AIB Global Treasury
Economic Research

THE IRISH HOUSING MARKET

WEALTH EFFECTS SUPPORTING DEMAND

The Irish housing market has been underpinned by sustained job creation and by increased personal wealth, manifesting itself through the purchase of second homes and rental property as an investment. Any significant downturn in either sector would obviously pose a threat to the overall housing market. However, with the risk of a price blowout moderating, continuing low interest rates and a robust labour market, we see little chance of a market crash and continue to believe that a soft landing is on the cards.

SUMMARY

- House price inflation is moderating, declining to under 8% year-on-year in February. By end 2005 it could be down to 5% or below. Prices may rise by less than 3% in 2006.
- The reduction in house price inflation has reduced the threat of a market crash. However, there are still risks, most notably the continuing high level of supply, the strong growth in second homes and the size of the investment market.
- Completions could again reach some 75,000 this year. However, we expect that the level of housing output will decline significantly thereafter, with the number of completions falling back to 65,000 in 2006 and possibly 60,000 in the period 2006 - 2011.
- This 2005 forecast still represents a high level of supply, especially as possibly 30% of current output may be accounted for by second homes. While SSIA flows should provide support over the next couple of years, this second homes sector may be approaching saturation levels. Any significant downturn in the sector could have consequences for the whole housing market if developers do not respond quickly to such an eventuality by reducing supply.
- We also continue to closely monitor the investment market. The overall housing market would be at risk should investors start leaving in the face of reduced rental incomes. However, rental levels appear to have stopped falling. Furthermore, many investors have amassed substantial capital gains. These factors should help maintain the attractions of property as a investment.
- Despite these potential threats, we see the market as remaining relatively well underpinned. Wealth effects should continue to support the market. The Irish economy continues to perform strongly with a robust labour market. Furthermore, SSIA monies could provide support, especially to the second homes market in 2006 and 2007.
- Lower house price inflation and rising disposable incomes should help to mitigate the impact on affordability of moderate rises in interest rates. Repayment affordability should, therefore, remain relatively comfortable, though the burden of deposit finance is likely to remain an issue.
- Despite this, we expect that the market will continue to gain support from the further gradual release of pent-up demand, as more lower cost units are completed.
- Meanwhile, mortgage lending remains buoyant, though the pace of growth should moderate in 2005 in line with lower house price inflation and as activity levels begin to top out.

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6th April 2005

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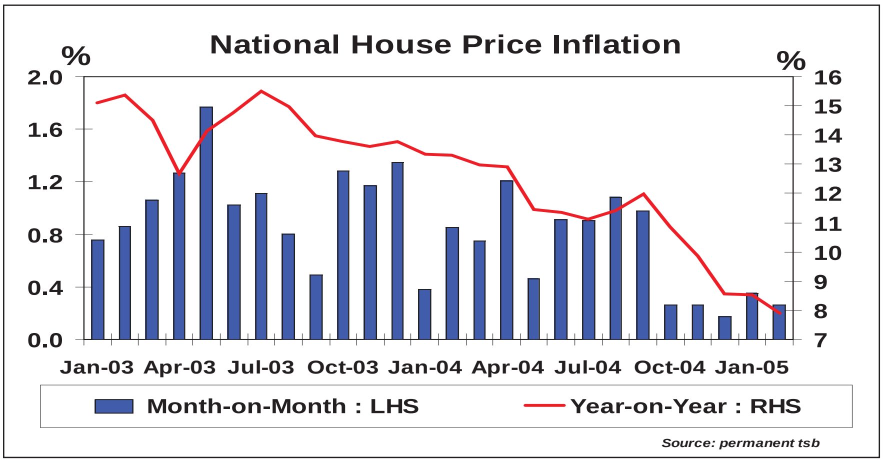
Prices :
Moderating Trend

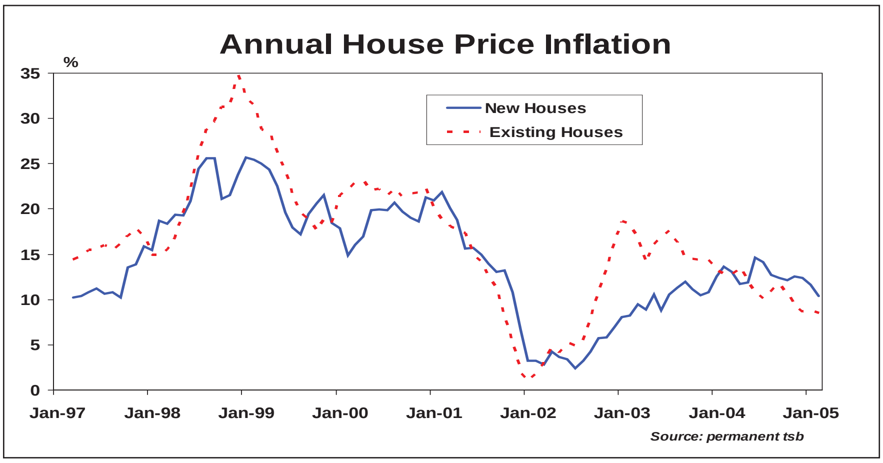
Overall, house price inflation moderating

Recent months have shown a distinct moderation in the pace of growth of Irish house prices. Permanent tsb data show that house prices grew by just 0.3% per month on average in the October 2004 to February 2005 period, well down on the 1.0% per month average increase recorded during the previous three months. The year-on-year rate of growth in February 2005 was 7.9%, somewhat lower than the rate of 8.6% in December and down from the 13.7% inflation rate recorded in December 2003. The February 2005 rate was well below the peak of 15.5% witnessed in July 2003 and was the lowest since September 2002.



Sticky new house price inflation .....

Permanent tsb also construct price indices for new and second hand houses. The most notable recent feature of these indices has been the stickiness of new house prices. However, in January this year, the annual rate of new house price inflation did at last fall out of the 12 - 13% range that it had been in since August (and which itself was not far below the June 2004 peak of 14.7%). It then declined further to 10.4% in February. Existing house price inflation, meanwhile, peaked in January 2003 at 18.6% and had declined to 8.5% by February 2005.



