Irish election threatens political uncertainty

**DAVY VIEW**

Our central view is that Fine Gael and Labour will fall short of a majority but may form a looser coalition with independent candidates and/or new parties Renua and the Social Democrats. However, the polls are uncertain and may understate support for the government parties.

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**Government gaining support but may struggle to form majority**

Opinion polls suggest that Fine Gael and Labour will fall short of a majority by 5-20 Dáil seats. Our central view is that a small shortfall will allow a looser coalition with independent candidates and/or new parties Renua and the Social Democrats. However, the polls are very uncertain. A Fine Gael-Fianna Fáil coalition or a stalemate leading to political uncertainty cannot be ruled out. With rising support for Fine Gael to above 30%, it is difficult to see any government that does not include this party – so the status quo in terms of economic and financial policy should be maintained. Fears of a more radical Syriza-style government, including left-leaning elements and Sinn Féin, is not plausible.

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**Opinion polls in Ireland can be unreliable**

Irish opinion polls can be misleading and can move sharply prior to elections. Mid-term polls attract a protest vote, but recent surveys indicate that Irish voters are increasingly satisfied with the direction the country is taking, suggesting that support may still ebb towards government parties. Irish opinion polls also systematically overstate support for Sinn Féin because its support is drawn from less affluent, younger voters who are less likely to vote. In addition, Sinn Féin’s historical baggage means that it is a toxic brand to many voters and struggles to pick up transfers in Ireland’s Single Transferable Vote system.

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**With fiscal consolidation complete, debt sustainability is assured**

In the absence of fully costed manifestos, the battleground ahead of the general election has been focused on voters who have not yet felt the recovery, with almost all parties promising lavish income tax cuts, spending rises and higher minimum wages. However, the €12bn ‘fiscal space’ upon which these promises rest looks questionable. As financial realities hit home, many pre-election promises may not be fulfilled. EU fiscal rules will also help to limit the ambition of Irish politicians. The bigger picture is that Ireland’s fiscal consolidation is complete, with a primary surplus achieved, low debt interest costs locked in and the debt/GDP ratio being pushed down sharply by strong nominal GDP growth.

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**Political pressure on banking sector and housing markets**

2015 saw political pressure on banks to cut mortgage interest rates. Both of the two main opposition parties indicate that they would give the Central Bank the power to regulate interest rates. Attempts to dilute or circumvent mortgage lending rules appear off the agenda, but Labour and Fianna Fáil are proposing to top up savings for first-time buyers. The key development to address housing shortages was the announcement that NAMA will now target construction of 20,000 homes by 2020.
Irish election threatens political uncertainty

Ireland’s strong economic recovery and emergence from the EU/IMF programme of funding support has made it a ‘poster child’ for austerity. GDP is now expected to have grown by close to 7% in 2015, buoyed by strong export performance and with the domestic economy making a growing contribution to growth. In 2015, Ireland’s gross debt to GDP ratio fell below 100% for the first time, and the deficit looks set to equal 1.5% of nominal GDP.

In this context, movements in Irish government bond yields have long diverged from Greece, Portugal and Spain. With the debt/GDP ratio on a clear downward path, and Ireland still set to realise windfall gains from selling its remaining stakes in the banking sector, the question has moved to whether Irish yields can converge with the ‘outer-core’ of Austria, Belgium and Netherlands.

However, amid that success, Ireland’s election in 2016 has come on the horizon, with opinion polls suggesting that the incumbent Fine Gael and Labour parties could struggle to attain a majority. Opinion polls had shown support for the Sinn Féin party and independents rising close to 50% at times following the fiscal consolidation. Despite recent improvements in support for Fine Gael, current polls still suggest that it may be difficult to form a majority government after the election without a broader coalition.

In this context, political uncertainties threaten to interrupt Ireland’s clear success story, with the prospect of a referendum on Brexit in the UK (and its implications for Ireland) also on the horizon.

Political support for Fine Gael has strengthened

Last year, we asked independent political scientist David Farrell to conduct an analysis entitled ‘Outlook for the political landscape in Ireland 2015-2017’; this was accompanied by our own discussion of the economic and financial sensitivities, ‘Political risks to Ireland’s recovery’. These reports provide an in-depth overview of the political landscape in Ireland and the broad policies of the different political parties. In this joint report, we update our analysis. In Section 1, David Farrell outlines political developments over the past 12 months. In Section 2, Conall Mac Coille outlines policy positions and economic and financial sensitivities heading into the election.

The key prediction from David Farrell’s analysis in early 2015 was that the economic recovery would ultimately lead to increased support for the incumbent Fine Gael and Labour government. Twelve months on, that thesis has proven broadly correct with Fine Gael now garnering over 30% in opinion polls. However, current polls still suggest that it may be difficult to form a majority after the election. However, as in other countries, the polls may be incorrect; they may move sharply during the election campaign and tend to systematically overstate support for Sinn Féin.

Heady pre-election promises may not come to fruition

Heading into the election, the main political parties have yet to publish their detailed manifestos outlining tax and spending commitments. However, pre-election promises have a strong left-leaning focus, targeted at voters that have not yet felt the recovery. All of the key parties have already committed to effectively abolish the Universal Social Charge (USC), at least for low- and middle-income earners. This poses the risk of unsustainably narrowing the tax base, although it remains to be seen whether these commitments will be acted upon once the financial reality of losing €4bn of revenue hits
home. The Labour party has committed to raise the minimum wage by €2 to €11.30 per hour.

