research

from Hurford Salvi Carr

MIDTOWN, CITY AND DOCKLANDS

RESIDENTIAL REVIEW 2008

Hurford Salvi Carr is an innovative firm of property advisors and development consultants who have become synonymous with urban living in central London. Our experience and expertise in both the residential and commercial markets, in the City, West End, Docklands and East London puts us at the forefront of property agency.

Since 1996 Hurford Salvi Carr has been a driving force of the 'city living' phenomenon having sold more than 3,000 new homes in over 175 developments, the majority created from former commercial premises, and we have played a pivotal role in the repopulation of Clerkenwell and the City fringes.

As real estate agents we are widely respected throughout London and are well known in property circles around the world. Our reputation is based on the accuracy of our advice, the quality of our marketing, and most importantly for achieving results.

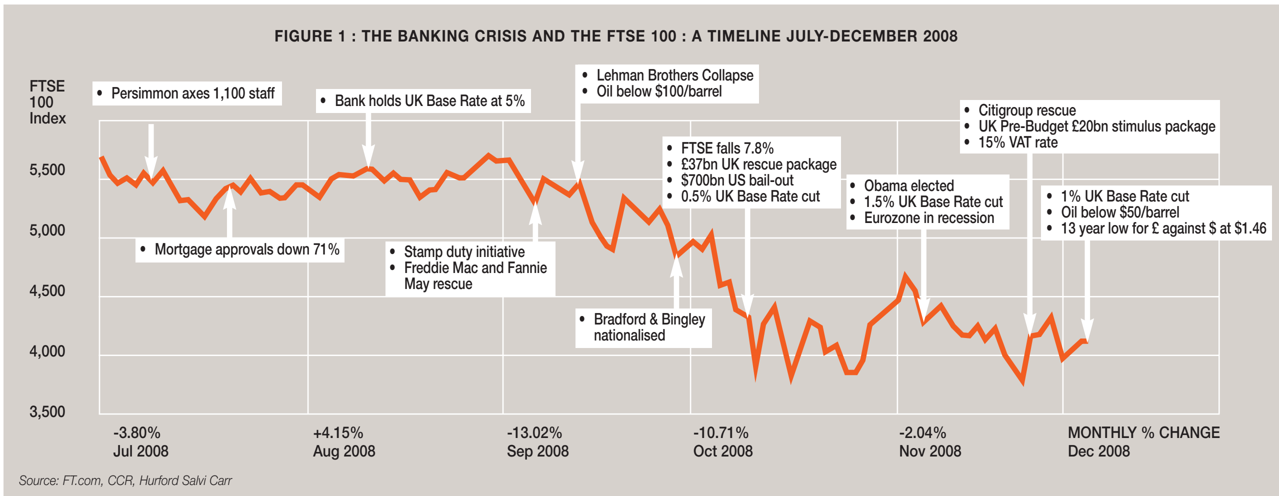
The Company is divided into six divisions, specialising in Residential Sales, New Homes, Residential Lettings, Residential Investment, Commercial Agency, and Property Management. In many instances the skills of each division combine to provide our clients with best advice. Our fresh approach and award winning marketing expertise complements our service.

We are committed to providing a personal service to each of our clients and we maintain the highest standards in every aspect of our business.

HURFORD SALVI CARR

market overview

BANKS PUSH UK INTO RECESSION



Source: FT.com, CCR, Hurford Salvi Carr

A year ago we reported that the economic difficulties then emerging were better described as a "banking crisis" than the "credit crunch" or "credit squeeze". This was in the aftermath of the spread of the sub-prime mortgage contagion from the US to Europe and the rescue of Northern Rock by Her Majesty's Government in September 2007. 2008 was the year in which financial institutions collapsed, causing global turmoil. In the second half of the year, the banking crisis claimed institutions deemed "too big to fail", such as Lehman Brothers and severely crippled sovereign states including Iceland, Hungary, Latvia, and mutated into a systemic economic crisis which initiated recession in most developed economies. The UK Base Rate ended the year at 2%, its lowest level since 1951.

Property, and the relationship between property and banking, is at the heart of the economic crisis and the rapid emergence of the recession. Acres of newsprint have been devoted to this complex relationship during 2008 and it serves no purpose to repeat the unprecedented and dramatic story here. Instead, Figure 1 outlines the main events of the second half of 2008 set against a graph showing the volatile and bearish FTSE 100 Index.

