London Residential Quarterly | Summer 2016

Research - Market View

UK economy Post-Brexit

Prolonged periods of low commodity prices and slowing growth in emerging economies continue to raise concerns of a global economic slowdown. Elsewhere, geopolitical tensions in the Middle East and Eurozone have heightened. US growth forecasts have been downgraded, and the global economic risks remain predominantly on the downside. On 23rd June 2016 the UK voted to leave the European Union (EU). Following the news, the country is expected to remain in a prolonged period of uncertainty until new agreements are ratified. As a consequence, financial markets are likely to be volatile and the pound is expected to fluctuate and may depreciate further.

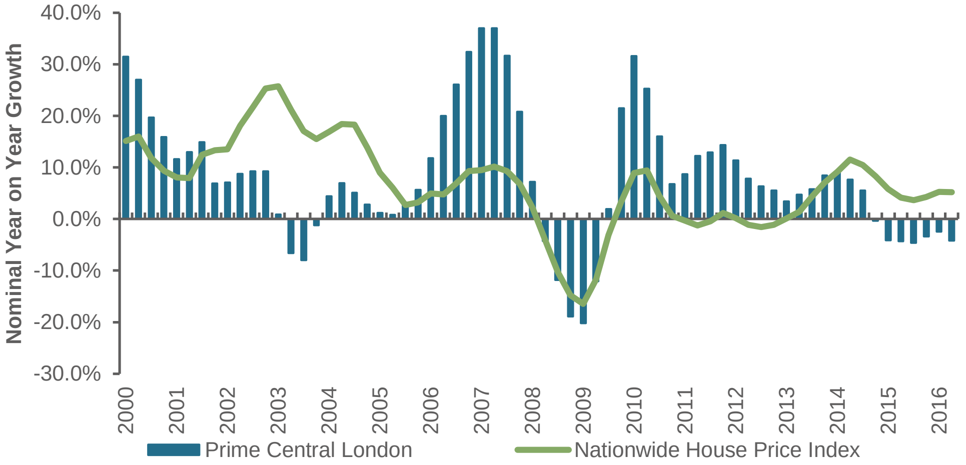
Despite heightened economic and political uncertainty, the outlook for the UK economy remains reasonable, whilst less positive than previously. The rate of employment increased to 74.2%, regular earnings were up 2.6% in the year to April and the rate of inflation fell to 0.3%. On the downside, the UK's trade deficit and public sector debt continue to rise. A weaker pound will provide a much needed boost to UK exports going forward, however.

The impact of Brexit is not exclusive to the UK, and global economies, particularly those in the EU, are facing a period of increased uncertainty which is likely to dampen their economic performance.

National property market

The Nationwide House Price Index (HPI) saw quarterly growth of 0.9% in the second quarter of 2016. Despite Brexit, demand for housing continues to outstrip supply and with employment at record highs, we expect activity and price growth to remain reasonable across the UK.

Figure 1. UK house price growth vs Prime Central London (PCL)



Source: Nationwide House Price Index, Volterra

The IMF has downgraded global growth forecasts for 2016 and 2017 to 1.7% and 1.3% respectively.

Despite much media speculation of an interest rate cut, the Monetary Policy Committee have held interest rates at 0.5%.

The national average house price has grown by 2.5% for 2016 and now stands 5.2% higher than a year ago.

Post-Brexit property impact

As noted previously, the UK voted by 52% to 48% to leave the EU on the 23rd June.

The immediate short-term effect has been volatility in financial markets, pressure on the pound and negative sentiment towards property market shares (although not close to the levels seen following the GFC). A wait and see mind-set for the medium- to long-term effects should be adhered to as they are very much dependent on: (1) the trade agreements the UK agrees with the rest of Europe and the rest of the world; and (2) UK domestic policy, with the hope of the Leave campaign that the economy will flourish without the shackles of European regulation, law making and the UK subsidising poorer-performing countries.

The key to how property markets will be affected after the short-term is whether the general public, property owners and investors have a clear and certain vision of what UK policy is.

- For the commercial property sector, this means businesses and consumers having the confidence to invest and spend, which depends on them being convinced that the medium-term economic outlook is positive, that the economy will continue to grow, and that their jobs are secure.

- For the rural sector, the key industry is farming, and this means having a clear vision of whether there will be a replacement for the Common Agricultural Policy and what levels of payments it will provide; secondary is the level of regulations it will impose, with many farmers' hope being that they will be significantly lower.

