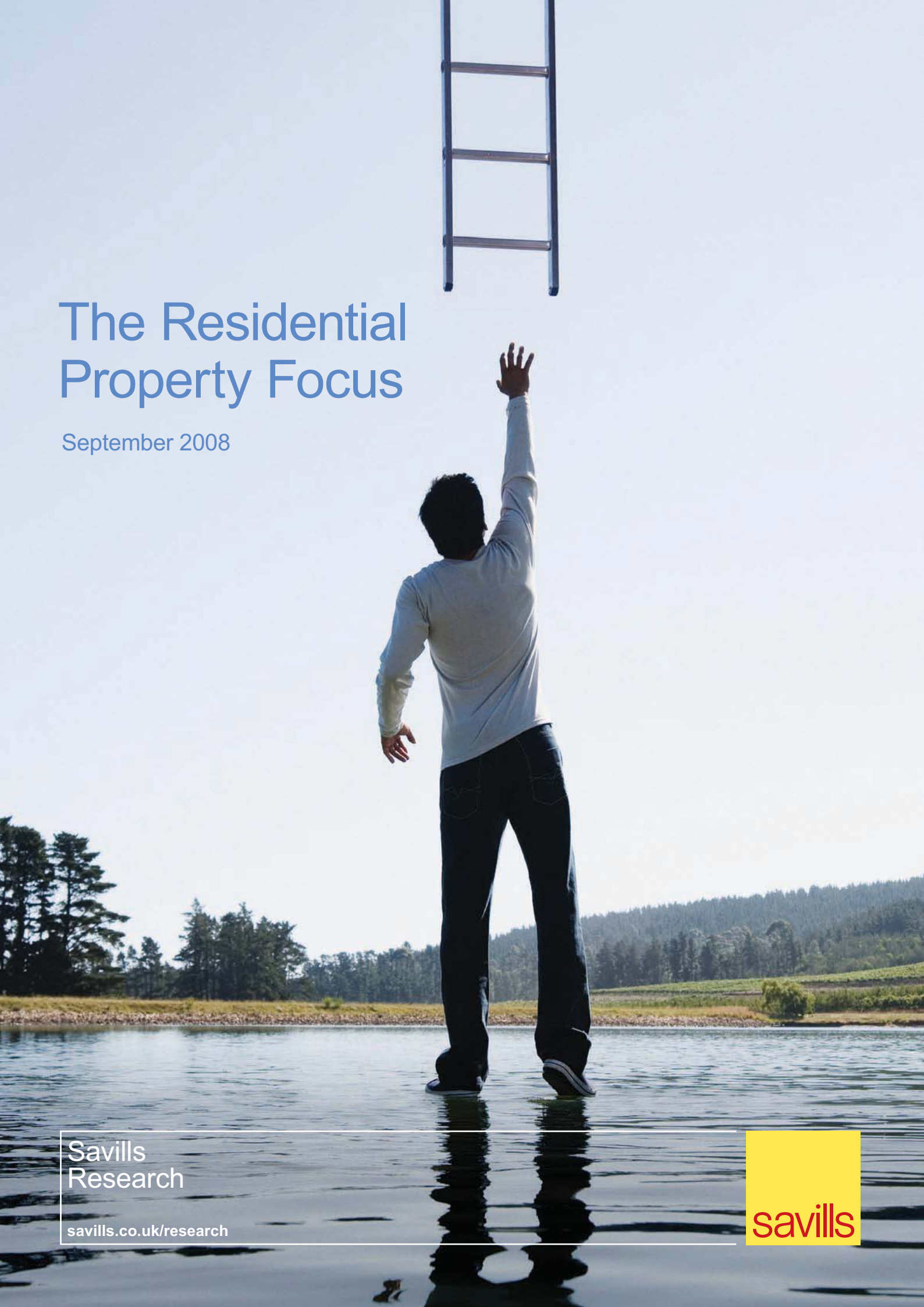
The Residential Property Focus

September 2008



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This publication

This document was published on 1 September 2008. It contains a review of all the key housing market indicators and news to the middle of August 2008. The data used in the charts and tables is the latest available at the time of going to press. Sources are included for all the charts. We have used a standard set of notes and abbreviations throughout the document.

