CLUTTONS

London, Spring 2018

RESIDENTIAL MARKET OUTLOOK

RESIDENTIAL SALES MARKET

2017 ends on a weak note

2017 ended with a glimmer of hope in the form of a breakthrough in the complex Brexit negotiations, offering some certainty of a transition period post March 2019, when Britain will officially leave the EU. This extended changeover period will certainly help businesses plan better for a post-Brexit Britain and more importantly, will prevent the triggering of contingency plans and a mass exodus of jobs from London. This should offer some comfort to owners and landlords worried about a 'cliff edge' drop in demand for residential and commercial property.

However, despite this, last year was characterised by sustained uncertainty. Indeed, 2017 was punctuated by events such as the snap General Election and the repeated roadblocks in the negotiations with the EU, which together had a profound dampening impact on the performance of the residential market in the UK and especially in London.

Our prime Central London residential capital value data has recorded a consistent decline in prices since the referendum in Q2 2016. Average residential prices in prime Central London fell to £2.94 million at the end of last year. This translates into a 1.1% fall during Q4 2017, making the final three months of last year, the weakest in 2017 (see graph on page 2).

On an annual basis, values declined by 3.4%, which leaves prime Central London home values at a level not seen since Q3 2013.

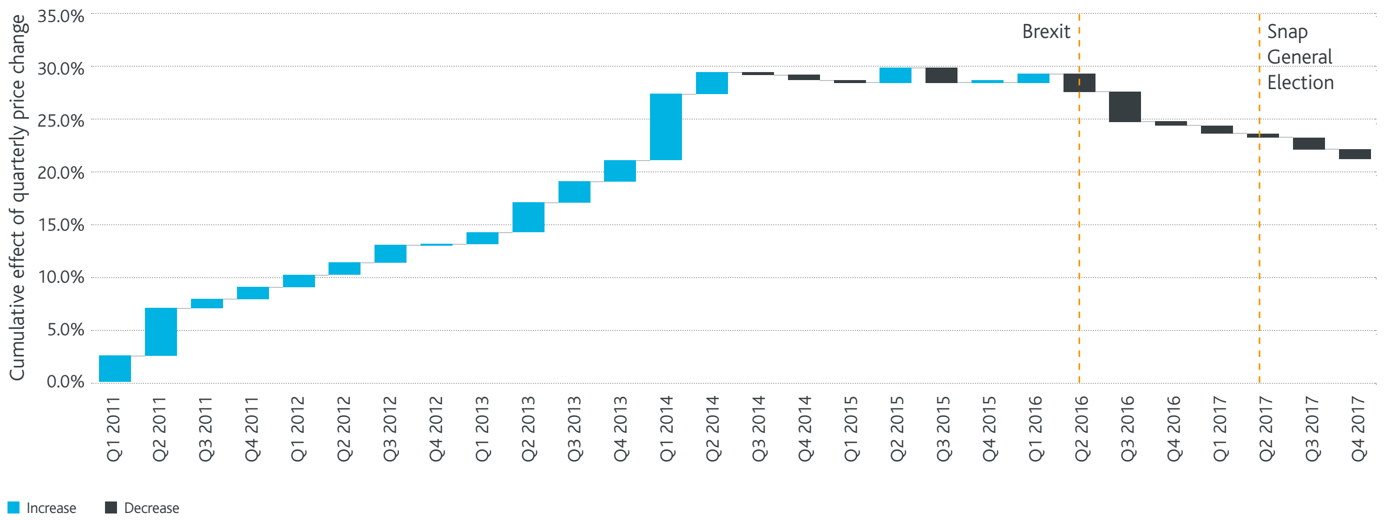
Performance across submarkets remains varied

As we have been reporting, the decline in average residential prices has been sharper at the top end of the market, with premium submarkets such as Belgravia and Kensington continuing to grapple with the most severe drops as demand for high end homes remains muted.

