Irish Life

Life \ Pensions \ **Investments**

Quarterly Report Q3 2023 **Irish Property Fund**

INVESTMENT MARKET

Investment turnover in Ireland amounted to amounted to approximately €444m in the third quarter of 2023 (Q3), a similar quantum to recent quarters, but notably down on the long-term quarterly average of €1.1bn. The year-to-date (YTD) turnover of €1.4bn is not anticipated to breach €2bn by year-end, which will account for a notable reduction on investment activity relative to the 10-year annual average of €4.3bn. This significantly lower volume of activity is consistent with broader European trends. Globally, investment volumes declined 54% year-on-year during Q2.

Institutional investors remain subdued, and several factors are influencing deal volume, including adjustment to the new cost of capital (based on the increased cost of debt financing), rebalancing of allocations (the ratio of real estate assets held relative to e.g. equities and bonds), and poor liquidity levels in the market (poor transaction volume means it can be more challenging to sell assets).

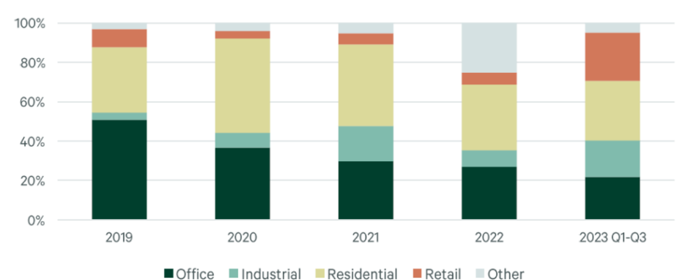
Private (as opposed to institutional) and opportunistic (those entities seeking higher investment returns in exchange for taking on more investment risk) investors targeting specific property types are providing some demand in the market with lower lot sizes and higher yielding deals. French SCPI funds still account for a sizable proportion of the market and accounted for the lion's share of office sector investment in Q3.

The French SCPI Funds have been a large investor in Irish Real Estate in recent times. The SCPI stands for 'Societe Civile de Placement Immobilier', and this ownership structure is similar to a REIT (Real Estate Investment Trust), although there are two differences: (i) these are not listed (publicly traded); and (ii) these entities are only mandated to hold real estate and not equities or bond products.

The period to the end of Q3 witnessed a reported 30 transactions. Of these, five deals were in the €20m to €50m lot size, which shows some positive momentum relative to the prior quarter. Almost 40% of deal activity in Q3 was in the office sector, and the retail sector accounted for 33% of spend, with the industrial and healthcare sectors making up 19% and 7% of spend respectively.

YTD, the residential sector has been the dominant sector (representing 30% of activity), although it is notable that no residential deals completed in Q3. The retail and office sectors have accounted for 24% and 22% of activity respectively. A total of 13 retail deals completed in Q3, including a portfolio of six assets. The slowdown in investment activity in the residential sector (also known as the Private Rented Sector or PRS) is down to the lack of available investment products. The viability of new products in the sector is suffering from higher financing and higher construction costs, in addition to yield expansion.

Breakdown of investment by sector in Ireland 2019-2023 YTD



Source: CBRE Research

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The largest transaction in Q3 2023 was of George's Quay House (on the south side of the Dublin Docklands in Dublin 2), which is an office property extending to 105,000 square feet, and which is multi-tenanted. This was acquired by Corum, a French fund, for €81m, reflecting an income yield of 6.25%. That deal includes an obligation on the vendor to fund the capital investment required to upgrade the building up to a BER rating of B, from the current C status.

