RESIDENTIAL RESEARCH

AUTUMN 2011

LONDON RESIDENTIAL REVIEW

Knight Frank

HIGHLIGHTS

Price growth in London's prime residential market has totalled 35% since March 2009, representing the fastest market recovery in 20 years. Sales volumes at the top of the market have reached record levels, and demand from both purchasers and tenants shows no signs of moderation.

Together with our usual round-up of key market trends from the sales and lettings markets, a global comparison of London's performance and an update on our forecasts, this edition considers how long the boom can continue, and whether riots, debt crises, or a second global recession will spell the end of the wealthy world's love affair with London. This is your definitive prime market briefing.

HOW LONG CAN THE BOOM CONTINUE?

With prices 35% higher than they were two years ago, and new records being broken each month, there is no escaping the fact that the prime London sales market has de-coupled from the wider UK residential market and economy. Are we seeing the beginning of a global de-coupling? Liam Bailey examines the evidence.

Liam Bailey
Head of Residential Research

Since the start of the most recent prime London recovery in March 2009, the rate of annual price growth at the top end of the London market has remained 10% higher than that of the wider UK market (figure 1).

It might be stretching a point to suggest that this gap represents the contribution made by wealthy international buyers active in London, but the pattern has been unusually constant. Where the UK market is flat-lining at best, the prime London market is booming.

The recovery in London's luxury housing sector over the past two years can be at least partly explained by the fall in the value of the pound, which attracted an influx of international buyers. The post-stimulus bounce in asset values, as hot-money sought safe haven investments, coupled with the recovery in the global economy, also contributed to London's property revival.

In many ways London's prime property sector has been one of the main beneficiaries of the global response to the 2008 financial crisis. So far, so good.

But there is a growing sense that the world is entering the second phase of the financial crisis, postponed rather than resolved by government stimulus. With rising fears over a double-dip recession and market panics over European and US government debt, has London's apparent inviolability begun to be undermined?

The short answer is: not yet.

Headline prime London prices have been surging, with growth of 8% since the start of this year and more than 35% since March 2009. The same positive story is told when we consider market activity.

To provide the most current analysis of activity in the prime London market, taking into account the financial market turmoil over the last few weeks, we have compared market activity in the four weeks to 12 August this year with the same period in 2010. The figures confirm a sector in rude health.

On the demand side, new buyer volumes are up by 11% over this period, viewings are up by 23% and the number of offers being made on properties is 13% higher.

Stock volumes are higher, by 13%, but the rate of sales is keeping pace with this rise, with the number of exchanges rising by 15% year-on-year and those going under offer rising by 67% over the same period. The proportion of available stock being sold each month hit 13% in July, up from 8% a year earlier.

In summary, prices are higher, as is demand, and supply increases are being absorbed by the market with a sharp rise in year-on-year sales volumes.

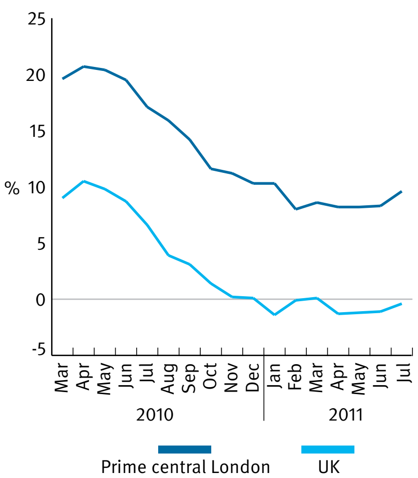
Heating up

With such a positive picture emerging, it is instructive to compare current market conditions with similar previous episodes.

When we compare historic market rallies in the prime London market, we can see a dramatic outperformance this time round. In figure 2 we have plotted the trajectory of the market during the three main market recoveries over the past 20 years.

In the last 28 months the market has risen 35%. This compares to 24% over a similar period after July 1992, and 13% in the period after June 2003.

Figure 1
Worlds apart
Prime central London and UK annual house price growth



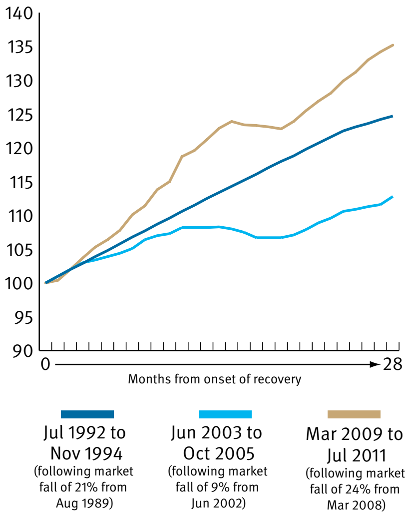
Source: Knight Frank Residential Research, Nationwide

In trying to explain the strength of the current recovery figure 3 provides a good starting point. This chart shows how pricing has fared in prime London since March 2008 (the pre-crash market peak), adjusted for currency movements. While purchasers buying with sterling are now paying prices in excess of 2008 peak prices, eurozone buyers are still able to achieve a 10% discount on 2008 prices and US dollar buyers can benefit from an 18% discount.

