RESIDENTIAL RESEARCH

SPRING 2012

LONDON RESIDENTIAL REVIEW

Knight Frank

HIGHLIGHTS

- Prime central London sales prices increased by a further 1.1% in March and have now risen by 11.3% over the past 12 months
- The volume of sales agreed was up 42% across prime central London in Q1 2012 compared to the same period in 2011, with the £5m+ bracket performing particularly well, up 93%
- Rents fell 0.1% in March, and have been falling since October 2011
- The six consecutive monthly falls total just 0.8% and Q1 rents were still 1.2% higher than they were in Q1 2011
- The £500 to £1,500 per week rental sector is performing much more strongly than the £1,500+ sector
- The new 7% and 15% stamp duty rates introduced in the Chancellor's recent Budget speech do not appear to be significantly impacting the prime London market, though we are seeing more negotiations around the £2m price level

INTRODUCTION

While prime central London's average sales prices continue to rise, hitting new record highs, rental values have been falling back for six consecutive months on the back of uncertainty in the City employment market and reduced corporate relocation budgets. Liam Bailey, Head of Knight Frank Residential Research, examines the numbers.

Liam Bailey
Head of Residential Research

Sales prices rise at the highest rate since May 2011

Property took centre stage in the run up to the annual Budget on 21 March, with a debate raging between political parties about a possible property tax on homes worth more than £2m (see pages 4 and 5).

But the rising level of speculation over property and wealth tax changes failed to dampen demand for central London's most desirable properties. The appetite for them has in fact grown.

Evidence from our Prime Central London Sales Index activity indicators confirms this – new applicant volumes rose 26% in the three months to March this year, compared to the same period in 2011.

The number of sales (subject to contract) were up by 42% in Q1 2012 compared to 2011, while activity in the £5m+ bracket has been particularly buoyant, up 93% over the same period.

But supply has once again failed to keep pace, with new instructions up by just 12%. The problem is even more pronounced in the £5m+ bracket, with new instructions down by 11%.

These positive indicators have contributed to prices rising in March by a further 1.1%, the highest rate since May 2011, when prices increased by 1.4%.

Prime central London property prices have been rising strongly for three years, on the back of foreign demand and London's status as a safe haven for investors.

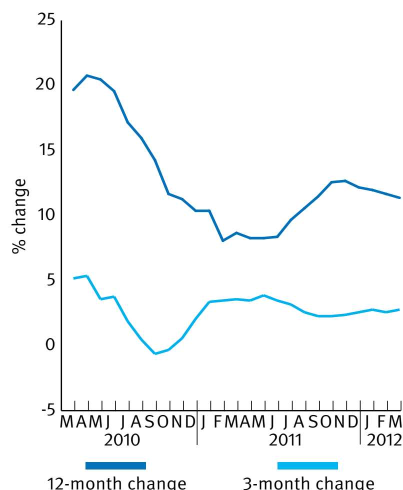
The strongest rises in Q1 were seen in the £1m to £2.5m price band (+3.2%) and the sub-£1m band (+3.1%), while the £10m+ bracket saw the smallest rises (+1.5%).

Among the areas to see the fastest price growth were Marylebone (+7%), South Bank (+3.5%) and Knightsbridge (+3.4%).

Apartment prices have risen more than house prices (+3% and +2.5% respectively).

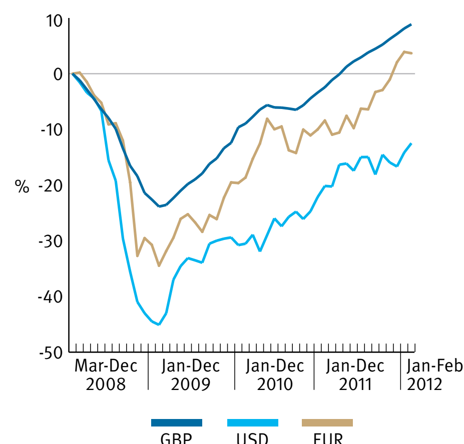
> "Prime central London property prices have been rising strongly for three years."

