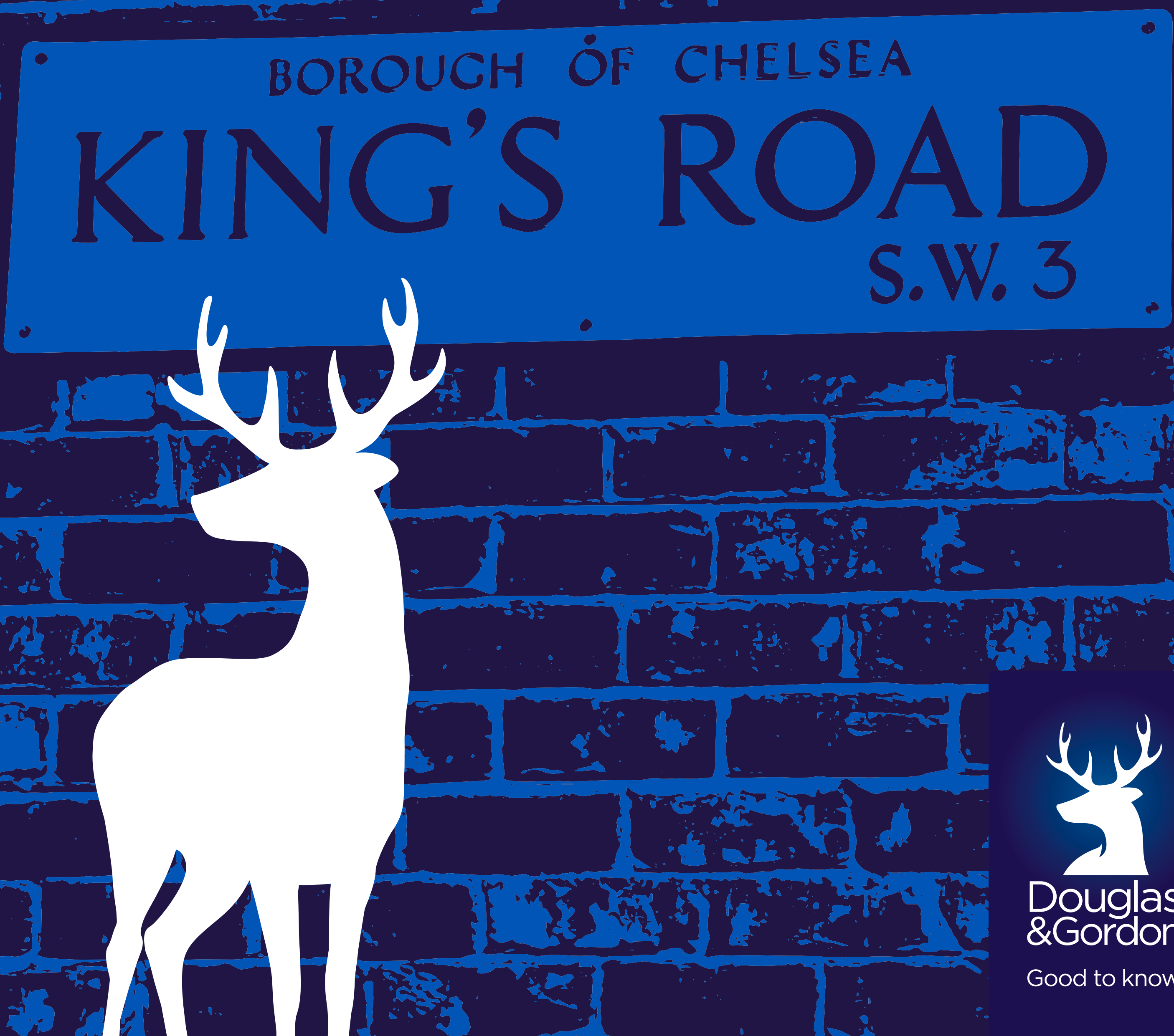
The Investor View

Chelsea
Q1 2015



Douglas
&Gordon
Good to know.

Introduction

Anyone who owns a property in London is a property investor. Our lives and plans often depend on the performance of what is likely to be the largest asset we own. So perhaps it will be helpful to take more of an investor's view of the market.

To produce this report we worked closely with D&G Asset Management, a company we co-founded in 2005. They deploy money into London residential property all the time, so they are constantly analysing different areas and the assets within those areas, seeking to maximise returns.

As well as publicly available sources, we have used the proprietary data that we have been capturing since 1996 to help us make decisions and provide advice and guidance to our clients.

