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London, Spring 2017

RESIDENTIAL MARKET OUTLOOK

RESIDENTIAL SALES MARKET

Values starting to stabilise?
Over the last few quarters, the shift in buyers' geographic preferences has become extremely evident. This phenomenon has been most notable in prime Central London, with values in the prime core bearing the brunt of the underlying weakness in enquiry levels. Last year alone, prices declined by 3.8%.

Q4 2016 however appeared to mark a turning point for the market, with the drop in values being limited to an average of 0.4%.

Over the fourth quarter of 2016, Belgravia (-2%) was the weakest performing submarket. This was followed by South Kensington, Chelsea and Knightsbridge where prices dipped by 1%. Across the other 13 submarkets we monitor in prime Central London, prices remained unchanged.

The apparent resilience has been underpinned by a lack of urgency to sell amongst vendors. In some instances, vendors who have been disappointed with offers received on homes for sale have decided to temporarily let their properties while the market meanders through the weaker conditions.

In addition, a lack of stock and strong level of buyer enquiries for properties priced around the £1 million mark, which remains a sweet spot, have also helped to support the increased stability in the market. In fact, many of our offices are reporting properties in and around £1 million going under offer within 48 hours of coming to market and transacting at, or close to, record highs.

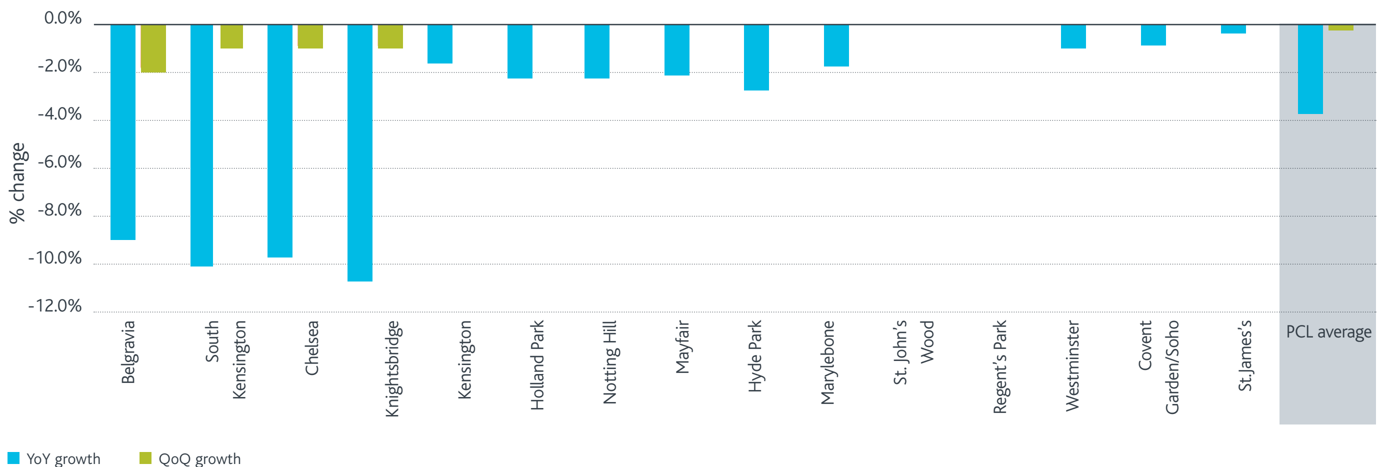
This trend has persisted into the new year, with most of our Central London offices reporting a busier than usual January and February. This mirrors the latest RICS Housing Market Survey results for London, which also showed an upturn in new buyer enquiries; the strongest level in 12 months.

The latest change now leaves average residential values a little over £3 million, with house prices standing at £5 million, and the average value of a flat falling just short of £1.7 million.

The performance of values remains linked to location, property type and price bracket. Knightsbridge (-10.8%), South Kensington (-10.2%), Chelsea (-9.8%) and Belgravia (-9.0%), were the worst affected submarkets last year. As we previously indicated, these submarkets appear to have been disproportionately influenced by the current downturn primarily due to the higher concentration of high-end homes in these areas.

Interestingly, international buyers, particularly those from the Middle East, remain active in these markets, seeking out and securing what they perceive to be the 'best deals' both for off-plan and secondary market homes, buoyed in part by the relative currency advantage available to them through the strength of the

Performance of capital values across prime Central London's submarkets



Source: Cluttons

US dollar. In fact, the dollar is currently 17% stronger than it was prior to the Brexit referendum.

