RESIDENTIAL RESEARCH

Knight Frank

LONDON RESIDENTIAL REVIEW

BREXIT AND THE PRIME LONDON PROPERTY MARKET

AUTUMN 2016

BREXIT VOTE REINFORCES PRICING TRENDS

STAMP DUTY REFORMS IMPACT LONDON MARKET

SUB-£2 MILLION MARKET OUTPERFORMS

BREXIT VOTE AMPLIFIES PRICE SENSITIVITY IN PRIME LONDON

Brexit has underlined how price-sensitive the market remains following two stamp duty rises since December 2014, says Tom Bill

KEY FINDINGS

Annual growth was -1.8% in prime central London and 1.4% in prime outer London in August

Higher stamp duty means transactions fell by an average of more than -5% in the five years to March 2016 in boroughs including Westminster, Kensington & Chelsea and Camden

Hackney, Southwark and Lewisham recorded the largest rises in the **number of property sales between £1 million and £2 million**

Price growth for properties under £1 million was 3.4% in the year to August in prime outer London and 1.2% for properties between £1 million and £2 million

The number of new rental properties placed on the market in prime London rose by 35% in the three months to the end of July 2016 versus the same period in 2015

TOM BILL
Head of London Residential Research

"Vendors were already adapting to the new pricing environment and in many cases Brexit became a trigger to make overdue reductions to asking prices."

While the decision to leave the European Union has created short-term uncertainty in the prime London property market, this needs to be viewed in the context of events in the two-year period preceding the vote.

In June 2014, annual growth in prime central London reached 8.1% before it began a steady decline to -1.8% in August 2016.

Two major factors caused the slowdown. First, the scope for future increases was limited following a four-year period of exceptionally strong growth. Second, two stamp duty hikes and a series of tax changes accelerated this process.

This period of government intervention has led to deepening distortions in the London housing market, which we examine in more detail on page 3.

The single biggest factor that curbed demand in the 18 months prior to the referendum was the increase in stamp duty in December 2014, widely seen as a political manoeuvre by the former Chancellor George Osborne ahead of a general election.

This measure has loomed larger than any other over the market, compounded by the introduction in April this year of the additional rate of stamp duty equating to three percent for buy-to-let properties and second home buyers.

The result of this two-year slowdown is that vendors were already adapting to the new pricing environment and in many cases Brexit became a trigger to make overdue reductions to asking prices.

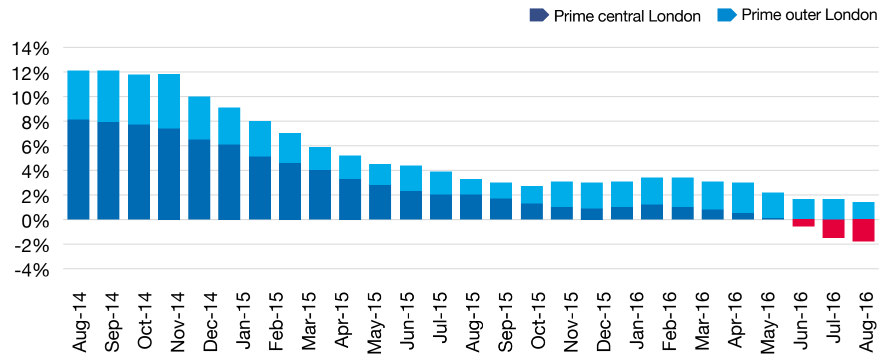
In the two months since the vote, while many buyers have sought asking price reductions the majority of sellers are adopting a wait-and-see approach though low to mid-single-digit declines are common.

There is no uniform picture however, and where asking prices were set at realistic levels before the EU vote, transactions have been achieved at or around the asking price.

Furthermore, currency is playing a more significant role, with the weaker pound spurring interest from buyers denominated in foreign currencies. The volatility of sterling in the past few weeks is leading many to speculate that overseas interest in the London market will filter through more strongly when there is greater confidence that the pound has hit its low point.

It should also be remembered that other asset classes are showing weak returns. Bond yields are at historic lows, hedge funds are struggling to anticipate central bank policy and many believe stocks look fully priced after successive rounds of quantitative easing.

FIGURE 1
Price growth slows in prime central and prime outer London



Source: Knight Frank Research

Please refer to the important notice at the end of this report

STAMP DUTY REFORMS DISTORT MARKET

UK Prime Minister Theresa May has stated that tackling the country's "housing deficit" is one of her priorities.

The issue of affordability caused by a shortage of homes is most acutely felt in London. Developers and housebuilders in the capital are likely to look for positive action on measures aimed at boosting construction volumes in the government's first post-referendum Autumn Statement on 23 November.

