Swedbank Analysis

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The Future of the Estonian Residential Real Estate Market

- The Estonian residential real estate market is showing signs of stabilisation and slow recovery, at least in the Tallinn region. But this will not be the prelude for robust growth. The growth of the market will remain weak for several years, if not for the next decade, despite the strong need for new and/or renovated residential real estate. Weak demand is the major obstacle for growth, and this weak demand stems from modest incomes and the high debt level, accompanied by cautious lending and borrowing.
- Demand growth will remain somewhat subdued even after five-seven years, when we expect wages and incomes to grow faster due to demographic factors, as the high debt level will persist and caution will be greater than five years earlier.
- Developments in the real estate market will be uneven due to a structural disharmony between demand and supply. We foresee a simultaneous growth and decline in activity and prices, depending on the type of real estate, and setbacks are likely as well. The development of the rental market in the long term is important for improving the living conditions of people having average or below-average incomes. But this development will be dependent on the enactment of better legislation.

Introduction

The real estate boom, which started in the spring of 2003, ended in the spring of 2007. The market took a second hit when the global financial crises erupted in September 2008. As of now, stabilisation and slight growth have emerged in the Estonian real estate market, especially in the Tallinn region. However, there are several reasons to claim that strong growth will not return in the next few years and, most likely, not even in the next decade. The weak demand is a major hindrance. This report examines the growth prospects of the residential real estate market (henceforth referred to as the “real estate market”) during the next decade.

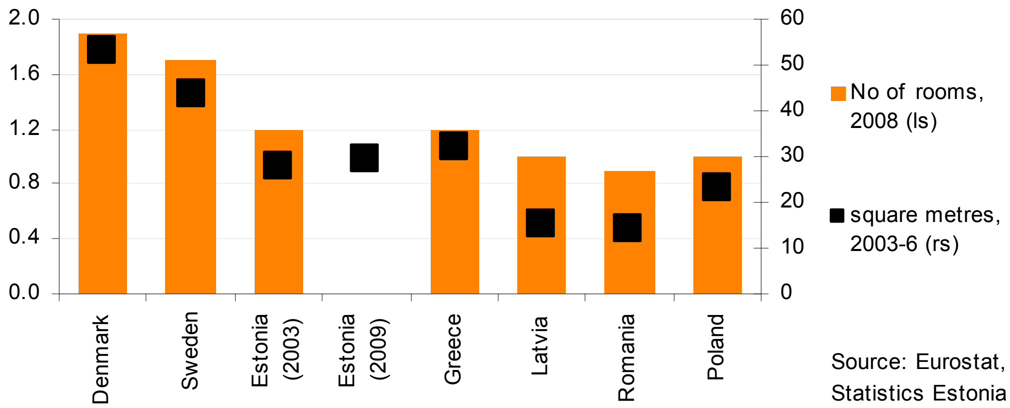
Two major indicators most characterize a real estate market: activity, or the number of purchase-sale contracts, and price dynamics. These indicators are connected with each other, but this connection is not necessarily a straight one. The number of purchase-sale contracts illustrates the readiness and opportunity of sellers and buyers to make deals, but price is an indicator of how demand and supply are balanced. While usually higher activity means also a higher price, it may not necessarily be the case on every occasion. Prices will grow if supply falls behind demand, and this situation may emerge even at times of rather low demand.

The three factors that affect the real estate market the most are need, demand, and supply. In this report we make a clear distinction between need and demand, which are often considered as one. Need reflects peoples' need to live somewhere and is highly dependent on existing living conditions and on the conditions in which people desire to live; expectations and demographical and economic developments have a strong impact on this factor. Demand emerges when the need is covered with finances. It is important to make a distinction between need and demand as a strong need does not necessarily mean that there is demand in the market, as households may lack finances to fulfil their needs.

Existing real estate and its development prospects

There is a huge need now for new and renovated residential real estate in Estonia, and this need is about to grow in the coming decades. Looking at the existing living conditions, one can easily see that there are possibilities for growth for several decades, even though living conditions have improved since the pre-boom time (prior to 2002) a lot (see charts 1 and 2).

