

Hot Topics

- "There are tentative signs that the housing market has reached the trough of the downturn; both market activity and house prices are fluctuating on a month by month basis around these low levels."
- "But, the recent pick up in house prices does not necessarily signal the beginning of a housing market recovery."
- "Land values are nearing the bottom of the market and no further substantial falls are expected."

OVERVIEW

THE WORST IS OVER IN THE HOUSING MARKET, BUT YEARS OF STAGNATION REMAIN IN PROSPECT.

The key housing market performance indicators suggest that the housing market is now nearing the bottom of the cycle.

Housing market activity appears to have reached a floor at very low levels, with only minor monthly fluctuations.

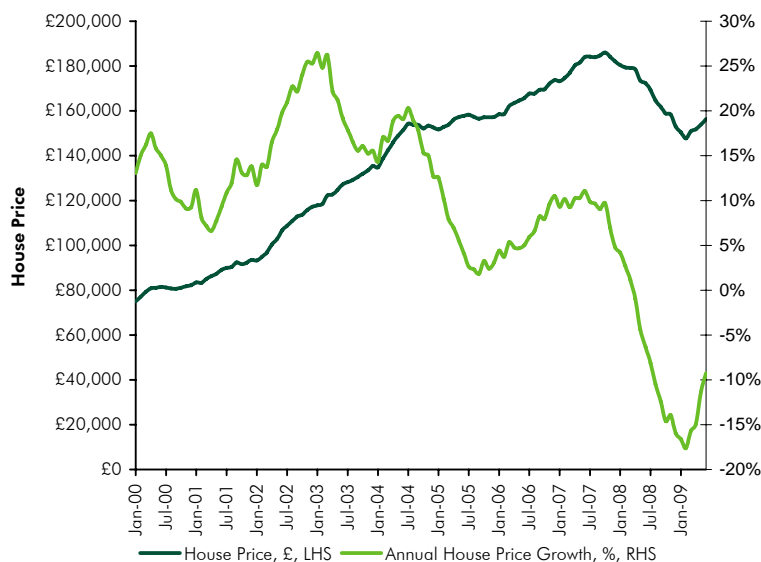
However, there is conflicting evidence from the various house price indices; while some indices have recorded several months of price increases, others are still reporting falls.

This volatility reflects the current market uncertainty and local market conditions. In recent months demand in some areas has begun to outstrip the very low levels of properties coming onto the market.

It is unlikely that recent price increases signal the beginning of a consistent upward trend in house prices. We expect the current demand and supply imbalance will shift over the coming months, which will feed through to pricing.

There are also signs that land values are nearing, and may have even reached the bottom of the cycle, as there is increasing interest from housebuilders looking to bolster their land banks and a number of funds looking for a good investment.

UK House Prices



Source: Nationwide

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SIGNS THAT THE HOUSING MARKET HAS REACHED A FLOOR

There are tentative signs that the housing market is stabilising and that we have reached the bottom of the downturn. Market activity has stabilised, albeit at low levels, with only relatively small month on month fluctuations. There were 60,000 residential transactions in May; 6% lower than the number seen in April and around a third lower than those a year earlier.

HOUSE PRICES ARE SENSITIVE AND VOLATILE

However, there is conflicting evidence from the various house price indices. According to Nationwide, house prices across the UK have risen in three out of the last four months and now stand at £156,442. Over the quarter they have risen by 1.1% compared with Q1 2009.

There have been mixed results across the regions in England, with the North, North West, West Midlands and South West showing further falls over the quarter; the other regions recorded house price growth. With a quarterly fall of 4.7%, Northern Ireland continues to have the most dramatic falls in the UK. Wales and East Anglia had the largest increases, where house prices grew by 7.7% and 5.2% respectively, over the quarter.

In contrast, other indices such as Halifax's house price index showed falls of 0.5% in June and 1.9% over the quarter, despite a number of increases in previous months.

This conflicting evidence highlights the volatility and sensitivity of house prices in the current housing market. With the current low level of transactions, local demand and supply dynamics have a considerable impact on house prices; the pick up in prices reflect the recent pick up in demand.