During 2017, both Belgravia (-7.8%) and Kensington (-7.8%) were tied for the weakest performing submarkets in prime Central London. In fact, since the referendum, Belgravia and Kensington have experienced a price drop of 13% and 10% respectively, compared to a 6% fall across prime Central London as a whole. South Kensington was the only submarket to have stabilised to some extent in the latter half of the year, recording growth of 2.3% last year, positioning it as the strongest submarket in prime Central London during 2017.

It is our view that the corrections observed throughout 2017 were aggravated by a weak level of requirements. This is corroborated by the latest RICS Housing Market Survey for London, which showed a 5% increase in the balance of surveyors reporting falling enquiries.

Residential price performance in prime Central London



Source: Cluttons

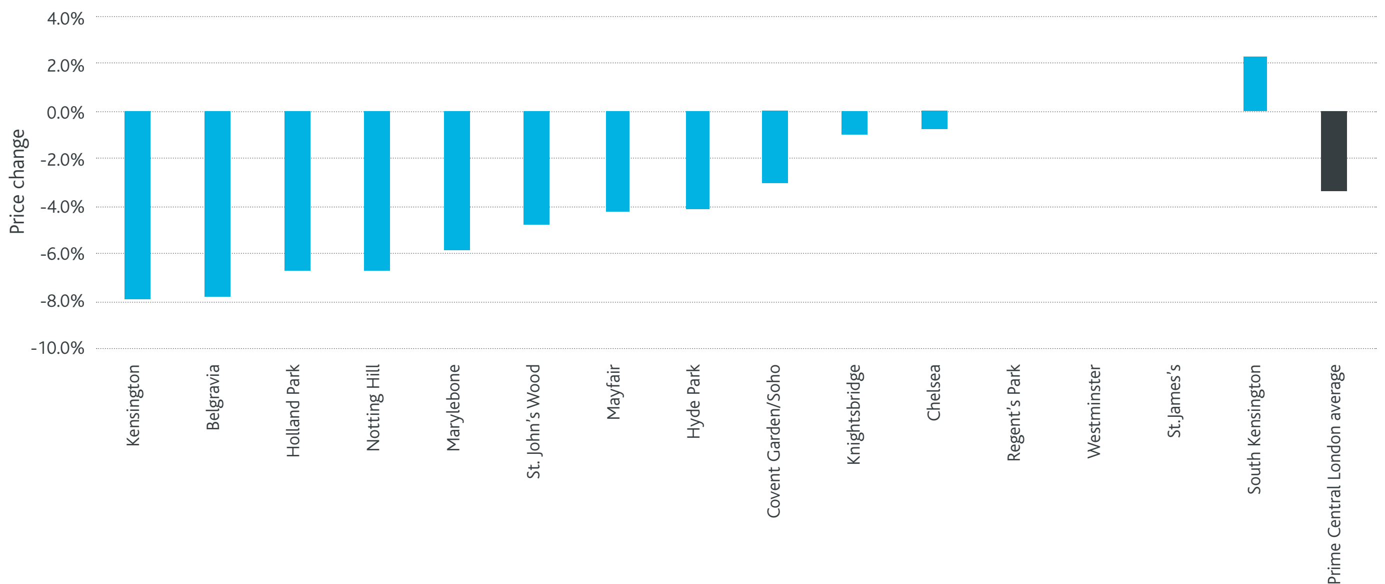
The flip side of the equation has been a tightening of supply on the secondary market, which is also echoed by the RICS survey results. Indeed, the restricted secondary market supply in prime Central London has likely been one of the strongest factors in helping values remain relatively stable since the Brexit referendum.

Lending figures mask persistent affordability challenges
According to the Financial Conduct Authority (FCA), the total value of residential property loans in the UK increased by 4.1% to £1.3 trillion in the 12 months to the end of Q3 2017. However, rather than being driven up by increased first time buyer (FTB) or buy-to-let (BTL) activity, this increase was primarily driven by remortgages, or home movers.

