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FACTORS SETTING UP THE PRICES OF RESIDENTIAL PROPERTY IN BULGARIA

Examined are the main factors influencing the increased demand for residential property as a main accelerator of the price increase. Special attention is focused on the significant increase of residential mortgage credits due to the more advantageous loan conditions and the improved acquittal capacity of households. Of great significance is the sharply increasing during the last years external demand for residences as an engine of the estate market. Analyzed are the perspectives for the development of the estate market and the factors for a future containment and eventual decrease of prices of real estates in Bulgaria.

JEL: G21; R21; R31

Stable increase in real estate prices has started in the Republic of Bulgaria, and in particular – in residential property, since 2001. The growth of the residential property prices was on the average of 243% in the period 2001 – 2007.¹ At the same time, GDP for the same period has increased by 85% and inflation (with an accrual) – by 52%. The growth of residential property prices (which exceeds inflation and the growth of GDP many times) has been a common fact, though with decreasing rates already. It makes sense to ask whether that growth has been objectively determined or some speculative expectations and predictions concerning the integration of Bulgaria with the European Union would rather prevail.

If we go through the main economic events worldwide, 2001 is the year in which the prices of shares decreased considerably at the biggest stock exchanges (the end of the so-called dotcom-economy). The first signs of a recession appeared in the developed economies and it happened before September 11, 2001. As a result of all this and with the purpose of averting an economic downfall, central banks decreased the main interests drastically to historically low rates - 1% for USD and 2% for EUR. At the same time processes of a stable devaluation of USD to EUR started - from 0.80 USD for 1 EUR (in 2000) to 1.50 USD for 1 EUR (at the beginning of 2008). This led to a change of the currency on the Bulgarian residential property market – from USD into EUR.

At the same time the privatization of the banking system came to an end in Bulgaria and as a result of it, 76% of Bulgarian banks were already in possession of famous foreign bank institutions. The decreasing profitability from operations on stock exchanges and from bank operations in Western Europe and the United States re-directed great capital flows from the bank central administrations to Central and Eastern Europe, in particular to Bulgaria. Processes of “opening” of

¹ <http://www.nsi.bg>

Bulgarian banks towards retail banking – consumer and residential mortgage loans, began. The growth of the latter was remarkable – these credits increased from 153.8 million BGN (toward the end of 2001) to 5,61 milliard BGN (toward the end of 2007),² i.e. by above 3548% for a period of seven years! A tangible external demand for real estates commenced parallel with the increasing growth of housing loans. The external demand for real estates is by Bulgarian emigrants and foreigners – especially English and Irish citizens who, according to the Invest Bulgaria Agency, were about 90 000 in 2007. A demand for residential property was registered as a result of the migration of people from smaller to bigger settlements, and especially – to the capital Sofia. Here it should be mentioned the penetration of institutional investors in the real estate sector – companies with a special investment aim, banks, insurance companies, pension and investment funds, etc. This way, the considerable financial pressure over the real estate market will lead logically to an increase of residential property prices too.

It should be said that *psychological and speculative factors* have been added to the main aforesaid objective factors for rising the residential property price. Referring to real estates in Bulgaria, some myths have arisen and have been well added to the Bulgarian national psychology according to which residential property traditionally takes one of the first places in the Bulgarian value system. There is a traditional saying that “Property is not for sale” and some other myths of that kind have been spread out widely in people’s minds like: “Property is the most certain investment” and “Real estate prices will become equal to the European ones after 2007”. The latter is the most harmful. This has led to the situation in which residential property prices in some complexes in Sofia have become equal or even higher in comparison with those in Prague or Budapest, having in mind that the nominal incomes of people there are 3-4 times higher! One simple comparison of the average market prices per square meter of housing area would show there is not such a term as “Unified European Prices”. Those prices vary from 900 €/m² in Istanbul to 11 000 €/m² in London, i.e. the differences are many times. The main reason for that is apartments are *international non-marketable goods*. It’s impossible, difficult or expensive for these goods (e.g. services) to cross national borders. Unlike them, marketable goods (commodity exchange items) cross national borders easily and world markets impose a unified price for them (e.g. construction materials).

