RESIDENTIAL RESEARCH

LONDON DEVELOPMENT 2012

Knight Frank

2012
LONDON DEVELOPMENT

This report aims to answer the most pressing question facing developers and housebuilders active in London: is the London market heading for oversupply?

“Measuring and anticipating demand is a key priority for developers as they look to add to supply.”

Gráinne Gilmore, Head of UK Residential Research

It is not surprising that the capital has become one of the main areas of focus for developers in recent years. The performance of the housing market in London, especially for prime property in central London, has been markedly better than elsewhere in the country (see box below).

An underlying driver of any property market is the relationship between housing supply and demand. Measuring and anticipating demand is a key priority for developers as they look to add to supply.

Historical data shows that the supply of new housing in London has failed to keep pace with demand for many years. This is a situation that has been replicated across the UK. In 2004, Kate Barker wrote in her review of the housing market that: “There is growing evidence of a persistent inadequate supply”. The situation since then has deteriorated rather than improved.

Housing completions hit their lowest level since the Second World War in 2010, and while completion numbers have risen modestly since then, they are still far below historical averages.

The problem has become such an issue for the Government that it has published a raft of consultations and introduced new schemes to try and ramp up supply, including Eric Pickles’ plan for ‘brokers’ to mediate between planners and developers and the extension of the Get Britain Building fund. Most recently, the Prime Minister announced plans to get stalled schemes with permission for 75,000 homes across the UK moving by waiving the affordable housing requirement, as well as offering Government guarantees of up to £10 billion for housebuilding.

There is clearly a problem in the supply chain of housing across the UK. In this report we drill down into the data focussing on London, particularly the prime London market.

We examine in detail government household forecast data to give the latest snapshot of the estimates of housing requirements over the next decade, scrutinising the figures and the assumptions made the official calculations.

Against this, we estimate the supply of new housing, using publicly available data as well as Knight Frank market intelligence on developments across London, and provide judgements on how the constrained funding environment will affect the potential delivery of units.

The figures suggest that overall undersupply will continue to be a feature of the London market. While it is impossible to second-guess how individual developers will react to different economic situations, it is worth pointing out that if bank funding recovered sharply, some areas might see a rate of supply which would significantly test absorption rates.

The underlying balance between demand and supply is evolving, especially as new data is released from the 2011 census, and we will update our findings accordingly on Global Briefing, our research blog.

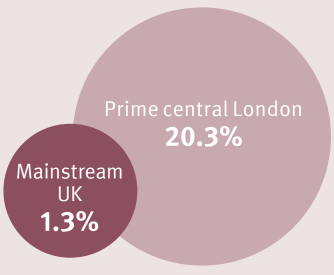
LONDON FUNDAMENTALS

Property prices in prime central London and Greater London have outstripped the wider housing market in England and Wales by quite some margin, as figure 2 shows.

Prices in prime central London have bounced back by nearly 50% since the post-crisis trough in March 2009 to hit new record highs, while prices across the whole of Greater London have risen by 20%. In contrast, prices in the rest of the England and Wales have risen by around 7% over the last three years, according to Land Registry data. Unsurprisingly, these market dynamics have pushed up development land prices in London, especially in the prime central areas.

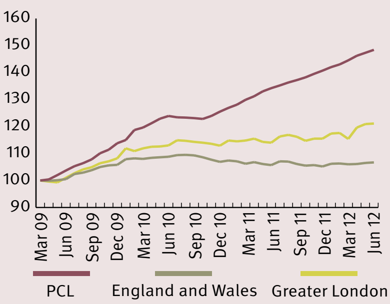
The Knight Frank Residential Development Land Index showed that land prices jumped by 20% in 2011 alone, although they have remained unchanged to date in 2012 (September).

Figure 1
Annual % change in residential development land values: 2011



Source: Knight Frank Residential Research

Figure 2
How house price growth compares:



Source: Knight Frank Residential Research

Supply and demand

Measuring demand

The population of London has soared over the last decade, rising by 850,000 to reach 8.17 million last year according to the 2011 census data. The growth in the number of people living in the Capital over the last decade is significantly higher than that seen between 1991 and 2001, and means the total population of London has expanded by 20% over the last two decades.