Thankfully, the starting point for the new government will be a deficit close to balance, a primary surplus achieved with low debt servicing costs locked in and with buoyant nominal GDP growth pushing down sharply on the debt/GDP ratio. EU fiscal rules will also constrain the ambitions of Irish politicians to raise spending aggressively. Also, the apparent €12bn of ‘fiscal space’ out to 2021, from which election promises are being drawn, does not include any increase in pensions, social welfare, public sector wage rises from 2019 or any indexation of tax bands or credits to CPI inflation. The new government may well find spending pressures mean that there is considerably less room for manoeuvre than the €12bn of fiscal space identified in Budget 2016.

**Political pressures on banking sector emerge**

Through 2015, political interference in the banking sector reared its head. In May, the Minister for Finance conducted a series of meetings with the six main mortgage lenders, saying that, in his view, standard variable rates being charged in the Irish market were too high. Moreover, the Minister threatened “the issue of a penal banking levy in the budget, or powers for the Central Banks to regulate interest rates will be considered at that time if sufficient progress is not made”. Mortgage interest rates had been cut in late 2014, with a diminishing pool of mortgage loans intensifying competition for new business.

The Minister for Finance has remained resolute that a sale of equity in Allied Irish Banks will take place in H2 2016. Neither Fianna Fáil nor Sinn Féin has made clear statements regarding their intentions in this regard. Sinn Féin leader Gerry Adams has in the past said that a potential sale of Allied Irish Banks was not a red line issue and would be subject to negotiation should his party enter a coalition government. The over-arching consideration is that state asset sales could reduce Ireland’s debt/GDP ratio by close to 10%, limiting the scope for interference in the sector or the divestment process. Realising this value will be a key goal for the next government, especially with the media narrative focused on retrieving as much as possible of the €64bn cost of recapitalising the banking sector.

Despite efforts to finally address the mortgage arrears issue, there has been limited action in this area through 2015. Having completed the Central Bank’s mortgage arrears resolution targets, headline arrears rates have continued to decline. However, a hard-core of long-term, 720+ days in arrears cases show little sign of resolution, currently making their way through the court system at an exceptionally slow pace. Two developments in 2015 were a reduction in bankruptcy terms from three years to one year and a dilution in banks’ voting rights to block personal insolvency arrangements (PIAs).

**NAMA targets 20,000 housing completions by 2020**

2016 saw the introduction of the Central Bank’s first macro-prudential tools – specifically, limits on high loan-to-value (LTV) and loan-to-income (LTI) mortgage loans, contributing to slowing house price inflation in Dublin. Since then, pressure to address the lack of housing supply and rising rents has intensified, culminating in the government’s decision to limit rent reviews to once every two years.

Supply-side reforms have been limited. Instead, the Minister for Finance tasked NAMA to conduct a review of the potential to build residential property on development land under its control, leading NAMA to announce a target to build 20,000 homes by 2020.
90% of which will be in the greater Dublin area. Other constraints such as access to finance, the planning system, high construction sector wages and other costs remain largely unresolved. For investors, a positive is that the government is now determined to stimulate housing supply. However, the only tangible outcome so far is that NAMA will undertake construction itself.
Section 1: Recent polling trends and political developments

In our analysis last year, we speculated that the autumn of 2014 may have been a high watermark for left-leaning, ‘anti-austerity’ parties such as Sinn Féin and left-wing micro-parties and independents that had gained support at the expense of the government parties. That period was dominated politically by controversy surrounding new water charges. At that time, the tax cuts announced in Budget 2015 had still to hit Irish households’ pay packets.

As that point (in January 2015), Sinn Féin’s support in opinion polls was averaging 22% (more than double its 10% vote tally in 2011), while the independents were on 27% (an increase on their combined 2011 vote tally of 15%), which – as we noted at the time – made this collectively ‘the most popular group in Irish politics today’. At that stage, Fine Gael was averaging 23.5% and Labour 7% – not the most electorally comfortable of positions for the two governing parties.

One year on, the government has announced a second giveaway budget including additional tax cuts. In addition, there is now more tangible evidence that the economic recovery is feeding through into wage and income growth for households. In the year to Q3 2015, private sector average earnings rose by 3.6%. These developments should clearly have helped the incumbent Fine Gael and Labour parties attract political support. As Figure 1 shows, the trend lines have shifted over the past 12 months: Fine Gael has seen its largest and most sustained increase in support, while Sinn Féin and the independents have lost support.
Figure 2 summarises the current state of play. Taking into consideration polling trends through 2015, our thesis has proved broadly correct. The poll of polls shows a clear gain in support for Fine Gael (up 7 percentage points over the past year). However, the Labour party has had less success (up just 1 percentage point in the period). In contrast, Sinn Féin’s support has dropped to 19%, down from 22% last year. Support for independents/others has declined by 6 percentage points to 21%. Fianna Fáil’s support has shown no change through the year, remaining at 19%, showing how that party is struggling to gain traction under the leadership of Micheál Martin.

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**How reliable are Ireland’s opinion polls?**

In Ireland, as elsewhere, mid-term opinion poll trends are notorious for underestimating true government support. Respondents are prone to exaggerate their dissatisfaction with the government of the day, using the opinion poll as an opportunity to register their protest with one or other aspect of government policy. This has been quite evident over the past 12 months as support for ‘anti-austerity’ parties has ebbed away as the reality of the recovery has become established in public opinion and those denying the improvement in economic conditions have lost credibility.

A key point is that Ireland’s opinion polls tend to systematically overstate support for Sinn Féin. This is because Sinn Féin’s support is greatest among the least well off and younger voters who are less likely to vote. The party consistently receives most support from those in the 25-34 age bracket, making it the strongest party among younger voters. Its support tends to be noticeably lower among older voters.

