Residential Research

Global City

London residential development review • 2008

Contents

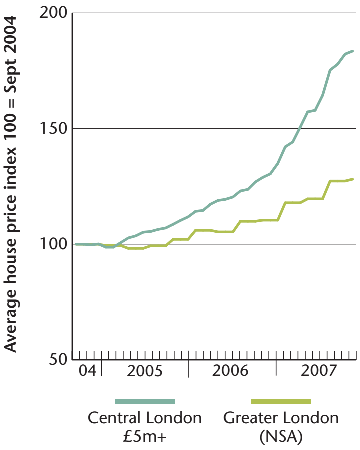
Cornwall Terrace, Regent's Park, NW1

Executive summary

- London's super-prime residential market (which we define as £5m+) continues to outperform all other UK markets, a trend we forecast will continue in 2008. The lack of available properties in key locations compared to the growing number of domestic and global wealthy buyers will continue to underpin capital values.
- The two main drivers at the top of the London market; global wealth creation and capital flows from the City, are experiencing contrasting trends. Wealth generation worldwide is rising at a rate of around 9% per annum and is likely to offset weakening domestic demand, resulting from the recent downturn in the financial markets.
- This report provides our assessment of how we see the super-prime market evolving. We look at future market drivers, the impact of continued tight supply, evolving design trends and changes to the UK's tax regime in respect of non-domiciled residents.
- London is not only set to witness some of the largest brownfield redevelopment projects in Europe (Kings Cross, the Olympic legacy) but, in addition, the transport network is facing a major overhaul (Crossrail, the new London Overground). We look at the impact of these projects and pinpoint the areas likely to benefit.

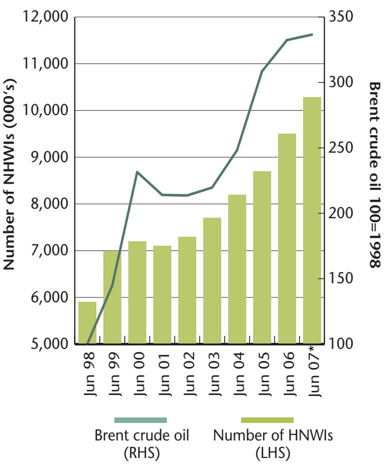
Knight Frank Newmark Global

Figure 1
Price performance: super-prime vs. Greater London market
(2004 - 2007)



Source: Knight Frank Residential Research/HBOS
NSA = Non-seasonally adjusted

Figure 2
Global wealth: oil revenues vs. growth of HNWIs (1998-2007)



Source: Bank of England, Merrill Lynch/Capgemini
HNWIs = people with net financial assets of US$1m+, excluding their primary residence and consumables.
*Estimate

The rise and rise of super-prime

In 2006 our 'Rich City' report analysed the unique characteristics of London's super-prime market (£5m+). We highlighted its dislocation from the prime London market (£1m-£5m), its strong performance (annual price inflation reached 27% in 2006) and the impact this niche sub-market was having on the wider London development market.

A year on, and in contrast to London's mainstream market, and to some extent the prime market, demand within London's super-prime market remains strong. Understanding the trends at the top of the market is a useful exercise not only for those interested in this specific sector. We have found time and again that themes from the prime market influence the mainstream market, development trends are trialled in this market and are then exported across the sector.

In the second part of this report, we look at the challenges facing the capital, where its strengths and weaknesses lie and what issues may need attention or further investment if London is to retain its premier global city status; a factor fundamental to the health of the economy and consequently its housing market.

How will London's super-prime market evolve?

More global

A London address, is, perhaps now more than ever, a central requirement for many of the world's super-rich in terms of their global property portfolios. London's international appeal stems from a number of factors but perhaps most influential is its status as a global financial market and its positioning in terms of international time zones. The London Stock Exchange is in an enviable position of being able to trade with both the US and Asian markets in a single working day. London's significance as a global transport hub is also key. Added to this is the UK's benign tax regime for foreign residents, not to mention the importance attached to a UK education (many foreign buyers wants a UK base whilst their children attend private school). Together, these factors ensure London has an enduring appeal for the world's wealthiest demographic.

