AUTUMN 09

residential insight

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CELEBRATING TEN YEARS OF GROWTH 2009

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SPECIAL POINTS OF INTEREST

INSIDE THIS ISSUE

welcome to the ARIM Autumn 2009 edition of Residential Insight

We remain uncertain about residential investment market prospects. ARIM sees a broad range of informed opinion but no compelling consensus view.

*Read more on **page 2***

UK Housing Market and Private Rental Sector

Updates and information on housing market activity, auction market, mortgage repossessions, housing development, housing market indices and pricing, market outlook, capital values and yields, PRS and lettings market. *Read more on **page 3***

ARIM Management Experience

The analysis draws on rental evidence from a sample set of in excess of 5,000 market rented residential properties under management for the review period January 2007 through to September 2009. *Read more on **page 5***

welcome to the ARIM autumn 2009 edition of residential insight

Whilst much has changed since our Spring 2009 edition, we remain uncertain about residential investment market prospects. ARIM sees a broad range of informed opinion but no compelling consensus view. Sentiment is seemingly positive yet the UK economy remains in recession and economic prospects are dim.

Irrespective of where we are at in the property cycle ARIM is firmly of the view that the optimisation of income returns will lead to relative out-performance for any residential investment.

overview

The UK remains in recession as at September 2009 and there has never been 18 months of consecutive GDP contraction before in over 50 years of economic experience. However, UK Government measures in terms of quantitative easing may well be having an effect and relieving the pain of recession. Certainly property lending has become more achievable if not cashflow lending. The practical reality is that any economic pain in the residential investment market appears manageable and with somewhat positive sentiment in the UK housing markets and commercial property markets (if not the residential investment market) the day-to-day market realities may be defying theoretical expectation.

mortgage repossession

Despite historically low interest rates, more flexibility from lenders and government schemes for borrowers in difficulty, retail mortgage default remains relatively high.

One of the more interesting features of mortgage repossessions in recent times relates to the realisation of the asset security. Mortgagees have withdrawn from auction disposal as the private treaty market has provided realisation at prices and cycle times more than meeting expectations. With limited discretionary private treaty vendors in the market and an underlying constant demand of "have to" purchasers, perhaps the lenders have operated as the only sellers in town and performed very well. Various house price indices suggest that house prices have been trending upwards over the last several months.

If there is increasing repossession flow driven in the main by worsening unemployment levels then this would surely be coupled with negative sentiment in the UK housing market generally and thereby having a negative impact on buyer demand. It would seem unlikely the private treaty market could then deliver a sustainable exit for such future repossession stock in those circumstances.

commercial lending

Commercial lending exposures are another matter entirely. The UK's Asset Protection Scheme according to The Guardian (September 2009) will support £575bn of commercial loan exposures secured on commercial and residential property. We also learn recently that the national Irish "bad bank" has upwards of £60bn of loan exposure secured on property upwards of 20% of which is secured on UK property. In our Spring 2009 edition we expected an acceleration in the pace at which loans might be called in but this does not seem to have been the case. If there is interest cover, loans are being left as they are. Whether such a position can be sustained is difficult to gauge but the expectation has to be that there will be a much greater flow of loans being called in during 2010 and 2011 as term arrangements fail to be renewed. Like mortgage repossessions, any defaulting commercial loans have had underlying asset realisations perform at good prices.

> Various house price indices suggest that house prices have been trending upwards

private rental sector and UK housing markets

As positive sentiment has returned to the UK housing market those "unwilling landlords" who made their way into the PRS are now marketing their properties for sale. With this adjustment in rental supply and continuing and reasonable rental demand we are starting to see a new upward trend in rental pricing with the premium end and London properties leading the way.

The underlying trend in mortgage approvals is increasing with late summer activity at much higher levels than seen earlier in the year but still at historically low levels. There is improving liquidity and whilst 100% mortgages may never return some higher loan to value products are returning to the market – albeit much more appropriately priced for risk. The CML report a twin track lending market with new lending for home starts improving but remortgage activity remaining weak.

The age profile of UK housing stock is becoming older and will age further if the relative suspension in housing development is sustained. Well maintained and presented property will stand at a relative premium across the near term.

prospects

Since Spring 2009 the FTSE 100 Index has gained 50% in value. Indeed for the 3 months to September 2009 the FTSE100 index gained 21% - its highest gain in its 25 year history. Despite such record gains the index remains some 26% below the 2 year cyclical peak and powerfully illustrates the inherent volatility in equity prices. Perhaps this volatility, historically low "risk" free cash returns and rates of return on 5 year UK gilts at sub-3% encourage greater interest in the UK private rental sector. This, coupled with the capital pricing correction in residential and thereby higher yields generated offer residential investment as an attractive proposition.

