Research Bulletin

Summer 2005

This Research Bulletin contains our views about the current state of the property and rental markets. However, the main focus of this bulletin is to look at the legislative changes that will be introduced next year as these will affect landlords, tenants and investors.

The current residential property investment market is completely unregulated – anyone can, and does, offer advice about investing in residential property. Anyone can be, and is, a landlord. Inevitably unscrupulous people are drawn into fast growing, unregulated markets where large amounts of money are invested. We are now at the point where the market is being investigated and inevitably it will change.

A number of initiatives – changes in pensions and the introduction of UK-REITs – will encourage investment into the property sector. The 2004 Housing Act, which will be implemented in 2006, will make it more onerous for some landlords. Some investment schemes have been closed down by the DTI and more will inevitably follow. The property market has gone ex-growth. All of these factors will inevitably lead to changes in the way people invest in property.

This bulletin looks at some of those changes and the impact that they may have.

We hope that this report is both informative and entertaining. We have had many positive comments about our bulletins – if there is any way you feel we could improve it, please contact:

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The times they are a changing

Whilst there is a long tradition of individuals investing in residential property, to rent out, the beginnings of the current market can be traced back to the marketing of buy to let mortgages, which began in 1999. In 1999 73,200 buy to let mortgages were made and £5.4bn was lent. In 2004, 526,200 buy to let mortgages were made with a value of £52.2bn. The market has grown by a factor of 10 in 5 years. During that period over £144bn has been borrowed.

The market as we now know it is therefore relatively young and immature. It is inevitable that it takes time for legislation and regulation to catch up with such a fast growing market. That is now beginning to happen. There are a number of changes that are scheduled to happen that will have a big impact on property investment and in this bulletin we will focus on what these are and what impact they may have.

Jailhouse rock

One feature of the buy to let market has been the growth of property clubs and investment seminars. Gullible investors are encouraged to spend several thousand pounds to attend a course on property investment where what they learn can be found on the internet with a couple of hours research – indeed our own website contains a great deal of information on how to invest in residential property. The investors are then encouraged to pay even more money to join a club or a syndicate where property is then sold at a "discount".

The DTI has decided to close down a number of these schemes, which implies that some degree of deception has been discovered. Inside Track, who claim to have sold 8% of all new developments in 2004 to buy to let investors, and claim to be market leader in this area are calling for regulation of the sector. A cynic may claim that they are opportunistically using the current bad publicity concerning their own market to gain an advantage. It is extremely difficult to see how any of the courses that are offered by any operator represents good value nor why joining a club and subscribing to monthly bulletins is a sensible or economic way to buy property.

It is likely that we are seeing the beginning of a trend that will inexorably lead to the residential property investment sector being regulated. Given that both the property industry and the investment sector always attract an element of cheats and charlatans, self-regulation is a non-starter.

Whilst it is impossible to predict the nature of the regulation, it is likely to have the following consequences:

- Fewer intermediaries will offer direct residential property investment and more investment will be made through regulated funds.
- It will be more difficult for developers to advertise properties promising specific yields or indicating potential future returns.
- Much more paper work and administration will be involved regarding any advice.
- The cost of investing will increase as it is always the investor who pays for the costs of regulation.
- The sales of new investments will be affected by the above as at least 50% of new investments are sold to investors.

This ol' house

Whilst as yet property investment is unregulated, the legislation regarding rental property is becoming more onerous on certain landlords.

The Housing Act 2004 received Royal Assent on 18 November 2004 and covers a wide range of issues in its 270 sections and 16 schedules. It aims to improve the protection of vulnerable people in the private rented sector. It will be implemented fully over the next year or so in various stages.

A key area of concern to us is the introduction of licensing for houses in multiple occupation (HMOs), which is due to come into effect in autumn 2005. The concern is that a house deemed to be an HMO may be difficult to convert back to use as a private residence. A further concern is the cost of complying with the legislation.

HMO applies to a wide range of housing types – mainly in the private rented sector – that young, lower income single people and vulnerable groups typically occupy. Quite often the properties' physical and management standards have been very low and the worthy aim of the Act is to eradicate this rogue element. However the Act will also impact on a large number of well run properties as local councils have a reasonable amount of discretion in how they chose to interpret the legislation.

