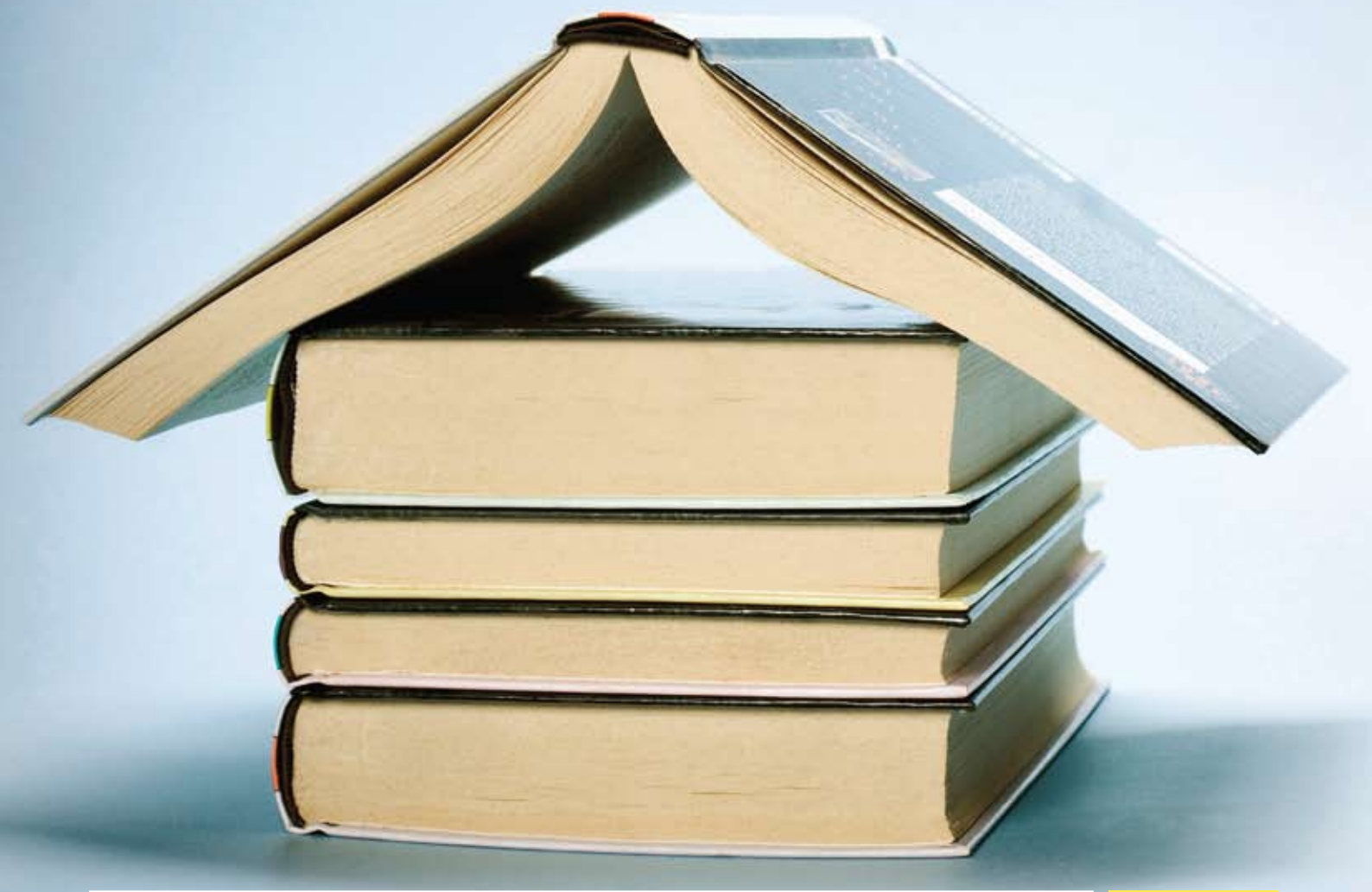
The Residential Property Focus

Winter 2008



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This publication

This document was published on 1 January 2009. It contains a review of all the key housing market indicators and news to the middle of December 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:

- **Q308** – refers to the third 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)

