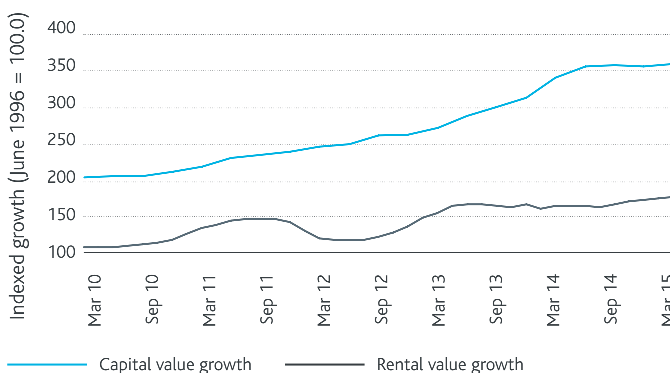
CLUTTONS

London, Summer 2015

RESIDENTIAL MARKET OUTLOOK

Pre-election jitters give way to housing market stability
The uncertainty fuelled by the General Election last month was unprecedented and the impact on the London housing market was a stifling of house price growth across vast swathes of the capital. Momentum was lost in most of the key core central submarkets, with the sales market recording a marginal 0.7% rise in average capital values during the first quarter of 2015, which followed a -0.4% decline in Q4 2014. The latest increase leaves house prices just under 4% higher than this time last year, significantly down on the 9.6% rise registered in 2014.

London housing market performance



Source: Cluttons

The emergence of the capital as a political scapegoat as the main parties traded blows in how best to tackle London's affordability and supply crises was interspersed with discussions on potential rent-caps and the highly charged issue of a 'Mansion Tax', targeting £2 million plus homes. According to Experian, London and the South East is home to almost 90% of the UK's properties valued over the £2 million mark.

The reality is that £2 million no longer buys you a mansion in London; average prime Central London property values breached the £2 million mark in Q1 2013 and currently stand at £2.3 million. Two bedroom flats in Shad Thames, St. John's Wood and Pimlico are all currently well within reach of the £2 million threshold and would have been netted by any new 'London housing tax' well before the end of parliament, suggesting that hard working households in London would have borne the brunt of any tax changes.

Both issues have now subsided following the surprise majority win by the Conservatives, but the damage done to domestic and international buyers' confidence was reflected in the sharp tailing off in demand during Q1; this was echoed in the latest RICS London Housing Market Survey results. Vendors began to withdraw properties, while buyers adopted a wait and see approach, resulting in widespread market stagnation.

In the weeks following the General Election we have recorded an upturn in overall activity, with properties coming back on to the market and buyer numbers starting to creep up in tandem. Most interest is however centred on properties in the £1 million to £1.5 million mark, with the availability of stock in this price bracket lagging current demand levels. Just outside our prime Central London boundary, budgets are, as expected, slightly lower, with buyers in Blackheath for instance snapping up homes priced under £1 million, while in Clapham, two-bedroom flats around the £700,000 mark remain in most demand, reflecting the dominance of 'starter-home' households in the area.

Average price of two bedroom flats in key submarkets during Q1

Chelsea	£2,425,000
Hyde Park	£1,500,000
Wapping	£917,500
Islington	£800,000
Clapham	£750,000

Source: Cluttons

Improving outlook

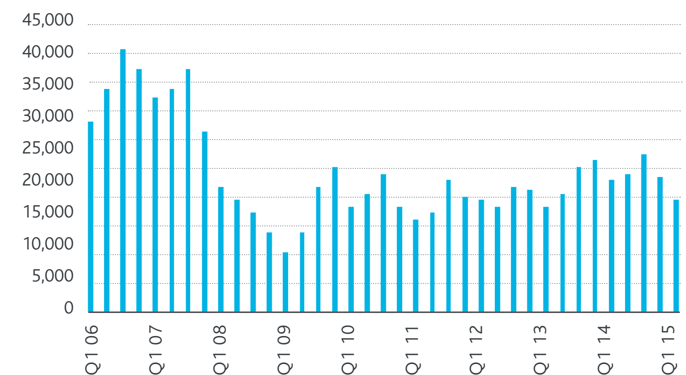
The concentration of demand on homes priced around £1 million reflects the core issue of affordability in London, which remains a key challenge for the capital. Compounding matters have been the Mortgage Market Review (MMR) recommendations, which to an extent have negated the benefits of the Help-to-Buy scheme since they were introduced just over 12 months ago.

