RETTIE & CO. RESEARCH REPORT
Summer housing market briefing

JULY 2023

A subdued market but still performing

NINE MONTHS ON

A lot can happen in just nine months. Conception and birth of a baby. A year at school. A full league season in football.

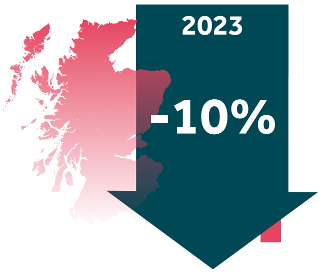
Yet it really is just nine months since Kwasi Kwarteng introduced his infamous mini-budget in September 2022. Of course, we probably all wish it hadn't happened, but the money market panic that followed the mini-budget, and then seeped into the wider economy, including the housing market, is now part of our history. Although some of the measures were reversed in late 2022, the hangover of the mini-budget, as well as other geopolitical events that started in 2022, are very much still with us.

The housing market is now a far more complicated landscape to navigate and, for many households, a more expensive one.

> *There can be no doubt that first time buyers and leveraged investors will find market conditions more challenging. These pressures will weigh down on all tenures, limiting people's choice and housing options. In this context, current legislation is not helping.*

Dr John Boyle, Director of Research & Strategy

KEY FINDINGS

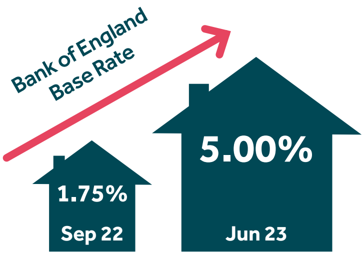


1. An adjusting sales market

Scottish house sales were **down 10%** Jan-May 2023 compared to the previous year, with the **rate of house price rises also falling**. Steeper adjustments are now expected over the course of 2023 as interest rate rises take effect.

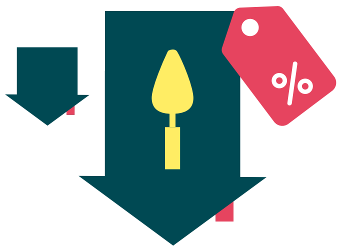
2. Supply and demand

Although sales have slowed, there remains an appetite for people to sell. The value of properties being listed is **broadly comparable with last year**, although sales will take longer in the slowing market.



3. Mortgage challenges

The main challenge in most parts of the housing market just now is the **rising cost of mortgages**. The latest Bank of England decision to raise base rates to 5% to try to tame a still stubbornly high inflation rate **will see mortgage rates rise further**.

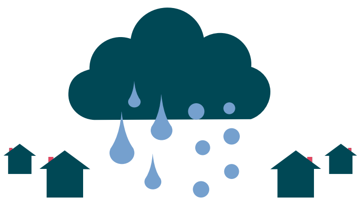


4. New build difficulties

A period of slower or negative house price growth, with material and labour costs remaining high, will **slow down housing delivery**, potentially leading to **subdued new build activity** for some time to come.

5. Rental market crisis

Rent increases are being driven by strong competition for **a smaller supply** of available housing. With further new legislation in the pipeline, there is likely to be **a further reduction in supply** at a time of increasing demand as landlords continue to choose to leave the sector.



6. A subdued outlook

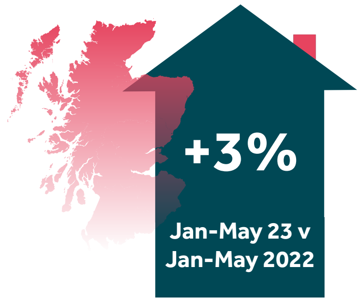
We believe that sales transactions will **drop back 15%** over the course of the year. While we expect **prime markets to remain more robust** as supply remains below demand, there can be no doubt that **first time buyers** will find market conditions more challenging.

