



Housing market On the mend

Arion Research's report on the housing
market

February 2018

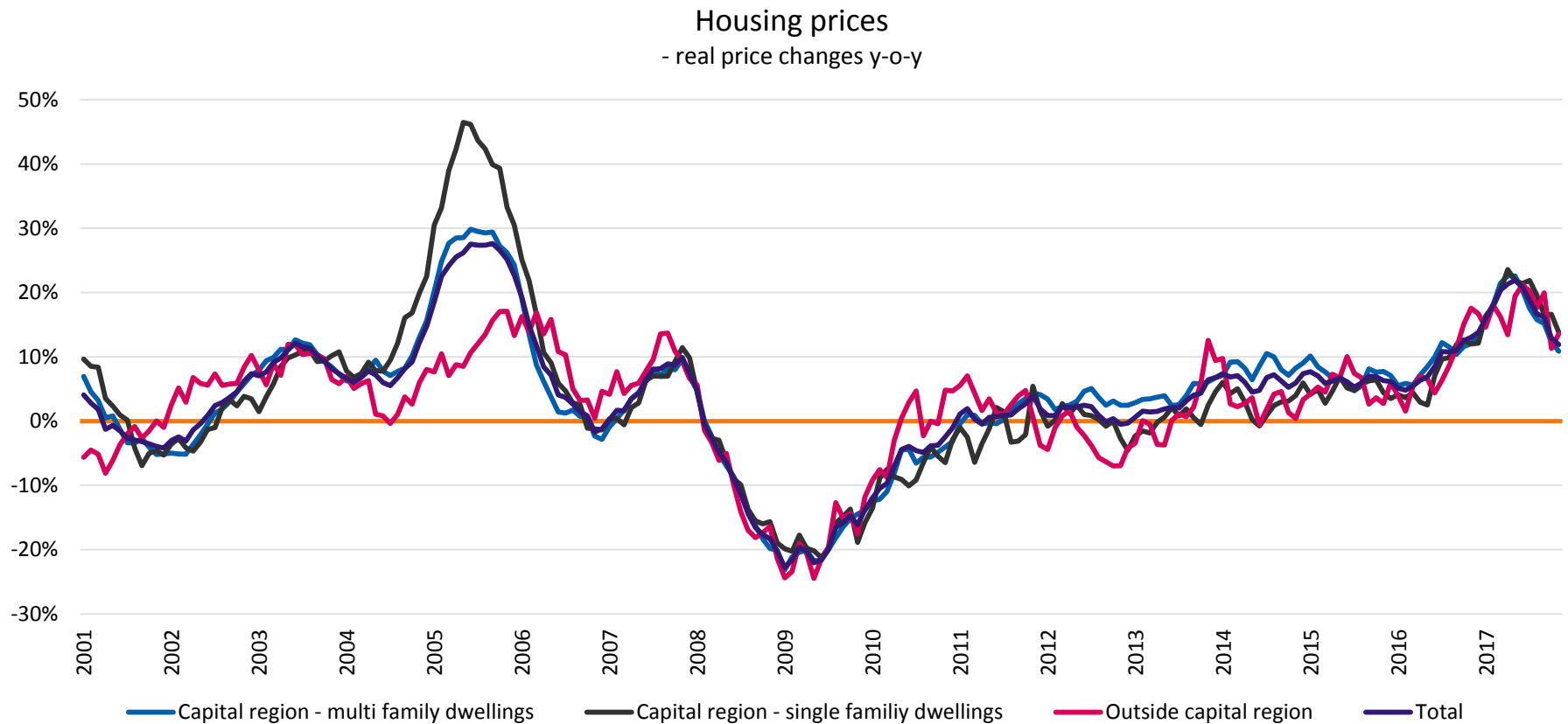
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Main conclusions

- The price of housing increased significantly in 2017, both in the Reykjavík area and outside the capital region. The steepest increases have been in the suburbs in Reykjavík and surrounding area.
- On the demand side there is little to suggest a general decline in prices over the next few years. The economic outlook remains bright, purchasing power will continue to rise and the population will grow. There is reasonably good access to financial funding and mortgage rates have dropped.
- The number of apartments in Iceland grew by 1,700 last year and more construction plans are on the drawing board. It will be necessary to build around 9,000 apartments in Iceland before the end of 2020, in order to deal with the housing shortage and to match population growth. According to our forecast this is unlikely to happen.
- We forecast a 6.6% increase in the price of housing this year, 4.1% in 2019 and 2.3% in 2020. It appears that the real price of housing will fall year-on-year towards the end of the forecast period. As ever the forecast is subject to certain assumptions and a scenario analysis shows that any change in these assumptions will alter the forecast.
- The price of housing has increased significantly more than underlying factors over the last two years. In contrast to the position a year ago, this applies to all neighbourhoods, not just the centre of Reykjavík. Price increases have spread out to the suburbs, resulting in a lower premium for living in the city centre.
- If our forecasts prove accurate there will be a certain correction on the housing market over the next few years, i.e. underlying factors such as salaries, will increase at a faster rate than housing prices. Although it is always possible, it is unlikely that this correction will be in the form of a drop in housing prices.

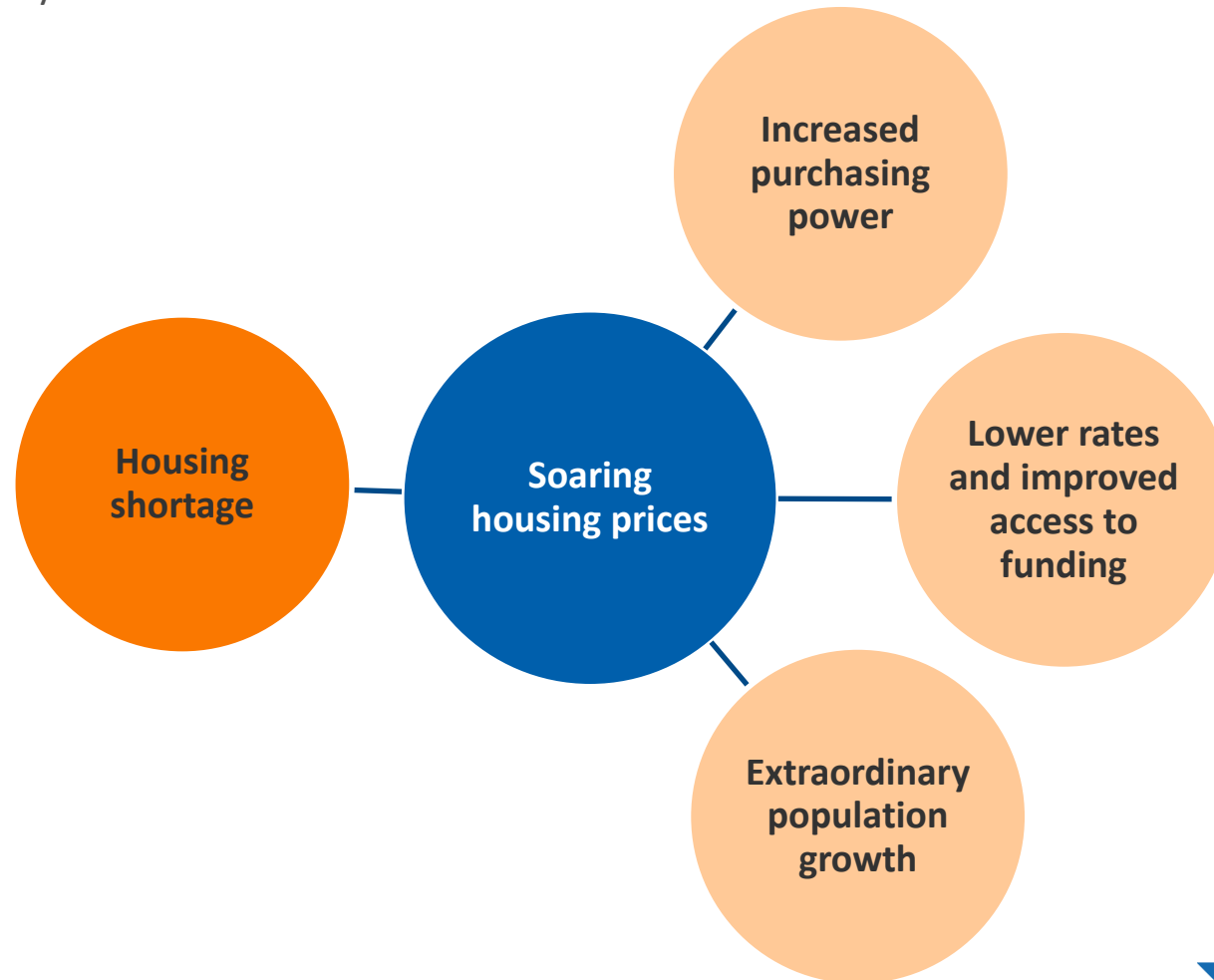
Real housing prices increased 12% YoY

Increase in property prices in recent years has been more stable than previous economic cycles



Why has the price of housing risen so much?

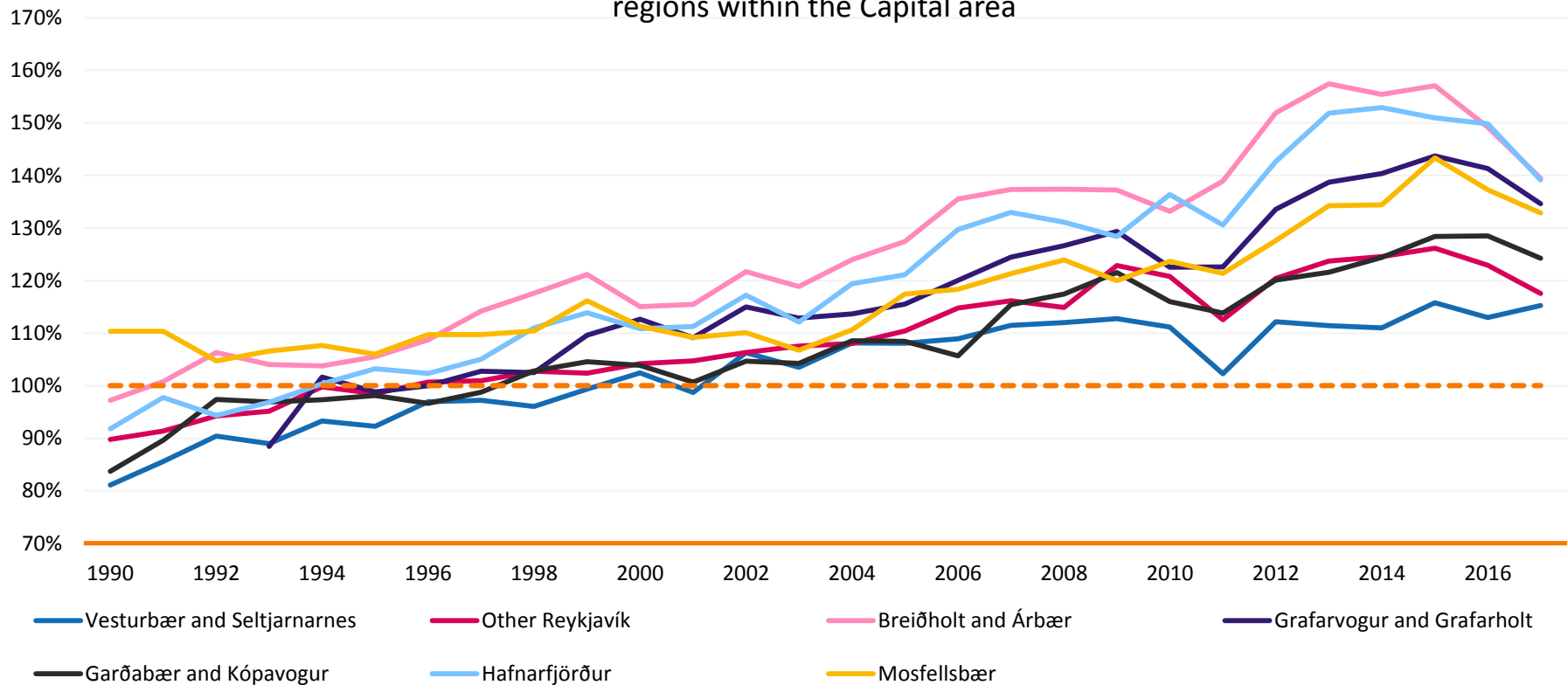
Combination of many factors



Premium for living in city centre dropping fast!

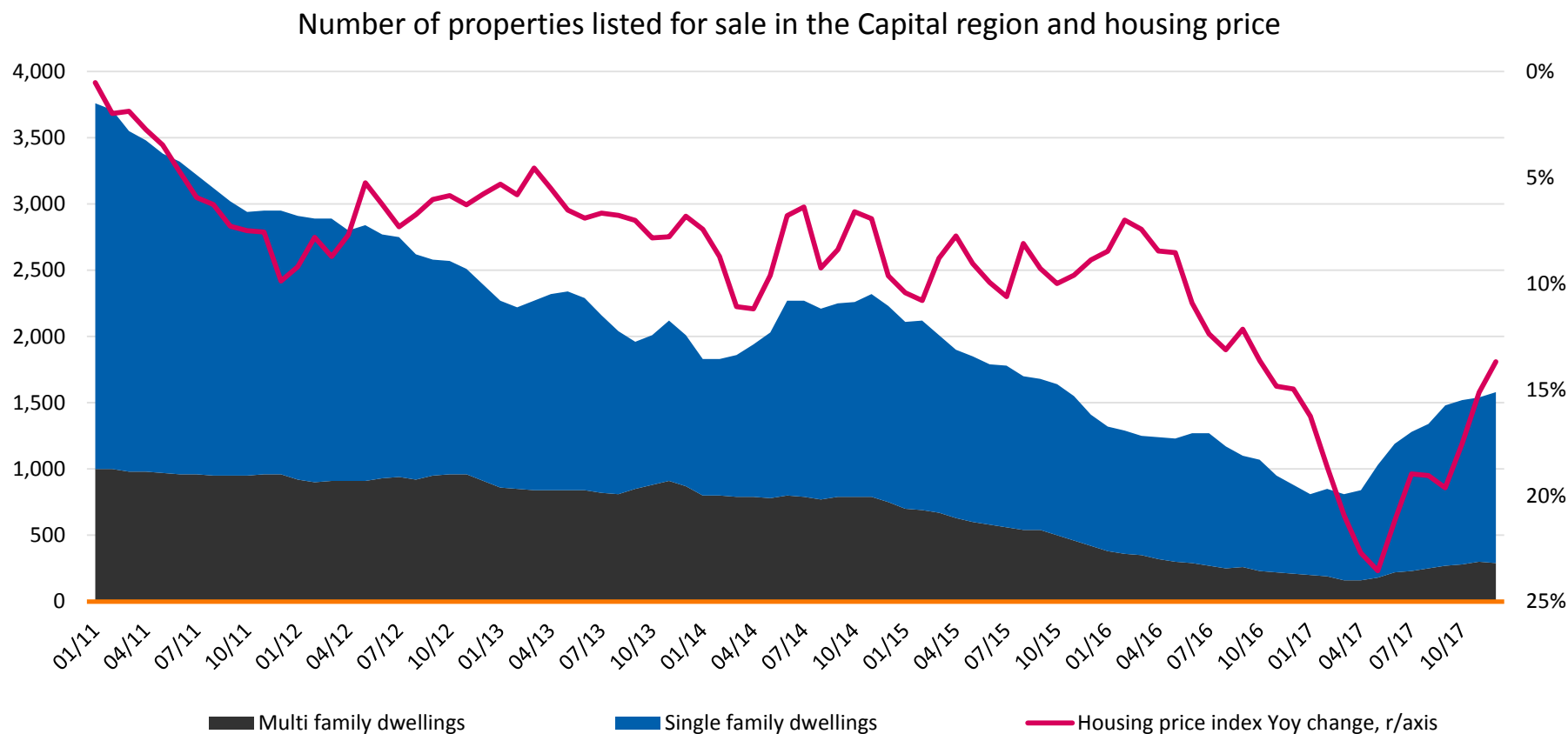
Prices are generally rising faster in other areas than the city centre, bringing prices closer together

