# London's residential property market

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**The London residential property market, for so long inured from international events and political interventions, faces unsettled times. Perspective is given by looking back on the past 20 years to see how London has developed so rapidly and how buyers and investors must adjust to the new landscape of market corrections, slower growth, illiquidity and a more expensive property tax landscape.**

The prime central London (PCL) property market is one of the most resilient in the world, but even PCL has been buffeted by the winds of change that have swept the world throughout 2016. Those in the business of advising wealthy clients have been frantically polishing the crystal ball to make sense of it all and to try to provide considered and coherent advice on the prospects for 2017, based on more than simple guesswork.

It is now clear that the 'high water mark' for most sectors of the PCL property market was the Spring of 2014. By October that year, Ed Balls (then Shadow Chancellor of the Exchequer, now better known for his Gangnam Style) had pledged to introduce a mansion tax (a 1% annual tax on all residential property valued over £2 million) triggering a political assault on high-value residential property. Within months (December 2014), the then Chancellor, George Osborne, had introduced shock reforms to stamp duty land tax (SDLT) increasing the top rate to 12% (further increased a year later with an additional 3% on second homes).

Almost all market commentators agree that these SDLT reforms have been the single biggest reason for the recent fall in values and the much more dramatic fall in transaction numbers, pre-dating considerably the surprise caused by the result of the United Kingdom's EU referendum in June 2016.

### Twenty years of growth

However, just in case we might allow ourselves to become too despondent about falling prices and calmer markets, it might be justifiable to turn the clock back, say, 20 years to 1996, to see the astonishing level of property price rises and the unprecedented upturn in the number of residential developments that have been undertaken, as London established itself during this period as, arguably, the most desirable city in the world in which to live, work and invest.

In 1996, London was emerging tentatively from the recession before last, the Spice Girls topped the pop charts and the Jubilee Line to Canary Wharf was still under construction. Then, the average home in London cost £70,000. Now, prices have risen by an astonishing 518% to an average of nearly £490,000, with this extraordinary growth reflecting the rise of London's financial services sector and unprecedented demand from international buyers and investors. It is worth noting also that during this time property prices rose more than 11 times as fast as local incomes, which effectively locked many Londoners out of the prime central market and, in some cases, from the fringes also. This imbalance formed the ongoing political debate as to the desirability of the capital city's prime property market being powered by demand, primarily from emerging economies, essentially to the exclusion of UK nationals.

### Trophy properties and icebergs

International buyers typically targeted trophy property in the best addresses of PCL, such as Belgravia, Knightsbridge, Chelsea, Mayfair, Marylebone, South Kensington and Notting Hill. These areas were seen as outstanding places to live, rather than necessarily as yield-bearing investments, with surging capital growth (often more than 10% per annum) providing a more than happy side benefit. The biggest value risers were seen in prime central areas with Marylebone (High Street), for example, showing a 936% increase over the past 20 years with Knightsbridge and Belgravia not far behind with increases of 892% in the same period.

The valuation of residential property on a £ per sq ft basis became the normal valuation practice and with every sq ft so valuable (rising to nearly £7,000 per sq ft in some PCL areas), owners and developers started to explore every opportunity to extend floor areas, leading to a vast number of very grand and hugely expensive refurbishments. In many cases, planning restrictions prevented extensions to buildings beyond existing 'footprints' so the only way was down thereby promoting the rise of multi-storey 'iceberg basements' often with cinemas, swimming pools and bowling alleys. Large and even small basement digs attracted controversy as schemes became even more lavish, often bringing longstanding building site inconvenience to the general neighbourhood and, in some cases, causing damage to the foundations of adjoining properties. The appeal of subterranean living had begun to recede by the end of 2016, with the tightening of planning regulations in parts of PCL, led by The Royal Borough of Kensington & Chelsea (RBKC), creating more obstacles and delays in obtaining planning permissions for such sensitive developments. At the same time, pricing for underground spaces became more uniform, with a typical starting point for valuations established at around 50% of the £ per sq ft value for the above ground level floors (with a progressively sliding scale for the iceberg developments).