KEY FINDINGS EXPLORED

1. An adjusting sales market

PRICES LEVELLING OFF

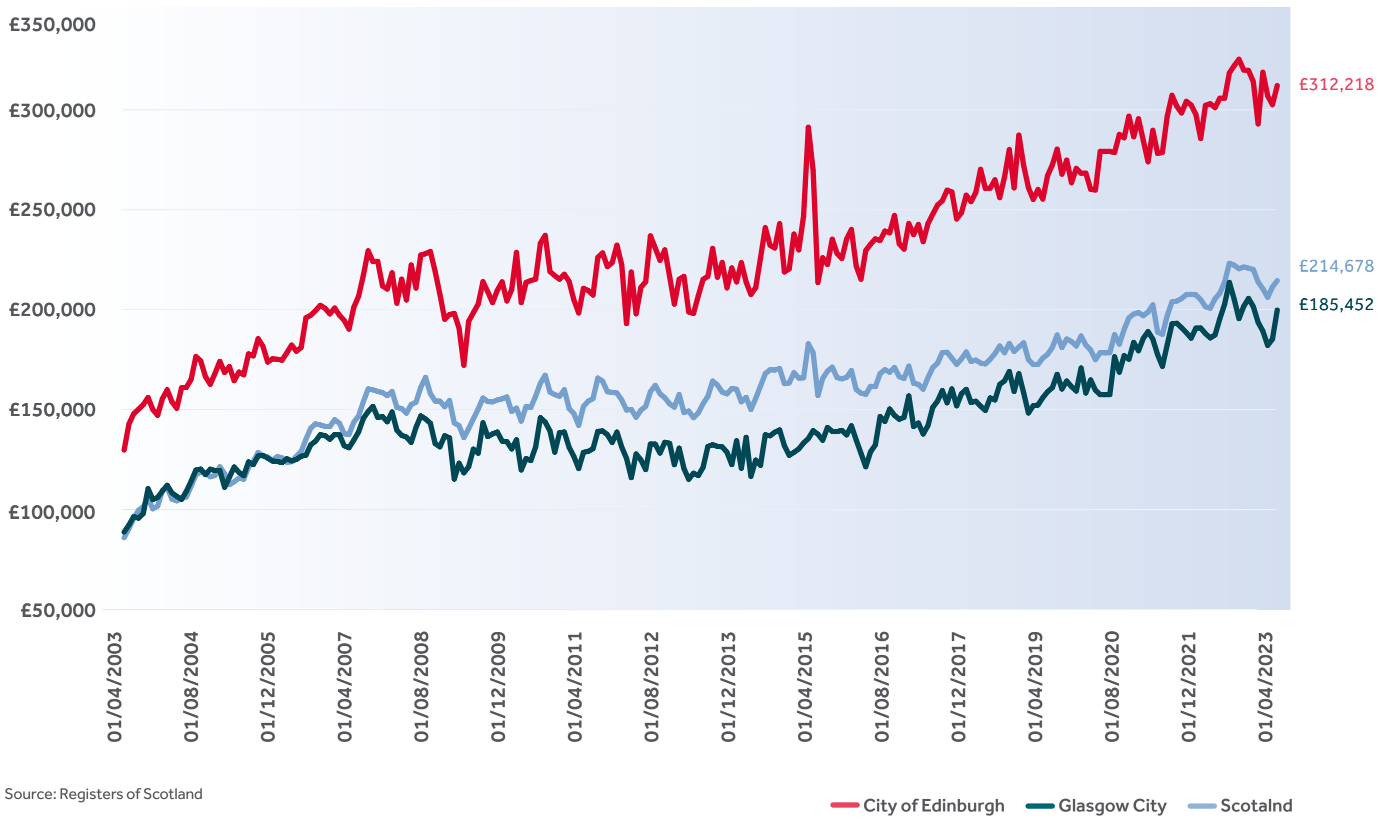
The average house price in Scotland has been levelling off since September 2022, with **growth slowing or stopping** and some markets turning negative. The causes of this cooling include the rising cost of mortgages, weakened buyer confidence, and a market correction after a period of strong house price growth. While this moderation in the market was anticipated before the mini-budget, the sharp rise in the cost of borrowing has accelerated it.



Prices

Figure 1. Average house price growth has slowed in 2023 as a result of rising cost of living and borrowing, and weaker consumer confidence

Average House Price in Scotland, Edinburgh and Glasgow, 2003-May 2023



Source: Registers of Scotland

KEY FINDINGS EXPLORED

1. An adjusting sales market *continued*

ACTIVITY FALLING

While average house prices always garner the most press attention, it's been the fall in **market activity** from the levels seen over the past couple of years that is currently driving market dynamics. The **number of registered sales** at the start of 2023 is down around -10% across Scotland compared to the same period in 2022, with Glasgow down slightly less at -8% and Edinburgh contracting slightly more (-14%) from the relatively buoyant 2021-22 market conditions. This has seen market activity in both cities drop to the pre-pandemic levels of 2018 and 2019.

