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Bank of Ireland Global Markets

The **Irish Property** Review

A quarterly analysis of trends in the Irish property market

Rents and lending rise but prices still falling

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- Apartments lead further price declines
- Affordability set to improve again in 2012

Mortgage lending for house purchase showed a second successive quarterly increase in the three months to September and the first quarter 2011 figure may prove to be a cycle low. Lending is extremely weak by historical standards, however, and is now dominated by first-time buyers as buy-to-let demand has collapsed with only €15m lent in that sector in Q3 2011. Mortgage lending for top-ups is also extremely weak, as is remortgaging, and despite the uptick in lending for house purchase we expect total mortgage lending this year to be €2.4bn, or half the figure in 2010. New lending is also not keeping pace with repayments with the result the total amount of outstanding mortgage debt is still falling, by 2.5% in the year to September.

One positive factor for lending is affordability and we noted in our previous *Irish Property Review* that it has improved substantially since 2008 and on our model will be the best this year in over a decade. We had expected no material change in 2012 but affordability now looks set to improve further given the prospect of stability in average earnings, the change in the interest rate outlook and the likelihood that the size of an average new mortgage will fall again.

The demand for house purchase and mortgages is also influenced by price expectations, and the recent price data is not indicative of any near-term change in trend. Indeed the pace of decline has accelerated, with a 2.2% decline nationally in October taking the fall over the past three months to 5.2%. On that basis, prices, as measured by the CSO index, are likely to fall by 16% in 2011 as a whole, following a 10.5% decline last year.

Against that backdrop many would-be purchasers are opting to rent and demand there has resulted in a modest rise in rents over recent months according to the CSO data, although still some 23% below the peak. House completions, like lending, may also have bottomed with the recent quarterly figures implying an annual total of under 11,000 this year which would be the lowest since the available records began in 1970 and represents a 0.5% addition to the housing stock, against a 5% annual increase at the peak of the boom. Single houses now account for over 60% of new houses built, presumably to demand, so the amount of speculative build is around 4,000 a year.

Capital values are also still falling in the commercial property market, with a 4.6% decline in the third quarter, according to the IPD index, bringing the fall from the peak to 65%. Total returns also fell in Q3, by 2.3%, and are likely to emerge at -7% for the year, against a 2.4% fall in 2010.

Residential Prices

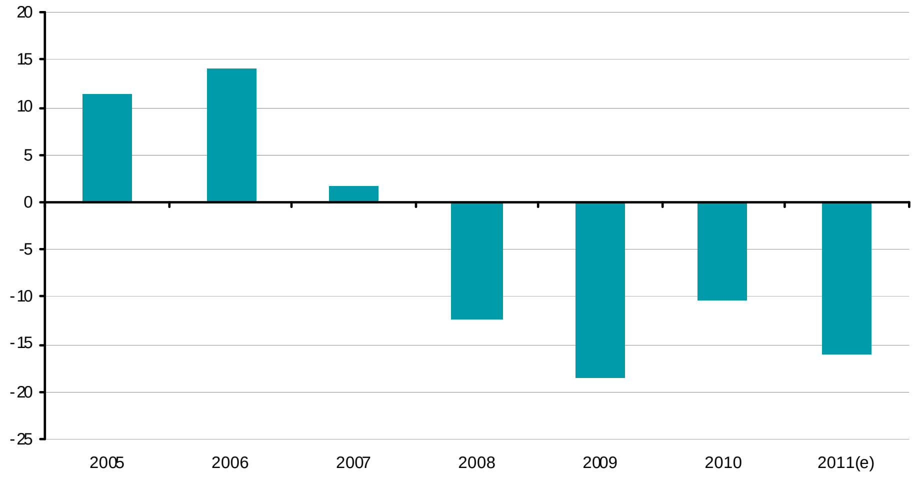
Apartments lead prices lower

The main source of information on the trend in Irish house prices is provided by the CSO's Residential Property Price Index (RPPI), published monthly. It is timely and comprehensive with sub-indices for houses and apartments and also differentiates between Dublin and the rest of the country. The data is based on mortgage drawdowns and this can lead to volatility in times of weak mortgage lending, as the sample size will be low. The number of mortgages for house purchase averaged less than 1,000 a month across the whole country in the third quarter, for example, against over 6,000 a month at the peak of the boom.

