

Residential Property Group Newsletter 2011

It is that time of year again, when we assess the predictions we made last year for 2010, review the market that was 2010 and give our predictions and recommendations for 2011.

Our predictions for 2009 were good, so were our predictions for 2010 any good?

The predictions we made in January 2010 for the UK property market in 2010:

Whilst it was more exciting (and potentially more dangerous) to make predictions for 2009, we believe that the outlook for the market in 2010 will be much less exciting and more sanguine. Property is not a racy commodity and its investment characteristics must be respected for this. **Correct**

1. There is an "air" of confidence at the moment in not only the economic recovery and the high street, but also in residential property. We would temper this enthusiasm and agree there are opportunities for carefully researched property purchases, but there will not be any dramatic return of confidence to the residential market. **Correct for the UK residential market**
2. House prices in 2010 will continue to be held back by the lack of mortgage availability (whilst banks repair their balance sheets), the threat of a potential increase in interest rates and increasing unemployment. **Correct, these seemed to be the main constraints**
3. First time buyers have been absent from the market for the past 12 months (with deposits on property purchases needing to be circa 30% this is not surprising) and this is likely to continue into 2010. Until we see these buyers return we doubt we will see a significant and sustained price rally. **Correct, these buyers have still not returned.**
4. The UK will be distracted by the general election, and regardless of the results, there will undoubtedly be hardship to come in 2H2010 and 1H2011; as taxes rise and we try and repair our country's vast debt. **Correct re hardship, general election was not such a large distraction really.**
5. As QE (quantitative easing) comes to an end, commentators will increasingly consider the risk of rising interest rates. Although rates are unlikely to increase dramatically (if at all) in 2010, the "threat of increase" will dampen enthusiasm. (If you think there are homeowners and investors struggling with mortgage payments at the moment, consider what the effect will be in a rising interest rate environment). **Correct, although QE continued longer than we expected, but the "threat of rate rises" remains like a stormy cloud over our heads.**
6. The UK will officially come out of recession, however, only on paper, there will be plenty of hardship and unemployment to temper any great enthusiasm. **Correct**

All in all we think our predictions were pretty good! We did not anticipate that QE would continue as long as it did and we anticipated the potentially interest rates may be increased 1Q2011, which we now think is less likely. Otherwise our general "call" of a less exciting, boring residential market was correct.

So what happened in the UK Property Market in 2010:

- Residential property prices across the UK fell between 1% and 3.5% depending on which survey one uses.
- Base rates remained at 0.5%, and mortgages (where available) remain affordable
- A new Government and a new budget asserts the need for budget austerity and the knock on effect of rising unemployment.
- The UK residential property market is not a homogenous product. What happens in the North is very different to the South East, and even more different to Prime Central London. We saw an even wider divergence this year, with London prices reaching their all time highs, whilst other regions are still 25-50% from their 2007 peaks.
- National House builders were quick to react in the downturn and have been far more conservative in the past year, only building houses they know they can sell. Gone are the days of speculation, and similarly there is significantly more construction of family houses, than buy to let flats as in the past.
- The level of repossessions was lower than we expected. Banks seem happy to sit on units, rather than releasing repossessed properties into the open market. The low interest rate environment has ensured that more people can afford to pay their mortgages. It is not a question of if but when interest rates increase we expect an increase in repossessions.
- Mortgage availability has freed up a small amount in 2010, but nothing like the previous number of products as 2007 and nothing like the LTV ratios of 100%plus.
- In 1H2010 a significant number of house builder sales were through shared equity schemes. The Government stopped their "Home buy Direct" scheme in the autumn.
- Regional Property Developers and Investors; continued to go into administration in 2010 and provided a flow of distressed stock to the market.
- The strength of the London market showed that London is a truly global market completely separate to the rest of the UK.
- As mortgage availability remained severely constrained, so more potential buyers turned to the rental market, with the obvious knock on effect of rental levels rising between 5% and 15% across the country.

As predicted 2010 was a relatively boring year in the UK residential property market. Transaction levels were down significantly, prices fell marginally.....the market was in limbo. We wished it wasn't but a period of consolidation does no harm. What it does present is an opportunity to assess where we are going from here. What will cause prices to rise? Where will prices rise most? What is the future for UK housing?

Our Predictions for 2011:

We have always reinforced that property investment is not a short term investment but should be viewed over a 3 to 5 year investment period. Rather than just assessing what will happen to the market in 2011 alone, we have also done considerable work on the property market over the period to 2015. Predictions for one year are difficult enough, predictions over 5 years more so but it is this time horizon that should be important to property investors.

- Unemployment will rise, especially in those areas most exposed to public sector cuts, notably the North of England. There will be no driver to push property prices up in these regions.
- Interest rates will increase to 0.75% from 0.5% by the end of 2011 to counteract inflation. Furthermore interest rates will rise to 3% plus by 2014.
- "new housing starts" will be even less than in 2010, hitting an all time low. The reason for this being the withdrawal of the "Home Buy Direct" shared equity scheme, and the continued constrained mortgage market.
- Property prices will be flat for the year as measured by the national surveys. There will be large variations throughout different regions of the UK and between different asset types eg. Country home or inner city flats.

- Mortgage availability will remain constrained, and despite its relative affordability will mean that there are few buyers, especially first time buyers.
- Liquidity and transaction levels will remain low; there is no short term catalyst to cause this to change in 2011.

Our Recommendations for 2011:

The above rather negative outlook does not mean there is a lack of opportunity, in fact it is the opposite. Whilst the market is flat and constrained in many ways, it presents **exceptional opportunities for selective buying** of residential property to achieve attractive total returns over a 3 to 5 year period.

