

UK Residential Property Market

Q2 2008

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“The MPC is between a rock and a hard place; despite falling house prices and a weakening economy, inflationary pressures are strong, which rather precludes a rate cut any time soon.”

Jennet Siebrits, Head of Residential Research

MARKET OVERVIEW

Activity in the housing market is slowing sharply as the credit crunch continues to hamper demand. This has led to house prices falling; so far there have been eight consecutive months of declining house prices with a total fall of 7.3%.

The combination of falling house prices and a weakening economy has led to confidence falling to an 18 year low.

Repossessions are yet to increase significantly. Communication between lenders and borrowers is essential to prevent repossessions spiralling as redundancies begin to increase.

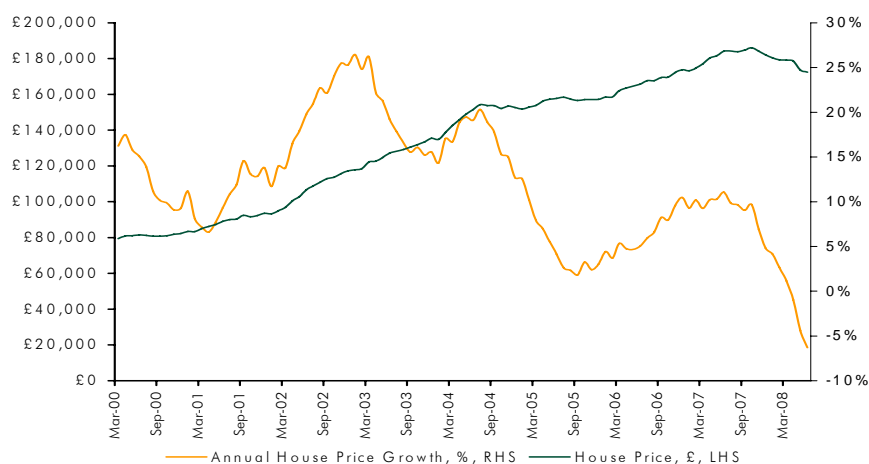
The similarities between now and the early 1990s mean house price growth is likely to follow a similar trajectory. But, there remain fundamental economic differences, which should prevent the downturn reaching the depths seen in the 90s crash.

We would expect house prices to fall by around 10% this year with further, but less significant, falls in 2009. We then expect a period of flat growth with the market picking up post 2010.

There are a number of options available to the government to stabilise the situation. For example, the re-introduction of income support for mortgage payments for home owners could weaken the link between repossessions and redundancies.

House builders are being squeezed at both ends of the development process; we expect housing starts to fall to lows not seen since 1980.

RESIDENTIAL PROPERTY PRICE GROWTH



Source: Nationwide

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The housing market has weakened further...

Activity in the housing market has continued to weaken over the last quarter. Mortgage approvals fell to 42,000 in May; a year on year fall of 64%.

Similarly, the National Association of Estate Agents (NAEA) reports a 28% fall in the number of registered buyers. With stock failing to sell, there has been a 35% increase in the number of properties on agents' books. This has created a shift in the buyer and seller imbalance with conditions now favoring buyers. However, buyers remain hampered by the ongoing effects of the credit crunch.

The credit crunch has yet to unwind

The availability of credit to households has worsened over the last quarter and mortgage finance is becoming increasingly expensive, despite the 50 basis point fall in the base rate this year. For example, the difference between the average Standard Variable Rate (SVR) and the base rate in April was 139 basis points; a year ago it was only 84 basis points. This is due to the historically wide spread between the LIBOR and the base rate, which reflects the continued uncertainty among banks.

And house prices are falling.

This has led to widespread price falls. So far there have been eight consecutive months of declining house prices; with a total fall of 7.3%. So far this year prices have fallen by 5.6%.

The difference between asking prices and sales price has increased. This implies sellers are not yet pricing realistically and buyers are able to drive a bargain. According to the NAEA, the difference between asking and sales prices for first time buyers is now 5.1%.

