Spotlight on
Prime residential East of City markets

Savills Research

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Spotlight on
PRIME RESIDENTIAL EAST OF CITY MARKETS

With a number of economic factors combining, the prime East of City residential markets look set to outperform the London mainstream.

Robust values

Throughout the Noughties the Prime East of City residential markets were somewhat volatile. This is due to the close ties with the financial and business services sector and the level of new development bringing stock to the market. Savills Prime East of City Index shows that values have increased by 33% during the past 10 years with periods of high value growth punctuated with price falls after the dotcom crash, 9/11 and the most recent financial crisis.

Recently, however, values have proved to be relatively robust given improvements in economic performance of the financial and business services (F&Bs) sector and the restricted amount of new build stock coming to the market.

In the final three months of 2010 the Nationwide Greater London House Price Index showed price falls of 3.4%, but growth of 2.7% throughout the year. The Prime East of City markets, although recording zero growth over the three months to the end of December, showed a higher overall annual increase of 7.3% during 2010, leaving values 7.8% from peak levels.

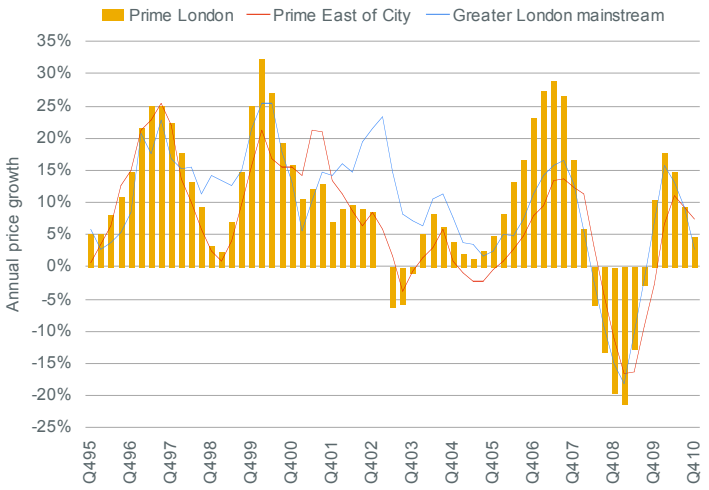
Transactions stabilise

In common with the wider UK market housing transactions have remained below the long term average for the past three years in Prime East of City as the appetite for residential purchases waned as recession took hold and mortgage markets retracted.

Nonetheless the demand for new build apartments over the past two →

GRAPH 1

Annual price growth Prime outperforms the mainstream



Graph source: Savills Research

SUMMARY

An overview of this document

- The Prime East of City markets showed an annual increase of 7.3% during 2010, leaving values 7.8% from peak levels.
- As with the sales market the rental markets also showed signs of recovery during the course of 2010 showing growth of 12.3%, compared to falls of 12% in the previous year.
- Demand for new build apartments over the past two years has regained pace, with annual sales above the 10 year long term average for this type of product, although at lower pricing levels.
- Since the financial crisis we have seen an influx of overseas buyers in the new build Prime East of City markets, partly a result of favourable exchange rates, but also motivated by London's position as a safe haven for overseas wealth.
- At the end of 2010 only five private residential developments within Canary Wharf, which are either completed or under construction, are offering units to the market, of which only two remain under construction.
- The lack of supply coming forward in prime areas is likely to increase demand for developments on the fringes on these locations.
- Looking ahead the availability of development finance continues to hold the key to the level of residential development across Canary Wharf and the Docklands.

"Values have proved to be relatively robust given improvements in the financial and business services sector…"

Lucian Cook, Savills Research

years has regained pace, with annual sales above the 10 year long term average for this type of product, although at lower pricing levels.

The nature of demand

Buyer demand in London's Prime East of City markets has historically been driven by a mixture of owner occupiers whose growth in personal wealth has been fuelled by earnings from within the financial and business services sectors, corporate tenants and predominantly domestic investors who have sought to capitalise on growing rental demand underpinned by employment growth.

The recovery in financial markets has underpinned demand from within this sector over the past year, with buyers from the F&Bs sector accounting for 65% of all Savills buyers. Of these buyers 68% of those bought a property for their own occupation, 23% were investment purchases and the remaining 9% bought to use their property as a second home. Second home purchases within the Prime East of City markets remains low, across all buyers, indicating that discretionary demand is still to improve.

Since the financial crisis there has been an influx of overseas buyers in the new build Prime East of City markets, partly a result of favourable exchange rates, but also motivated by London's position as a safe haven for overseas wealth. During the past two years the buyer profile has shifted from UK and European investors towards Asian buyers, who have invested heavily into the Prime East of City market purchasing over 16% of all property sold by Savills.

