RESIDENTIAL RESEARCH

Knight Frank

LONDON RESIDENTIAL REVIEW

POLITICAL EVENTS DAMPEN DEMAND IN THE PRIME LONDON PROPERTY MARKET

SPRING 2016

LONDON PROPERTY OUTPERFORMS OTHER ASSET CLASSES

THE RISE OF THE SUPER-PRIME LETTINGS MARKET

THE OPTIMAL LONDON PORTFOLIO MIX

KEY FINDINGS

Annual price growth in prime central London was 0.8% in March, the lowest rate in more than six years as tax changes had an effect

The sub-£2 million market performed more strongly in terms of price growth and transaction levels

The number of super-prime lettings transactions rose 29% in the year to 31 March 2016 as stamp duty reform dampened demand in the sales market

Analysis: The optimal portfolio mix across London's 32 boroughs over the last 20 years

Total returns in prime central and prime outer London outperformed a series of other asset classes

POLITICAL EVENTS SLOW DEMAND IN THE PRIME LONDON PROPERTY MARKET

The London Mayoral election and EU referendum are two events heightening a mood of short-term uncertainty, says Tom Bill

The prime London property market would benefit from something that appears unlikely in the near-term: an uneventful six months.

Annual growth remains positive and transaction levels are ahead of last year, but after multiple tax changes, a general election last May and volatility in global financial markets, two quiet quarters would provide some breathing room for a market regaining its feet.

Instead, the second quarter of 2016 includes tax changes in the April budget, the London Mayoral election in May and the Brexit referendum in June. Not to mention a US presidential race in the second half of 2016 that is increasingly capturing the world's attention.

However, it is not only the uncertainty of political events that is dampening demand. The market itself has become politicised, against the backdrop of the live issues of wealth and affordability.

Annual growth in prime central London was 0.8% in March, a rate that is unlikely to change significantly in the short-term as the market digests a series of tax changes that include an extra 3% stamp duty for buy-to-let properties and second homes introduced in April.

Growth in prime central London is only positive at all due to the stronger performance of eastern markets like the City & Fringe and Islington, as the map on pages 4 and 5 shows.

Tax changes have resulted in a market that is trading more freely in lower price brackets. This is underlined by figures 1 and 2 below, which show how transaction volumes have slowed more markedly above £2 million across London since the stamp duty reform of December 2014, which increased the rate above £1.1 million.

Furthermore, prices have declined by up to 7% in higher-value neighbourhoods like Knightsbridge. However, while demand has slowed, there are growing signs that traction is returning as asking prices align with the expectations of buyers, a trend reinforced by a narrative of declining values in the media.

Knight Frank forecasts a -2% decline in western prime central London markets and 5% growth in markets east of Mayfair and south of the River Thames in 2016.

Some buyers are likely to hesitate ahead of the EU referendum in June as they did before the Scottish independence vote in 2014, producing a "Brexit effect" irrespective of the result. On the other hand, the marked weakening of Sterling since the start of the year due to the uncertainty of the result will encourage others to act.

TOM BILL
Head of London Residential Research

"Two quiet quarters would provide some breathing room for a market regaining its feet."

FIGURE 1
Greater London sales £1 million-plus

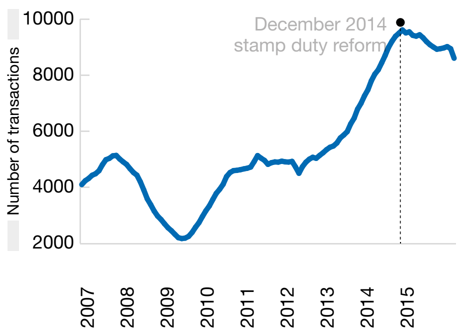
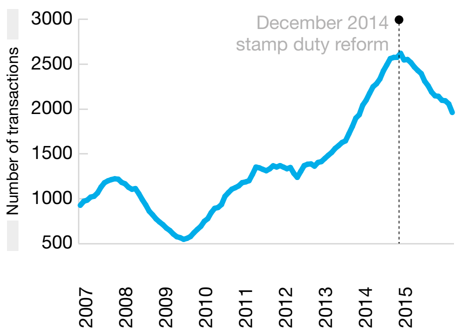


FIGURE 2
Greater London sales £2 million-plus



Source: Knight Frank Research

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

THE RISE OF SUPER-PRIME TENANTS

One sector of the prime London property market has benefitted more than most following a succession of tax changes in recent years affecting high-value property.

As stamp duty and other costs associated with buying and holding property have risen, so has demand for super-prime rental property.

London sits in the middle of the pack from a global perspective in terms of property taxes, but the recent changes have boosted demand in the lettings market at £5,000 per week and above.