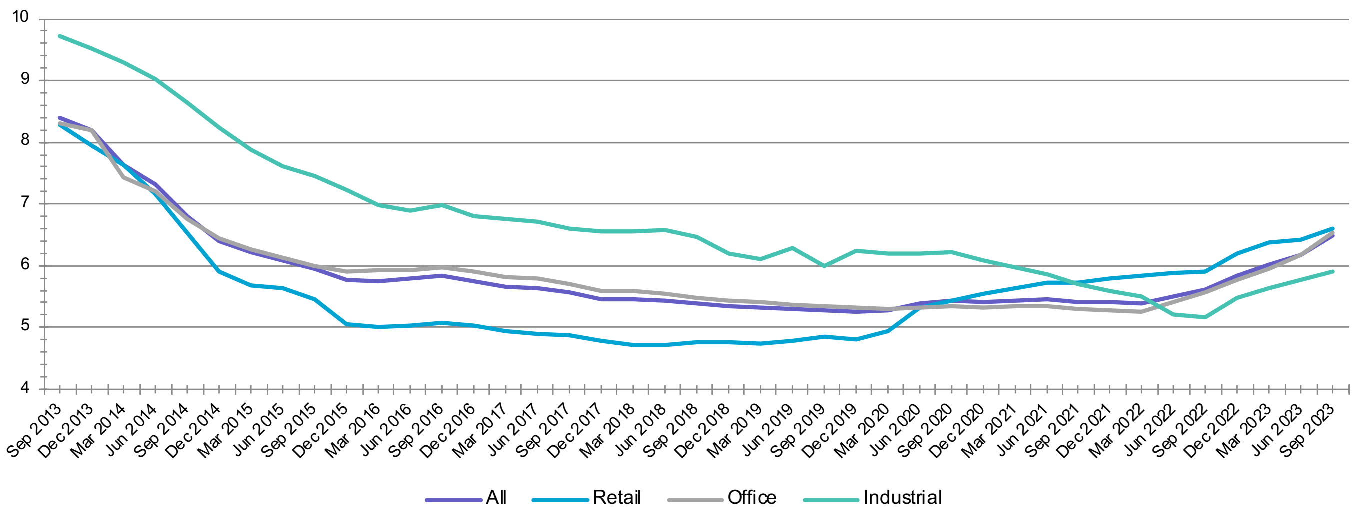
Otherwise, Davy secured the 'Hexagon Portfolio' of retail schemes for €74m, comprising Donaghmede, Letterkenny, Galway, Laois, Parkway, Limerick, Longwalk and Dundalk shopping centres. These schemes, which were developed by Harcourt Developments, had been under the control of a receiver. In addition, Davy acquired The Marshes Shopping Centre, in Dundalk, for €29.5m from Kennedy Wilson.

In the alternative sectors (so outside the office retail and industrial sectors, which have tended to form the vast majority of property investment in Ireland), Primary Health Properties PLC, a UK-based REIT, acquired a healthcare centre in Ballincollig, Cork from the O'Flynn Group for €31.4m, reflecting an income yield (the relationship of rental income to capital value) of 5.3%.

Valuations continued to trend weaker in Q3, with valuers reflecting lower liquidity and pricing levels in market transactions due to increasing yields in the office and retail sectors. (Increasing yields are a function of both increased cost of debt and lower investment demand). Equivalent yields on prime offices now range 4.50% to 4.85%, while the best industrial and logistics assets are now valued in the order of 5%. Following the completion of investment transactions in the retail sector during Q3, yields rose slightly following a period of pricing stability in that sector.

George's Quay House, Dublin 2, acquired by Corum in Q3 2023

MSCI Ireland Index – equivalent yield by sector to Q3 2023



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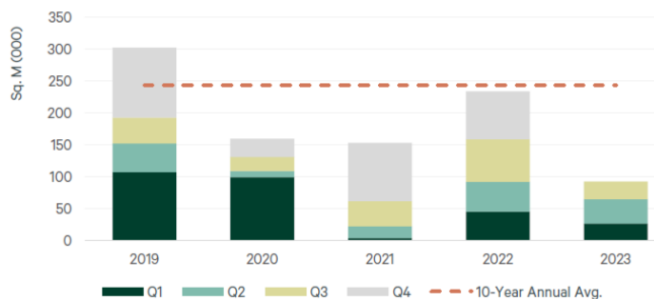
OFFICE OCCUPATIONAL MARKET

Take-up in the office occupational market was at 327,000 square feet, which brings the total for 2023 YTD to 1.014m square feet (according to Knight Frank, a real estate agency). Activity in Q3 was a reduction on the just over 400,000 square feet that was leased in Q2. The financial services and legal sectors accounted for the greater part of letting activity in Q3, accounting for over 40% of activity. On a YTD basis, the technology sector still accounted for the largest proportion of letting volume (at 24%, according to CBRE), although this percentage is lower than in previous years. CBRE also projects that this sector will account for the greater part of transaction activity at year end.