Diminished threat to sales market from supply surge?
Still, there exist a number of downside risks for the residential sales market. A previously reported risk was the potential for a supply surge, given the sharp upturn in construction starts, but this now appears to have subsided, with signs of recently completed stock drifting on to the lettings market instead of being resold.

Whilst this has been a challenge for the lettings market, which we will address in detail below; according to Molior, in submarkets such as Kensington, Chelsea and Camden, the number of construction starts for new homes has consistently exceeded sales in the last few years; however, 2016 marked a reversal in this trend, which may assist in a more rapid stabilisation in these core locations than previously expected.

Across prime Central London, most activity was concentrated in the borough of Westminster which registered approximately 2,200 unit launches last year (Molior).

In terms of wider Central London, Tower Hamlets, with its extensive construction at Canary Wharf (6,000 units), led the number of new starts in 2016. The borough had over 8,000 units under construction at the end of 2016 (Molior).

The total number of homes under construction at the end of 2016 across the capital reached almost 60,000, with nearly 25,000 breaking ground last year alone, mirroring figures from 2015 (Molior).

Affordability still stifling activity
Away from the diminished supply threat, the affordability issue has also curtailed activity in the capital for several quarters now. Whilst anecdotal evidence points to households being forced into renting for longer while they amass deposits in order to transition to property ownership, clearly there has also been a drive towards submarkets that are perceived to offer better value for money.

Many of these are situated outside our new definition for prime Central London, but still lie within our definition for Central London. Clapham, for instance, which has for many years been a magnet for young aspiring families in the capital has registered house price growth of nearly 90% over the last six years alone.

Clearly this increase has resulted in a slow but steady transition in the profile of buyers being attracted to the area, with a notable upturn in professional working couples, particularly those from the finance and banking sector now actively targeting this market.

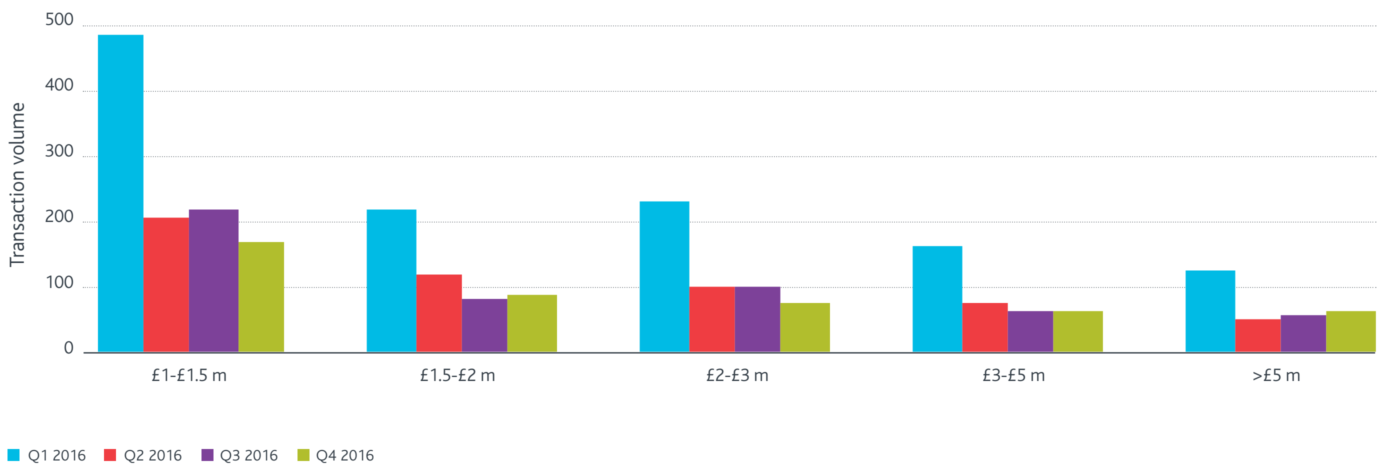
Transaction levels weakest since 2012
The prime risk to the market remains the volatility that set in with the Brexit referendum of 23 June last year.

The shock referendum result, alongside affordability issues and the Stamp Duty changes last April, continue to hamper overall activity in the capital, with deal levels reflecting the sting of the triad of growth dampeners. In fact, the total number of sales transactions in London fell sharply last year, recording a 26% year on year decline. Over the past three years, the city observed an average of about 100,000 transactions between January and October. In 2016, this figure was just shy of 75,000; the lowest since 2012.

