Bank of Ireland

DECEMBER 2007

- Introduction • Credit Crunch
- The Waste Sector • Sector Analysis - Retail, Industrial, Construction, Hotels & Restaurants and Agriculture

Irish Business Review

Research • Analysis • Commentary

"A week is a long time in business", surely a phrase we can all identify with after the last four months of turbulence on the International Foreign Exchange and Money Markets. These events have also shown that the economic environment we live in is now a truly global one. Seemingly unconnected events in the US have a direct and immediate impact on Irish businesses and individuals.

Credit markets have suffered dislocation...

Inside this IBR we look at the "Credit Crunch" from an Irish and International perspective. In addition, we provide an overview of the economy under sectoral headings capturing the key areas of activity and provide a more detailed overview of the consolidating Waste sector.

Growth in the Irish economy was strong in the first half of the year, at 6.7%, but looks set to slow somewhat, primarily due to a correction in the housing market. This has prompted a fall in residential construction, and house completions are expected to continue to decline in 2008, with the result that we expect GDP growth of 4% next year, from 5.3% for 2007.

From an Irish perspective it has been a very eventful few months since our March publication, which discussed the increasing level of M&A activity and highlighted the volume and quantum of transactions in the Irish market. In the interim, activity levels have been maintained but the "Credit Crunch", as it has become known, has given rise to some reassessment of asset values. This reassessment is largely driven by uncertainty around the availability and quantum of funding for transactions and the economics of the deals are being impacted by the broader economic outlook. This reappraisal of asset values comes as a "reality check" for the market and has broadly been welcomed as a necessary and timely correction.

...prompting a reality check for corporate transactions.

There have been some Irish transactions which have stalled temporarily as a result of this uncertainty but most are expected to proceed sooner or later but perhaps with some noticeable changes around price and structure.

At a sectoral level, retailers have continued to benefit from strong consumer spending, although the detailed picture is somewhat mixed with clothing and footwear very strong, but bars continuing to suffer. Elsewhere the indigenous manufacturing sector has had its best year since 2000 and agricultural prices have risen sharply.

As previously discussed, the key message is that the economy continues to grow despite turbulence on the macro front and some uncertainty/reassessment of asset values. The key constraint on Irish growth continues to be competitiveness and our capacity to manage cost moderation in an increasingly global economy. But the most pointed lesson of the past few months is a reminder, as if we needed it, that we are part of a globalised economy rendering us vulnerable to events apparently unrelated to our own economic performance.

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Credit Crunch

The past four months has seen an extraordinary, indeed unique, dislocation in credit and money markets, resulting in a rise in credit spreads, the effective closure of debt issuance in some instruments, a tightening of credit standards by the banking sector and an increase in the cost of borrowing for some corporates. The good news is that this very dislocation has also transformed the outlook for monetary policy. Central Bank rates have already fallen in the US and now look to have peaked in the Euro area and the UK, with an official rate cut in the latter likely to appear over the next few months.

The catalyst was the US housing downturn...

The catalyst for the market turbulence was the downturn in the US housing market, which in turn precipitated concern about mortgage defaults and the consequent impact on the value of debt secured on those mortgages. The percentage of loans classed as delinquent (more than 90 days in arrears) started to climb steadily last year, notably in the sub-prime area, and this trend accelerated in the first half of 2007. 14.8% of sub-prime mortgage loans were delinquent in the second quarter, up from 11.7% twelve months earlier, with every sign that the total would rise substantially above the previous cyclical high of 15%. With no signs of a recovery in the US housing market in sight (indeed the data over recent months has pointed to the likelihood of further price falls in order to clear the large overhang of unsold homes) the market lost confidence in the value of assets secured on US residential property. The result was a substantial widening in spreads on asset backed paper relative to government paper and a sharp decline in the volume of asset backed commercial paper at issue. In the US the decline was $300bn over August, September and October, equivalent to a 25% fall.

...but the issue now is liquidity.