The number of super-prime lettings deals across the whole market in the year to 31 March 2016 rose by almost a third, to 112 from 87 in the previous year, as figure 4 shows. By way of contrast, the number of £10 million-plus sales in the year to December 2015 fell by a third to 138 from 206 in the previous year.

Higher stamp duty may mean those with a shorter-term outlook decide to rent as pricing and demand in the sales market continue to adjust to the new transaction costs. For example, the stamp duty on the purchase of a £15 million property is £1.7 million, or the equivalent to about three years rent.

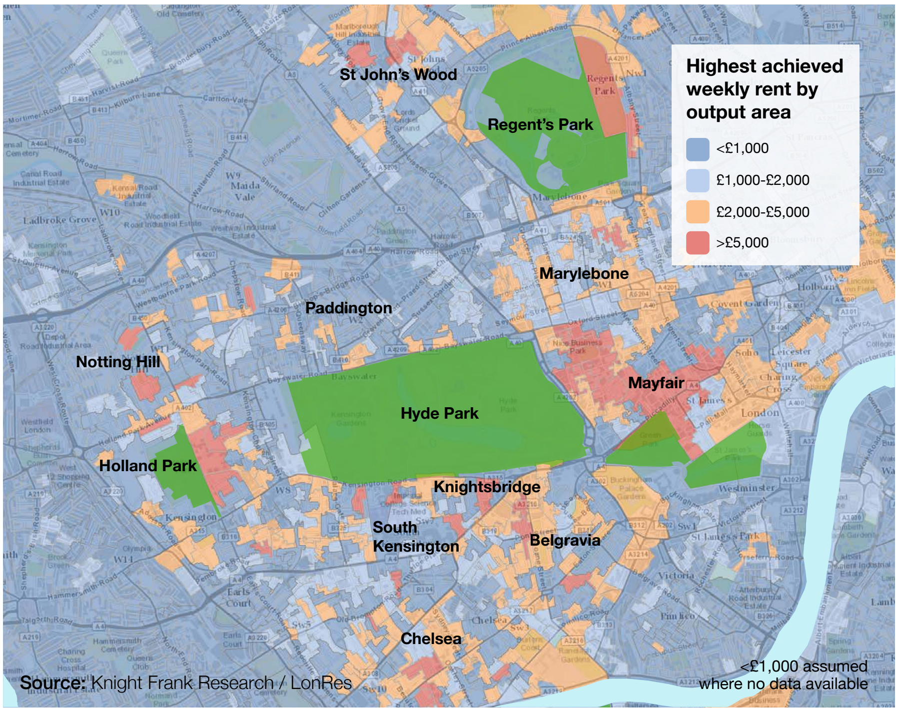
As the map in figure 3 shows, super-prime lettings deals in the year to March 2016 were spread across central London, with a focus on areas including South Kensington, Knightsbridge, Mayfair, Regent's Park and Holland Park.

However, despite growing demand, supply is not always keeping pace.

FIGURE 3

Where are London's super-prime letting markets?

Weekly rents, year to 31 March 2016



Source: Knight Frank Research / LonRes

As the market evolves, landlords do not always appreciate the demands of tenants in relation to specification and finish, says Tom Smith, head of super-prime lettings at Knight Frank.

"A common mistake is to think the requirements of a tenant are less stringent than they are if they were buying the house" he said. "It is no coincidence that those properties generating higher rents and yields are those originally destined for the sales market."

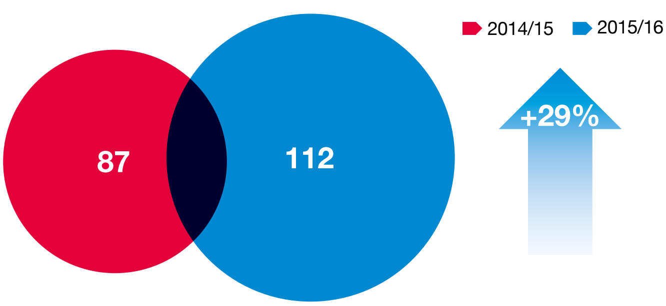
Yields can exceed 4% for best-in-class super-prime properties due to their scarcity, which compares to an average across prime central London of 2.9%.

As the market matures and uncertainty continues to surround the trajectory for price growth in the prime central London sales market in the short-term, the average length of tenancies has increased to two years, as figure 5 shows. It is further proof the market has evolved markedly in the last two years.

