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inspired property investment

Hitting the ceiling

2014 has seen a very clear shift in focus from prime London to secondary London and beyond. An unexpectedly robust pick up in the UK economy has been translated in to a surge in confidence for the broader housing market. With the Government's Help to Buy scheme having kick started much of this last year, the UK housing market has seen around 10% growth in prices since last summer (Nationwide today report 11% August to August). The momentum looks likely to carry through this year but with base rates set to rise most probably in early 2015 and the Government's efforts to prevent an overheating market (MMR rules etc.) the signs point to price rises at a more moderate level in the near term but most likely back to their long term, pre GFC average of around 5-6% pa over the next 4-5 years.

Prime Central London meanwhile has seen a slow down as prices reached a point where buyers were not prepared to go beyond. A base entry level approaching £1,500psf meant that values in excess of £2,000psf were becoming commonplace for properties that were ordinary at best both in terms of location and quality. Consequently it appears that a ceiling has been reached. Uncertainty over the Government's plans for introducing an annual property tax on higher value homes (referred to as the mansion tax) and a looming election in May of next year have conspired to further dampen enthusiasm for now. Savills report 2.5% growth in the first half of the year of which only 0.4% was in the 2nd quarter. The slow down in growth is likely to lead to a period of price stability while these new pricing levels bed in. Traditional Prime Central London has typically followed this pattern where sharp growth is followed by a period of flat lining.

We believe there are also issues of over supply which are dampening the broader upper end of the market as developers have looked to redraw the map of prime London. A further concern has been the rising number of speculators looking to punt new schemes through off plan pre-purchases.

Is £1,500 psf the new prime?

Ask most people what they believe to constitute the prime central London market and they would typically point to the boroughs of Kensington & Chelsea and Westminster or, more visually, the areas surrounding Hyde Park, Regents Park & Green Park. Apart from including many of the most professionally managed estates (Grosvenor, Welcome Trust, Cadogan, De Walden, Crown etc.), plus pretty garden squares and top end shops and restaurants, these areas have long been established as being the most expensive, internationally renowned and recognised as exclusive. There are of course prime areas beyond the two main boroughs which are still deemed to be central such as Hampstead, Parsons Green and Wandsworth Common where the character of the area is strictly controlled through conservation and listing restrictions and a refined, local village feel has blossomed.

In recent years newly emerged areas of London have appeared where the developers have looked to stretch or reclassify the borders. Olympia is marketed as Kensington, Sands End as Fulham, Nine Elms as Battersea etc. Shoreditch, Southwark & Kings Cross are examples of newly crowned prime central London locations, as determined by the marketing campaigns. It is perhaps subjective today to argue if Tottenham Court Road or London Bridge are deemed prime London, however what appears to have elevated these hitherto overlooked areas in to the prime category is the pricing on new build schemes being on par with many of the long established prime central areas.

Average prices for new schemes in these new areas are around £1,500psf. In areas like Nine Elms, being predominantly light industrial, there was hardly any existing residential stock and in Kings Cross, Southwark etc. what existed was typically run down and tacky commanding little more than £500psf 3-4 years back. No wonder a 'research' paper by one of London's leading estate agencies marketing these schemes predicted 140% price rises when first launching these a few years back, as the price rise was more or less established on first launching these schemes. Averages only provide a context of course. Upper floors with direct river views, or anything purporting to be a penthouse, are likely to be £1,750psf or more and prices closer to £2,000psf are being asked in several new towers along the south side.

At £1,500psf this equates to around £700,000 for a typical one bedroom apartment. By way of a reference starting prices are £850,000 at Battersea Power Station and at One Blackfriars prices start in excess of £1m. A 3.5% yield (a typical average yield quoted by developers) on £700,000 equates to a rent of £24,500 per annum. According to HM Treasury the average salary of the top 10% earners in the country is £60,500, the very great majority being concentrated in London and the South East, this is before tax which equates to around 25% after allowances. Understanding who has been able to afford to buy these apartments (predominantly from overseas) is much easier than determining who can afford to rent them going forward.

The sheer number of new schemes under construction and commanding prices that compare with the likes of South Kensington, Notting Hill or Marylebone is astonishing. As the first phases of these schemes are handed over and speculators look to flip, having finally had to come up with the lion share of the money, we will start to understand what depth there is to these new location projects.

Anyone looking to buy in to one of these schemes would be well advised to ignore the slick CGI's, fancy marketing suites and 'deposit down, pay later' appeal and before committing, physically walk the area in order to understand what they are actually buying.

We have aired our concerns about these new schemes before, this is a generalised view and therefore not all by any means are to be simply dismissed and some will quite fairly warrant inclusion in to the prime London category. With 70% having been bought by overseas buyers, maybe so called Buy to Leave 'investors' will mitigate the pending oversupply of apartments for rent. The growing number of rich students occupying high value homes will no doubt account for a meaningful percentage. However if, as we believe, prices have gone too far too quickly, the speculators and yield dependent investors may make a rush for the door and we might see a sharp correction. This in turn will slow down later phases and potentially stretch out the building programmes, particularly on the very large regeneration schemes like Battersea Power Station and Earls Court Stadium, for many years to come. This not only means extended construction disturbance and possible infrastructure delays, experience has shown that this also risks slowing down the openings of retailers and restaurants which are so key to making a new area come alive and enjoyable to live in.

