

The Residential Property Focus

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The Residential Property Focus

A combination of positive and negative factors means that our generally optimistic view of the housing market in 2008 remain in place at this stage

The second issue of our new look Residential Property Focus comes at a critical time for the future of house prices. The slowing market is set against a backdrop of reduced prospects for future economic growth, but also that following two interest rate cuts, affordability will ease.

This publication examines the true extent of the slowdown, not only in house price growth but also in market activity levels. It then goes on to look at prospects for 2008.

We have paid particular attention to the market for new homes, where developers face challenging times. Prime property also comes under scrutiny as lower City bonuses and new legislation for the taxation of so called non-doms have taken the froth off the markets.

Our analysis of 'super suburbs' and the trend towards modern suburban mansions shows the underlying demand for ultra prime property remains strong.

This issue also contains the results of our recent buy to let survey. This suggests that the sector will be far more robust than the prophets of doom would like us to believe.

Amongst all the uncertainty regarding house prices, the Government has issued a consultation paper for a localised development levy. If it works it could address the anti development culture and speed up the planning process. The risk is that it will be seen as the bureaucratic catalyst for falling land values - despite the fact that prices are already falling.



Limited risk of market collapse



For the next 6 months



Changing buy to let profile ahead



Uneven market conditions expected



20% fall in turnover in 2008

Residential property markets	4th Quarter Growth	Annual Growth 2007	2008 Forecast
UK Mainstream	-0.1%	6.9%	3.0%
Prime Central London	-2.0%	16.3%	5.0%
Prime Regional	-0.2%	8.7%	4.5%

Source: Savills Research and Nationwide

Taking Stock

Mainstream Market

The tentacles of the slowdown, previously confined to the North, have now spread across the UK. Low affordability has been compounded by the effect of the credit crunch as readily available, cheap money becomes more difficult to come by.

The reality of a slowdown in the housing market has been brought sharply into focus over the past three months. Reduced house price growth has turned to small falls, according to indices published by both the Nationwide and the Halifax. In London, where values had slowed for most of the year, the market cooled significantly in the last quarter.

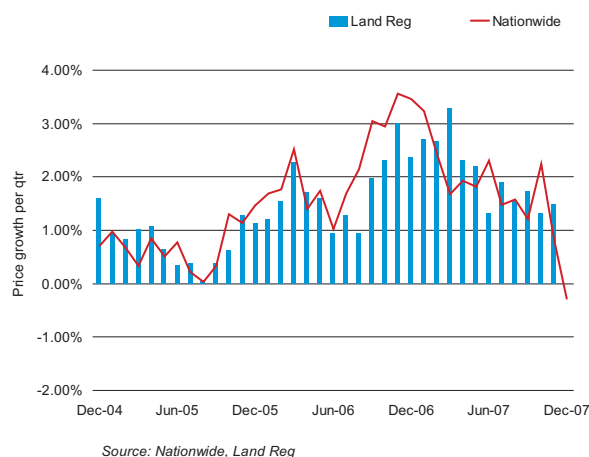
Prime markets also felt the chill. Although much more insulated against interest rate rises than their mainstream counterparts, they succumbed to reduced confidence amongst City buyers facing prospects of lower bonuses.

“The market is not in freefall. Prices in the fourth quarter hovered around zero”

All of this has been music to the ears of both residential property doom-mongers (who have dusted down and polished up their “end of the world is nigh” sandwich boards) and headline writers alike.

When we released our 3% forecast for growth in average national house prices in 2008, we also cautioned against those predicting significant falls in value, given the prospect that affordability issues would ease. This assumed that predicted cuts in base rates would materialise and that credit markets would ease.

National house price growth (q/q)



As the graph above demonstrates, house price growth was brought to an abrupt halt at the end of 2007. Annual growth (which was running at 10.2% at the

middle of the year) was brought back to 6.9% by the year end, according to the Nationwide index. The market is not in freefall. Prices in the fourth quarter showed continued quarterly growth or small quarterly falls depending upon whether or not figures are seasonally adjusted.

