Is there a Future for High Street Estate Agency?

BrightSale Research Department – April 2008.

Executive Summary

Traditional high street estate agency is living on borrowed time; and that time is running out. High cost traditional estate agents face a triple barrelled gun, and we predict that a combination of: 1) **lower house prices**, 2) **lower completion volumes** and 3) **fee competition from online estate agents** will relegate the traditional high street agent to a niche market position over the next five to ten years. Lower cost online estate agents will become the norm.

Unlike other industries that have used the internet to lower costs and provide a better service for their customers, estate agency has been sheltered from the need to modernise by almost freakishly favourable trading conditions – conditions which are now unwinding at a rapid rate. We explain how these boom-like conditions developed and how they have left an industry with too many offices, too many poorly trained staff, lacking in innovation and generally held in low regard by its customers. We explain how online estate agency is gaining market share at a rapid rate. Online estate agency listings rose by 58% in the last nine months alone to 3,204. This puts online estate agency (as a sector) in tenth place in terms of estate agency size in the UK.

The period 1996 – 2007 saw house prices rise by 232%, with completion volumes remaining fairly constant. Crucially, despite a dramatic surge in revenue, traditional agents were able to avoid any meaningful reduction in percentage fees (in stark contrast to other sectors, such as conveyancing). This caused aggregate fee income across the sector to jump from less than £2 billion annually in 1997 to almost £5 billion in 2007. This in turn created a mini-boom in new agencies, with almost 15,000 now in existence.

In Part 2 we explain how each of these supporting factors has now gone into reverse. Property prices are already falling, and we follow the property derivatives market in predicting a decline of around 12% in prices between now and 2013. Our analysis of completion rates in the last downturn (1989 – 1996) suggests that they too will now fall, we project from around 1.5 million in 2007 to just 1.1 million in 2013.

We estimate that commission rates are going to fall substantially, due mainly to competition from full service online agents (such as **BrightSale** and **Wow Property**). Such a fall has already revolutionized the conveyancing industry (where fees have fallen 72% in ten years). Online estate agents will gain market share rapidly for 7 reasons: 1) online estate agency is gradually becoming a genuine alternative to the high street agent, 2) significant venture capital investment will further boost marketing spending, 3) online valuation tools are becoming more widespread and more accurate, 4) accompanied viewings have already been abandoned in much of the country, 5) online agents provide much better value for money, 6) online agents will lead an innovation surge that will transform the way in which property is bought and sold and 7) 'second generation' search-based portals such as Globrix will make it much easier for online agents to market properties.

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We project that by 2013 total estate agency fee revenues will be 47% below their 2007 peak. By analysing the business model of a traditional agent (Humberts), we demonstrate the inevitability of high cost, high fee estate agents being relegated to niche status by 2013 in such a scenario. We see the current travails of Humberts as merely a precursor to what may happen to the whole industry if it fails to adapt to changing times.

Part 1: The Boom Years of 1996 – 2007

The boom years in UK estate agency, which we date from January 1996 to August 2007, were underpinned by three main factors:

i) **An unprecedented eleven year house price boom**;

ii) **Steady completion volumes**; and

iii) **A lack of real competitive pressure on fees**.

Let's examine each in turn.

i) An Eleven Year House Price Boom …

According to the most authoritative index of residential property prices in the UK, the average property rose in value from £60,638 (Jan. 1996) to £201,081 in August 2007 (Figure 1): a rise of 232%.

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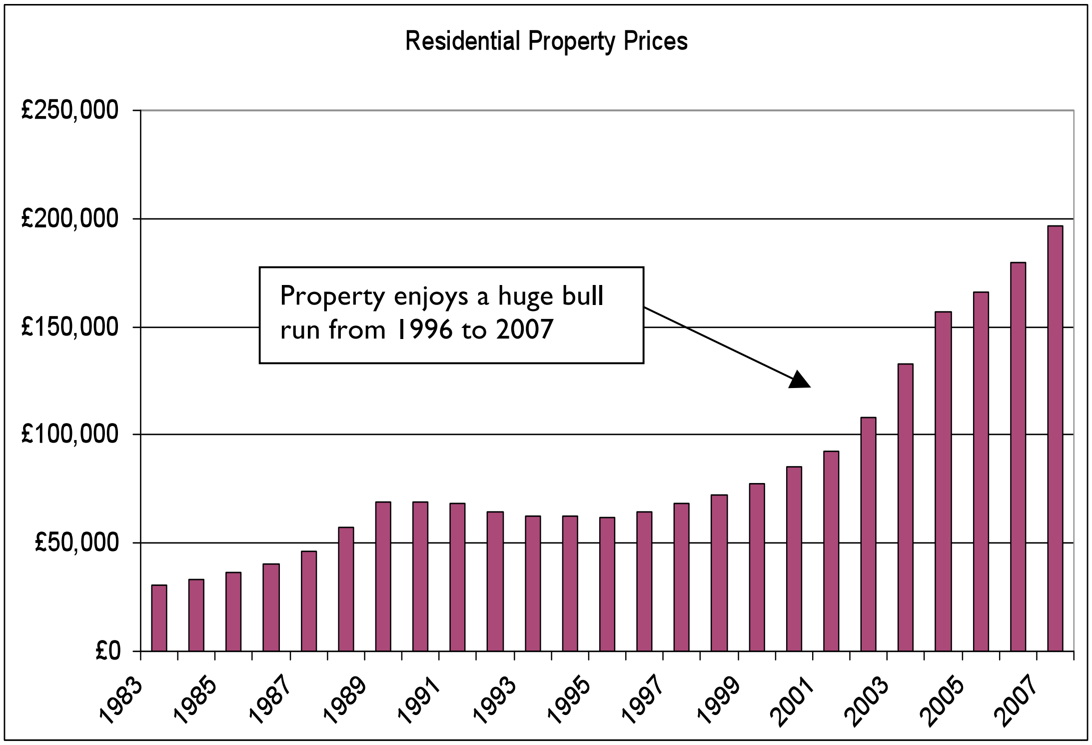
Figure 1 – Halifax Index of UK Residential Property Prices



Source: Halifax Residential Property Price Index, March 2007

This boom has resulted in a current level of overvaluation that has not been seen in the 25 years of Halifax Index data.

