TRENDS IN THE DUBLIN PROPERTY MARKET – SEPTEMBER 2008

A REPORT FOR THE IRISH AUCTIONEERS AND VALUERS INSTITUTE

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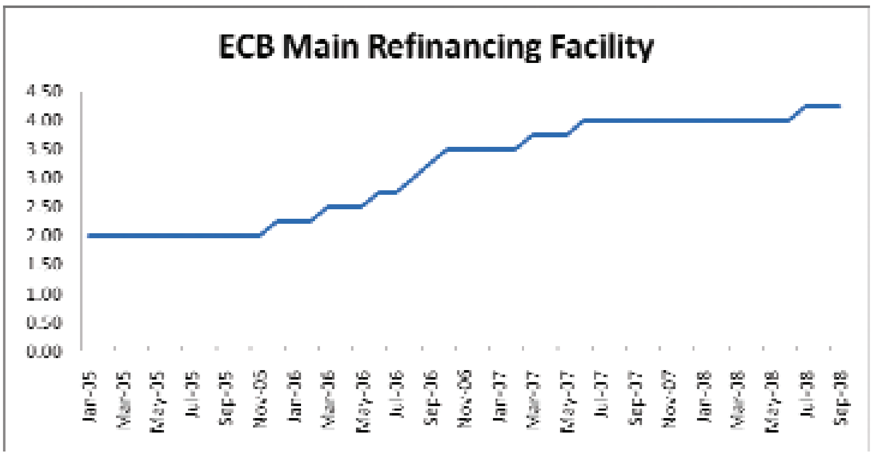
Background: International factors

Since August 2007 the world's economy has been hit by a barrage of adverse shocks, including a doubling of the oil price, a tight restriction on the availability of credit and a serious loss of confidence in the economies of the United States, United Kingdom – as well as economies like Ireland and Spain – in relation to their ability to sustain recent average growth rates. However the responses of central banks have differed widely to these challenges. In contrast to the Federal Reserve bank of the United States, which has cut its key interest rate by three percentage points since that time, the European Central Bank has actually increased interest rates by 0.25 per cent. This follows a two percentage point increase implemented between November 2005 and July 2007.



National House Price trends

For the first twelve months of this period the momentum of domestic economy growth was sufficiently strong to keep house prices increasing. However by late 2006 that momentum was halted as the impact of rising interest rates eventually took hold. At first slowly, average national house prices began to decline in the first half of 2007 before declining more rapidly towards the end of that year.

As measured by the ESRI permanent tsb index(which measures three monthly moving averages of asking prices), house prices as of July 2008 – the latest month available at the time of writing – had fallen back by just over 12 per cent to approximately the level they were at in late 2005. As far as indications are available, the momentum of house price decrease is slowing. Compared with the previous month of June – rather than with the previous year - prices fell by 0.2% in July , following reductions of 0.6% in June, and 1.2% in May.

The same index also reveals that house price falls in Dublin have recently been stronger than in the rest of the country, a finding borne out by this report. Falls were also heavier for first time buyers, reflecting the relatively tighter supply conditions prevailing in the second hand market. Falls were also in more recent times heavier for new as against second hand purchases, reflecting also a difference in supply conditions. However earlier in 2008 second hand house prices experienced stronger falls due to particular characteristics of the market discussed in this report.

Notwithstanding these recent falls, it remains a fact that house prices in Ireland today are and will remain – regardless of the extent of any further falls in the immediate future – significantly higher than at any time since the first half of this decade. As of July 2008, according to the ESRI permanent tsb index, prices remain 145 per cent above the levels prevailing in July 1998 and 21 per cent higher than levels prevailing in 2003, while being almost 9 per cent lower than a year previously. Most of this growth has very sound foundations; including Ireland's adoption of a permanently lower interest rate regime on joining the euro, strongly supportive demographic trends and a rise of 750,000 in the numbers at work.

The Dublin market

Several factors mark out Dublins's property market as distinct from the rest of the country. The first is that the average cost of a house is some 60 per cent higher than in the rest of the country. The second – a consequence of the first – is that the burden of stamp duty remains a significantly greater concern for the Dublin than the national market. With a differential of more than a hundred thousand euro between average house prices in Dublin versus the rest of the country, a purchase in Dublin incurs a stamp duty bill that is, on average, at least seven thousand euro higher. The significantly higher barrier to purchasing houses in the capital is therefore likely, in times when house price declines make funding a stamp duty liability more difficult, to have a more adverse impact on the level of activity of the housing market there than in elsewhere, with its attendant consequences for price trends.

