



The Irish Property Review

A quarterly analysis of trends in the Irish property market

Residential Market yet to bottom

- First-time buyers now dominate
- Commercial market may be at or near floor

The international property cycle has turned following the steep declines seen in recent years, with many countries seeing rising prices in both commercial and residential property, notably the UK. In Ireland, in contrast, there are few if any indicators that the residential market has hit bottom, although the signs are more positive on the commercial side, and we may be at or near the cycle low in that market.

Irish house prices continued to fall in the first quarter on the main published indices, by between 1.3% - 1.6% a month, although this does represent some deceleration in the pace of decline, as prices had fallen by 2% - 2.5% a month in the final quarter of 2009. The March data left prices 34% down from the peak on both the permanent tsb / ESRI index and Daft.ie and are now below the average of the last decade and back to levels last seen in late 2002.

Affordability has improved dramatically in the past eighteen months, with the average new 25-year mortgage costing €1,000 a month to service, against €1,670 two years earlier, and our affordability model shows payments are under 29% of income in 2010, and as such below the average over the last thirty five years. The average rental yield is around 4.3% on our model, which is not far below the 4.5% average recorded since Ireland joined the euro, and rents rose in May for the first time in two years according to the CSO.

Yet these factors are not impacting demand, at least year to date. First-time buyers now account for over half of new mortgages for house purchase but gross mortgage lending for house purchase fell below €1bn in the first quarter. Again, the pace of decline slowed relative to 2009, but the mortgage data shows that new lending is now being offset by redemptions and write-downs, with the outstanding stock of mortgage debt now contracting.

The outlook for the Irish economy has improved and growth may have resumed in the first quarter but the unemployment rate is still high (if stabilising) and employment falling, so would-be buyers may be waiting for a clearer turn in the labour market before entering the market in larger numbers.

The price and rent trends over the last three years also imply excess housing supply but the absence of timely data on transactions makes any estimates tentative. What is clear is that completions have fallen substantially, with 26,400 built in 2009 and perhaps 17,000 likely this year, the latter adding less than 1% to the housing stock, and as such around the depreciation rate. The Registration data does imply that this year may be the low of the cycle, however.

On the commercial market the main property agencies differ as to conditions in the office market in the first quarter, although most point to some pick up in activity. The IPD index also recorded its first gain in two years in the first quarter, and the fall in capital values slowed sharply. However, on that basis, we may be at or near the floor on that market and we now expect flat returns this year, from a 23% fall in 2009.

Dr. Dan McLaughlin.

House Prices Page 2

Now back to 2002 levels

House Completions Page 5

17,000 likely this year, broadly in line with obsolescence rate

Mortgage Lending Page 7

Stock of mortgage debt falling

Affordability Page 8

Historically large improvement in affordability of late

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Tracker rate unlikely to rise until next year

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Flat returns seen this year

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House Prices

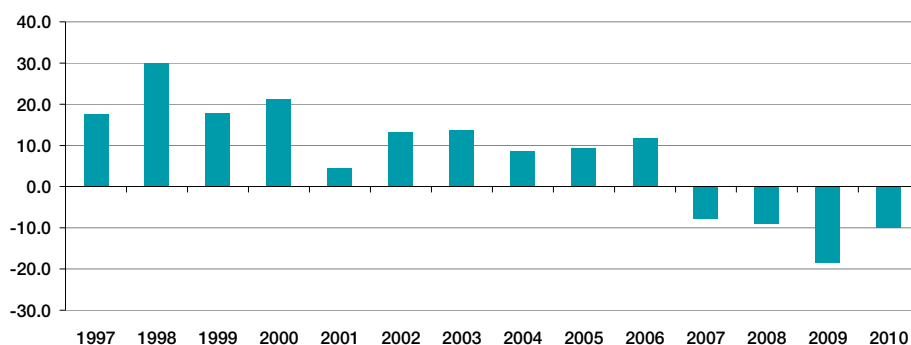
All indices still showing price declines...

As yet there is no published data on the Irish housing market signalling a recovery in prices, and the major indices are showing a broadly similar picture in terms of price declines.

The most comprehensive price information is supplied by the Department of the Environment (DoE) which collates data from the lending agencies on a quarterly basis. Unfortunately, the figures released are far from timely and the data is neither seasonally adjusted nor adjusted for a change in the mix up of houses sold. The latest data published refers to the fourth quarter of 2009 and shows an annual price fall for existing houses of 24.3% following revisions to the previously published data. The annual price fall in Dublin was higher, at 29.1%, with particularly large falls recorded in the capital and across the country in the third quarter.