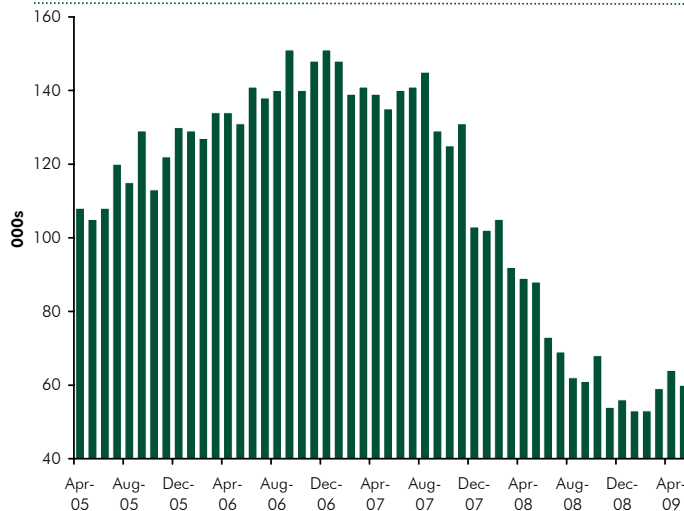
THE DEMAND FOR PROPERTIES HAS RISEN

In recent months demand for housing has picked up; according to the NAEA, the average number of house hunters per agent has risen by 60% since November 2008. This has been driven by a combination of a pick up in confidence and a slight improvement in the availability of credit. According to the Bank of England Credit Conditions Survey further improvements in secured credit are expected over the next three months.

THE SUPPLY OF HOUSING REMAINS DEPRESSED

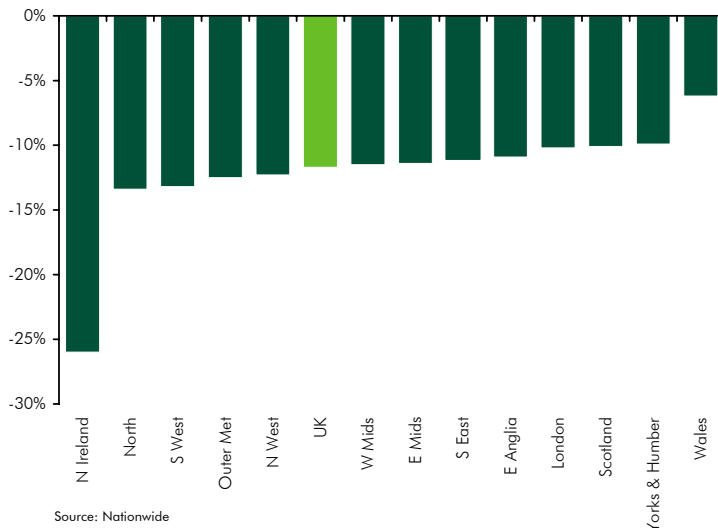
In contrast to the pick up in demand, the supply of housing for sale remains muted. A large number of potential vendors are delaying their selling decisions as a result of the dramatic falls in house prices seen over the last twenty months. This delay is partly to avoid realising any loss (albeit real or perceived) in value.

Transactions



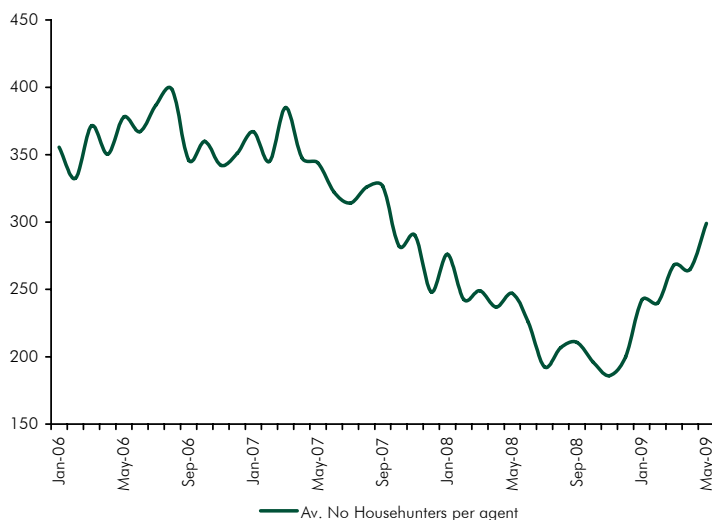
Source: HMRC

Regional House Price Growth (pa)