In fact, data from the FCA suggests that the share of BTL lending decreased to 12.8% of the total lending, which is the lowest it has been since Q3 2013.

Certainly, this mirrors our own experience in prime Central London, where the potent combination of repeated tax changes targeting

Price change across key prime Central London submarkets during 2017



Source: Cluttons

BTL investors, combined with a tightening in lending criteria, appears to have stifled investor activity. And while overseas investors from the Middle East and Asia continue to be drawn in by currency linked discounts, this has not been enough to offset the overall decline in requirements across the board.

Clearly efforts by the government to contain investor activity have been successful. However, the subsequent expectation of a rise in FTB activity through the compression of investment linked purchases has been largely curbed by affordability issues. Our analysis shows that average house prices in prime Central London, despite falling last year, still stand at 11.25 times average annual household incomes.

Continued Brexit anxiety hurting construction starts

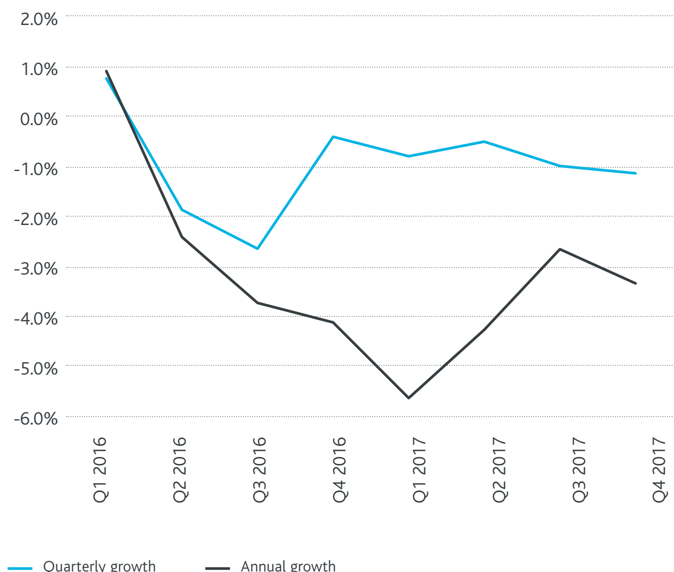
The affordability issues, as we have said previously, are further exacerbated by London's inability to keep pace with rising demand. While there was some apparent optimism as we ended 2017, with progress in the ongoing Brexit negotiations, the positivity was dampened by simultaneous warning bells from EU regulators to industries that are reliant on UK operating licences. These industries, which include aviation and pharmaceuticals, have been asked to prepare for compliance with the EU regulations, even after the UK officially leaves the EU in March 2019.

While the fears of significant job losses as a result of Brexit appear to be contained at this stage, any further bottlenecks in the negotiation process, as well as an unfavourable outcome for Britain during the negotiations, would likely pose a serious threat to the health of businesses in the country, while undoubtedly hurting overall inward investment volumes.

A recent study commissioned by the Mayor of London on the impact of Brexit, prepared by Cambridge Econometrics, titled 'Preparing for Brexit', suggests that in the eventuality of a hard Brexit, without a transition period, the UK could see a 15.4% decline in investments, a 3% loss in GVA and a 1.5% drop in both employment and productivity. These figures are in comparison to a scenario wherein the UK is able to maintain somewhat of a status quo, with access both to the single market and the customs union; however, this scenario appears unlikely. Instead, it is expected that the two sides will agree a half-way house deal, most likely mirroring the arrangements with Canada and/or Norway.