There were a few submarkets that suffered more than the others. The boroughs of Westminster (-49%), Islington (-21%) and Hammersmith and Fulham (-32%) were last year's top three weakest performing boroughs for sales transactions (Land Registry).

Tower Hamlets (-5.3%) and Hackney (-3.1%) on the other hand, were the least affected, reflecting perhaps their relatively greater offering of homes perceived to be more affordable.

Transaction volumes by price bracket across London



Source: Land Registry, Cluttons

Further detailed analysis of data from the Land Registry reveals that homes in the £1.5 million to £2 million range and those priced in excess of £5 million, have been amongst the weakest performing price brackets in the capital in the last year.

The declining performance of the £5 million plus price bracket can be attributed to the weaker international demand for high end homes as well as the Stamp Duty revisions.

Transaction volumes accross London

Source: Land Registry

2018 likely to mark a turnaround for house price growth
The pall of gloom cast over the market in the wake of the Brexit referendum accelerated a much-anticipated slowdown; however, the impending negotiations are likely to curb overall activity until the UK's post-Brexit economic position and global standing become clearer.

Furthermore, with no relief expected from recent Stamp Duty adjustments, individual BTL activity is expected to remain suppressed. In fact, while Middle East buyers remain notably active in prime Central London, anecdotal evidence points to a cooling in property capital inflows from China, particularly into the new homes market.

Whether this change is a precursor to looming Chinese government regulation capping overseas property investment to USD 100,000 per person, per year, remains to be seen. Clearly this too poses a risk to a normalisation in deal activity, especially given that Chinese nationals and those from South East Asia account for roughly 35% to 40% of international transactions in the capital; international buyers account for about half of all transactions in London.

As outlined above, a restricted supply of stock in the secondary market, driven by vendors moving into a holding pattern, letting out their properties instead, while waiting for more favourable conditions to return, along with accidental landlords who may be reluctant to lose out on recent capital appreciation after post-sale Capital Gains Tax deductions is expected to support price stability to an extent.

With this in mind, we expect house prices in prime Central London to fall by an average of 1.2% this year, underpinned largely by the uncertainty expected to ensue following the formal triggering of the process to exit the EU by the Prime Minister during March.

By the end of next year, we anticipate a return to growth, albeit weak, at 1.3%, as Britain nears the completion of the Brexit process and some confidence returns to the market.

Between 2019 and 2021, growth is forecast to average between 2.5% and 3%, which should deliver cumulative growth of 10.3% over the next five years.

RESIDENTIAL LETTINGS MARKET

Price corrections across prime central London continue
Away from the sales market, the lettings market also continued to soften, with rents ending last year, 2.2% down on 2015. During the final quarter of 2016, rents decreased by 1.2%. The latest change leaves weekly rents at an average of £1,406.

Hyde Park (-6.5%), Holland Park (-4.4%) and Knightsbridge (-4.2%) were the weakest performing submarkets last year.

Nervousness amongst tenants persists
As we reported above, the lettings market is experiencing a strong boost to supply levels, with all our Central London offices continuing to report record high stock levels across the price spectrum. Demand however remains centred on homes priced at approximately £500 to £600 per week, with properties in this price range turning over swiftly, with healthy enquiry levels. Elsewhere in the price spectrum, demand remains limited.

Average weekly two-bedroom rents in a selection of prime Central London locations

Submarket	Rent per week
Belgravia	£925
Chelsea	£895
Knightsbridge	£1,250
South Kensington	£850
Marylebone	£720
Mayfair	£1,300

Source: Cluttons

Despite the apparent buoyancy of the sub £500-£600 per week market, there remains a general nervousness amongst tenants, with many seeking to retain tenancy break clauses at six months or less. Job security fears and anxiety around the health of the British economy are the most commonly cited reasons for this.

While there is a general weakness in enquiry levels from core tenant source sectors in prime Central London, such as the finance and banking sector; the telecoms-media-technology (TMT) sector remains the most active elsewhere in Central London, with submarkets such as Islington still enjoying a high level of enquiries from this cohort. It is however worth noting that budgets from this group tend to hover around £500 per week, leaving properties at the higher end of the price spectrum in markets dominated by TMT professionals subject to further rent corrections.

Surging supply levels
The unusually high level of rental stock, stemming from the reasons discussed above, are undoubtedly contributing to the ongoing weakness in the market.

The surging stock levels have put tenants firmly in the driving seat, with many using the weaker conditions to shop around for the best perceived deals. Many landlords have responded by leaving rents unchanged at renewal in most cases and this is a trend that has persisted
into 2017.