- For the residential sector, this means what will happen to interest rates, bank lending and the government's policies to stimulate housing supply and demand.

The residential market effectively splits into three: PCL mainstream market, the London new build market and the UK domestic market.

There are two outcomes for PCL; one is the flight to quality driving demand for safe haven assets. The other is uncertainty resulting in a continuation of lower transaction volumes. Both outcomes have their merits. We anticipate in the short-term that dampened market demand and a lack of market supply will result in PCL property prices remaining stagnant over the remaining quarters of 2016. However, London in general, and PCL more specifically, remain a 'safe-haven' for foreign investors and, so long as the outlook for the UK economy remains positive, we anticipate price growth will return to a strong level in the medium/long-term.

The London new build market will experience interest with international investors seeking to take advantage of the weakness of the pound. The property fundamentals of location, quality and length of ownership will prevail.

The UK domestic market will be impacted by purchaser sentiment and the UK economic outlook. The likelihood of price increases in construction may well reduce supply levels and have the unintended consequence of putting further upwards pressure on prices even whilst demand levels soften.

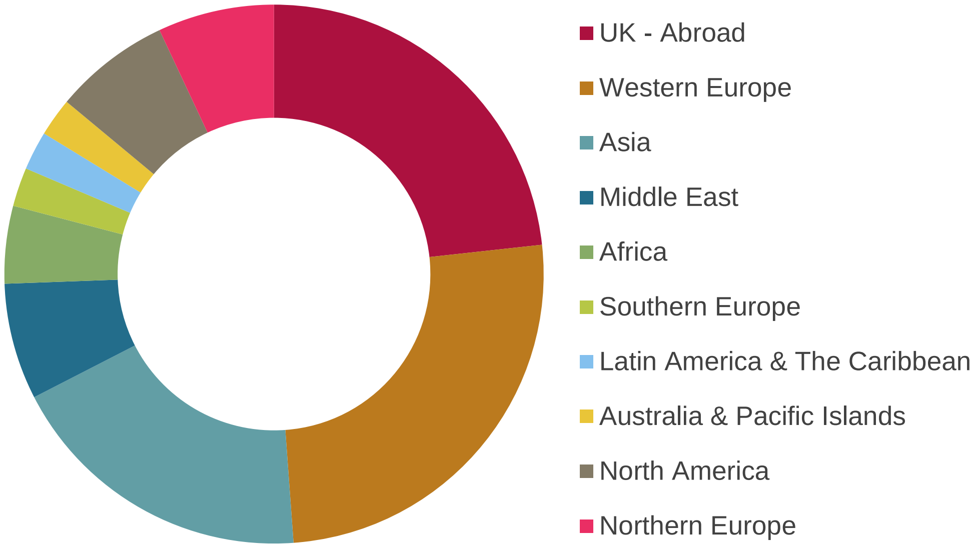
"It will be interesting to see whether the current currency play could be enough to spur activity for the market to make some form of recovery in the second two quarters of this year. The fall in sterling post-EU Referendum has helped to create further value for buyers seeking to get into the London market."

- Stephanie McMahon, Partner, Head of Research

Figure 2. Known PCL buyer nationalities for Q2 2016 (removing UK – domestic market)

Prime Central London second-hand sales market

Strutt & Parker's data for the second quarter of 2016 showed that nearly 33% of all buyers in PCL were originally from overseas. There was a significant increase seen from UK buyers from abroad when compared to the same period last year. Perhaps not surprising in the lead up to the Brexit vote and the uncertainty in the markets there was a decline in buyers coming from Europe as well as the Middle East.



