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Briefing
September 2020

London real estate: good time to buy?

For
Your family ✓
Your firm
Your society

Reading time
14 minutes

Enodo can help

By reviewing your current portfolio of real estate positions and making strategic recommendations for additions and reductions

By building a strategic portfolio against inflation

By reducing volatility in your portfolio through addition of low correlation positions

By assisting you with the sourcing, selection and financing process of properties

Executive summary

Property investment in UK's capital have lost some of their shine over the past few years as prices fell markedly following a long period of strong returns. The Covid-19 outbreak in the second quarter of 2020 has further stifled investor sentiment, with high levels of uncertainty about the economy becoming the new normal. But it is not all doom and gloom. On the contrary: A number of considerations point towards a renaissance, at least in parts of the market.

Property investments are by its nature a longer-term commitment of capital and an investor should therefore be first and foremost be driven by strategic, long-term considerations instead getting too hung up about short-term, tactical aspects. Making sure that the big picture looks attractive will help achieve satisfactory outcomes from the investment.

Our report tries to address exactly this. We focus on six distinct questions around London's longer-term attractiveness for property investments:

- Does the market currently represent good value for money?
- Does a property investment protect against inflation?
- How risky is a property investment in London compared to other places?
- Do property investments help to diversify overall portfolio risk?
- How costly and accessible is mortgage financing at the moment?
- With Brexit, Covid-19 and other uncertainties looming, is this the right time to invest?

We hope that elucidating these key factors will support you in your decision-making process.

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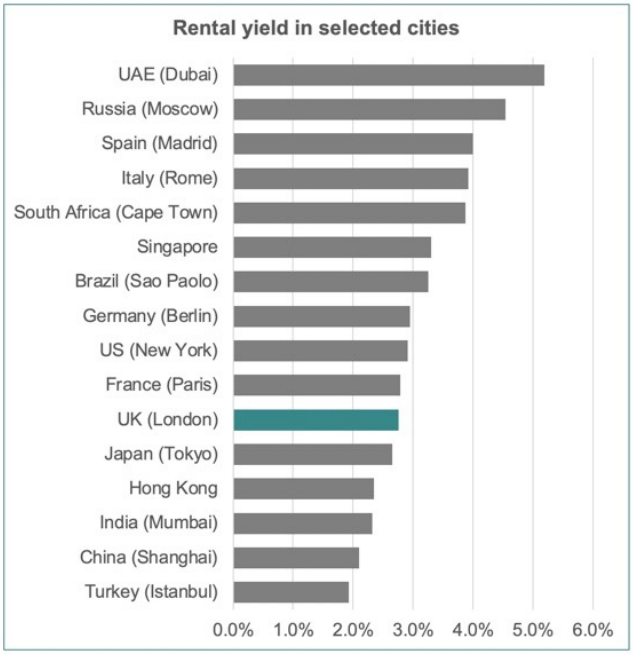
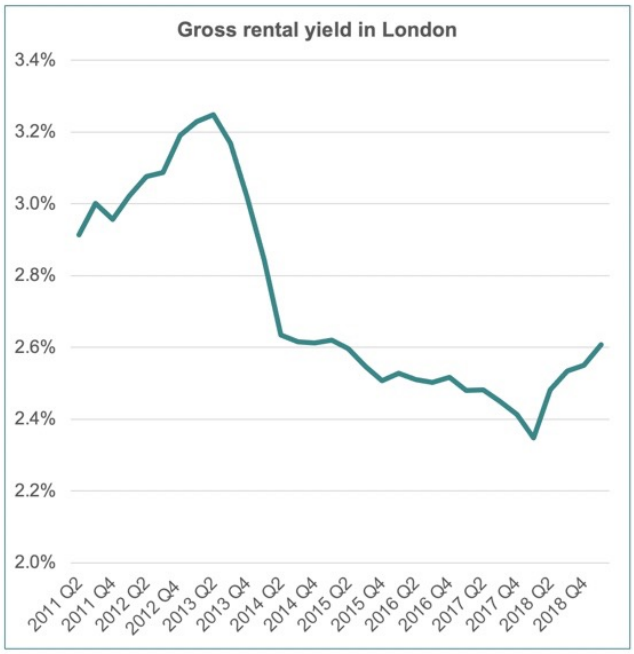
Does the market currently represent good value for money?

We look at three metrics to answer this question. First, we look at rental yields and compare the annual rental income from an average property to its purchase price across different cities and its development of London over time.

Chart 1: Rental yields



Notes:
Data sourced from www.globalpropertyguide.com



Notes:
Own calculations. Data sourced from Nationwide for average house prices and ONS for average rental prices in London.

