SPOTLIGHT
RESIDENTIAL PROPERTY

Coutts

OPPORTUNITY KNOCKS ON THE DOOR OF UK RESIDENTIAL PROPERTY

Policymakers have clearly targeted the log-jam in the UK residential property market with a series of new initiatives this year, which we think will be a catalyst for house prices to rise. In this document we look at how these policies should drive residential property prices higher in the short term. We focus on the longer-term outlook, opportunities and pitfalls of investing in the UK residential rental market and set out the key factors every potential landlord should understand before investing.

Key opportunities and risks

- House prices could rise by 8% per annum
- Already-high prices depend on cheap funding for more gains
- Population growing four times as fast as housing stock
- High deposits keep would-be first-time buyers renting
- Growing number of renting households supports market
- Rental income is capped by affordability; vulnerable to economic weakness
- Low rates exacerbate investment traps

OUR VIEW

Government plans to make mortgages cheaper and more accessible will support the housing market …

We believe that UK house prices are now set to rise after a couple of years where gains were focused in London and most other regions experienced declines. Recent government measures to make new mortgages cheaper and more accessible will support the housing market and the UK economy is forecast to improve. However, the key caveat is that prices would be rising from an already-expensive level, and advances would only be driven by the continuing availability of ultra-cheap finance.

…though UK house prices are above most estimates of long-term fair value

It is generally agreed that UK residential property stands at more than fair value by most measures. Our preferred approach is to look at the relationship between nominal gross domestic product (GDP), which is the total value of income produced in the economy including inflation, and the price of houses. House prices have broadly kept track with the growth of nominal GDP over the past 60 years, and have reverted back to trend following both booms and busts. By this measure house prices have been above average since 2002 and are currently 9% above their average value against nominal GDP.

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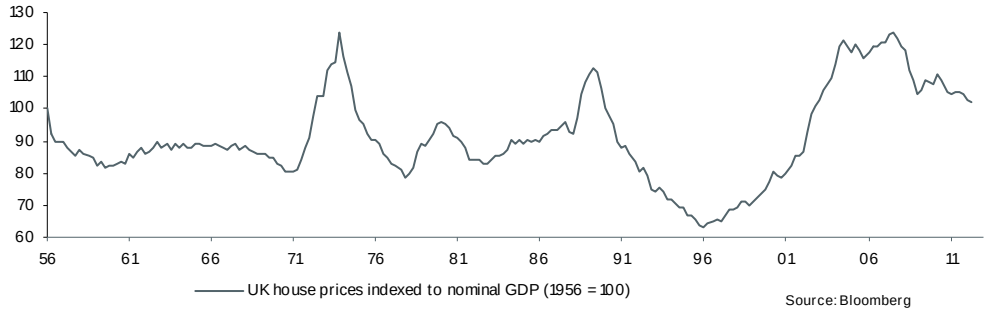
UK property prices remain above long-term value

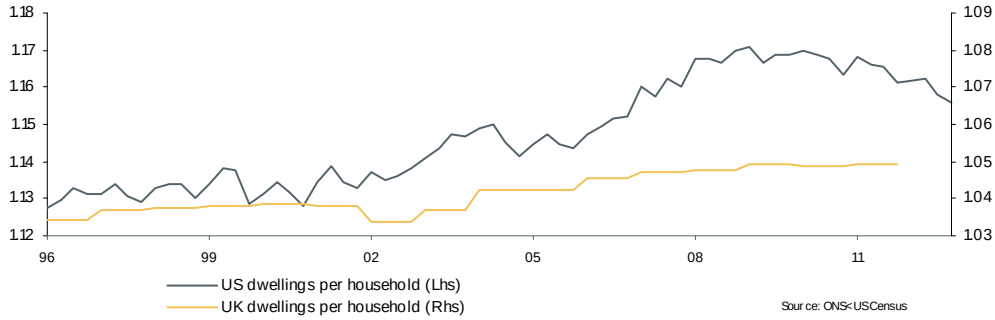


Scarce supply in the UK increases the resilience of house prices

So how has the UK housing market sustained such 'overvalued' levels and proved so resilient through the global financial crisis compared to other countries and asset markets? One important factor is the scarcity of dwellings in the UK relative to households, compared to other countries. What's more, this availability didn't increase significantly during the preceding boom.