The most commonly used abbreviations are:

- **Q208** – refers to the second quarter of 2008
- **H108** – refers to the first half of 2008
- **LHS** and **RHS** – refer to which data series in a chart is on the left hand scale (LHS) and right hand scale (RHS)

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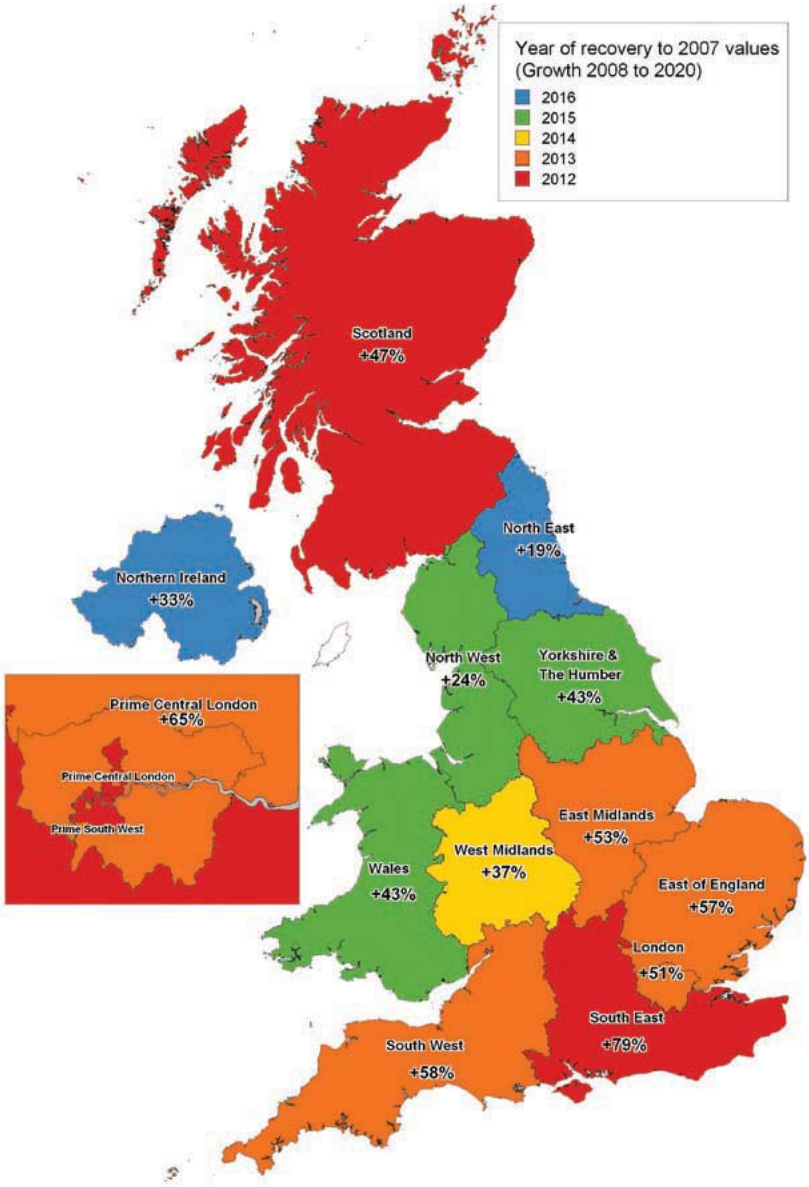
A quarter off values but all forgotten by 2020

As Autumn fast approaches, our third issue of the Residential Property Focus 2008 could perhaps be construed as a publication of two halves. For the first time since the onset of the credit crunch, we have included our view on the timings and nature of the recovery, when it eventually comes. Whilst the downturn almost simultaneously affected all sectors of the UK property market and across all Government regions, the map below shows that the nature of the recovery will be very different. Led by London and the South-East, where by 2012 values will have recovered to those pre-slump, between 2008 and 2020, average growth in the South-East will be +79%. Meanwhile, we include a detailed analysis of how the property market has fared since we last reported in June, and how the weakening economic position is likely to impact on the length and depth of the downturn. This is both in the mainstream and prime property markets as the disparity between the cost of renting and buying, which has built up since 2004 is set to narrow considerably with house prices set to fall by 25% since their peak. Also, this has been supplemented by an assessment of the impact which the downturn is set to have on house building and on the Government target to deliver three million additional homes by 2020. ■

Map 1.1
Recovery map



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Housing cycles, affordability and supply

'A much-needed and long overdue market correction' is a common verdict on falling residential property values. The doomsters who have been predicting double-digit house price falls since 2002 are now feeling vindicated. They shouldn't be. They may have got it right in 2008 but have done so for the wrong reasons, relying on the arguments which they have incorrectly put forward for each of the past six years.