The reforms to stamp duty we note on page 2 have had a sizable impact on demand and transactions and understanding this impact is important to inform future policy direction.

A fully-functioning London housing market is an important building block for a stronger economy, particularly in view of the economic and political uncertainty brought by the UK's vote to leave the European Union.

The importance of the prime London housing market in particular is underlined by the fact 11% of all stamp duty revenue in England and Wales is collected in the two London boroughs of Kensington & Chelsea and Westminster.

Furthermore, housing transactions play a key role in sparking wider economic activity and encouraging social mobility. Any knock-on benefits will be reduced if housing market activity in the economic epicenter of central London is curtailed.

Our latest analysis shows the government increasingly relies on London for its stamp duty revenue, an overall figure that now exceeds £6 billion a year.

However, while London's contribution rose to 44.6% in the year to March 2016 from 41.5% a year earlier, London only accounted for 12.3% of transactions, down from 12.7%. The picture emerging is one of growing fiscal reliance on areas where transactions are shrinking at the steepest rate.

There are also signs the stamp duty changes introduced by former Chancellor George Osborne are disrupting the natural cycle of the London property market.

Since 1995, rising transactions in central London have typically been followed by declines as activity and house price growth spreads to outer boroughs in a trend known as the 'ripple effect'.

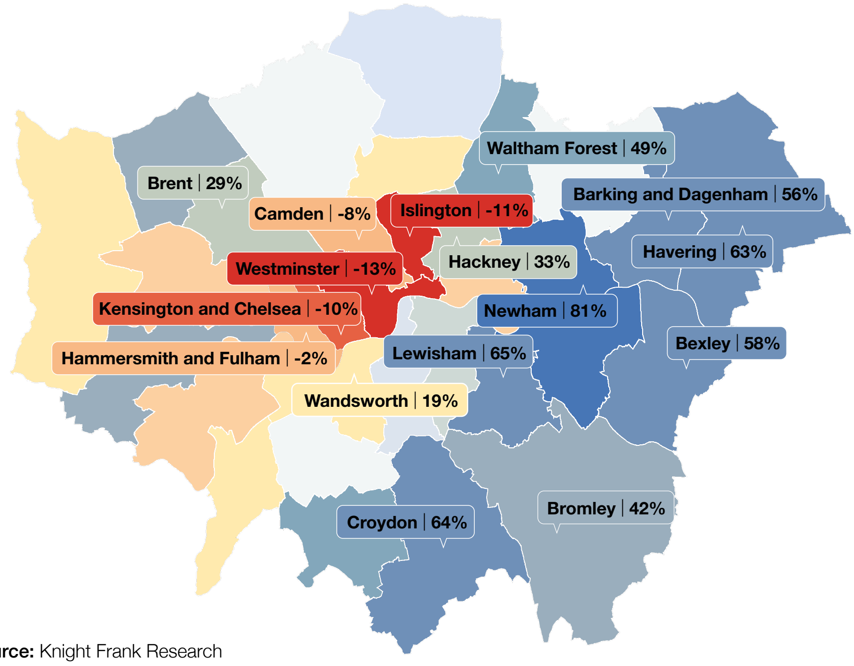
Following a two-to-three year period, this movement has typically reversed as central London prices become more attractive relative to outer London.

However, there are few signs of transactions increasing in central London following a broad decline in volumes that began several years ago, as figure 3 shows.

Transactions in Westminster, Camden, Islington, Hammersmith & Fulham and Kensington & Chelsea all fell by an average of more than 5% per year over the five year period to March 2016, versus the London average. It is the first time this magnitude of decline has been registered in this many London boroughs since Land Registry records began in 1995.

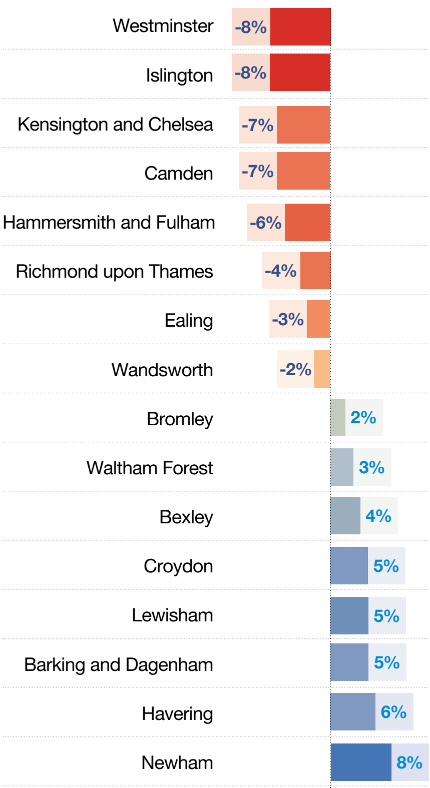
If the pattern persists, the risk is that demand and property prices in outer boroughs will become further inflated and more susceptible to future price instability.