In the US, the stock of new dwellings outstripped the increase in households by 4% during the house-building boom in the decade since 2000. In contrast, the increase in the UK was less than half that and started from a much lower base. While dwellings outnumber households in the UK, the surplus is in the wrong places, with a shortage in London and the south-east. This constraint on availability has helped UK rents hold up and continue to rise throughout the period.

UK housing supply remains tight, and in the wrong places



Nonetheless, being above average has not stopped UK house prices from rising further. A key factor is affordability, which has improved as interest rates have fallen to record lows. But despite the low cost of borrowing, the problem of raising the required deposit to obtain these affordable mortgages has proved a barrier for many, especially first-time, buyers.

Government to unblock log-jam in mortgage market

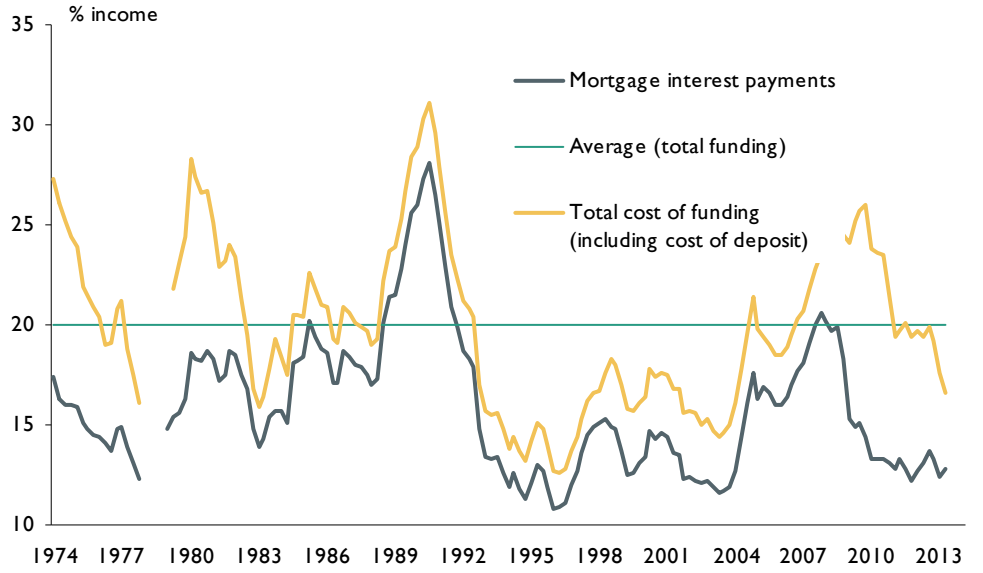
Our measure of affordability has fallen to its best level for nine years

This issue has been targeted by the Government's new Help to Buy scheme, which provides loans or guarantees for first-time buyers with a 5% deposit. The Coutts measure of affordability, which takes into account the total cost of purchasing a house by incorporating an inferred cost for the deposit, has fallen to its best level for nine years.

The expansion of the Bank of England's (BoE's) Funding for Lending Scheme will also increase the supply of cheap finance to the UK residential property sector. So-called "buy-to-let" mortgages will qualify for a bonus whereby lenders can receive funding at 0.25% from the BoE for up to 10 times the amount of new loans made.

As a consequence of these measures, the cost of mortgages to buy houses will be back to very affordable levels that have historically been associated with house prices rises of around 8% per annum. However, this is likely to require a further improvement in consumer confidence. But provided the economy continues to improve, as we forecast, we expect many people currently renting will look to buy, supporting prices.

UK house costs as percentage of first-time buyers' income



Source: Coutts, CML

That said, given the fundamental shortage of housing in the UK, the increased affordability of buying property isn't likely to materially impact the attractiveness of the longer-term investment case for UK residential property. However, it does shift the focus of returns from yield to capital appreciation and brings forward the likely returns.

THE UK RESIDENTIAL RENTAL MARKET

Investment in UK residential property, as opposed to owning a home, means entering the rental market. Returns can comprise both rental income and capital gains.

UK residential market will be worth £70bn in 2016, with nearly six million households renting

With interest rates remaining low, UK landlords acquired more than 70,000 houses in 2012 – the highest number since the "credit crunch" began in 2007. The higher yields in regional markets are proving attractive to investors, whereas the 4-6% gross yields in the south-east reflect greater competition for assets and the historically better prospects for longer-term capital growth.

