SUBMISSION TO THE IRISH BANKING INQUIRY
MARIE HUNT, HEAD OF RESEARCH, CBRE IRELAND

Thank you for inviting me to attend this Inquiry to address issues relating to the nature and functioning of the commercial real estate (CRE) market in the period prior to 2008 in the context of the banking crisis in Ireland. The items I have been specifically asked to address include:

- *The size and nature of the commercial real estate market in Ireland*
- *In general terms, the clients and types of services provided by CBRE in the context of the commercial real estate market in Ireland*
- *Sources and extent of funding of the commercial real estate market in Ireland*
- *The composition of investors in the Irish commercial real estate market*
- *Inter-relationships of international commercial real estate markets, including assets and investors*
- *The nature and impacts of advisory services provided to participants in the commercial real estate market*
- *Understanding of risk among advisors and participants in commercial real estate markets in the period prior to the banking crisis*

OVERVIEW OF THE IRISH CRE MARKET

The commercial real estate market in Ireland comprises a range of different sub-markets, namely the office, retail and industrial occupational markets, the investment market, the development land market and the hotels & licensed market, all of which operate independently of one another. Commercial real estate transaction volumes are considerably lower than in the residential property sector but the value of CRE transactions is generally considerably higher. In the absence of a national census or register of commercial property, it is difficult to quantify precisely the size of the Irish CRE market although some sectoral estimates on stock figures and transactional activity are collated by private firms such as CBRE. The commercial property market generally breaks down into three distinct elements, namely the development element where greenfield/brownfield land is developed; the occupier element, where real estate is leased to end users and thirdly the investment element, where occupied and income-producing real estate is sold to investors. In Ireland's case, in the period up to 2008, these three distinct elements effectively merged with many real estate developers holding onto the properties they developed for their own personal investment once they were leased and in many cases using these investments as collateral for funding additional investments and developments both domestically and overseas.

Commercial property is by its nature a long term investment. In general, commercial property is more complex than other forms of investment and less liquid, and, by virtue of the typical size of transactions, is generally not accessible to all investors. However, the emergence of the syndicate model in Ireland in the late 1990's enabled a larger cohort of investors to invest in commercial property from that point forward than would have been the case previously.

ABOUT CBRE

CBRE Group, Inc. (NYSE:CBG), is a Fortune 500 and S&P 500 company headquartered in Los Angeles. The company is the world's largest commercial real estate services and investment firm (in terms of 2014 revenue) with more than 52,000 employees (excluding affiliates), and serves real estate owners, investors and occupiers through more than 370 offices (excluding affiliates) worldwide. In Ireland, CBRE is the country's largest commercial real estate services company, employing over 140 employees with offices in Dublin and Belfast. CBRE Ireland is a multidisciplinary property services company offering a full range of property services including property sales and acquisitions, leasing and management, investment sales and acquisitions, corporate services, project management, consultancy, valuations and research on behalf of a range of different client types including vendors, purchasers, landlords, tenants, developers and investors as well as third party service providers including banks, solicitors, receivers, planners, accountants etc.

ABOUT CBRE RESEARCH

The research function at CBRE Ireland that I head up is modelled on the research platform in CBRE offices worldwide, with its main function being to track transactional and market information for the Irish CRE market. This includes tracking as much detail as possible on commercial property investment transactions; land sales, hotel & pub sales, office and industrial leasing statistics, supply and demand statistics and vacancy rates in different sectors of the market as well as producing historical time series on property rents, yields and capital values. This local market information is inputted into CBRE global databases to facilitate the production of European and global statistics and publications on CRE activity and performance. CBRE collate data in a manner consistent with our company's practices across the EMEA region, using common definitions, processes and systems so as to be able to compare the performance of the Irish market with that of other jurisdictions in a meaningful way. As a result of using standard definitions across the CBRE network, there are often minor discrepancies between our data and that provided by other market providers. Having access to accurate and timely market information on trends and transactions is vital to CBRE in being able to accurately assess the commercial real estate market and provide the best qualitative and quantitative information to our clients. The research function operates independently to the rest of the business and is charged with giving impartial and unbiased observations and commentary on our interpretation of market trends and the data available to us from the perspective of property market specialists.

