The Grand Cycle Guide to Property Investing

This report was originally written in 2017. Other than a few minor edits, it is recreated here in its original to demonstrate how you can use knowledge of the cycle to forecast and to develop a strategy for investing in real estate.
Akhil Patel

In property terms, 2017 has been a mixed year. The question on everyone's lips is whether property prices – which have fallen, according to *The Guardian* for three months in a row for the first time since 2008 but which, according to this morning's edition of Bloomberg, are rebounding after their worst streak in eight years – are experiencing a temporary blip?

Or is this the start of a prolonged and significant market correction?

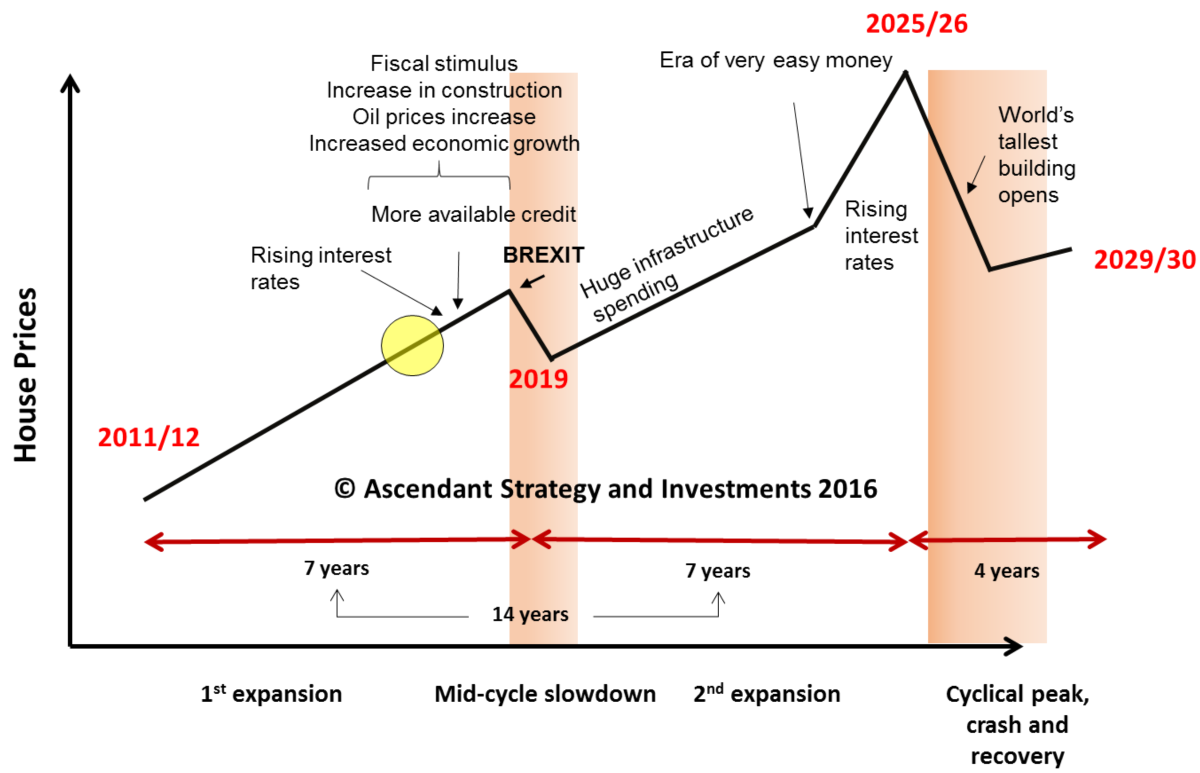
I've seen some of the doomsayers out and about calling for a major crash. This makes me comfortable that we're going to get the opposite.

First, let's review what the indicators are telling us.

I want to do this by way of introduction into the question that inevitably follows on from my research on the property cycle: how to take advantage of the knowledge. I will turn to that in the second half of the newsletter.

What the indicators are telling us

Below is my simple representation of the cycle, with the yellow circle marking where we are currently within it.



Source: Ascendant Strategy

I have dated the start of the cycle, at least in the UK, to 2011/12. Around this time the media was still discussing the possibility of a triple dip recession, we were still coming to terms with the London riots and the 2011 edition of the eurozone crisis was starting to have a major impact in the Greek sovereign bond market.

It's against the backdrop of crisis, anger, and recrimination that each new cycle is born. It's a difficult time to be a buyer.