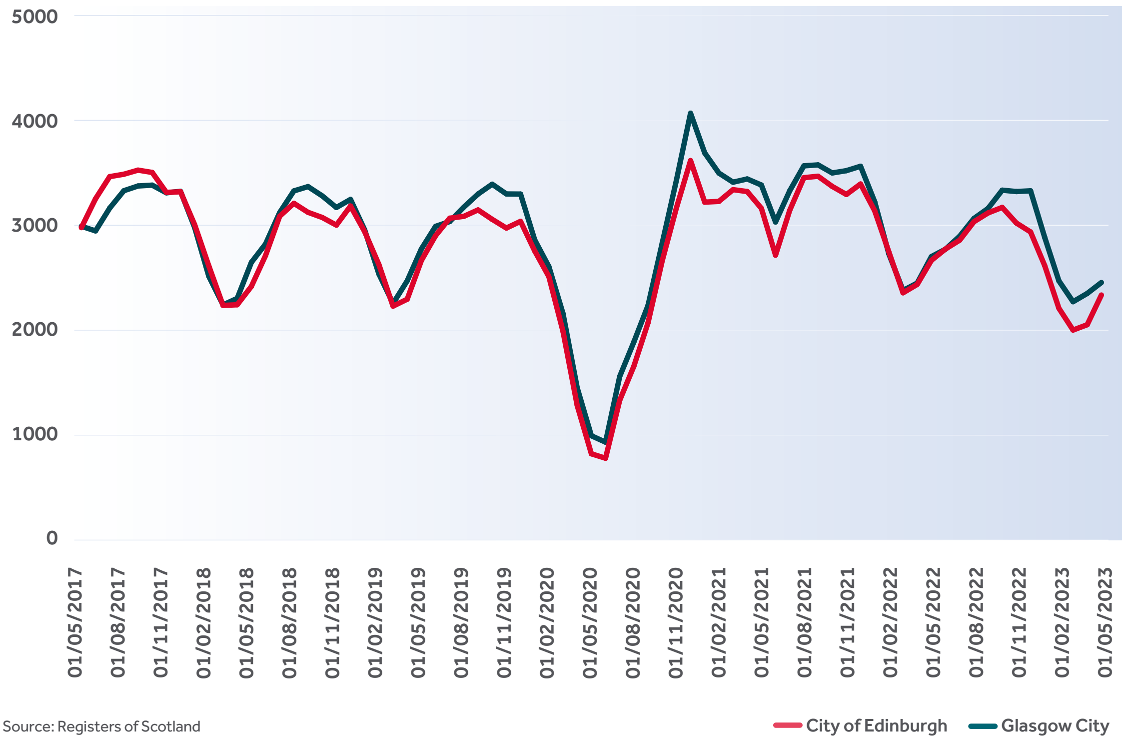
-10%

registered sales across Scotland at the start of 2023

Source: Registers of Scotland

Figure 2. The main market correction has been in volume of sales

Count of Registered Sales on a 3 Month Rolling Basis in Edinburgh and Glasgow, 2017- May 2023



Source: Registers of Scotland

2. Supply and demand

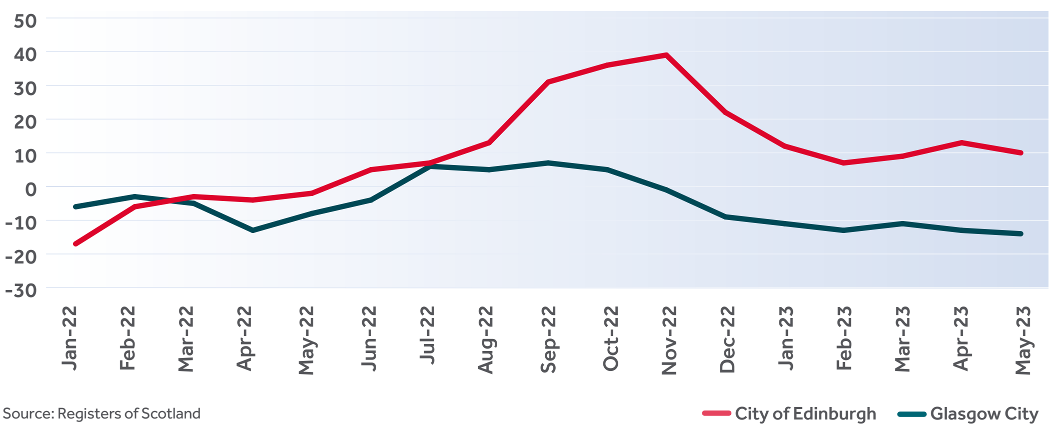
APPETITE FOR SALES REMAINS

Although sales have slowed, the **value of properties being listed is broadly comparable with last year**, although sales will take longer in the slowing market.

In **Edinburgh**, despite falling sales, **the supply coming to the market has remained up year-on-year** in the first part of 2023. In Jan-May 2023, the supply of new properties coming to the market is around **10% higher** than the same period last year. In Glasgow, supply has followed the downward trend seen in registered sales, falling back around 14% year-on-year.

Figure 3. The volume of property coming to the market in Edinburgh has remained up on last year while in Glasgow supply has dropped back

