

Romania - is the Party Officially Over?

Peter Hemple gives an update on the residential property market in Romania and wonders how property prices can continue to rise when mortgage rates are at 12%

Romania joined the European Union (EU) in January 2007 (with Bulgaria) and because of the country's size, location and population (21.5m people) it has been attracting foreign investment for quite a while now and many UK property investors bought off-plan units both before and after EU entry. This article will look at how the property markets are performing in Bucharest and in some of the smaller 'emerging' cities, whether the credit crunch is affecting Romania and what areas are in danger of oversupply plus analysis of key economic factors including inflation, interest rates and the strength of the Romanian currency.

Economy

Positives - As of June this year unemployment in Romania was at a low of 3.8%, down from 4.2% in March. However, low unemployment is a 'double edged sword' for Romania because the jobless rate has been falling steadily since last year when the country joined the EU, allowing many Romanians to emigrate to find better-paying jobs in other EU nations such as Italy and Spain. As a result, the Romanian government is already trying to get them to return home (more on that later).

GDP grew at an annual rate of 8.2% in the first quarter of 2008, the fastest pace since the

third quarter of 2006, according to the latest data from the National Statistics Institute (NSI). This compares with 6.6% in the fourth quarter of 2007 and 6.0% in 2007 overall.

The first quarter was described as 'the best for the Romanian economy in modern history' by Finance Minister Varujan Vosganian who attributed the surge in GDP growth to rising wages, increased tax collection (up 44% on the previous year) and growing foreign investment. Net wages grew at an annual rate of nearly 18% in March 2008.

Vosganian also indicated that the government expects a large agricultural harvest this year, which may further accelerate growth. A drought last year destroyed a third of Romania's crop, shaving more than a percentage point off GDP growth according to government estimates and pushing up inflation as the cost of food soared.

The Romanian currency has also performed well against the UK pound of late, increasing in value from 5.14 Lei to the pound at the end of January this year to 4.52 in mid-July an appreciation of 13.7% in less than six months, (which is only a positive if you have already bought a property in Romania and your mortgage is being fully paid by a tenant and not being subsidised from your UK income).

Foreign Direct Investment (FDI) peaked in 2006 at €9bn, up from €5bn in 2004 and 2005, and last year €7bn were pumped into the economy by foreign companies.

But the figure is expected to rise again this year, according to Simon Pearce-Hughes at homesinromania who says: "FDI is expected to exceed €8.45bn this year (making Romania the number one destination for foreign investment in the region ahead of larger countries such as Poland) according to the Romanian agency for foreign investment (ARIS). A 2007 investigation conducted by Ernst and Young recorded that 57% of western European companies surveyed had plans to establish operations in Romania within the next 12 months."

Negatives - Inflation rose to 8.6% in June, from 8.5% in May according to data from the NSI. On the month, average prices rose 0.3%, compared with 0.5% in May, which could be a sign that it is about to slowdown and the Romanian Central Bank has forecast that inflation will start to slow in August this year.

High inflation is a result of the food shortages caused by last year's draught, higher oil prices and the strengthening currency, which is pushing up the cost of imported goods. But the biggest factor has to be the fast rising salaries and they look set to continue increasing for some time

because the net average salary in Romania in 2007 was just €313 (£250) a month, (although they are just over 50% higher in Bucharest), and once Romanians are allowed to work in other Western-European countries without the need of a permit, salaries will have to rise very sharply to stop workers moving abroad.

These rising costs are pushing up interest rates in Romania, rising from 3.7% in March 2007 to 7.0% in June 2007 to 9.0% in February 2008 and most recently, in June this year, to 10%, which were the highest base rates in the EU. As a result, mortgage rates are currently over 12.0%! Property investors should note that if you plan on buying an apartment in Bucharest and financing it with a Romanian mortgage, you will need to put down at least a 50% deposit to come close to breaking even now that average gross rental yields in the city have fallen to 6% or less.