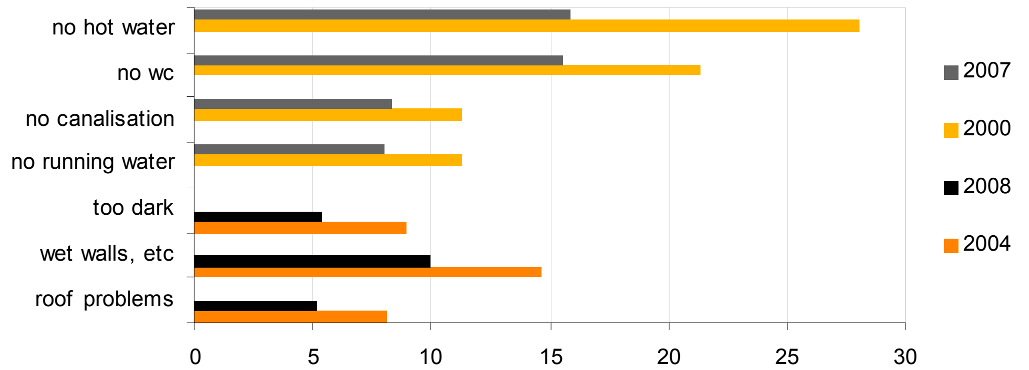
Chart 1. Rooms and square metres per person



Source: Eurostat, Statistics Estonia

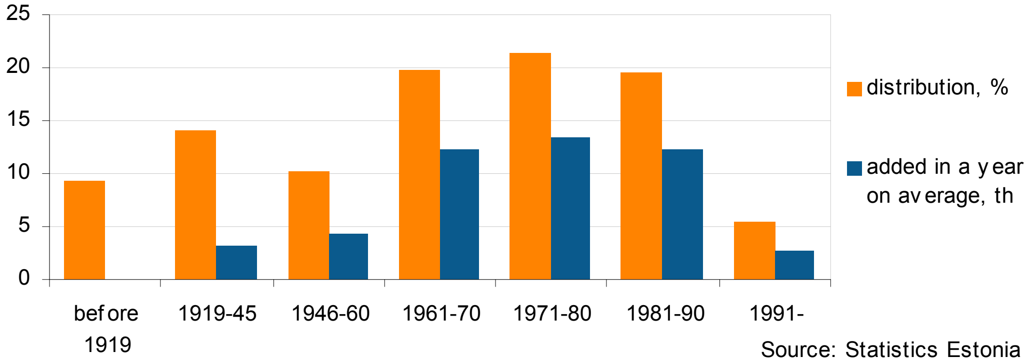
The biggest problems with the existing real estate are related to its quality and ageing. Most of Estonia's current housing was built during the 1960s-1990s, and its expected lifetime is 50 years. Definitely, some of these buildings will last longer; however, these will be only the buildings that have been properly taken care of and have been built with good quality. There are several reasons to believe that this will not be the case with most buildings. The renovation of the apartment houses built from precast concrete slabs (and these dominate among apartment houses) is expensive and might not be efficient enough or economically feasible;[1] however, there are no other good options, so renovation will increase in the future and will prolong the lifetime of many buildings.

Chart 2. Improvement of living conditions, % of families



Source: Statistics Estonia

Chart 3. Distribution of living rooms by age according to 2000 census



Source: Statistics Estonia

Estonian housing is dominated by Soviet-era apartment houses with very small flats and limited modern conveniences. Low energy- saving levels and outdated technology (e.g., *electricity, sewerage, water, heating, etc.*) are major problems. Lack of modern conveniences and low building quality are widespread problems for houses, and even houses built during the recent boom have quality problems. Many apartment owners cannot afford to make renovations due to economic reasons;[2] this may hasten the outdating process and, hence, the lifetime of the building. There is a greater likelihood that those living in nonrenovated buildings will have bigger (heating) arrears;[3] this increases the probability of abandonment and decay of the property, especially if the property has a low market value (including due to a lack of employment in the region).[4]

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[1] For example, the research done at Tallinn Technical University: „Eesti eluasemefondi suurpaneel-korterelamute ehitustehniline seisukord ning prognoositav eluiga"(Tallinn 2009); www.kredex.ee/eskuuringud

