Savills Research
UK Residential

RESIDENTIAL PROPERTY
FOCUS Q2 2012

Investment Special
Examining the yield potential across UK housing

Golden opportunity
Is it time to commit to residential investment?

Rental sector. Booming demand
Taxation: Budget measures 2012
Investment & development: Q&A

Foreword
THE RISE AND FALL OF THE UK MORTGAGE

With the new property world dominated by cash and not mortgage borrowing, the time for residential investment has finally arrived

Residential property is now a two-way street. An asset that used to be viewed as something in which you invested your income in order to create capital has become a capital asset that people are putting equity into in order to obtain an income.

When we first started to look at residential property as an investable asset class 25 years ago, it was deeply unfashionable. There was only a tiny, vestigial market rented sector left in the UK, following regulation-induced asset disposal by investing institutions. At that time the flow of occupier behaviour was away from tenancies and into ownership. This trend began to reverse at the millennium so that in future it might come to be viewed only as a late twentieth century phenomenon.

Mortgage rationing

Conventional wisdom has had it that housing values are determined by two main variables: household incomes and mortgage interest rates. Low income growth and high rates meant weak or falling house prices; high income growth and low interest rates meant rising house prices. Any recent analysis of the UK housing market since 2007 has shown that there is a third component in this model – the supply of debt finance.

Post credit-crunch a new form of mortgage rationing, forgotten since the 1970s, has re-emerged. The imposition of very low loan-to-value ratios and stringent qualification of applicants has created a major barrier to housing accessibility. The cost of deposits has overtaken the cost of debt repayments as the issue determining affordability.

The subsequent growth in the number of market-rented properties over the last five years has reminded us that the new property world is dominated by cash and not borrowing.

But what is the value of the income to the owner? Tying up cash in an asset like housing is only worthwhile if it produces a return greater than that available elsewhere – at equal or lower risk.

Finding hidden value

For most owner-occupiers and private investors, there are very few alternative investments that are genuinely 'as safe as houses'. Those that exist are very low yielding. Consequently, any asset with a net yield north of 3% and with the prospect of longer-term capital growth, looks compelling.

Not so for many corporate and institutional investors who still try to value residential property on the same basis as commercial properties. But commercial property returns are more volatile, show low rental growth and depreciate at a much faster rate than residential. IPD analysis shows that risk-adjusted total returns have been higher for residential property and we think this will remain the case in future.

Investment yields will be reset in the next few years as a consequence, and residential property will be increasingly favoured by corporate investors. This means we expect to see increasing capital values for investment properties, especially as rental growth further boosts income streams. As a result there are big opportunities for new investors who understand which stock will perform in this environment and what is currently mispriced – and how to find hidden value. After 25 years, it looks as if the time for residential investment has finally come.

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Executive summary

The key findings in this issue

■ The private rental sector has historically been the province of the young, but more people are remaining for longer in privately rented accommodation because it's cheaper for them to rent, or in some cases because they really can't afford to buy.
See pages 4/5

■ Tenant demand for private rental accommodation is not only expanding but becoming more long-term, as a result of the challenges of getting onto the property ladder. But what are the implications for the supply side of the private rental equation, and where are the investor opportunities?
See pages 6/7

■ Stamp duty rates for higher value properties have been on the rise since 1997. Receipts from housing rose by 670% in the 10 years to 2007/08, while house prices increased by just 180%. See pages 8/9

■ Continued stock constraints mean prices across prime London are above peak, driving strong growth in £1million+ sales in locations outside core prime central London which are increasingly attracting international buyers. See page 10/11

■ Development opportunities exist in markets that have recovered most strongly to date, with least reliance on high loan to value mortgage debt, which remains in short supply.
See pages 12/13

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Rental Sector

TAKING ADVANTAGE OF THE RENTAL BOOM

Private renting is becoming a way of life for a much wider spectrum of people in the UK and the number of tenants ‘trapped’ in the sector shows no sign of decreasing

Words by Lucian Cook

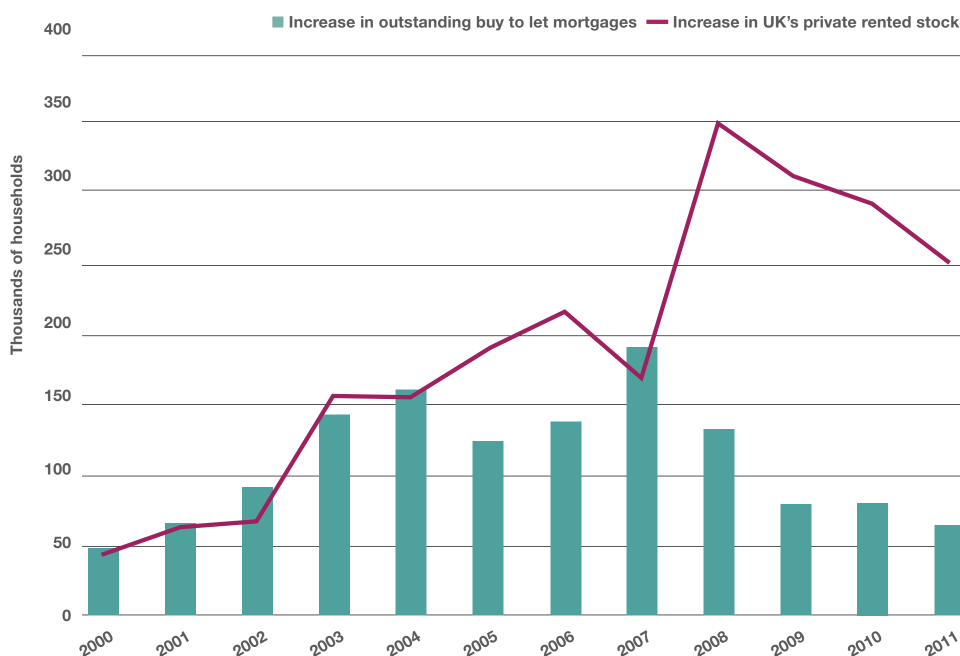
The past five years have had profound effects on Britain’s private rental sector. The combined impact of the property market slump and the credit squeeze has boosted longer-term demand from a whole tranche of Britons who in former times would have rented from a private landlord on a relatively short-term basis, before buying their own first property or as a stopgap between moves.

