UK prime residential markets Summer 2008

Prime London to lead the recovery

"The fall out from the credit crunch is suppressing values across the whole of the UK housing market. The shape of the recovery will be led by the prime London markets, which we expect to show rapid uplift in growth."

Yolande Barnes

"Supply scarcity in good quality country housing and the most desirable areas means that prime values look set to rise faster than elsewhere when the upturn comes."

Lucian Cook

Savills Research

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UK prime residential markets

No-one can deny that the UK's housing market is currently enduring a period of value correction. Throughout this bulletin, we look at how the prime markets in London and across the UK have reacted to date and consider the timings and strength of their recovery.

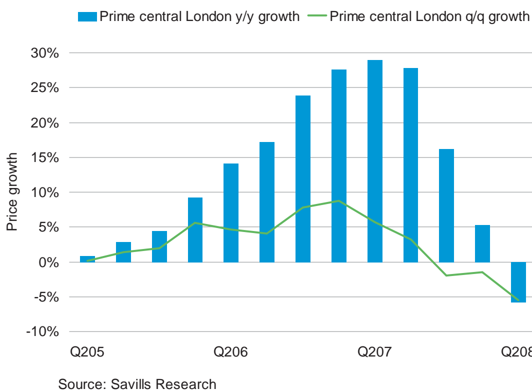
History shows that the prime markets behave differently to mainstream property (they are usually either more vulnerable or more resilient). But, the key symptom of the current credit crisis has been the simultaneous impact on all sectors of the market (albeit at varying degrees). The increasingly pessimistic economic outlook leads us to believe that weak market conditions, characterised by low turnover, will persist for at least the next 18 months.

Prime central London

"Values are falling more quickly in prime London than in other markets and we expect them to end the year down -15% and, by the end of 2009, we expect them to have lost 25% of their 2007 value."

Reduced earnings and job security expectations amongst City buyers has curtailed the demand for property in prime central London. The more pessimistic outlook over the last couple of months has fed quickly into values. Over the second quarter of 2008, our index of capital values in prime central London recorded its lowest quarterly figure since the index began with values falling by -5.5% (see graph below). Values are now -9% lower than their peak in the late summer of 2007.

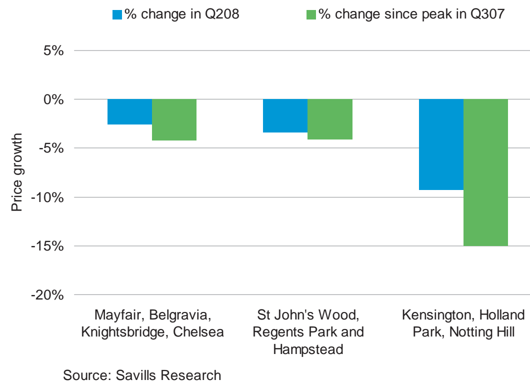
Values down -5.5% in Q2 2008



Source: Savills Research

The hardest hit parts of prime central London have been in the West (Kensington, Notting Hill and Holland Park). This area saw the biggest price rises in 2007 but has seen falls of -9.3% over the second quarter of 2008. This takes values down -15% since their peak in 2007. This market has been most seriously affected by the financial turmoil, uncertainty over future bonus payouts and fall off in demand from international buyers.

Greatest falls in the West of London

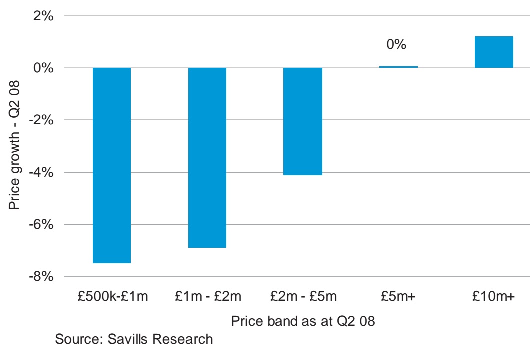


Source: Savills Research

Although the new legislation affecting the taxation of non-domiciles in the UK was less draconian than initially feared, it did have a knock-on effect on international demand in central London during the first half of 2008. This was particularly evident in the mid to upper prime price bands. The only market which has so far defied the downturn is the 'uber-prime' sector (properties over £10m) where values continue to rise, albeit more slowly than the unprecedented rates seen in 2006 and 2007.

"In this price band, demand for the most exceptional properties continues to outstrip supply resulting in prices rising by +1.2% in Q208 taking year-on-year growth to +11.5%."