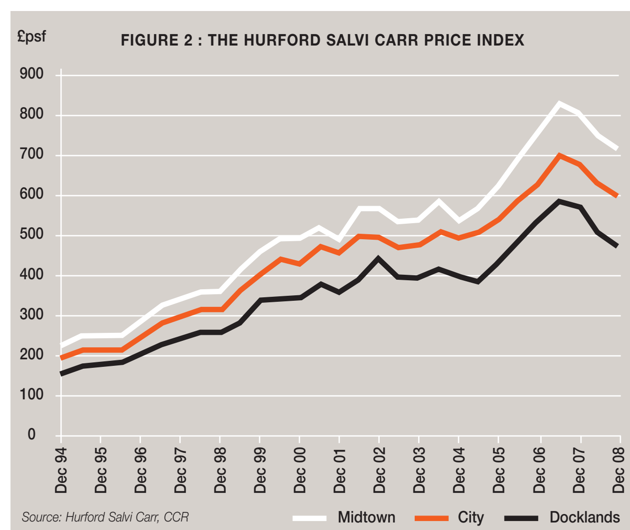
One of the key statistics throughout the banking crisis has been the volume of mortgage approvals, as a proxy for the numbers of sales (excluding cash buyers). The UK banks' preference to engage in re-mortgage business resulted in only 39,900 new mortgage approvals in October 2008, a 60% drop on July 2007 (CML). Homeowners paid off £691 million more than they took on in new borrowings in September 2008 – the first instance of "negative" borrowing in the monthly Bank of England figures since the previous recession in 1993.

The precarious position of most UK banks, and their culpability in the crisis, was underlined on 25th November 2008 by the Governor of the Bank of England in an appearance before the House of Commons' Treasury Select Committee. In his view, restoring normal credit levels was the most crucial issue in recovering from the slump and that if there was no thaw in lending to business and individuals, the UK would go into a steep recession. In these circumstances, "British banks", he said, "risk wholesale nationalisation."

We know from our own experience that perfectly good risks are being rejected by banks as they continue to hoard cash. There is a danger here of the banks contributing to a vicious circle that undermines their own asset base. The rationing of debt is the most significant factor causing lower asset prices in the property market, yet much of banks' assets and debts are secured against value in the property sector. Banks are in effect destroying their own collateral, while keeping cash on their balance sheets.

Although Figure 1 illustrates the deterioration of the economy in the second half of 2008, in some important respects the situation in the Midtown, City and Docklands residential market did not actual worsen during this period. Sales prices did continue to fall, but in our experience at a lower rate than in the first half of 2008. Sales transaction levels, already 50% down since the start of the banking crisis in autumn 2007, did not deteriorate in the second half of 2008. Residential rents fell, but this belied a significant increase in demand especially in Midtown and the City, where rental transaction levels hit an all-time high.

The impact on sales prices in the three sub-markets is illustrated in Figure 2. After an average reduction in prices of 9% across Midtown, City and Docklands in the first half of 2008, the second half saw prices continue to fall but at a lower rate of 6%. Overall, we consider that prices fell by 15% on average in 2008. Looking at the three sub-markets, however, there is divergence from the average rate, with Midtown and City performing better than Docklands.



Source: Hurford Salvi Carr, CCR

To summarise residential prices fell in 2008 by 10% in Midtown, 12% in the City and 17% in Docklands. The faster rate of price falls in Docklands is due to local supply and demand factors, including the amount of stock under construction in major schemes, a previous reliance on investor purchasers and a weakening of demand from owner-occupiers in the light of both availability of finance and deteriorating job security. The graph does show some flattening of the downward curves in the second half of 2008 in all three sub-markets, which we expect to see continue in the first half of 2009.

Comparing Figures 1 and 2, the residential property market in central London has actually fared rather better than the stock market during the current crisis. Although nationally house prices are down in the order of 20% from June 2007 to December 2008, the FTSE 100 Index was down around 38%. In the commercial property market (offices, retail and industrial), according to the Investment Property Databank (IPD), capital values in its UK All Property Index declined by 28% between June 2007 and October 2008. So, as an asset class, residential property actually out-performed its main UK rivals over the 18 month period.

2008 will go down in the annals as a watershed, where a system which permitted excessive greed was replaced by one with a stronger level of regulation and control, while still allowing markets to function and corporate profits to be made. As we enter 2009 with reduced land values and residential prices and with banks putting pressure on existing landowners, there are real opportunities emerging for cash-rich individuals and corporate investors to take advantage. This did not pertain at the start of 2008.

Given the long term relationship between the FTSE 100 and London house prices, we expect a further period of declining property prices in the first half of 2009.

sales market

TRANSACTION LEVELS ‘BUMPING ALONG THE BOTTOM’

In the second half of 2008 the sales market was characterised by a historically low level of activity. There were fewer properties on the market because:

- Discretionary vendors avoided selling in a falling market;
- Vendors elected to rent out property through the downturn in sales prices, with a view to selling at some point in the future when they hope to see prices recover;
- The flow of properties onto the market was disrupted by decisions to “batten down the hatches” and stay put to ride out the recession;
- Vendors were increasingly realistic about the lack of buyers able to achieve financing and complete a purchase.

Equally, there were fewer buyers, due to:

- City workers, and others, concerned for their job security as redundancies spread from financial services to other sectors;
- The restrictions on lending to new borrowers by the banks;
- The absence of buy-to-let, investment club, bulk investors and other private investors due to the credit squeeze;
- Decisions by City workers not to invest their (reduced) 2008 bonuses in an asset class where prices were falling, but instead to look at alternative investment vehicles and to reduce their borrowings.