The number of private rented households across the UK rose by 1.15m between 2007 and 2011. Research by property service provider Savills estimates that another 1.1m households will have joined the private rented sector by 2016, swelling the total to just under six million households. Assuming an average annual growth in rents, Savills estimates that this will lift rent paid within the private rented sector from £48bn in 2011 to £70bn five years later.

Market positives

Government policy initiatives worth £5bn are likely to shift returns, with a positive outlook for capital gains

We think the outlook remains attractive for the rented property market and hence residential investment, with positive drivers for both capital gains and income:

1) Capital: new measures to uncap demand and hence capital growth

The new Government measures are likely to unblock pent-up demand from tenants looking to buy their homes. This will increase demand for housing and house prices. As a consequence, we believe that returns from residential investment are likely to be driven by capital gains in the short term.

2) Income: demographics to drive residential rents

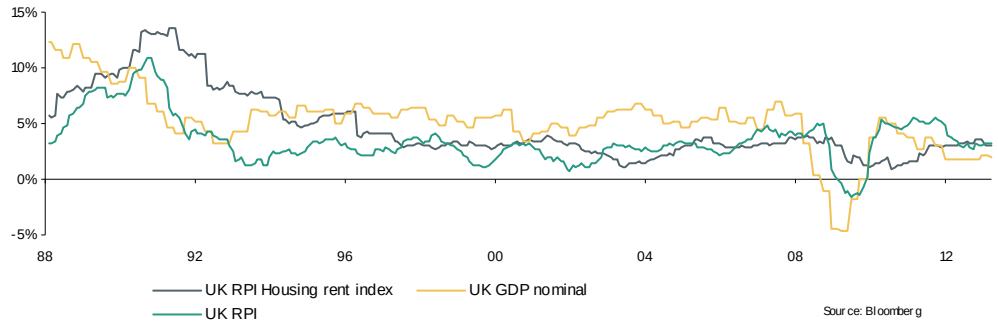
According to the Office for National Statistics' latest (2011) census, the population is increasing at four times the rate of new households, exacerbating the housing shortage. The undersupply of property is greatest in the south-east and major towns and cities.

Longer-term growth is dependent on rising rents driven by tight supply and ever-increasing demand

The 2011 census showed further demographic factors are driving housing demand, with 20-34 year-olds becoming increasingly concentrated in urban areas. Combined with a lack of house building, particularly at the cheaper end of the urban market, this is creating an imbalance between supply and demand.

The dramatic rise in the number of households joining the private rental sector is creating a need for both private and institutional investment. In response, the Government is providing help to stimulate investment in build-to-let.

Rents are keeping pace with inflation, but vulnerable to economic weakness



House prices remain high and rents will be capped by earnings growth and ultimately the economy

Market risks

UK houses are pricey, at 9% above their long-term average. Prime property in London is particularly expensive, which pushes down yields (rental income/purchase price). Stamp duty can also go as high as 7% for properties valued at over £2m.

House prices will be boosted by £5bn of government initiatives. However, these are set to expire in three years. This leaves the housing market exposed to government policy as well as interest rates.

Rents are also vulnerable to economic weakness since they are capped by their affordability. This is closely linked to earnings growth, and ultimately economic activity. We expect growth to remain weak, although it may improve in the second half of 2013, at which time the eurozone is also expected to emerge from recession while global growth continues to improve. We see no interest rate rises until 2014 as the BoE supports the weak recovery with accommodative monetary policy, although any interest rate rises would also temper returns from residential investment.

RESIDENTIAL INVESTMENT TAX BREAKS

- Mortgage interest can be offset against rental income
- Loan does not need to be secured on let property to qualify for a deduction
- Running costs such as insurance, cleaning and commission to letting agents can be offset against tax
- Losses can also be offset against tax
- 10% can be deducted each year from net rental income on furnished accommodation

PITFALLS FOR LANDLORDS TO AVOID

While the income is attractive and there are reasonable prospects for longer-term capital gains, residential property is not without its traps. In many respects, these can be magnified by the low-interest-rate environment.

Most landlords own just one residential investment property

As a consequence of the cost, lack of liquidity and time invested in managing residential investments, over 99% of residential landlords own just one property.