Year-on-Year % Change in New Listings Coming to the Market, 2022 - May 2023



Source: Registers of Scotland

KEY FINDINGS EXPLORED

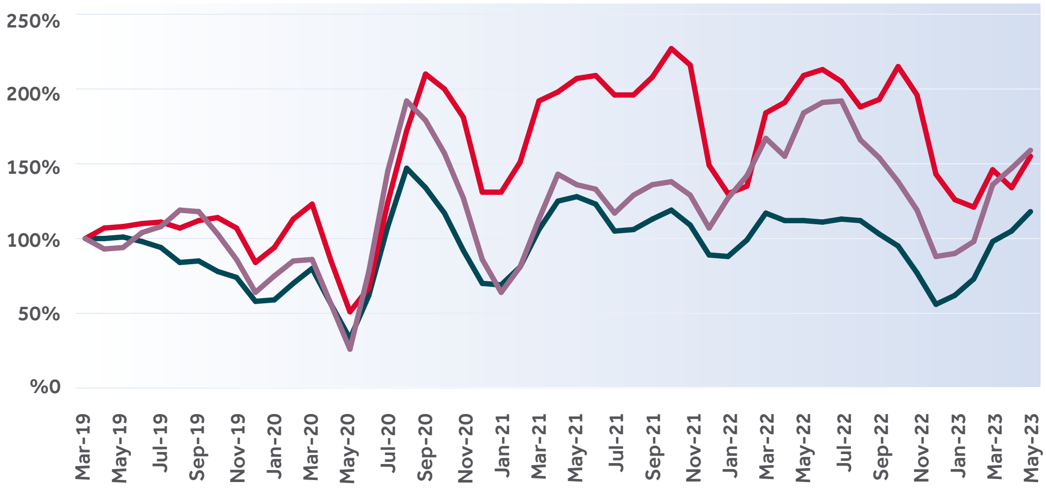
2. Supply and demand *continued*

DEMAND REMAINS ABOVE PRE-PANDEMIC LEVELS

In terms of market demand, **Edinburgh has had a notable contraction** in the registration of new buyers in 2023. In **Glasgow there is a more nuanced picture**. In Glasgow West End, buyer registrations have remained robust, while in prime family neighbourhoods, such as Bearsden, they have retreated slightly from 2022 levels.

Figure 4. The number of applicants registering to buy has fallen back in 2023 but remains above pre-pandemic levels

Count of Rettie & Co Applicants on a 3-Month Rolling Basis Indexed to Q1 2019, 2019 - May 2023



Source: Rettie & Co.

LOOKING AHEAD

Differences and nuances in the market between locations, price brackets and property types make navigating the current market more challenging. While there is **expectation of further price correction this year**, there are **equity rich buyers**, less affected by mortgage rates, who will **continue to make purchases** and there are decent supply levels to tempt them into the market. In **prime markets**, there remains strong demand for prestige apartments or living in areas with strong school catchments. However, **the market will be considerably less buoyant for first time buyers**, or those looking to make leveraged rental investments, due to mortgage availability and affordability.

> *While there is expectation of further price correction this year, there are equity rich buyers, less affected by mortgage rates, who will continue to make purchases.*

Simon Rettie, Managing Director

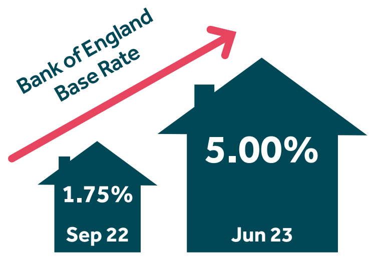
KEY FINDINGS EXPLORED

3. Mortgage challenges

MORTGAGE COSTS CONTINUE TO RISE

The main challenge in most parts of the housing market at the moment is **the rising cost of mortgages**, particularly at a time of rising inflation and a cost-of-living crisis.

The latest Bank of England decision to raise base rates to 5% to try to tame the still stubbornly high inflation rate that is close to 9%, **will see mortgage rates rise further**.

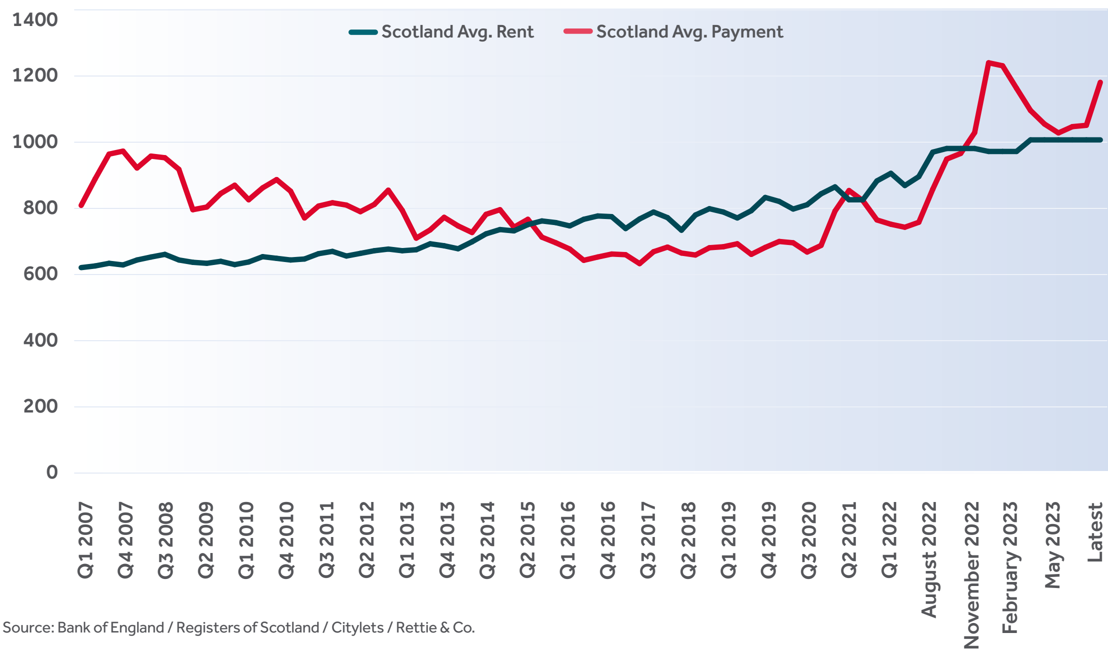


MORTGAGE v RENTAL COSTS

A useful indicator of how conditions have impacted households can be seen in the cost of the average mortgage payment against the average rent. While average rents have been on an upward trend, low interest rates have kept home ownership at an affordable level, despite rising house prices. The average monthly cost of a mortgage in Scotland was largely lower than the average rent over the 2015-21 period. This **reverted** in mid-2022 due to rising mortgage rates and is putting pressure on affordability.

