

RESIDENTIAL RESEARCH

A night-time photograph of The Shard skyscraper in London, illuminated with blue and white lights. The building is reflected in the water of the River Thames. Other buildings and the London Bridge are also visible and lit up.

LONDON RESIDENTIAL REVIEW

SHORT-TERM UNCERTAINTY
COOLS DEMAND IN PRIME LONDON
SUMMER 2014

CAUTION RISES IN THE PRIME
LONDON SALES MARKET

TEN AREAS OF LONDON WHERE
PRICES MOVE IN UNISON

THE LETTINGS
MARKET RECOVERY

KEY FINDINGS

Uncertainty ahead of the general election and an interest rate rise caused **new prospective buyers to fall 20%**

Number of viewings fell 15% but exchanges were broadly flat

Annual growth was **8.1% in prime central London** and **12.1% in prime outer London**

Rentals market continues recovery as **inspections rise 27%** and **viewings increase 20%**



TOM BILL
Head of London Residential Research

"Some degree of short-term caution is likely as financial markets are weaned off stimulus measures and a unique chapter in the UK's economic history comes to end."

SHORT-TERM CAUTION REIGNS

An election, a rate rise and growing clamour over house price inflation mean the financial crisis no longer dominates the fortunes of the prime London residential market.

Few things affect residential property prices more than a change in government or interest rates.

By the second quarter of 2014, both were likely within a year.

The uncertainty caused demand for prime London residential property to ease, a trend reinforced by a crescendo of warnings about a price correction, regardless of their validity.

Such concerns are relatively prosaic compared to the period between 2009 and 2012, when the fallout from the collapse of Lehman Brothers sparked inflows into London property from global investors seeking a safe investment.

Either way, short-term uncertainty has superseded the financial crisis as the biggest external influence on the market.

Prices are not falling but buyers have become more wary.

The volume of new prospective buyers fell by a fifth in the second quarter of the year compared to the same period in 2013 while the number of viewings fell 15%, as figure 2 shows.

The data did not paint a uniform picture, however, and the number of exchanges was only 1% down over the same period, which suggests asking prices are moderating.

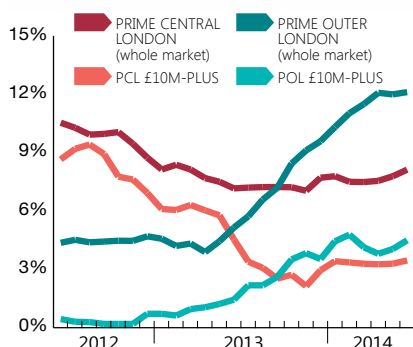
Moreover, the prime central London index reached 44 months of consecutive rises in June, taking annual growth to 8.1%, which was not far below the ten-year average of 9.8%. Growth over the second quarter was 2.3%, just above the ten-year average.

Growth has slowed as the safe haven impetus recedes as threats like the Eurozone collapse diminish but uncertainty over the outcome of the general election and the possibility of tax changes affecting high-value residential property are now cooling demand.

Meanwhile, the prime outer London index rose 12.1% in the year to June, which was almost double the ten-year average of 6.2%. It came after 37 consecutive monthly rises, with price increases accelerating in the last 12 months as growth spread outwards from central London.

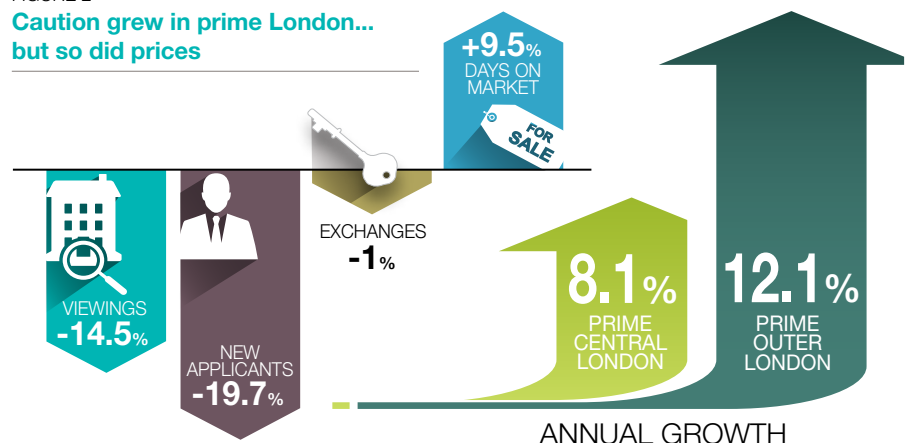
The first interest rate rise in about six years is likely to unnerve prime outer London buyers more than those in prime central London. The increase itself is likely to be modest but some degree of short-term restraint is likely as financial markets are weaned off stimulus measures and a unique chapter in the UK's economic history comes to end.

