Supply Demand and Politics

OCTOBER 2015

This year has been more or less dominated by the general election which was held back in May. The ramifications of which continue as we head deep in to the second half of the year. In my last comment I reported that there had been no post election bounce in the prime London residential market and with the autumn market well upon us, that hoped for bounce still remains elusive, but there are at least some stirrings afoot.

As far as the politics goes, things are far from being boring. The Tories surprise victory has provided much needed stability with cautious optimism for a continued economic recovery. The opposition's implosion leading to their choosing an old fashioned Trotsky rebel who can't bring himself to sing the national anthem is simply bewildering. The Liberal democrats, traditionally the third party and previously on an upward trajectory, have only 8 members of parliament or 1.2% of the total. The new third party are the Scottish nationalists whose dream of full independence from the UK is only matched by their desire for ever closer union with Europe.

Property however risks being quite dull by comparison and the reasons for this are more due to the actions of politicians as opposed to the more normal economic influences. Since the GFC we have seen perhaps the most extreme two tier market. Back in 2008 everything was heading south in the immediate after shock of the Lehman collapse. Seven years on and one looks back at a 'blink and you missed it' correction in the prime markets which have since seen an average 150% increase in values over and above the previous peak. This is contrasted by the rest of the market which saw prices fall by 20% only to be around 10% above their previous peak today.

The reality of the new world was most apparent in lending practices. As base rates were slashed to 0.5% those who didn't really need to could borrow at rates never seen before, whereas those in need were charged huge margins. First time buyer mortgage rates were around 6% in 2010 and private banking lending rates sub 2% for the very wealthy. In reality the sort of margins that a typical mortgage borrower could genuinely afford only started to be broadly available barely two years ago.

House builders and developers were quick to recognize this new era. Instability around the world added an additional dimension as investors were drawn to London as a safe haven. Prime London's inherent supply constraints led to a building boom for luxury, high end apartments, many in rather secondary addresses, with fears now of over supply in certain locations. Meanwhile, the supply of new housing stock in the mainstream market remains at a critical low forcing prices and rents up as the economy recovers and demand for new housing increases.

This polarized world seemed all too unfair and soon became politically uncomfortable……cue Government intervention.

Cooling & Stimulus

In my previous commentary I summarized a number of the changes introduced by the Government during the course of the past 2-3 years. There has been a rather relentless and confusing mix of new measures offering both give and take. The ‘take’ of course being at the upper end with increased Stamp Duty, increases in annual taxes for private homes owned through corporate vehicles, removal of CGT exemptions and a phasing out of mortgage interest relief effecting higher value buy-to-let investments. The ‘give’ has been through the much debated ‘help to buy’ schemes, extension of the ‘right to buy’ for council homes to include housing associations and an effective cut in Stamp Duty for properties under £937,000.

Many of these measures were clearly politically motivated and intended to stimulate the broader market whilst taking the heat out of the upper end which was seen to be dominated by foreign money. The Government has been vocal in their desire to help first time buyers get on the housing ladder but slapping big taxes on a Knightsbridge ‘mansion’ doesn’t help a first time buyer earning £40k a year get on the housing ladder. Equally, raising Stamp Duty to an effective 9% on a £3m purchase (compared to 4% back in 2010) doesn’t make for a fluid market and encourage mobility. More than anyone the Tories know that, often than not, raising taxes too aggressively leads to actual falls in receipts for the revenue. So it has been shown as the substantial increases announced last December have now seen the top end of the market stagnate with resulting falls in Stamp Duty receipts.

This all sat well with the voters. As they saw it, rich foreigners were being taxed more and the struggling domestic market was getting a few handouts. The Tories won the election and Labour’s feared ‘mansion tax’ was consigned to the bin. The reality though is that the first elected Conservative Government for 19 years is overseeing a new era of higher property taxes which look like they are here to stay.

