RESIDENTIAL RESEARCH

SPRING 2010

LONDON RESIDENTIAL

Review

Knight Frank

HIGHLIGHTS

London's prime residential market ended the decade with a snarl, shrugging off a populist attack on 'City' bonuses and brushing aside a lacklustre economy with contempt. In this, our first review of the year, we provide our insight on how the maelstrom will develop in 2010 and beyond.

In light of the recent strengthening of Sterling we explore the continuing foreign demand for property in central London, and in addition provide our traditional round-up of key market data and trends.

With an update on the luxury development sector, through to our views on the performance of the lettings market, and with a brief detour into global asset bubbles, this is your definitive briefing on the world's most exhilarating residential market.

The prime London market in 2010

In the space of little more than 12 months we have seen a shift from a near market meltdown to boom rates of price growth – the prime London market's capacity to surprise remains undimmed, comments Liam Bailey, Knight Frank's head of residential research.

Our view last January was that prime central London prices would fall by between 5% and 10% over the course of 2009. They did, they fell by 7%. But this price fall took place in the three months to March. After that prices began to move rapidly upwards. [see figure 1]

By last April the combined impact of ultra-low interest rates, government stimulus, and rising confidence from buyers – about their own and the economy's prospects – served to push prices higher, with 13% growth in the nine months to December.

Predicting future market performance, as we discovered last year, is a hard task at the best of times, when the ground rules that the market operates within are subject to imminent review there is an additional reason for caution.

The market has the ramifications of an imminent and potentially decade-defining general election to mull over, not to mention the great unknowns of life post-quantitative easing.

As we stand, at the beginning of the 2010 spring market, there still seems to be considerable life left in the recovery in pricing. While buyers are back in force, vendors are few and far between, creating a significant imbalance between supply and demand. Slim pickings are the fuel that has been driving this market bounce.

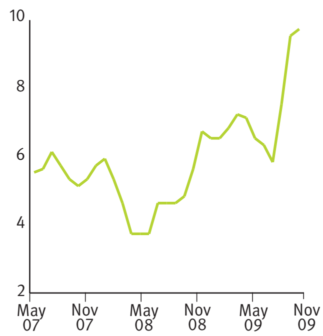
We are seeing increased demand in pretty much every price bracket, particularly the £2m-£5m 'City' segment. In fact, our figures suggest that applicant volumes in January were 15% above their five-year average. On the flip side, most of our offices have stock levels 15% to 20% below normal for the time of year. Some have seen declines of 30% or more. [see figure 2]

Anecdotally, the real problem for agents has been in encouraging prospective vendors to commit to a meaningful relationship. There are lots of people playing the dating game, inviting agents into their lives to inspect their homes and provide indicative asking prices, but when it comes to commitment they are still wavering.

Figure 1
A remarkable recovery
Annual price growth, prime central London (12 month % change)

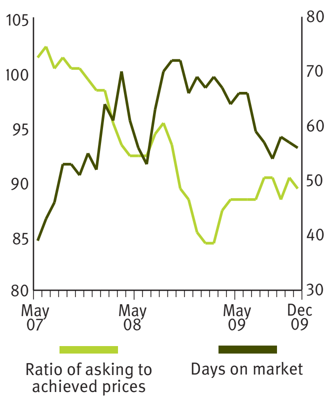
Source: Knight Frank Residential Research

Figure 2
More buyers, fewer properties
Ratio of new applicants to newly available properties, prime central London (%)



Source: Knight Frank Residential Research

Figure 3
Improving indicators
Ratio of asking to achieved prices, and average time between commencement of marketing and under offer date
(%) (Days)



Source: Knight Frank Residential Research

There are several reasons for this delay. The election is cited by some reluctant vendors looking for reasons not to take the next step. For others, however, it has galvanised them into action with the belief that early 2010 is a good time to sell – a window of opportunity before the election campaign starts.

The lack of stock in the market can create something of a vicious circle, with prospective vendors waiting until they can see a wide range of choice for their next move before committing to a sale of their own property.

There is also a degree of nervousness regarding the likely impact on London's economy following the withdrawal of the government's multi-billion pound economic stimulus package. More importantly it is the ongoing machinations around bonus payments that has provided a reason to delay for vendors and also to be fair for a good number of purchasers.

A growing concern for agents is heightened vendor expectations. Buoyed by heady talk of price increases, some vendors are beginning to request that asking prices are set at close to, and even above, peak levels again. With achieved prices rising and the average ratio between asking and achieved prices narrowing [see figure 3], there are some clear arguments in favour of a more ambitious stance. In reality, for anything other than perfect properties, this is a risky strategy as the market has not been truly tested by a well-stocked larder. If supply does rise it could serve to hold those ambitiously priced properties on the market.