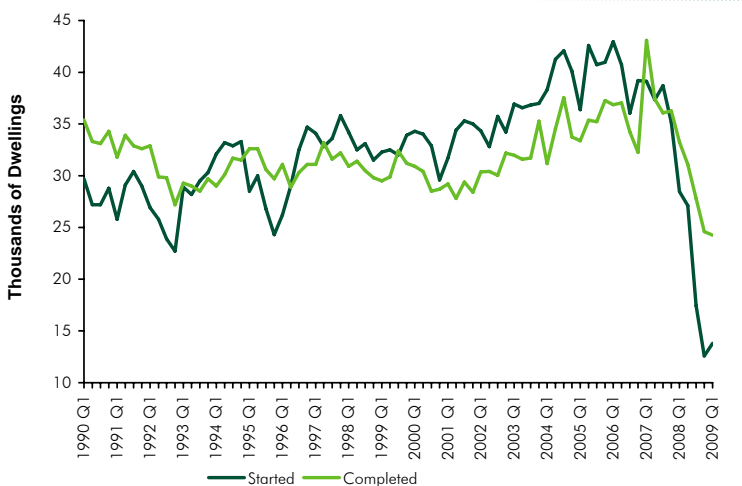
Source: Nationwide

Number of house hunters per agent



Source: NAEA

Housebuilding (England)



Source: DCLG

Those currently marketing tend to be forced sales, either financial or due to family circumstances such as death, divorces, a growing family etc.

The supply of new stock has also dried up with credit constrained developers focussing on securing their cash position and only selling existing stock or developments that were well underway.

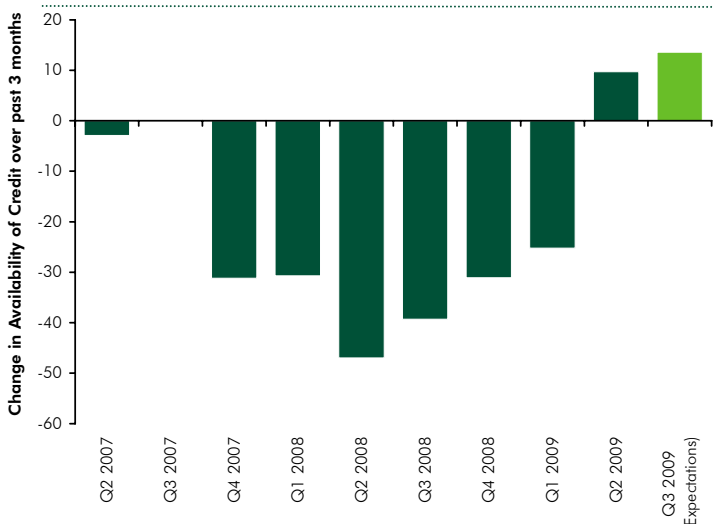
It is this current supply and demand imbalance that is putting some pressure on house prices, causing localised increases.

THE HOUSING MARKET IS UNLIKELY TO START ITS RECOVERY FOR SOME TIME

We do not think the recent pick up in house prices necessarily signals the start of a consistent upward trend in house prices. Over the next few months we expect the current demand and supply imbalance to shift, which will feed through to pricing.

There are a number of factors that could affect the current market imbalance. In particular, the stock of properties for sale is likely to increase as the recent rise in house prices could encourage home owners to market their properties. However, the unemployment rate is expected to hit 10%, or 3.2 million persons, in 2012; this level of joblessness would clearly stifle demand. In addition, mortgage rates have started to creep up in anticipation of interest rates rises in 2010. As a result, demand may weaken just as the supply of properties on the market begin to increase.

