UK Property Viewpoint

Summer 2010

To mark the start of the British summer, we turn to the pros and cons of investment in English country houses.

The category has seen steady growth in prices recently, with interesting trends on buyer appetite, domiciles and criteria. We report some of these, plus ways to protect investments, potential pitfalls and key considerations.

We remain somewhat cautious on the current state of the UK residential market and the nature of the recent recovery. The rebound has been largely confined to house prices - just one component of a healthy market – while overall market transaction levels remain depressed, 30% below the previous nadir. Few predict any quick return to long term averages of above a million annual house sales.

On these measures the recent recovery is perhaps less than it seems. We concur with Savills' view that transaction numbers are a better indicator for the health of the residential property market. These determine the ease with which homeowners can move, the pace at which they can work their way up the housing ladder and the frequency of the steps this requires.

Despite differences between mass market and country houses, all are ultimately, connected. A floundering mid-market is a weak foundation for out-performance by exclusive houses.

Current market dynamics could however improve potential for income growth, if the next decade of mortgage rationing, public sector cuts and austerity redefines the investment case for UK residential property. A lack of suitable alternatives may drive demand for rented accommodation; a cultural shift for those who see a home as an investment.

Domestic 'buy-to-let' investors may shortly be hit by changes to Stamp Duty and Capital Gains Tax, again shifting emphasis to higher rental yields. The latter may be achieved as occupier demand drives up rents, values fall, or most likely, by a combination of both.

An uncertain market could finally provide impetus for the emergence of the kind of dedicated, institutional investment in residential property, commonplace in markets outside the UK. That may require political moves including changes to UK Reit legislation, but a genuine shortage of housing stock could provide popular support for such moves. Property investment may return to its roots (and come into line with other developed markets), as investors seek income sufficient to pay down debt, rather than reliance on a one-way bet on capital value growth.

Finally, we look at two other perspectives on UK residential property. One is the increasing common reference to values on a per sq ft basis by investors and developers, to provide another view of the economic logic for any purchase and the value of UK property relative to other markets. The second has quirkier appeal, particularly for those who doubt the British government's commitment to protecting Sterling. This values UK house prices relative to gold and inevitably, reveals a less attractive investment return than that stated in nominal terms. It is worth considering if you believe the printing press/quantitative easing and inflation provides a more palatable political option than budget cuts.

Commercial Property

Any disruption caused by the election or indeed, the UK's economic issues hasn't derailed the commercial property recovery.

The second half of May saw the start of a strong results season, as the UK's leading commercial property companies reported better than expected uplifts in valuations of portfolios focused on the quality end of the market.

This was, perhaps inevitably, accompanied by warnings that the price of some prime UK property has reached unsustainable levels. This only shows how quickly things can turn. It may also mean that while there are reasons for optimism, this is still far from a 'normal' market.

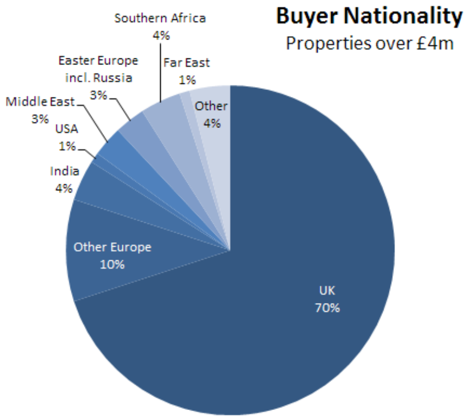
Country Houses

Trends from 2006-2009 show increasing appetite amongst overseas buyers

Q1 2010 Prime indices

	Q1 2010	Yr on Yr	% recovery	% from peak values
Capital values				
Prime Central London	3.0%	16.9%	16.9%	-10.1%
SW London	4.4%	26.6%	26.6%	-6.1%
Prime regional markets	2.0%	6.9%	6.9%	-13.7%
Rental values				
Prime Central London	2.8%	5.1%	5.2%	-7.1%
Prime SW London	4.4%	3.7%	7.9%	-11.8%
Yields				
Prime Central London	4.2%	2.7%		

Source: Savills



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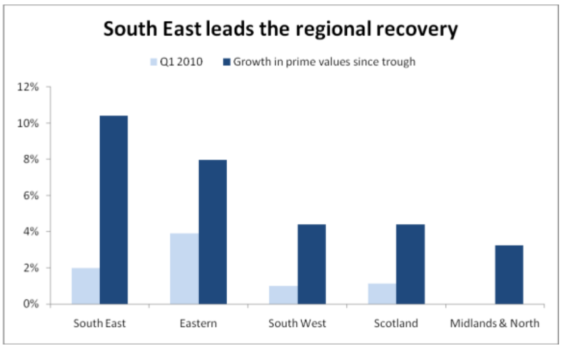