Housing prices per square meter in the center of Reykjavík compared to housing prices in other regions within the Capital area



As available properties decreased in number, prices shot up

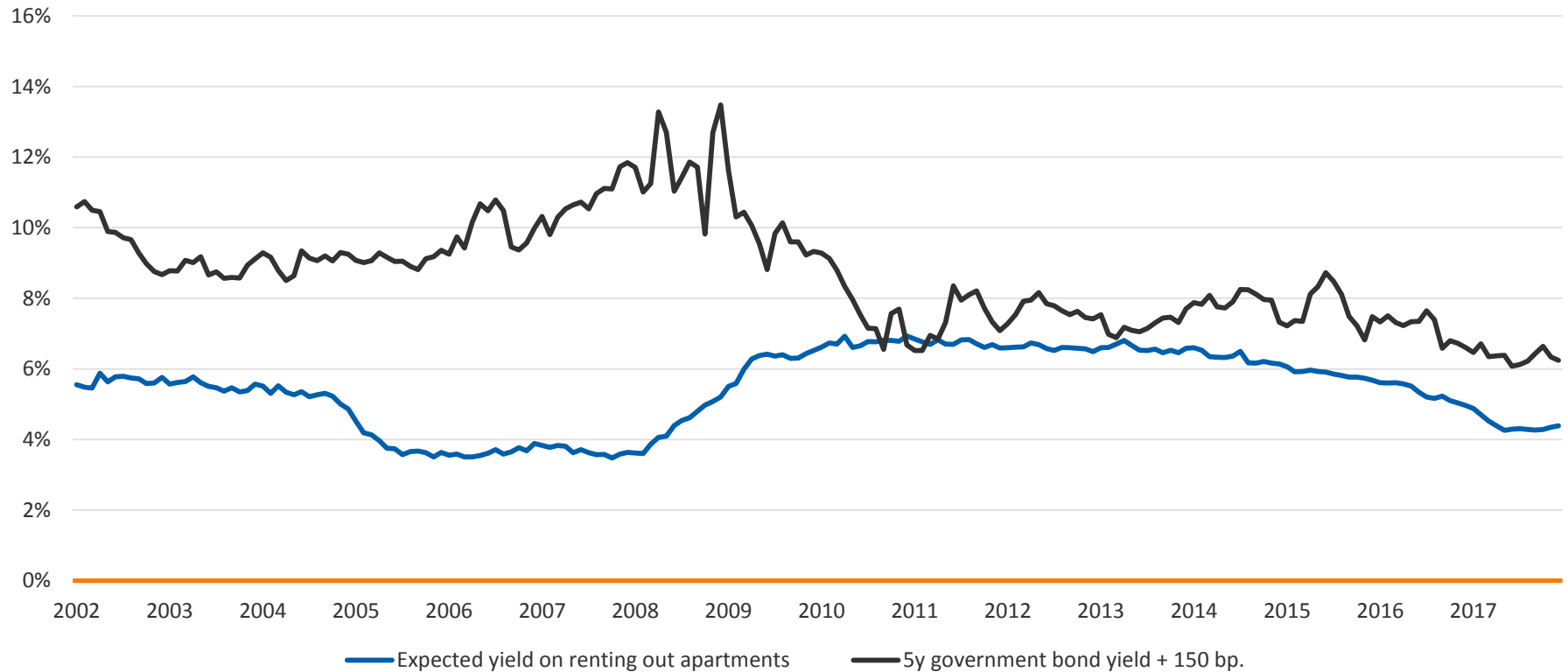
Availability reached a low in March, when 650 apartments were advertised for sale in the Reykjavík area



Is it worth renting given the current market price?

Calculations suggest it is not worth it - other factors must play a role

Historical government bond yield vs. expected yield on renting out apartments*



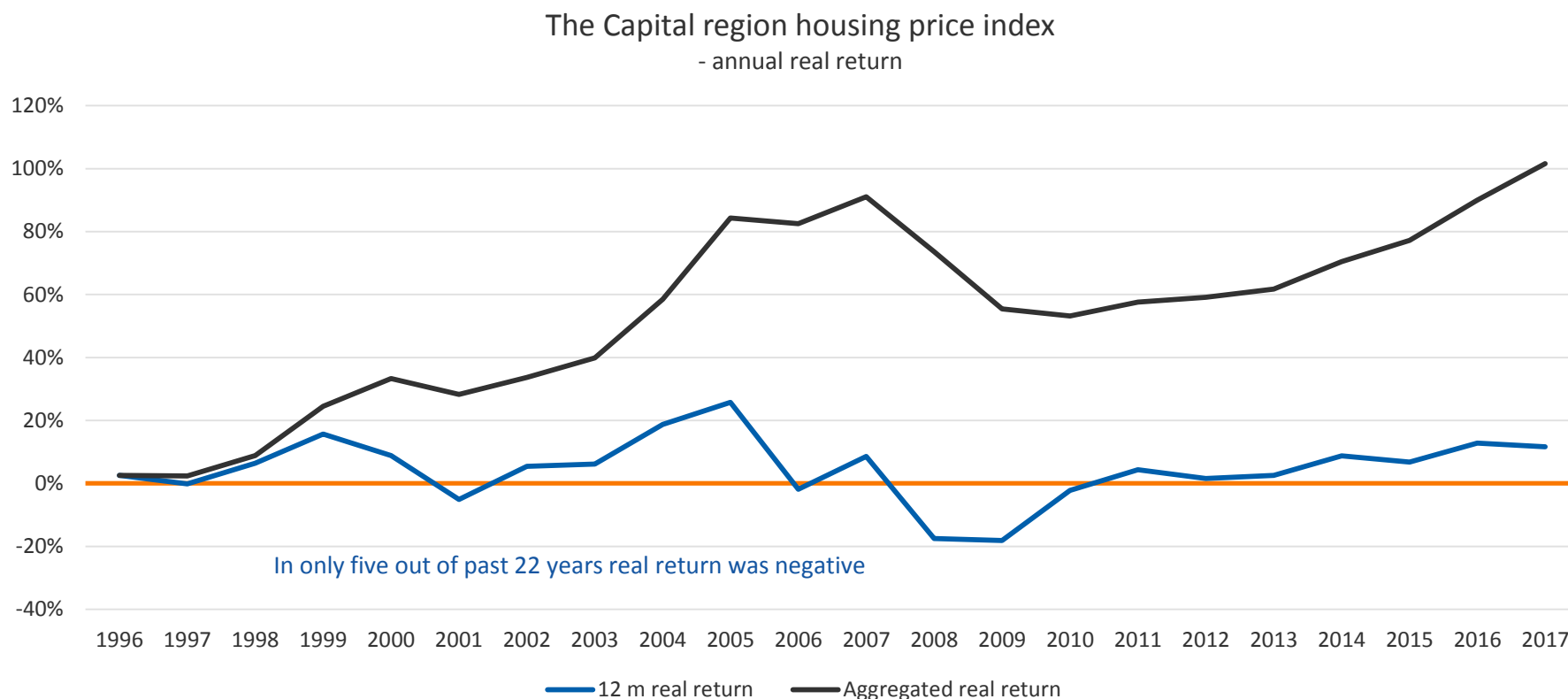
Sources: Registers Iceland, Statistics Iceland, Kodiak Excel, Arion Research

*Expected yield: $(12 \times \text{monthly rent per square meter} - 2\% \text{ depreciation per year}) / \text{market per square meter}$

5Y government bond yield + 150 bp. premium

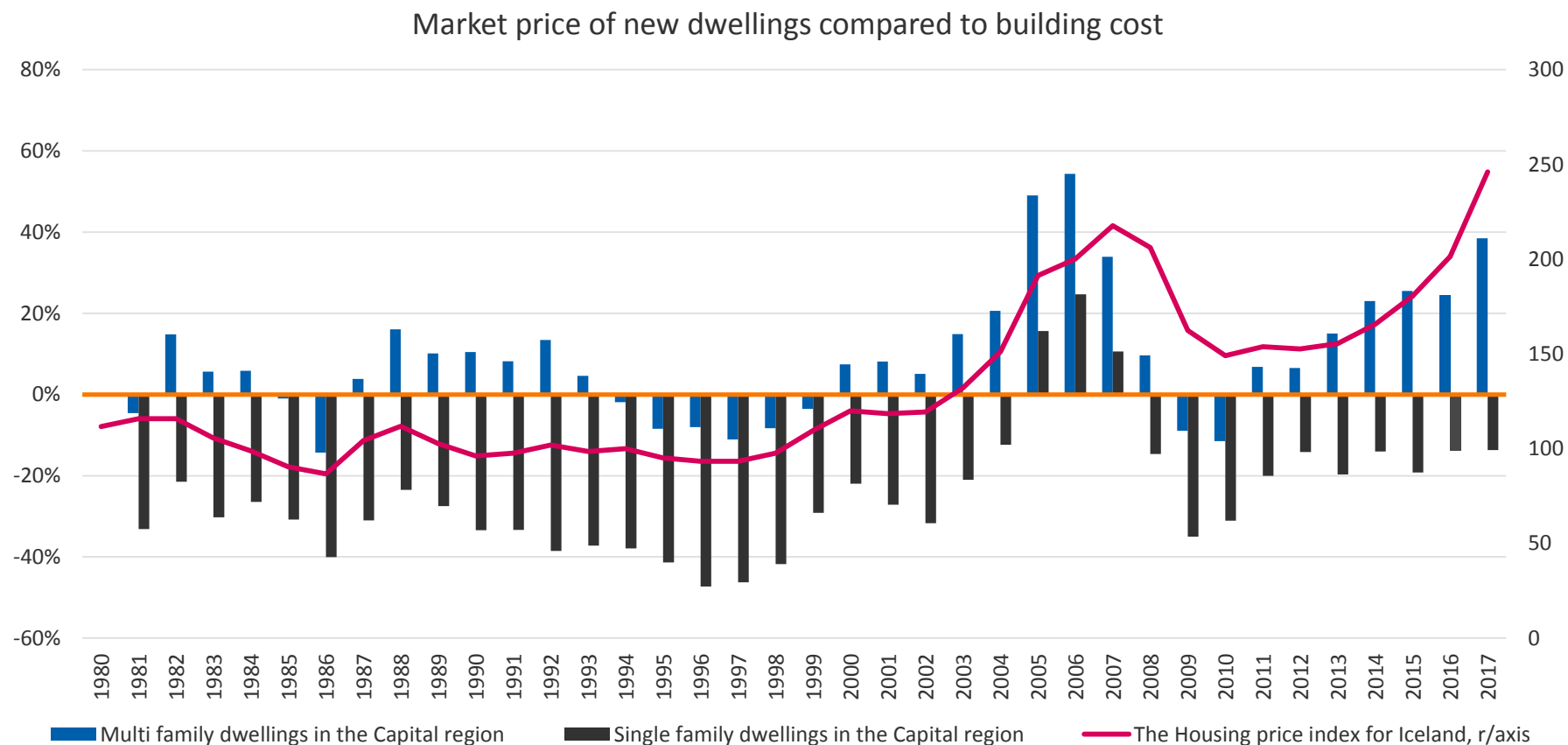
Average 12-month real increase in housing price index since 1995 is 4.6% and 9.1% in nominal terms

Perhaps not such a bad decision to buy an apartment with intention of renting it out, even if you do have to cover the shortfall in rent on the rented apartment every month



How do prices and construction costs look like from a historical perspective?

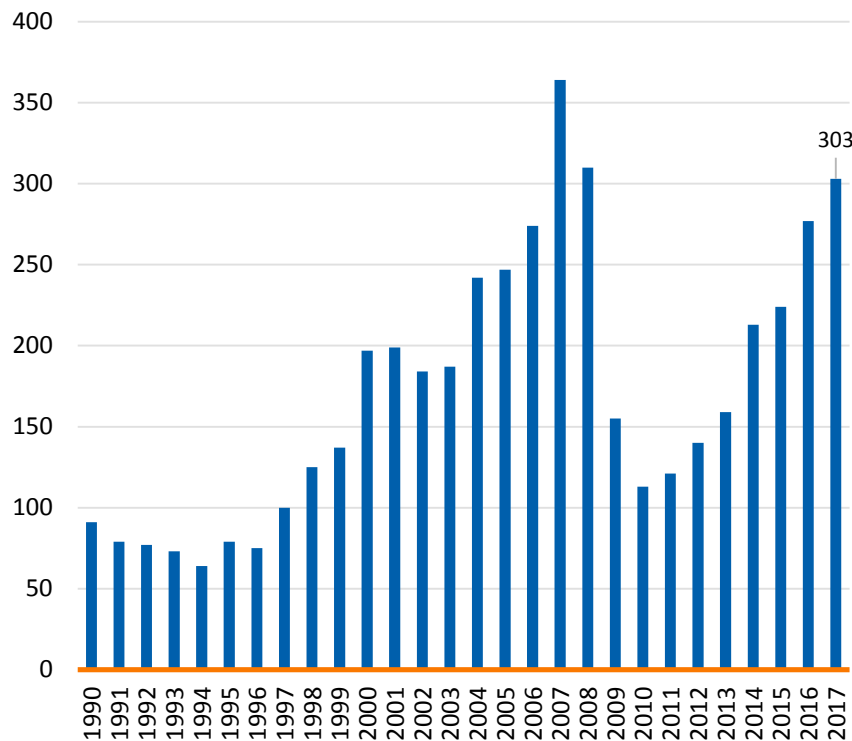
Even stronger incentive to build a multi family dwellings in the Capital Region



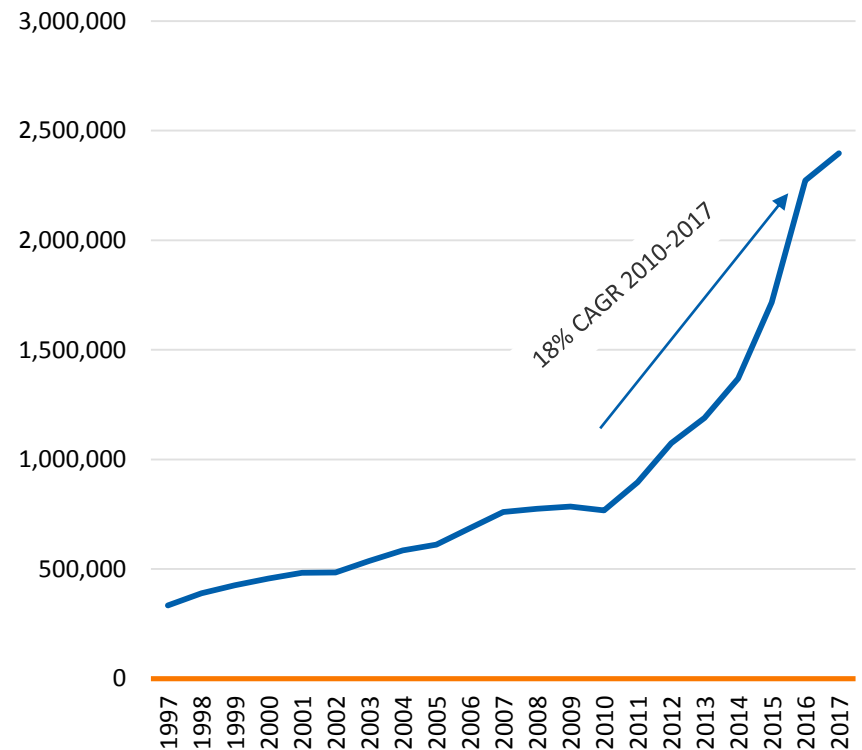
Cranes dot the horizon once again

Who are we building for this time? Initially for tourists but now increasingly for Icelandic homebuyers