... may reflect nature of the indices........

The continuing relatively high level of new house price inflation, which was still running at 10.4% year-on-year in February this year, is a surprise given the level of supply hitting the market. One possible explanation may be the nature of the permanent tsb house price indices. These are like-for-like indices, which attempt to capture price changes for a fixed basket of properties. As such, they indicate that the price for comparable new properties, in terms of type, location and size, is continuing to rise at a strong pace.

...... which ignore any move to lower cost units

There have, however, been fundamental changes in the structure of the new housing market. There has been a noticeable shift, particularly in Dublin and its environs, towards higher density apartment developments and away from traditional semi-detached housing estates. The scarcity of land in the major urban areas also means that the location of many new developments is tending to move further from the urban centres.

Both these factors serve to reduce the cost of a housing unit. Thus, we believe that there has been a significantly slower rise in the overall average price of new housing last year than suggested by the permanent tsb data, through a shift in the structure towards the provision of more lower cost housing units.

This view is supported by an examination of the Department of Environment's (DoE's) house price indices, which take account of the changing structures of the market, though DoE data are only available to Q3 2004. The DoE new house price index, which measures average house prices, rose by 10.6% over the year to Q3 2004, compared to a 13.0% increase in the permanent tsb new house price index over the same period.

It should be noted, though, that differences of this magnitude between the permanent tsb and DoE inflation rates have opened up in the past and too much should not be read into the current gap. However, should the DoE new house inflation rate continue to be lower than the permanent tsb measure, this would add weight to our supposition of a change in the pricing structure of the new house market.

High supply to dampen new house prices

While on a like-for-like basis new house price inflation has been slow to respond, we remain of the view that continuing high levels of supply will increasingly impact on the rate of new house price inflation.

Meanwhile, the stamp duty concessions for first time buyers of second hand properties are likely to provide some support to prices in this sector. Nonetheless, we would expect a continuation of the downward trend in the inflation rate for existing properties.

Overall house price inflation below 5% by end 2005

Combined, these should see the rate of overall national house price inflation moderate further, to 5% or below by end 2005, from 8.6% at end 2004. Low house price inflation is likely to persist in 2006, when we expect a rate of less than 3%.

Completions :
Output Remains High

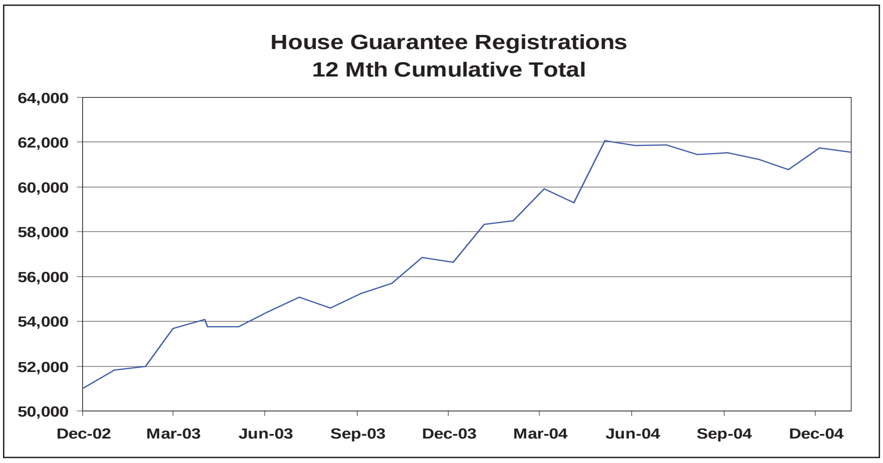
Another record year for completions

Data from the Department of the Environment show that there were a record 76,954 house completions in 2004, an increase of 11.8% on the previous year. The vast bulk of these, 71,803 (+14.5%) were private housing units, with just 5,151 social houses (-16%). Activity was strongest in the first half of 2004 with total completions up 21.4% year-on-year. The pace of output then slowed markedly in H2 last year, which saw completions up just 4.6% year-on-year.

New house guarantee registrations provide the best proxy for private housing starts. These showed an increase of 7% last year, totalling 60,782. However, after a strong first half, registrations slowed in H2 2004. New house guarantee registrations increased by 12% year-on-year in Q1 2004, and then by around 25% in Q2. Registrations subsequently fell by over 4% in both Q3 and Q4, compared to year earlier levels. However, registrations have shown some renewed growth in the early part of 2005, increasing by approximately 8% in January/February, in year-on-year terms.

House registrations appear to have levelled off

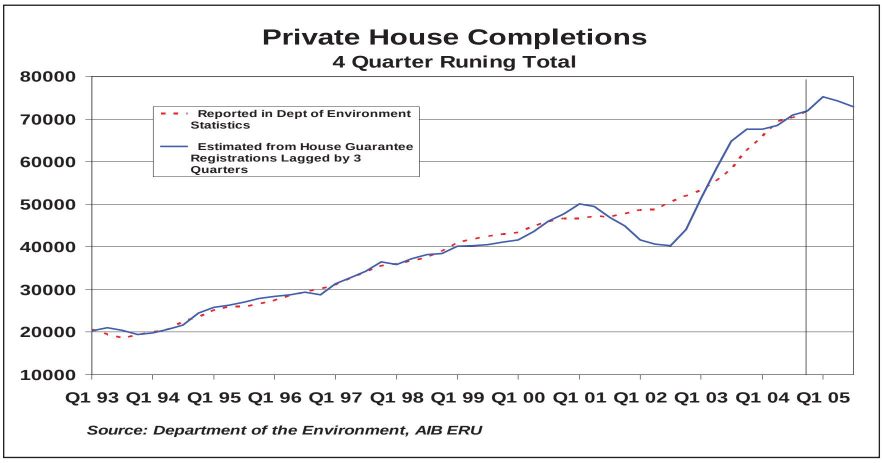
Overall, though, it looks as if house registrations have stabilised at a high level. Indeed, the trailing 12 month cumulative total of registrations has been close to the 61,000-62,000 level since last summer, following its sharp rise over the previous 18 months.