Figure 5. The average cost of a mortgage on the average Scottish property is now higher than the average rent

Comparison of the Cost of an Average Mortgage vs Average Rental Payment in Scotland, 2007 – June 2023



Source: Bank of England / Registers of Scotland / Citylets / Rettie & Co.

3. Mortgage challenges *continued*

STILL HEADROOM IN THE MARKET

While some commentators were in a rush to predict a 'house price crash', whether because they actually believe it or to garner clicks and engagement, **other fundamentals in the market remain less alarming**.

While the percentage of mortgages in arrears or in possession has ticked up from 0.81% to 0.89% in the past two quarters, this **remains at historically low levels**. While there will likely be an increase in arrears and repossessions if mortgage rates remain high or climb further, as mortgage deals come to an end, there does still seem to be some headroom in the market to cope with the upsurge in costs and a willingness by the banks to engage with customers to help them refinance, including taking out longer mortgage deals.

Mortgage forecasts by UK Finance for 2023 predict overall mortgage lending to fall back 15% and lending for house purchase to fall back 23%. With unemployment remaining low, UK Finance expects, by 2024, that arrears will rise to around 1% of outstanding mortgages.

UK Finance Forecasts

-15%
Mortage lending decrease for 2023

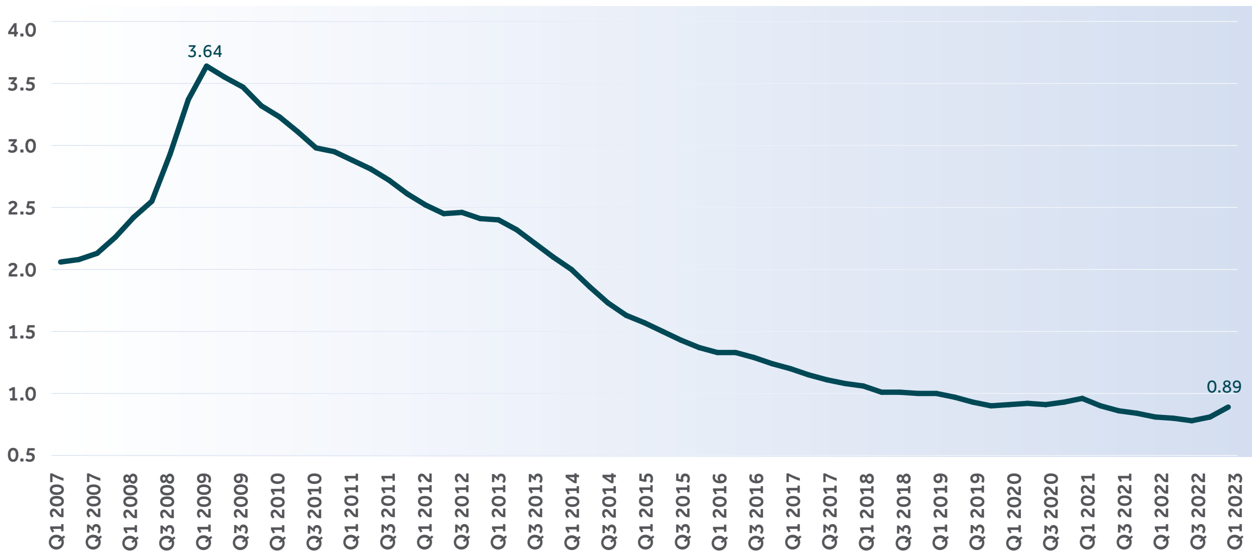
-23%
lending for house purchases for 2023

1%
arrears on outstanding mortgages by 2024

Source: UK Finance

Figure 6. The percentage of mortgages in arrears or in possession has increased slightly in Q1 2023 but remains at historically low levels

Percentage of Mortgages in Arrears or In Possession in UK, 2007-Q1 2023



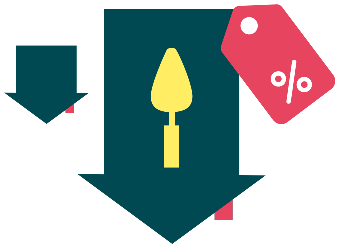
Source: FCA

KEY FINDINGS EXPLORED

4. New build difficulties

MULTIPLE CHALLENGES

As well as facing mortgage-related challenges, the new build sector is also having to address issues such as the **increasing cost of materials and labour**, with supply chains having been affected by the pandemic and Brexit.



Over the past few years, the cost of delivering a home has increased, with viability only being maintained by rising house prices in many areas. As we enter a period of slower or negative house price growth, while material and labour costs remain high, the viability of sites will come under further pressure, **slowing down housing delivery** across tenures and affecting Scotland's ability to respond to its housing availability crisis.