A notable trend in recent quarters is the lowering in size of the demises (properties let to tenants under lease agreements) that are being transacted. Of the 46 deals that closed in Q3, 41 deals involved units of less than 20,000 square feet and 35 deals transacted on units of less than 10,000 square feet. There were no deals on units above 50,000 square feet. This contrasts with the trend established pre-Covid-19, where average leased unit sizes grew notably. The trend post-Covid appears to be a return to the smaller office unit sizes. Many of the requirements that drove demand for office units of this size tended to be from the technology sector, which has for the moment reduced leasing activity relative to the time prior to the pandemic.

The table below captures the trend in office lettings since 2019 (and breaks out quarterly activity). It shows that 2022 activity was close to the 10-year average, and that 2023 YTD is at a lower level.

Dublin office take-up 2019-2023

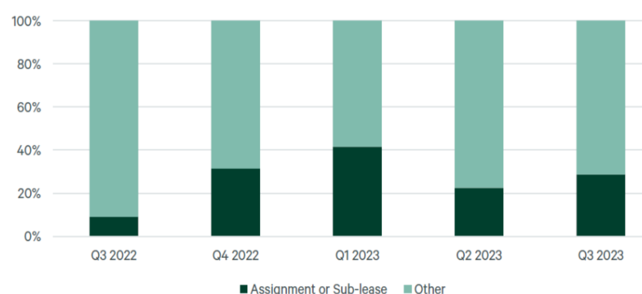


Source: CBRE Research

Another trend (that emerged some time ago) is the low level of leasing activity in the suburban sub-markets. Deal volume in the suburbs accounted for 25% of activity while the balance of 75% was for premises located in the city centre (70% of this was in the Dublin 2-4 submarket). This trend is consistent with other notable European cities, for example London and Paris.

Vacancy (reported by Knight Frank) is at 14.3% (up from 13.4% at the end of Q2 2023). The increase is to a degree attributed to the delivery of new schemes, but the 'grey market' (office units leased on a long-term basis but available for sub-letting) also contributes to this increased vacancy level. The grey market itself is a result of the changing occupational market that has developed from increased hybrid working. The majority of this space that is now surplus to requirements was contracted (leased) pre- pandemic, before the emergence of alternative working arrangements with office occupiers. Grey market space accounted for 30% of office leasing in 2023 YTD, according to CBRE. These transactions involved the assignment or sub-letting of premises that had already been held on long-term leases. These office units are attractive to many occupiers of office space that tend to be available for shorter terms, and in many cases these office units are already fitted out and are available in a condition for immediate occupation.

Letting activity by deal structure, showing the participation of the grey market as a proportion of overall transaction activity, since Q3 2022



Source: CBRE Research

It is important to note that demand for leased premises with strong environmental credentials continues to be relatively strong, but that those buildings with poorer specifications are suffering from lowering occupational demand. It is also notable that the 'equilibrium' vacancy rate (the healthy rate that avoids occupational shortages and provides tenants with reasonable choice) is between 6% and 8%.

Prime rents (for well-located buildings with strong specifications) are holding relatively steady at €62.50 per square foot for the very best products, while there is some evidence that tenants are starting to receive enhanced incentives when deals are being negotiated.

The development pipeline in Dublin delivered close to 480,000 square feet of office accommodation in Q3, and Knight Frank reports that 24% of this newly delivered space is already pre-leased (contractually leased in advance of construction completion). All notable completed projects were city centre locations. Projected completions are considerably lower for 2024 and into 2025 (with 1m square feet of scheduled completions in each of these years).