Having completed a BSc degree in Property Surveying and registering as a general practice chartered surveyor with the Society of Chartered Surveyors Ireland (SCSI), I commenced working at CBRE Ireland in 1995. I was charged with setting up the local research department and since that time have headed up this department and developed local databases and systems for tracking trends and transactions in the Irish CRE market. Over the last 20 years, I have been a regular commentator on the commercial real estate sector in Ireland and produce a regular series of publications on market activity across a range of different property sectors including the office, retail, industrial, investment, development land and hotels & licensed sectors of the market. I am not a banking expert or an economist and am not directly involved in real estate transactional activity. My commentary on the market has at all times been based on my interpretation of the facts and figures available to me from my perspective as a commercial property specialist. All research documents prepared by CBRE contain the caveat that any projections, opinions, assumptions or estimates provided are not intended to represent the current or future performance of the market.

LACK OF DATA

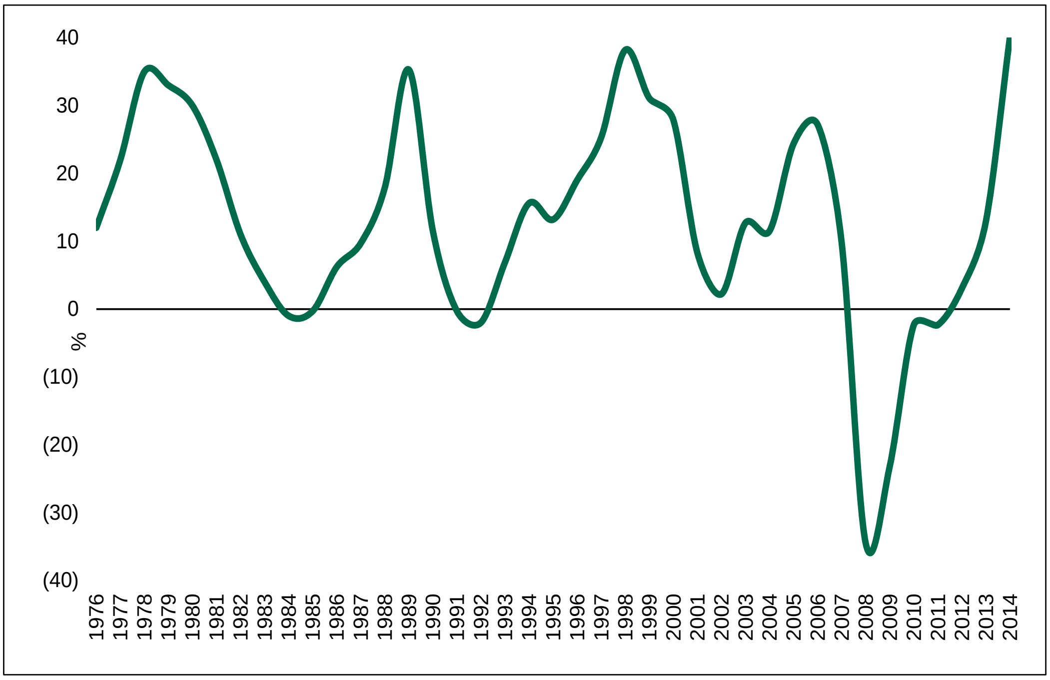
The most significant challenge in tracking the size, scale of transactional activity and performance of the Irish property market over the last 20 years has been a scarcity of property market data. Unlike many other jurisdictions where national property registers exist and all property transactions are collated and analysed centrally, the Irish Government have not invested in establishing a National Property Register or systems for tracking the market in sufficient detail leaving it up to private firms such as CBRE to conduct our own market research in order to be able to comment authoritatively on the CRE market.

UNDERSTANDING RISK

As outlined above, we do not have the luxury of a long time series to demonstrate the performance or the cyclicality of the Irish CRE market over the long-term. The data on the Irish market (compiled by the private sector company Investment Property Databank (IPD) in the absence of any Government data collation or analysis) is only available from the mid-1970s *(See Figure 1).* It is clear from this limited time series that in the period for which data is available, the Irish commercial property market has demonstrated a highly cyclical pattern. Although Irish CRE generated average ungeared total returns of over 16.4% per annum in the period 1976 to 2006 (proving that commercial real estate is a long-term investment), this annual average return masks high cyclicality.