Sinn Féin’s poor performance relative to opinion polls has been evident on several occasions in the recent past. In 2011, its presidential candidate, Martin McGuinness, came third, winning less than 14% of the popular vote – well below polls predicting 20% support. In the May 2014 local elections, opinion polls predicted that Sinn Féin would attract 22% of support; however, the party won just 15% of votes. This raises an important question regarding the degree to which the polls may simply overestimate the party’s support.
In addition, Sinn Féin’s historical baggage means that it is still a toxic brand to many voters, while also attracting a hard core of dedicated support. This is especially so while it retains Gerry Adams as leader. Recent revelations regarding the continuing hold that the IRA Army council has over the Sinn Féin leadership has not helped the party’s efforts to become more mainstream in the political system. This means that Sinn Féin struggles to pick up transfers in Ireland’s single-transferable vote system (STV), a crucial requirement to win Dáil seats.

There is also little reason to expect much electoral success for hard left elements among the independents and the micro-parties. The most significant initiative in recent months has been the efforts of the Anti-Austerity Alliance (AAA) and People Before Profit (PBP) – both far-left micro parties – to develop a common platform. However, the efforts have not amounted to much: the only name they could agree to call themselves is ‘AAA-PBP’; there is no agreement on a common leader; and they remain divided on core areas of policy and also on strategy (notably over whether they would countenance any cooperation with Sinn Féin). In short, the intense rivalry among the far left remains one of the constants of Irish politics.

What can we say about support for the government parties? How robust are the figures reported in Figure 2? What potential is there for further gains over the course of the election campaign? Clearly, it is not possible to give firm predictions; opinion polls at best provide a mere snapshot of public opinion at the time of the poll, and there is a risk – as we saw in the recent British elections – that the polls may be inaccurate.

Nevertheless, there are some indications from a recent poll (Sunday Business Post/Red C, published on January 17th 2016) that are pretty positive for the government parties (at least for Fine Gael). The analysis presented in Figure 3 provides some important clues.

Figure 3: Attitudes towards government and the economy

![Figure 3: Attitudes towards government and the economy](http://www.redcresearch.ie/wp-content/uploads/2016/01/SBP-Jan-2016-Poll-Report-General-Election-Vote-Intention.pdf)

Figure 3 shows how the economic revival is impacting on voters and how this is starting to concentrate minds as the election date draws near: 68% of voters think the country is on the right track; 42% are feeling the benefit of the economic recovery personally;
68% of voters think the country is on the right track

Almost half (46%) fear a change of government could stall the recovery. These trends suggest a strong potential constituency of support for the status quo.

The one fly in the ointment is the 60% who feel that, now the recession is over, a new government is needed to deliver a fairer society. It is likely that this indicator was influential in provoking recent announcements by the Minister for Finance that any future expansionary budgets would privilege expenditure rises over tax cuts.

The fact that Labour is struggling at about 8% is a cause for concern; it should expect support closer to 10%. If it performs badly in the election, it may choose to stay out of government, allowing it time to lick its wounds in opposition. The general feeling, however, is that this would be more likely in the event of a minority government being formed; if there is a chance of a new majority coalition, Labour is likely to want to be part of that.

There is also speculation over which other parties or individuals might be included in the ‘gene pool’ of potential support for a new coalition formed around Fine Gael and Labour. The contenders include: independents not on the far left or one or other of the new micro parties – Renua (led by Lucinda Creighton, attracting 1-3% in the opinion polls), the Social Democrats (established by three independent TDs, also attracting 1-3%).

The general view is that, in the first instance, Fine Gael and Labour would seek to pick off a few old stalwarts among the independents (e.g. Michael Healy-Rae, Noel Grealish, Denis Naughten, Michael Lowry, Finian McGrath or perhaps someone like Michael Fitzmaurice) before considering adding one of the new micro parties into the mix; this is due to some personality issues at the top of the new parties and also the practical reason that independents would not expect Cabinet positions.

Which parties could form a broader coalition?

**Renua:** formed by party leader Lucinda Creighton, who, together with three other Fine Gael TDs, was expelled from the party in 2013 after defying the party whip on an important vote relating to abortion. Its manifesto places the party firmly to the right of Fine Gael, proposing a flat 23% rate of income tax and a ‘three strikes and you’re out’ rule for dangerous criminals. Although Renua’s proposals for a flat rate of income tax are not realistic, its natural coalition partner would be Fine Gael, putting personal animosities aside after the election.

**The Social Democrats:** formed in July 2015 by three independent TDs, Stephen Donnelly, Catherine Murphy and Roisin Shortall. The latter is a former member of the Labour party, having resigned her junior ministerial position in September 2012 following disagreements with then Health Minister James Reilly.

The party’s manifesto places it on the centre-left, close to the Labour party, containing many laudable goals such as eliminating child poverty and providing affordable housing, but with no costings or financial plans to achieve these objectives. The manifesto does indicate that the Social Democrats would leave the USC in place to maintain a broad tax base but with few other specific proposals on taxation. In this context, there are red-line issues that would prevent the party entering a coalition government.

**The Independent Alliance:** founded in January 2015 by five independent TDs – the most prominent being Shane Ross. Ross has emerged as a spokesperson for the upwardly mobile middle classes that were hurt financially by the recession. Despite his
hostility to the banking sector, he remains to the right-of-centre in his political views. Less can be said on the disparate views of the remaining members. John Halligan is a former member of the Workers Party. Michael Fitzmaurice was principally elected due to his opposition to a ban on turf cutting. Tom Fleming is a former Fianna Fáil member of Kerry county council. Independent TD Finian McGrath initially pledged his support for the Fianna Fáil government in 2007 but withdrew his support in 2008 following unpopular budget cuts. It therefore remains highly questionable whether the Independent Alliance can form a coherent block with which to form a coalition government.