FIGURE 1
Annual growth by area and price bracket Annual % growth



Source: Knight Frank Residential Research

FIGURE 2
Caution grew in prime London... but so did prices



Source: Knight Frank Residential Research

HOUSE OF CORRECTION

In addition to the impending general election and interest rate rise, the belief that a price correction is inevitable has dampened demand.

This belief was reflected to some extent in the Knight Frank/Markit House Price Sentiment Index in June, which showed that growth expectations had fallen to a six-month low in London, down from a record high in April.

While the Knight Frank prime central and outer London indices show respective annual growth of 8.1% and 12.1%, there is evidence that asking prices are falling.

Knight Frank expects prime central London growth to reach zero next year as the general election approaches but forecasts cumulative growth of 20% between 2014 and 2018 as supply falls far short of demand. The imbalance will keep upwards pressure on prices and suggests any marked correction is unlikely.

It is also worth emphasising that price growth in prime central London has already been moderating for more than two years. Annual growth for £5 million-plus properties has been in single digits and falling since March 2012, when the government announced a series of tax changes including new stamp duty thresholds.

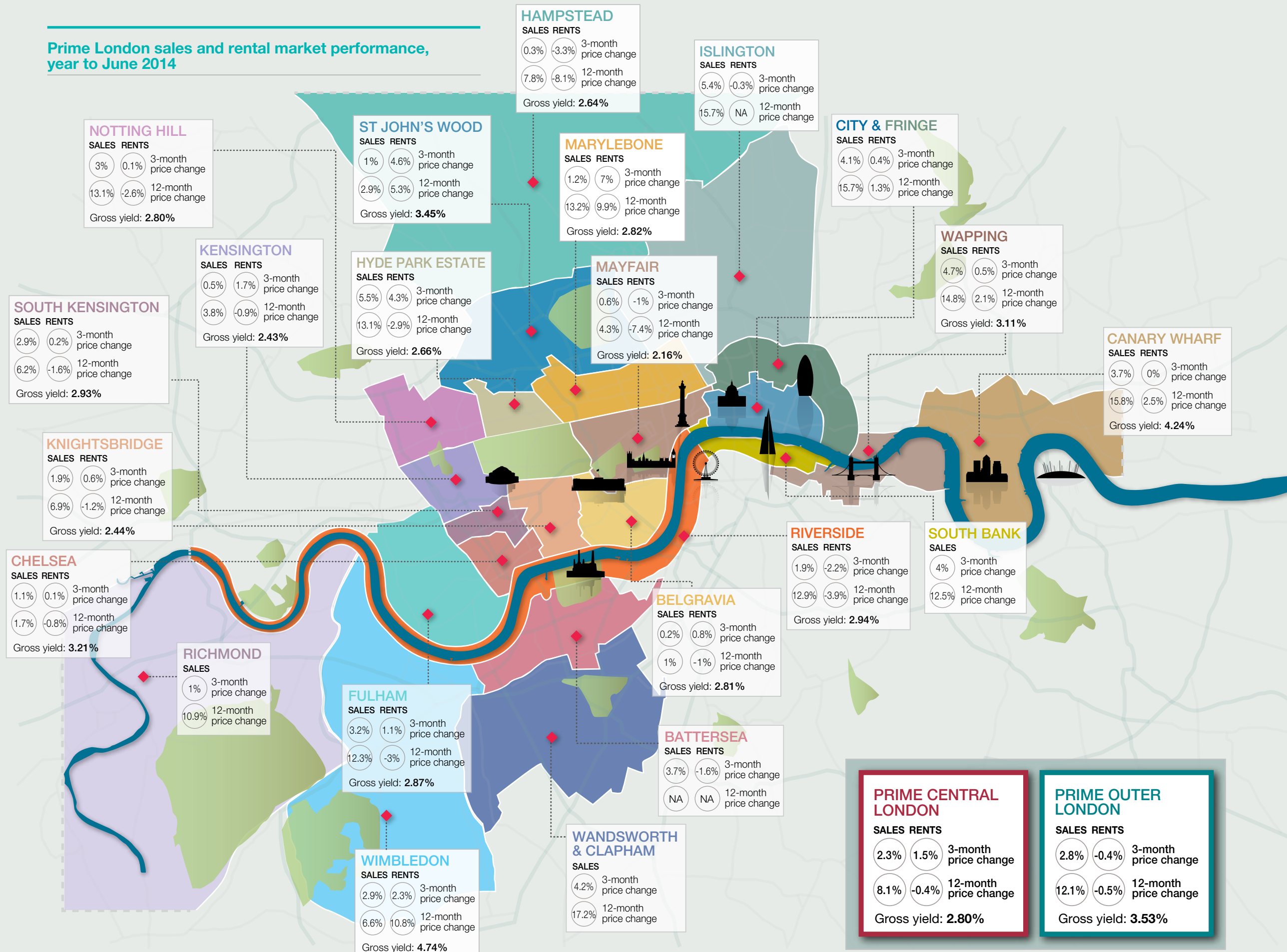
While growth in prime outer London has been accelerating over the last year across all price brackets, it was from a relatively low base and the increase only exceeded 5% a year ago and moved into double-digits in January this year.

