
Contact details

Economist	Rossa White
E-mail	rossa.white@davy.ie
Research	353 1 6148997
Institutional Equity Sales	353 1 6792816
Website	www.davy.ie
Bloomberg	DAVY<GO>

Disclosures

Davy is part of Bank of Ireland Group
Davy is a member of the Irish Stock Exchange and London Stock Exchange, authorised by the Financial Regulator under the Stock Exchange Act, 1995

All prices as of close of previous trading day unless otherwise indicated

For the attention of US clients of Davy Securities Limited, this third-party research report has been produced by our affiliate, J&D Davy

Please see important disclosures page 4

Dublin house prices heading for 100 times rent earned

The frenzy in the Irish property market has intensified. In the last six months, house price inflation has re-accelerated to an annualised rate of 15%. In the Dublin market, prices are now rising at an annualised 20% lick, up from only 3% less than a year ago. But rents have only recently recovered after a three-year period in which they were in decline. As a result, yields have been driven down to unprecedented depths. Something does not feel right.

A line frequently trotted out by estate agents is that “buy-to-let investors are not worried about rental yield; they are in it for the long haul of capital appreciation”. That is fundamentally unsound investment advice. In the long run, the value of any asset is dependent on the income it provides. In the property market, capital appreciation is theoretically a function of rental return.

What is buying a house in any case? It is the opportunity cost of not renting. An owner-occupier/investor is buying a discounted stream of rents for as long as he/she wishes to hold on to the asset. And vice-versa: a renter pays a monthly sum to a landlord rather than interest to a bank. The opportunity cost of not owning a home is forsaking the potential for a return on that investment. But if rents are relatively static, not only is the potential for capital appreciation reduced, it is also more attractive in cash-flow terms to pay rent rather than interest.

There has been much comment to the effect that desirable properties in Dublin’s prosperous inner suburbs will always hold their value, yet it is in these areas that valuations are at their craziest. We looked at many properties currently advertised for sale in Dublin’s inner suburbs, north and south. We then used the DAFT.ie website, which has the largest selection of rental properties in the country, to source the going rental rate for similar properties to those for sale. We tried to find an exact match in terms of area, dimensions, number of bedrooms etc. In some cases, we managed to find an identical house in the same estate. Our selection of properties for sale contains two, three and four-bedroom houses or apartments. Contrary to the common perception, there is a remarkably liquid rental market in the capital for three and four-bedroom houses.

Spiralling prices have sent yields well below the rate of consumer price inflation in many areas: gross, never mind net, yields have typically dropped to 2%. In Table 1, we present a sample of properties from those surveyed. The price used is the advised minimum value (AMV) or what used to be called the “guide price”. However, houses in these areas are habitually selling for at least 20% more than AMVs at present. For our baseline, we do not take this into account; if we did, the arithmetic would look even less healthy (see Table 2). The “total price” quoted includes the relevant rate of stamp duty and 0.5% costs (including legal and surveying fees). Annual rent is assumed to include the loss of one month to cover voids and other costs.

Table 1: Yield comparisons across Dublin

Dublin	AMV/quoted price	Total price*	Rent	Net rent**	Gross yield	Net yield	LTV break-even***	P/E gross	P/E net
Clontarf	1,100,000	1,204,500	19,200	17,600	1.6%	1.5%	41%	63	68
Ballsbridge	1,900,000	2,080,500	33,600	30,800	1.6%	1.5%	42%	62	68
Drumcondra	875,000	958,125	21,600	19,800	2.3%	2.1%	59%	44	48
Docklands	523,000	564,840	18,000	16,500	3.2%	2.9%	83%	31	34
Sandymount	2,000,000	2,190,000	30,000	27,500	1.4%	1.3%	35%	73	80
Terenure	1,000,000	1,095,000	26,400	24,200	2.4%	2.2%	63%	41	45

* Total price includes stamp duty and 0.5% legal fees

** Net rent is based on 11 months' rent: one month is debited for voids/costs

*** LTV break-even is based on an interest-only mortgage at an interest rate of 3.5%

Source: Davy; www.daft.ie; various newspapers

Table 2: Yield comparisons across Dublin incorporating AMV plus 20%

Dublin	AMV +20%*	Total price	Rent	Net rent	Gross yield	Net yield	LTV break-even	P/E gross	P/E net
Clontarf	1,320,000	1,445,400	19,200	17,600	1.3%	1.2%	34%	75	82
Ballsbridge	2,280,000	2,496,600	33,600	30,800	1.3%	1.2%	35%	74	81
Drumcondra	1,050,000	1,149,750	21,600	19,800	1.9%	1.7%	49%	53	58
Docklands	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Sandymount	2,400,000	2,628,000	30,000	27,500	1.1%	1.0%	29%	88	96
Terenure	1,200,000	1,314,000	26,400	24,200	2.0%	1.8%	52%	50	54

*For illustrative purposes: actual final sales prices exceed AMVs by a significant percentage at present

Source: Davy; www.daft.ie; various newspapers

For a novice buy-to-let investor, the arithmetic is now prohibitive. Take, for example, a house under the title “Worth the Investment?” in the property section of one of last week’s broadsheets. This was a four-bedroom townhouse in Ballsbridge, Dublin 4, with an AMV of €1.9m, close to the site bought from former ISEQ-listed Jurys Doyle for €54m per acre last year. On a traditional (capital and interest) 90% mortgage over 25 years, the cash flow shortfall would reach almost €83,000 annually. And remember, an investor is down 10% immediately because of stamp duty and costs.