Each cycle since 1976 has been roughly of ten years duration and subject to huge peak to trough variation. Taking this pattern into account, an Irish commercial property correction was predictable in the period up to 2007, particularly considering the fact that interest rates were rising and property development had occurred at an unsustainable pace in the preceding years (primarily as a result of the ready availability of cheap debt and Government tax policy which incentivised real estate investment and development).

Figure 1 - Total Returns Irish Commercial Real Estate 1976 – 2014 *(Source: IPD)*



Looking specifically at the period 2001-2008 *(See Figure 2)*, the cyclicality of the Irish commercial property market is again clearly evident.

Figure 2 – Total Returns Irish Commercial Real Estate 2001 – 2008 (Source: IPD)

2001	2002	2003	2004	2005	2006	2007	2008
8.10%	2.40%	12.40%	11.40%	24.40%	27.20%	9.90%	-34.50%

Having troughed in 2002 in the aftermath of the technology bubble and worldwide recession following 9/11, the cycle resumed in 2003 with a total ungeared return of 12.4% being achieved from Irish CRE market in that 12 month period. A total ungeared return of 11.4% was achieved in 2004. 24.5% was achieved in 2005 and the Irish commercial real estate market peaked in 2006 when a total ungeared return of 27.2% was achieved. The market clearly began to show signs of slowdown in 2007 with a total ungeared return of 9.9% achieved from Irish CRE in that year. The pace of Irish property development, Irish land sale activity *(See Figure 5)* and Irish investment activity *(See Figure 4)* had also begun to show signs of correction from late 2006/early 2007. However, there was no evidence to suggest that commercial property values in Ireland would suffer a collapse that was as severe as ultimately materialised in 2008. If global and domestic banking systems had not collapsed in the dramatic way that they ultimately did, the most likely scenario is that the Irish CRE market would have followed the same pattern as in previous recent cycles – i.e. experienced a downward correction due to one or more of the following factors.

1 economic factors
2 imbalance between supply and demand
3 funding factors such as interest rate movements
4 sentiment

If the cycle had followed its 'normal' or 'expected' pattern, as was our view at the time, Irish commercial property values would have fallen from peak levels, dipped close to or slightly into negative territory, plateaued and ultimately started to recover and the cycle would have started again. However, due to the unforeseen worldwide banking collapse and the complete disappearance of debt funding that materialised following the banking crisis, the commercial property crash experienced was much more severe than any previously experienced in Ireland. The extent to which Irish investors and developers were leveraged significantly exacerbated their losses.
As outlined above, we believe that the four key drivers of property market performance are **1)** economic, **2)** supply demand balance, **3)** funding and **4)** sentiment.

1 ECONOMIC

The underlying economic backdrop is critical to the performance of the commercial property market. Indeed, real estate is effectively a subset of the wider economy with a range of different economic elements (macro and micro) influencing the performance of the CRE market at any given time. CBRE are not economists but rely on economic performance data and projections produced by Government and credible economic houses and organisations. In the period up to 2008, CBRE had regard to economic projections and commentary produced by Ireland's Central Bank, the ESRI, the ECB and the IMF as well as the ratings given to Ireland by various rating agencies including S&P, Fitch & Moody's and this influenced our view on the likely trajectory of the Irish economy and in turn the Irish commercial property market. These economic forecasts would in turn have been fed into our econometric models.