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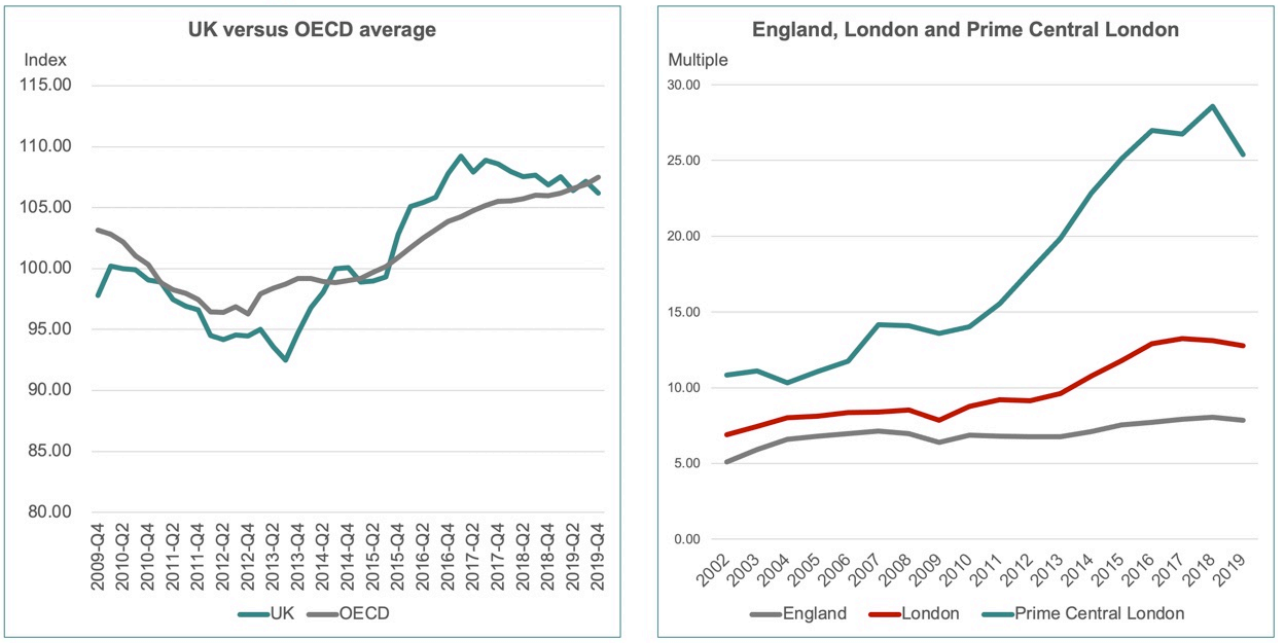
The left panel of Chart 1 indicates that rental yields in London are in a similar range as its main peers New York, Tokyo, Paris, and Berlin - at around the 2.5-3% mark. Historically speaking, this is below the 3%+ yields that investors could have expected at the beginning of the last decade. However, it has also bounced back somewhat from its recent lows in 2018 (see right panel). On the basis of this metric, London neither looks particularly cheap nor expensive.

A second indicator is to assess the affordability of property by relating income levels to property prices. This way we can infer if the pricing of property can be sustained by the economic situation of potential buyers. Again, we compare the situation of the UK to other countries and take a closer look at the development for London over time.

Chart 2: Affordability / Price to income ratios



Notes:
Data sourced from OECD data base

Notes:
Data sourced from ONS. Prime Central London is average of Westminster and Chelsea & Kensington boroughs

