# The Residential Property Focus

June 2008

Savills Research

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## This Publication

This document was published on 2 June 2008. It contains a review of all the key housing market indicators and news to the end of April 2008. The data used in the charts and tables is the latest available at the time of publication. Sources are set out for all the charts. We have used a standard set of notes and abbreviations throughout the document. The most commonly used are:

– Q108 refers to the first quarter of 2008
– H207 refers to the second half of 2007
– LHS and RHS refer to which data series in a chart is on the left hand scale (LHS) and right hand scale (RHS)

## Important note



## Contact and further information

If you have any questions or queries about The Focus please contact Lucian Cook +44 (0) 207 016 3837 or email residentialfocus@savills.com. A full set of contact details and services are available on the penultimate page.

# The Residential Property Focus

## The big question now is whether the credit crisis can be curtailed in time to allow markets to recover in 2009?

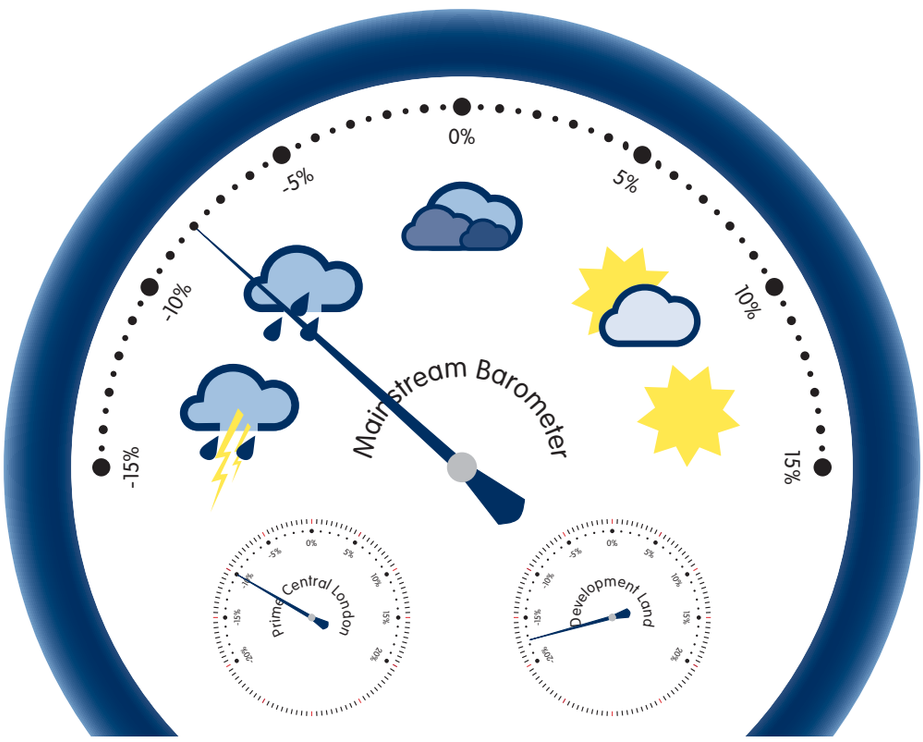
This publication comes at a time when the dark clouds of the credit crisis have gathered over the UK housing market. The mortgage drought has brought some parts of the market to a virtual standstill, with transaction numbers falling and likely to remain low.

The question now facing us all is for how long this current downturn will last and how deep its impact on the property market will be.

In the following pages, we consider what has caused the outlook to change and what this means for both our short and medium term forecasts of house prices and market activity. We look at the mainstream and the prime markets, including the very top end where values are still rising.

We have particularly concentrated on the domestic development markets looking at the implications for house building activity and development land values. Specific space has been devoted to the central London development market, which has seen strong growth in values in the past two years on the back of high investor demand and where the change in conditions has significant implications for the future development pipeline.

The change in conditions also presents different challenges for residential investment markets, where rents are set to rise, but total returns are set to fall. Investors will need to look for opportunities to create value through pro-active management if they are to weather the storm.