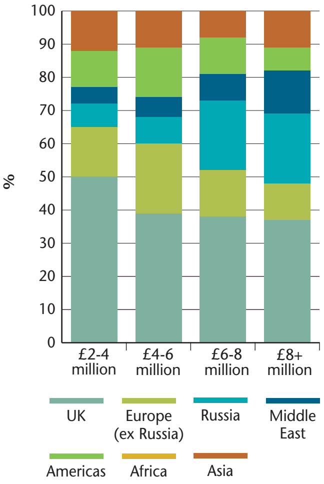
The influence of foreign buyers on London's luxury homes market is significant, around 60% of all purchases in prime central London over £4m are made by foreign buyers. Importantly, membership of this group is not static. The global population of high net worth individuals (HNWIs) grew by 8.3% in 2006, or in real terms, by 700,000. In the UK, estimates suggest that the number of HNWIs reached circa 485,000 in 2006.

Fundamental to the rise in global wealth has been the growth in oil revenues and commodity prices which has bolstered HNWI assets globally (see Figure 2). This effect has been most pronounced in the Middle East, South America and Russia. In December 2007 Brent crude oil (OPEC spot price) stood at its highest price for 29 years, having risen 66% or by US$36.01 per barrel in the previous year. The value of gold, steel and iron has followed similar paths with the construction booms in China and India fuelling demand further. Oxford Economics forecast that high commodity prices are here to stay, driven to a large extent by rising global demand. Whilst it is not good news for all, the rising cost of fuel and raw materials is likely to continue supporting London's super-prime market.

Aside from the rising number of HNWIs globally, their propensity to invest in property is also increasing. According to Merrill Lynch, in 2006 HNWIs around the world increased their allocation to property from 16% to 24% of their portfolios.

Housing demand from wealthy foreign purchasers is anticipated to grow significantly over the next decade. It would take a global economic downturn, one which impacts significantly on emerging markets as well as the developed economies, to temper this demand. The growth in London's luxury goods market underlines the strength and spending capacity of this rich elite. According to Stonehage's Affluent London Living Index (SALLI), London's rich experienced inflation of 6% in 2007, nearly three times higher than the Consumer Price Index in the UK. Using some selected luxury items, Table 1 shows the extent of the rich's increasing cost of living, fuelled principally by rising demand.

Figure 3
Purchaser nationality by property band in prime central London (2007)



Source: Knight Frank Residential Research

Table 1
London's super-rich cost of living index (selected items)

Item	2002	2007	% change 2002-2007
Annual membership of Soho House	£600	£900	50.0%
Aston Martin Vanquish S V12	£159,995	£188,000	17.5%
Limited edition Patek Phillippe Calatrava	£12,000	£19,000	58.3%
Case of Lafite Rothschild 2000	£2,100	£9,250	340.5%
Annual Wentworth Golf Club Membership	£3,912	£5,268	34.7%
Nobu, 19 Park Lane*	£56	£71	26.8%
Annual Queen's Club Tennis Membership	£1,100	£1,560	41.8%
Annual membership of Dorchester Gym and Spa	£1,200	£1,800	50.0%
One term of fees for two seniors at Westminster School	£12,576	£17,304	37.6%
1kg Beluga Caviar	£900	£2,300	155.6%
Prime Belgravia residence (average price £psf)	£1,972	£3,500	77.6%

Source: Stonehage Affluent London Living Index
Note:* Average meal inc one drink and service

More exclusive

London's super-prime market is a coherent and contiguous area which covers a relatively tightly defined area including: Knightsbridge, Chelsea, Belgravia and Mayfair. The high concentration of affluence in this market pushes super-prime buyers to work harder for exclusivity. It is hard to claim exclusivity in an area where you are surrounded by wealth. Close attention is being paid to specification, making use of the finest materials and bespoke finishes. One Hyde Park in Knightsbridge acts as an exemplary model in this respect, here, the quest for exclusivity has been fundamental in its concept and development.

