

London, Autumn 2016 | Post Brexit update

RESIDENTIAL MARKET OUTLOOK

RESIDENTIAL SALES MARKET

Market performance indicates peak is now behind us

Following a period of stagnation, prime Central London house prices slipped by 1.4% in Q2, the largest quarterly decline since 2009. This fall was primarily driven by poor performance in submarkets across Central South West, with the largest drops observed in traditional upscale areas of South Kensington (-5.6%), Knightsbridge (-5.5%), Belgravia (-5.3%) and Chelsea (-5.2%).

The average price in these areas declined by approximately 5.4% compared to the previous quarter. Capital values elsewhere remained largely unchanged.

On an annual basis, average house prices are up by a marginal 0.6%, sharply down on the 4.6% in the twelve months to the end of Q1, highlighting the depth of the slowdown currently underway.

Brexit shock

As expected, the referendum results have sparked the beginning of a period of uncertainty in the housing market. New buyer enquiries as well as stock levels fell to fresh historic lows in the immediate aftermath of the vote to leave the EU. In fact, according to the June RICS London Housing Market Survey, 57% of surveyors reported a fall in new vendor instructions, while 56% reported a fall in new buyer enquiries, reflecting the panic fuelled in the wake of the referendum.

Conditions appear to have improved in July, with only about a third of surveyors reporting a decline in both supply and demand, suggesting that some stability may be returning. In addition, we have noticed a slight upturn in buyer activity in the second half of August.

Change in residential capital values during Q2

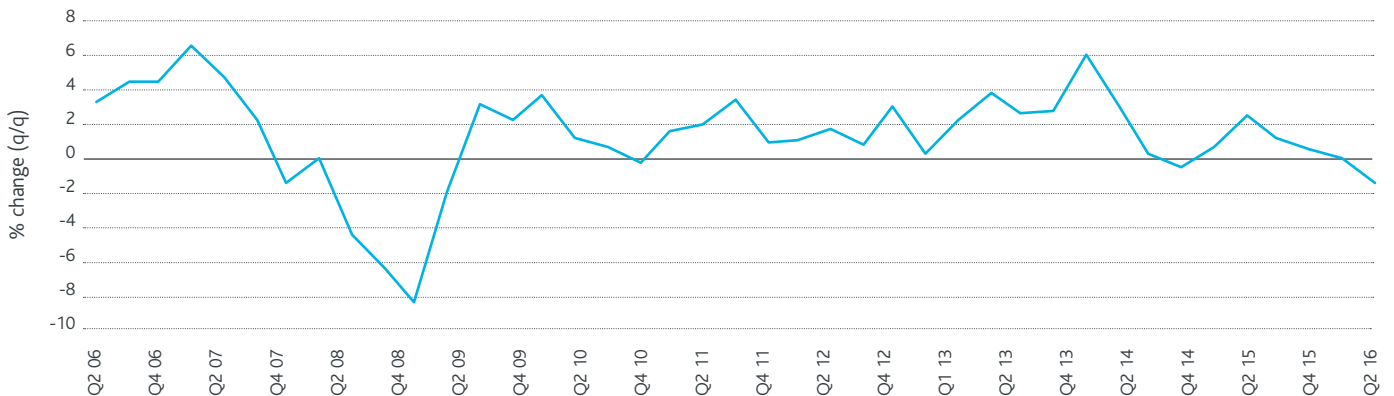
-1.4%

Change in residential capital values over the last 12 months

0.6%

Source: Cluttons

Prime Central London house price performance



Source: Cluttons

The full implications of Brexit on the housing market are still too early to assess, but it is increasingly clear that the referendum result has accelerated a slowdown that has been underway for over 12 months. The market has been stalled primarily due to affordability constraints, Stamp Duty adjustments that have hampered activity at the top end of the market and a lack of appropriate stock to satisfy domestic demand.