FIGURE 2
Transaction volumes decline in central London
Year to March 2016 versus year to March 2010

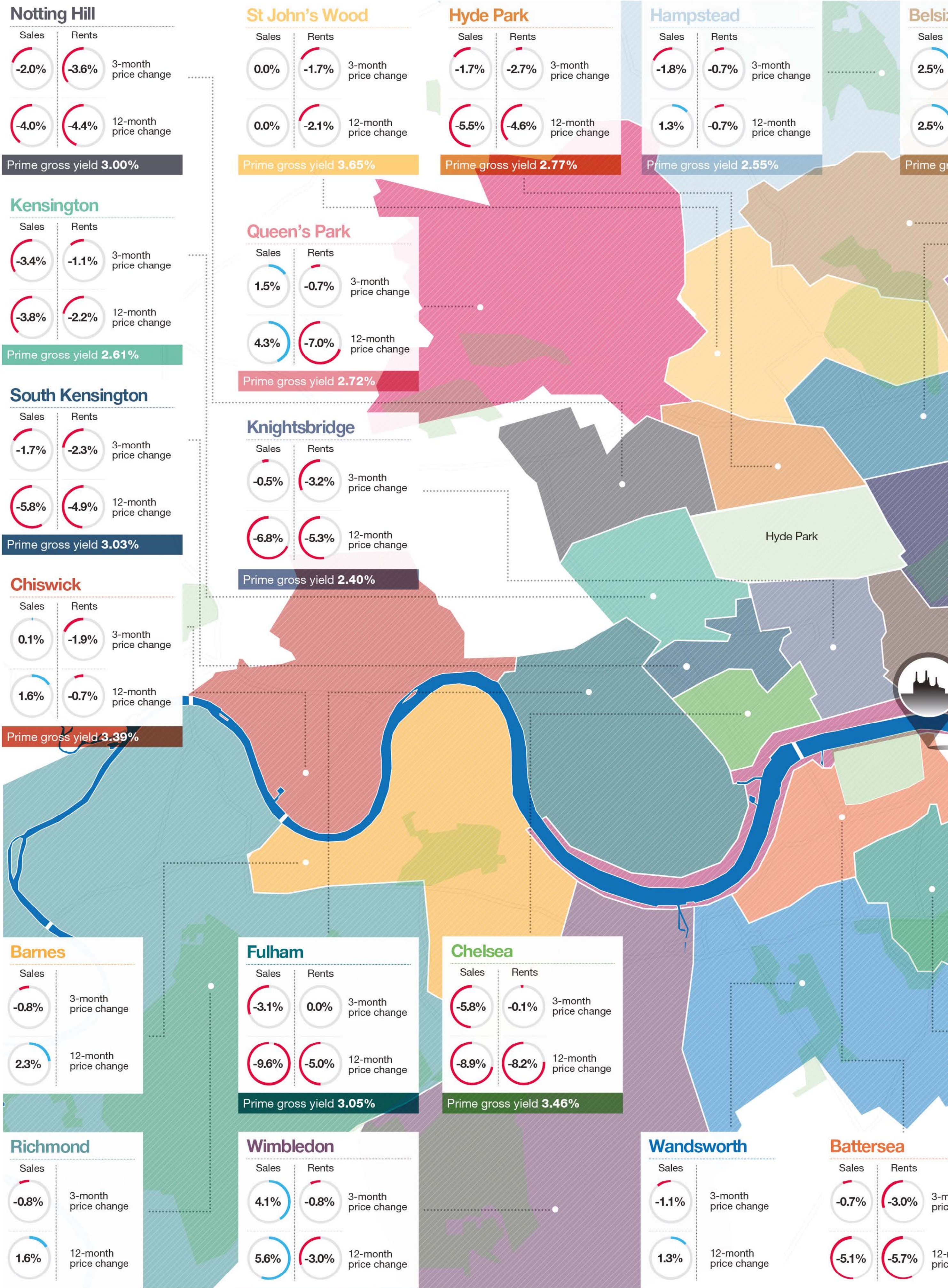


Source: Knight Frank Research

FIGURE 3
Five-year average annual % change in transaction volumes
Five-year period to March 2016, versus London average (updated 22/09/2016)