New projects in super-prime markets worldwide have seen an 'arms race' by developers to 'up-spec' their developments and keep ahead of the competition. A new market has been created where record prices are being achieved, as buyers find needs they never thought they had, being provided for.

Better designed

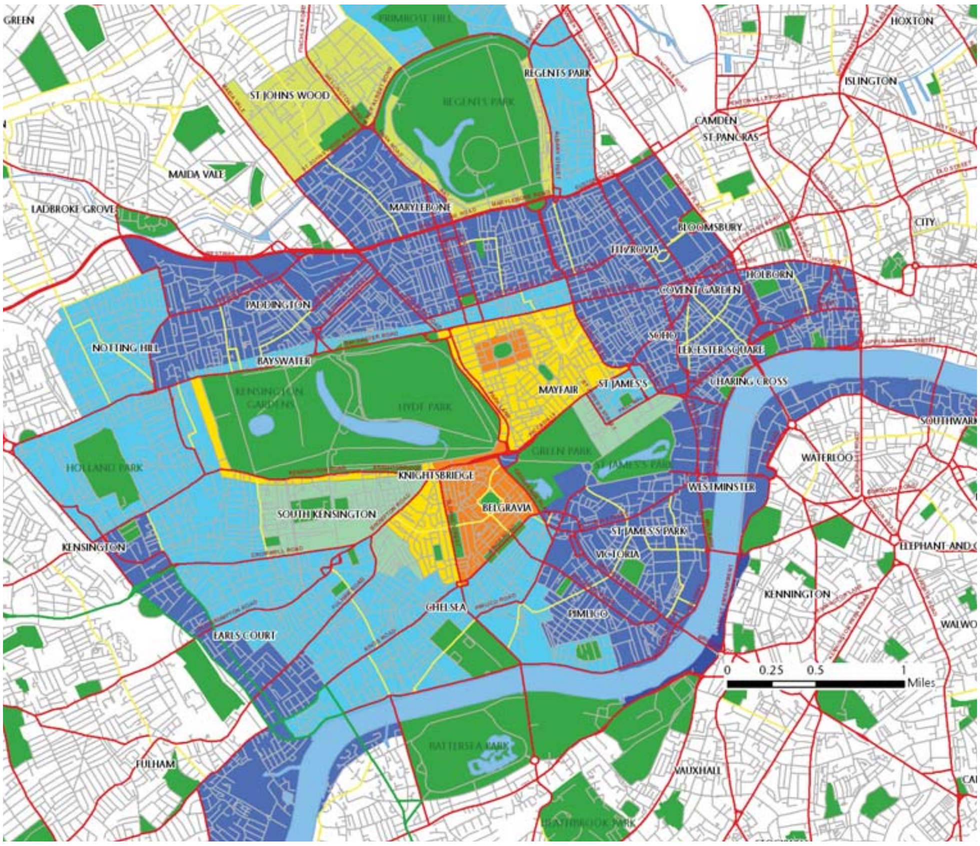
We believe that higher quality interiors and bespoke finishes will become even more important in new build schemes. Externally, the focus on aesthetics will be equally important with design, architecture and an element of branding becoming more central. In recent years several of the large firms of architects (Foster + Partners, Rogers Stirk Harbour + Partners, make (Ken Shuttleworth), Farrells (Sir Terry Farell)) have made significant inroads into London's prime and super-prime residential markets. In Knight Frank's view this is a welcome development for the new homes market, one which has helped raise standards and expectations across the board. A development designed by this exclusive set of architects benefits from worldwide recognition.

In Knight Frank's assessment Montevetro on Battersea Reach, built in 2000, continues to be regarded as one of London's few examples of high quality contemporary residential architecture. Key to its success was the ability to fit sympathetically within its varied setting; against a backdrop of terraced homes, social housing and adjacent to the listed St Mary's church on the river's edge. The design also took advantage of its riverside and parkside setting with generous glass facades and wide balconies. We estimate that Montevetro has outperformed its immediate market by 26% since its completion in 2000.