The hyperbolization of the meaning of the property ownership in people’s minds (private property of residences is 97.0% in comparison with the average 65% in EU and 68% in USA!) has been combined with the fomentation of adjustments of rising the prices in future on the part of broker and construction companies, banks and medias. This (together with the objective factors mentioned above) has led to the increase of the demand for housing parallel with the decrease of the supply on the part of sellers. Because construction companies

² <http://www.bnb.bg>

cannot offer new residences on the market in short periods the prices have started to increase – the typical situation of a prognosis that becomes true! At the same time BNB can't involve unhesitatingly in order to stop the property boom that has been caused mostly by the growth of residential mortgage loans. Since the Currency Board was established in 1997, BNB has not got enough active instruments available for interfering on the market – for instance, increasing the main interest, as it happens in developed countries in such cases.

Residential real estates are special goods combining a great number of economic and social functions. On the one hand, an owner benefits from a residential property directly – it is a shelter. On the other hand, it is a means of preserving wealth (a savings instrument). An apartment is a potential source of incomes (rents). An apartment can be a guarantee for receiving crediting for various aims.

The only adequate measure for the value of a good is its market price obtained as a result of a volunteer competitive exchange between informed and rational subjects. In most countries real estate prices have a direct connection with the Business Cycle. The stable increase of those prices can be used as an indicator for the overall well-being and overall solvent demand in economics. The high private residential property percentage in Bulgaria (97.0%) supposes an availability of a sustainable potential of gross wealth of households due to the change in real estate prices.

Dynamics of the town residential property market in Bulgaria

As a member-state of EU with a functioning market economy, the Republic of Bulgaria is already characterized as a country with a developed real estate market. One of the major indicators characterizing the state of that market is the number of the deals with real estates done. The number of the deals shown in Table 1 has been growing steadily since the establishment of The Currency Board in 1997. The growth of the number of the deals was 399% in the period 1998-2007.

Table 1

Deals with Real Estates

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Number	65 179	90 119	100 317	117 489	121 552	147 417	195 567	239 938	311 581	325 385

Source. National Statistical Institute, www.nsi.bg

The change in the average price per 1m² of residential area in BGN for the whole country is of great importance for the development of the real estate market. In last few years real estates, in particular residential property, have growing more expensive in Bulgaria parallel with the increase of the number of the deals. These processes were marked clearly after 2002 although Bulgarian economy registered a growth even after 1997. Thus, for example, for the whole period 1997-2007 the

nominal GDP increased with above 2.36 times but relatively steadily during the 9 years while residential property was growing more expensive hardly after 2002. In Table 2 the yearly change in the average price of 1m² residential area in BGN (on the average of the 28 district towns) is shown.

Table 2

Year	2001	2002	2003	2004	2005	2006	2007
Price (BGN/m ²)	318.3	331.9	386.3	540.5	738.0	819.3	1091.2

Source. National Statistical Institute, www.nsi.bg

It is obvious that the increase of the average residential property price was 243% for the period 2001-2007 in Bulgaria. That figure exceeded the growth of GDP and inflation considerably for the same period. In 2006 Bulgaria ranked third among the European countries where the price of apartments was growing more expensive even though the growth of the price was delayed considerably compared to the previous 24 months.³ A survey by the Royal Institution of Chartered Surveyors /RICS/ (the most competent British organization of professionals in the field of real estates) shows that Bulgaria is left behind only by Poland and Denmark and our country is ahead of Estonia. In accordance with the review of European residential property markets, which is made by the organization annually, in Bulgaria the prices have arisen by 20% in comparison with those in Denmark (22%) and in Poland (33%).

Here is the right place to mention two particularities concerning the estimation of the total residential property price index in the country. It is well known that when a price index is estimated, there must be made a correction for the change in quality of the relevant good even when we examine homogenous assets.⁴ This is a greater problem for real estates since there is no homogeneity here.

The location of a residence, as well as its construction technology and quality, are determining factors for the formation of its price. In real estates (where materials change fast, especially, those materials necessary for ending the project), we have a strong effect over the change in quality. In that case, the total price indexes for the real estate market do not make a correction for the change in quality and due to that they overestimate the growth of the prices partially.

The second particularity concerning the estimation of total residential property price index in the country is that NSI receives the data on residential property prices from The Registry Agency. Tax valuations, as well as sums paid in real (most often in deals financed through mortgage loans), figure as prices there. The methods (with two, in fact, different types of values) used by NSI distort the

³ Bulgarian residences are in the third place in connection with their price rising in Europe. - Construction and the town, February 12, 2007, p. 46.

