

UK Residential Research Bulletin

Summer 2007

Key housing market dynamics No.57

“A new north-south divide is opening up driven by housing supply imbalances and the use of equity funnelled through London”

Yolande Barnes - Director, Savills Research



“Whilst lower house price inflation and turnover is likely, significant falls in average UK house prices are not expected”

Lucian Cook - Director, Savills Research



■ With UK house price growth of 4.4% in the first half of the year, we continue to expect annual UK house price growth to end the year at 7%.

■ Our affordability measures suggest that a period of both lower house price inflation and turnover is likely. Average UK house price growth is likely to be no more than 5% in 2008. Growth in the five years 2007-2011 is unlikely to vary significantly from our existing forecast of 6% per annum given longer term interest rate expectations.

■ Constrained supply continues to push house prices in the south of the country. A lack of suitable property was a constraint cited by 40% of potential buyers in our recent Occupier Demand Survey.

■ A north/south divide is re-emerging on the back of a disparity of regional economic growth and the impact of London-generated wealth in the south.

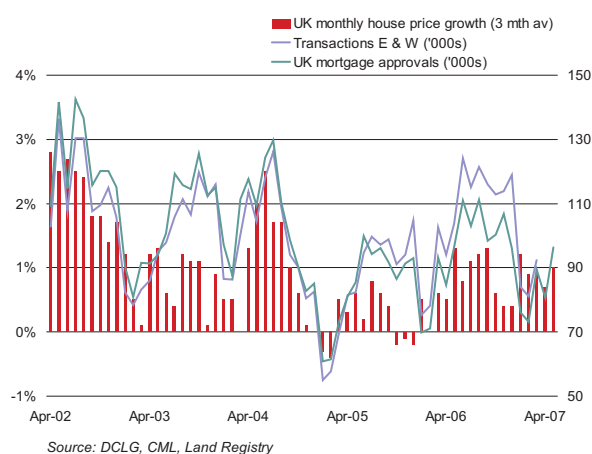
■ The prime London market is acting as a cash funnel for other parts of the UK market, with strong growth derived from overseas demand supplemented by City money.

■ We estimate that net investment in the residential market was 36.5bn in 2006 including buy to let. We expect future growth of the sector to be driven by both UK and overseas companies/institutions

investing in emerging investment sectors. Risk of over-regulation is the biggest potential barrier to growth.

■ A review of 600 large development sites has revealed a shift in the delivery of land for house building. Ownership tends to be vested outside of the property industry, but specialist property developers or property companies are still responsible for bringing these sites forward.

House price growth and turnover



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Market Overview

The prospect for future house prices has come under increasing scrutiny in the first half of the year, in light of a succession of interest rate rises imposed by the Bank of England in an attempt to curb inflation. There is widespread expectation that the latest rise to 5.75% will not be the last. Particular focus amongst commentators has been placed on affordability and the risk that pressure on household incomes will translate directly into house price falls.

Our view is that the risk of house price falls is overstated and that we are set for a short period of lower house price inflation and turnover, with a pronounced north-south divide and a clear differentiation between those markets driven by equity flows and those constrained more by affordability.

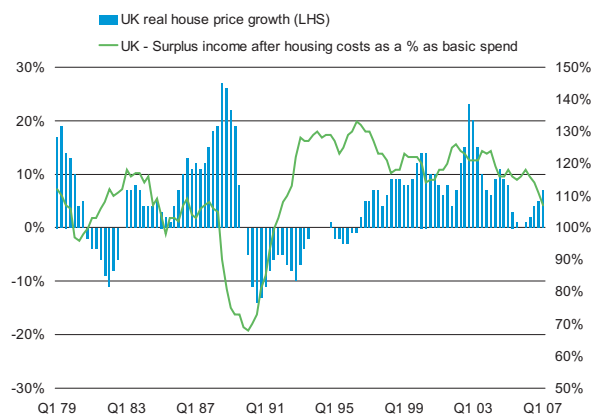
Set against this context, the UK housing market showed price growth of 4.4% in the first six months of 2007 according to Nationwide figures. With a picture of slowing price growth emerging, we remain of the opinion that, in 2007, average UK house price growth will be in line with our forecast of 7%.