Sharp declines over past few months…

The monthly index actually published by the CSO is a three-month moving average, in an attempt to dampen this volatility, but large monthly swings are still evident. Dublin houses prices rose marginally in May and July for example, raising the prospect that prices may be stabilising, but August saw a 3.4% plunge, followed by a 1.7% decline in September, and a 3.2% fall in October.

Residential Property Price (% change)



Source: CSO and ERU

Residential prices nationally have also fallen at a faster pace in recent months with a 2.2% decline in October taking the three month change to -5.2% and leaving prices 15.1% down on an annual basis. We estimate that the average house in Ireland now costs €193,000 and according to the CSO the fall from the peak is now 43.7%, with the decline in residential property overall (i.e. houses and apartments) at 45.4%

…and apartments have fallen more than houses…

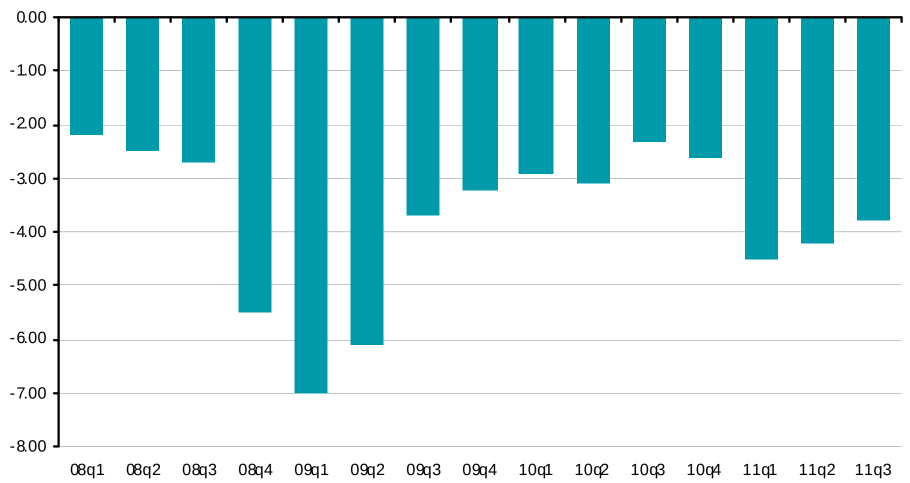
The decline in the price of apartments nationally has therefore been steeper than that of houses (a 57% fall from the peak) and that pattern is even more pronounced in Dublin, where apartment prices have fallen by over 60%.

Irish House Prices (end-year)

	National (€000)	Dublin (€000)
2005	286	386
2006	327	458
2007	334	451
2008	296	392
2009	243	296
2010	219	268
2011q3	194	235

ERU estimates

Residential Property (3 months, % change, National)

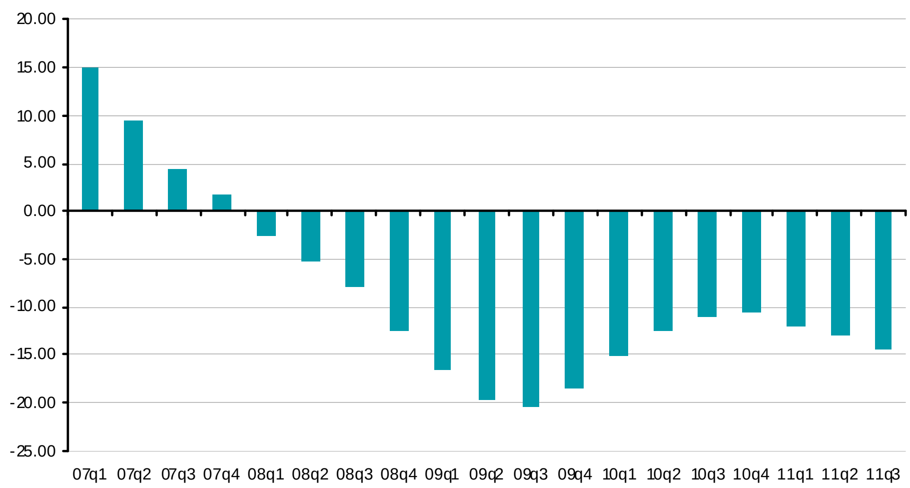


Source: CSO

...so no sign of stabilisation yet, although rents have ticked up.