In July and August 2008 the sales market in Midtown, City and Docklands was depressed, with negative sentiment compounded by the holiday season and a “wait-and-see” attitude on the part of potential buyers. In the first two weeks of September, however, there was an increase in sales across all our offices in part stimulated by banks such as Abbey and Halifax who lowered their mortgage rates in an attempt to stimulate new business. Anecdotally, this increase in activity was mirrored across the rest of central London. After 12 months of the banking crisis, it seemed that the green shoots of recovery were finally emerging in an arid market.

These fragile shoots were trampled, however, by the announcement on 15th September 2008, that venerable Wall Street bank Lehman Brothers had filed for bankruptcy and would not be rescued by the US government. From that point until 6th November, when the Bank of England’s MPC announced its radical base rate cut from 4.5% to 3%, the section of the sales market dependent on mortgage finance in Midtown, City and Docklands was effectively closed down. The choking off of new lines of mortgage finance in 2008 left the market almost entirely reliant on cash buyers, or buyers with very substantial proportions of equity – at least 60%. In Midtown, City and Docklands, cash-rich buyers account for about one third of demand in a “normal” market.

Cash buyers are often discretionary purchasers and, in a market where the UK economy was moving into recession, they were in no hurry to buy. They were also particularly interested in low risk property types at the cheaper end of the market’s price range, such as studio and one-bedroom flats at asking prices of sub-£300,000. There was much less demand from cash buyers for two bedroom property typically priced from £600,000 in Midtown, £500,000 in the City and £400,000 in Docklands.

RIDGMOUNT GARDENS, WC1 - 4 FLATS SOLD JULY TO DEC 08 £450,000 - £1,015,000

The volume of transactions remained low throughout 2008, due to the wide disparity in expectations on price from buyers and sellers. In the nine months to the start of July 2008, prices in Midtown, City and Docklands had fallen by 12% on average, but “bottom fishers” were making offers 20% below realistic asking prices, which vendors

PARAMOUNT BUILDING, EC1 - 1 BEDROOM LOFT SOLD OCTOBER 2008 £525,000

in the central area where we operate, were unwilling to accept. In the final three months of the year, however, there was some evidence emerging of distressed sellers accepting offers at 10-15% below asking prices. Given the outlook for jobs in London outlined in the Market Prospects section, the number of distressed sellers is likely to increase in 2009, especially in the Docklands sub-market where investors had pre-purchased off-plan prior to 2008 and are being asked to complete at prices which are no longer supported by mortgage valuations.

Tables 1 and 2 illustrate the impact of market conditions on prices during 2008. Whereas in 2007 the typical price for a one-bedroom flat in Midtown, City and Docklands increased by 9% (albeit with prices falling in the last quarter of the year), in 2008 prices have fallen by 15%. As Table 1 shows this has knocked in the order of £50,000 from the price of a one-bedroom flat. By extension, two-bedroom units have seen values fall in the order of £75,000. These are very significant reductions which have helped to stimulate interest from equity-rich purchasers, and to improve the position of some mortgage-driven buyers, but with confidence in the economy low buyers remain thin on the ground.

TABLE 1: ILLUSTRATED PRICE CHANGES FOR ONE-BEDROOM FLATS 1998-2008 IN MIDTOWN, CITY AND DOCKLANDS

Year End	Price Change %	One bedroom Illustration Market Value (£)	One bedroom Illustration Change in Value (£)
1998	N/A	150,000	N/A
1999	+26%	189,000	+39,000
2000	+11%	210,000	+21,000
2001	+10%	230,000	+20,000
2002	+13%	260,000	+30,000
2003	-6%	245,000	-15,000
2004	+0.4%	246,000	+1,000
2005	+10%	270,000	+24,000
2006	+26%	340,000	+70,000
2007	+9%	371,000	+31,000
2008	-15%	318,000	-53,000

Source: Hurford Salvi Carr, CCR

Table 2 illustrates a more sensitive analysis of the price of one-bedroom flats in the three sub-markets, indicating the greater resilience of Midtown and City and the vulnerability of the Docklands market. These differences reflect both demand and supply side factors, with Docklands having a large stock including recent and current development, more highly dependent on buy-to-let investors and strongly linked to the fortunes of financial and business services jobs at Canary Wharf, home to Lehman Brothers (as was) and Citigroup, to name but two.

Hence the percentage price reduction in Docklands in 2008 was 17% compared to 10% and 12% in Midtown and City respectively. In Midtown and City construction volumes have been relatively modest in the current cycle, not least due to increasingly onerous affordable housing policies and the improved viability (at least until recently) of office development. New residential stock is typically in small infill developments or office/warehouse/industrial conversions, with major developments restricted to the commercial fringe such as City Road, Aldgate and Southbank. Docklands is all about big schemes, high buildings, advanced marketing and off-plan sales, altogether on a different scale.