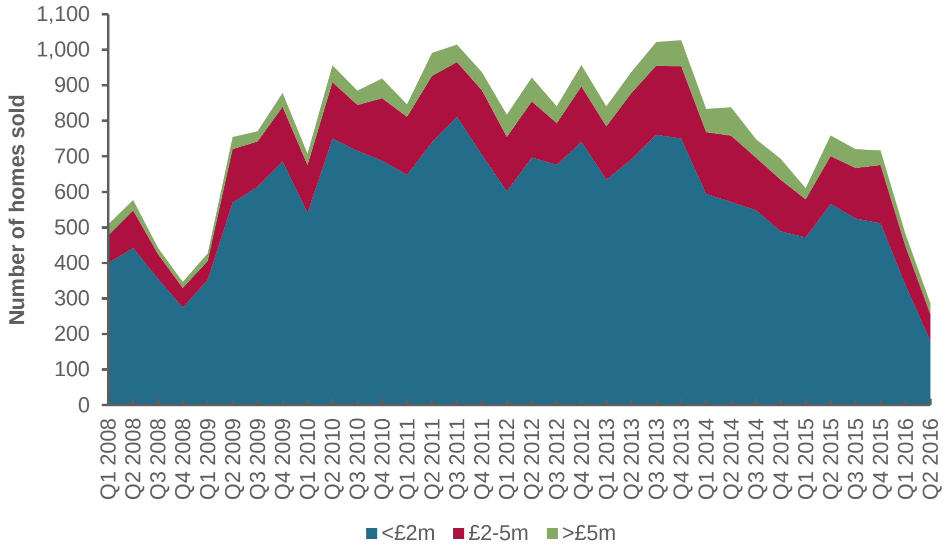
Source: Strutt & Parker

With the introduction of the Stamp Duty Land Tax on additional homes which went into effect on the 1st April 2016, a 28% decrease was evident in those purchasing homes for investment purposes in Q2 2016 compared to the same period in 2015.

By the numbers

A total of 286 properties were sold during the second quarter of 2016, which was an overall decrease of 62% when compared to the same period in 2015.

Figure 3. Historic number of sales in PCL



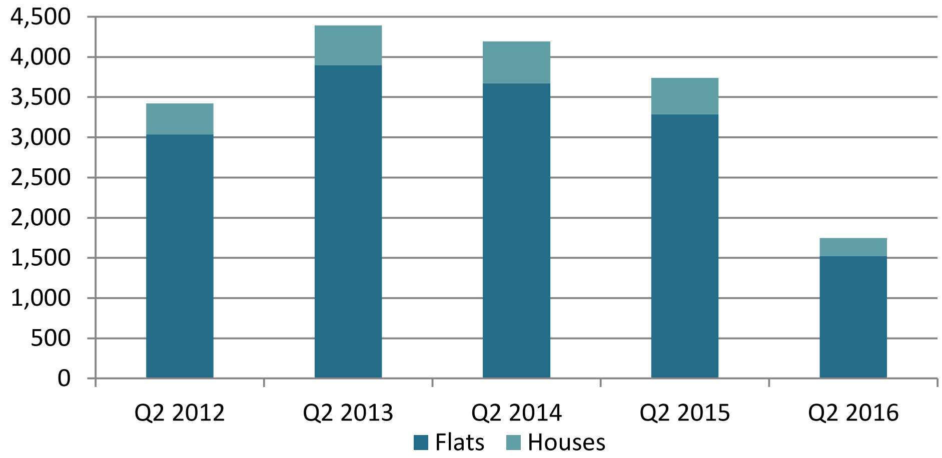
Source: Dataloft, Lonres.com, Strutt & Parker

Q2 2016 showed a lower level of transaction volumes compared to the last trough seen in Q4 2008 where 347 transactions were recorded in PCL.

Prime Central London lettings

There were 1,749 property lets agreed in PCL during the second quarter of 2016, which was 34% down compared to the second quarter of 2015.