Successful schemes are those that have maximised value at a design stage. This becomes even more apparent in a slower market. The two maps on page 4 demonstrate the added value that can be achieved if developers invest in design, place making and branding to deliver a product of the highest quality. Map 1 shows the development price potential for an entry level prime development, Map 2 shows the price potential for a product built to the highest design specification.

Montevetro, Battersea Reach

Map 1 **Development price potential: average specification**



Legend

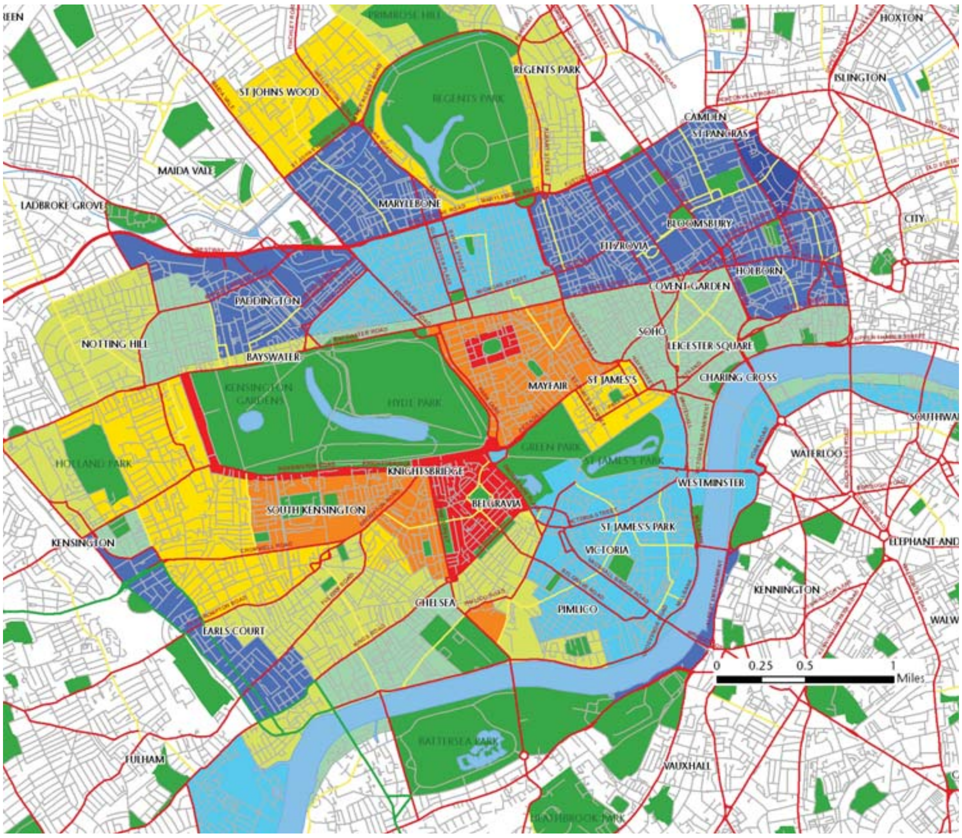
- Motorways
- A Roads
- A Roads Non Primary
- B Roads
- C Roads
- Parks and open spaces

Price potential for new developments
£ per square foot

- £700 - £750
- £750 - £1,250
- £1,250 - £1,500
- £1,500 - £1,750
- £1,750 - £2,250
- £2,250 - £3,000
- £3,000 - £4,000
- £4,000+

"The two maps demonstrate the added value that can be achieved if developers invest in design, place making and branding to deliver a product of the highest quality."

Map 2 **Development price potential: top specification**



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- £3,000 - £4,000
- £4,000+

Clareville Street, South Kensington, SW7
(computer generated image – details may vary)

Branding is already accepted as a key means of promoting products and services, but it is also likely to become more common in relation to luxury residential development, a logical step forwards from what has already been achieved for luxury hotel brands.

