Residential Property Focus

Saving the nation

How £4.1 trillion is stored in the housing piggy bank

Savills Research

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This publication

This document was published in February 2011. It contains a review of all the key housing market indicators and news to the end of January 2011. 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.

Glossary of terms

- **Mainstream**: mainstream property refers to the bulk of the UK housing market with, for example, price movements monitored by reference to national and regional average values.
- **Prime:** the prime market consists of the most desirable and aspirational property by reference to location, standards of accommodation, aesthetics and value. Typically it comprises properties in the top five per cent of the market by house price.

The most commonly used abbreviations are:

- Q410: refers to the fourth quarter of 2010
- Peak: refers to the first half of 2007
- PCL: Prime Central London
- DCLG: Department for Communities and Local Government
- RICS: Royal Institution of Chartered Surveyors
- ONS: Office for National Statistics
- HMRC: HM Revenue & Customs

Foreword

EQUITY: TO HAVE OR HAVE NOT

This decade could be seen as the beginning of a deep and permanent schism in housing between the equity haves and the equity have-nots

The importance of equity continues to be a major theme in the UK residential market. Property commentators who consistently relate the housing market to individual or household incomes are missing the point.

We see the housing market now as different to that of four years ago. The mortgaged market of that era no longer exists as the only deals being done are those that are equity reliant. There is no longer a housing market relying solely on the multiples of annual income that buyers can afford. The market now is about transactions where at least 25% of the property value is funded by the buyer, not a building society or bank (unless it's Bank of Mum and Dad).

This means the number of transactions taking place continues to be extremely low since few first-time buyers and mortgage-reliant households can raise the cash deposit necessary for house purchase.

Those who have a history of owner-occupation, and have accumulated a significant equity stake, are largely able to afford mortgage repayments at today's low interest rates and could probably continue to afford them even if interest rates rise.

Market segmentation

While this situation persists, the bulk of the UK housing market lacks fluidity. Buyers won't buy while they fear redundancy and austerity but at the same time owners won't sell for lower capital returns.

Meanwhile, a pool of potential buyers and sellers sit tight while the demand for renting (or co-ownership) begins to rocket. This analysis underlies our prognosis for market segmentation and delineation, as outlined in our last issue.

Accidental and non-accidental landlords will begin valuing some properties on the basis of the income streams provided from occupiers excluded from home ownership. At the other extreme, the value of the best properties will be determined by the amount of cash buyers are willing to use to compete for a rare commodity.

The coming decade could be seen as the beginning of a deep and permanent schism in housing between the equity haves and the equity have-nots. Right now, it is the availability of cash that drives the UK housing market. The market that caters for the equity have-nots has not yet been fully formed, but will be over the next decade or so.

The value of income

We have looked at the total value of UK housing and found that an astounding 70% is held as equity. Interesting, also, to find that 18% of units are owned by the public sector and housing associations and to realise that the value of this stock is determined by the value of income it produces and not the income multiple of those who occupy them.

Housing market commentators will increasingly have to understand this side of the market, not the mortgaged market, to make sense of how values in the lower tiers of the market will move in future. ■

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Executive summary

The key findings in this issue

■ With outstanding mortgage debt standing at around £1.25 trillion, net wealth in residential property has risen from £1.4 trillion to £2.9 trillion over the past ten years, such that it now accounts for around 70% of the total value of the UK's housing stock. *See pages 4/5*

■ The prevailing exchange rate and London's role as a safe deposit for international cash mean overseas investors have assumed greater importance, accounting for 53% of purchasers of prime central London property in the past two years compared to 45% in the preceding three. *See pages 6/7*

■ The £1 million-plus market has outperformed the mainstream across 2010, particularly in the core prime markets of London and South East England. Latest figures suggest that in the first nine months of 2010 sales worth £1 million or more had already exceeded the 2009 total by 17%. If the closing three months of 2010 saw the same level of £1 million-plus sales, then volumes would be 50% up on 2009 and just 10% off their 2007 peak. *See pages 8/9*

■ Savills Research has identified similarities between the distribution of transactions and repossession levels. Together they provide a good indication of where the financial pressures on homeowners are greatest, identifying differing rates of recovery in mainstream markets across the UK. *See pages 10/11*

■ For investors looking to build portfolios with strong income streams that will be attractive to future investors, the strategy of buying good Grade C letting properties with low capital values looks sound. *See pages 12/13*

Contents

Housing wealth

£4.1 TRILLION AND COUNTING

As the value of UK housing stock exceeds £4 trillion, property is unquestionably our greatest store of wealth. But it is how this wealth is distributed that remains key

Words by Lucian Cook

The last five years may have been volatile, but the past decade has seen the value of the UK's housing stock rise to more than £4 trillion (£4,156,000,000,000) from just under £2 trillion in 2000.

As a result, the level of equity tied up in housing in the UK has rocketed and housing has cemented its position as an unparalleled store of private wealth.

With outstanding mortgage debt standing at around £1.25 trillion, net wealth in residential property has risen from £1.4 trillion to £2.9 trillion over the past ten years, such that it now accounts for around 70% of the total value of the UK's housing stock.

The generation game

There is a yawning gap between the housing wealth held by different generations. We estimate that the over 45s now hold around 83% of the equity held in housing and the over 65s some 40%.

By contrast, we estimate that the under 35 age group hold just 5% of the UK's housing equity, with younger households heavily constrained by the limited availability of housing finance. In comparison, older, equity-rich households are the ones able to take advantage of current low interest rates and play the market.

This inequality of housing wealth distribution will shape the market going forward, affecting everything from price growth prospects for different tiers of the housing market to the way it is occupied.

The unequal distribution of equity is further illustrated by the fact that just 5% of the stock – properties worth in excess of £500,000 – accounts for an estimated 18% of the total value of the UK's housing stock, but less than 5% of the total number of properties.

Across the regions

The distribution of housing wealth has a similarly strong regional context. In 2010, residential property in London and the South East accounted for 25% of the total stock of the UK but 35% of its value.

This means the value of housing stock in these two regions alone was worth more than that of Wales, the Midlands and the whole of the North of England put together.