FIGURE 4

Growth in the number of super-prime lettings deals

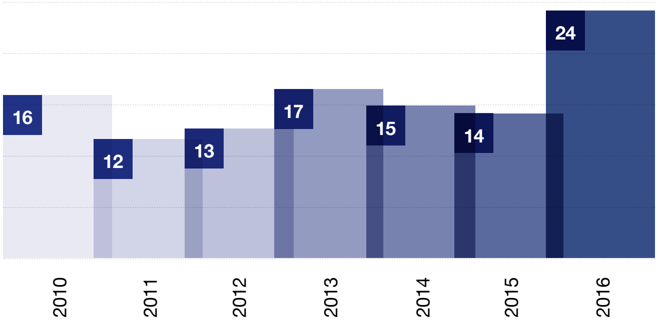
Year to 31 March



Source: Knight Frank Research / LonRes

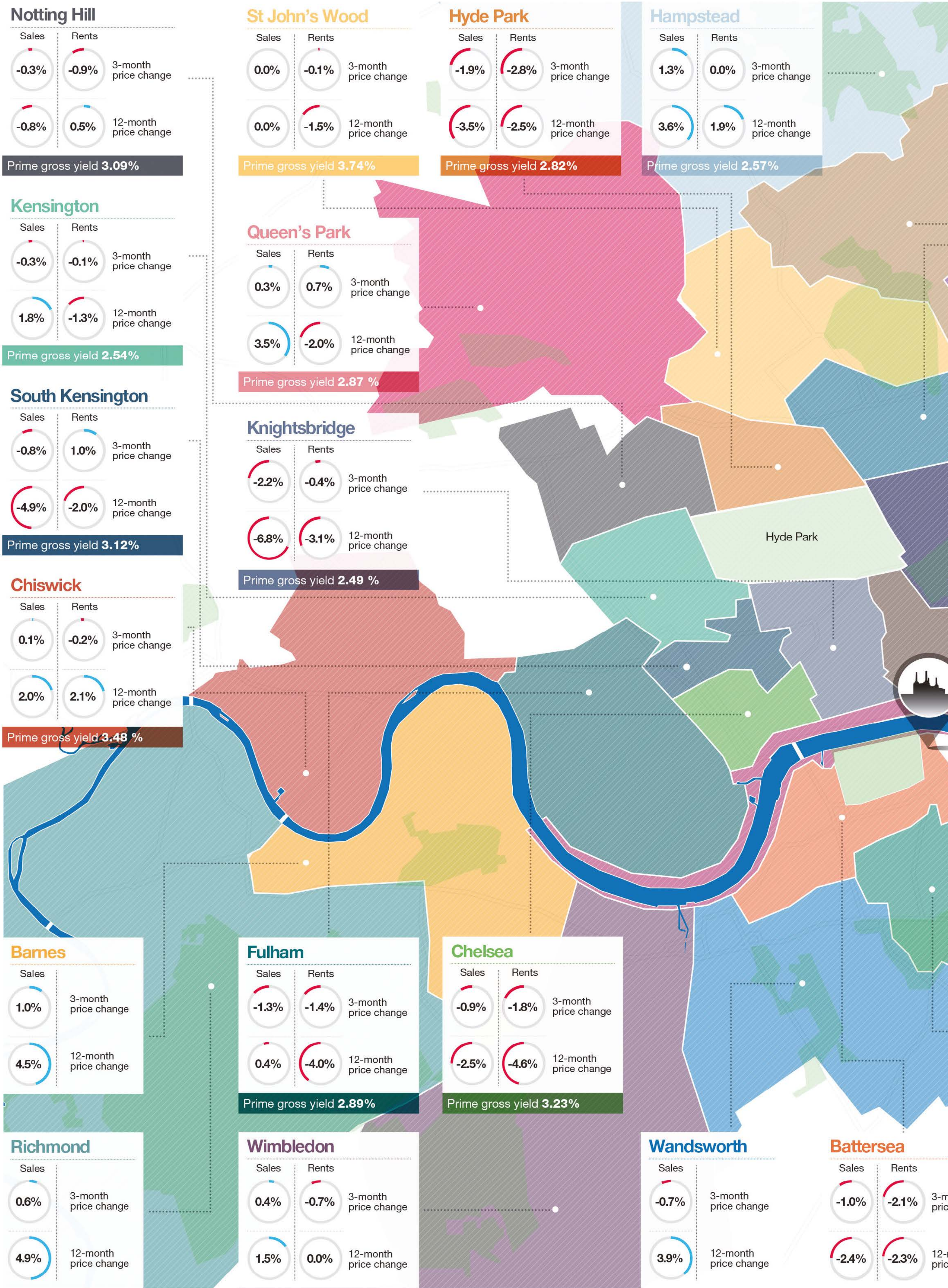
FIGURE 5

Average length of super-prime tenancies (months)