The economic meltdown of the last two years may well serve to accelerate even greater demand for good quality private rental supply. Longer term economic uncertainty and the need for personal flexibility, high levels of general and especially graduate unemployment and stringent lending criteria will help to drive this demand. Whether through the HCA Private Rental Sector Initiative or not there does not seem to be a better opportunity for the return of the institutional investor.

UK Housing Market updates and reports

auction market

- Prices achieved at auction in December 2008 are implying initial gross yields of just in excess of 9% (Source: Allsop LLP)
- Repossession stock reducing in extent across the summer months 2009 implying generally perceived market improvements (Source: Allsop LLP)
- Sales success rates holding up well over the last 6 months with 88% of lots sold out of in excess of 1,300 lots offered (Source: Allsop LLP)
- National auction success rate of 68% although improved on the 63% reported in August 2008 (Source: EIG August 2009)
- Repossession sales through UK residential auctions hits cyclical peak in Q4 2008. 2009 repossession sales through UK residential auctions back at 2007 levels (Source: Residential Auction Property Investment Data September 2009)
- Perhaps in view of the peak of repossession sales in Q4 2008 auction sales represented 4.7% of UK residential property sales. 2009 auction mix reducing somewhat to 4.1% (Source: Residential Auction Property Investment Data September 2009)
- Prevalence of private investors buying with cash in the auction rooms (Source: Residential Auction Property Investment Data September 2009)

housing market activity

View on house pricing turned positive for the first time in 2 years and becoming more so (Source: RICS Housing Market Survey – September 2009)

7 consecutive months of increased sales activity although pace of increase is slowing and comes from cyclically low levels and sales activity at highest point in 18 months (Source: RICS Housing Market Survey – September 2009)

Stock of properties for sale increasing (Source: RICS Housing Market Survey – September 2009)

New housing demand continuing to outpace housing supply (Source: RICS Housing Market Survey – September 2009)

CML say they are tempted to call the turn in the mortgage market as July 2009 mortgage lending increases by 24% on June 2009 and 19% higher than July 2008 (Source: Council of Mortgage Lenders)

Loan approvals for house purchase in July and August 2009 at highest monthly levels since April 2008 but still only half of where they were in August 2007 (Source: Bank of England)

Prime central London pricing increases of 4.3% in the quarter to September 2009 as a result of limitations in the supply of housing stock and some returning buyer confidence (Source: w.a.ellis September 2009)

Scottish housing market has gained momentum in recent months in both mainstream and prime residential markets resulting in higher sales volumes and stabilising market prices (Source: Savills September 2009)

New homes sales in recent months have performed well in Scotland, however, this is in part driven by deep discounting on prices. Given new build development being somewhat constrained there will be a limitation on new build homes for sale in the future (Source: Savills September 2009)

Increasing availability of mortgage finance – both a broader range of deals and more competitive pricing

Fixed rate mortgage deals available as at August 2009 at an average rate of 4.7% – 87 basis points below the 10 year average fixed rate deal (Source: Council of Mortgage Lenders)

indices and pricing

- Peak to trough pricing correction of 22.6% between August 2007 and April 2009 but followed by four monthly rises and 1 monthly fall in the index and reducing overall differential from peak to 18.1% (Source: Halifax House Price Index)
- Peak to trough pricing correction of 19.3% between October 2007 and February 2009 but followed by seven consecutive monthly rises reducing overall differential from peak to just 13.5% (Source: Nationwide House Price Index)
- First growth in house prices for 2 years in a market defined by limited housing supply (Source: Hometrack August 2009)
- Annual house price change at -9.4% and average house price in England and Wales now £155,968 (Source: Land Registry House Price Index September 2009)
- Housing transactions at 41,911 per month about 33% down on volumes for the same period on 2008 (Source: Land Registry House Price Index September 2009)

mortgage repossessions

- Start of year prediction for 2009 should see in the order of 75,000 mortgage repossessions. The substantial increase reflecting the much deteriorated general economic conditions mitigated by changes to benefits systems, more consumer friendly repossession procedures and other publicised mortgage rescue policy initiatives (Source: The Council of Mortgage Lenders – December 2008)
- Revised full year forecast for 2009 of 65,000 repossessions (Source: The Council of Mortgage Lenders - June 2009)
- 24,100 mortgage repossessions in the first half of 2009 (Source: The Council of Mortgage Lenders – August 2009)
- Worsening mortgage arrears in the second quarter 2009 from 2.38% default rate in Q1 to 2.43% in Q2 (Source: The Council of Mortgage Lenders – August 2009)

