RESIDENTIAL RESEARCH

SUMMER 2009

LONDON RESIDENTIAL

Review

Knight Frank

HIGHLIGHTS

- In the sales market the situation has improved markedly since the turn of the year. Prices fell in the first four months of the year, but at a much reduced pace. Like-for-like sales volumes are higher compared with the dark months at the end of 2008. The growing problem in the sales market is a lack of stock.
- The lettings market is experiencing the opposite problem – too much stock has acted to push rents down. However, sharply lower capital values have offered new investors the opportunity to secure improved income returns and there has been higher interest from funds and institutions eyeing buying opportunities.
- The critical question hanging over the market is the likely shape and speed of the recovery of London's economy. This issue, together with a review of key data from the sales and lettings markets, is covered in this edition. Finally, we have taken an opportunity to explore the world of corporate lettings – a bellwether for the health of the London market.

IN APRIL, OUR PRIME CENTRAL LONDON INDEX MANAGED TO POST A POSITIVE RESULT, WITH PRICES CLIMBING 0.4% – THE FIRST RISE FOR 13 MONTHS.

Market update

In our previous edition of the London Residential Review, written in January, we noted that 2009 was likely to be the year when house prices in central London hit their low point and began to turn a corner. We also suggested that sales volumes would begin to pick up from the low they hit in late 2008.

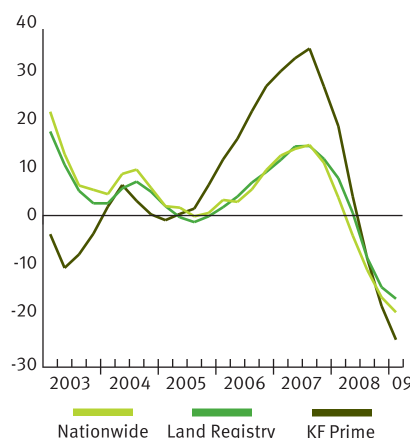
The first four months of the year developed pretty much as we expected. The period of rapid price falls we had seen prior to Christmas came to an end, and whilst prices continued to slide in the first quarter, the pace of decline was much reduced – drops of 1%-2% per month as opposed to the 3%-4% we became routinely used to in the run up to the year end. By April, our Prime Central London Index even managed to post a positive result, with prices climbing 0.4% – the first rise for 13 months.

Improved price performance was also reflected in the numbers of sales we experienced. In November last year, like-for-like sales rates in central London were running at around 60% below their five-year average but by April this had improved to a reduction of 34%.

The improvement in the market has been particularly pronounced at the lower end, with prices in the sub-£1m market rising by 1.6% in April, compared with a fall of 2.2% in the £10m+ super-prime bracket. If we cast our minds back to early 2008, it was the bottom end of the market that was hit first in terms of sales prices and the top-end has played “catch-up” on the way down since then. The bottom end is also the sector where investment purchasers have been concentrating their activity, which has undoubtedly helped to underpin prices.

The improvement noted in recent months needs to be set in context. Compared with the position before Christmas conditions are undoubtedly better, however compared to a “normal” market they still look bad.

Figure 1
Prime leads the market
Greater London versus prime central London annual house price growth
2003 Q1 - 2009 Q1 (% change)



Source: Nationwide, Land Registry, Knight Frank Residential Research

The difference between then and now is that we are concerned with different problems. One of the issues currently facing our sales teams is that revived hopes from vendors might translate into prematurely higher asking prices – which at the current time would lead to rapidly diminishing sales prospects.

The other problem concerns stock levels. There has been a lot of chatter about “lack of stock” since the turn of the year. However, a review of the figures reveals the speculation to be absolutely correct. In April there were 28% fewer properties available to buy in central London compared with a year earlier and the indications for May and early summer are that this deficit will grow.

There has been a clear trend towards lower new supply since the turn of the year, with new properties coming to market down 45% in the first four months compared with the same period in 2008, whereas on the demand side the number of applicants registering to buy has risen by 14%.

