RESIDENTIAL
RESEARCH

THE

LONDON REVIEW

INSIGHT AND COMMENTARY ON THE WORLD'S MOST PRESTIGIOUS RESIDENTIAL MARKET

Knight Frank

AUTUMN 2010

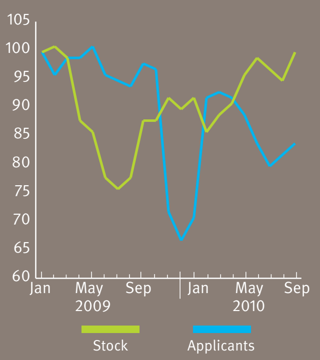
THE MARKET IN BRIEF

The following four charts present a selection of the key trends in supply, demand and activity in both the sales and lettings markets in prime London.

Figure 1

Property for sale and new applicant volumes

Index of available stock for sale and 'new applicant' volumes, prime London, indexed to 100 in January 2009



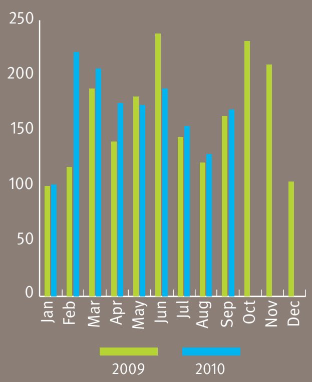
Low stock volumes were a major feature of the post-crash sales market. From early 2010 as prices rose and market conditions improved, vendors began to bring more properties forward for sale. Unfortunately, this process has coincided with a noticeable reduction in the volume of new buyers (applicants) coming into the market, which has put downward pressure on prices.

Source: Knight Frank Residential Research

Figure 2

Sales market performance

Volume of property sales (sold subject to contract), prime London, indexed to 100 in January 2009

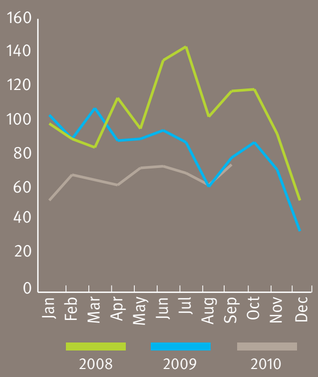


Despite a weaker volume of new applicants in the market, sales volumes have held up through 2010 compared to 2009. It will be a challenge for sales in the final three months of the current year to match the number seen last year when the volume of overseas interest was particularly strong.

Figure 3

Limited rental supply

Newly available rental properties, prime London, monthly volumes indexed to 100 in January 2008

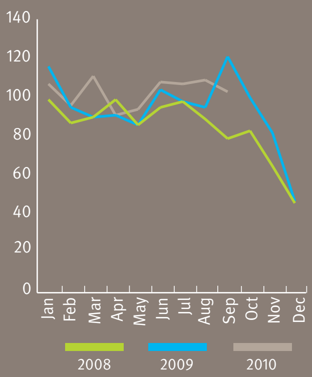


The rental market saw an unprecedented volume of rental stock flood the market in 2008, as vendors decided they didn't want to sell into a falling sales market and opted to let their properties. 2009 was characterised by a far more 'normal' volume of available rental properties. This year has seen real shortages across many sectors.

Figure 4

Rental demand resilience

Monthly prospective tenant registrations, prime London, indexed to 100 in January 2008



While stocks of rental properties have been thin on the ground, the volume of prospective tenants has been relatively strong this year. Most months have seen more new tenants coming into the market compared to either 2009 or 2008, helping landlords to raise rents through the year.

FOREWORD

THE CENTRAL LONDON HOUSING MARKET MAY BE INSULATED FROM SOME OF THE PRESSURES IMPACTING ON THE WIDER UK MARKET, BUT A SLOWDOWN IS BEING FELT EVEN HERE.

A more sober outlook for vendors offers hope for purchasers who have, until recently, felt the effect of rising prices and lower stock volumes. Landlords have been enjoying a strong lettings market, but there are signs that this too is set to change.

