RESIDENTIAL RESEARCH

2009

LONDON

Residential development review

Knight Frank

HIGHLIGHTS

- London has not proved immune from the crisis in the residential development industry. New build starts have fallen to unprecedented lows, further widening the gap between the number of new homes being constructed in the capital and the number of new households forming. Supply is particularly constrained in the super-prime sector.
- Demand from City employees will weaken with bonuses in 2009 predicted to be around a third of peak levels – but increasing interest from abroad, triggered by the weak pound, will provide some counterbalance. With prices falling by as much as 40% for new build stock in some secondary locations, gross yields are reaching double figures and investors are becoming more active.
- In this review, we set out the key issues impacting on the London development sector and Alan Benson, Head of Housing and Homelessness at the Greater London Authority (GLA) expands on the thinking behind the Mayor of London's new housing strategy.

DESPITE THE STALEMATE IN THE MARKET THERE ARE STILL HOMES BEING BOUGHT AND SOLD. SEVERAL SUB-MARKETS WILL BE LESS AFFECTED THAN OTHERS BY THE DOWNTURN.

Uncharted territory

When the credit crunch hit the UK in the second half of 2007, the general consensus was that London might escape its effects – or at least prove more resilient to the housing market turmoil that was already being observed across other UK regions. Data from the Land Registry suggests the downturn certainly took longer to take hold in London and the South East. Capital values grew for another three months after the North and Midlands peaked in October 2007. Now, in the first half of 2009, the scale and severity of the downturn is plain to see and no housing market or price bracket can claim immunity.

The extreme difficulty in obtaining a mortgage or development finance, combined with low market confidence, has caused significant problems for the development industry. Sales volumes have fallen by 61% nationally and by 65% in London (Land Registry), while construction starts and completions have reached record post-war lows. The added difficulty for developers is that they are being asked to meet ambitious affordable housing targets and demanding new policy requirements (from zero carbon homes to Section 106 agreements) at a time when their balance sheets are increasingly unhealthy.

However, there are steps developers can take to reduce their exposure to these issues. Many local authorities are aware that Section 106 agreements that were signed before the credit crunch are no longer viable in the current climate. It is vital that developers approach the relevant planning authorities with a view to renegotiating their obligations, particularly with respect to affordable housing and infrastructure. More generally, for landowners, it is a good time to submit planning applications. Government, both local and national, is increasingly concerned about development volumes and a planning application may be treated more favourably – particularly as many officers now have time to treat proposals thoughtfully.

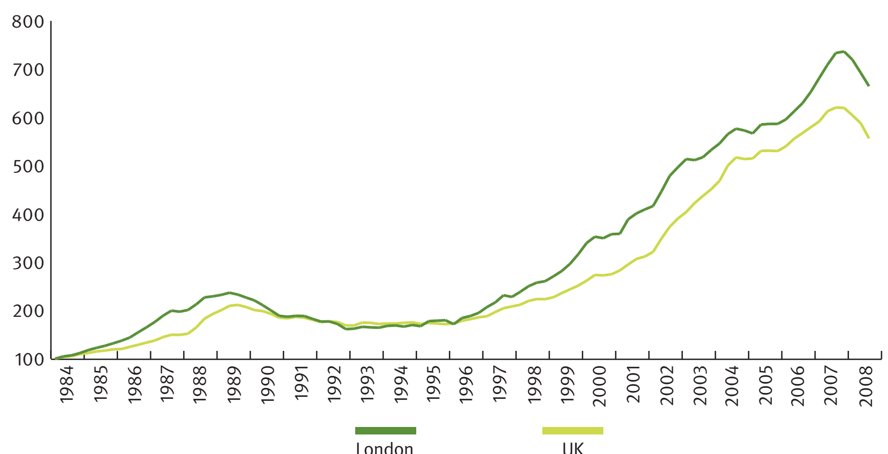
49 The Bishop's Avenue, N2

These steps are vital as, in the long-term, the prospects are improving. Affordability, which for a long time was considered the single factor capable of stifling housing market growth, has now increased as a result of falling house prices. The average house price to earnings ratio for first time buyers in London has fallen from 6.0 in Q4 2007 to 4.9 at the end of 2008 – even before taking into account the discounts available on some new build stock.