Scenarios for government after the election
It is fairly clear that we are not likely to end up with the type of stalemate witnessed recently in Portugal and Spain where different constellations of parties compete for power. The poll trends, Sinn Féin’s ‘toxic’ brand, the internal divisions in the hard left and the relative disproportionality of the electoral system (i.e. that it is ‘unfriendly’ towards smaller parties) combine to make it all but impossible for a government to be formed that doesn’t have Fine Gael at the heart of it.

Based on current poll trends, the coalition government is going to be short of the 79 seats required for an overall majority in the Dáil. As we argued above, it is possible that Fine Gael and Labour’s poll trends could improve as the election campaign unfolds, but current figures suggest that the parties could be anything between five and twenty seats short of a majority.

If the gap between Fine Gael and Labour’s coalition and an overall majority is only in single figures, then attention will turn to the potential for support from among ‘friendly’ independents or perhaps one or other of the new parties – Renua or the Social Democrats – each expected to win three or more seats. However, if the gap is in double figures, fresh elections cannot be ruled out. At this point, the two most likely outcomes are as follows:

• A version of the status quo: the current government perhaps with some additions from among like-minded independents and micro-parties. We cannot entirely rule out the possibility of a coalition between Fine Gael and Fianna Fáil.
• A minority government: either Fine Gael on its own or in coalition with Labour and other elements. This scenario would most likely result in fresh elections within a few months.

In the event that a minority government is formed, the expectation would be that it would be unlikely to pass a budget in October, thus sparking fresh elections – something Ireland experienced in the early 1980s and which ultimately resulted in a stable two-party coalition.
Section 2: Key policy positions and economic and financial sensitivities ahead of the general election

The main political parties have yet to publish their election manifestos. However, party conferences (Ard Fheis) in early 2016 have been accompanied by a range of election promises, albeit mainly uncosted and lacking detail. Of late, controversy has emerged that the political parties are assuming a far higher degree of ‘fiscal space’ than is actually available.

Both Fine Gael and Labour have indicated that there is €12bn (6% of GDP) available over the next five years to allocate between tax cuts and spending increases. However, the €12bn figure is not entirely indexed to CPI. That is, it does not incorporate any increase in tax bands and credits or social welfare payments and pensions that might be expected to increase in line with CPI inflation over the next five years.

Perhaps the most notable trend among the policy commitments is that Fine Gael appears to see little competition for right-wing voters. Despite being the only large right-of-centre party, Fine Gael has matched Labour and Fianna Fail’s commitments to cut the USC (the most broad-based part of Ireland’s income tax system) for lower- and middle-income workers and for higher minimum wages/earnings. Table 1 illustrates some of the key policy initiatives announced so far. The battleground for votes is focused on the centre-left voters who have not yet felt the recovery. In this sphere, no party appears willing to be outbid by its opponents on tax cuts, higher minimum wages or spending increases.

At the same time, the pre-election promises also appear designed to have broad appeal. Most of the parties have included initiatives to benefit the self-employed, pensioners and parents – a ‘no voter left behind’ strategy to maximise support at the election.
For these reasons, pre-election promises by Irish political parties need to be taken with a heavy dose of salt. Many of the commitments are only to be achieved by the end of the next Dáil and on the proviso that economic growth and the health of the public finances allow them to be implemented. There is ample room for parties to row back from rash promises made prior to the election.

Perhaps the most worrying development is the focus on abolishing the USC. Unfortunately, the USC has become synonymous with the EU/IMF fiscal consolidation programme. The prospect of abolishing the USC has a strong resonance with voters, especially for the incumbent parties keen to illustrate progress under the current government.

Ultimately, any plan to abolish the USC will have to confront the reality that it represents €4.2bn of revenues, close to 10% of the total. It may turn out that while the USC may be ‘abolished’, satisfying pre-election commitments, the revenues will be found elsewhere. For example, a re-branding or re-orientation of the income tax system could occur to maintain revenues. Minister for Finance Michael Noonan has already indicated that Fine Gael’s proposals to abolish the USC will include some additional mechanism to ‘claw-back’ revenues from higher earners. When Irish party election manifestos are published, it will be interesting to see how proposals to abolish the USC are costed.

Nonetheless, the risk remains that Ireland’s income tax base could be narrowed, repeating the mistakes of the Celtic Tiger era. In 2010, 45% of income earners were exempt from paying income taxes. The introduction of the USC addressed this problem, with only 31% exempt, broadening the tax base. One unwelcome step in Budget 2016 was the exclusion of 42,500 workers from the USC by raising tax bands. This is in the context of one of the most redistributive tax systems in the OECD, with the top 10% of income earners accounting for over 65% of income tax (including USC) revenues.

Ireland’s tax-benefit system is already one of the most redistributive across the OECD.

Fiscal policy – the heavy lifting has been completed

Ireland’s 2015 fiscal out-turn beat all expectations, set to come in at 1.5% of GDP – well inside the budget target of 2.8% and despite a policy decision to increase spending by €1.5bn (0.75% of GDP) ahead of the coming election. This means that Ireland will run a primary budget surplus for a second consecutive year of almost 1.5% of GDP, with debt interest payment close to 3% of GDP.
In Budget 2016, the government expected to reduce the deficit by 1 percentage point this year despite another €1.5bn package of tax cuts and spending rises. While the decision to announce a second consecutive giveaway Budget has drawn criticism from the Central Bank of Ireland, Irish Fiscal Advisory Council (IFAC), European Commission and IMF, the bigger picture is that the process of deficit reduction is now close to complete.

