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London, Winter 2016/17

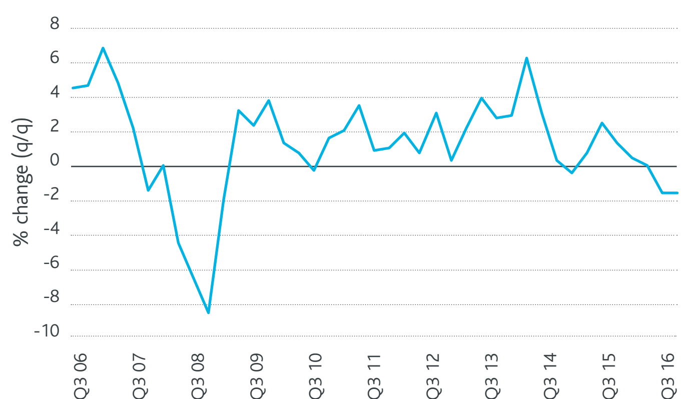
RESIDENTIAL MARKET OUTLOOK

RESIDENTIAL SALES MARKET

Values continue to weaken
Capital values in prime Central London declined by -1.5% in Q3, representing a second consecutive quarter of negative growth. The last time values in prime Central London declined for two successive quarters was at the height of the Great Recession in 2008. As was the case in Q2, some of prime Central London's most affluent submarkets in Central South West recorded the biggest dips, with Knightsbridge (-5.1%), South Kensington (-4.8%) and Chelsea (-4.4%) emerging as the weakest performers during Q3.

There were no regions in prime Central London that exhibited positive growth in Q3. The ongoing weakness in the market has driven the annualised rate of change down to -2.3%; the first negative rate of growth since Q3 2009.

Prime Central London sales market performance



Source: Cluttons

Prime Central London residential sales market in numbers

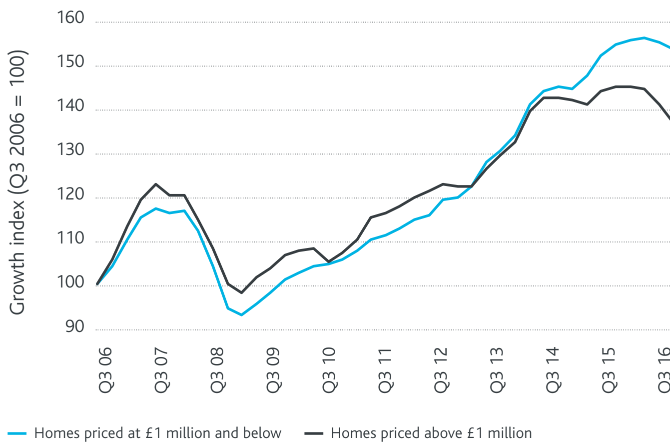
£1.2m
Average price of a flat in Q3

£4m
Average price of a house in Q3

Source: Cluttons

Market remains stifled
House prices in prime Central London have now declined for five quarters, driven at a macro level by uncertainty stemming from the impact of looming Brexit negotiations; while on the domestic front, stubborn affordability issues and perhaps most importantly for the prime core, the extra 3% Stamp Duty charge introduced on April 1, have together stalled overall transactional activity. In particular, the

Performance of properties priced under and over £1 million in prime Central London



Source: Cluttons.

buy-to-let (BTL) market has been stifled by successive Stamp Duty rises over the last few Budget Statements, which have been aligned with the government's noble vision of giving first time buyers fair access to the property market.

In the current economic climate, the latest Stamp Duty change in April has however had the opposite effect, locking up the market, with instruction levels in the capital falling rapidly since April (RICS London Housing Market Survey). Overall, properties priced under the £1 million mark, regardless of location, have outperformed the wider prime Central London average, with values in this bracket demonstrating far greater resilience in the current conditions, but transactions across London below the £1 million mark are down by 28% so far this year (Land Registry).

On an annual basis, properties priced under £1 million are down in value by 0.6%, while everything priced above £1 million has fallen by a sharper 5.5%.

Some pockets of the capital beyond the prime core continue to register price growth, particularly for homes priced around £500,000. Greenwich (1.3%), Deptford (1.7%) and Blackheath (1.9%) have all for instance posted rises during Q3, defying the slowdown in prime Central London.

Elsewhere, some submarkets have been impacted disproportionately by the ongoing price correction due to a higher density of luxury property. In the Royal Borough of Kensington and Chelsea for instance, overall year to date transaction levels are down 36%, while transactions for homes priced at over £5 million have fallen by 45% to just 119 deals, according to data from the Land Registry. Across prime Central London as a whole, year on year transaction volumes are similarly down by 34.8% (LonRes).