The DoE data is therefore of limited use in judging the current state of the market, and for that attention is focused on the permanent tsb / ESRI index, which was published monthly and statistically adjusted to take account of the housing mix, as captured by that particular mortgage lender. The index showed a pronounced acceleration in the pace of house price declines in the latter part of 2009, with the national index falling by 3.1% in the month of November and 3.6% in December, taking the annual decline in 2009 to 18.5% compared with 9.1% in 2008 and 7.3% the previous year.

House Price Inflation (%) (end-year)

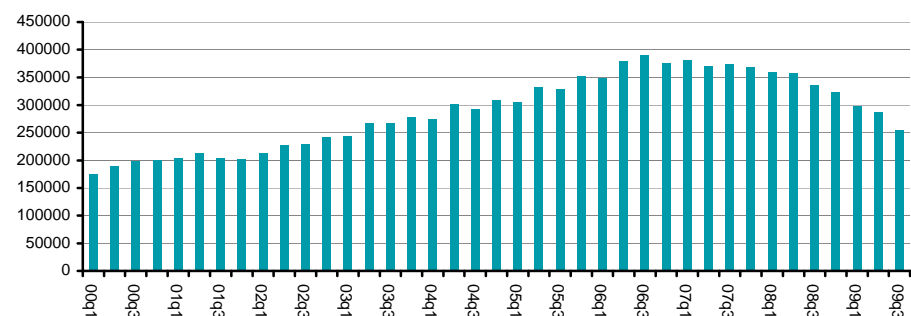


permanent tsb / ESRI

...although pace of decline slowed in Q1...

Unfortunately, the permanent tsb / ESRI index is now only published quarterly, so compounding the dearth of timely price information. The Q1 figure did record a slowdown in the pace of price falls, but prices nationally still declined by 4.8% in the three months to March, leaving the annual rate of decline at 18.9%. Prices fell by over 10% in the capital in Q1, leaving the annual decline in Dublin at 24%.

National House Prices (Euro)

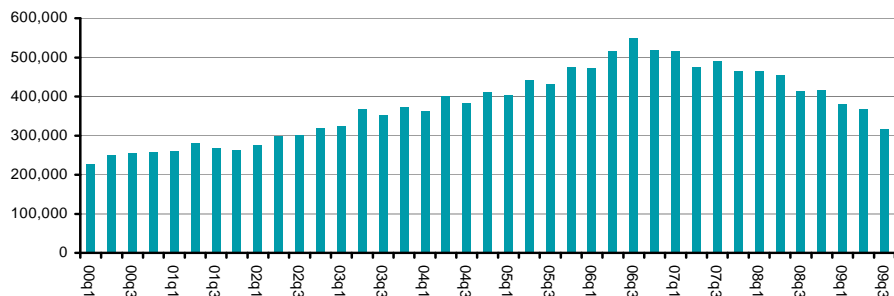


DoE

...prices now down 34% from peak.

The permanent tsb / ESRI index peaked in February 2007 and the cumulative fall to date from that cycle high is 34% which is identical to that recorded by Daft.ie, an alternative source of housing data, based on asking prices. That index too peaked in February 2007, and is also similar to the permanent tsb / ESRI index in showing some signs of a deceleration in the pace of price falls in Q1, with a 3.1% decline recorded in the three months to March. Again, the annual decline is almost identical, at -18%.

Dublin House Prices (Euro)



DoE

Rents rose in May...

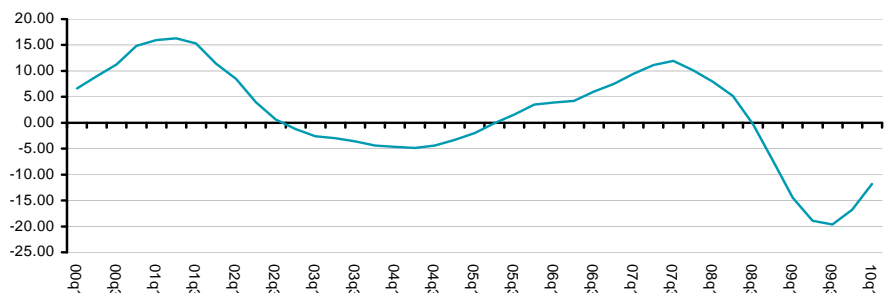
The Daft.ie website also provides data on private sector rents, as do the CSO, as rents are included in the monthly CPI data, albeit only updated every three months. The latest CSO figure, recorded in May, shows some signs of stability in the rental market, with a 1.1% rise on the month, thereby substantially reducing the annual pace of decline to -4.7% from -9.8%.

