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Strategy and Public Affairs for Real Estate

As Brexit looms, does developing in London still make sense?

If anyone still doubts that Britain's March 29th exit from the European Union will bring some tough tests, Mark Carney's September Cabinet briefing should have disabused them. The Governor of the Bank of England was in full merchant of doom mode as he warned ministers that a Brexit no-deal would bring economic chaos and a potential 33% fall in the value of UK homes.

Given Mr Carney's warnings and a steady stream of press headlines warning of "slowdowns" in the property market and "London price falls", this seems like a good moment to look beyond the short-term gloom and assess the longer-term attractions of London for the residential property developer.

A Cyclical Market

All markets are cyclical, the housing market no less than any other. In the decade between 2005-2015 - which of course included a global recession from which we are still recovering - the price of an average London home almost doubled, ballooning from £233,758 to £ 456,228. The years of crazy growth in London are now giving way to something more sustainable. House price growth in the capital fell by 12.2% between March 20916 and August 2017.* JLL calculates that prices across London have on average been stable, though development starts have slowed.

London remains a fantastic long-term investment

What continues to make London a great place for developers to work can be expressed quite simply:

- People consistently want to buy homes in London
- There are not enough homes to meet this demand

Why London continues to draw homebuyers is worth examining. Beyond the short-term lure of favourable currency rates, what made London an attractive place for homebuyers in 2000? What made it attractive in 2014? What will still make it attractive to buyers in 2030? The reasons people buy homes in London fall broadly into one of five categories:

- they want to live in the homes they buy;
- they want their children to live in them;
- they are buying to let;
- they are buying as a capital investment;
- any combination of the above.

Why London?

- London is a truly global city. It is cosmopolitan, diverse and like New York, Tokyo and Paris, London is an international business and information hub and a cultural mecca. Overseas buyers feel at home here. Geography, language, great schools and colleges and a serendipitous time-zone all help.
- The rule of law. To a Chinese, Russian[*1] or Middle Eastern buyer the UK remains a fundamentally safe haven. It is highly unlikely that the English courts would allow a government to arbitrarily confiscate legitimately owned real estate. Absent the occasional weak government or economic downturn, London has a rock solid, well respected rule of law which is centuries old and which spawned the legal systems of most of the English-speaking world.
- London is the economic engine of the UK. While this may sometimes annoy the rest of the country, it is undeniable that the capital drives UK productivity. As a result, the city attracts a steady inflow of domestic migrants searching for work and in need of homes.

Structural supply deficit

London's population continues to out-grow the rest of the UK. The GLA's latest figures put London's current population at 8.825 million. By 2030 the city's population is expected to hit 10 million.

To house all these future Londoners the Government's chief number crunchers - the Office for National Statistics - says that London will need to provide an extra 844,000 homes over the next 25 years. This figure, which takes account of migration trends and birth and death rates, indicates that we should be delivering 34,000 new homes every year between now and 2043.

Over the past few years annual completions have averaged closer to 24,000. The reasons for the discrepancy are complex but include: capacity issues within the construction industry; lack of central government support for large scale public sector house building; the current planning system. The end result has been an ongoing shortage of homes which feeds into the narrative of London's seemingly endless "housing crisis".

This "crisis" shows zero signs of abating and continues to fuel a reliable demand across both the resale and new build housing sectors.

Short-term difficulties

Because the housing market is cyclical it ebbs and flows. Residential investors have enjoyed great periods of growth in recent times but would be foolish to have expected these wins to be uninterrupted.

The London housing market is not a monolith. It is made up of several differently performing micro-markets separated by geography, operating on slightly different cycles and influenced by local factors. It is also comprises both secondary and new build products, a fact that is often lost in the statistics.

Though it is true that since 2014 the number of second hand transactions has fallen by 15% for properties above £1m, the new-build market has performed differently. High quality new builds - over £1m - have performed well. In 2014 they accounted for 10% of the market. "Fast forward to 2018 and during the 12 months to April this year, new build sales accounted for 18% of sales in this part of the market." Savills Prime London Supply 18 August 2018.