market outlook

- Property values will not return to 2007 levels until 2014 (Source: Ernst & Young Item Club)
- Limited mortgage supply and stringent lending criteria will be sustained moving forward limiting the extent of first time buyer activity which will restrict the rest of the market and limit overall market transactions (Source: Ernst & Young Item Club)
- Prospects of regulatory limits may further constrain already limited mortgage supply e.g. LTI and LTV limits
- With reducing rental supply and relatively stable rental demand the downward pressure of the last 12 months on rental prices will reverse. However, tenants will continue to exercise some bargaining power and will seek to differentiate rental stock on the basis of quality and perceived value for money
- Prospective tenants particularly in more prime rental markets looking to lock into term rentals of 2, 3 or 4 years. Landlords looking to respond by granting options but at future market pricing
- Private investor interest returning to the UK auction market. Average AST yields of 8.5% promotes relative attraction of UK residential over risk free cash returns (Source: Residential Auction Property Investment Data September 2009)
- Prospects for UK unemployment and general economic conditions are looking uncertain – unemployment rates increased 7.8% across the 3 months to June 2009 alone
- The age profile of UK housing stock is becoming older and may age further if the relative suspension in housing development is sustained. Well maintained and presented property will stand at a relative premium across the near term
- Slow recovery in UK mainstream market anticipated with upturn in prices not expected until 2011/2012 (Source: Savills May 2009)
- Prime residential market pricing has increased by almost 5% in Q2 2009 although in a cash buyer market and in the face of some degree of economic uncertainty it is not evident whether this is sustainable (Source: Savills July 2009)

Capital Values & Yields

Gross yields on Assured Shorthold Tenancies being achieved of 9.01% at September 2009 auction (Source: Allsop LLP)

Gross yields on Regulated Tenancies of 4.82% and Ground Rents of 3.99% at September 2009 auction (Source: Allsop LLP)

Gross yields on UK rental stock of 4.57% as at August 2009 (Source: FindaProperty.com August 2009)

Gross yields on Assured Shorthold Tenancies at 2009 auctions in the range 7.96% (London) to 8.97% (Midlands, Wales and the South West) (Source: Residential Auction Property Investment Data September 2009)

housing development

- Stock of unsold new build properties reducing within the major housebuilders as sales volumes have improved since Spring 2009. Selective and highly controlled opening of new development sites throughout the UK (Source: Savills September 2009)
- Off low land prices an competitive build costs will generate attractive returns from purpose built student housing development (Source: Savills May 2009)

UK Private Rental Sector analysis

PRS and lettings market

- Reducing demand for rental property but supply of properties for rental reducing more rapidly thereby reducing tenant bargaining power (Source: RICS Residential Lettings Survey July 2009)
- Small reductions in stock of supply of rental property in recent months as a result of improving prospects for home sales although still almost 50% greater rental supply than the same time last year (Source: FindaProperty.com August 2009)
- UK rental levels continuing to decline (Source: RICS Residential Lettings Survey July 2009)
- Rental levels at a 6 month peak of £829 per month but still 4.8% down year on year (Source: FindaProperty.com August 2009)
- Rental growth of 8.2% in the 3 months to September 2009 (Source: LSL September 2009)
- Expectations for rental levels improving although more surveyors still expecting a rental price fall over a rental price increase in the near future (Source: RICS Residential Lettings Survey July 2009)
- Expectations for rental levels improving although more surveyors still expecting a rental price fall over a rental price increase in the near future (Source: RICS Residential Lettings Survey July 2009)
- Despite a higher demand for flats than houses rental prices on flats performing less well (Source: RICS Residential Lettings Survey July 2009)
- Relatively strong demand for houses for rental but limited supply – possible future impact on rental prices for houses (Source: FindaProperty.com August 2009)
- Lettings complaints heard by the Property Ombudsman have risen by 26% year on year to June 2009 (Source: Property Ombudsman)
- Central London rental market very active. However, most activity is trading upwards for more space at less rental. Rental levels down 30% on what was being achieved in October 2008 (Source: w.a.ellis September 2009)
- Central London rental supply remains at high levels with no current evidence of the rental stock being prepared for sale (Source: w.a.ellis September 2009)
- Rental prices in Scotland 3.4% down year on year in September 2009 (Source: Citylets Report September 2009)
- Reducing levels of rental supply as unwilling landlords exit the market (Source: Citylets Report September 2009)
- Average time to let increased by 14 days year on year and only 40% of lettings are achieved within 4 weeks of initial marketing in Scotland (Source: Citylets Report June 2009)
- Purpose-built student housing expected to offer both rental growth and high occupancy with solid prospects for the future as the student population growing much more rapidly than the supply of student housing. Purpose built schemes will perform well under this scenario but there will also be a trickle effect into the mainstream rental market
- High level of additional London student housing demand but limitation on new supply