September traditionally offers the first real evidence of the future direction of the housing market after the summer lull, and in the experience of our London sales offices, the picture seems to be distinctly mixed.

The volume of available stock rose steadily throughout 2010 and now sits at its highest level since February 2009. While the volume of exchanges fell dramatically in September (down 15% on August, and 33% down on last September), the volume of properties under offer rose 31% between August and September, and was marginally higher (by 4%) compared to last September.

The health of the sales market in London earlier in the year is demonstrated by the fact that we were selling our properties at a monthly rate of 16% of available stock in February. The percentage dipped to 9% in August before recovering slightly to 11% in September.

Our offices have taken a degree of good cheer from the fact that viewing volumes surged as usual in September (up 67% compared to August), although they were unchanged from last September. While new applicant volumes rose 19% month-on-month in September, they fell back by 13% on a year-on-year basis, pointing to a more reticent attitude among prospective buyers.

Pricing performance in the prime markets has mirrored the wider UK market. Although prices in central London increased by 14% in the year to the end of September, they fell by a total of 1% across July, August and September. In the UK, prices have increased by 3% over the past year – a significantly lower rise than the 10% annual growth recorded in April. UK prices fell in two of the last three months.

Caution in the lettings sector

When we turn to look at the lettings sector, we find a healthier marketplace. While capital values have been falling since July, rents are still very much in the ascendency – rising for the fifth consecutive quarter in the three months to the end of September.

Although prime central London rents have risen 16% since their recessionary low in June 2009, they are still 7% below the peak level they reached in March 2008, when the London economy and employment market were yet to feel the effects of the credit crunch and job losses in the City.

Looking back further, we see that rents in central London have performed modestly over the past decade when compared with capital values. While average earnings in central London rose 42% in the ten years to the end of September 2010, average rents only rose 13.5% over the same period, a fact which ought to give landlords confidence regarding the sustainability of the market.

Landlords should not become overly confident regarding the potential for rent rises in the short-term. While further growth is possible, there are signs in the lettings market that the demand and supply balance is becoming less favourable for investors.

The volume of properties available to rent is still lower than it has been historically. The number of newly-available properties fell by 6% year-on-year in September, and by a massive 36% compared to September 2008. This was when the lettings market faced its most turbulent period, with a huge oversupply of properties resulting from the wave of 'forced landlords', which in turn forced down rents during the recession.

Demand for rental property has been very strong, with new applicant volumes between May and August running at around 10% above the levels seen in either 2009 or 2008. September saw this level decline, with new applicant volumes falling back noticeably by 14% compared to the level in September last year. The same was true of viewing figures, which again fell back in September after strong results throughout the summer period.

In summary, while there does not yet seem to be evidence of rapid weakening in the market, the emerging indications from both the rental and sales markets are that conditions are more difficult than they were in the spring or early summer. Looking ahead we provide our thoughts on the future of both sectors on pages 6 and 7.

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THE LONDON REVIEW
AUTUMN 2010

Liam Bailey
Head of Residential Research

MARKET INSIDERS

Insight from key players at the top of their markets

THE RECRUITMENT GURU

Andrew Evans, Managing Director, Morgan McKinley Financial Services

Recruitment activity picked up in all areas of the financial sector. The first half of the year saw a dramatic upturn in the number of jobs created in the city, with significant month-on-month increases. But activity began to stabilise and then tail off over the summer months, much like house prices. Nevertheless, new jobs in the financial services sector in London rose by 23% in September compared with September 09.

In the coming months, we expect a pause for thought from banks in terms of recruitment activity as they take stock and finalise their head counts for 2011. The recruitment of fee-generator roles in trading, sales, and mergers and acquisitions is likely to pick up early next year.

The government's tough new stance on tax and bank regulations has not yet driven swathes of high earners away from the capital as some would have us think. The one-off 50% bonus tax in particular is unlikely to have a significant impact as it only applies to this year's bonuses.

Ironically, the bank regulations have had a positive effect on some recruitment markets. A number of very highly-paid risk, compliance and change management jobs have been created to reduce the risk of a second credit crunch, for example. There is a 'war for talent' in these areas as firms have few suitably-qualified candidates to choose from.

