



AUTUMN 2009 LONDON RESIDENTIAL

Review

Knight Frank

HIGHLIGHTS

- What a summer. Prices in prime central London (PCL) have risen by a remarkable 6.4% since March and sale volumes have increased by 90% since the start of the year. After almost 18 months of appalling market conditions the capital's estate agents can be forgiven a little jubilation.
- In the lettings market, the army of 'forced' landlords has begun to slowly shift properties back into the sales market. It will take some time for the level of rental stock to return to normal levels, however, the decline in rents that we have seen since the middle of last year appears to be ending.
- So, good news all round? Well, maybe not entirely. In this edition of Knight Frank's London Residential Review we dig behind the headline figures and uncover the issues that could pose future problems for the market. We also take a look at the impact of the recent relative strengthening of Sterling on the market, and examine the key economic factors at play. Our conclusion – as always – is that sobriety remains a virtue for vendor and purchaser alike.

PRICES IN PRIME CENTRAL LONDON ARE NOW 6.4% HIGHER THAN THEY WERE IN MARCH, THE LOW POINT IN THE RECENT MARKET CYCLE.

The summer recovery

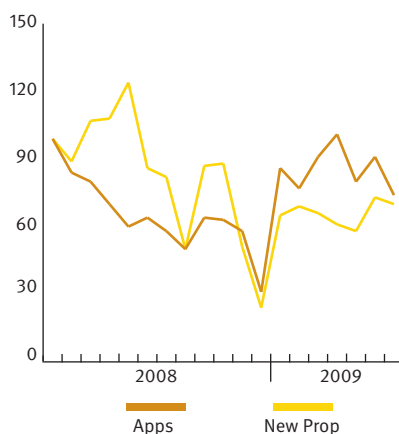
The sharp reversal of fortune in the central London housing market since the start of the year is shown up dramatically by a comparison of recent demand and supply figures. In Figure 1 we illustrate trends in both the supply of new property to the market and the volume of new applicants registering to buy. We have indexed the figures, with a base of 100 at January 2008, for ease of comparison.

The first point to note is that the normal seasonal growth of supply we saw in early 2008 dissolved rapidly through the year – there was barely any recovery at all in available property volumes during last autumn's market. Into 2009 the low supply of property became even more pronounced – for vendors the spring market effectively did not register.

On the supply side, Figure 1 confirms that the volume of new buyers coming into the market is still historically low. It was only in April that this measure recovered to the level last seen in January 2008. Nonetheless, there was a critical switch earlier this year between the rates of growth in the volumes of new buyers and new property put on the market – an improvement in demand volumes that has underpinned recent price growth.

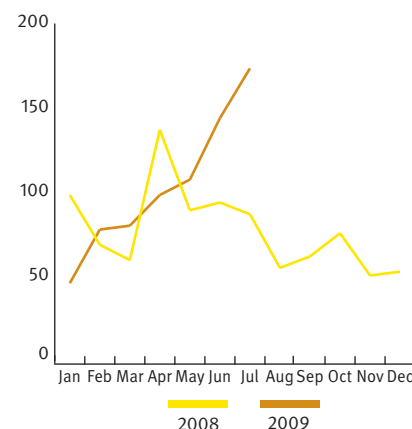
A more notable development has been the rapid growth of actual purchase activity. In Figure 2 we show an index of sales volumes in the prime central London market. The collapse of the market after April 2008 is clearly illustrated, but so too is the recovery since the beginning of the year – sale volumes have risen by 90% since January 2009.

Figure 1
Demand outpaces supply
Index of new properties for sale and new applicant registrations, PCL, January 2008 = 100.0



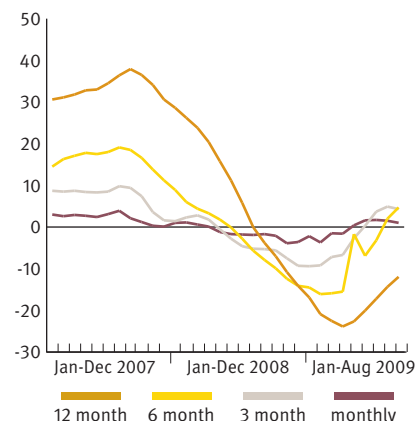
Source: Knight Frank Residential Research

Figure 2
Sale boom
Index of sale volumes, PCL, January 2008 = 100.0



Source: Knight Frank Residential Research

Figure 3
Rising prices
PCL price change



Source: Knight Frank Residential Research

Looking at the prospects for the autumn market – the key factors are low volumes of available property, which at the beginning of September were already 34% below the level seen at the same time last year, and the future supply of property.