Halifax's data suggests that the property cycle in the UK is driven by *the affordability of property as a multiple of earnings*. Figure 2 shows how (since 1983) UK property has regularly swung from undervaluation (versus earnings) to overvaluation. The ratio of prices to earnings rose steadily through the late 1980s to peak at exactly 5.00 in May 1989, before falling back to a trough of 3.11 times in January 1996, when the market bottomed. This increase in 'affordability' by 1996 allowed prices to being to climb again, which they did steadily until August 2007.

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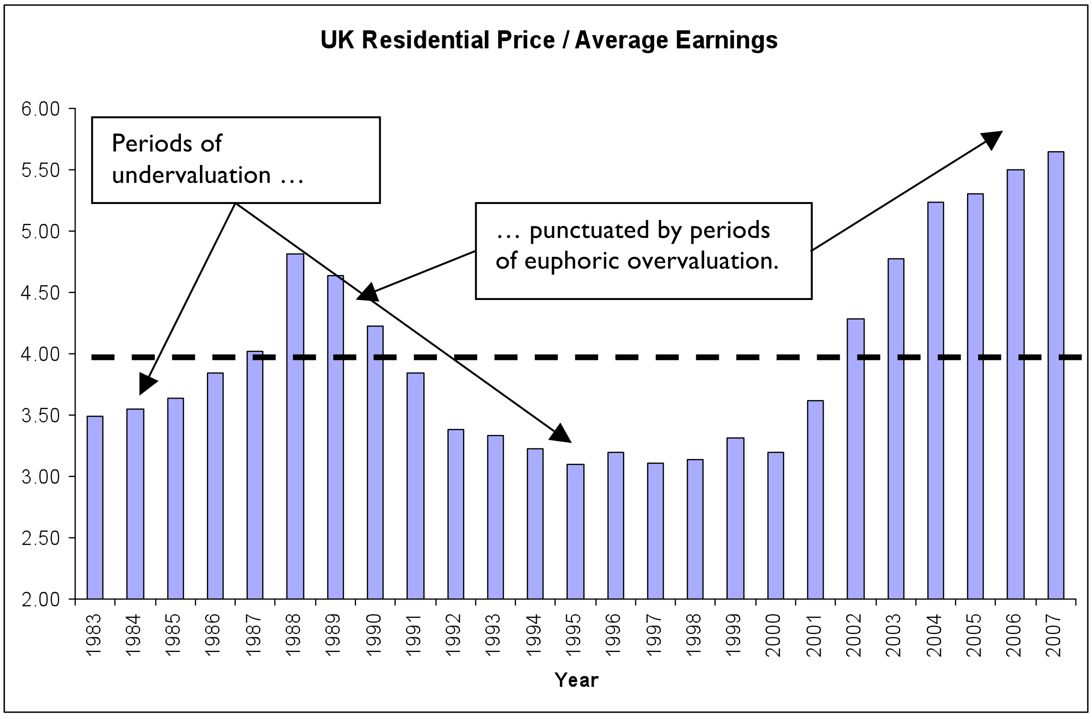
Figure 2: UK Overvaluation has now Exceeded 1989 Levels (Prices / Average Earnings)



Source: Halifax, March 2008

The level of overvaluation of UK property has now exceeded that of 1989 by some distance. The ratio of prices to average earnings peaked at 5.79 times in July 2007, and still stands at 5.65 times (December 2007).

ii) … and Steady Completion Volumes …

Figure 3 shows completion rates for residential property as recorded by HMRC. These are important because it is the product of house prices and completions that produces fee income for the estate agency industry. The fact that completions levels have remained broadly constant has been very significant in driving the boom-like conditions of the last decade.