As most newly built stock has already depreciated by between 20% and 40%, depending on location, this particular market may be stabilising. Indeed, there were signs of an increase in sales volumes in the first few weeks of the year in response to developers' discounts. Fair value may well be reached in the new build sector well before the remainder of the market and transaction volumes should continue to rise as the year progresses. There could begin to be shortages of stock in certain submarkets as supply dries up.

Land values have also fallen substantially – by as much as 70% in some secondary locations, although 30%-50% is more typical. The differences between neighbouring areas have also been accentuated, with some sites in super-prime areas changing hands for up to twenty times those in more peripheral areas. The land market currently offers significant opportunities for those who have capital or can access finance, and long-term returns are a virtual certainty.

Figure 1
London recovers faster
House price inflation, index linked (100 = Q1 1984)



Source: Nationwide

Meanwhile, considerable energy is being expended on shaping the London of the future. The Greater London Authority (GLA) has published its new housing strategy and there are some ambitious infrastructure plans including the creation of transport hubs across central London and the confirmed funding of Crossrail. Despite the perceived poor state of the market, these could as yet prove to be formative times for the city. Against this background, we ask Alan Benson, Head of Housing and Homelessness at the GLA, to explain the Mayor's key policy objectives.

As well as assessing future demand, supply and policy proposals the remainder of this report will assess the 'here and now'. London's housing market has entered uncharted territory but can developers use the period between now and 2010 to do more than just restructure or streamline their costs? What state is London's residential investment market in and what will be the first indication of a market recovery? We remain confident (based on past performance) that London will experience an upturn before any other UK region (see Figure 1).

Demand and supply

Housing demand in London, certainly up until 2012, will be affected by lower employment levels. The Centre for Economics and Business Research (CEBR) forecasts that 34,000 City jobs will be lost in 2009, while Morgan McKinley's employment monitor reports that new job vacancies in December 2008 were 65% lower than a year earlier (see Figure 2). The CEBR also believes that City bonuses in 2008 totalled £3.6bn, 60% below their 2006 peak of £8.8bn – and indicates that they will fall further, to £2.8bn in 2009. According to the CEBR around 50% of these bonuses are ploughed into the housing market, as a result demand and activity in the prime central London £1m-£5m price bracket will be heavily affected.

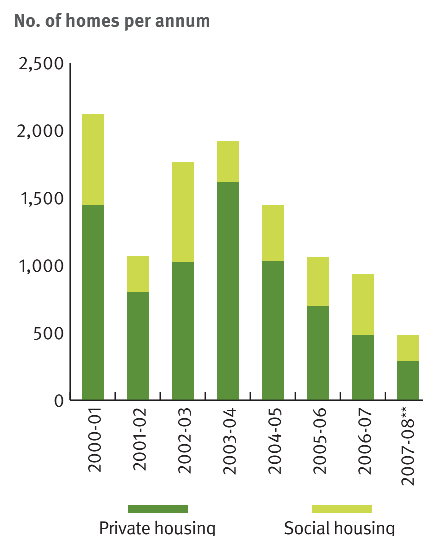
On the positive side, the weak pound is strengthening demand from abroad, particularly from Europe and the US. A fall of 20% in value over the past year translates to 39% and 47% falls if converted to euros and dollars respectively. Consequently, European and American buyers have become very visible in many prime markets. This is likely to continue for some time, although there are predictions that the pound will regain ground against other currencies as the year proceeds.

However, investors are beginning to look very carefully at the market. With yields of as much as 10% achievable in some locations, they are already beginning to buy properties – although they expect significant discounts. As the year progresses, we expect interest to accelerate, as even gross yields of as little as 5-6% will look attractive when compared to current savings rates and the volatile stock market – although buyers of this type of property are likely to be seeking capital gains in the medium-term. Demand for rental stock, particularly in the core market, is likely to remain healthy.