NEW PLANNING REGIME

In addition to these financial pressures, the introduction of the new National Planning Framework 4 (NPF4) is introducing **significant change** to the planning system. A good summary of some of the issues can be found in this blog post by Burness Paull. Although some in the sector may see the Government providing a minimum housing target across the country and for individual areas as a positive move, many house builders are concerned about the uncertainty and confusion around the interpretation of parts of the new planning regime, which will likely see sites held up and not delivered until these issues can be resolved.

New build activity could be **subdued for some time to come**, even with a wider market recovery.

KEY FINDINGS EXPLORED

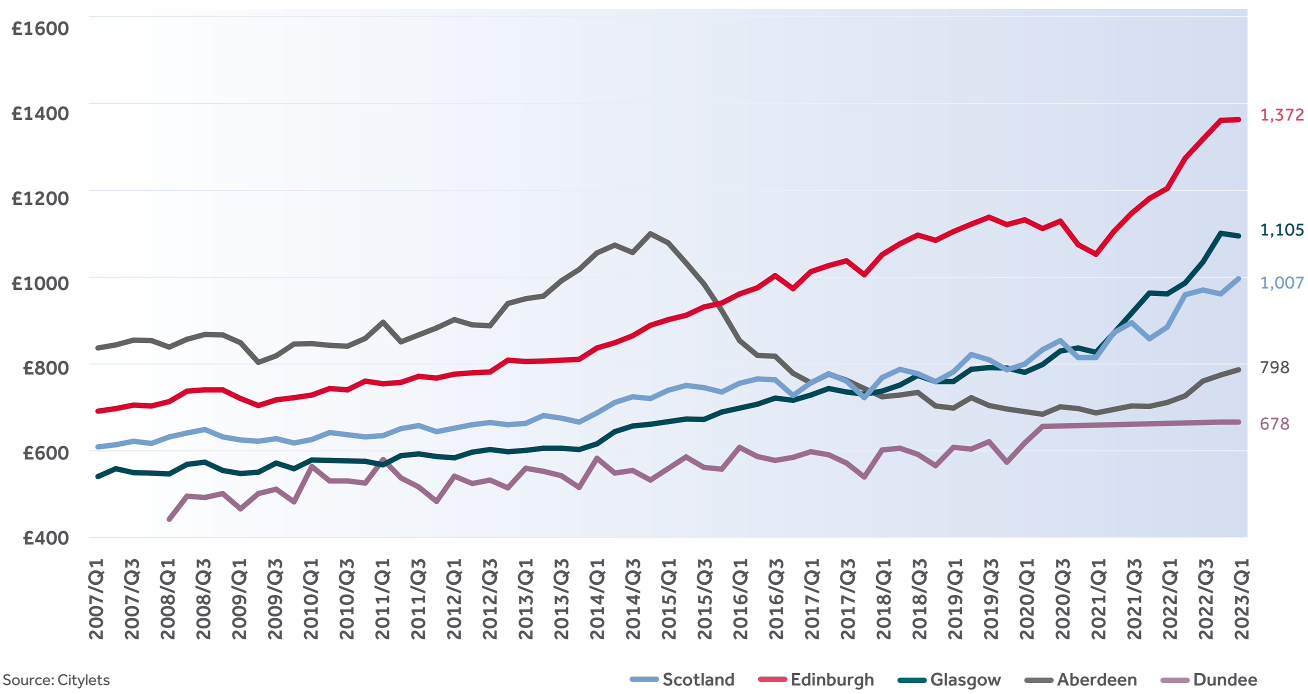
5. Rental market crisis

HOUSING SHORTAGE DRIVES UP RENTS

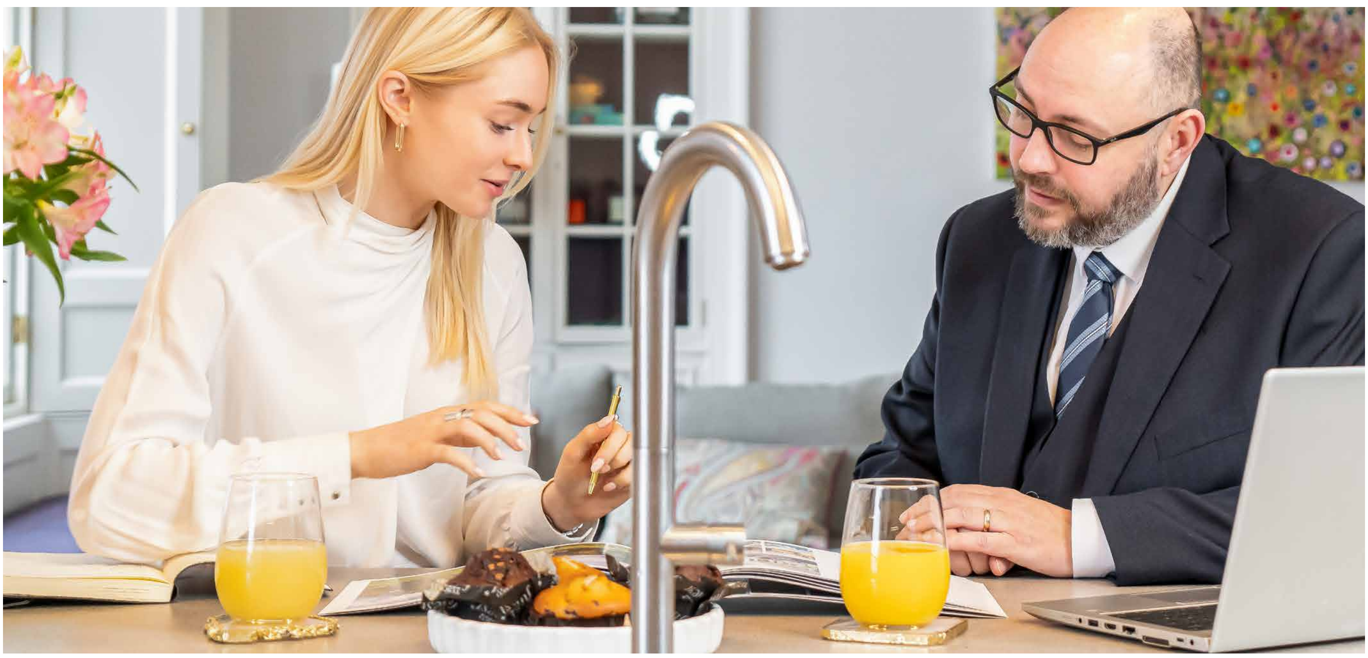