PRIME LONDON PRICE AND RENTAL GROWTH, AUGUST **2016**



Notting Hill

	Sales	Rents
3-month price change	-2.0%	-3.6%
12-month price change	-4.0%	-4.4%

Prime gross yield **3.00%**

St John's Wood

	Sales	Rents
3-month price change	0.0%	-1.7%
12-month price change	0.0%	-2.1%

Prime gross yield **3.65%**

Hyde Park

	Sales	Rents
3-month price change	-1.7%	-2.7%
12-month price change	-5.5%	-4.6%

Prime gross yield **2.77%**

Hampstead

	Sales	Rents
3-month price change	-1.8%	-0.7%
12-month price change	1.3%	-0.7%

Prime gross yield **2.55%**

Belsi

Sales
2.5%
2.5%

Prime g

Kensington

	Sales	Rents
3-month price change	-3.4%	-1.1%
12-month price change	-3.8%	-2.2%

Prime gross yield **2.61%**

Queen's Park

	Sales	Rents
3-month price change	1.5%	-0.7%
12-month price change	4.3%	-7.0%

Prime gross yield **2.72%**

South Kensington

	Sales	Rents
3-month price change	-1.7%	-2.3%
12-month price change	-5.8%	-4.9%

Prime gross yield **3.03%**

Knightsbridge

	Sales	Rents
3-month price change	-0.5%	-3.2%
12-month price change	-6.8%	-5.3%

Prime gross yield **2.40%**

Chiswick

	Sales	Rents
3-month price change	0.1%	-1.9%
12-month price change	1.6%	-0.7%

Prime gross yield **3.39%**

Barnes

	Sales
3-month price change	-0.8%
12-month price change	2.3%

Fulham

	Sales	Rents
3-month price change	-3.1%	0.0%
12-month price change	-9.6%	-5.0%

Prime gross yield **3.05%**

Chelsea

	Sales	Rents
3-month price change	-5.8%	-0.1%
12-month price change	-8.9%	-8.2%

Prime gross yield **3.46%**

Richmond

	Sales
3-month price change	-0.8%
12-month price change	1.6%

Wimbledon

	Sales	Rents
3-month price change	4.1%	-0.8%
12-month price change	5.6%	-3.0%

Prime gross yield **4.02%**

Wandsworth

	Sales
3-month price change	-1.1%
12-month price change	1.3%

Battersea

Sales	Rents	
-0.7%	-3.0%	3-m pric
-5.1%	-5.7%	12- pric

ze Park

	Rents	
	0.7%	3-month price change
	0.2%	12-month price change

ross yield **3.07%**

Islington

Sales	Rents	
0.2%	-1.6%	3-month price change
3.6%	-3.3%	12-month price change

Marylebone

Sales	Rents	
0.1%	1.0%	3-month price change
-0.9%	-7.6%	12-month price change

Prime gross yield **2.92%**

Wapping

Sales	Rents	
0.6%	0.3%	3-month price change
4.3%	1.6%	12-month price change

Prime gross yield **3.04%**

King's Cross

Sales	Rents	
0.1%	0.7%	3-month price change