D&GAM has helped us focus on the data that counts and we think the results make fascinating reading.

If you would like to learn more about the Chelsea area, please contact our office on Sloane Avenue. Contact details for this office can be found on the back page.

Property Values

Capital values softened in 2014 caused by weakness in the second half of the year.

Q4 2014 performance

In the last quarter of 2014 Chelsea experienced a decline in capital values. The flat market declined by 1.6% and the house market suffered a bigger fall of 2.9%. This pattern was not unique to Chelsea. On average across all Douglas & Gordon offices, both north and south of the river, capital values declined (-1.9%) for the first time in Q4 after 23 consecutive quarters of growth, beginning in Q1 2009.

2014: A year of two halves

- The first half of 2014 began with firm prices, continuing the trend of 2013 (when prices rose 6.9%).
- By June prices had peaked. The turning point happened just after the Financial Conduct Authority published their Mortgage Market Review at the end of April.
- Additional legislative concerns (Mansion Tax), as well as the Bank of England's, as we argued at the time, incorrect guidance on higher interest rates, meant that buyers approached the market in the second half of the year (H2) with a real sense of caution.
- Nervous buyers led to declining volumes. The future direction of capital values shifted to sellers.
- In the second half of 2014 we started to survey vendor intentions. The results indicated that we should expect a slight softening of prices – which duly happened in the latter part of H2.
- Although the year as a whole in Chelsea saw small declines in capital values, these were far from the crash that some commentators predicted – and proof for investors that prime residential real estate is less volatile than many other asset classes.

We expect capital values to have risen by the end of 2015.

Chelsea Nominal Property Values

	2014	H1 2014	H2 2014
1 Bed Flats	-5.07% ↘	2.06% ↗	-6.99% ↘
2 Bed Flats	-1.81% ↘	-2.36% ↘	0.56% ↗
3 Bed Houses	-4.08% ↘	2.45% ↗	-6.37% ↘
4 Bed Houses	-2.32% ↘	2.14% ↗	-4.37% ↘

Source: D&G proprietary data

Outlook for 2015

- In short: sub £1m will be strong throughout the year; we think that above £1m will start more slowly but gather momentum.
- With the current volatility in global financial markets and a general election on 7th May, the first half of 2015 is a buying opportunity for long term investors.
- Geopolitical uncertainty and sterling weakness may mean that the £2m - £3m market will pick up sooner than expected.
- Lower Gilt Yields have delivered cheaper mortgage deals and lenders are showing a greater propensity to lend into the prime London market. Increased credit flows will lead to higher capital values. Once the election is out of the way and with fiscal headwinds keeping interest rates low, we expect capital values to rally in H2 2015 – see page 4 for our forecasts.

How an investor looks at the market

Residential property investors use two key measures: the capital value of the property and its net rental yield.

You can make money from an increase in capital value and earn additional income by renting out a property you own. The net yield is the annual rent, less expenses, divided by the property's capital value.

Both are important and are influenced by many factors including: supply of new properties, infrastructure projects, demographics of the area, the economy (in particular, interest and tax rates) and the wider geopolitical picture.

The interplay of these factors is what determines investment returns and what makes property investment decisions so interesting. We hope this report provides some help as you assess your options.

Rental values during 2014 in Chelsea were strong – we think that 2015 will be a slower year.

Rental Growth & Yield

Average rental values across D&G Land in 2014 increased by 5.1%. In our non-prime offices rental values grew by 5.6%, considerably stronger than the figure of 2.1% in our prime offices.

Against this background Chelsea produced way above average growth of 11.7%. The correct way to interpret this data is to look at the numbers in the context of longer term rental growth (see 5 and 10 year rental growth data on page 4). As you can see, the numbers for 2014 make up a significant portion of the long-term growth. This illustrates the volatility, as opposed to the strength, of the Chelsea rental market.

What happened in 2014?

- The major theme across our offices was that the rental market benefited from a slowdown in the sales market, with potential buyers holding off and remaining in rental accommodation.
- An additional factor was that some offices experienced a fall in stock levels as investors took advantage of the strong sales market at the start of the year to crystalize their capital gains.
- A major reason that our non-prime offices performed better than the prime offices is due to a "post financial crisis" trend. It has become fashionable for corporate backed renters to live in other parts of the capital where rental values are typically cheaper - a factor that will continue to weigh on the Chelsea market.
- This latter point has been reinforced by the new tendency for corporates to pay their rental allowances directly to staff as opposed to directly to landlords.