Interest-only is the only option that makes such an investment possible but the break-even point requires an ever-increasing amount of initial capital. Take again the house in Ballsbridge, and others in Clontarf and Sandymount listed in Table 1. In each case, a loan-to-value (LTV) of less than 42% is required in order to cover the repayments with rent. In other words, a buyer would have to put up at least 58% of the total value of the property, including stamp duty and costs, at the beginning in order to avoid a cash flow drain each month. For each calculation we assume the lowest available variable interest rate of 3.5%. When mortgage rates rise to 4%, as they will later this year, the break-even LTV on the Ballsbridge property will fall further from 42% to 37%. Repeating the calculation based on a traditional mortgage, the LTV needed to cover annual repayments falls to 27%. All three properties mentioned are trading on a price-to-earnings (rents) ratio of 65x+. If prices continue to rise at 20% for the next three years and rents grow by an optimistic 5% per annum, the price of all of these houses will be 100 times the annual rent earned by 2009.

The evidence summarised in Table 1 refutes the theory that supply shortages are leading to rocketing prices in “desirable areas”. If that was the case, residential rents would be rising rapidly, but they are not. On a countrywide basis, private rents increased just 4% year-on-year in the latest quarter and were unchanged over a five-year period. Since April 2001, house prices are up 52% on average nationwide but rents are down 2%! The average P/E in Ireland on second-hand houses using net yields—11/12ths of annual gross rent—from official Central Statistics Office figures is now 40x, up from 26x five years ago and 13x ten years ago.

The proposition that scarcity of land close to the city-centre makes residential property a low-risk investment is not supported by evidence from other countries. The same argument was made in Japan in the late 1980s, as property soared in value. Residential land prices in Tokyo are down almost 60% since March 1990; there has been a year-on-year decline in every year since. Moreover, property is a risky asset, like equities, corporate bonds and commodities. Net yields of 1.5%, which are commonplace in Dublin, look ridiculous compared with a risk-free rate of 3.5% on ten-year gilts. It is better to compare residential property to a similar risky asset like the ISEQ index, which has an earnings yield of 7%. Not only that, but Irish listed companies’ profits are growing three times as quickly as rents in Dublin.

Investors must be extremely bullish about rental growth in order to justify the sort of record valuations ascribed to residential property in central Dublin. To us, this looks like boundless optimism. Supply in Dublin is set to remain plentiful for the next couple of years as we continue to build houses at a rate four times quicker than the European average. Meanwhile, interest rates will rise by at least one percentage point over the next year, pushing investors' break-even point lower and lower. The amount of cash sloshing around due to SSIA's and tax cuts, and the current buoyancy of the housing market, suggest that valuations will become even more stretched over the next 18 months. But the fundamentals suggest that it will be an adjustment in prices, rather than rents, that will eventually bring valuations down to more realistic levels.

Important disclosures

Analyst certification

I, Rossa White hereby certify that : (1) the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed in this report.

Share ownership policy

Davy allows analysts to own shares in companies they issue recommendations on, subject to strict compliance with our internal rules governing own account trading by staff members.

We are satisfied that our internal policy on share ownership does not compromise the objectivity of analysts in issuing recommendations.

Conflicts of interest

Our conflicts of interest management policy is available at <http://www.davy.ie/ConflictOfInterest>.

Davy is part of Bank of Ireland Group.

The remuneration of the analyst(s) who prepared this report is based on various factors including company profitability, which may be affected to some extent by revenues derived from investment banking. We are satisfied that this has not compromised the report's objectivity.

Stock Exchange Act, 1995

Davy is a member of the Irish Stock Exchange and the London Stock Exchange, authorised by the Financial Regulator under the Stock Exchange Act, 1995. No part of this document is to be reproduced without our written permission. This publication is solely for information purposes and does not constitute an offer or solicitation to buy or sell securities. This document has been prepared and issued by Davy on the basis of publicly available information, internally developed data and other sources believed to be reliable. Whilst all reasonable care has been taken in the preparation of this document, we do not guarantee the accuracy or completeness of the information contained herein. Any opinion expressed (including estimates and forecasts) may be subject to change without notice. We or any of our connected or affiliated companies or their employees may have a position in any of the securities or may have provided, within the last twelve months, significant advice or investment services in relation to any of the securities or related investments referred to in this document.

US Securities Exchange Act, 1934

This report is only distributed in the US to major institutional investors as defined by S15a-6 the Securities Exchange Act, 1934 as amended. By accepting this report, a US recipient warrants that it is a major institutional investor as defined and shall not distribute or provide this report or any part thereof, to any other person.

Davy, Research Department, Davy House, 49 Dawson Street, Dublin 2.

Confidential © Davy 2006.