

UK Residential Investment Report 2008:

Finding Opportunities in an Evolving Market

“The ‘Credit Crunch’ has severely limited residential investment activity, resulting in weak demand across the market.”

“Despite improving yields, we expect demand to remain soft until the housing and credit markets both stabilise.”

“Build-to-let offers a real answer to the question of how to meet government housing supply targets.”

Jennet Siebrits, Head of Residential Research

IN BRIEF:

- Residential investment demand is undergoing a slowdown, exacerbated by the credit crunch. Demand is likely to remain weak until both the housing and credit markets stabilise. In the interim, we expect equity-driven buyers to fill some of this void.
- Our Prime Central London Residential Yield Index shows that during 2007 yields declined from 3.8% to 3.6% by the third quarter. However, and reflecting a combination of slowing house prices and rising rental returns, the Index had climbed back to 3.9% by the year’s end.
- Build-to-let represents an opportunity to draw institutional investors into the sector. As large, discrete private rental blocks, they represent a product that should be attractive to professional landlords. We are encouraged that planners are recognising this opportunity. However, we are concerned that there are insufficient market-oriented solutions to generate interest.

INTRODUCTION

The UK private rental market is conservatively worth almost £500 billion, representing 12% of the total housing market, or 2.5 million privately rented homes. This is roughly the same as the total capital value of all commercial property in the UK. Residential property has also enjoyed strong returns relative to equities, bonds and even commercial property. For example, our research suggests that while the IPD All Property Index has grown by 4.9% per annum since 2000, house price growth was 12.1% per annum over the same period.

Ownership of private rental property is now dominated by the buy-to-let sector. Buy-to-let investment has grown considerably over the past decade and there are now more than 1 million mortgages across the UK. This represents between 50% and 60% of the total private rental market. In contrast, institutional property investors hold only around 5% of all private rental stock, with the rest held by estate landlords and private companies.

Institutional investors are being heralded as an important group to attract to residential property. Institutions can provide a professional approach to property management and the financial capacity to build, buy, or hold private rental units in large blocks. These are considered key attributes for a market that often suffers from negative perceptions and needs to mature in order to grow.

CHART 1: CAPITAL GROWTH: IPD UK ALL PROPERTY VS. NATIONWIDE



Source: Nationwide, IPD, CB Richard Ellis

Current Market Performance

According to the IPD, average UK total returns reached 17% in 2007. This continued to be driven by capital growth, which has been the key component of investment performance in recent years. In contrast, rental returns were 4.7%, in line with the trend over previous years.

However, 12-month growth figures show that this capital growth has now all but disappeared. Nationwide has reported six consecutive months of price falls, including 0.4% in March and another 1.1% in April. Year over year house price changes are now -1.0%. Negative capital growth will dramatically reduce total returns in 2008.

Due to five straight interest rate rises between August 2006 and June 2007, we had already forecast the slowing housing market in early 2007. However, the market has been disrupted due to the knock-on effects of the credit crunch.

Table 1 compares total returns in 2007 by region. The market slowdown is evident across most regions, although there is a wide disparity in performance. The resilience of Central London can be contrasted with very weak levels of growth in Northern England. Scotland showed the biggest year over year fall, however this is from the market-leading position of 24% in 2006. Although the Index does not reflect the full extent of the market slowdown, it clearly demonstrates the effect that the slowdown has had on total returns.

More recently, weaker capital growth and rapidly rising rental returns, notably in London and the South East, have caused yields to increase across the sector. This means that yield-based residential investment decisions may become viable. This has not happened for a number of years.