Figure 1
Annual and quarterly growth
Prime central London average residential price change



Source: Knight Frank Residential Research

Figure 2
Dollar based buyers capture "bargains"
Prime central London average discount from March 2008 prices, allowing for currency fluctuations



Source: Knight Frank Residential Research

Prime central London rents decline as central London employment weakens

While demand and supply in Q1 2012 were both up on last year (new tenant registrations are up 15%, viewings are up 23% and property instructions are up 34%), the number of tenancies commenced has fallen by 7%, indicating that potential tenants are looking but are reluctant to make firm offers.

This weakness in the market can be explained, in part at least, by the relatively poor job prospects in the City – confidence was particularly low in late 2011 and this has continued through to 2012. According to the latest figures from Morgan McKinley's London Employment Monitor, job vacancies across London's financial services sector fell by 8% from February 2012 to March 2012. Compared to the same month last year, this was a decline of 57%.

As well as individuals reducing the amount they are willing or able to spend on rent each month, many companies have slashed their corporate relocation budgets. This could explain why the £500 to £1,500 per week band has once again performed better than the £1,500+ sector (prices are up 1.5% and down -1.2% respectively over the past year).

Furthermore, tenants are increasingly choosing to renew existing contracts.

The market could however receive a welcome boost over the coming months as London hits the global spotlight and people from around the world choose to spend their summer here. Some international companies have even been enquiring about the availability of entire apartment blocks to short-let over the summer.

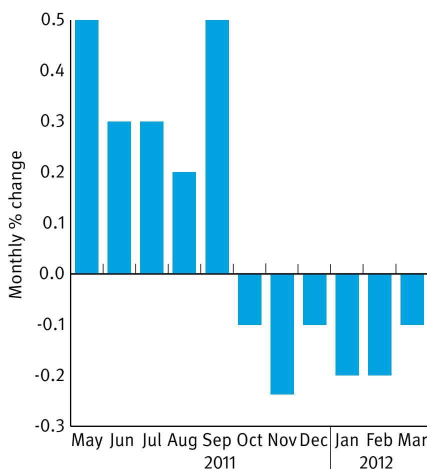
It is also important to note that rents hit an all-time high in October 2011, having risen by 26.9% since mid-2009. We therefore believe that recent falls represent the market adjusting to a weaker short-term economic environment. We remain of the view that rents can still rise by around 1% over the course of this year.

> "It is important to note that rents hit an all-time high in October 2011, having risen by 26.9% since mid-2009."

Figure 3

Rents fall six months in a row

Prime central London average residential rental change



Source: Knight Frank Residential Research

Know your tenant

Top 15 prime London tenant nationalities, past 12 months

Nationality	Share
United Kingdom	41%
US	14%
France	4%
Italy	3%
Russia	3%
Germany	3%
Spain	3%
Australia	2%
India	2%
Netherlands	2%
China	1%
Japan	1%
Canada	1%
Sweden	1%
Norway	1%

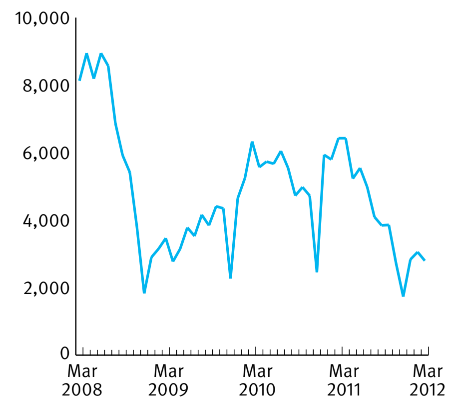
Asia-Pacific North America Europe

Source: Knight Frank Residential Research

Figure 4

City employment recovery stalls

Central London financial and business service employment vacancies



Source: Morgan McKinley

Figure 5

Prime London annual price growth forecast

	2010	2011	2012	2013	2014	2015	2016
Prime Central London Rental	15.7%	6.5%	1.0%	5.0%	6.0%	4.5%	4.5%
Prime Central London Sales	10.3%	11.0%	5.0%	0.0%	4.0%	6.0%	7.0%

Source: Knight Frank Residential Research

The new stamp duty regime

After a long period of speculation, the government's new approach to property taxation has been confirmed, including several changes to Stamp Duty Land Tax. In short, if you buy expensive residential properties as individuals rather than a company you will pay 7% rather than 15% stamp duty and avoid a future annual charge.