Regarding inflation, Pearce-Hughes says: "Such figures should be compared with those of Romania's neighbours e.g. Bulgaria, which joined the EU at the same time as Romania and today is experiencing inflation in excess of 12.5%. It is also worth remembering that availability of credit was extremely limited in Romania until around 2004, thus the country is somewhat insulated from the global credit crunch, moreover, the economy sank during the Russian collapse of 1999. Thus, Romania has not boomed for as long as her western counterparts and can now benefit from the tighter fiscal policy that was in place during a period in which other countries were less risk averse."

But it is called a 'global' credit crunch for a reason and already this year the Romanian stock exchange has recorded significant falls for no tangible reason apart from the fears that the US economy appears to be heading into a recession, and there are very few mortgage markets that are not at least being moderately affected by the lack of finance available at the moment.

Lastly, the strengthening currency, which is starting to be used by hedge funds due to the high interest rates offered, is likely to slow down FDI as foreign companies start to look at other countries where their pound, euro or dollar may go further.

Mortgage market

When I recently asked an employee at the European Mortgage Federation (EMF) about the Romanian mortgage market, he said: "Unfortunately, Romania is one of the

countries for which we do have the most concern due to the lack of statistical sources for mortgage indicators. It is a real pity because it is one of the most interesting and promising emerging markets, but also one of the least transparent."

What we do know about the Romanian mortgage market is that residential mortgage debt (total outstanding residential lending) is still extremely low when compared to the country's GDP, accounting for just 2.3% of GDP in 2006, compared to 36.3% as an average for the EU27 countries.

Pearce-Hughes says: "Domestic mortgages in Romania currently represent less than 5% of GDP compared to greater than 50% in the UK. Such financial products have only been widely available since 2003/4 and growth in their uptake, exponential. Availability of mortgages to foreigners from local banks is relatively new and, despite global credit conditions, it is generally easier to get a mortgage in Romania today than a year ago as a result of improvements in banking systems. LTVs are usually around 75%."

Romanian property market

In January 2008, Erste Bank published a report to comment on the evolution of house prices for 2008 in Romania. The bank is one of the big players on the Romanian market due to its acquisition, back in 2005, of the Romanian Commercial Bank (one of the largest banks in Romania) for €3.7bn.

According to the report, house prices in Romania are likely to stagnate over 2008 because the number of new developments is starting to counter-balance the demand for 'old flats', that is flats in blocks built before 1990, by providing more (and wider)

choice to the buyers. The report also advises that this overall stagnation will reflect differently for specific types of housing - the price of luxury flats will slightly increase, the price for new/affordable housing is likely to remain the same, while the price for old flats might see a decrease. So, what are the factors behind these changes?

According to data reported by the National Institute of Statistics in Romania, 45,867 new units were actually completed in Romania last year, 7,689 units more than the previous year. Among these, 8% were built of public funds, while the remainder belonged to the private domain. Most units were built in the north-eastern region (8,180), which was followed by the capital's metropolitan area of Ilfov (6,746 new units) and the south-east (6,684). On the opposite side of the country is the south-western region towards Oltenia, with only 3,457 new dwellings.

In 2007, a record number of residential projects were registered, both in Bucharest and the rest of the country. In the capital, last year saw the launch of nearly 60 new projects, with completion dates from 2008-2015. They account for around 65% of the number of projects initiated in Romania, while the remaining 35% are intended to be developed in the cities of over 150,000 inhabitants.

Bucharest (population 2m)

A new report by Colliers on Bucharest summarises what has taken place of late: '2007 was a record year for the residential market, with another 18 projects (of at least 200 units) launched, taking the number of large projects launched in the last 3 years to 39 in total. Demand grew as well with 7,300





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off-plan units being sold last year, doubling the previous year's figures. (However, investors' interest for this type of acquisition was very high, accounting for up to 50% of the take-up.'

According to Colliers, 'local investors are now buying larger packages of apartments, ranging from 10 to 15 units, as similar investments in the previous year had seen good profits'.

The company also says that in the second half of 2007 just 1,400 new units (from large developments) were completed in Bucharest, and that from the 39 large scale projects currently on the market, 35,000 new units could be completed in the next 7 to 10 years.