We also anticipate that slower house price growth in the latter part of 2007 will be followed by a further period of low house price inflation in the first half of 2008. On the basis that there is a market expectation that interest rates will fall back to 5.5% by the end of next year, we expect house price growth to pick up again in the second part of 2008.

Affordability

In considering house price prospects, we have been less influenced by house price to household income ratios (which do not take account of interest rate shifts) than measures which look at the ability to meet normal household expenditure out of income net of housing costs.

House price growth v affordability



In general terms, household income net of housing costs has run at about 120% of basic household spend in the period 1997 to 2003. This has supported steady house price growth. When this percentage falls below 100%, average household finances fall into deficit. History suggests that this is the trigger point for a reduction in average house prices in real terms.

Since mid-2004, the ratio of net income to basic spend has been steadily eroded by a combination of house price inflation and interest rate rises, to the point where it currently sits on average at around 106%. The prospect is that it may fall a little further as interest rates bite.

This suggests that there is a need for a period of significantly lower house price growth to restore the ratio back to the medium-term norm. Importantly it also suggests that we are **not** at the trigger point for widespread falls in average house prices.

Our analysis suggests that this trigger point is only reached under scenarios where;

- interest rates exceed 6.5% (a scenario which sits outside most economic commentators expectations). We anticipate that significant falls in average UK house prices will become a realistic prospect under this case; or
- if the market is subjected to a prolonged period of rates at 5.75% to 6%, such that investor confidence of a return to a lower interest rate environment in the short to medium term becomes eroded, then the risk of small price falls increases. This would be more of a risk in those markets that have shown less strength in the first half of 2007.

This analysis reflects the fact that buyers and sellers are generally prepared to accept short term sacrifices in their household income before reviewing their perception of property value. This assumes that there remains a reasonable prospect that financial conditions will improve in the near future and that this will allow future house price growth.

Market impact

One of the key reasons behind a continuation of price growth, albeit at a lower level, is the lack of housing supply and the effect which this has in supporting prices.

The extent and impact of a lack of supply is reflected in the findings of our recent Occupier Demand Survey. Within this survey, 17% of respondents said they wanted to move within the next 12 months. Only about 7% of them will succeed in doing so. In this group, the



“risks of house price falls are overstated, we are set for a short period of lower house price growth and turnover”

Market Overview

biggest barrier to moving, cited by nearly 40% of these potential buyers, was a lack of suitable properties which indicates a clear, ongoing imbalance between demand and supply.

This imbalance is not just a function of a lack of total stock. It is as much a reflection of the fact that there is a limited supply of the right types of houses in the right places. These limitations are most acute in the south of the country. They result in intense competition for housing, and force buyers to commit higher proportions of their salaries to service housing costs and also to use any equity which they have accumulated for housing purchase, rather than other purposes. As a result, assuming a stable interest rate environment over the medium term, we suggest that house prices will continue to increase beyond the rate of both inflation and earnings growth.

In addition, the more immediate response of the market to current interest rates will be affected by the significant proportion of home owners and buyers who view housing as a 'bricks and mortar' investment. These potential purchasers will often continue to bid at levels where affordability is stretched - as long as there remains a reasonable prospect for medium term capital growth - which adds to the ability of the market to withstand financial pressures for longer periods than pure economic analysis might suggest.

In light of these factors, we expect caution in the market to be initially reflected by a reduction in market activity (with lower turnover similar to that witnessed in 2004) as potential movers take stock of the situation. Whilst we envisage that a period of low house price growth is also an inevitable consequence, the prospect of a return to a low interest environment in the relatively short term means that this is likely to be shortlived.

Accordingly, we consider that house price growth in 2008 is likely to be no more than 5%, with very low growth in the first half of the year. Growth in the five years 2007 - 2011 is unlikely to vary significantly from our existing forecast of 6% per annum given a continuation of current longer term-interest rate expectations.

