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Residential Property Group: Newsletter 2019

As we indulge in our annual ritual of forecasting the next 12 months, we are reminded that predictions are only of use if we (the forecaster) have a good track record of forecasting! So, as usual, we're going to kick things off by reviewing how our predictions performed last year, before giving our forecasts for 2018.

Assessment of our 2018 predictions:

Our predictions in the past have been pretty accurate, so what about the predictions we made in January 2018 for the UK property market in 2018:

It is the same story as 2017; we remain "confidently optimistic" about the residential property market in 2018 excepting any extra-ordinary events! Whilst returns may not be huge, it is a good, positive, stable market; just the sort of market people should want exposure to. Correct; not huge but stable!

- **Capital values:** Direction: upwards, Magnitude: 3%.
  A national house price increase of 3%, or the equivalent of a real house price increase (after inflation of c2%) of 1%. This is down from 2017, and boring I know, but there is nothing wrong with a good steady long term positive return! This is the national figure, there will be large regional differences. Correct direction, correct magnitude Land Registry house price index at 2.8%.
- **Long term capital appreciation:** This will take another 3 years to really appreciate the accuracy of our prediction! In 2016 we forecast a 5-year capital return of 23%, we did 6% in 2016, 5% in 2017, we expect 3% in 2018, leaving 14% to achieve in 2019 and 2020; perhaps a bit punchy but we stick with our prediction; we don't continuously adjust like others! Combine this with a running net rental yield of say 5% in the Midlands, and this is an attractive blended return of capital appreciation and annual rental yield. Correct, so far so good, but perhaps 2019 and 2020 will need revision
- **Regional variations in property prices:** The market is highly fragmented and it is imperative that residential property is purchased in the right location (location, location). In 2017 broadly speaking the North outperformed the South. In 2018 this trend will continue, but regions and cities will vary. We believe the East Midlands (we predict 6%) and East of England will certainly outperform London and the South East. Pockets of the North East and North West will perform similarly as strongly. The "East" is economically vibrant and will benefit further due to its proximity to London and the South East. Correct on all accounts; north did outperform south, east midlands did outperform London and South East, pockets of NE and NW did outperform.
- **Rental growth:** Will be 3%, or in real terms flat. There is constrained supply of rental stock (becoming more constrained as there is less buy to let activity), whilst demand continues to grow, do they still call it "Generation Rent"?. Job mobility and a generation of younger workers priced out of home-ownership put further pressure on rental levels over the longer term. Speak to our lettings teams and we have very low void periods. Correct, though perhaps nearer 2%
- **Transaction levels:** Will be down a small amount from 2017; expect 1 million not 1.1 million or a c10% fall; a slightly boring stat but it was 1.7m in 2007! Tinkering with stamp duty levels did not help, new

buy to let lending and taxation rules do not help, Brexit and uncertainty does not help. This will not affect the market per se, but it does affect the revenue streams of estate agents! Wrong, it was c1.1million; no fall from 2017