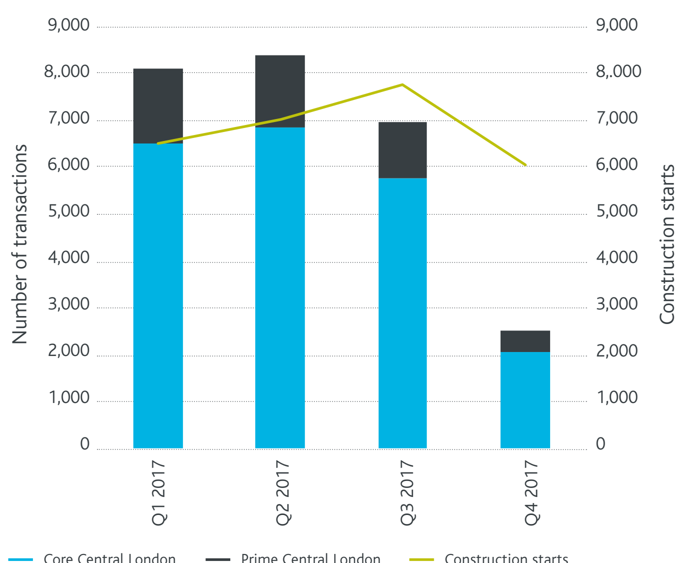
When it comes to the property market, this enduring ambiguity has further weakened developer confidence, with several putting new projects on hold. According to Molior, at the end of 2017, construction of 180,000 permitted units across London were yet to commence; an annual increase of 9%. Another worrying factor which may explain the restrained attitude of developers is the rising amount of unsold inventory in the market, which continues to rise. At the end of 2017, the count of new homes that were completed but unsold ballooned by 35% year on year. This equates to some 1,500 units, many of which are trickling on to the lettings market, triggering separate challenges. Just three years ago, in 2014, the number of unsold units was a mere 140 (Molior).

Residential price performance in prime Central London



Source: Cluttons

Residential transactional activity and construction starts across Central London



Source: Land Registry, Molior, Cluttons

*Note: Q4 transaction data is likely to be revised upwards due to the lag between transactions completing and the Land Registry publishing updated records

Despite the considerable slowdown in the number of new project starts, the level of sales transactions still remains behind the volume of new unit starts. This holds especially true for the outer boroughs in London which accounted for 66% of the 5,100 units that commenced in the last year (Molior).

Ripples of price abatement spread beyond prime Central London
Much of 2017 saw core Central London submarkets remain resilient in the face of value declines across prime Central London locations, but the end of last year saw prices in these outer locations also starting to slip. They appear to have finally succumbed to the near constant turmoil in the political environment, as well as the string of disappointing economic figures. In fact, the first estimate for GDP growth during Q4 2017 stands at 0.5%, which equates to an annual increase of 1.5%, the slowest rate of expansion since Q1 2013.

In a manner similar to the more central locations, declining buyer interest and a surplus of supply, led to prices contracting across core Central submarkets by 1.9% in the final three months of 2017; the most significant drop in two years. Shoreditch (-6.1%), Earl's Court (-5.9%), Highbury (-5.2%), and Islington (-5.1%) emerged as the four weakest markets during Q4 2017.

We expect this moderation in prices to continue in 2018. Our view is further corroborated with data from Rightmove which suggests that new-to-market sellers reduced asking prices by 1.4% in January 2018 in a bid to entice demand. Additionally, the time taken to sell a property has also increased by 18% over the last 12 months, to reach an average of 78 days at the end of December last year. (Rightmove)

Capital value forecasts
The capital's housing market continues to be buffeted by some very challenging conditions, most notably Brexit, its associated risks and unknown impacts. Whilst domestic buyers grapple with issues around affordability and the lack of appropriately priced stock in high demand locations, international buyers continue to show interest for prime Central London assets.

The recent tax changes appear not to have fazed this international group of loyal London investors. At the same time, the Chancellor's decision in the Autumn to raise the Stamp Duty Land Tax threshold to £300,000 for first time buyers does not appear to have delivered the expected demand boost to the housing market, although this is likely to benefit the regions far more than London, given the wide price differential between the capital and the rest of the country.