The price data is clearly indicative of a market with substantial excess supply, with no evident sign of a bottom, except perhaps in the rental sector. The consensus view, as revealed in the latest Reuters poll, is for a further decline in prices for the year as a whole, followed by a smaller decline next year before a modest recovery in 2012.

...with yields near 10-year average...

Affordability has certainly improved dramatically which may boost demand as the rest of the year unfolds, but the mortgage data would not indicate that there has been a material change as yet, although first time buyers now dominate the market. Buy-to-let investors now account for less than 10% of loans for house purchase, from a cycle high of 25%, and some argue that yields will have to rise substantially to entice investors back into the market, although this may not be the case. We estimate that yields are currently around 4.3% which compares with a risk free rate of return of 5% in Irish government bonds and an average cost of a new mortgage of 2.75%. Moreover, the average rental yield on our data base since 1999 (when Ireland adopted the euro) is 4.5%, so yields are very close to the average for the past decade.

Private Sector Rent (% change)



Central Statistics Office (CSO)

Second-hand Irish House Prices (Nationally)

	€ 0	% change	year-over-year (%)
1999	163.3	21.4	
2000	190.6	16.7	
2001	206.1	8.2	
2002	227.8	10.5	
2003	264.9	16.3	
2004	294.7	11.2	
2005	330.4	12.1	
2006	371.5	12.4	
2007	377.9	1.7	
2008	348.8	-7.7	
2009	q1 297	-8.1	-17.3
	q2 287	-3.5	-19.5
	q3 255	-11.2	-24.1
	q4 245	-4	-24.3

DoE estimates

...but sentiment and confidence also important.

The average house price on the permanent tsb /ESRI index fell to under €205,000 in the first quarter of 2010, which is below the average since 1999 (€229,000) and back to levels last seen in late 2002, which might also suggest a floor is at hand. Yet expectations of the likely price trend is an important factor in the market, in turn strongly influenced by sentiment and general economic confidence, and although the latter is improving it has not yet convinced sufficient numbers to buy.

The evidence would also suggest that the prospect of capital appreciation rather than running yield has been the main driver of investor demand, and therefore it is only when sentiment has sufficiently convinced investors that prices have bottomed that the market will turn. Consequently, we expect prices to fall some 10% this year although the national picture is likely to be very mixed between Dublin suburbia and the rest of the country, and between apartments and houses in established areas.

House Completions

Completions fell to 26,400 last year...

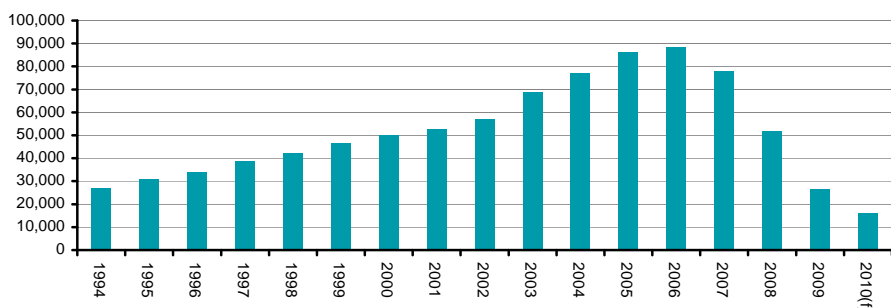
Most studies of the Irish housing market have shown that the supply of new property is very responsive to price and that is certainly the case in recent years as completions have fallen at a phenomenal pace. Supply peaked in 2006 when over 88,000 units were built, adding over 5% to the existing housing stock. By 2009 completions had plunged to 26,400, the lowest figure since 1993. Indeed, the 1.4% addition to the housing stock last year is the smallest recorded on our data base which goes back to 1970.