TABLE 2: PRICES FOR TYPICAL ONE-BEDROOM FLATS (500 SQ FT) DECEMBER 2007 - DECEMBER 2008

Sub-Market	December 2007	December 2008	Reduction (%)
Bloomsbury, WC1	£420,000	£378,000	-£42,000 (-10%)
City, EC	£395,000	£348,000	-£47,000 (-12%)
Docklands, E14	£340,000	£282,000	-£58,000 (-17%)

Source: Hurford Salvi Carr

In terms of market segmentation, the falling market has increased the differentiation of the three sub-markets, as follows.

- In Midtown there was sales activity where it merges into the West End, especially at the top end of the market for flats at or around £1 million. Here the profile of buyers is diverse including authors, actors and international buyers and not so dependent on the health of financial and business services. A shortage of properties being placed on the market for sale will result in further price falls being modest compared to other parts of London.
- In the City, on the other hand, there has been little activity at the top end of the market in the £600-£800,000 bracket, as owner-occupiers and investors hunt out low-cost studios, one-beds and pied-a-terres. The majority of sales in 2008 were completed at below the £500,000 level.
- In Docklands it is tempting to state that the market evaporated completely in the second half of 2008, with very few owners attempting to sell, but those who did attracted what they considered "silly offers" at substantial discounts to asking prices by unrealistic purchasers. There were, by the end of 2008, a few genuinely distressed sellers beginning to appear due, in part, to falling rents (see the Rental Market section).

The volume of sales being conducted through our offices is around 50% of the peak levels experienced in 2006 and the first half of 2007. We believe this to be the case right across central London. However, the volume of sales in the final quarter of the year was identical to the final quarter of 2007 when London's residential property market collapsed. It is therefore our view that the market has been "bumping along the bottom" of the current cycle, and as time passes we get closer to a position where the volume of transactions will start to increase.

Prices may have fallen by 15%, but we do not believe the volume of transactions will be further reduced. With the Base Rate set to fall below 2% for the first time since the Bank of England was founded in 1694, there is a strong chance that the number of transactions will slowly start to increase in 2009, in part due to Government intervention, lower asking prices and very attractive interest rates.

new homes market

STRONG LOCATIONS OUTPERFORM THE WIDER MARKET

In our half year Midtown, City and Docklands Residential Review published in July 2008, we noted that conditions in the property and mortgage markets had led to the postponement of off-plan launches for new homes. Launches cannot be postponed indefinitely unless the developer opts to retain the units and add them to its investment portfolio. Some developers elected to launch in the second half of 2008, with a number of surprisingly good results, especially for niche schemes in the Midtown and City sub-markets.

Between 11th and 13th September we launched a new scheme of 14 units at **8-10 Bowling Green Lane, EC1**, on behalf of Marldon who have a strong track record in Midtown. 84 prospective purchasers viewed the show flat and the scheme over the three days, with four sales taking place during the launch, including the show flat itself. Crucially, these sales took place at the developer's full asking prices in the range of £740-£825 per sq ft and unit prices from £435,000-£895,000. Completion is due early in 2009. Design, location, site characteristics and a marketing strategy aimed at owner-occupiers each contributed to the early success of this scheme in a difficult market. It is also worth noting that 10,203 sq ft of offices on lower ground and ground at this development were let to a media company at a best rent of £42.50 psf in September 2008.

In contrast, just around the corner from Bowling Green Lane, in October 2008 George Wimpey launched **Cromwell Place, Woodbridge Street, EC1**, a development of 16 town houses and six apartments. Despite an expensive advertising campaign and costly marketing material, less than ten people turned up to the launch and there were no reported reservations by mid-December 2008. The development is not scheduled to complete until the end of 2009, when we anticipate all the units will sell well. Selling off-plan, however, in the current market, with only the foundations in place, is no longer a viable option.

October saw the launch of another well-located scheme at **44 Hatton Garden, EC1**, a fine Portland stone-faced building on the corner with St Cross Street, and an increasingly rare office-to-residential conversion in Hatton Garden. There are ten flats ranging from £425,000 for a 1st floor one bedroom flat to £995,000 for each of two duplex penthouses of three bedrooms on 5th-6th, reflecting prices of £740-£880 per sq ft. The marketing strategy is aimed at owner-occupiers with a show flat completed early in the construction process and 50 potential purchasers attended the launch with two sales achieved at close to the asking prices. The developer declined numerous lower offers. Specification is a means of differentiating new schemes in a falling market, and at 44 Hatton Garden, Gaggenau kitchens, intelligent lighting and solid oak joinery are important in attracting prospective buyers.

This point was proved by British Land plc at **One Osnaburgh St, NW1**, where 62 units were offered to the market in phases from June 2008 onwards. By November 2008, 48 of the 62 apartments had been sold or reserved, a 77% success rate, with the scheme not due to complete until well into 2009. One Osnaburgh Street is an 18 storey residential tower at the western end of British Land's 2 million sq ft Regent's Place office development, where the upper levels offer views across Regent's Park. Johnson Naylor was responsible for the apartment interiors, with high value design helping to sell the scheme, along with the more obvious attractions of location and height. In July very modest reductions in asking prices were made of £5,000 for one bedroom units and £10,000 for two bedroom units, but achieved prices ranged from £665-£1,050 per sq ft, with some of the three bed units exceeding £1 million.

