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Booming Home Prices in Israel are Finally Moderating

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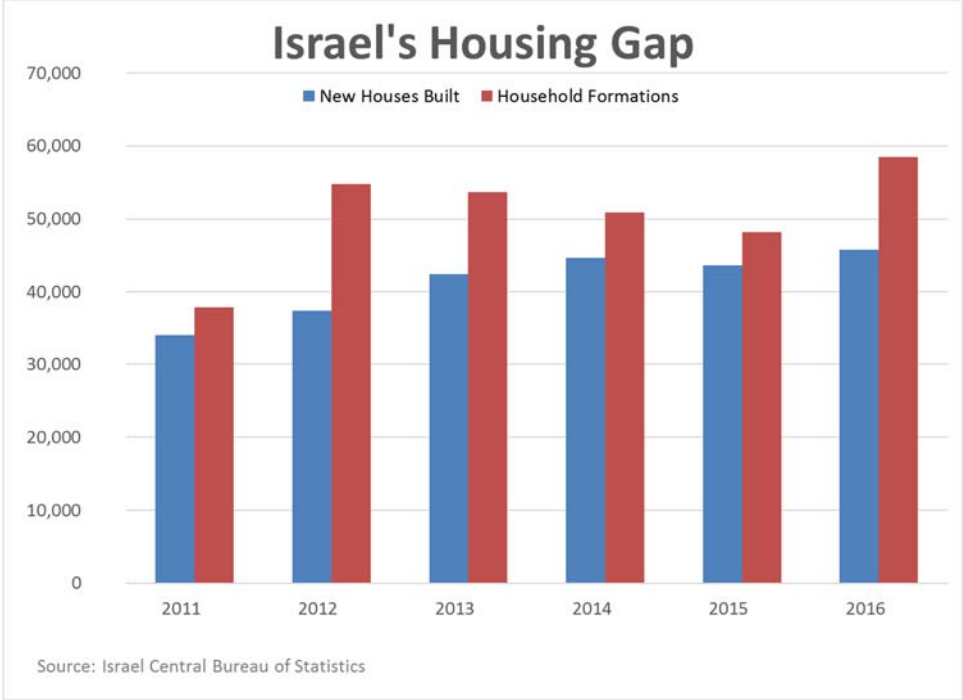
Home prices in Israel doubled over the past decade. The average apartment price exceeds \$750,000 in Tel-Aviv and more than \$500,000 in the surrounding communities. Salaries in Israel are about 35% less than in the United States, taxes are significantly higher, and housing costs take a larger bite out of disposable income. Over the past decade, the share of bank credit channeled to mortgages and home construction rose from 37% to more than 50% today. Some economists worry that Israel's housing market could crash, bringing the financial system and the economy down with it.

Almost 80% of Israelis live in apartments. In Israel the word "apartment" refers to both owned units we call condominiums in the United States, as well as rentals. Israel's homeownership rate of 68% exceeds the United States' 64%. According to Israel's Central Bureau of Statistics, 33% of Israelis live in three-room apartments, 28% in four-room apartments, 13% in five-room apartments and 5% in one-room apartments. Typical three-room apartments range in size between 60 and 80 square meters (650 to 850 square feet). Apartments larger than 100 square meters (1,100 square feet) are considered quite spacious.

The housing boom was caused by several factors. As in the United States and Europe, Israeli mortgage interest rates hovered close to historical lows in the 10 years following the global financial crisis. Unlike the U.S. and the E.U., however, Israeli banks were healthy and able to sustain solid mortgage lending. Israeli banks usually require home buyers to come up with 40% of the purchase price as a down payment. As such, bank balance sheets would be threatened by only dramatic price declines.

An unexpected upswing in population growth starting in the late 1990s led to accelerated demand for housing, but new construction failed to keep up. Investors also bid up apartment prices despite their meager rental yields, because rents nonetheless exceeded the interest available from banks and bonds.

The population boom should continue for the coming generation, but heightened demand due to inexpensive mortgage capital and investor purchases will diminish as interest rates rise. Residential construction accelerated over the past three years as the government improved a variety of permitting processes and accelerated urban redevelopment programs. For the first time in ten years, home prices posted modest declines in recent months.



Supply and demand are moving closer to a balanced equilibrium, but quantitative and qualitative shortages remain in the Israeli housing market. Prices are unlikely to double in the coming decade; therefore, long-term deflation is also unlikely despite the recent price declines.

Israeli Demographics

One of the most surprising facts of recent Israeli history is its demographic profile. Contrary to global trends, Israel’s population growth accelerated over the past 20 years. Last year, the Israeli population grew 1.9% to 8.84 million people. Israeli population growth is the fastest in the developed world and even faster than many developing countries. For example, average annual population growth in the U.S., Europe and China is 0.7%, 0.3% and 0.5% respectively.