Many institutions had relied on short term asset backed borrowings to fund the purchase of longer dated paper and so those with access to bank loans now sought to borrow from banks, who in turn were already being forced in some cases to support their own off-balance sheet conduits seeking liquidity. Investment banks, too, were left holding large amounts of asset backed securities which could not be off-loaded into the market. The resultant scramble for cash by the banking sector prompted a sharp rise in interbank rates, as lenders sought to hoard cash rather than extend unsecured loans into the market. The consequence has been a drying up of liquidity and a surge in interbank rates; 3-month cash in euros, for example, rose from 4.25% in early August to over 4.75% by late October, implying an effective 50bp tightening by the ECB even though the official repo rate has of course remained unchanged at 4%. Rates have eased modestly since, but are still extremely elevated.

The cost of funds has therefore risen for the banking sector and this is also reflected in credit spreads. Banks now have to pay a wider premium relative to governments in order to borrow in the market place. This change in investor attitude to bank risk will have consequences for borrowers. Loans tied directly to Libor rates will obviously adjust to the new environment and margins may widen. Credit standards may change and indeed have already started to tighten across the Euro area according to a recent survey by the ECB.

This impact on the cost and availability of credit also carries implication for economic activity, and the consensus growth forecast has already fallen for the major economies, including the Euro area, which is now expected to grow by 2.1% in 2008, from 2.5% previously. This in turn makes a further rate increase by the ECB less likely and we suspect that the next move will be down, albeit not till well into 2008. The Federal Reserve was already worried about the US economy before the Credit Crunch erupted and responded to the heightened downside risks to growth by

From an Irish perspective domestic credit spreads have widened...

cutting rates by three quarters of a percent, since mid-September with more rate cuts expected over the coming months. In the UK the liquidity squeeze spilled over into the High Street with a run on the retail deposits of Northern Rock, prompting an unprecedented intervention by the government to guarantee these deposits and a sharp turnaround in interest rate expectations, with the market now expecting rates to fall by as much as 75bp over the next twelve months.

It is important to stress that the Irish M&A market is less exposed to the impact of the Credit Crunch than the larger international markets. The consequences of the market volatility are more likely to be felt in the larger scale deals (over €100m) while the Irish market is characterised by deals below this level. As we have discussed in previous IBR briefings the trend in mid-corporate transactions remains positive but valuations were being impacted by rising interest rates and negative sentiment towards the short term prospects for the Irish economy.

...prompting a reality check on transactions.

The implication for Irish business of the "Credit Crunch" / lack of liquidity / cash shortage is that there has been a "reality check" and time taken to reflect on a number of individual transactions that were work-in-progress at the time. The clear lesson of the last few weeks is that credit structures have changed and a rebalancing of the terms and conditions and the quantum of debt in transactions will now take place. This in turn has fed into asset prices and a more realistic approach to raising finance and debt for M&A has resulted. Purchase multiples are being examined more closely reflecting the fact that financing package for the deal may be less generous than before and more expensive to service.

Despite this set-back for financial markets the Irish Corporate sector has not been impacted significantly in the short term due to the fact that the banking relationships established over a long number of years have sustained through the uncertainty. It is at times like this that the value of a long term solidly based banking relationship comes into play.

Bank of Ireland Corporate Banking has built a business on the premise of strong relationships both old and new and these are showing very significant resilience at present. In addition, the current uncertainty inevitably leads businesses to seek out quality financial service providers and that has also ensured a strong flow of new business opportunities from a range of sources during the past 6/9 months.

In summary, it is clear the global village is a reality for us and we have seen how decisions taken in parts of the US can impact on how much we pay for our business loans and household mortgages. For now it would appear that we are in for a period of correction but well managed businesses with sustainable business models will continue to thrive in any circumstances and will continue to get support from banks.

The Waste Sector

The industry is still relatively fragmented...

Ireland's fast growing waste industry is estimated to be worth €1.5bn. The sector is currently experiencing significant mid-tier consolidation driven by (i) the need for scale to drive a return on capital investment, (ii) the fragmented nature of the industry (there are an estimated 300 operators), and (iii) a number of large players with significant financial resources to fund acquisitions.

EU regulations (such as the 35% recycling target by 2013, and a requirement to progressively decrease landfill of biologically active waste through to 2020) and increasing commodity prices have resulted in waste operators focusing on maximising the percentage of waste that is recycled or recovered. Much of this recycled waste is subsequently sold, primarily to Asia where there is huge demand for raw materials such as paper and plastic.