Looking forward to better times

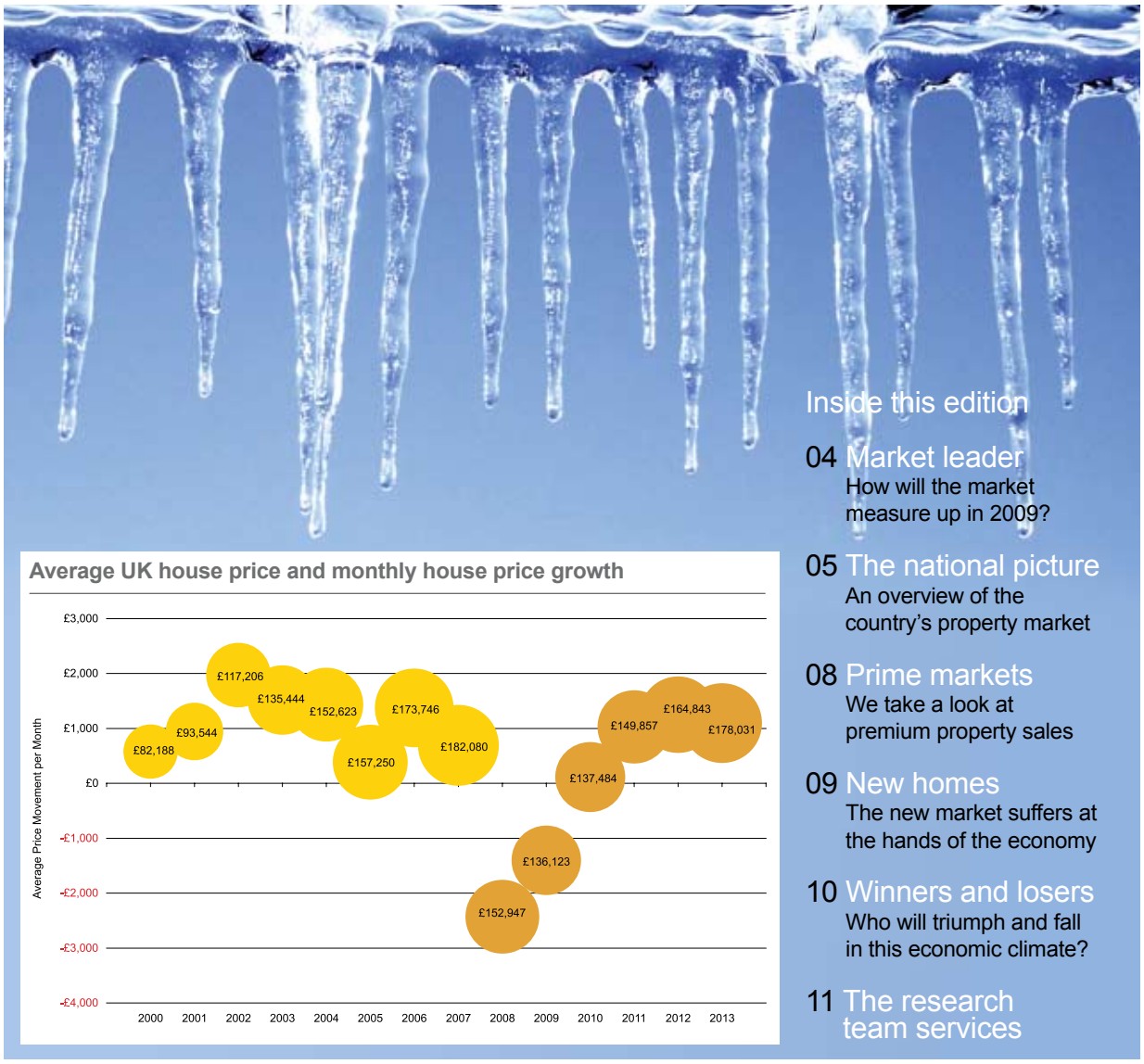
In this issue of the Residential Property Focus we have reviewed our short and medium term forecasts, looking beyond the current oppressive gloom hanging over the residential property markets.

Given the outlook for the economy, it is no surprise that, on the whole, sentiment remains weak. However, given the extraordinary rate of price falls, affordability has been rapidly restored. There are even whispers that the point at which residential property appears good value is in sight, an acknowledgement that, given the circumstances which have propagated the downturn, the market will overcorrect on affordability measures before a recovery is possible.

Exploiting the improved affordability, however, remains difficult for large sections of the market, and with little sign of the freeze of mortgage lending thawing, only cash buyers and the equity-rich can realistically contemplate entering the market in 2009 and 2010. Those with a significant equity margin are well-placed to take advantage of the rapid fall in prices, although it will only be those prepared to take a medium-term view of the market, and balance this against the risk that the economic outlook weakens further and drags the residential market down further than our central case forecast currently anticipates.