The new population figures for London are nearly 350,000 higher than policymakers had expected, thanks to an undershoot on the official population estimates in the years between the censuses.

These population estimates in turn inform estimates and forecasts for household growth. But in contrast to the population estimates, the household numbers in the census were lower than those shown in the forecasts from the Department for Communities and Local Government (CLG).

The CLG household projections indicated there were around 3.34 million households in London in 2011, while the census showed there were 3.26 million – a gap of 77,000. In central London, the shortfall was around 43,000.

12%

increase in population in London 2001-2011

There is an explanation for this differential. The census data reflects the number of households created, which in turn depends on the volume of housing actually built. As such, the actual number of households has been constrained by the lack of development over the past decade.

Interestingly the Greater London Authority's (GLA) household forecasts for the period between 2001 and 2011 were much closer to the growth finally confirmed in the 2011 census. The reason for this is that the GLA attempts to limit its forecasts in line with its views on future housing completions, so it takes a 'constrained' future view. In contrast, the CLG takes an 'unconstrained' view, estimating the number of households that could be created in line with population growth.

Over recent months we have been developing our own supply and demand model for London. We have taken account of the new 'confirmed' London household total for 2011 from the census and have adopted the current forecast rate of growth from the CLG to provide what we perceive to be the most up to date proxy of demand in London.

This remains a 'live' issue however, and we will continually update our models in line with revised population estimates and CLG growth forecasts as well as the latest intelligence on supply within the London and prime London market.

Demand in London

At present our data suggests that around 370,300 households will be created in London in the 10 years to 2021. We estimate that within this, the demand for private sector accommodation will be 264,000, with the remaining demand being for accommodation provided in the affordable sector.

When we turn to central London, we expect to see total household growth of 41,312 by 2021, with 31,769 of these households likely to be looking for private sector housing. For ease of analysis, central London in this report comprises the boroughs of Kensington & Chelsea, Westminster, Camden and the City of London.

> "For decades not enough new homes have been provided to meet the needs of our growing population."
>
> CLG December 2011

When we consider the central London market it becomes critical to assess the impact of international buyers, investors and second-home buyers. We need to separate these buyers into two groups; the first is the investment market. Buyers here, whether from the UK or overseas, are effectively providing accommodation which will be occupied by a household, albeit one in the private rented sector. These units are therefore contributing to meeting our demand forecast. The second market is those buying second homes, who keep their properties for their exclusive use, and therefore add to the total sum of demand.

Knight Frank intelligence suggests that second-home owners account for between 10% and 20% of purchases in the prime areas of central London. This is additional demand over and above the 40,000 household growth forecast confirmed above.

OVERSEAS DEMAND

Overseas buyers are especially active in the new-build market in London. In the current economic climate, lenders often insist developers pre-sell around 30% of a scheme before funding is released. In recent years, this has resulted in many schemes being marketed overseas, especially in Asia, given the increased ease with which investors can access mortgages for off-plan properties should they need to. However this trend could be shaken up, according to Stephan Miles Brown, head of residential development at Knight Frank.

"There are many other potential markets for property in London, not least Turkey, the UAE and the US. But ironically, possibly the most interesting emerging market for pre-selling is London. It is all but a forgotten market as developers have tended to concentrate on marketing overseas in recent years. As a result, tranches of wealth in the capital have been largely untapped. Expect to see more London launches in the next 12 months as developers attempt to tap into the domestic market."

> “Banks remained very wary of lending to the property sector.”
>
> Bank of England Agent’s Summary of Business Conditions, August 2012

Measuring supply

When examining the future supply of housing in London it is important to note that we cannot second-guess developers, who face hurdles unique to every scheme in which they are involved in terms of funding, infrastructure and planning. As such, there is no certainty about when schemes will be built out.

Funding is certainly a key issue. Housing supply across the UK has been affected by constrained credit conditions since the start of the financial crisis and despite the relative buoyancy of the London market compared to the rest of the UK, the funding landscape is still difficult.

There are of course some cash-rich developers who are relatively unaffected by the shortage of bank lending, and others have been active in sourcing alternative sources of funding. But the overall environment remains challenging. Added to funding difficulties, planning is also an issue with many developers locked into re-negotiations for planning on schemes where the development economics no longer add up in light of the new financial conditions.