2 SUPPLY DEMAND BALANCE

Another critical component driving property market performance is the balance between supply and demand. *(One only has to consider double digit house prices rises in Dublin or the 50% increase in office rents in Dublin 2/4 over the last 18 months to appreciate the extent to which undersupply in a particular property market sector can influence pricing).* In the period to 2007, it was obvious to us from our analysis of supply and demand across a range of commercial property sectors that there was an imbalance in some sectors of the Irish market. Cheap and plentiful bank debt and Government tax policy fuelled a construction boom and encouraged the development of both residential and commercial property, much of which occurred in parts of the country where there was limited demand. Extensive re-zoning of land for development across different local authority areas and the absence of a national planning strategy exacerbated this trend. We were building too much accommodation, much of which was in the wrong locations. The pace of development was unsustainable and needed to be curtailed. As a firm, having warned about the potential for oversupply in 2005, we welcomed the fact that development was beginning to slow down from early 2007. Against this backdrop of development continuing to slow down to a more sustainable rate and domestic economic activity remaining strong (as we believed to be the case based on the commentary being provided by houses such as the IMF, ESRI, Central Bank and ECB), a soft landing was plausible in our opinion. In fact, this was the most likely scenario according to a range of market advisors and participants at that time.

3 FUNDING

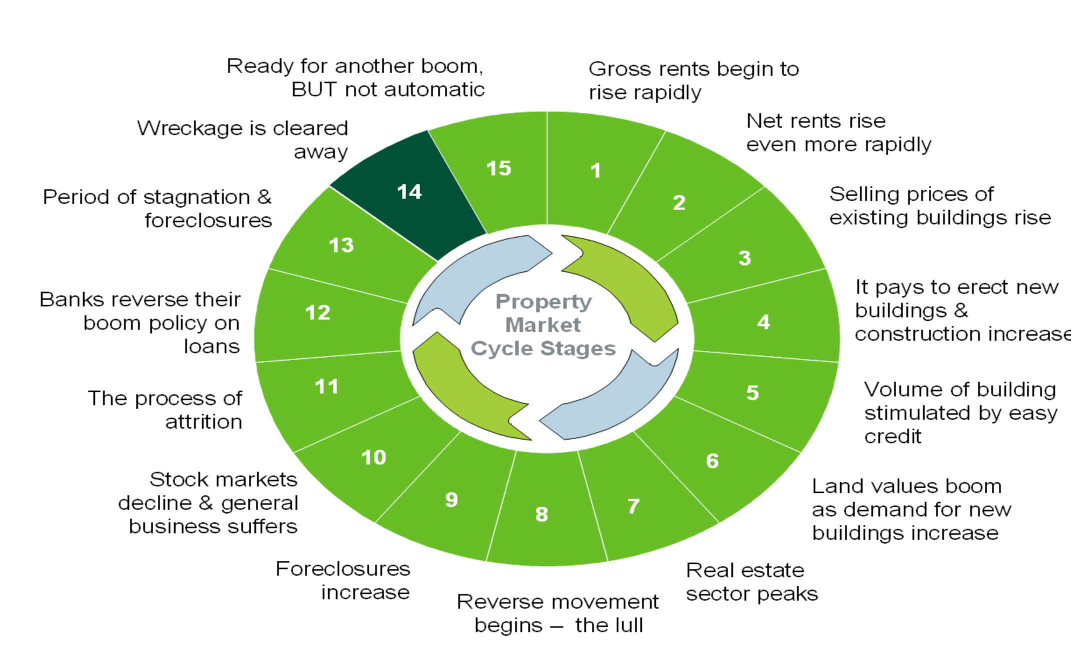
The third factor that influences the performance of the property market is funding. Property is by its nature a long-term investment. The ability to leverage is one of the key attractions of investment in the commercial real estate market as this significantly enhances returns when the market is improving. However, the opposite is also the case and leverage significantly exacerbates losses when the property market is contracting. Interest rates were increasing in the run up to 2007 and were expected to increase further and therefore impact further on activity and performance in the commercial property sector from that point forward, particularly considering the extent to which Irish investors were debt-funded. We believed that the Irish banks were stress-testing borrowers sufficiently to take account of these future interest rate hikes. Our focus from a funding perspective was firmly on interest rate movements. A scenario where the entire global banking system would implode and domestic debt funding would completely disappear (which exacerbated the pace and severity of collapse in the Irish commercial property market) clearly was not anticipated or envisaged.