Greener

The Code for Sustainable Homes, introduced in April 2007, established that from 2016 all new housing is to be zero-carbon. Eco-development themes are already becoming a key feature of London's super-prime development market. Environmental considerations will play a significant role in HNWI purchaser activity, some may use it as a means of offsetting their carbon footprint of air miles, others may embrace greener thinking more fully, focusing on build materials, energy choices and sustainable design. Prime market adoption of eco-themes has a significant impact on the wider market. Firstly, eco-homes are made more aspirational, and secondly, the super-prime market acts as a testing ground of innovation for the wider market.

Morpheus Development's Clareville Street in South Kensington is one market leader in this area. Here, three Georgian-style villas will include 12 geothermal boreholes providing underfloor heating, Forest Stewardship Council sourced timber, waste compactors and low energy lighting.

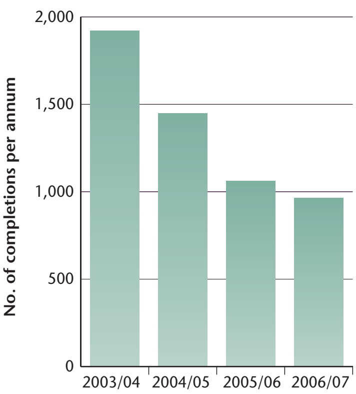
"Foreign investors have boosted London's economy in terms of employment, services and purchasing power but they add little elasticity to the market as they rarely have surplus property to trade."

Tighter supply

Sales activity in prime central London is mainly based on second-hand stock. New build properties form a very small portion of the market. Market activity and price performance continue to be determined by one issue – supply. The lack of properties available in the locations targeted by HNWIs suggest continued positive growth. Knight Frank has seen the residential market contract in size year on year as more apartments and houses move into private ownership. Foreign investors have boosted London's economy in terms of employment, services and purchasing power but they add little elasticity to the market as they rarely have surplus property to trade.

We estimate there are currently circa 1,140 'super-prime' units in central London's development pipeline. This compares to a total housing supply of 12,400 units (under construction and with planning consent).

Figure 4
Housing completions in prime central London (2003/4-2006/7)



Source: DCLG

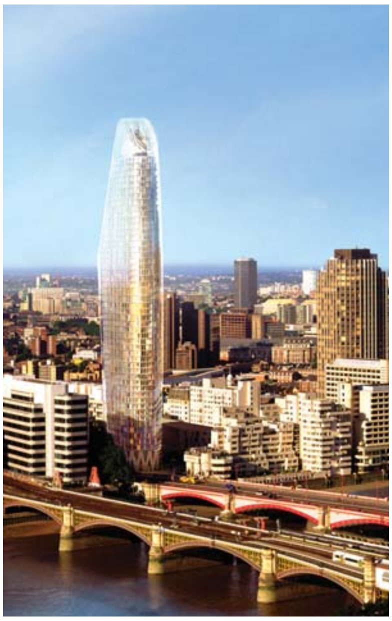
Note: Completions for Camden, City of London, Kensington & Chelsea, Hammersmith & Fulham and Westminster

Table 2
London's super-prime pipeline

Development	Status	Units
Chelsea Wharf, SW10	Completed	12
One Hyde Park, SW1X	Under construction	80
Montpelier Hall, SW3	Under construction	6
Cornwall Terrace, NW1	Under construction	10
Bankside, SE1	Permission granted	229
Lancaster Gate, W2	Permission granted	95
Shard, SE1	Permission granted	14
Lots Road Power Station, SW10	Permission granted	435
Kensington Thistle, SW8	Permission granted	97
Alpha Place, SW3	Permission granted	43
3-10 Grosvenor Crescent, SW1	Permission granted	14
Holland Park School, W8	Proposed	65
South Audley Street, W1	Proposed	24
Chelsea Barracks, SW1W	Proposed	TBC

Source: Knight Frank Residential Research

Knight Frank



Beetham Tower, Blackfriars Road
(computer generated image – details may vary)

Future challenges and opportunities

The continued expansion of London's super-prime residential market rests on several push and pull factors. Is this a city that the world's rich and successful want to come and live in? Are its high paid jobs safe? Can people move around the city easily and is London's physical environment attractive? Below we explore some of the key issues which could tip the balance for the world's super-rich elite.