We forecast more modest rental growth of 1% - 2% in 2015.

Outlook for 2015

- We are forecasting more modest rental growth of between 1% and 2%; but due to low inflation, we expect that rents will be flat in real terms.
- Two factors are behind our forecasts:

1. The City has come off the boil in the second half of 2014. Although we have long argued that with the growth of other sectors, the financial sector is becoming less relevant, it may weigh on sentiment.
2. Despite real earnings picking up, we remain concerned that in some instances they will dampen prices.

Finally, this is an election year and housing – notably the Private Rental Sector – will be a major political discussion point. Although there is no proposed legislation on the horizon to concern investors, we will keep all Douglas & Gordon clients informed of any news.

Chelsea Nominal Rental Growth

	2014	H1 2014	H2 2014
1 Bed Flats	10.00% ↗	0.00% →	10.00% ↗
2 Bed Flats	7.14% ↗	0.00% →	7.14% ↗
3 Bed Houses	13.04% ↗	4.35% ↗	8.33% ↗
4 Bed Houses	16.67% ↗	16.67% ↗	0.00% →

Source: D&G proprietary data

Current Rental Gross yields December 2014

1 Bed Flats	2.50% – 3.70%
2 Bed Flats	2.20% – 3.50%
3 Bed Houses	2.20% – 3.20%
4 Bed Houses	2.20% – 3.20%
10 Yr UK Gilt Yield	1.54%
FTSE All Sh Yield	3.39%
UK Base Rate	0.50%

Source: D&G Proprietary data

Market context

How we see 2015 unfolding.

1. Capital Values

Our forecast for 2015 is driven by two political factors. 1) The impact of the changes to stamp duty in the recent autumn statement; and 2) The threat of a mansion tax post the 7th May general election. We believe that, in contrast to 2014, the capital value growth will be weighted to the second half of the year.

Property Value	Prime	Non-prime	Comment
Up to £1m	+10% - +15%	+10% - +15%	Recent changes to the stamp duty regime in December's autumn statement have reduced the tax burden in this bracket. Our view is that it is a political green light for the market. This latter point may lead to strength throughout the year.
Between £1m and £3m	+7% - +10%	+0% - +5%	The proposed mansion tax rate in the £2m - £3m bracket has been signalled by the shadow chancellor. Our view is that the market in prime has over-discounted the situation; in addition sterling weakness will make this market more attractive for foreign investors. In non-prime the recent increased stamp duty for this price bracket will have greater impact for the (mainly) domestic buyers.
Stock between £3m and £5m	+0% - +5%		Although the precise rate of mansion tax is unknown, apart from the fact that the shadow chancellor has said that it will be 1) banded and 2) progressive, we feel that the market is already discounting bad news.
Stock above £5m	+0%		Not a place to be positioned.

2. Rental Values

Concerns over the City and real wage growth lead us to a cautious rental growth forecast for D&G Land in 2015. We predict that growth in rental values will track inflation at a rate of 1% - 2%.

Chelsea key facts & figures

Here are the key facts and figures anyone investing in the property market needs at their fingertips.

Nominal Capital Returns to Dec 2014

	2014	5 years	10 years
1 Bed Flats	-5%	53%	157%
2 Bed Flats	-2%	33%	116%
3 Bed Houses	-4%	31%	138%
4 Bed Houses	-2%	32%	114%

Nominal Rental Income Growth to Dec 2014

	2014	5 years	10 years
1 Bed Flats	10%	10%	32%
2 Bed Flats	7%	0%	36%
3 Bed Houses	13%	30%	30%
4 Bed Houses	17%	40%	40%

Other Assets Capital Returns to Dec 2014

	2014	5 years	10 years
Nationwide HPI*	7.20%	16%	24%
Halifax HPI*	7.80%	12%	16%
FTSE100	-2.70%	21%	36%
RPI	1.6%	18%	36%

**House Price Index*

Chelsea 2015 Our view

- **Capital values: Strong year ahead for sub £1m, above £1m slow start but picking up in H2 2015**
- **Rental values to plateau in real terms.**

Douglas &Gordon

Good to know.

Our Chelsea Office

45 Sloane Avenue, London SW3 3DH

Sales Caroline Anderson
T **020 7225 1225**
E **canderson@dng.co.uk**

Lettings Nicky Chambers
T **020 7581 6666**
E **nchambers@dng.co.uk**

To get an investor's view of other areas in central, west and south-west London, visit douglasandgordon.com

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