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2015 Target</th>
<th>% outperformance</th>
<th>% yoy change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax revenues</strong></td>
<td>45.6</td>
<td>42.3</td>
<td>7.8%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Income tax</td>
<td>18.4</td>
<td>18.0</td>
<td>2.1%</td>
<td>7.0%</td>
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<tr>
<td>VAT</td>
<td>11.9</td>
<td>11.8</td>
<td>1.4%</td>
<td>7.1%</td>
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<tr>
<td>Excise duties</td>
<td>5.3</td>
<td>5.2</td>
<td>0.9%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Corporation taxes</td>
<td>6.9</td>
<td>4.6</td>
<td>50.2%</td>
<td>48.9%</td>
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<tr>
<td><strong>Total revenues</strong></td>
<td>60.2</td>
<td>56.6</td>
<td>6.2%</td>
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</tr>
<tr>
<td><strong>Gross current expenditure</strong></td>
<td>50.8</td>
<td>49.3</td>
<td>3.2%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Social Protection</td>
<td>19.9</td>
<td>19.3</td>
<td>2.8%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Health</td>
<td>12.9</td>
<td>12.2</td>
<td>5.8%</td>
<td>-3.1%</td>
</tr>
<tr>
<td>Education</td>
<td>8.5</td>
<td>8.3</td>
<td>2.4%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Other</td>
<td>9.6</td>
<td>9.4</td>
<td>1.4%</td>
<td>5.3%</td>
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<tr>
<td><strong>Gross capital</strong></td>
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<td>3.6</td>
<td>5.7%</td>
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<tr>
<td>Debt interest</td>
<td>7.0</td>
<td>7.7</td>
<td>-9.3%</td>
<td>-6.6%</td>
</tr>
<tr>
<td><strong>Total expenditure</strong></td>
<td>63.9</td>
<td>62.8</td>
<td>1.9%</td>
<td>0.5%</td>
</tr>
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<td><strong>General Government Balance items</strong></td>
<td>-3.8</td>
<td>-6.1</td>
<td>38.2%</td>
<td>50.1%</td>
</tr>
</tbody>
</table>

Source: Department of Finance

One note of caution is that the €3.5bn outperformance of tax revenues in 2015 mainly reflected buoyant corporation taxes, €2.2bn, or 50%, ahead of target. The Irish revenue commissioners indicated that the bulk of these payments should be repeated in 2016, reflecting increased activity by companies rather than once-off temporary payments. Indeed, the ICT and pharmaceutical sectors both continue to grow, the latter bouncing back after patent cliff-depressed revenues in recent years. Nonetheless, as a small open economy, Ireland’s corporate tax base will always be vulnerable to global developments.

It is also worth bearing in mind the government’s track record in hitting deficit targets. Budget forecasts have tended to rely on conservative assumptions, particularly on non-tax revenues, to ensure targets are met (Table 1). Through 2012-2013, the end-year deficit was well inside the initial projections. Looking forward to 2016, the official revenue, expenditure and deficit forecasts do not look overly optimistic. Starting from a more favourable base of 1.5% of GDP and with a 1pp improvement for the deficit already pencilled in, a surplus in 2016 is certainly a possibility.

Nonetheless, the government’s decision to implement two successive giveaway Budgets – one worth €3bn, or 1.5% of GDP, in 2016 and a smaller €1bn package worth 0.5% of GDP in 2015 – have attracted criticism from the Central Bank of Ireland, European Commission, Irish Fiscal Advisory Council (IFAC) and IMF. The sensitivity around fiscal policy has been heightened by the range of promises from both government and opposition parties in the lead-up to the general election.
Now that Ireland has achieved its objective of reducing the government deficit below 3% of nominal GDP, it will move to the preventative arm of the Stability and Growth Pact (SGP). The key requirement is that the public finances are on a path towards a structural budget balance. It can be argued that Ireland is already running a structural, cyclically adjusted surplus. Put another way, because the Irish economy still has room to ‘catch-up’, as it closes spare capacity and its significant negative output gap, the government balance will naturally move into surplus.

The Department of Finance and the European Commission both estimate that Ireland’s output gap is now positive, the former by 2.5% of GDP, suggesting that Ireland’s economy is now ‘overheating’. The IMF estimates that Ireland’s output gap is still negative at 0.5% of GDP. These views seem highly conservative given Ireland’s still high unemployment rate. Employment in Ireland is still 8.7% below its pre-recession peak.

Nonetheless, the Department of Finance estimates that Ireland will only have achieved its Medium Term Objective (MTO) of a structural budget balance by 2019. So, according to the fiscal rules, expenditure can only rise by a rate linked to the potential growth of the economy – currently estimated at 1.9% after revenue-raising measures. These rules may act as a constraint on plans by politicians to raise spending at a more aggressive pace.

<table>
<thead>
<tr>
<th>Table 3: Projections for Ireland and UK cyclically adjusted balances, 2015</th>
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<tbody>
<tr>
<td>Government balance, % of GDP</td>
</tr>
<tr>
<td>Ireland</td>
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<tr>
<td>UK</td>
</tr>
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</table>

Some investors may have little faith in untested EU fiscal rules to ensure restraint by governments. However, it is worth pointing out that the key reason Ireland’s debt/GDP
Irish economy

Ireland is already running a primary budget surplus, with low debt interest locked-in, so the debt/GDP ratio is being pushed down by strong nominal growth.

The ratio is expected to fall is because of nominal GDP growth rather than substantial budget surpluses.

Table 4 and Figure 7 illustrate the respective contributions from expected real GDP growth, inflation, debt interest and the government balance. A key point here is that Ireland’s debt to GDP ratio is expected to have fallen by 10 percentage points to 97.0% of nominal GDP by end-2015. Furthermore, Ireland is already running a primary surplus, helping to reduce the debt/GDP ratio. The government has based its forecasts on an average interest rate on debt close to 3.2% through 2016-2018 and 2019-2020. This rate has largely been locked in by recent long-term issuance, with Ireland’s 10-year bond yield trading at 0.95%. So, if anything, debt interest costs could be lower than expected going forward.