Historically, there was a time lag of around three quarters between the number of private house completions (on a four quarter rolling basis) and the level of registrations. This, though, had been distorted in recent years by the introduction and subsequent removal of the planning guillotine. As these factors unwound, the old relationship was apparently re-established.

Time lag between registration and completion may be increasing

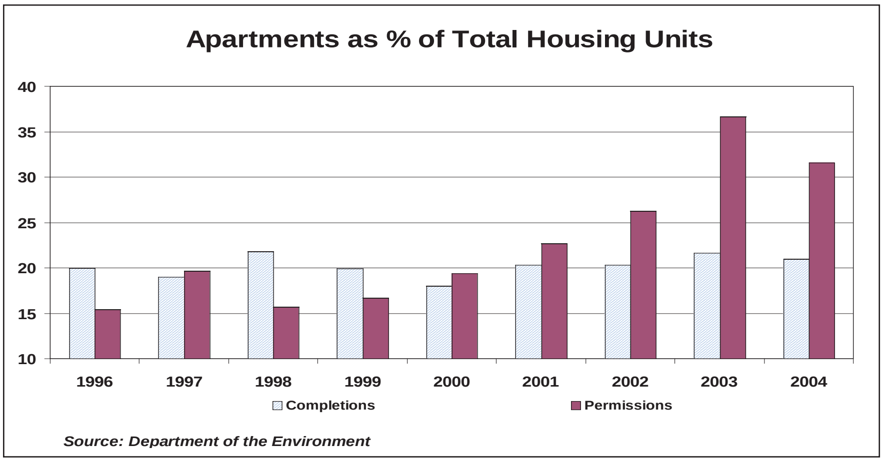
It would appear, though, that a shift in the relationship is again emerging, as the time lag between registration and completion lengthens. This is due to the increasing move towards higher density developments, apartment blocks in particular, most notably in the greater Dublin area. There are a number of developments due to be completed in the coming year, or even into 2006, for which planning permission was granted, and in some instances housing registrations obtained, as long ago as 2003.



Marked increase in permissions for apartments

As yet, the marked increase in the percentage of planing permissions for apartments, as opposed to houses, has yet to be reflected in completions. Nationally, apartments accounted for 36% of all permissions in 2003 and 32% in 2004. On the other hand, only 22% of completed units were for apartments in 2003 and 21% in 2004.

The difference is even more marked when looking at the greater Dublin area (Dublin City, Dun Laoghaire/Rathdown, Fingal and South Dublin). In this district, in 2004, 42% of completions were for apartments. Meanwhile, apartments accounted for 75% of total permissions last year.



The increased time lag between registration and completion should help to support the level of completions even, if as we expect, the number of starts begins to fall off. As a result, any fall in registrations over the course of 2005 may not be reflected in completion levels in 2005 or even fully reflected in 2006 completions.

Overall, however, the level of output depends on the extent to which developers slow the pace of completions in the face of slowing house price inflation. In this regard, it should be noted that the shift towards apartments makes it somewhat harder for developers to slow their pace of output as apartment developments do not permit the same flexibility to release properties on a phased basis that is provided by a housing estate development. However, the industry as a whole is in a healthy state after several years of strong profits and is not expected to find itself in the position of having to offer stock in difficult market conditions.

Completion may fall to 65,000 in 2006

Overall, the trend in registrations and shift towards apartment construction would indicate that completions may level off and then start to decline over the course of 2005, from the elevated levels of activity in 2004. At this stage, we feel that there will be at most only a small decline in 2005 from the 76,954 completions in 2004, and we are pencilling in a figure of 75,000.

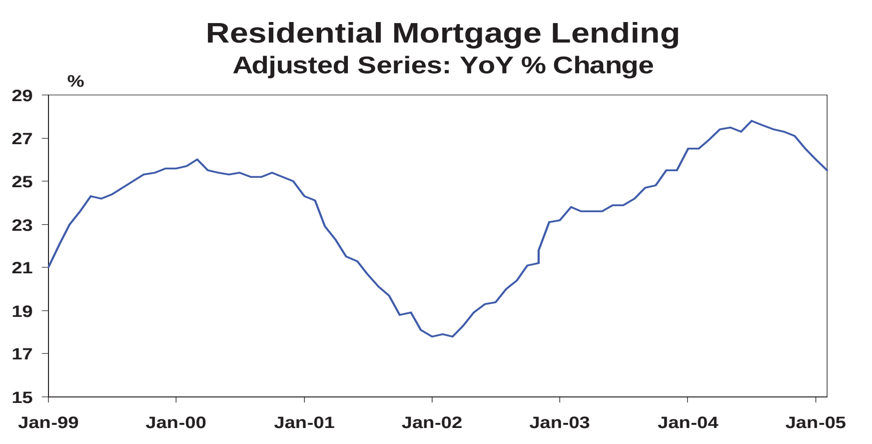
On the assumption that developers slow the pace of housing activity in order to reduce the risks of over supply and in the face of much lower levels of house price inflation, we are looking for a 13% fall in completions to 65,000 in 2006.

Mortgage Lending :
Pace Of Growth Begins To Ease

Mortgage lending firm but begins to moderate

The recent moderating trend in housing output and price inflation is reflected in some modest slowdown in the pace of growth of mortgage credit. However, mortgage lending remains firm. Indeed, the latest official data from the Central Bank and Financial Services Authority of Ireland (CBFSAI) show that net mortgage lending growth (new mortgages minus redemptions) on an underlying basis, had declined only slightly to 25.5% in February 2005, from its peak of 27.8% in July 2004.

