

RESIDENTIAL RESEARCH

A photograph of the Tower Bridge in London at sunset. The bridge is silhouetted against a bright orange and yellow sky. In the foreground, there is a paved area with steps and a modern glass building on the right. The text "LONDON RESIDENTIAL REVIEW" is overlaid in large white letters.

# LONDON RESIDENTIAL REVIEW

LONG-TERM REWARDS,  
SHORT-TERM UNCERTAINTY  
**WINTER 2015**

IMPACT OF TAX CHANGES

MANSION TAX AND  
THE LETTINGS MARKET

AREAS OF  
OUTPERFORMANCE

## KEY FINDINGS

**New stamp duty changes add to short-term uncertainties** but are outweighed by strong longer-term fundamentals

**Annual growth in prime central London eased to 6.1% in November**, with the strongest increases away from traditional prime areas

Price growth of 9% in prime outer London was led **by the eastern areas of Canary Wharf and Wapping**

**Knight Frank analysis shows there are approximately 20,000 rental properties in London with a capital value of more than £2 million**

**Total returns for prime London property far exceeded other asset classes** in the year to October 2014



**TOM BILL**  
Head of London Residential Research

*"The stamp duty changes have redrawn the parameters of a long-standing debate surrounding the taxation of high-value residential property."*

## LONG-TERM REWARDS OUTWEIGH SHORT-TERM RISKS

Growing uncertainty has caused demand to become more subdued in the prime London market. As high-value property comes under political focus in the short-term, the grounds for longer-term optimism remain strong, says Tom Bill.

At the start of 2014, the prime London residential property market was largely unaffected by the prospect of the upcoming UK general election. By the end of year, it was operating wholly in its shadow.

The impact of the election became notable by Q2 2014, causing demand to become more subdued as uncertainty grew over the prospect of tax changes.

By November prices had begun to soften and in December Chancellor George Osborne increased stamp duty for properties above £937,500 in a move designed to outflank his political opponents five months from the election.

In the short-term, the stamp duty changes will lead to some harder negotiations between buyers and vendors and instances where values may adjust downwards slightly to account for the new higher charge.

Given the phlegmatic way in which the London property market has reacted to previous similar changes, history indicates it will absorb the changes in the short to medium-term.

However, the stamp duty changes have also redrawn the parameters of a long-standing debate surrounding the taxation of high-value residential property.

After numerous changes in recent years that include capital gains tax reform for overseas-based buyers and higher taxation on 'enveloped dwellings', the stamp duty changes mean it is now difficult to argue that high-value property is under-taxed.

A comparison of taxation in New York, Paris, Singapore and Hong Kong shows London is in the middle of the pack in terms of property taxation. Stamp duty is higher in both Asian markets while, unlike London, New York residents are taxed on their global wealth.

Accordingly, the stamp duty changes have put a significant question-mark over the viability of the mansion tax proposal.

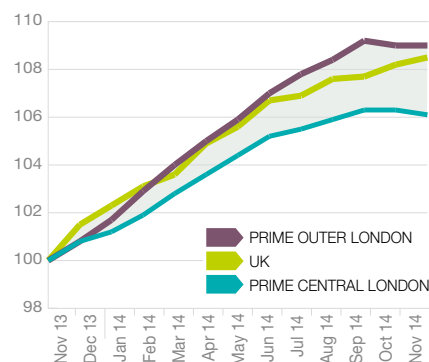
With opinion polls indicating that a majority government is unlikely in May, the uncertainty looks likely to continue in the first half of 2015.

Whatever the result of the election, growth is unlikely to be as headline-grabbing over the next five years as the last five. This fact, however, should be put in the context of an exceptionally strong and prolonged period of growth that has produced a 73% rise in prime central London since the post-Lehman Brothers low point in March 2009.

We forecast cumulative growth of 22% between 2015 and 2019 as demand continues to exceed supply. Forecasts indicate the London population will grow by in excess of 100,000 every year for the next ten years while it remains the city of choice for the global wealthy.

These longer-term fundamentals of the prime London property market are likely to continue to underpin its future performance.