Some high-net-worth individuals chose to leave the UK on the back of the changes. But the number is lower than many probably expected. Those that have moved or are talking of moving include well-known hedge fund owners who increasingly view Switzerland as a more desirable base.

Some firms have indicated that they will move their global HQs away from London if the regulations become too onerous. Banks talk of moving to key cities in Asia. HSBC, for example, has said it would consider Shanghai. But at the moment, it appears to be just that – talk. However, it will clearly impact on the jobs and housing markets if it comes to fruition.

THE ECONOMIST

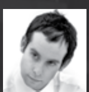
Ed Stansfield, Capital Economics

Banks and mortgage lenders are becoming more cautious and lending less as the year progresses. As well as uncertainty about the economic outlook, this renewed caution also stems from the implications of the withdrawal of support schemes next year and in 2012, specifically the Special Liquidity Scheme (which allowed banks to temporarily swap their mortgage-backed and other securities for UK Treasury Bills), and the Credit Guarantee Scheme (under which, for a fee, banks and building societies could issue debt backed by a government guarantee).

The Bank of England estimated that the two schemes are worth around £300bn to UK mortgage lenders, meaning their withdrawal will leave lenders with a potentially substantial funding shortfall. The situation is therefore very fragile and while that uncertainty persists, lenders are being increasingly picky. This is obviously less of an issue at the top end of the market in London, where buyers are less likely to have credit constraints.

When it comes to tax hikes and banking regulations, the fact that the goal posts keep moving means we are not sure where we are going to end up. But there does not seem to have been an identifiable detrimental impact on the London economy yet. Banks are well aware that the public attitude towards them is still relatively hostile and that they may therefore be used as a political football.

A double dip-recession cannot be ruled out, but does not seem the most likely outcome to me. With the economic recovery losing momentum and unemployment set to rise further due to public sector spending cuts, we should expect renewed falls in house prices this year and next, even in London. Without a further correction, high house prices will continue to present a major downside risk to the economic recovery. Of course, a further house price correction will not be painless, but it is important to recognise that prices are at unhealthily high levels. Further price falls are required to put the market onto a more sustainable footing for future growth.



THE WEALTH SPECIALIST

Graham Harvey, Director, Scorpio Partnership

There is a worry that London has or will lose its attraction as a place to live for the world's wealthy, but there are two camps in this respect. The first includes those who may have relatively little choice when it comes to where they live for work reasons. This community is highly influenced by the state of the economy and employment sectors. The resident non-domiciled (RND) tax regime and the cost of advice are also ongoing pain-points.

For the second group, made up of ultra-high-net-worth individuals, the view of London is fundamentally different. For them, London is one of their many residences and their view of the city is dictated by the service sector and the opportunities provided – professionally, personally and socially. The relatively benign political environment is also a trump card. The challenge for London will be to maintain and enhance these attributes through macro-austerity measures but also by responding to the competition presented by other leading global cities.

The initial negative response to the RND legislation appears to have calmed while professional advisors appear to be wrapping their minds around it to appease clients who are concerned about changes to the state's interest in their wealth.

London reached its zenith during the last decade when it was considered by many as the global mecca for the world's wealthy. I expect that it will go on to be seen as a top-three or top-five city, unless something radical and unforeseen comes to pass.

THE OFFICE EXPERT

James Roberts, Knight Frank, Commercial Research

A steady recovery is underway in the central London office market. Over 10m sq ft of office space has been let so far this year – the equivalent of 20 Gherkin buildings – compared to the 6m sq ft let during the same period in 2009. The headline figures perhaps overstate the situation as some large deals, mostly to financial institutions in the City, have boosted the statistics. But the letting of smaller office units is also increasing, albeit gradually, which shows the market is heading in the right direction.