As we move into the summer the hope is that the recently improved momentum is maintained on the sales side, but this will only be possible if more vendors can be persuaded to sell rather than opting to keep properties in the lettings market which – as we will see in the next section – is something that has contributed to an oversupply in that sector.

Lettings market update

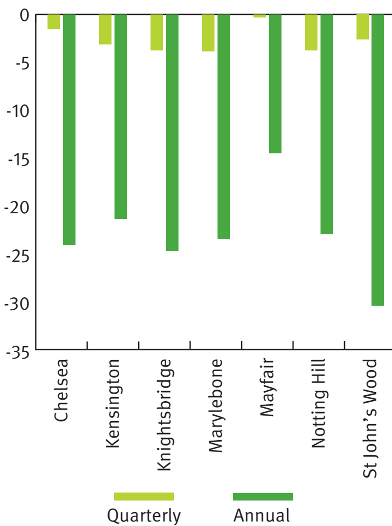
The lettings market has been the partial beneficiary of the weak sales market, with demand from tenants and the number of lettings being undertaken, both up by around 25% on a year-on-year basis. The problem for landlords is that the volume of stock coming into the market has risen so rapidly, by between 50% to 100% across central London, that competition for tenants has driven rents lower and pushed voids rates higher.

The competitive environment for landlords means that rents fell again in the first three months of 2009, by 7.4%, and are now 18.2% below their March 2008 peak, and 3.6% below the previous market peak in September 2001.

Figure 2

Sub-market analysis

Annual and three monthly price growth, to April 2009, split by prime central London market area (% change)



Source: Knight Frank Residential Research

Investment yields have pushed out, thanks to more rapid falls in capital values rather than to the resilience of rents. However, the 5% target for a central London gross yield is more achievable now than at any time in the past five years. For investment grade stock, gross yields of 6% or even approaching 7% have been achieved.

There has been a shift towards a longer-term investment approach through the downturn, with more investors talking of planning for a longer-term hold and looking more seriously at income return, rather than relying purely on capital growth. However, central London is a competitive market and even in a weak part of the cycle opportunities for higher yields soon get squeezed by opportunistic buyers.

OUR CONVERSATIONS WITH THE MAJOR FUNDS LEAD US TO BELIEVE THAT THE DESIRE TO BUILD PORTFOLIOS WILL SEE MORE PLAYERS ENTER THE MARKET IN THE SECOND HALF OF 2009.

The funds that began to study the market in detail in the first quarter have largely kept their powder dry, through a lack of opportunity to buy rather than a fear of further substantial price falls. Our conversations with the major funds lead us to believe that the desire to build portfolios will see more players enter the market in the second half of 2009.

The critical problem for all investors, large or small, will be the ability to acquire critical mass in the central London market. We noted above that stock levels in the established home sector are low. The new-build sector, which had under-built prior to the market downturn, is seeing stocks now run exceptionally low – with starts in the central boroughs down by 60% year-on-year, and 80% on 2007 levels.

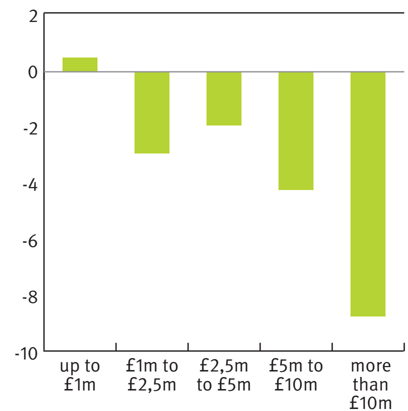
We believe that, on balance, the outlook for the rental sector is more positive than the last 12 months have proved to be for landlords. While rental levels are still pointing slightly down, there is growing evidence of stability in the market, especially in the lower price brackets (up to £1,000 per week). The growth of stock has not continued exponentially, and there appears to be some degree of balance emerging in the market, although the key advice for landlords – to keep asking rents competitive – remains unchanged.