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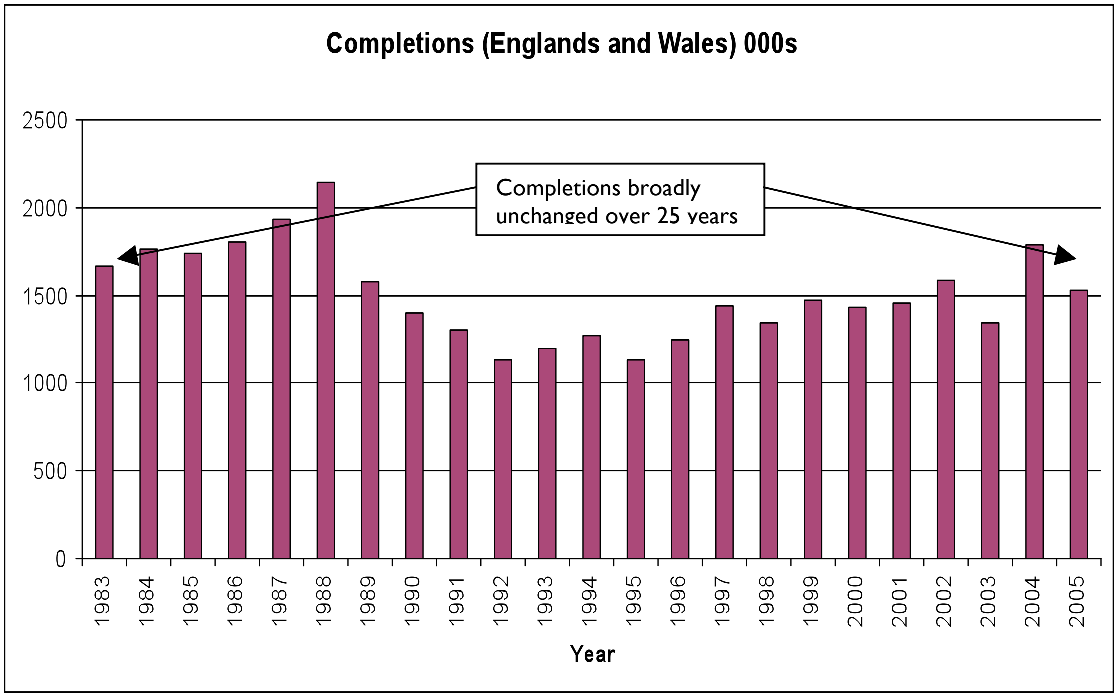
Figure 3: Completion Rates have not Changed much in 25 Years



Source: HMRC

iii) … plus a Lack of Competitive Pressure on Fees …

There has been precious little innovation in traditional high street estate agency in the last decade – in very marked contrast to other agency industries such as travel agency and conveyancing. The limited innovation that has occurred, such as the establishment of marketing portals like **RightMove** and **FindaProperty**, has occurred largely outside the scope of traditional agencies (although **Countrywide** and **Connell** were instrumental in setting RightMove up in 1999).

In our view, property portals have had an anti-competitive influence on estate agency fees, and in this regard traditional agencies did show commercial foresight. By refusing the listings of private sellers operating through 'sell it yourself' websites, portals restrict the marketing of properties to vendors using estate agents. We think that 'sell it yourself' offerings simply don't work, and hence their impact on fees may not have been great anyway; but 'first generation' portals have restricted competition in more subtle ways as well. They have hindered the development of 'national' online agencies such as **BrightSale** by restricting the number of properties that a 'branch' can list. If you want to list a lot of properties, you have to open a lot of branches (and pay for a lot of branch subscriptions): Catch 22 for agencies trying to lower costs by cutting down on expensive high street locations.

Fortunately, the stranglehold of the 'pay per branch' portal model is about to be broken by a new generation of search-based portals; the main one being the **News Corp**. backed **Globrix**, which we discuss in Part II.

Our research suggests that commission fees *have* edged down over the period 1996 – 2007, but not by a great deal given the rise in property prices. In 1997, Countrywide (the UK's largest traditional agency chain) reported that its average fee across 92,228 completions in the UK was 1.90%. In 2006, this figure had edged down a little to 1.66% over 103,252 completions. But this fall of 12.6% in fee levels is insignificant versus the 232% rise in property prices over the same period.[1]

Table 1: Countrywide Average Commission Fee Falls only Marginally over the Decade

Year	Commission Rate	Source
1997	1.90%	*1998 Countywide Annual Report*
1998	1.83%	*1998 Countywide Annual Report*
1999	1.84%	*1999 Countrywide Annual Report*
2001	1.80%	*2002 Countrywide Annual Report*
2002	1.74%	*2002 Countrywide Annual Report*
2003	1.76%	*2004 Countrywide Annual Report*
2004	1.71%	*2004 Countrywide Annual Report*
2005	1.66%	*2006 Countrywide Annual Report*
2006	1.66%	*2006 Countrywide Annual Report*