Number of registered building cranes in
Iceland

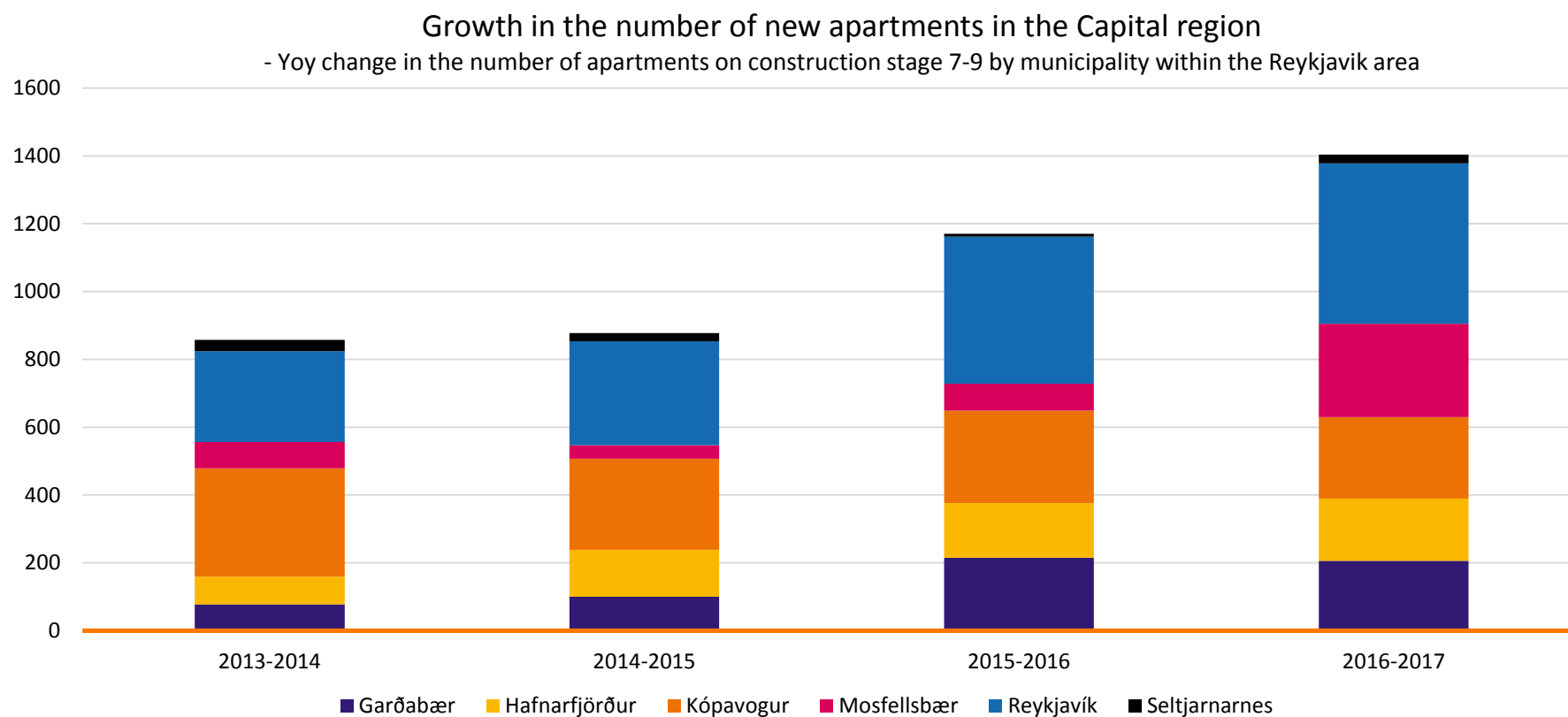


Overnight stays in Greater Reykjavík
- in hotel rooms by foreign visitors



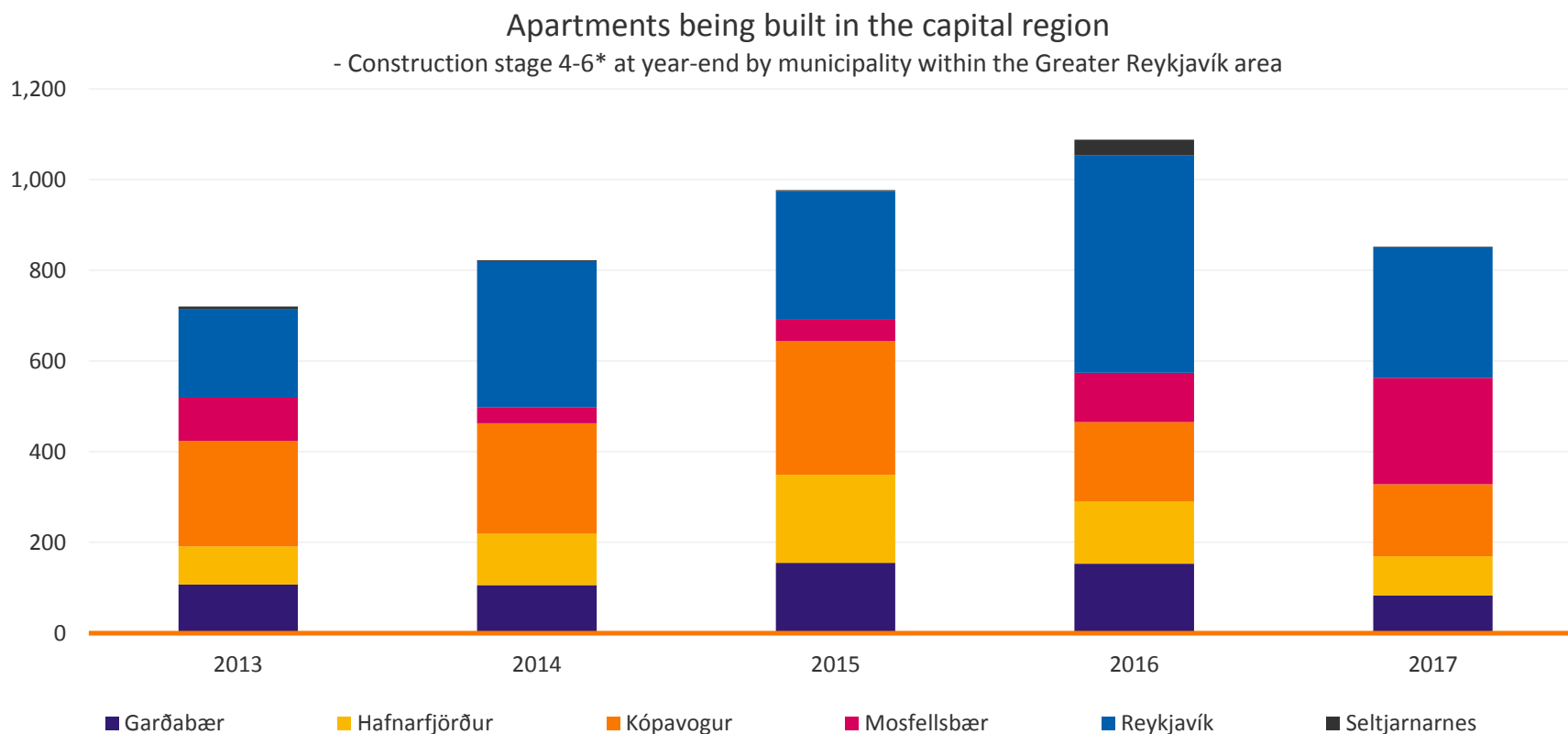
Estimate: 1,400 new apartments on market in Reykjavík area in 2017

YoY change in the number of apartments at construction level 7-9 indicates 1,400 apartment increase in Reykjavík area and 300 outside the capital*



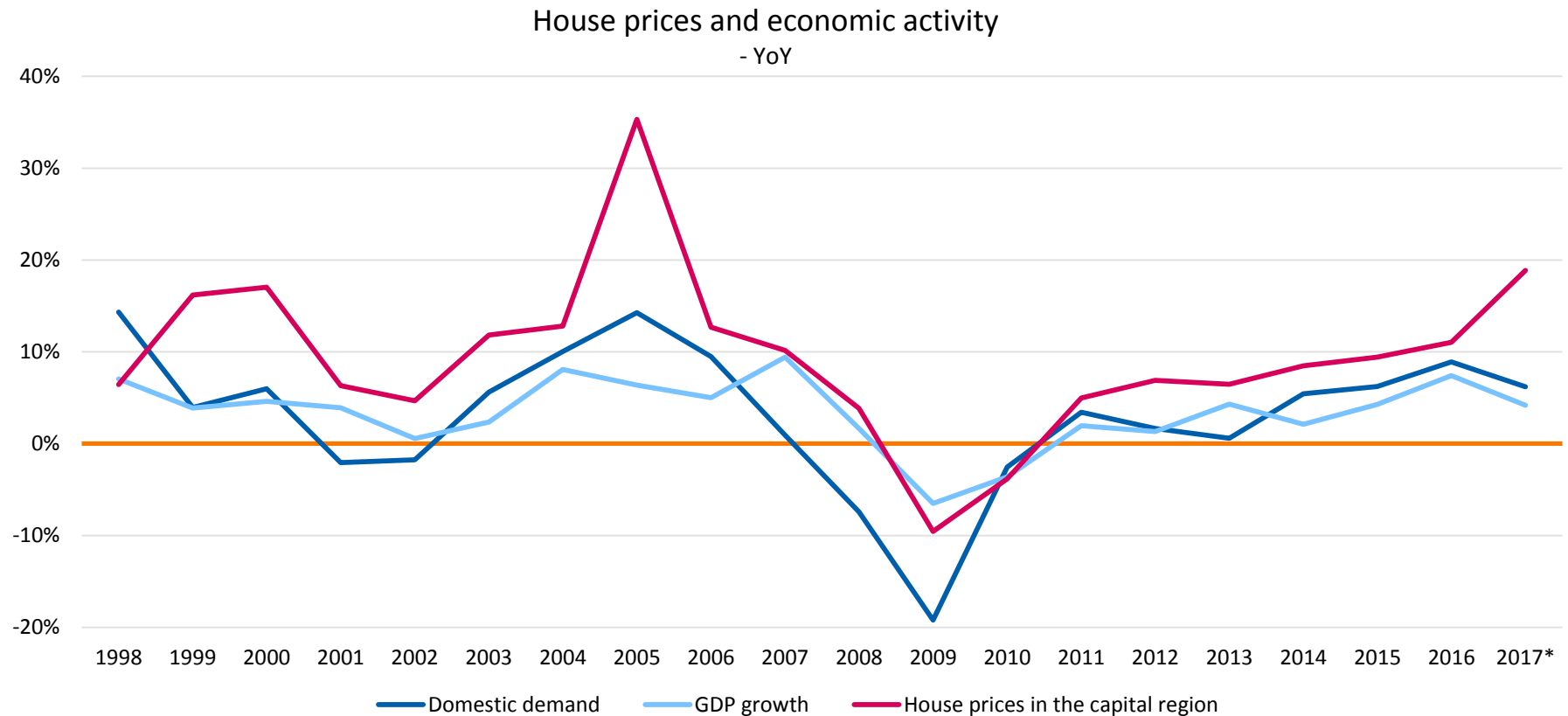
What about apartments just about to become available on market?

More than 800 apartments at construction level 4-6 at the end of 2017, 300 fewer than at end of 2016



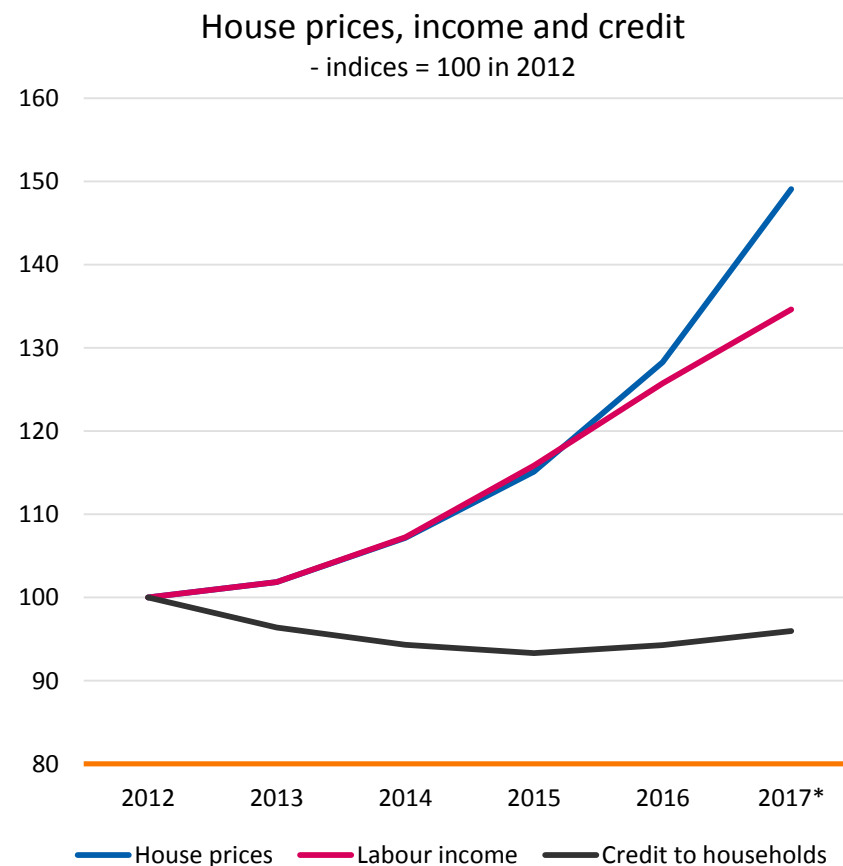
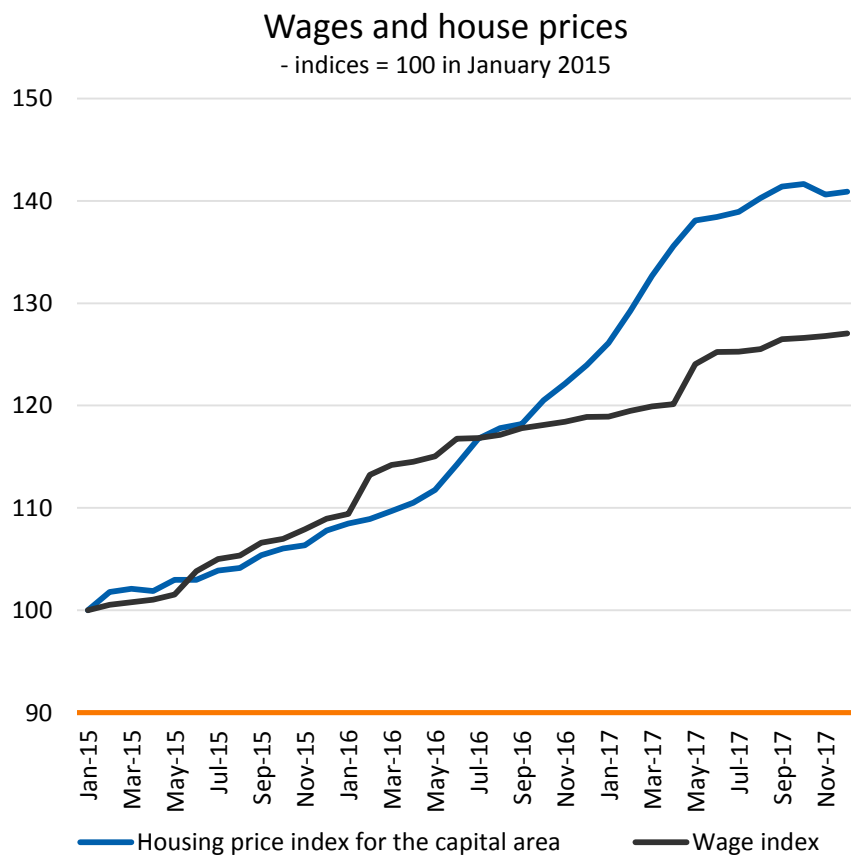
Housing market always dependent on economic environment