Commentary on the property market can be rather short-term in nature – for example tracking one month's statistics to the next. When we are in a boom or the market is in freefall – this approach makes sense. The market we are entering, and which will be with us for the foreseeable future, is likely to be less dramatic and favours a more long-term outlook.

Figure 3

Entry level prime begins to recover

Prime central London three monthly price growth, to April 2009, split by price band (% change)



Source: Knight Frank Residential Research

This more considered outlook is particularly pertinent for investors. Ultimately the decision to undertake an investment purchase in central London is a long-term play on the future of the London economy. The investment purchase is based on a belief that London will not only recover from this downturn, but will continue to attract people and jobs, generate wealth and thereby create enhanced value in property investments. This is the topic we turn to next.

The City economy and London's housing market

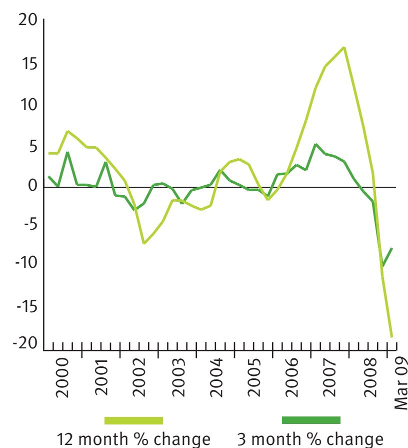
> "Now today over 40% of the world's foreign equities are traded here, more than New York: over 30% of the world's currencies exchanges take place here, more than New York and Tokyo combined, while New York and Tokyo are reliant mainly on their large American and Asian domestic markets, 80% of our business is international, and in a study last week of the top 50 financial cities, the City of London came first ... So I congratulate you Lord Mayor and the City of London on these remarkable achievements, an era that history will record as the beginning of a new golden age for the City of London."
>
> Rt Hon Gordon Brown MP,
> Mansion House speech, 20 June 2007

We ought to make a small apology to The Prime Minister for taking the above excerpt from his 2007 Mansion House speech – made a few weeks before the credit crunch began in earnest. Most economic and housing market commentators (ourselves included) have their own examples of "London – World City" pronouncements made in those heady days.

Figure 4

Stronger supply pushes rents lower

Prime central London prime rental growth, three month and annual % change, 2000 to 2009 (% change)



Source: Knight Frank Residential Research

The reason for drawing attention to the above quotation is to illustrate the remarkable transformation in the image of London's financial services sector since the current recession began. While the boom in wealth creation and asset prices lasted, the government was able to add costs to asset purchases for no reason other that continual price rises seemed to ensure that there was no harm done – think of stamp duty and home information packs for house buyers and Section 106 and affordable housing requirements for developers.

In a wider sense the ability of the centre of wealth creation – the City of London – to keep paying the bills was emphasised by the establishment of the levy on foreign non-domiciled residents and various attempts to capture additional corporation tax from globalised businesses. The most recent continuation of this policy strand has seen the top rate of income tax increased to 50%. Aside from the questions of fairness and equity, the most significant question which has been raised – especially since the Chancellor of the Exchequer's recent Budget speech – is whether these changes in aggregate pose a risk to London's claim to world city status?

Figure 5

Rent performance by price band

Prime central London prime rental growth, March 2008 to March 2009, split by price band (% change)

Source: Knight Frank Residential Research

is applied to central London, different and far less predictable variables are at play. The boom in central London house prices between 2005 and 2007 was partially the result of delayed growth being brought forward following the City's 2001 to 2003 downturn, but no-one was able to predict the rapidity and strength of the growth – the near doubling of prices in some areas in 24 months for example.