Domestic demand, for the most part, remains centred on secondary, period stock, which remains in finite supply. This may hint towards better prospects for this segment of London's diverse residential market once stability returns and activity levels normalise.

For now, neither of these core underlying issues have changed following the referendum result and so any correction in values may well be in the best interest of the market as it may spark more transactional activity.

No forced sales

For now, our post-referendum market experience also suggests that there are no forced sellers in the market. Indeed, many vendors are opting for a 'wait and see' approach by either withdrawing properties from the market, or letting them out instead. This is having ramifications for the already oversupplied rental market; a theme we explore in detail below.

Similarly, prospective buyers are also less willing to commit to a purchase due to the uncertainty around the immediate behaviour of London's residential market and are instead inclined to continue renting.

This trend is echoed by Q2 data from LonRes, which shows that the number of transactions across London fell by 38% when compared to Q2 2015. The new build/off plan market appears to have fared better, with Molior reporting 10,556 sales transactions in the first half of 2016, the highest level achieved in seven years, with the only exception being H1 2015, when transaction volumes were about a third higher.

Impact on international buyers

Away from the domestic market, the collapse in sterling as a result of Britain's decision to leave the EU, which now stands at a 30-year low against the US dollar, presents obvious buying opportunities for international buyers. Those eyeing up a London residential asset, particularly investors purchasing in US dollars, or currencies that are linked to the US dollar, such as those from the Gulf, would find London property significantly cheaper.

This suggests that we may be on the cusp of seeing a significant resumption in property investment activity in the British capital from the international community. In fact, through some of our banking contacts, we are also aware that interest from this cohort continues to rise with many Middle East buyers scouting the market for 'good deals'.

For Middle East buyers, who account for roughly 10% to 15% of all international residential property transactions in Central London, the appeal of a London acquisition being perceived to be more affordable due to sterling weakness has resulted in an upturn in enquiries in locations such as Belgravia and Chelsea, traditional stamping grounds for this cohort.

Top preferred London locations of the HNWIs from the Gulf

	Canary Wharf	South Kensington	South Bank	Prime Central London
Average house price (£)	429,000	3,222,000	927,000	2,300,000
Yield	5.62%	2.51%	3.46%	3.17%
20-year growth	132%	273%	141%*	267%
10-year growth	17%	54%	91%	67%
5-year growth	32%	28%	41%	39%
Post Brexit saving to USD investors	82,000	616,000	177,000	440,000

Source: Middle East Private Capital Survey 2016, Cluttons, YouGov, OANDA

*15-year growth

Others, such as domestic buyers, are waiting on the sidelines in the belief that more significant “discounts” may open up should sterling falter further and house prices depreciate by a larger than expected margin.

Still, according to the results of our 2016 Middle East Private Capital Survey, carried out in partnership with YouGov, London was named as the most likely property investment target for HNWIs from the Gulf during 2016. And with the recent currency market swings as a result of Brexit, they stand to benefit from substantial dollar discounts. In fact, in the locations named as the top London residential property targets (Canary Wharf, South Kensington and South Bank), these would range from USD 80,000 to USD 600,000.

Similarly, London’s commercial market has seen a rush of international funds targeting retail property, which, like the residential market, now appears to be “good value” in the wake of the severity of sterling’s fall.