The factors which affect demand for housing, e.g. population growth, purchasing power and unemployment, all correlate closely with developments in the economy



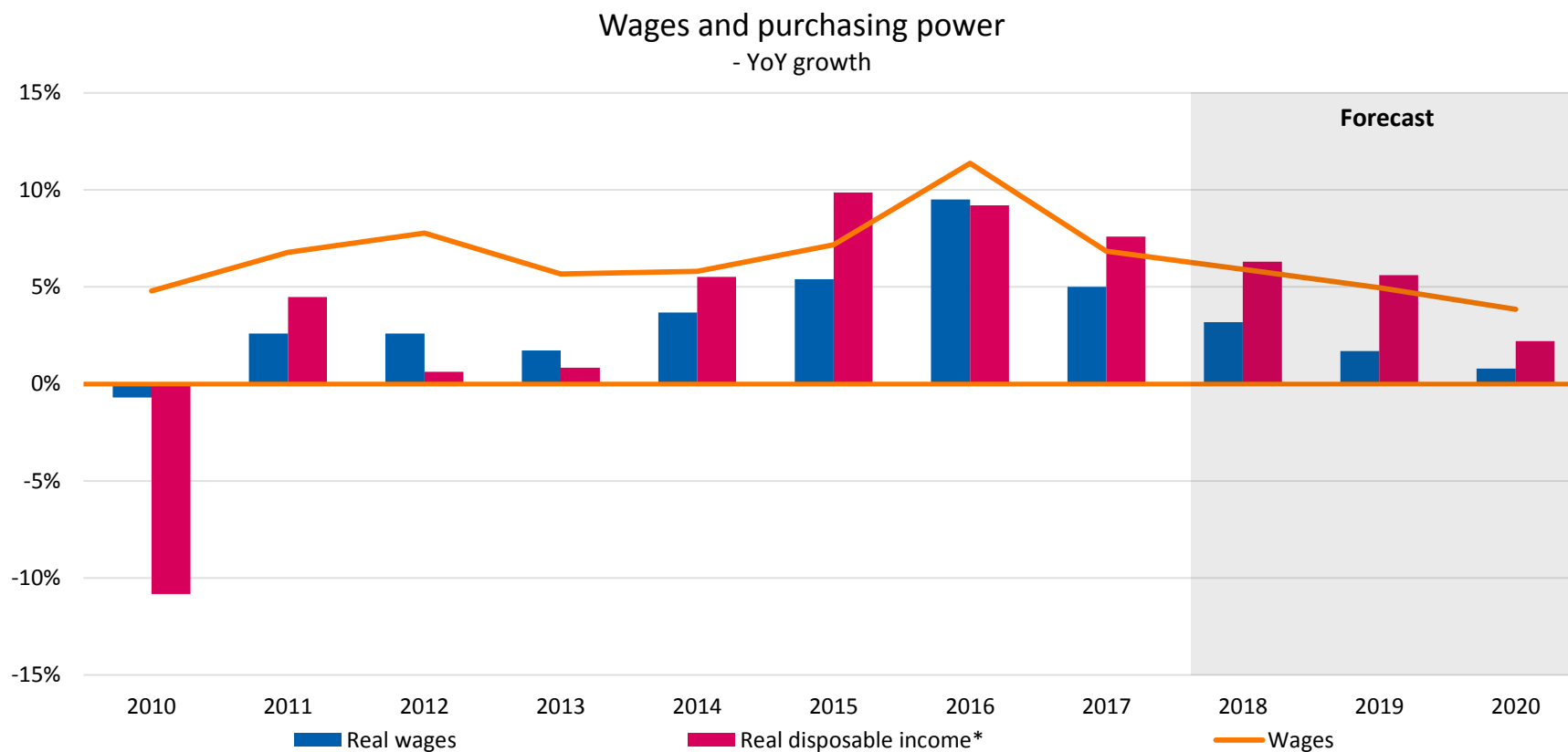
Wage developments also play a key role on housing market

Wage increases have slowed down in recent months – great uncertainty in coming months



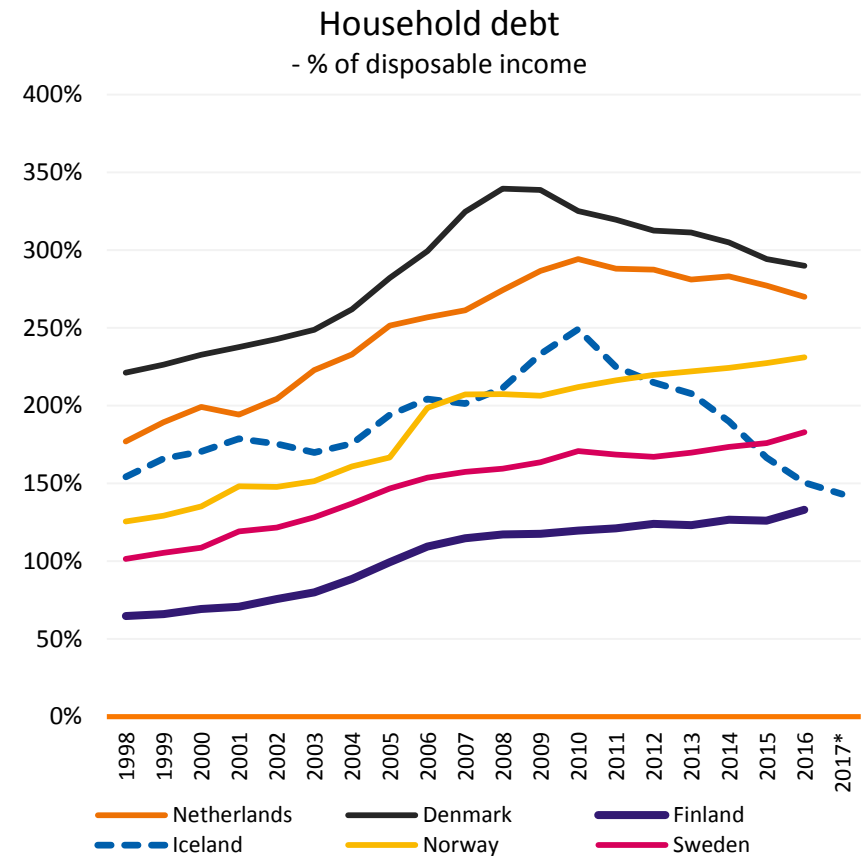
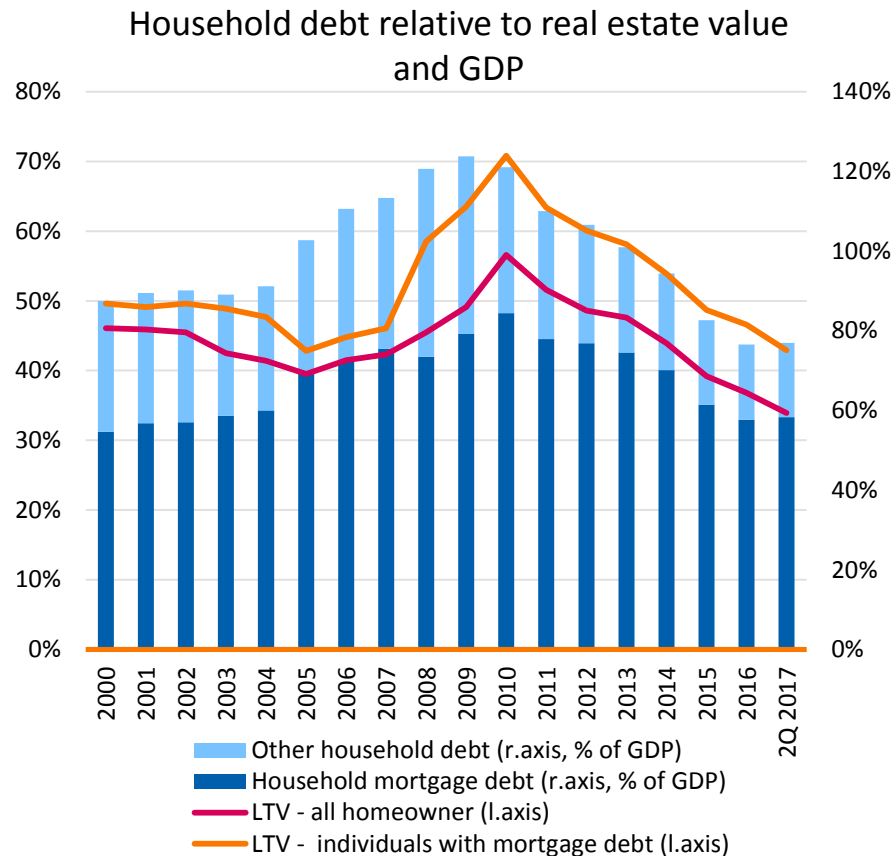
Salaries seem set to continue to increase

Unrest and tension on the labor market could lead to higher than forecast wage increases, but they are unlikely to go directly into pockets of wage earners



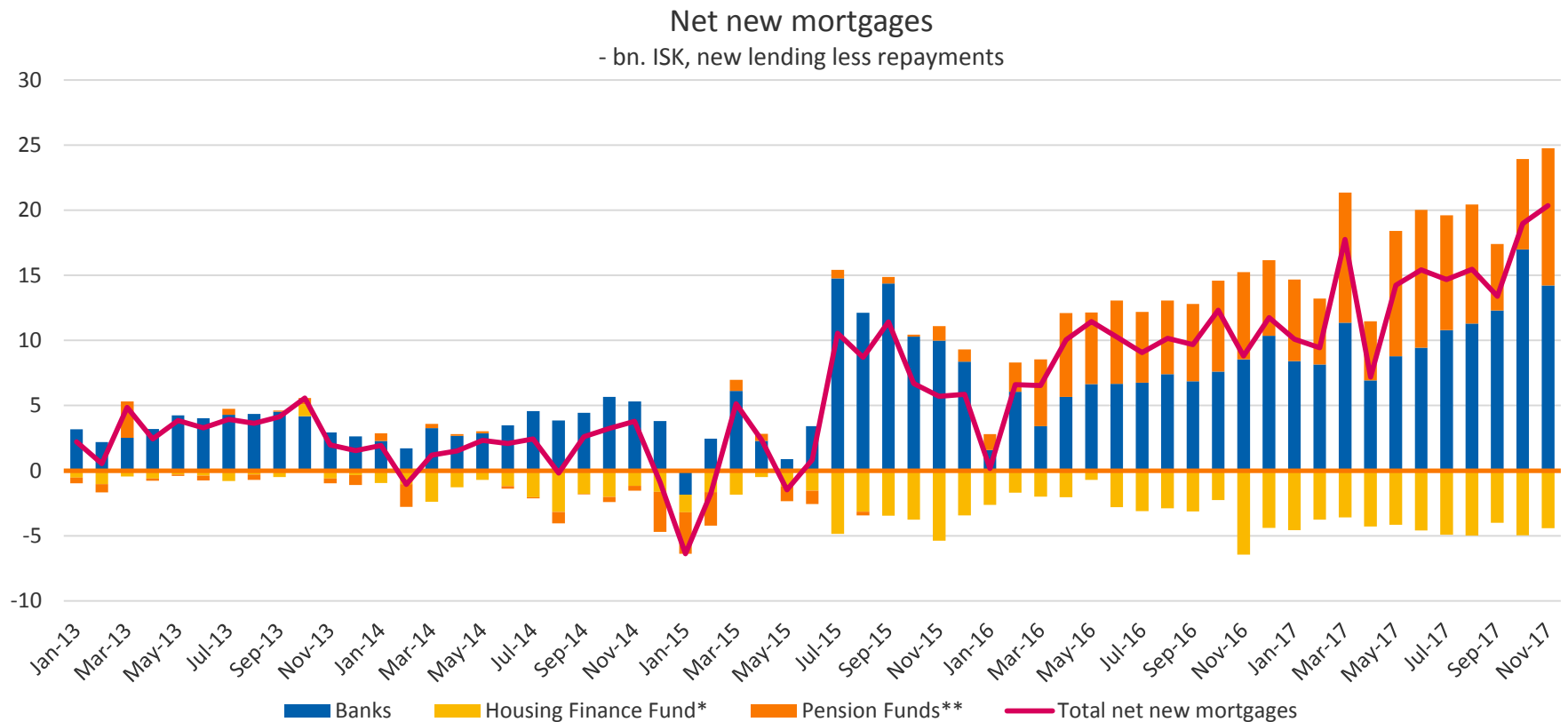
Higher house prices and improved debt position allows higher mortgages

