End Quarter 3 2016, PCL Lettings market report:

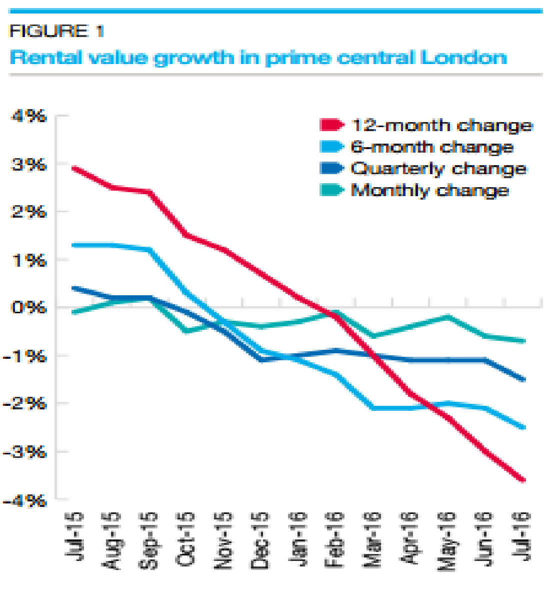
Since January 2016 stock levels in Prime Central London have risen sharply from 7,802 (Jan) to 13,723 in September *(source Lonres)*. September's stock level currently stands at 12,609 which is a 75% increase over the same month last year. This is the predominant factor impacting prices in the London lettings market.

Whilst stock levels have soared, underlying activity (number of Lets per month) have seen only a gradual increase in 2016 from 2,000 in Jan. to 3,621 to date in September. In any market, an increase in supply of this magnitude coupled to static demand is going to have an impact on prices, and our market is not immune to these fundamental economic forces.

As a result, rental values in Prime Central London have fallen by 4.1% in the year to August and in Chelsea specifically by 7.6% over the same period (*see Fig 1*). Having said that, we may be beginning to experience the "upside" of Brexit, from a Lettings perspective. August saw a jump in transaction levels of 42% from the month before, and there is an increasingly convincing argument that this pervasive uncertainty will push more and more London residents present and future into renting as a safer option, at least until the political landscape is clearer.

The graph below (courtesy of the Knight Frank prime London rental index) displays the lettings pricing trajectory in PCL over the last 12 months:

Figure 1.



Source Knight Frank.

The graph shows rental values softening for the last 12 months - since June 2015. N.b. Gross rental yields are starting to increase – now 2.7% % - as falling capital values outpace lettings negative growth.

Detailed analysis of the last 12 months:

The lettings market in 2015 was divided into two clear and distinctly different environments, pre and post the general election. The pre-election (mini) bubble was created by uncertainty over the election result; resulting fear of new property taxation and changes to non-dom regulations (which were widely discussed in the media), which drove potential buyers into rental accommodation and current tenants to renew their tenancies, adopting a wait-and-see approach. This manifested itself in strong tenant demand, upward price pressure (see Fig.1) and shorter void periods. Post-election, with the exception of some typical seasonal variation, a three-speed lettings market has emerged where demand is stronger in the lower and higher price brackets and weak in the middle sector.

The drivers behind the variations in the market are macro-economic, as continued nervousness surrounds global economic and political events. In particular the uncertainty over Brexit, the slowdown in the Chinese economy, a stuttering EU economy and falling/low oil prices. These factors have caused companies to reign in their relocation budgets, recruit home-grown talent and/or reduce their headcount in continued restructuring programmes. This in turn has impacted the sector of the market where corporate Tenants feature so strongly, namely £1,000 to £3,000pw.

In order to understand the overall picture of rental demand in PCL one must first understand that the market is intrinsically linked to employment in the financial services sector, which in turn filters to many other major London employment sectors that support this industry (lawyers, accountants etc.). Whilst the crash of 2008 is now past and the UK has returned to growth, the ramifications of that crash continue to have a long term impact on the liquidity of the financial services sector, risk appetite, effects on bonus pay structure for city employees and headcount.

Demand at the lower end of the market remains relatively stable as this tier is fed by the general growth of the PRS (Private Rental Sector) – new MMR regulations making it harder for first time buyers to get on the property ladder causing them to rent for longer, foreign students and recent graduates, tenants saving up deposits to buy and an influx from abroad (particularly the brain drain from struggling parts of Europe – Spain, Italy and Portugal in particular).

The super-prime tier has actually been aided by the stamp duty increases at the top end and the non-dom regulation changes, pushing super rich into rented property.

It is the middle ground price range – from £1,500pw to £4,000pw – traditionally so strong in PCL, and fed by the city to a large extent, that has struggled. What we can clearly see as we enter the last quarter of 2016 is that whilst uncertainty in the sales market and the concerns over Brexit act as a feeder stream of would-be buyers into the lettings sector, this has been outweighed by the

Re-appearance of the accidental Landlord (increased supply) and the macro factors restricting tenants' budgets, numbers and appetite to move.

Forecast:

In the short term we are seeing demand increase as uncertainty pushes more people into rented accommodation. This will help to soak up the high levels of stock and support lettings values, so I would not be surprised to see prices stabilise for the remainder of 2016.

In addition to this, there are several headwinds facing Landlords in the Private Rented Sector (PRS) which may cause stock levels to dry up over the medium term. The stamp duty increase on buy-to-let/second home transactions has caused many of the global real estate companies to predict a squeezing of stock levels in the medium term. On top of this, and what has been less widely reported, tax relief on buy-to-let mortgage interest payments is to be removed. In effect, the Chancellor wants to tax landlords on their turnover rather than profit. For those highly leveraged, tax rates could exceed 100pc: landlords will have to pay all of their profit in tax, and then pay more tax still. The tax increase will be phased in from 2017 and fully implemented by 2020.

Over the longer term the fear with Brexit is that, given the reliance of the PRS on job creation in the city, if we face a period of shrinking investment in the UK (short term though it may hopefully be) whilst we renegotiate our relationship with the EU, as appears a possibility, this will put downward pressure on demand. However, given the trade surplus / deficits highlighted in our Maskells Market Commentary, we believe the longer-term picture will look more positive once again. The appeal of London as a global financial centre seems inexorably on the up, and we believe attempts to broaden the City of London's appeal as an employment hub to other key sectors such as IT and Bio tech. will have a positive effect on the London lettings market, inextricably linked to the jobs these sectors create.