But, Scotland is lagging behind

All the regions in England, Wales and Ireland are now recording year on year house price falls. The largest falls have been seen in Northern Ireland and Wales with falls of 18.6% and 7.6% respectively. The worst performers in England are in the North and East Midlands. London, despite very strong growth in 2007, is now more in line with broader national trends and recorded a 2.3% annual fall in house prices at the end of this quarter.

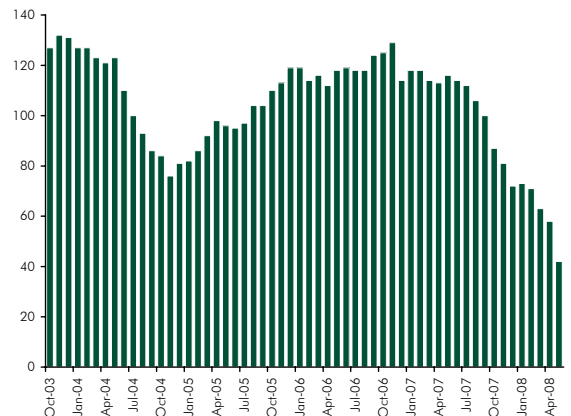
Only Scotland is recording positive growth, albeit just 0.6%. This is largely because affordability in Scotland is more favourable than in other regions and so the correction could be less marked. However, the region has seen quarter on quarter house price falls for the last two quarters, so we expect negative annual growth next quarter.

The economy is weakening...

There is a symbiotic relationship between the economy and housing market with weakness in one driving a weakness in the other. As Chart 5 shows, past economic and housing market recessions have closely mirrored one another.

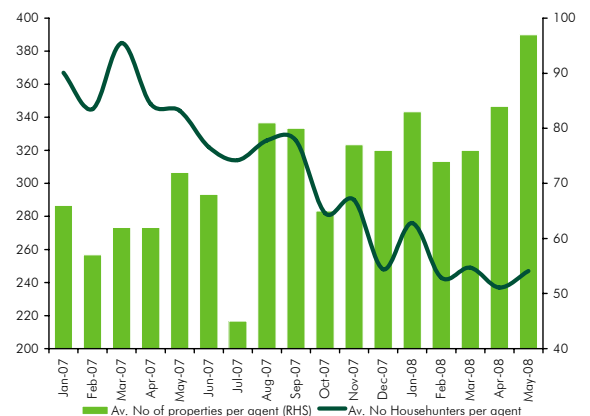
The effects of the credit crunch and property market weakness are now feeding through to the wider economy. Even the retail sector, which until now has performed well, is beginning to suffer. There have been profit warnings from retail outlets, such as Marks and Spencers and John Lewis,

CHART 1: MORTGAGE APPROVALS



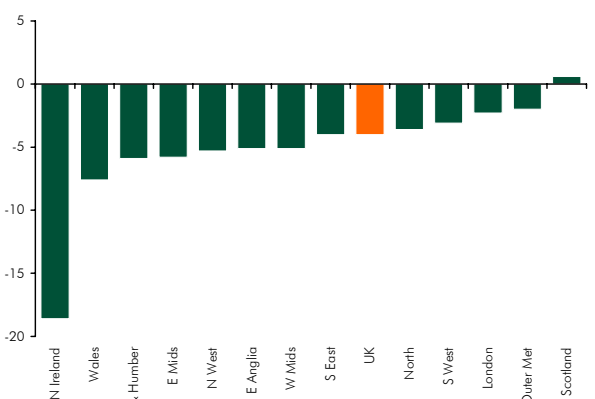
Source: CML

CHART 2: DEMAND AND SUPPLY IMBALANCE



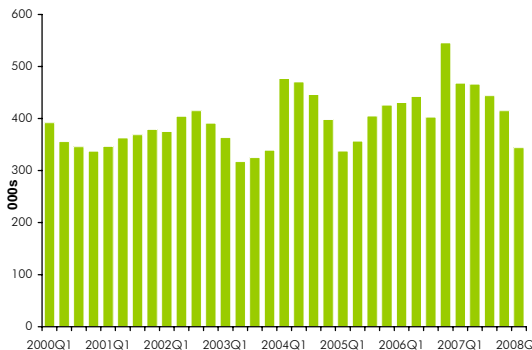
Source: National Association for Estate Agents