However, even if government deficits fail to be sustained, Ireland’s strong nominal GDP growth will push down the debt/GDP ratio. Table 4 shows that the pace of nominal growth is sufficient to reduce the ratio by 3-4 percentage points per annum. Another key point is that the official projections do not include any windfall gains from sales of Irish banks, with Allied Irish Banks set to return to the market in late 2016. Overall, the Irish government’s banking sector stakes are currently valued at close to 8% of nominal GDP. In summary, with the heavy lifting of achieving a primary surplus now achieved, it would take an enormous about-turn in Irish fiscal policy to endanger the downward trajectory of the debt/GDP ratio.

Figure 7: Change in Ireland’s debt/GDP ratio

Source: European Commission, January 2016

Table 4: Decomposition of change in debt/GDP ratio

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt/GDP</td>
<td>97.0</td>
<td>92.8</td>
<td>90.3</td>
<td>86.7</td>
<td>83.5</td>
<td>79.8</td>
<td>75.7</td>
</tr>
<tr>
<td>change</td>
<td>-10.5</td>
<td>-4.2</td>
<td>-2.5</td>
<td>-3.6</td>
<td>-3.2</td>
<td>-3.7</td>
<td>-4.1</td>
</tr>
<tr>
<td>Primary deficit</td>
<td>-1.1</td>
<td>-1.7</td>
<td>-2.3</td>
<td>-3.0</td>
<td>-3.6</td>
<td>-4.3</td>
<td>-4.8</td>
</tr>
<tr>
<td>Stock flow</td>
<td>-1.8</td>
<td>0.2</td>
<td>1.1</td>
<td>0.5</td>
<td>1.3</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>-10.8</td>
<td>-5.6</td>
<td>-4.2</td>
<td>-3.9</td>
<td>-3.6</td>
<td>-3.3</td>
<td>-3.1</td>
</tr>
<tr>
<td>Debt interest</td>
<td>3.2</td>
<td>3.0</td>
<td>2.9</td>
<td>2.8</td>
<td>2.6</td>
<td>2.5</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Source: Department of Finance
Foreign Direct Investment

Heading into the election, none of the main political parties has called for a change in Ireland’s 12.5% corporation tax rate\(^1\). The government remains resolute that the 12.5% rate will remain a cornerstone of Irish industrial policy. No political party will try to upset a clear success story of attracting foreign direct investment (FDI) into Ireland, helping the economy out of recession.

Through 2015, FDI into Ireland remained exceptionally strong despite the end of the ‘double-Irish’ tax structure to new entrants. Ireland also completed legislation for a new ‘Knowledge Development Box’ with a 6% rate. However, as in other European countries, qualifying revenues for similar patent box structures are being tightly tied to R&D expenditures in the home country. Clearly, developments in corporation tax arrangements continue to evolve. However, the key changes emanating from the OECD’s base erosion and profit shifting (BEPS) project now appear to have taken place.

That said, the double-Irish is being gradually phased out for existing companies that used the structure by 2020. Slowly but surely, multinational companies already operating in Ireland will no longer be able to channel their profits to Bermuda and other offshore tax havens. If anything, speculation has emerged that Ireland’s tax revenues stand to benefit as these profits are brought back ‘on-shore’, a topical issue given Google’s recent tax deal with HMRC.

\(^1\) With the exception of micro party ‘People Before Profit’ who have called for an effective 12.5% rate to be applied to total corporate profits.
Banking sector – political pressures emerge

Pressure on mortgage rates and banking sector weigh on profitability

Through 2015, political interference in the banking sector reared its head. In May, the Minister for Finance conducted a series of meetings with the six main mortgage lenders, saying that, in his view, standard variable rates being charged in the Irish market were too high. Moreover, the Minister threatened “the issue of a penal banking levy in the budget, or powers for the Central Banks to regulate interest rates will be considered at that time if sufficient progress is not made”. Indeed, mortgage interest rates on standard variable rates fell or banks started to offer new products with lower interest rates through the summer of 2015.

Following meeting with banks’ in Q3 2015, the Minister for Finance commented that “Competition is the best long-term way of reducing interest rates paid by Irish borrowers and ensuring that Irish banks offer a sustainable product range”. However, questions remain on potential interference and independence of the banking sector ahead of Allied Irish Banks’ IPO, scheduled for H2 2015, as both Fianna Fáil and Sinn Féin have stated that they would introduce legislation on interest rate caps.

Moreover, in the October Budget for 2016, Minister for Finance Michael Noonan, as expected, extended the current bank levy of €150m per annum out to 2021, albeit subject to a review of the methodology used to calculate the levy, which could result in a redistribution of the charge among the impacted institutions. Given the rising cost of regulation, an extension to the bank levy until 2021 will further impact banks’ ability to generate sustainable returns on equity.

Prize of large reduction in Ireland’s debt/GDP ratio will still limit interference with divestment strategy

Ireland’s debt to GDP ratio is expected to fall to 97% of nominal GDP by end-2015. One key aspect copper-fastening Ireland’s debt sustainability is the future proceeds from sales of stake assets in the banking sector. At current valuations, the remaining stakes in Allied Irish Banks, Bank of Ireland and ptsb are close to 8% of nominal GDP.

The Minister for Finance has indicated that if the government is returned to power, it would move to commence the reprivatisation of Allied Irish Banks with an initial sale of a 25% stake with a preference to sell the stake in the autumn but “with the possibility of an earlier window if that suits”. The political narrative is still focused on recouping the investment in the on-going banks, and in particular the €21bn invested in Allied Irish Banks. This limits the scope for policies from any party that could impede the profitability of the sector.