Growth positive in the 'uber-prime' price band



Source: Savills Research

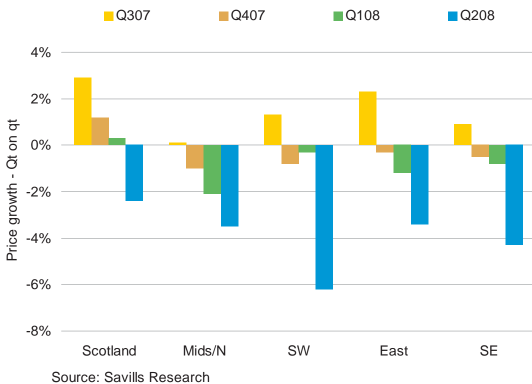
UK prime residential markets

Prime regional markets

The country house and other prime regional markets have, historically, been less volatile than prime central London. Prime property across the UK fell by -4% during the second quarter of 2008, which takes values down to -5% since their peak in September 2007.

So far this year, on a regional basis, the markets have reacted in varying degrees. The Midlands and the North have seen steady falls in values over the past three quarters as demand for prime property has fallen. More southerly regions did not see such early falls but have since ‘caught up’. The South West reacted most sharply in the second quarter with prices falling by -6.2% (see graph below). This region is most acutely feeling the effects of a reduction in the level of demand spilling out from London. There have been fewer relocations and fewer second home purchases. In the first half of 2008, just 28% of buyers in the South West commuted to work within London. This compares with 46% in the first half of 2007.

Reduced demand affecting South West



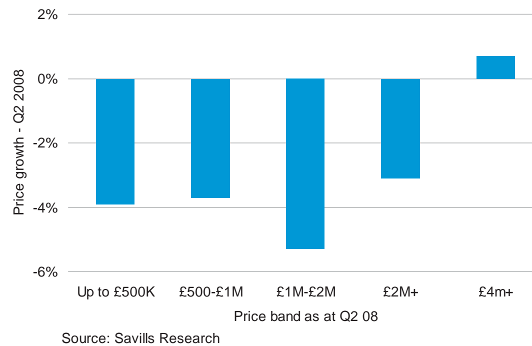
Source: Savills Research

Growth in the prime Scottish market turned negative for the first time in this downturn during the second quarter with values falling by -2.4%. The positive growth of the previous three quarters means that values are still +1.9% higher than this time last year leaving Scotland as the only region to currently remain in positive territory on an annual basis. Values of prime property within the City of Edinburgh are particularly bucking the downturn and remained static over the quarter. Demand for good quality, family housing in traditional parts of central Edinburgh continues to support prime values in all prime Scotland, albeit at reduced levels of turnover.

Very top of market remains positive

As in prime Central London, the only price band in the regional markets to record positive growth in the second quarter was the most expensive. Property over £4m rose by +0.7% over the quarter, taking year-on-year growth to +7.5%.

Top end of market holding value



Source: Savills Research

The prime regional markets outside of London are much less heavily reliant on international buyers than prime central London. Ninety four percent of buyers in the first half of the year were UK nationals. Demand is driven by occupiers and 85% of purchasers were buying a main residence in the first half of 2008 (up from 80% in the first half of 2007). This sector is characterised by much lower rates of turnover than in the mainstream markets. In the highest price bands, there are few who choose to sell on a discretionary basis. This keeps the levels of supply low, particularly in the highest price bands. Around one-third (31%) of vendors in the first half of 2008 had lived in their property for more than 10 years. This figure rises to 56% for sales over £4m.

Values at the top end to rise faster

This highly discretionary nature of sellers will be an important factor when the credit crunch and any associated economic downturn ends. Supply is likely to remain at low levels in the prime regional markets, which will put additional upward pressure on prices. Scarcity in the supply of good quality prime housing in the most desirable locations means that values at the top end look set to rise faster than elsewhere when the upturn comes. Meanwhile, values will continue to fall for a time on the back of low demand, but they may not fall as far as other sectors of the market and we would expect them to rebound more strongly once the market turns.

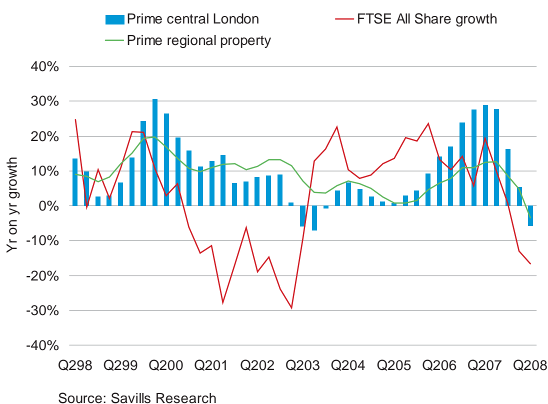
UK prime residential markets

Strong recovery on the cards in London?

The small and highly inelastic nature of housing supply in prime central London renders this market more susceptible to changes in values and more exposed to external factors than other prime or mainstream markets (see graph below). Current issues over job security in the City, coupled with negative market sentiment, concerns over the US economy and illiquidity in the financial markets are all currently affecting values in prime central London. There has been a rapid adjustment in house prices. With poor market conditions set to continue, we are in no doubt that the downturn will be more prolonged than expected at the beginning of the year.