Despite the gloomy predictions on the outlook for banks, the financial sector has led the recovery, accounting for 38% of office space acquired in 2010 (the long-run average is just over 30%). There has been a shift in financial demand towards institutions from the Asia-Pacific region. Most firms taking office space are doing so because they have an upcoming lease expiry, or are in a building that is approaching obsolescence. Some firms are expanding – notably certain Chinese banks taking new offices that are sometimes three or even four times larger than their previous office space to accommodate future growth in London. Some media and technology companies have also been expanding ahead of the 2012 Olympics.

But the market faces two key issues: the low level of development under construction, which is already pushing up rents; and the uncertainty over future financial regulation. The financial sector is key to London's economy, and a realistic balance needs to be struck between ensuring there is oversight without driving banks abroad.

SNAPSHOT

Local market summaries from six of our London offices

James Pace, Office Head, Chelsea

The third quarter was our strongest period this year for both sales and lettings. Stock remains pretty low – particularly for classic family houses on good streets – but we have a good number of focused buyers on our books. We have seen a huge surge in demand for unmodernised property – every property we've handled this year that has needed work has gone to sealed bids. We expect the coming months to be busy due to impending tax rises. The size of city bonuses will have a direct impact on us.

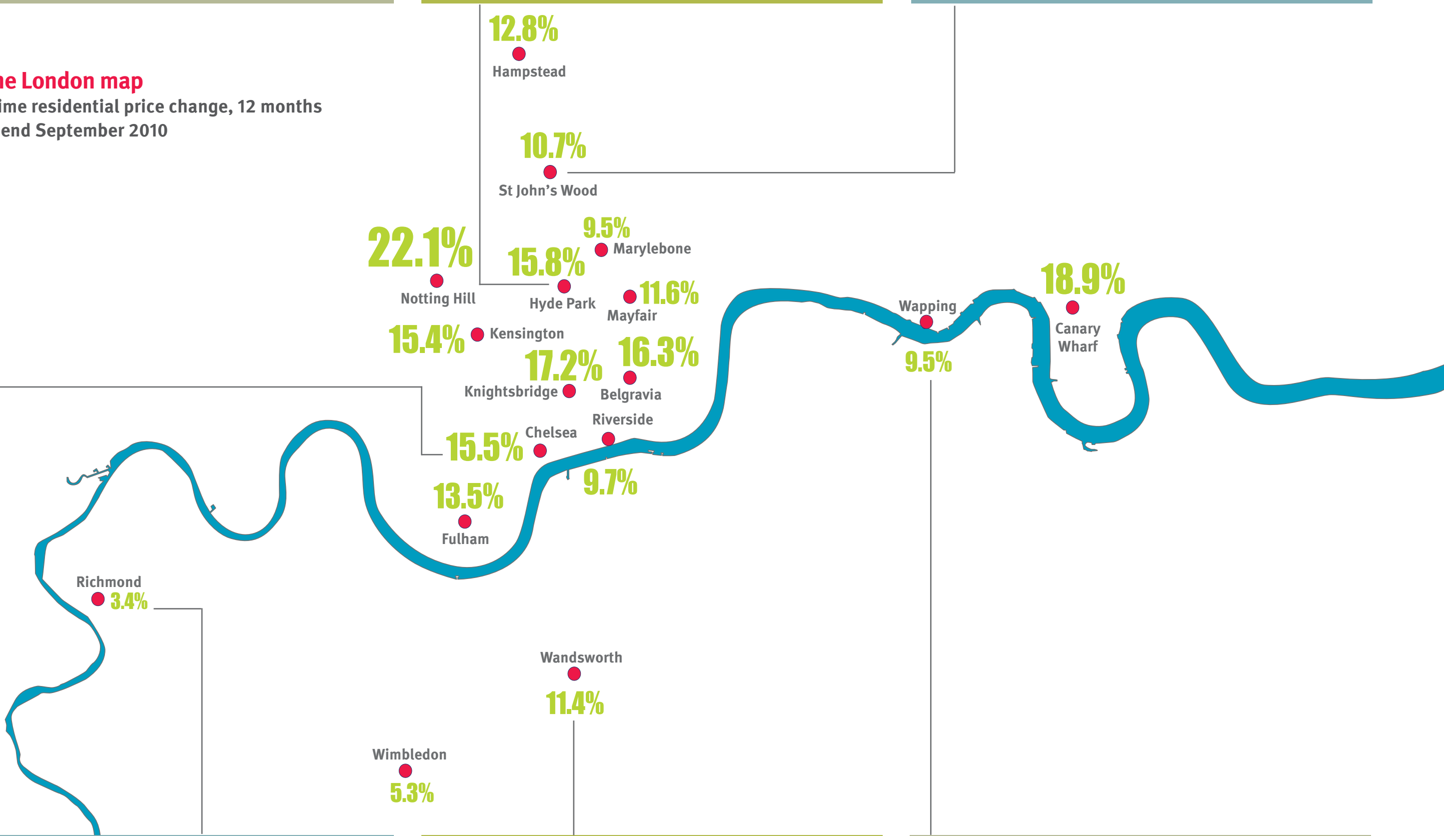
Sarah Harding, Office Head, Hyde Park

The sales market has performed very well this year and we recently sold two homes under best bid conditions. But there is a noticeable air of nervousness. We receive a lot of interest from international buyers – notably Russians and Middle Easterns – as well as people moving from other parts of London in the pursuit of more space and a more central location. Demand for lateral apartments with views of the park has shot up. The lettings market has also performed well and we are experiencing the usual post-summer surge in demand from young professionals and students, particularly international ones.

James Simpson, Office Head, St John's Wood

Excellent prices are still being achieved in most areas. Primrose Hill and Regent's Park continue to shine, partly because of the shortage of well-priced family houses there. The sub-£3m core market has driven sales but we are also seeing a return to the very top-end of the market, with grand houses such as the Cornwall Terrace development, generating a huge amount of interest from international purchasers. Domestic buyers are increasingly keen on unmodernised properties – an opportunity to add value rather than pay a premium for someone else's style.