Most people own more than they owe



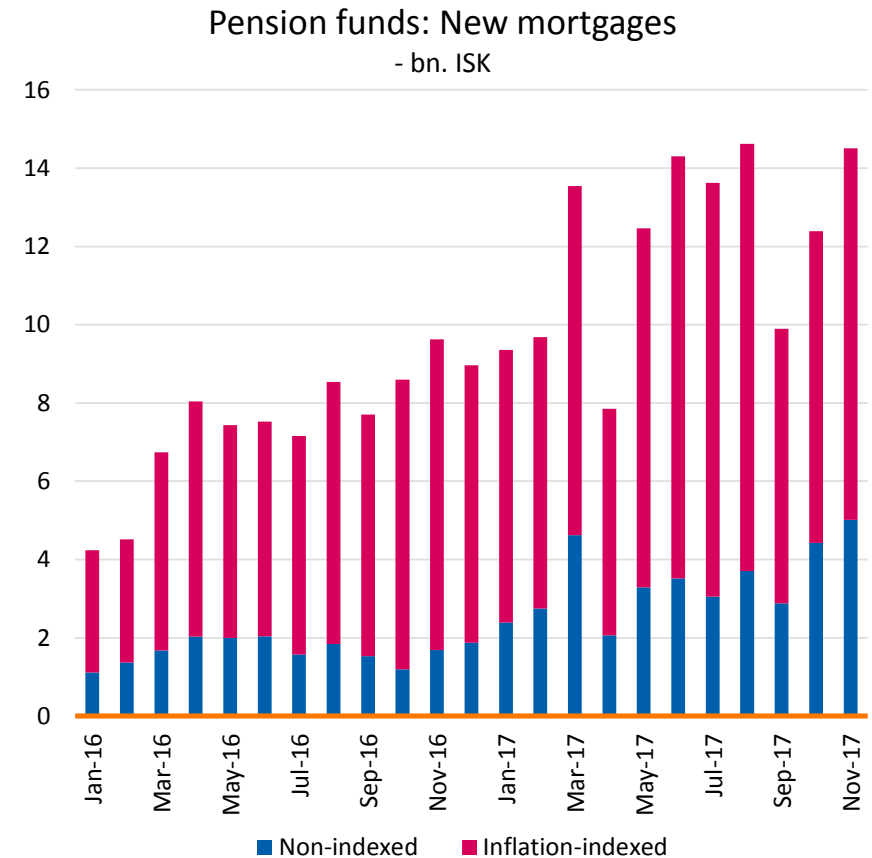
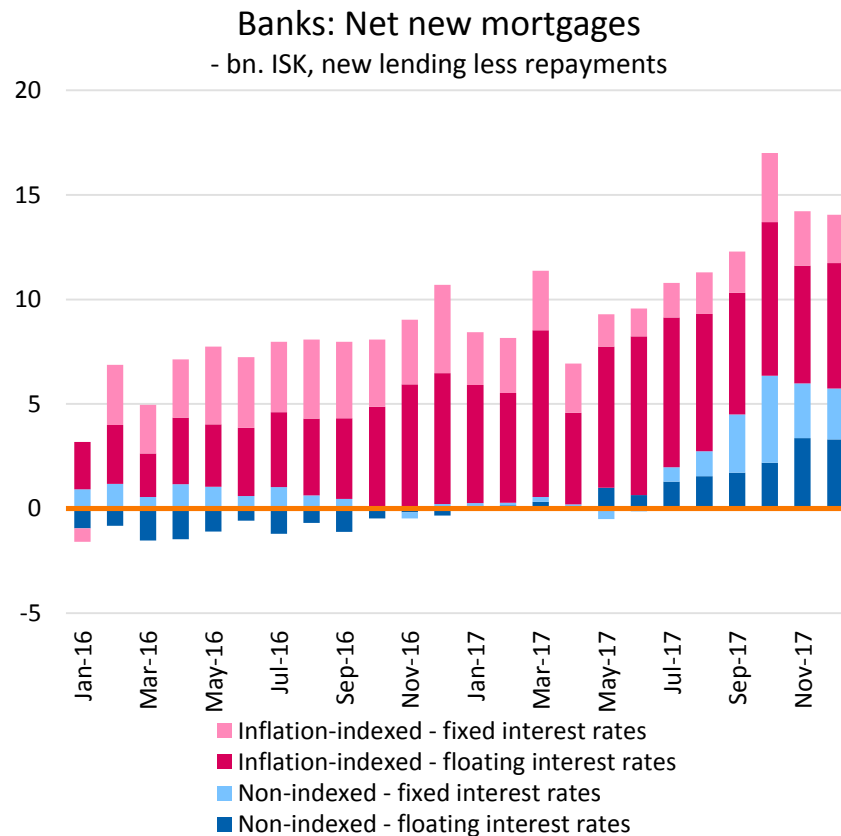
Fierce competition between banks and pension funds

The pension funds have burst onto the market while Housing Finance Fund's market share has gradually decreased



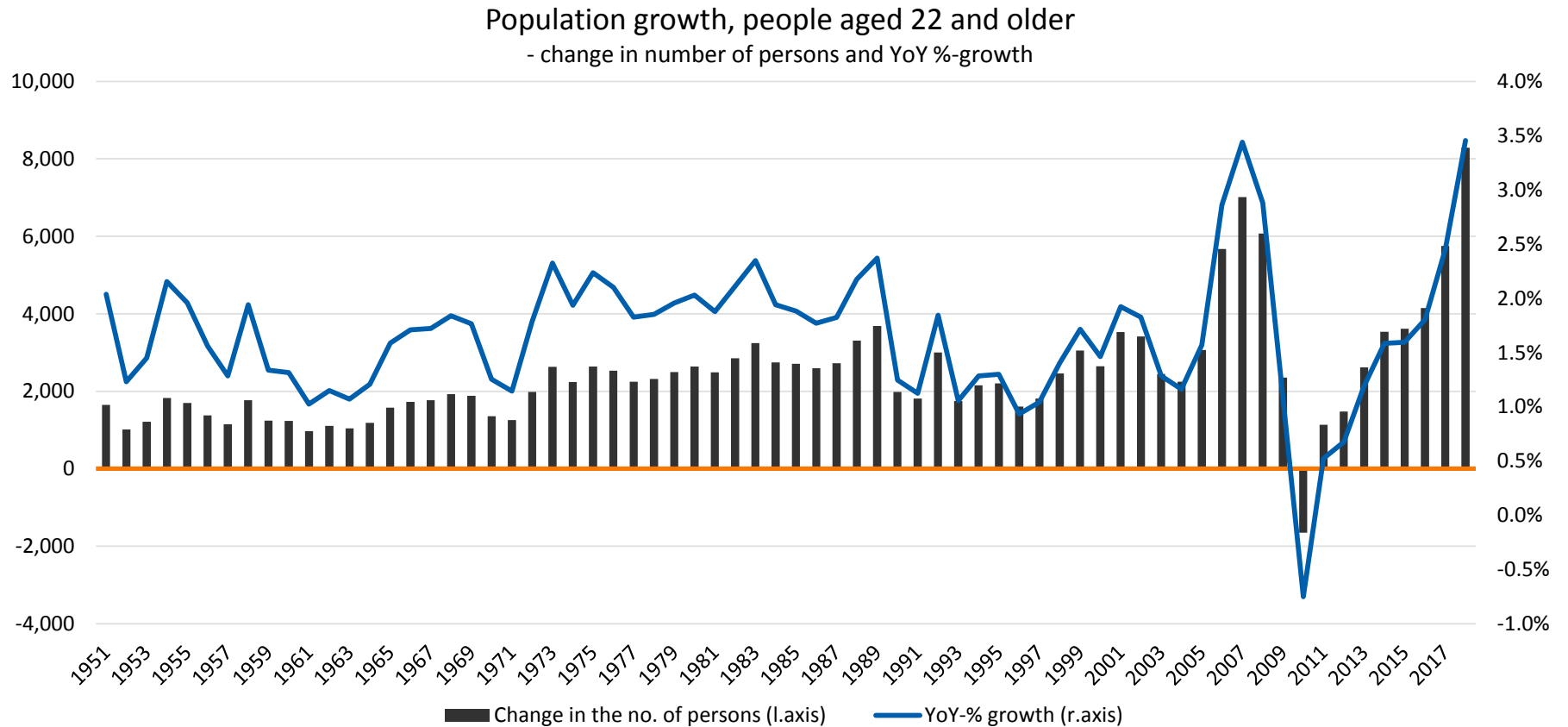
Inflation-linked loans more popular in Iceland

Approximately 22% of net new bank loans to households last year were non-indexed, compared with 30% from the pension funds



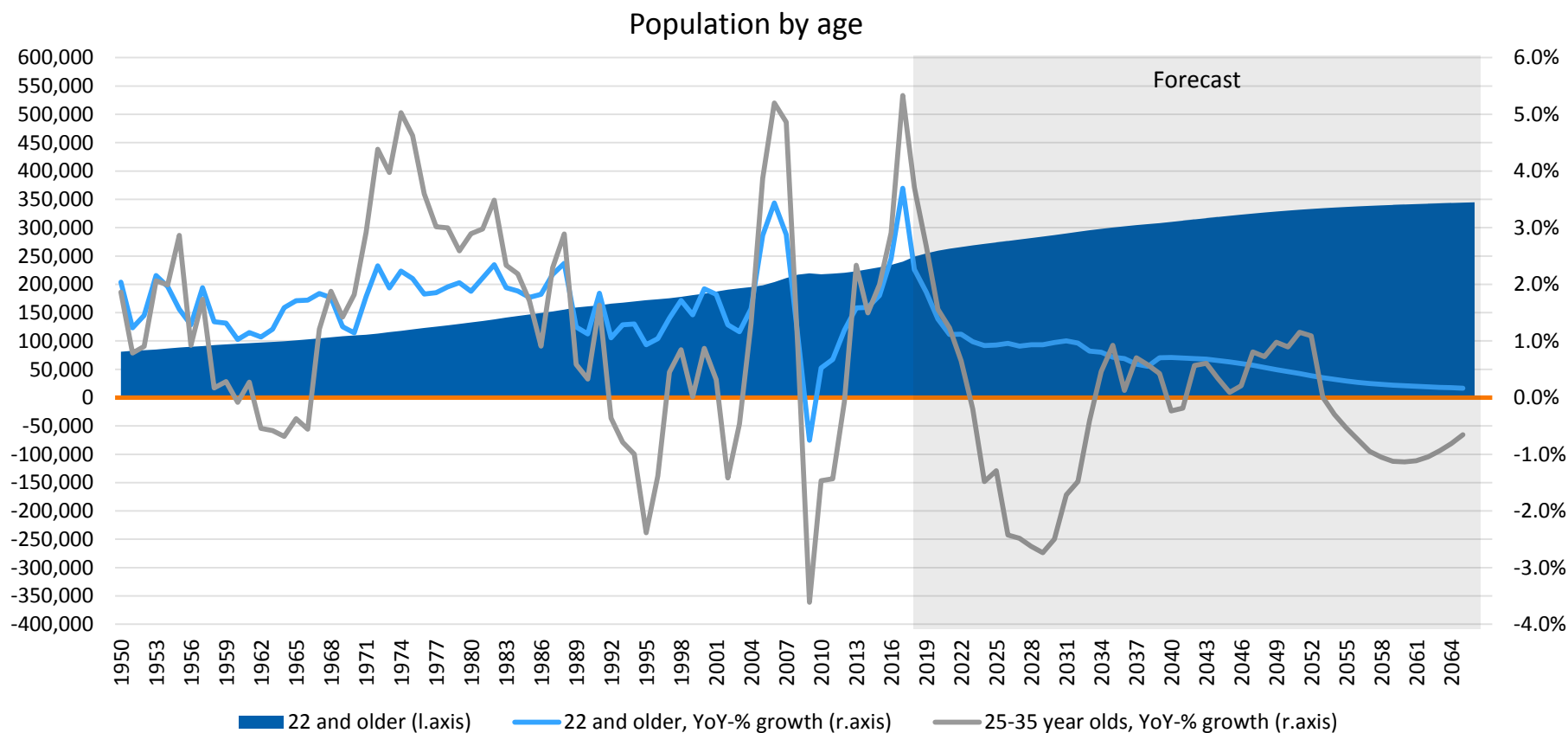
Unprecedented population growth in 2017

People aged 22 and older increased by more than 8,000 in 2017



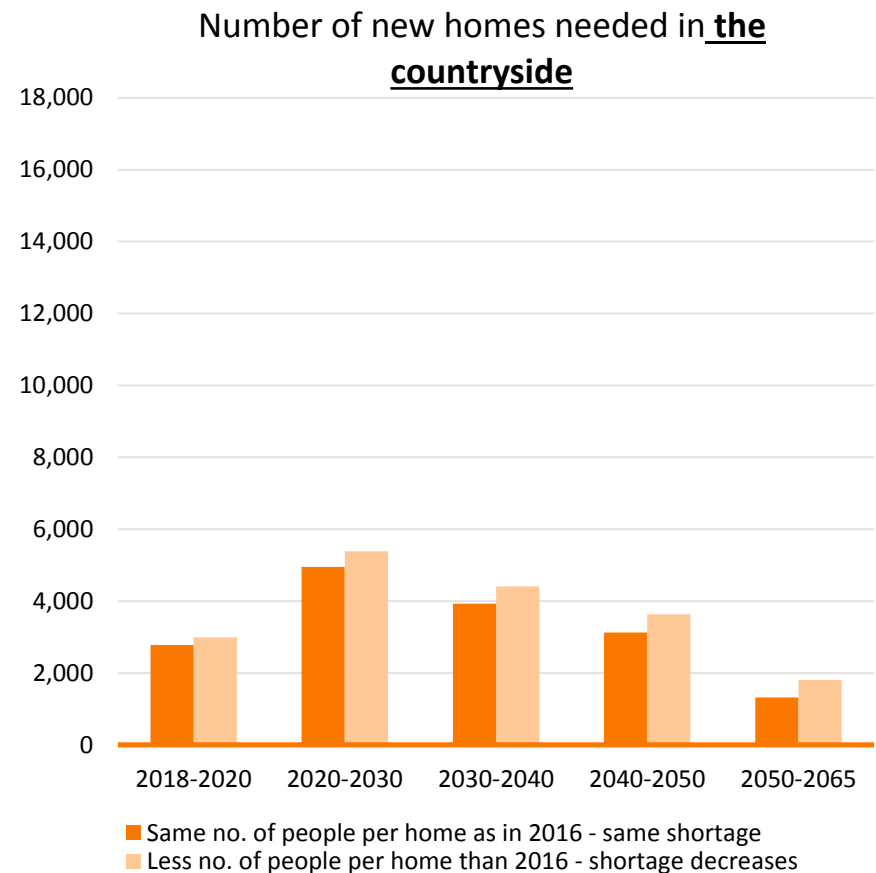
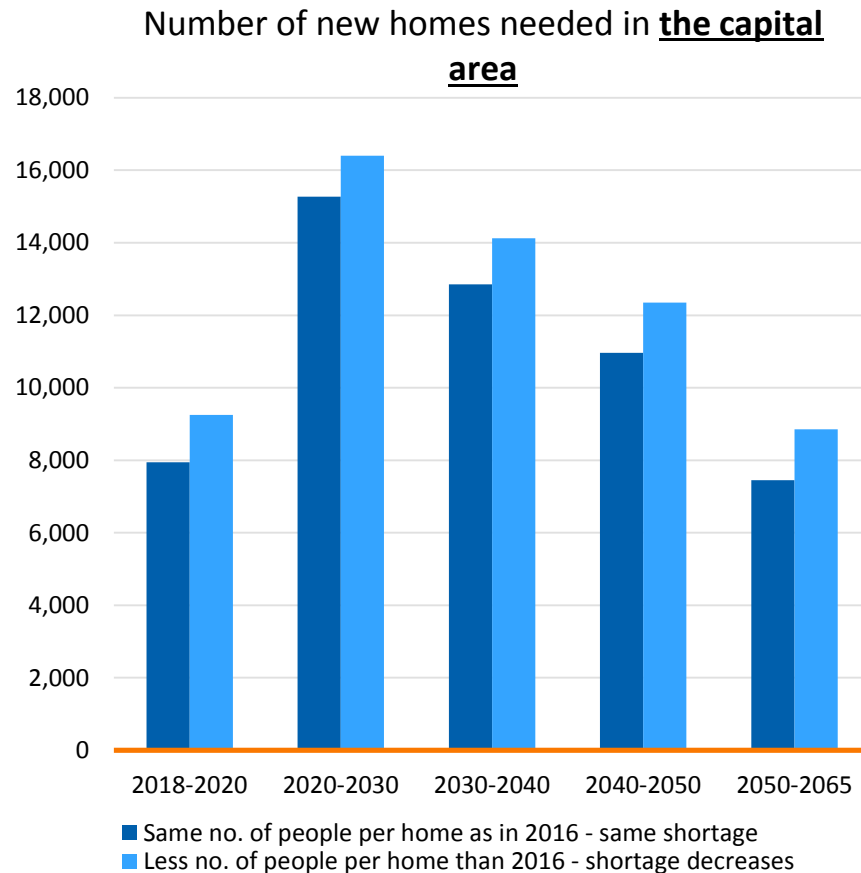
People aged 22 and older will increase by almost 14,000 until the end of 2020