The danger is that if they, and policy makers, persist in the belief that house prices have been fundamentally overvalued by 30% or more, they will have a nasty shock when the cycle of house price growth resumes again, as it surely will.

Looking only at factors such as house price to earnings and debt repayment costs is somewhat missing the point as to what is currently and will continue to drive the housing market. Some analysts talk about these relatively blunt measures of affordability in a market where, over the long term, fundamental supply shortages mean that they will continue to be stretched. It was always inevitable in this country that house price to income ratios, for example, would increase from their historic levels of the 1970s and early 1980s.

Lack of mortgage finance

The key factor which turned the affordability-driven slowdown of 2007 into a downturn in 2008 was the lack of mortgage finance, resulting in the credit crunch. The additional factors which are potentially set to drive house prices down by 25% from their peak of 2007 are the weak outlook for the economy and the impact which this has on buyer confidence. The correction means that UK households are set to rapidly rebuild their cash flow positions and balance sheets.

Those looking to buy will be less constrained by affordability issues whilst house prices fall. In London and the South East in particular, the underlying drivers of property values will kick in again when mortgage lenders are once again able to operate in more typical conditions. The end of the credit crunch is the key factor here. The financial markets appear to be pencilling it in for 2010, at a time when economic growth is forecast to return to more than 2% per annum.

In the interim, we are less likely to see local markets flooded with stock and are more likely to see a shortage of properties for sale than in previous downturns. The signs are that, even if the number of mortgage repossessions rise, as they did in the early 1990s, this time the sale stock may not rise. There is the prospect that lenders will manage repossessions more effectively and find alternative ways of realising value, perhaps even by becoming landlords.

Lack of affordability will not be a constraint when the credit crunch ends, but the lack of purchasing power amongst a growing proportion of the population will be. Although many would-be home owners are currently being 'priced in' to the market as a result of the credit crunch, many existing owners are experiencing negative equity for the same reasons. A number are unable to obtain the finance that they need to buy, and transactions have plummeted. Irrespective of the current market malaise, many more will still find themselves priced out in the years ahead, especially those non-home owners who are unable to afford deposits.

> "Over the medium and long term, the 70% of the nation who are home owners will continue to see excess house price growth"

The need for intermediate housing

For these reasons the need for intermediate housing for the people affected is as strong as ever and likely to become stronger. This reflects the disparity between those who have accumulated equity, having been in the housing market for some time. Over 40% of home owners now own outright, without a mortgage and there are high levels of equity in the market as a result of both this and three decades of high house price growth.

Over the medium and long term, the 70% of the nation who are home owners will continue to see excess house price growth, until and unless the rarity value of housing is diminished by large quantities of additional, high quality, competitive supply. ■

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The national picture – further falls

The downturn in the UK housing market has become more deeply entrenched over the past three months. House prices at the end of July were 8.1% lower than a year earlier according to Nationwide data. Transaction levels have remained suppressed as accessibility to mortgage finance has continued to be heavily constrained. While the downturn was precipitated by reduced availability of borrowing, the additional prospect of weak economic growth for the rest of 2008 and 2009 is set to put further pressure on house prices and keep transaction levels low over this period.

As a result, attention is increasingly turning to the extent to which house prices must fall during the course of the downturn in order to resuscitate the market and allow both buyers and lenders to be confident that when a property is purchased it will hold its value.

"Greater accessibility to mortgage finance will be a prerequisite of recovery"

Restrictive mortgage conditions

Greater accessibility to mortgage finance on reasonable lending criteria will be a prerequisite of recovery. The July report by the head of the Financial Services Authority indicates that restrictive mortgage conditions will persist through to the end of 2010, indicating that a return to consistent house price growth is unlikely before 2011. Currently the lack of liquidity in the credit markets continues to keep the cost of finance well above bank base rates, despite some recent reductions in interest rates for fixed rate and tracker mortgages. This has been particularly apparent in situations where borrowers are unable to provide sufficient equity to give lenders the 'buffer' which, they are often seeking to protect themselves from further house price falls.

