London, Autumn 2015

RESIDENTIAL MARKET OUTLOOK

Capital value growth resumes in Q2

The residential market saw a resumption in growth during the second quarter, with average house prices across prime Central London growing by 2.6%, after the slight increase of 0.7% in Q1. The latest increase means that values sit 3.3% ahead of this time last year, pushing average house prices to a fresh record high of £2.3 million, with the average cost of a flat approaching £870,000.

Although this is 34% higher than the previous market peak in Q3 2008, it is worth noting that average house prices in the capital have risen by almost 51% in the last 10 years alone, fuelled by an unprecedented housing shortage and London's appeal as a global safe haven for international wealth.

The severity of the supply shortage is highlighted by the fact that we have seen most offers just 2% below asking prices throughout the summer, highlighting the dearth of stock on the market in prime Central London.

The growth in Q2 has in part been fuelled by a return of buyers and vendors to the market following a lull in activity in the run up to the General Election in May. In fact our Central London offices recorded an immediate rise in the number of viewings across the capital following the perceived stability delivered as a result of the Conservatives' win in May.

Change in prime residential values during Q2

2.6%

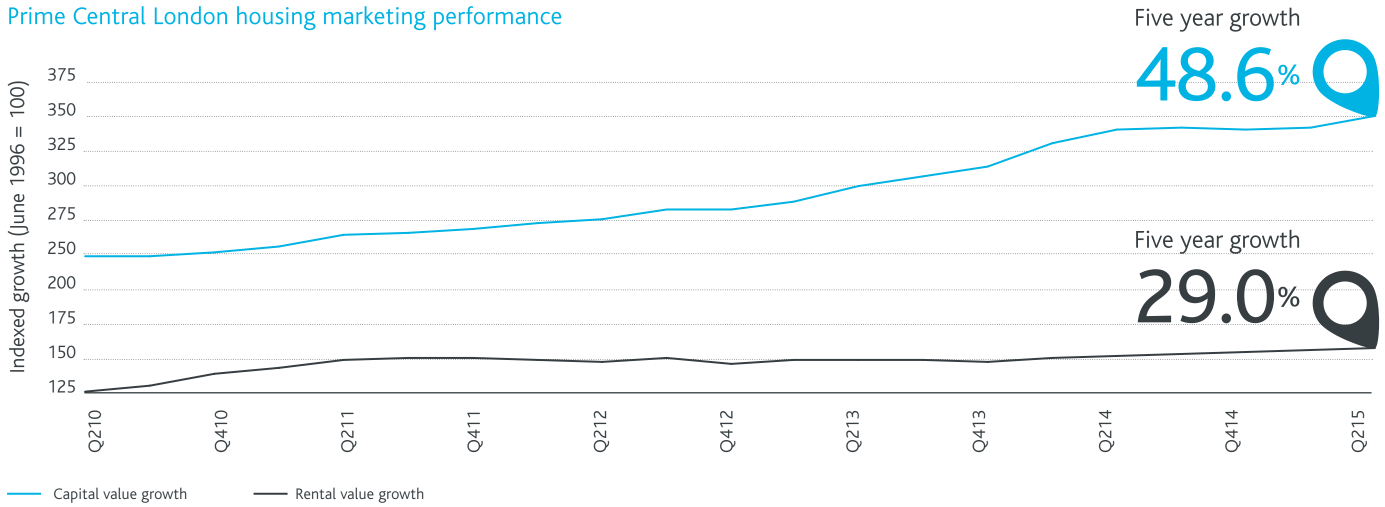
Change in prime residential values over the last 12 months

3.3%

Average residential values in prime Central London at the end of Q2

£2.3m

Prime Central London housing marketing performance



Source: Cluttons, Experian

Supply shortage persists

The shortage of stock in the market has distorted domestic buyer demand, which remains strong. Overall, the usual trend of instruction-led-demand persists; with a low number of new instructions, buyers have little motivation to register their intention to purchase. We have recorded this across all our prime Central London offices, where the dip in registered buyer demand over the summer has been a direct result of a shortage of stock, rather than a low level of requirements.

This situation is of course being further exacerbated by a lack of natural cycling on properties as most owners have little motivation to relinquish their prime Central London holdings, particularly as capital value growth prospects remain bright and the economy continues to expand, albeit at a slower pace than last year. This mirrors the latest RICS London Housing Market Survey, which shows a continuing deterioration in the number of new instructions coming to market.