Following the start of an 18.6-year Real Estate Cycle, the average length of each economic expansion is seven years. This is represented in the diagram above.

So, our forecast is for an expansionary period to go from 2012-2019 and 2019-2026. 2019 is forecast for the time of a mid-cycle recession. It's hard to be precise on both the start and/or the duration of the mid-cycle but this gives you something to look out for.

This places 2017 well within the first half, with the potential interruption to come towards the end of the decade.

This is the first clue on where property prices are heading if you are worried about the news: we should not be expecting a slump at this moment in time. My view is that in reality:

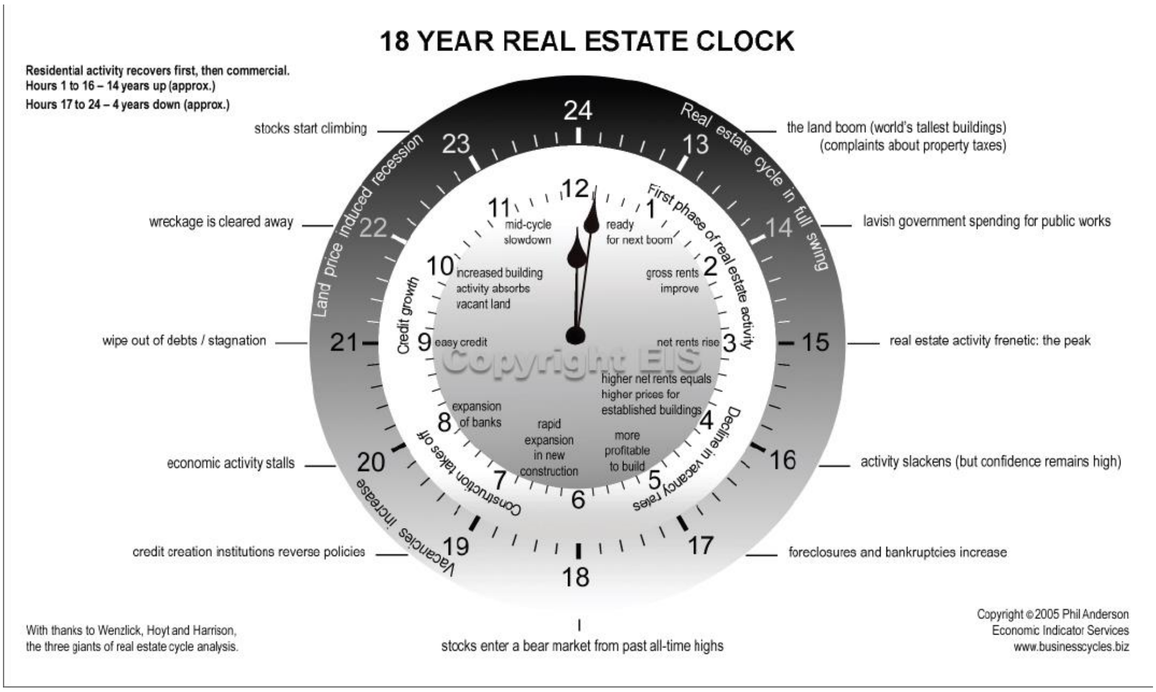
- The economic data is robust – plus growth has powered through the rather significant political shocks that took place during 2016, unemployment at record lows and asset prices robust. Q1 2017 data has been "disappointing" so far but the overall picture is solid enough
- There are some concerns about inflation, brought about by the fall in sterling and the corresponding increase in prices of imported goods. Again, there is nothing here to suggest this is something we need to be worried about.
- The Bank of England has held interest rates, but three members of the Monetary Policy Committee are supporting a rise on the back of the above data. This would not even be a possibility were the UK's outlook weak.

The reality is that with stock markets at all-time highs this early in the cycle, we really should be quite bullish on the outlook for the UK as I keep emphasising time and again.

Tell me if I am starting to sound like a broken record!

The cycle is very much on track – check out the time

Next let's look at the real estate clock.



Source: The Secret Life of Real Estate and Banking

I am sometimes asked about the clock. It was put together originally by my friend Phil Anderson in his book *The Secret Life of Real Estate and Banking.*

This book is a must read if you want to know how the cycle unfolds, time after time. It shows how the cycle repeats in quite different economic conditions and political eras. Upon reading it you'll have a much better sense of the resilience of the cycle through history.