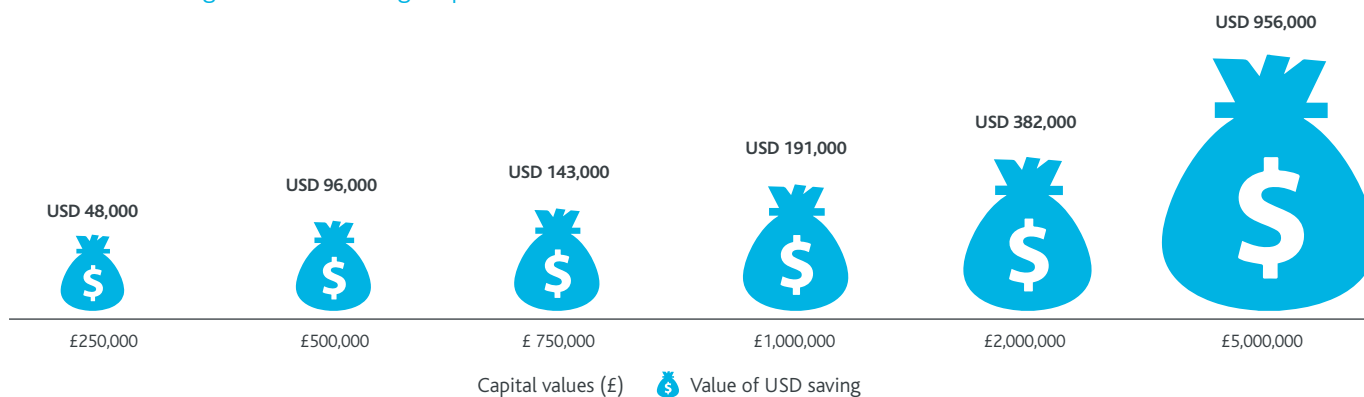
Looking ahead

Overall, given the high level of uncertainty and number of fast moving variables and market indicators, the forecasting environment is the most challenging we have experienced since the Great Recession of 2007/08.

What we do know is that Article 50, which is the formal mechanism the UK would need to invoke to begin the process of leaving the European Union, is unlikely to be triggered until at least 2017. As the exit process takes two years to complete, this implies that the uncertainty is likely to persist until 2019 at the earliest, unless further stealthy economic weapons are deployed by the new Chancellor and the Governor of the Bank of England, such as a surprise Stamp Duty holiday, which would be likely to fuel a spike in activity.

However, with the dust still settling, it is unlikely we will see any radical policy changes until Article 50 is formally invoked and the implications for London and the UK economy become clearer.

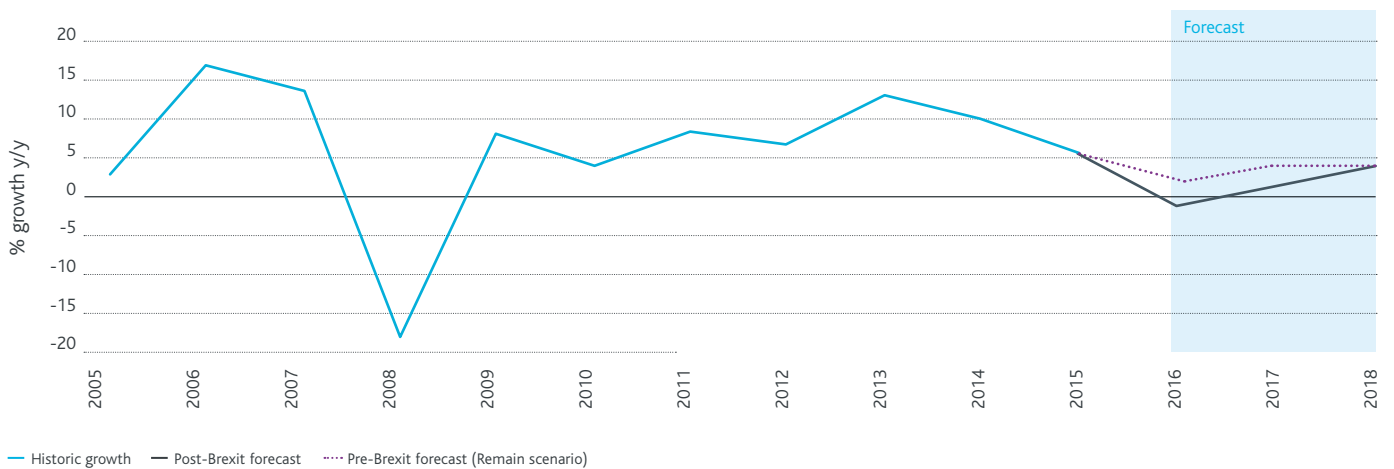
Value of USD ‘savings’ based on the original price in GBP



Source: Cluttons, OANDA



Prime Central London residential capital value growth forecast



Source: Cluttons, Experian

Taking this into consideration, our forecasts, prepared in partnership with Experian, are based on economic and real estate market data and expectations available as of the report publication date.