“Not only are more people renting, and for longer, but the social profile of tenants is changing and broadening”

Lucian Cook, Savills Research

GRAPH 1.1

Investors filling the gap left by the buy to let mortgage drought



Graph source: Savills Research using CLG and CML data

Rental Britain, our report on the private rental sector based on joint research with Rightmove, highlights the key challenges facing tenants in the private rental sector, and the outlook for the coming years.

The increase in tenant demand in the UK has been dramatic: over the five years to the end of 2011, the total value of housing in the private rental sector was up 42%, while the number of households renting privately had leapt almost 50%, from 3.4 to 4.8 million. And the trend is set to continue: by 2016 we estimate that figure will have risen to 5.9 million.

Trapped tenants

This shift in the way people access accommodation is underpinned by the retail lenders’ continuing reluctance to provide mortgages for prospective first time buyers at the high loan to value ratios (LTVs) they seek. Gross mortgage lending at LTVs of 90% plus has fallen by 95% since summer 2007, and the average deposit paid by first time buyers has more than doubled over that time. In London more than seven out of ten first time buyers now turn to their parents for help in raising the capital.

Further, where lenders do make available mortgages at suitably high loans to property value, they charge an inflated price. At the end of 2011, the interest rate on 90% LTV discounted rate mortgages averaged 5.1% – two thirds more expensive than the equivalent on 75% LTV, at an average 3.0%.

The consequence is that although the private rental sector has historically been the province of the young, more people are remaining for longer in privately rented accommodation because it’s cheaper for them to rent, or in some cases because they really could not afford to buy. More than half of private rented sector tenants are believed to be ‘trapped’ in this way – a quarter of them aged over 40.

Moreover, not only are more people renting, and for longer, but the social profile of tenants is changing and broadening. Private renting is increasingly becoming a way of life for a wide spectrum of people in their 30s and 40s.

Regional variations

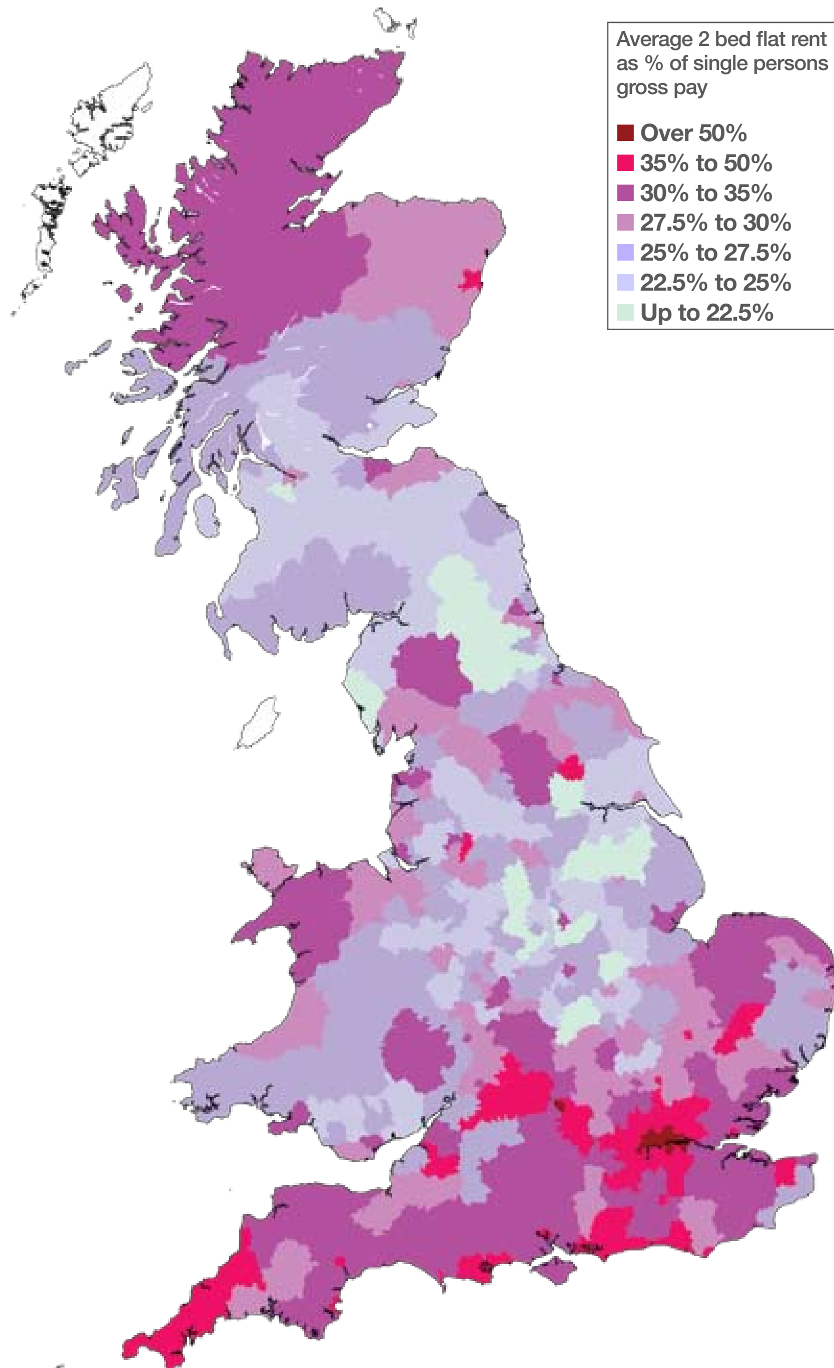
However, there is huge variation in average rents paid across the UK, though in general rents are

higher in centres nearer London. A comparison of the 30 largest rental markets outside London shows that the highest average monthly rent for two-bedroom properties (£1,320 pcm in Elmbridge) is three times that of the lowest (£470 pcm in Bradford). The differentials are even more marked in London, with two-bed properties almost five times more expensive in Kensington & Chelsea (£4,020 pcm) than they are in Bexley (£830 pcm).