Anyway, back to the clock. The clock was compiled based on insights contained in major property cycle researchers – principally Homer Hoyt, Roy Wenzlick and Fred Harrison.

You should read anything these guys have written. They are true titans of the investment world (if only the investing world paid attention to them).

You will note that it has an inner and an outer ring, the inner presenting the first half of the cycle and the mid-cycle recession; the outer representing the second half of the cycle and the peak, crash and recovery phases.

The way the cycle unfolds is not so precise that you can put a specific date to each event within the clock (I am sorry to say). In broad terms it should take around 7 years to complete the inner circle and about 11-12 years the outer one.

Since some readers are confused on this point let me note that one hour on the clock does NOT represent a year of the cycle. The numbers on the clock don't have any significance per se, other than to demonstrate that there is a regular sequence to the unfolding of the cycle.

The first stages of the cycle involve the following events, all of which have occurred so far

- Rents rise at the start of the cycle when the economy is or has just emerged from recession. This is because people are driven back to the rental market, being unable to obtain finance to purchase homes.
- This in turn leads to higher prices for established buildings because a building's value is its capitalised rent.
- Once there is an increase in the prices of existing dwellings, it becomes more profitable to build and you then see an increase in construction. Construction output will have collapsed in during the crisis following the peak of the last cycle.
- Banks are then more willing to lend to construction companies and expand their balance sheets (this is also taking place against the backdrop of an economic recovery that takes place after the prior cycle).

At the present time we are seeing an increase in both construction and bank lending to the private sector, confirming that the cycle is unfolding according to the clock and is still very much on track.

The next stage of the cycle to look out for would be further signs of "easy credit" and increased in building activity that absorbs available sites. This should then take us into the mid-cycle around 2019.

In relation to easier credit – regulators have been warning consistently during this year about the UK's borrowing binge, especially with respect to consumer loans and second mortgages.

But I don't think this is the full-scale lending to businesses that drives growth forward and creates a mini boom of the sort you see in the latter stages of the first half of the cycle.

But this will be something to pay attention to.

My overall conclusion is that the cycle remains on track. Property price growth has slowed on average in the UK during the first half of 2017, but this is not an uncommon feature of the cycle where growth can fluctuate from year to year.

Therefore, we are still at the point in the cycle where pauses like this are opportunities to invest.

It's on this side of things that I wanted to focus during the remainder of this newsletter – how the internal dynamics of the cycle can support your property investing

The Grand Cycle guide to property investing

The strategies that property investors can use to generate returns are many and various. Refer to any number of guides or attend property networking events to identify those which best suit your personal circumstances.

You will need to consider, as with investing in the stock market, whether:

- you are interested primarily in yield or in capital growth.
- you have funds available or need to obtain bank finance.
- your ability to raise finance.
- how much time you must devote to your property investing and so on.

That said, the property cycle does have some regular "internal dynamics" that can act as a handy guide to support how you approach the decisions on what to buy and where and how to time your investments carefully.

The following observations are based on my research on the property cycle. But this is not a comprehensive guide to property investing and I am not myself a property professional (although I do invest in property myself).

I would be interested in any further insights that readers have on how to take advantage of the cycle.

Insight 1. Land is the real asset (not the building), and it is volatile

What many property investors fail to recognise is that the primary source of return from a property cycle perspective is not the building but the land on which the building sits. When you watch property programmes on TV people are always about the size and quality of the building, its features etc rather than about the land (although there is some acknowledgement of the importance of location).

Each cycle brings with it a major increase in the value of land. Land is the real asset. And it is very volatile in terms of price.

If that's not clear to you, consider this example: Let's say a house (with a replacement value of £50k, which is the cost to replace the building if it burned down) sells for £100k at the start of the cycle. Let's assume that and over the course of the cycle it increases to £250k by the peak of the cycle, 14 years later.

This is not unreasonable, by the way – in fact that this represents a modest increase of 5% per year (roughly).

Assuming that the replacement hasn't changed, this would mean that the underlying land price will have gone from £50k to £200k – an increase of four times in the course of the cycle, compared with 2.5 times for the property as a whole.

Similarly, if property prices fell 30% during the downturn, the fall would be attributable to the value of the land. While the property would have fallen in value to £175k, the value of the land would have gone from £200k to £125k. A fall of almost 40%.

House prices can fall even further than that in the downturn. A reader pointed out to me in an email exchange that he bought a house in Sunderland in 2009 for around £100k which had been selling for over £500k only a couple of years before that. In other words, the value of the land had collapse completely.

