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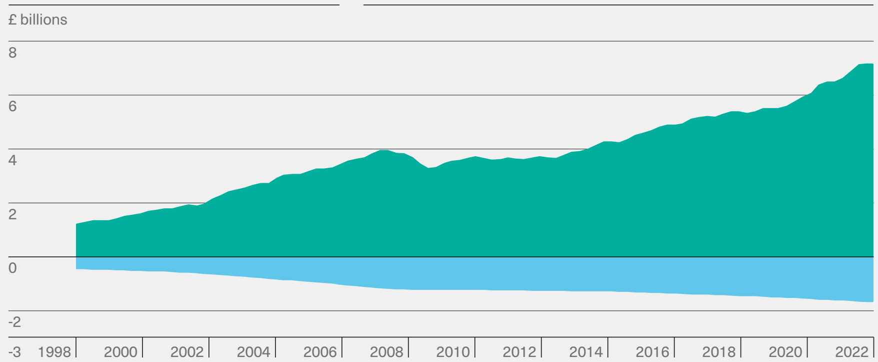
Home economics: Charting the course of the UK housing market

Introduction

The housing market is a national obsession in the UK, perhaps not surprisingly, since it accounts for such a large proportion of total household wealth. With that obsession comes a lot of media, political and financial market attention, but possibly surprisingly, debates about the housing market are often ill-informed and typically lack any focus on data and facts.

Gross housing wealth and mortgage loans

Source: Lazarus Economics, Bank of England



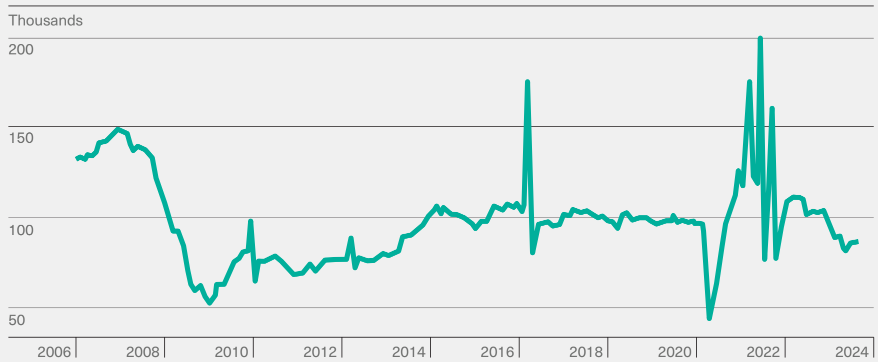
Over the last forty years, many macroeconomic factors and policy decisions have impacted the UK housing market. Some are obvious and include interest rates, fiscal policy measures and planning policy, but others are less obvious but equally important and include wage growth, mortgage regulation and housing supply (the rate of new build).

What is clear from this forty-year history is that different variables have exerted a dominant influence over the housing market and the direction of prices at different times. So, focusing on one historic variable as the apex predictor of future moves in the market and house prices will inevitably be a mistake. House prices move in different directions for different reasons, and the magnitude of those moves is often influenced by a more complex combination of variables than is widely assumed.

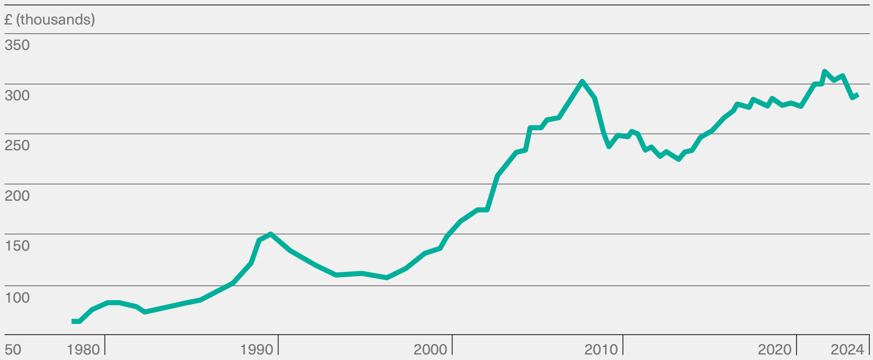
Right now in the UK, after a very prolonged period of rising interest rates from extremely low to relatively elevated levels, media and consensus opinion about house prices has been, and still is, consistently very negative. The reality is that the UK housing market has been pretty stable through this period of rising interest rates, experiencing only modest reductions in price and transactions and an approximately one-third reduction in new mortgage lending. We think this speaks to robust underlying support for the market and an immediate future likely to be characterised by lower interest rates, cheaper mortgages, lending growth, growing transaction volumes, higher new build rates and modestly rising prices.