“Significantly lower transaction volumes appear inevitable”

In most regions, the first slowing of prices in early 2007 was precipitated by interest rate rises and a corresponding squeeze on affordability. Until October, the effect was generally far less evident in London and the South than in the Midlands and the North. A more widespread slowdown in the final quarter resulted from a combination of additional factors.

Quarterly growth across the UK



The impact of the credit crunch became clearer in the latter part of 2007 and certainly much more visible, after the run on Northern Rock. A tightening of lending criteria directly effected some buyers and is expected to continue tempering the demand of first time buyers and buy to let investors, who are more reliant on mortgage finance.

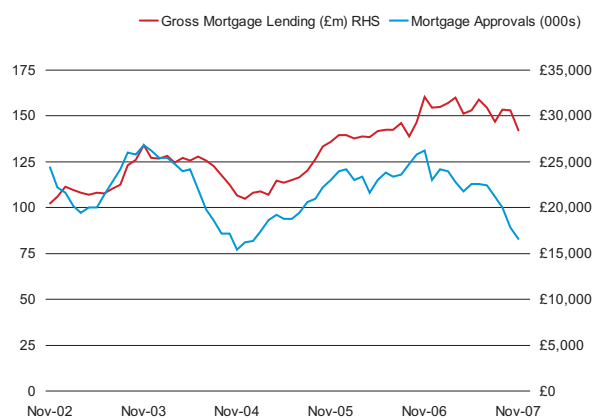
Caution has now spread noticeably more widely across the market. An erosion of confidence has been compounded by frenzied press speculation over whether a recession-led market correction is on the horizon. Irrespective of the likelihood of this occurring, many who were considering moving house are now choosing to stay put. It seems inevitable that the number of housing transactions will fall, possibly quite dramatically, under these circumstances. We are anticipating a 25% fall in transaction volumes.

Taking Stock

Mainstream (continued)

So, caution amongst both lenders and potential buyers has impacted on market activity. This is reflected in mortgage approval numbers declining significantly.

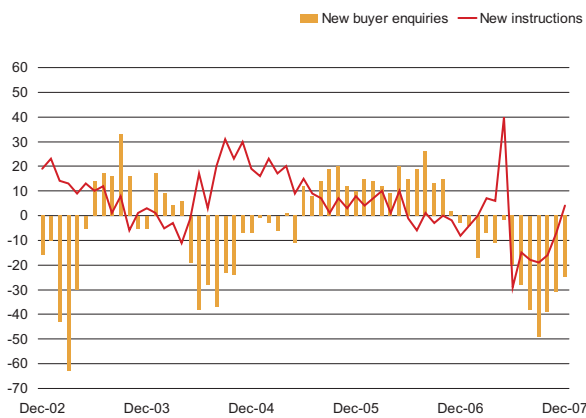
Mortgage Lending



Source: Bank of England

The climate of low market activity (in contrast to a flood of properties coming to the market) is also reflected in the latest result of the RICS housing market survey. Agents who witnessed reduced instructions compared to the same time last year outnumbered those who saw an increase. This has been the case for six out of the last seven months.

Market Activity



Source: RICS

Reduced market confidence is also reflected in the downturn in enquiry levels shown by the same survey, most notably in Wales and the Midlands.

The decline in turnover has had a particularly dramatic effect on the development sector. In this market, there is a geographically tighter and narrower range of product than in the wider second hand markets. Here, localised over-supply and reliance on particular groups of buyers can be a problem (see box below).

“Lower turnover in new build sales has already resulted in reduced building activity and ‘mothballed sites’”

New Homes

Reduced rates of sale are already a feature of the new homes market. In December 2007, 62% of developers witnessed a reduction in net reservations compared to the same time in 2006, according to the Homebuilders Federation. Seventy three per cent saw a fall in site visitors. New build flat prices have already significantly underperformed the wider market and increased use of sale incentives further reinforces this.

Demand from both buy to let landlords and those entering the market for the first time has been hit hardest by the credit crunch. Lenders have applied tighter lending criteria to these two types of buyer in particular, as they put a much greater focus on affordability and credit risk. Consequently it is demand for new homes which is hit hardest by the

change in market conditions.