4 SENTIMENT

The fourth influencer of property market performance (and the most difficult one to measure) is sentiment. 'Herd instinct' plays a part in the property market and the market is heavily influenced by sentiment. Commentary on property market performance (*positive or negative*) can influence sentiment to a large degree which can in turn significantly influence activity levels and ultimately pricing. As an organisation, CBRE were very mindful of our role in this respect. Any commentary or observations made about the market were made objectively and without influence. *'Talking the market up'* or *'talking the market down'* was not on our agenda nor would it have been in our interest to do anything but comment on the facts as we saw them. Our commentary has always been honest observation and interpretation of the market based on the information available to us and from our perspective as property specialists operating in the market. Commercially, it makes no sense for us to act otherwise as we act for buyers and sellers, landlords and tenants alike. In 2007, CBRE publicly welcomed the fact that development activity was slowing. We acknowledged that the Irish CRE market was in the downward phase of the cycle and our research reports from that time clearly demonstrated the extent to which transactional activity had slowed year-on-year in many sectors. We were very conscious that unfounded negative speculation had the potential to exacerbate the pace and severity of the correction that was already materialising and so took our role as market commentators very seriously.

From our perspective, the information available to us in the run up to 2007 suggested that a soft landing was the most likely scenario for the Irish CRE market. We believed that the Irish CRE market would most likely follow its 'normal' cyclical pattern. A property market typically follows the same pattern, as identified by Homer Hoyt in his classic text **"100 years of Land Values in Chicago".** CBRE regularly use the graphic below *(See Figure 3)* showing what Homer Hoyt identified as the stages of a typical property market cycle in reports and presentations to clients to emphasise cyclicality and therefore risk in the commercial real estate market and to explain the typical shape of a CRE cycle. The crash that materialised in Ireland in 2007 did not follow the 'normal' pattern as the unanticipated worldwide banking crash suddenly and completely removed bank debt from the market at the point where the reverse movement stage had commenced, which exacerbated the pace and severity of the downturn. The pace of decline and extent of the downturn had never been experienced in previous cycles of the Irish commercial property market (at least not in the four decades for which data is available).

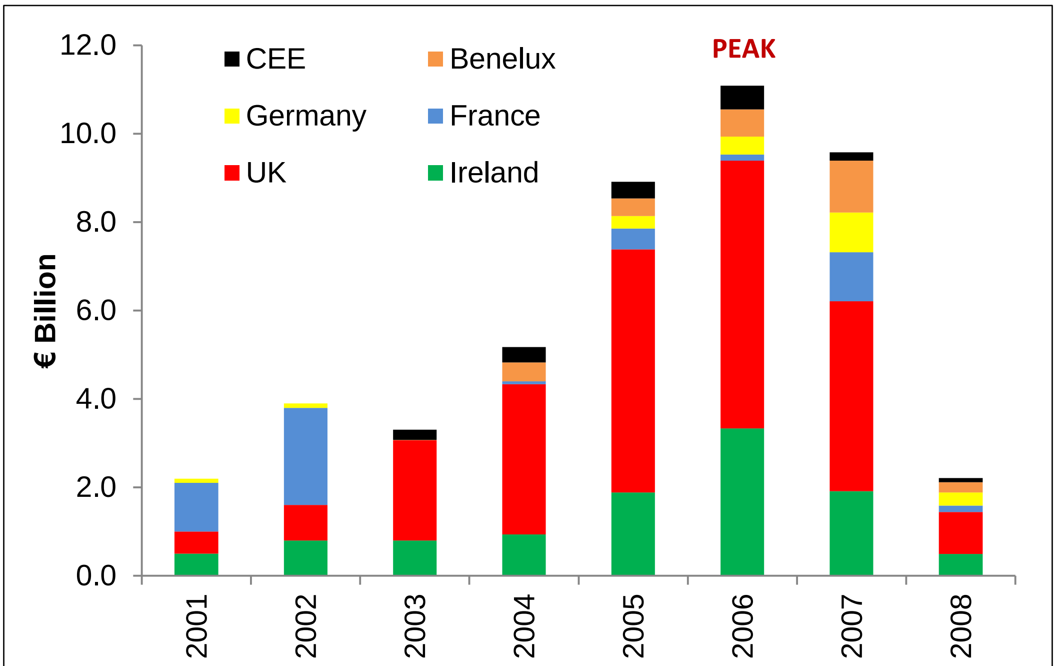
Figure 3 - Stages of a Typical Property Market Cycle (*Source: Homer Hoyt*)