Last year's completions total also overstates the effective supply available for sale in the market, as 46% of the total were individual houses, presumably largely built to order. The balance, comprising 9,200 in housing schemes and 5,100 apartments, therefore better represents the effective supply in search of a buyer. Only a quarter of completions were individual houses in 2007, so that share has risen very rapidly, with the trend continuing into 2010; individual houses accounted for half the 3,800 total completions in the first quarter, leaving less than 2,000 completions as housing schemes or apartments.

...but this overstates the effective supply.

This large share of individual houses also helps to explain why some of the proxies used for housing starts under-predict the completions total. For example, Guarantee Bond Registrations, a form of insurance taken out by builders, amounted to less than 4,000 in 2009 but neither local authority housing nor individual house completions would use this insurance scheme so unadjusted models using this data would seriously underestimate total completions, even allowing for appropriate time-lags.

House Completions

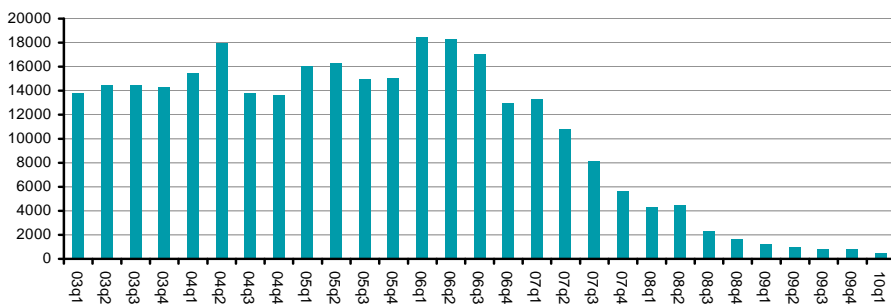


DoE

Large falls in the major cities...

Ireland's cities saw some of the largest falls in completions last year. Limerick for example, recorded a 75% decline in completions, with Galway seeing a 63% fall. Supply also fell substantially in Dublin city, by 55% as did the county: South Dublin saw a 64% fall, in Dun Laoghaire/Rathdown the decline was 54% with Fingal seeing a 40% fall.

New House Guarantee Registrations



DoE

We expect 17,000 completions this year.

The available data for 2010 points to another sharp decline in completions; the first quarter total of under 3,800 is some 50% below the corresponding quarter of 2009. Moreover, only 429 units were registered with the bond scheme in Q1, compared to some 800 in the previous quarter and over 1,100 a year earlier. The monthly Bond Registrations data imply that we may be approaching bottom, however, and we expect that the 2010 completions total may prove the low of the cycle. We expect that figure to emerge around 17,000, which would represent less than a 1% addition to the housing stock and broadly equivalent to the obsolescence rate. Given the trend year to date, it is likely that only 8,000 units will represent housing schemes or apartments.

Irish Housing Supply

	Housing Completions	New Home Registrations
1996	33700	23769
1997	38842	27080
1998	42349	29067
1999	46512	33852
2000	49812	34613
2001	52602	28845
2002	57695	51157
2003	68819	56859
2004	76954	60782
2005	86000	62284
2006	88400	66650
2007	78000	38352
2008	51700	12676
2009	26400	3743
2010	17000	2000

DoE

Mortgage Lending

First-time buyers now account for 55% of the market...

The flow of mortgage lending has changed substantially in terms of composition of late. First time buyers now dominate the demand for loans for house purchase, accounting for 55% of the total in the first quarter of 2010, against a third at the peak of the boom four years earlier. Existing borrowers trading up now account for a smaller share (36% against 41% in 2006) but first-time buyers have largely replaced buy-to-let investors in the market, with the latter now accounting for only 9% of the total, against a cycle high of 25%. House prices have fallen precipitously and rental yields have risen in the past few years (to 4.3% in our estimate) but many buy-to-let investors were seeking capital gains and the implication of the recent data is that investors are not confident that prices have yet reached a floor.

...but new lending remains weak...

Lending for house purchase now exceeds 60% of total lending, from 55% at the peak of the cycle, as both top-up and re-mortgage activity has fallen in significance: the former now accounts for 28% of the total with re-mortgaging at 12%. The flow of mortgage lending has also slowed substantially of course, with total lending amounting to only €1.2bn in the first quarter of 2010, compared with quarterly figures in excess of €10bn in 2006. Falling house prices is a factor but the main driver is a decline in volume, with less than 7,000 loans drawn down in Q1, from over 50,000 a quarter at the cycle high. The annual pace of decline in lending is slowing, however, due to base effects, with Q1's 39% fall compared with 50% in the previous quarter and 68% in the first quarter of 2009. Lending in the second and third quarters is likely to be higher for seasonal reasons and for the year as a whole we forecast a total of €6.5bn, which compares with €8.1bn in 2009 and a 2006 high of some €40bn.