- UK house prices 4.4% lower in May 2008 compared with the May last year. *(Nationwide)*
- UK house prices set to fall by 8% in 2008. *(Savills)*
- The number of mainstream mortgage products available to the market falls by 45% in the two months to the end of April. *(moneyfacts.co.uk)*
- Assuming credit crunch subsides, prices to show 7% total growth in 2008 - 2012 inclusive. *(Savills)*
- Prices in prime central London fall by 2.5% in the the first quarter, total price falls of 10% expected in 2008. *(Savills)*
- £5m+ market shows continued growth with prices up by 1.7% in prime central London. *(Savills)*
- UK rents grow by 7% across the UK and by just under 12% in London in 2007. (*IPD*)

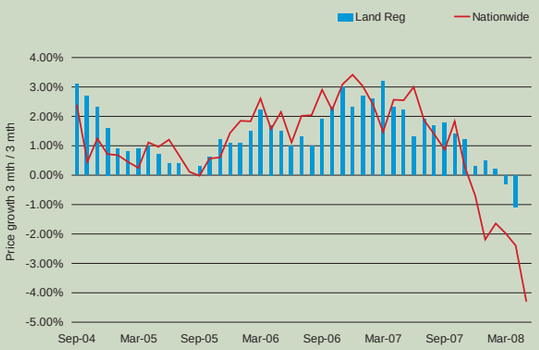
*Source: Savills Research and Nationwide*

# Taking Stock

## Overview

The housing market slowdown we faced at the beginning of the year has now become a downturn. At the end of April, the Nationwide mainstream house price index showed year on year falls in house prices for the first time during this millennium. At the end of May the index suggested that average prices were 4.4% lower than a year previously.

**National house price growth**




Source: Nationwide, Land Reg

The driving force behind these falls has been the ongoing credit crisis, which has significantly reduced accessibility to mortgage finance and prevented recent base rate cuts from being passed on to the consumer. This has occurred against a backdrop of a weakening outlook for economic growth and reduced buyer confidence.

Yet, as things stand, average household finances remain in surplus and, in theory at least, relatively small falls in prices over the next two years would allow households to rebuild this surplus back towards its longer term average. The immediate prospects for the market are therefore largely dependent on the severity and longevity of the credit crisis and its impact on the wider economy.

The shift from credit squeeze to credit crunch to credit crisis and from slowdown to downturn has led us to revise our market forecasts. Now our central forecast is for a -8% fall in mainstream UK house prices in 2008, followed by another -2% in 2009, assuming that access to borrowing and lending criteria ease.

The risk of a far more severe correction cannot be ignored because there are parallels to be drawn with the 1974 secondary banking crisis, during which the term “mortgage rationing” entered the lexicon. If the current initiatives by the Government and the Bank of England fail to restore the banking system to working order, then price falls of -10% this year are a realistic prospect, with the potential for further falls of -15% in 2009.

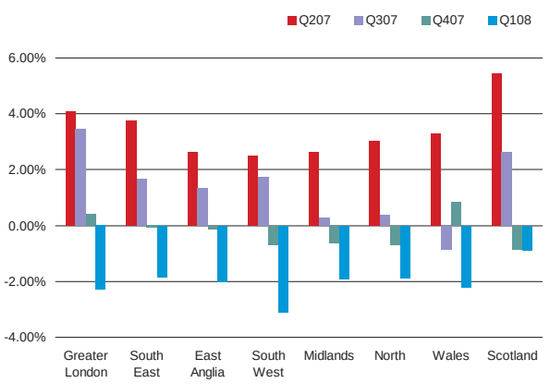
In the prime markets, the impact of the credit crisis has been different, but equally as effective at reducing prices. In this sector, reduced earnings and lower job security amongst City buyers has resulted in modest price falls. In prime central London, there were falls in value of -3.5% during the six months to the end of March. Although we expect prime London to be the first sector to recover, we are still forecasting falls of -10% in 2008. We expect however for there to be price growth of 3% in the “super prime” £5million+ market.

## National

House price movements are now firmly in negative territory. Values fell by -2.3% in the three months to the end of April and according to the Nationwide Index, all regions of Great Britain are similarly affected, a symptom of the credit, rather than affordability driven crisis.

The impact of the credit crisis on the mainstream markets has been two-fold - it has restricted the availability of mortgage finance and increased the margins over base rate at which banks are prepared to lend. Restricted access to mortgage finance has taken place via a wholesale removal of mortgage products from the market, an adjustment of loan to value ratios and a differentiation in the interest rates available to buyers determined by the amount of equity included in a purchase.

