An Opportunistic View of the UK Property Market, an article for Property Forecast

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Synopsis: What is MPL's own experience as an opportunity fund manager in terms of what types of property it is targeting? What are the market prospects from its own particular perspective in terms of challenges and opportunities?How easy/difficult is it to raise funds from investors and who are those investors (foreign?UK based etc)? How much is MPL trying to raise, and what competition is there with the many other opportunity funds arising at the moment?

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It was somewhat astounding to see so much investment into newly-launched property funds in the run-up to the current property slump. When it seemed clear to us at Managing Partners Limited that prices were clearly due a major correction, investors were being wowed by past performance. We held off soft-launching the British Property Opportunities Fund (BPOF) until February 2008 precisely because we anticipated a downturn. While we are hardly in the throes of a full recovery now, there are plenty of opportunities to earn good rental yields with the prospect of longer term capital gains if you know where to look.

So where exactly in the cycle is the UK property market now? There have been some positive signs: in May the Halifax House Price Index saw a monthly rise of 2.6%. This is after a big fall in prices: the average house price was estimated to be worth £183,694 in May 2008 and in May this year this figure had reduced to £158,565. The house price to earnings ratio (a key affordability measure) also declined from its peak of 5.84 (in July 2007) to 4.36 in May 2009. The ratio is now at a level last seen in January 2003.

Of course, we have yet to see any real general recovery in UK property. But a round-table debate we hosted recently for leading players in the market concluded that UK residential had either reached the bottom of the market or was very close to it. These industry players pointed out however that there are a lot of regional variations in the UK residential market and confidence is still being undermined by several factors, including a lack of supply, illiquidity in the mortgage market and deep uncertainties regarding the economic outlook. So investors need to be very discerning if they are to make returns.

One segment of the market that stands out above all others for us is the South East. As the market stabilises we expect the South East to show the earliest signs of recovery because of its density of population and its bias towards service industry rather than manufacturing, which we would expect to take longer to recover.

It appears that many agents across the country are pricing stock much more realistically so that the properties become more attractive to a larger number of potential buyers, which is leading to bidding wars that are influencing sales prices in certain areas. In London and the South East, a lack of stock is exacerbating this issue. The London market remains busy, probably assisted by European buyers looking to take advantage of the weak pound.

Key factors supporting investment in the South East include:

- The South East has already seen a considerable correction in property prices and rental yields of between 7% and 10% are now achievable, making property values extremely attractive. These types of yield suggest that house prices in the South East are reasonable, which would indicate that we are not too far from the bottom of the market.

- The South East has always had higher, more robust property values because of inherent local affluence and therefore the rise in property prices has not been as exponential in the South East as in other regions where property prices have been pushed to dizzy heights by buy to let investors.

- The South East has a much greater density of population that has continued to be a market driver for higher house prices and affordability levels have sustained greater property values as result of higher salary levels.

- There has been a shortage of housing in the South East since the Second World War and with a continued increase in economic migration, the demand for new homes in the South East will continue to rise during a period of time when new home construction is at a critically low level. When the property market turns, demand will outstrip supply.

- The region has a greater concentration of financial and service related industry, which is the sector that is likely to see more rapid recovery whereas the north of England has a larger manufacturing base where greater numbers of employees are reliant on the prosperity of industrial companies that will take a great deal longer to recover. We should therefore expect to see longer term unemployment in certain regions, which will depress property prices for longer.

The types of property we have been interested in include refurbished apartment blocks and Victorian terraced properties, all with high yields. We have avoided new builds because they have been notoriously overpriced by developers and tend to carry much higher management and service fees that can impact heavily on the net yield.

So far we have not invested the BPOF in commercial property. But that is likely to change this year. There are some very strong yields to be obtained in the sector and many commercial properties are currently attractively priced for cash-rich funds and investors. Commercial property values are now down by around 40% since their peak in 2007. This means there are a number of attractive opportunities in this market and again, current yields, even allowing for a realistic estimate of tenant fallout, will provide a strong real return.

Yields of 8% and 9% are available at present on commercial property that could also see some strong capital growth in the longer term. Compelling valuations, a degree of transparency and a relatively secure income are returning to the commercial property market and for that reason we are looking to increase our exposure to this asset class, although investors still need to tread carefully and choose a property that is in a good spot with reliable tenants and which is undervalued.

Another area that we have looked at recently is working with developers who have developments with lots of good potential but who are facing a freeze on funding because their banks have become cautious and want to see evidence of sales before continuing to lend against these projects. As a cash-rich fund, we are in a position to buy some of these properties off-plan, provided they offer strong rental yields, long-term capital growth prospects, or both.

MPL is not alone in launching a property fund over the last year but there still has not been that many, despite the logic in investing near the bottom of the market. Several of these launches have been close-ended funds, which are much less transparent and have no track record. To some extent this goes against the grain at a time when investors are nervous and need to see a track record and transparency.

Investors should certainly avoid the larger and older property funds because of the challenges they face as a result of holding a lot of legacy property bought at the top of the market. They have been in redemption mode for a long time with investors trying to pull their money out and they do not have free assets available to capitalise on the opportunities in the market.

To date we have not been particularly pro-active getting assets into the BPOF although it is available to both retail and institutional investors. We wanted to build up a track record by buying properties through the curve using seed money. Since its launch, BPOF has continued to deliver positive investment returns as a result of its sustained acquisition of property at substantial discounts to prevailing market values. Going forwards, we expect to raise substantial assets as investors both in the UK and internationally regain their appetite for British property.