Source: Knight Frank Research / LonRes

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



Notting Hill

	Sales	Rents
3-month price change	-0.3%	-0.9%
12-month price change	-0.8%	0.5%

Prime gross yield **3.09%**

St John's Wood

	Sales	Rents
3-month price change	0.0%	-0.1%
12-month price change	0.0%	-1.5%

Prime gross yield **3.74%**

Hyde Park

	Sales	Rents
3-month price change	-1.9%	-2.8%
12-month price change	-3.5%	-2.5%

Prime gross yield **2.82%**

Hampstead

	Sales	Rents
3-month price change	1.3%	0.0%
12-month price change	3.6%	1.9%

Prime gross yield **2.57%**

Kensington

	Sales	Rents
3-month price change	-0.3%	-0.1%
12-month price change	1.8%	-1.3%

Prime gross yield **2.54%**

Queen's Park

	Sales	Rents
3-month price change	0.3%	0.7%
12-month price change	3.5%	-2.0%

Prime gross yield **2.87 %**

South Kensington

	Sales	Rents
3-month price change	-0.8%	1.0%
12-month price change	-4.9%	-2.0%

Prime gross yield **3.12%**

Knightsbridge

	Sales	Rents
3-month price change	-2.2%	-0.4%
12-month price change	-6.8%	-3.1%

Prime gross yield **2.49 %**

Chiswick

	Sales	Rents
3-month price change	0.1%	-0.2%
12-month price change	2.0%	2.1%

Prime gross yield **3.48 %**

Barnes

	Sales
3-month price change	1.0%
12-month price change	4.5%

Fulham

	Sales	Rents
3-month price change	-1.3%	-1.4%
12-month price change	0.4%	-4.0%

Prime gross yield **2.89%**

Chelsea

	Sales	Rents
3-month price change	-0.9%	-1.8%
12-month price change	-2.5%	-4.6%

Prime gross yield **3.23%**

Richmond

	Sales
3-month price change	0.6%
12-month price change	4.9%

Wimbledon

	Sales	Rents
3-month price change	0.4%	-0.7%
12-month price change	1.5%	0.0%

Prime gross yield **4.30%**

Wandsworth

	Sales
3-month price change	-0.7%
12-month price change	3.9%

Battersea

	Sales	Rents
3-m pric	-1.0%	-2.1%
12- pric	-2.4%	-2.3%

Belsize Park

	Sales
3-month price change	0.8%
12-month price change	0.4%

Islington

	Sales	Rents
3-month price change	2.8%	0.2%
12-month price change	8.2%	0.1%

Marylebone

	Sales	Rents
3-month price change	-2.0%	-3.0%
12-month price change	1.2%	-0.7%

Prime gross yield **2.94%**

Wapping

	Sales	Rents
3-month price change	1.0%	0.2%
12-month price change	3.7%	2.1%