The London map
Prime residential price change, 12 months to end September 2010



Luke Ellwood, Office Head, Richmond

Richmond is popular with young families relocating from central London in search of a secure and comfortable family environment. Buyers are looking for value and sensible pricing has become the key determining factor in attracting success. Where the price has been set at a realistic level, we have seen competitive bidding and, in recent cases, have achieved over the guide price. Stock levels are always thin across the Richmond borough's prime areas – families tend to buy for the long-term. The majority of our clients are moving out to downsize following their children leaving home.

Luke Pender-Cudlip, Office Head, Wandsworth and Clapham

Although our market has been patchy and stop-start, the general trend has been positive, with many prices around peak-2007 levels. We recently achieved just under £1,100 per sq ft – an all time record for this part of Wandsworth, to our knowledge. Buyers tend to be upsizing or downsizing, with many coming from north of the river, and an increasing number of South Africans, Australians and Europeans. Vendor and buyer aspirations are more aligned than they have been for a long time.

Sarah Shelley, Office Head, Wapping

We had a fantastic run from the start of the year until late July when the holiday season struck. But normal market conditions failed to return in September. The number of enquiries has fallen significantly and buyer enthusiasm seems to have disappeared. It could be the case that some potential buyers turned to the lettings market, which has been frantic in comparison. There is still a shortage of stock in the area, particularly one-bedroom flats in west Wapping where there is pent-up demand.

OUR VIEW

Liam Bailey, Head of Residential Research at Knight Frank, provides his thoughts on the outlook for the central London market.

When we published our forecast for the central London market in October last year, asset prices had strengthened on the back of government stimulus and cheap debt. In London's residential market in particular, the weakening of Sterling had super-charged demand and therefore prices during the recovery phase.

Despite such positives, we were still nervous about three main issues which we felt would be major influences in 2010. The first and second of these potential issues – rising inflation and a second phase of rising unemployment – have yet to impact on the market. They could however affect the economy and housing market in 2011.

The third risk did present itself this year. This is what we described in the forecast as "...the rather nasty combination of spiralling government debt and the resulting tax rises and spending cuts...". Our concerns over this issue in particular fed through into our prediction for house price growth in London of 3% in 2010.