⁴ Hristov, K. There are bubbles only in fun-fairs. - Capital, March 3, 2007, p. 25.

reliability of residential property price data and their growth in time.⁵ The growing penetration of mortgage housing loans on the property market leads to the process of „lightening” of the real prices of deals, on the one hand, and to a false growth accounting, on the other hand. Thus the processes of turning property market into more transparent structures appear on the surface as an additional growth of residential property prices. Not very truthful data on market prices and their growth (the latter doesn't account the growing construction quality and the process of „lightening” of the market) spread wrong signals to the participants on the market which influences over them and introduces irrational elements in it. In Bulgaria most deals “remain in shadow” – i.e. there is an additional payment “under the table” which is not written down in a Notarial Act and Statistics and this makes the market non-transparent. The information on the real prices of deals and their periodical growth has turned into a monopoly of the biggest real estate companies. Appraisers, for example, who work for banks lending housing loans against a mortgage use the information on prices of deals concluded in reality by paying for the access to the data base of big mediatory agencies.

Indicators for the Presence of an Residential Property Bubble

The considerable growth of real estate prices in a comparatively short period of time arises the question whether this phenomenon is objectively determined or is a result of speculations on the market. The “Economic Bubble” phenomenon is observed when in a restricted market segment exorbitant investments (that rise the price of the marketed asset) concentrate and on the other hand, this causes a more massive concentration of invested capital due to the expectation that higher prices will be reached. The public expectations for a future rapid and stable increase of residential property prices are exaggerated and this makes these prices grow up – the typical example of a prognosis that becomes true. In such a situation buyers aren't hesitant at high residential property prices suggesting that a further future increase of these prices will compensate the capital that is being invested by them now.

The first case of “bubble assets” – real estates in Ancient Athens, entered annals in 333B.C.⁶ The “Economic bubble” phases are the following:

- *mania* – it is described as a desire for rapid and easy profits which leads to a growth of residential property sales and strengthened new construction. The town residential property market in Bulgaria is at the end of that phase. Prices are decreasing their growth rates, the number of new issuing construction permits is also decreasing and the time needed to sell a residence is increasing. Meanwhile, buyers become more and more pretentious and do not invest their money at any cost.

⁵ Yotov, St. Tax estimations and residential property market prices in Bulgaria. - Economic Thought, 2005, p. 76-77.

⁶ Harsev, E. Bubble Economics. - SEGA, June 20, 2005, p. 13.

- *panic* – the first indications that the market slows down its growth appear and that leads to a start in selling off in the residential property sector. The Bulgarian vacation residential property market is already at the beginning of that phase. English and Irish citizens have been withdrawing from the sea-resorts at the Black Sea on a mass scale. Sales of hotels in separated residences have started. Banks haven't already been lending loans for building new hotels in over-built-up sea resort areas. Only in Bansko there are more than 20 000 unsold residences and at the Black Sea - they are totally above 200 000.

- *downfall* – the bubble becomes flat because a “financial engine” has not been invented yet. Because of the concentrated the selling-off property prices fall down and banks restrict the new housing loans. Some borrowers stop serving the loans lent and banks start selling the mortgaged properties and that contributes to the slump of residential property prices once again. The “dominoes effect” appears in the whole residential property sector and this, under certain conditions, leads to the bankruptcy of some of the bank-creditors and a part of the credit-holders go bankrupt. In certain cases, all this could lead to a serious stagnation in the whole economy. All this happened (but in soft form) in the United States of America after August 2007. Mortgage and residential property downfall threaten to push the American economy to a recession – for the first time after the period 2000-2001.

The “speculation” phenomenon is described as a considerable increase of the price of a certain asset but always on the basis of a considerably growing credit that finances its purchase.⁷ “Considerable” is a term that defines the increase of the price of a certain asset (in this case – a residential property) which is at least two times more than the percentage of the total annual *inflation* (measured by the “December-December” methods). This means that if the inflation in Bulgaria is on the average of about 4-5% annually, the increase of the housing prices by more than 8-10% annually could be regarded as considerable, i.e. there is a speculation on the market! The second criterion for the presence of a speculation in the real estate sector is the growth of mortgage housing loans. “Considerable” is the growth of loans that is at least two times higher than the growth of GDP which has been on the average of 4.5% annually for Bulgaria in recent years. That's why an annual growth of mortgage loans by above 9% is regarded as considerable and it is a sign of a speculation on the residential property market in this case!

Both two major criteria of the presence of the “speculation” phenomenon the real estate market are met in Bulgaria now. It must be mentioned that it is hard to say there is a bubble with certainty before its getting flat which acknowledges its presence. Even if the presence of a bubble is registered early, its prevention by the Central Bank (mainly by credit restrictions) could lead to a shrinkage of economy. But this, however, is the result of the development of the bubble which the Central Bank tries to avoid!

