The London Real Estate Market

Investment Opportunity
The London property market is experiencing decelerating growth due to a combination of Brexit uncertainties, economic policies and a structural shift, even though Brexit has temporarily given London an economic boost. As it is a high risk investment destination and as the demand is slowing down, we expect London property prices to fall. Therefore, we identify the next 12-18 months as an investment opportunity before the UK economy recovers.

The UK and London Real Estate Market before Brexit
Before Brexit, the UK real estate industry had total revenues of $85.9 billion in 2016, representing a compound annual growth rate (CAGR) of 6.9% between 2012 and 2016 [1]. However, growth has slowed down post-Brexit. UK real estate market growth hit almost 9% in 2016 but is likely to drop down to 6.2% or lower in 2021, suggesting a decelerating growth. With the effect of Brexit realising, we can expect the prices of London properties to continue falling.

Note:
[1] The industry is valued using the total revenues generated by landlords via the leasing and renting of private and council properties. Values are calculated using the average annual rent multiplied by the number of rented properties. Volume includes number of houses/properties rented out (vacant properties excluded).
Source:
[1] [Figure 1 & 2] Marketline
The London real estate market has been hit particularly significantly. House price growth in London slowed down to 2.6% in August 2017, from a peak of 14.8% recorded in March 2016, according to figures from the HM Land Registry [2]. Almost half of the boroughs have <4.5% growth and 3, including Westminster(-20%) has negative growth in the last year.

The Brexit Effect [Figure 4]

Shortly after Brexit, London became a very attractive destination for investments, especially for foreign property investors. The fall in value of Sterling represented an approximate 20% discount on properties. (Referendum indicated by the arrow in Figure 3 - USD/GBP exchange rate chart).

However, the rise in interest rates and the fast recovery of Sterling have raised the cost of capital, resulting in lower returns on property investments.

Interest Rates

Bank of England raised interest rates for the first time after Brexit in November 2017 to suppress the inflation which is well over 2% [3].

After the interest rate hike, the central bank’s Monetary Policy Committee suggested that there will be at least two further raise of a quarter of a percent in the next 2 years [4]. Bank of England governor Mark Carney also expressed at Davos in January 2018 that “the ability of the UK economy to grow — plus the future direction of the exchange rate, trade costs and spending — would hinge significantly on the talks with the other 27 EU member states, and those negotiations would influence the level of interest rates”, suggesting that the future interest rates are highly uncertain. The cost of capital is unclear in the coming years and it will be particularly risky if investors opt a variable mortgage rate.

Source:
[2] KPMG
[3] Bloomberg
[3][4] Financial Times : First UK rate rise in a decade will be a slow burn
Exchange Rates
UK pounds recovered rapidly and has almost reached the pre-Brexit level in 2018. As Sterling appreciates, foreign investors are paying more to invest in the UK (Figure 3 shows the price of the pound against USD). Therefore, we can expect that the growth of sales volume will slow down and prices will fall.

Migration Uncertainty
London is the city with the highest proportion of foreign-born population in the world, with over 40% of people being born in foreign countries. Due to the uncertainty of Brexit negotiations about migrations, demand for housing from foreign populations might be vulnerable. Boroughs such as The Royal Borough of Kensington and Chelsea and Waltham Forest also have a high proportion of EU-born residents [5]. Therefore, demand for houses in these areas will be low, leading to a fall in price.

Structural Shift
A structural shift has occurred that residents are moving out of inner London, reducing sales volume of inner London properties. This is driven by the affordability crisis and the stamp duty reforms. This has been reflected in the falling property prices.

Affordability Crisis
In 2016, house prices in London were 13 times median earnings. First-time buyers struggle to obtain the capital to afford houses in inner London. The high cost to live in London might explain the low price rise of properties in London [6]. London’s price growth is expected to be lower than most regions in the UK except Wales, Yorkshire, Northern Ireland and North East.

Source:
[Figure 4] Bloomberg
[5] KPMG
[Figure 5] [6] PwC UK Housing Outlook 2017
Stamp Duty Reforms

In 2014, a progressive stamp duty reform has been introduced, which increased significantly the duty paid on properties valued above £937,000. This lowered the demand for properties in some boroughs in inner London [7]. In 2016, another reform raised the duty by 3% on second homes and properties. Both reforms had impacted the demand for properties in inner London. In 2017, a stamp duty land tax relief for first-time buyers is announced but it is not optimistic that it will drive the demand for properties in the short-term.

Global Real Estate Investor Sentiments

A survey conducted by KPMG shows that global real estate investors plan to slow down investments in the UK. Less than half of the investors intend to continue the same level of investments. 44% intend to slow down investments and 10% intend to stop all real estate investments.

Asian investors amongst all foreign investors represent 26% of the UK property market and over half of the London property market. The affect of the withdrawal of investments from the UK is therefore significant.

Note:

[Figure 6] KPMG conducted this survey at the RE-Invest Summit at MIPIM in March 2017. The 60 delegates comprised of global real estate investors from 45 institutions across 23 countries, with combined portfolios worth in excess of $600 billion.

Source:

[Figure 6] KPMG : Global real estate investors take a position on Brexit Britain

[Figure 7] Morgan Stanley Research

[7] KPMG
The Chinese investors, especially, represent 25% of buyers of central London commercial property in 2016. After the Chinese government has restricted foreign investments in 2017, Chinese investors pulled out 84% of their overseas property investments globally, lowering UK’s sales volume [8]. The pessimism amongst the foreign investors will continue and in the short-term, we expect the prices of London properties to fall as it loses momentum.

London will remain as an important financial hub or “safe haven” but its property market will experience slow growth in the next years. The uncertainty in Brexit negotiations, the rise in interest rate and exchange rate, and the negative sentiments of global real estate investors will make London a high-risk investment destination in the short-term, reducing the demand of properties and lowering their prices. We therefore believe that the next 12-18 months will be a good timing to invest in undervalued properties in London before the economy recovers and the foreign investors regain confidence.

Source:
[8] Business Insider