In part these rental differences reflect regional differences in income. The mean average single persons rent of a two-bedroom property as a percentage of mean average income, stands at an average 31% across the UK as a whole, but that nationwide average masks large disparities when regional or local averages are considered. In the North East and East Midlands, this broad indicator of rental affordability averages just 25% of the average incomes for these regions, while in the South East it rises to 35% and in London, where private tenants more regularly share accommodation and renting is more common in more affluent income groups, it rockets up to 53%.

MAP 1.1

Rental affordability varies across the UK



Map source: Savills Research, Rightmove

Question of affordability

Regional rental differentials, however, cannot be fully explained by variations in income. Another key factor is the existing supply of private rented accommodation, as well as the extent of social housing provision. Thus a high affordability ratio occurs in areas where rental demand markedly outstrips supply, pushing up rents regardless of average income levels.

The London market is particularly skewed. For a start, the public sector provides affordable housing for a large tranche of households on lower incomes, thereby taking them out of the equation. In other words, the average tenant in London's private sector is likely to be on a higher than average income. At the same time, owner occupation in the London market is lower than elsewhere, relative to the rental market, reflecting the high number of young people starting their careers there, and inflated property prices that make it even harder for them to get on the ladder.

Clear hotspots

Yet there are clear hotspots outside London too, where supply of private rental accommodation lags well behind demand for it. Oxford is an extreme example, with the average rent on a two-bedroom property amounting to 57% of average income; another is Brighton & Hove, where average rents are slightly less crippling at 47% of income.

In contrast, the private rental market is well catered for in Milton Keynes, and rental affordability there, at 32%, is in line with the national average. Clearly, each local market has its own dynamics and needs to be understood on its own terms, but investors could start by identifying those with a high affordability ratio as areas likely to be suffering from a shortage of good quality private rental accommodation.

Investment

HIGHER YIELDS ATTRACT INVESTORS

As the residential rental market continues to gain significance as an asset class, property investors will increasingly look to income generation as their measure of value

Words by Jacqui Daly

Tenant demand for private rental accommodation is not only expanding but becoming more long-term, as a result of the challenges of getting onto the property ladder. But what are the implications for the supply side of the private rental equation?

We estimate that £200 billion of investment is required in the next five years, if the demand for private renting is to be met. But banks remain much more constrained in their buy to let mortgage lending, and it's expected that only £50 billion of the required investment will take the form of buy to let loans. Attention is therefore increasingly focused on the attractions of the private rental market for institutions and investment funds, and to a lesser extent, those private investors with equity.

The key factor in this respect, of course, is the rental income yields available, and how they compare with alternative income-producing asset classes. Historically, residential property investment has attracted investors primarily on the basis of strong house price growth, and has struggled to attract income-seeking institutional investors because of the low net yields available.

But the past years have seen a shift in market fundamentals. First, tenant demand is fuelling sharp rises in rent. Across the UK as a whole in 2011, rents rose by 5.2%, though London saw a 7.2% increase over the year. Rental demand is expected to continue to outstrip supply in the coming five years, keeping rents under upward pressure. At the same time, the housing market recovery remains sluggish and there's little sign of any dramatic upturn in capital values looking ahead.

Improvement in yields

This combination is leading to some improvement in yield levels nationally. Our joint research with Rightmove shows average gross income yield now stands at 5.8% nationally, but there are significant variations within the market as a whole, for various reasons.

One factor is size: yields are much higher on smaller properties, where owner-occupier demand has been hardest hit by the squeeze on mortgage lending and rental demand is naturally concentrated. Thus, income yields on one-bedroom properties average 6.7%.

Regional differences are relatively slight, although yields tend to be higher in the North than in the South. But within regions there are also significant variations in yield, according to the value of the local market.

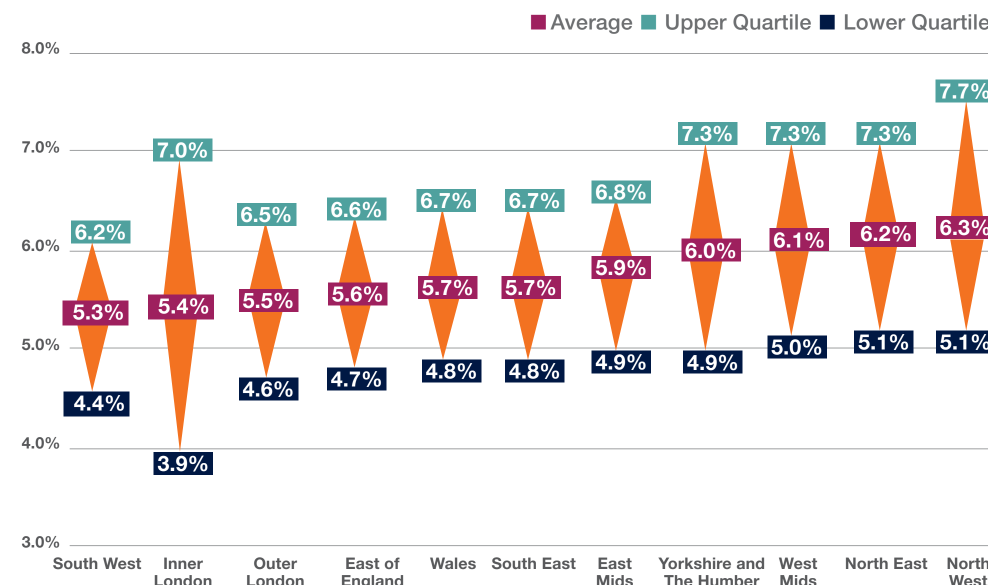
An analysis of yield on two-bedroom properties according to postcode reveals an average yield of 7.8% in the 10% of postcodes with the highest yields (where two-bedroom property prices average less than £100,000). This contrasts dramatically with the average 4.4% achieved in the lowest-yielding 10% of postcodes (where two-bedroom properties average £326,000).