The most obvious question is: will prices above £2m fall in response to the new rate? There has to be an element of price adjustment, and we are already seeing tough negotiations around the £2m level. It is important to bear in mind that prime central London prices have risen by 42% since 2009, with no pause in the increasing values following the introduction of the 5% £1m+ SDLT rate in April 2011. It seems unlikely therefore that the new 7% rate will result in dramatic price changes.

There is a bigger question around the tripling of the stamp duty paid by 'non-natural persons', from 5% to 15%. The objective is obviously to ensure that wealthy purchasers are not tempted to use off-shore companies or similar structures which are difficult for the UK authorities to track over time. But although tax may be the reason behind this approach in some cases, privacy is the main benefit of this route for many wealthy buyers.

The government said it will also consult on the introduction of an annual charge on residential properties valued £2m+ and owned by non-natural persons. The combination of these two changes to purchases by non-natural persons may dissuade some buyers from this route, and for some purchasers this will undermine the attractiveness of the UK as a home for their investment capital. It is far too early, however, to try to quantify the potential impact in terms of purchaser numbers.

Aside from pricing, the evidence from previous stamp duty hikes is that rising rates encourage owners to stay in their properties for longer. There is a greater incentive to improve and extend properties rather than move home.

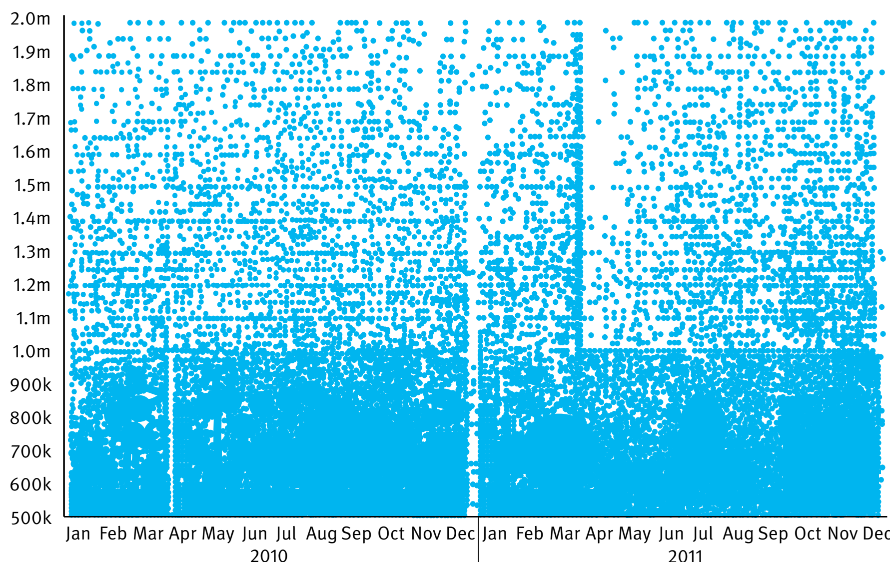
Stamp duty is such a blunt tax that changes to rates tend to have unintended consequences. One trend to watch will be the potential for the prime country house market to benefit from the new 7% rate.

Wealthy London buyers might decide to move out of London, reasoning that a few thousand pounds in commuting costs is worthwhile if, for example, it allows them to buy a house at £1.9m in the country rather than a similarly sized London property for £2.2m, saving themselves £59,000 in stamp duty in the process.

Figure 6

The impact of slab structure stamp duty

Sales by price and date, England & Wales



Source: Knight Frank, HM Land Registry

The impact of 'slab structure' stamp duty

Aside from the arguments as to whether the 7% or 15% rates will diminish London's appeal to wealthy purchasers, there is a broader argument around the impact of stamp duty on market behaviour.

The main problem with stamp duty is its so-called 'slab structure' – the fact that you pay the higher rate on the full purchase price as soon as you move a penny above each threshold. In short it is a clumsy tax which influences market behaviour in all sorts of unforeseen ways.