⁷ *Petrov, Kr.* Chronicle of a preliminarily notified speculation. - Capital, 24.04.2004, p. 48, 49.

Major factors influencing over the town residential property prices in Bulgaria

Local buyers' incomes

It's well known that consumers' incomes are the second major factor (after the price) influencing over the demand for a certain good.

The increase of incomes influences over the residential property market in form of an increased solvent demand on the part of buyers. The official statistics registers a constant increase of the AS (average salary) that is the most precise indicator for people's incomes. However, the following fact should be taken into consideration: the share of the "grey" economy is still considerable (between 15 and 25% of GDP compared to the European levels of about 10-12%) and a part of the incomes is not registered. That's why it could be concluded that people's possibility of buying real estates is greater. Another particularity (that has been reported on by NSI in recent time) is that AS in the different district towns differs from the total level for the country. Thus, for instance, AS was 384BGN during the first quarter of 2007 while its level for the town of Sofia – it was 502 BGN.

In recent years the incomes of potential buyers of residences have been in arrears with the growth of residential property prices in spite of their nominal increase. The increased prices have neutralized the effect of the falling down interests (up to 7-8% annually) entirely and the increased due times for redeeming mortgage housing loans (up to 35 years).

The Coefficient of accessibility to an average residence (on the basis of the incomes of an average household) shows how many average annual salaries (before taxes) are necessary for the purchase of an average residence. This coefficient for the EU member states varies between 7 and 9 years.⁸ There are not quite enough statistic data on the ratio "Residential Property Price/Average Salary (AS)" for Bulgaria. The information in this respect is shown in Table 3:

Table 3

Indicator	2002	2003	2004	2005	2006	2007
AS (BGN/per year.)	3 096	3 384	3 648	3 885	4 260	5174
Average residential property price (BGN/m ²)	331.9	386.3	540.5	738.0	819.3	1091.2
AS Purchasing Power (m ² /year)	9.33	8.76	6.75	5.26	5.20	4.74
Residential Property Price / AS (years)*	6.97	7.42	9.63	12.35	12.50	13.71

* The example relates to an average two-room residence (65,00 m²).

⁸ <http://www.properazzy.com>

It is obvious that except the absolute residential property price and also the relative residential property price goes up during the years – from 7- to above 13-year ASs. Referring to the average incomes of people, residences are definitely overestimated at the moment. It should still be mentioned that the considerable part of the “grey” economy, as well as unregulated incomes and profits, require the usage of other indicators measuring the *real* disposable income of the households in Bulgaria.

Another view point on the matter of incomes is: how many days should one work in order to buy 1m² of town residential area? GDP per capita in EUR is used as an indicator here. The European towns mentioned below have been arranged in an descending series:⁹

London (the United Kingdom) – 129 days
Sofia (Bulgaria) – 84 days
Paris (France) – 47 days
Ljubljana (Slovenia) – 43 days
Madrid (Spain) – 40 days
Amsterdam (The Netherlands) – 32 days
Berlin (Germany) – 31 days
Vienna (Austria) – 23 days

It's clear that one should work 3.65 times much more time in order to buy 1m² of town housing area in Sofia than in Vienna, for example.

The expectations of analysts and market stakeholders for the future real estate market development differ. One part (a smaller one) is of the opinion that residential property prices are already rather high for the solvent demand of a household and the great construction development in big towns will lead to an oversupply and a stagnation of prices in a medium-term and long-term plan. The other part of analysts is optimistic about the long-term income growth of the Bulgarians which will make housing prices grow higher constantly. The Bulgarian membership in EU itself (after the 1st of January 2007) does not guarantee for keeping the price levels that have already been reached, as well as it does not prevent from any further risk of downfall on the market.

The average inflation in Bulgaria was 5.5% annually in Bulgaria in the period 1998-2006 and it exceeded the inflation in the greatest European economy – the German economy, by 4%.¹⁰ According to EUROSTAT, in 2005 GDP per capita (purchasing power standard) was on average of 32% of the average GDP of EU - 25 while the common level of the prices of all consumer goods and services in Bulgaria was 43% of the that of EU – 25. In a medium and long-term plan the growth of GDP will be by 4-5% more annually and the inflation – by 3-4% more annually than that of EU – 25. Peoples' real incomes will catch up with EU ones

⁹ Capital, April 9, 2005, p. 46.