These factors continue to limit accessibility to both mortgages and the housing market and, increasingly, underlying demand is being eroded in light of the wider economic outlook. Current levels of inflation have prevented any cuts in base rates beyond the -0.25% seen in April. This has continued to put pressure on household finances.

The prospect of any further base rate cuts this year has been dealt a blow by rising rates of inflation. According to HM Treasury the average of independent forecasts for 2008 inflation has risen over the first half of the year from 2.1% in January to 4.2% in August.

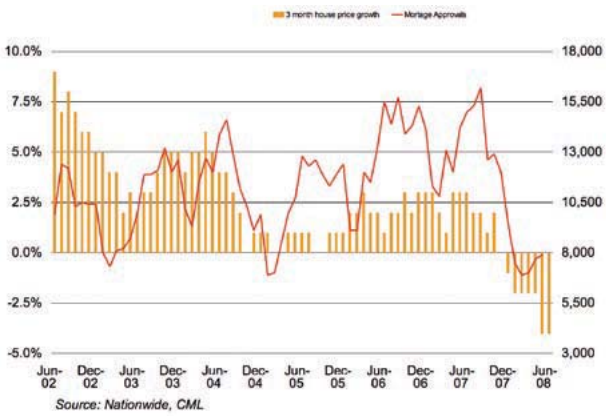
Although expectations for inflation in 2009 are less severe, they still remain above the Government target of 2.0%. This will limit the potential for significant interest rate cuts during the next 18 months. Indications are that this situation is impacting on prospects for economic growth which, in turn, may have a more fundamental impact on the extent of house price falls.

Continued price falls

Average forecasts for economic growth in UK GDP in 2009 have shifted from 2.2% down to just 1.4%, increasing the likelihood of continued price falls until the economy recovers. Given the speed at which house prices have fallen so far, the economic outlook and the ongoing constrained mortgage market, our forecast of -25% falls over 2008 and 2009 is looking like an increasingly safe bet.

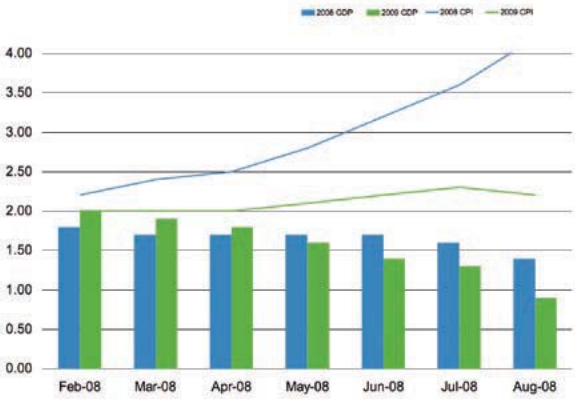
Our analysis shows that a fall of this magnitude will allow the market to bottom out and once again present opportunities to those in a position to buy. At this point the market may well become polarised between the equity rich, who will be able to buy and those with negative equity, who will be unable to transact so soon. ■

Graph 2.1
Consistent house price falls and lower turnover



Source: Nationwide, CML

Graph 2.2
Weakening economic forecasts



Source: HM Treasury

Costs of renting versus buying

A comparison of the cost of owning versus renting gives an insight into the point at which people shift from one tenure to the other. Graph 3.1 below shows how the costs of ownership, which includes mortgage payments, repairs, insurance and the notional cost of the equity introduced to a purchase, have outstripped the costs of renting over the past five years. This followed a period in which buying was less expensive than renting, even before accounting for the capital growth enjoyed by an owner.

By the time the market peaked during the third quarter of 2007, costs of ownership were 44% higher than those of renting, even before capital repayments. The additional cost of capital repayment increased this figure to 76%. It is not surprising in these circumstances, with household finances under pressure, that the number of interest only mortgages rose from 8% of all mortgages to 25% between 2002 and 2007.