**Gentrification and infrastructure**

As we continue through our 20-year journey and with PCL prices rocketing through international investment, those working and living in London began to move further out (the 'ripple effect') thereby gentrifying new areas such as Fulham, Queen's Park, Kensal Rise, Balham, etc. A number of high quality shopping brands (eg, Waitrose, Gail's, etc) responded swiftly to these changes and became synonymous with the migration of local buyers to more affordable zones. Essential to this exodus was the necessity to be within a 10-minute walk of a tube station, facilitating a journey time of perhaps only 30 minutes from the workplace.

These family areas and emerging areas (even outer areas) have benefited the most from recent transportation infrastructure projects due to provide improved connections to central London. In 2018 the Elizabeth Line (currently known as Crossrail) will open (having received Royal Assent in 2008) and in 2020 the Northern Line extension to Battersea Power Station will come into operation. There are even proposals for a Bakerloo Line extension and Crossrail 2 and 3.

**Agents come to the fore**

The advancement and maturity of online technology particularly suited the residential property industry, with selling agents able to present ever more lavishly photographed lifestyle presentations of property while providing even the most modest offerings with a glossy magazine-style appeal. Zoopla, Rightmove, Prime Location and, more recently, On the Market, offered online, detailed and collective search platforms which were, by definition, generally populated by seller's information.

Under the guiding legal principle of *caveat emptor*, or 'buyer beware' and with highly incentivised and sophisticated estate agents acting for sellers (epitomised by the arrival of the iconic Foxtons mini), the market saw the emergence of 'buying agents'. At their best, these agents (often small firms or individuals) provide impartial, independent advice to buyers of London property. They source the very best properties (both on and off the market) for their clients, undertake extensive due diligence and manage every aspect of the acquisition. At the other end of the spectrum, there are unscrupulous runners chasing fees often from both sides of the transaction with little or no care for the unfortunate buyer.

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**Developers cash in**

Always alert and aware of the rapid increase in interest from overseas, London developers turned their attention quickly to the task of finding well-located development sites to enable them to deliver a product that would have special appeal to international buyers, principally from Russia, India, the Middle East and South East Asia. The iconic One Hyde Park residential and retail complex in Knightsbridge had only just received planning permission in 1996 with approval to create 86 luxuriously appointed apartments within four separate 'Towers' and which, when made available to a deliberately restricted, exclusive market, broke all £ per sq ft records. One Hyde Park also established itself as one of the most prestigious residential addresses in the world and generated a renewed interest in London's high-end market, aimed fairly and squarely at the world's wealthiest buyers.

The demand for high-value property was by now comfortably outstripping supply and buyer interest turned, principally on the back of the success of One Hyde Park, towards exceptional quality new-build property. The overseas buyer acquired a preference for contemporary, high tech, 'international standard' accommodation, rather than the more established and often rather dated period houses and mansion blocks that had previously dominated the PCL market. The shortage of sites with development potential, however, required developers to look further afield to satisfy 'investor' demand, principally to the east of the City towards Canary Wharf which, 20 years ago, could have been described as very much a work-in-progress. Desirability of the commercial sector initially and then, by way of demand, the residential sector was hugely enhanced when London's transport system was significantly improved with the Jubilee Line extension to Canada Water, to Canary Wharf and beyond. HSBC and Barclays responded by building new head offices in the region and very soon the whole area was thriving beyond recognition with an

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abundance of restaurants, bars, clubs and shops providing a vibrant meeting place and playground for bankers, wealth managers and office staff. Developers then started to invest in the first residential towers, notably Pan Peninsula, the completion of which really did herald the dawn of London's high-rise market. The Shard, Heron Tower, the Walkie-Talkie and the Cheesegrater developments that followed have all combined to form the beginnings of a Manhattan-style skyline. There are around 250 new towers yet to be constructed but already in the pipeline, which means that the skyline is set to dramatically change again over the next 20 years.

Back in prime central, low-rise major developments, notably Chelsea Barracks and Grosvenor Square, have continued to feed demand and interest, primarily from overseas, for high quality 'international standard' principal homes. In addition, investment buyers can expect a long-term supply from the development of sites south of the River, at Nine Elms for example, which is helping to service the accommodation needs of, among others, staff from the imminent relocation of the American Embassy from Grosvenor Square and the redevelopment of the iconic Battersea Power Station which is expected to continue to attract international investors for a number of years to come.