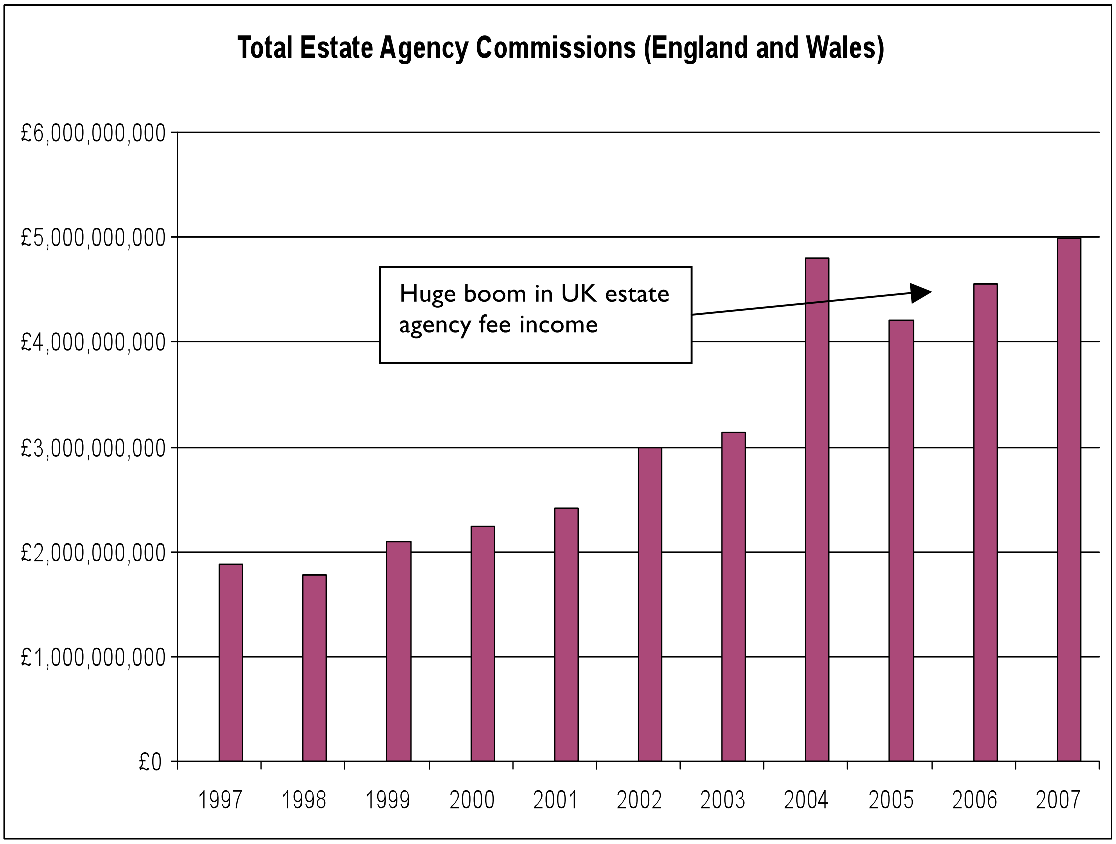
Source: Countrywide Annual Reports

iv) … leads to an Estate Agents' Fee Bonanza!

In Figure 4 we combine what has happened to house prices, completions and fees to produce our estimate for total UK estate agency commissions during the boom period.

[1] *It is also important to realise how traditional agencies have milked their ability to sell financial services as part of a property transaction. In 2006, Countrywide reported £91.6 million in revenue from 'financial services'. This is fully 25.3% of commission fee income. But this income too will now be squeezed, in the near term at least, by the significant drop in mortgage lending (source: Countrywide Annual Report, 2006).*

Figure 4: The Boom Years – Estate Agency Commissions Jump to almost £5 billion Annually



Source: BrightSale Research estimates, Halifax, HMRC and Countrywide Annual Reports

The explosion in fees is quite staggering. In 2007, almost £5 billion was paid to traditional estate agents in England and Wales alone. The fee explosion goes a long way to explain why the total number of high street estate agents has risen to almost 15,000, and why so many estate agent frontages now blight our provincial towns and villages.

But all this is about to change.

2. The Bust Years? (2008 – 2013)

In contrast to the 1996 – 2007 period, all three of the factors that were supporting traditional estate agency are now in reverse:

i) **Property prices are falling**;

ii) **Completion volumes are beginning to fall**; and

iii) **Pressure from online agents is forcing fees lower**.

Again, we need to look at each in turn.

i) Property Prices are now Falling …

House prices peaked (according to the Halifax Price Index) in August 2007 at £201,081 and have followed a steady path downwards path to the current (February 2008) level of £193,448 (Table 2).

Table 2 – UK House Prices Look to have Peaked for this Cycle

Month	Year	yoy Change	UK Average House Price
Aug	2007	11.0 %	£201,081
Sep	2007	9.1 %	£200,168
Oct	2007	6.7 %	£197,817
Nov	2007	3.2 %	£194,258
Dec	2007	6.4 %	£195,333
Jan	2008	3.9 %	£191,275
Feb	2008	2.2 %	£193,448

Source: Halifax Residential Property Price Index, March 2007

How great a fall will be required to make property 'affordable' once again?

As we noted in Figure 2, the average house price / earnings ratio between 1983 and 2007 was 3.95 times. With average earnings currently at £34,572, a decline to 3.95 times would reduce the average house price by 30.1% to £136,560. The experience of the previous bear market is instructive. Prices peaked in July 1989 at £70,588 and did not trough until January 1996 at £60,638 (a total decline of 14.1% over five and a half years). At the trough in early 1996, the price / earnings ratio had dropped to just 3.11 times.

History never quite repeats itself, but it is not surprising that a vast majority of serious property analysts are predicting quite dramatic falls in UK property prices for 2008 and beyond. The informative (if scarily titled) **www.housepricecrash.co.uk** keeps a list of predictions from all the leading market commentators. There are only four 'analysts' predicting gains for the market in 2008, and none of those four (**Knight Frank**, **Savills**, the **Council of Mortgage Lenders** and **HomeTrack**) could exactly be described as disinterested. No fewer than 26 analysts in the survey are predicting a flat or down market in 2008 and beyond.