CHART 3: REGIONAL HOUSE PRICE GROWTH (PER ANNUM)



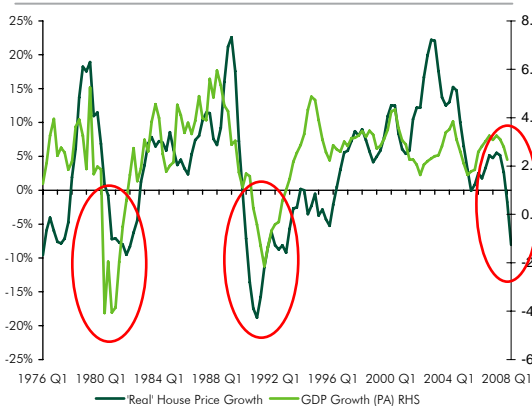
Source: Nationwide

CHART 4: TRANSACTIONS



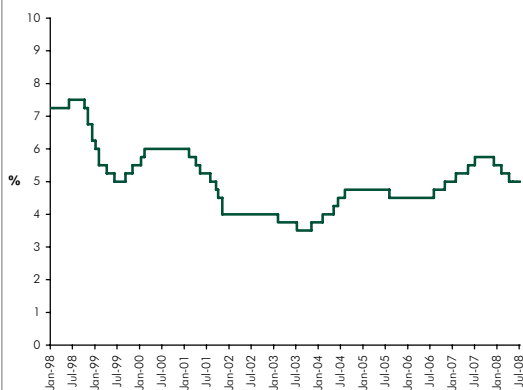
Source: CML

CHART 5: REAL HOUSE PRICES AND GDP



Source: Nationwide, Ecowin

CHART 6: BASE RATE



Source: Bank of England

which have led to the British Chamber of Commerce (BCC) suggesting a technical recession is on the way. We expect a mild and concentrated recessionary period at the end of this year and continuing weakness through 2009.

Inflationary pressures are strong

The Consumer Price Index (CPI) rose to 3.8% in June, but it feels much higher for many people with food and petrol prices rising by 6.9% and 17% respectively (year on year).

However, despite strong inflationary pressures the Monetary Policy Committee (MPC) is between a rock and a hard place; falling house prices and a weakening economy rather precludes a rate cut any time soon.

Confidence is at an 18 year low

The combination of housing market weakness, economic downturn and general bad news stories has fed through to consumers. Confidence is at an 18 year low. This in turn is affecting consumers' financial decision making. For example, housing equity withdrawal has declined by 64% in the year to March 2008. Until recently this form of borrowing has been quite popular; its decline reflects not only changing consumer sentiment but also fears of negative equity.

So are we really entering a 90s style crash?

There are certainly strong similarities between the current conditions and those seen in the early 1990s; see Table 1. In particular, house prices are clearly overvalued. We estimate they are somewhere around 15% to 20% above fair value; the IMF suggest it could be as much as 30%. Similarly, as seen in the 90s, demand has dried up very quickly and mortgage approvals have fallen sharply.

However, there remain fundamental economic differences. The economy (relatively speaking) is in much better shape. For example, there is not the economic pressures of the Exchange Rate Mechanism (ERM), which caused spiralling interest rates. And, despite the current strong inflationary pressures, the RPI is unlikely to reach the 1990s peak of 11%. The labour market remains buoyant; employment figures in the three months to April 2008 were the highest on record. This could protect against forced sellers and prevent a downward spiral. However, the labour market is weakening with redundancies expected.

What will the future hold?

All things considered house prices are likely to follow a similar trajectory to the early 90s. Although, the falls are unlikely to be as large and protracted as the 1990s as the economy is not as weak.

The largest falls will be in this first year of the downturn; we expect house price falls of at least 10% in 2008. In the subsequent year there will be consistent and continual falls in house prices. However, these will be more modest. We would expect to see house price falls levelling off in 2010. Transactions are likely to fall to around 750,000 this year and remain at this level until the market picks up.