Despite the slowdown of vendors withdrawing property from the market (a factor we investigate below), there is no indication that there will be a near-term rush of new property coming to the market. In August 'new property inspections' (the stage before the launch of a property) were 42% lower on a year-on-year basis, suggesting that the volume of available properties will fall further into the autumn market.

Impact on prices

Prices for property in central London rose by 1% in August (see figure 3), the fifth month in a row that prices have risen. The latest price rise means that prices are now 6.4% higher than they were in March, the low point in the recent market cycle.

Price growth has been most pronounced in the key markets for international buyers, such as Chelsea, Kensington and St John's Wood – all locations where prices have risen by 5% in the last three months alone.

It has been the lower end of the market that has led the recent recovery. Prices in the £1m to £2.5m market have risen more than 5% in the last three months, compared with only 2.4% for the £10m+ market.

Once again it has been houses rather than flats that have out-performed – with average three-month price growth up by 4.6% and 3.6%, respectively. Houses have generally seen stronger price performance during both the original boom, last year's downturn and this recent recovery.

Despite the recent growth, average prices for London's best properties are still 19% below the level they hit in March 2008 – the peak of the prime London market.

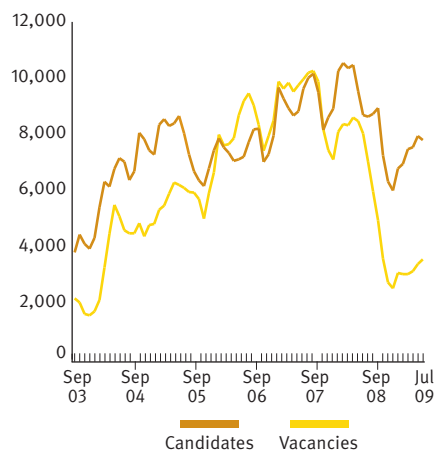
The economic environment

The recovery in the housing market this summer started from a very low base,

which tends to flatter the figures somewhat. The same factor can be seen in the UK economy – where appalling GDP results earlier this year almost guaranteed a sharp upward bounce in the second half of the year. Despite the potential for short-term improvements, critical economic issues overshadow the housing market.

So far, London has performed better than the UK as a whole through the recession. London's economy contracted by 3.6% in quarter one (latest figures) compared with 5.2% for the UK. Employment has fallen more slowly in London – by 0.6% in the first quarter compared with 2.1% for the UK.

Figure 4
City job vacancies begin to rise
Financial services and professional candidates and job vacancies



Source: Morgan McKinley

Focussing on the central London economy, the employment situation in the financial service sector is at last beginning to stabilise, according to data from Morgan McKinley, the specialist City recruiter. Job vacancies in the City fell sharply last year, however there has been a slight upturn in the number of vacancies since the early summer (see figure 4). Salaries in the City, again according to Morgan McKinley, are at least appearing to hold – and are down only 1% over the last year.

So economic and employment data suggest that things are beginning to stabilise. Unfortunately on their own we do not believe that this will be enough to maintain a rapid

recovery for the London housing market. It is the issue of mortgage availability that we think will have the ability to stunt the recovery of not just the mainstream UK market, but also potentially the prime London market.

IT IS THE ISSUE OF MORTGAGE AVAILABILITY THAT WE THINK WILL HAVE THE ABILITY TO STUNT THE RECOVERY OF NOT JUST THE MAINSTREAM UK MARKET, BUT ALSO POTENTIALLY THE PRIME LONDON MARKET.

The credit market

We noted in the August edition of our Residential Market Update that the residential market had divided into two. Those in the first segment, with limited housing equity, are either struggling to access new mortgage finance on acceptable terms, staying out of the market due to negative equity and the desire to avoid crystallising a loss, or because low economic confidence is encouraging them to stay put.

The second segment, comprised of the equity rich and economically confident, is the active part of the market. These have been the buyers behind recent price rises – having taken advantage of last winter's price cuts and the ultra-low financing rates they are able to access.