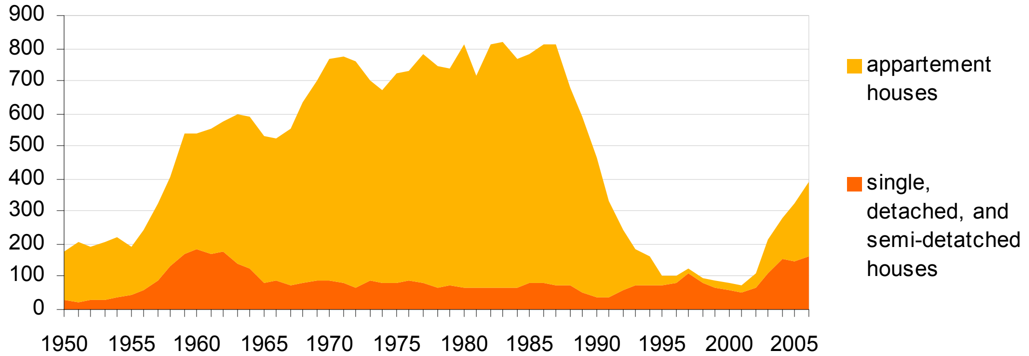
[2] In some cases there is a lack of interest as well.

[3] There have been many references in media to instances in which heating bills have fallen after renovation by 10-40%, depending on what has been done.

[4] Going to work in another region (and afterwards living there) is the most common reason why apartments are left. Almost equally important are too-high arrears and rapidly deteriorating living conditions. If one apartment is left empty, the likelihood that other apartments will have the same fate increases, as the costs and debts will be

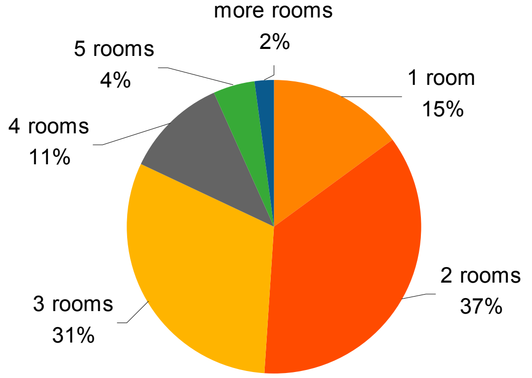
At least theoretically, the declining population should diminish the need for additional square metres. But as the number of households grows,[5] the need for additional living rooms grows; and as every flat/house requires certain rooms (kitchen, toilet, etc.), the square metres should also grow. One should also take into account the desire to live in bigger rooms as household wealth grows.

Chart 4. New construction, th sq metres



Source: Buildings Register

Chart 5. Distribution of living rooms according to the number of rooms in 2000 census



Source: Statistics Estonia

The current structure of living rooms (latest data are from the 2000 census of living rooms) is dominated by small apartments, which are suitable for families with one-two members. Buildings from the boom time followed the same tendency: mostly, very small apartments were built in the centre of the bigger towns, and in 2007-2008 also in the suburbs to some extent.[6] These small apartments are suitable for young, childless couples or single persons, but the number of people in

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distributed to other residents of the house. This happens because many housing services are provided to the house (not to the apartment) and then distributed among apartment owners: if there are payment problems with one apartment, it soon becomes a problem for all apartments in the house. This problem is quite widespread, and so far attempts by the authorities to find legal solutions have been unsuccessful.

[5] The size of households is declining. Most likely, this process will continue, albeit at a slower pace than heretofore.