This dynamic has led to the development of ultra-efficient recycling facilities that require larger volumes of raw materials to generate a return on capital. Consequently, scale is now even more critical to succeed in this sector and this has resulted in an accelerated pace of M&A activity as evidenced by the value (in excess of €100 million) and volume of transactions completed during the last six months (see table below).

Despite the ongoing acquisition activity, the Irish waste industry today is still relatively fragmented. The largest private operator, Greenstar, in which utilities conglomerate NTR plc has an 88.5% stake, has a less than 10% market share based on the performance of its Irish business. Greenstar's Irish business generated an underlying operating profit of €27.4 million on revenues of €134.5 million in the year to March 2007.

To maintain its market leader status, Greenstar announced last year that it had secured debt financing of €200 million to extend its national footprint in the commercial, industrial and domestic waste channels. Their expansion will be through acquisition (they have completed 13 in the last 8 years) and infrastructural investment.

However, other large conglomerates with significant war chests have also been building a presence in the sector. The €61 million acquisition of one of the industry's largest players, Naas-based AES, earlier this year enabled Bord na Móna to become a vertically integrated operator providing it with a stream of waste for a landfill it is developing in Drehid, County Kildare.

Bord na Móna intends to differentiate itself by offering sustainable, high quality, futuristic solutions. It has earmarked about €180 million to complete 3 to 4 significant acquisitions over the next 18 months in order to establish itself as a dominant player in the waste sector.

Date	Acquiror	Target Name	Region	Reported Deal Value
May '07	Bord Na Móna	Advanced Environmental Solutions (Irl) Ltd (AES)	Midlands	€61m
Jul '07	Mr. Binman	Clearpoint Recycling	Tipperary	€18m
Aug '07	Indaver	Cedar Integrated Waste Management Limited	Dublin & Cork	€10m
Sep '07	Panda Waste	Smurfit Kappa Recycling	Dublin	n/d
Sep '07	Greenstar	Bailey Waste Recycling & Rainbow Refuse	Dublin & Waterford	€15.5m
Sep '07	One51 Plc	The Hegarty Group	Nationwide	n/d

...but the pace of M&A has accelerated.

One51 Plc, which holds an indirect investment in Greenstar through its 25.52% in NTR Plc, is also building up its presence in niche areas of the industry such as WEEE (waste, electrical and electronic equipment). One51 Plc has also targeted hazardous waste through the acquisition of businesses such as Rilta (t/a SITA) Environmental, Thormac Engineering and TechRec and metal recycling companies like the Hegarty Group.

It is not just the domestic conglomerates that are acquiring market share. International operators such as Indaver Ireland, which is a subsidiary of the Belgian waste management group Indaver, recently acquired the hazardous waste service provider Cedar Integrated Waste Management Limited. This deal was the fifth acquisition made by the company in recent years having previously acquired Minchem, Ecotrans, and the liquid hazardous waste activities of Safety-Kleen and Cara. Indaver is also the developer of two planned incinerators in Ringaskiddy, Co. Cork and Carranstown, Co. Meath. It recently secured permission to accept up to 200,000 tonnes of waste at the Meath plant and, significantly, the ability to source waste from outside its immediate catchment area.

Veolia Environmental Services has also been a major operator in the Irish waste market (it formerly traded as Onyx/Ipodec). As a subsidiary of the French corporate conglomerate Veolia Environment, it has the firepower to complete a major acquisition to maintain or augment its current market position.

Against this backdrop, the large independent operators are not standing still with both Mr Binman and Panda Waste completing acquisitions that will reinforce their position at the vanguard of the Irish waste sector. In addition, a number of private waste operators are currently in dispute with Dublin City Council regarding collection rights to household waste in the Dublin area. In this competitive and dynamic landscape the battle for market share is set to intensify over the coming months.