In the City, at **84 Fetter Lane, EC4**, the developer adopted a strategy of partial sale, with retention of some units for the rental market. Fetter Lane is another strong location for the City pied-a-terre market at which this scheme was directed with three studios, three small one bedroom flats and a two bedroom split level penthouse. Without a formal launch, two units were sold, a studio and the two bedroom penthouse, with the developer electing to retain the other five units as part of its rental portfolio.

Back in Clerkenwell at **charterhousethesquare**, located at the junction of Clerkenwell Road and Goswell Road, the Thornsett Group, who started selling off-plan in 2006, heavily discounted the last remaining units in the final quarter of 2008, reducing prices back to 2006 levels, to reflect pricing in the overall market (see Fig 2 on page 1). This development, completed in 2008, is now largely occupied.

The picture for larger blocks, including those that are under construction or recently completed but which were sold off-plan to investors, is not quite so rosy. New blocks dependent on buy-to-let apartments have become viewed by banks as potential "toxic assets", mainly due to over-building, price-ramping and lack of demand from renters for major blocks in all of the UK's major provincial cities. Although in our view London is a different case, the banks' surveyors are significantly down-valuing schemes at completion, in effect putting a "forced-sale" valuation in place. It has not been unusual, in the absence of recent evidence, for prudent surveyors to down-value new developments by as much as 25%, even though this exceeds by around ten percentage points the reduction in value since August 2007 in the local market.

Hence, an investor who agreed to buy a unit for £500,000 off-plan with either explicit or tacit support from a mortgage lender, now finds that the lender is valuing it at £375,000, leaving the purchaser unable to complete because at this valuation alternative funding could not be arranged to meet the purchase price. We have huge sympathy for valuation surveyors, who were subject to litigation by the banks and building societies in the early 1990s crash, accused of over-valuing residential units in a falling market. It is, however, an all too convenient way for banks to legitimately (but often cynically) reduce their loan book exposure to the residential property sector in the current market by putting pressure on valuers, and this is a further example of the banks' lending policies forcing the market to fall artificially.

In October 2008 research released by Dresdner Kleinwort revealed that some lenders were asking surveyors for both current and 90-day forecast valuations. In effect, this is driving down the valuations at a faster rate, with urban flats in some provincial cities falling 40-50% compared to reductions for houses of 20%. London, and central London in particular, presents a very different case to provincial city centres with a high proportion of overseas and "second-home" pied-a-terre purchasers. Values are declining at a less steep rate, the market for sales and rentals is under-pinned by broader and deeper demand and in many parts of Midtown and the City new supply is limited.

Docklands, however, does look vulnerable in the short-term. It has a greater dependence on major blocks, including high-rise, high-profile forward-sold schemes, is dominated by buy-to-let purchasers and surrounds Canary Wharf which could be the epicentre of financial sector job losses during 2009. At the end of 2008 over 3,000 residential units, representing 62% of current construction in Midtown, City and Docklands, were located in the heart of Docklands in E14. In Midtown, in contrast, only 223 units were

underway (4% of the total), with a further 523 units in the City "proper" (10%). In the City fringe locations of E1 and SE1 there were 1,097 units, representing 23% of total construction (LRR).

With the possibility of many proposed schemes being "mothballed", there is likely to be a shortage of new homes in 2011 and 2012 due to lack of funding for land acquisition and development now. Some developers with cash are already taking advantage of falling land prices to build land banks for the recovery, accepting that they are unlikely to get funding for construction in the short term. There is still interest from developers for good sites in Midtown, City and Docklands, with up to 20 bidders for one City site in November 2008.

rental market

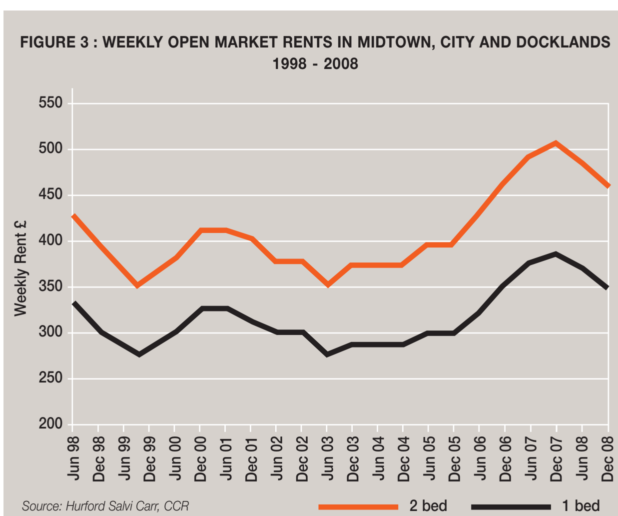
RECORD TURNOVER, FALLING RENTS

Residential rents continued to fall in the second half of 2008 due to unprecedented fallout from the financial sector reported in the Market Overview. This was not due to lack of demand, which in Midtown and City was at record levels, but rather to over-supply of units due to the near cessation of the sales market. This trend was repeated across other central London locations.