Competition helping to erode elevated SVR mortgage rates

In 2015, we forecast that there were close to 47,750, or €4.5bn, of new mortgages issued for house purchase, an increase of 20% versus 2014. With repayments exceeding new lending, the stock of mortgage lending contracted by 3.6% through 2015. Pepper Mortgages recently entered the mortgage market and is expected to concentrate on the non-standard lending sector. Of late, the Governor of the Central Bank has indicated that a policy goal is to stimulate the switcher market. If successful, this would help households lower interest costs.

Radio silence on long-term mortgage arrears

Investors in Irish banks have focused on the potential for write backs on non-performing loans, particularly on mortgage loans that are conservatively provided for. In 2014, the
Central Bank’s mortgage arrears resolution targets (MART) required banks to put in place ‘solutions’ for all of their non-performing loans. An audit of this process by the Central Bank revealed that banks had passed this test, albeit with close to 50% of account holders still heading towards court proceedings rather than having engaged with banks or had their mortgages modified.

Headline mortgage arrears rates have continued to decline. In Q3 2015, 8.7% or 65,584 owner-occupier accounts were in arrears over 90+days, down from 11.2% in Q3 2014. However, a hard-core of long-term arrears cases show little sign of improvement. In Q3 2015, the number of accounts over 720 days in arrears equalled 5%, up marginally from 4.9% in Q3 2014. Similarly, long-term, 720+ days buy-to-let arrears rose from 10.8% in Q3 2014 to 11.1% in 2015.

However, the number of repossessions has remained at exceptionally low levels. Essentially, the 52,500 owner-occupiers in long-term arrears have not been dealt with and are now slowly making their way through the courts system. Anecdotal evidence and some studies of the court process show lengthy delays in dealing mortgages in long-term arrears. In this context, coverage of the mortgage arrears issue has received limited attention heading into the 2016 election. The risk remains that political pressures emerge after the election to delay this process still further.

To some extent, several policy measures were taken in 2015 that might weaken banks’ hand in debt restructuring negotiations. The bankruptcy term has been reduced from three years to one year, while the terms of PIAs have been changed, lowering the voting threshold for the veto of an arrangement and allowing debtors a right to appeal to the courts where a creditor has rejected the proposal.
No clear-cut messages on state asset sales in the banking sector from Fianna Fáil or Sinn Féin

There have been few clear-cut messages from either Fianna Fáil or Sinn Féin on their policies towards future sales of state assets in the banking sector. Sinn Féin has said that it would oppose further sales of stakes in the banking sector. However, leader Gerry Adams stated that a potential sale of Allied Irish Banks was not a red line issue and would be subject to negotiation should Sinn Féin enter a coalition government. Fianna Fáil’s latest statement on banking sector policy appears to concede that Allied Irish Banks will be returned to private sector ownership over the next five years.

Both Fianna Fáil and Sinn Féin have proposed powers for the Central Bank to regulate mortgage interest rates. However, neither party has set out how mortgage interest would be deemed to be excessive. Fianna Fáil has also proposed a statutory code on mortgage switching to help existing mortgage customers avail of new mortgage products. These sentiments were recently echoed by new Central Bank governor Phillip Lane in his comments at the Oireachtas Finance Committee, conceding that the switcher market is weak and that a more active switcher market is a goal for the Central Bank.

Sinn Féin’s menu of policies with respect to the banking sector can at best be described as hostile. It envisages increasing the existing bank levy to raise an additional €44m and imposing the cost of financial regulation onto the sector, raising another €70m. In addition, it would remove the banks’ veto in blocking PIAs.

So far, neither the Labour Party nor Fine Gael has indicated any significant banking sector policy change in their pre-election policy announcements.

<table>
<thead>
<tr>
<th>Table 5: Banking sector policies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sinn Féin</strong></td>
</tr>
<tr>
<td>Central Bank to set caps on SVR interest rates</td>
</tr>
<tr>
<td>Increase bank levy by €44m</td>
</tr>
<tr>
<td>Increase pressure on banks to resolve mortgage distress</td>
</tr>
<tr>
<td>Amend the Insolvency Act 2013 to remove the bank’s veto</td>
</tr>
<tr>
<td>Move the entire cost of financial sector regulation onto the banking sector €70m saving/cost</td>
</tr>
</tbody>
</table>

*Source: Fianna Fáil, Sinn Féin, Labour and Fine Gael*
Housing market policy attracts political pressure

The introduction of the Central Bank’s mortgage lending rules contributed to a sharp slowdown in house price inflation in Dublin in 2015 by rationing high LTV and LTI lending. At the same time, the lack of housing supply has continued to gain attention with just 12,600 completions – well short of the 25,000 estimated necessary to satiate natural demographic demand.

The Central Bank rules have shifted the focus onto measures to help housing supply. However, speculation has continued that the lending rules may be relaxed – as if they would suddenly yield an increase in housing supply. The new Governor, Philip Lane, has said that the LTV and LTI rules will be reviewed in November 2016. However, he also indicated that “the evidence threshold to justify adjustments to these rules is significant”. There have been several proposals to circumvent the Central Bank’s lending rules such as using mortgage insurance or help-to-buy schemes. However, the Central Bank has given a cool reception to such proposals. More recently, both Fianna Fáil and the Labour party have proposed that the state provide top-ups on savings by first-time buyers to help them save for a deposit.

The lack of housing supply has been associated with soaring residential rents. According to the Consumer Price Index (CPI), residential rents rose by 9.6% in the year to December 2015. In November, the government announced reforms, extending rent review periods to two years. However, these measures fell short of political pressure to index-link residential rents to CPI inflation.