For now, demand levels are likely to remain subdued and while the low level of prime Central London inventory has perhaps shielded the market to an extent from sharper price falls than those that have been recorded, underlying issues around affordability and nervousness to commit to a purchase in a softening market are likely to overshadow any benefits from further government intervention. This is especially true in prime Central London, where average values are 14 times higher than the national average, according to the latest data from Nationwide.

While the government continues to work to ease access to the housing market for first time buyers, home ownership rates continue to decline. According to data from the Bank of England, the number of loans available for home purchases across the UK, declined to 61,039 in December 2017, significantly weaker than the 6-month average of 69,114. Despite 320,000 households taking advantage of the Tory government's flagship Help-to-Buy scheme since its inception in 2013, home ownership rates amongst young people has fallen by 5% since 2007, according to Halifax.

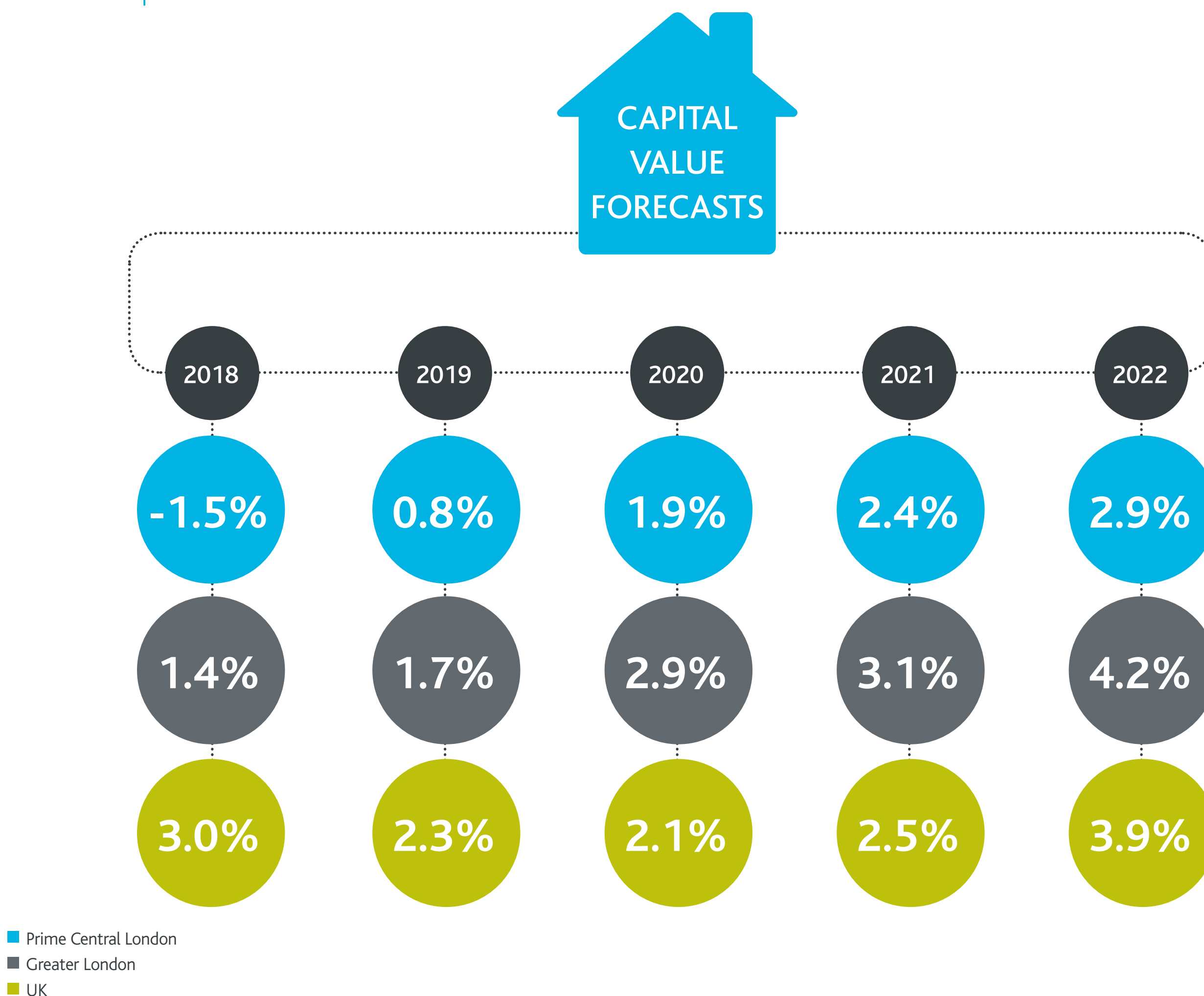
At the same time, buyers are struggling with weak wage growth which is being outpaced by inflation. That said, inflation has now eased from a six year high of 3.1% in November 2017 to 3% at the end of January 2018; a trend that we expect will persist as inflation dips back to around 2% to 2.5% by the end of 2018.