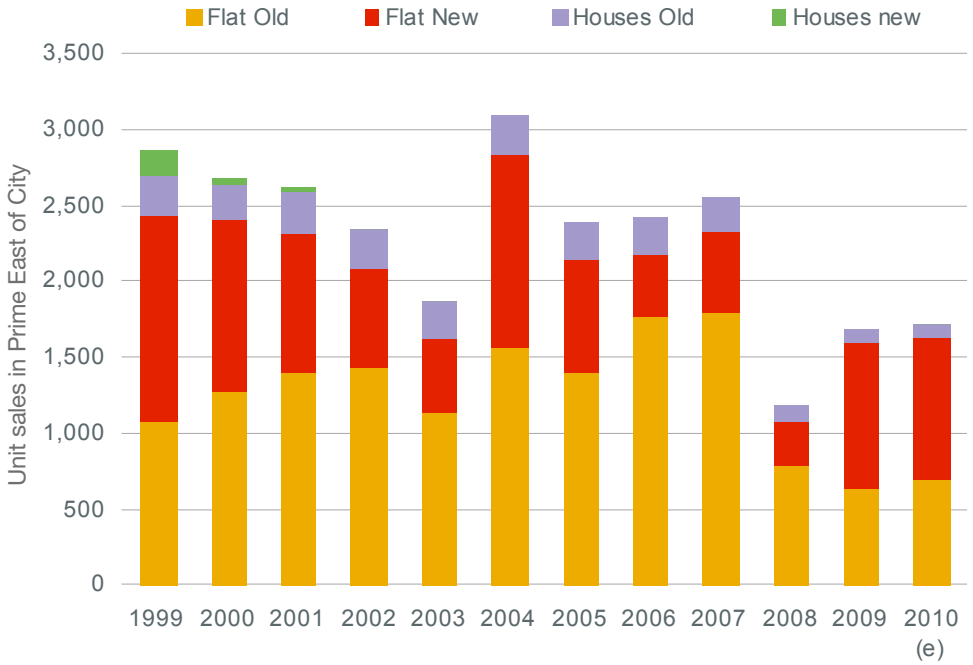
Constrained supply

The improvements in transaction levels over the past two years has occurred against the context of relatively little new build stock coming to the market; such that much of the excess stock that built up during the 2008 downturn has now been sold.

Given the impact of the financial crisis on development funding and the capital hungry nature of many of the schemes in the Prime East of City markets, it is no surprise that the deliverable development pipeline in these areas is now limited. This is beginning to have an effect on the level of available stock in the Canary Wharf and Docklands markets.

GRAPH 2

Prime East of City transactions New build flat sales over the past two years have been above the 10 year long term average



Graph source: Land Registry

According to data compiled by Molior at the end of 2010 only five private residential developments within Canary Wharf, which are either completed or under construction, are offering units to the market, of which only two remain under construction.

Supply remains low, in relation to historic terms, with only 222 private units available for purchase across the five schemes, The Landmark accounting for 90 of these units. This is a 90% reduction on the number of units available to purchase during the summer of 2009.

Supply remains constrained, with the pipeline of committed developments showing only one scheme with 120 units ready to be launched (Baltimore Wharf), thus facing little competition in terms of new developments nearing completion, according to Molior.

Looking ahead, the availability of development finance holds the key to the level of residential development across Canary Wharf and the Docklands. Since the financial crisis, developers have become more risk averse. This, together with limited availability of development finance, means the deliverable pipeline of high margin, high density towers has been severely reduced. Accordingly for those which are able to proceed there is less competition for the occupier demand in the area.

> "The availability of development finance holds the key to the level of residential development across Canary Wharf…."
>
> Paul Savitz, Savills Research

Demand driver: earnings

After three years of slender growth in earnings, average residence based wages are forecast to increase by 24% over the next five years across Tower Hamlets, according to Oxford Economics, in line with the Greater London average.

This expected growth in earnings is slightly lower than the corresponding

RENTAL & INVESTMENT MARKETS

New lettings and renewals continue to stabilise

Left: The rental market is inextricably linked with the performance of the Canary Wharf employment sector

As with the sales market, the rental markets showed signs of recovery during the course of 2010. Savills Prime East of City Index showed growth of 12.3%, compared to falls of 12% in the previous year. The falls during 2009 again exposed this particular market's close ties to the performance of the Canary Wharf employment sector. However, during 2010, stock availability reduced, corporate demand increased and employment prospects looked healthier. Together these allowed new lettings and renewals to stabilise above the long term average level.