I think of land increasing in value through three primary ways:

1. General gains from the cycle over time (in the sense that a rising tide lifts all ships). As economies progress and prosperity increases, the value of real estate goes up in general across the economy. This gain is the least specific to a location. Essentially if you were to buy in at the start of the cycle and sell at the end, you would be doing so at some sort of profit almost anywhere in the country.
2. Gains from the vicinity surrounding the site because of good local infrastructure and amenities – schools, transport links, recreational facilities, thriving local businesses, clean streets and lighting, safe neighbourhoods etc. – all of the things that make a place desirable to live and ensure there is demand for living there.
3. Gains from improvements on the site itself – through increasing the building footprint – adding rooms, floors etc. Or adding dwelling units on site.

In fact, the gains from each of these three channels are to do with the rental value of the site increasing. Remember, as economies develop land takes *all the gains* – the law of economic rent in action.

Insight 2. Borrowing to acquire a property in a good location and having someone else pay the interest

The simplest way to profit from this is to buy a good location and have someone else pay off the interest on the borrowing to acquire it. The earlier you buy in the cycle the better, but don't be afraid to buy even after it has started. There is still plenty of time in the current cycle as I mentioned above.

You will find that as the capital value of your property appreciates you will be able to refinance at a higher value, take out some capital and perhaps do the same thing again.

In this way you will be able to build a portfolio with a stream of rental income which you can use to buy other assets or as an income you can live off.

Make sure you don't over-leverage and pay attention to where we are in the cycle. At the end, your ability to recycle financing is likely to be at its highest due to easy credit conditions. You don't want to face a situation during the coming downturn where parts of your portfolio are "underwater" and/or your rents cannot meet interest payments.

If you were forced to sell property at this time because you default on a loan, you'd be doing so at distressed prices which could wipe out your equity. Or a distressed property might cause you to sell off a prize asset for less than its worth.

Buying into a good location is important. There are any number of books and guides out there to help you do this – the facilities and access to shops, jobs, schools, and recreational facilities that make a place a desirable one in which to live.

There is a variation on this which can help boost your returns even further – buying into a location *before* it has fully become desirable. This is taking advantage of the fact that prices in some locations start to adjust rapidly because of the development that is currently, or about to take place.

This is called the Law of Absorption.

Insight 3. Take advantage of the Law of Absorption

As far as I can tell, this term was first coined by Fred Harrison in his book *The Power in the Land*. I have referred to this before and some property investors intuitively understand it when they look at a currently undesirable location but see a buying opportunity because of improvements that will cause people to start looking seriously at moving there.

Once this start to happen prices can start to increase quite rapidly.

The key thing is to know when to do this, and when to recognise that these adjustments have already happened and therefore perhaps you might look elsewhere to invest.

Insight 4. Buying close (but not too close) to new or improved rail stations or transport links

There are several academic studies have been undertaken analysing the velocity of real estate gains following improvements to public transport.

Governments tend to keep quiet about these gains because they invariably reveal who the real beneficiaries of these improvements are (who receive gains paid for taxpayers all over the country). It falls to other organisations to tell us what we need to know.

For example, property consultancy, JLL, published a study of the likely impact of Crossrail on house prices along the route and forecast these would be on average 8% (and as much as 19%) higher than other London property between 2014 and 2020.

This builds on some of the gains that have already taken place. For example, between 2008 and 2013, residential prices in Stratford increased by 44% compared to 31% for London as a whole.

I expect that the overall impact will prove to be greater once you look at this over the course of the whole of the cycle into 2026. Indeed, findings from a broad range of studies show the likelihood of windfall gains in the order of 30 to 120% for residential and commercial property in areas surrounding such improvements.

The difference in price increase is dependent on proximity to the train station. The closer you are to the station the better…up to a point. Bear in mind, being too close (i.e. opposite or abutting the train line) is no better than being too far. So, select your property carefully.

In a previous newsletter, I have already referred you to a brilliant piece of writing by Don Riley in *Taken for a Ride.* As the owner of several properties on Southwark Street very close to London Bridge station (including one that accommodates my Southbank Investment Research colleagues) he had a first-hand view of the impact of the opening of the Jubilee Line on the value of his real estate portfolio.

He found that the increase in real estate values in the order of £4 billion around each station on the Line.

So, if you are looking at which places to buy, do research on where the government is building its new transport infrastructure and start looking there.