This is reflected in data from the Council for Mortgage Lenders (CML), which shows a 17% dip in the quarterly number of home purchase loans advanced across Greater London during the first quarter; the figure is 16% down on Q1 2014. Positively however, affordability for first-time-buyers appears to have improved slightly across Greater London, with the average loan size dipping to 3.84 times annual income in the first quarter, from 3.86 times in Q4 2014.

Furthermore, although the period of deflation is likely to be a short lived phenomenon, Consumer Price Inflation (CPI) levels are expected to remain below the Bank of England's 2% target till mid-2017 at the earliest. As a result, we do not expect to see an interest rise being effected until the first, or second quarter of next year, affording mortgaged households some comfort, particularly those that have capitalised on the low home loan rates offered in the wake of the Help-to-Buy era. And with oil prices continuing to stagnate around the USD 50 per barrel mark, imported inflation will continue to ease. This is however likely to be tempered to an extent by the relative weakness of sterling.

Still, despite this, the underlying supply-demand mismatch, coupled with the continued strong jobs growth in London, suggests that the strength of domestic demand is unlikely to wane in the near to medium term and will sustain upward pressure on house prices. In fact, while national unemployment levels reached a 7-year low of 5.6% in March, London too has seen a similar improvement in the employment picture, with unemployment falling to 6.2% in March.

Total number of home-owner house purchase loans advanced in Greater London per quarter



Source: CML

International risks remain

On the international front, an important upside risk is the relative weakness of sterling, which positions London residential properties as "good value" against this time last year. This is particularly important for buyers from the Gulf, where the majority of currencies maintain a fixed peg to the US dollar. Offshore bank Skipton International has, for instance, already reported an upturn in the number of UAE based British expats moving to take advantage of the favourable currency dynamics.

On the down side, uncertainty surrounding an in-out EU referendum, a disorderly Greek exit from the EU and the threat of another Scottish referendum linger and are all likely to have varying degrees of impact on the UK's economy.

While there is an outside risk of a British exit from the EU, the impact on the economy remains the biggest unknown. Furthermore, with business services still representing over three quarters of UK output according to the ONS, the recovery remains lopsided and therefore prone to global economic shocks, such as a potential Brexit. Should this materialise, we expect there to be a short, but sharp curtailing in jobs growth, with the housing market likely to emerge as one of the immediate casualties in the aftermath of a vote to leave the EU. This does not sit in our central scenario however, but is a risk we are monitoring.

Modest capital value growth outlook

With these factors in mind, we forecast prime Central London house price growth to reach between 2% and 3% this year, accelerating to almost 5% during 2016, before stabilising at around 4% per annum between 2017 and 2019. While this is below the long run average of just over 7%, the expected level of growth will deliver cumulative capital value appreciation of just over 18% over the next five years.

Rents hit an all time high

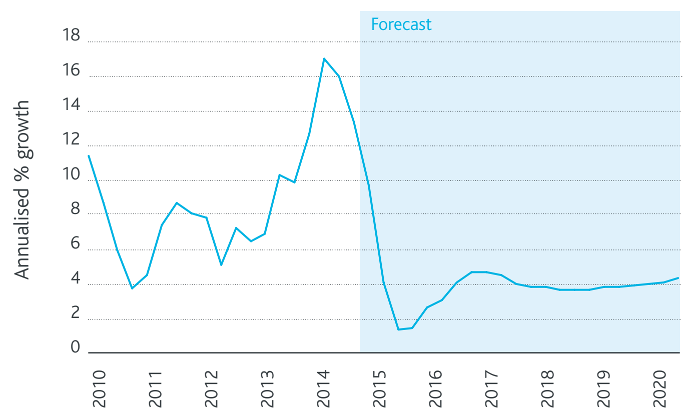
Following the 6% rise in average rents in prime Central London during 2014, which was driven primarily by strong rises in the first half of last year, we have seen weekly rental increases moderate to around 1% over the last three quarters. An increase of 1.1% was recorded during the first quarter, leaving annualised growth at 4.8%, which translates into £1,100 per week, an all time high.