North-South divide

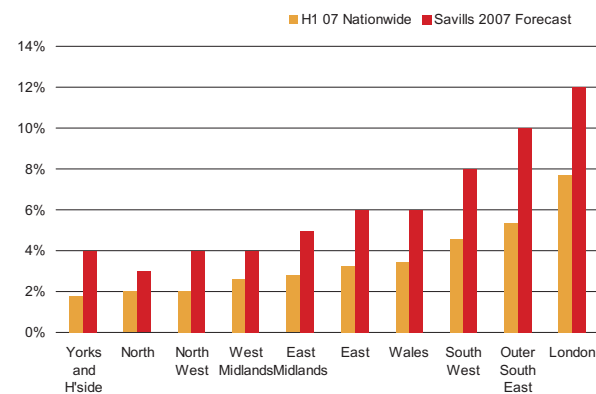
The behaviour of the market engendered by supply shortages is one reason why average house price movements across the UK disguise wide regional variations, particularly between the north and south of England.

Surplus income to basic spend ratios are far nearer 100% in regions north of the Midlands, which contain places of lower housing demand relative to stock levels. As a result, interest rate movements have had

more of an impact on house price inflation in these areas.

In the first half of the year, house prices grew by no more than 2.0% in the North East, North West and Yorkshire and Humberside, which compares to growth rates in the same six month period of 7.7% in London and over 4.5% in the South East and the South West. The one clear exception to the north-south divide is Scotland where house prices have continued to grow regardless of interest rate rises.

Interest rate rises have hit the Northern regions



Source: Savills Research; Nationwide

Disparity in regional economic activity is likely to support a continuation of this trend. Recent research from the OECD confirmed that the UK has some of the largest regional differentials in the developed world in terms of both GDP growth and GDP per capita (as a percentage of the national average).

The economic performance of southern regions (the South East, South West and East) reflects not only their own economic base but also their position in the hinterland of London. Wealth generated in the capital fuels the housing market across these regions. This fuelling takes two main forms:

- the application of London earnings and investment generated wealth to house purchases in the affluent suburbs and commuterland; and
- the export of equity generated from the buoyant London market through relocation, retirement, pre-retirement and second home purchases into the further reaches of southern, eastern and south-western England, as individuals buy properties further away from central London.

As a result, we expect growth in the next five years to be driven initially by the south, with the north seeing higher levels of house price growth later in the housing cycle (as was the case in the 1996 - 2006 period).

Development Land & Prime Markets

Role of additional supply

Gordon Brown has already issued very clear signals that increasing the supply of housing is a priority. Housing minister, Yvette Cooper, has been exalted to cabinet level, the OFT are leading an enquiry into the supply of land for housing and targets for new house building have been increased by 20% to 240,000 per annum by 2016.

The political driver is that inadequate supply, as clearly detailed in the two Barker reports, results in high levels of house price inflation. This, in turn, decreases affordability meaning that people on reasonable incomes cannot access the private housing market when they rely on mortgage borrowing alone.

If an increase in supply is to ease this situation, it must be both deliverable and meet the demands of the market. Market demand is for both the type of accommodation which is provided as well as the location in which it is provided.

Affordability issues mean that requirements remain for:

- a rented sector to meet the demands of those who need longer periods to build up the equity needed to enter the housing market; and
- the development of shared ownership models not necessarily confined to the social housing sector.

Development Land

A quiet revolution has taken place in the delivery of land for house building. The bulk of the UK's future housing supply will not be delivered on conventional sites and many of the dwellings will not be in the hands of specialist house builders over most of the development period.

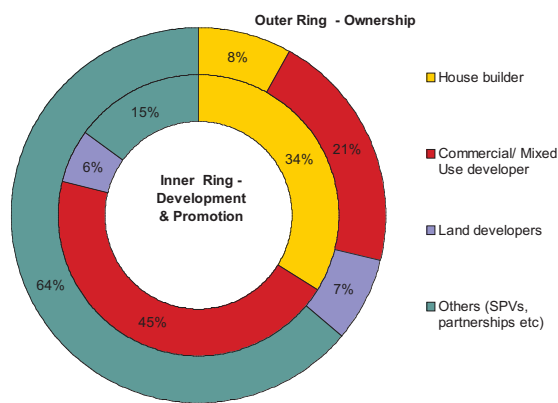
Savills Research has identified over 600 large development sites around the country that could deliver approximately 730,000 units over the next decade or so. 16% of these units are currently under construction and all are almost universally mixed use. Most of these sites (61%) are in the control of companies and organisations not normally connected with property. The specialist house builders, even including the more progressive companies, only own or control 8% of the sites studied and are actively developing on only 33%. Some are acting as little more than building contractors on small, 'oven-ready' sites.