Relet properties recording rent reductions
In instances where tenants are terminating tenancies, properties brought back on to the market are generally slow to relet, especially if they are priced above £600 per week. For homes in this category, rent reductions are now commonplace. For instance,

flats in Belgravia, or in the Tower Bridge area, priced upwards of £600 or £800 per week respectively, have, in some extreme cases observed downward revisions of up to £100 per week.

Some Central London locations remain resilient
Away from prime Central London, South East Central London (-0.4%) emerged as a stand out performer last year, with rents demonstrating a high level of resilience in the face of quieter conditions overall.

In South West Central London, on a submarket level, Wandsworth (5.1%) and Battersea (2.1%), recorded growth last year, fuelled by a rising level of new home completions and the gradual emergence of a community feel, which is affording landlords the opportunity to raise rents. At the same time, tenants are drawn into the area by the allure of renting a newly completed home, equipped with all the latest modern amenities, at a lower price than homes in more core locations.

On average, weekly rents in these two submarkets stood at between £550 and £650, making them approximately 50% to 60% cheaper than those in prime Central London locations.

Supply threat to rents
The current stagnation in rents is expected to persist, underpinned by our view that supply levels are likely to remain ahead of underlying demand in the short term.

The government's recently launched Housing White Paper appears to suggest a sharp deviation from the previous government's efforts to drive up home ownership levels. Instead, the White Paper brings into focus the state of the national lettings market, with a clear agenda of boosting rental supply.

It is encouraging to see this being addressed by the government, although it is perhaps tantamount to an acceptance of the growing permanency of Generation Rent and comes at a time when rental supply in London has edged ahead of overall demand.

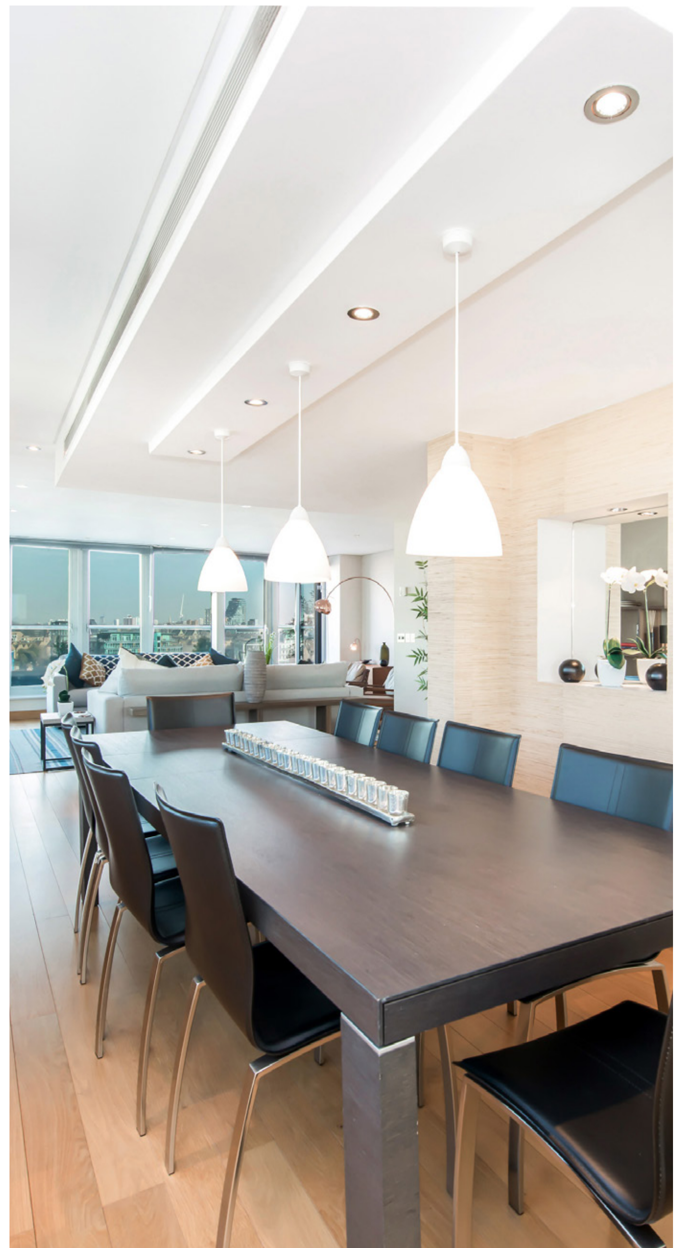
Mute outlook persists
Away from the domestic supply threat, the implications of Brexit on London's position as a global centre for finance and banking continue to stoke uncertainty about the future of this critical source of demand for both the residential and commercial markets in the city; however, a large-scale loss, or transfer of jobs to the EU does not currently sit in our central view.

