PRIME LONDON PROPERTY REPORT – January 2014

Implosion or Explosion?

Will property prices in PCL continue to rise or are we on the edge of a cliff (or a gentle decline at the very least)?

Firstly, Happy New Year. I hope you are full of vim and raring to grasp 2014 by the horns. I for one have started the year considerably heavier than I started December but that should give me great energy to fulfil my plans for 2014.

But before I look at the year ahead, let's quickly review 2013.

According to Savills, prime central London property has increased by 7.9% over the last twelve months which is another good year of gains. This compares to other markets:

Nikkei	+56.7%
S&P 500	+29.6%
FTSE 100	+14.4%
China	-6.75%

Venezuela	+452%	
Gold	-28.6%	

And property prices in other major cities:

New York	+4.9%	(Case Schiller)
Tampa	+15.18%	(Case Schiller)
Singapore	+ c.4%	
Hong Kong	+2.8%	

Of course, to say that property in prime central London has increased by 7.9% is actually rather misleading. Houses over £10m were only up 2.1%. The underperformance in this price range is also too much of a generalisation. Certain houses within this price range performed well. However, there was a definite oversupply of larger terraced houses which meant that buyers were in a stronger negotiating position than those buying apartments under £2m, for example.

The stand out performances were seen on the fringes of the prime areas:

Fulham	+21.5%
Battersea & Clapham	+22%

But is this general performance sustainable and what could derail the property market?

7 Reasons to be fearful

Politicians – There will be an election in 2015. Unfortunately this means that there will be even more attempts at political "point scoring" than normal, especially in the second half of the year. It is likely that some politicians will use populist soundbites to target international buyers and the wealthy in the hope of boosting their profile. Of course their idea of wealthy and mine differ considerably. They would regard me as wealthy but I certainly do not (admittedly I only have myself to blame for having children).

Although I think a mansion tax is highly unlikely, any talk of it or other meddling with the tax system will certainly cause many to delay making a purchase until after the election. We have just seen that CGT for international buyers will take effect from April 2015. This in itself was not an unreasonable tax to introduce (although developers on the river might beg to differ). However, the danger is that London/UK will lose its status for being a stable place where one can invest money for the long term without fear of the goalposts shifting on political quicksand.

Overdevelopment – The development of sites along the river continues apace. Although politicians and focus groups bleat about these being sold to overseas' investors, the fact is that there is simply not the demand for such units in the UK. If there was the developers would exclusively sell them here! However, I do think that these sites are vulnerable. Firstly the change to CGT mentioned above will reduce profits for investors making them less attractive. Secondly, there will be a high concentration of apartments but probably not enough tenant demand. If you buy a £1m apartment and expect a 4% gross yield you need to find an individual or sharers able to afford £40,000 per annum but who are also willing to live in a fairly remote area (whatever the marketing materials say).

There is also the danger that too many developments in prime central London will come to the market at once. The projects in "super-prime" locations should do well assuming the quality is high, but the lesser quality developments may struggle especially where the developer is hoping to set new records. I will give you my thoughts on these developments in more detail as they near commencement of marketing.

Interest Rates – There is a lot of talk about how the UK and US are showing signs of strength. It is the same kind of strength a baby shows when trying to stand up. The slightest nudge from any direction and the baby is back on the floor. Although significantly higher interest rates seem unlikely, they can move rapidly and unexpectedly as the 1990's showed us.

Euro Debacle – This would have a global effect. However, once it had played out, cities such as Barcelona, Rome, Madrid, etc. would trade at steep discounts to London and would likely see investment shift back in their direction reducing demand and prices in London.

Falling yields – this would be especially problematic if coupled with rising interest rates. As you will see later a low rental return is not problematic for many owners. However, there is a significant number of landlords who are highly leveraged. It is these forced sellers who will cause prices to fall. Savills reported that average rents across prime London fell by 0.5% in the three months to the end of September, leaving values down 0.9% year on year. In St John’s Wood and Hampstead rents were down 7.6% year on year. These have been due to significant reductions to family houses over £2,000 per week as increasing stock levels have coupled with reduced corporate relocation and city and financial sector employees budgets.

Stronger Pound – The significant increase in international buyers since 2008 has coincided with our systematic devaluation of sterling which has given international buyers significantly greater purchasing power. If the pound continues to strengthen then this will have the opposite effect.

The End of QE – Admittedly this seems highly unlikely as even the mention of tapering sent markets into a tailspin. This rather underlines the fragility of the entire system.