"By the end of 2009, the cost of buying should be in line with the cost of renting so making ownership attractive again"

Future capital growth

On the basis that our forecasts are for -25% falls in capital values and rental growth of 10% by the end of 2009, the cost of buying will fall back in line with the cost of renting. Although capital repayments would still represent an additional cost, the prospective returns from future capital growth, combined with a restoration of household financial surpluses above their long term average is likely to make buying look attractive again at this point.

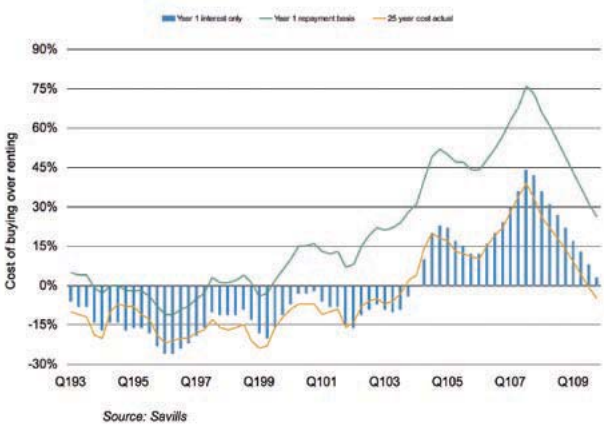
The disparity between rental and capital growth in the run-up to the third quarter of 2007 meant average gross and net income yields for residential property had been squeezed to just 4.8% and 3.0% respectively. This meant that only investors who kept their gearing at less than 50% were able to fund mortgage interest repayments out of net rental income.

This, together with the downturn in values and prospects of negative returns, has resulted in significantly reduced investment activity, exacerbated by the rapid retraction of lenders from the buy to let mortgage market. Those reliant on debt funding will be far more at the mercy of the lenders and their lending requirements, despite the fact that, according to our forecasts, gross yields will have moved out to 6.7% (4.1% net) by 2010.

This will make new acquisitions more affordable for buy to let investors but activity in this market is the least likely to be restored quickly because they have been most exposed to the downturn and are likely to retain the least amount of equity. Over 40% of buy to let lending occurred in 2006 and 2007, when capital values were near their peak.

The return of investment buyers is likely to be led by a new breed of investor and will be an early indicator of a change in market sentiment. Funds with equity to invest are likely to be the first to respond to signals of an upturn concentrating on sub markets, such as central London, where the speed of recovery is likely to be quickest and most pronounced. ■

Graph 3.1
Cost of buying versus renting



Source: Savills

Recovery more dependent on restored demand

The prime property markets have reacted far more sharply to the prevailing economic climate since March this year compared with the preceding six months. Values of prime property in central London fell by on average 5.5% in the second quarter of 2008. In the regional prime and country house markets average values fell by 4% during the same period.

Only at the very top of the market have prices held firm, with the £10m plus market in London and the £4m plus market in the country continuing to show marginal growth (1.2% and 0.7% respectively in the first half of 2008). Within the middle tier of the prime sector significantly reduced demand initially hit transaction numbers.

"Our expectation is that values of prime property in London will fall by 25% over the course of 2008 and 2009, and marginally less so in the regions"

Only as vendors have tuned into the fact that to achieve sales in a low turnover market asking prices have to give, have values followed. In London, the demand from investor and developers has been particularly hit in the market below £1m, with buyer numbers down by 77% in the first half of 2008 compared with the first half of 2007.

In the £1m - £2m market, it is the demand from those buyers employed in the financial and business services sector, whose employment and earnings expectations have taken a battering over the course of the credit crunch, which has seen the biggest decline, down 54% year-on-year.

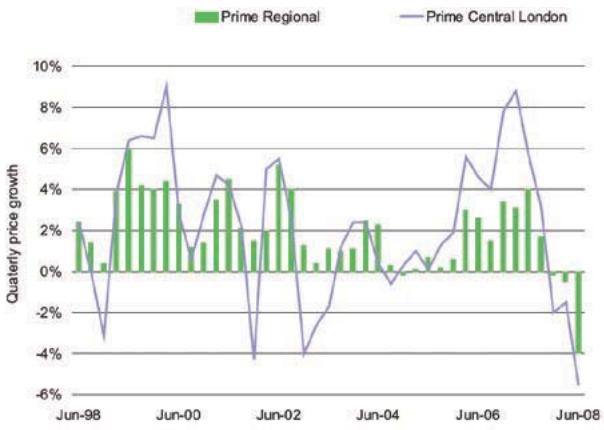
Our expectation is that values in prime central London will fall by 25% over the course of 2008 and 2009, marginally less so in the regions. Those who are unable to stomach the prospect of values returning to levels last seen in 2005 and 2006 are likely to withdraw their property from the market, thereby eroding some of the oversupply which built up in the first half of 2008.