The latest data therefore offers no sign of an imminent stabilisation in property prices, despite a marginal pick up in mortgage lending for house purchase and a further improvement in affordability. Supply clearly still exceeds demand, at least for house purchase, and would-be buyers may well prefer to rent given the uncertainty surrounding the economic outlook, particularly in relation to the labour market. The pace of employment loss has in fact slowed appreciably (employment fell by just 3,000 in the second quarter) but a period of rising employment will probably be required to boost confidence that an economic recovery is indeed underway. The demand for rented accommodation is beginning to push up rents, after a 25% fall from the peak, and according to the CSO, average rents in October were over 2% higher than a year earlier after a marginal rise in the third quarter.

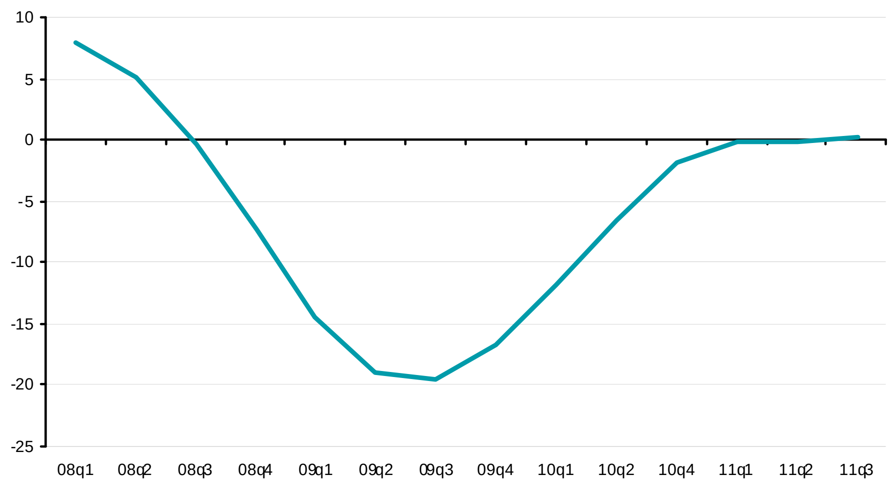
Residential Property Prices (annual % change, National)



Source: CSO

As we noted in our last *Irish Property Review* the OECD's housing model predicts that Irish house prices will bottom this year or next and if that occurs it is likely to be later next year than any time soon, given the available information.

Private Sector Rent (% change)



CSO

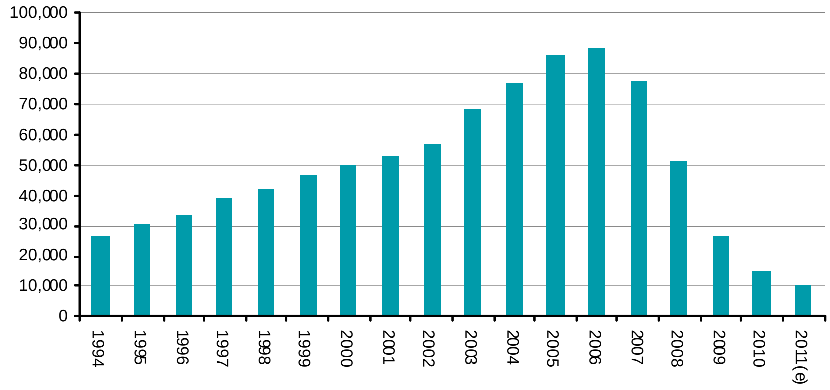
House Completions

Under 11,000 expected this year

Quarterly data implies a possible cycle low…

The Department of the Environment (DoE) has now published data on completions for the first nine months of the year and a number of conclusions can be drawn. The first is that completions may well be at or close to a cycle floor; the third quarter saw 2,590 completions, against 2,561 in Q2 and 2,766 in the first quarter. Another implication is that the total for 2011 as a whole is unlikely to exceed 11,000, which would be the lowest annual figure since the available records began in 1970. That total also implies a 0.5% addition to the housing stock which is below the depreciation figure that was assumed by the DoE. To put this year's likely outturn in further context it compares with a cyclical peak in excess of 88,000, which had boosted the housing stock by over 5%.