Environmental and Renewable Project Finance at Bank of Ireland

Bank of Ireland has identified the environmental, renewable and energy saving sectors as critical areas of development and has devoted significant resources to these sectors. As part of its Project Finance, Corporate Lending and Acquisition Finance activities, Bank of Ireland is active in funding environmental/waste sector businesses, renewable energy projects and related technologies. We have acted as arranger and/or participant in debt facilities for numerous environmental businesses, waste to energy and renewable energy projects in the UK, Ireland, Continental Europe and the US. We are also highly experienced in the underlying markets in which such projects or businesses operate - such as government-backed concession contracts for infrastructure, and the energy, oil and gas markets. The sectors in which Bank of Ireland has experience include (i) waste management, (ii) biomass and biofuels, (iii) waste-to-energy, (iv) wind energy, (v) landfill gas and (vi) carbon trading.

Recent transactions concluded by Bank of Ireland include acting as lead arranger of £155m debt facilities for a waste-to-energy plant in Slough, England, a waste treatment facilities for Lancashire County Council (£340m) and wastewater treatment facilities in Northern Ireland (£160m). Bank of Ireland is also mandated to arrange debt for a number of new schemes, including facilities to treat all 1.3m tonnes of Greater Manchester's household waste, which will be the largest waste sector project in the UK.

Sector Analysis

Retail

The Irish economy grew by over 5% a year between 2002 and 2006, driven in the main by consumer spending, which also increased in real terms by around 5% per annum over this period. During these five years, employment growth averaged just under 3.5% while earnings increased by around 5%, producing average growth in incomes of more than 8% and an average increase in nominal consumer spending of 7.9% a year, or 5% a year (after taking into account the increase in consumer prices over this period). Over the first half of 2007 real consumer spending increased by about 6% on the corresponding period in 2006, broadly in line with the average rate of growth recorded last year. The increase in the volume of retail sales over the first six months of this year was 7.4%, slightly ahead of the growth in consumer spending (which also includes spending on services). It looks as if the pace of retail spending slowed somewhat in the third quarter, to around 6.5%, which suggests overall consumer spending growth probably decelerated over this period as well. Nevertheless, consumer spending is still on track to increase by 6% this year, the same as in 2006. However, growth is likely to slow next year, due largely to slower employment growth, with the numbers in employment forecast to increase by 42k, or 2%, after a gain of 72k, or 3.6% this year, though earnings growth may also moderate a little in line with somewhat softer labour market conditions. Overall, consumer spending in nominal terms is expected to increase by 6.5% in 2008, or 4.5% (after taking into account the projected increase in consumer prices next year).

Consumer income growth has been buoyant...

...leading to robust retail spending...

Looking in more detail at retail spending in 2007 to data, a number of areas have performed very strongly. Most notable in this regard are the two categories of *Clothing and Footwear*, each of which have registered an increase in the volume of spending of about 15% over the first seven months of this year, almost double the increase in total retail sales over this period. Prices in these categories have continued to fall over the past year, so the increase in the spending in value terms is less than this but still strong at 12-13%. Above average increases in spending have also been registered in a number of other categories, including *Electrical Goods, Furniture & Lighting and Hardware, Paint & Glass*, with sales increasing by 11%, 8.9% and 9.9% year-over-year over the period January to August. Some slowdown in spending in these categories may be expected however, given the downturn in the housing market which is expected to continue into 2008. The pub trade continues to experience difficulties, with spending in *Bars* down 0.5% on the year in January-August having increased modestly - by just under 1% - in 2006. The *Motor Trades* have done reasonably well this year, though perhaps not quite as well as might have been expected given the maturing of the SSIA account, with spending overall up 8.3% after increasing by 4% in 2006.

Industrial

Output growth in manufacturing has strengthened further in 2007. After increasing by 5% on average in 2006, output over the first eight months (official data are only available up to August) was up almost 8% on the corresponding period last year, in response to strong global and domestic demand. The 'Modern', mainly multi-national, sector has led the way again this year, with output over the January-August period up almost 9% (fuelled by a big increase in the Chemicals sector output), though growth in the 'Traditional' sectors has strengthened notably, accelerating to 4% from an average of just 1.5% in 2006, the former the fastest pace of growth since 2000. Reflecting the strengthening of output growth, employment in Industry has increased, albeit modestly, over the past year - by about 3k - thus stemming the downward trend that has been in place since 2001, though the sector's share of total employment continues to decline and currently stands at just under 14%, down from 18% in 2001 and around 20% in the mid-1990s. The near term prospects for the sector remain favourable, though output growth is likely to slow given what is likely to be a more moderate demand both at home and abroad.