Greater stability to the market

This reduced supply may bring some greater stability to the market, however recovery in the prime markets will be more dependent on restored demand. When investors, developers, and overseas buyers see opportunities for value gains we expect them to return to the prime central London market in numbers, in the knowledge that this market has traditionally been one of the first to recover.

The restoration of owner occupier demand, including that from City bonus buyers, is dependent upon the economy and the financial markets regaining momentum. When this occurs we expect the scarcity of good quality prime housing to result in values at the top end rising faster when the upturn comes. ■

Graph 4.1
Prime markets falling



Source: Savills

Table 4.2
Savills latest forecast

	UK mainstream			Prime central London		
* total for period	2008	2009	2010-2012*	2008	2009	2010-2012*
Credit crunch continues through 2008, mortgage finance restricted in 2009	-10% ↓	-15% ↓	+20% ↑	-15% ↓	-10% ↓	+34% ↑

How the quality of the built environment affects value

Local house price premiums are often associated with social factors such as educational standards, however our research shows that the intrinsic quality of the built environment is possibly a more important factor in determining house price levels. Whereas the average house price premium in the areas surrounding the top 25% of secondary schools is 13%, the average premium in the 25% of areas with the highest concentration of listed buildings is 21%.

The appetite for conservation and restoration of residential property is well established. Architects are increasingly seeking to replicate favoured historic architectural styles when designing new homes and the movement to develop a sense of place amongst larger development schemes is causing planners and developers to look far more closely at the quality of the built environment that they create.

"Areas in London with more than one listed building for every 20 households average prices of 54% higher than the average for the local authority"

Design and value

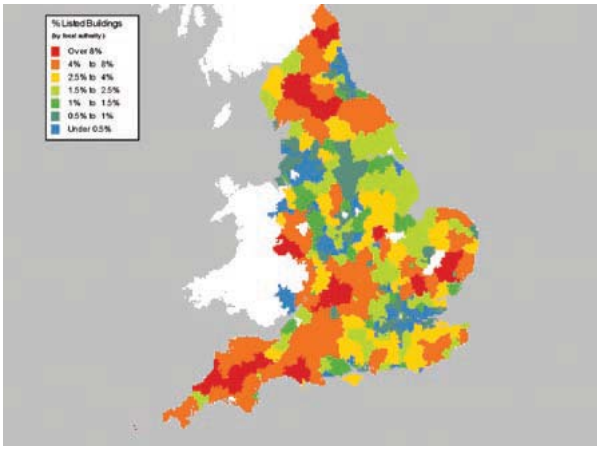
Our research has already established a relationship between design and value within the context of new developments and demonstrated that premiums can be achieved. However, by looking at the relationship between the listed building concentrations and house prices, we have been able to establish how the quality of the built environment affects value across a much wider range of mature settlements.

At a macro level, those local authorities with the highest density of listed dwellings are predominantly rural or semi-rural in nature with an absence of significant post- war urban sprawl, such as Uttlesford in Essex, the Cotswolds and South Shropshire. The trends at a more localised postcode sector level show that areas with a high density of listed buildings are relatively scarce. Most locations in England have less than one listed building for every 100 dwellings. Across England, only approximately 6.6% of all locations have more than one listed building for every ten households. In these locations the average house price is 29% higher than the average for the local authority.

