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Northern Ireland Commercial Property in 2012

Prepared by IPD in association with the University of Ulster

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Acknowledgements

This IPD report offers an objective, internationally credible evidence base on the performance of the Northern Ireland commercial property market. The research serves to enhance market transparency and communicates the investment opportunities afforded by Belfast and Northern Ireland to a wider institutional investor audience.

The research has been co-sponsored by Belfast City Council and the Department for Social Development (DSD) alongside a consortium of leading commercial estate agents comprising BTW Shiells, CBRE, Colliers International, Lisney, O'Connor-Kennedy-Turtle and Savills[1]

[1] Osborne King, while not sponsors, were key data contributors in 2012.

Foreword from Belfast City Council

I am pleased to be introducing this Northern Ireland Commercial Property Report 2012, which is the result of collaboration between IPD and the University of Ulster, co-sponsored by Belfast City Council, the Department of Social Development and leading commercial advisors. The research and key findings within the report are to be welcomed in providing a credible evidence base that highlights the 'investability' of Belfast and Northern Ireland as a region.

It is important that Belfast and Northern Ireland as a whole competes on the international stage in terms of attracting investment. Historically the absence of a timely and objective dataset on the performance attributes pertaining to the Northern Ireland and Belfast commercial property market could have limited the exposure to many of the key investment decision makers. However this commercial property research has served to improve the transparency of the commercial property market offering an internationally credible and objective assessment of key performance attributes. I believe that this research forms an integral component of the investment 'toolkit' serving to showcase the potential of Belfast and Northern Ireland.

The commercial property market in Northern Ireland continues to evolve and the performance data within the report did indicate a difficult period in 2012 for property performance, with the market continuing to face a number of challenges. However, the research has highlighted the competitive strengths of Belfast from a property investment perspective on a like for like basis relative to other UK and European cities. The Belfast market has demonstrated strong income returns as well as strong total return performance relative to other UK benchmarks over the medium to long term investment horizons.

Whilst the research does indicate that the performance of the Northern Ireland commercial property market suffered in 2012 in terms of the overall market position, the longer term picture is more positive. Over the last 28 years the NI market has provided a year-on-year return well ahead of the overall UK figure and the Belfast market has continued to perform in line with similar sized cities across the UK and Ireland and in some instances is outperforming other comparable cities. The research has indicated a continued strong income flow and yield shifts which are attractive from an investor perspective.

A key conclusion to be drawn from the research is that now is an opportune time for investment in Belfast and Northern Ireland. The evidence indicates that investor sentiment towards Belfast is improving and it is imperative that this is built upon and that the mechanisms and infrastructure conducive to attracting investment are put in place and that Belfast and Northern Ireland continue to be actively promoted as an attractive investment destination.

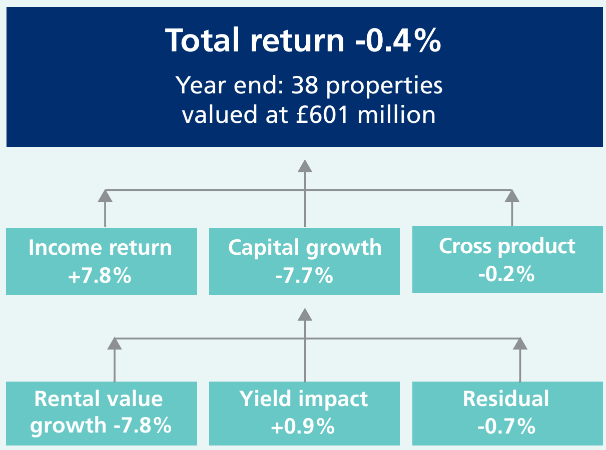
Gerry Millar
Director of Property and Projects
Belfast City Council

IPD Northern Ireland:
Performance review 2012

Key points:

- Commercial property in Northern Ireland posted a total return of **-0.4%** y/y in 2012. The total return was driven mostly by a decline of **7.7%** y/y in capital values;
- Capital values in Northern Ireland have fallen 32% since 2006. However the maintenance of passing rent, which resulted in a high level of income return, at **7.8%** y/y in 2012 means that Northern Ireland provides competitive income streams from heavily discounted assets;
- Belfast retails recorded a positive total return of **0.5%** y/y outperforming a number of key urban centres including Cardiff, Edinburgh and Newcastle;
- Equivalent yields for Belfast retails, the dominant investment sector, fell appreciably from 7.9% in 2011 to **7.6%** in 2012,suggesting an improvement in investor sentiment as buyers return to the market;
- Belfast offices saw a negative total return of **5.3%** y/y due to values falling by **14.6%** y/y, although it is noteworthy that the Belfast offices outperformed Liverpool, Leeds and Birmingham offices over the 12 months to the end of December 2012;
- The all property equivalent yield experienced some modest compression in 2012, with an end year value of **8.0%**, down 10 bps from 2011;
- Indeed, Belfast was one of only three cities (Dublin and London) to record an improvement in investor sentiment through a positive yield impact of **2.9%** y/y for the retail sector;
- It is also noteworthy that over the last 28 years, the NI market outperformed with an average year-on-year return of **12.7%**, well ahead of the overall UK figure of 9.4% and the Republic of Ireland with 10.1%.