As a result, residential rents fell by an average of 5% across Midtown, City and Docklands in the second half of 2008, compounding an average loss of 4% in the first half of the year (Figure 3). Rents were down by 9% on average for 2008, the first time rents had fallen since 2003. As seen in the sales market, there were important variations across the three sub-markets reflecting their different supply and demand profiles:

- Docklands (E14) – rents down 15% in 2008
- City (EC) – rents down 8% in 2008
- Midtown (WC) – rents down 5% in 2008

FIGURE 3 : WEEKLY OPEN MARKET RENTS IN MIDTOWN, CITY AND DOCKLANDS 1998 - 2008



Source: Hurford Salvi Carr, CCR

In September and October 2008 we took on additional staff in our lettings offices to deal with the burgeoning demand for rental accommodation in Midtown, City and Docklands. These months are always the busiest of the year for lettings, but in 2008 the volume of new tenancies and renewals was at record levels, with both Midtown and City tenancy turnover up 50% on 2007. In Docklands turnover was maintained at the previous record level set in September and October 2007. As a result we saw little evidence of reducing rents during these two months, but over the six months as a whole supply exceeded demand, and rents fell particularly in the final quarter.

Overall, demand for rental property increased during 2008 as it became increasingly difficult for first-time buyers to secure mortgages for their first home. The banking crisis meant that individuals and couples with no mortgage track record and with a low proportion of equity to value were unlikely to be able to secure loans. Lenders were also mindful of the future fragility of the employment market, but it was only at the end of 2008 that London began to see major job losses in the financial sector in the aftermath of Lehman Brothers.

Under normal circumstances this surge in demand for rental property would have led to further growth in rent levels. That did not occur due to the parallel increase in the availability of stock to rent. This stock came from a number of sources:

- Un-sold stock in the second-hand sales market, where owners were either unable to find a buyer or unwilling to sell into a falling market, with the decision taken to rent out until values rise in the future;

- New Homes schemes which had been forward-sold to investors in 2006-2007;

- Additional New Homes units from developers' own portfolios, which had been expected to be sold, but which were now retained to rent out until sales prices improve;

- Serviced apartment operators which have been reducing their exposure to the market, with some stock re-entering the conventional lettings market.

Excess supply has created strong competition between landlords for tenants, which has had the effect of pushing down asking rents. Tenants are canny and many have taken advantage of tenancy renewals to renegotiate rents. Corporate tenants, in particular, have been able to take advantage of market conditions to reduce rent levels across their occupational portfolios.

In Docklands there has been a much steeper increase in supply and hence a faster rate of decrease in rent levels. Here the proportion of existing and new stock owned by investors is higher than in Midtown and City. Equally, the economic powerhouse of Docklands, Canary Wharf, is over-weight in banking and financial services employment already in the firing line for job losses in the second half of 2008 including Lehman Brothers in September and Citigroup in November, never mind the general recruitment freeze and use of natural wastage to shrink headcount.

We experienced rents falling 15% in Docklands in 2008, with demand levels weakening but supply significantly increased. In the final three months of 2008, our property management department reported a number of applications from tenants for housing benefits as a direct result of job losses at Canary Wharf – the first "distressed tenants".

In Midtown and City the employment base has greater diversity and the stock of rental property, especially new stock coming through the development process (as we saw in the New Homes section on page 4), is much lower. Hence, the lower rates of reduction in rents of 5% and 8% respectively in 2008. These reductions are in part a recognition that London's residential markets are inter-linked and that downward pressure on rents in some areas has now affected every part of central London.

As we have stated in previous reports, the quality of rental accommodation in Midtown, City and Docklands is very high. With rents falling during 2008, tenants have taken the opportunity to improve the quality of their accommodation as well as moving to better locations more suited to work and social life. "Why buy when you can rent?", goes the slogan, especially with accommodation of a high quality available without the attendant costs and hassles of ownership, not least because some of the stock now coming into the rental market from both developers and the second-hand market was designed for or already part of the owner-occupied market.

There are important implications here for landlords in a market which will be increasingly competitive in 2009. Landlords learnt in 2008 that they have to work hard to keep tenants or get new ones. The condition and presentation of flats, their decorative order and facilities including appliances, white goods and entertainment systems need to be properly maintained.