On the supply side, new build flat development has increased dramatically since the millenium under the Government’s drive to increase housing numbers and, where possible, concentrate development on high density urban and brownfield sites. These sites rely on high housing densities to be commercially viable.

“Lenders have applied tighter lending criteria to buy to let landlords and first time buyers”

The challenge for developers in coming years will be to diversify their product away from their traditional markets, whilst maintaining high densities, and to offer a significantly superior product both in terms of design and place quality.

Changing Times

Economic Backdrop

The performance of UK house prices and the wider economy remain inextricably linked. Surplus income and buyer confidence fuel house price growth. Both are dependant upon continued growth in the economy, corresponding growth in household earnings and manageable costs of borrowing.

The fundamental economic assumptions behind our positive house price forecasts for 2008 were that:

- *There would be continued growth in the economy.* Our forecasts were prepared at a time when economic growth was close to 3.1%, but forecast to fall to between 2.2 - 2.3% by the end of 2008. At the time of writing, latest forecasts for GDP growth in 2008 have reduced to 1.8%. In isolation, the reduction in economic growth expectations have a negative impact on house price growth prospects.
- *Bank base rates would fall to 5.5% by the end of 2008.* Despite continued inflationary pressure (most notably given food and oil prices), base rates were reduced in December 2007 and again in February 2008 to 5.25%. This will help to improve affordability thereby counterbalancing the weaker prospects for economic growth.
- *There would not be significant falls in employment levels.* Forecasts are for job losses in the City, which have increased in the last quarter, but across the economy as a whole employment levels remain stable.
- *The credit squeeze would gradually ease,* ensuring

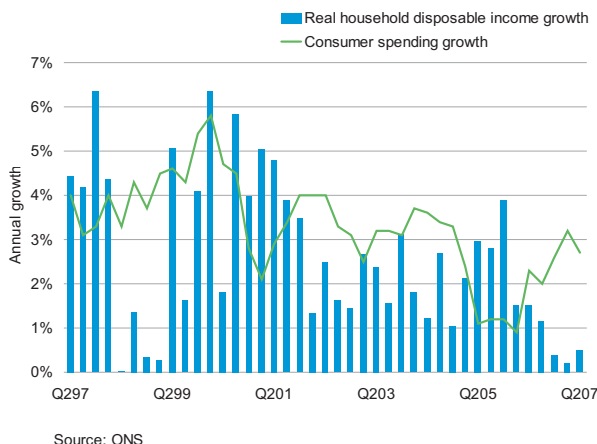
Limited risk of collapse?

Even in the event of further deterioration of economic conditions, causing slower earnings growth, we do not foresee very large falls in house prices. Our view is that even in these circumstances (barring a wholesale recession) prices would fall by no more than 5% over a 12 month period, much less than the 13% fall seen in the early 1990s. There are three key reasons for this.

- **Interest rates have not doubled.** At the end of 1989, interest rates were, far higher than now at 15%. They had doubled from their previous low of 7.5%. This had an immediate and drastic impact on affordability. This time it's different, base rates have already fallen back to 5.25% having peaked at 5.75% last year, up from their recent low of 4.25%.

more freely accessible mortgage finance albeit in the confines of reasonable lending criteria. Of all our key assumptions, this remains the greatest unknown.

Real incomes and consumer spending



“The combination of positive and negative factors means that our generally optimistic view of prospects for the housing market in 2008 remain”

We still expect UK mainstream house price growth of about 3% in 2008, but recognise the likelihood of small price falls in some areas over the short term before confidence and affordability are re-established. We fully expect market activity to be very subdued for the next six months, in a period characterised by largely static prices nationwide.