"Savills Research forecast that values in prime central London will fall by -15% in 2008 and a further -10% in 2009."

Prices react quickly to external factors



Source: Savills Research

History shows us that whilst values in prime central London dip more profoundly in a poor market, they are also the first to recover, and recover strongly, once conditions improve. From 2010, assuming that the financial markets regain momentum and confidence returns to the property market, we expect values in prime central London to turnaround and start rising again. This will then filter through into the prime regional markets (see graph opposite).

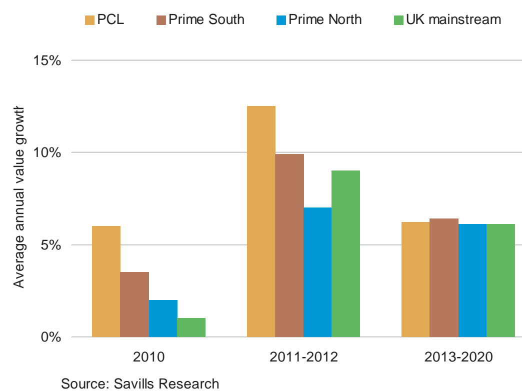
"We expect values in prime central London to rebound more than other prime or mainstream markets (recovering to 2007 levels by 2012)."

This upturn in growth will be fuelled by strong levels of demand coming back into the market. In common with investors, other overseas buyers tend to be highly discretionary. These buyers are quick to come out of the market in a downturn, as we have seen recently. Overseas purchasers comprised 60% of the market at the peak of the market during 2007 for property over £1m in core parts of central London, but this fell to 41% in the first half of 2008. As quickly as these buyers withdraw from the market, we expect they will be equally quick to return, when values once again look attractive. These buyers help to explain the quick turnaround in the prime central London market after previous recessions. By 2010, we believe that the market will be characterised by a shortage of supply coupled with high levels of pent-up demand from those who have delayed buying. This could put more upward pressure on values in an already fast-paced market.

'Uber-prime'

The very top end of the central London market - 'uber-prime', is also well placed to recover well. This is a relatively new sector of the market, driven by international billionaires, which emerged during the latest economic boom and, so far, it has escaped the downturn. Demand in this sector remains high for scarce, but highly exceptional, properties. We do not expect widespread falls in this sector unless global commodities and other asset markets turn substantially downwards. A collapse in the global asset price bubble would severely hit demand from economies otherwise not affected by the credit crunch. This would have a significant knock-on effect on 'uber-prime' property.

Prime central London to lead the recovery



Source: Savills Research

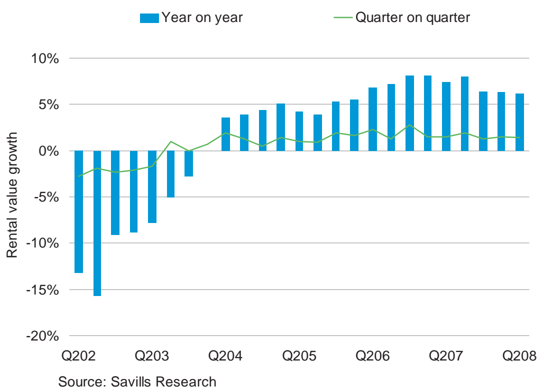
After any bounce-back in central London, we believe that other prime markets, particularly in southern England will follow, largely because these markets are less reliant on mortgage finance and are driven by higher levels of equity. The more northern regions, where demand is lower and buyers are more reliant on mortgage finance, after an initial upturn, are likely to rise at a similar level to UK mainstream price growth.

UK prime residential markets

Prime central London lettings

The prime rental market of central London continues to rise steadily on the back of increased demand from delayed house purchases and a withdrawal of new supply from investors. Additional supply is feeding into the market from vendors who are delaying sales and this, coupled with lower corporate demand, has tempered any take-off in growth. Values rose by +1.4% over the second quarter taking year-on-year growth to +6.2%.

Overall rental market growth stable

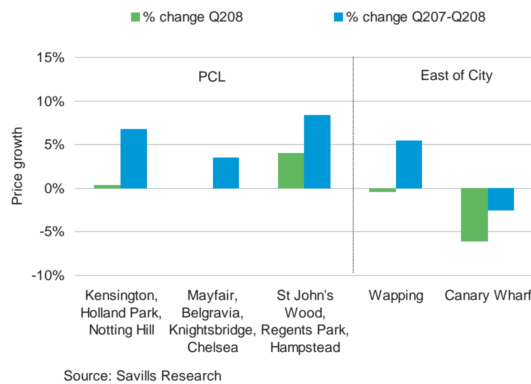


Source: Savills Research

A detailed analysis of different sectors highlights big differences between the rental markets of prime central London. Central, core parts of London around Kensington, Holland Park, Mayfair, Belgravia, Chelsea and Knightsbridge are hugely dependent on demand from corporate tenants. Their withdrawal in the face of financial sector turmoil, coupled with additional supply feeding into the market, has led to slower rental growth in the second quarter. Landlords have been willing to take on tenants at the same or similar rental levels to a year ago. Void periods may have increased in some areas.