Mortgage Lending for House Purchase

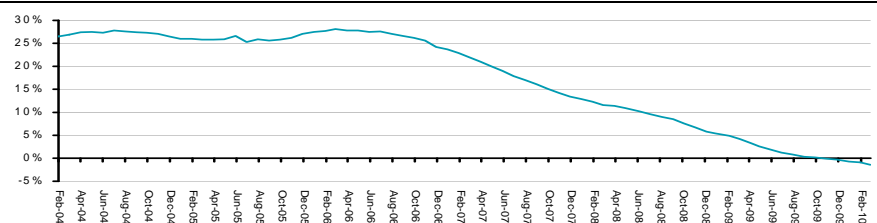
	No. of Mortgages	Average Value (€000)	Total Market (€bn)
2002	79,292	136.5	10.8
2003	84,750	159.6	13.5
2004	98,709	171.5	16.9
2005	107,700	200	21.5
2006	111,250	229.2	25.5
2007	84,200	266	22.5
2008	54,000	270	14.5
2009	25,100	232	5.8
2010	23,000	215	4.9

IBF

...although the pace of decline has slowed.

The pace of decline in lending for house purchase has also slowed, to -34% in the first quarter from -43% in Q4 2009, but the absolute sum lent fell below €1bn compared with €1.4bn a year earlier. Similarly, the number of loans declined to a new cycle low of 4,200 although again we expect a stronger reading in Q2 and Q3. For 2010 as a whole, we have pencilled in €4.9bn for house purchase, against €5.8bn in 2009 and a 2006 peak of some €28bn. The flow of new mortgage lending is now well below the pace of redemptions, pre-repayments and write-downs with the result that the stock of outstanding mortgage debt is falling. The monthly change in the total has been flat or negative since January 2009 according to the Central Bank, leaving the total at end-2009 at €147.6bn from €148.1bn a year earlier. The pace of decline accelerated in the first quarter, with a €1.1bn fall leaving the annual pace of decline at -1.4%. For the year as a whole, we expect the outstanding mortgage stock to have fallen by 3.5%.

Mortgage Lending (%) YoY Growth



Central Bank

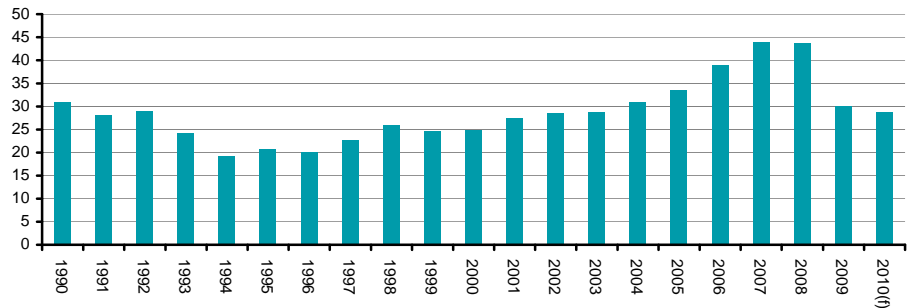
Affordability

The cost of a new mortgage has fallen sharply...

The interest rate on a new mortgage averaged 2.9% in Ireland last year according to the Central Bank, compared with over 5% in 2008, therefore representing a substantial fall in monthly repayments for new and existing borrowers. The average new loan also fell substantially, to €232,000 from €270,000 with the result that on a 25-year repayment mortgage the average monthly outlay declined from just under €1,600 a month to €1,088. Consequently, the combination of falling interest rates and lower house prices resulted in a very significant improvement in affordability, assuming an unchanged level of income.

Average incomes usually rise on a year-over-year basis, but wage incomes in Ireland probably fell in 2009: average weekly earnings declined by an annual 0.9% in the third quarter according to the CSO, following a 0.6% decline in Q2. Accordingly, we have assumed a 1% average decline in incomes on our affordability model and on that basis the average cost of a new mortgage still fell sharply to 30% of income in 2009 from over 43% the previous year, representing the biggest improvement ever recorded in a single year on our data base, which goes back to 1975.

Affordability (%)



Economic Research Unit (ERU)

...so affordability improved dramatically last year...