One of the worst manifestations of the 90s crash was negative equity and the extent of repossessions. In this downturn, we are unlikely to experience these symptoms to such a degree. This is mainly because fewer home owners bought at the peak of the market, with only a relative few taking out high loan to value loans.

Repossessions are increasing...

The number of repossessions has continued to worsen this quarter but not as dramatically as one might expect. The Essential Information Group reported that the number of lots offered at auction rose by only 3.6% in the period March – May compared with a year earlier. Most auctioneers believe that the bulk of this new stock are repossessed properties.

And redundancies and repossessions go hand in hand

We would expect repossessions and forced sales to pick up in line with redundancies. There are increasing signs that redundancies are on the up. The unemployment rate is rising and reached 5.3% in the three months to April 2008 (from 5.2% in the previous three months) with the financial and construction industries being the worst hit. For example, there were over 4,200 redundancies in the construction industry in one week.

CBRE forecasts 24,000 job losses in central London in the FBS sector over 2008 and 2009. This is significant, but to put it into context over 48,000 jobs were lost in this sector in the two years after the dot com bubble burst. The CML are forecasting that there will be 45,000 repossessions in 2008; a 66% increase on 2007. However, we have not yet seen mass redundancies across the wider UK economy. Only this would create an environment which would facilitate such a spike in repossessions as seen in the early 1990s; see Chart 8.

But, repossessions shouldn't reach the dismal heights of the 90s

People will usually do all they can to cover their mortgage costs and prevent their property from being repossessed. Many develop coping strategies so that they do not have to lose their homes. This can include cutting back on overall spending, relying on credit cards and taking mortgage payment holidays. And of course some households will sell their homes to clear debts before repossession is necessary. The key to surviving the rising mortgage payments, is communication between the lenders and the borrowers. Treating Customers Fairly (part of FSA regime) compels lenders to repossess properties as a last resort. Arrangements can often be made to help borrowers ride the storm, such as only paying the interest or even a payment holiday.

But, the downturn will continue to drive down house-building

Due to the problems of financing schemes and the risk associated with the end values, residential developers are increasingly reluctant to build. We are becoming even less optimistic about the number of starts this year. Anecdotal evidence suggests starts could be as low as 100,000 in 2008.

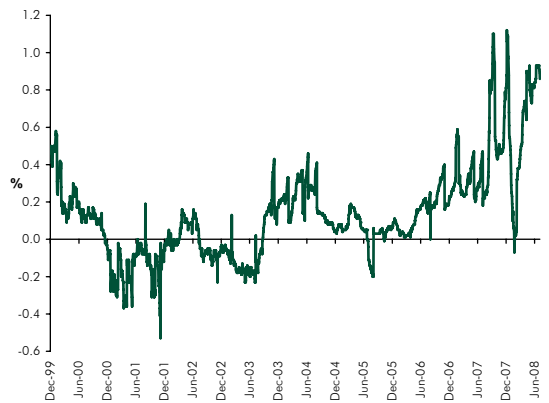
This is the lowest number of housing starts since 1980, 40% down on the number of starts in 2007. We do not expect to see a pick up until at least 2010. This affects both the private and affordable housing market and has serious implications for the government's annual target of 240,000 starts pa.

Government intervention could help to stabilise the market

Alongside the Government's housebuilding targets, there are also a number of reasons why they would want to stabilise the housing market, not least the need to improve their re-election prospects.

