New year, new challenges and new opportunities

January 2015

Few can deny that property investors in the prime London market have had a very easy ride these past 4-5 years. From studio flats in Chelsea to town houses in Belgravia, on average prices are around 50% up on late 2009/2010 with many examples where gains have substantially exceeded this. Few areas have underperformed and some, such as Bayswater and Marylebone, have outperformed. Back in 2009 achieving £2,000psf was generally limited to the rarefied addresses of Mayfair, Belgravia and Knightsbridge. By last year a good flat that ticked all boxes could confidently achieve this in South Kensington or Notting Hill. Meanwhile developers tapping in to the uber prime sector boldly asked, and have achieved, over £4,000psf on a regular basis. British Land for example presold 18 of their Clarges Street scheme in Mayfair last Sept (£227m in sales) averaging over £4,750 sq ft.

However those who have really coined it in, have been the house builders and developers who have taken hitherto unknown , or even avoided, parts of London and branded them as prime. Investors, some say as much as 70% of the demand is overseas, have lapped these schemes up and this is the year that many will be starting to make final payments and taking possession. A significant number of course will look to flip and take profits, however in so many cases it is the developer who has banked the profit and it remains to be seen what true upside can be realised for those looking for a second hand market.

A typical middle of the road example comparing a 2009 sale with 2014 (albeit a good flat in a very good address) would be a 1,450 sq ft three bedroom third floor flat on Mount Street in Mayfair bought in August 2009 for £2.05m which sold for £3.38m last Sept showing a 65% rise in value (no upgrade or improvements carried out). However, the rules of the game have changed somewhat since this flat was last sold. In 2009 the Stamp Duty payable was £102,500 and the 65% increase in value free of CGT for non residents. The property could have been owned through an SPV, thus avoiding potential Estate duties and used by one of the directors for his or her private use. Today the Stamp Duty for an incoming buyer will be £319,350 and from April this year future gains will be liable for CGT at 28%. If acquired through an SPV but intended for personal use, Stamp Duty will increase by a further £187,650 to £507,000 and the company will pay an annual tax of £23,350. However as a bona fide investment property the Stamp Duty does not increase, no annual tax is due and capital gains are paid as corporate gains thus reducing to 20%.

These changes to the taxation of property have thrown a bucket of cold water over the red hot prime markets. Demand has subsided as buyers look to see what impact these changes will have. Meanwhile sellers are withdrawing their properties sensing that they should wait it out. An election in May, together with the seasonal change for house selling, has provided both buyers and sellers a convenient timeframe within which to sit on the fence.

To illustrate this, the following is a sample of Flat sales in Knightsbridge, South Kensington & Chelsea from the LonRes database that we have referred to in previous commentaries (an agent subscription site with the most up to date data on around 70% of transactions in central London) in three different pricing brackets from 1st December to 15th January;

1st December to 15th January Sales/Withdrawals Comparison

	£750k - £2m		**£2 - 5m**		**£5 - 10m**	
	Sold	Withdrawn	Sold	Withdrawn	Sold	Withdrawn
2011/2012	44	26	27	11	4	3
2012/2013	50	41	23	16	6	4
2013/2014	73	23	25	14	8	0
2014/2015	49	49	16	23	2	5

The selected period is of course one of the least active in the year but relevant in this instance coming in the aftermath of the new tax changes announced on 4th December last year. I propose to conduct similar comparisons over the coming months. This illustrates an increasing trend of withdrawals but also the fact that the market may be quieter but has not altogether disappeared in these established locations.

Aside from those withdrawing from the market, there are of course those that have adjusted their asking price as the 5% froth that a rising market typically offers evaporates. Those who are transacting have found that the pendulum has swung in the buyer's favour and this has been reflected in Savills most recent statistics showing a fall of 4% in prime central London prices in the last quarter. I need not add that asking price adjustments, as reported by the likes of Rightmove and sometimes confused by journalists, and actual sales prices are two very different things.

Sniffing out the opportunities

A particular cliché I try and avoid but is nonetheless apt for these past few years is 'a rising tide lifts all boats'. Over the last few years the challenge for those looking to catch the tide coming in has been how to buy a 'boat' in the first place. Extreme lack of supply (except in the new build sector) and waves of cash from overseas, conspired to push prices up as referenced above. The current slow down in the market most likely marks the end of what has been a classic seller's market but with supply levels remaining stubbornly low and demand holding up, albeit at lower levels, we do not see the pendulum showing a mirrored swing towards the buyer, but clearly it has swung some way.

