Spotlight on Residential Investment
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This report examines the key trends impacting on the future shape of the residential investment market.

Rental growth fuelled by stock shortages

So-called ‘Buy to Let’ investment by private individuals was one of the major casualties of the meltdown in the financial markets in 2008 and the subsequent recession. Although very little buy to let stock has been repossessed (just 0.19% of the total 1.26 million buy to let loans), supply in the sector is shrinking.

The number of rental units available to rent dropped in 2010 because these landlords have been taking advantage of sales market buoyancy and trading out of the sector.

Mortgage rationing continues, particularly with this type of investment purchaser, so there is very little new rental stock entering the market. The supply pipeline is not expected to grow, but at the same time, demand for rental property is growing. These factors have already combined to fuel strong rental growth this year, especially in London and the South East of England, and this is expected to continue.

Graph 1
Mortgage rationing continues

Graph 2
Mortgage arrears and possessions remain low

Source: Savills

Source: CML, Savills
Yields and discounts diverge leading to strong buying opportunities

With negative sentiment surrounding the housing market, discounts applied by investors have increased over the last 3 months as investors look to insulate themselves against further falls in house prices. This contrasts with the previous 12 months as the UK emerged from recession and discounts narrowed as prospects in the economy appeared to improve. Currently discounts applied by investors to bulk purchases (lots of 5 units+) range from 0% in the most desirable parts of Prime Central London where overseas buyers with wealth held in dollar denominated currencies take advantage of sterling’s weakness, through to 35% in economically deprived areas of the north of England where unemployment remains high and the owner occupier housing market remains grounded.

There is presently a 2 tiered residential investment market in the UK. In London and key cities such as Bath, Bristol, Edinburgh and Oxford there is a buoyant and identifiable owner-occupier market for investors to sell back into. Therefore bulk investment purchases are made primarily with reference to a competitive discount to aggregate vacant possession values and also have reference to the high probability of house price growth over the medium term. Yield in these locations is of secondary importance.

On the other hand, in oversaturated city centre locations where investors perceive they may be unable to re-sell individual properties, discounts increase to insulate and yield becomes an important driver. Investors have appetite to acquire in these locations but demand a commensurate net income return on their investment to justify tying money up in locations where the local markets may dictate they have to hold property for the medium to long term. Target gross yields across the UK range from 4.6% in Prime Central London where rental demand remains strong, voids are low and tenant covenants are high through to in excess of 12% in regional locations where demand is comparatively low, voids are high and supply is also high.

There are also significant variances on pricing within regions depending on the exact demographics of the location and the profile of the investment.

Map 1
UK gross investment yields & discounts

(Figure stated on map: Discounts required for bulk purchase, 5-10 units +)
Change of direction for institutional investors

Over the past 10 years, we have seen the number of indirect vehicles investing in the residential sector grow steadily. These structures have been widely used for all types of property investment because they are tax efficient for investors. They also pool monies and spread risk, allow potential for gearing and they may be structured as open or closed after a defined investment period.

Many of the early indirect residential investment funds have now come to the end of their fund life and have been broken up and sold off. Funds such as Schroders ResPut, Charterhouse Residential Investments and ING Residential have all liquidated their portfolios. This reflects the fact that investors are moving away from indirect investment vehicles in favour of direct investment routes and/or joint venture opportunities.

The proven long term performance of residential is beginning to attract old and new investors, although investment, at the current time, is not directly into the AST market.

Big ticket investors are looking for ‘opportunity’ style investments with potential returns of 20% (IRR).

This means residential development currently looks attractive to them. It presents good opportunities to take development profit as enhanced yield but also has the flexibility to either hold the investment in the rental market or sell to the owner occupied market depending on market conditions.

Window of opportunity

The current lack of debt finance pervading all property markets offers a window of opportunity to equity investors. How long this lasts is dependent on how long it will take banks to recapitalise and return to former levels of lending. If they do not, the window may turn out to be long-lived. We do not expect that debt funding will be available for large, complex development schemes for some while so it is here where we believe, that the greatest opportunity for residential investment lies. This does not mean that institutional investors will necessarily come rushing in to build for letting but rather we expect that entrepreneurial property companies will start to build stock and portfolios of sufficient scale and with established cash flows to eventually sell on to institutional investors. Some have already teamed up in joint ventures with the institutions that will form the future of this sector.
Residential becomes “mainstream” for equity investors

The investment market as a whole has become much more equity driven since 2007 and this has led to a change in preferred investment routes for all property investment. Institutional investors do have large sums of money to invest and there is limited investment grade property available in the commercial sector. This is having a number of clear consequences on the residential investment market.