**The 2017 market**
While the current headlines are alarming (journalists prefer it that way), dramatic falls in transaction numbers and widespread falls in value – it is the story behind the headlines that is most interesting.

**Key drivers remain**
London has become one of the most open and dynamic cities in the world. It is one of the two pre-eminent financial centres (alongside only New York in a global context) and one of the most cosmopolitan cities globally (38% of London's population were born overseas). It scores highly across every measure:

- the availability of skilled personnel;
- a stable legal and regulatory environment;
- access to international financial markets;
- a globally significant stock market;
- infrastructure and property;
- quality of professional services and the judiciary;
- quality of life;
- safety and security;
- education, culture and language;
- world-class tourism and creative, stable corporate and personal tax regimes;
- low corruption and political stability.

According to Savills, London's metro area, that is the area within which most of its workforce lives, is the fifth largest in the world, at nearly 15 million people. London's metro economy ranks third in the world against other city metros.

In surveys, few (if any) predict that London will cease to be one of the top two global cities in the next decade.

**Politics come to the fore**
In the immediate aftermath of the global financial crisis, Britain was a haven of political and economic stability amid the turbulence in Europe. That stability began to falter as the starting pistol sounded for the 2015 General Election; from that point on politics (and with it London's high-value residential property) took centre stage:

- *September 2014:* Referendum on Scottish independence. While the unionists won this battle, the campaign caused widespread uncertainty in the markets (including a dramatic fall in sterling and uncertainty in the residential property market).
- *October 2014:* Labour announces an election promise to introduce a mansion tax on all high-value residential property (details were scarce but broadly a 1% annual tax on all properties worth over £2 million, the vast majority of which are in London). This announcement brings residential property squarely into the election battle.
- *December 2014:* Chancellor announces shock increase to stamp duty, increasing the top tier (for the value of properties over £1.5 milion) from 7% (itself last increased in 2012) to 12% (*see further insert box below*) and announces a 50% increase in the ATED charges. The market reacts almost immediately with buyers expecting sellers to absorb this tax increase (the Savills index notes a circa 5% fall in values around this time).

- *May 2015:* Property market stalls in the run up to the General Election. While the Conservatives win a surprise majority (providing greater stability than the feared coalition), their promise of a referendum on Europe dominates the headlines. While some estate agents predicted a boom in PCL property, more sensible commentators advised caution – we wrote at the time that:

  *Sterling will strengthen on the result (a factor for many foreign investors), the recent Stamp Duty reforms mean transaction costs remain high, capital gains tax is now a factor for everyone and, most importantly of all, much of the current stock is relatively poor (over-priced, recycled, compromised and/or illiquid).*
- *July 2015:* The Chancellor announces wide-ranging changes to the taxation of non-UK domiciled individuals (non-doms). The announcement triggered a long period of consultation bringing uncertainty to resident non-doms and international buyers.
- *December 2015:* Chancellor announces stamp duty surcharge on those acquiring a second home (if they already own another property anywhere in the world). The surcharge is set at 3% making an aggregate SDLT of 15% for high-value transactions. This caused a minor surge in transactions as buyers and sellers sought to transact ahead of the changes.
- *February 2016:* David Cameron announces the in/out referendum would be held on 23 June 2016. With campaigns focusing on the negatives and the country divided, the PCL property market stalled in the run up to the referendum.
- *June 2016:* United Kingdom shock vote to leave the European Union. David Cameron (the prime minister) resigns triggering a leadership election. All but the most committed sellers look to rethink their sale.
- *July 2016:* Theresa May becomes prime minister confirming a shift to the left of politics as she states that the "Government I lead will be driven not by the interests of a privileged few, but by the interests of ordinary, working-class families".
- *October 2016:* At the Conservative Party Conference, Theresa May announces that she will invoke Article 50 (the formal mechanism to begin negotiations for the United Kingdom to leave the European Union) no later than the end of March next year. She also made clear there would be no 'running commentary' on the exit negotiations – this was a matter for her government and her government alone.
- *March 2017:* Theresa May (the new UK Prime Minister) expected to trigger Article 50.
- *April 2017:* 2017 Finance Act to introduce substantial changes to taxation of non-doms (including taxation of residential property held by non-doms and offshore trusts) (*see further insert box below*).
- *April 2017:* The Prime Minister unexpectedly calls a snap election to take place on 8 June.
- *March 2019:* The United Kingdom will leave the European Union (unless the timeframe for negotiations is extended).