Changes in the Availability of Secured Credit Provided to Households



Source: Bank of England Credit Condition Survey Q2 2009

LAND VALUES FOCUS

DEVELOPMENT LAND ACTIVITY FALTERED...

In a downward market falling land values act as a disincentive for owners to sell their development land. Instead, landowners hold sites until the market shows signs of improvement. There may of course be forced sales, but in the current downturn, there have been far fewer than expected which is partly due to the low interest rates. With debt more affordable there is not the same urgency to sell. Banks' willingness to do debt equity swaps rather than putting the land up for sale has also prevented sharp increases in forced sales. Our research shows that in Central London, the number of major sites sold fell by over 60% in 2008.

...AND VALUES FELL...

Weaker activity has impacted land values; according to the VOA's Residential Development Land Index, land values across England and Wales fell by 33% in the year to January 2009. However, the average masks the true picture with evidence of certain site valuations falling by as much as 75% between 2007 and 2009.

According to the VOA, Scotland, Wales and the East Midlands have seen the largest falls of around 40%.

Base Rate vs. 2 Year Fixed Mortgage Rate



Source: Bank of England

In contrast, land values in the West Midlands fell the least; 22.5%. Although, these figures probably mask more severe falls in reality, if these sites were to be offered on the market today.

CONSENTED LAND VALUES SUFFERED SEVERELY

The froth in land values was particularly marked for consented land. However, with the increased risk of developing and financing development in the initial stages of the crash, this land rapidly lost its premium.

In the current market, negative/ minimal residual land values on consented sites is not unusual. This reflects a combination of factors including the dramatic fall in GDV as a result of house price falls combined with a developer view that GDVs would continue to fall further. In contrast, the developer's profit has increased to cover the current increased risks (associated with building in such an uncertain environment). Some S106 agreements that were viable in a frothy market are no longer affordable making many schemes simply undeliverable.

BUT, STRATEGIC LAND HAS RETAINED MOST OF ITS VALUE

Strategic land values have not fallen to the same extent as consented land. It is proving particularly attractive to cash rich investors and is becoming increasingly interesting as an investment to private equity groups and sovereign wealth funds.

Strategic land has the advantage of requiring a medium term view of the housing market. By the time planning permission is obtained many investors are expecting the market to have recovered somewhat. Similarly, the longer time frame means housebuilders hope they will benefit from a recovery in house prices.

BUT THERE ARE NOW SIGNS OF CONFIDENCE RETURNING TO THE LAND MARKET

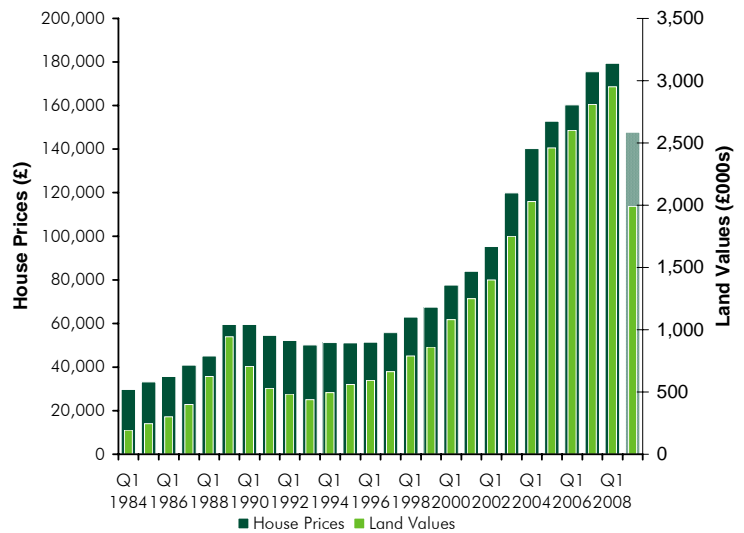
Over the last six to eight weeks there have been signs that developers are looking again to invest in land and build up their land banks. This is the result of increased market confidence and developers' need to bolster their shrinking land banks. A number of Plcs and housebuilders are back in the market for both consented and strategic land.