This then leads to the next question about when in the process you should be looking to buy.

Insight 5. *When* to buy

If you are investing in or around a station you need also to know *when* to buy.

The biggest gains, percentage wise, will be during the two years prior to construction and the two years following completion. Therefore, buy in as early as you can.
However, it's not too late if construction has already started: during this phase, noise and road works will detract buyers and disrupt business. As an investor, however, this can sometimes provide an opportunity to buy in to capture the gains once the line has opened.

Early morning road works will be a nightmare for existing residents, and some will inevitably want to sell. Keep your eyes open for opportunities as you monitor the market.

Again, even after the transport upgrades are in place general gains from the cycle make this a fine opportunity to buy – but bear in mind you will only obtain the general gains, not the ones due to development of the new infrastructure.

Insight 6. The cycle starts at the centre and ripples out

I have observed that during the cycle, property price appreciation tends to start centrally and then ripples out. Property investors who read this newsletter have also observed this.

London investors are lucky in the sense that Crossrail is such a major project, the gains will be priced in station by station along the route for years. Investors in other parts of the country must look at what is being proposed along other routes, e.g. High Speed 2 and rail links across the northern parts of the country.

It does not always have to be rail links – trams, improved road connections, cycle paths to name a few – all have an impact.

If you look at price increases in the areas surrounding Stratford (e.g. Leyton, Bow, Plaistow) since the start of 2014 you see this in action: they have all increased by more than house prices in Stratford which outperformed other areas before the opening of the Olympic Park.

Developers, investors, and homeowners have looked to the surrounding areas for more affordable land or housing.

This dynamic is not true of every city, however. According to one of my subscribers (a property professional) in some cities in the north of the country the movement happens the opposite way. As soon as people start buying again, they have tended to go for newer builds at the edge or just outside the city where they can get more space and a newer dwelling.

I expect what will happen here is that over the course of the next few years the cycle will move inwards as authorities decide to "regenerate" more central parts of the city. This underlines the importance of considering your local market when assessing any property investment.

You could also look at this central to regional effect at a national level. The cycle starts at the centre of a country and moves to outer regions during the cycle. Hence London's property market took off well before other ones.

But we are now starting to see the "ripple" effect taking place in the UK. 2016 was the first year when growth was higher outside London and the South East – with house prices in the East of England growing on average 10.6%.

In the year to 2017, according to Rightmove, all regions in England grew more than London (where property prices fell by 1.4%), with the East Midlands leading the way.

Insight 7. Growth in peripheral locations can outstrip central ones in the second half of the cycle

This is possibly more of a hypothesis now than something I have observed in lots of markets over time. But, linked to the insight above, property prices in all UK regions grew more than they did in Greater London between 2000 and 2007 – the second half of the last cycle.

In fact, while property prices grew by 100% (or doubled) in London they grew by more than 200% in the UK's most peripheral region – Northern Ireland - during that period.

Similar outperformance was seen by Australian cities relative to the major population centres of Sydney and Melbourne in the second half of the last cycle.

This is something to bear in mind if your property investing can take you across the country over the next ten years.

Insight 8. Finding sites where you can increase the development footprint

The third way of generating a return from property investing is to increase the value of the site itself. Sites which have additional space that can be used to extend or increase the development on them are an excellent way to generate a return for yourself.

Not only will your investment experience an increase in value, but any further gains also arising either because of improvements in local amenities or general increases due to the cycle over time will accrue based on the higher site value.

There is another reason why this makes for a good strategy – sites are become scarcer and scarcer, especially in cities constrained by a green belt. Rising demand meets fixed supply.

The only way to build more dwelling is to increase the density of development on each site. This is done in a number of ways, including subdividing houses into flats; extensions into gardens, extensions into the roof; dividing large rooms into two to create additional bedrooms; parcelling off parts of large gardens or garages to build additional dwellings and so on.

This dynamic is a great coup for landowners because the possibility of more intensive use of sites ensures that the value of sites everywhere goes up.

This brings us to the downside of this strategy – the need to secure planning permission. Having just been through a planning process myself, I can tell you it's a very random one.

My observation of the planning committee which was reviewing the merits of my scheme (and those of several others) in a south London borough was that the quality of questions was poor. There was no consideration of local economic development and housing need; a lot of attention was paid to local objections, some of which were valid, but much of which was simply down to people not wanting additional housing in their areas.