This has an impact on both landlords and tenants. For landlords, their portfolio oscillates between rented and vacant, which reflects the inherent risks in a residential investment strategy. For tenants, they often have to deal with inexperienced landlords, who may not have access to reliable maintenance and management resources.

Record-low interest rates mustn't mask the risks to income

Don't let record-low interest rates lull you into a false sense of security

Residential investments currently look fairly affordable for those who can obtain a mortgage. Yields average 7% across the UK against interest-only mortgage costs of around 5%. To the inexperienced residential property investor, this may appear a good deal.

However, it only takes interest rates to rise, or the property to become vacant for a few weeks – delinquent tenants and rental void periods are not only costly but also time-consuming to deal with – for the calculations to go completely awry. This could have a material impact on the landlord's ability to service the debt on the property.

Landlords must factor in running costs when estimating returns

Beware the fundamental flaw in quoted figures

While gross yields are attractive, few landlords appreciate that their net yield will be on average 30-40% lower (representing around 2 percentage points off the gross yield) depending on geography and their level of management experience.

Running costs include:

- Letting and management fees
- Insurance
- Decoration every three years
- Void periods
- General maintenance
- Time

These can amount to a substantial proportion of the annual rental income, in particular for the vast majority of landlords who own just one property. Significantly, institutional investors in residential property report higher net returns than individual investors. They achieve this through diversification, purchasing power, management expertise and being able to absorb vacant periods.

Location, location, location is just as important for residential investment property

Understand the area in which you intend to buy

It will pay residential investors to understand the rental markets in which they intend to buy, for example to identify where there might be a fundamental increase in property values as a result of new infrastructure or the 'gentrification' of an area. This requires speaking to local agents to understand the nature of the demand in one area compared to another, and takes time. However, given the costs of entry and exit, the likely lengthy investment period and the inherent costs of getting it wrong, this is time well spent.

Savills points to differences in affordability levels and growth in the younger population as the causes of significant variations in regional rental growth. For example, while rents have risen by more than 20% in Manchester, Liverpool, Nottingham, Bristol and Milton Keynes, they have fallen in Warrington and Stockport. Even different areas of London show markedly contrasting rental growth. Hackney, Tower Hamlets and Newham have seen growth of over 50% whereas rents have fallen in Sutton, Richmond and Bromley.

In conclusion, the potential for short-term income and longer-term capital appreciation is a valid reason to explore investing in residential property. Understanding the nature of the local market is crucial to success, and in most cases investors can squeeze better returns from owning a portfolio of properties and gaining experience of property management.

TOP TIPS FOR RESIDENTIAL PROPERTY INVESTORS

- Your head must rule your heart when investing. Don't just pick homes that you want to live in. You are not the target market so keep in mind that you are looking for properties that are suitable for your prospective tenants.
- Identify your target tenants and ensure your property meets their needs; for example, one or two-bedroom flats near train stations for professionals, and shared larger houses close to a university or city centre for students.
- Remember the basics of investing in locations with high and diversified employment, good transport links and proximity to good schools, shops and other facilities.
- If you plan to employ a letting agent, likely because you are a novice investor, get them involved right from the start. They will be able to provide useful information on the tenant market and can guide your choice of property.
- Buy in winter when the market is illiquid, maximising the benefit of your position as a cash buyer to pick up properties more cheaply.
- New-build properties have a premium. But that premium will erode over your period of investment, so reducing your returns.
- Be wary of ground-floor or basement flats, which are not favoured by potential tenants because of concerns over security, greater noise and lack of sunlight.
- Don't overpay. If you are outbid because somebody else has fallen in love with their ideal home, walk away.
- Prime locations, such as central London, hold their value best during market downturns.
- Don't waste money on furnishings. Most tenants have a budget and won't pay extra for better furnishings, and an expensive stained rug will need to be replaced just like a cheap one. If tenants want a refit, that cost should be considered alongside a review of the rent.
- Your mortgage is generally the biggest single monthly cost. Look carefully at rates and flexibility, remembering to factor vacancies into rental income and the impact of higher interest rates so that your borrowing costs don't become unsustainable.
- Running costs eat into your profits and cash flow. You can mitigate these costs by utilising your own skills and time or by spreading costs across a portfolio of properties.
- Draw up a profit and loss statement for your property investment venture. This will help ensure you don't overpay for the property and help you keep on top of other costs.