Though remaining relatively robust, global economic growth is set to ease back in 2008, to around 4.8% from 5.2% in 2007 according to the latest projections from the IMF, largely reflecting slower growth in the US in particular but also in the Euro Area and UK economies. This means goods exports, which are up almost 9% in volume terms to date this year, are likely to increase more slowly in 2008. Domestic demand is likely to increase somewhat more slowly next year also, reflecting amongst other things more moderate employment growth, and hence consumer spending growth, in 2008.

...indigenous sector has best year since 2000...

...but residential construction output is falling...

...sharp increase in agricultural prices.

Construction

Though the number of new homes built rose to a record level of 88,400 last year, the pace of increase actually slowed to 3% from 11% in 2006 and a recent peak of 20% in 2003. It has been apparent from various indicators that the number of new houses built was going to decline in 2007 and this is now being confirmed in the official data. According to the Department of the Environment, house completions over the first nine months of the year totalled just over 56,000 down about 8% on the corresponding period in 2006. Consensus within the industry suggests that final output figures for 2007 may show an even steeper decline than the first nine months suggests. A further reduction in output is expected next year. This further decline in completion should be viewed as a continuing adjustment towards sustainable levels of house building over the medium term - generally considered to be around 60-65k per annum. The fact that rents have continued to increase even as house prices have softened suggests there is pent-up demand for housing - with would be buyers putting off purchasing for the time being - while projections for the population over the next number of years point to house building being maintained at a relatively high level. The contraction in residential construction will be partially offset by continuing growth in the non-residential sector, including public spending on infrastructure (which the Government has committed to maintaining the latter at a level equivalent to 5.5% of GNP on a multi-annual basis) which is projected to increase by over 12% in 2008. Private non-residential construction may increase more slowly next year, reflecting amongst other things tighter credit conditions.

Hotels and Restaurants

The Hotel and Restaurant sector has continued to operate against the backdrop of a favourable economic environment, both domestically and internationally. The Irish economy is on track to grow by 5.3% in 2007, driven by another large increase in consumer spending, while the global economy set to record a fourth consecutive year of growth of around 5%, the longest period of sustained above-trend growth since the early 1960s. Reflecting this, the numbers employed in the *Hotel and Restaurant* sector have risen by almost 7.5% over the past year - about twice the increase in total employment in the economy over this period - and now stands at about 125k, or about 6% of total employment. After rising by almost 11% in 2006, the number of overseas trips to Ireland rose by 4% over the first seven months of 2007, with the annual growth in visits from continental Europe again in double digit territory. Visitor numbers from North America increased by just 2% over the same period however, although this followed an increase of 10% in 2006. Slowing economic growth in the US as well as the fall in the value of the dollar may curtail visitor numbers from this region over the coming months. Visitor numbers from the UK actually fell - by 2% - over the first seven months of this year. While visits to friends and relatives accounted for about a quarter of total visits so far this year the bulk, about two thirds were for holiday/leisure or business related reasons. The Hotel sector continues to gain market share in terms of the type of accommodation chosen by visitors in this category. Measured with reference to the total number of bed nights, its share increased to 36.5% over the first half of this year, up from 34% in the corresponding period in 2006.

Agriculture

According to final estimates published recently, agricultural income (i.e. operating surplus) fell by 12% in 2005. However, this followed a 22% gain in 2005, with the swing between the two years reflecting a fall (of 13%) in net subsidy payments last year after payment of arrears due boosted the former the previous year (net subsidy payments increased by almost 44% in 2005). According to the CSO, the terms of trade for the sector have improved notably this year. Preliminary estimates show output prices will rise by almost 10% this year, due to sizeable price increases for a range of produce including cereals (up almost 68%), milk (up over 23%), and vegetables (11.5%). At the same time, input prices are expected to rise by just over 5%, with a 10% increase in the price of feeding stuffs countered by a modest increase (of less than 2%) in fertilizers. Energy costs have risen more slowly, on average, this year than last (3% after 9% in 2006), though the renewed rise in oil prices recently will put some upward pressure on this particular input cost. Employment in this sector (including forestry and fishing) appears to have stabilised after declining in recent years, with the number employed standing at around 115k, or 5% of total employment.

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