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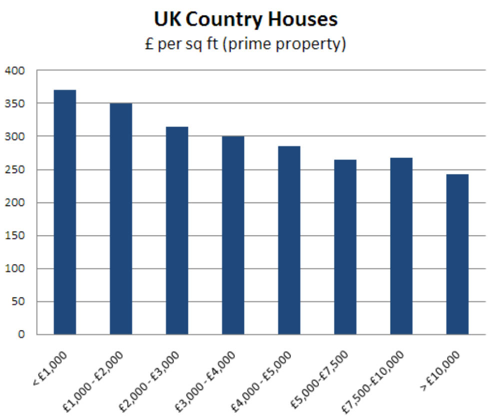


Source: Savills

The housing market is expected to have paused during the run up to a general election; the coalition's promised budget cuts and tax increases add another layer of uncertainty. In the pre-campaign Q1 2010 Savills and Knight Frank reported 2% growth in the value of UK country houses (prime regional markets in the table) due mainly to a shortage of quality houses for sale.

Knight Frank reported a 30% fall in country house instructions and a similar rise in sales in 2009. That squeezed a dwindling pool of really good houses. The niche's performance lagged prime Central London, but in the period since valuations bottomed out (H1 2009) the South East has seen a 10.4% recovery.

Relative underperformance reflects the fact that the market for premium provincial houses is less international than London, but that appears to be changing. The UK's capital city has attracted strong demand from overseas buyers since market prices and sterling weakened post the credit crunch - in 2009 Knight Frank sold London houses to buyers from 49 different nationalities. However it also sold country houses to buyers from 38 different countries, which reveals overseas appetite for the English countryside.

Savills has compiled figures for country house and prime residential markets for 2006-2009. These reveal interesting trends, especially for houses valued above £4m. During the period, non-UK buyers accounted for 31% of such properties - just 18% of sellers - but only 9-10% of properties below £4m. In all categories, suburban UK markets are most popular with international buyers.

The pie chart to the left shows a broad distribution of buyer nationalities for all houses above £4m. Strongest demand is from Europe and India has recently emerged as an important source of buyers. For all houses above £2m the south east - the Home Counties around London - account for 87% of all properties acquired by overseas buyers; 43% of which were in Surrey's suburbs. Regions further north fared less well; nothing above East Anglia and little interest in large estates in the north of England and Scotland.

Second home ownership is an emerging component of the market, at some 13% of all purchases (£2m-£4m) in the period. That category of buyers outnumbered sellers by 56%, rising to 90% in the £4m+ category.

Savills also records income sources in each category. This revealed shifts towards finance and business services (43% of all buyers over £2m), fewer property magnates, inherited or private wealth. The latter accounted for less than 3% of purchases in any category.

Investors may also consider that, on a per sq ft basis, there is a material decline in valuation as property sizes increase. Buyers of country houses seem less interested in substantial houses. This is the opposite of the case in London, where Savills reports a 'scale premium'.

This may mean that potential buyers of country houses perceive little additional amenity in a larger property, yet remain keenly aware of the additional costs of ownership, which we discuss on the next page. This is illustrated in the bottom chart; prime residential property of 1,000-2,000 sq ft is valued at above £350/sq ft, vs. £250/sq ft for properties above 10,000 sq ft.

Complex Investments

Attention to detail at the outset may be key to cost control and protect a property's long term investment value

The enjoyment and investment performance of a high-value house may be materially affected by decisions at the outset.

Expert advice is available for the management of large, high value country house properties, but consultants recommend clients undertake full due diligence ahead of acquisition, to help avoid issues associated with ownership of a complex investment.

Specialist consultants, such as Philip Eddell of Savills' Country House Consultancy help purchasers identify possible issues. He draws attention to challenges inherent in running a second property, especially with large staff complements.

He regards it as vital to establish controls at the outset to ensure that a large house is efficiently run. A purchaser will be aware of the expense associated with owning any 'grand residence', but unable to benchmark costs or fully appreciate the implications of decisions on a property's long term investment value. That is where an external consultant may be useful.

Mr Eddell reports instances of annual costs above a million pounds per annum, perhaps four times the appropriate figure, due mainly to a lack of experience and knowledge of the local market. This is particularly serious where a decision may erode the property's value. A consultant can benchmark running costs against similar properties within their portfolio.

Savills and others seek to assist buyers immediately post purchase. They can access expertise in areas such as project management, design, staff recruitment and implement financial controls, schedule regular visits and provide on-site support for all full-time staff.

Bureaucracy provides pitfalls for owners

It is understandable that many owners entrust existing staff with management of their new property, but this may not be best placed to navigate a raft of local laws and regulations.

Firstly, recruitment of a large staff complement makes it essential to comply with the relevant employment and Health & Safety rules.