For now, tenant demand levels remain weak and at levels not seen since the depths of the Great Recession of 2009, according to the latest RICS London Lettings Market Survey. This is expected to keep rental growth rates suppressed this year, with our forecast model suggesting a contraction of 0.4% on average through 2017 and a further drop of 0.8% next year, while we work our way through the tangled Brexit web and the associated economic complications.

Between 2019 and 2021, we forecast a return to growth, with values trending towards our 20-year annual average of 2.7%, delivering cumulative rent rises of 9.1% between now and the end of 2021.

Rental value performance

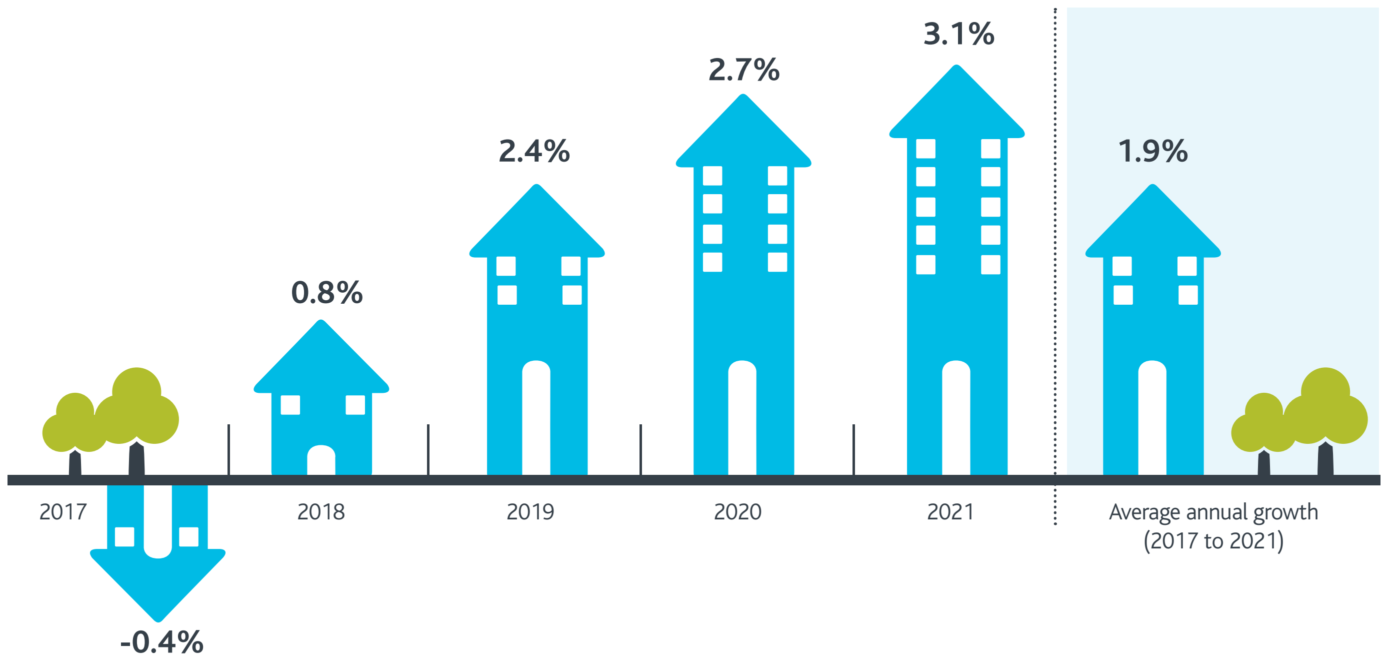
Source: Cluttons



Prime Central London capital value forecasts

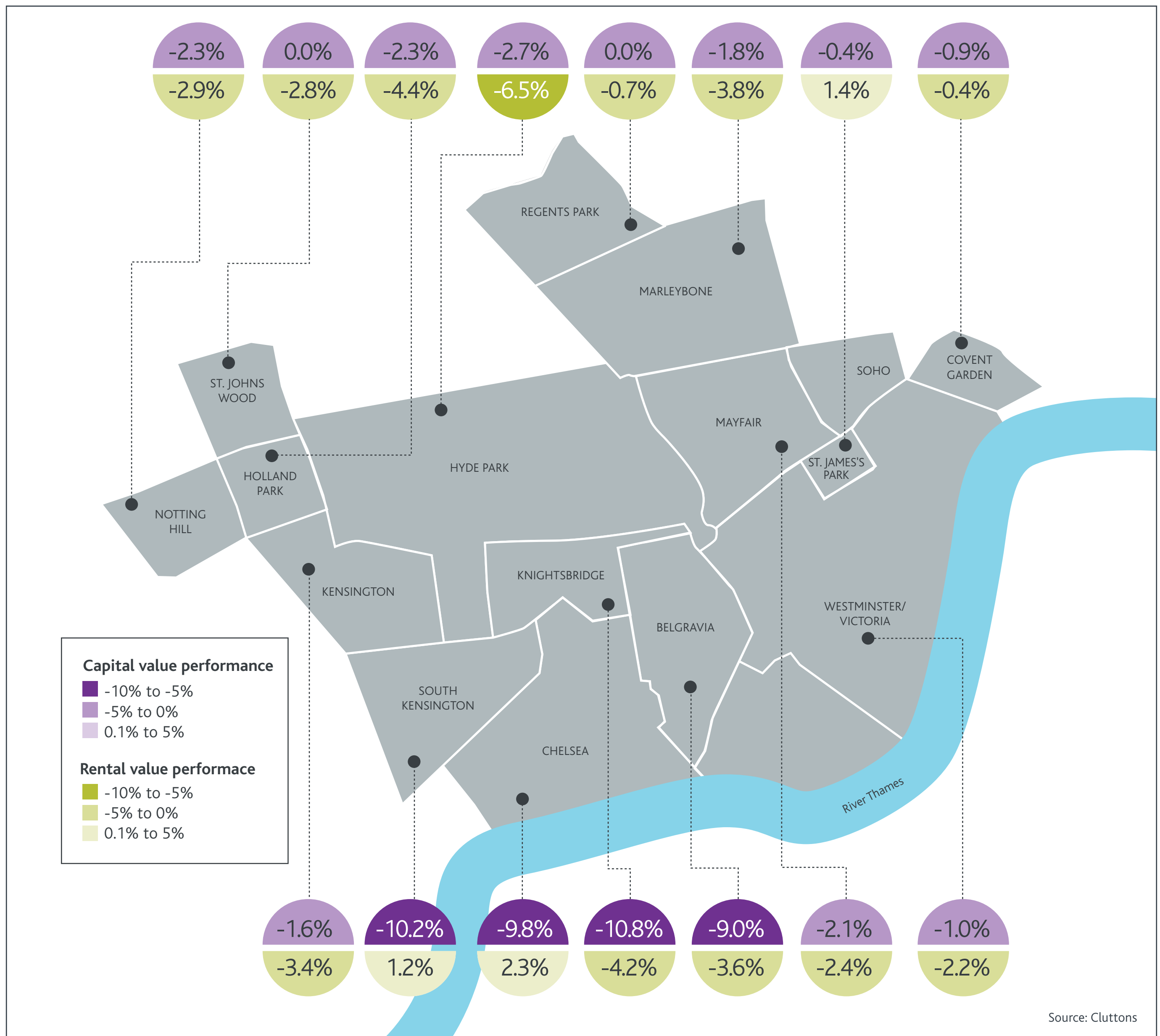
Source: Cluttons, Experian

Prime Central London rental value forecasts



Source: Cluttons, Experian

Prime central London annual % change – capital and rental values



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. (PCL)

Revised classification

We have revised our 20-year old definition for Prime Central London. This new classification groups markets within the prime core with similar characteristics., whilst also expanding the geography of the areas that fall under our new broader Central London definition.

Prime Central London (PCL)

Belgravia, South Kensington, Chelsea, Knightsbridge, Kensington, Holland Park, Hyde Park Marylebone, St. John's Wood, Westminster / Victoria, Covent Garden / Soho, St. James's, Regent's Park, Fitzrovia

Central London (CL)

CORE – Wapping, South Bank, Shad Thames, Canary Wharf, The City, Shoreditch, Clerkenwell, Farringdon, Fulham, Maida Vale, Earls Court, Hampstead, Hammersmith, Islington, Highbury, King's Cross

SOUTH WEST – Battersea, Clapham, Wandsworth, Vauxhall, Nine Elms, Putney, Wimbledon, Richmond, Chiswick

SOUTH EAST – Greenwich, Blackheath, Dulwich*, Canada Water, Elephant & Castle, East Dulwich

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