Within the following pages we have looked at all of these issues in more detail, both in the mainstream and prime sectors of the market, paying particular attention to the role and source of the equity needed to keep the market alive.

For those who are looking to buy at or near the bottom of the market, the myriad of different house price indices and the various pictures they paint, make the decision of when to buy all the more difficult, an issue which Yolande Barnes looks at in her lead article. ■



Inside this edition

How will the market measure up in 09?

Talk to just a few housing market analysts and you will probably hear a wide range of predictions for the coming year. Similarly, over the last year, if you spoke to an economist several times, then the number of different forecasts you will have been given would probably rise in direct proportion to the number of conversations you had, such has been the volatility of the market and the speed with which opinions have shifted.

At the end of 2007, many of us were anticipating that the sub prime and Northern Rock issues were the product of a financial sector problem that would remain confined to that sector. Our own forecast of a very soft landing in the housing market at this time last year was based both on this widely-held belief and the benign economic scenarios that most economic forecasters were then painting. What a difference a year makes.

"While we are expecting activity to rise next year, we do not anticipate this being on the back of mortgage borrowing"

Leaving aside the doom-mongers who have been predicting -40 or -50% falls in the housing market since 2003, we have been among the more pessimistic of the commentators since the spring, when it became apparent that the credit crunch was morphing into a credit crisis. Our predictions are of -25% falls across the board from the peak values of September 2007 to the trough values that we believe will be seen during 2009. Shock after economic shock has made it particularly difficult to factor in all the variables of housing market forecasting this year. However, one key variable in the predictions made by different forecasters has nothing to do with economics and everything to do with the different house price measures that they are using.

The Halifax and Nationwide indices now measure the valuation of properties at mortgage approval stage, regardless of whether a deal does eventually go through. They are therefore picking up valuers' opinions and potential transactions, rather than only sales that actually take place. In consequence, they have registered the full impact of market sentiment earlier, and more fully, than their Land Registry counterpart, which relies on housing transaction evidence, which by its nature is likely to be historic. Furthermore, the Land Registry data can only record those exceptional deals that have actually taken place – even after turnover has dropped by -64%.

Our forecasts for the UK are made using the Nationwide Building Society's index for the mainstream markets and our own indices for the prime markets. This choice of measure in itself dramatically affects our forecasts in both magnitude and timing. If we were forecasting the time-lagged Land Registry results, we would be predicting lower falls this year, sharper falls next, and probably a delayed recovery.

So what will happen to values next year? It is possible that we will see the end of the worst falls early, but any index that looks only at mortgaged transactions and mortgage valuations is unlikely to pick up the earliest of the recovery activity. While we are expecting activity to rise next year, we do not anticipate this being on the back of mortgage borrowers. Instead, we expect to see a number of equity-rich purchasers entering the market motivated by 'bargain' prices which will look even cheaper to buyers from overseas who are benefiting from sterling's depreciation. Our prime (valuation based) indices will probably pick up on this activity first (especially in London).

Even for domestic purchasers, there is still the lure of higher yields beating returns from alternative property investments and a belief that longer-term capital growth might be more reliable and worthwhile, certainly less risky, than investment in stocks and shares and other alternative investments.

We may even start to see residential property investment for income returns rather than capital growth performance. This could make build-to-let schemes one of the most active of all property development scenes for the next few years.

Maybe this will mean that, by the next property market downturn, valuers will be paying much more attention to rental income streams than the arbitrary capital value that owner-occupiers are prepared to pay for a property and against which lenders are prepared to offer credit. In any case, next year will start to see capital values reflect much more closely the capitalised value of rent paid on it by tenants, or foregone by owner-occupiers. With interest rates plummeting, the biggest question is, at what rate will income streams from property be capitalised in the future? This point could be surprisingly low and, if matched by a substantial rise in demand from equity-rich buyers and a reduced supply as discretionary sellers withdraw from the market, a turnaround in market fortunes could come quicker than we currently expect. ■

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The national picture – heading south

Those who had hoped that the autumn market would bring renewed confidence to the housing market soon saw their hopes dashed as house price falls gathered pace, housing transactions contracted further and the outlook for the economy weakened significantly. By the end of November the average value of housing in the UK had fallen by 13.9% in a year according to the Nationwide indices, meaning that prices had fallen faster than during the downturn of the 1990s.