Underscoring the severity of the supply shortage across prime Central London is the fact that properties are more often than not going to sealed bids. In addition, over the summer, our offices have been reporting a 98% conversion rate; an all time high.

The picture is similar on a national level, with the number of surveyors reporting a fall in the number of new instructions reaching an eight year low. Despite these conditions, data from the Bank of England has shown that mortgage levels are quickly closing in on their pre-recession peak, with an average of over 60,000 mortgages offered each month during the second quarter, suggesting that the impact of the Mortgage Market Review recommendations on a national level may be dissipating.

Affordability challenges persist

Still, in our experience across the capital, most first-time-buyers appear to be getting support from family funds to make the transition to owner-occupation, highlighting London's wider affordability issues. In fact, general buyer demand is still centred on properties priced around the £1 million mark, which remain in short supply.

This is however driving up demand on the peripheries of prime Central London in locations such as Clapham and Blackheath, where we continue to record a steady rate of deals in the £500,000 to £700,000 bracket, with many buyers drifting outward from more central locations such as Shad Thames and Wapping in search of what they perceive to be better value for money.

For Greater London as a whole, the latest figures from the Land Registry show average house prices have surged past £480,000, over 2.5 times the wider UK average; Barking & Dagenham and Bexley are the only two areas in the capital where average values sit under £300,000.

While the base rate rise event horizon appears closer now than it has been at anytime for the past six-and-a-half years, our own expectation is for this to start nudging upwards by about 0.25% every six months, starting in Q1 or Q2 next year. This may of course be pushed back further, if the global economy continues to falter. Even across in the United States, which appears to have weathered the global economic slowdown this year better than most other advanced economies, the tide may be turning. The US Business Round table CEO Economic Outlook Index, for instance, which is a measure of CEO expectations for revenue, capital spending and employment, fell to its lowest level since 2012 in September.

Average price of two bedroom flats in top five demanded submarkets during Q2

Submarket	Price
Chelsea	£2,500,000
Hyde Park	£1,500,000
Wapping	£918,000
Islington	£875,000
Clapham	£800,000

Source: Cluttons

A further delay in an interest rate hike will of course offer some comfort to mortgaged households in the UK; however any impact of a rate rise on this cohort is expected to be slight, rather than substantial.

Downside risks gather momentum

The slow down in the number of residential requirements over the summer is in sharp contrast to last year and may be an indicator of the market's behaviour for the rest of the year. In fact the latest house price data from the ONS shows annual house price growth in London dipped to 5.3% in June, down from just under 20% last summer.

There are a number of factors that are likely to contribute to the ongoing stabilisation in growth. There has been some anecdotal evidence to suggest that the Stamp Duty changes announced in the autumn have stalled the market for £1,500 psf plus properties, with limited demand at this end of the market. In response to this, a handful of developers has begun to split larger luxury penthouses in an effort to drive up demand.

Other developers such as Dubai's DAMAC have taken a different approach. DAMAC has teamed up with Versace to offer 360 branded flats in Vauxhall, as it extends its 'fashion-residences' concept to the UK, where it hopes to entice wealthier buyers. That said, areas perceived to be below their full price potential in proximity to core locations are attracting increased interest from both domestic and international buyers.

In W2 for instance, which encompasses the likes of Bayswater, Paddington, Hyde Park and Notting Hill, average prices stand at around £1,100 psf. It is these areas in particular where we have recorded a fresh wave of demand, underpinned by the proximity of the West End. Similarly, in SE1, large parts of which front the Thames, price growth has been catalysed by its central location and ease of access to the City. Although values here are in the region of £1,500 psf on average, the depth of demand we have been recording suggests there is still potential for further growth.

While there are other macro-economic factors that have no doubt contributed to the waning of demand at the top end of the market, the step change (see table) in the rate of Stamp Duty for properties priced over £937,000 has also clearly dented demand.