Prime central London growth in the year to June was stronger in the lower price brackets and away from traditional areas like Mayfair and Belgravia.

Prices grew 13.6% in the sub-£2 million price bracket and an average 14.2% along a strip that runs from Notting Hill along the north of Hyde Park to the City & Fringe and Islington districts in the east.

In prime outer London, growth was stronger in the eastern district than the south-west though Wandsworth recorded the highest annual growth of 17.2% in the year to June as more buyers crossed south of the River Thames in search of more square feet for their money.

Prime London sales and rental market performance, year to June 2014



PARALLEL WORLDS IN PRIME LONDON

The ten different colours on the two maps below show ten different patterns of house price growth in London since 1995.

Two areas of the same colour indicate where the timing, volatility and magnitude of price rises and falls closely mirror each other though not necessarily the prices themselves.

It shows different parts of London can respond in comparable ways to the broad range of factors that influence house prices, including supply, access to finance, housing type, transport links and depth of international demand.

The data is based on properties sold more than once, which suggests prices in the same-coloured areas are likely to behave in a similar way in the near-term future.

The map shows a residential market in the centre with a pronounced boundary to the south and west. The central purple area indicates where prices move in relative unison, a district that broadly tallies with the Knight Frank definition of prime central London.

It is bordered to the west by the Holland Park road and to the south by the River Thames. The northern boundary runs along Westway and takes in the area around Regent's Park and parts of St. John's Wood. Meanwhile Charing Cross Road serves as a boundary in the east.

It demonstrates that roads, parks and the River Thames don't just affect prices but create sub-markets with similar long-term pricing behaviour. Other roads that act in the same way include the North and South Circular and stretches of the M4 motorway, as the map to the right shows.

