by a further 25 bps by the end of the year, up from the current target range of between 5.25% and 5.5%. By the end of 2024, it is expected to still be above 5%, and just under 4% by the end of 2025 – this represents an outward shift in the interest rate curve of 80 bps compared to the March 2023 expectation.

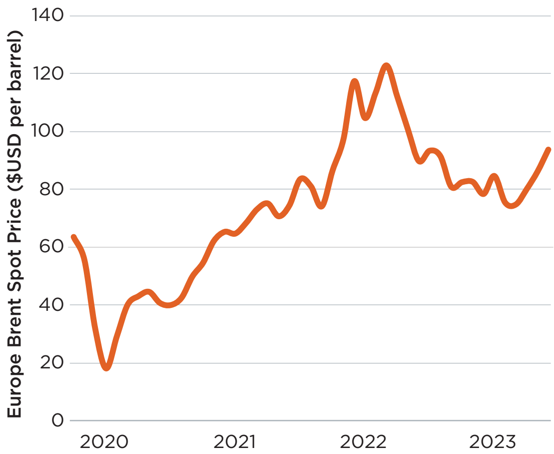
In Europe, Q3 saw two further rate rises of 25 bps to bring the ECB's main financing operations rate to 4.5%, as it seeks to bring inflation under control. The European Commission's latest economic outlook projects inflation of 5.6% this year – down from 8.4% last year – before declining further to 3.2% in 2024 and reaching 2.1% in 2025. The likelihood of this happening is questionable when the EU Commission is also projecting wage growth of 5.3% this year – up from 4.3% in 2022 – with further growth of 4.3% in 2024 and 3.8% in 2025, meaning real wages will grow compared to a contraction of 4.1% witnessed in 2022. It is nevertheless hard to see how inflation will be tempered when wage inflation is expected

Figure 8: EU Commission wage and inflation forecast



Source: Eurostat, Savills Research

Figure 9: Europe Brent Spot Price ($USD)



Source: Eurostat, Savills Research

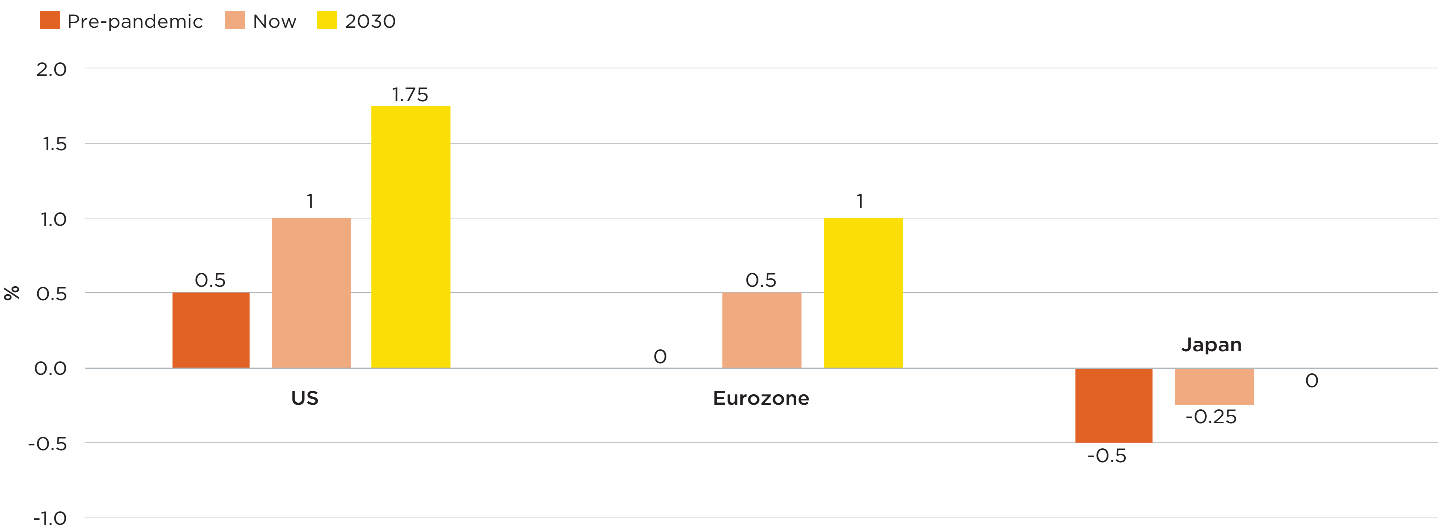
to grow at almost double the target general price inflation level of 2%. Wage inflation has been the driving force behind general service sector inflation, replacing the energy-fueled inflation of 2022. However, there are signs that energy could once again be a driver of inflation as we go into winter, with the price of a barrel of Brent oil rising by 25% in Q3.

LONGER-TERM OUTLOOK FOR RATES

Looking beyond the medium term, Capital Economics released interesting research on the longer-term outlook for interest rates. It did this by estimating the long-run neutral real rate (before inflation) of interest rates, otherwise known as R*, for various periods. This is an unobservable and theoretical number but dictates what interest rates should trend towards in the long term. In effect, it can guide us on the expected level of interest rates if and when the current bout of inflation is brought under control.

Following the Global Financial Crisis, we had structurally low-interest rates driven by a decade of deleveraging. Capital Economics says that the end of this era, combined with a long-term boost to economic growth driven by Artificial Intelligence, means that R* has risen in the United States from its pre-pandemic level of 0.5% to now stand at 1.0%, and will increase to 1.75% by 2030. In Europe, R* is estimated to be 0.5% now, up from a pre-pandemic rate of 0%, and will grow to 1.0% by 2030. To convert the real rate to the nominal rate, we add the 2.0% rate of inflation targeted by central bankers. This implies that nominal interest rates in Europe theoretically should be 2.5% now, up from 2.0% pre-pandemic, and will rise to 3.0% by 2030. The authors also suggest that while the 2% rate of inflation was never consistently achieved in the last decade, they do expect inflation to average the target rate in the coming decade. For real estate investors, this research suggests that when rates do fall from their currently high levels, they will not return to the ultra-low level witnessed pre-pandemic.

Figure 10: Neutral real interest rates estimates



Source: Capital Economics

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