Leo Yard, Great Sutton Street, EC1, in the heart of Clerkenwell illustrates these points well. Designed with owner-occupation in mind, the developer elected to rent out the 12 apartments on the 4th and 5th floors of this brand new mixed-use building where the offices below had been let to Unicef. All 12 were let at launch in September 2008, with tenants enjoying air-conditioning and terraces with views over the grounds of the Charterhouse gardens and St Paul's.

investment market

VULTURE FUNDS CIRCLE THE MARKET

Buy-to-let investors, investment clubs and other categories of private investor were squeezed out of the market in 2008 by the radical curtailing of bank lending. In the first half of 2008 there was very little investment activity at all in Midtown, City and Docklands. In the second half, however, vulture funds which had been expected to enter the market once values fell, did begin to bid aggressively for bulk units, as well as for individual units at auction. By the end of 2008, however, there was little evidence of sales at deep discount. When we say aggressive, we mean that they are offering to buy bulk units in Midtown, City and Docklands at up to 40% below the developer's or vendor's asking price. We expect vulture funds to have limited success in 2009 in Midtown and the City, instead they will turn their attention to Docklands bearing in mind the potential upside of the Olympics in 2012.

With no sales or slow sales, for some hard-pressed developers and housebuilders outside of London unable to hold their assets for the rental market, bulk sales offer a solution to pay off debt rapidly, even if profit is foregone. In the regions, we have evidence that housebuilders are accepting 40-50% discounts for bulk sales, with 35-40% more typical of the Home Counties.

In Central London, including Midtown, City and Docklands, there is little evidence to date of bulk discounts being accepted. Some serious overseas investors with a long-term view are buying at more realistic rates of discount of between 10% and 15%.

The movement of capital value and rents over the past 18 months has led to an increase in yields from 5.2% to 5.8% (Table 3). The yield curve flattened, however, in the second half of 2008 as rents came under pressure. With the expectation of further reductions in rents and capital values outlined in the Market Prospects section (opposite) yields are likely to remain in and around 6% in the short term.

Investors were encouraged, of course, by the three significant cuts in the Bank of England Base Rate of half a point on 8th October 2008, one and a half points on 6th November and 1 point on 4th December 2008. Broadly speaking, however, experienced investors tell us that they are looking for residential gross initial yields exceeding 8% before considering acquiring residential stock.

Accordingly, established property investment companies with funds available have not been sufficiently tempted by the discounts available on residential rental portfolios across London, but instead have preferred to preserve their cash and buying power for later in this cycle. This risk-averse attitude mirrors the majority of individual landlords and owner-occupiers, who have little enthusiasm for discounting given London's position as the pre-eminent World City – they expect the market to bounce back!

In a competitive market property investors became increasingly conscious in 2008 of the need for asset management, portfolio management and building management. Hurford Salvi Carr's property management division is now our largest department and manages over 120 residential blocks across London and the south east for a range of investor clients.

TABLE 3: ILLUSTRATED INITIAL YIELDS FOR ONE BEDROOM FLATS IN MIDTOWN, CITY AND DOCKLANDS 1998 TO 2008

	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Dec 2008
Gross Annual Income £	15,600	14,300	16,900	16,120	15,600	14,820	14,820	15,340	18,200	20,020	18,220
Capital Value £	150,000	189,000	210,000	230,000	260,000	245,000	246,000	270,000	340,000	371,000	315,000
Gross Initial Yield %	10.4	7.6	8.0	7.0	6.0	6.0	6.0	5.7	5.4	5.4	5.8

Note : gross yields are typically reduced by 2.5% points by costs and voids

Source: Hurford Salvi Carr, CCR

market prospects

FORECASTS FOR 2009

2009 is going to be the toughest year for the London and national economy since the early 1990s slump. Headlines are likely to be dominated by job losses and it has been widely predicted that there will be an avalanche of profit warnings. A PACEC study for the Local Government Association published in November 2008 suggested that London could lose 370,000 jobs, 1 in 12, by the end of 2010, with London disproportionately affected due to its focus on vulnerable sectors such as financial and business services. In the same month the CBI indicated that national unemployment could hit 2.9 million by the end of 2010, with London badly hit.

Lest we get despondent, London is resilient. The capital has experienced losses before on the scale projected by economists and subsequently recovered. In the "dot com" inspired downturn of 2000-2001, the number of employees in London fell by 100,000, but in the early 1990s recession, employee numbers fell 485,000 (11%) from 1989 to 1993.

The employment impact of the banking crisis will be worse than in 2000-2001, and we maintain that the human toll could have been avoided if the banks had acted more responsibly in the spring of 2008 when there was no valid reason not to re-enter the mortgage market, rather than hoard cash. In the longer term the London economy will recover, jobs will be created and property prices will re-gain lost ground. But what of the short term forecast for 2009?

BAKER'S ROW, EC1 - NEW BLOCK OF 7 FLATS FOR SALE, LAUNCH SUMMER 2009

The Sales Market

We see no reason why confidence will return to the sales market in the first half of 2009, given the global downturn. Midtown, City and Docklands will be affected by the consequences of the mutation of the banking crisis into recession and the resultant impact on job security and employment numbers. City bonuses, which have stimulated the housing market over the past five years, are expected to be cut by an estimated 60% in 2009 to their lowest level in a decade, and it has been reported that bonuses are to be paid predominantly in shares rather than cash. The impact of the recession will continue to spread from financial services to other sectors of the central London economy, including the professions (although law and accountancy will flourish, lending support to the Midtown residential market), business support services, the hospitality sector etc.