Figure 2

Rapid recovery

Prime central London market recoveries compared, index rebased at 100 for each period

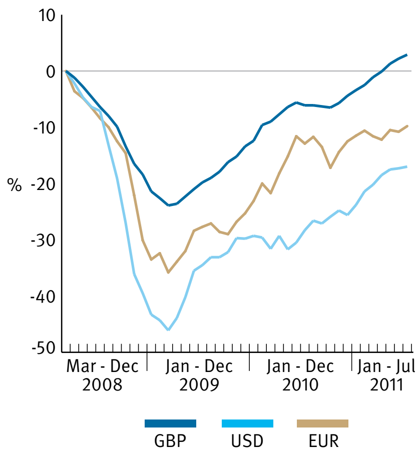


Source: Knight Frank Residential Research

Figure 3

London is still a bargain...for some

Prime central London average discount from March 2008 prices, allowing for currency fluctuations



Source: Knight Frank Residential Research

It is not only exchange rates which have aided the market. We ought not to forget that the UK base rate has been held at 0.5% throughout the entire recovery period, whereas rates averaged 6% and 5% respectively during the 1992 to 2002 and 2003 to 2008 booms.

London's much-touted 'safe haven' status took more than a little bruising in August, with pictures of looting, petrol bombs and rioters replacing William and Kate's wedding as the stock image of London in the global consciousness. It is far too early to say whether any lasting damage to London's economy or housing market will result from the riots, but it seems unlikely to dent most international buyers' desire for property in the city.

From the current vantage point the strength of the market in London appears to be untroubled by the latest bout of the global financial crisis, although a full-scale decoupling is a little early to call.

Our outlook for the prime London market is for price growth to run a little further this year. We forecast growth of 9% for 2011 as a whole, and with an uplift of almost 8% having already taken place since the start of the year, there is real potential for double digit growth by the year end.

Our view that prices will rise during 2012 by a further 6% is likely to be supported by lower than expected interest rates and, ironically, by lower-than-trend economic growth in the UK, which should put downward pressure on exchange rates.

As we note later, London's current performance might be considered heroic in domestic historical terms. But compared to other key global cities its recovery has been almost reassuringly pedestrian.

Lettings market update

The boom in the sales market is reflected by an almost identically upbeat picture in the rental market. Rents have jumped by 25% since their low point in June 2009, highlighting the dramatic turnaround in landlords' fortunes since then.

While the summer of 2009 was categorised by an oversupply of properties and weak demand from tenants, the picture now has reversed, with demand for good properties far outstripping supply. Increasing competition between tenants has, in turn, boosted rents.

Landlords are renegotiating rents while supply remains so constrained. There is evidence that some owners are choosing to sell their property and rent instead, taking advantage of record sales prices. With these sales going to new entrants to the sales market – especially overseas buyers – this process is adding to rental demand but is not aiding the supply of rental property.

There appears to be increased demand from those working in the financial and professional services, as the City rebounds from the worst of the recession. Evidence also suggests a number of European tenants are choosing to relocate to London to escape the economic turmoil in their own countries.

The pace of growth may have slowed slightly in the second quarter, but we expect rents to continue to rise due to the supply shortage.

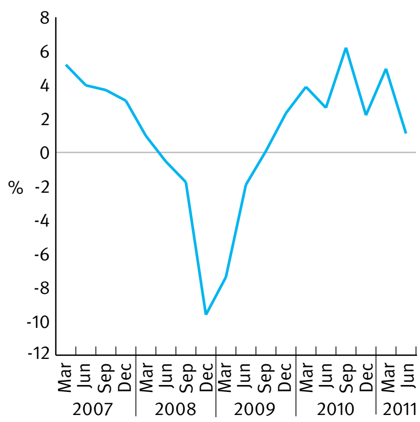
Lettings market conditions

Conditions in the prime London rental market have favoured landlords for almost two years. The post-crash oversupply of rental stock disappeared during 2009. As a result, in the first seven months of 2011 the volume of new rental instructions was running approximately 35% below the level seen in 2008 and 2009.

Figure 4

Rents still rising

Prime London rental performance, 3-month growth rate



Source: Knight Frank Residential Research

That said, there has been a recovery in supply from last year's low point. New rental instructions were 13% higher between January and July 2011 compared to the same period in 2010. There appears to be a prospect that rental stock could rise more substantially over the next few months – with inspections of potential new rental properties between May and July running at 45% above the level seen a year earlier.