[6] Private (including semidetached and attached) houses were also popular.

the first category is declining rapidly due to demographical reasons, and retired people are unable to purchase new real estate, as a rule.[7]

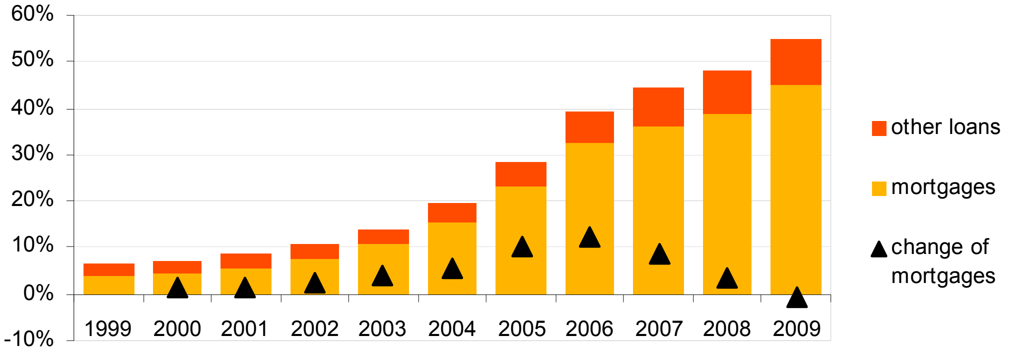
All these factors lead us to consider that **the need for new or substantially renovated living space will be strong for several decades.**

Demand outlook

This need does not necessarily mean that there is demand. The latter requires finances, and this aspect is rather unpromising for the next few years. The high debt level, loan-to-value problems, fallen incomes, growth uncertainty, and limited lending opportunities are the reasons for such an expectation.

As a rule, Estonian families have to take loans to purchase real estate as their savings are very modest. Consequently, the possibility of lending is the major factor determining whether the need will be transformed into demand. Household debt grew during the boom years to a level that very significantly limits the borrowing ability of households in the next few years. The other aspect is that there are relatively few families that can afford to take loans due to the low level of incomes. And most of those who potentially could apply for mortgages have done so already. The income decline in 2008-10 is limiting the number of potential borrowers despite the falling real estate prices, as banks have tightened lending conditions.

Chart 6. Households' debt burden, % of GDP



Source: Bank of Estonia, Statistics

Many of those who already have taken loans are in quite unpleasant (and unfavourable for the market) positions: the loan-to-value ratio for them has grown to over 100%. Banks have not required additional guarantees if the loan payments have been made without delay, and we do not expect this approach to change. However, this situation means that households that have taken mortgages cannot sell (and buy new) properties without creating financial problems for themselves.[8] Those households that took mortgages in the expectation of selling smaller properties and buying larger ones after family or income increases in the future (i.e.,

[7] Of course, at the same time many single retired persons are living in apartments too big for them. However, the process of changing apartments is complicated and often resisted by old people for to emotional reasons.

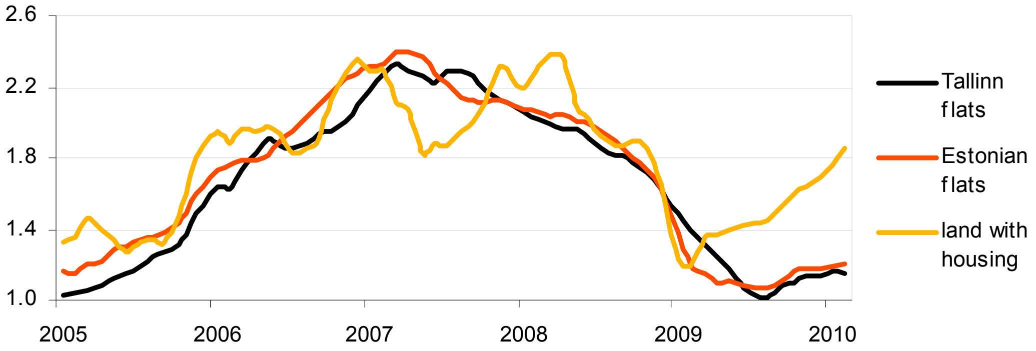
[8] Although the debt level will fall after the sale of the property, the interest rate will grow strongly for the remaining of the debt as it will be not granted by security. In some cases, this might result in much higher loan payments from much lower debt.

hoping to benefit from the value increase of real estate), are in a quite difficult situation. The problem might be very big for a household if the first purchase had been made on the secondary market and it now owns property in an old, non-renovated building.

Consequently, the mortgages can grow on account of (1) those who took them on several years ago (as a rule before 2006) and whose loan-to-value ratios are well below 100%, and (2) new borrowers.