What's more, the housing stock of London, valued at around £750 billion, is alone worth more than the combined value of the urban counties of the West Midlands, Greater Manchester, Merseyside, Tyne and Wear, South Yorkshire and West Yorkshire, despite having over 30% less housing stock.

These regional disparities undoubtedly have far-reaching implications for the geographical distribution of future house-price growth and property-based wealth across the UK.

Importantly, they also have major implications for the depth of demand for, say, retirement housing from potential downsizers or affordable housing for key workers unable to compete with equity-rich buyers.

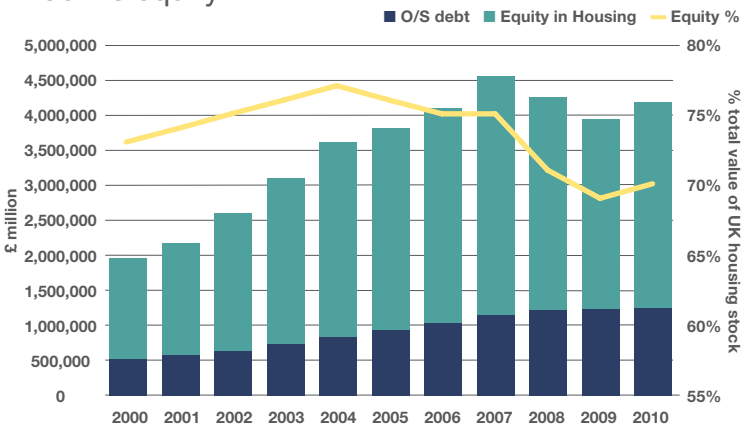
VALUE OF UK HOUSING STOCK

With outstanding mortgage debt standing at around £1.25 trillion, figures illustrate that 70% of the value of UK housing stock is held as equity.

GRAPH 1.1

UK housing stock 2000/2010

Debt vs equity



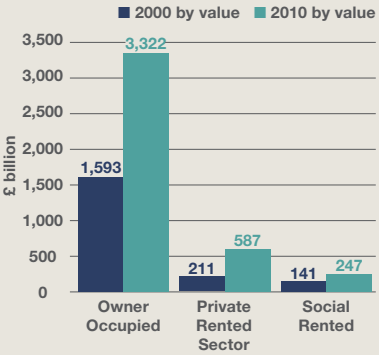
Graph source: Savills Research / Bank of England

Methodology

The figures referred to within this article are based upon Savills own valuation of the housing stock of the UK. Various data sources have been used, but most notably house price data from the Nationwide House Price Index, Land Registry Sales and the make up of the housing stock from DCLG data, Council Tax Records and, at a county / borough level, Land Registry sales profiles.

GRAPH 1.2

Value by Tenure



Graph source: Savills Research/Land Registry

Change of occupation

Finally, there is a wealth gap between owner occupiers and renters. Across the UK some 70% of residential property is owner occupied, but this accounts for around 82% of the total value of the UK housing stock and is worth around £3.3 trillion. Still, the big growth sector of the last decade has been the private rental sector.

The growth in private renting and in the underlying capital value of privately rented properties, has boosted the aggregate value of housing in this sector by an estimated 180% over the past 10 years, to a figure of almost £600 billion.

A continued shift towards private renting, particularly in the lower tiers of the housing market, will not only boost the value of private rented stock. It also means housing wealth is likely to be concentrated in still fewer owners' hands in the future, not least as wealth earned in the owner-occupied sector is reinvested in the private rented sector.

By contrast, the value of housing stock in the social rented sector – where growing housing waiting lists are testament to the level of demand – grew by just 75% over the decade. Unlike other parts of the UK housing market, values in this sector are dictated solely by the investment value of the income stream they produce.

This results is a significant disparity between the total returns that have been generated by private and public sector housing. This gap should begin to narrow as a new generation of affordable housing provision arrives and fixed-term tenancies and higher affordable rents present a stronger financial model for providers. ■

HOW IS HOUSING VALUE DISTRIBUTED ACROSS THE UK?

Analysing residential values on a per hectare basis reveals where wealth is concentrated in the market

Comparing the relative values of different urban areas is challenging, not least because they differ in size and housing densities. Examining residential values on a per hectare basis is therefore the best way to assess urban residential values to establish comparables.

Beyond London, the average value of residential real estate per hectare ranges from £750,000 (Leeds and Sheffield) to £3 million (Brighton & Hove). However, London shows the true extent of the geographical polarisation of housing wealth.

In the outer boroughs of London the value of residential stock per hectare is similar to the average for other urban areas in the South East. However, as housing densities and average values increase in the capital's more central districts, so the value of residential property per hectare rises.

Within London's most valuable borough, Kensington & Chelsea, the total housing stock is estimated to be worth just below £60 billion - more than twice the value of the entire housing stock of the City of Bristol and equivalent to more than £50 million worth of housing stock for every hectare.