Despite the challenges, applications for planning permission for new schemes in London have picked up in recent years. This is perhaps a reflection of an increasing trend among developers and housebuilders to focus on London and the South East.

There are currently around 3,600 schemes in pre-planning or in the planning pipeline across London with the potential to provide more than 630,000 new homes. But some of these schemes will not be built out for decades.

To provide an estimate for potential supply over the next decade we have assessed the planning and development pipeline and made assumptions for all sites based on construction and planning status. We have paid particular attention to the larger sites in the pipeline which have the potential to significantly alter delivery volumes across central and outer London. Our conclusions feed into our estimates of likely development potential for the decade to come.

Schemes of 1,000+ units account for around 35% of total units currently in the supply pipeline.

To assess the potential supply from such schemes, we considered how they might be phased, adding the phases which we assume will deliver units within the next 10 years to our forecasts.

Supply in London

Our final estimates for total supply show that, averaged over the next 10 years, around 24,000 units could be completed across London each year, up from the average supply of around 20,000 units seen over the last ten years.

We expect 17,000 units to be for private sale each year over the next decade. These totals fall short of expected household growth, as well as missing the target for delivery of around 19,000 new private units a year spelled out in the London Plan.

Focusing on central London, we estimate that the pipeline could deliver an average of 1,850 units every year, slightly lower than the average development volumes over the last ten years, and falling short of the demand suggested by the number of new households that will be formed. This shortfall is replicated when examining private housing, with around 1,390 private units being completed each year, compared to household growth signalling demand for 3,177 private units a year. Discounting demand from second homeowners, this still suggests a cumulative shortfall of 17,865 units by 2021. As Liam Bailey comments on page 5, this headline shortfall in supply will not protect the developers who have been chasing the prime, and especially super-prime markets, with the wrong product.

Figure 3
Housing supply vs demand in Central London

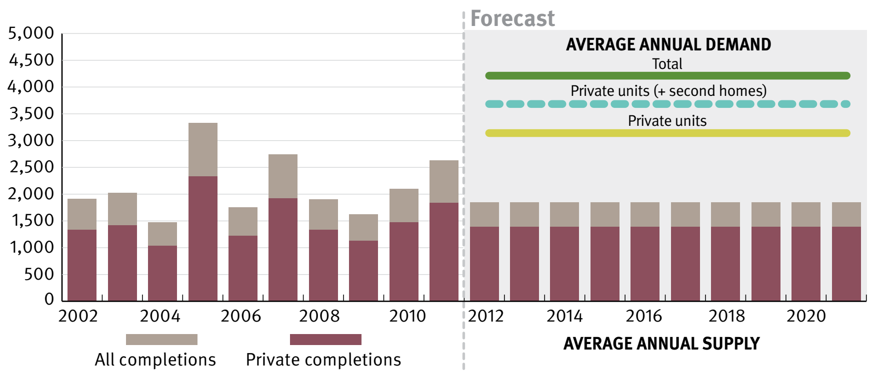
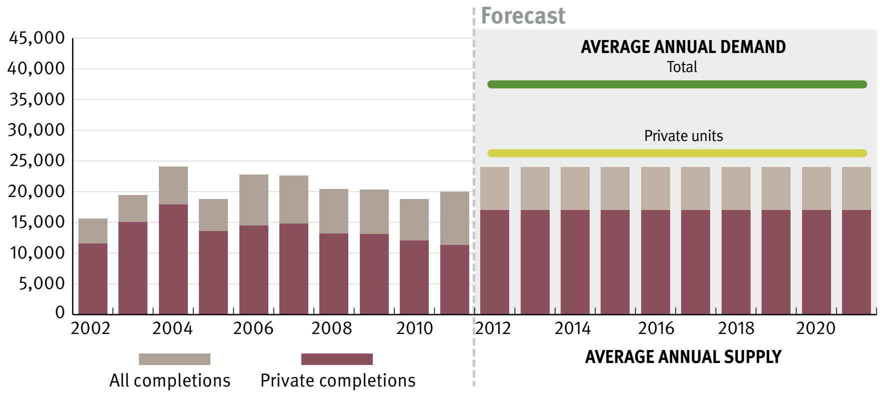


Figure 4
Housing supply vs demand in Greater London



Source: Knight Frank Residential Research, CLG, ONS, Molior London

Reality check

While our headline numbers point to an excess of demand over supply, competition at the top of the market is hotting up. Liam Bailey examines the prospects for developers targeting the prime and super-prime markets.