The speed of falls over the six months to the end of October, during which time prices fell by 9.5%, is unprecedented and reflects an acute imbalance between the high levels of property on the market and that which is selling. RICS data indicates that agents were selling an average of just 11.3 properties in a 12 week period to the end of October – just half of the figure reported in January 2008 – while the average numbers of properties on their books remained at over 80, some 21% higher than a year previous, all absolute confirmation that this is a buyers' market.

"Both unemployment and repossessions are set to rise which will exacerbate the property downturn"

Transactions plummet

At the heart of the dramatic falls in transaction numbers, down by 60% year on year, has been the restricted availability of mortgage finance. Mortgage products are much thinner on the ground, or are much less accessible given the increasing levels of equity demanded by lenders, at a time when that equity is being eroded by house price falls. Bank of England data for 75% loan to value deals shows rates are increasingly divorced from bank base rate, most particularly for new tracker products. Mortgage rates increasingly appear more closely aligned to Libor and bank deposit rates, and reflect a general reluctance to add to loan books.

The upshot is that the slashing of bank base rates to historic lows is unlikely to stimulate demand significantly in the short term. While the underlying measure of affordability, namely surplus household income (after costs of housing and basic expenditure), has already been rapidly restored by both the house price falls seen to date, and the limited falls in mortgage rates, the continued constraints on the availability of mortgage finance, and the shackles of recession will cause property prices to fall further in the short term.

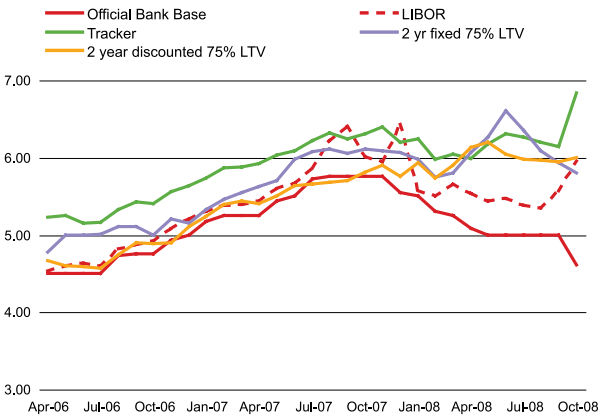
Sentiment in the market has been hit by the turmoil in the banking sector and by the looming clouds of a severe downturn in the "real economy". The outlook for the economy in 2009 has weakened sharply since the summer, culminating in the Bank of England forecasting that the economy will contract by between 1.5% and 2.0% in 2009. Both unemployment and repossessions are set to rise which will exacerbate the property downturn.

Affordability restored

As a result, prices will inevitably overcorrect. Average price falls of -25% from the peak to the end of 2009 are expected, possibly bottoming out well before. This will mean that by this time next year, when bank base rates are likely to remain at 2.0% or lower, with borrowing rates might be nearer 4.5%, average net household incomes should be in excess of 30% higher than basic household spend after the cost of acquiring a property. A surplus of this magnitude will be much higher than that which drove the sustained house price growth between 1995 and 2007.

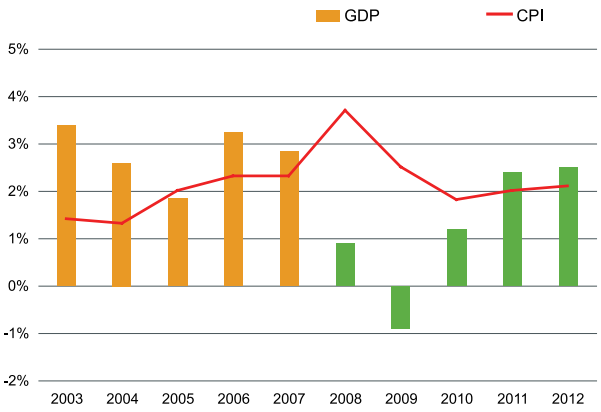
This should provide a sufficient affordability cushion, apply to a brake on further house price falls, and bring

Graph 1.1
Reservations and prices (HBF)



Source: Bank of England

Graph 1.2
Weak economic outlook



Source: HM Treasury (Nov 08)

equity-rich bargain hunters, currently hovering in the wings, back into the market.

Those more reliant on mortgage finance will find it more difficult to access the market, particularly given the anticipated hangover from both the credit crunch and the recession. This will keep transaction levels low and lead to a period of price consolidation, before a wider recovery occurs on the back of an improved financial outlook and an easing of credit markets.