Despite the uncertainties, sentiment in the market is, if anything, probably more positive now than it was even six months ago. There is a feeling that London has weathered the economic storm, although some jobs may have been lost to Geneva. Buyers, both domestic and foreign, of which more later, are still more than willing to commit to purchases.

Eventually, however, more stock is required if we are to achieve some measure of stability – strong transactional activity is a prerequisite of a healthy market. After a tumultuous rollercoaster ride that has included the 2005-2007 boom, the 2008 crash and the 2009 revival – it might be desirable to see slightly more stable conditions.

The hope is that the election, and subsequent budget, will provide a degree of certainty regarding the regulation of the financial services sector and taxation – both of critical importance to the London market.

New developer activity

Up until 2008 one of the most important sources of high-quality property coming into the central London market was the small-scale luxury developer. Over the past decade countless period houses and flats were professionally overhauled – bristling with technology and gadgets, pumped up with basement and roof extensions, underground swimming pools, car lifts and quarry loads of granite and marble.

The market bust killed this trend. Overnight developers found they had spent too much acquiring refurbishment projects at peak prices; at the same time they found that bank funding had dried up. The result was that this important source of high-quality supply all but closed down.

In the last six months there has been some good news from this market at long last. Some developers found that rising prices alone came to their rescue, and schemes which were unviable a year ago – suddenly started to stack up again. For others it was a case of private equity coming into the market to provide the capital needed to complete projects. Either way, from Mayfair to Chelsea we can expect to see a trickle of some stunning properties coming into the market over the next 12 to 24 months – plugging what has been a significant gap for estate agents.

The prospects for continued price growth in central London, particularly at the mid to upper end look good. With thin stock levels and healthy demand there is room for further growth and we stand by our forecast for a conservative 3% increase in prime London prices in 2010.

Global city revival

A year ago a weak pound, together with house price falls, encouraged international buyers to rekindle their love affair with the central London market. But now, with prices rising and sterling strengthening is the relationship turning sour?

There is no doubt that the opportunity of effective 50% discounting (due to currency swings and price falls) in early 2009 kick-started London's international market. However the impact of recent price rises and a more expensive UK currency have been minimal on this burgeoning demand source.

Compared to the relative pricing and currency position two years ago, Australian, Chinese, Eurozone, Hong Kong, Israeli, US, Swiss and Middle Eastern buyers are still able to achieve an effective 30% reduction in price for their London purchase. [figure 4]

If we take our comparison over one year, since the beginning of 2009 the position is rather different; London property for foreign currency purchasers has risen in value by 7% for Euro buyers, 16% for US Dollar buyers and 24% for those using Russian Roubles.

Despite this recent upward shift in cost, the most significant trend has been for the spread of nationalities to widen and for the market share of overseas buyers to grow. In Kensington, for example, there has been ongoing interest from Russian and Middle Eastern buyers. In Belgravia, where 60% of buyers are international, there is significant interest from Indian buyers, Kazaks and Italians, among others.

In Mayfair there has been the arrival of the much anticipated Chinese buyer. It is still early days, but the requirement for these new entrants into the market is for discreet negotiations over centrally located, high-quality, new-build apartments. The pattern the new wealthy Chinese buyers are following seems to be that set by the Russians who first arrived in strength almost a decade ago.

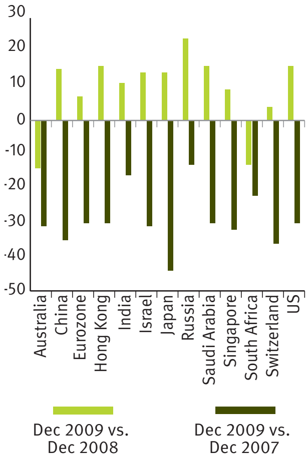
Asian interest is not just limited to those from mainland China, Hong Kong buyers are back in force – particularly in Canary Wharf – and we have begun to see Malay and Thai buyers enter the market for the first time at the mid to top end (£5m-£10m) price bracket.

In 2009 international buyers made up 45% of all central London purchasers above £2m, above £5m the proportion reached 60%. The most important individual nationalities were Russians (14% of all international buyers), Italians (11%), US (9%) and the French (7%).

The European presence in London has grown steadily year on year, accounting for 36% of all international purchases last year. [Figure 5]

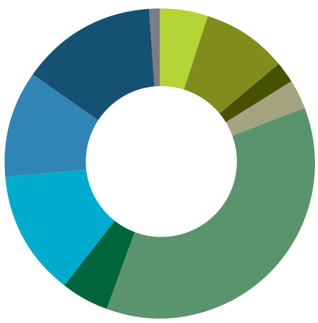
Who are the international buyers? They divide into two broad camps. Firstly, about half are broadly related to London's financial and professional services cluster – these are the knowledge workers who populate Mayfair, the City and Canary Wharf by day.