House Completions



DoE

The data year to date also highlights the collapse in the supply of new apartments, with just over 1,000 built, accounting for less than 14% of the total. Individual houses, presumably largely built to demand, accounted for 60% of the total completions against under 25% at the peak of the boom, and this figure may also account for a discrepancy we have noted in previous copies of the *Irish Property Review* – the huge gap between New House Registrations and completions. The former is an insurance bond often taken out by builders of developments and as such was often used by analysts as a proxy for housing starts. These registrations have fallen to extraordinary low levels, and well below recorded completions, even allowing for a reasonable time lag; registrations amounted to just 500 in the second half of 2010, for example, and just 168 in the second quarter of 2011. They have picked up slightly since, nevertheless, to 183 in the third quarter, again implying that house building may have bottomed, albeit on this unreliable measure.

…but no significant pick up expected.

It is hard to see any significant acceleration in completions against the current market backdrop even if 2011 proves to be the floor. Supply tends to be driven by current prices (which are still falling) and price expectations (unlikely to be positive) and there is a widespread view that the existing supply exceeds demand. Consequently, we expect completions in 2012 to be broadly similar to this year, a view shared by the consensus, although if that does indeed prove to be the case it would mean that house building would cease to make a negative contribution to Irish GDP for the first time since 2008.

Irish Housing Supply

	Housing Completions	New Home Registrations
1996	33,700	23,769
1997	38,842	27,080
1998	42,349	29,067
1999	46,512	33,852
2000	49,812	34,613
2001	52,602	28,845
2002	57,695	51,157
2003	68,819	56,859
2004	76,954	60,782
2005	86,000	62,284
2006	88,400	66,650
2007	78,000	38,352
2008	51,700	12,676
2009	26,400	3,740
2010	14,602	1,680
2011(e)	10,500	800

DoE

Mortgage Lending

A second quarterly rise

The third quarter saw a further increase in the number of mortgages drawn down for house purchase, with a total of 2,939 compared with 2,643 in Q2 and 2,325 in the first quarter. The latter figure may prove to have been a cycle low although the market does tend to pick up in the spring and summer for seasonal reasons, so it may be premature to be definitive on the issue.

Pick up, but from a very low level…

The third quarter figure is also still extremely low by historical standards, as it compares to over 5,100 a year earlier and a cycle high of around 30,000 a quarter. Average new mortgage lending has also fallen precipitously over the period, and the total amount lent to house purchase in Q3 was just €548m, against over €1bn in Q3 2010, although again there was a pick up from the Q2 figure of €509m and the first quarter outturn of €466m.

Mortgage Lending for House Purchase

	No. of Mortgages	Average Mortgage (€000)	Total Market (€bn)
2005	110,500	200	24.4
2006	110,800	251	27.8
2007	84,200	266	22.5
2008	53,600	270	14.5
2009	25,100	232	5.8
2010	18,300	207	3.8
2011(e)	11,000	190	2.1