"Investors need to delve below the headline figures and have a clear grasp of the underlying complexities of particular markets"

Jacqui Daly, Savills Research

GRAPH 2.1

Gross Income Yields for 2 bedroom properties by region (2011)



Graph source: Savills Research / Rightmove

There are therefore opportunities for investors to improve on headline gross yields, whether by buying smaller units or in lower-value local markets. Large-scale investors buying units in bulk are also able to boost yields by buying at a discount to the vacant possession rate (the price paid by an owner occupier).

The headline average gross yield of 5.8% rises as high as 7.7% for those investors in a position to negotiate discounts through bulk purchases.

A reliable income stream

Of course, investors do not pocket their gross yields in entirety. After accounting for costs and void periods, the average net yield for typical private landlords comes in at around 4.1%.

Nonetheless, relative to cash returns averaging less than 2%, and given the outlook for a continuing mismatch between rental demand and supply over the coming five years, it's perhaps unsurprising that investors are increasingly focusing attention on the potential of the private rental sector to generate a reliable income stream.

A survey conducted by Rightmove in October 2011 discovered that over 40% of investors in residential property pointed to attractive yields as their primary reason for holding the asset class.

Total returns are of course also influenced by capital growth in the housing market, which averaged 6.7% a year over the past 30 years. Based on Savills house price forecasts, total returns (net of rental expenses) are likely to average around 6.9% a year over the coming 10 years.

But investors need to delve below the headline figures and have a clear grasp of the underlying complexities and trade-offs of particular markets. Different locations will offer different combinations of rental yield against capital growth prospects or capital stability, as well as opportunities to enhance that yield further, for example by focusing on specific market segments.

Ultimately, as the residential rental market gains in significance as an income-generating asset class, it's likely that investors will move away from their historical focus on a property's capital value to owner occupiers, and concentrate increasingly on the income stream as a measure of value, in line with other income-producing assets such as bonds and commercial property.

THE INVESTMENT MATRIX

The prospective total 10-year investment returns

TABLE 2.1

Investing in London

Proportion of Total Return coming from Rent	Forecast Total Returns 2011-2021				
	7.0% to 7.5%	7.5% to 8.0%	8.0% to 8.5%	8.5% to 9.0%	Over 9.0%
Less than 40%			Kensington & Chelsea, Westminster		
40% to 45%	Hounslow	Barnet, Kingston, Harrow, Camden, Hammersmith & Fulham	Wandsworth Richmond	Islington, City of London, Southwark Hackney	
45% to 50%		Croydon, Bexley, Havering, Sutton, Brent, Enfield, Redbridge, Haringey, Hillingdon, Bromley	Lewisham Ealing Lambeth Merton		
50% to 55%		Waltham Forest			Greenwich Tower Hamlets
55% to 60%			Barking and Dagenham		Newham

Table source: Savills Research / Rightmove

TABLE 2.2

Where to invest outside of London

Proportion of Total Return coming from Rent	Forecast Total Returns 2011-2021					
	Less than 6.0%	6.0% to 6.5%	6.5% to 7.0%	7.0% to 7.5%	7.5% to 8.0%	Over 8.0%
Less than 50%					Brighton & Hove	Elmbridge
50% to 55%			Southend	Bournemouth Bristol, Colchester	Oxford Southampton	Reading Woking
55% to 60%				Northampton	Portsmouth Medway	Milton Keynes
60% to 65%		Edinburgh Stockport Warrington	Cardiff	Leicester Nottingham		
65% to 70%	Bradford	Newcastle, Leeds Manchester Sheffield	Coventry Birmingham			
Over 70%	Kirklees	Glasgow Liverpool				

Table source: Savills Research / Rightmove

Stamp duty
THE TREASURY'S WEAPON OF CHOICE

The 2012 Budget saw new rates of stamp duty introduced for properties sold for more than £2million. But what effect will these measures have on prime residential property?

Words by
Lucian Cook

Never has the prime residential property market been more in the spotlight in the run up to and wake of a Budget than in March 2012.

The focus was first turned on prime housing by the Liberal Democrat proposals for a mansion tax, championed by Vince Cable. The proposals were justified on the premise that taxing wealth in the form of immoveable property was more efficient than taxing moveable income, that it would affect only the very wealthy and that, in light of council tax receipts, such property made an unfairly modest contribution to tax receipts.

Our work with the Centre for Policy Studies showed that not only would such a tax be complicated and costly to administer given the nuances of valuation, but would also unfairly penalise asset rich, income poor owners who had seen dramatic growth in the value of their homes over their period of ownership. Valuers would have had a feeding frenzy, whilst once but no longer affluent pensioners could have been really squeezed.

Perhaps more pertinent to the wider debate is the extent to which high value property already contributes to the tax take. Our analysis of HMRC data suggests that even before the 5% stamp duty rate was introduced in April 2011 for properties over £1million, such sales were already delivering 26% of the stamp duty take, but accounting for just 1.6% of recorded sales. Also, over one third of all inheritance tax (IHT) receipts from residential property came from less than 1% of the housing stock held at death.

The red box shocks

Of these two taxes stamp duty has been successive governments' weapon of choice for the direct taxation of property, and no surprise that stamp duty was reviewed in the Budget rather than introducing a new more controversial tax.

Stamp duty rates for higher value properties have been repeatedly increased since 1997. As a result, tax receipts from housing rose by 670% in the 10 years to 2007/08, while house prices increased by just 180%.

Since then stamp duty receipts have fallen as constrained access to mortgage finance and weak buyer sentiment have led to greatly reduced housing transactions, but more robust sales volumes in the prime markets, particularly in London, and higher rates of duty for these properties, have mitigated these falls.

So, while tinkering with stamp duty for first time buyers has had little impact on Treasury receipts, an additional 1% stamp duty on sales over £1million since April 2011 has added an estimated £290million to the £1.2billion of receipts from top end sales.

Anti-avoidance

The fly in the ointment for the Treasury was that the higher the tax the greater the incentive to seek to avoid tax.