0.1%	1.3%	12-month price change

Prime gross yield **3.77%**

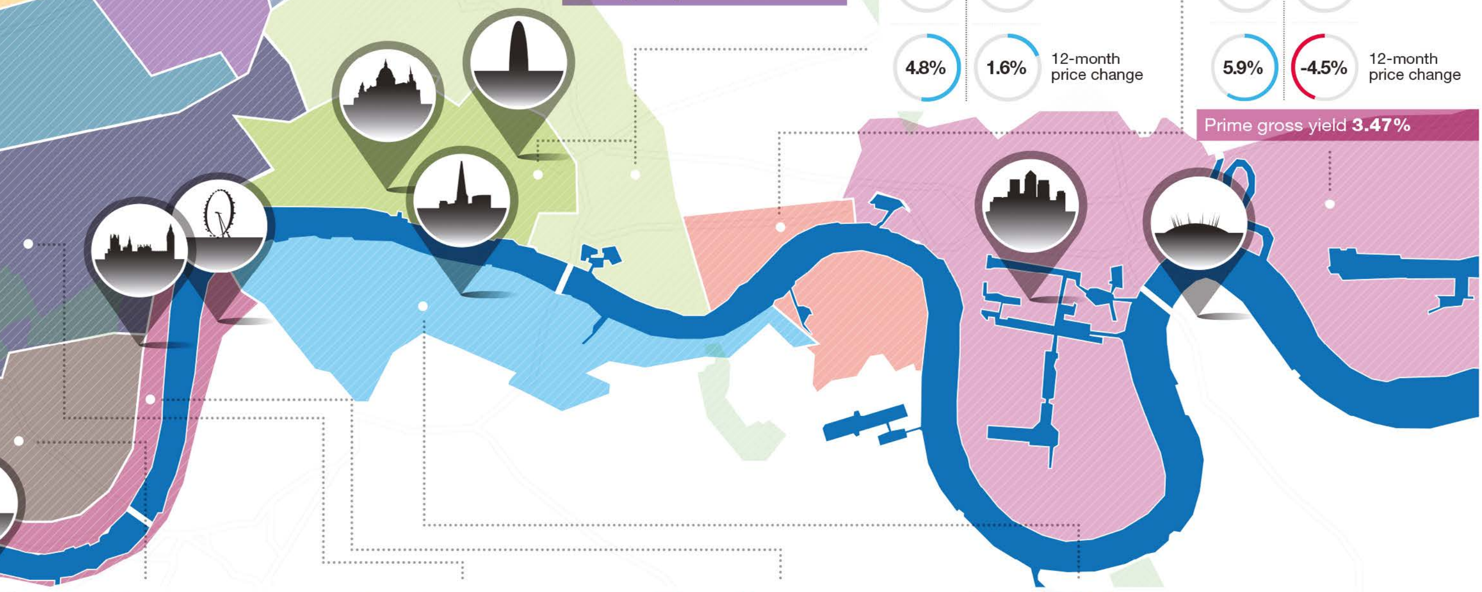
City & Fringe

Sales	Rents	
1.1%	0.4%	3-month price change
4.8%	1.6%	12-month price change

Canary Wharf

Sales	Rents	
0.0%	-1.4%	3-month price change
5.9%	-4.5%	12-month price change

Prime gross yield **3.47%**



Belgravia

Sales	Rents	
-0.6%	-2.4%	3-month price change
-0.8%	-6.6%	12-month price change

Prime gross yield **2.74%**

Mayfair

Sales	Rents	
-0.2%	-1.1%	3-month price change
0.7%	-3.1%	12-month price change

Prime gross yield **1.93%**

Riverside

Sales	Rents	
-0.9%	-3.9%	3-month price change
-2.7%	-8.3%	12-month price change

Prime gross yield **2.77%**

Tower Bridge

Sales	Rents	
-0.3%	-0.5%	3-month price change
2.8%	-0.3%	12-month price change

Prime gross yield **3.23%**

Clapham

Sales	Rents	
1.3%	-0.4%	3-month price change
4.7%	-0.1%	12-month price change

Prime gross yield **3.20%**

Prime central London / Prime outer London

	Prime central London Sales	Prime central London Rents	Prime outer London Sales	Prime outer London Rents
3-month change	-1.1%	-1.6%	0.1%	-0.8%
12-month change	-1.8%	-4.1%	1.4%	-2.9%

Prime central London: Prime gross yield **3.10%**

Prime outer London: Prime gross yield **3.18%**

onth
e change

onth
e change

Dulwich

Sales	
0.6%	3-month price change
1.6%	12-month price change

SUB £2 MILLION LONDON MARKET INSIGHT

Following the UK's decision to leave the European Union, speculation has intensified surrounding what the Brexit vote means for the prime London property market.

As we discuss on page 2, high rates of stamp duty are a more significant influence on demand than the EU referendum result.

Accordingly, price growth below £2 million has been stronger than above that level, as figure 8 shows.

For this reason, while many areas of prime London experienced price declines in the year to July 2016, exceptions to this rule include less central areas like Canary Wharf, Wimbledon and Belsize Park, as illustrated on the map on page 4 and 5.

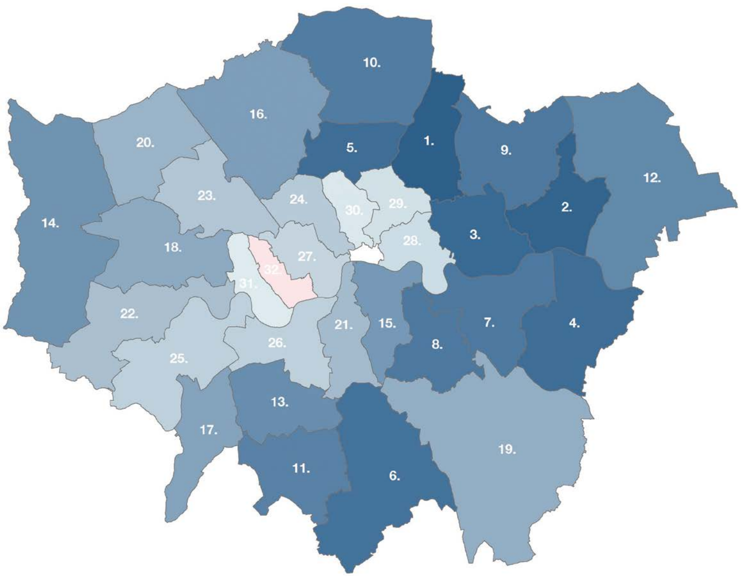
This trend is replicated across the whole of London in the year to 2016, as figure 4 shows. While annual growth continued to slow in the centre, prices in outer boroughs including Waltham Forest, Bexley and Lewisham have grown strongly, as buyers seek greater affordability.