The northern areas of St John's Wood, Hampstead and Regents Park are less dominated by corporate tenants and enjoy significant levels of domestic demand. This has been supported by those delaying house purchase and, on the back of this, rental values increased by +4% over the second quarter (see graph below).

Strongest growth in the north



Source: Savills Research

The East of City market is not as mature as other prime central London markets and is performing differently again. Rental values fell by -4.4% over the second quarter with Canary Wharf particularly hard hit. Demand has suffered due to both a fall-off in corporate tenants but, more significantly, the area has a considerable amount of recently built new stock in the hands of new investors. This will take a while to work its way through the system.

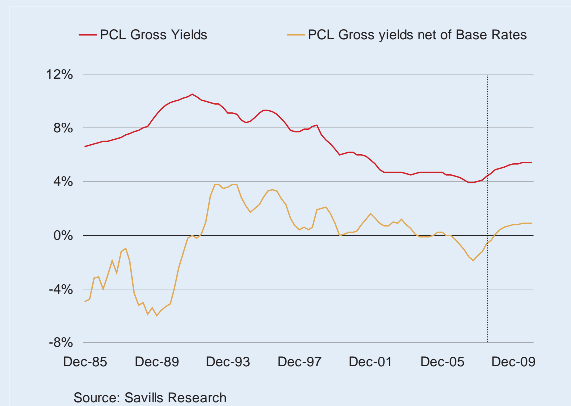
Yields hardening in central London

Rapidly rising capital values in prime central London over recent years coupled with more modest rental growth has led to lower yields. The recent decline in capital values, along with steady growth in rents, has caused yields to move out again.

Given the conditions outlined above, we anticipate continued modest levels of rental growth in the short term with +6% growth in 2008. The anticipated capital value falls will push gross yields up to 5.4% by the end of 2010. This is the level seen at the end of 2001.

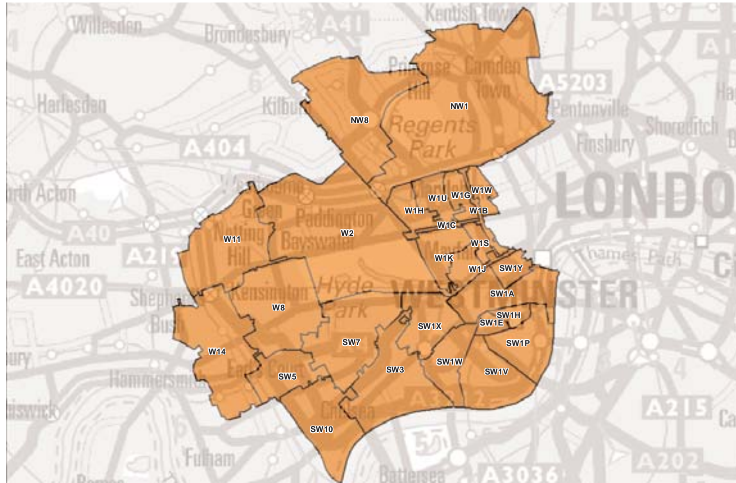
Will these projected yield figures be sufficient to attract investors back into the market? Expectations for capital growth, particularly from 2010 onwards, should be encouraging news for developers and investors alike. Furthermore, the prime central London residential investment market has historically experienced strong and stable performance, out-performing many of the other mainstream asset classes and being less volatile than equities and gilts.

Gross yields back to 2001 levels by end 2010



Source: Savills Research

Savills residential research team



Prime Central London (PCL)
Residential areas of Knightsbridge, Chelsea, Mayfair, Belgravia, Holland Park, Notting Hill, Kensington, St Johns Wood, Regents Park and Hampstead

For further research information please contact

Lucian Cook
Director
020 7016 3837
lcook@savills.com

Yolande Barnes
Director
020 7409 8899
ybarnes@savills.com

Anna Zaccaria
Associate
07967 555 817
azaccaria@savills.com

Abbie Greisman
Analyst
020 7409 8841
agreisman@savills.com

Agency contacts

Jonathan Hewlett
Head of London Region
020 7824 9018
jhewlett@savills.com

Crispin Holborow
Head of Country Houses
020 7409 888
cholborow@savills.com

Jamie Macnab
Head of Scotland Residential
0131 247 3711
jmacnab@savills.com

Jane Ingram
Head of Lettings
020 7535 2981
jmingram@savills.com

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