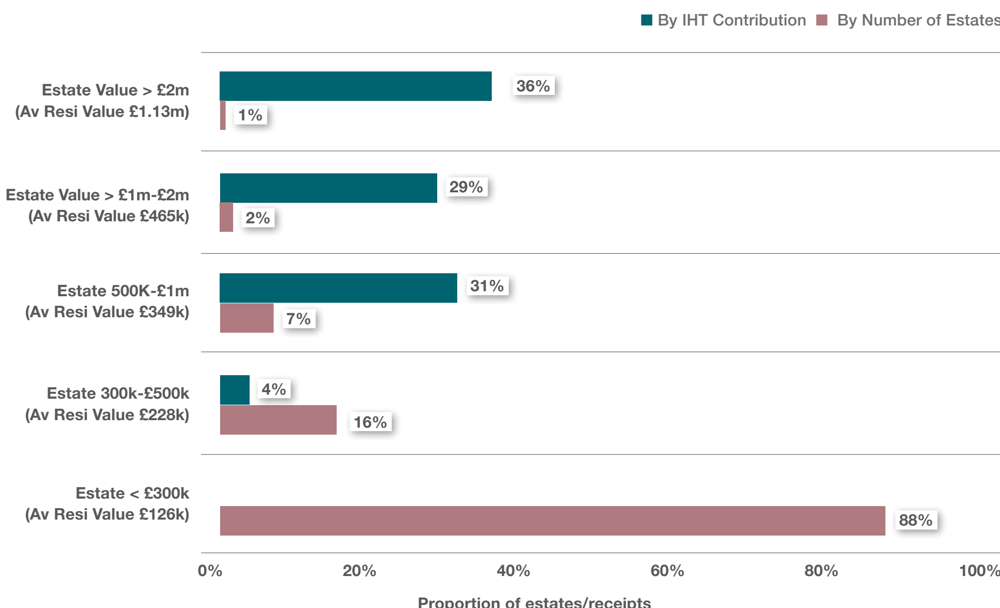
As mansion tax proposals lost favour so attention turned to stamp duty avoidance, and in particular the use of offshore corporate ownership.

Our pre Budget analysis suggested the extent of stamp duty avoidance, however undesirable, had been overstated. We expected associated loopholes to be closed in the Budget, but we didn't expect the chancellor to tackle the issue with such gusto.

Raising stamp duty for properties worth over £2million from 5% to 7% was perhaps predictable, as was the closure of some specific loopholes.

Equally, given a purchase of shares in a property holding company would be difficult to tax, a 15% charge on transferring that property into a company in the first place is logical.

GRAPH 3.1
Division of IHT Receipts from Residential Property (2009/10)



Graph source: Savills Research using HMRC data

The international context

Taking a broader view, the fundamental demand drivers of London as a global city were significantly boosted by other measures in the Budget, such as lower rates of corporation tax, which significantly improve London's global competitiveness.

A 7% stamp duty charge does not cause London to be substantially out of kilter with other global cities. Before the Budget, London was less expensive than Paris for property acquisition, now it is marginally more expensive.

A 15% SDLT charge would make London significantly more expensive than its peers though it should be remembered that this only applies where a property is transferred into the ownership of a 'non natural person', namely a corporate vehicle.

Other global cities

For those buying shares in an existing Special Purpose Vehicle stamp duty will not be a consideration, rather they will be focused on the prospective annual charge and the effect of a proposed CGT charge, if and when the property is sold out of the corporate vehicle. Though offset by ongoing stamp duty savings, the annual charges would be high relative to other global cities for our typical 'billionaire' residence in those circumstances where they are charged.

TABLE 3.1

Stamp Duty or Equivalent for a Typical 'Billionaire' Residence

	Purchase costs as % of property value	Rank
Singapore	13.1%	1
Sydney	10.5%	2
Mumbai	9.0%	3
London	7.0%	4
Paris	6.5%	5
Hong Kong	5.3%	6
Tokyo	5.3%	7
Shanghai	4.5%	8
New York	3.3%	9
Moscow	0.0%	10

"There is little doubt the Budget measures could present a challenge to the smooth recovery in prime central London markets"

Lucian Cook, Savills Research

But it didn't stop there. A proposed annual levy on corporate ownership of £2million+ property might best be described as retro-active, targeting owners who had sought to avoid stamp duty prior to the Budget.

The impact

Together the measures are likely to significantly curtail the acquisition of property through special purpose vehicles, though it remains to be seen whether property already owned in this way will be switched into personal ownership.

In their current format the proposals will also impact established corporate and institutional investors with high value residential holdings.

Undoubtedly, this was an unintended consequence and corporate and institutional investors caught by the new stamp duty banding, and at risk of being caught by the annual levy, will almost certainly seek exemption from these provisions.

The effect on the market remains to be seen, but these measures could present something of challenge to a smooth recovery in the prime central London markets.

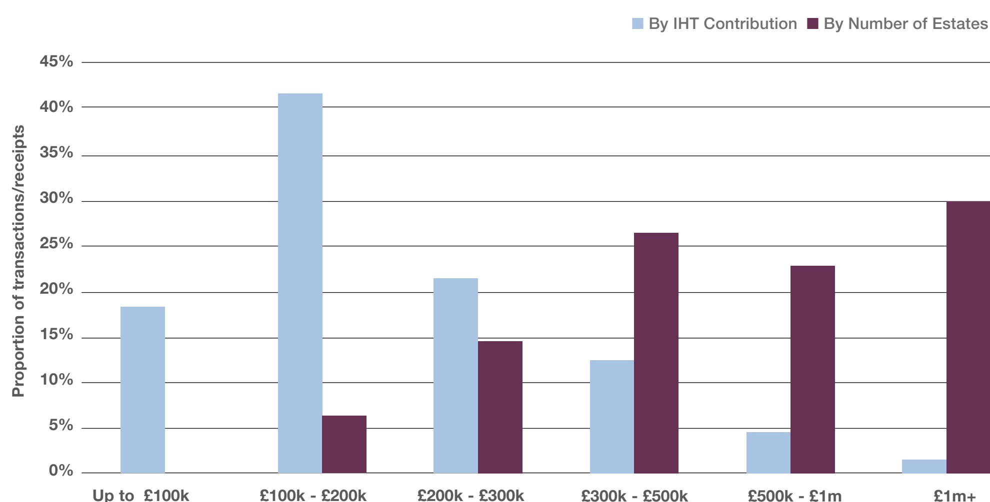
Our view, supported by early evidence in the market, is that they will not undermine market demand or bring a significant amount of new stock to the market to the extent that sudden price falls are triggered.