ARIM Management Experience

Current Trends in Rental Pricing and Arrears

The following analysis draws on rental evidence from a sample set of in excess of 5,000 market rented residential properties under management for the review period January 2007 through to September 2009.

Graph 1 illustrates year on year rental growth for the market rented tenancies managed by ARIM. Using actual rental levels where let and expected rental levels where vacant, the profiles illustrate a significant regional variation but an underlying trend in reducing rental growth and, indeed more recently, evidence of overall reductions in rental levels.

supply and demand

The experience of the ARIM market rented portfolio seems to be consistent with the experience of the UK PRS sector in general. Over the last 18 months to June 2009 we have seen a period of substantial change to the nature and profile of UK residential investment. The impact of "unwilling" landlords entering the PRS has been significant. Distressed lender and builder stock has entered the PRS alongside stock traditionally destined for private treaty sale. Despite rental demand at reasonable levels the additional supply has had a significant effect on existing PRS stock. Often newer and better presented and equipped this new supply had adversely impacted on pre-let void periods and overall portfolio occupancy rates. Consideration of rental pricing, review of letting and marketing strategies and development of capital investment programmes are amongst the asset management strategies open to investors. Re-adjustment of rental pricing to market levels are the most effective short-term strategies available to investors.

pricing

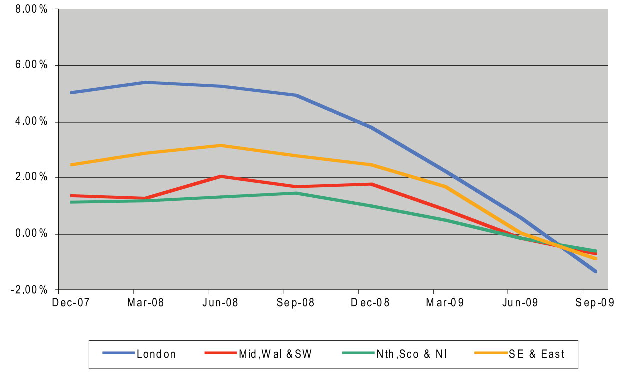
We are mindful of certain lettings market claims of a fairly recent (last quarter) increase in rental pricing. We have analysed our experience based on quarter by quarter actual pricing evidence achieved. Whilst there has been a slight upturn the general pricing trend across all regions is downward. We will be looking at this closely over the coming months although it is difficult to isolate the effects of pure rental pricing from property quality, existing positions on portfolio occupancy and where our portfolio is already at in terms of market rental pricing.

Graph 3 illustrates ARIM experience of rental growth for ARIM PRS stock where tenants remain in occupation for in excess of 12 months. Perhaps expectedly, this analysis presents a similar regional profile and presents a similar underlying trend to the presentation of overall portfolio rental growth. However, what is evident is that there is a relative premium to underlying rental levels from tenants in occupation – around 1-2% - in terms of the rental growth tenants in occupation will absorb versus the experience of other PRS stock.

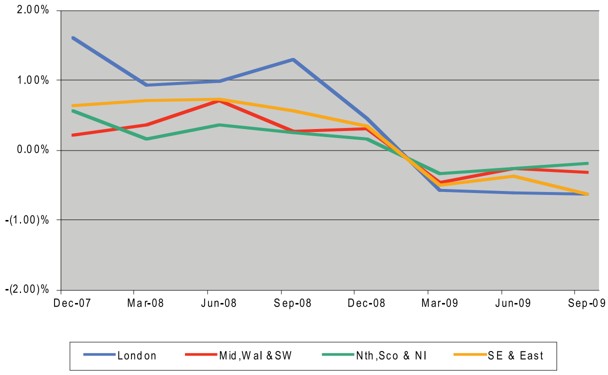
tenant retention

Vacant properties not only have a direct cost of void losses, often consequential property refresh costs to prepare for let but also the opportunity cost of occupational tenant rental growth premium. An ongoing commitment to high levels of service to occupying tenants, proactive renewal and rollover strategies and of course appropriate and timely capital improvement programmes can help sustain tenant retention rates.