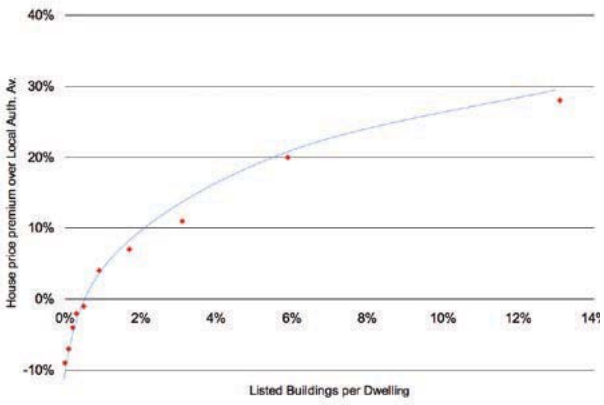
While the headline premium in these rarified markets is significant, the correlation between the density of listed buildings and house prices runs more deeply.

Local authorities with the highest density of listed dwellings are predominantly rural or semi-rural in nature

Map 5.1
House price premium v density of listed buildings



Graph 5.2
House price premium v density of listed buildings



Source: Savills (using Land Registry and English Heritage Data)

Across England, only approximately 6.6% of all locations have more than one listed building for every ten households

Areas that are bereft of a strong built heritage have much lower average house prices than the local authority in which they sit. Practical examples put this into context. When we recently published a list of Great Britain's 50 most expensive towns, we were easily able to identify those which fell into the categories of second home hotspots (such as Salcombe and Southwold) and high value commuter towns (such as Beaconsfield and Ascot).

Trophy Towns

The remaining category is defined as 'trophy towns', which includes Marlborough, Stockbridge, Petworth and Watlington. These towns contain one listed building for every seven households and house prices averaged 27% more than the average for the local authority. If the correlations were confined to semi-rural settlements, then it could be argued that the lessons which we can draw from the figures are limited as it might be rurality that is deciding value. This appears to the be the case as our analysis of London suggests that the quality of the built environment is key within this urban setting too.

Overall, concentrations of listed buildings in London are lower than in other government regions. Areas with more than one listed building for each 20 households only account for 5% of all locations yet in these areas average prices are 54% higher than those for the local authority. In the 6% of locations where there are between one in 50 and one in 20 listed buildings per household there is a premium of 32%. It is not possible from this research to say that the act of listing a building will add value to it but rather that there is something about neighbourhoods with a high proportion of heritage buildings that appear to be more desirable to homeowners and which adds value. ■

Prospects for house building

Expectations of future sales amongst house builders have plummeted since March this year, as a lack of buyer confidence and restrictive mortgage terms have increasingly become major constraints on demand. For the majority of developers, this has left the level of work in progress significantly greater than prospective demand in each of the past three quarters. In response, rates of new development activity have slowed, with the number of new private housing starts in England 27% lower during the first half of 2008 compared with the same period of 2007 according to the Department of Communities and Local Government.

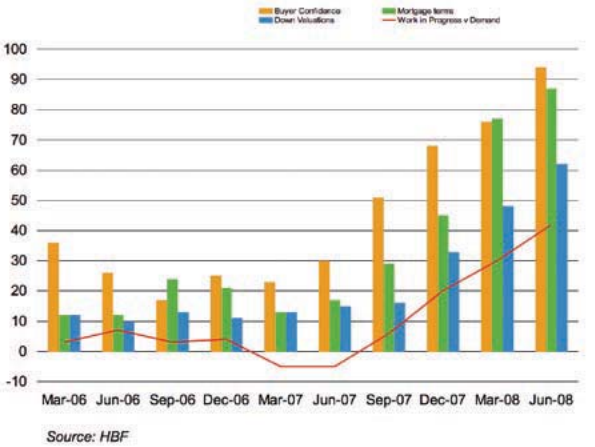
Over the longer term, our analysis indicates that the number of additional new homes created in England through new development and conversion is set to fall further from its peak of around 200,000 units per annum at the end of 2007 to just under 130,000 by the end of 2010, as weak housing demand and rising build costs affect viability of both consented sites and those in the planning pipeline.

Response to market conditions

The speed at which development responds to improvements in market conditions (as and when they occur), will affect the level of supply available to meet restored demand. This in turn will determine the extent to which the Government's targets to build two million new houses by 2016 and, perhaps more realistically, three million by 2020 can be met.

Whilst overall housing market activity can be quick to recover to a change in demand, it is far more difficult for developers to respond to this change. Once the housing market bottoms out, it will take additional time for house prices to recover to a point where mothballed schemes ▶

Graph 6.1
Constraints on demand (% respondents)



Prospects for house building continued

become financially viable, particularly when the drive to provide carbon neutral homes creates the prospect of additional build cost inflation.