¹⁰ Capital, February 17, 2007, p. 25.

parallel with the total level of prices. The aforesaid process will continue even after Bulgaria will have joined the Eurozone (2011 – 2012) and its concrete speed will be determined by the speed of integration of the national labour market, commodity and capital markets to the relevant markets in EU. Inflation will be a little higher than that of EU due to the growth in the non-marketable sector (including rents and residential property prices), the prices that are administratively fixed by the government, the harmonization of excise duties with their minimum levels in EU and the growth of primary energy resources like oil, natural gas, etc. The construction sector will continue moving the industry up and the flow of foreign investments in real estates will continue entering the country.

Accessibility to mortgage residential property loans

The prices on the residential property market (other things being equal) are determined by the residential property demand-supply equilibrium in a medium and long-term plan. In a short-term plan, however, prices are determined mainly by the demand since time is necessary for building up new residences. The supply of newly built-up residences reacts with some delay of rapid changes in the demand because of the long production cycle, construction regulations and investors' uncertainty whether the changes in the demand are temporary or constant. That is why, when there is a constant demand for real estate prices grow up inevitably and as a result of this, the gearing of households arises as a secondary effect. The internal demand for residences depends on peoples' incomes and savings mainly, as well as on the accessibility to profitable mortgage loans. Housing prices will be taken up in the view of the ratio between the annuity payment of the typical housing mortgage loan issued by a Bulgarian bank and the average salary (AS).

What does "an accessibility to a housing loan" mean? Generally speaking, this is the ratio between the annuity payment of a housing mortgage loan and a borrower's average income. The practice shows that the banks in Bulgaria require that this ratio should be from 40% to 60%. For instance, there are standardized practices in that field in USA. This ratio (annual payment/average income) can be up to 29% (if a borrower has only a housing loan) or up to 41% (if a borrower has also other loans).

Let's take the following example: a borrower draws on a housing loan amounting to 70% of its price and the bank requires that the "annual payment-income" ratio is up to 40%. If described as an inequality, it is as follows:

$$AP = DC \times CRF \leq 0.40 \times AS,$$

AS is the average salary;

AP is the Annuity Payment of the loan;

DC – the amount of the debt capital – 70% of the residential property price (P);

CRF is Capital Recovering Factor:

$$CRF = \frac{(1+r)^n \cdot r}{(1+r)^n - 1},$$

r – it is the average interest of housing loans (BGN) in the country (according to BNB);

n – it is the number of years necessary for paying off the debt.

Let's take the following value of quantity:

AS = 474 BGN/per month (December 2007);

r = 8.03% annually (January 2008);

n= 35 years – (the maximum for Bulgaria).

And then we substitute in the formula and we receive:

$$0.70 \times P \times \frac{(1 + 0.0803)^{35} * 0.0803}{(1 + 0.0803)^{35} - 1} \leq 0.40 \times 474 \times 12$$

$$P \leq 37\,766 \text{ BGN}$$

If we accept that the average built-up area of a Bulgarian residence is 65 m², then the price must not exceed 581 BGN/ m². At the same time, according to NSI data, the average market price of residences in Bulgaria was 1091.2 BGN/ m² in 2007. This means that from the view point of a compatibility with an AS for paying off an annuity payment for a housing loan, residences in Bulgaria are overestimated – in this case by 87.8%:

Here it should be repeated that incomes in Bulgaria are really higher due both to the great part of “grey” economy and payment “under table” that exist in most private companies.

A justified question arises: Is the creation of a financial liability by a buyer of a residence (a mortgage over it) justified from a financial view point when the costs for serving that liability are not compatible with the incomes? If we substitute again, we shall receive the following result:

$$AP = 0.70 \times 65 \times 1091.2 \times \frac{(1 + 0.0803)^{35} * 0.0803}{(1 + 0.0803)^{35} - 1} = 4273 \text{ BGN/years}$$

The annuity payment of 4 273 BGN/per year calculated in this way is 75.1% of AS – a value that exceeds the reasonable 40%.

It should be mentioned that, in spite of the great part of annuity payments in comparison with average incomes, the growth of the internal demand for residences is moved mainly by buyers with incomes above the average who get bank loans. According to the mortgage intermediary “Credit Centre”, the income profile of housing credit holders is the following (in January 2008): with a monthly income of a household up to 750 BGN – 18%, from 750 up to 1500 BGN – 44%, from 1500 up to 2500 BGN – 27% and above 2500 BGN – 11%. On its part, the growth of a credit goes ahead of the growth of current incomes, i.e. clients rely on a future income. This optimism about a future income is based on a macro-economic and political stability, a good development of the labour market, an economic growth, an increase of investments and a flow of foreign capitals in the country.