The income variable in the model is a gross measure and therefore does not take account of any changes in the tax burden, or indeed adjust for any tax incentives on housing. Nevertheless, it is a simple and useful gauge of affordability through time, showing that a new mortgage has cost as little as 20% of income in the mid-1990's (when rates started falling and house prices were much lower) to almost 40% in the late 1970's (when interest rates were over 14%) and almost 44% in 2007, reflecting rising interest rates and much higher house prices.

Affordability

	Mortgage Cost (% of average earnings)
1995	20.7
1996	19.8
1997	22.4
1998	25.5
1999	24.3
2000	24.9
2001	27.4
2002	28.5
2003	28.7
2004	30.8
2005	33.6
2006	38.8
2007	43.9
2008	43.6
2009(e)	30.0
2010(f)	28.8

Economic Research Unit (ERU)

...and is set to improve further this year.

The rapid deterioration in affordability from 2006 onwards was a significant factor behind our view at that time that house prices would stop rising. Similarly, one could say that the recent improvement in affordability is more positive for the housing market particularly as a forecast further fall in the average new mortgage this year leads to an additional improvement in affordability in 2010, with a 28.8% model reading. This is below the long-run average, despite the fact that mortgage rates are unlikely to fall further (indeed they have risen marginally in recent months) and incomes may decline again. Sentiment and expectations play a significant part in the timing of house purchase, however, and the undoubted improvement in affordability has to be weighed against falling employment in Ireland and uncertainty about the fiscal situation.

The economic picture is brightening of late, however, and a return to economic growth in 2010 is likely to make affordability a more significant factor in the decision whether to rent or buy.

Interest Rates

Weak euro growth means ECB rate rise unlikely this year...

The majority of existing mortgage holders in Ireland are on ‘tracker’ mortgages, with the interest rate set at a fixed spread over the ECB’s repo rate. The latter moves with the economic cycle because the ECB, like most central banks, believes that inflation is largely determined by the amount of spare capacity in the economy, and will therefore fall in a recession and rise following an economic upturn.

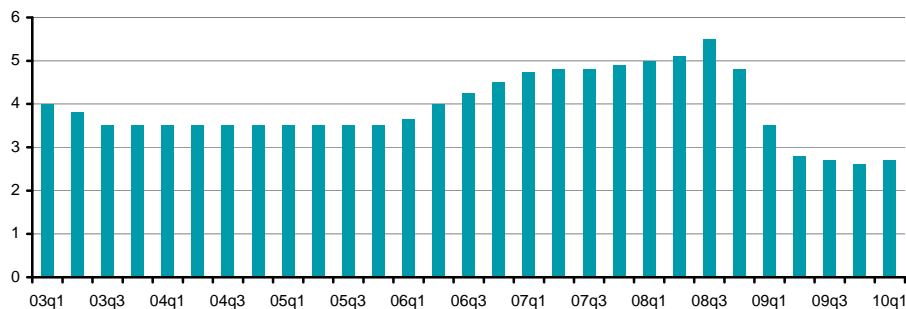
The global economy is certainly experiencing a pronounced recovery but the euro area is lagging, as the pace of economic expansion has been limp; GDP rose by 0.2% in the first quarter of 2010, following a zero reading in the previous quarter. As a consequence, GDP is still over 4% below its level at the peak of the cycle in early 2008, implying that inflation is unlikely to be a threat any time soon. This is certainly the ECB’s view and for some time now it has been signalling that the repo rate will remain at 1% for a while.

The euro’s recent fall does imply some upward pressure on prices (imports become more expensive) as well as providing a potential economic stimulus but GDP may face some downward pressure from tighter fiscal policy in the euro area and increased uncertainty about the future prospects for the zone. Certainly the market does not expect the ECB to start to raise rates until next year and we adjusted our own rate view some months ago, pushing the timing of a rate rise out until the second quarter of 2011.

...but new Irish mortgage borrowers face higher rates.

The wholesale cost of borrowing at a fixed rate has also fallen since the turn of the year, reflecting the above change in expectations. Three-year swap rates, for example, are now below 1.60% from over 2.2% in January but Irish banks, and many others, have to pay a premium over the minimum wholesale rate for funds. Consequently, the interest rate cost of a new mortgage has begun to pick up in Ireland as banks adjust to the higher cost of funds. The average new floating mortgage rate has risen of late, averaging 2.76% in March according to the Central Bank, from a cycle low of 2.57% in January. Existing borrowers on a tracker mortgage are unlikely to see higher rates for some time but the cost to new borrowers may continue to drift higher.