Although rising unemployment, a lack of credit and falling prices are dampening demand for private sector housing in the short-term, projections from the Office of National Statistics (2006 based) suggest that 32,950 new households will be created each year between 2006 and 2026 – a total of 659,000. On the other hand, despite current conditions, supply remains constrained across the capital, particularly in prime locations. London mirrors the national trend, with completions rates now at their lowest level since the Second World War. According to Communities and Local Government (CLG), 400 homes were completed across prime central London* in 2007-08 and 20,740 across Greater London (see Figure 3). We estimate less than 15,000 homes will be built in London in 2009, around 20,000 fewer than the GLA believes London needs.

On this basis, the capital could face a shortfall of more than 60,000 homes by 2012 when the market is expected to recover,

Figure 3
Slowing completions in prime central London
No. of homes per annum



Source: CLG
Note: *Prime central London = the five London boroughs of Camden, The City of London, Hammersmith and Fulham, Kensington and Chelsea and Westminster
**Provisional

Figure 2
The City's employment status
No of jobs/candidates

Source: Morgan McKinley
Note: Job surplus = number of jobs available less the number of current applicants as reported by Morgan McKinley.

potentially provoking another period of sharp growth as a result of the pent-up demand that will accumulate in the interim. The shortfall will be largest in prime central London.

Developers looking to this long-term imbalance in supply and demand and attempting to take advantage of low land values and a more favourable planning climate need to consider what sort of properties will prove popular over the next few years. A range of tenure options, including private rented or 'build-to-let', may need to be explored in the medium-term if revenue is to be realised, particularly as mortgage finance is likely to remain difficult to access for some time. In short, schemes need to be socially and financially sustainable – providing an adequate mix of uses while providing
slower, but more sustainable returns.

The more adventurous should consider how prime London will expand during the next property cycle. The regeneration of King's Cross may help push the boundaries of prime London further east, potentially enveloping parts of Fitzrovia and Bloomsbury. The revival of the Battersea Power Station site by Treasury Holdings will also inject greater dynamism into the SW11 area. In both cases the scale of investment in housing, transport and commercial uses will act as a catalyst for development in the wider neighbourhoods.

Super-prime: still the upside of the downturn?

After a strong run and unrivalled performance in recent years the super-prime sector has peaked in pricing terms. In September 2008 prices began to fall, and by early 2009 the sector was catching up with the substantial price falls seen across the wider central London market.

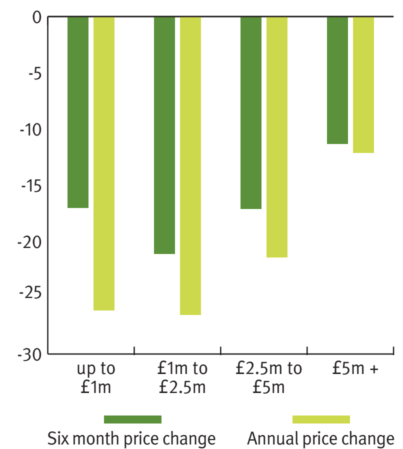
The fragility of the economic climate is provoking differing responses from the international super-rich elite, largely determined by their level of exposure to the financial markets, the structure of their investments and the volatility of their own domestic economies.

For most affluent City employees, the fear of job cuts, gloomy bonus forecasts and weakening commodity prices are likely to dampen their plans to acquire property, be it as an investment or a home. For other high net worth individuals (HNWIs) heading up multi-national companies, they may still have the funds but not the time as their professional operations take priority over house-hunting.

On the upside though, many will continue to generate a multi-million pound income and their recent exposure to the stock market may make them more risk-averse, motivating them to diversify their investments. A tangible asset in the form of bricks and mortar may start to appear increasingly attractive once the super-prime's 'floor' in values is deemed to be reached.