MAP 1.1

Value of residential property per hectare

England and Wales

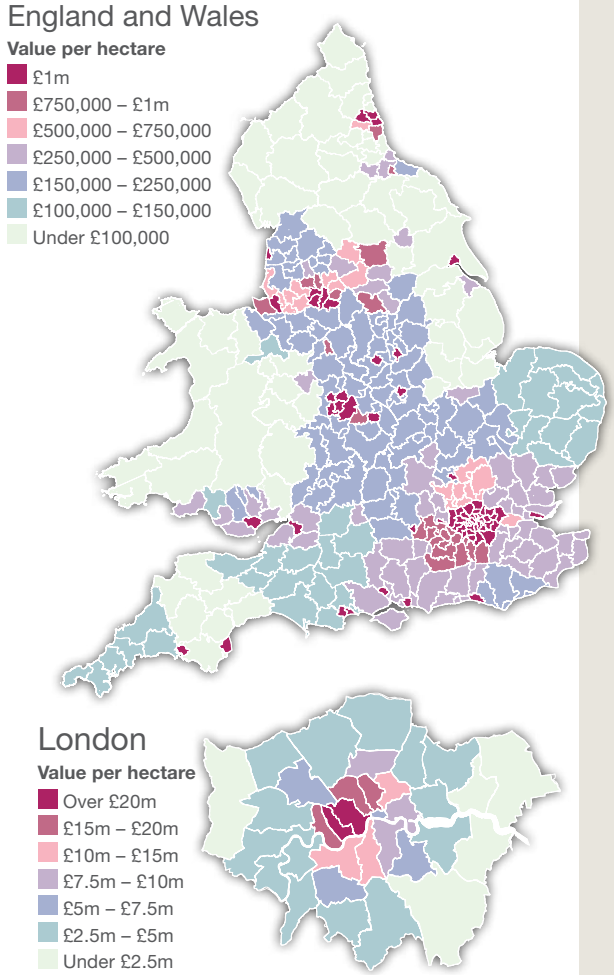


TABLE 1.1

Value of UK urban areas

Local Authority	Dwellings	Total value	Value per ha
Birmingham	416,686	£48,700m	£1,818,000
Leeds	326,506	£43,000m	£778,000
Bristol, City of	180,072	£29,000m	£2,481,000
Sheffield	231,752	£28,400m	£764,000
Brighton & Hove	123,252	£25,300m	£3,025,000
Bradford	203,914	£23,200m	£644,000
Manchester	210,682	£22,700m	£1,963,000
Liverpool	211,908	£21,600m	£1,337,000
Cardiff	133,307	£20,400m	£1,468,000

Data source: Savills Research

TABLE 1.2

Top 5 London boroughs

Value per hectare

1. Kensington & Chelsea
£51,460,000

2. City of Westminster
£26,501,000

3. Camden
£19,736,000

4. Islington
£17,816,000

5. Hammersmith & Fulham
£17,373,000

Prime London

THE CHAMPAGNE TOWER EFFECT

London's undiminished standing as a world-class city continues to boost overseas investment into its prime residential assets

Words by Yolande Barnes

The marketing hype for London in the lead up to the 2012 Olympics is getting into full swing. Billboards announce that London is the world's capital while the media have long proclaimed it as the 'world in one city'.

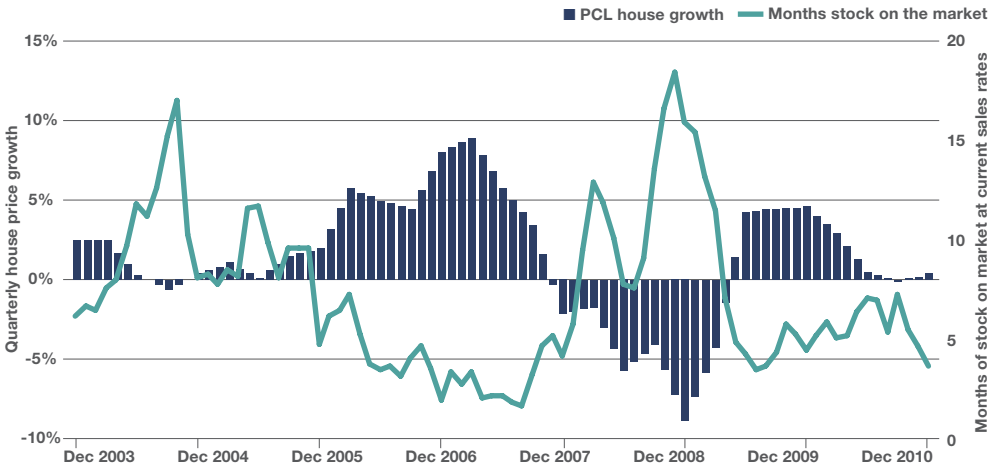
There has long been a flow of overseas wealth, as well as people, into London. This has the ability to impact housing markets well away from its epicentre in much the same way as the champagne glass at the top of the tower feeds those further down the tier and out towards the periphery.

It is London's status as a world-class city that sets it apart in value terms from the rest of the country. We have seen that London's housing accounts for 18% of the value of all the UK's stock, a concentration of wealth and value that goes way beyond its status as capital city.

A significant proportion (37%) of this value is located in the most central areas of the capital, in the areas that we call prime. The two most prime of London's 33 boroughs – Westminster and Kensington & Chelsea – account for over a sixth of London's total residential property value, equivalent to around £115 billion and see significant inflows of overseas and London-generated wealth each year.

GRAPH 2.1

Available stock vs price growth How low levels of available housing stock have historically supported house prices



Graph source: Savills Research

More international

London's cosmopolitan nature is not exactly breaking news, but our evidence suggests that central London is becoming increasingly international. Overseas buyers have accounted for 48% of all prime central London buyers over the past five years but just 31% of all sellers, and this overseas equity is increasingly dominant in higher value markets.

The effect is most noticeable at the top end of the market. Five out of ten buyers of central London property between £5 million and £10 million are now foreign nationals, rising to eight out of ten in the £10 million plus price bracket. Over the past five years, foreign national buyers have bought property totalling over £6.5 billion in the £5 million-plus price range alone.

Increasing importance

The effects of the prevailing exchange rate and London's role as a safe deposit for international cash mean overseas investors have assumed greater importance, accounting for 53% of purchasers of all prime central London property in the past two years compared to 45% in the preceding three.

In the higher price brackets, Russian and Middle Eastern money continues to dominate, while uncertainty in the Eurozone economy has meant that European buyers accounted for 21% of all prime central London buyers in 2010.

Overseas equity inflows have been particularly important recently as new domestic sources of housing equity have become relatively less important. City bonuses, for example, may have contributed as much as £5 billion to the London housing market in 2006 but are forecast to contribute just £1 billion in 2011.

Impact on stock

The drivers for overseas buyers to acquire prime London property have been the very same factors that have been motivating existing overseas owners to adopt a holding

Above: The One Hyde Park development is testament to London's appeal as a global city

position. In the past two years just 26% of all sellers have been foreign nationals, down from 34% in the three preceding years. A lack of liquidity of foreign owned prime London property is therefore contributing to the current low stock levels which is, in turn, underpinning prime London prices.

A good measure of this effect is the number of months' stock on the market at the prevailing rates of sale. Over the past five years there has been on average 6.4 months' worth of stock publicly available in the prime central London market. In the period immediately post Lehman Brothers the figure peaked at 18.4 months as transactions dried up and the prime London market saw its biggest ever quarterly price fall. By September 2010, this figure had reached 7.5 months, but was back to 3.7 months by the end of December.