The Act redefines an HMO as a building (or part of a building) that is occupied by persons that do not constitute a single "household". A household is defined by reference to a family relationship (although other relevant relationships may suffice). The building can even comprise entirely of self-contained flats (converted pre-1991 building regulations) where tenants occupy at least one third of the flats in the building and do not even share amenities.

The licensing of many HMOs – those over three storeys with five or more occupants – will be mandatory. Local housing authorities (LHAs) will be given powers to grant and enforce these five year licences. Importantly, they will be able to apply to the Secretary of State to extend the licensing to other types of HMO or to specific cases. Substantial differences will emerge on how these are interpreted and implemented from one authority to another. Landlords and many owner occupiers have good reason to be worried. For example, students or young professionals sharing a house would not necessarily constitute a "single household". Four investment bankers sharing a penthouse in Holland Park could be deemed to be in an HMO.

A major fear has recently been raised by The Association of Residential Letting Agents who warn that the "licensing and regulation in the private rented housing sector could follow parking fines and speed cameras to become another contentious revenue raiser". Under the secondary legislation they warn that LHAs could raise the level of new fines and licences to be imposed on private landlords.

The Association of Residential Managing Agents has highlighted a further potential problem. The new definition of an HMO means that many houses converted (pre-1991) into self-contained flats (even without sharing of amenities), may have to be licensed with perhaps dire consequences for anyone owning a long-leasehold flat in the building.

We will see over the coming months and years how each LHA interprets their wide ranging powers under the legislation. It is likely that London boroughs such as Camden and Hammersmith and Fulham that are already regarded by many property professionals as awkward will make life more difficult for private landlords.

The legislation counters recent government edicts saying they are looking to encourage the growth of the private rented sector. Legislation often has unintended consequences and whilst preventing unsafe properties being let to vulnerable tenants is a necessity it is possible that the legislation will also lead to some or all of the following consequences:

- Increased costs for landlords and ultimately tenants.

- Some boroughs becoming much less attractive for landlords than others – this could also lead to distortion of property prices for some types of property.

- A reduction of supply of certain types of property to the rental market. The legislation is likely to affect many properties let to students.

When I'm 64

In April 2006 new legislation will come into affect that will drastically change personal pensions. A ceiling of £1,500,000 will be introduced on the size of a pension fund, pensions will not have to invest in annuities and Self Invested Personal Pensions (SIPPS) will be allowed to purchase residential property.

Higher rate tax payers will be able to get a 40% rebate on the price of a residential property if they bought it for cash. Investors will also be allowed to borrow 50% of the value of their fund to use towards purchase costs. The following simplified example, illustrates how attractive this is to higher rate tax payers:

- ***Property price:* £300,000**
- ***Investor invests:* £150,000**
- ***Investor borrows:* £150,000**
  (existing fund of £300,000)
- ***Overall "net" cost of property:* £240,000**
  (£150,000 loan and £150,000 of equity less £60,000 tax credit)
- ***Increase in value of pension fund:* £300,000**
- ***Additional net investment in fund:* £90,000**
  (£150,000 equity less £60,000 tax credit)

Even if the property were to fall in value by 20% the investor would still not make a loss. If the property were to rise in value by 10% he would achieve a 30% return on his net investment.

Another interesting consequence is that investors with existing property and a large capital gain can reinvest in property in a more tax efficient way. Whilst selling a property will still incur CGT, if the money is reinvested in property through a SIPP the tax benefit on the new investment partially off-sets the CGT. This is illustrated in the following example:

Investor owns property bought for £200,000 now worth £350,000. The property is sold which leads to a CGT liability of £60,000 (40% of £150,000). The investor reinvests the net proceeds of £290,000 through a SIPP into property. The investor then receives a credit of £116,000 (40% of £290,00). Once a property is in a SIPP it can be sold within the SIPP and new property can be bought without triggering further CGT liabilities.

A further potential consequence of the new pension regime is that for those investors who have already invested the maximum amount of £1,500,000 in their fund, a geared property investment is a natural alternative to a pension. Investors will receive tax relief on their interest payments and property is a sensible long term income producing investment that lends itself to pension planning. There could therefore be additional demand for property investment from very wealthy investors who can no longer invest in their pension.