Fig 1: Performance summary, % year on year (y/y)



Source: IPD

Introduction by University of Ulster

The propensity to grow and expand the Northern Ireland economy is intrinsically linked with the capacity to attract new forms of Foreign Direct Investment (FDI) whilst successfully retaining and growing existing business enterprises. Creating the necessary 'investment infrastructure' in the form of policy frameworks and legislative structures are all pivotal to the successful expansion of the Northern Ireland economy. In light of the intense competition between nations, regions and cities to attract investment allied with the heightened levels of investor due-diligence increased emphasis must also be placed on the provision of robust and credible datasets which serve as an evidence base to inform investment decision-making.

This collaborative report between IPD and the University of Ulster will not only enhance the transparency of the Northern Ireland commercial property market but will also serve to communicate the investment potential of Belfast as a city and Northern Ireland as a region to the institutional investment community in a format with which they are familiar. In conforming with the IPD methodological framework this report affords the opportunity to compare the performance of Belfast relative to comparator cities across the UK and Ireland on a like-for-like basis. Consequently, the findings from this report depict objective and internationally credible interpretation of the performance attributes of the commercial property market and can be used to support the competitiveness profile as well as highlighting the investment potential.

The Obel Tower on Belfast's Waterfront is a prime, mixed-use office and residential scheme completed in 2011

University of ULSTER

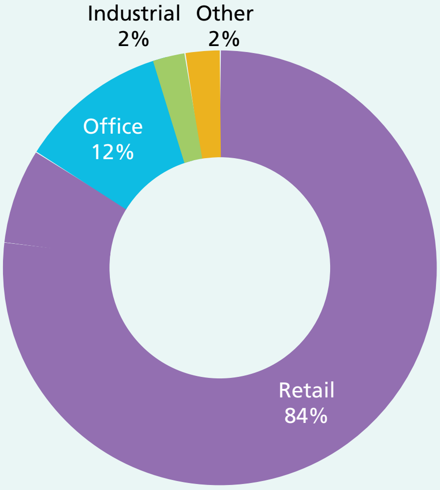
IPD sample overview

IPD was commissioned to prepare this report depicting the performance of Northern Ireland's investment property performance in 2012. The IPD commercial property sample for Northern Ireland comprised **53** properties with a total capital value of **£667** million as at the end of December 2012. The average lot size of assets in this sample was **£12.6** million as at the end of 2012, of which 84% were retail sector assets. Due to the nature of investor focus and indeed the availability of institutional grade investment stock in Northern Ireland the analysis is predominantly focussed on the Belfast retail and office investment sectors.

Table 1: Total sample size

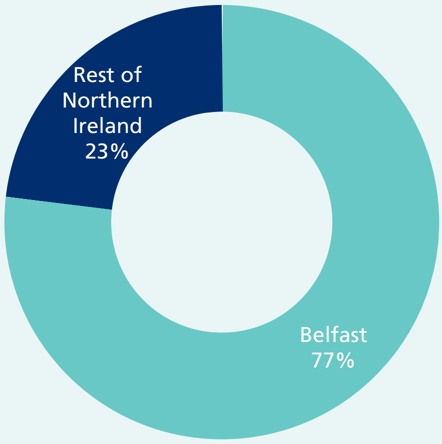
Full sample	No. of properties	Value £m	% of total value
All property	53	667	100
Retail	33	559	84
Office	13	83	12
Industrial	4	14	2

Fig 2: IPD Northern Ireland sample 2012, % of capital value



Source: IPD

Fig 3: IPD Northern Ireland sample 2012, location as a % of capital value



Source: IPD

Table 2: Direct property standing investments (DPSI) sample size

DPSI only	No. of properties	Value £m	% of total value
All property	38	601	100
Belfast retail	17	426	71
Belfast office	6	37	6