Mortgage Rate (%)



Central Bank of Ireland

Commercial Property

Returns were positive in first quarter...

The Irish commercial property market may be at or around the bottom of the cycle judging by the latest IPD data: returns in the first quarter were positive for the first time in two years, albeit a modest 0.4%. Capital values continued to fall, by 1.8%, but this represented a substantial easing in the recent pace of decline, with a fall of 4.9% recorded in the previous quarter and an extraordinary 18% in Q4 2008. The latest reading brings the cumulative decline in capital values in the downturn to 56%, and as such marks the Irish commercial property fall as much more pronounced than in the UK, which saw a 42% peak to trough move. The latter market also bottomed earlier than in Ireland (in Q2 2009) but the trend here now implies that capital values may be around the floor.

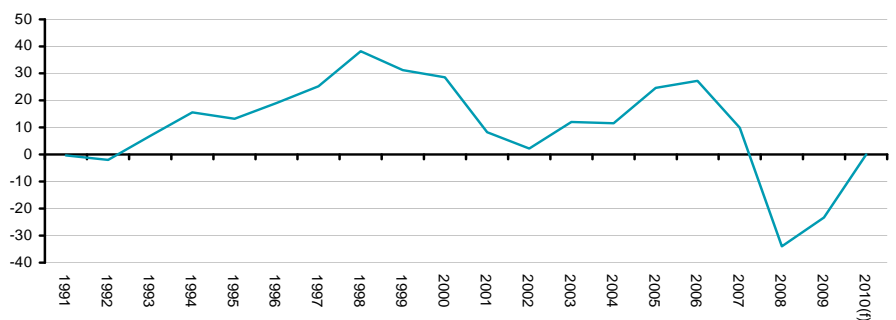
The equivalent yield on Irish commercial property, at over 8%, has certainly risen to levels which would normally prompt investor interest, given a risk-free rate of return (on 10-year government bonds) of 5.0% and a 5-year swap rate of under 2.15%. That combination of attractive yields and low funding costs precipitated the turnaround in the London market, but the small scale of Dublin and the absence of significant foreign investor interest will make for a much more muted cyclical turning point in Irish property. There has been a pick up in activity in the Dublin office market, according to the main property agencies, but they differ as to the scale of take-up, although all agree that the supply of new office space has fallen substantially from the levels coming on to the market in 2008 and 2009.

Commercial property income grew by 2.2% in Q1, thereby offsetting the capital fall, with industrial income growth leading at 2.6% followed by office at 2.3% and retail at 2%. In terms of the latter, consumer spending in Ireland plummeted in the six-months from September 2008 to March 2009, but stabilised at the latter end of last year and appears to have picked up in 2010 – car sales have risen substantially and core sales (ex cars) rose in the three consecutive months to March.

...signaling market may be at or close to bottom.

Any upturn on the high street is likely to be modest, however, given the scale of unemployment, which dampens spending directly and indirectly, by encouraging those in work to save more.

Commercial Property Returns (%)



SCS/IPD

Nevertheless, the economy appears to have returned to positive growth in the first quarter of 2010, and sentiment and confidence may well continue to recover. The Irish commercial market has also suffered from a lack of ‘price discovery’ and NAMA will provide that, although not all will be happy with the result. We had pencilled in a 10% fall in returns for 2010, but the Q1 data makes this less likely, although we suspect some volatility in the coming quarters rather than a string of positive readings. Consequently we forecast flat returns this year.

Contacts**Bank of Ireland Global Markets**

Chief Executive: Austin Jennings
Head of Global Customer Business: Kevin Twomey

Colvill House, Talbot Street, Dublin 1, Ireland
Tel: +353 1 799 3000
e-mail: info@boigm.com

Economic Research Unit (ERU)

Chief Economist, Bank of Ireland: Dr. Dan McLaughlin
Senior Economist: Michael Crowley
Economist: Patrick Mullane

Tel: +353 1 609 3341
e-mail: eru@boigm.com
Listen to Daily Commentary on Freephone: 1800 60 70 60

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New Century House, Mayor St. Lower, Dublin 1, Ireland
Tel: +353 1 611 3000
Fax: +353 1 611 3100
e-mail: info@mortgagelink.ie

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