Our forecast model suggests that prime Central London house prices will decline by 1.5% in 2016. The severity of the correction will vary based on location and price bracket. As it stands, properties valued at under £2 million have seen very little price fluctuation over the past 12 months, while the upper echelons of £4 million plus, have seen dips of close to 10% in some cases, particularly in core markets like Chelsea and Belgravia where average falls of 5% over the past 12 months have been widely reported, marking the first price decrease in over three years. Further slight softening at the top of the market is likely to persist, driven by market fundamentals and the cyclical nature of property cycles, rather than as a direct result of Brexit.

Resilience in peripheral locations?

Further away from the core, values have demonstrated greater resilience as starting price points are lower and buyers continue to focus their attention on areas they perceive to offer the best value for money. This behaviour of course stems from the affordability issues that are now synonymous with home ownership in the capital. Prices in these more peripheral areas have also been supported by changing attitudes towards acceptable commute times into London, which have risen sharply over the past two decades, while house prices in prime Central London over this period have increased by 267%, driving a significant rippling of housing demand outward from the city centre.

Significant downside risks

The upside risk to this year's growth forecast is the potential of an amendment to the residential tax regime during the Autumn Statement, although as outlined above, this appears unlikely at this stage. The downside risks are more significant. Further economic fallout from the referendum results, the far reaching consequences on job creation rates and the knock on effect on the appetite to purchase this may have, are very real threats to the market.

Our base case forecast is based on the assumption that the UK will briefly enter a very mild technical recession this year during Q3/Q4, before a weak return to growth unfolds. Should this play out, 2017 is likely to end the year with capital values 0.9% up on this year, before accelerating to 3.1% in 2018.

However, again, the implications of Article 50 being triggered cannot be stressed enough as this may cause any nascent return to growth to unravel, dragging house prices into negative territory, should the UK's new EU relationship not be perceived to be favourable, or amicable.

Prime Central London residential capital value growth forecast

2016	-1.5%
2017	0.9%
2018	3.1%

Source: Cluttons, Experian

RESIDENTIAL LETTINGS MARKET

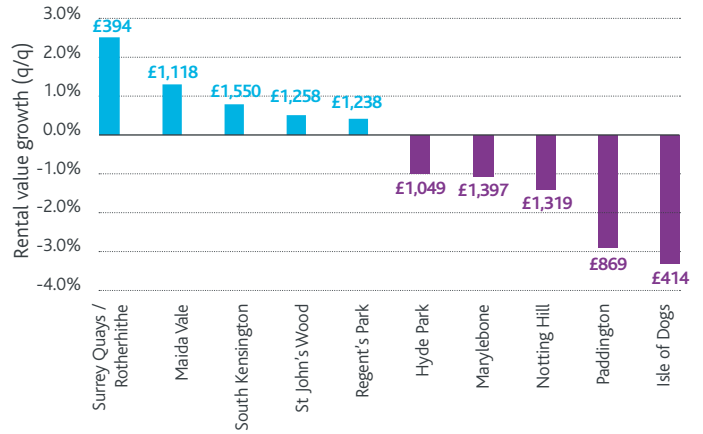
Rental weakness persists

Following two quarters of negative growth in average rents across prime Central London, rental prices continued to fall in the second quarter of 2016, slipping by a further 0.2%. On an annual basis, rents fell by 0.6%, the first negative growth since Q3 2013; however rental growth has been slowing for the past six quarters.

Although most areas registered marginal declines, Central West is primarily responsible for the weak picture across prime Central London.