- **Interest rates:** base rates are presently at 0.5%. We expect a small further rise to 0.75% or even 1% by the end of the year. The rise will be due to inflationary pressure and prudent management. Suffice to say interest rates will not rise aggressively; look at the 5 year swap rates or 5 year fixed mortgage rates at 2.5-3%. Correct, spot on!
- **House builders:** another fantastic year for housebuilders in 2017. After getting this really wrong in 2017, I should perhaps caveat this prediction, share prices for housebuilders will fall c10% in 2018. Correct they did fall, but even more than 10%, more like 25% (although they have bounced back strongly in January)
- **Prime Central London:** A difficult one. We think this will be small down for 2018, say 4%. Properties under £1m will be more in demand from investors, and from the perspective of a wider buyer base. There will be differences depending on location, type of property, new build or traditional etc. Due to the weak pound, international buyers are still in the market but London is far more affected by Brexit and sterling than the rest of the UK. We do not think there will be massive job losses, and this "pause" in the market is a sensible re-adjustment for a market that badly needs a breather. Correct. Small weakness.
- **Buy to let sector:** OK; today as a buy to let investor (compared to 2 years ago) you have a 3% extra stamp duty charge, phased withdrawal of mortgage interest relief, a tougher market to attain a buy to let mortage, a higher capital gains tax on second homes; George Osborne did what was only correct with hindsight and killed the golden goose. BUT, it is still an extremely attractive asset class, even after these changes. Residential investment property is a real, tangible investment that people understand. A lack of credible, understandable alternative asset classes, an investment that will slowly and surely rise over the longer term. I may sound like a broken record but show me an investment that I would better understand with better justified reasons for growth. And if all goes horribly wrong then I can always live in the place! All correct
- **A couple of other predictions for 2018:** Given poor success on this part in 2017, this prediction is for entertainment purposes only, although we were pleased last year to predict in 2017 that North Korea will increasingly worry the world! Oil prices will trade between $50 correct and $70 actually $80 allbeit briefly throughout 2018, our stock pick for the year is Bacanora Minerals (130p and first tipped at 70p in Jan 2016) very wrong, ended at 22p!, our short is Purplebricks (with a health/wealth warning)correct, it halved in value, the FTSE 100 will end 2018 lower than it started the year correct c10%, Brexit sentiment will become generally positive crikey where did that come from; wrong I think!, sterling will strengthen against the euro to E1.2 wrong more like E1.15 but heading there this week!. Theresa May will remain Prime Minister correct. Germany will win the football world cup wrong, france. And I might as well stick with this wrong 2017 prediction; that one of the world leaders will be assassinated wrong again; do two wrongs make a right?
- **We predict that 2018 predictions will be OK only!** A bit harsh, we think they were pretty good! We called the market well in 2015 despite not knowing who would govern the UK nor indeed what their economic policies might be. Our predictions were not too bad for 2016 considering Brexit and Trump. Our predictions above in 2017 were generally good for property and weak on other subjects! We expect more of the same in 2018! Stick to what we know best is the adage. That definitely correct, our best predictions are on residential property (not share tips!)

We are pretty happy with the above, importantly, we seem to understand the UK residential market and predictions on this over the long term seem to have been good. Importantly we got the direction and magnitude of movement of the wider property market broadly correct. Our niche is the Midlands and especially East Midlands and it seems we know and understand our local market.

<u>Our Predictions for 2019:</u>

As per previous years, we repeat and reiterate that; residential property investment is a long-term investment over a 5+ year time horizon. Predictions over 12 months are provided for interest only, rather than any forecast of investment performance.

It is going to be a similar story to 2018 but with a sprinkling of caution; we are <u>"cautiously optimistic"</u> (downgraded from 2018's "confidently optimistic") about the residential property market in 2019 excepting any extra-ordinary events! Whilst returns may not be huge, it will be a good, positive, stable market with limited volatility; just the sort of market people should want exposure to in these uncertain times.