Anti buy-to-let rhetoric intensifies

As outlined above, it is clear that the successive Budget Statements have taken direct aim at the BTL investment cohort. The sheer cost differential of the changes introduced by the government have exacerbated the slowdown. For instance, a £2.1 million property (the average price of a home in prime Central London) now invites £228,750 in Stamp Duty fees for a BTL investor, or second home buyer, compared to £165,750 previously. This equates to a 38% hike. To put it into perspective, with average weekly rents in the capital standing at £1,046, it would take more than four years for rental income to cover current Stamp Duty costs.

In addition, the BTL market is expected to be further squeezed by the amending of rules around mortgage interest tax relief. At present, landlords are able to claim relief on mortgage interest payments, which is linked directly to their overall income. So a basic rate tax payer landlord is able to claim 20% relief, while those with higher incomes can claim relief of 40% or 45%. Under new rules from April 1, 2017, this relief will be phased down to 20% by 2020 for all income bands, eating into high earning landlords' profits. Clearly, landlords with high loan-to-value mortgages are likely to be the hardest hit.

Furthermore, the Bank of England has set a January 1 2017 deadline for lenders to introduce new tougher requirements for BTL investors, which would require landlords to have higher projected levels of rental income relative to their mortgage costs; this will rise to 145% from 125% of the mortgage taken. BTL mortgages will also be 'stress tested' at a base rate of 5.5%.

The new Chancellor also set out in the Autumn Statement plans to end all lettings agent fees for tenants "as soon as possible". While it is unclear at this early stage how this will play out, our concern is less around this cost, but rather the constant anti BTL rhetoric from the government. This risks further alienation of a core investment group that is delivering rental property into a market like London, characterized by an ever expanding Generation Rent class who will continue to be priced out of the housing market.

Clearly these anti BTL measures come as good news for first time buyers in the current economic climate. They are being afforded an equal footing with BTL investors in their pursuit of transition to home ownership, taking advantage of a cooling market, where demand continues to wane. Unsurprisingly, several of our offices have reported an increasing proportion of genuine home buyers versus BTL investors. This emergent trend is visible at a national level as well, with the share of loans granted to first time buyers increasing from 40% in March, to 50% in October (Bank of England).

Phasing of new mortgage interest relief rules

Tax year	Share of finance costs deductible from rental income	Share of basic rate tax reduction
2017-2018	75%	25%
2018-2019	50%	50%
2019-2020	25%	75%
2020-2021	0%	100%

Source: HMRC

Away from individual BTL investors, the build-to-rent (BTR) sector can take some comfort in the November 25 decision to allow the emergence of a landmark classification for BTR schemes that will now be exempt from providing the same affordable housing requirements as homes built for sale. This will apply to all BTR developments over 50 units, which are covenanted for at least 15 years. Units will have to be a minimum of 420 sq ft in size. So while individual BTL investment activity may remain suppressed in the short term, institutional BTR activity is likely to intensify.

Affordability issues persist

Despite the favourable market dynamics for buyers, the issue of affordability remains a thorn in the market's side. In fact, mortgage lending activity in London slipped to £6.2 billion during Q3, 15% up on Q2, but 14% lower than the same time last year. Also, the average income multiplier for first time buyers in London continues to edge up, reaching 4.02 during Q3, up from 3.85 a year ago. This is in stark contrast to the rest of the UK, where the income multiple dipped to 3.26 at the end of September; the lowest level since the spring of 2013 (Council of Mortgage Lenders).

In prime Central London, buyers continue to grapple with ballooning deposits and while the cooling market allows many to catch up, the vast majority of stock is out of reach for typical Londoners, with average home values now standing at £2.1 million. Prices have risen by nearly 60% in the last 10 years and as a consequence, home ownership continues to remain a distant dream for many, especially given that average incomes have clearly not risen by the same magnitude.

The affordability issue is not just confined to the top end of the market. Hometrack has reported that the average price of a home in London has risen 86% since 2009 to £482,000, which equates to 14.2 times average earnings.