Supply side cannot afford to relax if it is to meet growing demand



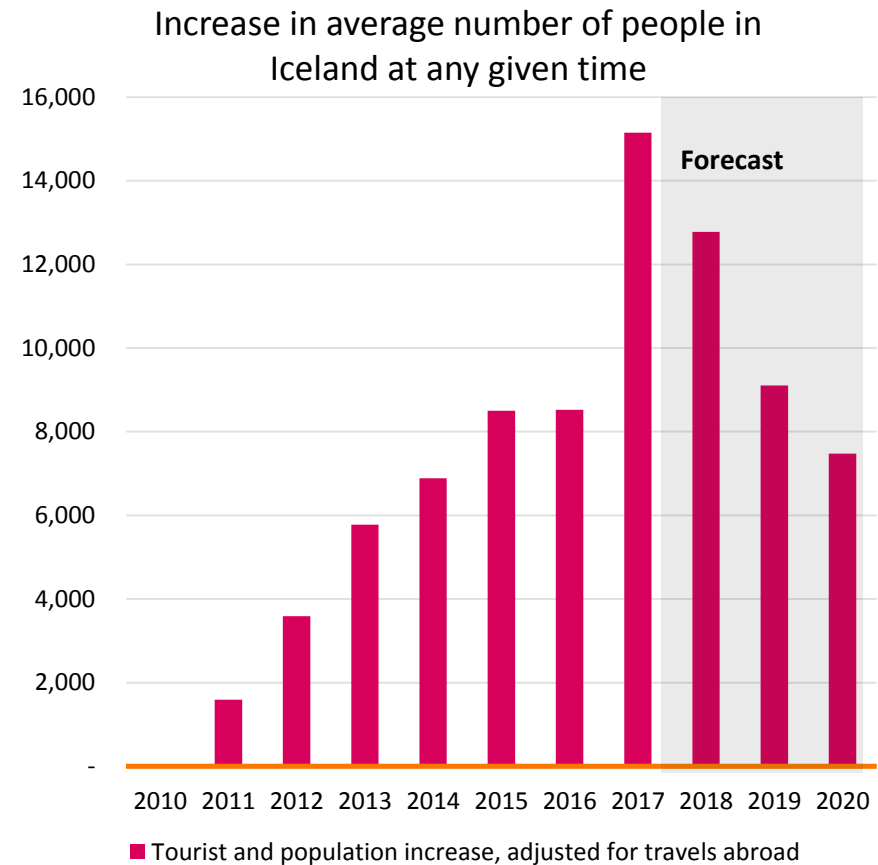
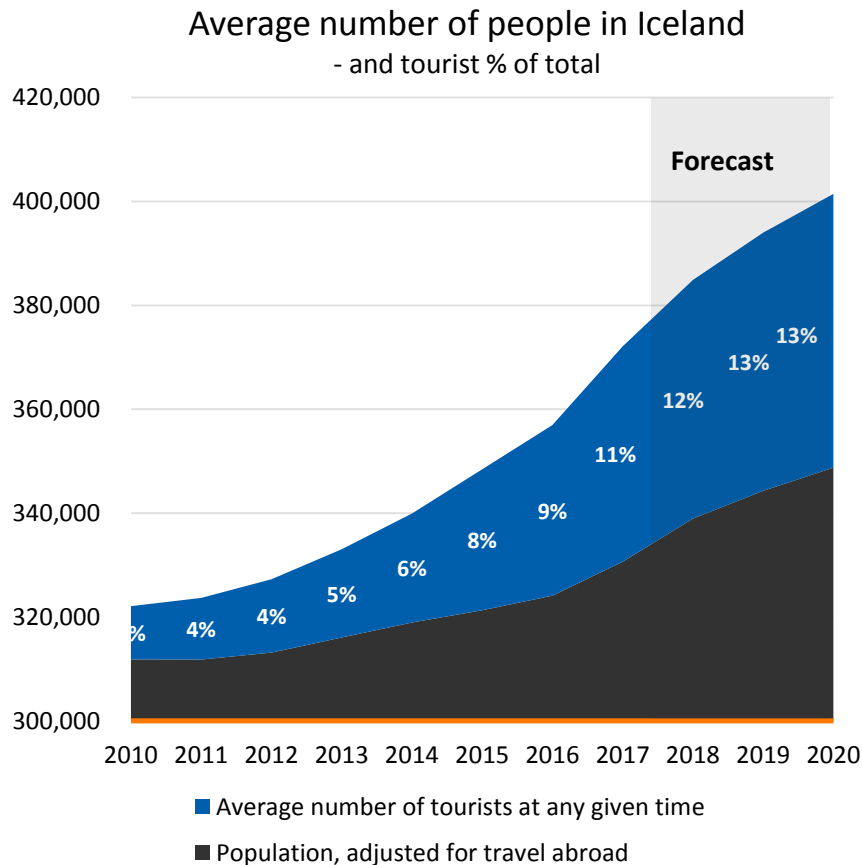
What does it mean in terms of building housing?

Before 2065 around 60,000 new apartments need to be built throughout Iceland!



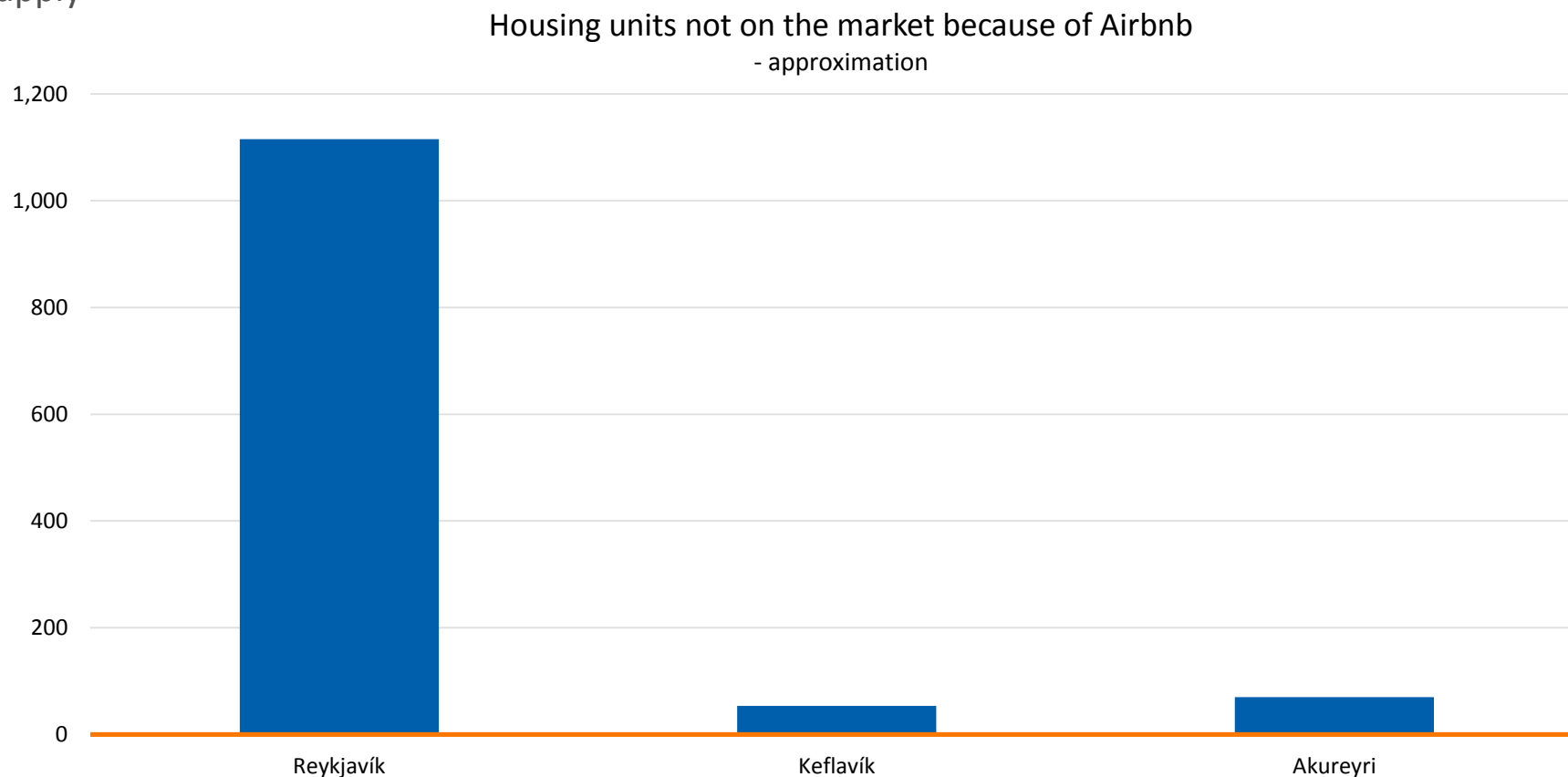
We mustn't forget the tourists! More and more people in Iceland at any given time

The flow of tourists to Iceland acts like population growth. They all need a roof over their heads!



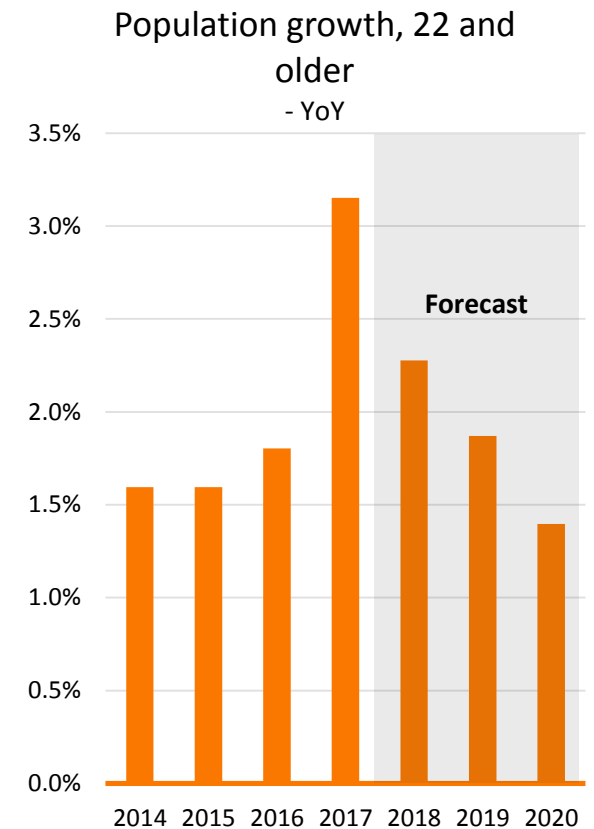
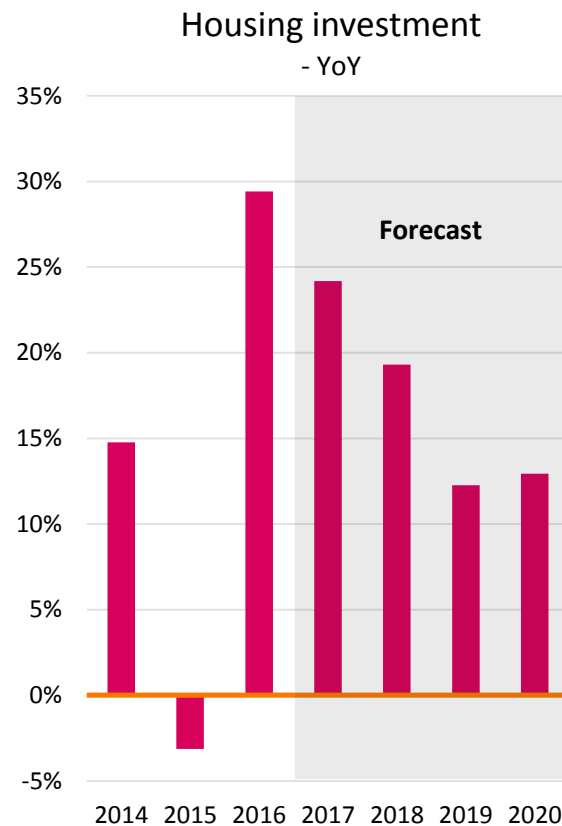
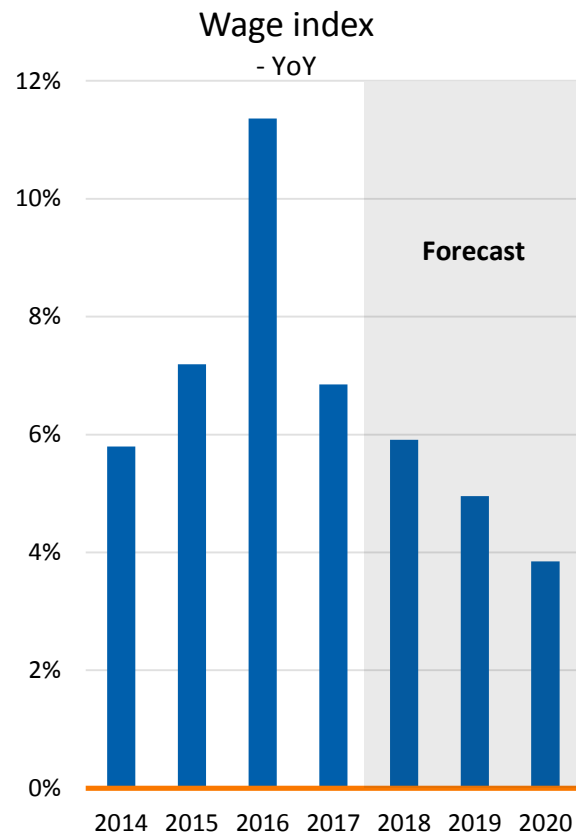
The Airbnb enigma: How many apartments are taken off the market?