Prime gross yield **3.05%**

King's Cross

	Rents
3-month price change	-0.4%
12-month price change	1.8%

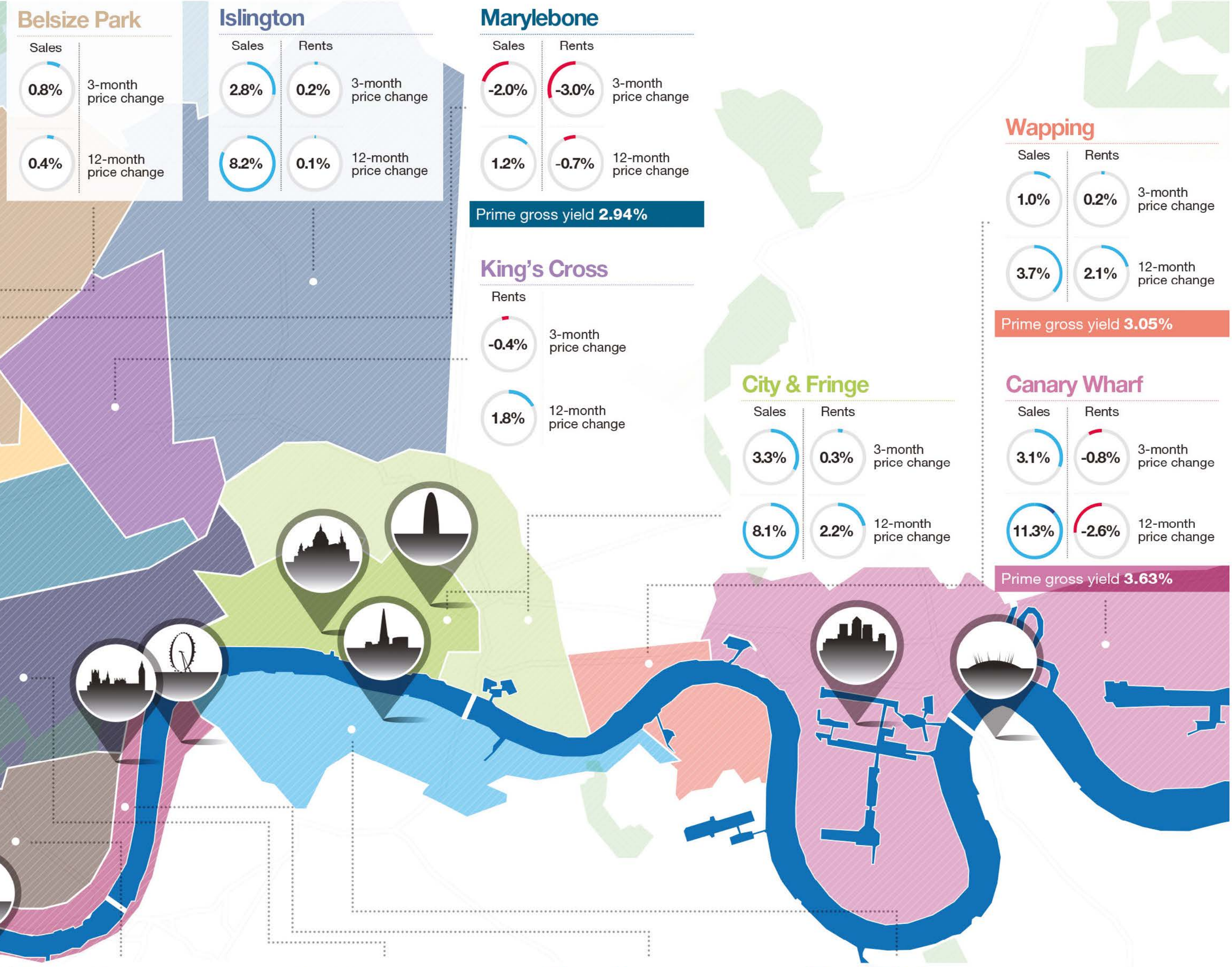
City & Fringe

	Sales	Rents
3-month price change	3.3%	0.3%
12-month price change	8.1%	2.2%

Canary Wharf

	Sales	Rents
3-month price change	3.1%	-0.8%
12-month price change	11.3%	-2.6%

Prime gross yield **3.63%**



Belgravia

	Sales	Rents
3-month price change	-0.0%	-2.0%
12-month price change	-0.2%	-2.2%

Prime gross yield **2.79%**

Mayfair

	Sales	Rents
3-month price change	0.3%	-0.5%
12-month price change	2.6%	-0.1%

Prime gross yield **1.96%**

Riverside

	Sales	Rents
3-month price change	-0.6%	-3.8%
12-month price change	2.9%	-2.6%

Prime gross yield **2.89%**

Tower Bridge

	Rents
3-month price change	0.3%
12-month price change	1.4%

Clapham

	Sales	Rents
3-month price change	0.5%	-0.1%
12-month price change	2.8%	2.7%

Prime gross yield **3.31%**

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Dulwich

	Sales
3-month price change	1.2%
12-month price change	3.0%

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	0.0%	-1.0%	0.5%	-0.7%
12-month change	0.8%	-1.0%	3.1%	-0.6%

Prime central London: Prime gross yield **2.91%**

Prime outer London: Prime gross yield **3.28 %**

SUB £2 MILLION LONDON MARKET INSIGHT

April's increase in stamp duty for buy-to-let properties will focus the minds of investors in what is already a price-sensitive London market.

The mood of sensitivity follows a succession of tax changes in recent years, which has slowed the pace of price growth across the majority of prime London markets.

The additional taxes have had a more marked impact above £2 million than below, as Figure 2 on page 2 shows. In turn, this has dampened price growth to a greater extent in higher-value areas around Hyde Park.

Against this background of heightened uncertainty, it is increasingly important for property investors to strike the right balance between risk and reward.

The stamp duty increase for buy-to-let properties introduced in April will deter some investors but demand is likely to remain fundamentally strong for an asset class that has outperformed many others in recent years, as figure 12 on page 8 shows.