Figure 4
Currency play
Relative change in prime central London prices, taking account of price and currency shifts (%)



Source: Knight Frank Residential Research

Figure 5
Global market
Split of prime central London buyers by main world regions and countries 2009



Africa	5.0%
Asia	9.0%
Australasia	2.0%
CIS	3.0%
Europe	36.0%
India	5.0%
Middle East	13.0%
North America	11.0%
Russia	14.0%
South America	1.0%

Source: Knight Frank Residential Research
Note: Figures may not add up to 100% due to rounding

The other half are the 'principals', from across the world who own and run oil or commodity businesses and industrial companies.

Where the first group are mainly contained in the £1m-£5m bracket – with some senior managers looking up towards the £10m or £15m level, the second group start at £5m and at the upper end have in effect no limit.

There has been considerable speculation regarding an exodus in the opposite direction as increased taxes and curbs on bonuses are predicted to send London's bankers scurrying to more favourable destinations overseas. Our experience is that while some hedge fund bosses and other financial specialists are looking to move to Switzerland, they seem committed for now in keeping their London properties. In many cases it took them an age to move around London to find their perfect house, and now they have discovered it they are not particularly keen to sell up.

The evidence from the market over the past 12 months seems to suggest that London is still able to attract foreign wealth. It appears that increasingly arbitrary taxation and a near bankrupt economy have not dimmed the appetite of foreign buyers for the capital's best properties. Indeed it seems difficult to envisage what would be needed to put them off.

Lettings market activity

The huge surplus of rental properties that appeared a year ago, as prospective vendors became landlords in the falling market, has all but disappeared. At the most extreme point our lettings teams saw a 150% increase in stock levels, but by January this year the situation has reversed, and the year has started with 15% fewer properties available than normal.

Where has the supply gone? Anecdotal evidence would point to the steady transfer of former rental properties back into the sales market. Between May and December last year, the army of forced landlords saw that they were able to sell into a rising market as their original six or 12-month tenancies fell in.

If stock is low, the opposite is true of applicants – who are back in the market in some strength, up 20% on this time a year ago. Corporate demand is a particular bright-spot, with a 20% uplift in requirements year on year, led by the legal and financial sectors.

The monthly ratio of new prospective tenants to new properties has averaged 2.8 over the last five years. With the rapid growth of stock in 2008, the ratio fell to 2.1 in that year. In 2009, as landlords left the sector and entered the sales market, and as tenant volumes picked up, the ratio peaked at 4.0 in August as employees began to search for accommodation for the traditional autumn new starters peak. At the current time the ratio is standing at 3.1.

As usual the £500 to £1,500 per week segment, comprising 71% of total prime lets in 2009, provides the largest share of tenant demand. Although international tenant requirements are increasingly noticeable at higher rental brackets, with Australians and Russians prominent in Mayfair in recent weeks. In south-west London the significant European and US demand has increased again over the last six months.

The result of the greater balance between supply and demand is that rents have begun to rise again. After falling 20% in the year to June 2009, they then recovered in the final six months of last year by 2.4%. Our view is that the dearth of stock will see rents climbing further this year. In fact, for the better properties in west and south-west London 10% might not be unrealistic for rental growth over the year.

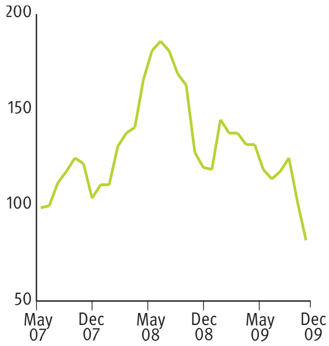
The same problems that have bedevilled the sales market over the past few months are now developing in the lettings sector. Tenants are having to adjust to the need to compete for good quality properties. In the corporate sector managing new tenants' expectations has become a significant issue; when new arrivals come into London their reference point is the rents their colleagues paid a year ago – suddenly they are having to accept that similar budgets do not stretch as far.

Investor attitudes

The London investor market contains a wide range of landlords, each following their own investment strategies. One group that has become increasingly important in terms of acquisition activity in recent years has been the 'semi-professional investor'.