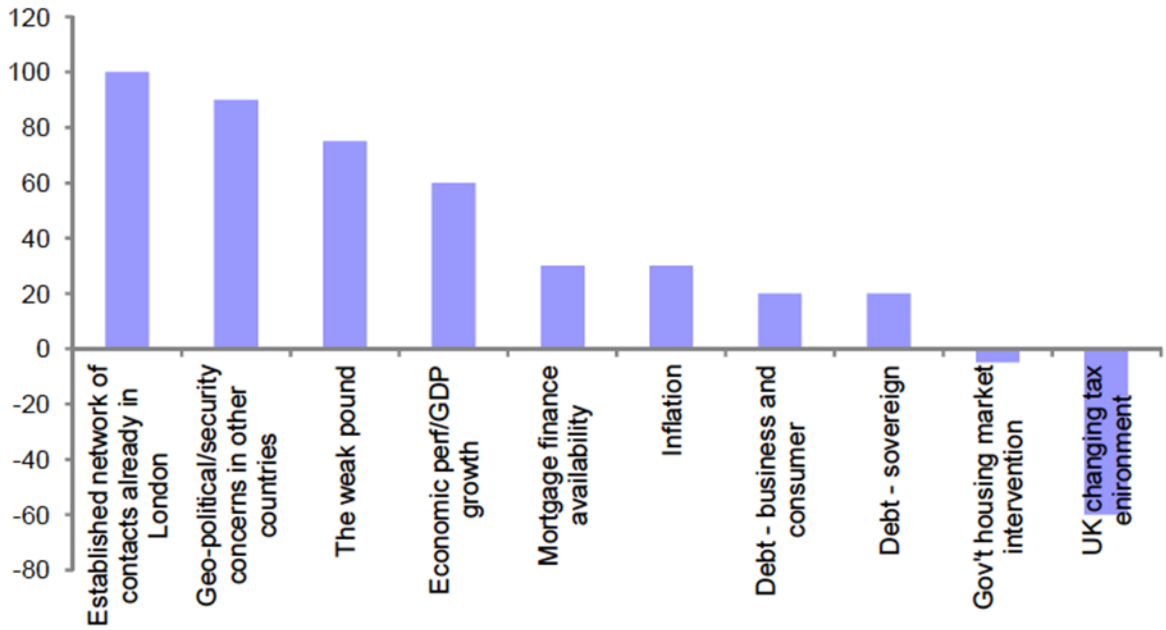
So there are a number of realistic, potential headwinds that could affect the market. Of course there are many positives too:

Reasons to be cheerful

1. **London is a fantastic city –** "Why, Sir, you find no man, at all intellectual, who is willing to leave London. No, Sir, when a man is tired of London, he is tired of life; for there is in London all that life can afford." **— Samuel Johnson.** Never has this been truer and it was even sunny in 2013!

   CBRE conducted an interesting survey showing :

Figure 33: Factors influencing wealthy peoples' decision to buy property in London 2011



Fleming Family & Partners have also released the results of a poll of 90 families with collective assets worth £100bn and found that they predict London to remain the most popular place in the world for finance and that London's property market will remain a good investment. London was the favoured city by a considerable margin, with 56% of respondents ranking it as their favoured financial centre for performance up to 2043, and 87% of respondents putting it in their top three cities. Number two on the list was Singapore.

2. **Relatively Affordable!** **-** This may have you spluttering into your tea but according to Dent Research:
   "Home prices in Shenzhen, China's largest coastal industrial city, are 35 times income…. Beijing is at 30 times, Shanghai and Guangzhou are at 28 times… Hong Kong is at 17. Singapore is at 26 times, Mumbai at 19 times and London, now the most expensive city of the developed countries, is at 15 times income". There are a host of reasons why comparing figures in India and China to London is absurd (and was not the driving point of the Dent Research in their defence) but I just love how stats can be manipulated.

3. **Politicians –** they will continue to support the housing market. Despite the rhetoric about affordability issues they continue to stoke the market with schemes such as help-to-buy and continuing low interest rates (central bankers are effectively ex-officio politicians). This has increased demand domestically – indeed prices across the UK were up 7.7% (another idiotically "accurate stat!) – admittedly, mainly in the south of England. Rightmove reported 21% year on year increase in traffic. It should also be noted that Stamp Duty Land Tax now contributes billions to the government coffers – thank goodness they use the money so wisely…

4. **Foreign Investment –** The scale of which is breath-taking in both the commercial and residential sector. The latest example is Greenland Holding Group, the state-owned Chinese builder, has invested £1.2 billion on the Ram Brewery site in Wandsworth and another site in Canary Wharf (and this is just the initial foray apparently).

   This coincides with a survey by the Association of Foreign Investors in Real Estate which asked global investors from 21 countries to consider cities for criteria such as their stability and level of returns. They ranked London top with 24 per cent of the votes, followed by New York at 21 per cent, with San Francisco, Houston and Los Angeles in third to fifth place

   The South China Morning Post also reports on a new idea: Crowdbaron.com for HK investors – "the newly launched site focuses on off-plan central London property. For a minimum outlay, typically 1 per cent of the purchase price, an investor can join a syndicate. If the target funds are raised, an offshore limited company is formed to acquire the property and investors get shares equal to their stake."