With nine month's data now in, it seems very likely that prices in central London will end the year around 5% higher than they started it. So our forecast was either very close, or 66% out, depending on how charitable you are feeling.

External influences

The two biggest determinants of house prices in the UK, and in London too, are the cost of borrowing and the performance of the economy. It is likely that 2011 will see a continuation of very low base rates and therefore mortgage rates (figure 5). From 2012, however, the cost of borrowing is likely to rise steadily, as economic growth recovers (figure 6) and the risk of inflation rises.

It seems likely that London and the wider UK markets will experience below-trend price growth for an extended period. This is because it is likely that economic growth will improve, but remain sluggish for some time. In addition, while borrowing costs are likely to remain low in a historic context for a number of years, the volume and availability of finance is likely to remain constrained.

The impact of a weak pound looks set to remain for some time to come (figure 7), although its value is likely to rise slowly but steadily from 2011 and beyond. This will encourage further demand for London property from international markets, supporting our view that London will continue to outperform the wider UK market.

Short-term indicators

As well as considering longer-term macro-economic factors to underpin our forecast model, we are also able to take advantage of our own market experience which can provide some very useful insight into shorter-term market movements.

By analysing historic data from our offices – buyer volumes, available properties and sales volumes – and setting these against actual price movements, we are able to assess the relationship and correlation between activity data and market performance. For example, rising applicant volumes now might be expected to translate into price rises in the future.

Our analysis suggests that recent trends in available stock, new applicant registrations and the number of properties going under offer, provides a very reliable guide to where prices are likely to move over the next six months. In addition, recent trends in property exchanges appear to provide a reliable guide to where prices will move over the next nine months.

In figure 10 we provide a view of where these short-term activity-based indicators suggest the market will move over the next few months. The measures of properties going under-offer, new applicant volumes and stock levels all point to price falls between the end of September 2010 to March 2011 of between 5% and 9%. The slightly longer-term view provided by trends in exchange volumes points to prices being just under 4% lower in June 2011 compared with the end of September 2010.

In figure 10 the dots denote where we expect prices to sit at the end of 2010 and 2011 to provide context for the other indicators.

The outlook provided by these indicators chimes fairly well with our own view that the second phase of the market downturn, which began in July this year, will probably continue throughout the remainder of this year and during the first quarter of 2011 before a modest recovery takes hold in the second quarter of the year. We will report back in early 2011 to update you on our accuracy (or otherwise).

MARKET OUTLOOK

The sources that feed our forecasts.

> OUR VIEW IS THAT CENTRAL LONDON HOUSE PRICES ARE LIKELY TO UNDERPERFORM THEIR HISTORIC TRENDS UP UNTIL 2013, WHEN PRICE GROWTH COULD RISE STRONGLY ON THE BACK OF GROWING WEALTH AND JOB CREATION.

Figure 5

Interest rate outlook

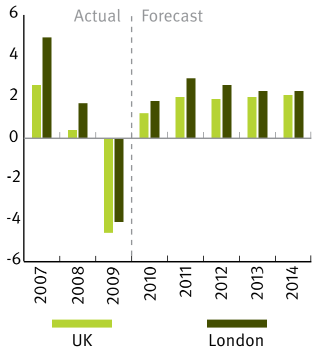
UK annual average base rate and mortgage rate

A key input into our forecast model is the outlook for the cost of borrowing, here illustrated by the forecast for the UK base rate and the average annual mortgage rate. While both rates are forecast to rise over time, the shallower increase in mortgage rates points to a narrowing in lenders' margins over time.

Figure 6

Forecast economic recovery

Economic growth, GVA annual % change

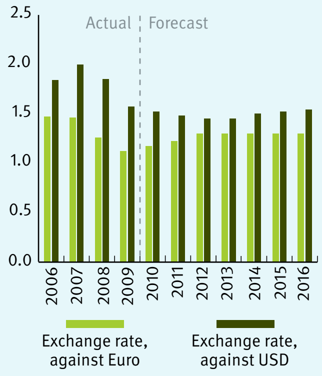


The other main influence on housing market performance is the outlook for economic activity. In this chart we can see a clear rational for the expected outperformance of the London market versus the wider UK market, with a more rapid recovery expected every year up until 2014.