It is common for the prime central London markets to go through lulls at this stage of a market cycle however, and we believe that these measures are likely to be a catalyst for a period of relatively static prices, in line with our existing published forecasts.

Beyond central London, where tax avoidance planning was much less common, the effect will be lessened. There is also a distinct possibility we will see growing demand from Londoners wishing to avoid the £2million price point, making trading out to a larger £1million+ house an increasingly attractive option.

GRAPH 3.2

Analysis of Transactions and Stamp Duty Receipts 2011



Graph source: Savills Research using HMRC data

House price values
MARKET FORECASTS

PRIME MARKETS
Five-year forecast values, 2012-2016

	Change from peak to 2011	2012	2013	2014	2015	2016	5 years to 2016
Prime Central London	16.9%	3.0%	0.0%	5.0%	6.5%	6.5%	22.7%
Prime Regional	-17.1%	-3.0%	2.5%	4.0%	5.5%	5.5%	15.1%
Prime South East	-13.0%	-2.5%	3.0%	6.5%	6.5%	6.5%	21.3%
Prime South West	-21.7%	-3.5%	2.0%	4.0%	4.5%	5.5%	12.9%
Prime East	-19.8%	-2.5%	2.5%	4.0%	4.5%	6.0%	15.1%
Prime Midlands/North	-24.1%	-6.0%	2.0%	2.0%	4.5%	5.0%	7.3%
Prime Scotland	-18.6%	-4.0%	1.0%	2.0%	3.0%	5.0%	7.0%

Source: Savills Research

Prime performance

The prime markets have been much more active than their mainstream counterparts. In 2011 sales of homes worth £1million+ were within 8% of their 2007 peak across England and Wales according to Land Registry data.

In London's prime markets which have seen the strongest price growth since the downturn, £1million+ transaction levels exceeded 2007 levels by 5%. Q1 2012 price growth of 2.8% suggests London continues to outperform.

Continued stock constraints mean prime London prices are consistently above peak, driving strong growth in £1million+ transactions outside prime central London which are increasingly attracting international buyers.

In 2011 £1million+ sales were more than 25% up on 2007 in Maida Vale, Notting Hill, Camden/Regents Park and Fulham. The prime domestic markets of south west and west London have also benefited, with £1million+ sales in Battersea and Chiswick up by 28% compared to 2007.

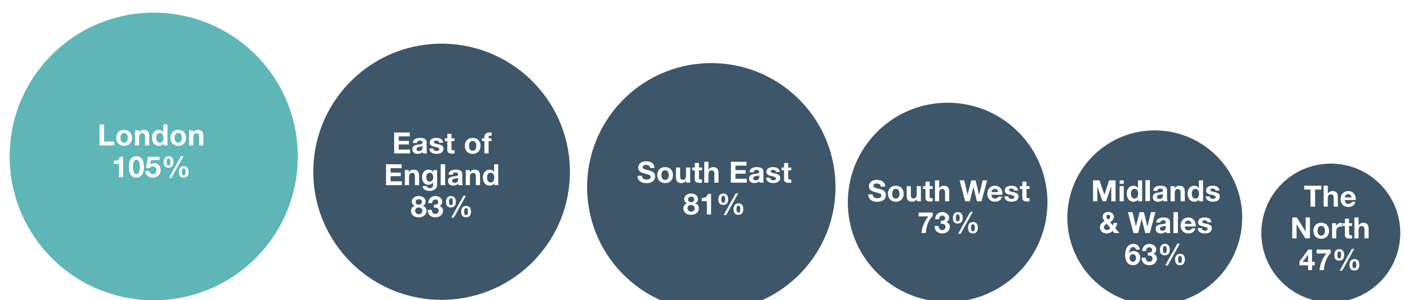
Generally, the further from London the more constrained the prime markets become. In Yorkshire and Humber £1million+ sales last year were 35% below 2007 levels - a better performance than the mainstream market but much weaker than the South East where such sales were within 20% of their previous peak.

In 2011 all regions witnessed a dearth of imported London wealth, though there are now signs of a change, corresponding with a return of price growth in the South East, particularly in some key commuter hotspots.

If these early signs of improvement continue markets such as Sevenoaks, St Albans and Oxford, will see their tally of £1million+ sales rise further beyond the records set in 2011.

GRAPH 4.1

Strength of Prime Market Recovery – Sales of £1m+ property 2011 vs 2007



Graph source: Savills Research, Land Registry

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

MAINSTREAM MARKETS
Five-year forecast values, 2012-2016

	Change from peak to 2011	2012	2013	2014	2015	2016	5 years to 2016
UK	-10.5%	-2.0%	0.5%	1.0%	2.0%	4.5%	6.0%
London	-1.8%	-0.5%	1.0%	5.0%	6.0%	6.5%	19.1%
South East	-6.3%	-1.0%	1.0%	4.0%	5.0%	6.0%	15.7%
South West	-9.8%	-1.5%	0.5%	2.5%	3.5%	5.0%	10.3%
East	-8.7%	-1.0%	1.0%	3.5%	4.5%	5.5%	14.1%
East Midlands	-11.0%	-1.5%	0.5%	2.0%	3.0%	5.0%	9.2%
West Midlands	-11.5%	-2.0%	-1.0%	0.0%	0.0%	3.5%	0.4%
North East	-14.0%	-2.5%	-1.5%	-1.5%	-0.5%	3.0%	-3.1%
North West	-14.9%	-2.0%	-1.0%	-1.0%	0.0%	3.5%	-0.6%
Yorks & Humber	-14.0%	-2.0%	-1.5%	-1.0%	-1.0%	3.0%	-2.6%
Wales	-12.7%	-2.0%	0.5%	0.5%	1.5%	4.5%	5.0%
Scotland	-10.6%	-4.0%	0.0%	0.0%	0.5%	2.0%	-1.6%

Source: Savills Research forecasts based on Nationwide actuals

The mainstream view

Though still 46% below the pre crunch average for the period, housing transactions in the first quarter of 2012 were at their highest level since 2008. This corresponds with improved demand for mortgage finance reported by the Bank of England in their Q1 Credit Conditions Survey.