Global premier financial market

Crucial to London's future growth and development is the need for the City to retain its place as the premier global financial market. London, as a financial services centre, has long since left behind its European competitors and now competes head on with New York. However, HNWIs are a highly-mobile group whose loyalties are easily transferable. The increased pace of globalisation, including growing competition from the emerging BRIC economies (Brazil, Russia, India, China) looks set to intensify. Added to this, are the 'N11', a group identified by Goldman Sachs as the 'next 11' countries in hot pursuit of the BRIC nations displaying significant economic growth, these include; Bangladesh, Egypt, Indonesia, Iran, South Korea, Mexico, Nigeria, Pakistan, the Philippines, Turkey and Vietnam.

If London can continue to attract the financial world's key personnel its future looks assured. The fact that the world's largest financial services group, Citigroup, has recently announced plans to give greater prominence to its London operations, (three out of five global heads will be based in London) demonstrates how critical a commercial presence in London is still considered to be.

"Crucial to London's future growth and development is the need for the City to retain its place as the premier global financial market."

Tax regime for non-domiciled residents

Arguably, the largest challenge facing London's super-prime market are the pending tax changes for non-domiciled residents. For decades the UK has benefited from a benign tax regime compared to other key HNWI locations. The UK has, historically, offered exemption from tax on income from foreign investments for those people who are resident but not domiciled in the UK. In an increasingly mobile and competitive world, London's comparative advantage should not be taken for granted. Regulatory or tax changes could have a significant impact on London's competitiveness.

According to the Treasury there were 114,000 people claiming non-domiciled status in the UK in 2005, but some commentators believe this figure is now closer to 200,000 as a result of the City's performance over the past two years. From 5th April 2008 those non-domiciled residents who have lived in the UK for more than seven years will pay an additional flat rate charge of £30,000 or they will be liable to pay tax on their overseas income and capital gain.

The announcement, which came as part of the government's 2007 Pre-Budget Report, could be perceived by wealthy foreign residents in one of two ways. Firstly, some non-domiciled residents may see this as the start of a slippery slope, indicating a change in attitude by the Brown government and the emergence of a less friendly tax system. In contrast, there is a chance that the proposed levy may be considered an acceptable trade-off by some in return for the certainty that the non-domicile tax regime will not face further wholesale changes.

The reality is a few HNWIs have started reviewing their property portfolios. Most are looking to restructure their offshore investment portfolios to ensure they are UK tax efficient whilst only a minority are considering a sale pre-April 2008. The concern is that cities such as Monaco and Geneva, places which many wealthy non-domiciled residents previously overlooked in favour of London, may start to attract more of the world's super-rich as their tax advantages become more apparent.

Lots Road Power Station, Chelsea
(computer generated image – details may vary)

Infrastructure

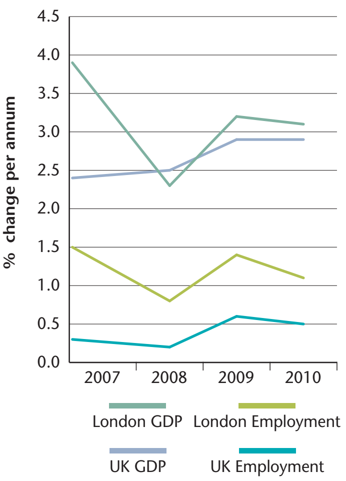
Investment and improvements to infrastructure are set to have a major impact on London, its residents and economy over the next decade. The new Eurostar link into St. Pancras, combined with the confirmed funding of Crossrail, the extension of the London Overground (previously Silverlink), the opening of Heathrow Terminal 5 and the improvements resulting from the 2012 Olympics will help upgrade London's transport network.