Despite widely held beliefs to the contrary, population growth rates for Israel’s Arab citizens and Ultra-Orthodox Jews decelerated, while growth rates for more religiously liberal and secular Jews increased substantially. According to the Central Bureau of Statistics, the average fertility rate for Israeli Arab women is now 3.1, down from 4.3 twenty years ago. Meanwhile, the average fertility rate for Jewish women in Israel is 3.0, up from 2.6. In comparison the average fertility for industrialized countries is 1.7, well below the 2.1 replacement rate.

In an interesting article in Mosaic magazine, Ofir Haivry uses surveys of religious self-identification to estimate fertility rates for various segments of the Israeli Jewish population. He estimates the fertility

rate for Ultra-Orthodox (Haredi) women declined from 7.5 in 2000 to 6.7 today. Non-Haredi religious women average 4.2 children. Fertility among observant Masorati (traditional) women rose from 2.6 in 2000 to 3.0 today. Fertility among non-observant traditional women rose from 2.1 in 2000 to 2.6 today, and for those classifying themselves as completely secular, the fertility rate rose to 2.1 from 1.8 in 2000.

Immigration also ticked up in recent years. More than 1 million immigrants arrived in Israel between 1990 and 2000 after the Soviet Union's demise, but immigration dropped sharply during the Second Intifada in the early 2000s. From 2001 to 2010, only 225,000 people immigrated to Israel. Since 2007 immigration increased by 4.5% per year, and emigration decreased. Many recent immigrants come from more affluent countries such as France, and the incentive to emigrate diminished with Israel's low unemployment rate.

Israel's Booming Economy

Meanwhile the Israeli economy boomed. GDP per capita increased from \$25,000 in 2007 to \$40,000 at the end of 2017. After adjusting for inflation, income per capita grew by 1.7% per year over the past decade. GDP per capita in the United States, by comparison, increased by 0.7% per year during the same time period.

Israel's economic and population upswing caught the government, banks and home builders off guard. Demand for new housing units exceeded 50,000 per year, but finished construction averaged just 38,000. The supply imbalance hit just as mortgage interest rates plummeted, pushing prices ever higher.

In recent years the government – both national and local – improved permitting processes for new construction. While still a work in progress, building permits and new residential construction finally caught up to the demand for new housing. The backlog will take many years to clear, but rapid home price inflation is moderating.

Housing Quality

Much of Israel's housing stock was built during the Socialist era from the founding of the state in 1948 through the late 1970s. Construction was inexpensive and particularly rapid during the 1950s and 1960s when Israel's population doubled from the influx of Holocaust survivors and Jewish refugees from Arab countries. With Israel's shortage of developable land, even these dilapidated buildings significantly appreciated in value over the years.

Prior to 1980 Israel's building code enforced lax earthquake standards, and only apartments built after the 1990 Gulf War have Mamads or safe rooms to protect occupants from missile or chemical attack. The Israeli government enacted several programs to incentivize urban redevelopment by private real estate developers. For example, "Tama 38" is a program to beautify and strengthen older apartment buildings to withstand earthquakes. Apartment owners collectively contract with developers to improve their building in exchange for several extra floors that the developer can sell for a profit.

Another large scale urban redevelopment program is called Pinui Binui or Vacate and Build. As with Tama 38, current owners sign over their property to a developer in exchange for an upgraded apartment. In this case, however, blocks of low-rise buildings are demolished and replaced with a complex of apartment towers and common space. Existing property owners exchange their dilapidated unit, often only 50 or 60 square meters, for a brand new four or five-room unit with modern finishes,

Mamad, parking and often a balcony. Residents of the demolished buildings typically occupy 25% to 30% of the new complex, and the developer sells the remaining units for a profit.

Price Appreciation will Diminish, but Opportunities for Improvement are Abundant

Price appreciation in the Israeli housing market is cooling, but deflation is unlikely. Apartment construction is no longer running short of new household formation, so upward price pressure is less intense. Israel's population boom, however, continues apace, as does its economic growth. Rising living standards will sustain demand for improved housing and living environments. The quality of Israel's housing stock remains subpar in many areas, and developable land is in short supply. Israel's population will remain concentrated in the center of the country, and high-rise towers are already reshaping Tel-Aviv's skyline. The trend toward urban redevelopment is accelerating as Israel streamlines its permitting processes for these projects. Given these trends a housing market crash seems unlikely. Fortunately for Israeli home buyers, price appreciation should moderate substantially in the coming years.