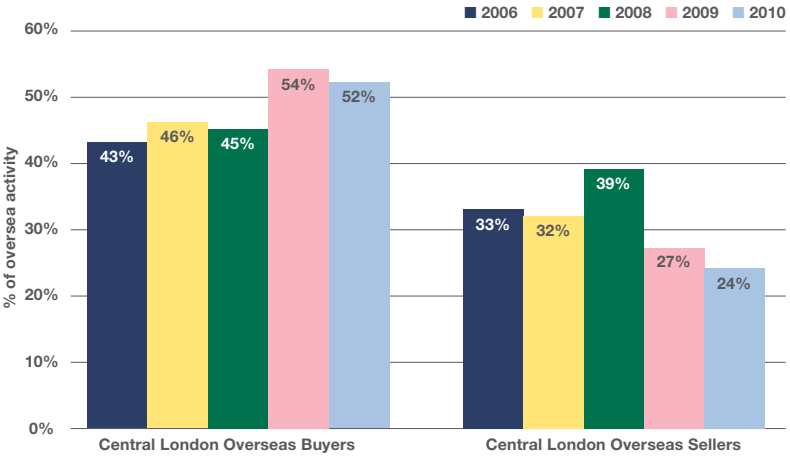
As a consequence, London's prime market continues to outperform the mainstream with price growth of 4.6% in 2010. Even as the market weakened in the second half of the year, locations in prime London still remained more resilient than the mainstream market and in the last quarter, prices were all but static (-0.2%) compared with a -2.5% fall in the mainstream market.

In 2011 we do not expect prime London to be completely immune to the second slip in values as weak market sentiment feeds up through the market.

However, supply constraints driven by actions of overseas owners and buyers will play their part in limiting the extent of the second slip in these markets. From 2012 onwards, they should have a positive impact on prices as the global economic recovery strengthens. ■

GRAPH 2.2

Overseas activity in PCL There has been an increased number of overseas buyers and a reduction in sellers



Graph source: Savills Research

THE PRIME RIPPLE

How overseas investment has expanded the prime market

As more international wealth has flowed into the most desirable locations, properties have increasingly been held as investment assets, so the number of locations deemed 'prime' have expanded over recent decades. This has happened in several ways.

As the core prime stock available to buy has shrunk, so high value developments have successfully opened up new areas to the prime market. More organically, the proceeds of sales from central London are often reinvested in other high value markets as domestic demand is displaced. As many as one in five buyers in southwest London come directly out of central London, as equity funnelled in at the centre migrates down London's wealth corridors.

So, as billionaires displace multi-millionaires from the top addresses, so they in their turn displace millionaires. Equity migrates to more peripheral areas of the capital and, eventually, out of the capital to the rest of the UK as homeowners invest their equity in country houses, second homes and retirement properties and so housing wealth and the prime effect spread.

"Foreign nationality buyers accounted for 53% of purchasers of prime central London property in the past two years."

Yolande Barnes, Savills Research

Prime regional

£1M-PLUS SALES LEAD THE MARKET

The £1 million mark is the benchmark that distinguishes the prime market from the top end of mainstream

Words by Marcus Dixon

Our estimates suggest that just one in twenty of the UK's homes has a value of £500,000 or more, but together, these homes account for more than a sixth of the total value of the UK's housing stock. However, such has been the effect of house price growth in the period 1997 to 2007 that in many parts of the country, a £500,000 budget will not buy access to the sector of the market referred to as 'prime'.

Clearly, price alone does not confer a 'prime' status, though it is fair to say that, in many locations, it is the £1 million price tag that benchmarks the distinction between the top end of the mainstream market and the highly aspirational prime market.

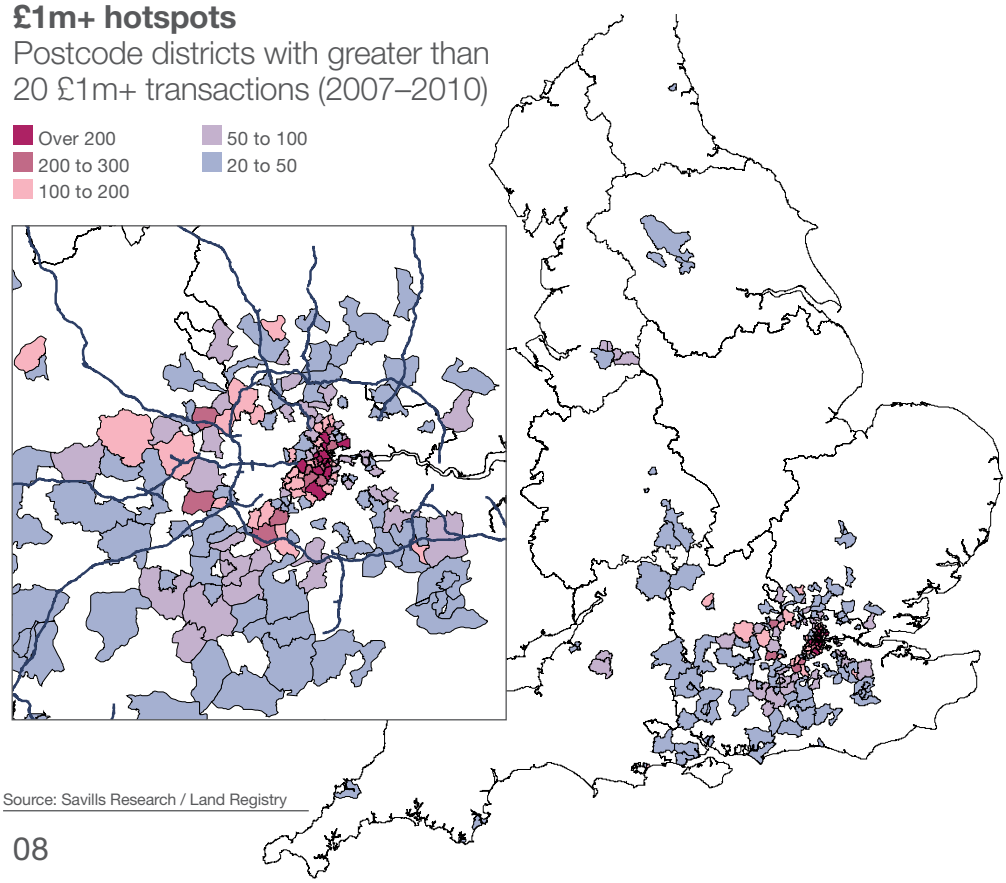
Tellingly, the £1 million-plus market seems to have outperformed the mainstream across 2010, particularly in the core prime markets of London and South East England. Latest data available from the Land Registry suggests that in the first nine months of 2010 sales worth £1 million or more had already exceeded the 2009 total by 17%. If the closing three months of 2010 saw the same level of £1 million-plus sales, then volumes would be 50% up on 2009 and just 10% off their 2007 peak.