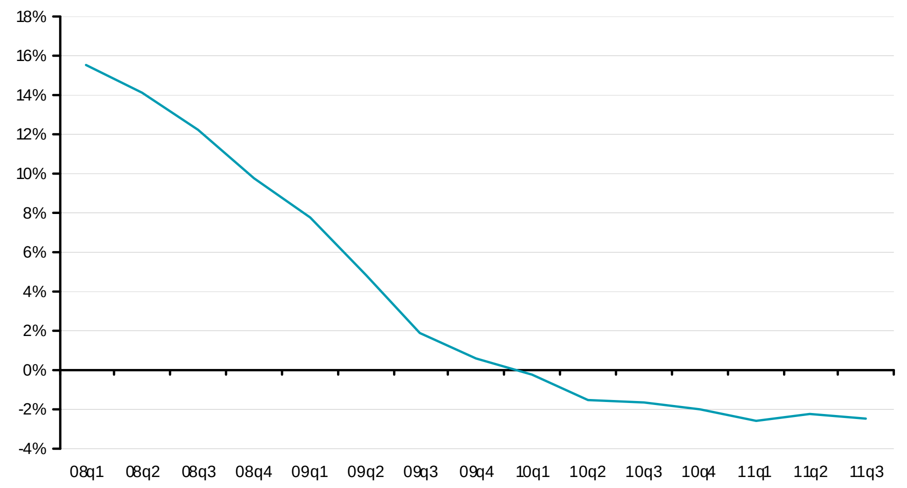
IBF/PWC and ERU estimates

The latest figures also illustrate the collapse of buy-to-let demand in Ireland, with only 98 mortgages in the third quarter, amounting to just €15m. First-time buyers now dominate the market, accounting for 58% of mortgages for house purchase, and again showed two consecutive quarterly increases in terms of both volume and value.

…and top-up and remortgage demand still falling.

Borrowing to top-up existing mortgages or to switch mortgage providers, in contrast, is still falling and is now also down to extremely low levels. Top-up mortgage borrowing amounted to €39m in the third quarter, from €100m a year earlier, and now accounts for just 6% of total mortgage lending, from over a third at the peak of the cycle. Similarly, re-mortgaging has tumbled to just €36m in Q3 and just 6% of total lending. Despite this, the number of total mortgages (i.e. for house purchase and other purposes) also rose in Q3, to 3,607 from 3,551 in Q2 although the total lent was broadly unchanged at €623m.

Outstanding Mortgage Balances (annual % change)



Central Bank of Ireland

Significant rise in mortgage demand unlikely near term.

New lending on that scale is not sufficient to offset the flow of debt repayments and as a consequence the amount of mortgage debt outstanding is still declining, falling by 2.5% in the twelve months to September according to the Central Bank. Household income is the key driver of mortgage demand and that remains under pressure in Ireland so a significant pick up in lending is unlikely. That said, the fall in employment slowed to just 3,000 in the second quarter of 2011 and if the labour market has also reached a cyclical turning point it would provide some support to mortgage demand, alongside the continuing improvement in affordability.

Affordability

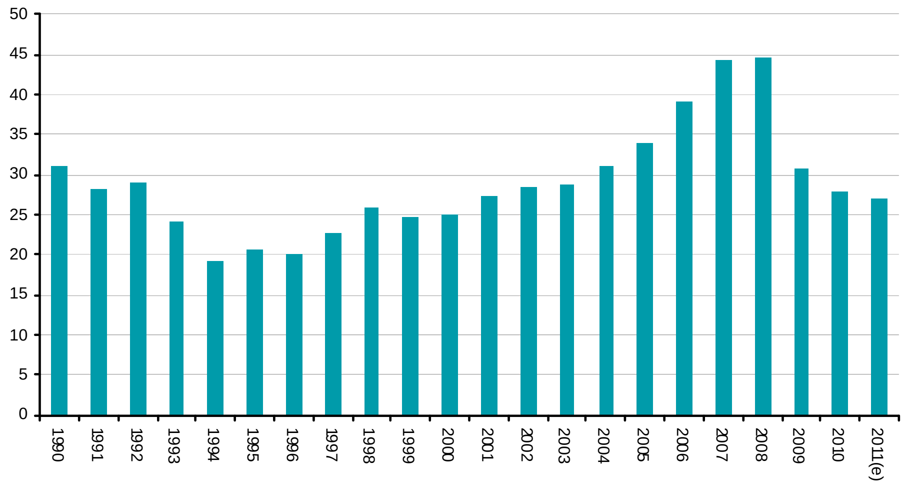
Further improvement likely next year

The Irish property market peaked in 2006 in terms of mortgage lending or in 2007 in terms of prices and this timing is broadly consistent with the substantial deterioration in affordability as recorded in our model. Affordability did not reach its worst level until a year later, however, coinciding with the peak of the interest rate cycle; the average new mortgage rate in 2008 was 5.1% and the average new mortgage amounted to €265,000, giving a monthly payment of €1,567. The latter exceeded 44% of average income, a record high on our data, which goes back to the mid 1970s.