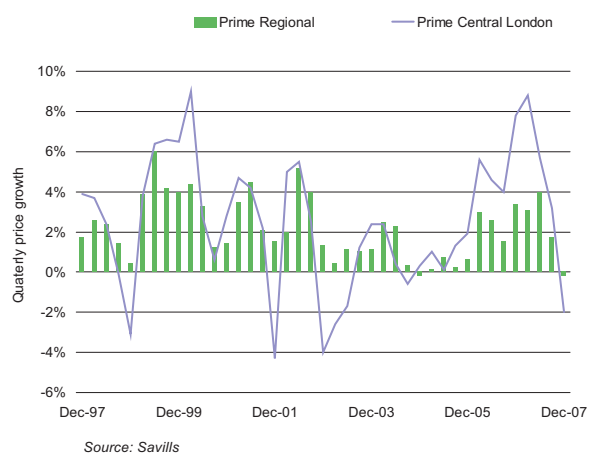
- **There is no house price bubble.** House price growth has already slowed. At the end of 1988, average house prices in the UK were growing at an unsustainable 32.9% a year. In 2007, growth peaked in June at a more modest 10.9%. In the three years to the end of 1989 house prices, on average, grew at nearly twice the rate than witnessed in the past three years.
- **Household finances are still positive.** Net household incomes still exceed basic expenditure (including housing costs) by about 6%. This is in sharp contrast with the third quarter of 1988, when average UK household finances were already in deficit by 10%. This deficit rose as the recession of the early 1990s progressed and reached more than 30% of annual household incomes by the end of 1989. There are no signs of this being repeated this year.

Top End

Prime Property

The prime residential markets showed remarkable performance in the first three quarters of 2007. They were relatively insulated from the affordability issues which dogged the mainstream markets but this all began to change in October. The markets had to contend with the global credit crises and, as a consequence, reduced demand from City buyers who were harbouring reduced bonus expectations.

Prime London market is more volatile



In prime central London, the effect was felt most acutely. A 20% - 25% fall in the number of buyers from the financial services sector in the last quarter caused the froth to come off the market leading to a 2% fall in values. That said, annual growth was at 16.2% by the year end. This fall came as little surprise to us. It is similar in extent and effect to previous falls following



shocks to the financial sector.

“The very top end of the markets have performed best”

The much less volatile prime regional and country house markets were less affected. Values effectively stood still in the last quarter due to a much quieter market. The headline figure of a -0.2% movement in values during this period owed something to a continued growth in the prime Scottish market, which has a tendency to lag London by up to a year or, occasionally, buck downward trends completely. In the South East, values fell by -0.5%, still much less than in prime central London.

In both London and the regions, the very top end of the prime markets performed best. Values of properties above £5 million in London grew by 2.4% in the quarter and 30% in the year. Outside of London property above £4 million showed growth of 1.6% and 14.3% in the last quarter and for the year respectively.

Demand in this sector comes from a broad range of high net worth individuals and is consequently less reliant on City money. In the last big downturn of 1989, the super prime market continued to be active until 1991 so it may well continue to ignore the gloom prevalent further down the property ladder. Constrained supply might also be expected to support markets, resulting in further, but reduced, growth in 2008.

Prime central London growth is expected to occur mostly in the second half of the year, if the global credit crisis eases and confidence is restored. Reduced City bonuses will temper demand in the £1 to £3 million brackets.



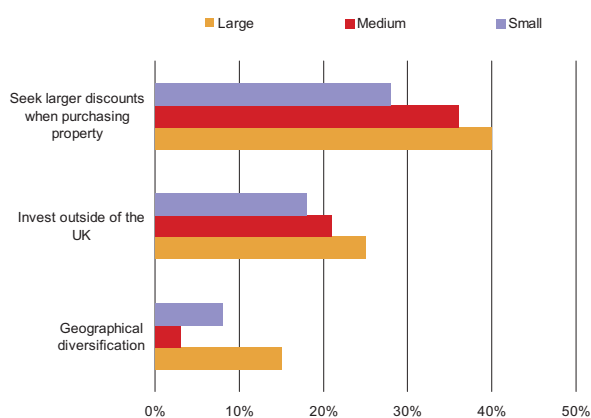
Investment

Buy to let

The acquisition of residential investment property has grown rapidly since the introduction of tailored buy to let mortgages in the late 1990s. By the year to the end of June 2007, net additional annual lending to buy to let investors had reached some £23.9 billion.