With Irish housing output levelling off and house price inflation moderating, mortgage lending growth should decelerate somewhat this year, and we are pencilling in a growth rate of 18% by end 2005.



Meanwhile, Department of Environment data on gross new mortgage lending also reflect the strength of housing market activity. These show that in Q3 2004, the latest data available, 24.5% more new mortgages were paid than in the same period a year earlier, up slightly on the 20% growth rate in H1 2004.

The number of new mortgages continues to grow

The total number of new mortgages written in 2004 could well have breached the 100,000 level, compared to 84,749 in 2003. While these numbers greatly exceed the level of completions, they also include equity withdrawal, overseas property investment and home improvement loans. While completions are expected to stabilise or possibly fall back in 2005, we would expect a continued increase in demand for overseas property investment and home improvement loans. Thus, we are forecasting further modest growth in the number of mortgages written to an estimated 110,000 (+8%) in 2005.

New Loans Paid

	Number	**YoY%**	**Average Value (€)**	**YoY%**
2000	74,258	4.9	102,322	11.2
2001	66,786	-10.1	114,755	12.2
2002	79,292	18.7	136,523	19.0
2003	84,749	6.9	158,892	16.4
2004 Q1-Q3	72,625	21.9	168,029	5.4
Year (est)	101,500	20.0		
2005 (f)	110,000	8		

Source: Department of the Environment, AIB ERU

Estimated Demand :
Higher Than Expected

Our estimates of housing demand are based on the following factors:
- Population growth
- Migration
- Change in Headship
- Second, or otherwise vacant homes
- Replacement of obsolete units

We review these factors below and adjust our previous estimates as required in the light of any new data.

Population Growth and Migration

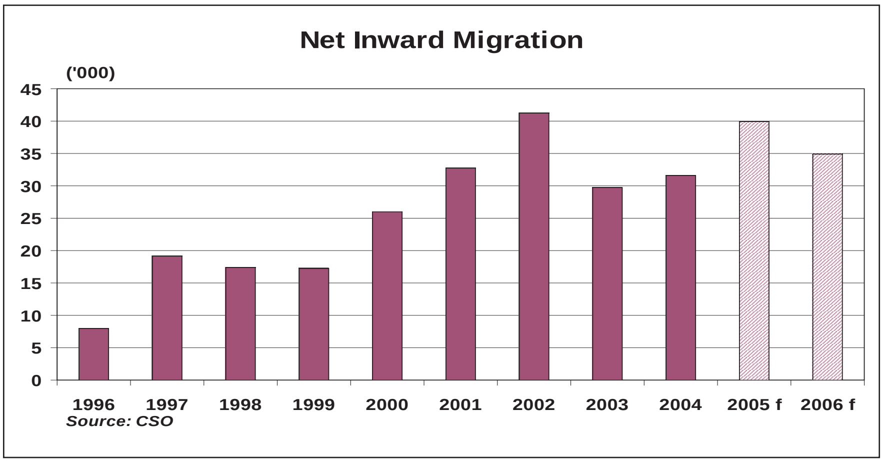
Revised population estimates

The CSO has published revised population estimates based on the demographic structure identified in Census 2002. These data provide an estimate of the total population in 2006 on the basis of assumed net inward migration of 30,000 per annum.

Over the two years from April 2002 - April 2004 net inward migration just slightly outpaced this level, averaging 30,700 per annum. Since then there has been an influx of workers from the new EU states. However, until migration data for the year to April 2005 are published later this year, it is unclear how many of those who have registered for work (some 50,000 between the beginning of May 2004 and end 2004) remain in the country. Many will have been students who came to Ireland for the summer or other transient workers who have subsequently returned to their native countries.

Continued strong net inward migration

It does look, however, as if both the basis for the CSO's population projections (i.e. net inward migration of 30,000 per annum) and our earlier estimate of net inward migration over the two years from April 2004 - April 2006 of 32,000 per annum will prove to be too low. Figures of approximately 40,000 and 35,000 for the years to April 2005 and 2006, respectively, seem more realistic. This would mean that net inward migration would average 34,100 per annum over the four year April 2002 - 2006 period. This represents an additional 3,100 per annum inward migrants on top of the figure used as a basis for the CSO's population estimates.



Applying unchanged headship ratios to each age cohort in the CSO's new estimated demographic structure would imply the need for 29,700 new housing units per annum over the April 2002 - 2006 period.

Our assumption, of an additional 3,100 immigrants per annum over and above the CSO's estimate, implies the need for a further 1,200 housing units each year, giving total housing demand from population and migration factors of 30,900 per annum over the period.

Looking to the 2006 - 2011 period, the CSO provides estimates of the population structure based on net inward migration of either 20,000 or 30,000 per annum. These imply housing demand of 27,300 or 30,400 per annum, respectively, again on the basis of unchanged headship rates.

Strong economic growth to support inward migration in 2006/2007

Irish economic growth is expected to be particularly buoyant in calendar 2006 and 2007 due to the impact of SSIA monies. This should help sustain a high level of net inward migration over these years, even as the impact of EU expansion diminishes. The level of net inward migration, though, could well drop back in subsequent years as growth turns back down towards trend levels.

Overall, for the April 2006 - 2011 period, net inward migration may well approximate around 25,000 per annum. On the basis of the CSO's population projections, this would imply the need for 29,800 additional housing units per annum.

Headship

Headship rates low and unchanged between 1996 and 2002 ......