FIGURE 7

Average Annual Price Return

Two decades to December 2015

Barking And Dagenham	8.3%
Barnet	8.8%
Bexley	7.8%
Brent	10.4%
Bromley	8.4%
Camden	10.7%
City Of Westminster	10.6%
Croydon	8.3%
Ealing	9.3%
Enfield	8.0%
Greenwich	8.9%
Hackney	11.9%
Hammersmith And Fulham	10.7%
Haringey	10.3%
Harrow	8.5%
Havering	7.9%
Hillingdon	8.7%
Hounslow	8.2%
Islington	10.4%
Kensington And Chelsea	10.8%
Kingston Upon Thames	8.9%
Lambeth	11.2%
Lewisham	9.8%
Merton	9.3%
Newham	9.3%
Redbridge	8.3%
Richmond Upon Thames	9.6%
Southwark	10.9%
Sutton	8.1%
Tower Hamlets	9.7%
Waltham Forest	10.2%
Wandsworth	10.6%

Source: Knight Frank Research

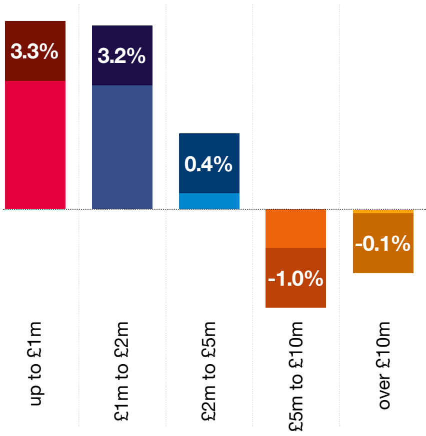
With this in mind, Knight Frank has analysed the price performance of every London borough over the two decades to December 2015. We have then applied a formula known as the Sharpe Ratio, a method that is used to calculate the most beneficial trade-off between risk and return.

In simple terms, it allows investors to gauge what would have been the optimal portfolio mix over the last 20 years to maximise returns while minimising risk.

FIGURE 6

Stronger growth in lower price brackets in prime central London

Annual growth in the year to March 2016



Source: Knight Frank Research

While prices in some boroughs have risen more steeply than others, they have also experienced greater volatility. The Sharpe Ratio is a method that allows investors to hedge against such swings by, in this instance, investing in lower-value markets.

The highest average annual price growth over the last 20 years was in the borough of Hackney with a figure of 11.9%, followed by Lambeth at 11.2%. The prime central London boroughs of Westminster and Kensington and Chelsea experienced average annual growth of 10.6% and 10.8%, respectively.

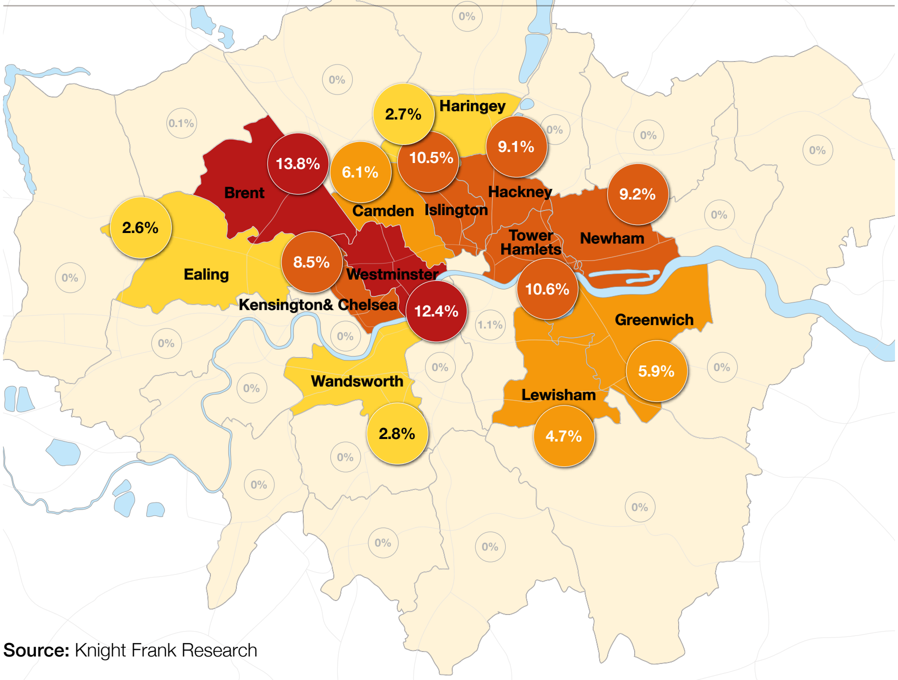
However, when the Sharpe Ratio is applied and different price growth patterns and volatility are taken into account, the London borough of Brent would have been the largest element of the optimal portfolio mix, with 13.8%. This was followed by Kensington and Chelsea (12.4%) and Tower Hamlets (10.6%), as figure 8 shows.

The fact some outer London boroughs have weights of zero does not reflect weaker price performance. Instead, it indicates price growth has behaved in a similar enough fashion to other boroughs that there was no extra reward for an investor to buy there as part of this theoretical model.