   Good news for the developers along the river but I always think that this sort of scheme hints at a bubble top. In this case I expect such funds will be focussed on new builds on the river which are marketed on the roadshows and you know my views on these.

5. **Increased Commercial Demand –** The Evening Standard reports that "A raft of big names are looking for large offices in the capital with internet giant Amazon searching for another 380,000 square foot straight after taking 210,000 square foot at Sixty London, while Omnicom, Estee Lauder, Mishcon de Reya and Yahoo are all on the hunt.

   CBRE says companies should plan up to five years in advance to be sure of securing new space. Tenant advisory experts Simon Calvert and Frances Warner-Lacey said: "Employment is at a record high in the capital. The fall in office supply is now greater than the demand. Take up of new office space is as high as pre-2007 but there is now starting to be less choice."

   According to Estates Gazette "there are 71 office schemes being built… Next year will see 6.6m sq.ft. of space developed in London – the largest amount for 10 years. More than 2m sq.ft. has already been pre-let, highlighting occupier confidence and a lack of supply".

6. **Increased activity outside of London** – Estates Gazette reports that Deloitte's latest crane survey shows that there has been an 80% increase in new project starts in cities outside of London. This will have been from a very low base but is nevertheless encouraging.

7. **Cash is King –** "Cash buyers, unaffected by constrained lending, have driven the prime markets through the downturn. In Q2 2007, cash buyers in Kensington and Chelsea accounted for just 30% of purchasers, in contrast to Q2 2013 when the figure rose to 52%" & "£21bn spent on central London residential property since lehman's collapse." (W A Ellis).

   Estates Gazette concurs saying that 35% of homes in UK were bought without mortgage finance in the year to September 2013 (£83bn of 237bn). In the five years to 2007 cash purchases averaged 10-15% of transaction totals.

Summary

So plenty of positives, but by no means is prime London property immune from potential falls in price. The simple fact is that there is far too much debt in the world. As many of you have pointed out, many western countries are effectively bankrupt with very little if no chance of ever repaying their debts, hence the monstrous amounts of counterfeit money being printed by BOE, The Fed, BOJ, China, etc. to try to boost their economies.

Unfortunately the effect of this has not been to boost economies – unemployment figures are still desperate especially for those under 25 and a large percentage of the increases in profit margins have been due to decreased borrowing costs. QE has, however, been exceptional at boosting assets - see the performance of share indices in the countries that are printing money but also classic cars, diamonds, art, stamps and of course prime London property.

So two questions:

1. How will this unravel: Inflation, Deflation, Stagflation or will we return to that fabled era of the “Goldilocks’ economy” where boom and bust has been eradicated (I am happy to take all bets on the latter*)?

2. When will such an event, be it inflationary or deflationary, happen?

Quite frankly your guess is as good as mine. It could happen this year or be a decade away. Ultimately I suspect that most people will find that they become poorer. But if the vast majority of people are losing money and you are losing less or treading water (or even making gains as some inevitably will) then you will end up ahead.

This is one of the reasons why so many people from across the world are buying prime London property – as a hedge against the inflationary danger. However, it would be unwise to go “all in” on London property in case the deflationary forces take hold.

London has changed enormously in the last 15 years – from the skyline to the quality of the shops and restaurants. It has become a truly global city and judging by the amount of money flowing in London is consolidating its position as the pre-eminent global city in the world.

This may be unpalatable to those who can no longer afford to live in London but it is a fact. Consequently London’ economics have detached from the rest of the U.K. This is why looking at prices in Kensington & Chelsea in relation to UK earnings is absurd. You need to look at the prices in relation to the earnings/net wealth of the people who buy there. The fact that there are so many cash purchases tells you everything you need to know.

I must stress that does not mean that prices cannot go down. I think that the developments on the river are particularly vulnerable as are any high density areas which have been predominantly bought by overseas' investors – I simply cannot see where the rental demand will come from to fill these apartments **at the yield that justifies the purchase price.** This is unlikely to manifest itself immediately but the introduction of CGT for international buyers in April will be the litmus test. If/when there is a global meltdown there will be forced sellers even in Knightsbridge & Belgravia and they will suffer. The key is to make sure that you are not one of them.

This is not to say that I am bearish or gloomy about the prospects for London. Firstly, we could avoid a catastrophic economic collapse or it may take decades to actually unfold. Ultimately, the world will keep spinning whatever happens in the markets. All I know is that if things do go horribly wrong, there are a lot worse places one could live than in London and there will always be opportunities here.

I wish you a healthy and prosperous 2014 and for those of you who have made a New Year's resolution, I refer you to the Mexican proverb:

A good resolution is like an old horse, which is often saddled but rarely ridden.

Best regards,

Jeremy McGivern

p.s. If you know someone who would find this report helpful, please do forward it to them and ask them to contact us if they would like to receive future editions.

*Terms and conditions will apply!