Affordability has improved since 2008…

Interest rates fell precipitously in 2009 and were broadly unchanged in 2010 which would have boosted affordability, even allowing for the fall in average incomes over the period. The fall in house prices was another factor as it resulted in a decline in the average new mortgage which by 2010 was down to €207,000, requiring a monthly payment of €966 to service, equivalent to 28% of average income, and as such below the average figure over the previous 35 years (29.4%).

Affordability (%)



Economic Research Unit (ERU)

…to a 10-year high with another improvement likely in 2012.

The average interest rate on a new mortgage has risen through 2011, according to Central Bank data, and looks set to average around 3.25% over the year as a whole, which would be negative for affordability. Average earnings fell by an annual 0.8% in the first half of 2011 and we had anticipated a similar decline for the year but in the event weekly earnings unexpectedly rose in the third quarter, by 1.4%, and we have revised our forecast , with a smaller fall now expected, but still another negative for affordability. Against this, the average new mortgage for house purchase is still falling, again largely reflecting the fall in house prices, and looks set to average around €190,000, so reducing the monthly payment to €926. This amounts to 27% of income on our model, indicating that affordability has improved further this year. Indeed, it is now at the best level since 2000.

We expect Irish incomes to stabilise next year (this may now be conservative given the latest earnings data) and this allied to the change in the interest rate outlook and the prospect of a further fall in the average new mortgage size (to €180,000) yields a forecast monthly payment of less than €900, equivalent to 25.9% of income. That is significantly below the long run average but alone does not guarantee a revival in the housing market although it is clear that affordability is certainly not a factor inhibiting any recovery.

Interest Rates

More ECB cuts to come

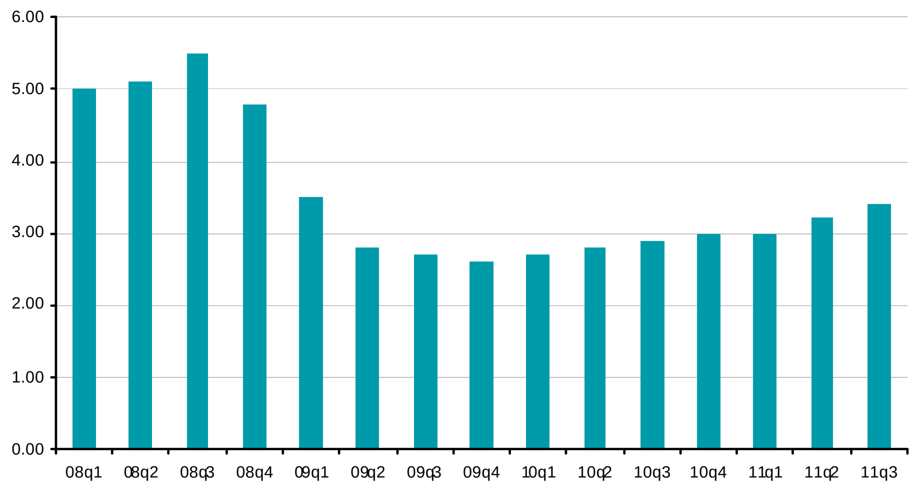
Outlook for tracker mortgages has changed…

For the majority of existing mortgage holders the interest rate outlook has been transformed by the recent change of stance by the ECB. For them, borrowing costs are determined by the Bank's repo rate and the quarter point cut in November is unlikely to be the last. That reduction, taking the repo rate to 1.25% and hence benefitting all those on tracker rates, was a belated recognition by the ECB that the economic outlook for the euro area has deteriorated significantly, with the prospect of a contraction in GDP in the fourth quarter and the possibility of recession. The global economy has also slowed but the sovereign debt crisis in Europe has hit business and consumer confidence particularly hard in the euro area. Against that backdrop the ECB now sees the risks to inflation as balanced but the risks to growth on the downside, hence the change in monetary policy. We expect the repo rate to fall to at least 1% over the next few months, taking it back to the level existing in the first quarter of 2011. Further cuts are certainly possible (the equivalent rate in the UK is 0.5% and in the US only 0.25%) depending on how the economic climate evolves.

…but high cost of funding remains big issue for Irish banks.