On the demand side new applicant registrations are rising steadily after a very weak start to the year. The first quarter saw new applicant volumes slip by 12% year-on-year to their lowest level for four years. More recently there has been a surge in new tenant registrations – with an annual rise of 16% between May and July – taking registrations in this period to their highest for five years.

The balance of supply and demand still favours landlords, with the ratio of new applicants to new instructions, which hit a low of 2.6 in 2008, still holding up above 4, at 4.1 between January and July this year, only marginally down from the peak of 4.6 in 2010.

The number of tenancies started in the three months to July rose by 13% year-on-year, but the pipeline of tenancies agreed, which is up by nearly 50%, suggests new lettings volumes will rise steadily through the third quarter.

What next for investors?

The context for this edition of our London Review is a remarkable combination of positive noises from the sales and lettings sectors, the upshot being that demand from investors has been steadily rising throughout 2011.

These investors will be cheered by the fact that the investment banking job cuts announced in July have so far had no discernable impact on the market in terms of demand for rental stock.

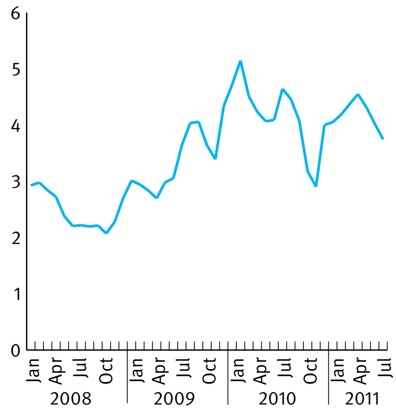
Figure 6 illustrates the volume of newly available 'City' job vacancies from Morgan McKinley. While still 25% lower than the level seen during the period immediately prior to the Lehman crash, this indicator has steadily been moving higher over the past two years. Investors will want to monitor this measure. It seems possible for conditions in the employment sector to become more difficult, especially if the recent stock market volatility and global debt concerns are a presage for a second recession in the City.

In figure 7 we provide a view of the tenant base across prime London in the first seven months of 2011 compared to the same period in 2010. The importance of global demand in the rental sector is even more pronounced than in the sales sector, with almost six out of 10 tenants coming from overseas.

Tenants from Asia-Pacific have risen in importance this year, doubling their representation in our table of top 15 nationalities. However, as a proportion of the overall market, European tenants have seen the largest growth. This reflects the demand for accommodation from smaller banks and financial organisations from Europe who have been setting up or expanding operations in London over the past two years.

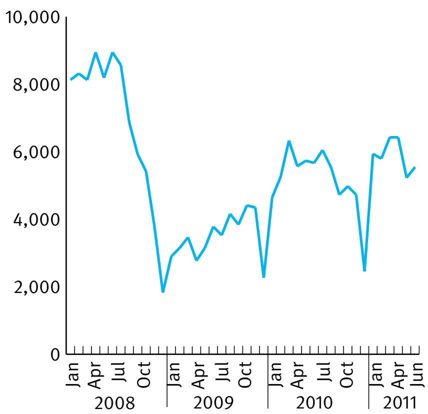
Knowing your tenant is a critical issue for investors. The growth in demand from European tenants has driven demand for unfurnished accommodation, likely to be let for 12 to 24 months, while the new Asia-Pacific tenants have led a trend for furnished accommodation. This requirement suits employers who are increasingly placing employees in London on short-term contracts while the current bout of economic uncertainty lasts.

Figure 5
Landlords market
Ratio of new prospective tenants to new lettings instructions



Source: Knight Frank Residential Research

Figure 6
City employment recovery continues...slowly
Central London financial and business service employment vacancies



Source: Morgan McKinley

Figure 7
Know your tenant
Top 15 prime London tenant nationalities, 2010 and 2011

2010		2011	
40%	UK	UK	42%
15%	US	US	14%
6%	France	France	5%
3%	Germany	Italy	3%
2%	Australia	Russia	3%
2%	India	Germany	3%
2%	Italy	Spain	3%
2%	Spain	Australia	2%
2%	Russia	India	2%
2%	Sweden	Ireland	2%
2%	Netherlands	Sweden	1%
2%	Canada	Netherlands	1%
1%	Ireland	Canada	1%
1%	Norway	Japan	1%
1%	Switzerland	China	1%