Investment performance

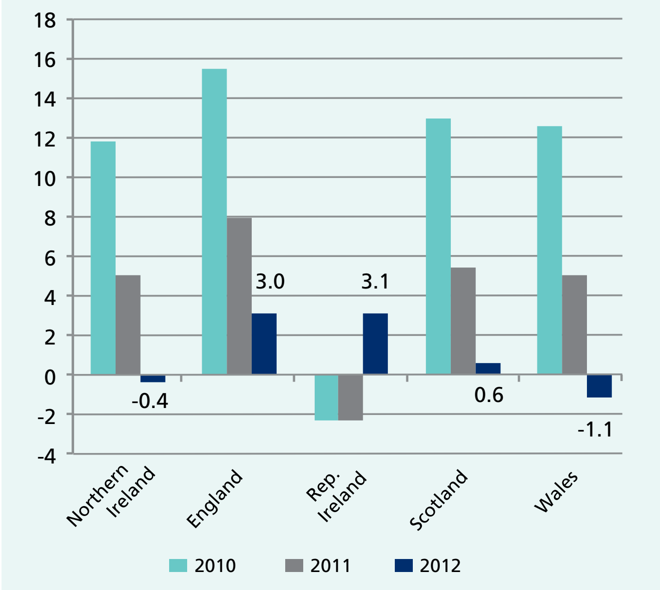
The significant rebound in UK commercial property performance that occurred in 2010 and continued through much of the following year had shown clear signs of faltering by late 2011. Indeed in 2012, returns across the UK market had dwindled, with even prime central London witnessing more modest return levels. The performance of property in the IPD Northern Ireland sample had followed that of the broader UK market, posting positive total returns in 2010 and 2011 despite volatile capital value movement due to lack of sufficient transactional evidence.

For the year ending December 2012, the IPD Northern Ireland sample of commercial property produced a total return of -0.4% y/y, down from the 5.1% y/y posted in 2011 and a dramatic reversal of the 11.8% y/y achieved in 2010. Accelerated capital value falls of 7.7% y/y drove this decline although the stabilisation of income return helped to somewhat offset the contraction in performance. Income return of 7.8% y/y in 2012 was consistent with 2011 and represents somewhat of a consolidation following pronounced growth from 6.6% in 2010.

By way of comparison, UK commercial property as a whole returned 3.4% y/y in 2012 which was less than half the 7.8% y/y returned in 2011 and marked a significant turnaround in fortunes since the 2010 return of 15.1%. UK returns were weakened by falling capital values, the first such falls since 2009, with a decline of 2.2% y/y. It is noteworthy however that the decline in the UK commercial property sector as a whole has been buffered by the London market which continued to perform strongly. In 2012, London properties returned 9.6% y/y, meaning that when the London area was stripped out of the UK figure, total returns dropped to 1.1% y/y overall. As a result, the polarisation of the UK property market widened in 2012, with values in London gaining 5.0% y/y and the UK excluding London losing 5.0% y/y.

Cross-jurisdictional performance analysis (Figure 4) shows that Northern Ireland fared comparably well against Wales, which had a return of -1.1% y/y, and Scotland with 0.6% y/y in 2012. Total return for the commercial property market in England was positive at 3.0% y/y driven by the continued strong performance in the London market as previously discussed.

Fig 4: Total return performance by market, % year on year



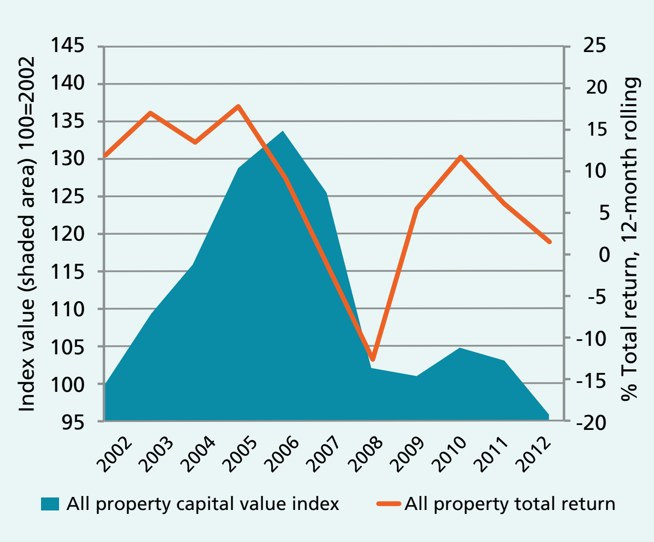
Source: IPD

Long-term investment performance

Figure 5 shows the considerable rebound in total return investment performance in the Northern Ireland market during 2009 and 2010, levelling off in 2011, before returning to negative territory in 2012. Meanwhile, the capital value index (shaded area) shows that nominal values are now at levels similar to the year 2000, with the gains of the last cycle totally eroded.