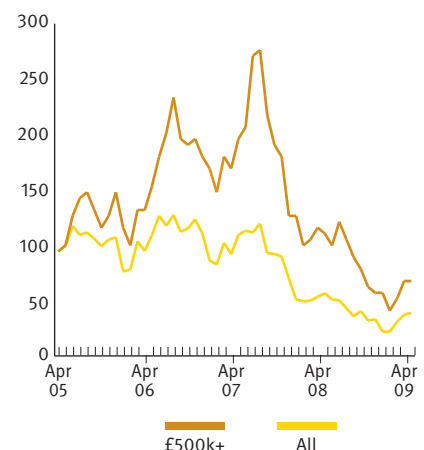
The central London market has so far fared well on the back of weaker than normal

demand, partially because this is a market more than usually dominated by the cash-rich buyer – but also because supply collapsed and more than compensated for the dearth of buyers.

To understand how the market might perform over the next year or so, we need to answer two questions. Firstly, what needs to happen to open the mortgage market to more buyers, thereby increasing demand? Secondly, what would it take to raise the volume of properties for sale and potentially reverse the benign impact of weak supply conditions?

The answer to the first question is not straightforward. The credit market is still fragile. The real concern is that despite an improving economic picture, the banking system simply does not have the ability to supply the required level of credit. Mortgage approvals are rising – but they still remain depressed. Added to this, credit spreads have remained extremely high, suggesting that the banks are still very nervous of the condition of household finances in the UK.

Figure 5
Prime and mainstream mortgage drought
Indexed mortgage approval volumes
April 2005 = 100.0



Source: Bank of England, CML, BBA

The additional issue is that even assuming funders were willing to lend at capacity, the maximum size of the mortgage market has shrunk by almost 40% since the 2007 peak (see figure 5). This dramatic shrinkage has resulted from the departure of foreign banks from the UK mortgage market as well as the specialist and buy-to-let lenders.



It looks increasingly clear that credit supply will remain limited over the next few years by a shortage of wholesale funding and a desire to run down risky loan books. The mortgage market will see improvements, but this will only happen over time. In estimating this timescale it would seem fair to think in terms of the medium rather than the short term, and therefore 2011 rather than 2010 at the very earliest.

Our second question, regarding the need to identify the key drivers that will push more people to sell, has several answers. The positive response is that improved sentiment in the market, following a future economic revival, will begin to encourage more discretionary buyers to come forward to the market, and therefore encourage them to release their properties – again this must be seen as a medium term outcome.

A more negative response relates to interest rates. A key support for the market has been unusually low interest rates, which have protected so many overstretched borrowers. This factor has helped keep housing off the market and aided price growth.

The key unknown is whether interest rates are likely to rise in the short term. Economists' views on this issue have fluctuated widely in recent months – depending on the prevailing view of the risk of high inflation stoked by quantitative easing, or alternatively deflation.

The consensus view (at the moment) appears to favour the latter option as the most likely downside risk. In fact, the world's central bankers recently signalled that they felt that ultra-low interest rates could be held well into 2010 and 2011.

Rental market improvements

For well over a year the London lettings market has been characterised by very high supply levels that have pushed rents lower. Over the past two months this situation has begun to reverse.

The volume of new properties available to rent declined by nearly 35% in July and August compared with the same period in 2008 (see Figure 6). The pattern of rental property availability has almost exactly mirrored the volume of property withdrawals from the sales market (see Figure 6), confirming the phenomena of the forced landlord.

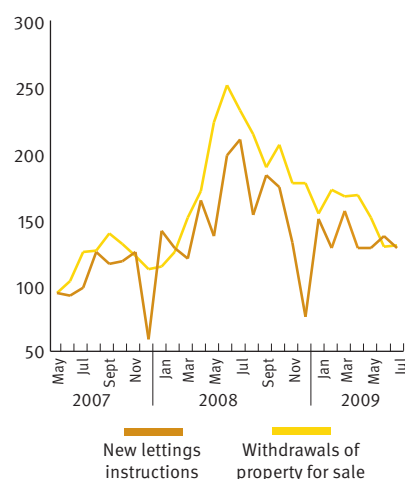
While supply has begun to fall, the number of new applicants registering for rental properties has remained constant on a year-on-year basis. This greater balance between supply and demand has meant that rents are more stable – with even cases of competitive bidding between tenants emerging for the best properties.

THE VOLUME OF NEW PROPERTIES AVAILABLE TO RENT DECLINED BY NEARLY 35% IN JULY AND AUGUST COMPARED WITH THE SAME PERIOD IN 2008.

One piece of evidence underlines the more positive sentiment in the sales market, namely that average initial rental terms are slipping. Average terms have stood above 12 months since January 2008 – peaking at over 14 months in January this year. Tenants were content to extend their sojourn in the rental sector as they witnessed the sales market implode. Now – with average terms dropping to 11.5 months – tenants are signalling a desire to increase their flexibility in response to the newly invigorated sales market and are less willing to be tied in to long rental agreements (see Figure 7).