The future of buy to let has become increasingly uncertain given the pressure on income yields, increased costs of borrowing and a slowdown in the sales market. Our recent buy to let survey indicates that we are set for a period of consolidation and a slowdown in the growth of this sector, but no exodus.

Limited likelihood of disposal



Source: Savills Buy to Let Survey

The survey, of just under 400 buy to let investors owning 2,782 properties with an approximate portfolio value of in excess of £600 million, identified four key reasons why it is unlikely that there will be a significant withdrawal from the sector:

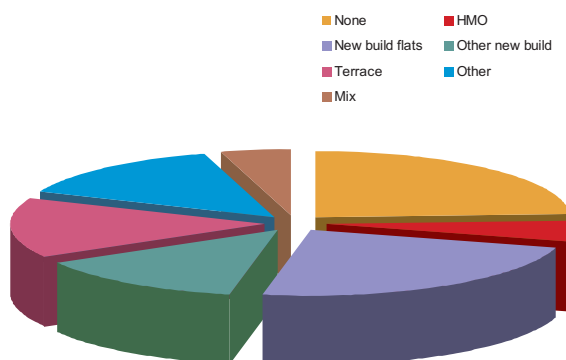
- The vast majority of owners view their investment as long term, with 55% of owners looking to retain their portfolio for at least 10 years and 71% relying on their investment to provide part of their pension.
- There is a dominance of large investors with an equity cushion – 70% of landlords owning at least 20 properties have more than 25% equity in their property holding.
- The majority of owners are able to meet existing borrowing costs out of rental income.
- Only 10% of owners would currently consider an outright sale even in the event of further pressure on returns.

The survey found that two-thirds of all buy to let investors are still looking to increase the size of their portfolio. Where owners hold at least 20 properties, the proportion looking to expand increases to 84%. This reflects the fact that these owners have accumulated more equity in their property and are best placed to take advantage of prospective rental growth and future interest rate cuts.

Nonetheless, future investment is more likely to be less aggressive and more discerning as investors focus more closely on properties which maximise potential returns.

This is likely to mean a shift away from new build flats where returns are under the greatest pressure. While 55% of investors own new build flats within their portfolio, only 24% of respondents would look to expand their portfolio by acquiring this property type. This is, no doubt, a reflection of oversupplied flat markets in some locations.

Future investment plans (by investor)



Source: Savills Buy to Let Survey

“Only a handful of buy to let investors are considering investment into niche markets such as student housing”

It also seems that we shall see a greater diversification in future - 42% of owners of large portfolios are looking to acquire a mix of housing types to spread their investment risk. Currently, only a handful of buy to let investors are considering investment into niche markets such as student housing (in the form of houses for multiple occupation). Overseas investment on the other hand is preferred by the majority. This is representative of a wider trend towards cross border investment and the growth of the so called “fly to let” market.

Developing markets

Taxing times

The Government's latest attempt to devise a development levy came a step closer to reality with the publication of a consultation report in January.

The Community Infrastructure Levy is designed to provide a standard charge fixed at local authority level. A key aim is to introduce a system which provides developers with greater certainty as to their financial contributions and, as far as possible, replaces the need for protracted s106 planning obligation negotiations.

There will be no uniform system of charging nor will adoption of the levy be mandatory. Each authority will therefore have discretion to introduce the levy or not and also to determine whether, it is charged as a sum per dwelling, so-called 'roof tax' or on a per sq metre of development basis, for example.

This raises the prospect of allowing for geographical variations across the market. Whether the charge will have a significant impact on development output and on land values will depend upon how it is implemented at a local level.

The consultation report makes clear that if the levy is

set too high it will cause some development to become unviable. It also recognises that, even as a simplified system, it will need to have regard to the uplift in value resulting from different forms of development.