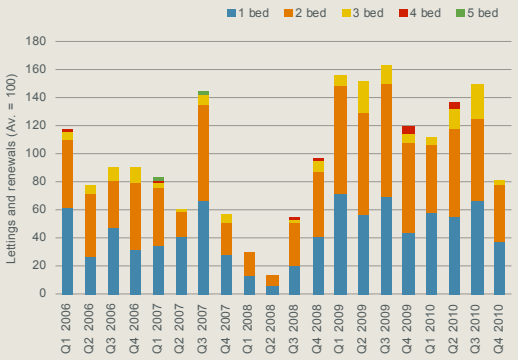
Over the last five years the proportion of overseas tenants has steadily been increasing. Tenants from Asia have risen from 5% to 14% of all Savills lettings in the area.

The momentum behind the increase in activity from tenants across Asia can partly be attributed to the rising demand for higher education places from overseas students, which increased by 12% over the year. London and the UK remains a destination of choice for international students due to its high profile and high ranking universities. Over 280,000 students from non-EU countries currently study in the UK, with a large proportion of these students located in London. Students from China, India, Hong Kong and Malaysia account for over 40% of these totals, according to latest 2009/10 HESA figures.

Similarly, during the same period, the proportion of overseas buyers from Asia has seen a notable increase with a significant number of investors purchasing accommodation for family members in the UK for education purposes. The Prime East of City market is fast becoming a place for both investment and occupation by overseas Asian buyers and tenants.

GRAPH 3

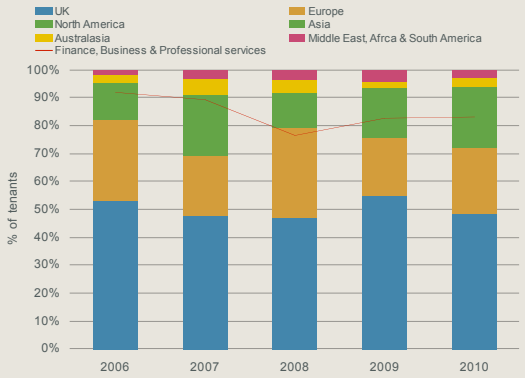
Prime East of City lettings activity



Graph source: Savills Research / Oxford Economics

GRAPH 4

Prime East of City tenant profiles



Graph source: Savills Research

five year period to the end of 2007, although such strong growth is significant when assessing the potential ability of domestic purchasers returning to the prime East of City market.

Additionally, financial bonuses are key to the purchasing power of these buyers. The Centre for Economic and Business Research (CEBR) forecast that bonuses in the London financial services sector will total nearly £7 billion in 2010. While this is 5% less than 2009, it could provide a significant capital injection into property markets in the forthcoming year.

Although the prospects for the London market in 2011 look much better than for much of the rest of the country, the bonus effect will be weaker than the headline figures suggest. This is because higher taxation will reduce net bonus receipts. Net bonuses, after tax are expected to fall by 13% this year and are estimated to be 45% less than net bonuses at the top of the market in 2007. In addition, the way bonuses are paid has changed with many more being deferred or paid over a three year period, for example.

> "We expect bonuses to progressively feed into the market and support price growth…"

Nonetheless, the £3.8 billion bonuses that the CEBR forecast will be paid net of tax at the end of this year and early part of 2011, we estimate that around £1 billion will find its way into residential property markets. Some of the deferred payments will find their way into the property markets, largely depending on how the private banks choose to treat them as collateral.

As a result we expect bonuses to progressively feed into the market and support price growth slightly ahead of that expected for Greater London.

The role of Canary Wharf

Future performance of residential stock in the Prime East of City markets depends on the performance of Canary Wharf as an employment centre. Therefore, it is important to look towards the commercial property market when considering the prospects for residential in the area.

Improving confidence in the financial sector throughout 2010 pushed the take up in office space in the core Docklands area, to a little under 1.2m sqft, back to 2006 levels. Increasing take up levels, 160% greater than 2009 figures and 17% above the ten year average, indicates a return to pre crash levels.

Unsurprisingly, the business sectors that have most heavily dominated the demand for office space in Canary Wharf and the Docklands have been the financial and business services sectors. Significant lettings to the financial and banking sectors should silence those who believe that major banks were preparing to downscale their London operations.

During 2010 JP Morgan purchased 25 Bank Street, the glass tower that once housed the London base of Lehman Brothers, the US investment bank that collapsed during the credit crisis in 2008. From 2012, the £495 million building will be the European headquarters of JP Morgan's legion of investment bankers. A decision London mayor Boris Johnson claimed would "help ensure the capital retains its position as a banking powerhouse, which drives the UK economy and attracts the brightest and best stars from the financial world".