A MIXED MARKET

Prime market subdued

The traditional prime central London market (typically defined as the boroughs of Kensington & Chelsea and Westminster) have seen transaction volumes drop sharply this year. Knight Frank recently reported a drop of 19% on transactions over £1.3m and 25% in excess of £3.3m for the year. Savills on the other hand report prices having fallen by 1.1% on values in excess of £2m, rising to 4.6% for homes in excess of £5m. This contrasts with the Halifax broad UK house price inflation index showing prices up 9% year on year in August with the Government’s Office for National Statistics showing a 5.2% increase.

Having failed to see a post election bounce, around one third of sellers have revised asking prices down. With the pendulum swinging now in the buyer’s favor, the overpriced and mediocre are quickly being revealed. However, where value or genuine rarity are to be found, prices are proving to be very robust. The following are some examples from our own experience in the past couple of months;

- Short list of 5 houses between £5-£7m prepared for a client saw 4 agreed before he had time to get over to London to view.
- £4m house on the edge of Belgravia in need of work asking under £1,600psf exchanged within 72 hours of agreeing terms
- 1,350 sq ft top floor flat in Notting Hill needing refurbishment with a £2.2m guide price went to best offers after 58 viewings in two weeks, receiving 6 offers none of which were from developers.
- £5.25m house in Knightsbridge in good condition saw the initial buyer gazumped.
- £2.3m flat purchase agreed in South Kensington saw the initial buyer gazumped.

- £2.85m flat in Holland Park with development potential went to best bids receiving 11 offers.
- A genuinely uniquely positioned development in Richmond at the entrance to the park, with typical one bedroom flats starting from around £1m, had over 2,000 buyers register and the developer stating buyers need queue to put down reservation fees

A couple of other notable stories from high end developers were;

- A small scheme of 7 units in Mayfair saw six sold on release at an average £5,500psf with the penthouse selling just shy of £7,000psf.
- Northacre have discreetly launched their new project at One Palace Street by Buckingham Palace with around 30% immediately sold at prices around £3,000psf +

Although the market is subdued compared to the frenetic pace of the previous 3-4 years, it seems very apparent that the appetite for London property remains firm. Agents report good numbers of registered buyers but not the levels in transactions. For now the seemingly never ending rise in values has abated and there is quite clearly a wait and see attitude being adopted by many.

There are several clear reasons behind this current slow down;

VALUES

There is a widespread view that London prices are fully valued and accordingly buyers feel they are under no time pressure. Equally sellers, who themselves can take a longer term view, are under no pressure to adjust their expectations.

TAX

As discussed above, there have been many and frequent changes over the past 2-3 years. A period without more Government meddling will help rebuild confidence in what has historically been a very stable environment both in terms of the market and taxation.

CURRENCY

Sterling's weakness has been lessened for some jurisdictions such as Singapore and Europe but for others, like Malaysia (a big market for London property) their own currency's weakness has become a significant barrier.

Outlook

A modest price adjustment is taking place, around 5-10%, which is felt to be as a direct impact of the latest Stamp Duty rises. We see the market remaining pretty flat for a while to come. We see no serious pressure on sellers to start dropping prices, the first 5% coming off is always the froth as a market peaks. Therefore buyers waiting for this eventuality, and who focus on true quality and rarity, will likely have a long and fruitless wait ahead. The market is going to be challenging with quality and value shining through and the mediocre suffering. The second home market is as strong as its ever been and, assuming no new perceived anti-foreigner taxes, we see this market kicking back in to life. Continued turbulence in global markets and geopolitical concerns will ultimately be to London's advantage.

We believe the luxury new build sector outside of core prime London will see the brunt of the change in climate and predict quite a significant readjustment in pricing as well as the likelihood that additional phases will be postponed leading to some of the mega projects being 'under construction' well in to the mid 2020's.

Strong upturn in the broader market

Outside of the well defined prime locations the picture is more varied. The market remains very active at prices sub £1m and this extends to locations well beyond the London postcodes. Closer in, what one might call the 'squeezed 1%' who own relatively high value property on a national comparison but somewhat modest for central London (properties around £2m to £3m) are being hit hard by the Stamp Duty rise as alluded to earlier and the accumulated costs in moving home.