In the 10 years covered by Figure 5 (2002-12), total returns for Northern Ireland have averaged 6.6% y/y, even higher for Belfast retails with 6.7% y/y, placing the market very much in line with mainland UK performance.The UK market excluding London which returned 6.9% y/y over the same time series. In comparison, the Republic of Ireland returned 3.4% y/y on average over this period. It is noteworthy however, that over the longest period of analysis, 28 years, properties in NI have significantly outperformed their neighbours with an average annualised total return of 12.7% y/y which is over 330 bps higher than the UK average, and 260 bps stronger that the Republic of Ireland market.

Fig 5: IPD Northern Ireland sample performance 2002-12

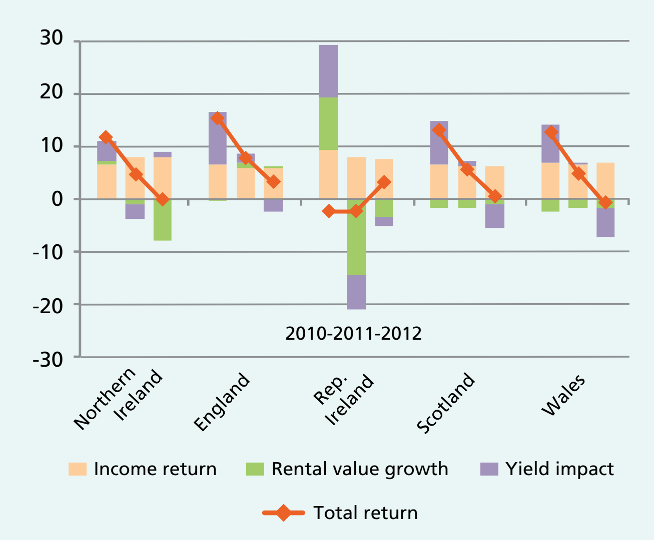


Source: IPD

Performance drivers

Acceleration in capital value decline during 2012 set the tone for the Northern Ireland market. Despite the resilience, and in some cases strengthening, of income returns, this could not keep performance for Northern Ireland in positive territory. Total return is made up of two components; capital value growth and income return. In turn, capital value growth is driven by rental value and yield movements, with a residual element that reflects the valuer perception of the risk of the future cash flow. Figure 6 shows the drivers of total return for commercial property in Northern Ireland relative to the rest of the UK and the Republic of Ireland.

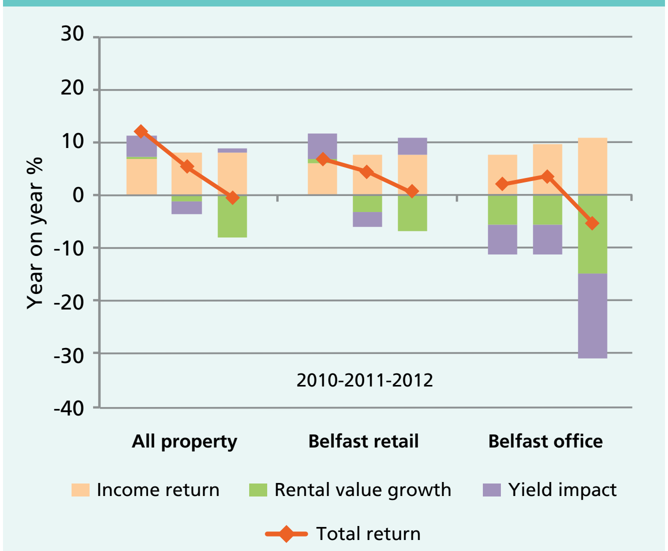
Fig 6: Drivers of total return performance, by market 2010-12, % year on year



Source: IPD

The capital value performance for Northern Ireland all property represents the fifth year in six of value decline. Only 2010 provided growth when markets across the UK rebounded with early, perhaps misplaced, enthusiasm. In the case of Northern Ireland, the strong performance during that year was driven by Belfast retails despite consumer spending falling dramatically during that period. Overall, performance has been weak since early 2007, with rental value and capital value decline the main features of the market. Figure 7 illustrates this trend for the Northern Ireland market and the two Belfast sectors in this analysis; office and retail.