The third is the higher proportion of those whose incomes are not only high relative to the rest of the country, but more variable and dependent on the state of the economy. A final factor is that psychological perceptions of the relative desirability of different parts of the city are more likely to play a far stronger role in driving demand for property in the more desirable parts, than is the case for other towns in Ireland. In conditions where either low interest rates or strong income growth prevail, or both, these perceptions are likely to be strong drivers of demand. When such conditions reverse, they are equally likely to disappear in a manner that rapidly makes house price levels more dependent on fundamental economic drivers.

Survey trends

Data for the purposes of this survey was collected from Gunne Residential, Hooke and MacDonald, Sherry FitzGerald and Lisney. Data referred to is an amalgamation of data from these sources. Four areas of the capital were selected to provide the broadest possible overview of market trends: Blackrock/Booterstown, representing the more affluent south-eastern suburbs, Lucan, representing a critical and growing market in the emergent economic zone in the west of the city, Stoneybatter, representing a more mature part of the city centre, and Donabate/Lusk/Swords, representing traditional suburbs on the city's northside. It should be noted that Blackrock is – compared to other areas - more likely to be subject to the psychological factors prevailing in the market during 2006, while the property markets in Lucan and Donabate/Lusk/Swords have been subject to strong growth in development in recent years whereas Blackrock and Donabate/Lusk/Swords, in this respect, represent more mature areas.

Data was collected for both new and second hand properties for two categories of property: 2 bedroom apartments with car park spaces and 3 bedroom townhouses with front and back gardens.

For each segment of the market, a comparison was undertaken between average prices in the January to June period of 2007 compared with the same period a year earlier, and between average prices in the January to June period of 2008 compared with the same period a year earlier. Thus the periods of comparison all occur after the peak in house prices identified at the end of 2006.

January to June 2007 compared with January to June 2006

It is to be expected that property falls in the first half of 2007 would be moderate compared to subsequent falls. As noted above, national average prices began to fall in earnest in the spring of that year and average June 2007 prices remained within three percentage points of their peak levels of six months earlier. However there was rising skepticism about the sustainability of recent peak house prices.

Prices fell least in the Blackrock/Booterstown area. Second hand apartment prices here fell year-on-year by just 1.7% from around €530,000 to just under €520,000 while new apartment prices fell from €580,000 to €550,000, a drop of 5%. House prices suffered more severe falls of 11% for new and of 10.5% for second hand developments. In both cases the price of a three bedroom house went from around €900,000 to around €800,000.

The next largest price falls were experienced in Stoneybatter where new and second hand apartments fell from €375,000 to €350,000 and from €401,000 to €375,000, respective falls of 6.7% in both cases. There was a more pronounced difference for house prices, where new house prices fell from around €550,000 to €500,000, a fall of 9%, while second hand house prices fell from around €496,000 to around €488,000 a fall of just 1.6%. Although a less desirable residential area than Blackrock, Stoneybatter's proximity to the city centre clearly limited the extent of falls during this period and mature properties sold at a premium to more recent developments.

As might be expected by the stronger growth in development and its relative location to the city centre, falls in the Lucan and Donabate/ Lusk/Swords areas were stronger. In Lucan, New apartment prices fell from €400,000 to €350,000 while second hand apartments fell from €380,000 to €340,000, falls of 12.5% and 9.9% respectively. House prices fell from €575,000 to €500,000 for new houses and from €483,000 to €423,000 for second hand houses, respective falls of 13.0% and 12.5%. Apartment prices in Donabate/Lusk/Swords fell from €375,000 to €325,000 for new developments and from €344,000 to €309,000 for second hand developments, falls of 13.3% and 10.2% respectively. New and second hand house prices fell by 11.1% and 8.7% respectively, from €450,000 to €400,000 in the case of new houses and from €365,000 to €325,000 for second hand houses.