INVESTMENT SPEND

CBRE maintain a European investment property database tracking all investment transactions with a value of more than €1 million. We track transactions by location, sector, price, yield, purchaser, vendor, nationality of buyer etc. The database enables us to compute overall investment spend figures for the EMEA region and track buyer activity on a regional and sectoral basis. According to our research, *(See Figure 4)* Irish investors invested a total of over €46.35 billion in income-producing assets (*with a value of more than €1 million*) in the period 2001-2008, with over 50% of this total investment occurring in the UK and approximately 23% occurring in Ireland. The volume of Irish investment in CRE increased year-on-year from 2003 to 2006 peaking at over €11 billion in 2006. Unusually, 100% of investment spend in Ireland in the period 2001-2008 comprised domestic investors. At the peak in 2006, 30% of Irish investment occurred in Ireland with almost 55% occurring in the UK in that year. There were 98 individual transactions *(with a value of more than €1 million)* totalling over €3.3 billion completed in the Irish market in 2006 compared to only 26 transactions totalling less than €500 million two years later demonstrating the extent to which market activity declined when debt funding ultimately disappeared. This data was reproduced in various CBRE research publications and available in the public domain.

Figure 4 - Irish Investment in Commercial Real Estate 2001 – 2008 (*Source: CBRE*)



According to our research, at the peak of the market in 2006, 36% of investment spend in Ireland was attributable to developers; 26% was attributable to syndicates, 20% was attributable to private investors, 10% to institutional buyers with the remainder attributable to investment funds, pension funds, occupiers and others combined. Outside of Ireland, 58% of Irish investment spend in 2006 was attributable to private investors and developers, 25% was to syndicates, 4% was to institutional buyers with the remainder comprising a combination of investment funds, pension funds, occupiers and others.

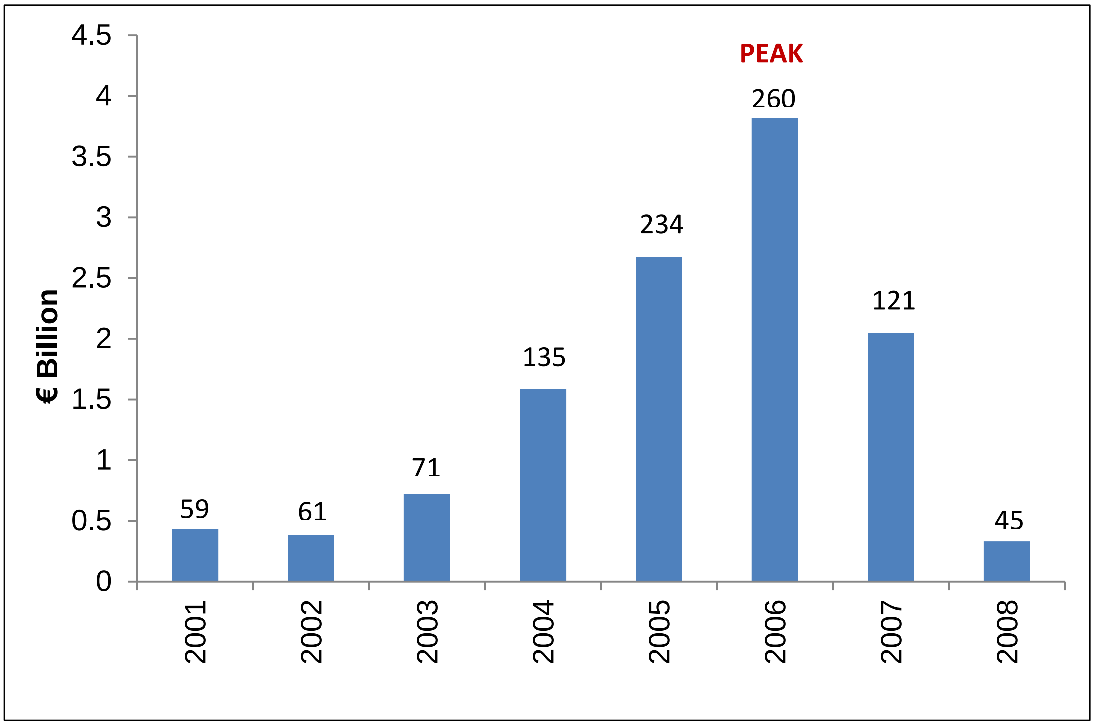
Irish investors had a preference for office and retail properties. Indeed, at the peak of the market in 2006, 42% of Irish investment activity in Ireland comprised office properties, 39% comprised retail properties, 13% comprised mixed-use properties, 3% comprised industrial properties with the remaining 3% comprising other property types. Outside the jurisdiction, 45% of investment activity by Irish investors in 2006 comprised retail properties, 43% comprised office properties with the remainder comprising other property types.