FIGURE 8

The optimal portfolio mix

All London boroughs, 20 years to December 2015, applying the Sharpe Ratio



Source: Knight Frank Research

PRIME OUTER LONDON MARKET UPDATE

Prices grew 3.1% in prime outer London in the year to March 2016, marginally down on the rate of 5.2% recorded in the same month last year.

This lack of significant movement is indicative of a prime outer London property market that has largely been in a holding pattern for the last 12 months.

Demand, particularly in the higher price brackets, has been kept in check by a general election in May 2015, two stamp duty changes and the prospect of a London Mayoral election and EU referendum in the second quarter of this year.

As a result of these accumulating uncertainties, buyers and sellers are feeling markedly more price sensitive.

However, sales volumes in the first quarter were marginally ahead of last year and factors driving demand included an incentive to act before a deadline for the introduction of an additional 3% stamp duty for buy-to-let properties and second homes at the start of April.

The strength of the UK's economic recovery has also underpinned the market, with GDP increasing 0.5% in the final quarter of 2015 due to the growth of the services sector.

The relative strength of the financial services sector also played a part. The value of merger and acquisition deals in Europe rose by 33% in 2015 to 1.3 trillion euros, according to the Institute of Mergers, Acquisitions and Alliances. While the number of IPO's in London fell in 2015, there was an increase across Europe and a higher number of deals raising more than 1 billion euros, said accountant PWC.

The knock-on effect for bonus payments may explain tentative signs of stronger demand in higher price brackets in markets including Wimbledon and Canary Wharf.

However, it is not a uniform picture and trading is thinner above £2 million because sellers are typically more discretionary and there is a smaller pool of buyers.

The same trend also explains why annual growth across prime outer London remains skewed towards east London, where property values are lower, as figure 10 shows.

The fall in Battersea refers to the Battersea Park SW11 area towards Clapham and Wandsworth Commons, where prices are declining after three to four years of exceptional growth.

Annual rental value growth was -0.6% in March, as corporate budgets for housing costs remain under pressure. In similar fashion to the sales market, the performance is stronger in the lower price bands, with an annual decline of -0.4% below £500 per week comparing to -0.9% between £500 and £1,500 per week.

FIGURE 9
Annual rental value growth in prime outer London by area Year to March 2016

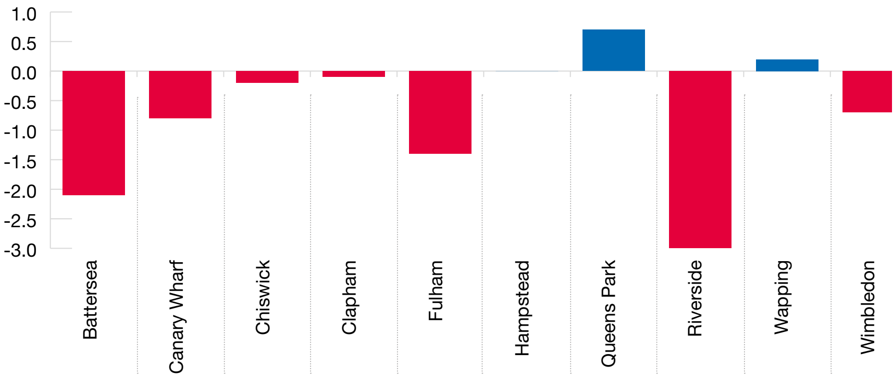
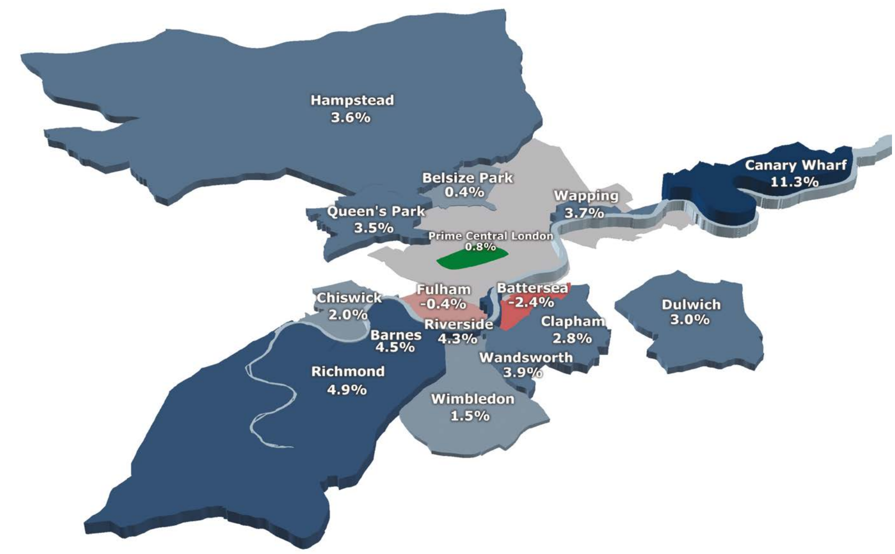
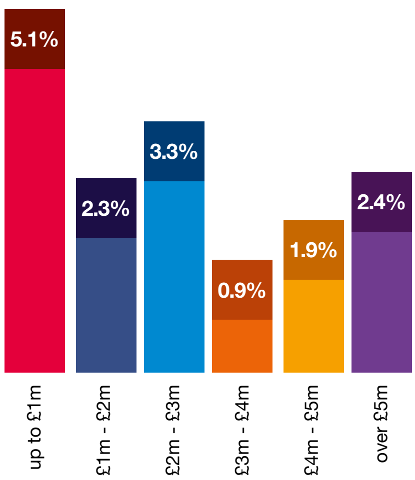