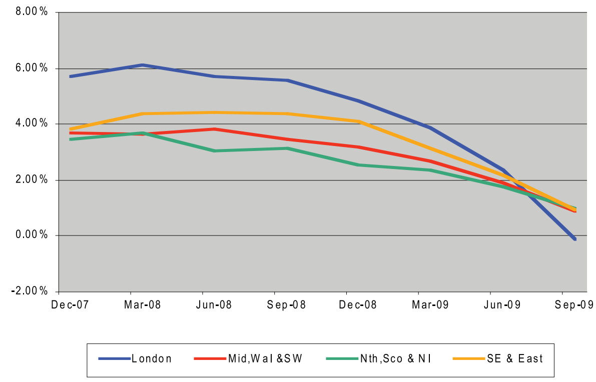
Graph 1 Portfolio Rental growth



Graph 2 Portfolio Rental growth – Quarterly



Graph 3 Occupational rental Growth



Current Trends in Rental Pricing and Arrears

default rates

Graph 4 illustrates the presentation of live tenancy default rates as measured by current tenant arrears as a proportion of annual rental demands.

Despite a worsening general economic backcloth from late 2007 the profile of market rental arrears default has remained largely constant over the review period and indeed on an overall ARIM portfolio basis the extent and depth of default has improved over the review period. The following factors appear to have contributed to this improvement:

- tenants are generally able to settle their liabilities to landlords in the face of the very real threat of losing their home – often deferring and displacing rental debt onto credit cards
- offering flexible payment arrangements and a broad range of methods of payment
- early tenant contact with the offer of flexibility and a firm but constructive dialogue

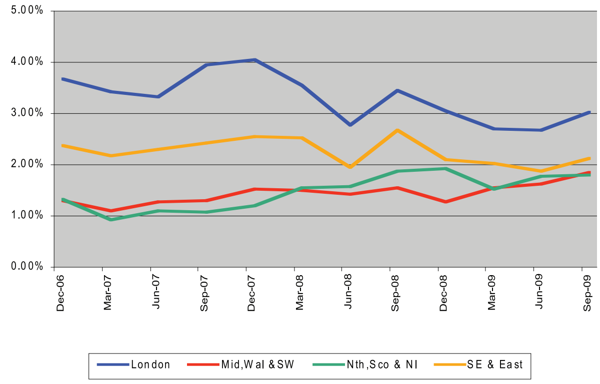
Perhaps one of the more interesting features of current arrears default is that the greatest regional exposures are in the higher rental locations in London and the South East. With higher average rentals in these same locations there is a compounding effect which under certain economic conditions would give rise to concern.

Live tenancy default rates are though only part of the overall story. Graph 5 presents the ARIM view of bad debt as represented by tenancies attaining "former" status in the period gross of any written-off tenancy charges but with carried arrears balances. This is a worst case presentation of "bad debt" as it takes no account of the potential for downstream former tenant debt recoveries. Nevertheless it is indicative.

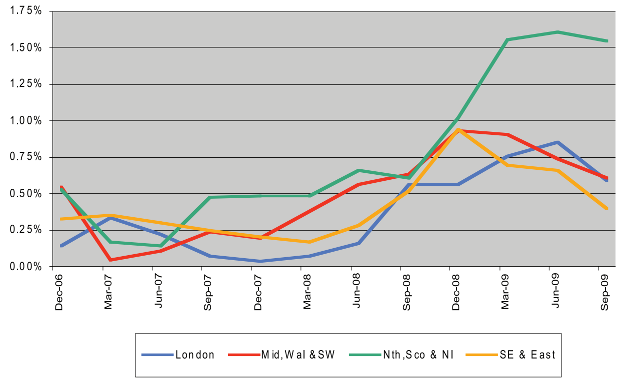
the near future

What we can see is that there has been a substantial increase in bad debt rates during the latter half of 2008 into 2009. All regions display the same general upward trend although the North, Scotland and Northern Ireland have had the most significant erosion in bad debt performance. Given general economic conditions over the review period an increase in bad debt rates is to be expected. However, bad debt rates in the current economic conditions are still no more than 1% and in comparison with void losses of in excess of 5% look good value.

Graph 4 Live Tenancy Default Rates



Graph 5 Bad Debt Rates



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