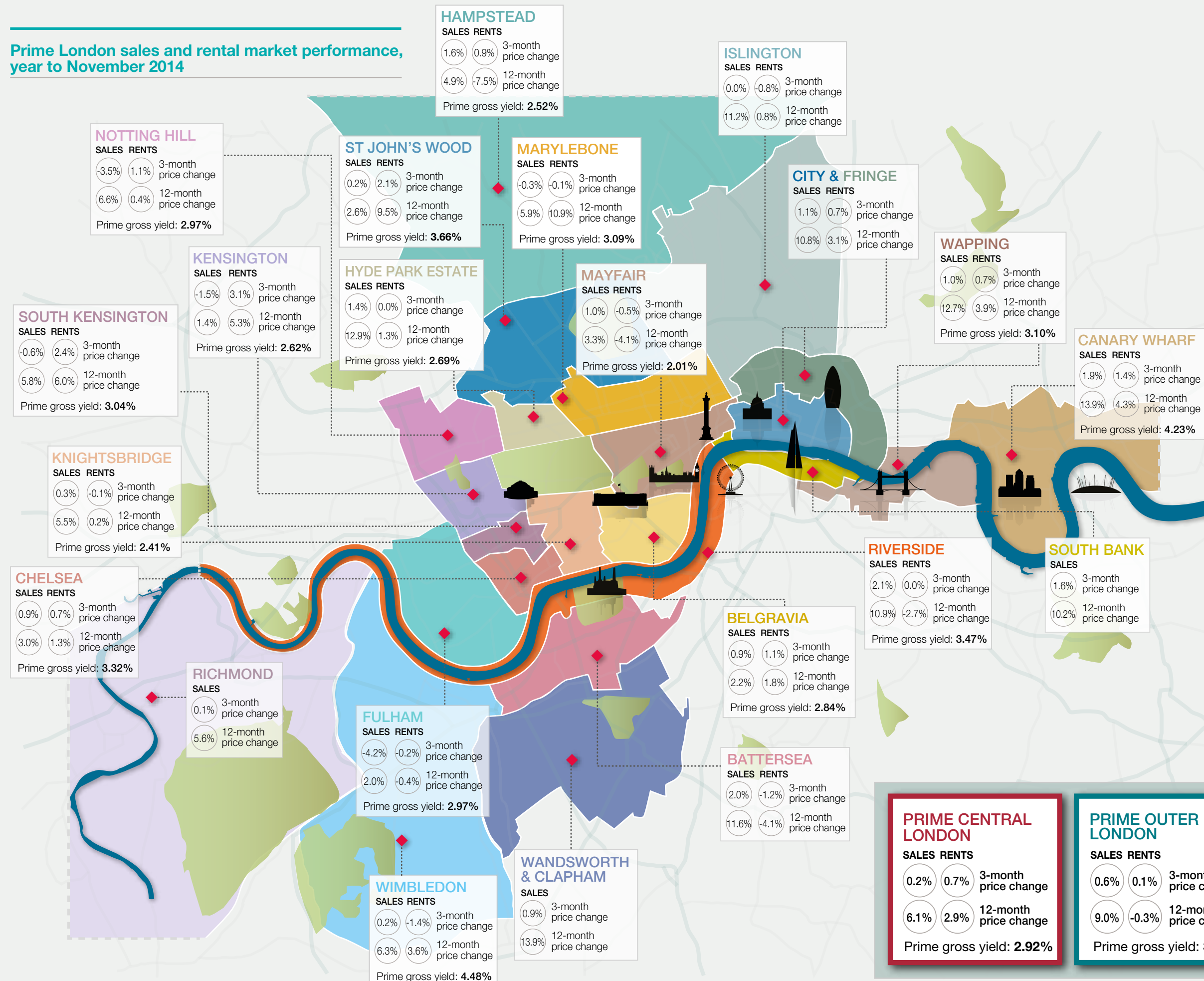
FIGURE 1  
**Price growth in the year to November 2014** (Rebased to 100)



Source: Knight Frank Residential Research / Nationwide



## Prime London sales and rental market performance, year to November 2014



## PRIME LONDON MARKET PERFORMANCE

Annual growth in prime central London was 6.1% in November, driven by residential markets north of Hyde Park as well as Islington and City & Fringe in the east.

Buyers are seeking value away from traditional prime postcodes to the immediate west, south and east of the park due to strong growth in these areas which has driven prices higher in areas like the Hyde Park Estate.

We forecast cumulative growth of 22% between 2015 and 2019 as demand continues to exceed supply. However, a trend among buyers to focus increasingly on the right specification and facilities and less narrowly on the right postcode suggests overlooked residential areas like Bayswater, Victoria, the City and the Midtown district, which includes Holborn, Covent Garden and Bloomsbury, are likely to outperform the prime central London average due to the high-quality new-build pipeline in these areas.

In prime outer London, growth in the eastern districts of Wapping and Canary Wharf exceeded that in south-west London or Hampstead. Both eastern areas benefit from their relative proximity to London's two financial centres of the City and Canary Wharf, a series of high-quality new-build schemes and the fact they have fewer £2 million-plus properties that could be subject to a mansion tax.

For the same reason, prices in Fulham have softened in recent months due to its high proportion of family homes between £2 million and £4 million.

Further afield in south-west London, prices continue to be underpinned by a flow of buyers from more central areas like Notting Hill and Kensington seeking more space for their money.