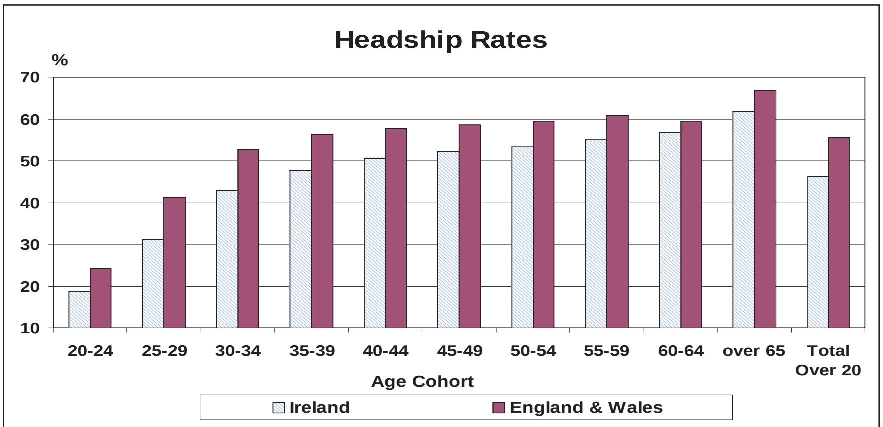
As we have remarked before, one of the most notable findings to emerge from an examination of Census 2002 was that there had been virtually no increase in Irish headship rates between April 1996 and 2002 - that is to say, little or no overall increase in the percentage of adults that were heading up households.

While there was some slight increase in headship rates in the lower age cohorts (under 35s) this was compensated for by a slight fall in headship rates for the older age groups. Furthermore, Census 2002 indicated no increase in the number of single adult households.

Irish headship rates are low by comparison with, for example, the UK, with the greatest shortfall in the 25-34 age cohort. This implies a level of pent-up demand, most notably from young adults and from single people, the latter especially so given the increasing prevalence of marital breakdown.

.......but should pick-up as pent-up demand unlocked

Anecdotal evidence points to some unlocking of this demand as an increasing number of young adults enter the housing market, helped by improved affordability, particularly through the introduction of longer term mortgages.



Source: Ireland - CSO ; UK - National Statistics Office

Our previous estimates included increased housing demand from a pick-up in headship rates. In light of the anecdotal evidence, we have increased these estimates slightly to 10,000 for the April 2002-2006 period and 12,000 for April 2006-2011 (from 8,000 and 10,000, respectively, previously). The increase in headship implied by these levels would, though, still leave Irish headship rates significantly below those in the UK.

Second, Vacant or Replacement Units

Large number of second, vacant or replacement units

Assuming that our other demand estimates are correct, the balance of estimated housing completions in the April 2002 - 2006 period, totalling an average of 30,600 units per annum, would represent either second homes, otherwise vacant units or the replacement of obsolete units. Vacant properties includes investment properties which are currently unrented or otherwise unoccupied properties. Any property that is occupied either by owners or on a rental basis represents household formation and as such is included in either the demographic/migration or headship categories.

No accurate data ...

There are no accurate data available on the level of replacement of obsolete homes nor on the extent to which the balance represents second (holiday type homes) or investment properties that are currently vacant.

... but possible to make estimates from Census data

It is possible, though, to make some estimate of the historic level of stock replacement from the Census data. The ESRI, using unpublished Census data on the number of vacant dwellings on Census night, puts the replacement rate for the April 1996 - 2002 period at around 0.8% of the housing stock, or almost 11,000 units per annum.

This compares to the international norm of a replacement rate of 0.7% of the housing stock. However, both this ESRI estimate and the internationally accepted rate would seem too high in an Irish context, given the relatively young average age of the housing stock. Indeed, the ESRI query the estimate of total housing stock based on Census data as being too low in relation to the number of properties with ESB connections.

Meanwhile, data from the Census on the number of residences built since 1996 would imply that the number of replacement units over the period was closer to 5,500 per annum, or 0.4% of the average housing stock. This figure, however, may be too low, especially as not all respondents replied to the question.

Bearing in mind these concerns, we have taken as the basis for our estimates of stock replacement a rate of 0.5% of the housing stock. This is broadly in line with the the ESRI's estimate of an average replacement rate (based on census vacant dwellings data) for the longer 1991-2002 period. Such an assumption of a 0.5% replacement rate would imply that some 8,000 per annum of completions over the April 2002-2006 period would be replacements for obsolete stock.

Irish holiday home market remains strong ....

The balance of 22,600 units per annum in the second, vacant or replacement category would thus represent second, or otherwise vacant homes. Indeed, the anecdotal evidence supports the view that the second home market in Ireland remains strong. There have been large number of tax based and other holiday developments built over the past few years, with a significant number due for completion over the balance of 2005.

While holiday home purchases are most likely the dominant reason, there are other factors behind the strong demand for second homes in Ireland. These include pre-retirement purchases; homes bought for college students which are subsequently retained for city visits; homes for use as an employment base when jobs are relocated some distance from the primary residence, and as an investment in the housing market when the primary residence is a rental property.

SSIA monies should provide support ...

The purchase of a second home has been facilitated by the growth in household incomes and the long-term growth in housing equity, as a result of which there is more housing wealth available to help finance a second home. During 2006 and 2007, the flow of funds from maturing SSIAs is likely to provide some continued support to the second homes market. The amounts are small in terms of overall house prices. However, along with the fact that SSIA inflows no longer have to be financed, they are likely to be sufficient to enable the purchase of second homes for a significant number of households.

... but market risks becoming saturated

Despite this, looking to the whole April 2006-2011 period, there could well be a substantial fall off in the number of second, vacant or replacement units, as demand for second (holiday) homes in Ireland declines and with housing less appealing as an investment.

Mainly a domestic market

The growth in second homes is not a uniquely Irish feature. The Mediterranean countries, of Spain, France and Italy have seen a similar boom, though, in this instance, demand has been driven to a significant extent by foreign investment, whereas demand in Ireland is largely domestic.

The ESRI estimates that, overall, one in nine homes is now vacant, at least on a temporary basis. Thus, given the domestic nature of the market and the limited pool of Irish buyers, demand for second homes risks reaching saturation. Furthermore, with the increasing attractions of overseas investments, it is hard to see the current demand for second homes being sustained.