TABLE 1: TOTAL RETURN BY REGION, 2007 VS 2006

	2007	2006	Difference (%)
Central London	25.6	18.7	6.9
Inner London	17.4	20.1	-2.7
Rest of South East	12.6	15.1	-2.5
Middle England & Wales	8.1	6.7	1.4
Northern England	4.3	11.4	-7.1
Scotland	11.0	24.0	-13
All Residential	17.0	16.8	0.2

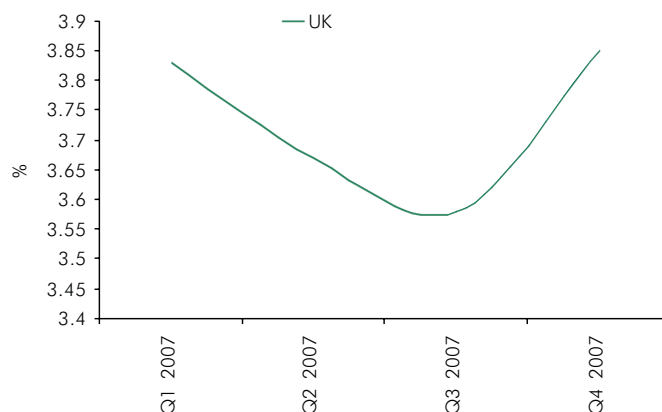
Source: IPD

London

The CB Richard Ellis Prime Central London Yield Index (Chart 2) demonstrates the clear shift in the market over the past 12 months. Our figures show that yields continued to compress from 3.8% in the first quarter of 2007 to 3.6% by Q3. This reflected a trend of tightening yields that has been observed for nearly four years. However, the drastic fall in sentiment on the back of more difficult credit conditions precipitated a sharp correction. By the end of the year, our Index shows that yields have moved out to 3.9%.

Hamptons has also noted this trend, but it is yet to impact larger, suburban homes as noted by Research Manager, Rob Bruce. "Yields across London have moved out to around 4.5%, but across the South West we continue to see yields as low as 3.8%, with particular pressure on the upper end of the market."

CHART 2: 12-MONTH QUARTERLY GROSS YIELD, PRIME CENTRAL LONDON



Source: CB Richard Ellis

Future Prospects

Domestic investors often adopt a high degree of leverage for residential investments. However, they are likely to have real difficulty in accessing debt at an attractive price in the short to mid-term. As a result, equity-based investors, notably from cash-rich regions such as the Middle East and Asia, should form a larger proportion of potential buyers. This group will be important to offset a lack of domestic investor demand.

Investors will also consider locations with a greater degree of scrutiny. Areas with the potential for over supply will experience softer demand. In addition, regeneration zones and developments with a higher perceived level of risk could suffer. As funders are requiring a higher level of off-plan sales for the release of development finance, construction starts will be delayed. This will affect the more ambitious city centre schemes, notably for tall buildings.

With the onset of a slowdown in the housing market, the prospects for residential investment are changing dramatically. Mortgage-backed securities in the United States were developed as a way for institutions to gain indirect exposure to the residential market. The strong appetite for exposure eventually included riskier sub-prime properties. However, the turn of fortune in the US housing market has forced a rethink about the risk profile of investment in residential property. This presents some uncertainty about the volume of new investment in the mid-term.

Rental Demand

The RICS Q4 2007 Residential Lettings Survey showed that rental growth across the UK remained at twice the long-run average. This has meant that in places with strong demand such as the South East, rents increased at their fastest rate since Q1 2001. Continued affordability issues, notably for first-time buyers, have been exacerbated by housing market uncertainty and a much tougher mortgage market.

The rental market has benefit from the declining affordability of house prices in recent years. Young workers increasingly demand flexible household arrangements, driving demand in the private rental sector. For example, around 65% of buy-to-let renters are below the age of 35. The flexibility of private renting facilitates this interim period. Similarly, the Association of Residential Letting Agents (ARLA) suggests that only 40% of tenants have been renting for more than two



Athlete's Village, Lend Lease

years. This percentage lowers to just 13% beyond five years. Although young people are staying home with parents for longer periods before moving into their own accommodation, they are also getting married and 'settling down' at a later age.