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OFFICE OCCUPATIONAL MARKET (CONTINUED)

It is expected that occupier demand for newer buildings will exceed supply over the coming years, as occupiers continue to focus on modern specifications, to the detriment of older buildings in peripheral locations. Reportedly, demand requirements are at just over 2.4m square feet, which is in line with the 10-year long-term average take-up volume. Of these demand requirements, it is reported that 26% comes from professional services, 13% from financial services and 11% from the public sector. Almost 90% of these requirements are focused on city-centre locations. This shows a healthy demand for modern, well-located city centre office buildings, despite the flux in working practices.

There is some evidence of older office buildings being examined with a view to repurposing for alternative uses. CBRE has reported that two city centre buildings are under consideration for conversion to hotels following the conclusion of feasibility studies (the former Ulster Bank building at College Green and at 5-9 South Fredrick Street in Dublin 2).

RETAIL OCCUPATIONAL MARKET

The increased investment into high street retail property, which accounted for 33% of investment trade during Q3, is underscored by the increased strength of the occupational market. Occupational vacancy has dropped considerably in the Grafton Street sub-market, and this strength in occupational demand is now evidenced in the Henry Street sub-market by the number of deals agreed over 2023. The strength in demand has driven rental growth in the high streets, which had suffered considerably since the Covid pandemic.

Rents in the Henry Street sub-market have increased to €280 per square foot (area in terms of Zone A, or 'ITZA'), which shows good growth from the post-Covid days. Rents on the Grafton Street sub-market are in the order of €480 per square foot (ITZA).

High street footfall is trending higher than in any year since 2019, but still lags the pre-pandemic period during weekdays – an impact of the growth in remote working.

Lease lengths in high street units continue to have tenant termination options after year five of the term (usually) to provide retailers with the flexibility to exit the lease in the event of changing economic conditions. The retail business is highly dependent on disposable income, and, due to the ever-changing economic conditions, flexibility in occupational lease lengths has become a feature of the high street leasing market.

Evidence of new leases in 2023 has been reflected in rental values on retail properties, which have increased to Q3 2023, a trend that started in mid-2022. Astrid & Miyu opened its first Irish store in 2 South Anne Street, a property managed by Irish Life Investment Managers, in Q3 2023. Additionally, a number of new deals were contracted in the major shopping centres in Dublin, including leases to Lego and Bershka in Blanchardstown Shopping Centre, leases to Penneys, Skechers, and Mango in Dundrum Town Centre, and leases to Hobbs and Levi's in Liffey Valley.

Bannon Commercial (a real estate agency that has a strong retail practice) tracks occupancy levels across retail schemes nationwide and reported an increase of 2% to 92% during the year to September. Footfall continues to recover in shopping centres and is now higher than ever in retail parks. The retail park sub-sector tends to trend with the health of the housing market and, in the current environment, the good retail park schemes are performing very well, with low lease turnover (tenants are not vacating at lease expiration), low vacancy and reasonable rental growth. Similarly, neighbourhood shopping centres are also experiencing strong performance. These are profiting from the lower footfall in the city centres, which is a direct result of remote working practices.

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INDUSTRIAL MARKET

Leasing take-up volumes remained reasonably solid with almost 650,000 square feet of take up in Q3 2023, which is very close to the Q2 level of absorption. This brings the YTD take-up close to 2.22m square feet, which is notably 40% behind letting activity at the end of Q3 2022.

However, the constraining factor is the lack of available product to lease, as occupational demand continues to be very strong, and this is evidenced by continued rental growth in the industrial sector. Another notable point is the fact that three of the top five deals (in terms of area of premises leased) were structured as pre-lease agreements[1], and these deals accounted for 25% of Q3 deals completed. This is supported by a vacancy rate in the top 36 industrial and logistics parks in Dublin of less than 2%.

Demand for leased space continues to outweigh supply. The current demand requirement (according to CBRE) is reported to be at 1.45m square feet. Supply has been slow to respond, with approximately 650,000 square feet of stock having been delivered in Q3, and another 700,000 square feet having commenced construction over the quarter. Of all the stock scheduled to be delivered over the remainder of 2023 and into 2024, it is reported that 40% of this stock has already been pre-leased.