However, at a national level the Nationwide, Halifax and Land Registry data all suggest UK average house prices little improved, with supply and demand both subdued, though broadly balanced according to the RICS.

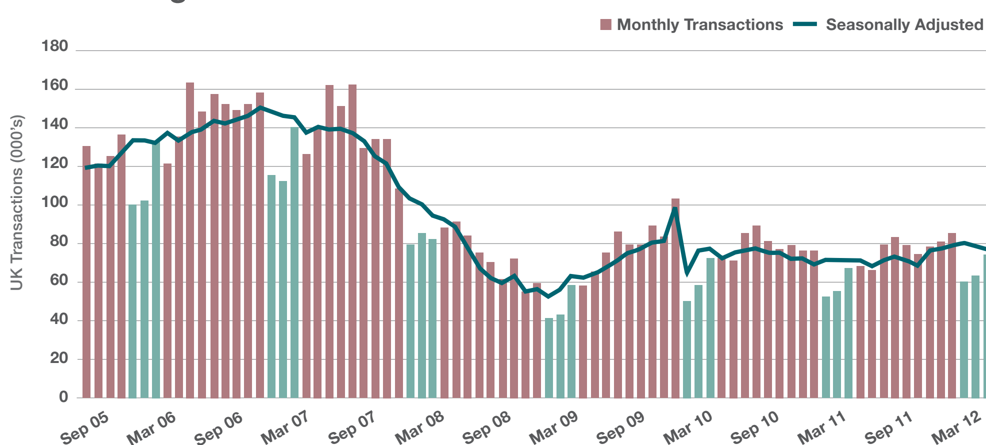
Land Registry figures continue to show a wide divergence across the UK. In Oxfordshire prices rose 2.8% in the year to February 2012 to leave them just 4.8% below peak. By contrast prices fell by 9.0% in County Durham to leave them 29% below their peak.

London continues to be the strongest regional market, but there is huge divergence in activity levels across the city. In Islington annual transaction levels are running at 82% of their pre crunch norm while in Barking and Dagenham they are down 57%

With little sign of improvement in the availability of mortgage finance and an increase in the standard variable rate of interest charged by some lenders, there seems little prospect of a sustained improvement in mainstream market activity over the next two years at least, as reflected in our house price forecasts.

GRAPH 4.2

UK Housing Transactions



Graph source: Savills Research/Land Registry

TABLE 4.1

Mainstream House Prices

	Q1 2012	Compared to	
	Average house price	1 year ago	5 years ago
England & Wales	£160,889	-1.1%	-6.8%
Kensington & Chelsea	£973,856	+12.4%	+41%
Oxfordshire	£240,551	+2.8%	+0.9%
Durham	£82,932	-9.0%	-25.1%

Table source: Land Registry

Development

WHERE BEST TO DEVELOP?

Scarcity of deliverable land with consent is a constraint in low delivery, strong markets, so prospects are good for those who can get land with consent to the point of delivery

Words by Jim Ward

Q Prospects for development and investment vary across the country, at a local level. To find the best development opportunities, should the same selection criteria be used as for investment?

A To some extent, yes. We expect the markets that are currently strongest to continue to show the highest rates of growth in house prices, rents and land values during the next five years.

New homes will generally be sold most easily into markets that have recovered most strongly to date, with least reliance on high loan to value mortgage debt, which remains in short supply.

Q Are all the development opportunities found in stronger markets?

A No. The flipside of investing and developing in stronger markets is that there is more competition to acquire investment stock and land. The higher investment yields available in weaker markets can underpin performance, particularly if growth is driven by the strength of adjacent markets. Conversely, a well located development site in a weaker market can deliver good sales rates, but with less competition to acquire the land.

Q Where are the best development opportunities in stronger markets?

A Development volumes have bounced back most sharply in the stronger markets, with a 6% shift in housing delivery towards the strongest markets, compared with the peak delivery year of 2007/08.

Examples are Ashford, South Norfolk (including development on the fringe of Norwich) and Cornwall, underpinned by a robust recovery in market activity and the availability of deliverable land.

In contrast, delivery in markets such as Oxford, Solihull and Wokingham have stayed relatively low, despite strong market recovery. Scarcity of deliverable land with consent is a constraint in these markets, so development prospects are good for those who can get land with consent to the point of delivery.

Other markets with strong market recovery but below par levels of delivery include Mid Sussex, Guildford and York. In London, Islington, Hackney and Wandsworth have delivered less than might have been expected given their market strength.

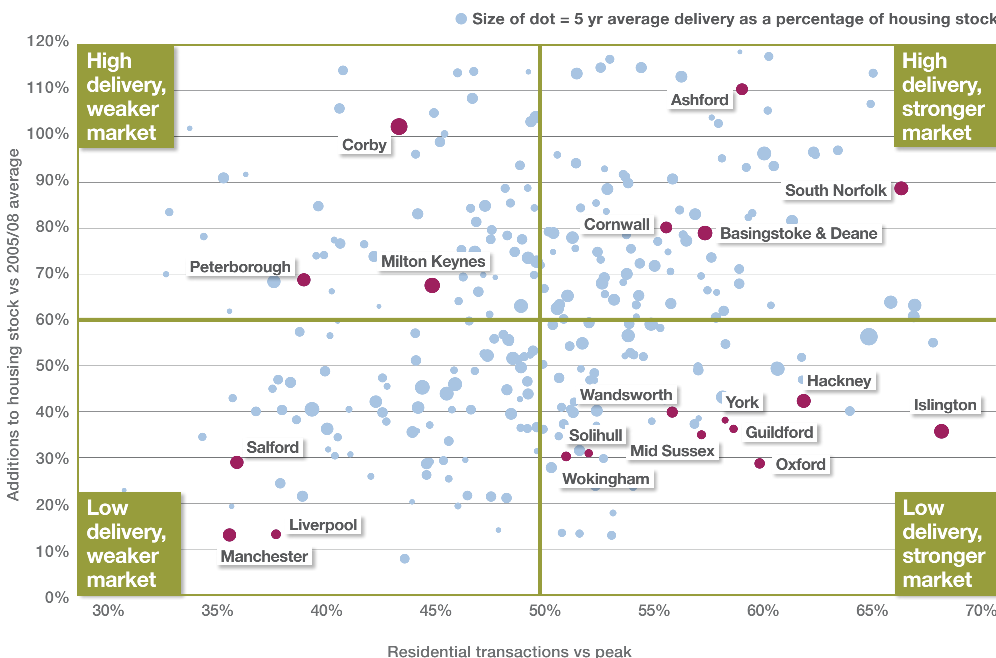
Q Does NewBuy mortgage indemnity open up opportunities in other markets?