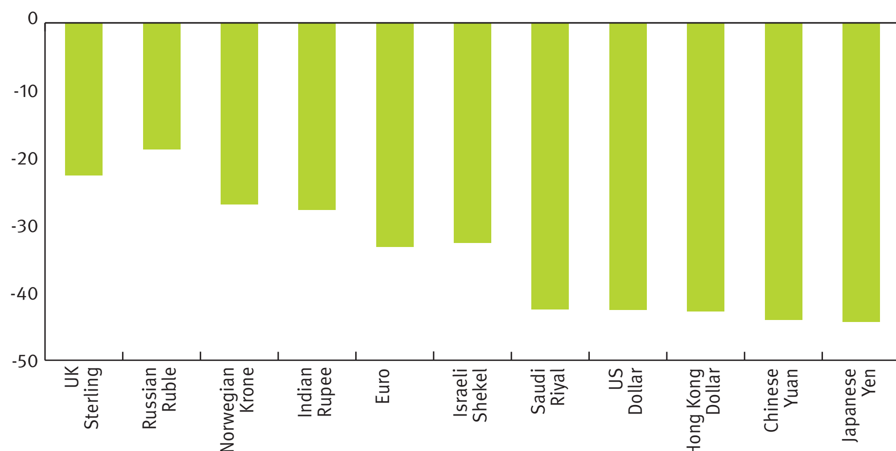
Forecasting housing market performance in the UK as a whole is not easy, but the rules are fairly well understood – there are key relationships between incomes, cost of finance, supply and demand dynamics and so forth which can be modelled to produce intelligible results. When the same approach

The performance in the period up to 2007 was a result of the set of circumstances which brought 80% of Europe's hedge fund market to settle in Mayfair, and saw the same concentrations of activity in private equity and other high-value sectors. Will we see the return of these conditions – and

Figure 6

Sterling's weakness creates opportunities

Prime central London price change March 2008 to April 2009 – allowing for currency fluctuations (% change)



Source: Knight Frank Residential Research, Bank of England

the rapid recovery of prices and demand in central London?

The above question is one we examined in the 2009 edition of The Wealth Report, which we published jointly with Citi Private Bank in March this year. The results of our World City Survey, pointed to risks to the established centres, not just London, but also New York and Tokyo, and the growing challenge posed by locations like Shanghai and Dubai. However the survey results also suggested we ought to be more positive about London's ability to reinvent itself over the next decade. The city's key strengths being the size of its high-end service sector, the central London lifestyle offer and also the "soft power" offered by an open economy, and an acceptance of new ideas and invention.

The risks to a positive outcome for London are, as is often the case, avoidable. The zeitgeist has changed substantially from that which held sway when Gordon Brown spoke to the City grandees in the summer of 2007. Now a competitive advantage in high-value services appears to be something to keep quiet about. The risk is that a UK and EU regulatory and policy backlash ends up damaging the key area of strength for the London economy. Unfortunately determining the likely outcome of the political debate is even more problematic than forecasting the future direction of house prices.

Corporate lettings – a bellwether for the London market

In each edition of this review we take the opportunity to examine a particular facet of the London residential market. This time it is the turn of the corporate lettings market – i.e. the rental of properties by corporate organisations for key or relocating staff. This sector is very apposite at the current time. Demand in this sector is considered to be a lead indicator of a strengthening or weakening economic outlook for London as a whole.

Our Residential Corporate Services team saw demand in the sector fall as early as July 2007, and by early 2008 demand was down significantly – with a particular decline in demand from financial service sector clients. Demand has risen since, in line with wider demand in the lettings sector – the key issue for most corporate clients is not a reduction in demand, but rather the need to ensure value for money.

The market has broadened over the past 12 months, with demand from media, legal and insurance organisations taking up some, but not all of the slack, from the financial sector. Some corporate tenants are looking at alternatives to traditional relocation packages, such as fixed sum allowances. However certain industry specialists - especially the pharmaceuticals and energy sector always require specialist skills – so there is no question of a freeze on relocation, just a focus on making it as cost efficient as possible to attract and retain the best staff.