Over the previous four pages we have explained in detail why we believe London and central London in particular, will avoid development oversupply over the next decade.

Despite this benign outlook a problem is growing for developers who are targeting the top of the market. The strength of prime sales over recent years has made developers concentrate in ever greater numbers on the prime and super-prime segments.

For most developers with sites in the traditional prime postcodes this is a sensible strategy. The problem is that an increasing number of developers, with decidedly secondary sites, are beginning to lose sight of market reality, with price aspirations being ratcheted ever higher based on hearsay from achieved prices in other schemes.

There are two dangers in the price-setting process; exceptional prices for individual developments rapidly become accepted as "averages", and developers who believe their scheme to be better than the competition and therefore capable of commanding an additional price premium over their competition.

During a period when prices across prime London have surged by 50% in three years it has been very easy for developers to put constant upward pressure on prices per sq ft.

The problem with this process is that it can lead to unrealistic pricing, and unsuitable buildings being brought forward for development. Too many commercial buildings in central London near the end of their leases are thought to be suitable candidates for luxury residential redevelopment.

A reality check is needed and the best place to start is by looking at actual market capacity at the top of the market.

The number of £5m+ sales in London over the past five years has averaged 350 annually, of which 30% at most have been new-build. 70% of these sales have taken place in six postcode districts (SW1, SW3, SW7, W1, W8 and W11).

We have identified at least 1,500 units in the pipeline which are nominally targeting this market. At historic sales rates this total equates to 14 years of delivery.

We believe there is demand for the very best in prime central property. But our conclusions around demand and supply do not preclude limits to market capacity being breached in specific sub-markets, and some developers targeting the top of the market may be the first to be forced to rethink their schemes. The biggest shift may be a reappraisal of the now established rule regarding the need to build large units to maximise £ per sq ft values.

For the best-located schemes in the heart of PCL, the aspiration to achieve upwards of £2,000 or £3,000 per sq ft, and capital values of £5m, £10m or more can make perfect sense. Our recent London Residential Review confirmed that the new top rates of stamp duty have not yet hindered sales volumes above £5m, while sales above the £2m threshold have been hit.

It is the assumption that the right marketing approach can lift schemes which are not in the right locations or built to right specifications into these price brackets which is dangerous and which is likely to become unstuck as development volumes rise over the next few years.

> "The greatest risk is developers taking a generic approach to schemes with the expectation of prime pricing."
>
> **Liam Bailey,** Head of Residential Research

CHANGING TAXES

In March this year, the stamp duty rate for the purchase of properties worth £2m or more rose to 7% for individuals and 15% for some offshore companies. This came after a hike in stamp duty from 4% to 5% in March 2011 for properties worth £1m or more.

So in the space of just over a year, buyers of £2m+ properties have seen their stamp duty charge rise from 4% to 7%. For those buying through an offshore company, the charge has nearly quadrupled.

In addition, there is uncertainty lingering over other tax arrangements for offshore companies and any non-UK residents who own or buy a property worth £2m.

A consultation on levying annual charges, ranging from £15,000 to £140,000 a year, for £2m+ properties held by offshore companies and extending the capital gains tax net to such property owners in the UK recently closed. The results will be shared around the time of the Chancellor's autumn statement, and will be introduced into law in April next year.

The initial signs from the market in London show that the changes and the uncertainty over the new rules are having some impact, especially in the £2m to £5m bracket. Transactions for homes in this price bracket have fallen since the new rules were introduced in March. But notably, to date, the market for super-prime £10m+ homes has held up.

Developers, especially those launching schemes with units priced at £2m+, will have to consider how the overhaul of the tax regime for units priced at £2m+ could impact the market in the coming years.