Looking forward, the super-rich demographic is set to expand significantly in global terms,

Figure 4
Price growth in prime central London by sub-market
Annual and six month % change to December 2008



Source: Knight Frank Residential Research

Table 1
London's prime pipeline

Prime new development (selected schemes)

Development	Status	Private Units
Bankside, SE1	Under construction	197
Grosvenor Waterside (Bramah) SW1	Under construction	103
One Hyde Park, SW1	Under construction	86
Lancaster Gate, W2	Under construction	77
Park House, W1	Under construction	39
3-10 Grosvenor Crescent, SW1	Under construction	17
Lygon Place, SW1	Under construction	12
Cornwall Terrace, NW1	Under construction	8
Montpelier Hall, SW7	Under construction	6
St James' Square, SW1	Under construction	6
Lots Road Power Station, SW6	Permission granted	435
Noho Square, W1T	Permission granted	182
Holland Park School, W8	Permission granted	72
Kensington Odeon, W8	Permission granted	40
Alpha Place, SW3	Permission granted	18
Chelsea College of Arts, SW3	Permission granted	17
Shard, SE1	Permission granted	14
Metropole Building, WC2N	Permission granted	12
Chelsea Barracks, SW1	Proposed	278
St John's Wood Barracks, NW8	Proposed	78
20 Grosvenor Square, W1A	Proposed	29
South Audley Street, W1	Proposed	24
158 Brompton Road, SW3	Proposed	12
Libyan School, SW3	Proposed	10
Normandie Hotel, SW7	Proposed	5
American Embassy, W1	Proposed	-
Clearings Site, SW3	Proposed	-
Total		**1,777**

Source: Knight Frank Residential Research

although it may slow over the next few years. The International Monetary Fund predicts that annual GDP growth will enter negative territory in the US, Europe (including Russia) and Australasia. However, while growth in Brazil, India and China will slow substantially, it will remain positive. New wealth generation will continue in these developing countries, which may offset some of the stagnation elsewhere.

Despite increasing demand, the supply of super-prime homes will shrink as premier sites – those close to London's cultural, retail and social amenities and with unrivalled views of the city – are fast becoming a finite resource. Table 1 sets out Knight Frank's assessment of London's prime development pipeline. A total of 1,777 units are anticipated, accounting for only 8% of the London Development Agency's ten year housing delivery target for prime central London (22,450).

Future performance of the super-prime market will be driven by economic conditions – both global and local to London. As usual, quality homes in the most desirable locations will perform more strongly.

Investment: bricks and mortar's enduring appeal

Despite the headlines depicting a depressed and cash-strapped banking and investment industry, London's residential investment market is beginning to attract interest. There is little expectation of rapid capital value growth – most interested parties are approaching it as purely an income-driven play, eyeing low finance costs and the low returns available from other investments.

Some are eager to take advantage of any distressed sales, conscious that when the market does find its floor the best opportunities may already have disappeared. Institutional investors, sovereign wealth funds, property companies with existing finance or lines of credit, HNWIs and recovery or "vulture" funds are largely behind this latent level of activity.

Investors are targeting blocks of reasonably-sized flats in central locations, occupied by professionals and showing income yields that reflect the fall in value of the past year.

Crucially, those properties still being priced at October 2007 values are attracting little or no interest. Acceptable income yields range between 6% and 10%, depending on the location and quality of the investment block, and transactions within this bracket are on the increase.