Residential investment market
Calculated gross yields continued to slip in the capital, reaching 3.21% at the end of Q1 2015. However, as has been proven through our research, yields come second to capital value growth for residential investors in the London market. In fact, markets like Chelsea, for instance, continue to attract high levels of interest, despite yields standing at 2.62%.

At 13a Cranley Gardens (SW7), for example, there is significant potential for investors to remodel the 6,600 sqft property, which is spread across four apartments and add value to the building. The property will shortly be released onto the market at a guide price of £8.75m.

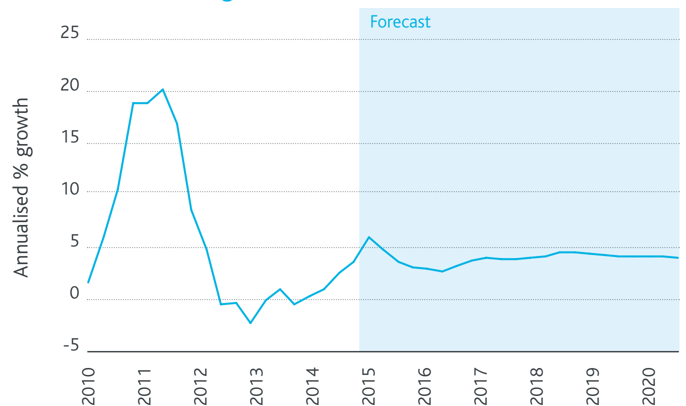
We have already seen evidence of value driven investments where investors are looking for properties where further capital value can be derived through high-quality refurbishments. In fact we have already seen this in Islington, where a recently refurbished two bedroom maisonette set a new record for the highest rent achieved in the area due to the outstanding quality of refurbishment work undertaken by the landlord. It let for £975 per week, 37% higher than the average rent for a large two-bedroom flat in Islington.

London residential capital value growth forecast



Source: Cluttons, Experian

London rental value growth forecast



Source: Cluttons, Experian

A moderating outlook for the rental market
Rental growth is expected to largely stabilise going forward, moving towards the long run average of around 4% per annum for the next 5 years, translating into growth of about 20% between now and the end of 2019.

This will be driven by a number of factors, but the propensity of tenants to show less geographic loyalty now means that households are not put off by the idea of moving out of the prime core in search of lower rents. The key driver of course for this behaviour is the desire to purchase. The breach of affordability thresholds and the rippling out of buyer activity from the prime core markets has meant that Greater London boroughs such as Newham (17.2%), Lewisham (16.4%) and Enfield (16.3%) have all emerged as the capital's best performing markets over the last 12 months according to data from the Land Registry.

This certainly reflects our own experience in the market. Clapham (13.6%), which sits just outside our prime Central London geographic boundary, has registered the strongest house price growth of the last 12 months according to our data. We have also seen family tenants replaced by a growing number of sharers. The market for larger houses has been acutely impacted by this change, with properties often sought by families now sticking on the market, with sharers negotiating and driving down rents for larger homes that are slow to let.

Rising supply will peg back pace of rental growth
Additional downward pressure on rental growth is materialising in the form of rising supply levels across the capital. In particular, supply of the buy-to-let variety is expected to dampen the prospect of any above average rental value growth. Figures released by the HMRC in June show that at almost 33%, Newham has the highest concentration of privately rented residential stock in the capital, followed closely by Southwark (22.2%), which sits in the prime core.

While the ongoing growth in job creation levels in London will go some way towards helping to absorb some of this upcoming supply – chiefly the TMT and business services sectors – we expect supply and demand to remain quite evenly matched in the near term, which again will contribute to lower rental growth rates.

This is already impacting markets across prime Central London. Some landlords, conscious of the increasing amount of choice available to tenants, have begun to initiate rent renewals well in advance of the end of tenancies, often seeking to leave rents unchanged in order to minimise void periods. We have seen this pattern mirrored across all our Central London offices, with many reporting the rate of tenancy renewals reaching an all time high.

CLUTTONS

For further details contact

Residential agency
James Hyman
+44 (0) 20 7407 3669
james.hyman@cluttons.com

Residential lettings
Zoe Innes
+44 (0) 20 3641 0517
zoe.innes@cluttons.com

Research
Faisal Durrani
+44 (0) 20 7647 7166
faisal.durrani@cluttons.com

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