Fig 7: Drivers of total return 2010-12, % year on year

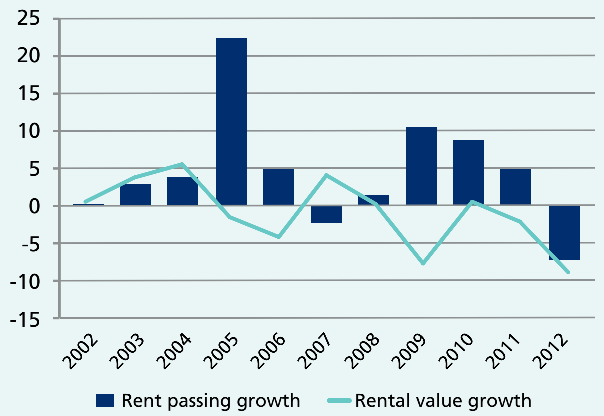


Source: IPD

Negative capital value growth was recorded across both the retail and office sector for Belfast in 2012. The capital value of Belfast retails fell -6.7% y/y but the decline was much more pronounced within the office sector at -14.6% y/y. Belfast offices have continued to suffer from weak job growth leading to minimal take-up levels. One noteworthy feature of the Belfast office market is the limited supply of third-generation, prime office stock. As a consequence there is little opportunity for institutional investors to buy as well as limited options for modern, global occupiers looking to secure space in Belfast. However, the counter effect of this is that the limited supply of prime stock is increasing both tenant and investor competition for top assets, which is likely to boost returns in the near future.

The positive strong capital performance in 2010 was largely as a result of the strengthening position of the broader UK market, a case of everything benefitting from a rising tide, and somewhat ignored the weak underlying position of Northern Ireland assets at the time due to lack of transactional evidence.

Fig 8: Income performance of Belfast retails, % year on year



Source: IPD

Income return, as with most European markets, was the primary total return component throughout this analysis. Income return was strongest for the Belfast office segment adding 10.7% y/y to total return in 2012, growing from 9.4% y/y in 2011. For Belfast retails, income return contributed 7.6% y/y, unchanged from 2011. As the retail sector is the dominant asset type in this analysis, the income position has been examined in more detail, with particular focus on the passing rent position versus open market rental value growth.

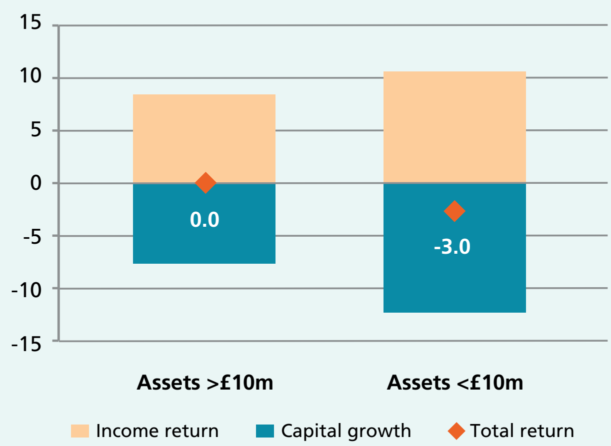
Figure 8 shows that despite rental values contracting between 2009 and 2011 in the Belfast retail sector, the income position of the investor actually strengthened, this was most likely due to rent free periods coming to an end or increased active asset management by landlords. However, income fell by 7.6% y/y in 2012 in line with rental values falling by 9.0% y/y. As over-rented assets move towards break options and expiry dates this income position may weaken further, especially if rental values continue to fall in the meantime. This expiration of income is nonetheless not unique to Belfast with the majority of UK and Ireland markets exposed to the effects of tenants locked into peak time rents exercising break options or seeking to re-gear lease terms.

Asset size variance

Building location, building quality and quality of income came to the fore during the cycle's trough in 2009, and investor aversion to risk meant that quality assets continue to weigh heavily on investor decisions against the poor economic backdrop. As the broader Northern Ireland market remained volatile, risk adverse investors targeted better quality assets with strong, often international, tenants in place. In the main, these are the larger assets by capital value often dominated by supermarkets and retail warehouses. To emphasise the spread in performance separate analyses have been compiled for assets less than £10 million in value, and for those greater than £10 million.

Figure 9 illustrates the components of total return in 2012. This analysis was based on a bespoke sample with 16 properties falling into the larger asset band, and 17 properties in the smaller band. While the samples are roughly equivalent by asset count, the largest asset band accounts for 86% by capital value, further highlighting the investor appetite for larger assets in Northern Ireland than would be the norm in the rest of the UK or in the Republic of Ireland. Average investment lot sizes were £12.6 million in 2012 for the Northern Ireland market, almost double the equivalent for the comparable markets.