November revealed a government ready to amend policy dramatically in the face of an impending recession. Interest rates have been cut sharply by the Bank of England as inflationary pressures faded, VAT has been reduced (albeit marginally) to stimulate consumer spending, and there are proposals to bring forward public spending to support levels of economic activity. However, the measures to tackle the issue of a shortage of finance – key to restarting housing market activity – remain a work in progress.

"The prospect is that prices will bounce back as surpluses in household finances grow"

Liquidity issues

Faced with the biggest banking crisis since 1929, there is no obvious quick fix. As such, the injection of capital into the banking sector increasingly looks like an emergency measure to save the banking industry, which has done little to improve access to finance for home owners.

Hopes have been pinned on the final report and recommendations of Sir James Crosby, a report which concludes that lenders will have to live with little or no asset-backed funding in the period to 2010 and that their capacity to lend will be further constrained by significant downward pressure on inflows of capital from savings. As a result, the report suggests that even well-capitalised banks are unlikely to return to normal lending criteria in the short term.

It must be hoped that the proposals to reinvigorate lending by auctioning government guarantees for new mortgage lending will speed up the process, but all the indications are that any easing in lending constraints will be gradual.

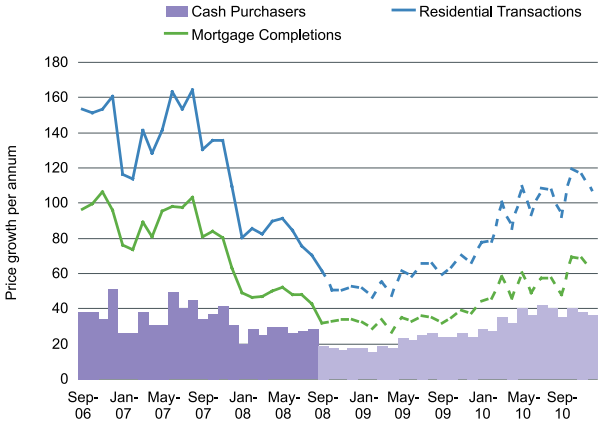
This, combined with the impact of negative and constrained equity, means that the number of mortgage-backed buyers who are able to enter the market will be limited, and cash buyers will initiate a turnaround in the fortunes of the UK housing market. Those cash purchasers are set to increase from 25% of all buyers to 40% in 2009 and 2010, and together with the equity rich who have made substantial inroads into their mortgage in the boom years, they will be part of a select group able to buy at the bottom of the market when prices have over-corrected.

2011 – the year of the bounce?

Because of this over-correction the prospect is that prices will bounce back as surpluses in household finances grow, but only when sentiment has improved. We are forecasting that following further falls in values of -11% in 2009 and stabilisation of prices in 2010, house price growth will to be back up to 9% in 2011 and 10% in 2012.

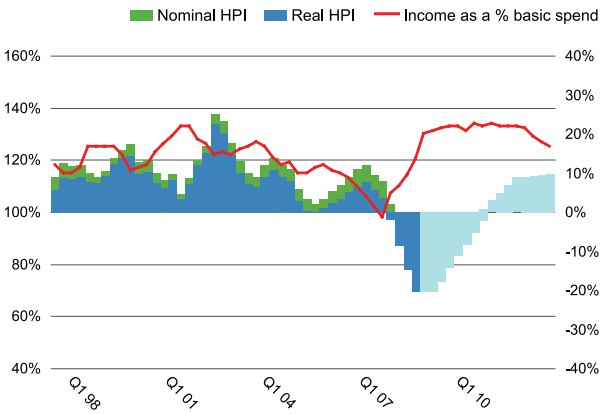
The relative levels and distribution of equity which remain when the market bottoms out, will influence the geographical pattern of the recovery. This, combined with differentials in household surpluses, varying prospects for regional economic growth, and the inherent under-supply of housing in the south of the country, suggest that the South East will lead the restoration of average values to their 2007 peak, with all regions back to peak values by 2018. ■

Graph 1.3
Turnover and mortgage approvals



Source: BoE, CML

Graph 1.4
Restored affordability



Source: Savills

	2008	2009	2010	2011	2012	2013
UK	-16%	-11%	1%	9%	10%	8%
London	-15%	-11%	2%	12%	10%	6%
South East	-16%	-10%	5%	14%	10%	9%
South West	-16%	-10%	1%	9%	12%	12%
East	-17%	-10%	1%	8%	12%	12%
E Midlands	-15%	-12%	1%	8%	12%	12%
W Midlands	-15%	-12%	1%	6%	10%	12%
North East	-14%	-13%	0%	1%	6%	8%
North West	-15%	-12%	0%	1%	6%	8%
Y and H	-15%	-12%	1%	2%	6%	10%
Wales	-15%	-12%	1%	2%	6%	8%
Scotland	-14%	-6%	2%	8%	12%	10%
N Ireland	-33%	-11%	1%	6%	10%	6%