In addition, during the same period, the government also introduced:

- major reforms to the mortgage markets which made substantive changes to affordability tests for residential mortgages and buy-to-let mortgages affecting all but cash buyers in the London market;
- substantial changes to taxes affecting every aspect of residential property (including changes to stamp duty, income tax (mortgage relief), capital gains tax (non-residents), inheritance tax (non-doms/trusts) and ATED). In fact, the Chancellor's Autumn Statement in 2016 was the first time in four years that there had not been a headline change to taxation of residential property.

For most market professionals and participants, a period of calm reflection on the outcome of these political, market and tax adjustments and how residential markets absorb and then react to them, is now desperately needed.

Looking beyond Britain's shores, international headwinds have had an equally dramatic impact on London's residential market (especially PCL which is

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driven by international buyers). The most obvious examples of these with a direct effect on international buyers are: the sudden collapse of oil prices from their peak of $115 per barrel in June 2014 to under $35 by the end of February 2016 (one of the most dramatic global macroeconomic developments in the last 20 years); the tumbling value of the rouble (which has fallen by circa 60%); and, most recently, the election of Donald Trump as the 45th president of the United States (although it is yet to be seen what macroeconomic impacts this may have – positive or negative).

Notwithstanding these varied headwinds, almost all market professionals agree that the shock reforms to SDLT have had the biggest impact on the market (both in terms of value and volume of transactions).

The greatest uncertainty that remains particularly if there is no change of Government following the June General Election, is the terms on which the United Kingdom will exit the European Union and its longer-term impact on the City of London. Unfortunately, that uncertainty is likely to remain throughout 2017.

**Sterling**

Sterling has been mauled since the United Kingdom voted to leave the European Union. It has fallen circa 19% against the US dollar, 25% against the Russian rouble, 20% against the Brazilian real and South African rand. The actual nadir may have been November 2016 when sterling fell to €1.02.

While undoubtedly the fall in sterling is good news for international buyers (in part as it mitigates all the SDLT), uncertainty over the impact of Brexit and valuations are leading many buyers to remain cautious (even if they have already converted their funds into sterling).

**Lack of distressed sellers**

Britain ended 2016 as the strongest of the world's advanced economies with growth accelerating in the six months after the Brexit vote. Interest rates remain at record lows (0.25%) and the FTSE at a record high (up 14.4% in 2016).

With little sign of a recession or rapidly rising interest rates and with sterling at a three-year low, there appear to be few distressed sellers in the market (save for those affected by the three Ds – debt, death and divorce).

If markets were to change, the statistics from the height of the global financial crisis suggest that most investors (and almost all home owners) are reluctant to crystallise losses in a falling market.

**Liquidity**

Transactional volumes in PCL are likely to remain depressed until Brexit negotiations are concluded and the market has factored in the outcome. Changes to the current non-dom rules (including inheritance tax on residential property) due to come into effect in April 2017, have been suspended, following the announcement of a General Election in June. Many have already re-structured their affairs to meet with the 5th April deadline but if, as the polls would suggest, a Conservative Government is returned, the suspended legislation is expected to be re-introduced. Whenever this legislation is eventually implemented, it is likely that demand will be further depressed throughout the year as structures are re-organised.

Marketing periods are no longer three months but perhaps six months and even up to 12 to 18 months at the higher echelons of the market. More property will be transacted 'off market' to seek to increase its allure and prevent the damage caused by overexposure/stagnation. Clearly, there is a lot of smoke and mirrors with off-market properties – some are very discreetly marketed by experienced sales agents while others (regrettably) are openly touted to introducers for excessive fees (which only serves to heighten the sense of the seller's desperation).

**Values**

Participants in the PCL property market must distinguish between 'asking prices' and actual value. The former is either set by estate agents (acting for the seller) or vendor-led (and often inflated depending on whether the agent is competing for a mandate or the vendor has an inflated view of the value of their property). The wave of recent price reductions in the market (and the statistics that surround them) is more indicative of overpricing than falling values.