Table 3 – Bearish Predictions from Property Analysts

Company	Analyst	Date	Price Move	Range	Comment
Invesco Perpetual	Neil Woodford	Jan 2008	↓8-10 %	2008	Neil Woodford, goes further than his prediction to say that areas which have seen a concentration of speculative development and buying, such as regional metropolitan centres, could be subject to much sharper falls.
Institute of Economic Affairs	Philip Booth	Jan 2008	↓10%	2008	Mr Booth says that more falls are possible after 2008 but also says that this should not affect the economy greatly as long as monetary policy is conducted appropriately.
FirstRung.co.uk	Paul Holmes	Nov 2007	↓12%	2008	The mortgage broker, firstrung said that predictions of gentle slowdowns were off the mark.
MarketOracle.co.uk	Nadeem Walayat	Aug 2007	↓15%	2007-2009	Market Oracle believe that the crash will be led by the buy to let sector jumping ship.
Fool.co.uk	David Kuo	Dec 2007	↓20%	2008	David Kuo believes that the average price of a house could fall by up to a fifth to £157,290 in 2008.
London School of Economics	John Van Reenen	Jan 2008	↓20%	Not stated	John Van Reenen, expected prices to fall 20% before bouncing back but he doesn't state a time period for this prediction.
Morgan Stanley	David Miles	Mar 2008	↓20%	2008-2009	David Miles, chief UK economist at Morgan Stanley predicts that house prices will fall by up to 20% over the next two years.
Boom Bust	Fred Harrison	Jan 2008	↓30%	2008-2012	Fred Harrison predicted a drop of 20% in his book Boom Bust (2005) but he now believes the drop will be around 30%.
London School of Economics	Willem Buiter	Jan 2008	↓30%	2008-2009	Mr Buiter says that on average, lower house prices don't make UK consumers worse off. They lose as owners but gain as renters.
Housepricecrash.co.uk	Jonathan Davis	Sep 2007	↓35%	2008-2012	In our view, history and economics leads us to believe that the boom is over and there will be a gradual and cumulative fall annually from this point forward.
Numis Securities	James Hamilton	Mar 2008	↓44%	Not stated	James states that "UK property prices remain 44% over valued we expect them to go to a discount to fair value."

Source: www.housepricecrash.co.uk – March 2008

Perhaps the strongest evidence is provided by the nascent property derivatives market. This is a place where investors place *real* bets with *real* money. Conveniently for us, this marketplace actually references the Halifax Price Index, and allows investors to bet on its level over the next 15 years. Table 4 shows future house prices as predicted by the derivatives market.

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Table 4: Property Derivatives Market Suggests Steep Falls Ahead

Date	Average House Price	% Change
Feb-08	£193,448	N/A
Feb-09	£176,038	-9.0%
Feb-10	£168,300	-13.0%
Feb-11	£166,365	-14.0%
Feb-12	£164,431	-15.0%
Feb-13	£170,234	-12.0%
Feb-14	£172,169	-11.0%
Feb-15	£183,776	-5.0%
Feb-16	£187,645	-3.0%
Feb-17	£187,645	-3.0%
Feb-18	£193,448	0.0%

Source: DTZ / Tullet Prebon UK HPI Forward Prices – 20th March 2008 (bid side prices).

We use the prices as predicted by the derivatives market for our analysis.

ii) … completion Volumes are set to Fall Heavily …

Let's look again at the completion volume numbers, focusing on the last recessionary period of 1989 to 1996.

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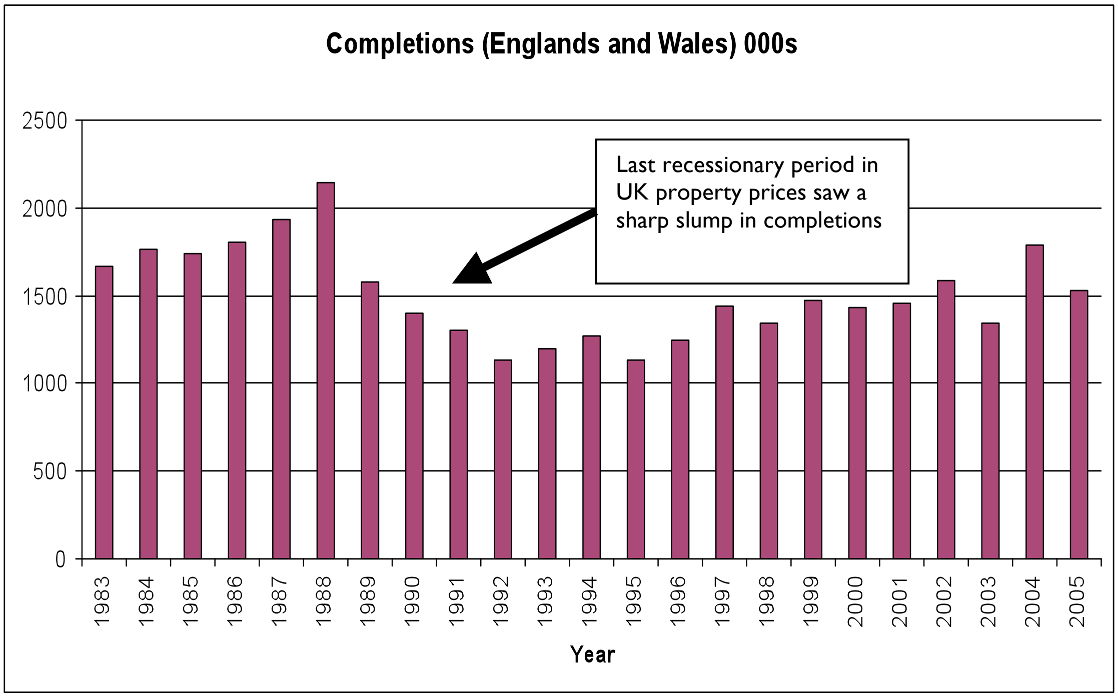
Figure 5: 1989 – 1995 did see a Temporary but Sharp Decline in Completion Rates



Source: HMRC

It is very significant that during 1989 – 1996 there *was* a significant fall in completions. In fact, there is what statisticians call a positive correlation between house price levels and completion volumes across the last 25 years. As prices rise, so do completions, and *vice versa*.[2] In 1988, completions peaked at 2,148,000 and then troughed at 1,135,000 in 1995 (a fall of 47%). Even we cannot foresee a situation in which property transactions fall by the amount, and so we model a scenario where they trend down to the 1995 trough of 1.135 million per year by 2013.

iii) … competitive Pressure on Fees will Increase Substantially …

Our estimate is for average estate agency fees to fall to around 1% by 2013, and then to converge at the prevailing online agency rate of 0.5% by 2018. This will reflect the relegation of traditional high street agency to a niche status sometime between 2013 and 2018. This fee compression will initially be driven by competition from online estate agents.