The average price of a home in prime Central London stands at £2.1 million

Prime Central London capital value growth forecast

	2016	2017	2018	2019	2020	2021	2017-2021
Scenario 1:							
Two year Brexit negotiations	-4.0%	-0.6%	1.0%	2.1%	2.7%	3.2%	8.6%
Scenario 2:							
Four year Brexit negotiations	-4.0%	-1.5%	-0.6%	1.0%	1.9%	2.3%	2.9%
Cluttons baseline forecast	**-4.0%**	**-1.0%**	**0.5%**	**2.0%**	**3.0%**	**3.0%**	**7.7%**

Source: Cluttons, Experian

2016 set be weakest since the Great Recession

The tumultuous political and economic conditions continue to create a challenging forecasting environment, so we have run two separate models this quarter with Experian in an effort to quantify the uncertainty that lies ahead. What is clear at this stage is that 2016 is shaping up to be the weakest year for the prime Central London market since 2009, with both our models suggesting we will end the year at close to -4% down on 2015.

Assuming that the UK's negotiations to leave the EU take precisely two years from the time Article 50 is triggered in March next year, our first forecast model shows greater stability in 2017, with a marginal 0.6% decrease in values expected in 2017 as we work our way through the tangled web of negotiating an orderly exit from the EU. By the time we arrive at the end of 2018 and assuming negotiations have concluded, we expect a rapid diminishing of the uncertainty plaguing the market, which should help support growth of 1% in 2018.

Between 2019 and 2021, further momentum is expected to build, with average prices rising by between 2% to 3% per annum. Overall, cumulative growth of 8.6% is forecast between 2017 and 2021 in this first model.

We have also run an alternative second model that assumes Brexit negotiations take an additional two years, prolonging the uncertainty. While the 4% contraction in values in 2016 remains unchanged, this scenario results in price drops in 2017 (-1.5%) and 2018 (-0.6%), with growth expected to gradually return in 2019 (1%), before rising to 1.9% in 2020 and 2.3% in 2021.

In reality, we expect the negotiations to take between two to four years, with the performance of the market likely to be a hybrid of the above two scenarios. With this in mind, it is our expectation that prime Central London residential values will slip by a further 1% in 2017, before weak growth returns in 2018 (0.5%), picking up to 2% in 2019 and stabilising at 3% p.a. in 2020 and 2021, delivering cumulative growth of 7.7% over the next five years.

2016 is shaping up to be the weakest year for the prime Central London market since 2009, with both our forecast models suggesting values will end the year at close to -4% down in 2015.

RESIDENTIAL LETTINGS MARKET

Biggest rent falls since Christmas 2012

Like the sales market, average rents across prime Central London have also declined for a fifth consecutive quarter, with rents dipping by 0.5% in Q3 to reach £1,046 per week. Average rents are now 1.6% lower than this time last year, which translates into the largest fall in rents since Christmas 2012. Unsurprisingly, gross calculated yields have moved in to 3.16% from 3.18% during Q2 as house prices are retreating faster than rental rates.

The only prime Central London region that recorded positive rental growth in Q3 was Central South East (0.5%), with rents in Surrey Quays/Rotherhithe (2.3%), Wapping (1.4%) and South Bank (0.5%) outperforming the rest of the capital. In contrast, Central West (-1.5%) and Central North West (-0.7%) were the weakest performing regions. Holland Park (-3.4%), Hyde Park (-2.7%) and Kensington (-1.8%) emerged as the weakest performing submarkets in the capital.

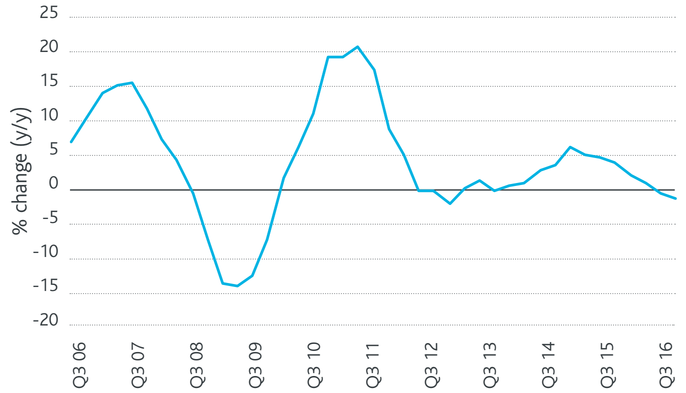
Prime Central London residential lettings market in numbers

-0.5%
Change in average rents during Q3

-1.6%
Annualised change in rents (Q3 2015 – Q3 2016)

Source: Cluttons

Prime Central London lettings market performance



Source: Cluttons

Rising rental stock contributing to rent falls

While the ongoing correction in the lettings market is in part due to the end of the current property cycle, which has clearly been accelerated by the overall economic anxiety; rising concentrations of BTL stock have upset the delicate supply-demand equilibrium in the capital. This is certainly not a new phenomenon and has been bubbling away in the background for the past three years. Results from the RICS' London Lettings Market Survey corroborate our current record high levels of lettings stock, with the balance of surveyors reporting a rise in the number of instructions remaining consistently high since 2014.