2015 offers greater opportunity for those, to risk another boating analogy, who believe in tacking and catching the wind while the tide is slack rather than passively waiting for the flow. The following are examples where we are focusing our efforts;

SELLERS IN NEED

It took quite a while following the 2008 financial crisis for opportunistic investors to realise that there was no distress in the prime London residential market. With base rates stuck on 0.5%, mortgage rates at historical lows and job security as good as it has been for a very long time, there still is no distress. However, there are sellers in need for personal reasons and with the right negotiation there are sweet deals to be had;

Example - Chelsea, SW3

- 1,400 sq ft upper maisonette 3 beds, 2 baths, with stunning view of Royal Hospital from large roof terrace. Needing some upgrading (estimated costs £250- £300k)
- First came to the market at £3m, an over ambitious asking price
- Reduced to £2.65m having failed to achieve a sale after 4 months
- Seller retiring to the US and has a tax deadline in April.
- In the aftermath of the new SDLT announcements we started negotiations for our client.
- Terms agreed at £2.25m on a one week exchange.
- Price agreed represents 25% drop on original asking and 10% on what we feel to be true current adjusted value using a direct market comparable nearby which we bought and developed and had revalued for mortgage purposes @ £3.1m in 2013.

DOMESTIC TURNAROUND

It has been widely reported that the broader UK housing market picked up significantly from mid 2013. It remains a patchy recovery with a stuttering start in the north of England and mortgage affordability rules placing obstacles in the way of some. However, with the UK economy having shown a robust recovery and this now finally translating in to real wage increases, we can look forward to a proper cyclical recovery in the housing market and, as ever, greater London and the South East are set to out perform. Added to this has been the recent Stamp Duty changes that have effectively reduced the charge for purchases sub £937,000. 2014 saw a classic initial recovery bounce (some locations rising by over 20%) and therefore price rises for the past couple of months have been far more subdued, but the outlook for the next 5 years is very enticing in what remains one of the most undersupplied property markets in the western world.

Example – Putney SW15

- Two storey house to be demolished and replaced by 6 apartments
- All 6 apartments to be sold at values sub £750k
- Site Cost £1.5m. Development Cost £1.85m. Other Costs £450k. ROC 18%
- Strategy…once developed sell 2-3 units to pay down debt and hold balance for long term capital growth over 5 years

PRIME LIFE GOES ON

Much was said about the Russian exodus from London last year, as sanctions were imposed, and the impact on prime London property. However in November we sold our Knightsbridge development at £9m to a Russian buyer and we have a £15m search ongoing for a long standing Russian client of ours. Meanwhile, current development projects we are already working on for 2015 include a 4,000 sq ft house in Kensington, a 2,800 sq ft house in Knightsbridge and a 2,300 sq ft house in South Kensington, in addition to 5 smaller flats in RBKC.

Example – Notting Hill, W11

- Our most recently completed scheme is a jewel of a house on Portobello Road.
- Originally bought as a rental investment 11 years ago by our client, we have totally reconfigured it for sale carrying out a top to bottom refurbishment.
- Being offered off market to buyer’s representatives but able to view on our website as follows;
- http://www.obbard.co.uk/property-development/notting-hill-portobello-road

THE NEW WORLD

Readers of these commentaries will know we have great concerns with regards to many of the luxury new build schemes in secondary locations. These concerns are less about international buyer demand as we recognise London's continued appeal for investment, but more connected to rental affordability (affecting those buyers expecting some sort of real yield to service outgoings and bank debt) and local affordability to fill the gaps when international demand tails off periodically. We see a situation where many investors will be eager to sell, this is happening to an extent already, and currency changes will play a big part I suspect. Second hand flats are likely to start competing with later phased releases by developers and within this will be good units to pick up at yesterday's prices within the right part of these schemes (river views not railway views!) and which can achieve market yields.

Example – Victoria, SW1

- Waterside development where last of 6 phases was completed last year. Sales prices achieving average £1,650psf
- No further phases and no new comparable schemes planned in the area
- 2 bed unit in phase completed around 5 years ago. Purchase price at £1,450psf
- Majority of units for instant rental release in latest phase reducing anticipated rents by 15%
- Choice of two beds in target block was limited to 3 apartments.
- Post completion of purchase and minor upgrade in preparation for let, achieving market 3% gross yield.

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