1. The first is that there are many new potential players – investors who have previously preferred other asset classes over residential. Some of these investors have come to the sector by default (through exposure to mixed use development). Others have recognised the long-term performance of residential and that the housing market is under-supplied and offers potential for high returns as the market recovers.

2. Second, and a potential issue in a sector where portfolio sizes are still relatively small, big ticket commercial investors want large, club-size deals that allow them to invest in bulk.

3. Third, the residential market is increasingly beginning to be considered as a mainstream asset class. It is being included in the IPD All Property Index for the first time next year. The consequence is that institutional investors should perceive the sector as better researched and with better-known risks going forward. As they realise that the sector is relatively low risk and high return in contrast to some commercial sectors, we think that they will want greater exposure to it in future.

Big-ticket, commercial investors are coming into the market but they are not institutions

These entrepreneurial property companies are vital to the development sector because, by funding new product, they are contributing to the institutional stock of the future.

Forward funding of development projects in London and the South East is the key target market for these property companies. These investors are looking for development partners or joint venture opportunities where skills can be matched and there is the potential to invest in large lot sizes for high returns. Helical Bar, for example, have recently teamed up with Grainger to bring residential expertise to their regeneration development in Hammersmith and Fulham.

London is the target market for larger investors because it is perceived to be less risky for speculative development. The widening supply demand imbalance is most evident in the capital and there is also the opportunity to acquire large lot sizes.

Private property companies respond quickly to the market

Institutional investors continue to “sit on their hands” (despite some high-profile announcements) and eye the residential market from the sidelines. Meanwhile, private property companies are snapping up the residential investments that are coming to the market.

Private property companies are well capitalised and respond quickly to opportunities offered to the market. These investors can make decisions quickly, taking advantage of their strong buying position.

The main driver for these investors is the discount to vacant possession value and the potential to enhance value through active asset management; such as refurbishment, lease extensions and change of use.

Capital growth prospects

Owner-occupied house prices have grown strongly since the end of Q1 2009 when prices bottomed out at -18.7% below peak (Q3 2007). The recovery since March 2009 has seen average house prices grow by 11.8% to the end of Q3 2010 but still remain -9% below peak. Our forecast is that house price growth will ease back in 2011 because of increased pressure on household incomes from far-reaching austerity measures and fear of unemployment in the public sector together with the prospect of more prolonged constraints on mortgage lending.

We expect average UK house prices will be relatively static for a period. As the country returns to peak economic output, we expect that real house price growth will return. The pattern of mainstream price growth over the next five years will depend on the extent to which the mortgage markets are able to normalise. This will affect the timing, geographical spread and the ability of different tiers of the mainstream housing market to grow.
Outlook for rents
The dynamics in the housing market and the lack of traditional methods of funding are presenting equity investors (small and large) with attractive investment opportunities. While banks replenish their balance sheets there is very little debt funding available for new residential development. The supply-demand imbalance in the housing market means that there will be substantial demand for rented housing - including open market rent and intermediate rented property.

The pick up in the sales market seen over the last year has meant that owners have transferred their rental property back into the sales market. In addition to a lacklustre investment market and a decrease in new build development activity, fewer new properties have entered the rental market whilst demand continues to grow. Clearly, this supply demand dynamic is driving rental growth and having a positive impact on landlords’ returns.

Therefore, our medium and longer term outlook for the rental market remains broadly positive, with rental growth expected to exceed income growth over the next few years.