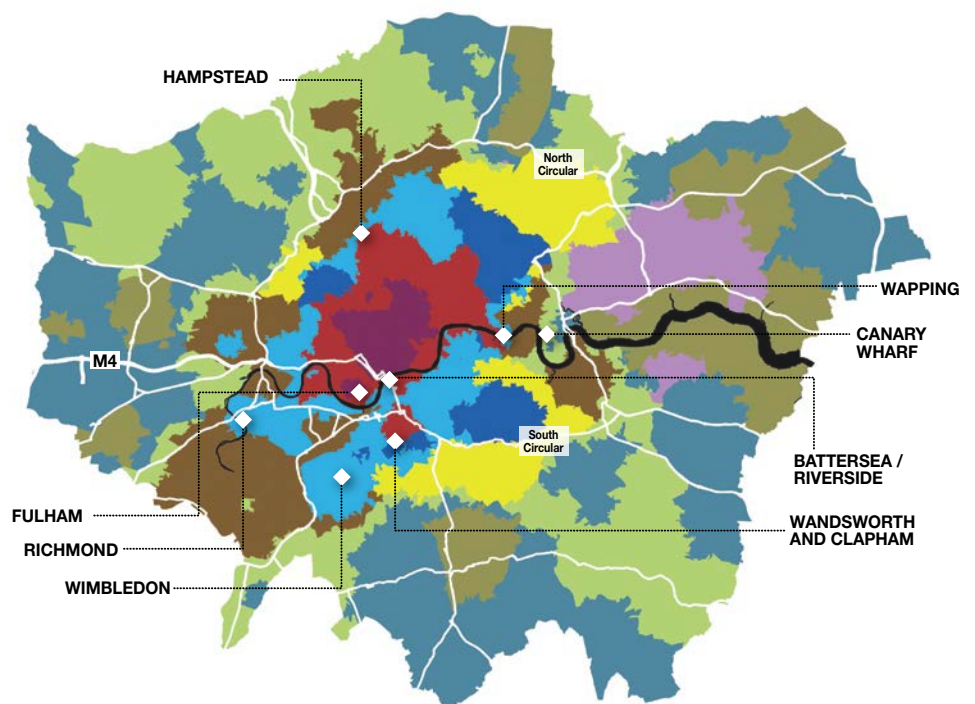
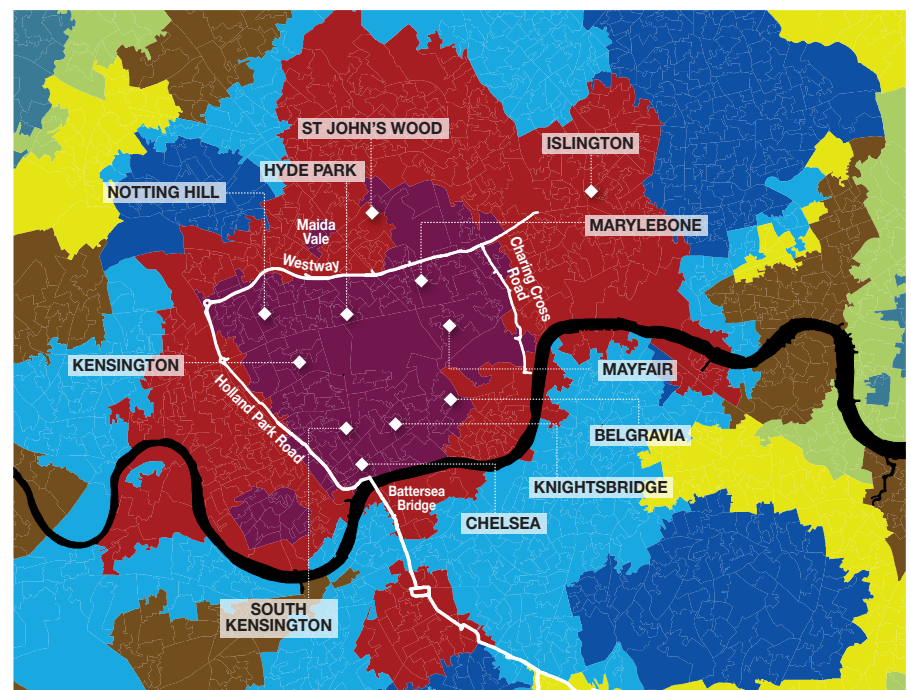
Areas outside the main purple cluster where prices behave in the same way include Maida Vale and a district around the Fulham Road.