In fact, there appeared to be no real downside to a planning committee rejecting an application – but some upside if it might appear popular with residents (and therefore voters). The Appeals system exists in any case to ensure that the more outrageous rejections are reversed – but this is a cumbersome process and involves a lot of additional bureaucracy.

You will need good planning advice if you go down this route because you only want to acquire sites that have a good chance of getting planning permission and then you will need to navigate through this byzantine complexity of this regime.

Insight 9. High land prices make housing smaller and of poorer quality

High land prices force developers to use land more intensively. This means getting as many dwellings on to a site as possible. This in turn means that over time, dwellings will get smaller and smaller.

People are forced to accept this because for a given location, over time, they will only be able to afford a smaller dwelling as house prices go up through the course of the cycle.

It’s got the point where the average size of a dwelling in the UK is smaller than such land constrained countries as Denmark, the Netherlands and Japan.

Our planning system and constraints on development are a major driver of this. The UK is the least built up country in Western Europe so it’s clearly not a fundamental lack of land that is responsible for this situation.

Contrast this with the period in the 1930s when land was readily available as rising population found its outlet at the edges of London where a wave of suburbanisation was made possible with the development of the London Underground extensions into the agricultural hinterlands.

Relatively low-priced land enabled a single income working class family afford a large house and garden on the edge of London. Such dwellings are now beyond most double income professional families. What they can afford now is far, far smaller.

A related impact is that as land prices increases, developer margins get squeezed. This means they will have to find ways of lowering the cost of construction. This results in builds of lower quality. Again, the pressure to acquire housing means there is a steady supply of buyers who accept poorer quality dwellings.

Something to look out for is the digitisation and automation of construction. Balfour Beatty, a major construction company, believes that by 2050 most construction sites will be “human free” with large robots assembling buildings automatically. This will have an impact on cost – perhaps reducing it further.

Insight 10. Buying new build apartments and housing

Given the dynamics I have outlined above, I would recommend (if you’re looking at a new build apartment or house), to really consider the quality of the builder. Look at their track record, access reviews, speak to people who have lived in buildings they have built etc.

Try to find a way of going around a building the developer has built that is two, three or five years old. Poor quality builds will age rapidly. Whether you are buying it to live in or to let out, you will want to look at the state of the dwelling as it will appear to a potential buyer down the road because they won’t be buying the shiny new building that you are.

Another insight on this front is to consider how many new builds will go up in the area you are buying into. If there is a huge surge in building in a local area, then this will put a lid on price increases – something that we have seen in the Nine Elms regeneration district in London.

In addition if you wanted to sell your two to five year old new build apartment in an area where a lot of building has been going on, remember that your now slightly shabby apartment will be competing against much newer, snazzier builds.

You won't be able to achieve the same price as those, likely.

The way to mitigate this risk to have something genuinely scare about your housing, such as having a great view, being on the top of a building, having an extra-large balcony etc.

That will at least ensure there is something unusual to attract would-be buyers.

Buying new builds towards the end of the cycle can be particularly risky from this point of view. If a locality has a surplus of new apartments, as prices start to level off and come down developers or owners might dump a lot of stock on the market at once and collapse the price.

If you must sell into this market you could lose a lot of money.

Insight 11. Commercial real estate comes into their own during the second half of the cycle

I have so far talked about residential properties which I understand more than commercial ones. However, investments in commercial real estate can also be lucrative. I don't have much to say about this other than the observation that, from a cycle perspective historically, residential real estate picks up before commercial real estate.

Commercial real estate comes into its own during the second half of the cycle (not a hard and fast rule).

A key marker of the cycle peak is the announcement of the world's tallest building. These tend to be mainly <u>commercial</u> real estate buildings, in the centre of cities where high land values make building as high as possible a necessity and available credit to finance the building.

When you see the announcement in the middle of the 2020s you will know it's time to move out of the markets, look at your risk exposures and have a source of cash available to ride through the downturn and/or finance bargains that come available at the bottom of the cycle.

So, there you have it. Several insights on the internal dynamics of the property cycle. This is what I have learned to date through my research and my own forays into the world of property investing and represent suggestions for how you can take advantage of this knowledge in a practical way.

No doubt there's much more to learn and consider. Do you have any other experiences or observations? Am I correct in what I am saying?

I think there is a wealth of knowledge out there and it would be good to pool it together for our mutual benefit.

Please write in to let me know what you think. As ever, you can reach me at info@propertysharemarketeconomics

Best wishes,

Akhil
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