When buying land, housebuilders take a medium term view of the market and many have already factored in future house price falls. Therefore, we think land values are nearing, and maybe have even reached, the bottom of the cycle. We would not expect to see further significant falls going forward.

THE DEAL STRUCTURE HAS ALTERED

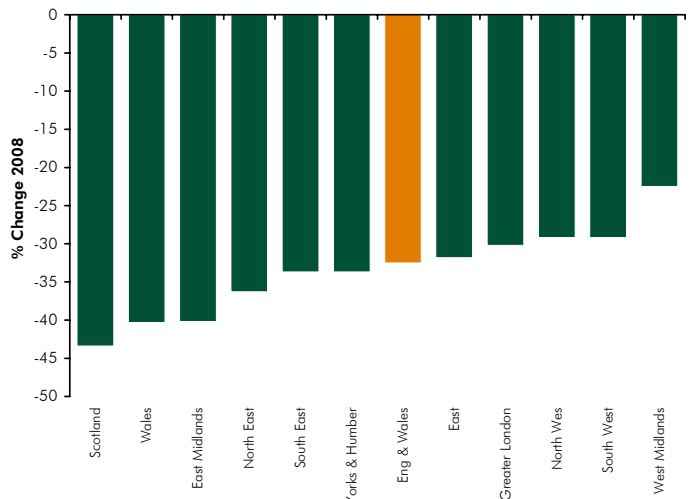
Before the credit crunch, land was bought outright and purchasers/ developers committed large amounts of capital to secure the freehold. In the current climate there are an increasing number of joint ventures, conditional contracts and deferred payment profiles. We expect these variations in the deal structure to persist for at least the short term, until there are clear signs that land values are growing and the market has started to recover.

Land Values Vs. House Prices



Source: Nationwide; VOA

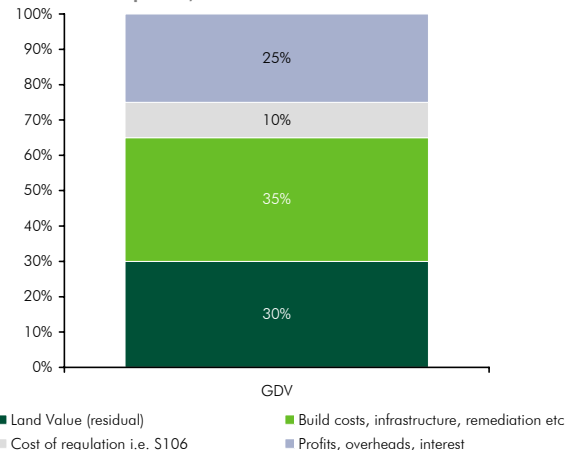
Falls in Residential Land Values (2008)



Source: VOA

Illustrative Residual Land Valuation Method

GDV - build cost - profits, etc. = Land value



Source: Homebuilding Market Study; Annex O, September 2008



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HOUSE PRICE INDICES				
	M-on-M	Q-on-Q	Y-on-Y	Level
Nationwide (Jun)	0.9%	1.1%	-9.3%	£156,442
Halifax (Jun)	-0.5%	-2.7%	-12.5%	£157,713
Land Registry (May)	-0.2%		-15.9%	£152,497
Hometrack (Jul)	-0.3%		-10.1%	
CLG (May)			-12.5%	£188,991
Rightmove (Jun)	-0.4%		-5.5%	£226,436

ACTIVITY INDICATORS				
	M-on-M	Q-on-Q	Y-on-Y	Level
Mortgage Approvals (Nov)	0.5%		9%	43,400
Gross Mortgage Lending (Nov)	-2%	3%	-58.3%	10,300
Housing Completions (Q1)		-22%	-27%	21,900
Housing Starts (Q1)		-9%	-52%	13,700

ECONOMIC INDICES				
	M-on-M	Q-on-Q	Y-on-Y	Rate
GDP (Q1)		-2.4%	-4.9%	
CPI (Jun)	0.3%		1.8%	
RPI (Jun)	0.3%		-1.6%	
Unemployment				7.6%

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