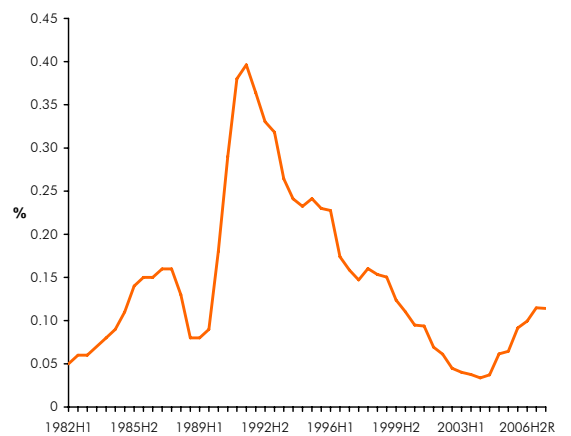


CHART 7: DIFFERENCE BETWEEN THE BASE RATE AND LIBOR



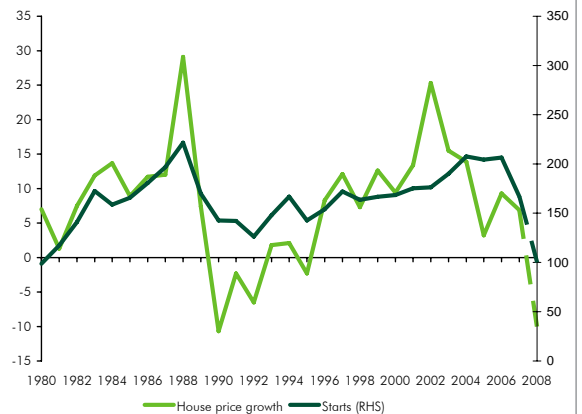
Source: Bank of England; HM Treasury

CHART 8: REPOSSESSIONS (AS % OF ALL LOANS)



Source: CML

CHART 9: HOUSING STARTS AND HOUSE PRICE GROWTH



Source: DCLG; Nationwide; CB Richard Ellis

CHART 9: THE RATIO OF APPLICANTS PER INSTRUCTION



Source: Hamptons International

There are a number of options available to the Government to both stabilise the housing market and aid the economy. For example, a Stamp Duty holiday would lower the costs of buying a house and removing Home Information Packs could entice purchasers back into the market. In addition, the Government could lessen the implications of the downturn by protecting households against repossession. Several options have been mooted by the Government including a publicly funded 'rent-back' scheme, similar to the mortgage-to-rent scheme used in Scotland. This would involve a public body, such as a social landlord or a Housing Association, buying homes that are at risk of repossession and enabling the owner to continue living there as a tenant. However, this will raise a number of difficult questions that the Government will need to address, including the implications of the right-to-buy scheme going forward.

A simpler idea would be to re-introduce income support for mortgage interest payments for homeowners who are made redundant. Currently only those in rental accommodation qualify for housing benefit, which seems to contradict the Government's policy to encourage home ownership.

The Housing Minister's recent announcement of measures to support delivery of affordable housing through the credit crunch will provide a small degree support to housebuilders. These measures include providing funds to the Housing Corporation to buy up unsold stock from developers. However, housebuilders need far more help and we wait with anticipation to see what the full package of measures promised by the Government will include.

The rent-to-buy scheme has also been announced which aims to help first time buyers get on to the property ladder. The scheme allows households earning £60,000 or less to rent at 80% or less of the going rate for two or three years so that they can save up for a deposit. There are concerns that this measure does not go far enough and for the scheme to have any serious impact on the housing market it should be open to all first time buyers.

There will be signs when the market is bottoming out

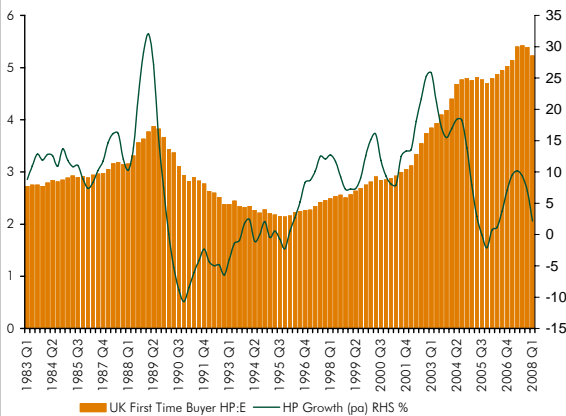
Exactly when the market will bottom out is nearly impossible to accurately predict. But, there are various early warning signs to look out for.