Within Central West, the largest declines were observed in Paddington (-2.9%), Notting Hill (-1.4%), Marylebone (-1.1%) and Hyde Park (-1.0%). These were mainly driven by the drop in rental values for houses (-3.9%), whereas rents for flats (0.1%) were virtually unchanged during Q2.

Top 5 strongest and weakest performing submarkets and corresponding average rental values



Source: Cluttons





With stock levels at all-time high, tenants remain in the driving seat

Across our Central London offices, stock levels are at an all-time high, with properties available across the price spectrum, which has been in large part responsible for some of the rental declines being observed.

This sharp upturn in stock levels appears to be a direct result of the uncertainty triggered by the June 23 referendum, with many vendors opting to let their properties while further clarity emerges on the potential impact of Brexit on home values. This 'wait and see approach' is becoming further entrenched in the market and is driving up levels of lettings stock, which first showed signs of edging ahead of demand when a buy-to-let stock surge materialised earlier on in the year, following the Stamp Duty changes introduced on April 1.

Increasing supply however presents prospective tenants with a wider range of options, whilst also improving their bargaining power. Tenants are now taking longer to make a selection and are often able to negotiate more favourable terms.

The magnitude of rent reductions being offered by landlords varies by both location and price band, with traditionally affluent areas in Central West reporting large 'discounts' in higher price bands (above £1,500 per week). In addition, we have seen some examples of price reductions in the region of 3% to 4% in more affordable

locations in Central South East for mid-range homes (~£600 per week). This is being driven by an upturn in newly built properties, which tenants are gravitating towards particularly in instances where their current accommodation has not been regularly refurbished and maintained to a high, comparable standard to that available in recently completed developments.

Clearly, this presents an opportunity for landlords to undertake refurbishment programmes in order to drive up demand.

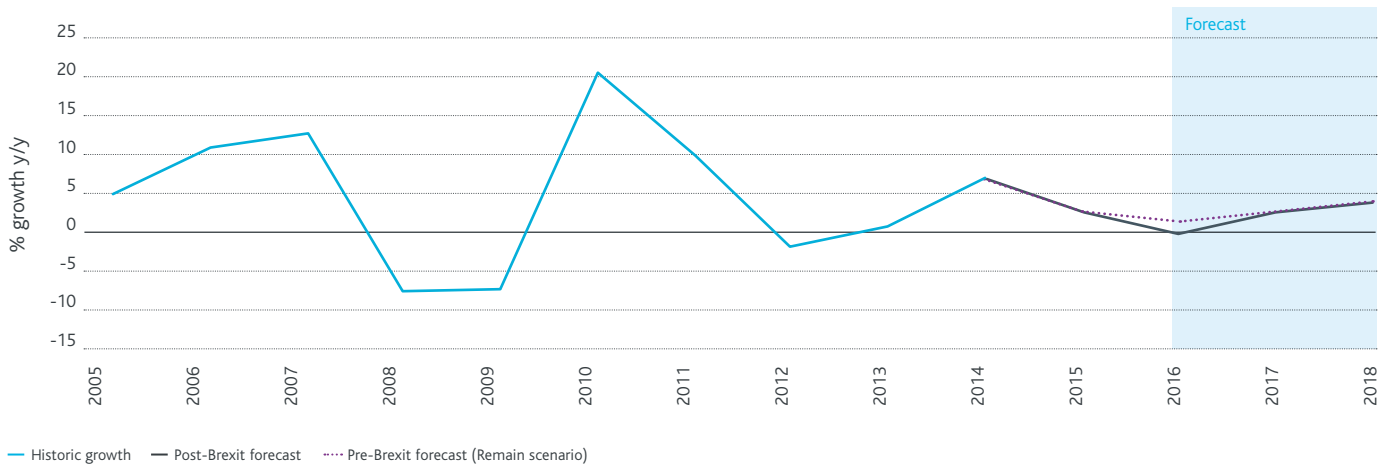
The largest share of demand across prime Central London continues to be represented by professional workers in the finance and banking sector, the technology-media-telecoms sector and international students, with the latter being characteristic of this time of year.