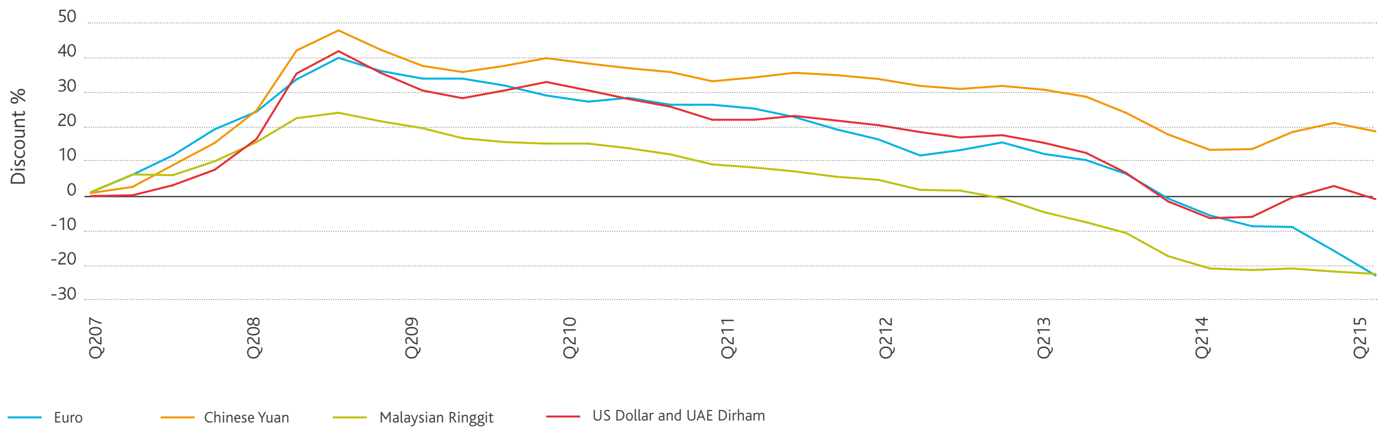
Furthermore, during the Summer Budget statement, the Chancellor also announced the government's decision to abolish long-term non-domiciled status by 2017, which effectively means that individuals residing in the UK for over 15 years under 'non-dom' status will be subject to the full rate of capital gains tax, inheritance tax and council tax, which also includes all residential property owned by an offshore company or structure.

Stamp duty

Purchase price	New stamp duty paid	Old stamp duty paid	Difference in duty paid
£500,000	£15,000	£15,000	no change
£750,000	£27,500	£30,000	-£2,500
£1,400,000	£83,750	£70,000	+£13,750
£2,000,000	£153,750	£100,000	+£53,750

Source: Cluttons

International buyer currency 'advantage'



Source: Cluttons, OANDA

Currency advantage for international buyers reversing
Stepping back from the domestic market, the international stream of buyer requirements is also coming under increased pressure from weakness in the wider global economy, which may constrict demand from this crucial cohort of the capital's demand equation. While those looking for a global safe haven from geo-political turmoil in other parts of the world will always continue to target London residential assets, the recent reversal of a sterling currency advantage enjoyed by many international buyers threatens to undermine budgets, while squeezing others out of the market altogether.

With the Greek financial saga still weighing on overall growth in the Eurozone and China's economy slowing as the EU, which remains one of its largest trading partners, struggles to find its feet, the indications are for further anaemic growth globally. Furthermore, as global oil prices continue to tumble, the downward pressure on emerging market currencies is quite substantial. This may have direct consequences for private capital flows into London's residential market, particularly those from the OPEC states and Russia.

For those buying in Euros, London property is now 25% more expensive than it was during the market peak in Q3 2007, while Malaysian buyers have seen the Ringgit slide by 23% against sterling in the last 12 months alone.

That said, our recent experience at the Middle East's largest real estate exhibition, Cityscape Global, suggested that the appetite for London residential from high net-worth individuals in the Gulf is showing no signs of weakening (see next page).

Residential outlook remains stable
On balance, the general mismatch between supply and domestic demand is still expected to support house price growth in the capital, but the rate of increase is expected to ease over the remainder of the year for the reasons outlined above. During the second half of the summer we have already begun to note some minor downward price adjustments by vendors to entice demand, particularly for larger, more expensive properties.

Although economic growth remains robust, the expansion is still lopsided and underpinned by consumer spending. The fragility of the global economy remains one of the biggest threats to the UK economy, although unemployment has stabilised, standing at 5.5% in the three months to the end of July.

Meanwhile, annualised wage growth during Q2 eased to 2.9%, down from 3.3% in the three months to May, suggesting a plateauing in business activity may be imminent and highlighting the intrinsic way in which the UK is linked to the wider global economy.

Still, despite this, it is our view that the prime Central London residential market will build on the growth so far during 2015, ending the year between 4.5% to 5% up on last year; about half the rate of increase in 2014. A slight moderation is expected between 2016 and 2019, with an annual rate of increase of around 3.5% to 4% p.a. forecast. This translates into a 21.3% rise over the next five years.