Mortgage housing crediting will continue growing in future too due to its high yield for bank-creditors. Currently interests of housing loans are around 7-8%

annually and they will hardly go down considerably in future while in other EU countries they are between 4,5% and 6%. In February 2008 the main interest for EUR was 4%, for USD – 3% and for GBP – 5.25%. The leverage of Bulgarian households is still comparatively low. The gearing of households towards the banking system is still growing and the “Debt-GDP” ratio is 18% - rather lower than the average one in the Eurozone (54%). The ratio between the gearing of households and their income is more indicative. It is around 48% in Bulgaria (according to the research company Industry Watch) while it is 90% in the Eurozone, 120% - in USA and 140% - in UK. The extent of the “penetration” of housing crediting is small – its part towards GDP is about 10% while it is on the average of 40% for EU. The ascending trend for this indicator, however, means that a greater part of incomes of households will be re-directed to serve the debt decreasing consumption costs this way.

We might conclude that the major factor for the continuing increase in real estate prices is the change in demand as a result of the increased capacity for serving the debt and a greater accessibility to loans. The increased capacity for serving the debt is defined by the trend to a decrease of the nominal interest in consequence of the one-figure inflation rate after the Currency Board was established and the stabilization of the inflation expectations. The greater accessibility to loans is determined by the privatization of the banking sector, the liberalization of the capital movement and the subsequent financial innovations which give a greater number of households an access to loans. The considerable diminishing of interests is at heart of the increased inclination of households for investing in real estates through a debt accrual.

Rent profitability of town residences

A major price-forming factor for a residential property is what incomes (rents) that property can generate. Firstly, there should be a solvent demand for renting real estates which can reflect on their prices. For example, the jump in prices of residences in Prague and Budapest was preceded by a considerable rise of rents in these cities. It was determined by the big flow of foreign investments which brought a great number of foreign investors ready to pay almost western rents. Foreign investments generated incomes even for the internal specialists who exerted additional pressure on rents. All this was the reason for the increase of residential property prices.

This situation is different in Bulgaria. Rents remain comparatively the same due to the standstill of the real incomes of people while residential property prices grow up. Tearing up the “price-rent” connection is one of the most explicit indicators for the formation of a speculative bubble in housing in Bulgaria. Nowadays the gross rent profitability r (annual gross rent R to the market price P) of an investment in a town residence varies from 5% to 7% annually while it was 7% to 9% in 2003.¹¹ The gross profitability means that the property management

¹¹ [http:// www.imot.bg](http://www.imot.bg)

costs on behalf of its owner (on the average of about 20%), as well as the income taxes have not been deducted. Such costs are: current repairs; property taxes, charges and insurances; overheads; property management costs; risk premium for vacancy. As to the tax on rent incomes, it depends on the legal status of the owner – a local or foreign owner, a physical or legal entity.

A common rule on mature investment markets is that the price of a real estate is “paid back” by 100-120 monthly rents, i.e. for 8-10 years.¹² In this case, the “pay back period” (PBP) is reciprocal to the rent profitability r :

$$\text{PBP} = \frac{1}{r} = \frac{P}{R} \text{ [years]}$$

Gross rent profitability on the average of 6% annually means that “paying back” of such a property is for 16.6 years by 200 monthly rents. If we make a comparison - the profitability is 4-6% annually in Western Europe but in these countries risks on the residential property markets are smaller. Here we should clarify that the indicator “PBP” doesn’t give an account of the “time factor” but the static model of calculating PBP presented in this way is widely regarded as a primary investment evaluation of profitable residences in the developed countries. In this case, there is an implicit assumption that nominal incomes from rents will increase in time so that their discounted (up-dated) value will be equal to the current size of the rent

Gross rent profitability of town residences (6% annually) is smaller than the average interest of long-term mortgage housing loans in BGN that is now 8.03% annually. After all these comparisons it is obvious that from the view point of rents, prices of town residences are overestimated – a profitability of 6% annually is typical for more developed markets with a smaller risk (for example, for CEE countries). At the same time the rent market of residences in towns in Bulgaria is very tiny since 97.0% of residences are private property and 90% of the owners live in them. We should add some other things to the tiny rent market like the insufficient protection of the right of an ownership and the contract observance, as well as the insufficient culture in renting – all things that require a higher risk premium of the gross rent profitability, i.e. lower market residential property prices! The following fact is indicative of all this: a part of the newly bought residences have no inhabitants and are not rented at the same time but a future increase of their prices and a resale are expected!