**Quarterly growth across Great Britain**



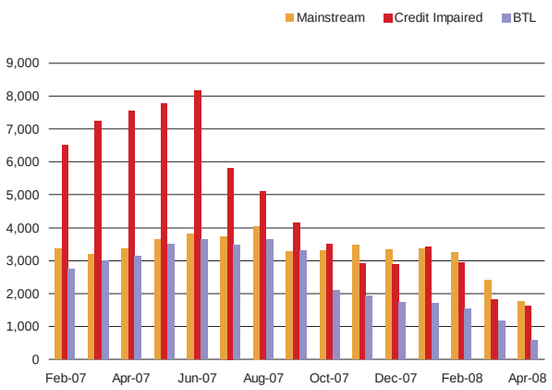

*Source: Nationwide*

# Taking Stock

## National (continued)

In the months leading up to the credit crisis the number of mortgage products available to poor credit rated borrowers outnumbered mainstream mortgage products by over two to one. During the first wave of the credit crisis, July to September, the number of those products fell by almost half, while the number of mainstream products fell by just over 15%.

### Shrinking Mortgage Availability (number products)




*Source: MoneyFacts.co.uk*

With low income yields unable to offset prospective falls in capital values, mortgage products servicing the buy to let market were also withdrawn at a dramatic rate in the latter part of 2007.

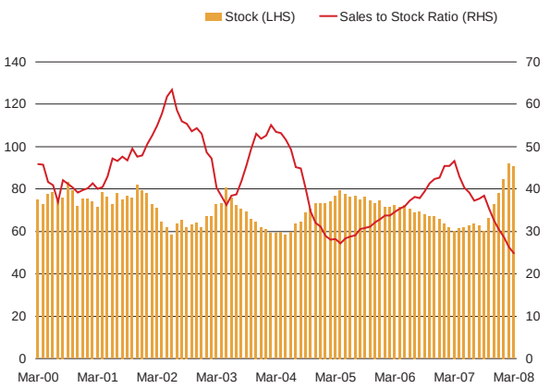
**"The driving force behind falls in values has been the credit crisis and the lack of access to mortgage finance"**

Since February the withdrawal of mortgage finance has become more widespread, with the number of mainstream products available on the market falling by more than 46% over just two months, at the rate of 24 per day.

The restrictions on mortgage lending has exacerbated the reduction in market activity normally associated with a slower market. Potential buyers who have decided against moving because of market uncertainty have been joined by a new group, those for whom mortgage terms have become increasingly harsh.

The consequential reduction in transaction numbers has led to a dramatic increase in the number of properties on estate agents' books, whilst reduced demand has further contributed to a sharp decline in sales as a percentage of that stock.

### Market Activity

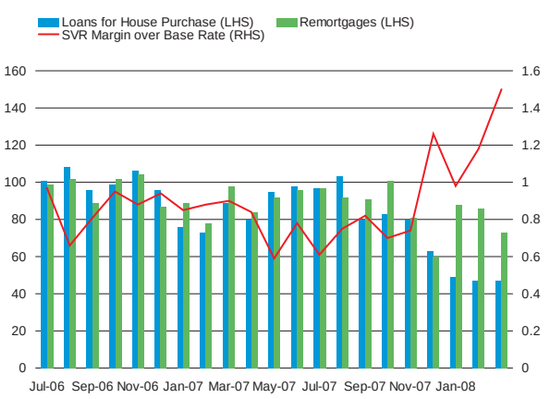



*Source: RICS*

On the supply side, there are concerns over the ability of existing home owners to remortgage and some commentators expect this to bring a surge of properties on to the market. By contrast, current evidence shows that the levels of remortaging, whilst less than last year, have been much less affected than those for new mortgages.

Repossessions, which currently remain below the levels of the early 1990s, are not driving the market. This said, increases in borrowers' margins have prevented households from reducing their debt adding to the likelihood of more repossessions in the future. The risk is that, if financial pressures do not ease and price falls continue, increased numbers of forced sellers could exacerbate the downturn.