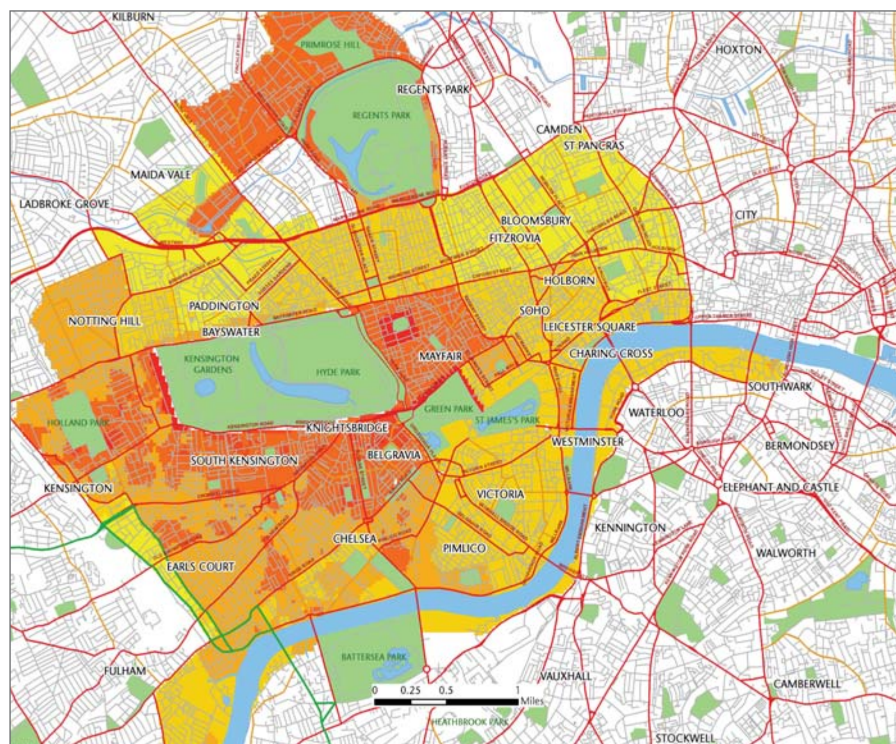
As the security of banks and the risks associated with the stock market are being highlighted so 'bricks and mortar' is gaining ground as an investment asset – its tangibility and proven performance boosting its credentials. Provided it is purchased at a price reflective of market movements, investing in a residential block in a central London location is deemed to provide an income return that will both service money borrowed and provide a small income over the next 18 months. Once capital growth returns to the market there will eventually be capital gain on top of the rental income.

In a low-return economic climate the investment sector could provide a safety net to protect against price falls. Income yields will increase as capital values are set to fall faster than rents. With base rates at unprecedented lows, the market will pass a point where residential investment blocks become an obvious 'buy'. We are approaching this zone right now.

Potential purchasers should bear in mind that once the bottom of the market is reached and price movements become a one-way bet then the opportunity to secure good deals with little competition will have passed.

For those investors considering prime central London, the map opposite shows the values a top specification new home can still achieve.

Development price potential: top specification



Source: Knight Frank Residential Research

Interview

Alan Benson, head of housing & homelessness, Greater London Authority

1. What are the key initiatives proposed by the GLA to kick start London's housing market?

The Mayor recently launched his £3 bn Economic Recovery Action Plan aimed at getting London back on track and through the economic downturn. Not surprisingly, investing in housing is a key element of this Plan.

The Mayor is looking to intervene in London's housing market by:

- Putting measures in place to help Londoners at risk of losing their homes;
- Supporting London's housing development and construction industries;
- Ensuring that London is well placed to increase build out rates as confidence returns to the housing market.

The Plan identifies a number of specific measures from ensuring that Londoners facing repossession have access to support and the opportunity to remain in their homes through to developing new approaches to public sector involvement, such as the sharing of development risks.

2. The creation of an Outer London Commission suggests that there is a concern that development and investment has been too focussed on London's central core in recent years. How do you intend to strengthen the offer and mix of homes in the more peripheral London boroughs?

Housing is not within the remit of this Commission. The Mayor is looking to move to a more polycentric form of development where people live nearer to where they work, and this Commission will advise the Mayor on how to promote economic growth in outer London through the development of new economic sub-hubs.

There is a range of constraints on residential developments in many outer London boroughs. The Mayor is currently undertaking a Strategic Land Availability Assessment which will identify potential residential sites across London. It is hoped that this assessment, together with the work of the Commission, may identify areas around town centres where there is potential to build new homes.

3. How will the borough by borough approach for affordable homes delivery be more effective than the previous blanket threshold that was applied?

I welcome this opportunity to clarify what the Mayor is trying to achieve. These two targets are neither interchangeable nor comparable: we are talking about two different targets, seeking to meet different objectives.

The Mayor will be amending his London Plan 50% affordable housing target as he believes that London boroughs are best placed to decide the overall tenure mix of new housing in their communities. His new approach will be outlined in Housing Supplementary Planning Guidance, to be issued for consultation later this year.

The Mayor is responsible for setting the strategic housing policies for London. As part of this work he is looking to agree with each borough an affordable housing investment target that reflects development opportunities and the increased investment available through the Homes and Communities Agency during this and the next two financial years.