Figure 7

Current movements

£ versus Euro and US Dollar, average annual exchange rates

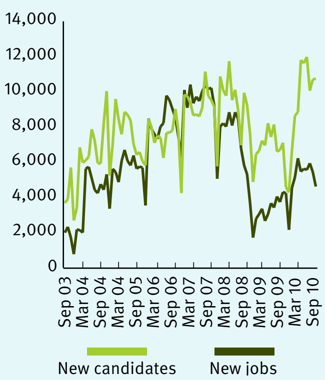


The decline in the pound in 2008 and 2009, provided a strong impetus for the market recovery during the past 18 months. The outlook is for a steady strengthening of the pound against the Euro and also against the US Dollar, however in neither case is the pound expected to regain the strength it last saw in 2007.

Figure 8

City employment monitor

London's financial services sector job opportunities and candidate volumes

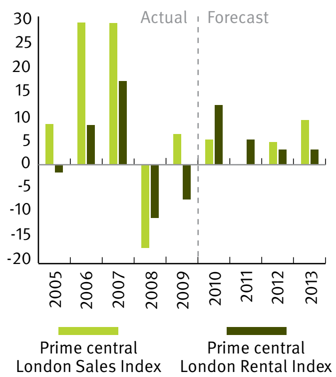


Morgan McKinley, the City recruitment agency, provide a useful monitor of trends in London's financial services sector. The positive sign comes from the number of new job vacancies, which has been rising since the beginning of 2009. There is slightly more concern over the high number of candidates looking for work at the current time.

Figure 9

Price and rent forecast

Prime central London capital value and rental value forecast

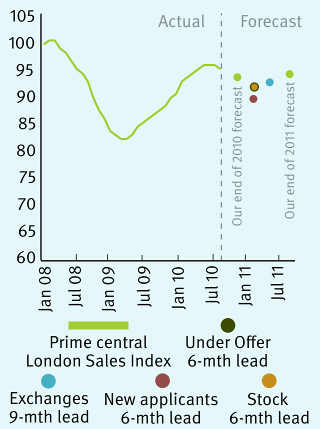


Our view is that central London house prices are likely to underperform their historic trends up until 2013, when price growth could rise strongly on the back of growing wealth and job creation. The short-term view is 5% growth in 2010, 0% in 2011 and around 4% to 5% in 2012. Rents are likely to outperform significantly this year and next, but return to a more traditional pattern of growth from 2012.

Figure 10

Short-term market indicators

Prime central London price index (Jan 2008 = 100), with implied forecasts from activity measures



Recent trends in market activity provide a strong indicator of short-term future price change. This is illustrated above, using four measures: the volume of properties going under offer, new applicant levels, stock levels, and exchanges. The first three measures point to what prices may be in six months' time and the fourth suggests what they may be in nine months' time.

Sources: Knight Frank Residential Research, Bank of England, Morgan McKinley's Employment Monitor, ONS, Oxford Economic Forecasting

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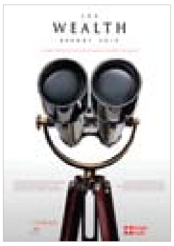
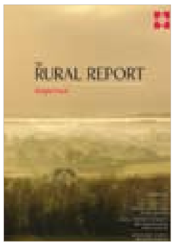
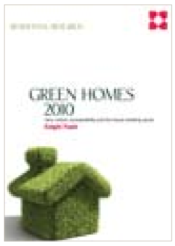


The Wealth Report 2010

Private View 2010



The Rural Report 2010



Green Homes Report 2010

Our Residential Research team provides strategic advice, forecasting and consultancy services to a wide range of clients including developers, investors, financial and corporate institutions. Further details are available on our website at KnightFrank.co.uk/research

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Knight Frank area definitions – Prime central London: Belgravia, Chelsea, Hyde Park, 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

*Riverside covers the Thames riverfront from Battersea Bridge in the west running east to encompass London's South Bank