2012
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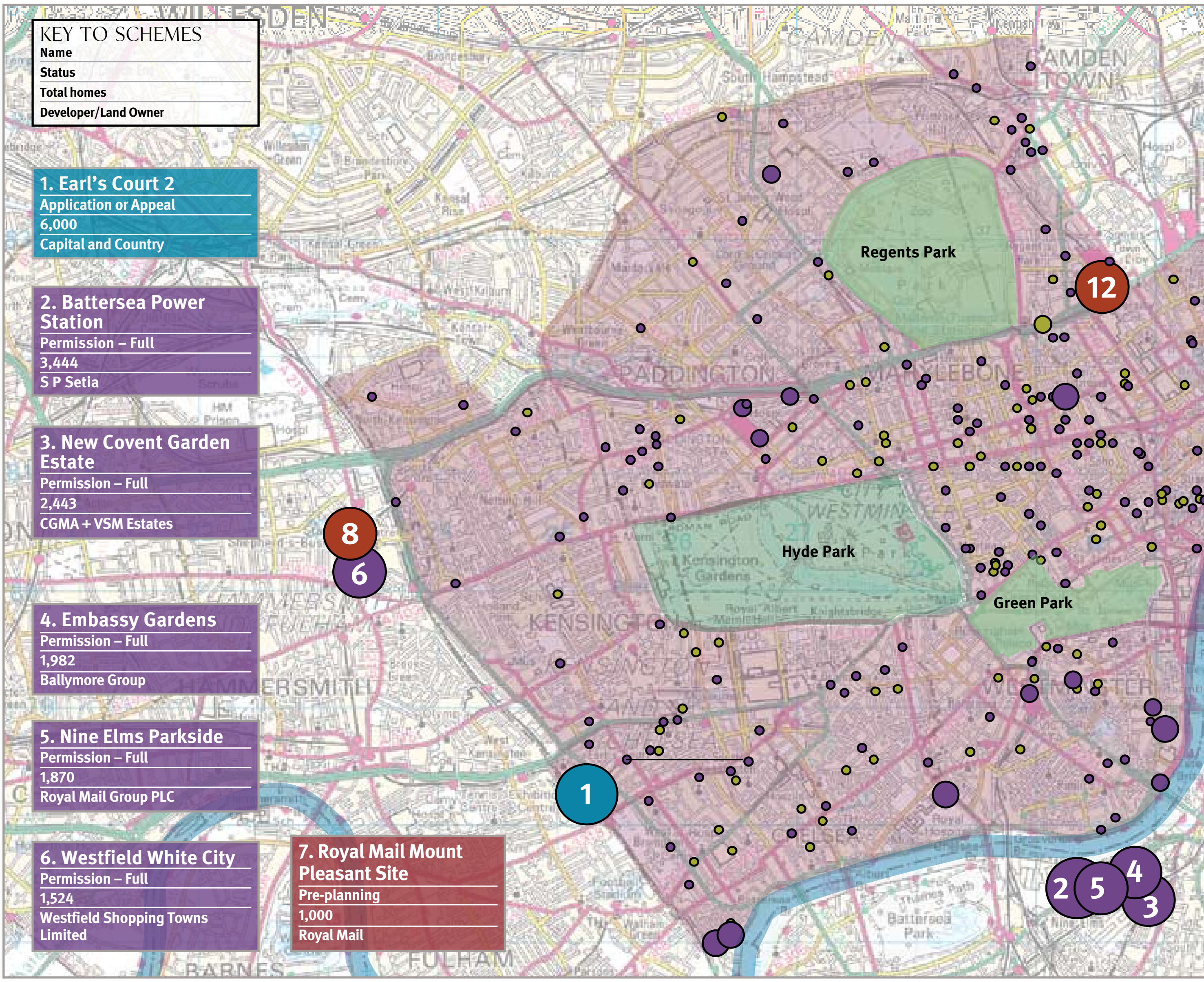