Although there have been indications of an upward revision to interest rates, to be introduced as early as May this year, we expect that these changes will likely have a marginal impact on mortgaged households. Indeed, data from the Council of Mortgage Lenders shows that over half the regulated mortgage loans across the UK are based on fixed rates, which will help shield these households from the rate changes in the short term at least. Furthermore, the expected upward move in base rates in May would still keep interest rates near historic lows and more importantly, only marginally increase the cost of servicing existing mortgages, although there are likely to be some households that are stretched financially as a result.

With these factors in mind, our forecasts remain relatively unchanged on our view at the start of last year. Capital values in prime Central London are expected to retreat by about 1.5% this year; which will leave prices at levels not seen since 2013. 2019 is likely to mark a turning point as the Brexit negotiations draw to a close, with growth likely to return in a meaningful way from 2020 (1.9%) onwards.

In the five years to the end of 2022, cumulative capital value growth is forecast to touch 8.2%.

Residential capital value forecasts*



Prime Central London
Greater London
UK

*Average annual growth rate

Source: Cluttons, Experian

RESIDENTIAL LETTINGS

Lacklustre performance

The lettings market across prime Central London stagnated during the final three months of 2017, with rents ending the year 1.3% down on 2016, leaving average rents, for all property types, across all our submarkets, at £1,387 per week.

Rental values remained flat due to muted demand, coupled with a fall in the level of new instructions. The number of agreed lets also fell sharply, dropping by 42.2% between Q3 and Q4 2017 (LonRes). At the same time, the number of rental properties available on the market declined by 25%. A strong indicator of the mounting pressures faced by rental property in the capital has been the reduction in asking rates, with LonRes noting a decline in advertised rates for over 40% of all available homes.

St. John's Wood (-8.5%) and Notting Hill (-6.5%) emerged as the weakest performing markets last year, with average weekly rents ending the year at £1,116 and £1,214 respectively.