Recent Investment Deals

<table>
<thead>
<tr>
<th>Prime West London Investment</th>
<th>Unbroken Grade 2 Listed Estate of Cottages in West London</th>
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</thead>
<tbody>
<tr>
<td>• Price circa £2m</td>
<td>• Price circa £4.25m</td>
</tr>
<tr>
<td>• Approximate discount to VP 10%</td>
<td>• Approximate discount to VP 15%</td>
</tr>
<tr>
<td>• 7 Flats Income Producing</td>
<td>• 20 Cottages and ancillary buildings</td>
</tr>
<tr>
<td>• Approximate Gross Yield 5%</td>
<td>• Vacant possession</td>
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<tr>
<td>• Opportunity – existing planning</td>
<td>• Opportunity – existing planning consent for</td>
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<tr>
<td>consent for refurbishment</td>
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<tr>
<th>Former sheltered accommodation in South London</th>
<th>Forward Sale North London</th>
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<tr>
<td>• Price circa £1.8m</td>
<td>• Price circa £8.5m</td>
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<tr>
<td>• Approximate discount to VP 25%</td>
<td>• Approximate discount to VP 20%</td>
</tr>
<tr>
<td>• 20 Flats</td>
<td>• 32 Flats</td>
</tr>
<tr>
<td>• Full vacant possession</td>
<td>• Full vacant possession</td>
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<tr>
<td>• Opportunity to regularise planning</td>
<td>• Opportunity to buy at a discount off plan, which</td>
</tr>
<tr>
<td>consent to C3 residential and increase</td>
<td>enabled the developer to secure exit and assist with</td>
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<tr>
<td>scheme density</td>
<td>funding.</td>
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<th>Ground Rent Portfolio</th>
<th>Ground Rent Portfolio</th>
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<tr>
<td>• Price circa £1m</td>
<td>• Price circa £3.5m</td>
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<tr>
<td>• Approximate yield 7%</td>
<td>• Approximate yield 6%</td>
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<tr>
<td>• Over 200 units</td>
<td>• Over 600 units</td>
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<tr>
<td>• Ground rent income circa £60k</td>
<td>• Ground rent income circa £200k</td>
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<tr>
<td>• Rent reviews every 25 years to house price inflation</td>
<td>• Rent reviews linked to house price inflation every 25 years</td>
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<tr>
<td>• Lease lengths 999 years</td>
<td>• Lease lengths 125 years</td>
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Summary

• There is strong appetite from private property companies for small to medium sized investments where there is the potential to enhance value through asset management.
• These investors are well capitalised and respond quickly to opportunities offered to the market. They recognise their strong buying position.
• Big-ticket, commercial investors are coming into the market. These entrepreneurial property companies will start to build stock and portfolios of sufficient scale and with established cash flows to eventually sell on to the institutional market.

• Many of the “old” institutional backed residential funds have been broken up and sold off as their fund life has come to an end. This reflects a change in investment strategy rather than disenchantment with the residential sector.
• London is the target market for investors because it is perceived to be less risky due to favourable supply demand dynamics.
• The medium term prospects for the rental market are very good given the lack of grant funding for low cost housing as well as mortgage rationing for owner occupied housing.
Residential research services

Savills has had a dedicated residential research team for the past 20 years. Based in London the team provides advice and analysis to clients, on all aspects of the residential market. The department has built up a strong reputation for producing accurate, well-informed and independent analysis and commentary on the UK’s housing market. The team is a leading national commentator on housing 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 public and private sector organisations across the UK.

Typical consultancy projects include:
- Local area supply and demand analysis
- Research to support planning applications and development feasibility studies
- Investment strategy and advice
- Place-making site studies and research into housing-led regeneration
- Forecasting rents and capital values
- Research to inform policy making and statements of best practice
- Research for property finance and business planning purposes

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RESIDENTIAL INVESTMENT SERVICES
The Savills Residential Investment team are recognised as the market leaders in their field. With nationwide coverage, the team are able to draw on a wide range of skills and market knowledge and can offer advice nationally.

Our network of regional offices with detailed local expertise and our renowned research team means we are uniquely placed to bring you up-to-date market knowledge, whether you are looking for strategic, transactional, or asset management services on anything from large-scale portfolio acquisitions to small multi-unit deals.

Our diverse client base includes private property companies, institutional investors, housing associations, investment funds, banks, and high net worth individuals.

Areas of expertise include:
The provision of agency, consultancy and valuation advice in relation to:
- Bulk disposals and acquisition
- Reversionary investments
- Portfolio rationalisation strategies
- Ground rent portfolios
- Shared equity / ownership portfolios

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