External demand for real estate

It is formed by: Bulgarian emigrants living and generating incomes outside Bulgaria; western European pensioners who cannot have a descent life in their own countries; foreign speculators who buy mainly because of the potential capital

¹² *Yotov, St.* Return on real estate investments in Bulgaria. - Economic Thought, 2006, p. 104 – 118.

profit; western buyers of vacation homes (English, Irish, Russian and Greek citizens, people from the Near East, etc.). The common thing is that the external demand for real estates is generated by incomes that are not generated in local economies.

We should underline that an important source of financing a purchase of a residence is money that is sent by Bulgarian emigrants back to the country. Official data (by BNB and NSI) show that these transfers are the second biggest flow after the direct foreign investments (DFI). Emigrants' money transfers to Bulgaria were 6.16 milliard euro which was about 30% in relation to DFI in the period 2001-2007. The amount of emigrants' money is still supposed to be greater than the one officially announced since some of them are not included in statistics at all. In reality money transferred through Western Union, Money Gram or money carried over by hand is not included. According to brokers' observations up to 10% of the purchases of newly-built apartments in the most attractive regions are financed by similar funds.

Foreign investors' purchases of real estates including purchases of individual residences are one of the main engines on the real estate market in Bulgaria. Some BNB data per year (in million euro) are given in Table 4.

Table 4

Year	2001	2002	2003	2004	2005	2006
Foreign Investments in Real Estates	13.4	67.2	163.1	225.3	464.1	1 204.9

Source. BNB, <http://www.bnb.bg>

Toward the end of 2006 foreign investments in real estate operations were 30.2% out of all direct foreign investments during the same year.¹³ Residences, business-property (offices and shops) and terrains were going ahead of recently leading investments in manufacturing industry (776.6 million euro) and financial mediation (627.2 million euro). They increased above 2.5 times, more than 5 times and about 90 times compared to those in 2005, 2004 and 2001 respectively! Foreigners have been buying mainly in sea resorts at the Black Sea (in the regions of Burgas, Varna and Dobrich) and this way they have been stimulating the continuing boom in the construction of residential buildings and vacation homes. Purchases have been made by foreigners in the region of Smolian and Blagoevgrad as well where winter resorts like Bansko and Pamporovo are situated. Meanwhile dozens of English families have bought country houses in regions like the region of Veliko Tarnovo with the purpose of living in them. More and more buyers and corporate investors have been swinging towards towns like Sofia, Varna and Plovdiv where they have been building housing complexes for sale or they have been buying residences for renting them to the representatives of the foreign community.

¹³ Purchases by foreigners move the real estate market. - Construction and the town, March 5, 2007, p. 48.

Now let's have a look at the *vacation residence market*. These are residences, houses and villas that are for a seasonal use. They are mainly situated at the Black sea and in mountain resorts. Vacation real estates form a significant segment on the residential property market in a tourist country like Bulgaria. However, these vacation apartments are "export-orientated" products (i.e. the demand for such real estates is on behalf of foreigners) in comparison with town residences. This segment is influenced by the globalization compared to the town residence market that is predominantly local. Vacation real estate prices in an absolute value are still lower than those at some other sea coasts in Southern Europe – Spain, Portugal, Italy, South France, Greece, Montenegro, Croatia, Turkey, Malta and Cyprus. According to real estate agencies prices in this segment of the market will continue growing up till they become equal to the price of similar residences in the major Bulgarian tourist competitors.¹⁴

The major incentives of foreign buyers in this market segment are real estate prices that are still low, the low standard of life in the country, as well as the beautiful nature and favorable climate. Bulgaria can become more accessible to foreign investors after low-cost airlines enter the country. This is expected to lead to an increase of vacation residence prices and their gradual becoming equal to the prices in the competitive tourist destinations.

What are the problems in the vacation residence market segment?

- obsolete infrastructure - roads, electricity and water supply, purification stations;
- low quality services – property management and rental management have not been well developed yet;
- one-typed overbuilding (especially at the Black Sea), eclecticism and exhausting natural resources;
- the major type of tourists are low-profitable ones;
- there is no possibility of mortgage loans to foreign citizens by Bulgarian banks;
- rare flights to the country – only few times a week to the major sea resorts (in comparison with Spain – a few flights a day);
- short summer season at the Black Sea – about 2-3 months.