Average rents for two-bed flats in the best performing submarkets

Source: Cluttons

While the rising rental stock levels have been readily absorbed by the market, we appear to have reached a tipping point. Supply has edged ahead of demand, leaving tenants spoilt for choice, while landlords of more secondary stock struggle to compete with newly completed properties and rising tenant expectations. We have also observed instances where minimal renovation of older properties has helped to slow rental declines, or stabilise rents at best, rather than reverse them, as many landlords expect.

Geographic supremacy of some submarkets ending?

Still, aside from the lure of branded homes, such as those of London's Great Estates; recently renovated or new build properties continue to command the most interest. Following an active rental market during September and October, demand has receded, despite the availability of a wide range of properties virtually across the price spectrum, ranging from £350 per week to £9,000 per week, ending the usual instruction-led-demand phenomenon. The diminished tenant requirements remain concentrated around the £400-500 per week bracket, with very limited activity in higher price bands.

Given the abundance of choice in the market, tenants continue to show almost no geographic loyalty and are influenced by price, rather than location. One of the few exceptions to this rule in prime Central London is St. John's Wood, which continues to attract families looking to place children in the American school.

Interestingly, the disparity in the rate of falling rents across the city means that two-bedroom apartments in some markets such as Hyde Park and South Bank are now almost at parity. This ongoing amalgamation of rents across Zone 1 is likely to continue chipping away at the geographic supremacy of some prime Central London submarkets.

Tenants spoilt for choice as demand ebbs

The demand from relocation agents has been tapering off as well, with most activity concentrated at the lower end of the budget spectrum. Our relocation partners have all cited diminished budgets that reflect a weaker than normal number of new job starters, or movers. Still, for the capital, the finance and banking and technology-media-telecoms sectors remain at the heart of most relocation activity.

For now, the tenants on the market appear to be testing the waters, positioning themselves for a move in January or February by seeking out the best perceived deals as we head towards Christmas. Interestingly, there are a growing number of instances where tenants are seeking longer tenancies of 18 months to two years as they prepare to make the leap from renting to ownership, but most still want to retain break clauses at six months to keep their options open and also due to job security concerns.

Landlords remain wary of current market conditions and are for the most part leaving rents unchanged at renewal, with a handful seeking and achieving RPI linked rises, hinting that mute conditions are likely to prevail for a few more quarters yet.

Lettings growth to outperform sales market

Clearly, the wider economic conditions inhibiting a turnaround in the residential market's fortunes extend to prime Central London's lettings market as well, with its growth profile being adjusted downwards throughout the course of 2016.

Like the sales market, we have run two forecast scenarios; one which assumes a two year Brexit negotiation period and the second factors in a four-year period for the UK to complete its exit from the EU. The results of these scenarios are presented below and in the case of a prolonged four-year exit, the return to growth is pushed out by a year. It is worth noting that in either scenario the market does not register a contraction in rents beyond 2016.

Undoubtedly the future of London's global finance and banking crown is critical to both the exit negotiations and indeed the future of the capital's residential market. With nearly 20% of London's GVA stemming directly from this segment of the economy, its loss, or erosion, would have serious ramifications for demand in the residential and commercial markets.

For now, our assumption is that London will retain full access to the EU with no loss of passporting rights. As outlined earlier, Generation Rent continues to expand unhindered, putting tremendous pressure on the relatively limited short term development pipeline of residential property in the city. In the long run, this suggests that there will be a growing pool of households that will be permanently unable to access the property ladder, excluded purely by the fundamentals of supply and demand. This hypothesis is clearly evident in both our forecast models, with rents expected to stage a quicker and stronger turn around than values over the next five years.