4. What role does the GLA envisage that the rented sector (both social and private) will play in London's future housing market?

The Mayor is committed to developing a range of policies aimed at supporting and improving this sector. Coupled with his commitment to the creation of sustainable communities, in part through the development of mixed tenure housing schemes, there should be opportunities for both the social and private rented market to grow.

An interesting development in London is the growth of intermediate rented housing, under which homes are let at below open market levels (at least 20% below market rents).

The Mayor believes that current housing market conditions offer an opportunity to substantially expand this sector.

5. Does the GLA's drive to deliver more family homes mean we will see lower densities for new development in the coming years?

New residential developments in London have to be built at appropriate densities to meet the demand for housing in a city where land capacity is constrained and open space is valued and protected.

Building family homes is not necessarily synonymous with lower densities. The highly popular Georgian terraces of Islington and Notting Hill have a higher density than recent new homes and successfully house families. Likewise many contemporary European developments demonstrate that family housing can be built at higher densities.

Our challenge is to build higher density family homes that are both desirable and attractively designed. The Mayor's focus is firmly on promoting high quality design.

6. Has the policy on tall buildings altered since the preparation of the London Plan? Will they still be encouraged in clusters across the city and continue to form an integral part of the city's evolving skyline?

The London Plan policies that seek to manage the design and location of tall buildings are to be reviewed to ensure that future development outcomes are in line with the Mayor's objectives. They must be located and designed to be more responsive to local need, character and microclimate, as well as each borough's development aspirations.

The Mayor has already stated that tall buildings could be accommodated in the existing clusters within the City, Canary Wharf and Croydon. The revised London Plan policies will reflect this and his intention to work with the boroughs to identify other locations where they might be suitable.

Conclusion: overcoming the stalemate

The ramifications of the credit crunch are clearly significant and it has exposed the fragility and failings of the global banking and financial model adhered to in recent years. Nevertheless, London's housing market is the UK's most dynamic and responsive when it comes to adapting to changing economic circumstances. The climate is unfavourable but the upturn could still come relatively quickly, particularly as the new build sector appears to be approaching a 'floor' in values.

Much depends on the wider economic situation. Unemployment is increasing and finance remains extremely difficult to obtain. However, attempts to stimulate the economy and lower interest rates may begin to have an effect later in the year. Competition among investors and international buyers may stabilise markets in some sectors.

Logic dictates that prices will stabilise once people are confident they will not fall further. Prices for both prime and new build property have dropped (see Figure 5). In some cases, they are as much as 40% below 2008 values and there are signs of increased interest. The point at which buyers believe fair value has been reached is approaching, but transactions will remain subdued for at least the first half of the year.

The climate is tough for developers and they are having to adapt. Some are approaching housing associations with a view to disposing of surplus stock, others are re-negotiating their Section 106 agreements or re-visiting their planning applications in relation to the mix or housing type. It is difficult to judge to what extent the GLA's new housing strategy, which is in its early consultation phase, will assist developers, but the overall sentiment looks promising in the medium term. An emphasis on family sized homes, a higher income limit of £72,000 for low cost home ownership and a commitment to bring forward public sector land for new development – together these initiatives should, in theory, help strengthen demand and broaden supply.