January to June 2008 compared with January to June 2007

According to the Economic and Social Research Institute's summer quarterly economic commentary, 2008 will be a very different year economically from 2007. Due to a combination of factors – SSIAs, strong public spending growth and strong growth in private sector credit – Gross Domestic Product grew in 2007 by 5 per cent. But if ESRI forecasts are correct – and more recent forecasts are more pessimistic than the ESRI – GDP will actually decline in 2008 by 0.5 per cent. There was also a pronounced deterioration in consumer sentiment compared to the previous year, with the Irish Intercontinental Bank and ESRI's monthly consumer sentiment index falling to record lows during the summer as news of rapidly rising unemployment and a deteriorating economic situation – reflected in the government's announcement of emergency cutbacks – affected confidence across the economy.

So it was unsurprising that house prices fell by more than in the first half of 2007. In Blackrock new apartment prices fell from €550,000 in the first half of 2007 to around €500,000 in the first half of 2008, a 9% fall, while older and probably less desirable second hand apartments fell by a much more significant 16% from €519,000 to €436,000. House prices in Blackrock/ Booterstown also fell more sharply than other areas surveyed, reflecting a possible correction in the aforementioned psychological motivations behind demand for property in the area in preceding years. From €800,000, the price of a new house fell to €675,000 while second hand properties experienced a comparable fall from €805,000 to €675,000, falls of around 16% in both cases.

Lucan fared badly also, with new apartment prices falling by 14.3% (from €350,000 to €300,000) and second hand ones falling by 17.8% (from €341,000 to €281,000) while house prices fell by 14% for new houses (€500,000 to €430,000) and by 9% for second hand houses (from €423,000 to €385,000).

Donabate/Lusk/Swords saw new apartment prices fall by 12.3% (€325,000 to €285,000) while second hand ones fell by 11.6% (€309,000 to €273,000). House prices fell by 12.5% for new houses (€400,000 to €350,000) and by 11.0% for second hand houses (€365,000 to €325,000).

Stoneybatter's location allowed it to fare better in the housing market, but its apartment prices suffered similar falls to those in other areas. New apartments fell in price from €350,000 to €300,000 (14.3%) while second hand apartment prices fell from €374,000 to €328,000. But new house prices fell only 4%, from €500,000 to €480,000, although second hand houses fell by 12% (from €375,000 to €328,000).

Average selling times

As shown in Irish Banking Federation quarterly statistics, the number of mortgages outstanding was 14% lower in the second quarter of this year than the same period before. Having said this, it was considerably higher than the first quarter period, although seasonal factors may account for this. Data collected on average selling times by one survey respondent suggests that the market remains considerably more sluggish in the second half of 2008 than in the second half of 2007. Note that data are only available for second hand properties.

Selling times have lengthened considerably as a result. From around 5 weeks in the first half of 2006, average selling times for apartments and houses in Blackrock/Booterstown had a year later lengthened to 15 weeks for apartments and 10 weeks for houses and, a year after that, to 20 weeks in both cases. In Lucan selling times had been 3 weeks in the first half of 2006 for apartments and houses, lengthening to around 6 weeks in the same period of 2007 and to 12 and 14 weeks in the same period of 2008 for apartments and houses respectively. The relatively lower times compared to Blackrock for all periods probably reflects the more practical, less psychological, nature of demand for property in Lucan.

An even more pronounced lengthening in waiting times occurred in Stoneybatter. In the first half of 2006 it took only 2 weeks to sell an apartment and 4 to sell a house. By the same period 2007 it took 5 and 8 weeks respectively but by the same period of 2008 it was taking 24 weeks to sell an apartment and 28 to sell a house. This suggests that the demand for property here is more elastic. Selling times in Donabate/Lusk/Swords have been traditionally longer given its location. From 16 weeks in 2006 for both houses and apartments, times lengthened to 20 weeks in the 2007 and to 38 weeks in 2008, again these figures applying to houses and apartments also.

Affordability

Taking a sample property worth €500,000 as of June 2006, purchased by a €450,000 mortgage agreed when the ECB's main refinancing facility stood at 2.5 per cent. Average variable mortgage rates would have averaged 3.9% at the time. Assuming a 25 year mortgage repayment period, the monthly mortgage repayment on this would have been approximately €2,350.