# MANSION TAX AND THE LETTINGS MARKET

In the five years since the possibility of a mansion tax was first raised, the debate surrounding its impact on the London property market has grown.

Politicians from all parties have criticised the plan for its disproportionate impact on London and Knight Frank analysis shows 74% of all £2 million-plus properties in Greater London are either flats or terraced houses, demonstrating the mismatch between perception, in particular the term 'mansion', and the reality of the London property market.

After recent increases in stamp duty for properties over £937,500, the questions over the feasibility of the proposal have grown louder.

Here, we examine the potential impact of a mansion tax on the London lettings market, which raises its own questions in terms of the proposal's unintended consequences.

Knight Frank analysis shows there are about 20,000 rental properties in London worth £2 million or more, which represents about a fifth of the UK's housing stock in the price bracket.

As the map in figure 2 shows, the highest concentration is in the prime central London boroughs of Westminster and Kensington & Chelsea and there are clusters in Camden and an area of south-west London that stretches from Hammersmith & Fulham to Richmond.

While the widespread assumption is that any cost would be met by the landlord, a degree of uncertainty will inevitably surround the drafting of lettings contracts until any new legislation is enacted.

For landlords, any additional annual cost would make their investment less viable. This is especially true in prime London, where the contribution of the rental income is outweighed by capital value growth in terms of calculating total returns.

The impact would be particularly marked when, as is often the case, landlords are also paying a mortgage on the property. Anecdotally, some are suggesting tenants may ultimately absorb the cost

in the form of higher rents as landlords make their investment viable as opposed to reducing maintenance budgets or trading out of the sector. Some landlords may re-invest in less expensive property, a move that could potentially drive prices higher in lower price brackets and impact affordability.

The impact of higher costs would be felt more strongly by young professional renters who have chosen to share a house in areas like Wandsworth or Clapham because of affordability constraints in the sales market.

While the mansion tax debate has remained in the realm of theory over the last five years, strong price growth in areas like Wandsworth and Clapham during the same period means many more properties are now in the £2 million-plus price bracket.

In both the sales and lettings market, the uncertainty is likely to mount as the election approaches.

## Tim Hyatt, Head of Lettings

There has not been any clarification as to whether the proposed mansion tax would be the responsibility of the landlord or the tenant but our assumption is that it will be the landlord.

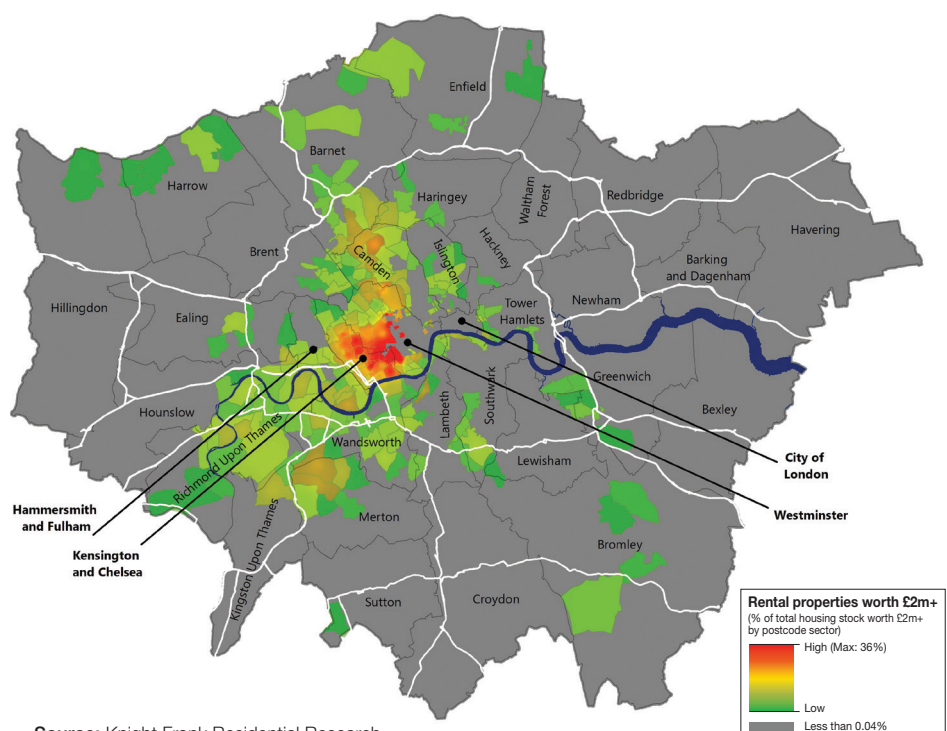
However, there is a degree of uncertainty in the run-up to the election and we are aware of instances of tenants asking to be protected from any liability arising from a possible mansion tax and for that to be written into the tenancy contract.