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Middle East high net worth individuals' (HNWI) appetite for London residential

The demand from regional HNWI was exceptional during our recent showcase of schemes in Paddington, Bayswater and Ladbroke Grove at Cityscape Global in Dubai. The focus remains on residential schemes in or within close proximity to the West End. For most Middle East based HNWI, the appeal of London stems from the cosmopolitan lifestyle it offers and the perception of exclusivity, particularly for addresses in Mayfair or Chelsea postcodes.

Gulf-based investors looking at London are well informed and up to date with the current market conditions and generally looking for either prime postcodes or areas where they can see a story for potential growth in the future. At the time of our property showcase, both Bayswater and Paddington were of significant interest due to their central location and relatively lower prices.

Gross yields, which currently stand at 3.25%, seem less relevant to this group. In fact, most HNWI we spoke with were looking to secure holiday homes, or investment properties for their children. In particular, Compass House in Bayswater was seen as 'good value' and many investors were impressed with the regeneration story of Queensway and Whiteleys. The scheme's central location and accessibility to other more prime and upmarket areas was a strong selling point. There was a significant amount of interest and a number of reservations were taken, highlighting the depth of demand for this location.

Supply challenges ahead for the lettings market
Contrary to the sales market, the capital's letting market is coming under increased pressure from a rise in new-build supply, which is predominantly materialising in the form of buy-to-let stock. In particular, we have noted a rise in properties on the market from international investors who are unable to re-sell homes purchased in markets such as Battersea and Wapping, where void periods are in general creeping upwards.

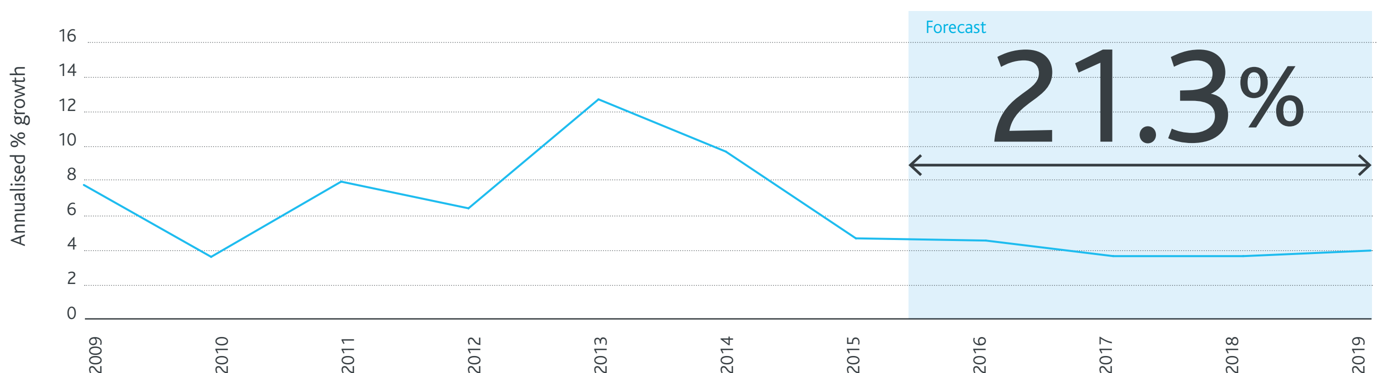
Furthermore, anecdotal evidence has shown that these landlords are undercutting the market by offering homes at below average prevailing rental rates. This is of course aiding in their take up, while at the same time pegging back a return to strong rental value growth.

Some of our Central London offices are reporting a renewed focus by tenants on new-build flats, fitted with modern amenities and finished to a high standard, which is challenging rents for older properties that have not been recently refurbished. In fact, in some cases, properties returned to the market are letting for up to 10% less than that paid by the last occupant, which many landlords are willing to accept in order to keep voids to a minimum. In particular, we have noted this trend in Holland Park, Belgravia and Chelsea. Where landlords are unwilling or unable to reduce rents, properties are 'sticking'.