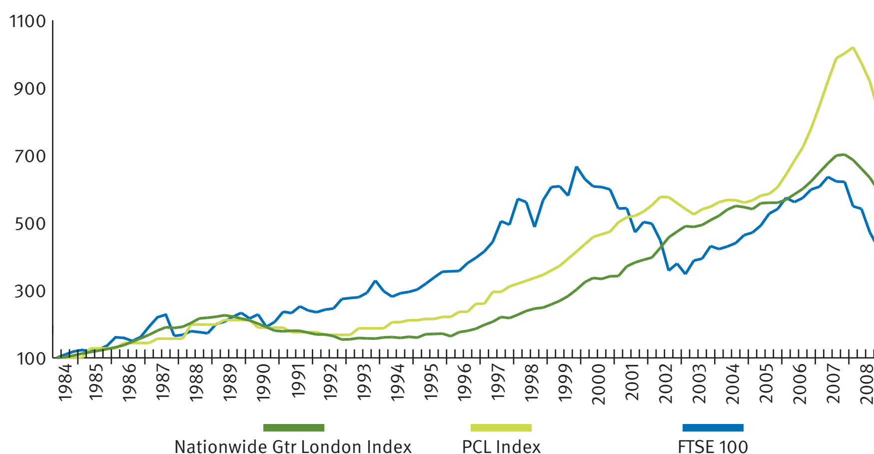
Embassy Court, NW8

For now, for those bold, equity-rich developers who are willing to put their heads above the parapet and continue building, there may be significant dividends when the market does recover, given the scarcity of supply in the city, although some should certainly consider the option of 'build-to-let', dependent on the location and the level of demand.

The key question is when will the market recover and what will be the first signs that the recovery is underway? Knight Frank's assessment is that land values will reach their floor first, probably later this year. Vulture funds and speculative investors are already starting to identify and acquire sites, schemes and properties belonging to forced sellers. As evidence grows of a change in conditions, these funds will be confident that a new willingness to lend will emerge, as banks recognise that the bottom of the market has been reached. This will spur on purchasers and bolster confidence levels.

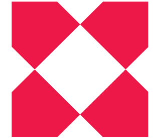
There are two certainties. Firstly, when the market does strengthen it is unlikely to follow a steep line of recovery due to the fragility of the global economy and an inevitable amount of hesitancy and nervousness on the part of lenders, investors and homebuyers. Secondly, London and the South East will be the first to regain the peak values of October 2007. For this reason, everyone with a stake in the UK's housing market will be monitoring London's performance over the next 12 to 24 months.

Figure 5
London markets vs. FTSE 100
Performance, index linked (100=Q1 1984)



Source: Knight Frank Residential Research, Nationwide

RESIDENTIAL RESEARCH



Americas
USA
Bermuda
Brazil
Caribbean
Chile

Australasia
Australia
New Zealand

Europe
UK
Belgium
Czech Republic
France
Germany
Hungary
Ireland
Italy
Monaco
Poland
Portugal
Russia
Spain
The Netherlands
Ukraine

Africa
Botswana
Kenya
Malawi
Nigeria
South Africa
Tanzania
Uganda
Zambia
Zimbabwe

Asia
Cambodia
China
Hong Kong
India
Indonesia
Macau
Malaysia
Singapore
Thailand
Vietnam

The Gulf
Bahrain

Residential Research

Liam Bailey
Head of Residential Research
+44 (0)20 7861 5133
liam.bailey@knightfrank.com

Jon Neale
Head of Development Research
+44 (0)20 7861 1551
jon.neale@knightfrank.com

Residential Development

Stephan Miles-Brown
Head of Residential Development
+44 (0)20 7173 4903
stephan.miles-brown@knightfrank.com

London Residential Development

Ian Marris
+44 (0)20 7173 4904
ian.marris@knightfrank.com

Justin Gaze
+44 (0)20 7173 4907
justin.gaze@knightfrank.com

Charles Leigh
+44 (0)20 7173 4969
charles.leigh@knightfrank.com

Rupert Dawes
+44 (0)20 7173 7945
rupert.dawes@knightfrank.com

Knight Frank Residential Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide including developers, investors, funding organisations, corporate institutions and the public sector. All our clients recognise the need for expert independent advice customised to their specific needs.

Knight Frank Research Reports are also available at **www.knightfrank.com**

© Knight Frank LLP 2009

This report is published for general information only. Although high standards have been used in the preparation of the information, analysis, views and projections presented in this report, no legal responsibility can be accepted by Knight Frank Residential Research or Knight Frank LLP for any loss or damage resultant from the contents of this document. As a general report, this material does not necessarily represent the view of Knight Frank LLP in relation to particular properties or projects. Reproduction of this report in whole or in part is allowed with proper reference to Knight Frank Residential Research.

Knight Frank LLP is a limited liability partnership registered in England with registered number OC305934. Our registered office is 55 Baker Street, London, W1U 8AN, where you may look at a list of members' names.

Knight Frank
Newmark
Global