However, 16,000 new units could be completed over the next 12 months, a substantial increase on the 6,000 completed in Bucharest last year, but most estate agents are sceptical the construction industry will be able to complete that many given the current labour shortages.

Colliers reports a trend taking place with regards to construction in the capital: 'Considering the rising prices and the limited land available inside the city, some developers have headed towards the outskirts of the city, creating a new concept in the Romanian market, referred to as satellite cities. Cosmopolis is the first of this kind.'

Another trend appears to be the move away from constructing houses in favour of apartments and just 200 new houses/villas were built in Bucharest last year, mainly due to a lack of people that are wealthy enough to buy them at current price levels.

However, the biggest problem facing the construction industry in Romania is the lack of qualified workers - estimated at 300,000. 'This shortage is caused by three converging factors: a dramatic increase in the demand for professional construction services, a drop in the available qualified labour force (due to the migration abroad of Romanian workers), and insufficient training opportunities for the recruitment of new workers. This shortage has already led to delivery delays of 2-3 months', reports Colliers, which added that the cost of construction increased from €600/sqm in 2006 to €750/sqm in 2007.

More recently, in April 2008, residential building permits grew by 28.5% year-on-year (in urban areas by 20.7%) according to the Ministry of Housing.

Apartment prices in the capital are currently twice as high as prices of homes in the next 10 largest Romanian cities,

according to property consultant CBRE Eurisko. While a three-bedroom apartment in the first half of 2008 will cost €120,000-220,000 in Bucharest, similar homes were sold for €40,000-130,000 in the countryside. Reasons given for the disparity are the higher wages in Bucharest (estimated to be between 30-50% more) and the higher demand. But as mentioned earlier, over 50% of this demand is coming from property investors, which means that thousands of apartments will be entering the Bucharest rental market over the next 18 months.

Average prices for 'middle class' new developments in Bucharest are €1,300+sqm (+VAT) but more developers are now targeting local workers and reducing the size and quality of finish and selling at €1,000-1,200/sqm, and this is pushing down average prices overall. The most important infrastructure works for Bucharest are the Bucharest to Brasov Highway and the extension of the belt road (construction works for the roadway connecting DN1, Bucharest-Pitesti Highway and Bucharest-Constanta Highway started in November 2007).

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With regards to the rental market, CBRE/Eurisko reports that 2-bed properties were most in demand for rent in 2007, accounting for 43% of tenant demand, followed by 1-bed (23%), 3-beds (13%), studio's (10%), 4-beds (9%) and 5-beds (2%). Eurisko reports that rental prices are still high in Bucharest and that 'more than half of the properties that were traded on the market in Bucharest in 2007 (namely 54%) were rented at values between €2,000-4,000'.

However, rental prices are falling as new supply comes on stream. Pearce-Hughes says: "Rental yields vary greatly and have been artificially high in some market sectors e.g. the communist blocks. One can still reasonably expect to achieve 4-6% for residential rental in Bucharest and more outside the capital. As with all relatively young markets a glut of 'cowboy' developers is active, these have concentrated in the capital, though operate in all cities.

"One should conduct a personal inspection of any property before purchase and be aware of planning laws which are much less stringent than those of many Western nations, (proximity of apartment blocks to one another is a particular concern in this context). Prices in outer central Bucharest are around €1,500/sqm.

"Whilst value is still to be found, we now recommend avoiding the capital altogether as many consider this market to be overheating. Within the capital, the most questionable projects are to be found in the north of the city, towards the airports, though there is some quality here also once again thorough inspection is the key.

"The market is exceptionally regional and certain sectors such as the old communist apartment blocks (in Bucharest) are even expected to drop in value this year by up to 15% but prices in regions such as Iasi and Cluj may well continue to grow by more than 30%."

Other cities

Bucharest is by far the largest city in Romania but there are another half a dozen cities with populations of 300-400,000 people. Now that there are widespread fears that the market is overheated in Bucharest, many of these cities are now being targeted by property investors. The second-tier cities in Romania attracting the most attention include Constanta, Timisoara, Ploiesti, Craiova, Cluj-Napoca, Iasi and Brasov. However, while the population of Bucharest is still increasing, most of these secondary cities have seen a decline in population since the early-1990s.