“A well located development site in a weaker market can deliver good sales rates, but with less competition to acquire the land”

Jim Ward, Savills Research

GRAPH 5.1

Recovery in House Building and Market Activity



Graph source: Savills Research, HM Land Registry

A The upturn in delivery has also been above par in high delivery markets such as Peterborough, Corby, Milton Keynes and Basingstoke, where overall market activity has not recovered so strongly, constrained by scarcity of mortgage finance.

Equity loans, including FirstBuy and Homebuy, have been an important part of delivery rates in these markets, so developers that offer these products are well placed to compete. NewBuy mortgage indemnity has the potential to extend the positive impact.

Q Will the new National Planning Policy Framework lead to more financially viable consents?

A The guiding principle of the new framework is the so-called golden thread of the presumption in favour of sustainable development. The document's forward sees planning as a creative exercise in achieving sustainable development, rather than simply an exercise in scrutiny.

This should, in theory, lead to an increase in the number of viable planning consents, but much will depend on whether the Secretary of State embraces the creative tone of the framework's preamble, as appeals work their way through the new system.

Among the positive features of the new framework is the requirement for Local Plans to meet the full objectively assessed needs for both market and affordable housing, with reference to market signals of the balance between supply and demand.

This is in contrast to the evidence base for existing policy, which rarely makes use of such market evidence. The addition of such evidence will justify higher housing requirements in some markets, particularly once employment related inmigration and travel to work patterns between local authorities have been properly factored in.

A further positive feature is the requirement for the Plan to be based on a financially viable five year land supply (plus a buffer), whereby policies should not threaten that viability.

The assessment of viability should, having taken account of the normal cost of development and mitigation, provide competitive returns to a willing land owner and a willing developer, such that development is facilitated throughout the economic cycle.

This is a clear signal that assessments of Plan viability should represent the reality of the economics of development in the current market. This is potentially the most important section of the new framework, as it should ensure that development is not stifled by unrealistic policy aspirations that go beyond what is required for sustainable development.

Q Are the larger strategic sites now being developed?

A Much of the development opportunity is in strategic sites of more than 250 unit capacity, which provide a total development capacity of 1.5 million new homes nationally.

These sites account for some 45% of the five year land supply pipeline identified by local authorities, where specific sites have been identified in Annual Monitoring Reports. Some 53% of their capacity is in stronger markets and many of these are close to higher value markets.

These sites have been difficult to bring forward since the 2007/08 downturn, because of their greater requirements for both scarce development finance and costly infrastructure. As the steady pace of refinancing of banks and developers continues during the next five years, and market recovery ensues in due course, balanced against higher build costs, then a growing proportion of sites will become deliverable, providing land for the higher number of new homes completions that we are projecting. Whether this materialises will be a central test of the new National Planning Policy Framework.

Q What about surplus public sector land? Are there opportunities?

A Surplus public sector land is also part of the land opportunity, albeit that much is in mid to lower strength markets. Of the land identified by Government as having a development capacity of 100,000 new homes, 65% lies in the local authorities with below average market strength, so structuring the right land deal and planning consent will be crucial.

Market dynamics

BUYING VS RENTING

To buy or to rent? A simple question, but a complex answer

One of the features of the housing market since the downturn has been that some households have chosen to rent, either taking a break from home ownership or in the case of the lucky first time buyers sitting on a sizeable deposit, delaying the decision to make their first move onto the housing ladder.

For both groups the relative costs of buying versus the costs of renting is critical both at a given entry point and in the future. Simply comparing mortgage interest costs against rental costs is a start point. For example, for someone looking to buy a two bedroom property at £150,000 with a 25% deposit, interest payments of just under £4,000 per annum would compare favourably to rent of £9,150, assuming a rental yield of 6.1%.

This simple analysis suggests that despite high lenders' margins, the so-called 'dead money' of renting is a high price to pay. But this is before taking account of the additional costs of ownership, such as repairs and insurance, or the cost of funding mortgage repayments at a time when interest-only mortgages are a rare commodity.

Buyers should also take account of the income their deposits would deliver if invested rather than being tied into a property. On the basis of the same example that would swing the balance in favour of renting, with home ownership costing £1,300 more than renting over the course of a year.

Watching the market

At the peak of the market the additional cost of buying was substantially higher because both mortgage rates and returns on savings were higher and the relationship between house prices and rents had become out of kilter.

Scroll back 10 years and the cash comparison was much more like today's, though lower house prices meant lower capital repayments, making it cheaper to buy than to rent both before and after accounting for the costs of ownership.

What distinguishes then from now are the house price growth prospects. In 2001, prices rose by 25%. A decision to delay moving and staying in rented accommodation could therefore be very costly indeed. By contrast, with further small house price falls forecast in the short term, there is no rush to beat price growth – just one among many reasons why housing transactions remain depressed.

Prospective buyers should watch the market carefully. As house price growth returns so the balance will shift again. This will be seen first in London and the South East where house price growth is expected to return more quickly and more strongly. And this is likely to be particularly relevant to those more mature households who have taken time out of home ownership. Despite lower rental yields, and therefore lower relative rental costs, recovery is expected to be stronger in these equity rich sub-markets, potentially bringing such households back into the market ahead of first time buyers lucky enough to be sitting on a deposit. ■

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"There are big opportunities for new investors who understand which stock will perform in this environment and what is currently mispriced – and how to find hidden value."
Yolande Barnes

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"Never has the prime residential property market been more in the spotlight in the run up to and wake of a Budget than in 2012."
Lucian Cook

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