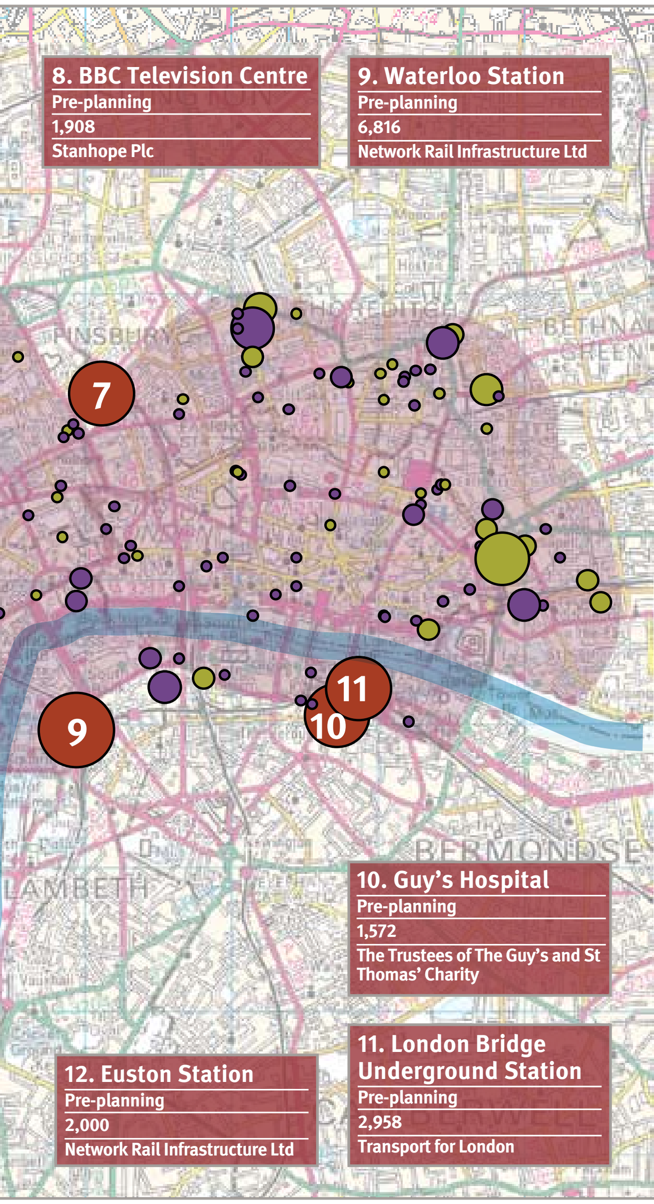
Development focus: prime central London

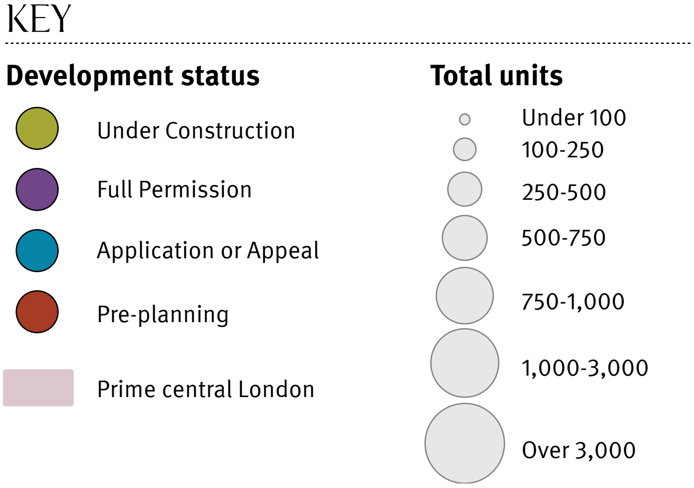
As can be seen from the map of pipeline developments above, the majority of developments in the traditional postcodes of prime central London are for schemes of up to 250 units.

Over to the east, in the City and City Fringe, there are some larger developments under way, taking advantage of increasing interest from buyers in these areas. The improved transport links offered by Crossrail will only enhance the attraction of the eastern fringe of prime central London.