The attraction to many for buying in to new build schemes has been the payment terms. A small reservation fee, followed by a 10% down payment, maybe a further 10% payment and the balance in 2-3 years. During which time the market was predicted to rise sharply. Often mortgage funding would be packaged to go hand in hand adding another level of ease. If buyer demand falters and investors struggle to secure tenants as further phases are completed, all at a time when interest rates are at the start of an upward cycle, £1,500psf and the 'Prime London' tag may start to rapidly unravel.

Government sending out mixed messages

It is quite possible that the Government will introduce further taxes on property, one stated target has been on those who Buy to Leave. Proportionate tax increases will be acceptable and deemed fair just so long as they are indeed proportionate. Up until now the property sector has been taxed with the lightest of touches and therefore some changes are arguably long overdue.

Unfortunately being seen to do something about wealthy foreigners 'pushing up property prices', albeit in sectors that only truly affect a small upper end of the market, is seen as more important than addressing the fundamental issues of the market, i.e how to encourage and assist developers to build for the broad market and shift focus away from the congested South East of England.

The availability and affordability of housing is one the hottest political potatoes of our time. This is an issue seen in many parts of the world and it has far reaching implications on issues such as tax, immigration, welfare etc. Our Government does not help the situation by sending out mixed messages;

- We are told that we need to be weaned off our dependency on house prices as this endangers the economy. Yet one of the most frequent utterances by the politicians is the 'urgent need to get the young on to the housing ladder'.

- We are told that household debt is at dangerous levels. With first time buyers unable to save for mortgage deposits the Government introduced Help to Buy to bridge the gap by providing additional debt leading to LTV's upwards of 90%.

- We are told house prices are too high in areas where demand is greatest. Rather than introduce radical changes to planning policy and accelerate infrastructure investment, the Government slashed interest rates to prop up the housing market, amongst others, and later introduced Help to Buy.

- A construction boom took off post GFC as developers built in London to meet a seemingly insatiable overseas demand. In 2012 the Government introduced penalty taxes on properties over £2m bought by 'non natural persons' (overseas companies and the like). This diverted some offshore buyers to lower value properties under £2m. The threshold is about to be lowered to £1m and then further to £500k thus encouraging foreign investors towards pricing levels suited to the professional local market where the need is so fundamental.

Where are the opportunities?

PRIME CENTRAL LONDON (> £5m)

Suffering from insufficient demand from genuine end users to match the significant increase in supply from property developers.

Perception of prime London prices having gone too far and uncertainties over tax changes dampening demand

Surge of new schemes coming on stream with high value units in newly crowned prime locations

OPPORTUNITIES
To buy poorly presented properties, in targeted established prime addresses, that have been sitting on market since late 2013 between now and election at 15% off peak
Take 12-24 months to redevelop and sell back in to market in 2016/17 once election ramifications have settled and market has plateaued for 2-3 years leading to pent up demand for the very best.

PRIME CENTRAL LONDON(£2m -£5m)
Likely to remain relatively active for domestic principle home buyers but supply levels up and only the best will sell.

OPPORTUNITIES
To super prime sector but probably more challenging to buy well due to active local buyer interest supported by a resurgent economy giving impetus in areas of focus (typically established locations served by good schools and amenities).
Core 2nd, 3rd home owners will still remain a significant market from various parts of the world, if a bit subdued compared to the last few years.

PRIME LONDON (£750k - £2m)
The stated upper end category for 'non natural persons' is about to be reduced thus changing the £2m barrier introduced in 2012 (Stamp Duty is expected to remain the same).
Over supply of high value new build schemes and lack of sufficient tenant demand to support values leading to price cutting by as much as 15-20%?
£2,000psf to remain the preserve of only the very best. Expect adjustment of prices to start taking place over the next 12 months.

OPPORTUNITIES
Extremely limited as prices need to adjust and slowing demand, particularly from overseas, will likely enforce this over time.

MAINSTREAM LONDON (< £750k)
Gross yields at 4% imply fair value with some headroom for base rate rises.
Significant domestic demand with rising affordability yet to be met with sufficient supply.
Informed investors have recognised this and there is much activity in this sector with a very sharp price rises seen over past 12 months
Likelihood of fairly consistent price growth in the medium to longer term make this sector the most appealing.

OPPORTUNITIES
Smaller schemes where small developers are tightly managing cash flow
Small sites with planning risk with some underwrite (unlikely to appeal to larger house builders and risky for small/medium developers)
Build up of cherry picked portfolios where management can be effective and efficient.

SUBURBS/SOUTH EAST (< £750k)
As one goes farther from London, international buyer interest subsides and so this should imply less competition.
Best placed for continued economic recovery with implied better upside in part due to critical undersupply
Rental demand the likely big growth area

OPPORTUNITIES

Target locations where access to centre is fast & efficient (cross rail etc.) and young professionals priced out of London

Underwrite model for small/mid sized house builders (pre purchase)

Small sites with planning risk with some underwrite.

BROADER UK (< £500k)

Prices still barely back to peak prices in many parts

Key is to identify wage growth hot spots

Rental demand the big growth area

Market has picked up but will be very sensitive to rate rises. Rental demand will grow exponentially

OPPORTUNITIES

The next areas for the ripples to hit

Lack of buyer competition, relatively speaking

Yields of 6% would imply good value

Sharp upward pressure on rents

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