In terms of the types of properties in demand from corporate tenants, the general rules remain unchanged – neutral properties, wooden floors rather than carpets, open plan living, close to good travel hubs, and, for the higher price brackets, porterage and concierge services. Interestingly, while there is a bias towards new-build properties from most clients – US and European tenants often prefer a traditional house or flat for the "London experience".

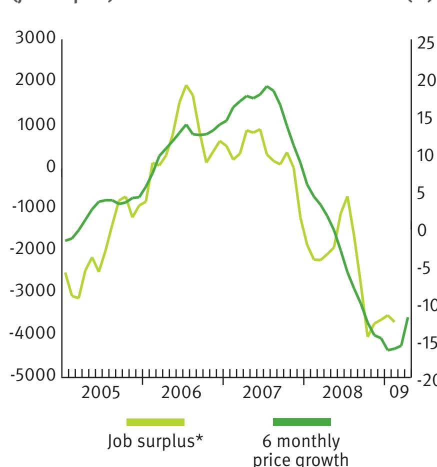
What has changed through the recession has been the demand from corporate tenants for the structure of tenancies. There is a desire to achieve flexibility and certainty – with six-month break clauses required alongside clauses providing the tenant with an option to renew for a second and even third year.

The changing nature of tenant demand is reflective of the shift in London's economy away from a dominance by financial services – towards a more balanced and diverse mix.

Figure 7

'City' jobs market decline begins to plateau

'City' job surplus versus prime central London house prices



Source: Knight Frank Residential Research, Morgan McKinley

*Job applicants less job vacancies

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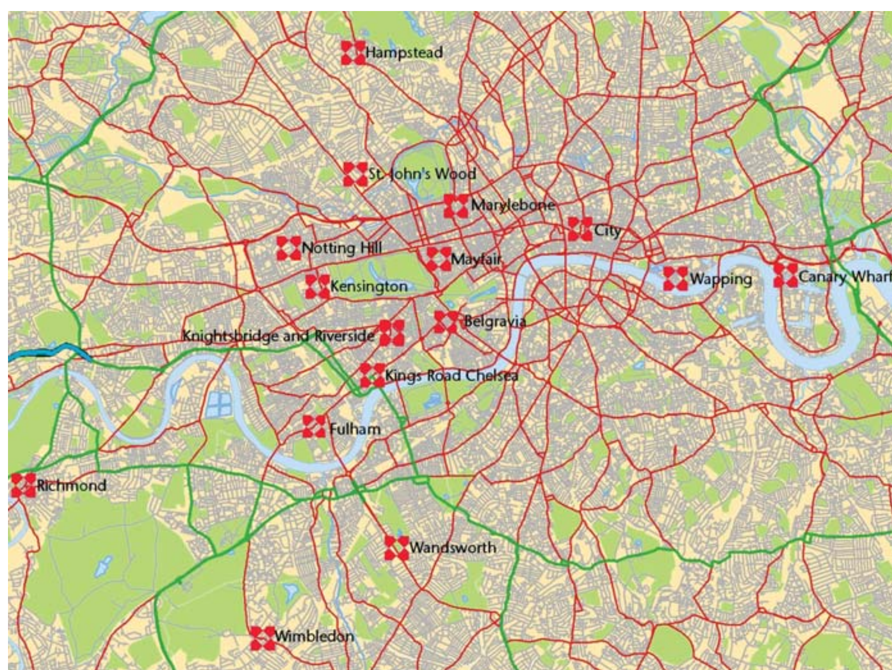

Knight Frank area definitions – **Prime central London:** Belgravia, Chelsea, Kensington, Knightsbridge, Marylebone, Mayfair, Notting Hill, Regent's Park, Riverside and St John's Wood. **Prime London:** All areas in prime central London plus Canary Wharf, Fulham, Hampstead, Richmond, Wandsworth, Wapping and Wimbledon

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