While generic figures can be misleading (as they belie the myriad of markets that make up PCL and its surrounding areas), the sense from participants is that some areas of PCL have fallen as much as 10 to 12% in 2016 and perhaps 15 to 30% (in aggregate) since 2014 (albeit this depends somewhat on the valuation applied in 2014). For the lower echelons of the market, the family and emerging areas, this sector has fared better with the market broadly flat and perhaps down as little as 5% (in aggregate) since 2014.

Looking forward, the majority of commentators see little (if any) growth in the next two years with some (including Savills) predicting strong growth from 2019 (potentially circa 20% over the next five years). In reality, predicting growth beyond 2019 is very difficult – it can only be based on assumptions that are impossible to make until the negotiations around Brexit are concluded.

For the few commentators who foresee a market surge, they base this on a sudden influx of capital, perhaps because of:

- a further fall in sterling spurring international buyers to invest. Our sense is that some buyers

may buy sterling but will take their time to then buy property (waiting to see how the market and perhaps Brexit play out);
- uncertainty in Europe (triggered by elections in France, Germany, Italy and perhaps by Brexit) driving safe haven capital back to London. Again, our sense is this is unlikely in the short term – if anything, European countries are vying for a share of London's market (noting Italy's new territorial tax rules for NHW and France's overt attempts to lure the City's elite).

Although prices remain high in the PCL property market, in terms of unaffordability (based on household income), London doesn't even feature in the top 10 (according to the 13th Annual Demographia International Housing Affordability Survey). The top five in that survey are Hong Kong, Sydney, Vancouver, Auckland and San Jose.

**The good, the bad and the ugly**

To steal the title to one of the greatest Westerns, the market can be divided into the good, the bad and the ugly:

- *Good stock:* these are properties which have been properly priced, are uncompromised, are light, well proportioned, in good locations (for their price point) and are unblighted. These properties are still trading (albeit slowly) and prices are holding up. For these properties it is not a buyer's market; sellers know they have a good property.
- *Bad stock:* overpriced and often recycled, there may be compromises but these can be factored into value. For these properties we are in a buyer's market and sellers will have to be realistic and accept market conditions; for these properties to trade the asking price has to reflect today's value (not the high water mark of 2014).
- *Ugly stock:* this is the truly awful stock: overpriced, compromised, blighted, poor location, dark, recycled over and over again. For this stock there may be no buyers at all – hence long-term illiquidity. Sellers of these properties may have to wait for the next cycle to try to exit their position.

**New build may not stand the test of time**

One area of the market where there is oversupply and which looks most susceptible to significant price corrections is the new-build market. However, even here developers are finding ways to trade out of positions, with some family offices and institutions agreeing to bulk purchases at a discount (part of London's growing private rented sector). The traded nature of these units and varying quality of developments (which can age quickly and often fail to address demand) means further weakness is likely in this sector.

**Summary**

In summary and in the short term, it is clear that a slightly 'patchy' picture is emerging. In general, transactional volumes are likely to remain low until the terms of Brexit and, crucially, the role of the City are defined. Most of these transactions will be needs driven, rather than discretionary, other than perhaps at the very top of the market. Values are likely to remain broadly flat with further, less obvious falls perhaps, in some prime areas. As has been the case in previous market adjustments, the very best quality stock (unlikely to fall into the category of 'distressed sale') will hold its value and trade, albeit at reduced transactional numbers and with longer marketing periods. Poorer housing stock, especially in compromised locations, is more likely to be adversely affected both in terms of value and illiquidity.

The average 10% year-on-year growth, to which we have become accustomed, has probably departed for now. Costly investment mistakes will not be so easy to cover up in a flat market, especially where the acquisition costs now exceed 15% for most buyers of PCL property.

In the longer term, despite the inevitable media speculation and short-term uncertainty, it really does need to be kept in mind that the majority of drivers behind London's popularity, as outlined earlier, remain, regardless of the United Kingdom's impending exit from the European Union. Is it likely that these drivers will prove sufficient to counter any negative factors of withdrawing from the European Union. We believe that, in the medium and longer term, they will and it just might be possible that we are on the cusp of yet another golden age for London.