"For as long as the world's top investment banks, private equity firms and hedge funds make London their favoured market London's super-prime market will follow an upward trajectory."

The new Eurostar connection at St Pancras has made the 'Euro-commuter' a reality, putting central Paris within two and a half hours reach. According to the think tank Future Forum, around 20% of UK citizens moving to France intend to commute back to the UK and by 2020 a total of 1.5 million people will work in Britain while living in another country.

Making London more accessible will have multiple benefits; it will expand the city's employment catchment area, make the city more attractive in terms of foreign direct investment and help breed a wider feeling of confidence in London's capacity to grow. Crossrail alone is forecast to add between £36 billion and £64 billion to London's GDP in present value terms. The expansion of London Heathrow, with the building of a third, short runway, could increase the volume of flights by 50% to 700,000 a year by 2030. Furthermore, around £1.4 billion is being invested in the London Overground, the first step towards an orbital rail link around London, joining together the North and East railways. Clearly, progress is being made, the challenge will be to make sure London's entire transport network reaches a similar standard.

Figure 5
GDP & employment forecasts: London vs. UK



Source: Oxford Economics/Experian Business Strategies

Regeneration & emerging markets

London is due to witness some of the largest brownfield regeneration projects in Europe. Strong demand (the formation of 35,000 new households per annum is forecast), major infrastructure projects along with sustained economic growth are driving the capital's widening process of urban renewal. The priority is to keep up the momentum for regeneration whilst still paying close attention to quality.

The confirmed funding of Crossrail, linking Maidenhead in the west to Shenfield and Abbey Wood in the east, will mean some locations previously disregarded by potential purchasers due to poor transport connections will see heightened interest. Clear winners will be those locations where the large infrastructure projects converge e.g. Stratford (Crossrail, Eurostar terminal and The Olympics) as well as those likely to emerge as important interchanges e.g. Abbey Wood and Ealing Broadway. To the west, clear beneficiaries will be those markets where there is limited connectivity at present, areas such as West Drayton, Hayes, Southall and Hanwell.

Aside from the impact of Crossrail on London's mainstream market, emerging markets are also identifiable within London's prime market (£1m-£5m). A desire for new build lateral living and a greater appreciation for modern architecture and design has broken the long held perception of prime central London i.e. classic Georgian, Victorian and Edwardian homes. As a result, areas such as the South Bank, which combine the exclusivity of a riverside setting with iconic design and a dynamic cultural quarter (The Tate Modern, Borough Market, The Globe Theatre etc) are breaking the mould. Areas on the fringe of prime central London, previously overlooked due to failing infrastructure or a lack of investment, are emerging as prime development opportunities, suggesting significant future growth potential for London's prime market.

Market outlook

As we have discussed, whilst the turmoil in the financial markets, coupled with three interest rate rises in 2007 and the fallout from the US sub-prime market have had a dampening effect on the UK mainstream market, the super-prime market continues to operate via a separate set of dynamics.

11 Cavendish Avenue, NW8

The City bonus round is likely to be weaker in 2008 and it is widely acknowledged that the capital sums made in the past three years are unlikely to replicated in the short to medium-term. Nonetheless, London remains well placed to benefit from global wealth creation, the scale of which is on unprecedented levels and may well offset any potential lull in domestic demand. Wealth generation worldwide is being driven by real GDP growth and market capitalisation, key areas tipped for growth in the emerging markets.

Long-term there are positive projections for the London economy in terms of employment growth, improved infrastructure and foreign direct investment. For as long as the world's top investment banks, private equity firms and hedge funds make London their favoured market London's super-prime market will follow an upward trajectory. We envisage that whilst the super-prime market will not see the level of growth witnessed in 2006 and 2007 we believe it will still be the top performing market in the UK in 2008.

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