A year later the ECB's main refinancing facility would have risen to 4 per cent and average variable mortgage rates to 5.4 per cent. Assuming no change in the term of repayment and no change in price – a conservative estimate - would imply a monthly repayment of approximately €2,735, an increase of €400 on the equivalent monthly repayment of a year earlier. Following some decline from the peak prices established late in 2006, prices according to the ESRI/permanent tsb index in mid-2007 were roughly level with those prevailing a year earlier or perhaps slightly higher. However according to survey evidence cited above, prices had fallen by between 3 and 10 per cent implying that for buyers, for whom this evidence is a more accurate reflection of market trends, affordability had not deteriorated by the full magnitude of subsequent interest rate increases.

By July 2008 ECB rates had risen modestly to 4.25%. Thanks to increasing tightness of credit, however, the rise in average variable mortgage rates compared with a year earlier was more than proportionate with rates of around 5.9% prevalent. According to the ESRI / permanent tsb index, prices in mid 2008 nationally just under 10% below June 2007 levels. Because – following their peak at the turn of that year – prices in mid 2007 had fallen back to levels close to those prevailing in mid 2006, prices in mid-2008 were also around 9 per cent lower than in mid 2008.
The evidence drawn from the narrower sample of properties in this survey suggests that prices in June 2008 were in the region of 12% lower than a year earlier and some 20% lower than two years previously. At the most conservative estimates in terms of price decline – assuming a price decline of just 10% between the June 2007 and June 2008 period (from €500,000 to €450,000, with a consequent fall in the size of the mortgage loan from €450,000 to approximately €410,000) - a monthly mortgage repayment would have cost approximately €2,615, still higher than two years previously, but lower than a year before. For properties experiencing more significant falls of around 20% between June 2006 and June 2008 affordability would actually have improved on June 2006.

The Outlook for the Property Market out to 2010

Although predicated on simple assumptions, the analysis immediately above suggests that a fall in nominal property prices of 20% from the middle of 2006 should – subsequent increases in interest rates and the subsequent increase in the gap between average mortgage variable rates and the ECB's main refinancing facility notwithstanding – have resulted in a situation where affordability is broadly unchanged as between the two periods. It should be noted that even if affordability was less in mid-2008 than in mid-2006 this would be supportable by a not insignificant – perhaps as high as 10 per cent – rise in nominal incomes during the intervening period.

On this basis it seems reasonable to conclude that house prices have returned to or are close to returning to levels that are consistent with equilibrium in the market. However there are three obstacles to translating this affordability into rising activity and a firming of prices.

The first is an inertia in relation to seller unwillingness to accept that market prices are going back to levels prevailing in 2005.

The second, however, is a fear on the part of buyers that even these levels may not constitute a market clearing equilibrium. Adverse comment on the prospect of further price falls below these levels – much of it unsupported by evidence or analysis – may be creating an expectation that prices will continue to fall indefinitely. In such an atmosphere it is harder to convince buyers to make a commitment.

How justified is such comment? It is instructive to note that in the autumn of 2005 the OECD reported to the Central Bank of Ireland that, in its view, property prices in Ireland were then overvalued by some 15 per cent. As prices nationally have now returned to the levels prevailing at that time, the question begs asking, is a further fall – perhaps of the order of 15 per cent – now in prospect? With nominal incomes rising in the subsequent period by around 10 percent, buyers' ability to service mortgages has risen, not accounting for interest rate increases. Had interest rates remained unchanged and had the deterioration in the availability of mortgage credit not become a feature of the current market, it is reasonable to conjecture that the price levels prevailing in late 2005 constitute a floor for the market that would by now have become sustainable.

The prospect of a further interest rate rise towards the end of the year, makes a recovery before 2009 impossible. Further falls in the market are likely between now and early 2009. The question is whether this process will be a moderate one that removes any remaining pockets of unaffordability or overvaluation, or whether it becomes a self-fulfilling and circular dynamic whereby house prices are driven downward largely by the expectation that they will fall further.

The latter scenario is by no means inevitable: The time when the ECB will signal that interest rates are going to begin to come back down, an event likely to come as early as March 2009, by which time the worst of the international credit crunch should have passed and financing cost pressures for banks should begin to ease. Although income growth between then and now is likely to be modest, demographic pressures are likely to stimulate a healthy growth in the demand for property.