After struggling in the first half of 2008 with both the economy and the Opposition, Gordon Brown emerged from the banking crisis in October 2008 as a hero on the international stage – the potential saviour of market capitalism. If the Labour government's various rescue packages for the banking sector and the economy appear to be working in the first half of 2009, it is possible that a snap General Election could be called in May 2009, although May 2010 seems a more likely date in the current circumstances. The possibility of a General Election as early as May 2009 could generate some further uncertainty in the housing market in the first half of 2009.

On the positive side, the Base Rate is likely to fall further from the 2% level reached in December 2008, with the prospect of low rates being maintained until there is clear evidence of economic recovery. Looking at individual measures, we would not be surprised if the Government changed the Stamp Duty rules in the next Budget, given that November's pre-Budget announcement did not contain any particular stimulus for the housing market. The accession of Obama to the US presidency could boost confidence and lead to more radical steps to shore up the US financial system and economy than the Bush administration was willing to entertain.

As a result, we consider that the first half of the year will see average residential prices across Midtown, City and Docklands continue to decline by a similar rate to that in second half of 2008, a reduction of 5%. This would take the overall reduction in prices since October 2007 to around 23%. Prices may stabilise in the second half of 2009 in Midtown and in the first half of 2010 in Docklands, by which time prices will be tempting renters to become owner-occupiers.

What happens beyond mid-2009 is very much in the hands of UK banks and the Government. The Government has a stake in some of the banks, and those that remain fully private will be stimulated to seize market share. If by the middle of the year the banking sector has failed to engage with the market, then the economic slump will deepen, more jobs will be lost and residential property prices in Midtown, City and Docklands could see a reduction of 10-15% during 2009.

On the other hand, if the banks do start to lend again on competitive terms in a low interest rate environment, there is the potential for owner occupiers and investors to re-enter the market in 2009. In this scenario, we see the potential for an easing of price falls in the second half of 2009 responding to an increase in the number of sales transactions. We are pleased to note that in December HSBC announced plans to make £15bn of loans to UK homeowners in 2009 – double the equivalent amount it lent in 2007!

Whichever of these two scenarios proves the most accurate for 2009, the further depression of prices will deter vendors from putting property on the market. Discretionary vendors will either sit tight or rent out. As a result, the rate of turnover in the sales market is likely to remain low throughout 2009, giving fewer opportunities to buy. Some investors, especially buy-to-let investors who bought into the market in 2005-2007, will be put under severe pressure in 2009 as capital values reduce and rents fall below the level required to match debt repayments. Equity-rich investors, on the other hand, will be able to take advantage of depressed prices in 2009 and pick up "bargains" in a less competitive market.

It is not only Hurford Salvi Carr who has repeatedly laid the blame for the current problems in the UK economy at the door of the banks. In the pre-Budget report of 24th November 2008, the Chancellor of the Exchequer, Alistair Darling, announced a new panel to monitor bank lending to home buyers. The Panel is to be chaired by Lord Mandelson, who has proclaimed that he will "force open the banks' coffers", punishing any resistance in the courts or through the ultimate sanction of nationalisation.

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The Rental Market

In the rental market we expect to see a continuation of the trends established in 2008, including a record level of tenancy renewals across our markets in 2009. Whereas in 2008 demand for rental property increased in Midtown and the City, it is likely to be tempered in 2009 as the recession claims jobs. There will certainly be far fewer corporate tenants seeking accommodation in 2009, and those that do will be driving very hard bargains on rents. Potential vendors in the sales market are likely to continue to become landlords rather than selling out of the market, and with other sources of rental property from developers, investors and serviced operators continuing to flow into the market, supply is likely to outstrip demand.

In these circumstances new tenancies and renewals are likely to be the subject of negotiation in a tenants' market, with downward pressure on rents. Low rent is better than no rent. Looking across the whole market, we expect to see rents fall in the order of 10% in 2009 – a similar quantum to the reduction in 2008 and taking rents back to levels last seen in late 2005 when the most recent up-swing in the cycle began. As in 2008, we would expect to see lower rates of reduction in Midtown and the City than in Docklands, with significant implications in that sub-market for buy-to-let investors. The only respite for landlords will be in September and October 2009, when there will be a seasonal increase in demand, as well as reduced interest payments throughout the year.

Tenants, meanwhile, are the short-term winners in the Midtown, City and Docklands residential market - as long as their jobs are secure. They will get quality homes, often designed for or by owner-occupiers, in some of the best locations in London at historically affordable rents.

ZENITH, LIMEHOUSE BASIN, E14 - 2 BED FLATS £450 PW 2007 FELL TO £350 PW DEC 2008

As we reported in our half year Residential Review, tenants continue to monitor the sales market, with a view to entering the market when they consider that prices are at, or close to, the bottom of the cycle. With rents expected to fall in line with sale prices, tenants will not be in a hurry to take on mortgage debt in the first half of 2009, but if the Government gets its way and banks do start to offer attractive mortgage products, we can expect to see greater numbers of new purchasers entering the market in the second half of 2009.

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