From a landlord's point of view, any hit on their gross to net yield calculations will be a deterrent, particularly bearing in mind that yields in many instances are only marginally higher than their all-time lows.

The impact in terms of pricing for rental stock and to what extent costs are passed on remains to be seen and will be dependent on the supply/demand dynamic at the time.

FIGURE 2

### Location of £2 million-plus rental properties in London



Source: Knight Frank Residential Research



# RENTALS AND INVESTMENT MARKET FOCUS

The prime central London lettings market has been in recovery mode since the start of 2014, with rental values rising 3.3% between January and November.

It follows a shallow two-year decline against the backdrop of a faltering economy and a surging sales market.

In prime outer London, an annual decline of -0.7% in November 2013 had eased to -0.3% by November this year though values remained largely flat over the 12 months.

Prime central London rental values have been rising this year as the UK economy improved, though growth was zero in November due to a seasonal slowdown and a degree of caution over economic conditions in other parts of the world.

China cut interest rates for the first time in more than two years in November and there is speculation the European Central Bank is getting closer to full-blown quantitative easing, both of which will support their respective economies.

Next May's general election is adding to a sense of uncertainty and wider optimism among companies is tempered to some extent by a number of profit warnings and regulatory uncertainty in the financial services sector.

In a further move that may dampen short-term demand, mortgage lenders have cut rates as the likelihood of an imminent interest rate rise recedes and they attempt

to bolster their loan books after the introduction of stricter lending criteria earlier this year slowed the pace of loan approvals.

Rental values above £1,500 per week in prime central London grew 3.8% between January and November, while the figure was 2.9% for properties below £1,500 per week, reflecting how properties in higher price brackets are performing better.

The super-prime market, which covers rental values of £5,000 per week and above, is buoyant versus last year and indicates how relocation budgets are growing for the most senior positions in companies.

Demand has also recovered strongly since last year, as figure 4 shows, with the number of viewings, new prospective tenants and contracts started and agreed all rising strongly in the year to November 2014 compared to the previous twelve-month period.

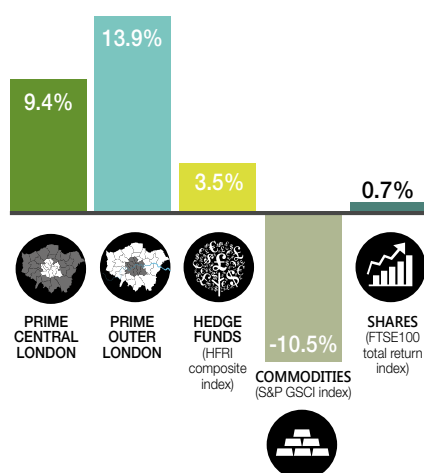
Rental yields in prime central London rose to 2.92% in November, continuing a climb back towards 3%, a figure they last surpassed 18 months ago. Meanwhile in prime outer London, yields were 3.59%, their highest level in seven months.

Prime London property remained an attractive proposition for investors in 2014, with total returns in prime central and prime outer London markedly higher than other asset classes despite the backdrop of global economic uncertainties, as figure 3 shows.

FIGURE 3

## Prime London property outperforms other asset classes

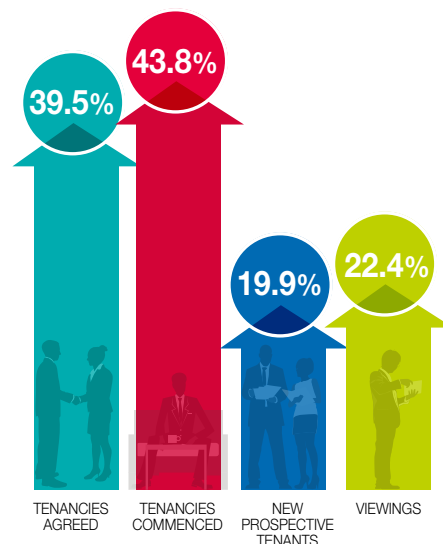
Total return (year to October 2014)



Source: Knight Frank Residential Research

FIGURE 4 The rental recovery

Year to November (2014 vs 2013)



Source: Knight Frank Residential Research

## RESIDENTIAL RESEARCH

### Tom Bill

Head of London Residential Research

+44 20 7861 1492

[tom.bill@knightfrank.com](mailto:tom.bill@knightfrank.com)

## HEAD OF LONDON RESIDENTIAL

### Noel Flint

+44 20 7861 5020

[noel.flint@knightfrank.com](mailto:noel.flint@knightfrank.com)

## HEAD OF LETTINGS

### Tim Hyatt

+44 20 7861 5044

[tim.hyatt@knightfrank.com](mailto:tim.hyatt@knightfrank.com)

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