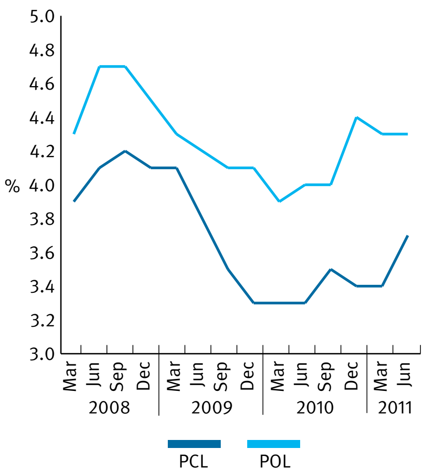
Asia-Pacific North America Europe

Source: Knight Frank Residential Research

Despite the high levels of capital value growth in London over the past two years, investors have been looking at higher investment yields (figure 8). In both prime central and prime outer London gross yields have been pushed higher by rapid rental growth, moving from 3.3% to 3.7% in central London over the 12 months to June 2011.

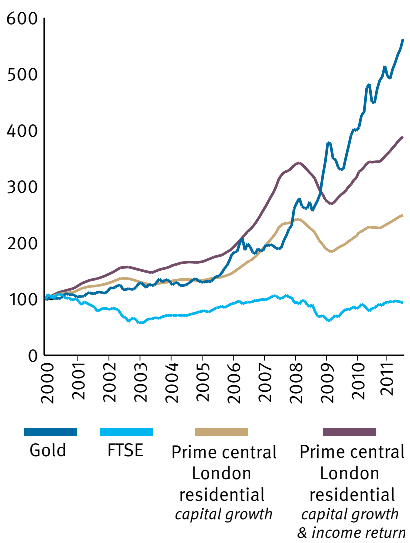
Our view is that rental growth should continue in the prime London markets. Rents have surged recently, by 15% in the last 12 months. Over the long-term, however, rents have not kept pace with average earnings growth in London, meaning that renting prime property is cheaper now than it was a decade ago. Our forecast points towards above-inflation levels of rental growth over the next two to three years.

Figure 8
Gross yields
Gross income yield on prime London property



Source: Knight Frank Residential Research

Figure 9
Gold standard
Investment returns indexed from January 2000



Source: Knight Frank Residential Research

How does prime London property compare against other investment options? In figure 9 we have compared prime London property returns against equities and gold over the last decade.

In terms of competition from the equity market, represented here by the FTSE 100, we can safely say there hasn't been any. Gold is a different issue. In the eight years running up to the global financial crisis, London prime property (capital and rental returns) outpaced returns from gold. Since 2008 gold has outpaced prime London property returns by some margin.

The one element we have not allowed for in figure 9 is the ability to borrow against property assets – an option which would substantially improve the return on equity profile for prime London property ownership over the period.

In summary our forecast for both capital and rental prices are for continued growth for the rest of this year and also for 2012. It would be unfair to ignore the numerous dark clouds and even storms on the horizon which threaten London's property market – but for the moment the prime residential sector remains a very bright spot in a troubled world.

Global city performance

How does London's prime market bounce compare with the performance of the other key international cities?

In figure 10 we have assembled data from Knight Frank's unique Prime Global Cities Index which provides a telling context for our analysis on the luxury market in London. In the two years to Q2 2011, price growth in London stood well ahead of key western city markets, but lagged the remarkable performance seen in Asia.

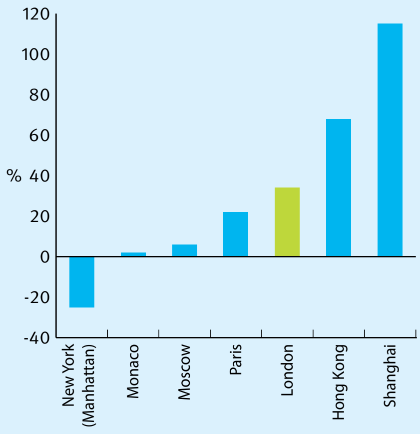
New York's lacklustre performance is explained by a much more savage downturn in the Manhattan market following the Lehman collapse, which took much longer to reverse than was the case in London. Additionally, in the absence of a significant decline in the dollar's value in 2009, there was no driver for a boom in international purchases in the city.

Paris is interesting in that a very quiet period in 2009 and early 2010 has been replaced in the last 12 months by a much more active market which has seen significant price growth. The 'Arab Spring' has contributed to demand from that region for Parisian property, mirroring the trend in London.

Asian markets have boomed on the back of economic growth and escalating demand. Despite these compelling drivers of price growth, the very high rates reported in both Hong Kong and the main Chinese cities raise obvious concerns over the sustainability of pricing and the risk of speculative bubbles.

To follow trends on all of these key global markets follow our analysis at: KnightFrank.com/GlobalBriefing

Figure 10
Global city performance
Prime residential price performance, Q1 2009 to Q2 2011



Source: Knight Frank Residential 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

Front cover image: Hereford Square

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