Prime markets – wait for the bounce

The downturns in the fortunes of the square mile, initiated by the credit crisis and exacerbated by the increasingly widespread concern for the economy, continues to apply downward pressure on the value of prime property, particularly in those markets most reliant on demand from employees in the financial and business services sector. Hence, by the end of third quarter, values in the prime South West London stockbroker belt had fallen by -16.5%, more than the -12.3% seen across the prime central London market as a whole, where demand from wealthy international buyers at the top end has lessened the aggregate effect.

"There is now little regional distinction in terms of the effect of the downturn"

Job losses hit the middle tier

In the lower and middle tiers of the prime London market demand has been stifled not only by the prospect of reduced bonuses but perhaps more acutely by the spectre of significant job losses. Some forecasters have predicted job losses of 62,000 in the City over a two year period, equivalent to some 18% of the workforce. While the reality of City unemployment may be less severe than these headlines suggest, it is widely accepted that job losses will be significant, and this has served to erode market sentiment.

The combination of increased levels of supply of prime rental stock (not least because a 50% reduction in transaction volumes has forced would be vendors to place their property on the rental market) and a reduction in demand from corporate tenants, has also resulted in falls in the rental value of prime London dwellings. While these rental falls were contained to just -1.4% in the third quarter of the year, anecdotal evidence is that the effect has been much greater since the collapse of Lehman Brothers sparked a new wave of turmoil in the banking sector. As a result, we expect to see further falls of -10% to -15% in rents in the prime London market in the last quarter of the year, while capital values are likely to be down -20% from their peak by the year end.

Regional impact

Values of prime regional property had fallen by -10% by the end of the third quarter, a figure expected to increase to -15% by the year end. Those properties which are best in class continue to be less affected than the average or the now very heavily discounted blighted properties. However, even the best properties in each price bracket are now affected by the downturn, in marked contrast to the position in spring. In April, properties in the best locations, and offering the best standard and levels of accommodation, were expected to achieve a sale in a 12-week period at a price just -2.4% below the peak of the market, a figure which increased to -10.6% by October. Meanwhile the discount for an average property had reached -16.4% and that for a blighted property stood at -24%.

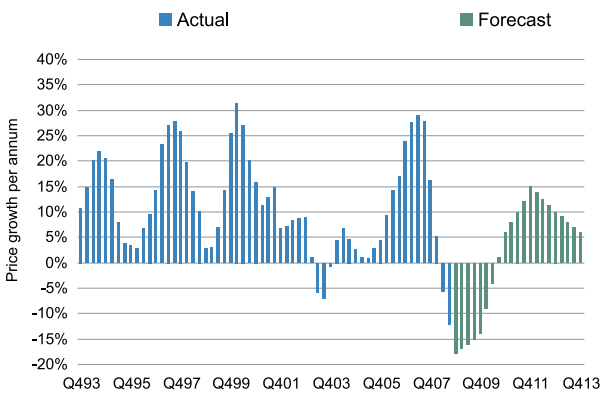
There is now little regional distinction in terms of the effect of the downturn, with the pockets of resistance identifiable back in the spring no longer evident. While the Scottish markets held out for longer, they have seen similar falls to those seen in England in each of the last two quarters.

In the regional prime rental markets, which have historically been viewed as offering a niche product in a low turnover market place, increased supply of high value properties placed onto the market by frustrated sellers has left renters with sufficient choice both to pick and choose, and to negotiate rental discounts.

Ultra prime demand softens

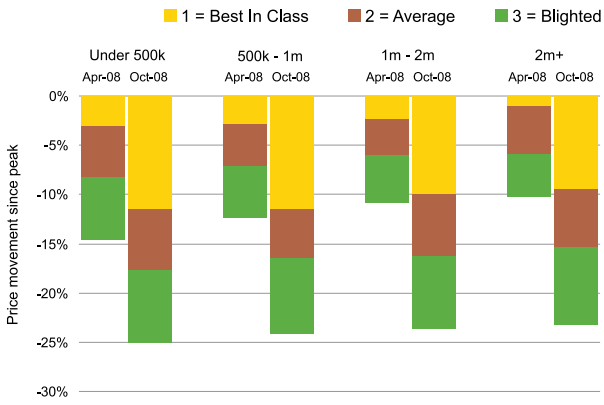
The signs are that the very rarefied top end of both

Graph 2.1
Prime central London price movements



Source: Savills

Graph 2.2
Falls across all property classes



Source: Savills

the central London and country house markets, where values typically exceed £10m, could also falter somewhat in 2009, having remained resilient to the end of September, and are expected to see sharp falls in transaction levels.