Number of housing transactions

Source: Lazarus Economics, Land Registry



Real average house price
Source: Lazarus Economics, Land Registry

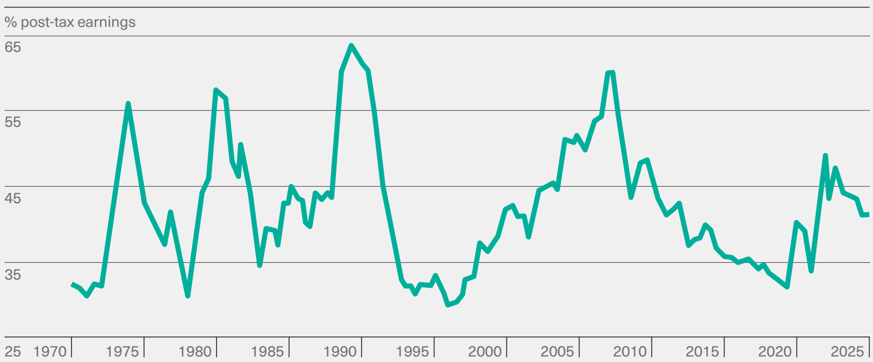


Recent history
The 1980s was an interesting decade for the UK housing market. Significant financial deregulation alongside big political changes (the "Right to Buy") resulted in a huge increase in owner-occupation in the housing market, which grew from 56.5% at the start of the decade to 66.3% in 1989, an increase of 2.75 million home-owners. There was a coincident and significant fall in private and social renting. This growing trend in home ownership continued throughout the 90s and peaked at 71% of the housing market in 2003.

After the early to mid-90s housing recession, prompted by higher interest rates and relatively high levels of consumer borrowing, the UK housing market embarked on a sustained rally from 1998 through to 2007/8, when the financial crisis prompted another significant setback in activity and prices. The growth in house prices between 1998 and 2007 at 10% per annum had closely tracked the annual growth in mortgage lending over those ten years.

After the disruption of the financial crisis and the abrupt tightening in credit conditions that came with it (constraints on mortgage lending), housing transactions fell to below one million per annum, having peaked at 2.5 million per annum in 1988 and remained at this low level until 2013. Interestingly, house prices rose on average by 3.5-4% pa between 2010 and 2019, but on this occasion, the rally was not prompted by abundant mortgage availability but by lower borrowing costs. During this period, wage growth averaged 2% pa, and consequently, the house price-earnings ratio rose from an average of 4.5x between 1998 and 2007 to an average of 5.25x between 2010 and 2019. Having averaged close to 7% between 1998 and 2007, the interest rate on a 90% LTV mortgage fell from an average of 45% of post-tax earnings over this period to 35-40% between 2010 and 2019.