Some facts for you to consider;

1. Residential price performance over the past 10, 20 and 30 years has been extremely good, and has outperformed both commercial property and equity investments. Not only has it outperformed but with lower volatility.
2. There is a long term imbalance between the demand for, and the supply of, housing in the UK. Demand is being driven by an increase in the number of households due to later age of marriage, increase in rates of divorce, an ageing population living longer, combined with a growing population and inward migration. Supply has been constrained for the past 5-10 years, but the challenges presented today are significantly greater (the number of new homes built in 2009 was 93,000; the lowest since 1923). We expect supply to remain severely constrained in the short term. Low supply and high demand provides long term price support.
3. The number of new mortgages being arranged is at its lowest level since 1975. The combination of new FSA rules, tight credit conditions, scarce mortgage funding and tougher bank capital controls produce a severely constrained mortgage market. Limited mortgage availability, means fewer buyers, less competition and more purchase opportunities.
4. Increasing Rental Demand: A huge pent up demand is in evidence. First time buyers are simply unable to purchase homes at present. In 2008 and 2009 there were less than 200,000 first time buyers; less than half the long run average. Not only can they not access funding, but also the average cash deposit needed now is 25% or the equivalent of £35,614; this is simply unachievable for some when disposable incomes are being squeezed, despite the age of the average first time buyer being 38 years old. First time buyers frustrated in their attempts to buy are being forced into the rental market.
5. Rental Growth and lower void levels: Over the past 3 years, the private rental sector has shown its contra cyclical credentials with average rental values up by an average of 4.2% pa, whilst average void periods have fallen to their lowest level for over 8 years.
6. The supply of rental stock from the buy-to-let market and from institutional investors will not meet the unprecedented rental demand. Rental growth and lower void levels are likely to remain for the long term.
7. Mortgage affordability is the most affordable it has been for 35 years due to prevailing low interest rates. If mortgage rates rise to 4.5% in 2014 this would bring affordability back into line with its 25 year average. The importance of the UK housing market to the economy as a whole and the affordability of mortgages for the next 5 years will prevent further significant price falls.
8. Economic Growth: There are suggestions the UK economy is expected to grow by 8% from 2011-2013, and return to 2007 peak economic output levels by late 2012. As the country returns to peak economic output we expect real house price growth to return. Economic Growth will drive house prices longer term.

So WHERE should one buy?

Our focus and expertise is in “England outside of London”, as such we do not consider the London market, other than we believe it will perform as strong as our chosen market.

There are very attractive purchase opportunities in the following areas;

Birmingham, Leicester, Peterborough, Northamptonshire, Cambridgeshire.

Why?

Exposure to areas of stronger economic growth with lower public sector employment.

Exposure to areas where people can afford larger equity/cash deposits that are needed by buyers, ie. higher earning areas.

Absolute Prices are around the national average price level in these areas.

Prices are still some 30 to 50% less than their peak levels in 2007.

There are opportunities to purchase properties at distressed levels.

There is a lack of competition from other professional cash buyers in these areas, in comparison to London.

Rental Yields attainable in these areas are above the national average. A target gross yield of 7%+ is achievable.

What are our forecasts for capital appreciation over the next 5 years?

Capital appreciation for the UK market to be +12%.

Our chosen regions above that capital appreciation will be circa 20%.

Certain regions such as the North East and Yorkshire&Humber may only increase 0-5% over the next 5 years.

Total returns will obviously be higher due to the rental yield attainable in these areas.

A quick comparison to the London Market:

Many readers may live or own a property in London and we thought including this section may be of interest.

London will perform well over the next 5 years and certainly above the UK average. London, and in particular Prime Central London, have transformed into a truly international market, where many buyers are driven by exchange rates and the global economy more than the local UK economy. The following points, however, are central to our investment rationale for the East Midlands and East of England.

What	London	East Midlands/East of England
Price from 2007 peak:	at or above their peak	still some 50% below
Absolute Prices:	significantly above nat. average price	discount to national average price
Gross Rental Yields:	c4%	c8%
Economic Activity:	focussed on financial services	broadly diversified
Professional cash buyers	Many; highly competitive	Few; limited competition

Conclusion:

As one can see above we expect the property we buy to attain capital appreciation of circa 20% and rental yields of circa 7%.

Furthermore we expect “normalisation” of the market. At present properties can be purchased at circa 20% discounts to their valuations done today, when the market “normalises” the “distress” will leave the system and in turn these discounts will narrow to parity. This process will be accompanied by improved sentiment, a return of confidence and, albeit from a very low base, an increase in the amount of homebuyer activity, .. We expect the residential market to “normalise” in 2012-2013 when the UK begins to show signs of growth. Banks will increase their mortgage availability once more (albeit considerably more conservatively than in the past) and this will be the catalyst for the UK market to normalise.

Total returns will be a combination of capital appreciation of 20%, a rental yield of 7% per annum, and a discount narrowing to parity of 25%.

There is a buying opportunity in 2011 whilst sentiment is weak to acquire good quality residential property at significant discounts to valuation.

Our Services:

As highlighted there are good, selective, well researched buying opportunities now. Once purchased residential investments must be pro-actively managed; any potential loss of income impacts returns.

A: We recommend, as a property finding agent, specific investment opportunities;

We highlight above the geographic areas we are focussing on. However, it is identifying the correct unit, from the right seller, in the right development, in the right location at the right price; that defines a good investment from a bad one.

B: We provide a pro-active property management service for our clients.

C: For those who would prefer indirect exposure to this asset class and strategy through a fund then please contact us.

We wish our clients and friends a very prosperous 2011

The Team at Residential Property Group Limited