Number of new second homes could fall substantially

In addition, the tax incentive holiday home schemes are reaching completion. Meanwhile, there have been suggestions that the government might impose infrastructural levies on second homes to cover part or all of the costs of connections to utilities. Such a measure, or any other charges or taxation measures could put additional pressure on the sector.

Overall, we expect that there will be continued demand for second or otherwise vacant units over the April 2006-2011 period. However, we feel that the peak in this market may well have passed and that demand will decline closer to an average of 9,000 units per annum in these years, compared to an estimated 22,600 in the period 2002 - 2006.

Revised Demand Estimates

Thus, overall, housing demand could be around 60,000 per annum in 2006-2011. While such a level represents a significant 16% fall from the estimated annual average 71,500 level of output for the 2002-2006 period, and a 20% decline from forecast 2005 output levels, it does not imply a dramatic collapse in housing demand.

AIB Demand Model

April to April **Per annum**	**1996-2002**	**2002-2006 Estimate**	**2006-2011 Forecast**
Population Growth (Including Migration)	26,200	30,900	29,800
Change in Headship	1,250	10,000	12,000
Second or Vacant Units	10,800	22,600	9,000
Replacement of Obsolete Units	6,500	8,000	9,000
Total	**44,750**	**71,500**	**59,800**

Market Supports :
Continue To Underpin Demand

While we expect the overall level of demand to decline, there are several factors that should provide ongoing support to the Irish housing market, helping to underpin activity.

Favourable Economic Outlook

Economic outlook remains supportive

The overall economic environment remains supportive of the Irish housing market. There is no apparent pressure from either the economic or interest rate outlooks. Indeed, the Irish economy would appear to have moved onto a firm growth path. GDP grew by 4.9% in 2004, in line with trend, helped by a marked improvement in the performance of the global economy.

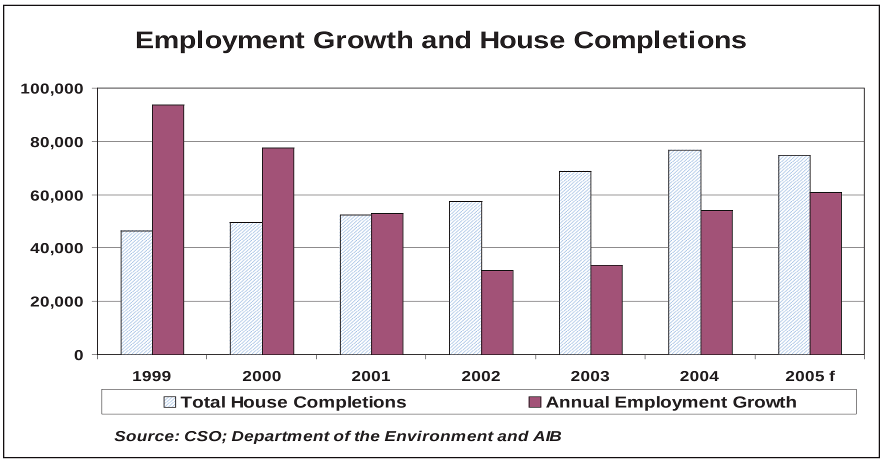
We expect that the Irish economy will grow above potential in 2005 with GDP growth of 6.0% and GNP rising by around 5.5%. GDP growth is then likely to move further above potential in 2006 and 2007, as the release of SSIA monies into the economy will provide a major boost to domestic demand. GDP growth could accelerate to 6.5% in these years.

Strong Labour Market

Strong employment growth

The strength and resilience of the Irish labour market is a key factor supporting the economy, and the housing sector in particular. The strong economic performance in 2004 has resulted in a significant increase in employment, which rose by 3.0% last year. Meanwhile, the labour force grew by 2.8%, helped by continuing strong net inward migration. However, job growth has been sufficient to generate a modest decline in unemployment from already low levels, with the unemployment rate dropping to 4.4% last year, down from 4.6% in 2003.

A growing indigenous population, continuing sizeable net inward migration and rising participation rates, augur well for labour force growth, which we expect to continue to expand by around 3% in 2005 and 2006. Given the favourable prospects for economic growth, employment growth should average 3% or above over the next two years.



Relatively Low Interest Rates

Only modest rise in interest rates

Meanwhile, official interest rates in the euro area are set to remain at exceptionally low levels. The ECB has maintained the refi rate at 2% since June 2003. The grounds for any early policy tightening look weak. There has been only a modest upturn in activity in the eurozone, while there is considerable spare capacity in the economy. Core inflation has fallen to well under 2%. Wage increases remain very subdued. Meanwhile, the euro has strengthened. Furthermore, we do not see any major second round price effects emanating from the rise in oil prices.

However, the ECB does see a risk of inflationary pressures from excess liquidity, combined with accelerating credit growth, and it fears that unsustainable high rates of increases in property prices in some countries (including Ireland) could pose upside risks to price stability over the medium to longer term.

While comments from ECB officials in recent months imply a bias towards policy tightening, we do not see the ECB hiking rates anytime soon. Indeed, we do not foresee an increase in rates until the end of the year, when a 0.25% hike is possible.

Given the importance of variable rates to the Irish corporate and household sectors, the continuing low interest rate environment will be of considerable support to the economy, especially the housing market.

Comfortable Affordability

Repayment affordability may deteriorate somewhat.......