### Mortgage Lending




*Source: CML*

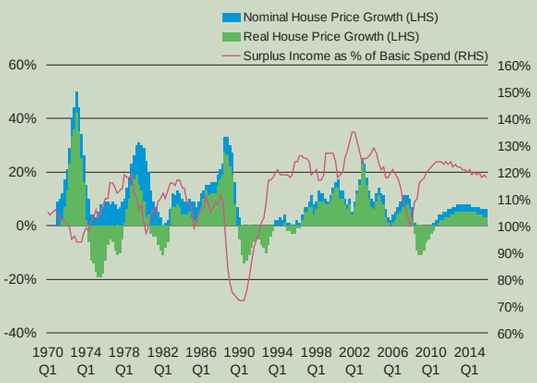
# Changing Times

## Outlook

The severity of the credit crisis has fundamentally shifted the balance between demand and supply of housing heavily in favour of supply in the early part of 2008. The overriding question now is whether this is a short term imbalance or the trigger for a much deeper and prolonged downturn.

A comparison with past property downturns, suggest that whilst affordability (as measured by surplus household income) is stretched, it is not in crash territory.

**Small falls restore affordability**




*Source: Savills*

In theory, relatively small short term falls in house prices combined with an easing of credit markets, within a low interest rate environment, should allow household finances to be restored with stability in house prices returning by the end of next year.

The risk is that the credit crisis hit at a time when (whilst not negative) household finances were already finely balanced. Economic growth was waning and food and fuel bills had started to rise, affecting all but the most affluent households. Confidence is low so that, although there are not currently the unemployment and affordability pressures, which accompanied previous downturns in the early 1970s, 80s and 90s, there is a real risk that liquidity will not be restored to the credit markets. This will lead to negative sentiment and restricted access to mortgage finance, overriding the broader economic prognosis.

**"Whilst affordability is stretched, it is not in crash territory, but there is a real risk that sentiment will prevail over economics"**

A further risk is that the credit crisis has a much greater impact on the wider economy. Currently the Treasury is forecasting that economic growth will slow to 1.7% in 2008, down from 3.1% at the end of 2007. Whilst the Treasury then forecasts a bounce back in 2009, their view is not held by independent forecasters who are forecasting similar limited rates of growth next year.

In the short term, the severe drop in transaction numbers will lead to more price falls. In current circumstances, we are forecasting house price falls of 8% in 2008 and 2% in 2009. In the new build sector, the prospect of standing stock could exacerbate the impact.

Theoretically this would considerably ease affordability. If, however the credit crisis is not resolved, more significant falls in 2008 and 2009, perhaps up to 25%, cannot be ruled out. For this to occur, employment prospects would have to weaken to the extent that forced sales become a common feature of the market with confidence eroded to such a degree that other households would choose to build savings rather than enter the housing market.

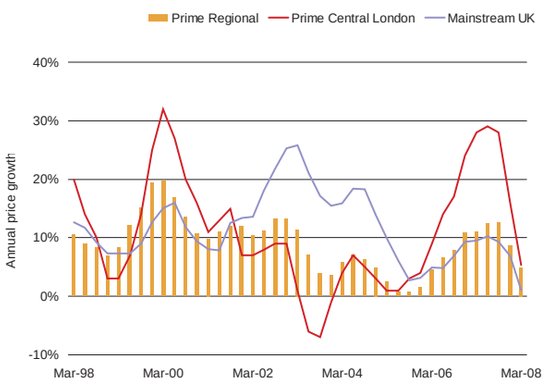
| Scenarios | UK Mainstream | | | Prime Central London | | |
|---|---|---|---|---|---|---|
| * total for period | 2008 | 2009 | 2010-2012* | 2008 | 2009 | 2010-2012* |
| Credit Crisis eases in 2008 and recession is avoided | -8% | -2% | +19% | -10% | -4% | +30% |
| Credit Crisis continues through 2008, mortgage finance restricted in 2009 | -10% | -15% | +20% | -15% | -10% | +34% |

# Top End

## Prime Property

With the possible exception of the £5million+ super prime market, we believe that the bull run for prime residential property petered out during the final quarter of 2007.

### Prime London market is more volatile




*Source: Savills, Nationwide*

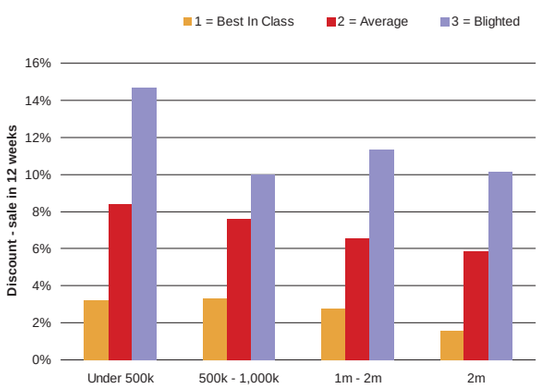
In 2008, prime markets have contended with both reduced City bonus and job security expectations and the furore caused by the proposals for the taxation of so called non-doms. This led to modest price falls both in central London and in the prime regional / country house markets of 1.5% and 0.5% respectively.