Increasingly, commercial property companies and specialist developers understand that, on the big sites, it is the act of putting together a viable, value-added scheme and obtaining planning permission that creates

value, not building houses. It is this stage on strategic sites that can eat up the most capital, require the greatest skill and carry the greatest risk.

It would appear that the business models available to the commercial property companies and other sources of 'patient equity' are more suited to the long-term, complex and 'finance-hungry' periods of land acquisition, master planning and promotion common to housing delivery on these new era sites.

Ownership and control of big sites



Source: Savills Research



“It is commercial property developers who are now the major drivers of housing delivery on large sites”

Prime Markets

Whereas there is already evidence of the UK mainstream market reacting to higher interest rates, there is currently little, if any, evidence of a significant impact on prime markets.

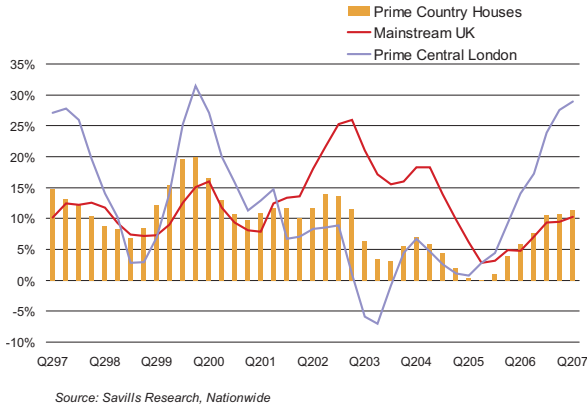
We see the prime London market as a 'cash funnel' for other parts of the market. In London's £1m plus market, 48% of all buyers are from overseas. In the £4m plus market, the figure is 65%. As a result, we estimate that about £15bn from overseas currently finds its way into the prime London market each year to supplement domestic demand.

A number of factors are contributing to the popularity of London to overseas buyers including its continued growth as a global financial centre, relative political stability and a relatively benign tax structure. On top of this, are large amounts of equity created in London's financial markets which find their way, through City bonuses, into the housing market.

The resultant strong demand, set against finite stock levels, has led to house price growth in prime central London of 28.9% in the year to the end of June. This, in turn, has created equity for the vendors of these properties. That equity works its way through the mainly southern housing markets, as individuals buy properties further out from central London.

Residential Investment

Growth in prime markets



The effect of these equity flows is most immediately reflected in the top-end markets gradually filtering into the mainstream. This explains why, for example, house price growth in the Home Counties country house market is currently running at 15%.

For more information on prime markets please refer to our Prime Markets Bulletin which can be found on our website - www.savills.co.uk/research.

Residential Investment

Residential investment property currently represents 14% of the total value of the UK housing market. With a total estimated value of £540bn, it is substantially larger than the commercial property investment market at circa £355bn. The open-market, private rented sector (which includes buy to let) comprises three quarters of the UK residential investment market and has been the main contributor to new investment in this sector over the recent past.

In 2006, the private buy to let market (characterised by private individuals directly investing in single properties or small portfolios using tailored mortgages) saw net additional lending of £21.4bn compared with total estimated new investment in the whole residential investment sector of £36.5bn.

Looking forward, Savills envisage that demand from small investors will continue, although at a slower pace due to current yields, rising interest rates and reduced prospects for capital growth in the short term.

Where then is the growth for expansion of this sector?

Growth of institutional investment

We consider that there is considerable capacity for property companies and, eventually, institutions to

incorporate a significantly higher residential property component within their overall asset allocation.

Currently the exposure of the investment market to residential property is small. We estimate that listed property companies (plcs), non-listed property companies and indirect residential investment funds collectively only hold in the order of £22bn of residential assets. Further, UK institution's exposure to the residential sector is currently amongst the lowest in Europe at just 1% of holdings.