We anticipate that 2008 is the year when online estate agency really starts to gain significant market share in the UK, and that this share will grow rapidly to 2013 as traditional agents refuse to abandon their established business model (until it is too late).

[2] This analysis lays to rest another lazy myth peddled by traditional estate agents, namely that property prices are 'squeezed' up by lack of supply on the market. This data proves that when prices are rising more property is coming on to the market and completion rates go up. This is strongly supportive of the theory that what makes prices go up is the belief on the part of buyers that prices will continue to go up, bounded by the over/undervaluation constraints of the price / average earnings multiple.

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Substantial market share gains will be driven by seven factors:

1. **Online Estate Agency is now a Realistic Alternative** – Our analysis shows that online estate agents are gaining market share at a rapid rate, as customers wake up to the benefits of the service. We began tracking online estate agency market share in 2007. On 30th June 2007, there were 2,022 properties listed with full service online agents (we do not count any 'sell it yourself' websites).[3] By 31st March 2008 this number had jumped to 3,204. In market share terms, we project that online estate agency's share of the total market increased from 0.2% to 0.32% over this nine month period. Given the incredibly fragmented state of the UK market, this total places online estate agency (as a sector) 10th largest in terms of traditional estate agents (**Kinleigh Folkard & Hayward** was 10th largest with 2,757 properties listed on their website in March 2008).[4]

2. **Venture Capital Investment Boosts Marketing Budgets** – Online agencies such as **BrightSale** and **Wow Property** are starting to attract substantial venture capital investment. This will enable them to raise the profile of their services, and the online sector generally, through major marketing campaigns in 2008 and beyond.

3. **Online Valuation Tools becoming Widely Used and more Accurate** – Vendors have an increasingly wide array of online valuation tools (e.g. HomeTrack). Online estate agents can also access both these valuation estimates and 'sold prices' data direct from the Land Registry. This is eroding the advantage the traditional, locally-based agents had up until now in valuing property.

4. **Conducted Viewings have been all but Abandoned in much of the Country** – In many parts of the country estate agents no longer provide accompanied viewings. This decision is very foolish, in our view, because it is the only differentiating factor that an online agent cannot easily replicate. Online agents will make more rapid market share gains in areas where accompanied viewings have been abandoned.

5. **Value for Money** – The average estate agency fee in Britain today is £3,211 (£193,448 x 1.66%). The average online agency fee is £967 (0.5%). This saving of £2,243 is a very significant amount for most families. As online agents move into the main stream, this cost advantage will be impossible for many vendors to resist, particularly as the service offering between traditional and online agents starts to tilt in the direction of the latter.

6. **Online Agents will Drive Innovation and Services for Vendors –** Online agents have a huge interest in designing tools and services to make the (outdated and stressful) sales process easier. We have only just begun to see how it is possible to make the process of finding, viewing, buying and selling property easier using information technology. But we feel certain that online agents will lead this process and that customers will respond to it.

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[3] *A company such as **HouseLadder.co.uk** is a 'sell it yourself 'agent. They do not offer any negotiator support and the vendor is completely on his own. Companies like this have a limited future following the recent OFT ruling that by providing things like 'For Sale' boards and communications between buyers and sellers, 'sell it yourself' sites are acting as estate agents (despite the misleading claims that often appear on website home pages). This means that vendors using these services will be liable to a double fee if they have signed a sole agency contract with a traditional estate agent.*

[4] *Estate Agency News*, January 2008 - see http://www.estateagencynews.co.uk/league.asp

7. **Second Generation Portals (Globrix) Level the Playing Field** – As we have seen, the 'first generation' of portals established by high street agencies had the effect of stifling competition from agents trying to employ a 'no branch' business model. We predict that by 2013 search-based portals like Globrix will have displaced them. As these portals are funded purely by advertising, they will no longer charge on a pure branch basis and hence will allow online agencies to advertise in exactly the same way as high street agents.

Does Conveyancing Point the Way to the Future of Estate Agency?

For a glimpse into the future for estate agency fees it is instructive to look at what has happened to conveyancing over the last ten years.

In March 2008, the *Solicitors Journal*, ever the consumer's friend, bemoaned the falling price of conveyancing. The journal quoted research from Propertyfinder.com that over the past ten years estate agents' fees had trebled (in cash terms) whilst conveyancing fees had actually fallen 20%. Given the rise in property prices over this time period, this means that conveyancing fees, in percentage terms, have actually fallen by 72%. It is not hard to see why this has happened.

Ten years ago conveyancing was done by local solicitors in local offices who charged a very large sum for what is (in most cases) and very straightforward job. Fast forward ten years and things are very different.