Uncertainty driving requests for shorter break clauses

The overall uncertainty in the market means that some tenants are seeking more amenable terms around break clauses. Landlords are wary of the current market conditions and are demonstrating a greater degree of flexibility, while rents are being maintained at the same level or going through with token increases of £5 or £10 per week at renewal.

The Brexit result appears to have galvanised a much anticipated correction to the market, which began last autumn. The minor

Prime Central London rental value growth forecast



Source: Cluttons, Experian

downward adjustment has not negated the wider affordability issues, which still persist. According to Countrywide, rental growth in London outstripped growth in earnings, with the proportion of monthly take-home pay allocated to rental payments increasing to 57% in May 2016 from 41% in 2007, underscoring the core issue of affordability that continues to undermine home ownership aspirations. Interestingly, most referencing agencies in the capital set the affordability pass threshold at 43% of annual income.

Navigating the uncertainty

Given current all-time high stock levels and rising anxiety around job security, particularly in the critical finance and banking sector, our forecast model suggests a rental contraction of -0.7% this year across prime Central London. Like the sales market, this is likely to vary greatly across the capital and will be substantially different for properties at the top end of the rental spectrum, where rent drops so far this year have been in the region of 3% to 5%, with further falls likely.

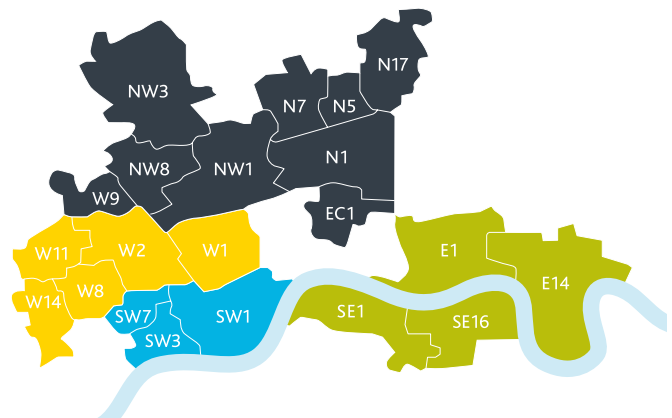
Going forward, the biggest risk to our rental growth forecasts is the way in which Brexit affects the City’s passporting rights access to the EU’s financial markets and what number, if any, of finance and banking jobs are transplanted to the continent. The finance and banking sector is a critical source of tenants across all prime Central London submarkets and the weakening of demand from this cohort will likely have significant ramifications for our forecasts, although this does not currently sit in our central scenario. It is worth noting that finance and banking accounts for roughly 20% of London’s GVA (ONS, 2012).

The fundamental issues around affordability are expected to persist, with more trapped in a “renting for longer” lifestyle in the medium to long term. With this in mind, we anticipate growth to reach 2% in 2017, before rising to 3.2% in 2018, however again, these forecasts are predicated on no further economic shocks around the UK’s new EU relationship and eventual exit from the bloc.

Note on methodology

Our residential capital value and rental growth models are prepared by Experian and are primarily driven by demand-side indicators (in particular, labour market drivers such as job creation, income growth, unemployment changes), financial variables (such as mortgage rates) and key demographic trends (such as population growth) to derive medium term forecasts for expected growth in prime Central London.

Prime Central London definition



Central South West
South Kensington, Chelsea, Belgravia, Knightsbridge and Pimlico

Central South East
Shad Thames, Borough, South Bank, Rotherhithe/Surrey Quays, Wapping, Limehouse and Isle of Dogs

Central North West
St John’s Wood, Regent’s Park, Hampstead, Primrose Hill, Belsize Park, Maida Vale and Highbury & Islington

Central West
Hyde Park, Notting Hill Gate, Marylebone, Bayswater, Kensington, Mayfair and Holland Park

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