Additionally, advice may often be sought after the event, when lease conditions or planning regulations – often particularly strict for older properties - have been breached. This can relate to quite modest improvements or navigation of the planning process, to obtain consent for extensions or modernisation. Owners should also seek opinion on how proposed alterations may affect values.

Newer properties, or those which have undergone extensive modernisation will often have complex mechanical and electrical - including entertainment – systems built into the fabric of the building. The purchase price will almost certainly include a premium for these amenities, so buyers must ensure that they are in full operating order, understand how they function and assess the need for ongoing maintenance and repair.

The need for regular visits and ongoing maintenance is particularly keen for second home owners who intend to use their properties for a few months each year, or arrive at short notice. A house that stands empty other than a skeleton staff, for up to nine months may not cope with the demands of a sudden family visit, including simultaneous use of all facilities, so all must be kept in working order. A long period of relative inactivity can also make it difficult to keep staff 'match fit'.

Professional management and administration of any substantial property will help protect the capital value and contain running costs. Consultants generally expect to produce a better result for less money.

A last point, often overlooked, is the need to administer complicated ownership structures. Consultants report offshore tax advantages are coming under increasing scrutiny, so it is important that these are administered correctly. 'Command and control' must be offshore and the client able to prove this. The value of expert advice may be as important from a financial and taxation, as well as pure property perspective.

House Prices

What do alternative measures of value say about the UK market?

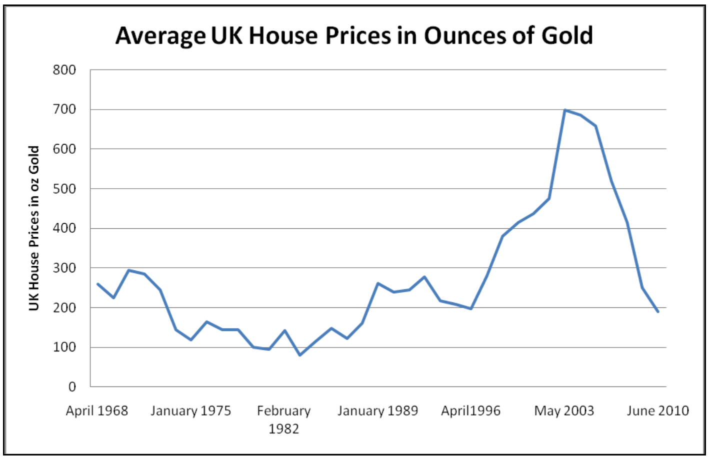
Sterling weakness may be a boon to overseas investors in UK property, but mainly if it is a temporary phenomenon. Economists' opinions are as divided as ever, but if as some predict, Western governments intend to resort to the printing press or colloquially, 'quantitative easing' to relieve their debt burdens, there are implications for future value of property investments.

Investors are becoming more discerning regarding assessment of intrinsic value. Although it has, to date, been relatively uncommon in the UK market, international residential markets typically quote prices on a per square metre basis. As the UK domestic market comes under scrutiny from foreign buyers, this approach appears to be gaining credibility.

A number of reports suggest that this yardstick is becoming more popular with potential buyers, mortgage valuers and developers seek to benchmark valuations and ascertain the viability of particular developments. The approach helps adjust for distortions caused by the make-up of a specific area's property stock.

Savills' figures reveals the disparity between the UK's most and least valuable locations, as well as a comparison of exclusive boroughs. For example, valuations in three London boroughs, Kensington & Chelsea, City of Westminster and the City of London are on average above £1,000 per sq ft, over four times that of boroughs at the other end of the scale. Outside of London that multiple falls to a less extreme two and half times.

These figures should help investors to distinguish between equity-rich and mortgage-dependent areas, regarded as a useful indicator of future house-price growth prospects.



Readers may also be interested in a second, more unusual test of the nominal, sterling value of UK residential property, referred to in a recent issue of MoneyWeek.

This analysis, carried out by mathematician, Professor Tom Fisher of University of Wurzburg, Germany, assesses the value of an average UK house in terms of its weight in gold. It paints a less flattering picture of the asset class's investment performance.

His figures illustrate that the average UK house currently costs just over 200 ounces of gold, similar to 1994, at the bottom of the last residential cycle and indeed, 1970. The price peaked at 700 oz; Prof. Fisher expects it to hit 50 oz.

Inevitably, this drew an animated response from readers, possibly strong believers in the merits of home ownership. The value attributed to this measure also depends upon whether you believe that the gold price is subject to its own bubble, or reflects a wider view of the readiness of sovereign governments to debase their currencies.

Whether that means houses are cheap now, or a poor long term investment, is open to interpretation. In sterling terms, an 'average' house – which itself requires some analysis - has increased from £4,874 in 1970, to £168,000 currently. That suggests that houses may at least provide a reasonable hedge against government inspired inflation.

About BLME

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