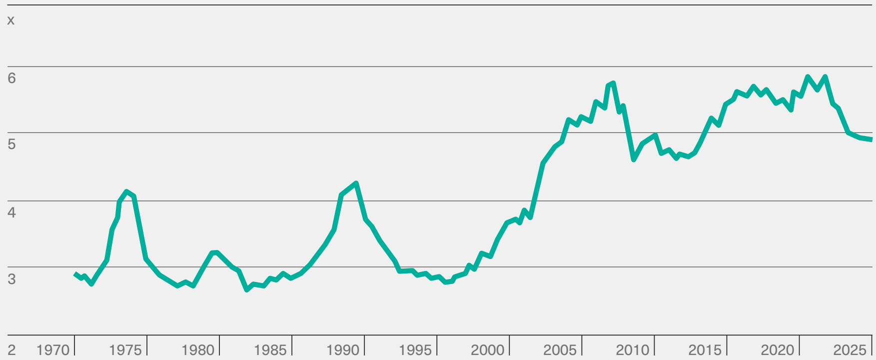
First-time buyers mortgage payments
Source: Lazarus Economics



After 2019, as a result of the pandemic and the further significant cuts in interest rates it prompted and stamp duty cuts, house prices continued to rise, and transactions, which had fallen significantly as a result of the COVID restrictions, bounced back rapidly to close to 1.5 million per annum. To put this into context, this was 25% above pre-pandemic levels and the highest since 2007. Between February 2020 and November 2022, house prices rose by more than 25%, taking the average nationwide house price to £292,000, with the first-time buyer house price-earnings ratio climbing to 6x.

More recently, the prolonged tightening in monetary policy, which has now ended, has resulted in falls in affordability, lower transactions, and a modest price setback. So, first-time buyer mortgage payments have risen to nearly 50% of post-tax earnings, transactions have fallen to about 85,000 per month (average over the last three months to September 2023), and real house prices have fallen by about 6% since the peak in November 2022.

First-time buyers house price/earnings ratio
Source: Lazarus Economics



What next?
In common with most developed economies, as the unwinding of the energy price shock that followed the outbreak of war in Ukraine and post-COVID supply disruptions wash through the official statistics, we can expect further significant inflation falls. Indeed, we expect inflation to continue to fall throughout the remainder of 2023 and 2024 and to bottom out at about 2-3% at the end of next year.

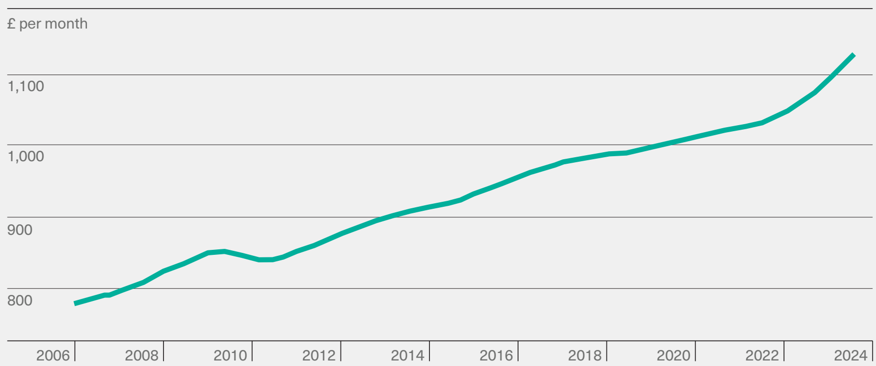
Policy interest rates have peaked, and market rates have started to fall significantly. This is already impacting the fixed-rate mortgage market and will likely continue to do so for the foreseeable future. Consequently, we expect to see a sustained and significant improvement in housing affordability due to falling rates and robust growth in real and nominal wages. Cheaper mortgages and rising wages will prompt more mortgage approvals, higher transactions, and, with a lag, growth in new housebuilding activity. We expect average pricing to stabilise and to see modest growth in the second half of 2024 and into 2025, in line with anticipated wage growth. In addition, we also expect to see fiscal policy initiatives directed at stimulating home ownership, given that both leading political parties in England see housing as a policy priority ahead of the next general election, which we expect to take place in Q4 2024.