These demographic and social trends, alongside weakened affordability, will continue to underpin demand for rental property. This will be crucial for small buy-to-let investors if they are to survive the current market shake out. Attracted mainly by capital growth rather than income in recent years, this group is often highly leveraged. Media reports cite the number of investors who are forced to supplement rental returns with their own cash in order to cover mortgage repayments. In worse shape still are the 'yet-to-lets', who are widely criticized for not letting out the property at all to avoid the hassle and to keep the property in a new condition. Although this group does not represent a large proportion of all investors, many will either sell up or reconsider letting the property as a supplement to the current poor performance that their investment is providing. Strong rental demand may be a vital supplement to the investment return of this group in particular.

Institutional Investment Transactions

Continued uncertainty on future price movements and a perception of considerable downside risk should subdue demand going forward. However, there may be a heightened interest from more sophisticated investors, notably from institutions. Although stronger rental growth may provide some succour for all investors, improvements in the forecast yield are likely to entice traditional commercial property investors to consider residential. In particular, institutions are a major potential source of investment should the right market conditions exist. We consider this in the following Focus section.

TABLE 2: SELECTED PORTFOLIO TRANSACTIONS, APRIL 2008

Property	Date	Sale Price	Parties	Comments
Mann Island, Liverpool	Q1 2008	£144 M	Vendor: Countryside Properties Purchaser: Dylan Harvey	379 units to be completed in 2009.
Jennens Road, Birmingham	Q1 2008	£65 M	Vendor: Watkin Jones Purchaser: Cordea Savills	596 units to be completed in 2009.
The Magdalen Portfolio	Q1 2008	£43 M	Vendor: Morley Purchaser: Mountview	209 self contained flats and 25 houses. The buildings are all located in South West London. The portfolio was subject to a range of tenancy types. Current rent reserved per annum £879,360.
Fulham Road	Q2 2008	Currently under offer at £5.7 M	Vendor: Private individuals Purchaser: Unite	24 flats / maisonettes, in need of modernisation. Current gross rent is £218,880 per annum. Guide price £5.5m. Estimate gross yield of 3.8%.

Source: CB Richard Ellis

Focus: Build-to-let as the Saviour of Government Supply Targets

As noted earlier, institutional investment represents around 5% of the private rented sector. However institutions, while interested in residential property, have not yet been presented with the right opportunities to enter the market in large numbers. Small lot sizes, opacity of reliable market information and an unfamiliar regulatory environment are some of the reasons given for current institutional reluctance.

The build-to-let approach may provide the necessary fillip to make the sector an attractive opportunity. At its core, the approach generates economies of scale for developers and investors by creating bespoke private rental buildings with a minimum of 100 residential units. This critical mass allows for efficiencies in property and lettings management. It also provides property investors with the opportunity to benefit from a more traditional balance of income growth and capital appreciation. When the private rental block forms part of a larger scheme, additional benefits can include:

- Facilitating early sales momentum over the entire scheme by removing a large volume of early units from the traditional sales approach;
- Creating an earlier buzz to the area through faster occupancy of rental units;
- Demonstrating a commitment to the success of the overall scheme, which is clear to investors and potential purchasers;
- Maintaining control of early occupancy and public realm; and
- Ultimately, realising the above average capital growth associated with public realm and amenity improvements that the development generates over time for an area.

A recent report for the British Property Federation suggested that specific policy measures may be of particular benefit for discrete private rental blocks. Pronouncements of support from Ken Livingstone suggest that the weight of policy may also encourage institutions to reconsider residential investment. The GLA also see it as a useful way to support a faltering supply in the new homes market in London. Although any efforts to encourage institutional investment are laudable, we would suggest that policy changes adopt a light touch when considering rental-only applications. More dramatic changes such as a separate "rental only" use class will not drive demand and may be counter-productive.