Indications from the consultation report are that the levy will seek to fund a wide range of infrastructure needs wherever there is a "reasonable prospect of provision". Infrastructure for which funding will be sought will go beyond transport to include social and environmental items such as schools and parks, as well as sub-regional requirements such as hospitals and waste facilities. It will not do away with site specific matters such as social housing which will continue to be dealt with through planning obligations.

This risks adding yet another layer of costs to development at a time when housing delivery is most challenged. Its biggest impact is likely to be on smaller developments, which planning obligations have been less effective in targeting before now.

Setting the levy will require assessments of the likely level of future development and both the level and cost of corresponding infrastructure requirements. Again, this adds another layer of bureaucracy to an already process-laden planning system. The coincidence of other new processes such as stakeholder consultation design codes and review processes will add to the risk.

Focus on the East Midlands

The cities of Derby, Leicester and Nottingham provide a useful insight into the issues currently facing developers.

In the area encompassing these three cities the number of homes built on greenfield land have declined significantly since 2000 with a corresponding shift towards new flat developments in existing urban areas. Such developments increased their share of all new developments from 5% to 41% between 2000 and 2006.

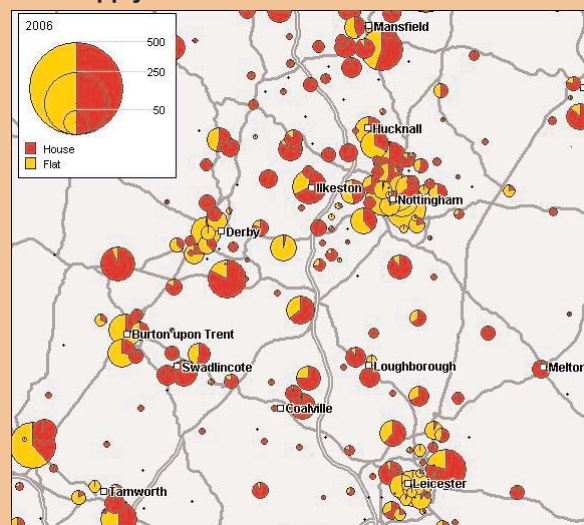
The shift from houses to flats has met the demand from young singles and childless couples of working age, however it means that scarcity exists in the family housing market. This has been compounded by the fact that just under half of all households in the area are empty nesters or retired. These occupiers are often reluctant to downsize and leave the family home which contributes to a log-jam in the family housing market.

This has caused a noticeable divergence in rates of price growth between housing types. Over the past five years, new build flat prices in the area have increased by an average of 3% per annum, whilst house values recorded average annual growth of 11%.

It also means that, in a slowing market, rates of sale of flats which are in abundance are adversely affected. In practical terms whilst some families maybe happy to occupy larger flats, the development of houses will be necessary if developers are to maintain sales rates.

It also means that there are opportunities to provide properties which meet the requirement of downsizers who are then able to release their family homes to a hungry market.

New supply in 2006

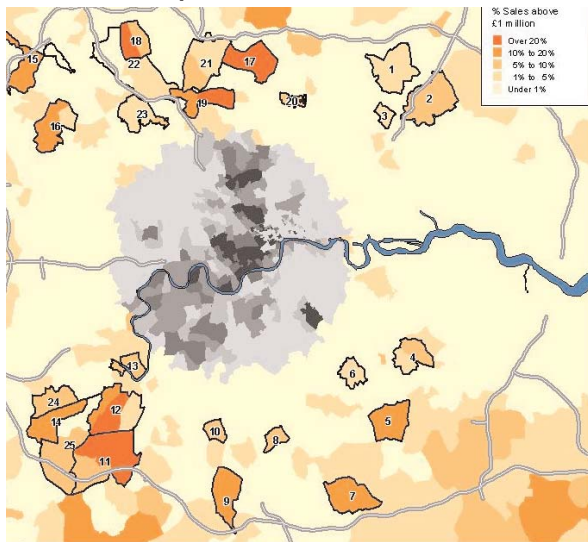


Superbia

London's super suburbs

Although prime London is readily associated with the central areas such as Kensington and Knightsbridge and the inner south west suburbs including Fulham, the desirability of suburban life and the post war encroachment of suburbia across previously distinct settlements, has created the prime suburb.