Despite such robust transaction levels, however, the market did not generally see price growth in the last three quarters of 2010. Rather, by preventing excess stock building up, this activity underpinned the price rises driven by the supply/demand imbalances of late 2009/early 2010, notably in London and the South East.

GRAPH 3.1

£1m+ hotspots

Postcode districts with greater than 20 £1m+ transactions (2007–2010)



Source: Savills Research / Land Registry

The halo effect

Wealth generated in London flows down several high value corridors into the prime commuter areas of Surrey, Hertfordshire and Kent, making the South East well-linked into the wealth flow.

This wealth effect also spreads out into Berkshire, Buckinghamshire and, to a lesser degree, Essex, creating a halo of areas able to sustain high numbers of £1 million transactions, not least because they combine quality of life and proximity to London.

As a result, some 82% of all sales at or above £1 million occur in London, while the surrounding counties of Essex, Hertfordshire, Buckinghamshire, Berkshire, Surrey, Kent, Hampshire and Oxfordshire together account for a further 4%.

In the few markets outside of these areas where the remaining 14% of £1 million-plus sales occur, price performance over the past two years has been weaker; the ripple out of London has taken longer to arrive and had a more diluted impact when it has occurred.

Prices have increased by 15.5% and 6.7% in London and the South East respectively over the past two years. By contrast, the average price of prime property beyond London and the South East fell 1.5% in the two years to December 2010.

Prime hotspots

These prices reflect the shallower nature of prime markets outside of the London hinterland, where £1 million-plus sales are more likely to be clustered in hotspots.

These comprise a combination of prime second home markets, such as the South Hams, as well as lifestyle relocation markets such as Bath. the Cotswolds and Harrogate. Also included are locations attracting wealth generated within regional economies such as the belt that runs from Altrincham to Knutsford in Cheshire, and the high value suburbs of Gosforth in Newcastle and Clifton in Bristol.

As a result, the prime markets of the South East differ significantly to, say, the North West of England where five postcodes, WA14 (Altrincham), WA15 (Hale), WA16 (Knutsford), SK9 (Wilmslow and Alderly Edge) and SK10 (Prestbury), have accounted for 60% of £1 million-plus sales in the past four years. ■

STAMP DUTY ADDS BARRIER

An extra 5% for £1m properties

The £1 million price tag has been deemed an appropriate point at which to apply the new 5% stamp duty rate with effect from April 6 2010.

Data from HMRC suggests that a little over 1% of all residential transactions were valued at over £1 million in the period 2007, 2008 and 2009.

This means that there is little prospect of an extra 1% stamp duty making a significant contribution to HM Treasury, nor is it expected to distort the wider residential housing market.

The new 5% rate is not expected to impact the £1 million-plus market longer term. However, it may affect buyer psychology at or around the £1 million mark and could well cap at £1 million the value of properties that might previously have achieved £10,000 or £20,000 over this threshold.

A number of sales are expected to be brought forward to beat the April 6 deadline and, as a consequence, the number of £1 million transactions could well fall for a period thereafter.

Forecast values

PRIME MARKET FORECASTS

The prime markets of London and the South East will lead the recovery in house prices

FORECAST HIGHLIGHTS

Biggest rise… PCL in 2012

Strongest year for London and South West… 2012

Strongest year for North and Scotland… 2015

PRIME MARKETS: Five-year forecast values

Forecasts	2010	2011	2012	2013	2014	2015	5 years to end 2015
Prime Central London	3.8%	-1.0%	10.0%	8.0%	6.5%	6.5%	33.4%
Prime Regional	1.0%	-1.5%	6.0%	5.5%	6.0%	6.0%	23.8%
Prime South East	1.8%	-1.0%	7.5%	7.6%	7.0%	6.0%	39.8%
Prime South West	0.1%	-1.0%	6.5%	6.5%	6.0%	6.0%	26.2%
Prime East	3.4%	-1.0%	7.0%	7.0%	6.5%	6.0%	28.0%
Prime Midlands/ North	-1.2%	-2.2%	4.0%	4.0%	5.0%	5.5%	17.2%
Scotland	0.1%	-1.5%	4.5%	4.5%	5.0%	5.5%	19.2%

Annual house price growth key:
■ 8% and over ■ 6% to 8% ■ 4% to 6% ■ 2% to 4% ■ 0% to 2% ■ Below 0%

Regional focus: Scotland

Faisal Choudhry shares his expert perspective

■ While high value homes in Scotland are proving less easy to sell than in the South East of England, there was still a rise in the number of residential property sales valued at £1 million and above during 2010 compared to 2009.

■ Latest available figures show that a total of 137 homes in this price range were sold between January and November 2010, compared to 97 in 2009 as a whole.

■ Despite this 41% annual increase, these numbers are well below the levels experienced between 2006 and 2008.

■ Overall, the £1 million-plus market in Scotland during 2010 was restrained, but we are optimistic that the market will be more active in 2011, particularly if sellers accept that prices have fallen from their 2007 peak and are realistic in their expectations for the coming year.

Mainstream market

DIFFERING ROADS TO RECOVERY

What can the experience of the past year tell us about the relative strengths and weaknesses of the mainstream markets over the next five years?

Words by Jim Ward

At the end of 2010, mainstream UK house prices remained 11.3% below their 2007 peak according to Nationwide quarterly index, having fallen by 3.2% over the second half of the year. In short, mainstream housing market recovery appears to have stalled in 2010.

Looking back, it is easy to recognise similarities with other housing market downturns of the mid 1970s and early 1980s. In all three cases, in real terms, the size and speed of the first leg of a downturn was comparable.

