The Outlook for the UK Property Market, an article for Investment Adviser

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Synopsis: The UK residential property outlook, particularly the pros/cons, why now is a good time (if it is), how residential is likely to stack up against commercial property funds etc.

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The British have had a long-running love affair with property. Like many affairs it has had its ups and downs, but the gains in residential property prices in real terms since at least the end of the Second World War cannot be ignored.

House prices cannot keep going up forever, of course. Yet this fact seemed to be forgotten in the run-up to the latest slump. It was somewhat astounding to see so much investment into newly-launched property funds when it seemed clear to us at Managing Partners Limited that a major correction was due. So much so we held off launching our British Property Opportunities Fund until 2008.

The latest downturn has been severe, having gone hand in hand with what has been the sharpest economic downturn in the UK since records began. Confidence has been hit hard, but is now a good time to invest in one of the several residential property funds now coming on to the market?

There have been some positive signals. The latest data from Nationwide said that the average house price rose by 1.6% to just over £160,000 in August. This was higher than the 1.4% rise seen in July but did still mean the average house price was 2.7% lower than a year ago. August's figure was the fourth consecutive monthly rise in house prices reported by Nationwide. According to the Land Registry, house prices in England and Wales rose by 1.7% in July compared with June, which was the biggest monthly rise since July 2004. Against these positive numbers, according to property website Rightmove asking prices in fact fell by 2.2% between July and August, with the price of homes on the market in England and Wales averaging £222,762 over the four weeks to August 8, or just over £5,000 less than in the previous month.

The reality is that we have yet to see any real general recovery in UK property. A round-table debate we hosted in May this year for some leading players in the industry concluded that UK residential most likely had either reached the bottom of the market or was very close to it but the lack of mortgage finance and economic backdrop was weighing heavily. But investors still could exploit some fantastic yields available in certain pockets of the market.

Participants in the debate pointed to buy-to-let investors quite possibly playing a key role in helping the property market to recover, attracted into the market because of the availability of yields of up to 10% or more. The prospect of capital growth in the longer term through buying at or near the bottom of the market is attractive, too.

One segment of the market that stands out above all others 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. Because of the employment challenges that lie ahead for the UK, the worst place to be employed is manufacturing. So the further north you are the more difficult the property market becomes. It is fair to assume those cheaper properties in the North East will be hit hard for longer.

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.

Until quite recently, to invest in a “property” fund to all intents and purposes really meant investing in commercial assets as far as UK retail investors were concerned. There are now some very strong yields to be obtained in the commercial property 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.

But investors interested in the commercial property sector should 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. Many of these funds put up barriers to investors withdrawing their cash because of the liquidity issues involved in selling the underlying assets in a depressed market. Many investors have had to wait many months to cash in their units, and even then incurring big losses and it will take a considerable period of time for these older funds to shore up their cash flows ands as a result they are highly likely to miss out on the opportunities in the market today

What cannot be denied is the logic in investing at or near what is probably the bottom of the UK property market. When the recovery comes it is likely to be rapid in the first year so there is a good reason to be invested in a fund now that can buy through the curve, taking advantage of property available at substantial discounts. The growing availability of residential property funds also means that UK investors will have another, more diversified way other than by direct ownership to rekindle their love affair with property.