Prime rents are at €12.75 per square foot for the best products, and the shortage of well-located buildings is pushing rents for secondary product (buildings with lower specification) to higher levels (at over €11.00 per square foot).

The Dublin south-west corridor (roughly along the N7) witnessed the most activity, accounting for over 30% of deal volume, followed by 26% and 17% in the North-East M1 and M2 corridors[2] respectively. On a YTD basis, the N7 accounted for over 50% of leasing activity, and this has been a consistent trend over the past several years.

The fundamentals that have driven recent strong growth in the industrial market continue to operate are:

(i) The high growth of e-commerce penetration (the percentage of the population that conducts on-line shopping). Data on the UK market (which tends to be mirrored by the Irish market) puts the rate at 32% at this time, which is a significant increase on 23% which was the rate reported by CBRE in 2020; this alone supports a strong increased requirement for product.

(ii) Adapting supply chains to combat inventory disruption that was caused by Covid-19. This has resulted in the requirement to stock greater levels of inventory to reduce the disruption of shortage of products.

(iii) The increasing instability in the geo-political landscape is encouraging closer overseeing of manufacturing and inventory storage. Political tensions with China and the war in the Ukraine are events that have resulted in unanticipated difficulties with supply chains.

Investment in the Industrial sector totalled €86.5m in Q3 2023, which accounted for 19% of transaction activity in the period. Overall, the sector is on course to account for 20% of investment activity in 2023, which would be the highest proportion of the overall annual investment activity on record.

[1] A pre-lease agreement is one where the lease is contractually documented prior to the unit being available to lease. This deal structure generally pertains to a unit either under construction/refurbishment, or else one where a unit is scheduled to be surrendered, and these deals tend to signify a tight letting market.

[2] The N7, the M1 and M2 are the motorways, as the most attractive industrial facilities are those located close to transportation corridors.

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FUND STATISTICS

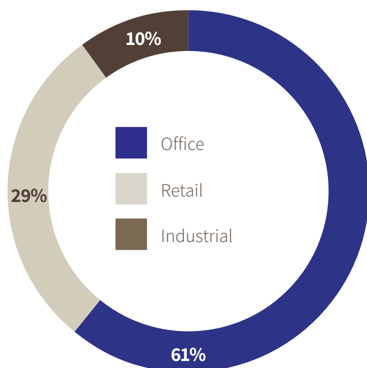
Total returns	
Q3 2023	-2.01%
1 Year	-8.06%
3 Years (annualised)	+0.69%
5 Years (annualised)	-0.11%
10 Years (annualised)	+8.38%

Property income yields	
Office	6.2%
Retail	6.9%
Industrial	4.7%
Portfolio	6.5%

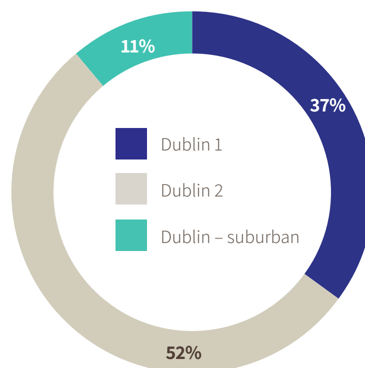
Source: Irish Life Investment Managers. Data is accurate as at end of quarter three (30 September 2023).
The pricing basis of the fund changed in January 2020 from acquisition to disposal basis.

Source: Irish Life Investment Managers. Data is accurate as at end of quarter three (30 September 2023).

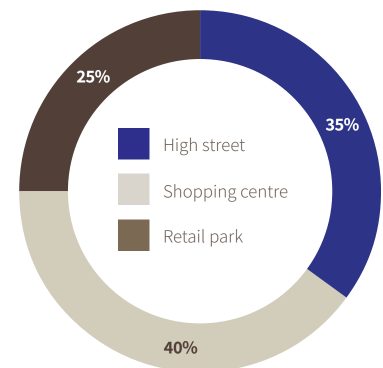
Sector Weightings:



Office Sub-Sector Weightings:



Retail Sub-Sector Weightings:



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FUND ACTIVITY

The Fund imposed a six-month deferral (notice period) to all withdrawal and switch requests on 3 March 2023 as communicated to customers at that time. The decision was made in response to investor flows and is not a reflection of our view of the long-term suitability of property as an asset class, nor the quality of the portfolio of properties within the Fund.