Cluj and Ploiesti are expected to see an increase in demand for new apartments in the near future due to international companies relocating some of their production lines there, including Nokia entering Cluj where it is rapidly setting up a strong production division near the city, and Ploiesti has already been favoured by an increasing number of large companies due to its closeness to Bucharest (about 40 miles) and the relatively lower price tag for land in the area.

Is it better to buy land and wait for more companies to arrive?

Pearce-Hughes says: "The growth in land prices has historically been sharper than that seen in property. Even in the capital Colliers reported a high increase in land values in some areas during 2007. Much ▶



of the land in the capital has now been acquired by speculators and investors as well as developers, thus we anticipate most rapid growth to take place away from the larger cities.

"Areas in the north of the country such as Suceava, Bacau, Bisitria, Iasi and Botosani are all likely to boom in the same way the southern regions did during 2005, rapid growth in Transylvania is expected also. These areas are still relatively cheap and strong (recession proof) agricultural markets (soil and climate are most favourable in this region) are causing rapid growth in the regional economies (and rising local populations). The national association of farmers recently predicted a trebling of land values in the near future as crop prices soar and markets mature.

"We therefore favour agricultural land though acquisition of this asset can be troublesome due to a high degree of fragmentation and young land registry. Land in areas which might get building permissions is also of interest. The impact of global credit conditions on Romanian developers still needs to unfold, as such investors in this asset class should target prime locations (very close to city, coastal, mountain). If pressed our advice would be first to target agricultural land (preferably north of the Carpathians). Second look for prime building locations/development land (avoid the capital), and finally seek apartments and houses with good build quality suitable for middle class buyers in the secondary cities and larger towns (visit the site, take a builder if possible!)." **Declining population**

It would be impossible to write about the housing market in Romania without

mentioning its rapidly falling population, a problem that is expected to continue for many years. But a more pressing concern is the number of workers choosing to emigrate and thus far Italy has attracted the lion share of Romanian workers, which increased from 100,000 Romanians living and working in Italy in 2002 to 350,000 in 2006, according to the Italian National Institute of Statistics (Istat). Although the real figure, including Romanians working illegally is thought to be much higher, with the total estimated to be around 800,000.

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Apart from its obvious close proximity, the overwhelming reason Romanian workers choose Italy is the similarity between the Italian and Romanian languages, which makes it possible for even someone with a low education level to assimilate basic knowledge of the language within a matter of weeks. A Romanian newspaper recently reported that Romanians working in Italy are asking for wages of at least €600 a month to return back home.

The Romanian authorities organised a job fair in Rome in February and most of the men that attended were men aged 35-45. The country's Labour Ministry said most of the workers demanded salaries of €600-800 and more than half of the 700

Romanians who attended the job fair admitted that they work illegally in Italy. They also held a job fair in Spain in April.

But it is not just Italy and Spain. The UK government is currently granting over 20,000 work visas a year to Romanian and Bulgarian workers and the number moving to the UK is expected to rise substantially once restrictions are lifted, possibly in 2009.

Conclusion

Bucharest property prices are similar to Central London property prices insofar as they appear completely out of touch with what the local average worker earns. On average, a decent 3-bed apartment within walking distance of the centre will cost a worker in either city around 20 times their annual salary.

While London workers are not receiving annual pay increases of 18%, they are also not having to pay mortgage rates of 12% so there are pro's and con's for both cities.

The main concern for Bucharest though has to be the number of local investors that are speculating as if there were no tomorrow and that the only way for prices has to be up. Many are buying a dozen apartments at a time because they made a good profit the last time round. This sounds distinctly familiar. In fact, it sounds identical to the property price bubbles that we have seen go 'pop' at numerous destinations across the new-EU over the last year or two and also at some city centres here in the UK. It appears likely then that those countries that were last to host their own 'off-plan residential property party' may also be the last to get a hangover once the festivities come to an abrupt end.