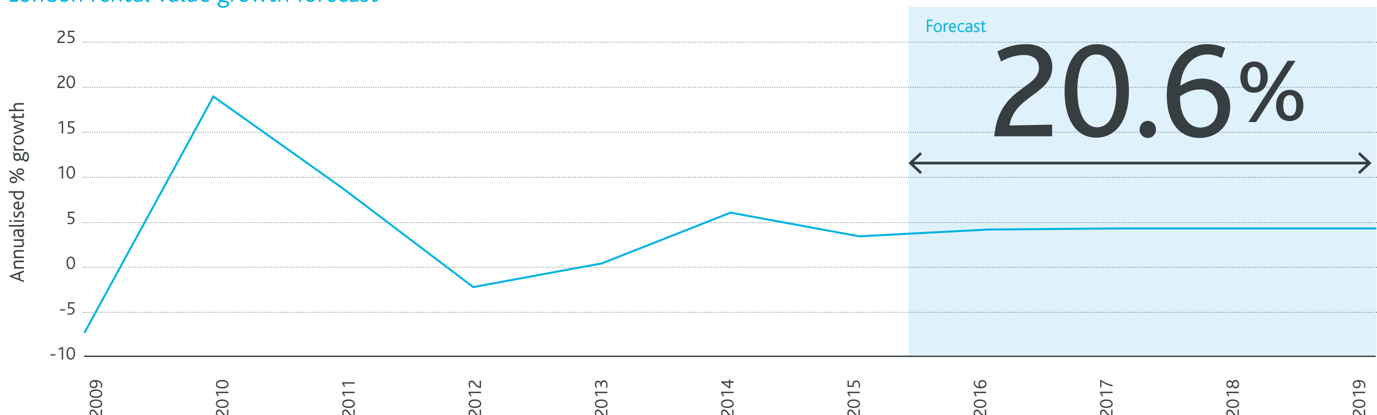
Larger properties record slight rent reductions
Not all markets are however experiencing a slowdown in requirements and deals. In St. John's Wood for instance, the advent of the new school season has helped to drive up tenant activity significantly, with a notable rise in the number of professional sharers in the market. Further afield in Blackheath, value driven tenants from the prime core continue to home in on the area, while young professionals are moving in from Kent to an area which they perceive to be aspirational, and offers them a midway base between the City and Kent.

In general, larger houses are increasingly slow to let as the usual family tenants have either moved further out of London in search of what they perceive to be better value for money, or transitioned to owner occupation, therefore reducing the size of the family tenant pool. In their place, professional sharers have begun to target larger homes, particularly those that have been on the market for a while as they sense the opportunity to secure a 'good deal'. In many instances, we have seen landlords bow to the pressures of rising costs associated with void periods and this is a pattern we expect to persist. This again highlights the wider affordability issues in the capital. We have noted this in submarkets in Central North West such as Maida Vale and Belsize Park, where large five bedroom plus family homes rent for £2,800 and £3,200 per week, respectively.

London residential capital value growth forecast



London rental value growth forecast



Source: Cluttons, Experian

Tenancy renewals reach an all time record-high
Seasoned landlords are for the most part aware of the quieter market conditions and are either leaving rents unchanged at renewal, or seeking token increases of £10 to £20 per week. In the vast majority of cases, tenants are eager to remain in situ, rather than expose themselves to property searches and high moving costs.

This has helped to drive the rate of renewals across the capital to all time high record levels. Of course the desire to purchase is continuing to fuel cost conscious behaviour, which is further exacerbating this trend. Across prime Central London, we have recorded a 1% rise in rents during Q2, which equates to a marginal £8 per week rise on Q1 and takes average weekly rents to £1,108; 4.1% ahead of this time last year.

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Lettings market outlook
The lettings market continues to hold steady with growth hovering at roughly 1% per quarter for the past four quarters. Based on the strong rate of job creation levels across London, combined with the sharp upturn in fresh buy-to-let stock, our expectation is for the market to remain fairly stable.

With the growing potential supply pipeline of further buy-to-let stock, the downward pressure on the rate of rental value growth is expected to persist, against the wider backdrop of affordability challenges. In fact the latest English Housing Survey estimates that tenants in London spend 72% of their annual earnings on rents, well above the 47% for England as a whole (see table). According to the latest data from the ONS, the median annual income in the capital is £35,069 (November 2014), while average annual prime Central London rents currently stand at £57,616.

Calculated annual income for tenants

Weekly rent	Assuming 47% is spent on rent	Assuming 72% is spent on rent
£500	£55,000	£36,000
£1,000	£111,000	£72,000
£1,500	£166,000	£108,000
£3,000	£332,000	£217,000

Source: Cluttons, English Housing Survey

Despite this, our central forecast scenario points to a stable, albeit weaker, rate of job creation in the capital. However as outlined above, the downside risks to the economic outlook may hamper tenant demand should the global economy succumb to the current pressures.

With this in mind, our expectation is for 2015 to register between a 3.5% to 4% increase in average rents, with further annual rises stabilising at about 4% between 2016 and 2019 as the upward creep in supply levels across London are expected to help moderate growth.

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