For new borrowers the choice is between a fixed rate or a standard variable rate, and the average rate for new mortgage loans has moved higher this year according to the Central Bank, from 3.0% in January to 3.50% in September. The repo rate rose by the same amount over that period but the wide divergence in standard variable rates across the market illustrates that these rates are driven by the cost of funding for the relevant bank and the appetite of the various lenders to add new loans to their balance sheets. The costs of funding for Irish banks in general has risen significantly over the past few years, of course, and as a consequence there is no automatic link between a change in the repo and a change in variable rates. Similarly, longer term euro fixed rates in the market are unusually low but Irish banks have to pay a premium if they can access such funds, again giving rise to a wide variation in fixed rates on offer in the retail market. Consequently, the path of Irish rates for new borrowers will depend on both the evolution of ECB rates and the perceived credit risk involved in lending to Irish banks. The former looks set to fall but the stress in the euro money markets will not help the latter, although at a minimum we expect the recent trend in rising average new mortgage rates to come to a halt.

Mortgage Rate (%)



Central Bank of Ireland

Commercial Property

Fourth consecutive year of negative returns

The Irish commercial property market looks set to experience a fourth consecutive year of negative returns in 2011, marking the current cycle as easily the worst on record. Moreover, returns for this year alone are likely to be more negative than 2010, so dashing hopes that the modest decline seen last year was the harbinger of some stabilisation.

Weak end-user demand, notably in retail…

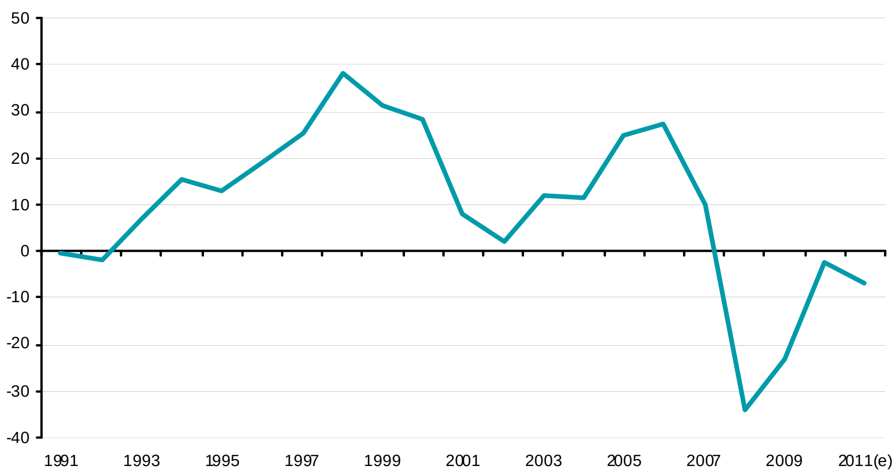
End-year demand remains weak, notably in the retail sector, with consumer spending still falling. Foreign Direct Investment has picked up, however, emphasising that Ireland is still an attractive base for companies selling into the global market place. On the investment side the scale of the price falls seen across all sectors is prompting some interest but as yet not on a scale to make an appreciable difference. Most property commentators also highlight the potential impact of the upcoming legislation on rents, with the uncertainty on the timing adding to the negative sentiment pervading the market.

The third quarter IPD figures were certainly sobering. Capital values fell by 4.6% following a 5.3% decline in Q2, so bringing the fall from the peak to 65%. The retail sector is now underperforming with a cumulative decline of over 10% in capital values over the past six months. This left the total return for the Retail sector at -6.2% over the period, against a 4.5% fall for the Office sector. The net result was a fall of 5.2% in total property returns in the six months to September following a flat first quarter. On that basis we now project a 7% decline in returns for 2011 as a whole.

…and outlook remains cloudy.

Growth in the Irish economy has surprised to the upside in the first half of 2011, prompting an upward revision to the consensus for the year as a whole, but the market turmoil surrounding the euro debt crisis has resulted in a downward revision to prospects for 2012. Uncertainty dominates, however, and it is therefore difficult to envisage a recovery in commercial property in 2012 from the current vantage point.

Commercial Property Returns (%)



SCS/IPD

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