An example of how the housing shortage is impacting affordability is very clear in the rental sector. Over the past five years, Scotland and Edinburgh have seen **an annual compound growth rate of over 5%**, while, in **Glasgow**, recent rent increases have pushed this to over 8%.

Figure 7. Average advertised rents have increased in recent years as supply has fallen

Average Advertised Rents for Scotland and Main Cities, 2007-23



Source: Citylets



KEY FINDINGS EXPLORED

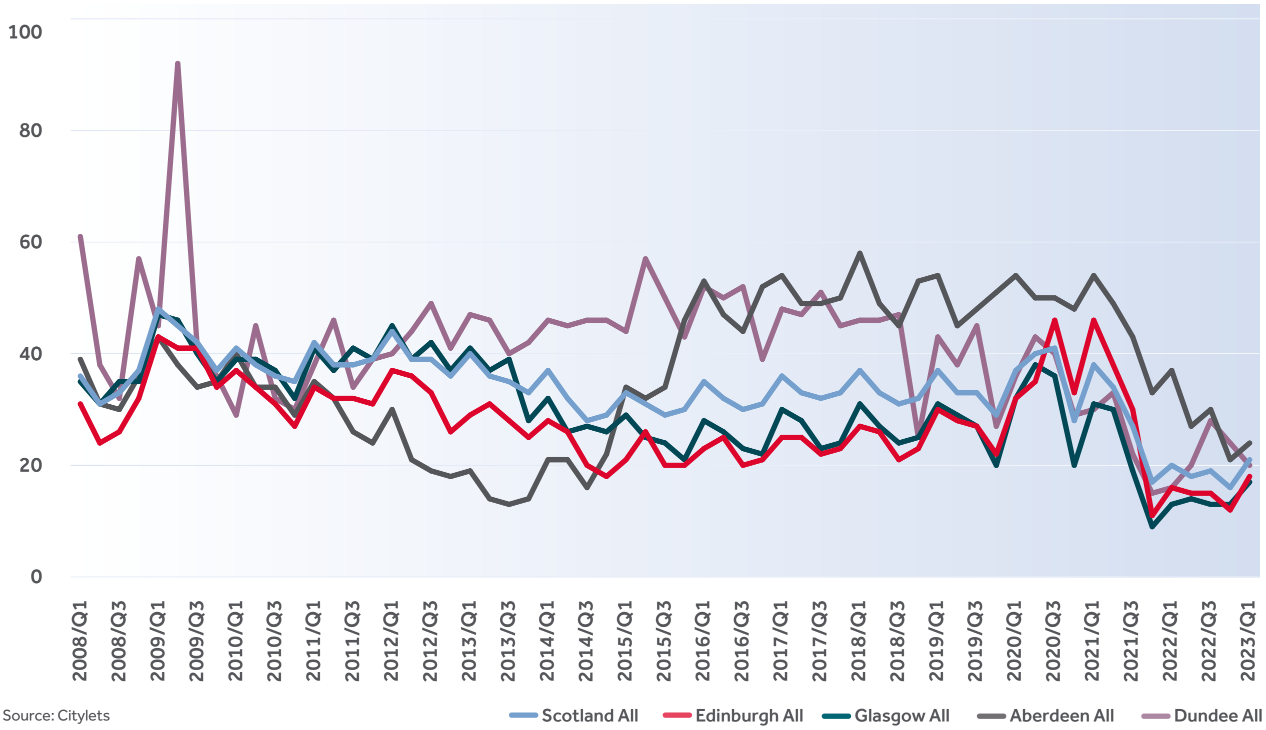
5. Rental market crisis *continued*

TIME TO LET DROPS SHARPLY

Rent rises are being driven by strong competition for a smaller supply of available housing and this competition is reflected in the average time taken to let a property. Having historically been somewhere between 20-30 days, in recent figures from Citylets, this figure **fell to 10-15 days** in the main cities.