- **Capital values:** Direction: upwards, Magnitude: 2%.
  A national house price increase of 2%, or the equivalent of a real house price increase (after inflation of c2%) of 0%. This is down from 2018's 3%. Hardly exciting stats but this is a mature, stable, low volatile asset class. This is the national figure, there will be large regional differences.
- **Long term capital appreciation:** It will take another 2 years to really appreciate the accuracy of our prediction! In 2016 we forecast a 5-year capital return of 23%, we did 6% in 2016, 5% in 2017, 3% in 2018, leaving 9% to achieve in 2019 and 2020. We are saying only 2% for 2019, so that would leave the market having to do 7% in 2020; do-able but probably a bit punchy! It is important we review our 2016 predictions. For new prediction of 2019-2023 we would go for 17% (Savills 15%); steady away, this being capital appreciation, combine with the running net rental yield of say 5% per annum in the Midlands, and this is an attractive blended return of capital appreciation and annual rental yield.
- **Regional variations in property prices:** The market is highly fragmented and it is imperative that residential property is purchased in the right location (location, location). This is always the case, BUT perhaps the variances will narrow in 2019; some places will see +4%, some see -4%; the North and Midlands will outperform London and South East. For our favoured region of the East Midlands we predict +4%. The "East" (East Midlands and East of England) are economically vibrant and will benefit further due to its proximity to London and the South East.
- **Rental growth:** Will be 3%, or in real terms flat. (Savills forecast 1% in 2019 or 14% over 5yrs) There is continued constrained supply of rental stock (buy to let supply falls), whilst demand continues to grow. Technology has enabled the younger generation to have more job mobility and more demand for renting as a whole; rent a car, rent a TV, rent a house; why own when you can rent? Not that affordability allows many to buy houses anyway!
- **Interest rates:** base rates are presently at 0.75%. We expect no further rise in 2019, for choice there is more upside risk and could be 1% by the end of the year. Any rise will be due to prudent management post brexit. Suffice to say interest rates will not rise aggressively; look at the 5 year swap rates or 5 year fixed mortgage rates at 2-3%.
- **House builders:** we said their share prices would fall in 2018 which they did. We think they will have another year of negative share price returns; they will fall 15% over the year. The Help to buy scheme will continue until 2020 this effectively allows housebuilders to charge a 5% premium over market price; which goes straight to the housebuilders bottom line, but the end of this ludicrous scheme is in sight.
- **Prime Central London:** Whilst there may be pockets of value in PCL it is still difficult to say what the catalyst will be to drive the market up higher. As such, we forecast another year of negative returns, like 2018, at -4%. Properties under £1m will outperform (marginally more affordable!). Non doms are punished, buy to let investors punished, the pound will likely strengthen; it is unlikely that international buyers will drive the market. Like much of these forecasts, the success (or not) of Brexit will determine how we kick off in the 2019-2021 period.
- **Buy to let sector:** we have stopped moaning on about the increased taxes and lack of reliefs; suffice to say the sector had it very good for a very long time. Some of the "allure" may have gone, BUT fundamentally the asset class is still attractive. Residential investment property is a real, tangible investment that people understand and will steadily rise over time. There is simply a lack of credible, understandable alternative asset classes. If I had £500,000 cash today where would I put it? Not volatile

shares, not loss making cash, not classic cars. No, I would put it into residential property, and if it all goes horribly wrong then I can always live there!

- **Brexit:** too much of "the elephant in the room" to not mention; the route Britain takes will have large implications for the future strength of the UK economy. The fundamentals of the UK economy we predict will remain broadly positive, but sentiment will be very fickle.
- **Headwinds:** this is a new addition to the list, and we do feel for the first time in 10 years that there could be headwinds to the UK residential market. Aside from Brexit, and the Buy to Let and stamp duty tax rises there is, of course, President Trump; he seems serious about trade war, serious about confronting Iran, serious about intimidating the US Federal Reserve; is this a global risk, possibly. There are signs of faltering growth in China and just too much debt globally. Also it is only fair to mention the Labour Party; if there was a snap election and the Labour party were to govern, then there is a real risk that rent controls would return, which would be disastrous for the residential investment sector.
- **A couple of other random predictions for 2019:** for entertainment purposes only! Oil prices will trade between \$50 and \$70 throughout 2019, our stock pick for the year is Microsoft (\$106), our short is Purplebricks (again!), the FTSE 100 will end 2019 lower than it started the year (again!). Brexit will happen, and come the end of the year sentiment <u>will</u> be positive. Sterling will strengthen against the euro by 18% to E1.3. Theresa May will remain Prime Minister (the lunatics cannot decide who should run the asylum). Scotland will win the 5 nations and there will be no assassinations in 2019.
- **We predict that these 2019 predictions will be good!** We called the market well in 2015 despite not knowing who would govern the UK nor indeed what their economic policies might be. Our predictions were not too bad for 2016 considering Brexit and Trump. In 2017 our predictions were generally good for property and weak on other subjects and likewise in 2018. For 2019 I think it will be a subdued year from a property perspective BUT both globally and domestically the economic and political environments remain volatile.

Residential Property Investment in 2019:

Given our predictions for 2019 above, residential property will continue to be a steady, stable performer. Past performance is no prediction of the future, but the historical attractions of "residential property" remain as strong today as ever;

- lower volatility than other asset classes
- a tangible asset, a real asset with real tenants, and most importantly an investment that people understand
- a macro environment of limited, constrained supply and increasing demand from both house buyers and tenants
- a low interest rate environment with the ability to attain cheap fixed rate debt
- a relatively stable economy, with some small wage growth

It is no wonder that pension investors think residential property is the best asset class. I think importantly, it is the fact that it is a relatively easy investment to understand. It is credible.

In an increasingly unstable world, we believe the lower risk returns of residential property will prove attractive to many investors.