A clear sign will be a pick up in investment activity as funds with large amounts of equity look to capitalise on the falls in values. Many investors across the world are sitting on large amounts of equity, waiting for what they view as reasonably low prices. This form of "Vulture Company" is very common in the commercial market where the funds look to buy stock at the bottom of the market cycle. In the residential market these funds tend to look more towards buying up the development companies and their land banks.

It would be no surprise if land values lead the recovery in the housing market. Land values have led the falls in house prices and have arguably over corrected. Reports suggest that land values have fallen by as much as 30% over the last six months.

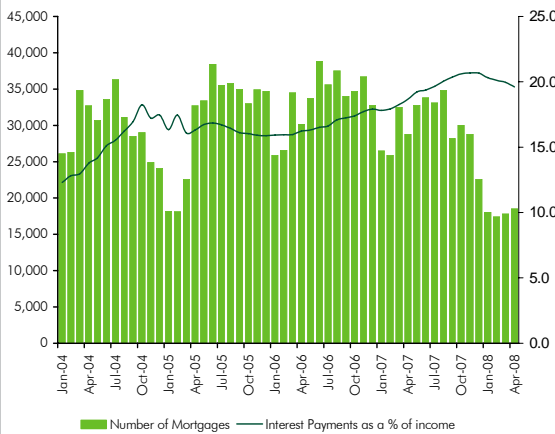
The lag between the buying of land and the completed end product will act as an advantage to developers. Therefore, as confidence returns to the market and risk decreases we would expect developers to reduce their margin requirements. As a result, we will see land values stabilising or even increasing.

CHART 10: FIRST TIME BUYER HOUSE PRICE TO EARNINGS RATIO



Source: CML

CHART 11: FIRST TIME BUYER MORTGAGE AFFORDABILITY



Source: CML

TABLE 1: EARLY 1990S VS CURRENT MARKET CONDITIONS

Variable	Early 1990s	Current
General		
Interest Rates	The BoE interest rate peaked in the 1990s at 14% as a result of entry into ERM.	Interest rates set by MPC; currently 5%.
Inflation	RPI – Peaked in 1990 at 10.9%.	RPI 4.6% in June 2008. Above target and expected to remain so.
UK GDP	The economy contracted and GDP fell by 1.4% in 1991.	GDP Q1 growth below trend at 0.4%. sharp slowdown expected, growth 1.5% in 2008 and 1.3% in 2009.
London GDP	GDP fell by -4.4% in the early 1980s (1980 and 1982) and -3.4% in 1991.	Slowdown in FBS to dampen London economy, London expected to under perform over at least the next 2 years.
Unemployment	Peaked at 10.4 % in 1993.	Recently rose to 5.3% and forecast to rise further.
House Prices		
House Price Growth	Between 1989 and 1992 house prices fell by 18.5% across the UK and 31% in London.	House prices have fallen over recent months; annual growth is now negative at 6.3%.
Mortgage Approvals	Peaked in 1988 and fell by 65% over the following two years.	The interest rate rises of 2006/07 and the credit crunch resulted in approvals falling dramatically. May saw approvals fall by 64% yoy to 48,000.
Property Transactions	Peaked in 1988 and fell by 35% the following year.	The market is thinning but the peaks and troughs of the late 1980s and early 1990s are not as distinct.
Repossessions	Peaked in 1991 at 0.77% (as a % of all loans).	Risen recently but remain historically low. Reached 0.1% in 2007.
Equity Release	Not a large factor in the boom and subsequent crash in the 1980s but became more prevalent in the late 1990s. As house prices have increased rapidly over the last five years. This has been a major driver behind consumer spending.	Stabilisation and the threat of declining house prices have reduced the equity release market. Continued uncertainty in house prices and the more restricted mortgage lending with the removal of 100% mortgages and requirement for 25% to 50% equity for the most attractive interest rates will reduce this form of credit further.
Lending to Individuals	Unsecured lending reduced in the early 1990s as interest rates peaked and consumer confidence fell.	Lending criteria tightening for unsecured borrowing and credit cards. Lending growth reduced. Increasing interest rates despite BoE base rate cuts.

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