Our real estate price index (see chart 7) shows that as of now prices are approximately on the level of the 2nd quarter of 2005.[9] The amount of mortgages was then approximately EEK 27.2 billion, or around 3.5 times smaller than now. In a worst-case scenario, only one-third of the current mortgages have loan-to-value ratios below 100%; however, this level is better (even 50% might be too pessimistic a view).[10] The growth in real estate prices will improve the loan-to-value ratios (as well as loan payments) and, hence, those “trapped” families will gradually regain their borrowing capability. However, due to other constraints (mostly income related), price growth looks rather modest over the next few years, and, therefore, a significant share of current mortgage owners will be out of the market for several years.

Chart 7. Median price of real estate sq metre, index 2004=1



Source: Land Board; Swedbank calculations

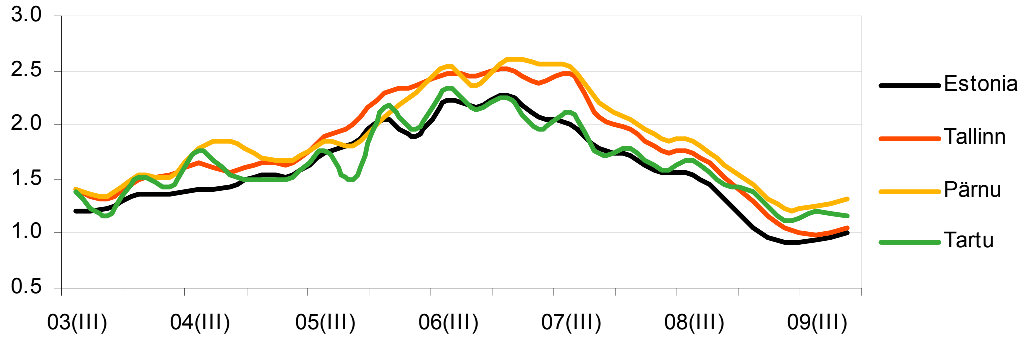
When estimating the number of possible new borrowers, one should take into account the rather modest expectations for income growth. If we look to the ratio of household incomes to real estate prices, then it seems that the situation has substantially improved despite falling incomes (see chart 8; we have used net wage as there are no data available for household incomes). The problem is that the number of potential borrowers is small. Indirect estimates suggest that, at the beginning of 2007, most potential borrowers and those interested in mortgages had already taken loans or their ability to borrow had declined due to the rapidly growing real estate prices. Since then, real estate prices have fallen more than wages; however, incomes have declined sharply among medium- and high- wage earn-

[9] The lowest point for prices was in the summer of 2009, when they were comparable with the level of the 4th quarter of 2004 level (possible seasonal fluctuations are not excluded from the index).

[10] Usually a 10-30% own financing was required;, however, the average loan-to-value ratio at the time of borrowing was better than that. Additionally, loan repayments have diminished the debt of households. The older loans were usually smaller (as the value of property was lower); hence, a mere monetary comparison of the previous and current total loan amount is not proper.

ers-- i.e., among those who could be borrowers.[11] One should also remember that the average wage is not a good indicator for estimating households' borrowing capacities at a time when unemployment is growing and working hours declining, as was the case in 2009. We foresee that unemployment will reach a peak in the 1st half of 2010 and the average wage will continue to decline. However, those employed will see their incomes grow due to an increase in working hours. Still, wage income growth will be modest. Income growth, which could support borrowing and real estate purchases, will appear at the end of 2010 at the earliest, but most likely in 2011.

Chart 8. Median price of square metre to net monthly wage



Tartu and Pärnu wages that of county

Source: Statistic Estonia, Swedbank calculations

Some other factors may affect real estate demand. First, there are still some buyers (although in declining numbers) who try "to fish for the bottom," expecting that prices will continue to decline. This expectation is based on weak domestic demand and uncertain developments in the global economy (expectation of a W-type cycle). Although the most active market – Tallinn – shows a slight growth in prices the real estate market in the rest of Estonia is still very weak and prices are generally declining. Tallinn's price increase is most likely because of growing number is considering that the lowest prices have been reached and returned to the market, but also result of structural change, i.e. sale of higher-quality property. Second, euro adoption might bring foreign investors into the Estonian real estate market, which may raise the prices of certain types of property at the end of 2010 and early 2011. However, this foreign interest may remain short term, and, hence, its impact on prices may be also transitory.[12] Of course, there are local people who hope that euro adoption will bring price growth per se, and they also may be looking for real estate purchases if they have money or are able to borrow money.