Where should one buy?

Whilst we predict national house price increases of only 2% in 2019; as mentioned above there will be large regional differences. Please note we always recommend purchasing on a 5 year + investment horizon. As many of you know, we cover the whole UK residential market, but we focus on the **East Midlands and East of England** where we manage c 1000 residential units, and where we are active in helping our investor clients source attractive investment properties to buy.

As in the past couple of years, we particularly like this geographical market at the moment (and yes, we would say so if we thought there were better opportunities elsewhere!). Indeed, we believe that there may be buying opportunities in London, potentially towards the end of 2019 and we will be advising our clients accordingly when the time is right.

Why? In a nutshell: relatively strong economic activity, good employment prospects, good transport links, house prices below national average, and still rising from a low base (prices are only up c20% from 10 years ago), an active first time buyer market, benefitting from the ripple effect of wealth flowing out from London, areas which are within a 1hour commute of Prime Central London at a fraction of the price.

Expected Returns: The blended returns of superior capital growth potential (4%+) accompanied by an attractive rental yield of c 6-7% make for an attractive total annual return of 10% +. Longer term, we forecast 5 year capital appreciation of c20% (Savills 19%) combined with rental growth of similar amounts (Savills 14%). This makes the **East Midlands** region one of the top forecast areas for capital appreciation in the UK.

How should one buy? **(this section does not change year to year, but is important)**

It is all well and good us predicting 4% capital appreciation in the East Midlands, but there will be opportunities for 20%+ returns and no doubt others that will make the equivalent of 20% + losses. There are 4 key components of residential property investment;

A: Buy Well: you must get proper advice and use the expertise of someone like us who work in the market 24/7. It always amazes us that people use stockbrokers to buy shares and use estate agents to sell houses but often do not use property finders to buy investment property. Residential investment is typically a significant amount of money (hundreds of thousands of pounds) and it is important you spend it with the best possible advice. Yes, there are fees to property finders, but at c1% and amortised over the 5-10 year life of the investment it is a small price to pay for good advice.

B: Manage tightly and control costs: It is imperative that your asset is well looked after. The wrong manager, the wrong tenant, the wrong contractor can all greatly affect the net rental income of the property and thereby the total return on the investment. We manage and let properties in Hull, Leeds, Nottingham, Rutland, Leicestershire, Lincolnshire and Northamptonshire. Furthermore , we have the skills to manage properties throughout the UK and we can gladly recommend others where applicable.

C: Financing: Monitor the performance of the asset over the longer term. Consider leverage and money is cheap at the moment. Build a portfolio of properties if possible to diversify risk. All important considerations.

D: Sell Well: It is important you receive the very best price for the asset you are selling. Not only should you appoint a good agent but you need ensure the property is presented as well as possible. Might it be better to sell the property tenanted, could a redecoration improve returns, could a refurbishment improve returns etc. Through our local branches we offer estate agency services. We differentiate ourselves from other estate agents in many ways (we hope!) but not only in customer service; we have access to a large database of active regular buyers, but also a very large database of active investors who are continuously seeking new units to purchase.

If you can buy well, manage tightly, finance the investment as best possible, and sell well then you will achieve the very best returns; a blended return of capital appreciation and rental yield.

To do all this it is imperative you seek the right advice, and we would be delighted to advise you. A poor purchasing strategy (or indeed exit strategy) can have drastic effects upon the total return.

We continuously review investment opportunities throughout the UK and we are not geographically constrained. Each opportunity is assessed on a project by project basis on its own merits. As always, due diligence of the unit(s) concerned is imperative. You must choose the right area, the right location, the right development, and the right unit(s) in which to invest in.

We have been actively finding properties for investors since 2001, we know the local markets, we have the contacts, and we manage properties throughout these regions and we are therefore able to advise and assist our existing clients as well as new landlords.

It means you are being hand-held in what can be a complex purchase procedure, it means being confident in the decisions you have made to invest, and it means that we do not just source a property then run, but once

sourced we will manage the property, and hope to forge a long term relationship with all our clients, old and new.
Our property services include property finding, lettings and management and estate agency. Please see links for further details;
www.osprey-property.co.uk
www.residentialgroup.co.uk

We wish our clients and friends a very prosperous 2019
The Team at Residential Property Group Limited