Instead of allowing households to increase their leverage, the policy debate has focused on measures to stimulate supply. Minister for Finance Michael Noonan has committed that the next government will ensure housing output rises to 25,000 units by 2020. The government also announced rebates for developers on development levies paid to local authorities. In December, the Department of the Environment, Health and Local Government also announced new building standards for apartments – reducing the proportion required to have dual aspect and allowing for eight apartments per core rather than the previous four. The Department calculates that these new minimum standards would reduce build costs for apartments by €20,000 per unit. That said, this estimate has been highly disputed by industry experts, drawing attention to inconsistencies in the minimum standards.

Through 2015, the housing market and policy debate have adjusted to the Central Bank’s mortgage lending rules – towards efforts to stimulate supply

The governments’ new regulations set a two-year review period together with limited action to address supply constraints

Table 6: Construction sector policies

<table>
<thead>
<tr>
<th>Sinn Féin</th>
<th>Fianna Fáil</th>
<th>Labour</th>
<th>Fine Gael</th>
</tr>
</thead>
<tbody>
<tr>
<td>Build 100,000 social &amp; affordable homes</td>
<td>First-time buyer savings scheme, 25% top-up provided by the state, €5,000 cap</td>
<td>Save-to-buy scheme, 25% top-up provided by state, €6,000 cap</td>
<td>Commitment to double housing output to 25,000 by 2020</td>
</tr>
<tr>
<td>Re-instate PARTV 20% social &amp; affordable housing requirement on new developments</td>
<td>€7bn strategic investment fund to partly finance lending to homebuilders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent certainty – link rents to CPI inflation</td>
<td>Vacant site levy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Abolish property taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Fianna Fáil, Sinn Féin, Labour and Fine Gael
Irish economy

NAMA sets targets for residential construction

One year ago we speculated that political pressures relating to the housing market could raise questions regarding NAMA’s role. NAMA has always been politically contentious. The accelerated run-down in NAMA’s assets, resulting in a revised target that all senior bonds will be repaid by 2018, rather than 2020, has been criticised at finance committee hearings. Sinn Fein still indicates that it would revise NAMA’s wind-up deadline to 2020 and require a temporary freeze on all non-contracted disposals. However, the key development in 2015 has been the announcement of new targets for residential construction by NAMA.

In his Budget 2016 speech, the Minister for Finance indicated that he had asked NAMA to review residential sites under its control and estimate the number of residential units that could be constructed within five years. In response, NAMA is now aiming to deliver 20,000 units by 2020, 93% of which will be in the greater Dublin area. To achieve this target, NAMA will work with developers and will not compromise its mandate to deliver the best financial return to the taxpayer or compromise debt repayment commitments. To do so, NAMA will provide €4.5bn of funding, peaking at €1.8bn. NAMA has indicated that it will seek joint venture expressions of interest in early 2016.

Table 7: NAMA site planning lifecycle

<table>
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<th>Status</th>
<th>Total residential units</th>
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<tr>
<td><strong>TIER 1 sites</strong></td>
<td></td>
</tr>
<tr>
<td>Completed – end-2015</td>
<td>2,300</td>
</tr>
<tr>
<td>Under construction</td>
<td>2,950</td>
</tr>
<tr>
<td>With planning permission but not yet under construction</td>
<td>4,900</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td>10,150</td>
</tr>
<tr>
<td><strong>TIER 2 sites</strong></td>
<td></td>
</tr>
<tr>
<td>Planning applications lodged</td>
<td>3,900</td>
</tr>
<tr>
<td>Planning applications to be lodged within 12 months</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td>9,900</td>
</tr>
<tr>
<td><strong>TIER 3 sites</strong></td>
<td></td>
</tr>
<tr>
<td>Pre-planning work underway</td>
<td>16,850</td>
</tr>
<tr>
<td>feasibility and pre-planning on longer term sites</td>
<td>15,800</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td>32,650</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>52,700</td>
</tr>
</tbody>
</table>

Source: NAMA Investor Presentation, Dec 2015

Indeed, NAMA’s 2015 end-year view suggests that it intends to meet its residential construction targets – indicating that construction has already started on sites that will deliver 3,000 units. NAMA also indicated planning applications have been lodged (or will be in the next 12 months) for construction that will ultimately yield 9,900 units. Additional construction for a further 32,500 units was at a pre-planning or feasibility stage.

However, NAMA insists that it is still on track to meet its target to redeem all senior bonds by end-2018 despite its new ambitions on homebuilding. In 2015, NAMA saw €8.5bn of loan and asset sales and redeemed €5.5bn of senior bonds. This brings the total amount of senior bonds redeemed to date to €22.1bn, or 73%. NAMA is still targeting that 80% of its senior bonds will have been redeemed by end-2016.

Suffice to say that private developers have not welcomed the news of large-scale expansion of home building by NAMA with universal acclaim. Private developers may have hoped pressure to stimulate home building would have led to accelerated land sales by NAMA. There is also concern that the market leader in homebuilding will not have an explicit profitability goal. Indeed, five developers – New Generation Homes,
MKN Properties, David Daly, Paddy McKillen and Michael O’Flynn, lodged a complaint in late 2015 with the European Commission claiming that NAMA’s plan constitutes state aid.

**Commercial property market remains strong**

One year ago, we speculated that political uncertainty could potentially disrupt the rotations from short-term private equity investors in Ireland’s commercial property market to longer-term institutional capital such as pension funds. However, through 2015, that scenario has shown absolutely no sign of materialising. CBRE calculates that there was more than €3.5bn of commercial property transactions in 2015, associated with further increases in office rents and declining yields.
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<th>Percent</th>
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This is a summary of Davy ratings for all companies under research coverage, including those companies under coverage to which Davy has provided material investment banking services in the previous 12 months. This summary is updated on a quarterly basis. The term 'material investment banking services' includes Davy acting as broker as well as the provision of corporate finance services, such as underwriting and managing or advising on a public offer.

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