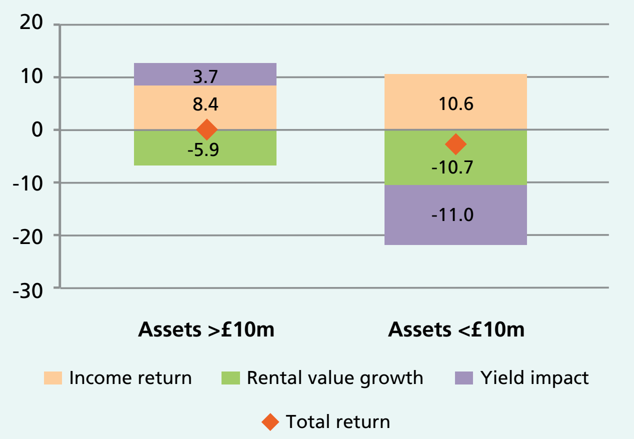
Fig 9: Components of total return 2012, % year on year



Source: IPD

Capital values fell for both assets worth over £10 million and assets worth under £10 million, however, values fell significantly more for smaller assets with a drop of -12.4% y/y in 2012 compared to -7.7% for larger assets. Recognising the higher risk of tenancies in small assets, the income return was also higher, at 10.6% y/y, meaning a stronger income position for investors but with the likelihood that this cash flow poses a higher risk of default or vacancy. An income return of 8.4% y/y for larger assets outpaced capital value falls which resulted in flat total returns of 0.0% y/y in 2012, compared to a weak -3.0% y/y for assets under £10 million in value.

Fig 10: Drivers of total return 2012, % year on year



Source: IPD

The significant capital value fall for the small asset segment was driven by a combination of weakening investor sentiment, as expressed by a yield impact of -11.0% y/y, and a similarly deteriorating occupier market, as rental values declined by 10.7% y/y. This decline in both indictors highlighted the lack of investor attraction to small secondary assets, and the weakening tenant appetite for small, often older units in less prime locations. The comparisons to larger assets are stark. Larger assets saw a strengthening in yields, with a positive yield impact of 3.7% y/y suggesting an improvement in investor sentiment towards such investments. However, in line with the weak retail picture, rents fell by 5.9% y/y as poor consumer sentiment and flat job growth punished occupier confidence.

The Belfast market in context

This section analyses the performance attributes of the Belfast retail and office markets relative to neighbouring (and often competing) city markets. The analysis is based on a sample of 23 direct property standing investments (DPSI) located within the Greater Belfast area. This sample had a capital value of £463 million as at the end of December 2012.[2]

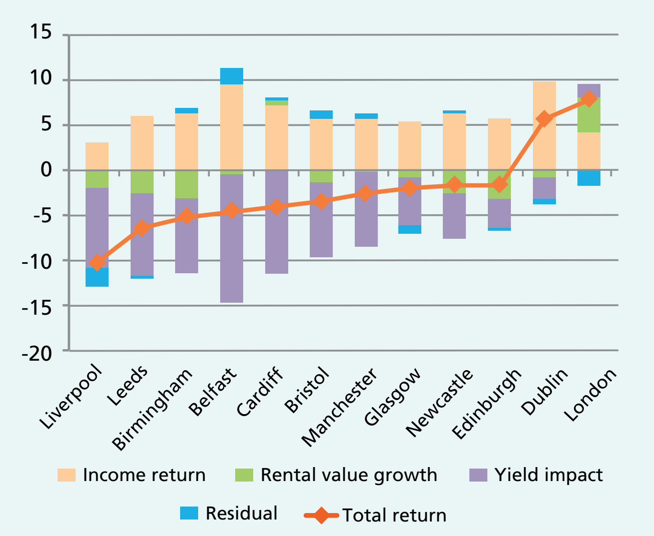
Office

This analysis compares office market performance for Belfast with eleven other cities across the UK and Ireland. Belfast Offices returned -5.3% y/y in 2012, with capital values falling by 14.6% y/y, the largest annual fall since the market crash of 2008. However, falling rental values did not cause this, rather a dramatic weakening in investor sentiment was the key driver, as witnessed by a yield impact of -16.0% y/y. Equivalent yields jumped from 8.6% to 10.3% reflecting heightened perception of risk in this sector of the market.

With the exception of Dublin, which improved dramatically since 2011, most cities in this analysis saw a fall-off in performance, with several regional office markets falling back to negative total returns. The total return of -5.3% y/y ensured Belfast offices marginally outperformed Birmingham and Leeds whilst Liverpool was the weakest performing office market in 2012, with a dramatic return of -11.6% y/y, as capital values fell heavily. London was, again, the top performing office location with a total return of 8.7% y/y, down from 12.5% y/y in 2011, while Dublin was second best returning 6.4% y/y as strong income returns boosted performance.

London was the only city to have experienced capital value growth (+3.9% y/y) while on average cities in this analysis saw office values fall by 9.1% y/y. The heavy value falls for these cities was driven primarily by weakening investor sentiment, as evidenced by the strongly negative yield impact in most locations, whereas rental values only fell by 1.2% on average. Figure 11 examines the drivers of capital value movement for offices in the twelve cities of this analysis.