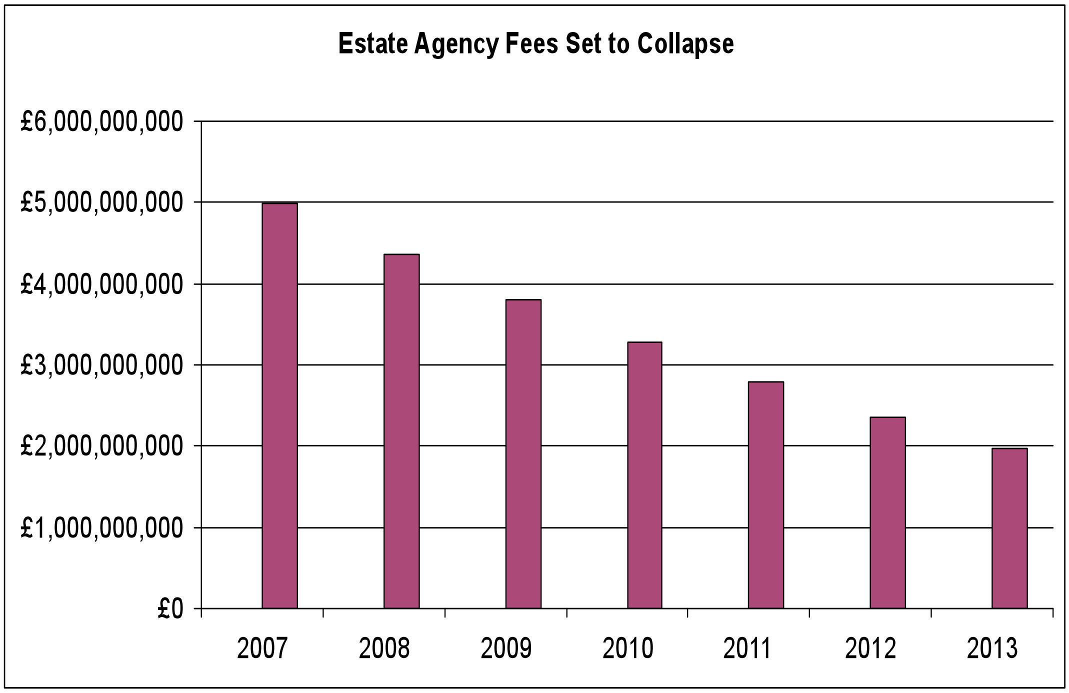
Today price comparison websites such as www.legalbrokers.co.uk collect leads from the internet and pass them on to giant conveyancing companies that operate from call centres. This model has enabled companies like Barnetts (operating the brand clickconveyancing.com) to reduce the cost of conveyancing to a standard charge that starts at just £187 (plus VAT).

We anticipate a very similar market evolution for estate agency.

iv) … all adds up to Big Trouble for the High Street Estate Agent.

Figure 6 shows our projections for estate agent revenues over the next five years. It makes grim reading for the high cost, high street sector.

Figure 6: Total Estate Agency Fees for England and Wales Projected out to 2013



Source: BrightSale Research Estimates

Because the data is so shocking, we reproduce the numbers underlying the graph in Table 5.

Table 5: Data and Assumptions behind our Future Total Fees Estimate

Year	Completions	Average Fees	Average Property Price	Total Estate Agency Fees
2007	1,529k	1.66%	£196,478	£4,986,886,709
2008E	1,463k	1.55%	£192,548	£4,367,319,533
2009E	1,398k	1.44%	£188,619	£3,796,219,026
2010E	1,332k	1.33%	£184,689	£3,271,882,117
2011E	1,266k	1.22%	£180,760	£2,792,605,735
2012E	1,201k	1.11%	£176,830	£2,356,686,807
2013E	1,135k	1.00%	£172,901	£1,962,422,264

Source: BrightSale Research Estimates

The traditional agency model simply cannot survive in this scenario.

Branch and staff costs make up the vast majority of traditional estate agents' costs, and these are difficult to reduce in downturns. Traditional agents can close their high street branches (and they will), but because of the way they are set up this will just reduce their fee income. It won't help per branch profitability, which is the root cause of the problem.

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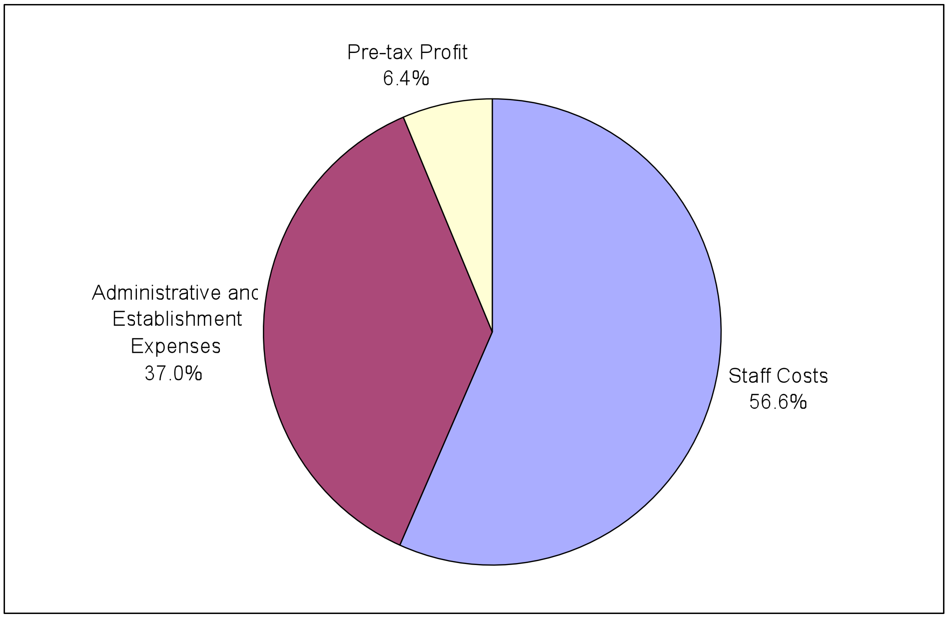
The old style traditional estate agency Humberts is perfect illustration of the problem. Figure 7 shows that staff costs and the maintenance of the branch network swallow fully 93.6% of its revenues. We do not believe that there is any way an agent such as Humberts operating this business model with these staff and branch costs could survive the decline in revenues we anticipate.