The outer red ring occupies most of the rest of Knight Frank's definition of prime central London, including areas like the City & Fringe and Islington. While the

Thames acts a natural barrier for this cluster, exceptions south of the Thames include Wandsworth, Clapham, Battersea and Barnes.

The most fragmented market is to the east of central London, which may be due to the fact that regeneration has been more prevalent since 1995, a trend likely to continue.

FIGURE 3 **Where London house prices move in unison**



Source: Knight Frank Residential Research / Land Registry



RENTAL AND INVESTMENT MARKET FOCUS

Rental values in prime central London grew 1.5% in the second quarter of this year, which was the highest quarterly increase in more than three years.

The market turned positive at the start of the year as global economies returned to health, encouraging companies to hire more staff and increase relocation budgets.

The recovery is more tentative in prime outer London, where the index has been broadly falling for two years.

However, after decreasing for two consecutive months, rental values in prime outer London grew 0.7% in June. It was the highest monthly increase in more than three years, with none of the offices registering a decline.

In terms of corporate lettings, demand comes from a range of industries including oil & gas and mining. The latter has benefitted from positive economic data from China while oil & gas stocks have been buoyed by new discoveries.

The recovery has been more hesitant in the banking sector due to regulatory constraints and judicial investigations, which led to an 11.7% fall in the FTSE 350 banks index in the six months to June.

Proof of the broadly more positive sentiment in prime London is that global corporate relocation enquiries to Knight

Frank are on course to be 50% up on last year.

The lettings market is also poised to benefit from softening demand in the sales market. Inspections increased by more than a quarter, while new prospective tenants and the number of viewings both rose by about a fifth in the second quarter compared to the same period in 2013, as figure 5 shows.

By contrast, new prospective buyers fell by a fifth while viewings decreased 15% in the sales market.

Uncertainty in the sales market is likely to mean growing numbers of buyers and vendors consider the rental option, as they have in previous cycles.

Rental yields in prime central London were 2.8% in June, down slightly from 2.86% at the start of the year. The fact rental values are climbing and growth in the sales market is slowing suggests the shallow decline in yields will flatten out or turn positive in the short to medium term.

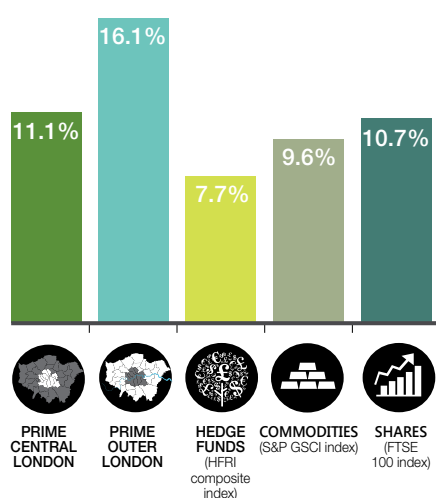
This effect was demonstrated in prime outer London in June when, after two years of declines, yields were flat at 3.53%.

Total returns for prime London property, which combine rental income and capital value growth, remained strong versus other asset classes, as figure 4 shows.

FIGURE 4

Prime London property outperforms other investment classes

Total return (year to June 2014)

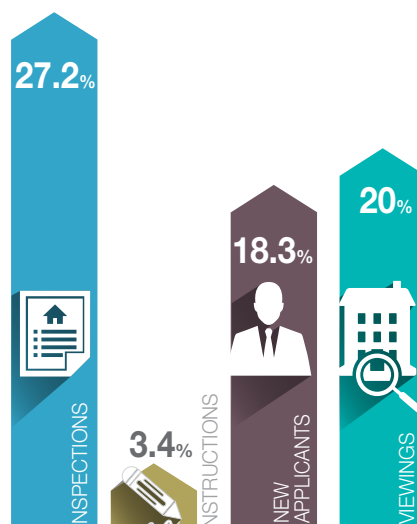


Source: Knight Frank Residential Research

FIGURE 5

The rental recovery

Q2 2014 vs Q2 2013



Source: Knight Frank Residential Research

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