Core Central submarkets inch closer to recovery

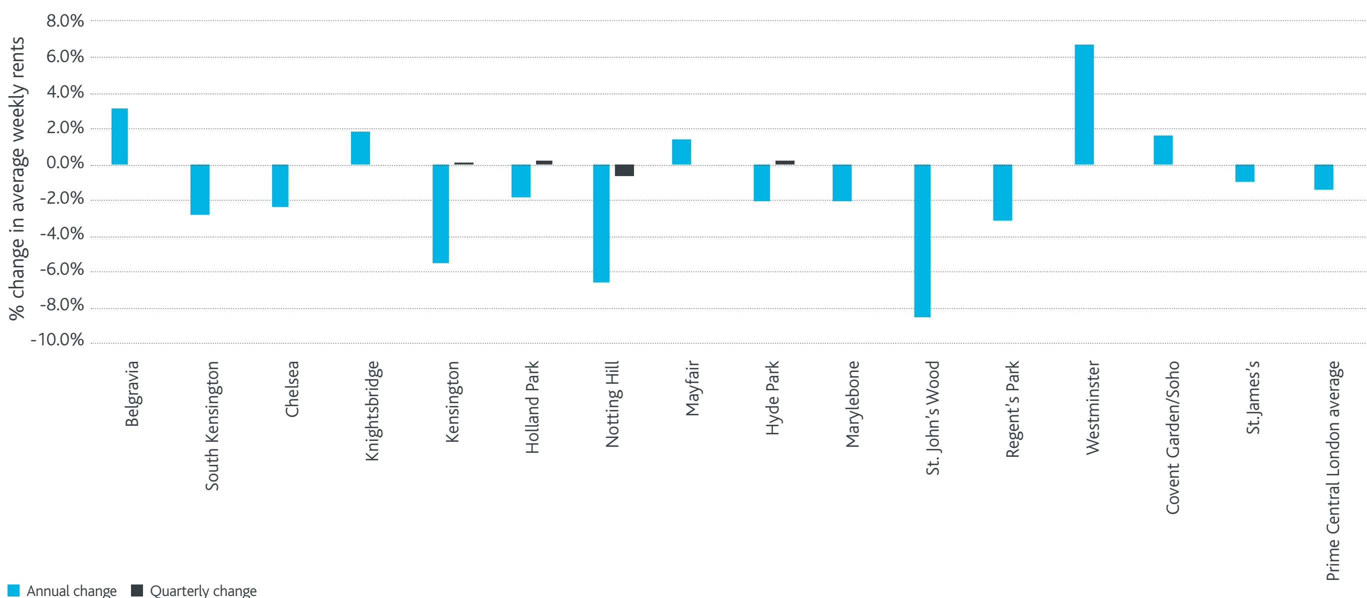
In contrast to the lethargic performance in prime Central London submarkets, the lettings market in our core Central London region recorded a 0.2% rise in average weekly rents during Q4 2017.

The marginal increase in rents was a first in five quarters, hinting perhaps that we may be on the cusp of greater stability in the areas that surround prime Central London. These of course remain significantly cheaper than prime Central London locations and are therefore both more affordable and more attractive to domestic households looking to contain costs as concerns around job security remain high. Average weekly rents in our core Central London region stood at £706 at the end of last year.

Shad Thames (1.5%), Southbank (0.9%), Shoreditch (0.8%) and Highbury (0.6%) were the main contributors to growth, while most other submarkets registered little or no growth. Driven primarily by the finance and technology-media-telecom (TMT) sectors, these locations have enjoyed comparatively stronger levels of demand than elsewhere in the city.

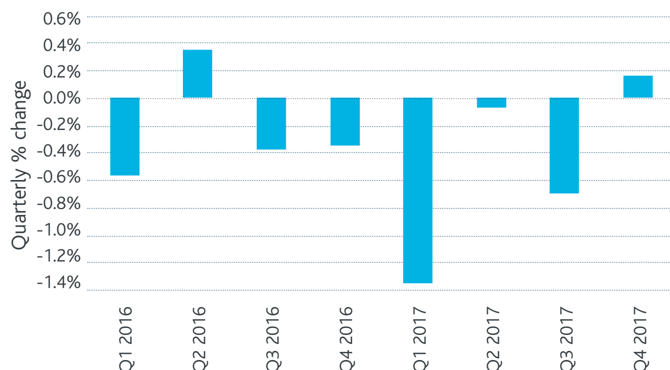
Furthermore, we have observed a decline in the number of properties available for rent in these areas, which has also likely supported the return of stability in rents. In fact, the total number of properties available across these areas declined by 27% between Q3 and Q4 last year (LonRes).

Performance of rents across prime Central London during Q4 2017



Source: Cluttons

Rental value performance in prime Central London



Source: Cluttons

Pace of lettings transactions slackens

Despite this decline in stock levels, some Central London locations remain awash with rental stock. This supply-demand imbalance continues to cement the tenant led market that bedded in about 18 months ago.