Equally, in each downturn there has been a stabilisation or partial recovery followed by a secondary dip in real price movements as the recovery has faltered, before a subsequent return to sustained price growth. The first-stage recovery of 2009 was more pronounced in terms of price growth than after previous downturns, but less so in terms of transaction volumes.

Annual transactions in 2009 were 49% below their 2006 peak. In 2010, transactions were just 3% higher despite the slight easing of mortgage constraints, reflecting weakened confidence among those buyers able to transact in this environment.

Market strength

Comparing local transaction levels in the third quarter of 2010 to the three month average in the five pre-credit-crunch years lays bare the relative strength of the housing market in different parts of the UK. This analysis highlights a number of differences between the equity rich and the mortgage reliant, the south and the north, and between urban and rural.

There are startling similarities between the distribution of transactions and repossession claims. Together they provide a good indication of where the financial pressures on homeowners are greatest, identifying locations closest to normal activity levels and those set to languish in the doldrums for some time to come.

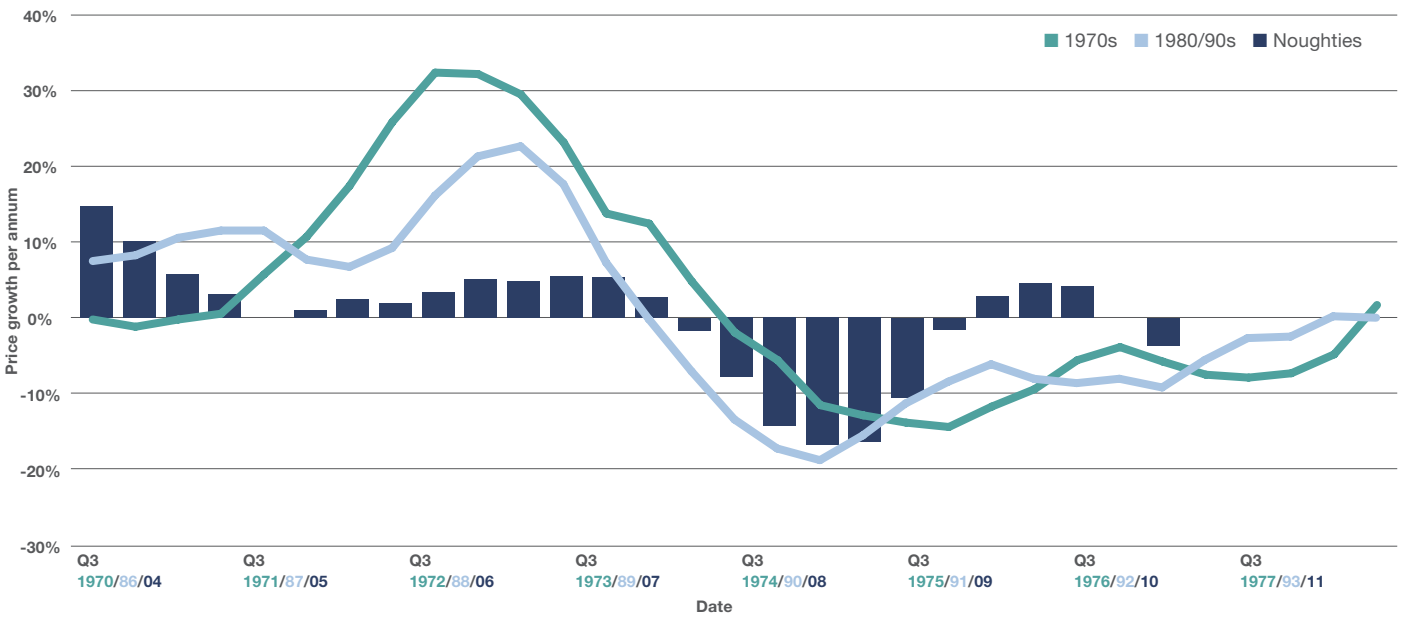
Impact on stock

Recent repossession levels have remained well below those of previous downturns and are now tailing off in a similar pattern. A low interest rate environment is expected to persist which should keep repossessions at a relatively low level and help to avoid the market being flooded with distressed stock.

At a national level, the amount of unsold stock on agents' books has not risen by anything like the same degree as in 2008. This reflects a market where homeowners have been reluctant to sell in the face of weak buyer demand, much quicker to withdraw stock where it is not selling and rarely forced to sell as a result of financial pressures.

