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inspired property investment

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Looking back to see what lies ahead.

Is the UK housing market heading for another boom and bust? After a 5 year stagnation, the broader UK property market has leapt back to life and with prices having risen by around 9.5% in the year to the end of March (17% in Greater London) all the talk is about bubbles as we head in to the busiest time of the year. These growth figures compare to a mere 0.8% rise in the previous year to March 2013. As ever, the reporting and the stats hide a myriad of variances and performance across the country. If one excludes London and the South East the average increase reduces to a relatively modest 4.7%.

The Government's help to buy scheme has been blamed by many for fanning the flames of an overheated property market, yet 85% of these loans are outside of London and the South East where prices have only just started to rise above their high point of 2007. Help to buy was intended to assist those with very little equity get a foot on the property ladder. In many cases this has worked but it has also allowed the relatively cash rich to borrow more.

The reaction to one year of robust growth verges on the hysterical. House price to earnings ratios have remained at an historical high throughout the downturn. However, thanks to the low interest rate era which started back in the early 2000's, house price affordability has changed significantly due to the lowest mortgage rates seen in generations. Having then gone through a mortgage drought which started back in 2007 , the situation has changed noticeably in the past 18 months or so with lenders opening their doors wider and offering rates of interest that reflect their true cost of funds.

All is starting to change as new measures have been introduced to curtail mortgage lending (the MMR rules) to ensure borrowers do not over extend. Essentially these rules require the borrower to disclose their existing financial commitments (car loans, pension contributions, school fees etc.) in order for the lender to assess their ability to service the mortgage…..sort of what we had to do 25 years ago when asking our bank manager for a mortgage! The current discussions are all about how to introduce stricter lending criteria as concerns rise on the impact from anticipated base rate rises in the near future. Historically lending was based on multiples of earnings but this was then seemingly replaced by a simple loan to value assessment. Added to this was the risky introduction of interest only loans. This is now being addressed and just this week Lloyds announced that they were introducing a tighter criteria on mortgage applicants with others expected to follow.

Under supply remains the fundamental issue.

As usual the problem is being tackled back to front. Ensuring borrowers do not over extend is all well and good but focusing simply on the demand side ignores the fundamental problem which is the lack of supply. The UK needs around 250,000 new homes to be built each year and the figure has averaged closer to half this over the past two decades. New supply hit a peak of 220,000 in 2007 but quickly slipped back to 100,000 in 2008 and 70,000 in 2009. House builders naturally saw little or no opportunity in recession hit Britain in the aftermath of the GFC and so the deficit has grown dramatically. However, in the past 3 years the Prime London property market kicked off a construction boom that has seen a vast number of new schemes getting underway in and around central London. Even so, with 16,800 new homes started in 2013, this was still well under half the Mayor's stated target of 42,000. In central London a sizeable proportion of the new supply is high end property that is clearly targeted at overseas investor demand. With success of off plan sales to overseas buyers, house builders now have the confidence (and cashflow) to build further out to meet the need of domestic buyers. Stifling the demand from this target audience is hardly going to encourage them to build.

Clearly there are big risks ahead, rising interest rates being the most obvious. QE has softened this recession and protected many home owners from a severe property crash. Many relatively new home owners will never have experienced the impact of sharp rate rises. If you were born in the 1950's/1960's you will know what a hard recession really means and will probably have experience of 15% mortgage rates. You may know of people who have lost homes or been forced to downsize and take children out of private school. If, on the other hand, you were born after 1980 you probably remember 3% base rates as being rather high and have witnessed everyone you know make a mint simply by being lucky enough to own a property.

The Government introduced help to buy to kick start a moribund housing market. They are now appearing to introduce a phase of 'Restrict to borrow'. Meanwhile despite all the rhetoric, new housing starts are just 31% up on last year. Its all a bit confused to say the least.

Prime London has led the charge but its headwinds are totally different.

The prime London market has led an extraordinary boom in high value properties servicing a seemingly insatiable overseas demand. Thanks in part to the politicians 'tax the foreigners' rhetoric and the measures introduced since March 2012, the established and recognised prime areas are taking a breather. Transaction levels are down and the very top end (£10m +) is significantly quieter than last year. Press reports of an overheated UK housing market have helped dampen demand as well. I suspect we might be entering another plateau (last experienced in 2001 to 2004) when buyer appetite subsides but seller's expectations remain relatively constant leading to a drop off in transactions. This tends to be the pattern for Prime London with sharp rises followed by periods of flat lining. Even going back as far as the late 1980s and early 1990's the genuine prime areas showed this pattern with little downward movement in nominal values apart from the 5-10% froth that quickly evaporates when a rising market stalls.

In contrast to the broad UK picture, certain parts of the prime London market now face a potential oversupply. Prime Central London used to be determined by area. Initially this was recognised as the boroughs of Westminster and Kensington & Chelsea. This then expanded to encompass the likes of Wandsworth, Islington and Canary Wharf. In recent years it has become more price driven and thus properties of a value in excess of £1,500psf are deemed as prime, this now includes parts of Battersea, Vauxhall, Southwark, Clerkenwell and Shoreditch.

We remain very wary of vast schemes such as Battersea and Nine Elms. The image below is an updated artist's impression of all the new schemes in the pipeline between Battersea power station (the dark square at the top) to Vauxhall Bridge on the left. Around 16,000 new homes are planned for completion between now and 2020. This is some five times the number of apartments developed as part of the Olympic legacy at Stratford. Bearing in mind the most recent phase of 257 apartments at Battersea power station, which were all snapped up, had prices starting at £800,000 for a studio flat, the question that should be foremost in the minds of investors is, who can possibly afford to rent these?

Bubble or Squeak?

The backdrop to the current housing market is an impressive economic recovery coupled with increasingly positive sentiment nationwide that follows a very positive overseas view on London. It remains to be seen how the politicians and the Bank of England manages the year(s) ahead. With an election in May of next year, this Government won't want to damage the feel good factor that rising house prices bring. Commentators are totally divided in their views on whether we are entering a genuine bubble phase. Central London is recognised as being fully priced on any measure, but all the talk about pricing out local buyers ignores the relative availability of affordable housing stock in up and coming areas East of the city.

The black cloud on the horizon is the threat of rising interest rates, far less the fact that prices have risen 10% in one year. The ability of home owners and investors to manage their debt is fundamental and all previous downturns have revealed this. Prime London has proven time and again that its under reliance on debt has ultimately underpinned prices through all stages of a cycle.

Speculators are usually the first to be caught out and we believe there is evidence already of flippers finding it tough to sell on as buyers prefer to buy in to the next phase release in preference to a first phase flip. Many investors will feel content that their entry price was X and the next phases are being offered at X + 20-30%, however once the music stops and all the like minded buyers act as one, the reality can deal a bitter blow. We saw it so clearly in Docklands in the late 1980's and see similarities today. On that note I will end with my favourite quote of the month;

Crashes don't destroy wealth, they just reveal the wealth you thought you had never really existed.

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