Fig 11: Office sector drivers of total return, % year on year



Source: IPD

[2] While the broader Northern Ireland sample in 2012 includes a number of industrial and 'other' assets due to sample size constraints and the protection of investor confidentiality, it was not possible to include a performance breakdown of these sectors at the present time.

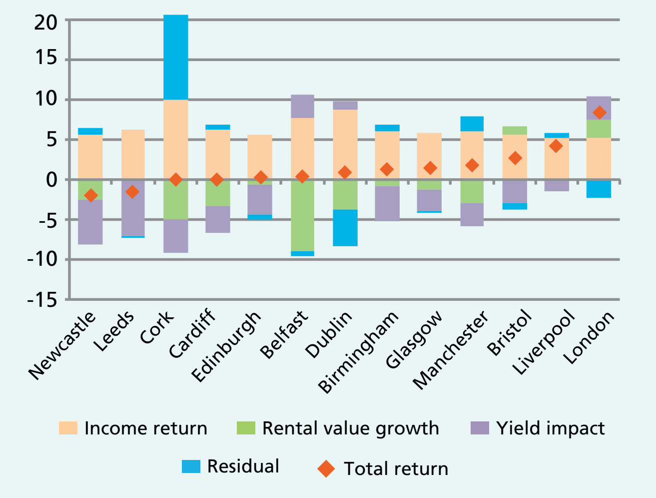
Retail

In comparison with other regional cities, Belfast retails performed admirably during 2012, with a positive total return of 0.5% y/y, marginally ahead of Edinburgh on 0.4% y/y and just behind Dublin which returned 0.9% y/y. Newcastle and Leeds were the two weakest performers with total returns of -2.0% y/y and -1.5% y/y, respectively. These were followed by Cork which had a flat return of 0.0% y/y as an almost double digit income return of 9.9% y/y kept returns positive. In each of these three weakest cities, total returns marginally were dragged downwards by heavy capital value falls, driven by weakening yields and poor rental value growth.

Belfast stayed positive due to strong income return outpacing capital value declines. Capital values for Belfast retails fell by 6.7% y/y in 2012 as a consequence of weakening rental performance which dragged returns downward. The decline in value was offset by a comparatively high income return of 7.6% y/y, although like in Dublin and Cork, a large portion of this is due to the legacy effect of over-renting. While the long term sustainability of high income returns in the Belfast market is unlikely, it is an encouraging indicator for the market considering its combination with an improving investor appetite for assets as highlighted by the positive yield impact in 2012.

Belfast was one of only three cities (along with Dublin and London) to record an improvement in investor sentiment through a positive yield impact of 2.9% y/y. By contrast most cities in this analysis saw investor sentiment weaken, with an average yield impact of -2.4%, with cities such as Newcastle and Leeds suffering the most. This suggests that investors are again looking closely at the Belfast retail market, and assets with strong covenants, particularly international occupiers, will have the ability to provide investors with a secure income stream. Figure 12 shows the comparable city performance for the retail sector in 2012.

Fig 12: Retail sector drivers of total return, % year on year



Source: IPD

Victoria Square in Belfast City Centre. A popular retail location with leading multinational occupiers.

Conclusion

In 2012, commercial property in Northern Ireland mirrored the weakening performance of mainland UK rather than the improvement witnessed by commercial property in the Republic of Ireland. The NI market underperformed the rest of the UK as capital value decline dragged returns negative. However, the broader UK performance was boosted by the dominance of London and when analysed on a city level Belfast outperformed a number of key locations, including Liverpool for the retail sector and Edinburgh for offices.

The Belfast market has continued to perform in line with similar sized cities across the UK and Ireland. Retail performance was positive in 2012, with a total return of 0.5% y/y, ahead of key urban centres such as Newcastle, Leeds, Cork, Cardiff and Edinburgh. Crucially, Belfast was one of only two other cities (Dublin and London) to see investor sentiment strengthen for the retail sector, as recorded by a positive yield impact. Belfast offices were weaker with a negative total return, but nonetheless outperformed Liverpool, Leeds and Birmingham in 2012.

While on an overall market position, Northern Ireland underperformed compared to the rest of the UK in 2012, the longer term picture is more positive. Indeed, over the last 28 years, the NI market provided an average year-on-year return of 12.7%, well ahead of the overall UK figure of 9.4% and the Republic of Ireland with 10.1%. In particular, the performance of Northern Ireland property post-Good Friday Agreement in 1998 was impressive, with returns averaging 14.8% between 1998 and 2005. Since then, NI returns have averaged 1.4% y/y, higher for retails at 1.8% y/y, which was comfortably ahead of the equivalent performance for Scottish and Welsh retails, which returned 1.1% y/y and 1.2% y/y respectively.