GRAPH 4.1

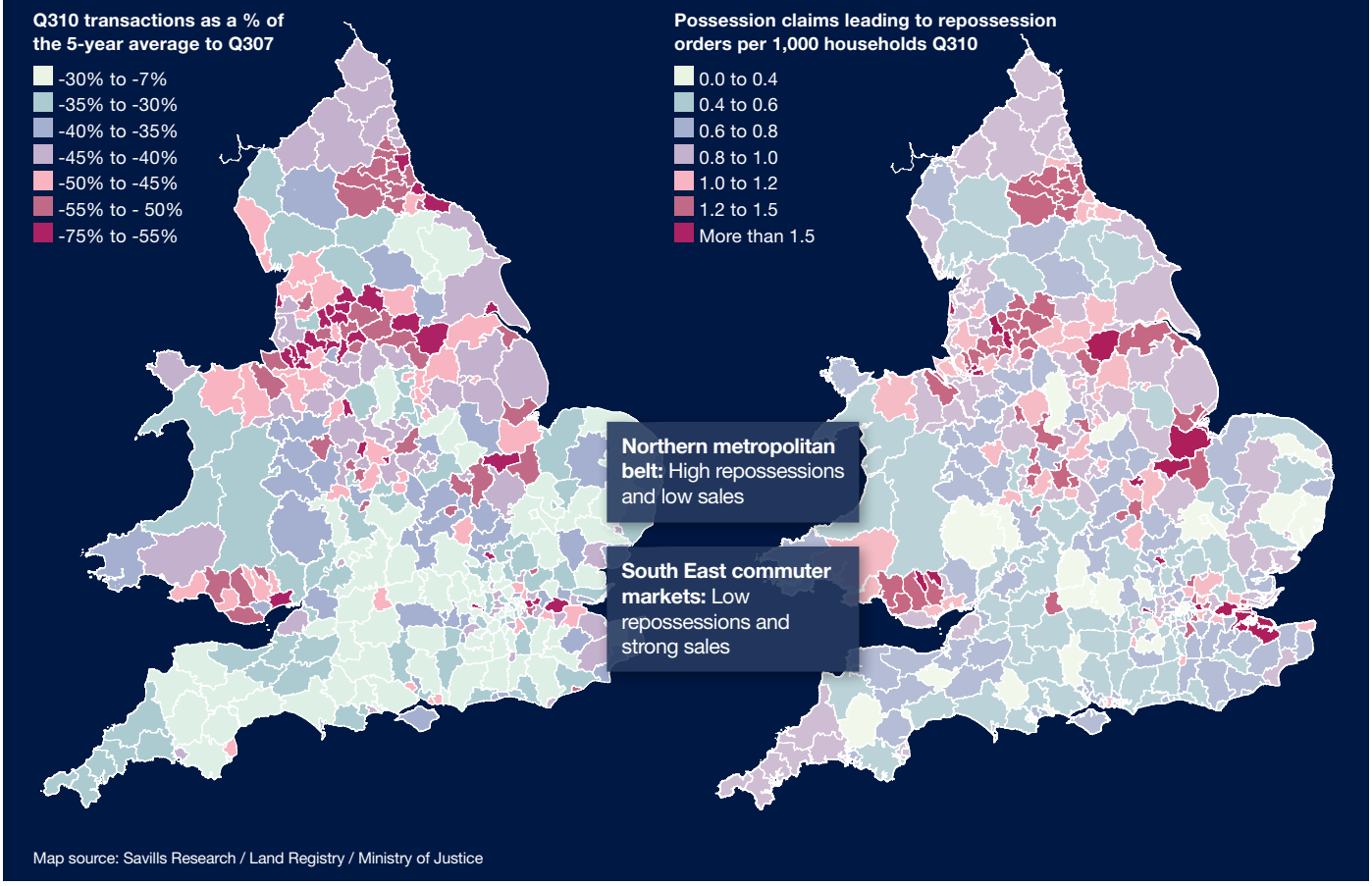
Real house price movements Comparing the downturns of the 70s, the 80/90s and the Noughties



Graph source: Nationwide / ONS

INDICATORS OF MARKET STRENGTH

Comparing transaction levels with the number of repossessions in Q310



Map source: Savills Research / Land Registry / Ministry of Justice

This means the monthly price falls that have so far followed the unexpectedly high price growth of 2009 and early 2010 have been relatively small, in line with our expectation of a relatively modest second slip rather than a deep double dip.

Localised variations

However, at a regional and more particularly, local level, there are significant variations, not least because the areas with high repossession levels are exactly those where turnover has been at its lowest and where buyer demand has been at its weakest. This is a combination that translates directly into lower price growth.

In areas such as the metropolitan belt from Liverpool to Hull, house prices are currently much further from their peak than in, say, the commuter heartland of South East England. This helps us to identify those markets where the outlook in the medium term is most challenging and those which are likely to recover fastest after the second slip. It suggests that higher value, equity-rich locations are likely to outperform lower value locations where home ownership constraints are greatest.

This analysis also indicates that London boroughs such as Islington and Camden, where Q310 transactions were within 10% of the pre-crunch norm, will continue to outperform the likes of locations such as Barking & Dagenham and Newham, where transactions remain down by over 55%.

Similarly, we can conclude that higher transaction locations in the South East such as the Chilterns, Sevenoaks, Windsor and Maidenhead will recover the most quickly, while lower value locations where the levels of transaction remain more constrained, such as Slough, Hastings and Dartford, will be much slower to pick up.

As a result, we expect the gap between the equity haves and have-nots to widen, both between and within different regions of the UK. ■

"There are startling similarities between the distribution of transactions and repossession levels." Jim Ward, Savills Research

Connectivity

Of course, it is not just the existing equity in an area that will dictate the ability of its housing market to recover and the pace of that recovery, but an area's ability to draw in new equity through, for example, improved connectivity will be critical.

Residential investment

WHY GRADE C STOCK WILL HAVE ITS DAY

By 2015, the value of Grade C properties will be worth more to investors than owner occupiers

Words by Jacqui Daly

The strategy of buying good Grade C letting properties with low capital values seems sound in locations with high rental demand

In our last Focus, we outlined our case for the UK housing market continuing to polarise between owner occupiers with equity to spend and rental occupiers without equity.

We anticipated that housing stock would divide into grades A to C, with Grade C stock driven by demand from investors and prices based increasingly on the rental income they are able to generate. This is a significant departure from what the residential investment market experienced over the last decade or so when the main motivation of investors has been capital growth rather than income.

If there are fewer owner occupiers entering the lower tiers of the housing market in future, then the private investors who want to sell their lower value properties for capital growth may have trouble doing so.

Lacklustre capital growth will haunt these investors unless they can find a market from other investors. If they do, they will probably find these investors are increasingly valuing the income derived from property rather than the possible future capital growth. This is how we anticipate Grade C stock will become divorced from the owner-occupier market within the next housing market cycle.

It is already possible to see signs that this is happening. The polarisation of equity means that rental demand has already been increasing for the last 20 years. Demand for private renting in England, for example, has grown from 7% of all stock in 1988 to around 14% in 2008.

This demand from renters was matched by supply because it has been coupled with investment demand – and investor purchasing power. This enabled the stock of privately let, Assured Shorthold Tenancies in England, to double from 945,000 properties in 1995 to 1,864,000 in 2007.

Rental stock constraints

This supply surge came to an end in 2008 as lenders withdrew their products from the buy to let sector and falling prices discouraged investors from buying rental properties. New rental stock at this time may have been added in the form of 'accidental landlords' letting their property because they were unable to sell and, in a few cases, unsold and unoccupied new flats boosting rental supply in some city centres.

In prime London, disappearing corporate tenants also increased available supply. Yet elsewhere, supply was becoming more limited and many areas have seen stock stagnation or contraction.