Spoilt for choice, tenants are taking increasingly longer to select a property. The number of days taken to let a property rose to 82 days in Q4 2017 across core Central London. At the same time, asking rents in the final three months of last year declined by 5.2% (LonRes).

In contrast, across prime Central London, which is dominated by more expensive stock, most properties now take on average over three months to let. Average asking prices for rental stock slipped by almost 6% between October and December 2017 (LonRes).

Rental forecasts

Average rents across prime Central London are showing signs of bottoming out and this trend is expected to further strengthen as the year progresses.

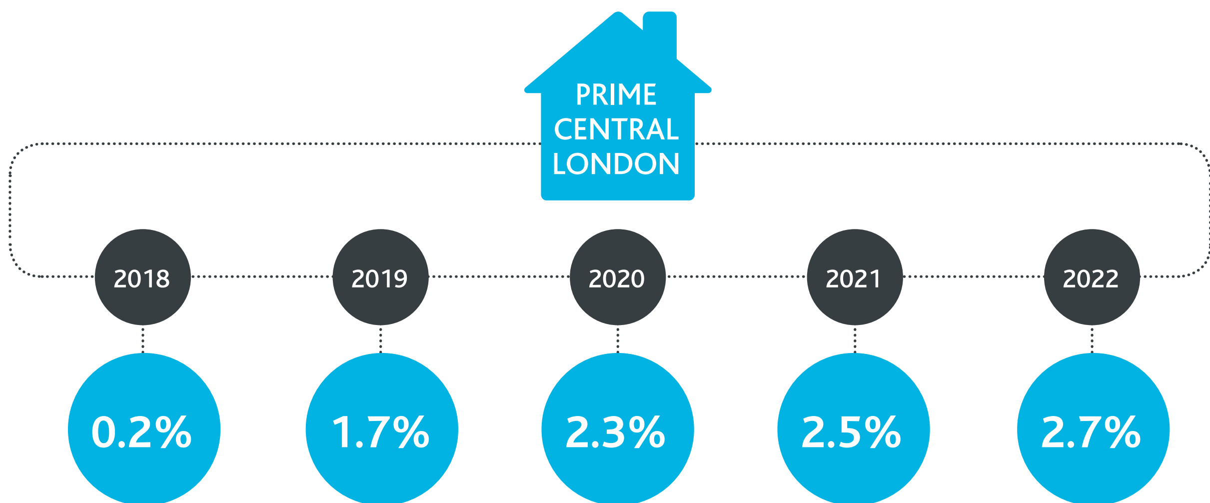
A sudden and sharp recovery for the lettings market seems optimistic at this stage, given the continued pipeline of newly completed property owned by 'accidental' landlords, as well as the build-to-rent (BtR) stock in the city (10,900 BtR units are under construction in London), which together are expected to suppress a rebounding in rental value growth rates, at least during 2018.

However, our Experian developed forecasting model does suggest that demand levels are likely to support an increasingly stable picture as we close out the year, with average weekly rents in prime Central London likely to increase by a marginal 0.2%.

Towards the latter half of 2019, with businesses likely to regain confidence, following widespread clarity on Britain's post Brexit EU relationship, we expect growth to strengthen on the back of a rise in business investment and employment, boosting rental demand and helping improve rental values across the city by a further 1.7%.

We expect a cumulative rental value growth to reach 9.6% in the five years between now and the end of 2022.

Rental value forecast*



*Average annual growth rate

Source: Cluttons, Experian

Cluttons' definition of Central London

Prime Central London: Belgravia, Chelsea, Covent Garden/Soho, Holland Park, Hyde Park, Kensington, Knightsbridge, Marylebone, Notting Hill, Regent's Park, South Kensington, St.John's Wood, St. James's, Westminster

Central London Core: Canary Wharf, Clerkenwell, Earl's Court, Farringdon, Fitzrovia, Fulham, Hammersmith, Hampstead, Highbury, Islington, King's Cross, Maida Vale, Shad Thames, Shoreditch, South Bank, The City, Wapping

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