Figure 6

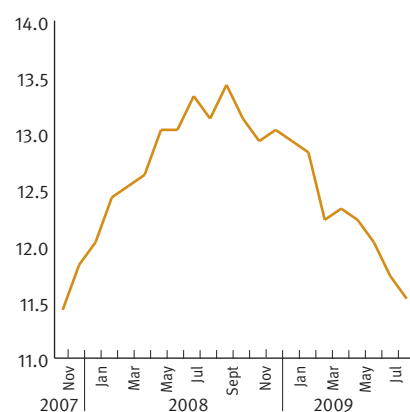
'Forced' landlords become vendors
Indexed new lettings instructions and withdrawal of 'for sale properties', May 2007 = 100.0



Source: Bank of England, CML, BBA

Figure 7

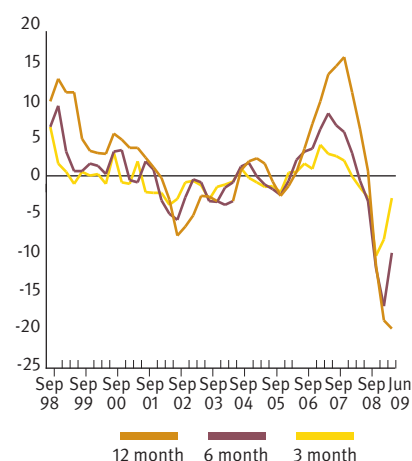
Shorter rental terms in demand
Average rental term (months)



Source: Knight Frank Residential Research

Figure 8

Rental falls easing
PCL % rental change



Source: Knight Frank Residential Research

The fall in central London rents continued into the early summer – our prime London rental index confirms that for the three month period to the end of June 2009 rents fell by 1.9% on average. On an annual basis in June rents were 19.3% lower than they were in 2008 (see Figure 8).

It has been more expensive properties that have borne the brunt of the rental falls – with rents on properties costing up to £500 per week falling only 11.3% over the year to June, and those costing over £1,500 per week falling by 27.3% over the same period.

Most central London sub-markets have been hit by falling rents. Chelsea and Kensington have been particularly affected with declines of over 26% in each area. Only the City – with a rental fall of just 9.7% over the past year – has been partially protected from the downturn. The City benefits from a high proportion of lower priced properties – which as we note above – have been better performers during the downturn.

New rentals have outpaced new supply since early May – and this is helping to reduce void periods. The autumn market is likely to be characterised by hard negotiations for landlords – but significant rental reductions from here are unlikely. The traditional busy September market could see the beginning of rental increases in some areas – as demand from new employees and their families comes into the market.

Falls in rents over the last year have meant that investment in London has not turned into a one-way-bet just because capital values fell from the peak. Investors are having to work very carefully at stock-picking, they are having to commit much more equity to purchases than they were doing 18 months ago and they are planning for longer-term, more sustainable returns.

Weak rental performance and stronger sales market activity and pricing have combined to put downward pressure on prime market residential yields – which for many landlords struggle to stay above 4% let alone 5%.

Our advice to landlords remains cautious. There is a real need to be competitive, over ambitious asking rents will lead to prolonged

void periods. The objective through the brief autumn rental market is to secure occupancy for the next year.

International demand

One factor that aided the recovery of demand in central London was the weakness of Sterling around the start of the year. The UK appeared to have been worse hit by the credit crunch and the world recession than the US or Eurozone at this time and Sterling suffered as a result. It meant that by March prices of central London property had fallen almost 50% in US Dollar terms.

The realisation that other countries have been hit as badly by the recession has led to the strengthening of Sterling and the reversal of this currency benefit for several nationalities (see Figure 9). Between March and the end of August prime London prices have risen by almost 21% in US Dollars, and 12% in Euros. This special incentive has dissipated for lots of overseas buyers.

Overseas buyers have retained their share of the market, despite the removal of this incentive. If we consider the £2.5m+ market, which excludes the UK dominated ‘entry-level prime’ market, the international buyer share of the market peaked in Q2 2008, at 68% – as the late super-prime boom worked its way through. By the end of last year – following the Lehman’s scare – this share had dipped to below 40%. This year the share has been building steadily to hit over 50% again by the summer.