Transaction numbers have been significantly affected, particularly in the sub £1million market. In many cases, this reflects a discrepancy between pricing and supply and demand levels. In March, the number of new applicants registering for prime property across London fell by 23%, whilst the number of properties on the market increased by 10%. To date vendors have been reluctant to adopt a commensurate asking price. In all likelihood prices will, therefore, have to fall further before parity is restored.

### "Discounts in London tend be slightly higher than in the regions, where the ripple effect is taking time to filter out"

In April, we surveyed a sample of our agents to consider how much 2007 values would need to be discounted to secure a sale within 12 weeks in the current market. The results showed a marked difference between the performance of property which would be considered best in class (by virtue of its location, setting, quality and type of accommodation) and that which is less well appointed.

### Form is temporary, class is permanent




*Source: Savills*

Whilst asking prices of the best property would be expected to be 2.7% lower than in 2007, this figure increased to 7.1% for average property and 11.6% for the blighted stock. Discounts in London are overall slightly higher than in the regions, where the ripple effect is taking time to filter out.

Generally the impact is greatest in the lower price brackets, although the City buyer driven £1million to £2million London market falls foul of this generalisation. Latest estimates from the Centre for Economic and Business Research indicate that job losses in the City could reach 20,000 by the end of 2009, whilst JP Morgan has forecast 40,000.

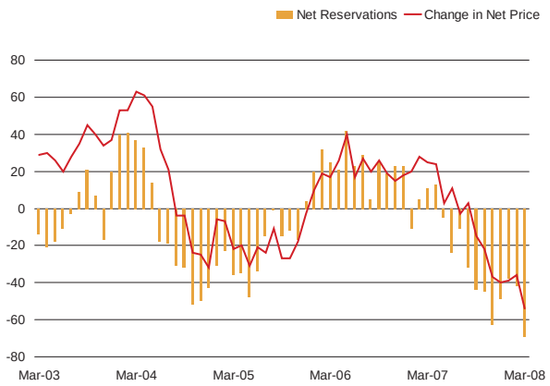
In contrast, the non-doms taxation provisions have been less draconian than many feared, which should mean that the distinction between the prime and super prime markets will be a continuing feature of the market this year.

# Developing Markets

## National Development Land

The downturn in the housing market has had a major impact on the house building industry, with net reservations, prices and site visitor numbers all adversely affected.

**New build pressure (year / year balance of opinion)**




*Source: HBF*

Historically, during housing market downturns developers have significantly cut back on development activity in an attempt to minimise capital outlay, while rates of sale are under pressure. In the early 1990s, for example, levels of house building were 15% to 20% lower than in the late 1980s.

**"Housing completions could fall 35% below the five year annual average of 160,000, a far cry from the Government's long term target of 240,000"**

In the current downturn, falls in prices and rates of sale are not only affecting developers' profits and confidence, but also contributing to a tightening in the availability of development finance, as lenders take a far more cautious approach to new build residential schemes in the wake of the credit crunch. No wonder then, that several major housebuilders have already made public their intention not to embark on new development projects in the current market.

Against this backdrop, housing completions are likely to fall some 30% to 35% below the five year annual average of 160,000 in England, a far cry from the Government's long term target of 240,000.

**"Put simply, the one size fits all approach will be replaced by one of being responsive to the local housing need"**

Within the Barker report, one of the stated objectives behind increased house building targets was to keep real house prices within 1.1% of the general rate of inflation, by reducing scarcity in the housing market. It appears that, in the short term at least, this will be turned on its head, as reduced demand for housing will eliminate scarcity.

The mothballing of new developments until market conditions improve will, to a degree, counteract this, but it will also have knock on implications for the development land market.

Until recently both urban brownfield and greenfield development land values have been supported by a rising market and an overall scarcity in the number of sites coming through the planning system. This pushed development land values above and beyond their economic or "residual" value based upon day

# Developing markets

## Development land (contd)

one values of completed units, prospective costs of development and the developer's anticpated profit margin. Already brownfield values have fallen 12.1 % in the past year and greenfield values 6.4%, with falls in value concentrated in the first quarter of 2008.