By way of demonstration, consider the chart below. Based on sales data collected by Knight Frank, the impact of the increase in stamp duty from 4% to 5% on £1m+ properties in April 2011 is fairly clear.

You can see the bunching of sales in the run up to the new rate's introduction, followed by a lull as the market adjusts to the new rate. Then, from summer onwards, £1m+ sales returned to their usual frequency.

What is perhaps not so obvious is the significance of the cliff created in the market at around £1m. Having examined the numbers in detail, allowing for wider market movements in sales volumes, we estimate that in the months following the imposition of the new £1m+ rate, the number of sales in the £1m to £1.05m bracket fell back by 20% from the level we would have expected to see. Even in the £1.05m to £1.2m bracket sales volumes were 10% lower than expected. Unsurprisingly, a significant number of these sales turned up in the £975,000 to £1m bracket.

The lesson from last year's increase to the 5% rate was that market behaviour is significantly impacted by stamp duty, and that pricing becomes much more complicated and negotiations more protracted around each step. Expect more of the same around the new £2m step.

Tax changes

Amanda O'Keeffe and Charles Hutton, partners at law firm Speechly Bircham, explain the implications of the Chancellor's new stamp duty and other property tax changes.

"The changes bring the UK more into line with other European countries, where wealth taxes have already been introduced or are in the process of being applied."

A surprising theme of the Chancellor's announcements on stamp duty was the speed of introduction of some of the new measures. The 7% stamp duty charge on properties worth more than £2m is now in force for all transactions that had not progressed to exchange before midnight on March 21st – Budget day – while the 15% stamp duty charge for properties purchased by corporate entities ('non-natural' persons) came into force the morning before the Chancellor even stood up to deliver his speech – making it retrospective.

The other key measures – the annual charge on properties held in the particular types of companies identified by the Chancellor, as well as the possible capital gains tax charges, will come into force next year. This is probably just as well, as the detail of the Chancellor's plan has been very slow to emerge. It looks as though the rules will also affect companies that hold more than one residential property, although the draft legislation suggests that properties held or bought by trusts will not be affected by the new stamp duty rules. The news CGT rules may however have an impact.

On a broad scale, the ramifications for the UK property market, and the prime London market in particular, are unlikely to be catastrophic. Overseas buyers looking at buying London property in their own name will probably reflect that the 7% stamp duty charge, while a steep uplift from the 4% they would have paid back in early 2011, is still broadly in line with the property taxes charged in other key European and international destinations. Likewise, the other changes bring the UK more into line with other European countries, where wealth taxes have already been introduced or are in the process of being applied.

The shake-up in the rules around owning properties through companies may give those who value their privacy pause for thought. But there are other ways to preserve anonymity when buying a property in the UK, and advisers to international buyers will be able to advise on this. Likewise, there are alternative ways of passing assets onto children in a tax-efficient manner which some buyers or owners may want to investigate, as the inheritance tax benefits of certain company structures is a major draw.

Looking at the other changes to the regime however, including the sudden and steep increase in stamp duty from 5% to 15%, may prompt some investors to reorganise their affairs. The year-long window before the capital gains charges and the annual charges on assets already held within a company means that there is time to do this, and it is possible that some properties, especially at the very top end, which have been held by families for a long time, may come to the market as homeowners take action before the CGT charges come into force in April next year.

The measures will have an effect on the market – overall transactions may slow and like Knight Frank we expect tougher negotiations over price. At the same time, we can see that activity in the sub-£2m bracket is poised to pick up appreciably.

But it is worth remembering that London, and the UK, is still an attractive destination for international buyers and, with careful planning, it will often still be possible to minimise exposure to IHT and CGT. The change in the stamp duty regime has not dented the benefits that draw many buyers to these shores.

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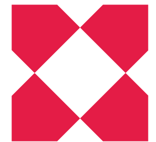

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Knight Frank area definitions – **Prime central London:** Belgravia, Chelsea, Hyde Park, Kensington, Knightsbridge, Marylebone, Mayfair, Notting Hill, Regent's Park, Riverside* and St John's Wood. **Prime London:** All areas in prime central London 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

Front cover image: Hyde Park Gardens

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