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**Stamp Duty (SDLT)**
In the 2014 Autumn Statement, Chancellor George Osborne announced root and branch reform to stamp duty (SDLT) to remove what was known as the 'slab element'. Under the old rules, a buyer would pay tax at a single rate on the entire property price. Now a buyer pays the rate on one part of the property price within each tax band, similar to income tax. In the 2015 Autumn Statement, Chancellor George Osborne announced further reforms to stamp duty targeting the buyers of second homes. With effect from April 2016, buyers of second homes, whether buy-to-let or holiday homes, pay a 3% surcharge over the standard rate for each of the tax bands.

| Purchase price | Buyer's only property SDLT (% of purchase price) | Buyer owns another property* SDLT (% of purchase price) |
|---|---|---|
| Less than £125k | 0% | 3% |
| £125k – £250k | 2% | 5% |
| £250k – £925k | 5% | 8% |
| £925k – £1.5m | 10% | 13% |
| rest over £1.5m | 12% | 15% |

* *there are certain limited exceptions/reliefs (eg, where a buyer is replacing his main residence)*

To give a working example: if a buyer were to acquire a £5 million property, the SDLT liability would be as follows:

| Tax band | % | Taxable sum | Tax |
|---|---|---|---|
| less than £1.25m | 0 | £125,000 | £0 |
| £125k – £250k | 2 | £125,000 | £2,500 |
| £250k – £925k | 5 | £675,000 | £33,750 |
| £925k – £1.5m | 10 | £575,000 | £57,500 |
| rest over £1.5m | 12 | £3,500,000 | £420,000 |

Total SDLT would be £513,750 (giving an effective rate of 10.27%). If that buyer owned another property anywhere in the world (subject to some exceptions/reliefs), the SDLT would be increased by a further 3% of the purchase price to £663,750 (giving an effective rate 13.28%).

**Inheritance tax (IHT) on residential property for non-UK domiciled individuals**

**Current position**
Non-UK domiciliaries tax changes have been withdrawn from the Finance Bill 2017 due to the General Election announcement. The most likely outcome (particularly if there is the no change of Government) following the Election is that most (or all) of the omitted legislation will be re-introduced in a subsequent Finance Bill later in the year (post-election or at the beginning of the new Tax Year). The originally drafted legislation broadly encompassed the following:

Individuals who are domiciled in the United Kingdom are liable to inheritance tax (IHT) on all their property whether it is situated in the United Kingdom or overseas. The current IHT rate is 40% of the value of the property (subject to any available reliefs and exemptions).

Non-UK domiciled individuals (non doms) are liable for IHT only on property situated in the United Kingdom (eg, if they own a UK residential property directly). If, however, they own the property through a non-UK company or partnership, no IHT is payable. This is because the shares in the non-UK company or partnership are currently considered 'excluded property' for the purposes of IHT.

**What is changing with regard to residential property?**
With effect from 6 April 2017, non doms owning UK residential property through an offshore company, partnership or other opaque vehicle, will be subject to UK inheritance tax (IHT) on the value of such property (regardless of its use).

**What is the impact?**
The changes effectively remove the only remaining reason for using indirect ownership structures. In fact, such a structure may well have a tax cost (the annual ATED charge) together with other administrative costs (offshore directors).

For many, de-enveloping such structures will now be the right course of action. However, the government has purposely offered no transitional reliefs in the draft legislation. Non doms holding residential properties in structures should now review these to consider whether to de-envelope. It is important that professional advice is sought to avoid inadvertently triggering other tax liabilities (eg, SDLT and CGT).

Going forward, there are ways to mitigate IHT exposure. These include the use of acquisition debt (as IHT applies only to the net value), life assurance (to provide third party cover for the IHT exposure), spousal exemption (as transfers between spouses are free from IHT) and gifts to children (subject to certain rules).

**Trusts, loans, collateral**
The above is a short description of the changes affecting individuals. The government is also changing the IHT rules for offshore trusts holding residential properties. These will now also be subject to IHT with a charge of up to 6% of the value of the UK residential property in the trust on the 10-yearly anniversary of the settlement of the trust or the purchase of the property (plus a potential for a 40% charge if the settlor retains a benefit in the trust).

In addition, with any loan or collateral for a loan to purchase UK residential property, the loan and even the collateral will now attract IHT as a UK-situs asset.

The lesson is, as ever, to get advice early.

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