**"We anticipate that land values will be linked to the type and scale of new build housing for which there is demand from owner occupiers"**

Looking ahead further adjustments in value are likely, with high density brownfield sites which feed into already well supplied city markets being most affected. Even after an adjustment in values, price growth is likely to be subdued for some time by both increasing costs of development and levels of regulation.

This reflects the prospect of a fundamental shift from the prevailing position where scarcity of sites and high land values have dictated the nature of development undertaken. Instead we anticipate that land values will be linked to the type and scale of new build housing for which there is established demand from owner occupiers. Put simply, the one size fits all, planning led approach, will be replaced by one of being responsive to the localhousing need.

With the viability of brownfield sites in question, developers' attention could turn increasingly to greenfield sites, whilst they seek ways of identifying and delivering these viable, high density, urban residential developments. The ability to provide residential property within mixed urban developments, is likely to be a key part of this longer term solution.

This is just one of the many challenges and opportunites facing developers over the medium term. In the current market conditions the roles of developers and housebuilders will become more distinct.

## Investment

The buy to let market has been particularly hit by the withdrawal of mortgage finance and the immediate outlook for house prices. We expect growth in the size of the residential investment sector to be significantly weaker in 2008 than in previous years.

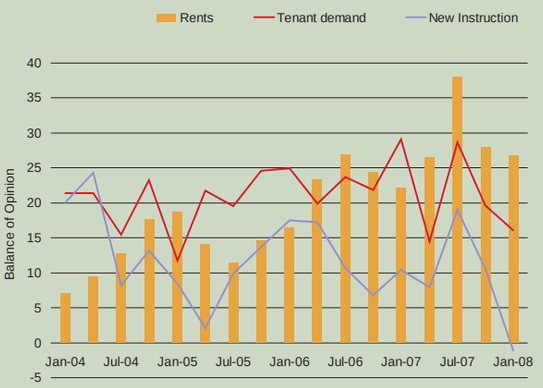
**"Investors continue to show interest in portfolios where there is the opportunity to unlock additional value"**

Most investment activity is likely to be confined to larger scale investors who, although currently unwilling to commit to stock let on the open market, continue to show interest in portfolios where there is the opportunity to unlock additional value. This means investing in portfolios where the rights of existing tenants (such as life tenants for example) currently suppress values. In these circumstances investors are not wholly reliant on market led capital growth and income yield. We estimate that this market is currently worth some £500 million per annum.

The Savills investment index indicates that residential income returns reduced to just 3.0% in 2007. In the commercial property market, an adjustment in income yields has led to sharp falls in asset values. In the residential market, where capital values are far more driven by demand from owner occupiers, an increase in yields will result from both reduced vacant possession values and, importantly, rental growth.

IPD figures indicate that average residential rents increased by 7% across the UK in 2007. Further rental value growth is expected in 2008 as demand shifts into the rental sector from hesitant house purchasers, and reduced buy to let investment brings less property into the rental market.

**Future investment plans (by investor)**




*Source: RICS*

# Focus on.....

## Central London Development

During the past three years, the central London development market has been riding high on the back of the significant wealth generated in, and attracted to the Capital. Average prices for new build units increased by 52% from between 2004 and 2007, a growth rate which marginally outpeformed the prime second hand market, which in turn substantially outperformed the mainstream market.

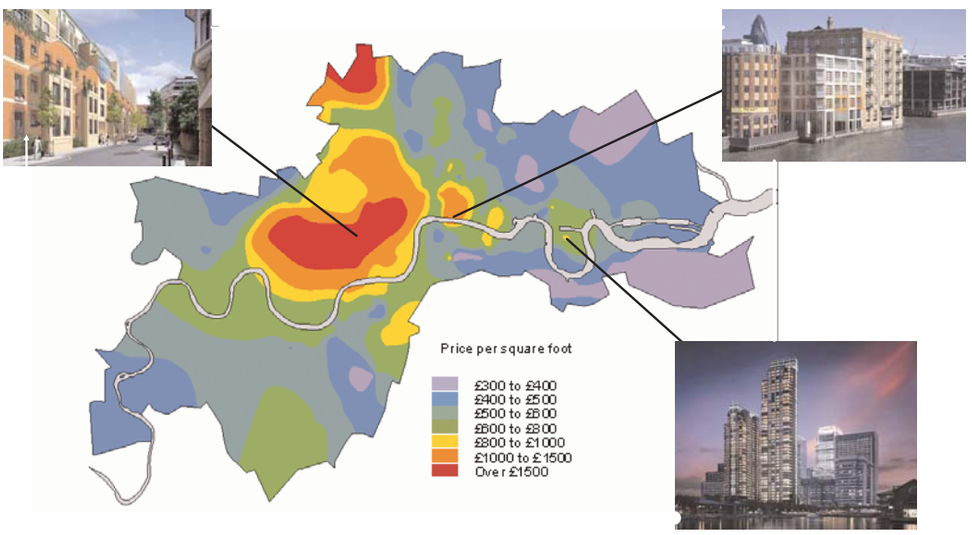
Across the market sale prices broke through all previous price ceilings, but particularly for the high specification schemes in the most exclusive areas. In 2007 the average sale price reached £650 per sq ft in the central London area running from Highgate to Wimbledon and from Ealing to the Royal Docks.