This movement of higher growth away from central areas is a natural part of the cycle in the London housing market, though, as we explore in more detail on page 3, stamp duty is beginning to disrupt this pattern. Growing demand in zones 3 to 6 has also been fueled by investors seeking to limit higher rates of stamp duty.

Sales volumes are also stronger below £2 million. While the number of sales in Greater London between £1 million and £2 million increased 10.7% in the year to 30 April 2016 versus 2015, the number between £3 million and £5 million declined -4%.

Figure 5 shows where the increase in sales between £1 million and £2 million was most marked, which sometimes contrasted to the movement in sales volumes across the whole borough. Hackney, Southwark and Lewisham were the three boroughs that registered the largest increase, reflecting how demand has shifted east, and in particular, south-east, where relative affordability is greater.

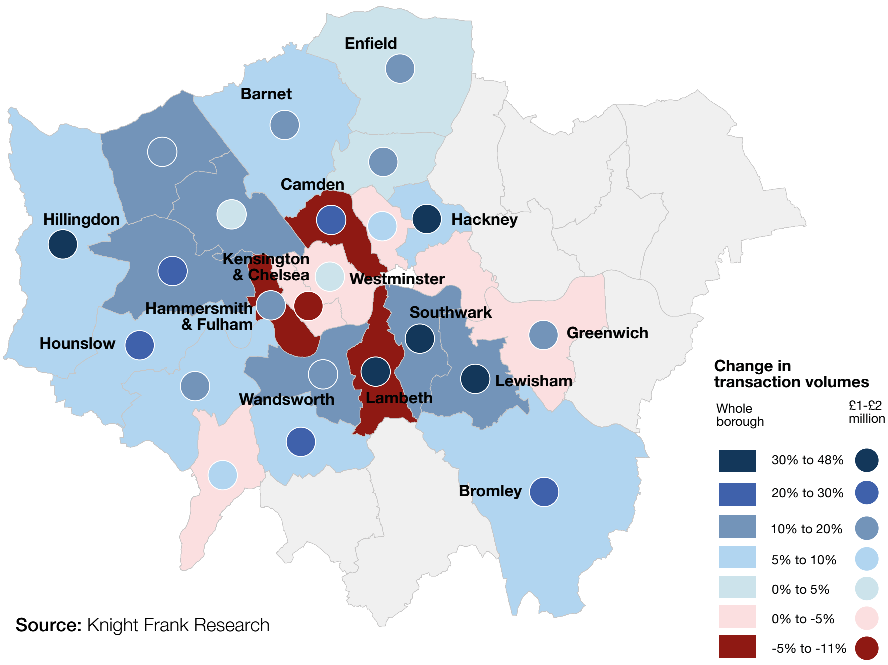
FIGURE 4
Annual growth is stronger in outer London Year to May 2016



1. Waltham Forest **22.1%**
2. Barking & Dagenham **21.1%**
3. Newham **20.7%**
4. Bexley **20.2%**
5. Haringey **20.2%**
6. Croydon **19.3%**
7. Greenwich **18.8%**
8. Lewisham **18.8%**
9. Redbridge **18.8%**
10. Enfield **18.3%**
11. Sutton **17.4%**
12. Havering **17.1%**
13. Merton **16.1%**
14. Hillingdon **15.7%**
15. Southwark **14.4%**
16. Barnet **13.8%**
17. Kingston Upon Thames **13.7%**
18. Ealing **12.5%**
19. Bromley **12.2%**
20. Harrow **12.1%**
21. Lambeth **11.9%**
22. Hounslow **11.4%**
23. Brent **11.1%**
24. Camden **9.9%**
25. Richmond Upon Thames **9.7%**
26. Wandsworth **9.7%**
27. Westminster **8.1%**
28. Tower Hamlets **7.8%**
29. Hackney **7.0%**
30. Islington **4.9%**
31. Hammersmith & Fulham **2.7%**
32. Kensington & Chelsea **-2.5%**

Source: Knight Frank Research

FIGURE 5
London's fastest-growing £1 million-plus markets
Transaction changes in the year to March 2016 versus year to March 2015



Source: Knight Frank Research

PRIME OUTER LONDON MARKET UPDATE

Annual price growth in prime outer London slowed to 1.4% in August as the UK's decision to leave the European Union heightened a mood of price-sensitivity that pre-dated the vote.