Suburban Hotspots



Our research shows that the top 25 prime London suburbs can be subdivided into five main areas.

- A south west cluster around Esher, Weybridge, St Georges Hill and Cobham – the outer part of the “wealth corridor” running from Fulham to Guildford.
- Hotspots of high quality housing in the suburban heartland of south London such as South Cheam together with larger urban fringe areas including Kingswood.
- Three identifiable areas in north west Kent perhaps best described as urban fringe surrounded by “green



wedges”. These include Pratts Bottom and affluent suburban areas either side of Bromley.

- A cluster to the North East on the Essex borders comprising Chigwell, High Beach / Loughton and the more built up hotspot of Woodford Green.
- A further cluster in the North / North East including areas such as Loudwater, Northwood, Radlett and Totteridge and hotspots in the more built up suburbs including Winchmore Hill.

Whilst the prime suburbs would once have been the domain of middle management, the purchaser profile in these areas indicates that high ranking executives now account for 50% of all buyers.

Yet these suburbs often comprise a high proportion of aesthetically challenged dwellings dating from the 1960s and 1970s. Some 8.5% of buyers of prime suburban property acquire with an intention to redevelop the property. In the most affluent suburbs the figure is much higher.

For example, in the year to the end of June 2007, 31 out of 49 applications to “super size” an existing suburban house (through demolition and rebuild) in Oxshott and Stoke D’Abernon were granted consent. This accounted for 21% of all planning applications.

On average, successful applications resulted in a planning permission for a house just under 2.5 times the size of the original (an average increase of 145%). Typically this would mean demolishing an already fairly large four-bedroom detached house of around 3,300 sq ft (set within grounds of 2/3rds of an acre) and replacing it with a 8,500 sq ft six / seven bedroom mansion.

As a result, a £1 - £1.5 million house could be redeveloped to produce a £3 - £3.5 million mansion. If all planning consents are implemented the value of the housing stock in Oxshott / Stoke D’Abernon would be increased by some £60 million in one year alone.



Housing Research and Consultancy

Savills Research team is headquartered in London and provides advice and analysis to clients on the rural, residential, commercial and leisure property sectors in the UK and Europe. Savills also provide similar property research services throughout South East Asia and Australia. In the UK, Savills has had a dedicated residential research team for the past 18 years. Over this time, the department has built up a strong reputation for producing accurate, well informed and, above all else, independent analysis and commentary on the UK's housing market. As a result, the team are a leading national commentator on market trends.

The success of the department has been built on a strong 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. It enables us to provide you with analysis, commentary and forecasting that adds value to both your assets and your businesses. The department has been involved in a wide range of consultancy projects for a variety of public and private sector organisations across the UK. This has involved research into housing of all tenures and across all price ranges and rental levels.

Typical consultancy projects include:

- local area supply and demand analysis
- development feasibility studies
- investment strategy and advice
- place making site studies
- forecasting rents and capital values
- research to inform policy making and best practice statements
- research for property finance and business planning purposes
- research to inform housing-led regeneration initiatives

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A unique combination of sector knowledge and entrepreneurial flair give clients access to real estate expertise of the highest calibre. We are regarded as an innovative-thinking organisation backed up with excellent negotiating skills. Savills chooses to focus on a defined set of clients, therefore offering a premium service to organisations with whom we share a common goal. Savills takes a long-term view to real estate and works hard to invest in long term and strategic relationships and is synonymous with a high quality service offering and a premium brand

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This Publication

This document was published on 20th February 2008. It contains a review of all the key housing market indicators and news to the end of the fourth quarter 2007. The data used in the charts and tables is the latest available at the time of publication. Sources are set out for all the charts. We have used a standard set of notes and abbreviations throughout the document. The most commonly used are:

- Q407 refers to the fourth quarter of 2007
- H207 refers to the second half of 2007
- LHS and RHS refer to which data series in a chart is on the left hand scale (LHS) and right hand scale (RHS)

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