While prices have been supported by the extraordinary levels of wealth held by the global super rich, demand has fallen in a similar manner to the rest of the prime markets, as that wealth has been eroded by falls in the value of investments across the globe. The expected response is for owners to sit on their hands, with transactions only occurring when either an exceptional deal is in the offing or where there is a very pressing reason for sale.

Further falls, steeper rises

It should be remembered that prime London markets have always been volatile, and that once values have fallen to a point where they become an attractive medium-term prospect, this has historically stimulated significant overseas investment demand. Already there is evidence that overseas capital is being allocated to permit future investment in prime London property, in order to exploit both the weakness of sterling and the likelihood of a bounceback ahead of the rest of the UK residential market. The prospect that domestic owner-occupied demand will take longer to recover (particularly given the expectation that City bonuses and earnings will be suppressed over at least the next three or four years) indicates that overseas investment will take the lead, with that demand being especially strong from countries most able to exploit the weak pound, such as Hong Kong and Singapore.

We believe that it will require total price falls from the peak of the market of -30% in London and -25% in the regions to stimulate this demand, although if the more negative predictions regarding City employment prove correct, a worse case could see the bottom of the market a further -5% lower. Nonetheless, we expect strong growth to occur in the prime London market when the upswing occurs, with the prospect that this will cascade through the regional prime markets over time. In 2011, we expect double digit growth for London's prime residential markets and for prices to be restored to their 2007 peak by 2013. ■

Will new homes be built in 09?

The new build housing market has been hit much harder than its second-hand counterpart, with some house builders in a position akin to forced sellers as they seek to protect their balance sheet by maintaining sales rates in turbulent times.

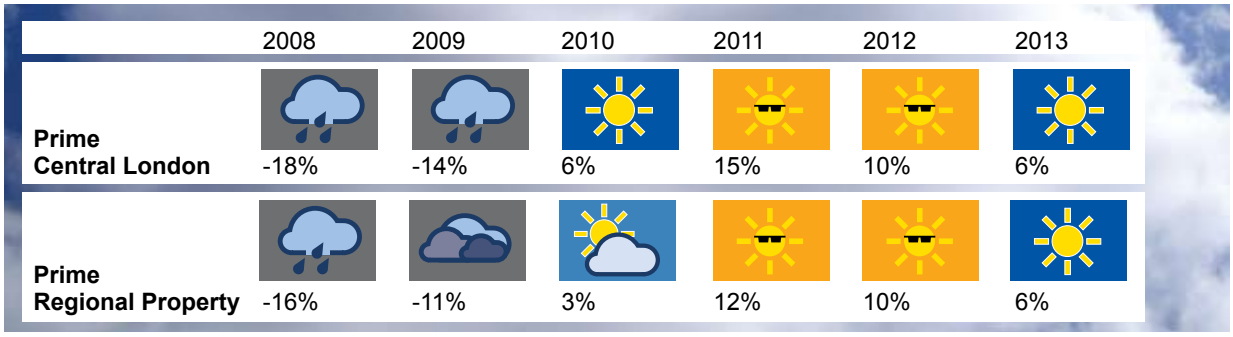
Typically, we are seeing new flats selling for 20-25% less than they were at last year's peak, with premium over the second-hand market having been all but eroded. Some oversupplied regeneration markets are showing higher falls. New houses are generally 15-20% less than peak, with the higher falls in areas where certain house builders have been achieving rate of sale aggressively. For most new product there is now little or no new build premium, apart from highly specified units in prime locations, where buyers will still pay extra for a unique product.

> "The development industry is at a crossroads as it grapples with increased government house building targets"

House building will fall dramatically, our best estimate being that just 75,000 units will be built in England next year, compared with probably 125,000 this year and a peak of some 175,000 in 2007, before conversions are added in. As a result the development industry is at a crossroads as it grapples with increased government house building targets, the challenge of delivering zero-carbon homes and meeting section 106 affordable housing requirements, and the emerging Community Infrastructure Levy, and this against the context of concerns over the level of occupier demand for high density housing.