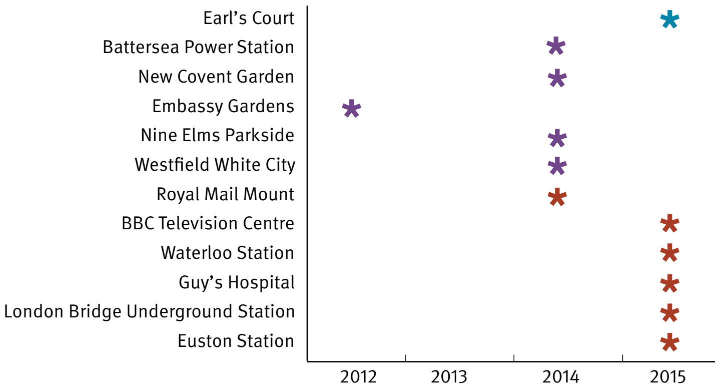
But as clearly illustrated, some of the biggest schemes planned for London in the coming decades are poised just on the edge of prime central London. For developers, the challenge and opportunity offered by these locations is to create a product pipeline and development form which will appeal to buyers who would have traditionally looked in the prime central London postcodes only. If developers get this right they will be perfectly positioned to 'draw out' unmet demand for prime central London property.

As we previously forecast, in our London development hotspots report, developments which mark the complete regeneration and renewal of an area could be enough to extend the boundaries of prime central London to encompass them. This will be particularly applicable in the western 'quadrant' of the PCL fringe, where there will be an overhaul of the established areas of





Estimated start dates



Source: Knight Frank Residential Research/Molior London

Earls Court (1) and Westfield White City (6), both of which already benefit from excellent transport links.

Yet such a concentration of larger schemes also poses some risks. If all or a majority of schemes are built out along the same time-frame, a scenario which would to a large extent be reliant on a turnaround in the funding landscape, we are not discounting the chance that there may be localised areas where the absorption of units may be more challenging. This would be especially true if the units were priced to reflect a premium prime London location rather than the new marketplace that has been created. This could create benign conditions in terms of price growth in contrast to other areas of prime central London. Developers must take these factors into consideration when looking at schemes, and temper their expectations according to the area in which they are developing.

Overall, we expect the supply/demand dynamics in London to reflect those seen over the last 10 years, with a fundamental shortage of housing in the Capital. As the economy recovers in the years to come, a rebound in growth that London is likely to spearhead, demand from residents to be based in the City is only likely to intensify. The shortage of housing in prime central London areas is likely to lead to demand filtering out to fringe locations and further afield.

Conclusion

In this report we have shared our thoughts around housing supply and demand in London. We have made estimates for future household growth and assessed the planning and construction pipeline to provide a view on potential delivery volumes over the next decade.

Our headline conclusions are fairly stark. Demand for new private or 'market' properties based on the growth in households in Greater London is likely to total 264,000 over the next decade, whereas new housing supply is likely to be nearer to 170,000 meaning 36% of potential demand will remain unmet.

When we concentrated our analysis on central London our conclusion on unmet private demand hit 56%, 13,904 units in the pipeline against demand for 31,769 between now and 2021.

Despite our rather specific headline figures, it must be noted that they are assumptions based on government forecasts and the likely actions of hundreds of private developers. Delve into the world of official population and household projections and you find statisticians layering assumptions onto estimates, a necessity as official population figures are updated only once a decade. Updated forecasts for population and household growth will affect the outlook for demand, whilst the supply pipeline will be affected by decisions made by individual developers as they assess how and when is best to bring their unique schemes to the market.

The lack of bank funding is a critical barrier to development at present. We see little prospect of an easing in this constraint for developers, given the current economic situation, as well as the phasing in of new higher capital demands for banks under Basel III from next year. We do not, however, discount the possibility of a period of higher than average supply in localised areas if the funding environment does improve dramatically, and unexpectedly, as a larger number of pipeline schemes come to market.

London is a key global city. The population growth seen over the last 20 years illustrates that the demand to live in the UK's capital is only growing, and we anticipate that this will continue to be the case.

13,904

Forecast supply of private units in central London 2012-2021

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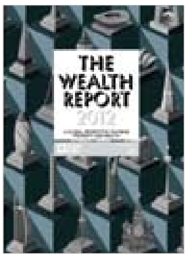
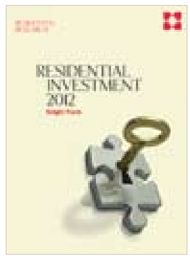


The Wealth Report 2012

Prime Central London Sales Index July 2012

Global Development Review 2012



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