It is hardly surprising then that while capital values plummeted in 2008, the mainstream UK rental market saw falls of just -3% in the face of economic recession. While capital values contracted again in the second half of 2010, rental values

TABLE 5.1

Grade C investment How the value to an investor exceeds the value to owner occupier by 2015

	2007	2010	2015
Notional owner occupier property value	£100,000	£88,818	£94,446
Notional annual rental value	£5,000	£5,057	£6,640
Running yield (gross)	5.0%	5.7%	7.0%
Value of property to investor wanting a 7% gross yield	£71,429	£72,248	£94,851

Graph source: Savills Research

"The polarisation of equity means that rental demand has been increasing for the past 20 years."

Jacqui Daly, Savills Research

have grown at a continued pace, finishing the year up by around 7%. In London, the growth has been even more marked, finishing the year up 13%.

Implications for investors

This growth, and our expectation of it continuing in 2011 and beyond, has important implications for investors. A Grade C investment property bought at the end of 2007 for £100,000 and currently renting for £5,000 per annum is theoretically now worth £88,818 on the open market to owner occupiers.

Meanwhile, the rent on that property has risen to £5,057. Valued on a 7% yield basis, this means that the capital value to an investor has increased by 1%, while it has fallen for the owner occupier by -11%.

This increase is insufficient to put the investment value on a par with owner occupation right now but, if our forecasts of capital growth and rental growth are correct, and if Grade C stock underperforms the rest of the market as we think it will, the investor will be prepared to pay more by 2015.

The same property will be worth just £94,446 to an owner occupier by then but to an investor who values the income on the basis of a 7% gross return, it will be worth £94,851 (see Table 4.1).

If bought now, on a 7% yield, this theoretical property would see capital growth for an investor of 31% while its value to an owner occupier is only expected to grow by 6%.

For investors looking to build portfolios with strong income streams that will be attractive to future investors, the strategy of buying good Grade C letting properties with low capital values looks sound. The time to act is now. ■

Forecast values

MAINSTREAM FORECASTS

The mainstream market will witness wide regional variation, and a return to growth in 2012

FORECAST HIGHLIGHTS

Biggest rise… London in 2013

Strongest year for Scotland… 2015

Strongest year for East of England… 2014

MAINSTREAM MARKETS:
Five-year forecast values

Forecasts	2010	2011	2012	2013	2014	2015	2011–2015 inclusive
UK	0.7%	-3.0%	1.5%	3.0%	5.0%	5.0%	11.8%
London	2.7%	-1.0%	6.0%	8.0%	7.5%	6.0%	29.1%
South East	2.5%	-1.5%	5.0%	7.0%	7.0%	6.0%	25.5%
South West	2.1%	-2.5%	3.0%	5.0%	6.0%	5.5%	17.9%
East of England	3.8%	-2.0%	4.0%	6.0%	6.5%	5.5%	21.4%
East Midlands	1.8%	-2.5%	2.5%	4.0%	5.5%	5.0%	15.1%
West Midlands	0.7%	-4.0%	-0.5%	1.0%	4.0%	4.5%	4.8%
North East	0.8%	-4.5%	-2.0%	0.0%	3.0%	4.5%	0.7%
North West	-1.3%	-4.0%	-1.0%	0.5%	3.5%	4.5%	3.3%
Yorkshire & Humber	-3.4%	-4.5%	-1.5%	0.0%	3.5%	4.5%	1.7%
Wales	-1.5%	-3.0%	0.0%	2.5%	4.0%	4.5%	8.1%
Scotland	-2.0%	-2.5%	0.0%	1.0%	3.5%	4.5%	6.5%

Annual house price growth key:
8% and over | 6% to 8% | 4% to 6% | 2% to 4% | 0% to 2% | Below 0%

Making the grade The impact of grading on residential values

Deviation from forecast
(end of 2010 – end of 2015)

The new Savills model for evaluating UK residential property anticipates Grade A properties exceeding their local mainstream market 5-year house price growth by 5%, while Grade C properties will underperform by 5%.

Grade A +5%

Grade B 0%

Grade C -5%

MARKET OUTLOOK

Stock shortages, in both the prime and mainstream markets, look set to bolster house prices

While the mainstream mortgage market faces significant challenges, equity-rich markets look to be more insulated against a second leg of price falls, not least because of the stock shortages emerging in the markets of London and the South East.

Although we expect a marginal softening in prices, transaction volumes are expected to remain more buoyant than in the mainstream. The extent to which bonus money finds its way into the prime residential markets will be key to the depth of domestic demand during 2011.

Increasingly, the higher tiers of the prime markets of London need to be considered in an international context, with demand driven by global wealth generation and the state of the global financial markets.

Mainstream matters

The strength of the economic recovery has been brought sharply into focus with the news that, after four quarters of quite strong economic growth, the UK economy contracted by 0.5% in Q410. At the same time, inflation rose to an eight month high of 3.7% in December, raising questions over how long interest rates will remain at their current level.

This continued economic uncertainty goes some way to explaining why the Bank of England credit conditions survey indicates a fairly sharp dip in the demand for secured credit in the last three months of 2010.

All of these factors point to continued price falls in the mainstream market. However, the RICS survey suggests that the reduction in buyer demand has been accompanied by a roughly equivalent fall in the amount of new stock coming to the market. Accordingly, while we expect prices to soften, a relative balance between supply and demand, coupled with the relative affordability of mortgage finance should put a floor under prices.

While a 25 basis point interest rate rise would add £2.3 billion to the UK's mortgage interest payments, this amount needs to be set against the context that total mortgage payments have fallen by an estimated £24 billion over the last two years. ■

For commentary on the Spring market, our next Residential Property Focus is due for publication in May 2011. If you do not currently receive your own copy, please register your details at savills.co.uk/research

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"The coming decade could be seen as the beginning of a deep and permanent schism in housing between the equity haves and the equity have-nots. Right now, it is the availability of cash that drives the UK housing market." Yolande Barnes

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"The inequality of housing wealth distribution will shape the market going forward, affecting everything from price growth prospects for different tiers of the housing market to the way different properties are occupied." Lucian Cook

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"In terms of price movements, the partial recovery of 2009 was much more pronounced in terms of price growth than in previous downturns, though much less strong in terms of transaction levels." Jim Ward

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