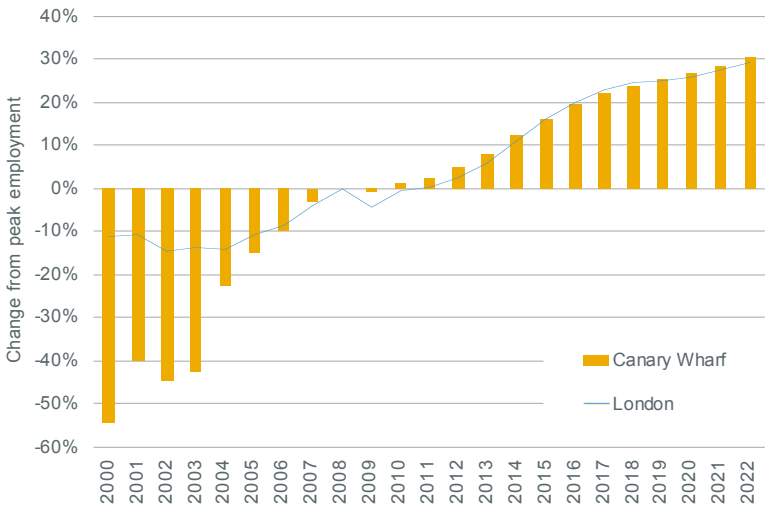
A point matched by the September 2010 Global Financial Centres Index report, which ranks London first out of 75 world financial centres for the second consecutive edition. It concludes "despite the concerns over London's competitiveness, it seems to be maintaining its predominance over other leading European centre. Looking at the profiles, London is assigned the profile of a Global Leader."

The addition of JPM staff together with recent office occupiers such as KPMG, Shell, MF Global, Fitch Ratings, HSBC and the retail expansion, will increase the working population of Canary Wharf to above 100,000 for the first time.

This expansion in financial and business services sector employment will, according to Oxford Economics, continue over the next five years above the wider London average, growing by 13.4%, albeit this figure is very much dependent on development and availability expanding across Canary Wharf. ■

GRAPH 5

Financial & Business Sector employment growth from peak Expansion throughout 2011



Graph source: Savills Research / Oxford Economics

OUTLOOK

The key findings from this document

■ Although economic and employment forecasts are relatively positive, compared to the previous three years, the softening of capital values over the course of the year remains a distinct possibility, as evidenced by the second half of 2010. This will be as a result of continued weakened buyer sentiment across all markets, as uncertainty throughout the economy remains.

■ If sentiment weakens further, then the Prime East of City markets are likely to be more affected than the rest of Prime London due to its less diverse stock range and close connection to one employment sector.

■ Earnings, as a source of funding, are an important component of our value forecasts. Accordingly we expect that the Prime East of City sales market will fall less than the mainstream markets over the next 12 months. We anticipate that bonus money will be fed into the market over a longer time period than has previously been the case in the past, with a less pronounced effect on the early spring markets.

■ We expect that overseas equity will continue to flow into London's residential property and is expected to continue to provide a safe 'deposit' for international buyers. This will support both sales and rental values over the medium term. We forecast capital value growth in Prime East of City residential market, over the next five years, to be 31%, with rental growth also exceeding the mainstream market at 38.9%.

■ Factoring in a depleted residential new build supply pipeline, intertwined with healthier looking employment levels across Canary Wharf and the City, we expect to witness the Prime East of City rental and sales markets to outperform the Greater London mainstream markets over the next five year period. ■

TABLE 1

Capital value forecasts

	2010 (actual)	2011	2012	2013	2014	2015	5 years to end of 2015
Prime Central London	3.8%	-1.0%	10.0%	8.0%	6.5%	6.5%	**33.4%**
Greater London mainstream	2.7%	-1.0%	6.0%	8.0%	7.5%	6.0%	**29.1%**
Prime East of City	7.3%	-1.0%	7.0%	8.0%	7.0%	6.25%	**31.0%**

Data source: Savills Research

TABLE 2

Rental value forecasts

	2010 (actual)	2011	2012	2013	2014	2015	5 years to end of 2015
Prime Central London	5.1%	7.0%	7.5%	6.50%	5.5%	5.5%	**36.3%**
Greater London mainstream	16.6%	9.0%	7.0%	6.0%	5.0%	5.0%	**36.3%**
Prime East of City	12.3%	10.0%	7.25%	6.25%	5.25%	5.25%	**38.9%**

Data source: Savills Research

"We forecast capital value growth in Prime East of City residential market, over the next five years, to be 31%, with rental growth also exceeding the mainstream market at 38.9%." Lucian Cook, Savills Research

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