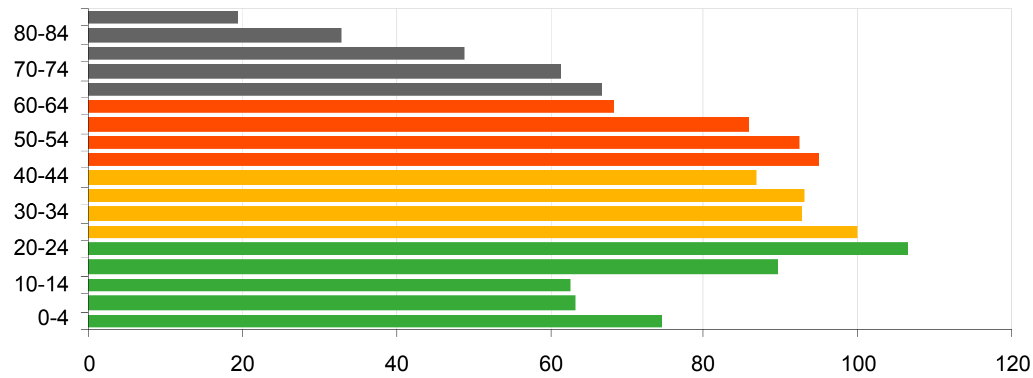
These expectations are determined by confidence, which, although improving, is still below the long-term average. Household confidence is strongly dependent on labour market developments; however, we expect that clear improvement in the labour market will be seen only in 2011 and even then very gradual at first. So the readiness to buy real estate will remain weak at least for the next one-two years.

[11] According to the Tax Office, the number of those who earned more than 8,000 kroons in a month in 2009 declined more than 14%, or by 55,700. The number of lower-income earners declined by 4%, or by 12,700.

[12] Many foreign investors hope to gain from rental. However, the current price level in Tallinn will yield only a small if any profit. The Estonian rental market is very small as most households own their living space.

Looking into the more distant future, we forecast a strengthening of demand, but its extent will depend on the banks, regulation, and the global economic situation. Demand growth is expected because of demographic developments: due to population decline and ageing, the labour supply will decline substantially after five-seven years (we estimate that it could be by as much as100,000 persons;[13]; estimates do not account for strong emigration). This will create labour shortage and strong wage growth, and will mean an increase in the number of loan-eligible families; it will also improve confidence and raise interest in buying real estate. Also, families currently "trapped" in a high loan-to-value situation will gradually return to the real estate market (at least they potentially will be able to do that). Banks will ease their lending conditions gradually; however, we do not expect that the conditions will be the same as in 2006-2007, due to both tightened financial rules[14] and banks' high, although falling, debt level.[15] Of course, a lot will depend not only on the general economic situation in Estonia and in the world, but also on banks' policies: of particular interest will be the interest rate level and the size of the risk premiums applied, as well as the own-financing requirement.

Chart 9. Population by age groups, ths



Source: Statistics Estonia

In conclusion, we see that demand in the real estate market will grow, and that growth will strengthen; however, we do not expect a repetition of the credit growth of the mid-2000s.

Real estate supply

It is difficult to estimate the size of the supply in the real estate market due to the lack of data; however, taking into account the overall situation in the market, one can easily conclude that supply still exceeds demand substantially, although the gap is diminishing. The stoppage of the price decline and signs of price growth are the factors supporting this opinion.

[13] This is somewhat smaller than the current number of unemployed persons.

[14] As of now, there is uncertainty regarding the possible changes in banking regulations on the Estonian, EU, and global levels, but the intentions of the authorities are very strong, particularly on the international level.

[15] It is highly probable that Estonian banks have to lower their debt level substantially in the long term. This general tendency does not mean that there will be periods when the debt level will not grow.