Figure 7: Humberts Branch and Staff Costs Eat 93.6% of Revenues



Source: Humberts Interim Results – 6 Months to 31st March 2007.

Indeed, the stock market appears to be coming to the same view. Humberts' share price was trading above £1 a share in early 2007. Because of its ill-feted expansion of high street branches right at the top of the market, it is now tottering on the brink of administration, with the share price (at the time of writing) down over 90% from its 2007 high.

It may well be that Humberts is merely the first traditional agency casualty of many, as the industry moves away from the high street and on to the internet.

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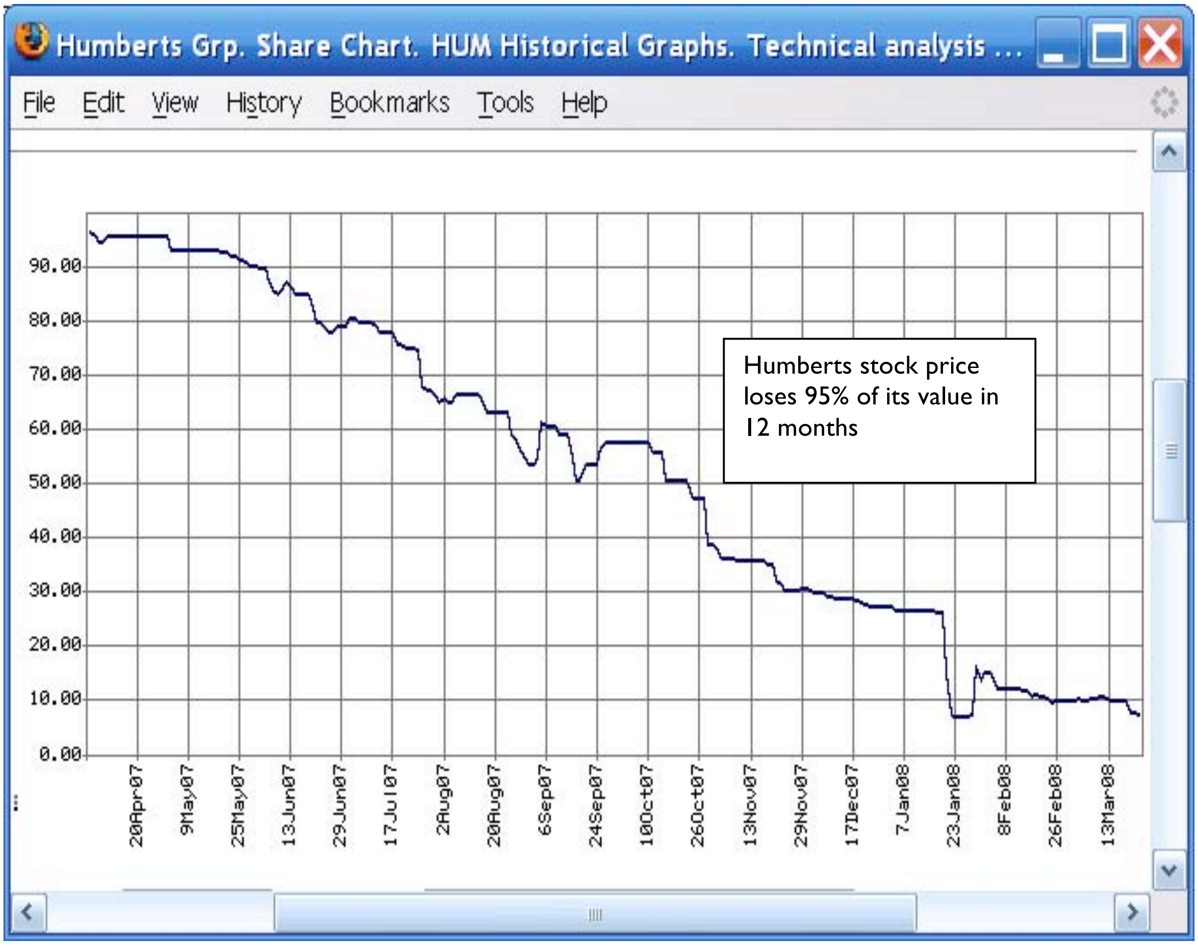
Figure 8: Humberts Share Path Points the Way for Traditional Estate Agency



Source: www. LondonSouthEast.co.uk

Conclusion

We conclude that estate agency is poised for a seismic upheaval - one that will see the traditional, but increasingly costly and irrelevant, high street branch network challenged as never before.

The transformation in the industry should have started before, but a combination of near perfect market conditions and some shrewd defensive measures enabled traditional estate agency to sustain its out-dated business model far longer then comparable sectors such as conveyancing and travel agency were able to.

But time is running out. 2008 will be the year when online estate agents start to make significant inroads into this market. And with the reduction in fee income that we foresee out to 2013, this is going to make life harder than ever before for the high street estate agent.