<u>DEVELOPMENT SPENDING</u>

CBRE Ireland also maintains a database tracking all Irish development (excluding agricultural) land transactions completed in the market. According to our research, *(See Figure 5)* a total of almost €12.5 billion was invested in 986 individual development land transactions in the period 2001-2008. In addition, in the period 2001 to 2008, there was a notable increase in the volume of hotel and pub sales in the Irish market, many of which were effectively land sales.

The volume of spend increased more than nine-fold between 2001 and the peak in 2006 when over €4 billion was invested. In addition to increases in land values in the period, there was a notable increase in transaction volumes recorded, from 59 individual development land transactions in in 2001 to 260 individual development land transactions in 2006. This data was reproduced in various CBRE research publications and available in the public domain.

Figure 5 - Irish Investment in Development Land 2001 – 2008 (*Source: CBRE*)



SOURCES & EXTENT OF FUNDING

As Ireland's largest commercial real estate services provider, CBRE were involved in some capacity in many of the commercial property transactions that occurred in the Irish market in the period in question. We were also involved in some capacity in many of the transactions involving Irish buyers overseas and carried out valuations for lending purposes for many of the purchasers and all of the Irish lending institutions. However, we were not privy to detailed information on how specific transactions were being funded. Anecdotally, we were aware that a large proportion of transactions by Irish investors were debt-funded compared to other countries and were aware of commentary on increases in property lending in the Irish banks and individual financial institutions exposure to the commercial property sector. However, we were not privy to the specifics of how particular transactions were being funded or how banks were financing themselves and were not aware of the extent of cross-collateralisation that was occurring.

We presumed that a central register of commercial lending activity tracking individual borrower's exposures across all lending institutions existed. We weren't aware of particular banks' exposure to specific individual borrowers. We are not banking experts but had regard to assertions from The Central Bank, the Financial Regulator and others that the Irish banks were sufficiently well capitalised and robust. We were also cognisant of ratings given to Ireland by various rating agencies including S&P, Fitch & Moody's. Based on this, we believed that the Irish banks were well funded and appropriately regulated and that borrowers were being sufficiently stress-tested. We had no reason to suspect otherwise and had no specialist training, insight or knowledge that would have enabled us to question this hypothesis.

LESSONS FOR THE FUTURE

To my knowledge, in the period up to 2008, CBRE were not contacted by the Irish Government, the Central Bank, the Department of Finance or the Financial Regulator at any stage for our view on property market trends from our perspective or to ask for the data we were collating on transactional activity or property market performance. In general, Government intervention in the property market was largely done in the absence of any engagement whatsoever with the property industry. Going forward, we recommend engagement with organisations that have access to reliable information on trends and transactional activity in the commercial real estate market and the ability to cross-reference these with trends and transactions in other geographies, which we believe would give a valuable perspective to decision-makers and those in authority.

In terms of lessons learned, it is encouraging that the Irish Government in their recent **"Construction 2020"** report acknowledged the need to improve data collection and analysis to ensure that the real estate sector in the future is evidence-based and underpinned by the best available data. Had robust, reliable, timely and accurate data been collated historically and reviewed in the context of a national planning framework, the scale of the downturn in the most recent cycle may have been somewhat less severe.

I have made every effort to address the specific items I was asked to address within my submission. I trust that this will give the Inquiry a better understanding of the nature and functioning of the commercial real estate (CRE) market in the period prior to 2008.

Marie Hunt, Executive Director, Head of Research, CBRE Ireland