It is therefore likely that there will be a significant increase in activity in the residential property investment market at the beginning of next year. The consequences of this are likely to be:

- It will create genuine opportunities to include property in pensions. This has a particular attraction as pensions do not have to be converted to annuities. A portfolio of property within a pension fund could therefore provide a long term income with potential of capital gain within a tax efficient structure.

- A lot of spurious offers to tempt investors (as it is unlikely that the sector will yet be regulated) – this will lead to a lot of disappointed investors, which will then hasten the regulations, which should have been in place beforehand.

- A plethora of new funds offering investors the opportunity to invest in new developments at a 40% discount. In effect all they will really be saying is that the pension rules have changed. This per se does not mean that investing in new developments is an attractive way to invest in residential property although it will be interpreted this way.

- The level of activity may have a short term impact on house prices. Conversely, it may have a depressing impact on rents as more property will be available to let.

Handbags and gladrags

New rules are also being introduced for commercial property investment. Commercial property can already be bought within a pension scheme, however the cost of buying a good quality commercial building usually precludes this option for the majority of investors.

The government are planning to introduce UK-REITS next year. These are tax transparent vehicles for investing in both residential and commercial property. Similar structures exist in US, Japan, France and Australia and all have attracted significant amount of investment.

Whilst the focus of Residential Property Investment Management has always been on residential property, it is worthwhile to compare the characteristics of commercial and residential property.

Over the last five years, because of the significant increase in residential property prices, yields have fallen. In our view, residential property at the current stage of the market does not represent an attractive income based investment. If an investor is only interested in an income return it is almost certain that other investments would make a more attractive option. However, we continue to believe that residential property offers the potential for long term, low risk capital growth. Over time residential property will increase in price due to a combination of factors such as demography, imbalance between supply and demand, increased household formation and immigration. Whilst no one can predict short term movements in price it is unlikely that over a longer period a house will fall in value. Investment in residential property is therefore suited to low risk and long term capital gain.

Commercial property has provided more attractive returns than most other investments over the last five years. Last year commercial property provided income and capital returns of 18%. Commercial property covers everything from a corner shop to Bluewater Shopping Centre, a basement office to Canary Wharf and an old shed to the Nissan car manufacturing plant. Unlike residential property, commercial property can provide a secure long term income. A further difference is that the difference between gross income (ie the rent) and net income (ie what you actually receive) is much smaller with commercial property.

With residential property, according to IPD, the net income tends to be around 35% less than the gross income due to void periods, management charges and maintenance. Whereas with the majority of commercial property the gross and net income are the same. Capital growth is achieved in commercial property because people are simply prepared to pay more for it – which has been the case for the last three years – or because the rents have increased, which they have not done much over the last three years.

Commercial property however is riskier than residential property in that the capital value can fall. Commercial buildings can become obsolete and require rebuilding, whereas Victorian terraced houses are still likely to be occupied in another hundred years. Value can fall significantly if a tenant fails because part of the purchase price of a let commercial property includes the value of the rent – therefore values can be more volatile.

There is a case for investing in both commercial and residential property depending on the risk profile and the type of returns an individual investor is after. The introduction of UK-REITs is likely to have the following consequences:

- Commercial property investment will become more accessible. There will be a great deal of press coverage about these new funds and many investors will be tempted into investing into an asset class they know nothing about.

- As with residential property and SIPPs, there may be a short term impact on commercial property prices as a result of the increased activity.

- Property generally will form an increasing element of individual's pension planning and investment strategy.

...and now the end is near...

There is an unprecedented amount of new legislation which will on one hand encourage investment in property and on the other make it harder to be a landlord and more expensive to be a tenant. It is a curious mix of initiatives which will inevitably have unforeseen consequences. Property investment will have a higher visibility than it has had before and this will bring all sorts of schemers, charlatans and crooks out of the woodwork.

This in turn will mean that some people will receive poor advice and will make poor investments. As with all investments, property is not a one way bet. Eventually the sector will become regulated which will reduce some of the excesses but will add cost to investors who want professional advice.

Just as the property investment industry has grown significantly over the last five years and is now unrecognisable compared with the situation in 1999, the next five years will see the industry beginning to mature.

I can see clearly now

In a sense, however, nothing changes. Property is illiquid no matter how it is held – it is both expensive and complicated to buy and sell property. As with any investment, expertise is required to do it successfully.