In 2014 Savills calculated that there was a 10% gap between asking and selling price in prime central London[*4], other parts of London were less affected by SDLT rises. Areas with lower starting values such as Southwark and Lambeth enjoyed healthy grow post-2014.

The politics of building in London

Business likes nothing more than certainty and clarity and while London's fundamentals remain excellent, Westminster's current crop of politicians is contributing mightily to short-term uncertainty and confusion.

Hampered by a negligible parliamentary majority and querulous internal party wrangling, the Government seems largely paralysed by Brexit. HM's Opposition has its own problems and the cult of Corbyn has had a particularly negative impact on London local government which is so dominated by Labour. Many local constituency Labour parties have been taken over by Corbyn supporting left-wingers who tend to be passionately opposed to anything other than utopian development schemes funded by fantasy-finance.

In the run-up to May's local elections many moderate Labour councillors were ousted in favour of more militant reps. This has had immediate consequences. In the short-term, the certainty that developers look for at Planning committee is now much less evident in a number of Labour held boroughs. In July, Haringey's new council cabinet "formally scrapped" the joint venture with Lendlease that had been due to deliver 6000 new homes[*3], choosing to set up its own housing delivery vehicle and face any legal consequences that might arise.

This return to the leftist militancy of the 1980s means that the planning landscape in many London town halls is now much less certain than it was and it accounts for the rough passage that the Elephant & Castle Shopping Centre Application received before it finally won approval from Southwark in July.

And this degree of uncertainty has played a part in the decision of large scale developers such as Berkeley to look for new acquisitions in cities like Birmingham where obtaining consents is perceived to be that much easier.

Government policies and the London market

Stamp Duty Land Tax - The changes and rate increase initiated by former Chancellor George Osborne to SDLT (in 2014, 2015 and April 2016) had a significantly negative impact on the wider London housing market, not least on housing supply.[*2] The introduction of a new SDLT charge for overseas property owners outlined at the Tory party conference will likely have a similarly negative effect.

Interest rates – While mortgage requirements have become more stringent borrowing is still cheap. The base rate of 0.75% is by historic standards remarkably low. In the long term rates must surely rise but the Bank of England's Monetary Policy Committee has made (few) changes to date in the very gentlest increments.

Sterling – Continued Brexit uncertainty and a Government propped up by the DUP has kept the GBP low and wobbly. This is no fun for the British traveller but makes UK property very attractive for non-sterling investors.

Party Conferences: Housing Announcements

Conservatives

This week's Tory party conference saw the governing party announce several new housing policies, two of which have the potential to significantly impact London resi development.

- Stamp Duty Land Tax – an additional SDLT will be chargeable on homes purchased by "foreign residents and entities".
- Cap to be scrapped on Local Authority borrowing against HRA – announced by the PM herself in her keynote speech. This is a significant; recommended by London councils, the Treasury select committee and the Lib Dems but opposed by HM Treasury. It has the potential to unlock a raft of social homebuilding though industry labour capacity issues remain, particularly once Brexit ends free -movement.
- Building Regs – as expected and responding to the Grenfell fire disaster the Secretary of State for announced that combustible materials will be banned from use in all "high-rise residential buildings, hospitals, care homes and student accommodation".
- New Home Ombudsman - empowered to hold house house-builders to account when things go wrong.

Labour

Labour unveiled a series of housing pledges. The most relevant for developers are:

- Redefining "affordable homes" – linking affordability to average local incomes.
- Planning Commission – Labour wants to reform the planning system and has set up a commission comprising residents, council, HA, planning and development sector reps to advise it.
- New protections for tenants – covers both social and private rental sectors.
- Ending Rough Sleeping – within one parliamentary term.

*1 In 2017 estimated £22 Billion of "officially" Russian owned assests in the UK Bloomberg 25 Sep 2018 Has Anyone Seen Roman Abramovich? The Last Days of Londongrad

*2 Savills Prime London Supply 18 Aug 2018 & May 2016 PWC (report for Berkeley Group)

*3 Infrastructure Intelligence 18 July 2018.

*4 prime central London top = here defined as the top 5% of the market