A separate planning use class will decrease land values. As such, it will be unattractive to landowners. With the vast majority of development currently being provided on brownfield land, there will be limited demand for a private rental-designated change of use. Further, these properties would have reduced flexibility in an exit strategy, which is likely to include outright sale of individual units in the long term. This would dissuade take up of build-to-let, leaving a strong concept in tatters.

Alternatively, planners could choose to recognise private rental property as a part of the quantum of intermediate

housing stipulated in Section 106 agreements. This would provide a real incentive for developers to include more of these units within development plans. Further, this would increase the flexibility of developers to deliver new supply in the face of changing market conditions.

The key lesson from the unsuccessful Real Estate Investment Trust (REIT) launch is that without recognising the dynamics of the market, good ideas can still be executed badly. As the Callcutt Review points out, planners need to develop strategies that work with the grain of the market in order to be successful. Build-to-let is indeed a great opportunity to facilitate new housing supply, but serious consideration for the concept will come after it is made sufficiently attractive to investors. This might include recognition of the private rental market as intermediate housing, or acknowledgment of the positive regenerative benefits of creating an early and robust local private rental market. In terms of placemaking, this early activity is crucial to attract purchasers and longer-term commitment to an area.

A large proportion of government-proposed locations for new supply are on vast tracts of public sector land. Making a success of the build-to-let approach will be an important way to turn the challenging supply targets into delivered units.



Wirral Waters, Peel Holdings

	Measure	Timing	Source	Lag	Monthly Growth
Nationwide	House Price Index	Price agreed post mortgage survey approval stage	Nationwide Building Society's lending data for UK	1 Month	-0.6% (Mar)
Halifax	House Price Index	Price agreed post mortgage survey approval stage	Halifax Bank of Scotland's lending data for UK	1 Month	-2.5% (Mar)
Land Registry	House Price Index	Agreed price at completion of sale	All registered property sales in England and Wales	2 Months	0.0% (Feb)
Rightmove	Survey of House Prices	Asking prices of properties as they come on to the market	Rightmove's member estate agents	1 Month	0.8% (Mar)
Hometrack	Survey of prices	Estimated average prices	Survey of approx 4,000 estate agents	1 Month	-0.2% (Mar)
RICS	Survey of confidence	Current opinions of market price activity	A sample of RICS members	2 Months	Decline (Feb)
DCLG	House Price Index	Agreed price at completion of sale	Lending information from survey of mortgage lenders	3 Months	1.7% (Jan)

Source: Nationwide, Halifax, Land Registry, Rightmove, Hometrack, RICS, DCLG

Region	Average Price (£)	Quarterly % Change	Annual % Change
North	132,349	-0.7	2.3
Yorkshire & Humberside	151,764	-0.9	0.2
North West	154,124	-2.3	-0.2
East Midlands	153,066	-0.8	0.3
West Midlands	160,715	-2.5	0.2
East Anglia	179,868	-1.4	1.8
Outer South East	211,119	-0.8	3.3
Outer Metropolitan	253,880	-1.4	3.6
London	296,772	-1.5	5.6
South West	196,711	-2.5	0.3
Wales	151,499	-1.8	1.0
Scotland	149,834	-0.1	6.3
Northern Ireland	196,892	-10.0	-3.4
UK	179,363	-1.7	2.2

Source: Nationwide

CBRE HAMPTONS INTERNATIONAL

To purchase the full report, please contact:

JENNET SIEBRITS

Head of Residential Research
Jennet.siebrits@cbre.com

CB Richard Ellis
 St. Martin's Court
 10 Paternoster Row
 London EC4M 7HP

Tel: 020 7182 2000
 Fax: 020 7182 2001

NICK JOPLING

Executive Director
nick.jopling@cbre.com

CB Richard Ellis
 Kingsley House
 Wimpole Street
 London W1G 0RE

Tel: 020 7182 2000
 Fax: 020 7182 2001

MARK ANDERSON

Managing Director
andersonm@hamptons-int.com

Hamptons International
 32 Grosvenor Square
 Mayfair
 London W1k 2HJ

Tel: 020 7758 8488
 Fax: 020 7758 8442

DISCLAIMER 2008 CB Richard Ellis

Information herein has been obtained from sources believed reliable. While we do not doubt its accuracy, we have not verified it and make no guarantee, warranty or representation about it. It is your responsibility to independently confirm its accuracy and completeness. Any projections, opinions, assumptions or estimates used are for example only and do not represent the current or future performance of the market. This information is designed exclusively for use by CB Richard Ellis clients, and cannot be reproduced without prior written permission of CB Richard Ellis.