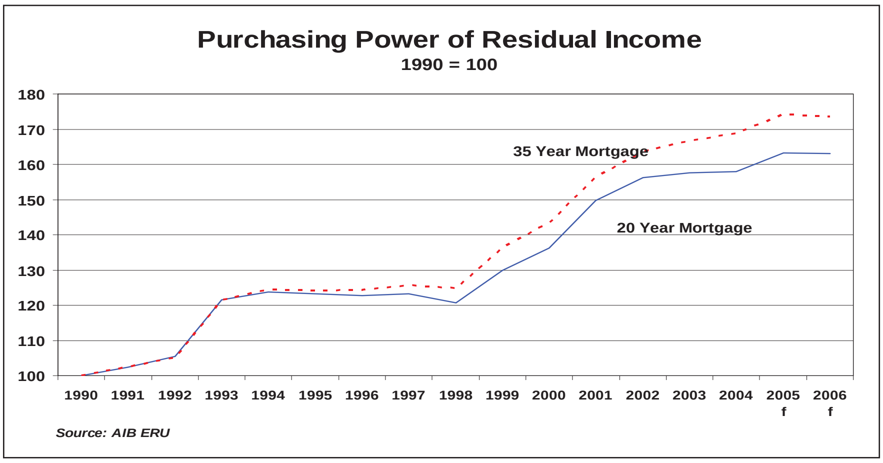
The moderation in the uptrend in house prices last year, in the context of stable mortgage rates, means that there was only a modestly deteriorating trend in overall affordability in 2004. For 2005, the combination of the reduced income tax burden, a further moderation in house price inflation and only a modest rise in interest rates towards end year should mean that affordability remains relatively stable.

Looking to 2006, though, given the expected further rise in interest rates, it is to be expected that there will be a moderate deterioration in the overall affordability trend - in the absence of a marked fall in house prices.

.... but remain relatively comfortable ....

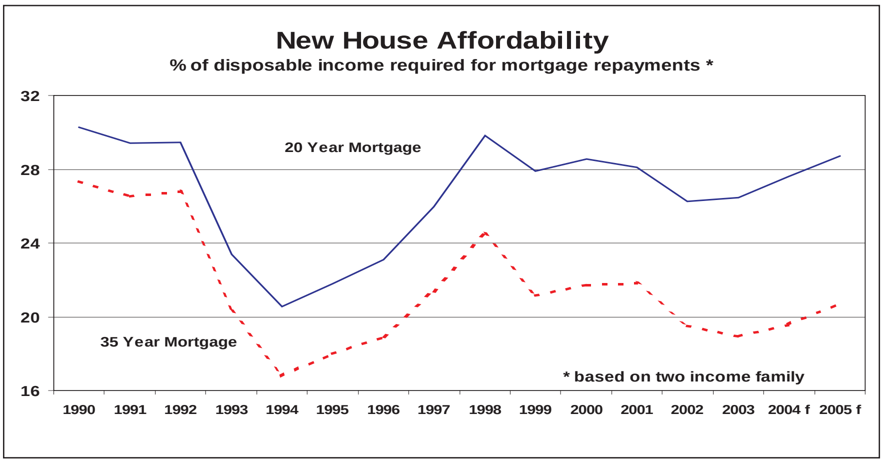
Such a modest deterioration in repayment affordability should not pose any major problems given the current relatively comfortable affordability levels. The fact that the pace of growth in disposable income has almost consistently outpaced the rate of consumer price inflation has resulted in a significant increase in the purchasing power of the residual income, after mortgage repayments.

For those taking out a 20 year mortgage in 2004, the purchasing power of residual income (disposable income minus mortgage repayments all deflated by the change in the consumer price index) was over 1.6 times what it would have been in 1990. The difference is even greater on a 35 year mortgage at over 1.7 times.



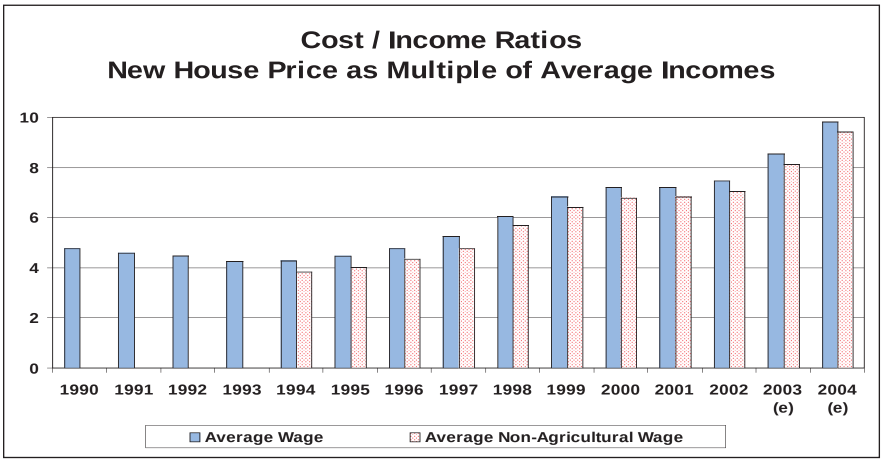
........helped by extension of mortgage terms

Furthermore, it should not be forgotten that the extension of mortgage terms out to as far as 35 years in some instances, compared to the 20-25 year mortgages that previously were the norm, has led to significant improvement in overall affordability, for those able to take advantage of these products. This more than compensates for any deterioration in the affordability trend and, in general, repayment affordability would appear to be relatively comfortable.



Fall in cost/income ratio

Meanwhile, with house price inflation moderating, the expected rate of growth in nominal wages should outpace the rate of growth in house prices over the next two years. This will serve to reduce the cost/income ratio for new houses, which has been on a steadily increasing trend in recent years.



Raising deposit finance still a strain ....

Despite comfortable repayment affordability, and a fall in the cost/income ratios, the cost of access in terms of raising the initial deposit can be a significant strain. A 90% mortgage remains the norm. Due to the rise in house prices, the cost of raising a 10% deposit has risen to over 40% of annual disposable income (for the same two income household as in the above repayment affordability calculations), compared to around 25% in the early 1990s.

Anecdotal evidence suggests that many first time buyers are turning to parental support to raise the deposit finance. This, though, is somewhat at odds with a survey by the Irish Mortgage Corporation, conducted amongst first-time buyers purchasing a home between January 2003 and March 2004. This found that 65% of first-time buyers used their own savings with only 28% relying either wholly or in part on parental assistance or gift. Some reluctance to admit to parental input may, in part, account for the difference between the anecdotal and survey evidence.