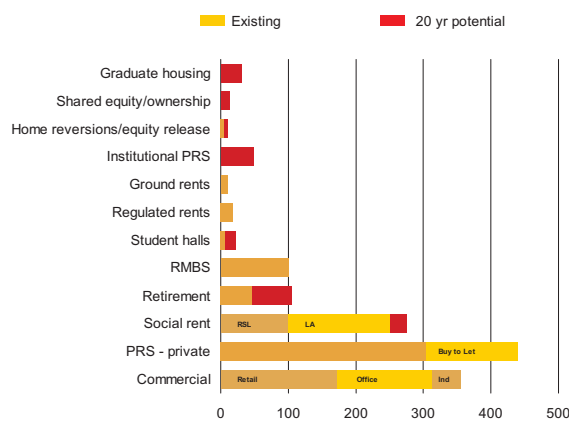
With the weight of money pressing on the UK commercial property sector and limited levels of new supply in that sector, residential investment has become an attractive alternative. It should remain so, given high longer term returns, coupled with the relatively low volatility, that is seen in this sector. Nevertheless, we do not foresee the traditional private rented sector as the main focus of expansion over the next 20 years.

The new, expanding sectors are likely to be more 'niche' than they have been in the past and to rely more on purpose-built stock rather than competing in the owner-occupied market. We therefore envisage that the next coming of age will be 'build to let' rather than 'buy to let', servicing retirement, student and shared equity sectors.



"the next coming of age in residential property will be build to let, rather than buy to let"

Estimated expansion by sector



We do expect the ownership of existing rental stock to change hands as small portfolios become amalgamated into larger lots sizes and move from individual investor portfolios into property company portfolios and, finally, when the lot sizes are big enough, into indirect property funds.

We anticipate that the return to residential by the UK domiciled investing institutions may well be spurred by their European counterparts who, at present seem keener on UK residential property than the home teams.

Residential Investment

Risks of further regulation

The main risk to expansion of the residential investment sector is the risk of over-regulation. This means that recent Government announcements, suggesting that the private rented sector needs to be more regulated, may threaten the development of this sector. This is unfortunate as the rationale for increased regulation is far from clear given that buy to let and the associated expansion of the private rented sector has:

- provided an alternative to owner-occupation for new households outside of the subsidised sector and improved choice at the bottom end of the market;
- kept rental growth low which has made renting a valid tenure alternative to owner occupation;
- reduced the exposure of the freehold market to over-g geared owner occupiers of the kind who contributed to the sharp and prolonged falls in housing values between 1989 and 1993;
- raised standards within the rented sector; and
- removed more vulnerable households from the mortgaged, owner occupied market thereby

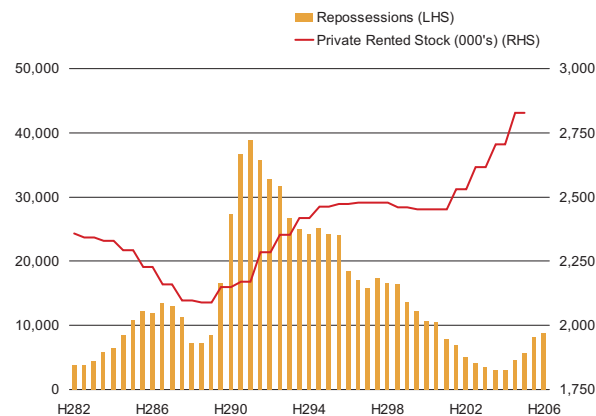
decreasing the likelihood of repossession.

It may nevertheless be said that the expansion of buy to let has served its purpose and, going forward, the Government's stated objective is to encourage investment in the residential market on an indirect basis. If this is to be fulfilled, any regulation of the private rented sector will need to be very well thought out if the adverse consequences are to be avoided.



"the increase in availability of open-market rental property has, indirectly, reduced the number of repossessions that will take place as interest rates rise"

Renting reduces exposure to repossession



Source: DCLG, CML

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Savills plc

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