Figure 4. Historic agreed lets in PCL by housing type



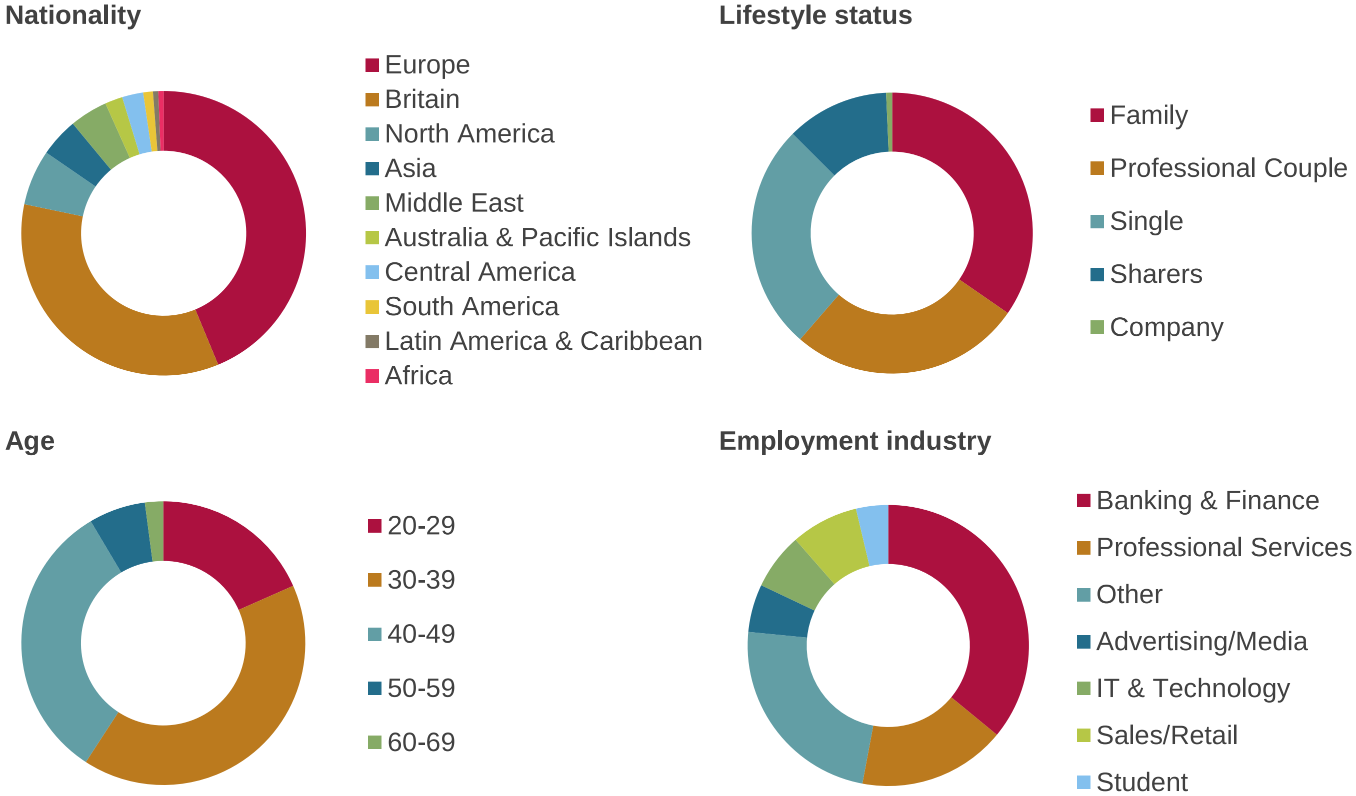
Source: Dataloft, Lonres.com, Strutt & Parker

"While we have seen a drop in number of tenancies, we have seen an increase in the length of these tenancies with many tenants wanting to agree minimum terms of 18 months or more."

- Kate Eales, Partner, Head of Lettings

The current economic conditions and SDLT for additional homes are having an impact on the lettings market in PCL. However, Knightsbridge and Belgravia reported that volumes were up 20% on the five year average.

Figure 5. Tenant profiles in PCL Q2 2016

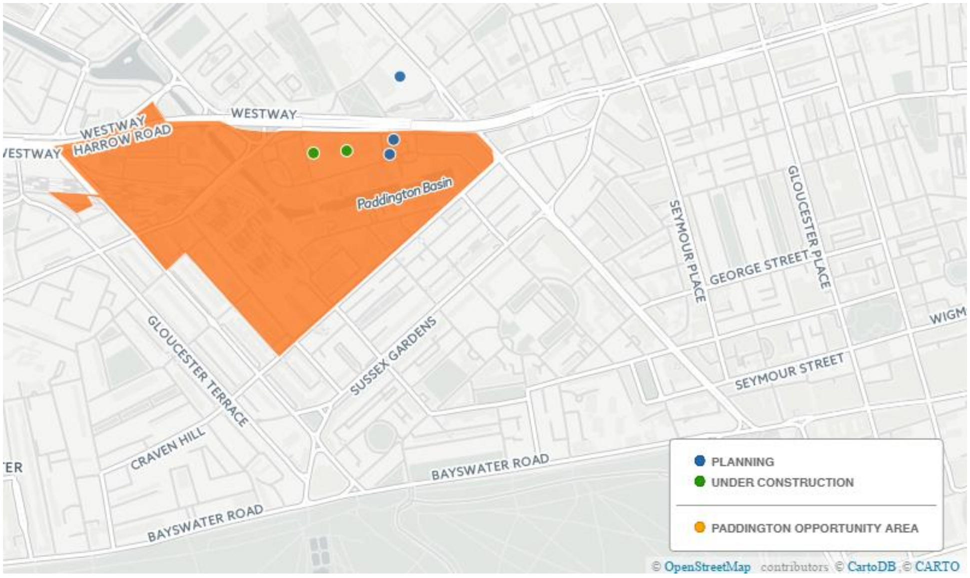


Source: Strutt & Parker

New home sales – A focus on Paddington

The Greater London Authority (GLA) has forecasted that from 2004 to 2036 nearly 222,000 additional jobs will be created in the City of Westminster. Within Westminster, one of the significant opportunities to deliver this forecast is within the area referred to as the Paddington Opportunity Area (POA). This large regeneration area is focused around Paddington Station and the Grand Union Canal.