.... but should not prevent further release of pent up demand

Despite this, the continuing relatively comfortable affordability, coupled with the change in the market structure towards the provision of more lower cost units, (through either location or higher density) should allow for a further gradual release of pent-up demand. Even so headship rates are likely to remain low, which will serve to provide fundamental underlying support to the market.

Risk Factors :
Rental Sector and Supply Levels Main Threats

Housing market crashes tend to be generated by either a significant deterioration in the labour market situation or a sharp increase in interest rates. As we have already highlighted, neither of these seems a likely scenario in the short term. In their absence, the continuing high level of supply, any significant withdrawal of investor interest, or a sharp downturn in the second homes market would appear to pose the greatest potential threats to the market.

Oversupply

Current supply levels cannot be absorbed indefinitely

The market cannot continue to absorb supply of some 75,000 or more units per annum indefinitely. However, it should be noted that we estimate that current output is only about 15,000 units per annum above our estimate of long term demand, which is not as great an overhang as commonly perceived.

In addition, we continue to believe that the Irish house building industry is flexible and responsive. Current output is being driven by strong demand and, should there be any evidence of a potential supply overhang, we expect to see builders quickly moving to slow the pace of completions.

Furthermore, the industry, as a whole, is in a healthy state after several years of strong profits and is not expected to find itself in the position of having to offer stock in difficult market conditions. However, we may see increasing incentives being offered - such as better fittings or higher decoration allowances - to increase the attractiveness of properties if the market outlook begins to deteriorate.

Second Homes Market

Strong reliance on second homes market poses a risk

The threat of oversupply is intensified by the fact that some 30% of current output would appear to be second homes or otherwise vacant properties, rather than being either owner occupied or rented properties.

A study contained in the recent RICS European Housing Review 2005 identifies some of the risks to the second homes market which, in particular, are likely to result in a higher level of volatility compared to the primary homes market. These include the fact that:

- Demand is more discretionary than in the primary homes market;
- Lenders may be more concerned about defaults given that second home owners are likely to be less tenacious about maintaining mortgage repayments;
- There is no fall back demand as is the case in the primary market, where those priced out in times of strong price rises are attracted in as prices fall, acting as a cushion to any downturn; and
- Increased supply side volatility due to developers lagged response to sometimes sudden changes in demand.

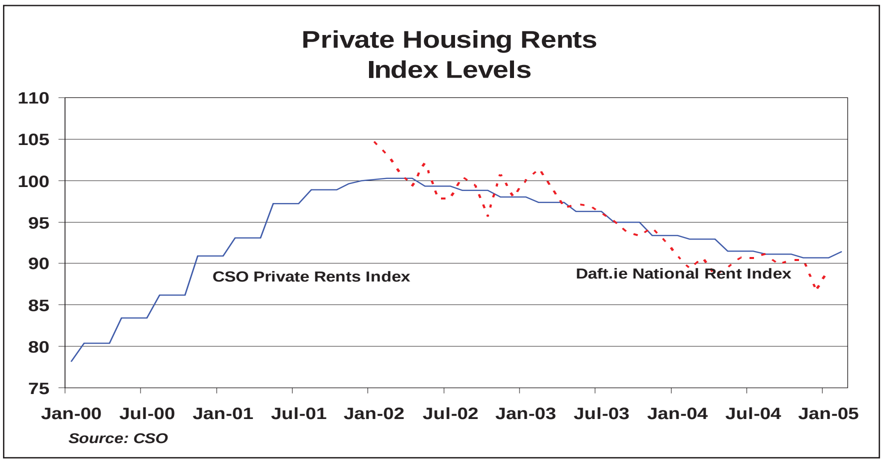
Thus, the impact of any downturn in this sector is likely to be magnified and could have a disproportionate impact on the market as a whole. Wealth effects, though, should help sustain demand in the sector to some extent. However, we do not believe that the current high level of second home purchases can be maintained over the medium term, especially after any support from SSIA monies runs out. Thus, developers will have to be vigilant to prevent undue supply, which could have a major impact on the whole housing market.

Investment Sector

Rental incomes have stopped falling

Meanwhile, we continue to monitor the investment market for any signs of a significant withdrawal of investor interest in the light of reduced investment returns. However, the private housing rents component of the consumer price index, which had been in continuous decline since the second quarter of 2002, appears to be stabilised.

In February 2005, rental levels, according to this index, edged up by 0.8% on three months earlier. However, they were still down 1.1% on year earlier levels and almost 9% off their early 2002 highs, leaving them back at levels of four years ago. A similar pick up is indicated by the national rent index calculated by property website Daft.ie, though this tends to be volatile on a month-on-month basis.



Meanwhile, average house prices have increased by over 45% over the four year period since rents were last at current levels. These price rises, coupled with low interest rates, provide a significant cushion to investors already in the market. For new investors contemplating entering the market, however, rising prices and the fall in rental incomes have led to a substantial erosion of yield levels.

Investment sector also requires continued monitoring

While, against this background, there is some evidence that investor demand has waned, investors would appear to still have been net buyers of the market last year. An analysis by Sherry FitzGerald of 3,000 new homes traded during

2004 found that investors still accounted for 22% of purchases, only down modestly from the 28% level recorded in 2003.

Meantime, in the second hand market, Sherry FitzGerald estimate that investors purchased 19% of properties traded in the opening months of 2005, in a continuation of a very gradual downtrend from 20% during 2004 and 21% in 2003. Meanwhile, there has been a significant increase in the number of investors selling investment properties. Investors accounted for 34% of sales in the opening months of 2005 compared to just 26% of sales during 2004. This may reflect to an extent the strong capital gains in the sector but it is a trend which warrants careful watching.

However, with rental incomes apparently stabilising or beginning to turn back upwards, we believe that there is likely to be continued investor interest in the market, especially given increased wealth and the attractions of property as a pension investment. The sector, though, still requires continued monitoring, especially should continued equity market recovery lead to a revaluation of the attractions of stock market investment.

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