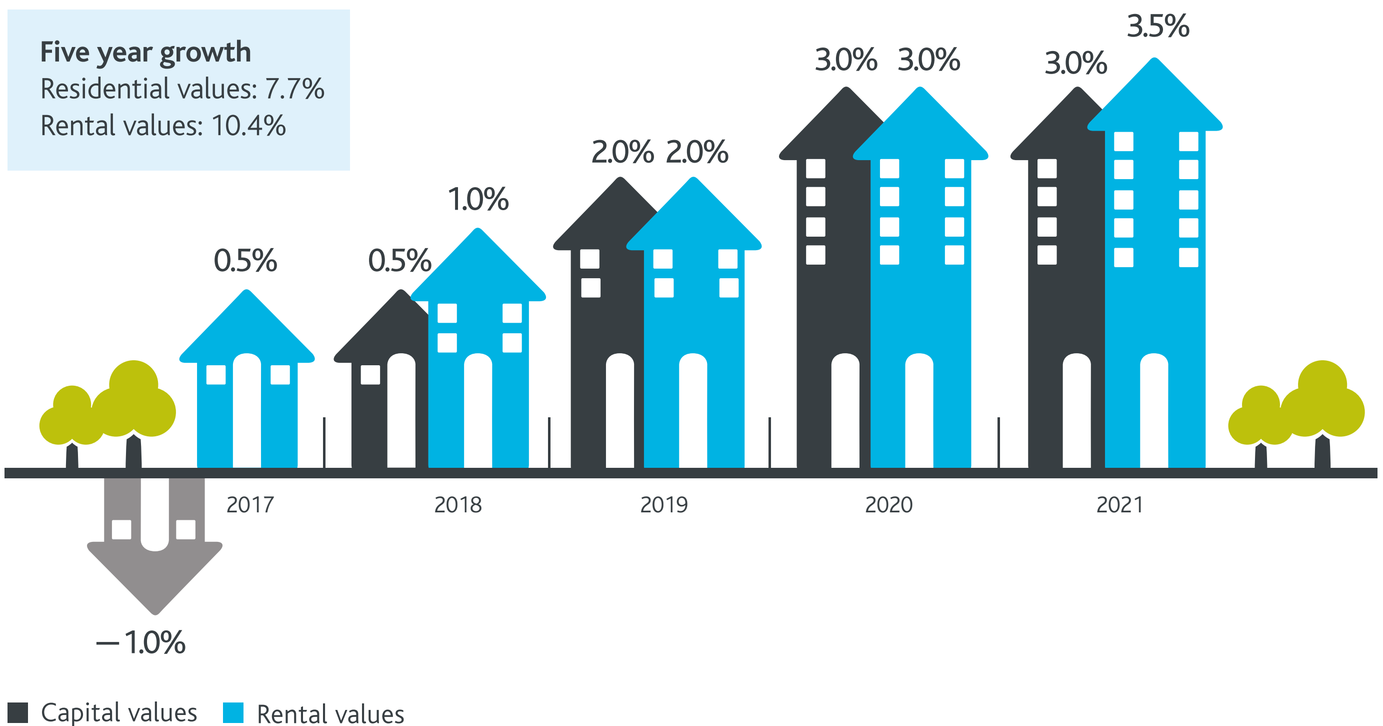
We expect the rental market's performance to fall in between our two scenarios, with 2016 and 2017 likely to be years in which tenants remain firmly in the driving seat. For 2016, rents are likely to end the year 1.7% down on 2015, with a marginal 0.5% rise forecast next year. We expect rental growth to accelerate from 1.0% in 2018 to about 3.5% in 2021, once the UK is free of the Brexit shackles. This will deliver cumulative rental value growth of 10.4% over the next five years.

Prime Central London lettings growth forecast

	2016	2017	2018	2019	2020	2021	2017-2021
Scenario 1:							
Two year Brexit negotiations	-1.7%	0.8%	1.8%	2.7%	3.5%	3.8%	13.3%
Scenario 2:							
Four year Brexit negotiations	-1.7%	0%	1.2%	1.6%	2.8%	3.2%	9.2%
Cluttons baseline forecast	**-1.7%**	**0.5%**	**1.0%**	**2.0%**	**3.0%**	**3.5%**	**10.4%**

Source: Cluttons, Experian

Cluttons five-year baseline forecast summary for the prime Central London residential market



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).

Prime Central London definition

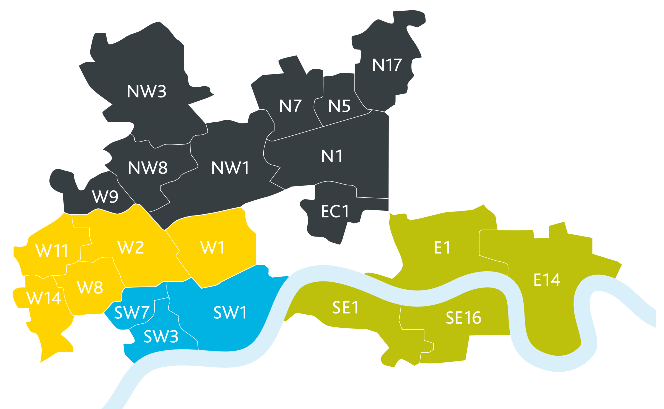
Central South West
South Kensington, Chelsea, Belgravia, Knightsbridge and Pimlico

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

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

Prime Central London



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1423