Private sector rents (PRS)

Some recent history

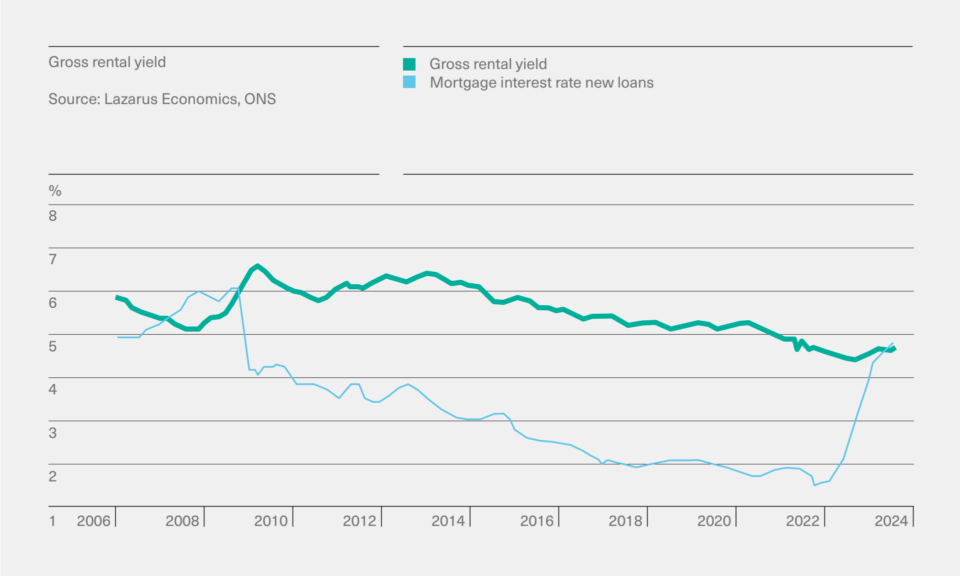
Average private sector rents

Source: Lazarus Economics, ONS



As the chart above shows, ahead of the 2007/8 peak in the housing market, average private sector rents were around £800 per month, broadly equivalent to a quarter of full-time average earnings. Average monthly mortgage payments at this time were approximately £600 per month. With the national average house price at the time of £190,000, private sector rental yields were around 5.25%, with the average interest rate on mortgage loans at about 6%.

Over the ten years from 2010 through to 2019, average private sector rents increased by about 2% per year, in line with the increase in average earnings over this period, but lagging behind annual average house price inflation of 3.5-4% pa. As the next chart shows, over this period, as rental growth lagged house price growth, rental yields compressed (fell) but still remained well above mortgage interest rates.