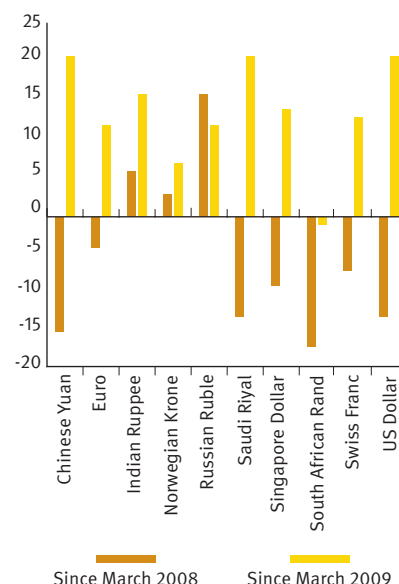
The biggest change in the actual nationalities buying has been their spread – which keeps widening year-on-year. In 2009 significant demand has been seen from: South Africa, Nigeria, Kazakhstan, India, Jordan and UAE. The Chinese are just beginning to make their presence felt – but Russians at 12% of all foreign buyers are still a serious force (see Figure 10).

The real players, however, this year – and this has not slowed despite the weakening Euro – have been the traditional European buyers, especially the Italians (representing 16% of all foreign buyers), the French (8%) and the Germans (4%).

Figure 9

Currency play

Impact of price change and currency fluctuations on PCL pricing

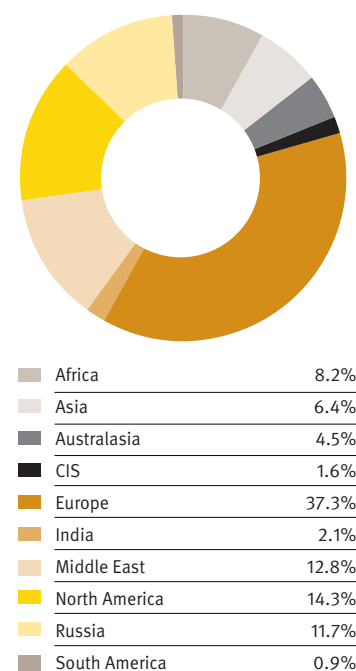


Source: Knight Frank Residential Research

Figure 10

An international market

Nationalities and regions for overseas PCL buyers, 2009



Source: Knight Frank Residential Research

RESIDENTIAL RESEARCH



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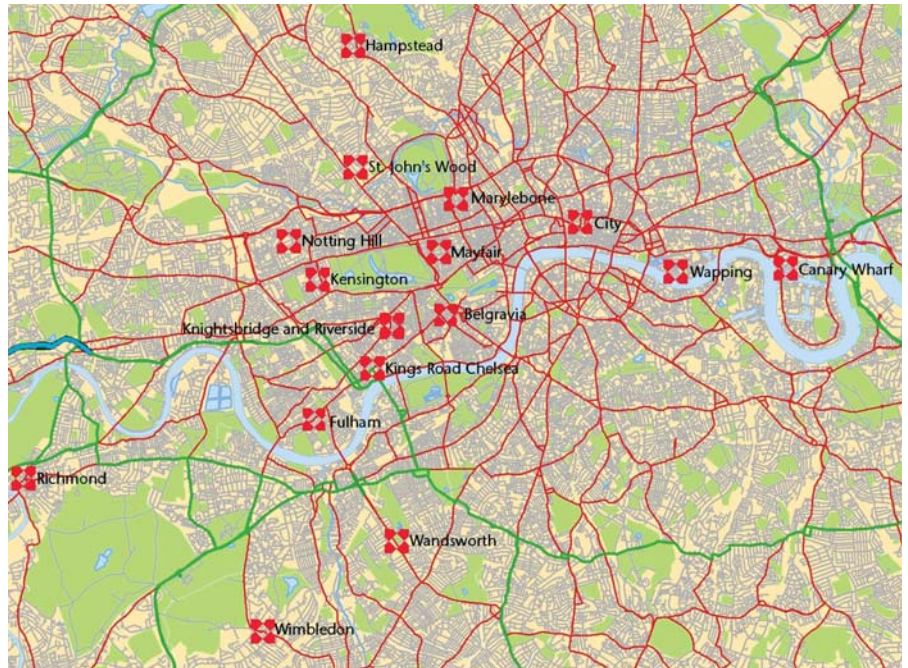
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Knight Frank area definitions – Prime central London: Belgravia, Chelsea, Kensington, Knightsbridge, Marylebone, Mayfair, Notting Hill, Regent's Park, Riverside and St John's Wood. **Prime London:** All areas in prime central London plus Canary Wharf, Fulham, Hampstead, Richmond, Wandsworth, Wapping and Wimbledon

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