FIGURE10
Annual growth by region Year to March 2016



Source: Knight Frank Research

FIGURE 11
Annual growth by price band
Year to March 2016



Source: Knight Frank Research

RENTAL AND INVESTMENT MARKET FOCUS

In the first three months of 2016, rental value growth in prime central London continued a decline that began in May 2015.

Since the month of the UK general election, annual growth has declined from 4.2% to -1% in March this year, a slowdown linked to the fortunes of the financial services sector.

The start of 2016 has been overshadowed by fears surrounding the impotence of central banks and the prospect of negative interest rates has spread uncertainty in markets already digesting low oil prices and a Chinese economic slowdown.

As a result, corporate budgets have been cut and headcount has been reduced further at many banks, which has reduced demand for rental property in prime central London, particularly at the senior executive level of more than £1,000 per week.

However, as we analyse on page 3, the market has been performing more strongly in the super-prime price bracket of £5,000 per week and above.

As a result of this uncertainty, rental values fell -0.6% in March, which was the sixth consecutive monthly decline. Meanwhile, average gross prime yields were flat at 2.91% in prime central London and 3.28% in prime outer London.

The downwards trend in rental value growth has been exacerbated by higher supply levels, particular at above £1,500 per week, as more vendors decide to let their properties due to uncertainty over taxation and price growth in the sales market.

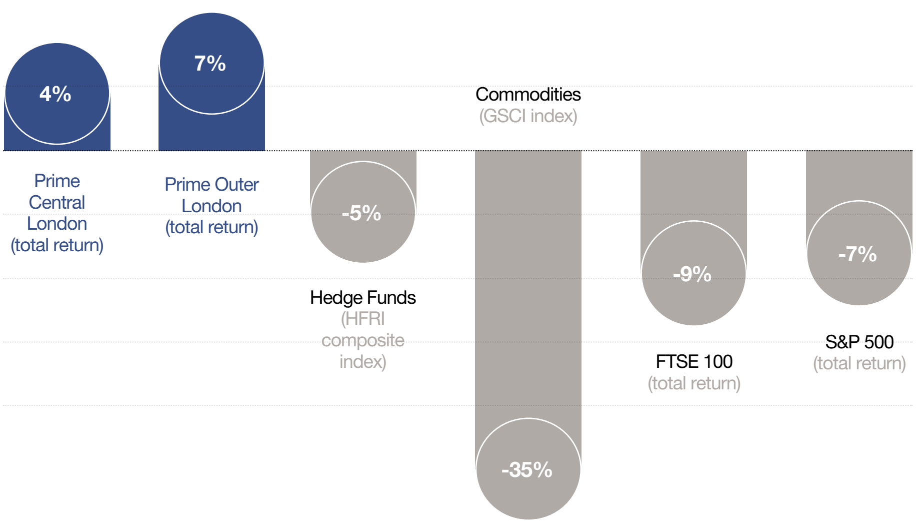
Landlords were initially prepared to withstand void periods but this began to change at the start of 2016, and asking rent reductions have led to an increase in deal volumes. The number of tenancies agreed in prime central London in the first two months of this year was 12% higher than in 2015.

Despite the wider financial uncertainty, London's role as a leading financial centre received a boost in February when HSBC, the world's fifth largest bank, announced it would keep its head office in London after considering a move to Asia.

The decision was announced ahead of the EU referendum in June, an event that has also put London's role as a financial centre under the spotlight, with many commentators arguing London will remain a dominant financial centre irrespective of the outcome.

The rental market performance should also be put into the wider context of volatile financial markets, where traders have found it difficult to second-guess central banks. Over the last 12 months, total returns for prime London property exceeded benchmark hedge fund, commodity and stock market indices, as figure 12 below shows.

FIGURE 12
Property outperforms other asset classes
Total returns in the year to February 2016



Source: Knight Frank Research

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