The external demand for real estates in Bulgaria is made by English and Irish citizens who have got long traditions in investing in real estates. The high residential property prices in UK in past 6-7 years and the historically low interests have led to a cheap mortgage financing of their owners by the banks. This has led to an additional demand for vacation residences outside UK.

Vacation residences are entirely completed and furnished. A management service (to rent through tour-operators during the low season) is offered for them, as well as a support of the property and common parts is offered against management fee.

¹⁴ Lenkova, B. Growth of residential property prices up to 10%. - Capital, December 24, 2004, p. 47.

Vacation real estates abroad as a segment on the market are put under the extreme competition in an international plan in contrast to the town residence segment. Except in a regional plan, the competition here is in a global plan – by countries like France, Italy, Egypt, Dubai, Australia, the State of Florida, New Zealand. The only category of buyers for whom the purchase of a real estate is profitable and cheap (according to their standards) are foreigners buying real estates for living in.

Conclusion

Having in mind all mentioned above we could state explicitly that town residential property prices in Bulgaria are speculatively high now! The practice of banks shows that mortgage housing loans are a privilege to the those groups of people with high incomes while workers with average incomes are practically “out of” the residential property market. The average residence market prices reached in 2007 (1091.2 BGN/m²) were disproportionately high to:

- *the average salary* – the „overestimation” of prices is about 75% (8 annual ASs in EU “buy” an average Bulgarian apartment compared to 14 annual AS in Bulgaria);
- *the average annuity payment* - the „overestimation” of prices is about 90% (this annuity payment in Bulgaria is 75% of AS compared to the normal correlation up to 40%);
- *the average rent profitability* - the „overestimation” of prices is at least 33% (in Bulgaria this profitability is 6% compared to about an 8%-mortgage interest);
- *average construction prime cost* – the „overestimation” of prices is 90% at least (the prime cost of 1 m² residential area – without the land and V.A.T., is 550BGN, according to Industry Watch).

In practice the “overestimation” of residential property prices is still bigger since statistics does not account the real situation on the market fully – due to the already mentioned tax estimations of real estates...

The single effect of the increase of residential property prices after a 6- 7-year standstill up to 2002 seems to be depleted. That presumes a *stabilization* of the average prices at their current levels (even a slight decrease) in future. The most essential factor for calming the market down will be the new residence construction that will balance the demand that is still strong. The decrease of the rent returns from investments in town and vacation residences is one of the main reasons that will be an obstacle to the growth in their prices. Currently rent profitability has dropped to the levels lower than the mortgage interests. That makes senseless investing in residential property. Despite rents, incomes are the other restrictor for residential property growing more expensive.

The increase of transparency of residential property market will contribute to the decrease of the speculations with property prices. Currently participants in deals conceal the reached price with the purpose of avoiding the tax payment when a property is transferred. That is way, however, expectancies are formed that

could differ in the two directions greatly. At the moment there is lack of a reliable and generally accessible source of real residential property prices and that contributes to speculations on the market. Sobering, which will occur, will lead to a distinct *segmentation* on the town residential property market – low-cost, medium-priced and luxurious segments (according to the region and quality). There will not be a total rise of all types of residences as it is now. Real estates with qualities above the average ones will account a faster growth (but not more than by 10-12% annually) while panel residences in complexes there will be a standstill or a downfall. The differentiation in the demand for residences will become greater on behalf of buyers. The growth of vacation home prices will continue since their market has been globalized in comparison with the town residential property market which is mainly local. It is more likely for vacation homes to grow up until their prices become equal to the prices in tourist destinations of a similar latitude. The late stage of speculation coincides with the late stage of normalization of the residential property market in the country. That's why property investments at the late stage of speculation will lead to losses. Judging from history, residential property prices follow the trend to fall down at local level and this is less probable to happen on the national market. With a great extent of certainty it may be said there is no risk of a collapse (a "hard" landing) on the residential property market. The main reason for that is that 70% of the newly built residences are deposit paid in advance by clients at a price per square meter (at the beginning of construction prices are considerably lower) that is preliminarily determined in the contract. Pegging the prices on the primary residential property market (new construction) will peg the prices on the secondary (used residences) as well. All this ought to soften the macroeconomic influence of an eventual puncture of the residential property bubble. In other words, we may expect a "soft" landing on the real estate market in Bulgaria. A relatively balanced situation on the market will be a reality may be in the first half of 2009.

14.III.2008