Since the market crash of 2008, performance has been more subdued with the market struggling with low transaction levels and poor investor confidence. This weakening of investor sentiment, particularly in 2008 and 2011, had seen yields rise significantly in the market, however extant leases with strong covenants have meant that tenants, many of whom are international retailers have maintained passing rent (landlord income) levels. This has helped safeguard the investor position and maintained relatively secure cash flows from Northern Ireland assets. The strong rental position has provided the market with a regionally strong income return combined with an offering of well-located and heavily discounted assets. This is offering value for new entry investors, particularly as UK and Irish banks begin to offload properties in their struggling loan books.

Author details:

Colm Lauder

Senior Associate - IPD
Tel: +44.20.7336.9689
Email: colm.lauder@ipd.com

Martin Haran

Senior Research Fellow - University of Ulster
Tel: +44.28.9036.8757
Email: m.haran@ulster.ac.uk

Glossary of terms

Total return is the overall level of return derived from property. This can be split into income return - the money investors receive from rent (net of costs) - and capital growth - the change in the capital value of the property. Income return might be compared to the dividend on a company's share; capital growth could be compared to the change in price of the share.

The **capital value** of a property is affected by two factors, rental levels and yield levels, meaning that capital growth can further be split out into two drivers.

- **Rental growth** is the change in the level of rent that a valuer estimates a property might achieve were it let on the open market. If a valuer thinks that open market rental values have risen from say £40 psf to £50 psf, rental value growth would be 25%, and capital values would increase by this amount, all other factors remaining the same.

- **Yield impact** quantifies the impact on capital values of a change in yields. If yields rise, capital values fall; conversely, if yields fall, capital values rise. A positive yield impact of say 10% would indicate that yields had fallen by such an amount as to increase capital values by 10%. Likewise, a negative yield impact of say -15% would show that a rise in yields had caused capital values to fall by 15%.

- The **equivalent yield** is the rate at which the prospective rental income over the entire length of a lease is discounted to equate with the current capital value.

- **Capital growth** is the change in the capital value of a property over 12 months net of capital expenditure, expressed as a percentage of the capital employed over the year. The capital value of a property is in the view of the valuer, the price the property would achieve on the open market. On a rack-rented or reversionary property capital growth is roughly equal to the product of Rental Growth and the Yield Impact.

- The rate of i**ncome return** is the rent actually paid by a tenant over 12 months, divided by the capital employed in the property. The income measure is net of any revenue expenditure incurred by the landlord, including incentives.

- **Over-renting** occurs when the open market rental value falls below the rent actually paid by the incumbent tenant. Between 1991 and 1993 and again in 2002 it cushioned the impact on capital values of falling rental values, as valuers focused increasingly on the income protected by the lease. Correspondingly, between 1997 and 1999 it tended to detract from performance, because a significant proportion of the increase in rental values had no immediate impact on the future income stream and on capital values. In addition, because valuers have introduced a second yield to value the `top-slice' of over-rented rental income, the condition has made equivalent yields more sensitive to fluctuations in gilts yields.

- A **reversionary property** is one where the open market rental value exceeds the rent paid; a rack-rented property is where the two are equal.

IPD

IPD is a leading provider of real estate performance and risk analysis, providing critical business intelligence to real estate owners, managers, brokers, lenders and occupiers worldwide. Our unique database holds searchable information on 77,000+ properties, valued at approximately $1.9 trillion, which are located in 32 countries, with a long performance history (25+ years) and which are mostly appraised quarterly.

IPD is well known for its sophisticated research capability and provides fundamental analysis that can be applied across all types of real estate: direct property, listed and unlisted vehicles, joint ventures, separate accounts and debt. IPD's clients are global industry leaders and we have a symbiotic relationship with them. This includes nine of the top ten global fund managers* and nine of the largest ten European REITs**.

Within the UK, IPD's suite of performance indexes is accepted as representing the performance of the UK property market. As at the end of 2012, the IPD UK Annual Index represented information collected from 304 funds investing in property which held a combined total of 21,012 assets valued at over £140 billion – equivalent to approximately 60% of the UK institutionalinvestment market. In the Republic of Ireland, the SCSI/IPD Ireland Quarterly Property Index was based on a sample of 304 properties covering €2.0 billion at the end of 2012. This is equivalent to approximately 80% of the Irish institutional investment market.

IPD contact

Tel: +44.20.7336.9200

Email: enquiries@ipd.com

ipd.com

* INREV/ANREV Fund Manager Survey 2012
** MSCI 2013