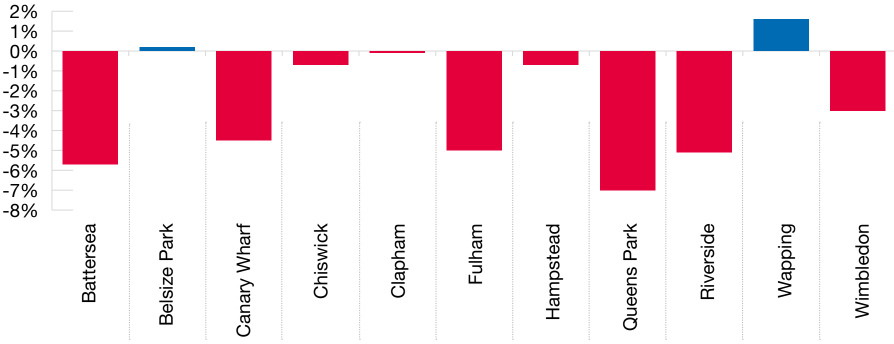
In the two months since, the economic indicators have been mixed. Positive employment and retail spending data has been balanced by weaker sentiment around the prospects for house price growth and weak purchasing manager's data, which paved the way for an interest rate cut and further quantitative easing before the figures turned more positive again in August.

This wider economic picture is more closely aligned with the performance of the property market in prime outer London and the mood has been one of cautious optimism over the summer despite the lack of trading evidence during the seasonal lull. Unlike prime central London, there are fewer US dollar-denominated or dollar-pegged buyers to support demand.

The strongest annual growth was in Canary Wharf, as figure 7 shows, and demand remains strong despite the area's links with the financial services industry. The flow of transactions is helped by the fact vendors are increasingly flexible on their asking price and that demand remains particularly strong in the sub-£750,000 price bracket.

FIGURE 6

Rental value growth in prime outer London Year to August 2016



Source: Knight Frank Research

Activity has been slower in Wapping because of the higher numbers of owner-occupiers who have delayed decisions in the run-up and aftermath of Brexit, leading to a degree of pent-up demand.

There are similar dynamics at play in the south-west London market, an area still benefitting as demand spreads from central London. However, transactions remain dependent on asking prices being reduced to the point that buyers can see good value.

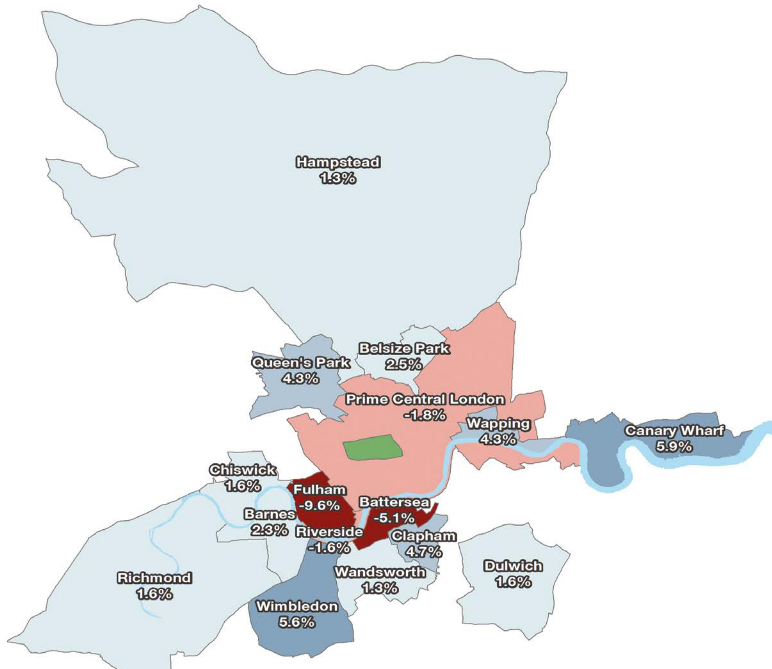
Activity has been weaker in Fulham, as figure 7 shows. This is due to its popularity among European financial services workers and the fact it is a property market buyers moving from central London can overlook in favour of areas further out, where they get more space for their money.

There is similar price sensitivity in north London, where activity has been notably stronger in lower price brackets due to the ongoing impact of stamp duty changes.

Activity in the prime outer London lettings market has risen for the reasons that we explore on page 8. New supply rose 41.8% between January and August this year versus 2015, while viewings and the number of tenancies agreed rose 19.5% and 20.9% respectively, underlining the continued appeal of London after the EU referendum.