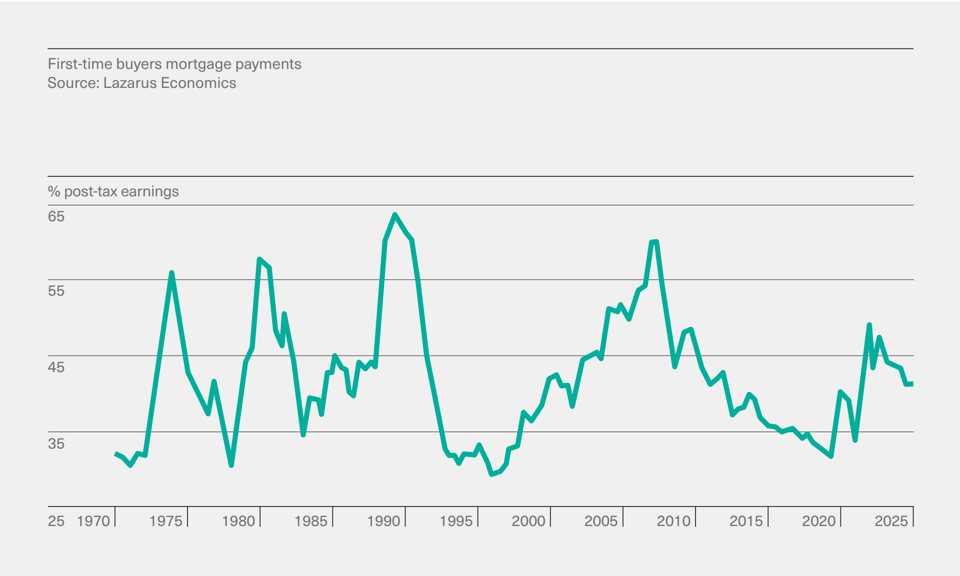


More recently, as rental growth lagged well behind house prices during the COVID period, yields compressed further and fell to a low of about 4.5% in 2022. However, following the inflation spike that followed the outbreak of war in Ukraine and the subsequent significant monetary policy tightening that followed, house prices have fallen in real terms, and rents have increased significantly, pushing rental yields back up to just under 5%. In the very immediate future, we expect rents to grow ahead of house prices, pushing yields up again over the next six months to slightly above 5%.

In terms of consumer preferences for renting relative to ownership in the housing market, many factors play a part. No one variable generally predicts how these preferences play out. For example, between 2003 and 2017, private renting increased from 10.8% of the housing stock to 20.3%, despite mortgage rates being consistently well below rental yields throughout most of this period. Access to mortgage finance and the requirement for larger deposits (90% LTV mortgages were tough to get after the financial crisis) were the key factors that drove consumers into the rental market during this time.

The future

Now, with rental yields and mortgage rates on new loans broadly similar and with access to mortgage finance beginning to improve, we would expect to see the percentage of home ownership to rise slightly and the proportion of private renting to decrease somewhat in the immediate future, reflecting in part, better affordability following strong wage growth, both nominal and now real.



Within the PRS sector, though, we expect small-scale private landlords to continue to exit the sector and institutional interest in this asset class to grow rapidly. Reflecting this trend, Vistry, one of the UK's largest new house builders, this week announced a very significant £820mn deal with two Blackstone-backed funds (Leaf Living and Sage Homes) to deliver a total of 2,900 homes into the PRS and affordable homes for rent and shared ownership sectors. This is one of the largest deals of this type yet announced, and we expect many more along these lines in the months and years ahead.

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Accessing this PRS opportunity
Curated is working with Edenstone Group, a UK, mid-sized, innovative and very entrepreneurial housebuilding business, to find an appropriate and aligned PRS capital provider to partner with the Group to build a significant (up to £250mn) portfolio of exclusively net-zero surburban housing. The aim is to start the joint venture in mid 2024 with Edenstone providing the completed homes alongside the property and tenant management services. The expectation is that the project will deliver up to 750 homes per year over a five year period.

The proposed structure for this joint venture entails Edenstone delivering the net-zero homes at a discount to open market value alongside the property and tenant management services with the financial partner providing the requisite capital over the five year life of the venture. The anticipated returns to the JV include the rental yield and rental growth alongside modest house price inflation, and are forecast to deliver between 10-12% per annum over the initial five year life of the vehicle.

Edenstone has an established and successful PRS relationship with Eden Living, which is owned and financed by funds managed by Warwick Capital. Edenstone has delivered 199 homes into this PRS joint venture with a value of approximately £60mn alongside the provision of back-office support through a services agreement. This JV has provided Edenstone with the necessary knowledge and experience crucial for success in the PRS space, something that will prove invaluable in the JV Edenstone is now looking to put together with an aligned capital provider.

Curated believes this is a rare opportunity for an investor able to deploy significant scaled capital into an attractive, low risk but high return, hard to access and differentiated asset class with a proven operator. Edenstone not only has an established track record in the PRS sector but also leads its industry in terms of net zero housing, having built its first zero carbon home in 2019.

Find out more about the Edenstone PRS opportunity
Curated is representing Edenstone in its current funding round. To find out more about the business, how to invest or to meet with the management team, visit the company profile page.

Find out more

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Curated Capital
Curated Capital Ltd is authorised and regulated by the Financial Services Conduct Authority, ADGM.
Registered address Al Sila Tower, ADGM Market Square, Abu Dhabi, UAE.

hello@curatedim.com
www.curatedim.com