It is difficult to sell property that was built in 2007-2008, as it is often considered to be of bad construction quality,[16] with poor location and underdeveloped infrastructure. The complaint is often made that houses, particularly apartments, from that period are poorly planned.

However, the major problem with the existing supply is related to its structure: there is much real estate that is hard to sell not only in the current financial situation, but maybe even long term. During the boom time, two types of problematic real estate were developed in amounts exceeding possible demand. First are the so-called field developments, or residential areas around bigger towns with family houses (including semidetached and attached houses). Second, particularly during the second phase of the boom, apartment houses were built, generally in the centre of bigger towns, and later in the suburbs to some extent.

Apartment houses having very small flats in town centres are usually expensive, and, hence, are not suitable for young and retired persons, who could be the possible buyers. In addition, they are unsuitable for families with small children. The other category oversupplied is the very big apartments in the big centres, which are expensive and therefore affordable only for a few buyers.

At the same time, there is a big shortage of cheap and modest-quality real estate that could be available for households with medium and below-medium income. Those households can only buy flats in old houses, what at best are renovated (or could be renovated), and which are located far away from bigger centres. There is also a lack of apartments for families with children, and with modest price level (even for somewhat higher than average income levels), as there is a widespread opinion that families want to live in private houses.

The renovation process has clearly intensified (being supported also by the state programmes); however, it is highly probable that a substantial part of the apartment houses built in the 1960s-1990s will be not renovated, or that renovation will be minimal due to financial difficulties or troubles in reaching a consensus among apartment owners.[17] While renovation lengthens the lifetime of a property, it does not solve problems of the quality and size of the property.[18] So it is highly probable that in the future (10-20 years) many (maybe most) of these apartment houses will become unattractive for buyers and will gradually fall out of the market (of course, this depends also on their location).

A look at current development plans indicates that many expensive real estate developments are still being planned (e.g., on the coastal area of Tallinn), which means that wealthy consumers are still being targeted, although the size of this consumer group is small. The modest growth of incomes in the next 5 years will not increase this group substantially, although in 10-15 years this might happen (as noted above, wage growth will strengthen then). But this would require real estate prices to grow slower than incomes and structural changes to take place in the Estonian economy such that the overall wealth of households grows; we are not sure this will happen.

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[16] In 2007-2008, the construction sector workers generated "value-loss," i.e., the value added generated by an additional worker was negative. The reason was that the labour quality declined; hence, the construction quality also suffered.

[17] As a rule, there are owners' unions in the apartment houses, i.e., apartments are owned by people, and they are working together to manage the whole house (e.g., stairs, elevators, outside walls, and garbage collection).

[18] For example, the size of apartments, small bathrooms, basic building quality (construction), access, and movement of elderly and disabled persons (narrow staircases, no elevators).

To conclude, despite the quite substantial oversupply in the residential real estate market, a significant structural disharmony between supply and demand exists and will remain. This means that developments in the real estate market may become uneven, resulting in a situation of simultaneous strong growth and decline, depending on the type of property.

Summary

Recovery has begun in the Estonian real estate market, with stabilisation and a slight growth in activity and prices in Tallinn. However, there are several reasons why this recovery will remain rather slow for several years. The major obstacle is weak demand, suppressed by low incomes, the high debt level, and cautiousness in borrowing and lending. Global financial markets are an important factor in determining overall developments in Estonia, as well. While demographic developments may bring strong wage and income growth after five-seven years, the high debt level and cautiousness will most likely prevent a repetition of the recent boom. Still, some types of real estate may show strong price growth as supply does not match demand. At the same time, some types of real estate will see a decline in prices, and some living space will gradually become unusable. The supply-demand mismatch may become pronounced in 10-20 years if not handled.

The development of modest-quality standard real estate, suitable for medium-and below-medium-income families, bears watching. As this social group will not easily gain access to loans most likely (at least not to a great extent), it could be advisable to develop a rental market in Estonia to satisfy their demand for living space. This will require changes in legislation to secure the confidence of owners and tenants. The current preference for owning real estate could be changed slowly if a suitable environment is created.

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