Much is unclear surrounding Airbnb and its impact on the housing market as information is in short supply



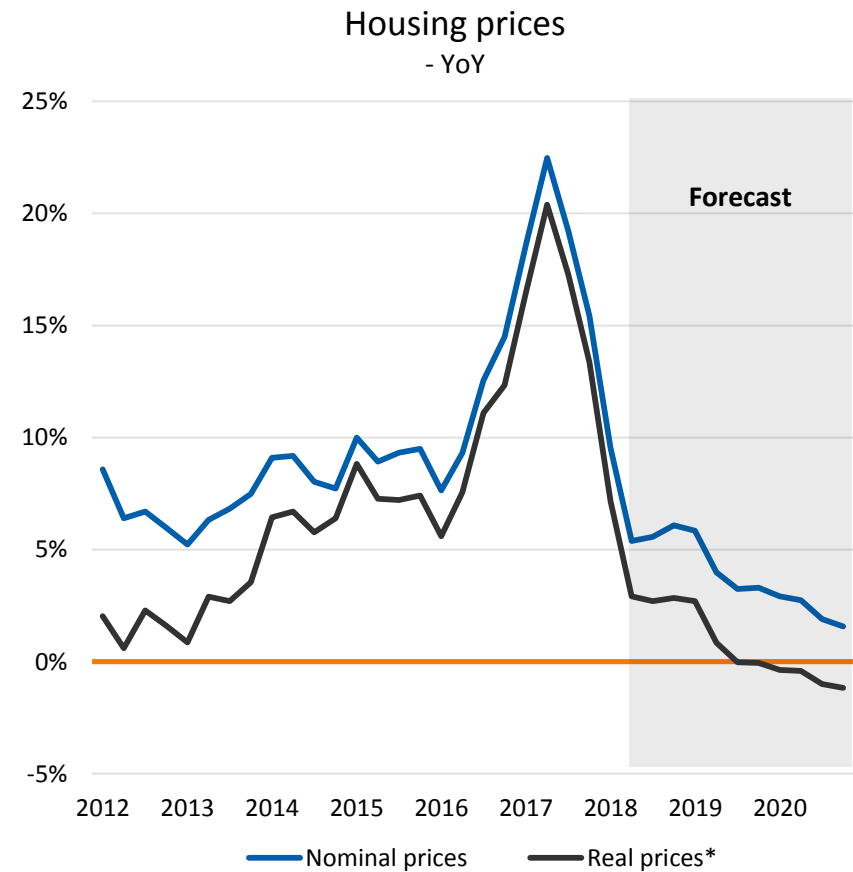
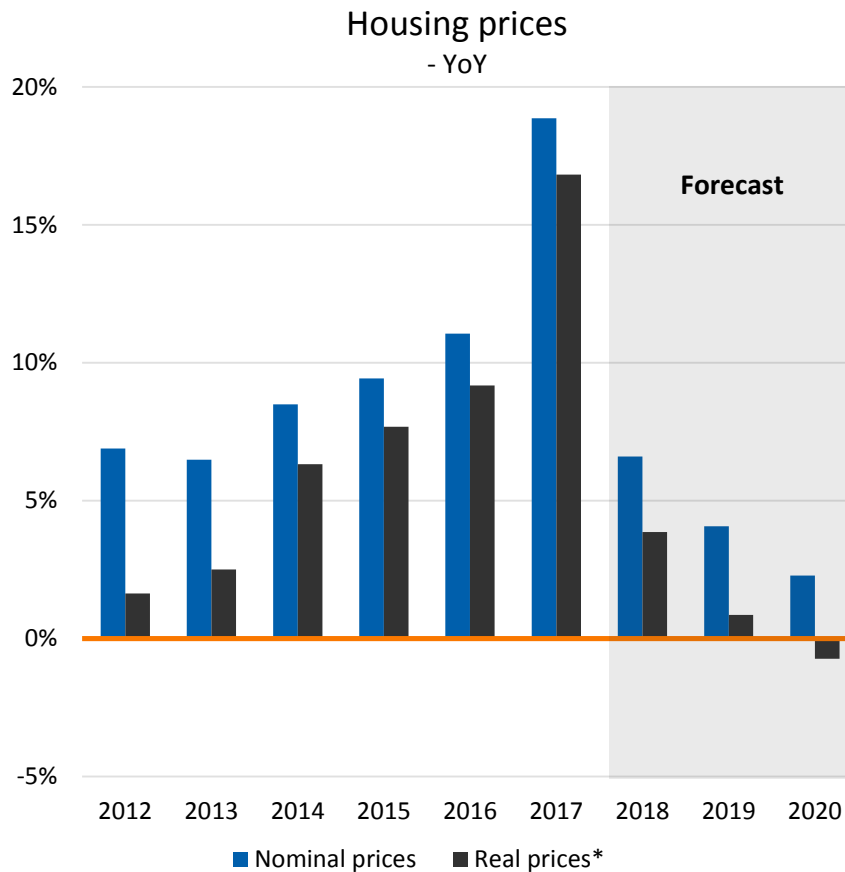
Key assumptions in the baseline forecast

A statistical model is only an approximation of the truth. It is never possible to account for all factors which may affect the price of housing



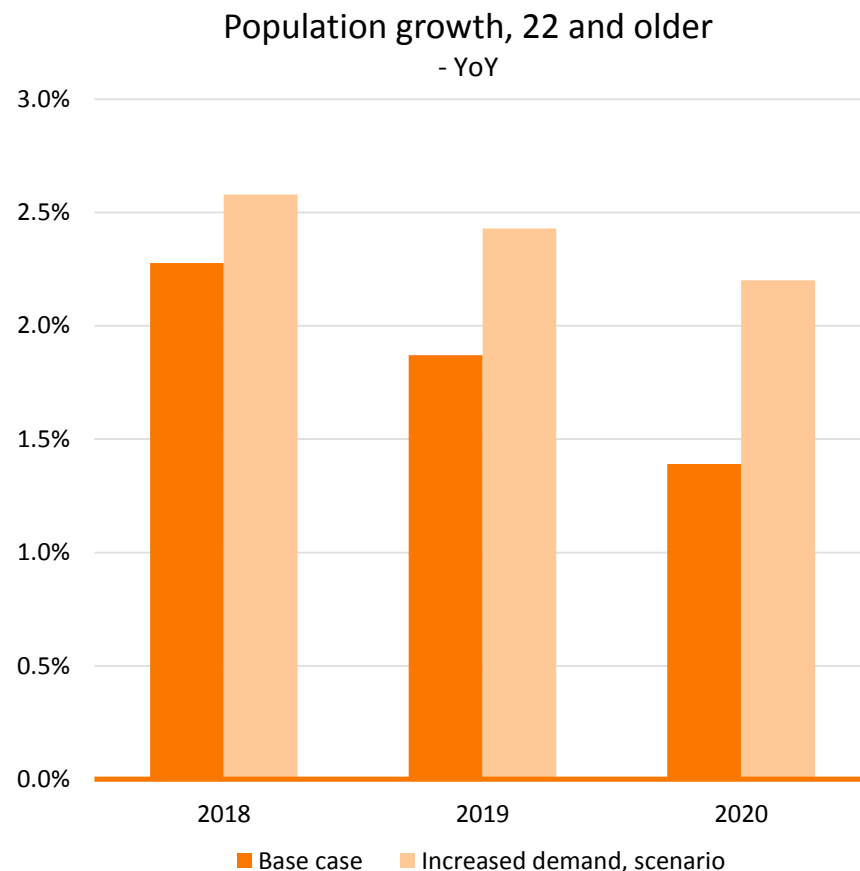
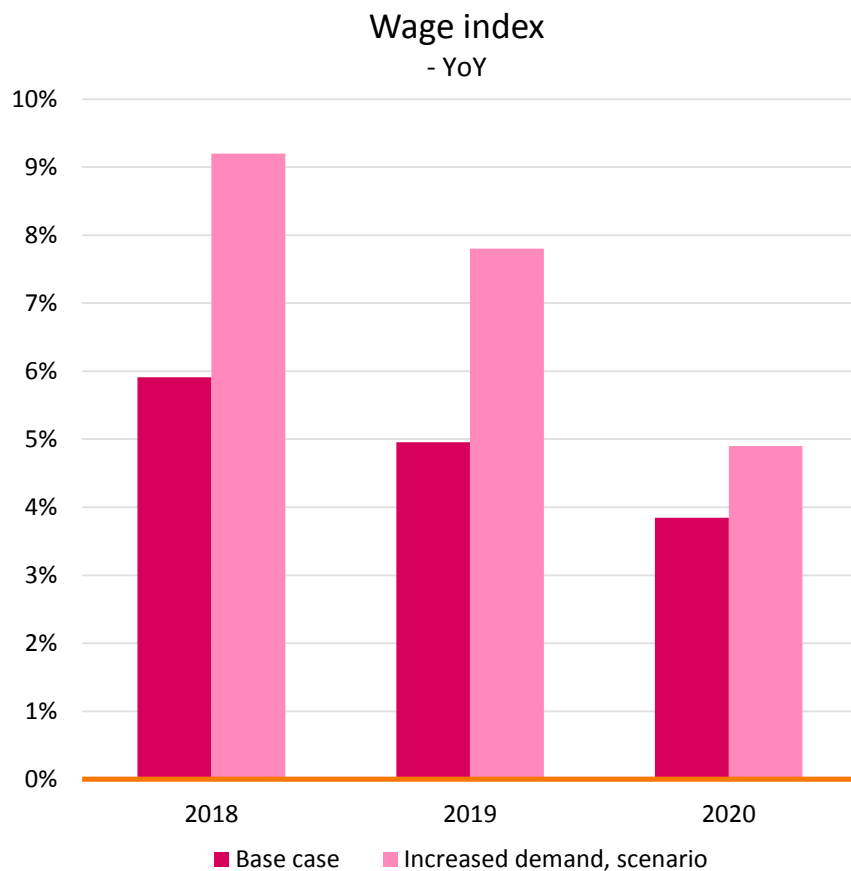
Rate of increase will slow down substantially as early as this year

Nominal price increases through forecast horizon, real prices drop later on



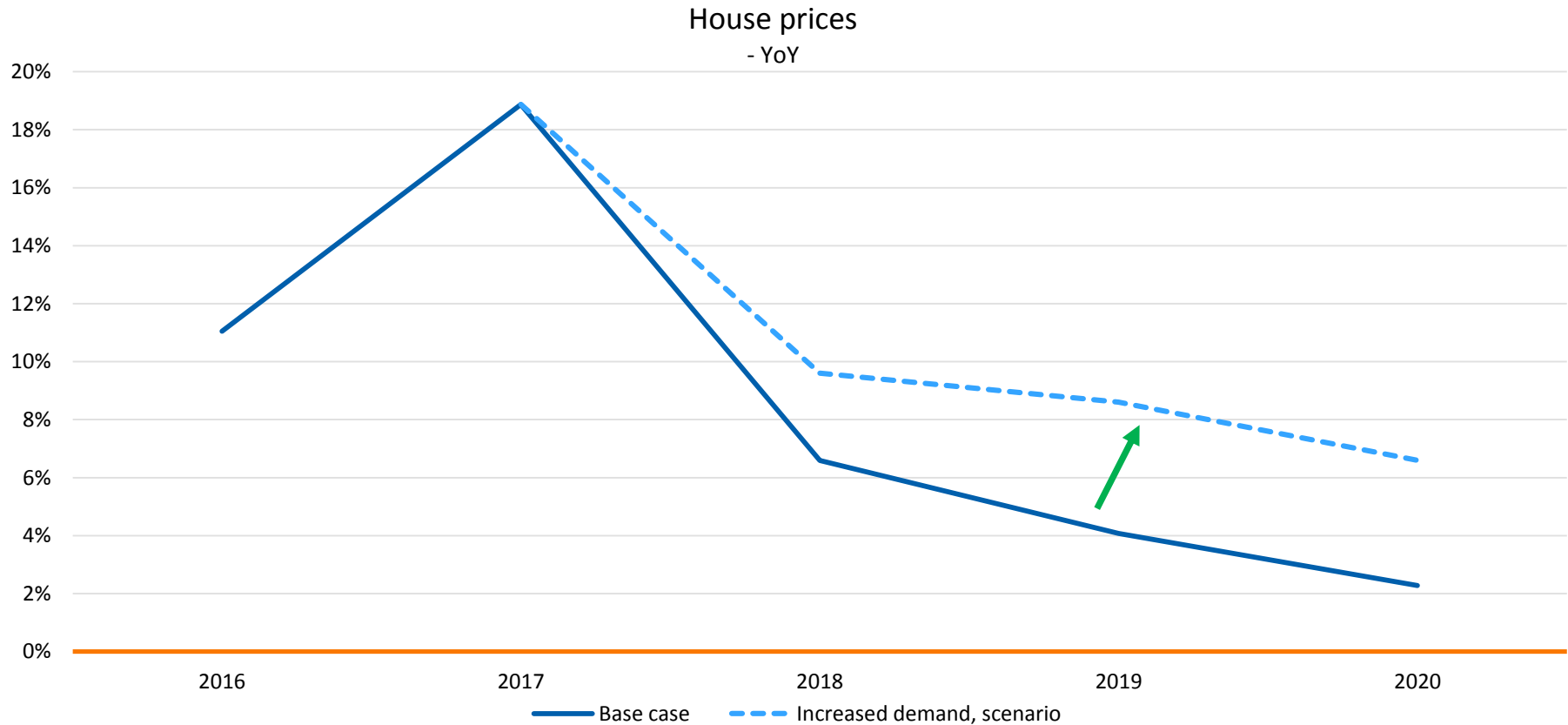
What if Statistics Iceland's population forecast* is accurate and the labor market goes off the rails?

It would mean that the baseline forecast underestimates demand in the economy



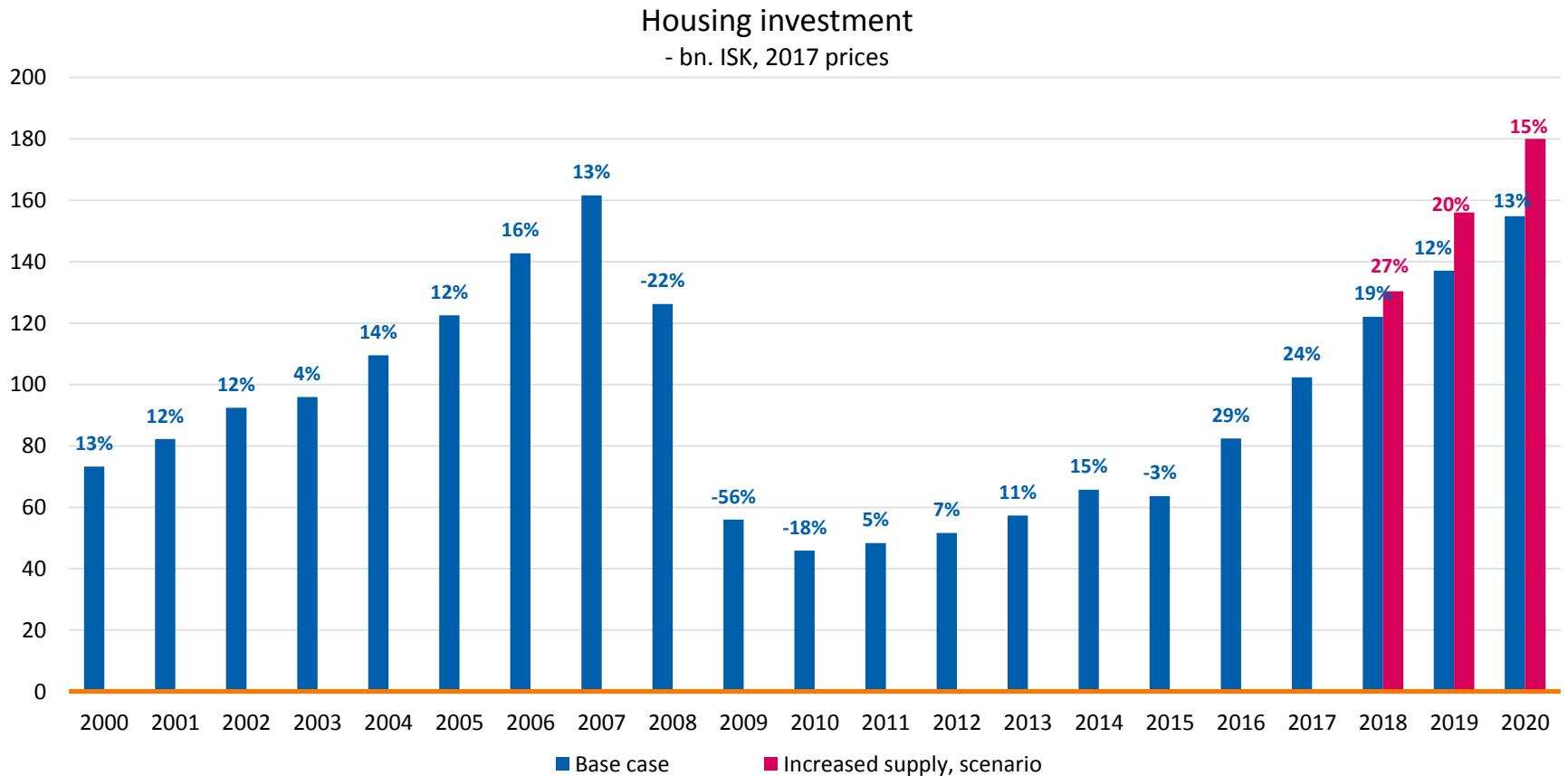
Increased demand means higher price increases