The property markets, at a global level, are being impacted by various headwinds. Most pertinent to the real estate industry is the increased cost of debt financing that has been driven by increased interest rates. All properties in the Fund are valued monthly by independent valuers (across five investment agencies). The independent valuers review market transactions and apply a market value to each property from an analysis of comparable market transactions. Most market investment transactions involve debt financing, and so the increased cost of debt has tended to mean that the price an investor would pay for a building has reduced relative to the time that debt financing was less expensive.

While the Fund has no leverage (debt financing), the negative market moves that are happening in the market are impacting all real estate values, including those in the Fund. These negative capital value moves are driving the Fund's returns, and so the negative returns generated (set out in the Fund returns section) are a result of market-driven capital falls as opposed to being driven by property-specific events such as lease terminations and resulting vacancies in buildings. The Fund has very strong occupancy levels, and so, while the income returns are strong, they are being diluted by negative capital value returns.

> The weighted average unexpired lease term across the Fund is 4.11 years across over 250 tenancies.

> Rent collection rates in the Fund are at virtually 100% for Q3, which is a strong attestation of the Fund's durable income profile.

> Two letting deals in particular, in 48-49 Patrick Street in Cork (lease to Carroll's Gifts) and a re-gear of a lease to Apex Fund Services in Block 5 Irish Life Centre (which extended the lease term by 10 years), were completed in Q3 2023. This letting activity is an important part of portfolio management as it continues to strengthen the Fund's income profile.

> Four properties were sold in Q3, as the Fund continues to re-position the portfolio in line with the strategy, which is to modernise the assets in sectors and markets where rental growth is anticipated.

> Of the assets sold, two were in the industrial portfolio. After a successful refurbishment and re-letting, unit 35 Rosemount Business Park was sold, the Fund having produced a very strong return as a result of the asset management. Also in the industrial portfolio, the lease in unit 20 Fonthill was assigned and extended which enhanced the value in advance of the sale.

> In the office portfolio, the leases in unit 4 Earlsfort Terrace (which had been extensively refurbished in late 2017-2018) were renewed in 2022, achieving full occupancy. The asset was sold in Q3 2023, in line with the strategy to divest out of older assets.

> Lastly, unit 39 Patrick Street in Cork was sold, following a moderate refurbishment and closing of a new lease. The Fund has reduced its number of high street retail holdings in recent years, in line with the strategy. All of these buildings were positioned to be sold so the fund could maximise disposal proceeds, having optimised value though successful asset management initiatives.

> The Fund's vacancy rate at the end of Q3 2023 was at approximately 6.6%.

> The Fund is continually looking to optimise the portfolio, and continues to review sales opportunities and opportunities to recycle capital into investments within the existing portfolio.

> The Fund has a well-constructed portfolio of assets, with a strong income profile and low vacancy.

> The strategy is to continue to improve the assets within the portfolio, to create value-enhancing opportunities and to further improve the portfolio structure, the income profile and the returns of the Fund.

OUTLOOK

There has been limited investment activity in 2023 YTD, and it is expected that this low level of activity will continue into 2024. The combination of increased interest rates and economic headwinds have not been ideal for trading activity, despite the health of the occupational markets (strong employment and strong demand for most property sectors that is underpinning a reasonably high occupancy across the markets). There is a reasonable case for continued rental growth in certain sectors and sub-markets into next year.

Valuations, which have remained under pressure for all of 2023, will likely continue to feel the impact of the forecasted 'higher-for-longer' interest rates into 2024.

The office market will continue to evolve into 2024 and in the years beyond, as occupiers continue to refine working model strategies which encompass the hybrid working model. Demand will continue for well-located stock with a good environmental specification. The market for shorter term, flexible lease terms will also continue to evolve for those with transitioning requirements.

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