The broad UK housing market appears to be well in to its second year of a new cycle. Having required the Government's intervention to kick start the housing market, we are finally seeing the fruits of the economic recovery with real wage increases which is the vital ingredient for a sustained housing recovery. Having bashed the rich, the Government now need to address the fundamental issues of critical under supply of new housing which goes back decades. Barely a day goes by when this isn't being discussed in the media and the solutions are far from easy given the UK's archaic planning laws and the sanctity of the greenbelt.

For the wider investor market, the higher the value the bigger the tax implications which is encouraging a focus on lower value properties. George Osborne's tax crackdown on buy-to-let landlords has failed to dampen demand and simply directed investors to lower pricing sectors. Buy-to-let borrowing has in fact surged since the last Budget making a joke of the chancellor's attempt to "level the playing field" between buy-to-let borrowers and first-time buyers. Mortgage brokers have reported that the months since the changes were announced have been the busiest of the year for buy-to-let applications with deals having risen by more than 10%.

Outlook

The broad UK housing market has extreme supply constraints which points to rising prices and rising rents in areas best placed to enjoy a continued economic recovery. The traditional ripple effect is starting to take hold with prices outside of greater London and the South East recovering well. The broad national picture is mixed however and therefore focus will continue to be greater on London and its broad catchment area, prices are likely to perform robustly over the next 4-5 years with pressure also on rents which should offset concerns connected to anticipated interest rate rises.

For those interested in the broad domestic market the following is our 'opportunity' summary.

THE DOMESTIC RESIDENTIAL MARKET Target Price £300k to £850k

Cyclical recovery story backed by historically low mortgage rates.

Investments in strong secondary locations that meet certain criteria as follows;

- 1 bed units £300k to £650k
- 2 bed units £500k to £850k
- Gross Yields at or close to 4%
- Within 5-10 minutes walk of main line station or tube line
- Locations benefitting from new infrastructure – Cross rail being the most obvious and HS2 further in the future.

- Close to leading super market chains – Tesco, Sainsbury, Asda, Waitrose and M&S Foods
- Close to one of Top 3 coffee chains –Starbucks, Café Nero, Costa or quality independents.
- Close to colleges and quality education establishments
- Within 10 mins of public park or gardens.
- Safe neighbourhoods
- Purchaser profile of developments with high levels of domestic buyers (all investor owned blocks tend to underperform on yield and capital values)
- Less than 1 hour door to door commute to the likes of Liverpool Street, Canary Wharf or Piccadilly.
- Off plan, new or recently built schemes with professional building management

Target locations;

WEST LONDON & BEYOND from Shepherds Bush out as far as Maidenhead. Much of this area is known as the M4 corridor which has easy access to Heathrow some major employers (Vodafone for example) and the full benefit of Crossrail which is due to be operational in 2018.

SOUTH WEST LONDON Wandsworth to Wimbledon. The best parts will be too expensive but there are areas in between and to the south such as Southfields, Mitcham, Colliers Wood, Merton

SOUTH EAST LONDON With the regeneration of SE1 (Southwark with the Shard and Borough Market) and now Elephant & Castle. Bermondsey to Deptford are strong areas to focus on.

The greater majority of new stock at this pricing point is in East London, north of the Thames, due to the greater availability of brownfield sites to develop. The quality of the local infrastructure in many parts is still poor. Although London is by and large a relatively safe city, there are also locations which are not at all 100% safe. Issues of potential future oversupply stretching East from Stratford (Olympic Park) down to Isle of Dogs (Canary Wharf) are a concern.

As investments we see a very strong rationale. For clients looking to give children a foot on the ladder, we see affordable options in safe locations offering strong capital and rental growth potential that may or may not be used in years to come but can be easily sold for alternative purchases in other preferred locations. Sensible tax planning can ensure these are owned efficiently to optimise future tax exposure.

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