Figure 8. The average time to let has fallen back sharply in recent years as demand has outstripped supply

Average Time Taken to Let in Scotland and Main Cities, 2008-23



Source: Citylets

NEW LISTINGS FALL BY MORE THAN A FIFTH

Analysis of the number of new rental listings coming to the market shows that while there were around 49,000 listings in Scotland in the 12 months to Summer 2021, in the past 12 months the figure has **fallen to under 38,000**, which is a **reduction of more than 20%**.

Figure 9. The total supply of new rental listings has been falling in recent years

12-Month Rolling Total of New Listings in Scotland, September 2020 to April 2023

5. Rental market crisis *continued*

IMPACT OF LEGISLATION

At the heart of this supply issue is the **incentivisation and regulation of the sector**.

Over the past six years, the Scottish rental market has had numerous interventions that have changed how the sector operates, including the introduction of the Scottish Private Rental Tenancy (SPRT), the removal of mortgage interest relief, the introduction of ADS (and increase from 3% to 4% to now 6%), plans for rent control, and, most recently, the rent freeze/cap and evictions ban. These interventions have made the financial incentives to operate in the Scottish PRS, at best, more challenging, or, at worst, unviable. With further new legislation in the pipeline, **there is likely to be a further reduction in supply** at a time of increasing demand, as some landlords choose to leave the sector (and are not replaced).

The great hope for supply had been the emerging Build to Rent (BtR) sector. Indeed, over the past ten years, a pipeline of over 17,000 potential units has emerged in Scotland. However, delivery has been slow and well behind other parts of the UK. There are a number of reasons for this, including political and planning risk.

The arbitrary introduction of a **rent freeze** (now cap) by the Scottish Government without sectoral consultation has increased political uncertainty for investors and many moved Scotland off their investment radar. A recent Rettie & Co. report for the British Property Foundation summarises how this political intervention has stalled the sector. A copy of this can be found on the BPF website here.

At a time of rising demand for rental housing, the Scottish Government does appear to be 'encouraging' private landlords to leave the sector, perhaps in the vain hope that the public sector will buy-up their distressed rental stock (which is alarming if true). Institutional investors now feel unable to price the risk of Scottish investment due to changing rules set by arbitrary legislation. A supply crunch is already with us and will likely worsen without a clear and stable political vision based on economic realities rather than political ideologies.

> *With further new legislation in the pipeline, there is likely to be a further reduction in supply at a time of increasing demand, as some landlords choose to leave the sector (and are not replaced).*

Karen Turner, Director of Lettings

KEY FINDINGS EXPLORED

6. A Subdued Outlook

As we highlighted in our Winter Briefing at the end of last year, we anticipate that average house prices will **fall back over the course of 2023 by around 5%** on the central forecast and may see **continued weakness** in 2024 before returning to positive growth in 2025.

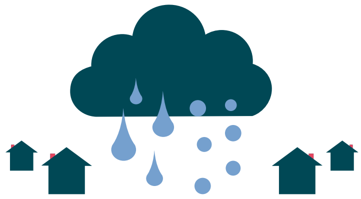


Figure 10. Average house prices are forecast to fall back by around 5% in 2023 based on our central forecast

Scottish House Prices (Actual and Forecast), 2023-2026

Year	Downside	Central	Upside
2023	-7.0%	-5.0%	3.0%
2024	-4.0%	-2.5%	-1.0%
2025	2.0%	4.0%	6.0%
2026	2.0%	4.0%	6.0%

Year	Downside	Central	Upside
2023	£199,470	£203,760	£208,050
2024	£191,491	£198,666	£205,969
2025	£195,321	£206,613	£218,327
2026	£199,228	£214,877	£231,427

Source: Registers of Scotland/Rettie & Co.

Although the outlook has arguably worsened since our previous briefing, we are not anticipating the 15-20% fall that has been forecast by some commentators. This is because unemployment and arrears remain at low levels and banks are still lending, although at reduced volumes and higher rates. However, our prognosis could become gloomier over the course of 2023-24 if interest rates continue to rise (as a result of high inflation) and mortgage rates follow. Although this will primarily affect the mortgage dependent part of the market, it will also impact on market chains, resulting in slowed activity and likely leading to further price reductions as affordability is pulled back and repossessions and arrears increase.

We believe that **transactions will drop back 15% over the course of the year**, but the downside scenario of a **25% reduction** has become **more likely** with the recent 0.5 percentage point rise in the base rate.

It's worth noting that these forecasts cover Scotland as a whole and, in reality, **different markets will be impacted differently**. We expect **prime markets to remain more robust** as supply remains below demand and higher levels of equity insulate these markets from mortgage rates. By contrast, there can be no doubt that **first time buyers** and **leveraged investors** will find market conditions **more challenging**. These pressures will weigh down on all tenures, limiting people's choice and housing options. In this context, current legislative reform is not helping.

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