Property is most sensible as a medium to long term investment. Market buoyancy generates short term returns but this should be seen as a bonus rather than an expectation. Next year sensible long term investors will have more opportunities to invest in property in interesting and tax efficient ways. Investors looking for a quick buck will also have plenty of opportunities to be parted from their money.

Current Market Conditions

Introduction

Our aim when reviewing current market conditions has always been to give an account using our own experiences in the market as an active participant. This inevitably means that our view is somewhat anecdotal and based on empirical information rather than dependent on an analysis or summary of the regular research that is produced by banks, building societies and estate agents. Our focus is the secondary areas of London but we speak to participants in all sectors of the market. We like to feel that it is a real rather than an academic view.

The overall picture of the market that is painted by the various surveys and statistics is that volumes have dropped significantly and prices have eased off. Transactions are down because sellers have unrealistic expectations of prices and buyers are not prepared to meet them. There is somewhat of a stalemate which means that prices are drifting on low volumes. As first time buyers have been priced out of the market, demand for rental property has increased and so yields for investors, whilst still low, are improving marginally.

Whilst the above may be a reasonable generalisation, our experience is somewhat at odds with this view.

The Property Market

The part of the London market in which we are active is still robust – the supply of property coming on to the market has been tight for the last three or four years and this has not changed significantly. Our observation is that sensibly priced properties still always sell quickly. If anything prices have risen slightly over the last twelve months rather than fallen.

The London market as a whole was the first to improve after the last property recession and slowed down sooner than the rest of the market. Prices in London have been stable and in some areas – particularly prime areas – prices are picking up. It is now the rest of the country where values seem to have got ahead of themselves. It seems as if London has had a soft landing.

A number of people have recently expressed the view to us that there are real difficulties with selling new developments in the provinces and that developers are having to give very generous incentives to sell them. Real prices in this part of the market are probably falling significantly – as one would expect in a softer market where the vendor has to sell, as developers do, and the buyers are predominantly investors rather than owner-occupiers. This does not necessarily mean that these developments have become good value although there are probably instances where very attractive deals can be done.

The Investment Market

We have looked at a number of investments outside London and we have found that yields on Victorian terraced houses are roughly the same – around 5.5% to 6.5% – to comparable properties in London. We feel this is a very strong indication that London now represents a much more attractive investment than most of the rest of the country.

Over the medium to long term our view remains that pressure on supply in London will be greater and this will lead to greater capital growth than in the rest of the country. If yields in London are more or less comparable with those in Oxford, Newcastle, Leeds and Manchester it is difficult to see a case for investing in these areas rather than London, at the current time.

The rental market is now stronger in terms of demand and in our experience rents have risen from their low point. If one allows for inflation of 2.5% a year, rents would have needed to rise in nominal terms by around 10% since the beginning of 2001 to stay level in real terms. At their low point around eighteen months ago nominal (excluding inflation) rents in our part of the market were probably around 10% below their 2001 peak. Around half of this fall has now been recovered so rents are now 5% below their peak in nominal terms – which represents a fall in real terms of around 15%.

There has been a considerable increase in the amount of rental property available – £144bn has been invested by individuals – and this gives tenants more choice. The rental market has gone through a fundamental change. It has switched from a landlord's market to a tenant's market. Tenants now have more choice and can get more for their money compared with five years ago. For most landlords rents have at best remained flat or have fallen over the last five years and the quality of tenant has decreased. We believe that this is a trend and that it is extremely unlikely that the rental market will ever be as favourable to the landlord as it was at the end of the last century.

In the end market forces come in to play – and whilst it is correct that the government should protect vulnerable tenants – it is totally unnecessary for HMO legislation to be used to control landlords who rent to tenants who have a plentiful choice of property and are free to live wherever they want and how they want.

The Future

The property market is seasonal – generally the first half of the year is stronger than the second half. It is likely that as the national market has been soft so far, this trend will accelerate in the second half of the year. If interest rates fall then the market may continue at its current level for the rest of the year – if not, it is likely that we will see doom and gloom headlines about the housing market towards the end of the year.

This in turn could either begin a downward spiral or could cause purchasers to come back into the market. The market as a whole is at a critical stage. However, barring any major unforeseen economic or other disasters London is likely to outperform the rest of the property market.