EMEA Offices

- Abu Dhabi (971) 0 2674 3399
- Aix-en-Provence (33) 442 60 01 31
- Amsterdam (31) 20 626 2691
- Amsterdam B&O Partners BV (31) 20 676 4676
- Athens Danos & Associates (30) 210 756 7567
- Barcelona (34) 93 444 7700
- Belfast (44) 28 9043 8555
- Berlin (49) 30 72 61 54 0
- Birmingham (44) 121 609 7666
- Bratislava (421) 259 110 181
- Bristol (44) 117 943 5757
- Brussels (32) 2 643 3333
- Bucharest (40) 21 312 7000
- Budapest (36) 1 374 3040
- Bulawayo (263) 9 630 20
- Cape Town Broll Property Group (21) 419 7373
- Casablanca (212) 229 584 92
- Copenhagen CB Richard Ellis Cederholm (45) 70 22 96 01
- Dubai (971) 4 362 0818
- Dublin (353) 1 618 5500
- Durban Broll Property Group (27) 31 277 2900
- Edinburgh (44) 131 469 7666
- Frankfurt (49) 69 17 00 77 0
- Gaborone (267) 3188 200
- Geneva CB Richard Ellis PI Performance (41) 22 322 80 60
- Glasgow (44) 141 204 7666
- Gothenburg (46)31 761 8750
- Hamburg (49) 40 80 80 20 0
- Harare (263) 4 707 1018
- Hoofddorp (31) 23 565 7700
- Istanbul CB Richard Ellis LS (90) 212 259 36 29
- Jersey (44) 1534 874141
- Johannesburg Broll Property Group (27) 11 441 4229
- Kampala (256) 41 345165
- Leeds (44) 113 233 7666
- Lisbon (351) 21 311 4400
- Liverpool (44) 151 227 4611
- London (44) 20 7182 2000
- Lyon (33) 472 83 48 48
- Madrid (34) 91 598 1900 (34) 91 678 2078
- Malaga (34) 95 207 0710
- Manchester (44) 161 455 7666
- Marbella (34) 95 276 5130
- Marseille (33) 496 11 46 11
- Milan (39) 02 303 7771 (39) 02 655 6701
- Moscow Noble Gibbons (7) 501 258 3990
- Munich (49) 89 2420 600
- Nairobi (254) 20 248 106
- Neuilly sur Seine (33) 1 46 24 53 46
- Oslo Atrium AS (47) 40 00 57 66
- Palma de Mallorca (34) 97 145 6768
- Paris (33) 1 5364 0000
- Port Elizabeth CB Richard Ellis Broll Property Group (27) 41 363 5559
- Prague (420) 224 814 060
- Pretoria Broll Property Group (27) 12 431 7180
- Rome (39) 06 4523 8501 (39) 06 4544 1550
- Sofia Elta Consult AD (359) 2 987 7647
- Southampton (44) 23 8033 8811
- Stockholm (46) 8 4101 8700
- Tel Aviv M.A.N. Properties Real Estate (972) 3 561 6161
- The Hague (31) 70 750 8900
- Thessaloniki Danos & Associates (30) 2310 244 962
- Valencia (34) 96 316 2890
- Vienna (43) 1 533 4080
- Warsaw (48) 22 653 7000
- Zagreb (385) 1 487 8600
- Zurich CB Richard Ellis PI Performance (41) 1 226 30 00