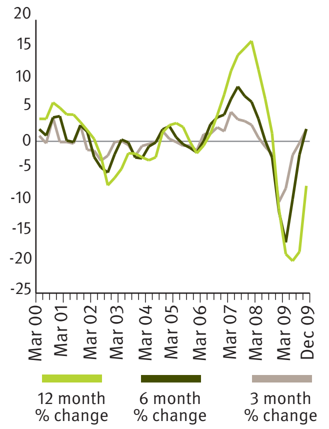
These investors are generally affluent professionals, particularly from the financial services sector, looking to build portfolios of between £1m to £10m. They have been active over the past six to nine months,

Figure 6
Decline in rental supply
Index of supply of new properties to rent, prime central London (May 2007 = 100)



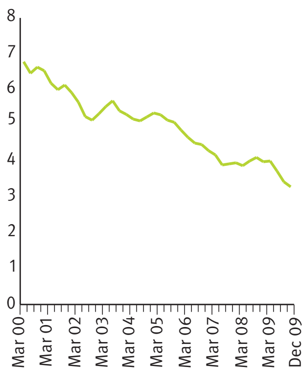
Source: Knight Frank Residential Research

Figure 7
Rental recovery
Prime central London rental change (%)



Source: Knight Frank Residential Research

Figure 8
Falling returns
Gross yields for prime central London (non-investment grade stock %)



Source: Knight Frank Residential Research driving demand for un-refurbished stock and smaller investment blocks.

The objective for most of the investors in this market is to achieve good capital growth over the medium-term, with a five to seven-year hold a typical investment timeframe. Ideally, they look to add value to their properties through extensions or improvement works. Recent feedback from these investors suggests that while their outlook diverges in terms of capital growth potential for 2010, their views are optimistic with regard to the medium-term outlook.

Interestingly, their stance on the London market has shifted over the past three months and most have become very positive on London's longer term potential as a prime market location. With many enjoying a high-level inside track on the financial sector – they feel the risks to the City are over-played and are very upbeat on longer term demand trends.

These investors are generally targeting a 5.5% gross yield on their investment purchases, down from 6% and above a year ago. With rents beginning to edge up and potentially a slowing in capital appreciation in 2010 there is the expectation that yields will push higher through the year. Away from investment grade stock, prime properties yields have slipped again to sub 4% following the capital price growth we saw in 2009.

Global markets

The last 12 months have seen a considerable improvement in performance of housing markets, here in London and across the world. However, the speed of this recovery and its apparent reliance on ultra-low interest rates and government stimulus points to the need for caution.

First, the good news – house prices are rising in lots of countries, 20 out of the 37 we monitor in our Global House Price Index saw price growth in 2009. Even in locations where prices are falling, such as Spain, Dubai and Ireland, they are doing so at a much slower rate than they were a year ago.

In fact, the bounce we have seen in central London prices has been replicated in prime locations in cities across the globe – Hong Kong (up 40% during 2009) and Singapore (17%).

With the global market seemingly moving back into balance – can we assume that the 2008 market crash had its effect and that prices are back to sustainable and affordable levels?

How is it possible so soon after the recent downturn that markets could have become so buoyant again? In fact, it is not just property markets which have succumbed to this exuberance – equities and commodities have seen prices pushed up sharply over the past 12 months.

It appears that increasingly arbitrary taxation and a near bankrupt economy have not dimmed the appetite of foreign buyers for the capital's best properties.

The answer to the above question is that it is government stimulus, through rock-bottom interest rates and the creation of money through quantitative easing that has led to an injection of liquidity into the world economy, which inevitably has found its way into asset markets, including property, gold and shares.

Low interest costs have protected potentially distressed owners of property and reduced the supply of property for sale. At the same time low savings rates have encouraged the wealthy to move investments out of cash and into property in the search for acceptable yields.

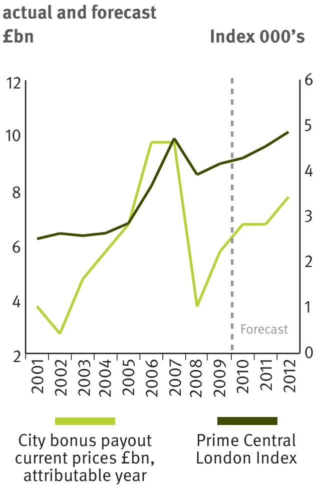
This has driven demand for property higher, and when set against tight supply this has pushed values upwards in many locations.

Over the next few months we will see the beginning of the unwinding of these stimulus measures, with an end to quantitative easing and potentially rising interest rates in the face of resurgent inflation. It is only when we see the retrenchment of government support that we will be able to understand the true level of market resilience.

Figure 9
Sales boom
Aggregate value of monthly sales, selected Knight Frank prime central London offices, indexed, May 2007 = 100

Source: Knight Frank Residential Research

Figure 10
City bonuses and prime property
Annual City bonus pool and Knight Frank Prime Central London Index, actual and forecast



Source: Centre for Economic and Business Research, Knight Frank Residential Research

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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

Front Cover image: 1 Paultons Square, SW3, currently for sale with our Chelsea office, please contact James Pace for further information.