FIGURE 7

Price growth in prime outer London Year to August 2016

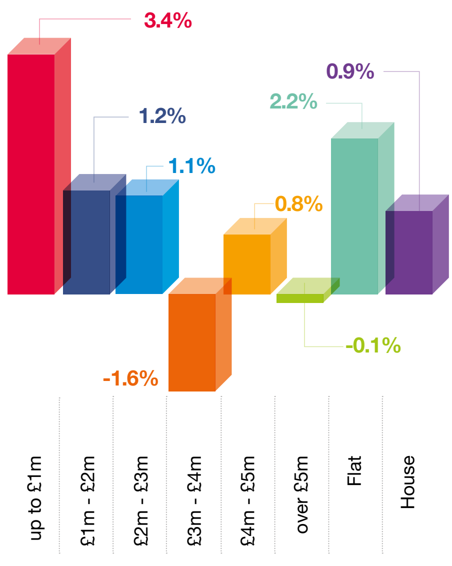


Source: Knight Frank Research

FIGURE 8

Growth is stronger in lower price brackets

Year to August 2016



Source: Knight Frank Research

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RENTAL AND INVESTMENT MARKET FOCUS

The lettings market is benefitting from a period of weakness in the sales market. As more potential purchasers rent for longer and delay their entry to the sales market, lettings volumes are rising.

But with stock rising and a period of economic uncertainty surrounding the potential fallout of the Brexit vote, landlords are having to be competitive to secure tenants, and headline rents are still under pressure.

Annual rental value growth in August was -4.1% in prime central London and -2.9% in prime outer London.

Demand has been kept in check due to uncertainty surrounding the state of the global economy, particularly in the financial services sector, which contributed towards a slowdown in rental value growth from its last peak in prime central London of 4.2% and 2.1% in prime outer London.

This trend has been compounded by higher levels of supply, with more vendors becoming landlords due to more uncertain conditions in the sales markets.

In the three months to the end of July this year, the number of new rental properties placed on the market across prime London rose by 35% compared to the same period last year.

As a result, landlords are reducing asking rents to prevent void periods and tenants are becoming more selective. Properties where the asking rent is perceived as too high are struggling to get viewings.

The referendum result has reinforced this dynamic and landlords are increasingly taking a pragmatic approach to asking rents against the background of wider Brexit uncertainty and rising stock levels.

It also means landlords need to show greater flexibility around break clauses, works to the property, levels of furnishing and payment arrangements.

The number of new registrations of prospective tenants rose 10.1% in the three months to the end of July 2016 versus 2015, the number of new tenancies agreed rose by 19.9% and viewings increased by 20.3%.

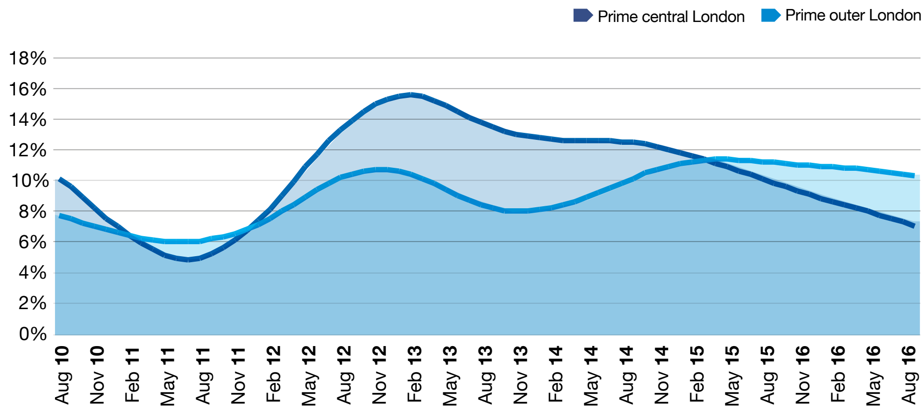
Relocation budgets in many cases have risen due to the effects of a weaker Sterling, which means more tenants are looking in higher-value areas and at higher-value properties compared to last year. The number of new prospective tenants registering with a budget of £1,500-plus per week increased 5.7% in the three months to July compared to 2015.

Elsewhere, property returns remain attractive versus other asset classes such as hedge funds and commodities. While stock markets have performed relatively strongly, due to bouts of quantitative easing, there are some concerns over the current sustainability of equity prices.

Against the background of ultra-low government bond yields and recent rate cuts in major economies like India and Indonesia, the current strength of demand in the prime London lettings market and strong medium-term returns (see figure 9 below) will encourage some investors to act.

FIGURE 9

Total annual returns in prime London Three-year rolling average



Source: Knight Frank Research

RESIDENTIAL RESEARCH

Tom Bill
Head of London Residential Research
+44 20 7861 1492
tom.bill@knightfrank.com

HEAD OF LONDON RESIDENTIAL

Noel Flint
+44 20 7861 5020
noel.flint@knightfrank.com

HEAD OF LETTINGS

Tim Hyatt
+44 20 7861 5044
tim.hyatt@knightfrank.com

PRESS OFFICE

Jamie Obertelli
+44 20 7861 1104
jamie.obertelli@knightfrank.com

Harry Turner
+44 20 3861 6974
harry.turner@knightfrank.com

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