build market exposed, particularly as in 2007, 71% of purchasers were investors, specifically looking for future capital growth.

The impact of a downturn will vary across London and is likely to reflect the distribution of the development pipeline, which is heavily skewed to the East of the city, where 57% of new supply is located.

Given that developers' balance sheets are likely to dictate that rates of sale will need to be maintained, pricing on schemes in high supply areas will be put under pressure, especially where future supply is already committed on high density schemes.

Where possible, we anticipate that developers will initially look to delay implementation of planning consents and, as a result, housing starts will fall.




In the heartland of prime London, comprising Knightsbridge, Chelsea, Mayfair, Kensington and Bayswater, over 50% of new supply has achieved prices in excess of £1,000 per sq ft.

**"The prospect of 10% falls in prime London values this year leaves the high supply new build market exposed"**

With the lure of record sale prices and policies promoting increased supply, it is unsurprising that the development pipeline has swelled dramatically in this period. The five year pipeline of units, which will be available for sale on the open market, is currently 36% higher than past supply across central London.

On the face of it, the prospect of -10% falls in prime London values this year leaves this part of the new

Notwithstanding the fact that the future development pipline remains higher than past supply, caution amongst developers and funders has already contributed to a 15% reduction in the five year pipeline in the past 12 months.

The effect of this reduced supply is unlikely to be fully felt until 2009. In January 2008 approximately 1,000 units were completed and available, with a further 4,500 units under construction and due to be completed during the year. This equates to two-thirds of the development pipeline for the year. In comparison, of the 2009 pipline only 2,900 units are currently under construction, just 27% of the potential pipeline.

By contrast, in the core central areas future supply remains heavily constrained and we anticipate that this scarcity of product will continue to support prices.

# Housing Research and Consultancy

Savills Research team is based in London and provides advice and analysis to clients on the rural, residential, commercial and leisure property sectors in the UK and Europe. Savills also provides similar property research services throughout South East Asia and Australia. In the UK, Savills has had a dedicated residential research team for the past 18 years. Over this time, the department has built up a strong reputation for producing accurate, well informed and, above all else, independent analysis and commentary on the UK's housing market. As a result, the team are a leading national commentator on market trends.

The success of the department has been built on its market insight, provided by the Savills network, in conjunction with a significant external consultancy business. This market-led approach to our research is vital to our clients. It enables us to provide you with analysis, commentary and forecasting that adds value to both your assets and your businesses. The department has been involved in a wide range of consultancy projects for a variety of public and private sector organisations across the UK. This has involved research into housing of all tenures and across all price ranges and rental levels.

Typical consultancy projects include:

- local area supply and demand analysis
- development feasibility studies
- investment strategy and advice
- place making site studies
- forecasting rents and capital values
- research to inform policy making and best practice statements
- research for property finance and business planning purposes
- research to inform housing-led regeneration initiatives

## For further information please contact


**Jim Ward**
Director
020 7409 8841
jward@savills.com

**Yolande Barnes**
Director
020 7409 8899
ybarnes@savills.com

**Lucian Cook**
Director
020 7016 3837
lcook@savills.com

**Jacqui Daly**
Director
020 7016 3779
jdaly@savills.com

**Carrie Scrivener**
Associate Director
020 7409 8744
cscrivener@savills.com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**Savills Residential Research** Lucian Cook +44 (0) 207 016 3837 lcook@savills.com