Furthermore, even once the decision to re-instigate development has been made, the lead time to review development proposals, comply with regulatory requirements including planning, secure development finance, and mobilise a site will be significant.

This goes some way to explaining why house building levels remained depressed for much longer periods than housing market transaction numbers following both the downturns in the early 1970s and early 1990s. This creates the prospect of an undersupply of new homes during the recovery in the housing market and may increase the speed of the recovery. For those brave enough to anticipate the upturn and build into a market where supply is scarce the rewards may be substantial.

"For those brave enough to anticipate the upturn and build into a market where supply is scarce the rewards maybe substantial"

Serious implications

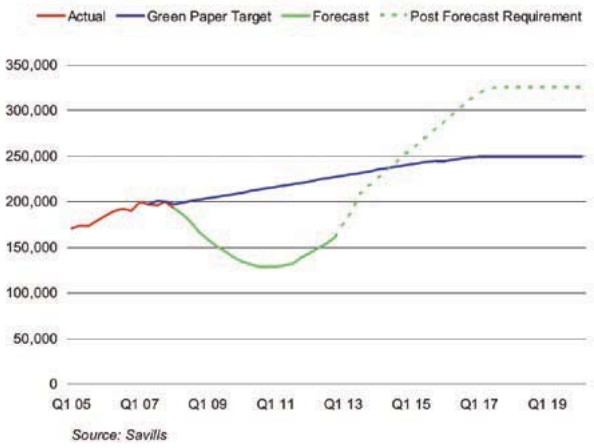
A prolonged period of low development activity also has serious implications for the Government's targets for the number of additional homes to be delivered.

Calculations based upon our forecasts indicate that to ensure the creation of 3 million additional homes by 2020, the number of additional homes created each year would have to rise to 325,000 by 2016 and remain at that level for four years. This would be the highest rates of house building since the late 1960s, but without the significant level of local authority house building, equivalent to 140,000 units per annum, which was being undertaken then.

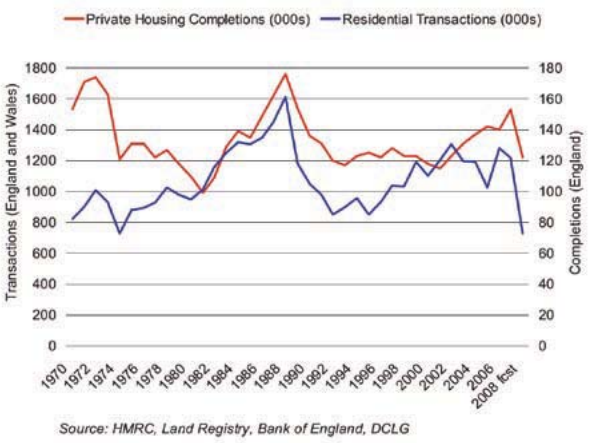
It is likely that this will be unsustainable, but if the shortfall is to be minimised then a radical review of policy will be needed to ensure sufficient land is identified and taken though the planning process and that the identified sites are financially viable. Lower land values will be key to improving development viability, but this will also require a realistic assessment of affordable S106 obligations and community infrastructure levy payments, which are not based on the boom time economics of the recent past.

In the meantime, in order to minimise the shortfall as the mortgage and development finance markets are repaired, development will need to be targeted at sites in areas of greatest scarcity where viability is most robust and in sectors, such as intermediate housing, where demand is greatest. ■

Graph 6.2
House building targets and forecasts



Graph 6.3
Development lag



Our services

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. Through the provision of analysis, commentary and forecasting we can add value to both assets and 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

We hope you have found our research thought provoking and informative. If you would like further information please contact a member of the team below.

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A unique combination of sector knowledge and entrepreneurial flair give clients access to real estate expertise of the highest calibre. We are regarded as an innovative-thinking organisation backed up with excellent negotiating skills. Savills chooses to focus on a defined set of clients, therefore offering a premium service to organisations with whom we share a common goal. Savills which is synonymous with a high quality service offering and a premium brand, takes a long term view on real estate and investing in strategic relationships.

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