Figure 6. Map of POA



Source: City of Westminster Local Plan (November 2013), Molior, Strutt & Parker

"The swift appointment of the new Prime Minister has certainly helped to alleviate initial concerns surrounding political and economic turmoil in the UK which has calmed the new residential development markets, such as Paddington."

- Mark Dorman, Partner, London Residential Development & Investment

One of the new offices planned for the POA is the newly designed Paddington Cube by Renzo Piano. Once completed, this building, with subterranean access to a new Bakerloo line tube station, will be capable of accommodating up to 4,000 office workers.

The current population in Westminster is 238,437 according to the GLA and is forecasted to increase 13% by 2036. This increase will naturally escalate the demand for housing within the borough and to that end between May 2015 and April 2016 there has been 979 residential units added to the planning pipeline.

Table 1. Paddington planning highlights

Site location	Application granted	Total residential units
Merchant Square 1 (A) The Cucumber, W2 1LA	May 2015	209
Merchant Square 6, W2 1JU	May 2015	118
West End Green, W2 1LG	April 2016	652

Source: Molior, Strutt & Parker Residential Development Database

At the end of Q2 2016 there are currently 485 units under construction in Paddington, across two main schemes: Paddington Exchange being developed by Taylor Wimpey and North Wharf Gardens being developed by Meritas.

The Paddington Exchange building provides 150 new BREEAM residential units (Class C3). Construction is due to complete in February 2017 and at the end of Q2 2016 eights units remain on the market. The current price list shows 1-beds from £975,000 up to 3-beds from £1,930,000 and an average of £1,600 psf.

The North Wharf Gardens mixed-use scheme will deliver 335 new BREEAM residential units (271 will be private). At the end of Q2 2016 construction is progressing and is expected to be complete by June 2019. In addition to the homes the scheme will include a hotel, business and retail space.

Looking at the past ten years of land registry data for Westminster postcode, W2 1, the increase of new flats sold between the £1m - 2m price range increased to 135 units in 2015 compared to eight units in 2005.

The POA is also set to experience significant infrastructure projects and public realm improvements, which includes enhancements to the railway station, Bakerloo underground station, the bus network and a new Elizabeth line station, previously known as Crossrail.

Outlook & forecasts

Continued uncertainty surrounding the implications of Brexit and resulting concerns over the performance of the domestic economy have the potential to further increase investor and consumer uncertainty, and adversely impact the domestic economy, upon which the national housing market is heavily reliant. However, demand for housing continues to outstrip supply and with employment at record highs, we expect activity and price growth to remain reasonable across the UK.

In PCL this uncertainty is likely to result in a continuation of low transaction levels as discretionary buyers and sellers are likely to wait until confidence returns. The subdued market demand is expected to result in PCL property prices continuing to decline for the remainder of 2016. However, it is expected that historic structural supply imbalances will underpin prices and prevent excessive falls in the near-term. Additionally, PCL and London in general remain a 'safe-haven' for foreign investors, and demand for PCL property depends on a range of different drivers – many of which will be unaffected by the Referendum decision. Therefore, it is anticipated that price growth will return to a strong level in the medium/long-term.

"There is a disconnect of expectations between buyers and sellers which is underpinned by the staggering stamp duty increases and uncertainty surrounding house prices. This means that challenging negotiations and flexibility on both sides is required."

- Charlie Willis,
Head of London Residential Agency

Methodology

As the housing market is seasonal, for the purposes of this report; data is compared year on year, i.e. looking at Q2 2016 in light of changes since Q2 2015. Data may also be compared on a rolling month on month basis. When referring to the PCL market it includes those markets which Strutt & Parker operate in (Knightsbridge, Belgravia, Kensington, Chelsea, Notting Hill & Fulham) and as such is reflective of London's most prime markets. Economic views are attributed to Strutt & Parker's retained economic advisors, Volterra. Additionally, Lonres.com data is used to assess the London sales and lettings market. The behavioural data is collected from our activity in PCL markets: our proprietary "behavioural data" is not representative of the UK as a whole. The global economy remains volatile and therefore there is risk that any market commentary provided will become out-dated within a very short timescale.

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