With the development of most sites not viable under last year's market and policy assumptions, the treatment of planning gain will require a substantial rethink as will many large scale development projects. ■

For further information and analysis please refer to our Residential Development Focus also published in December 2008.



Winners and losers in the market cycle

As the availability of competitive mortgage finance has become increasingly dependent on the level of equity which a homeowner has accumulated in their property, so the level of equity which homeowners retain following the downturn is likely to determine the extent to which they are able to take advantage of the housing recovery.

While those who have been able to pay off the whole or a substantial part of their borrowing are likely to be in a position of relative comfort, for others the ability to move up the housing ladder is likely to be largely dependent on the point at which they entered the housing market. At one extreme, for those who have entered the housing market in the past five years by buying into the new build flat market, the ability to continue to move up the housing ladder is likely to be heavily constrained unless they have been able to make substantial inroads into their mortgage borrowing.

"It is likely that the longer term home owners with the greatest equity will initially drive the housing recovery"

Hypothetical case studies illustrate the extent to which the year of entry to the market, and purchasing patterns thereafter, can impact on a homeowner's position now in trading up.

1. 2003 market entrant

A first time buyer of a new build flat in South East England in 2003 (2) at, say, £170,000, who took out a 95% mortgage, would by 2007 have accumulated equity of 22%, worth £37,400, according to statistics from the Halifax house price indices. On the face of it, this would appear a reasonable trade-off for the additional cost of owning rather than renting in the same period.

This is likely to have been just about sufficient to enable them to make their first move up the housing ladder, say, to a Victorian semi-detached property at the back end of 2007 (1). With hindsight, they may have been better to postpone their move up the ladder: price falls could leave them with negative equity of just under -15% of the value of their new property, equivalent to some £36,000. By contrast staying put, while frustrating, is likely to have cut that prospective negative equity by some £20,000, even if the price of their original property (now in competition with a plethora of recently completed flats) drops in value by -5% more than the rest of the market.

Those who bought their first property in the period since 2003, will suffer greater pain, finding themselves in a position similar to those people who first bought in 1988. Their housing cost them substantially more than those who remained in the rented sector for longer, and they suffered the curse of negative equity for a five-year period from 1990 to 1995.

2. 10 years in the market

By contrast, the hypothetical buyer who first bought on the same basis 10 years ago has fared rather better (3). Assuming they used their accumulated equity to graduate up the housing market by making two moves, each at five-year intervals, to leave them in a modern detached dwelling, they are likely to retain 25% equity in a much higher value home, even after the full extent of the downturn has stripped -25% off its value. For those who have worked their equity harder, and borrowed at the limit of loan to value ratios, the position is likely to be less appealing to the extent that they may even struggle to re-mortgage.

3. Equity-rich long termers

It is likely that the longer-term homeowners with the greatest equity, will initially drive the housing recovery as they see the opportunity to trade up. There will also be a few lucky first time buyers able to buy at the bottom of the market. They will be hoping, eventually, to put themselves in a similar position as the lucky generation who first bought in 1993 and for whom, over the past 15 years, owning has consistently been cheaper than renting (4). Even without making any capital repayments, the first time buyers of 1993 who have upgraded to, say, a 1930s detached house, could retain 34% equity even at the bottom of the current downturn. Overall this could put them in a comparatively better position than those who bought five or 10 years earlier. ■

Date of First Purchase	Living in	2008 Value	2008 Equity	2010 Value	2010 Equity
(1) 2003 (market entrant)	Pre 1919 Semi	£317,349	£34,304	£251,340	-36,465
(2) 2003 (market entrant)	New Build Flat	£200,344	£39,064	£144,749	-16,531
(3) 1998 (10yrs in market)	Modern Detached	£383,433	£160,267	£303,679	74,762
(4) 1993 (Equity rich long term)	Interwar Detached	£471,509	£213,931	£403,329	138,678
(4) 1988 (Equity rich long term)	Pre 1919 Detached	£510,623	£247,428	£460,837	189,983

Source: Savills using Halifax Data (assumes 5 year moves in SE England, 95% initial LTV and no capital repayments)

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 is 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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Savills plc

Savills is a leading global real estate service provider listed on the London Stock Exchange. The company established in 1855, has a rich heritage with unrivalled growth. It is a company that leads rather than follows, and now has over 200 offices and associates throughout the Americas, Europe, Asia Pacific, Africa and the Middle East.

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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