Price increases at the end of the forecast period could to some extent be overestimated if wage increases were to result in higher unemployment and/or inflation than assumed here



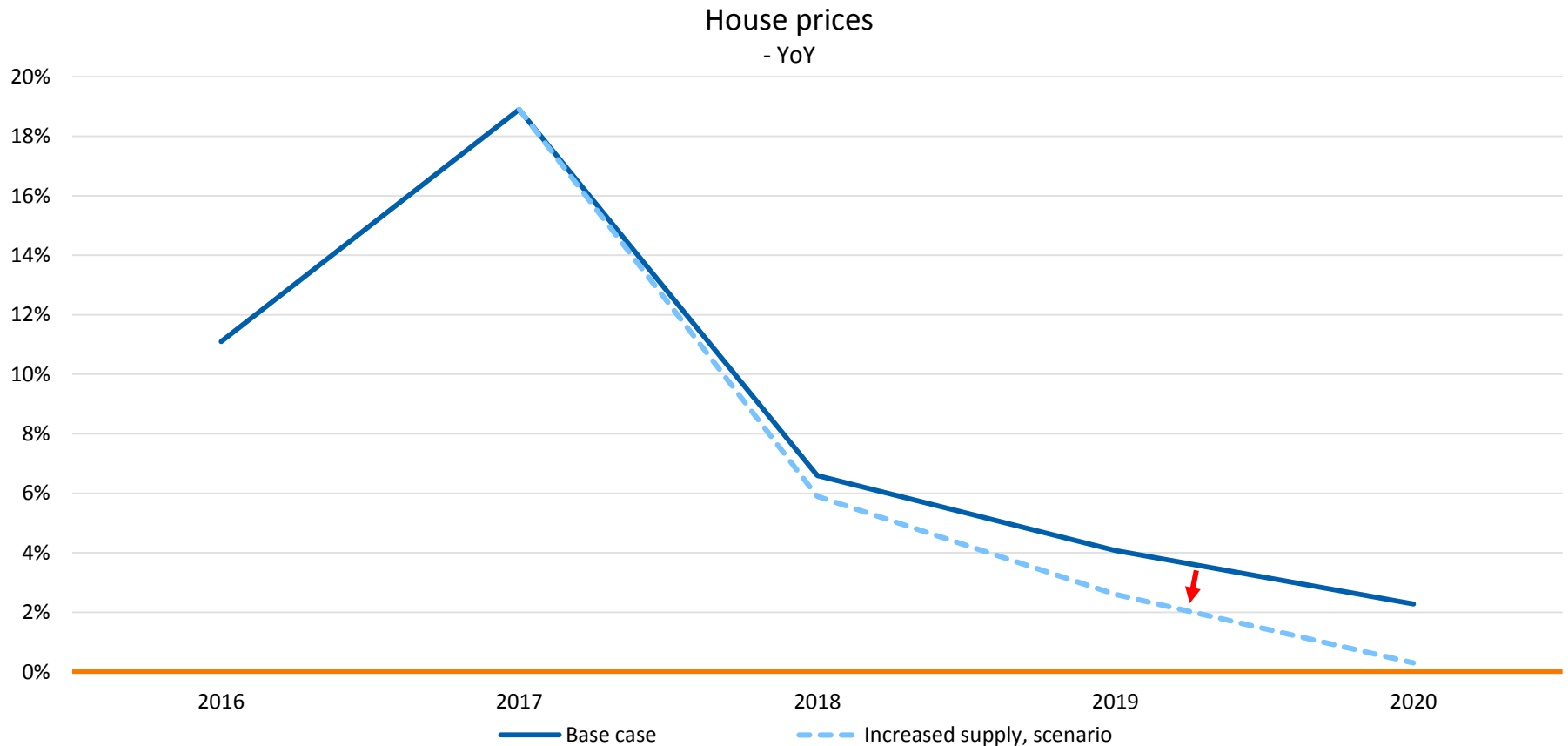
What if the supply side comes to life?

Increased supply should rein in price increases if other factors remain unchanged



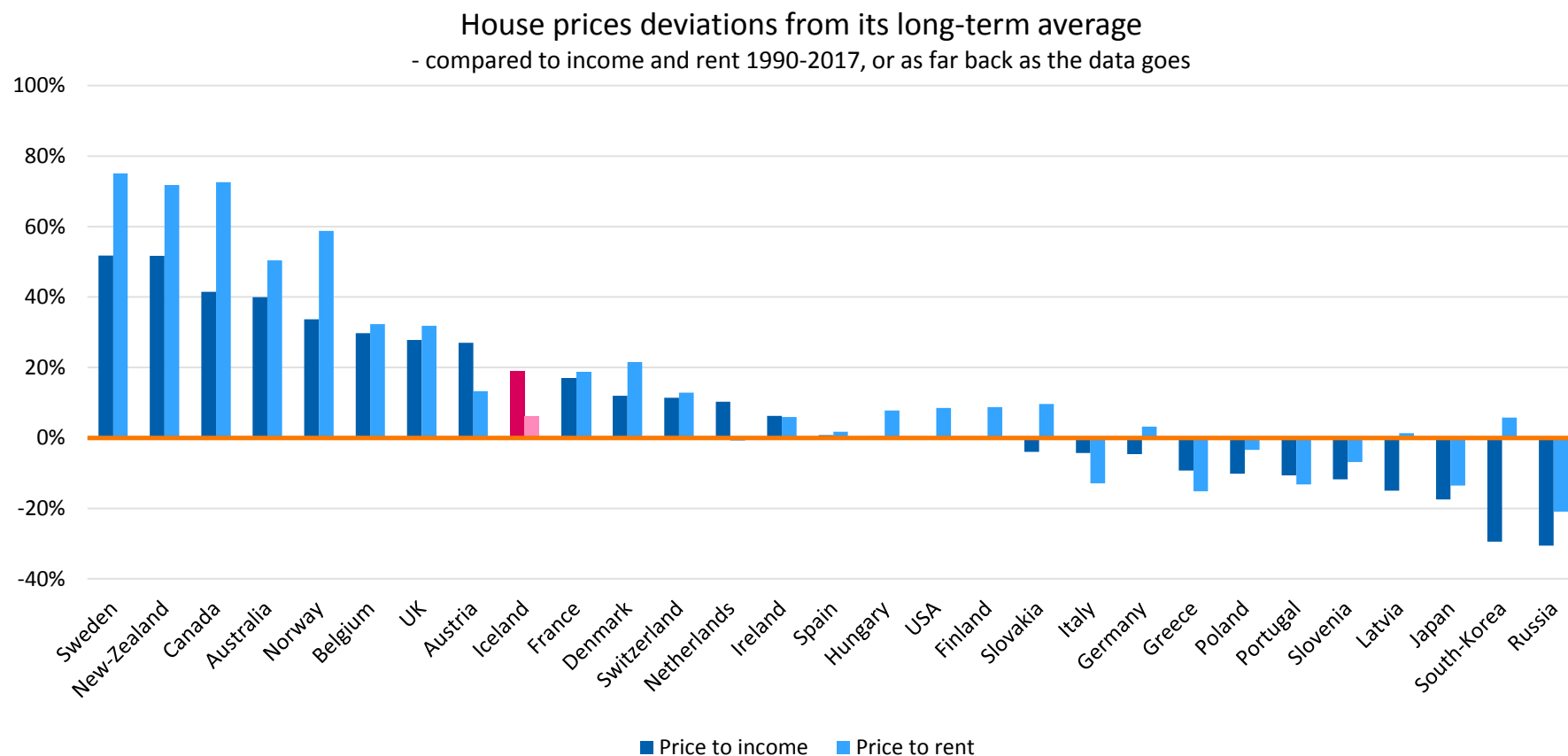
Increasing supply will slow down rate of increase

Minor difference between forecasts initially as it takes time to build a house



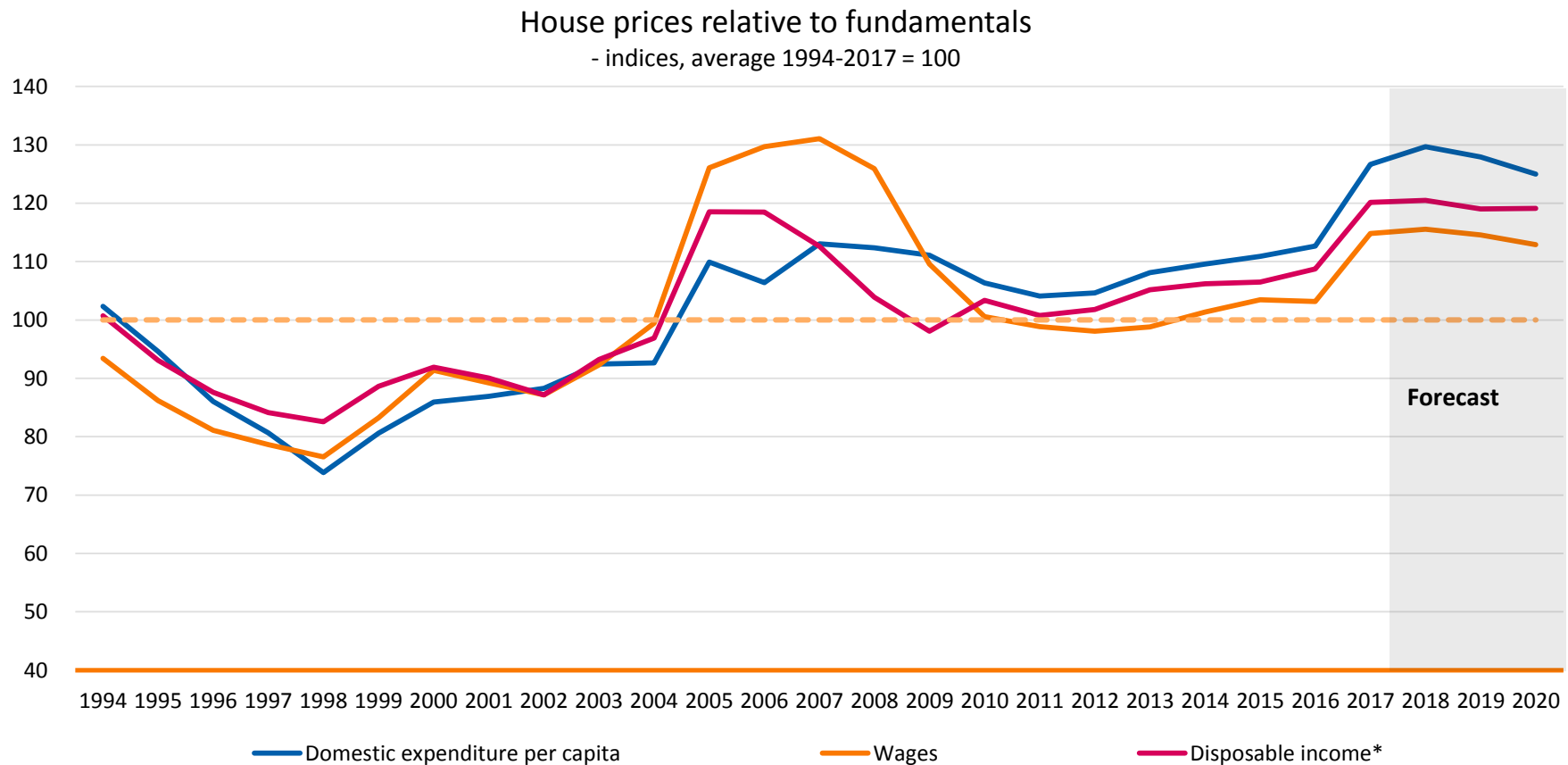
Imbalance is greater in many places despite the massive price increases in Iceland

Few countries, if any, have experienced such an increase in purchasing power as Iceland in recent years



Housing market heated up quickly last year – switched off later in the year

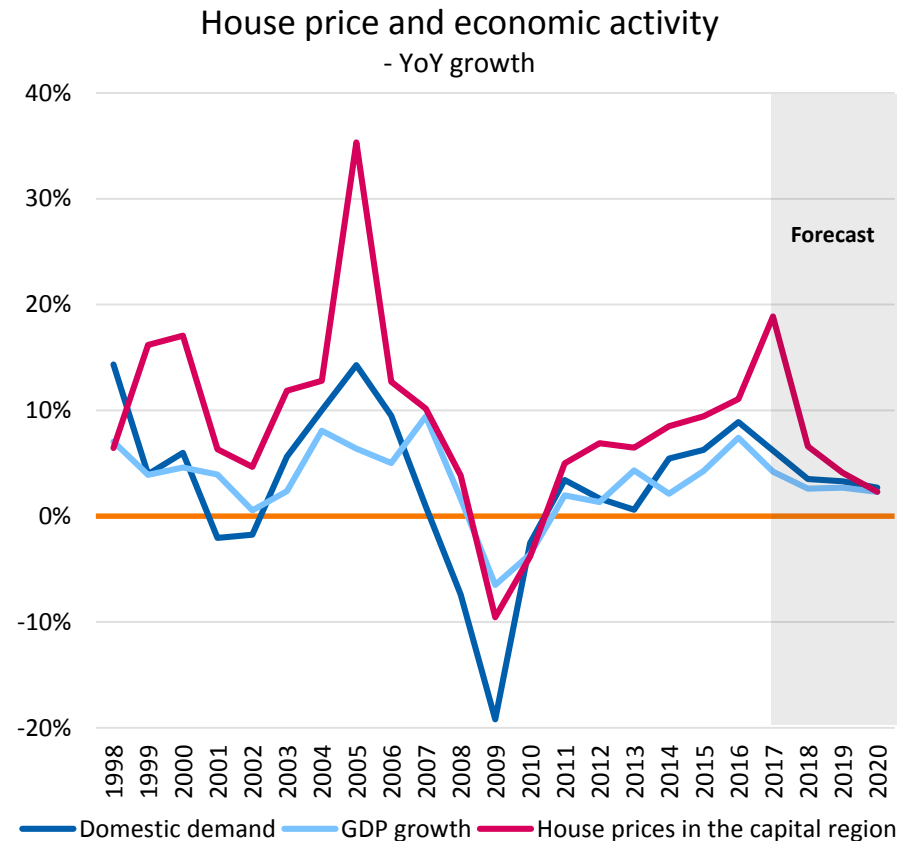
Looking at housing prices in relation to underlying factors gives an indication of the health of the market



Main uncertainties

What might prevent a soft landing for both the economy and the price of housing?

- Higher **lending growth** could fuel rise in housing prices.
- **Interest rates** in Iceland have a major impact on lending growth and therefore housing prices. Many households have variable rates on their loans, which means changes in interest rates affect their spending.
- **Supply side** could react too little – or even too much
- If there is a downturn in **tourism** it will have a spillover effect on the economy.
- High **wage increases** will in the short term force housing prices up. The long-term impact, both on purchasing power and housing prices, could be negative.
- Further **fiscal** relaxation could result in more tension in the economy.
- Building houses requires a lot of material to be imported. The exchange rate of the **króna** affects all areas of the economy, including the housing market.



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