The building of some 171,000 dwellings – according to Department of the Environment figure - over the 2006 and 2007 period, however, constitutes a significant increase in supply. This has been commented on by some as evidence of a significant overhang in the market that will lead to stagnation for several years to come. What is too often ignored, however, is that according to population forecasts from the Central Statistics Office, the population of the state increased during those two years by anything between 140,000 and 190,000 persons. Applying headship rates of 2.8 persons per dwelling, - and assuming that the population increase translated into a proportionate increase in demand for house purchase - approximately one third of the houses built should have already been demanded in the period. In fact, the proportion demanded is likely to be higher as headship rates are lower for first time purchasers of property, many of whom have not yet formed families.

The fact that the CSO's latest estimates project the population is to increase by anything between 107,000 and 362,600 between the beginning of 2008 and end of 2010 suggests that – even on the most conservative estimates – any remaining overhang in the property market will by 2010 have been cleared. The fact that most economic forecasters predict the economy to begin growing again in that year will also underpin confidence in the market. Looking further out than 2010, both the CSO and EU Commission have forecast that the population of the twenty-six counties of Ireland will rise to 6.7 million by 2058, a rise of just under two and a quarter million from current levels. Such numbers place recent concern about the level of house building in a clear perspective. Monetary developments over that period are also likely to be extremely supportive, however challenging over the coming year.

However tempting to draw conclusions from events like the collapse of Lehman bank in the United States, the Irish banking sector is not nearly as vulnerable as some of its US counterparts. The nature of its difficulties – access to funding – constitute a challenge rather than a crisis, and one which, using the correct instruments the European Central Bank and Irish central bank and government are well placed to deal with. Beyond the immediate turmoil in financial markets, the most serious aspects of which are likely to last until the end of the year, most financial market commentators expect interest rates to rise to begin falling in the Euro zone from the Spring of 2009. On previous form, the ECB takes roughly two years to implement a downward cycle of rate reductions. This suggests that most of 2009 and all of 2010 will be characterised by falling interest rates. Thus, demographic and monetary factors are likely to provide strong supports for a resumption of very low single digit percentage increases if and once the equilibrium floor of house prices is attained by further falls during 2008.

The only remaining question is whether that floor will be reached this year. Two factors will be crucial: Confidence is the first. Taxation is the second.

In relation to confidence, the analysis of affordability above suggests that psychological factors have taken over from fundamentals as a driver of market price expectations. However, even if such expectations could be grounded on a rational assessment of fundamental factors, such price expectations cannot be realised if there are significant barriers to activity in the market.

This is where the government's role as a tax agent comes in. Even if the more modest price falls implied in trends in the ESRI / permanent tsb average house price index are indeed reflective of market trends, it would remain the case that house prices are lower than at any time since October 2005. For those who purchased their property since that date and now need to sell, the bulk of any housing equity on a loan-to-value ratio of 90 per cent or more now faces a position of zero or negative equity. Given the loosening conditions applying to mortgage credit between autumn 2005 and autumn 2007, this number is likely to be not insignificant (and in a falling market, growing).

But this is only the first barrier facing the market. Any such buyer also faces a stamp duty liability of at least 7 per cent on the portion of the property price purchased above €125,000. Assuming that all house prices have followed the trend of the ESRI / permanent tsb index – and this is a conservative assumption – then for the seller of a €500,000 property in June 2008 to be able to fund such a liability in order to trade up – in the absence of savings and assuming that they also had sufficient funds to meet mortgage deposit requirements - they would have to have sold the property before the end of 2004. Otherwise the capital appreciation would be insufficient to meet the liability.

Since it became a tax relevant to the bulk of the housing market in the middle of the 1990s, stamp duty has until mid-2007 been operating in a market where rising housing prices have made it possible for those trading up to fund. Since the middle of 2007 and for the first time, its effect in a falling market – is to erect a transaction barrier which cannot be funded in times of capital depreciation.

The government states that intervening in the housing market would be unwarranted. The question is whether by retaining stamp duty at present rates, it is not in fact doing so.

On balance and despite an outpouring of negative news headlines concerning the state of the economy and the property market, there is a need to stand back and assess the future prospects of a housing market in a country whose population is rising relentlessly. Of course, any prognosis of the domestic economy and housing market is dependent on the course of global economic events. But if not undermined by badly informed comment and if adequately supported by government action, the housing market in Dublin and nationally still retains a healthy prospect of regaining stability by the year 2010. ■