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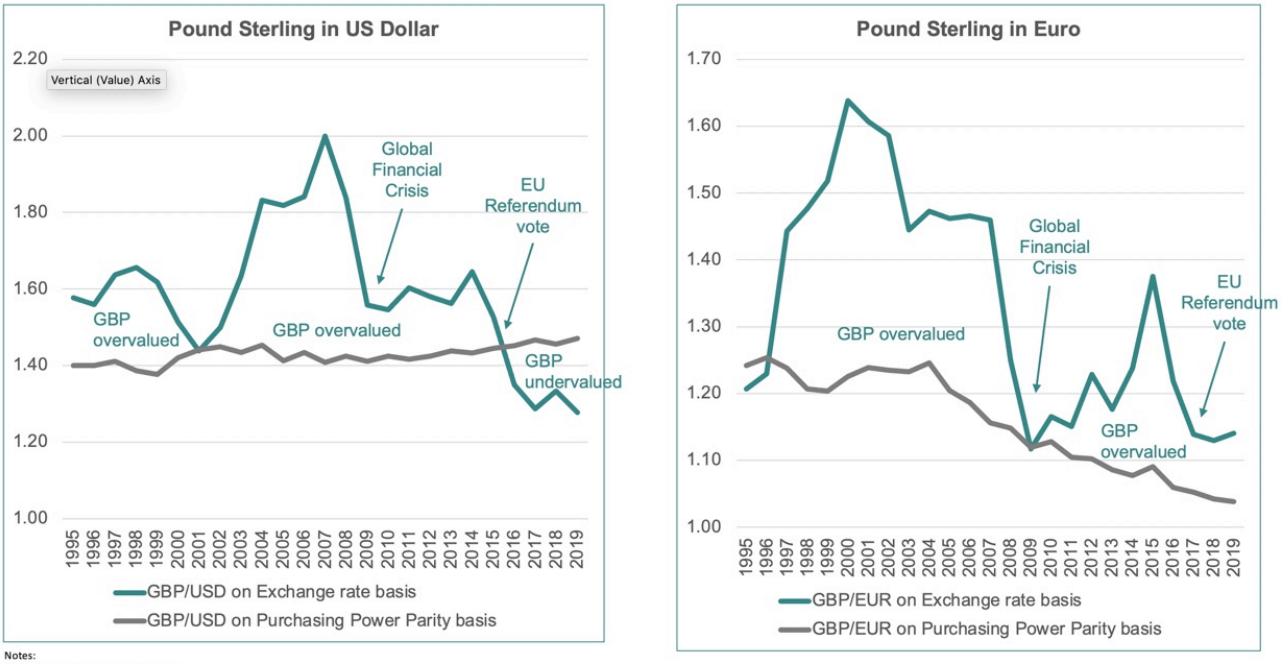
The left panel of Chart 2 shows that the index of price to income ratios – after a strong rise between 2012 and 2016 - has levelled off somewhat in the UK and that other countries (represented by the OECD average) have caught up and recently surpassed UK levels. As can be seen in the right panel, the "levelling off" effect has been particularly pronounced in London's most exclusive boroughs Westminster and Kensington & Chelsea (denoted as "Prime Central London"), where most recent data puts the price of a property at ca. 25x the average income. For London more generally, the rise was much less dramatic, although significant nevertheless, and still stands at 13x income levels. Overall, the figures represent a challenge for the property market as the number of local buyers being able to afford their own home has gone down as consequence. However, most other global cities suffer from similar challenges.

Lastly, international investors will need to take into account currency effects when purchasing property in the UK. Dollar-based or euro-based investors effectively take an additional bet on the British pound when purchasing a property in London. How these currency pairs will evolve over time is therefore an important driver of the total return on the investment and investors will prefer to invest into a UK property when the pound is relatively cheap.

A common method to ascertain this is by comparing the observable exchange rates between dollar or euro and the pound with the calculated Purchasing Power Parity (PPP) rate – a theoretical exchange rate that compares economic productivity and standards of living between countries. The PPP rate is considered the fair value rate of a currency. If the observed exchange rate is higher than the fair value rate, the currency would be considered overvalued and in the opposite case undervalued.

Chart 3 displays the pound sterling against both US dollar (left panel) and euro (right panel). As can be seen, in both cases the exchange rate moved against the pound sterling over the past 10 years, most notably after the global financial crisis in 2009 and after the vote to leave the EU in 2016. Compared to the US dollar, the pound is now considered undervalued by as much as 20%, whereas compared to the euro, sterling remains overvalued by roughly 10%, however, down from 25% prior to 2016.

Chart 3: GBP valuation against USD – Exchange rate versus Purchasing Power Parity



Notes:
Data sourced from OECD data base
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To summarise, our findings conclude that the property market in London – while by no means a place for deep discount bargain hunters - has recently gained back some of its attractiveness in terms of valuation, especially for dollar-based investors.

Does a property investment protect against inflation?

Can property investments shield us effectively against a surge in inflation? The short answer is to this is yes, as broadly speaking the research literature shows that real estate responds well to inflationary environments.[1]

However, perhaps unsurprisingly, there are nuances to this. The degree to which real estate can protect you from inflation depends on a number of aspects. To begin with, inflation is typically decomposed into expected or unexpected inflation. Unexpected inflation is less well protected by real estate than expected inflation, but it still does this better than other candidates for hedging inflation, such as gold or inflation-protected government bonds (TIPS).

Furthermore, different types of real estate display varying degrees of protection. Retail and, to a good extent also industrial properties, managed to protect income from inflation effectively, whereas residential and office real estate did not manage to do this to the same extent. When considering the value of the property itself, it was best preserved for retail and residential dwellings, whereas office space was least able to hold its value.

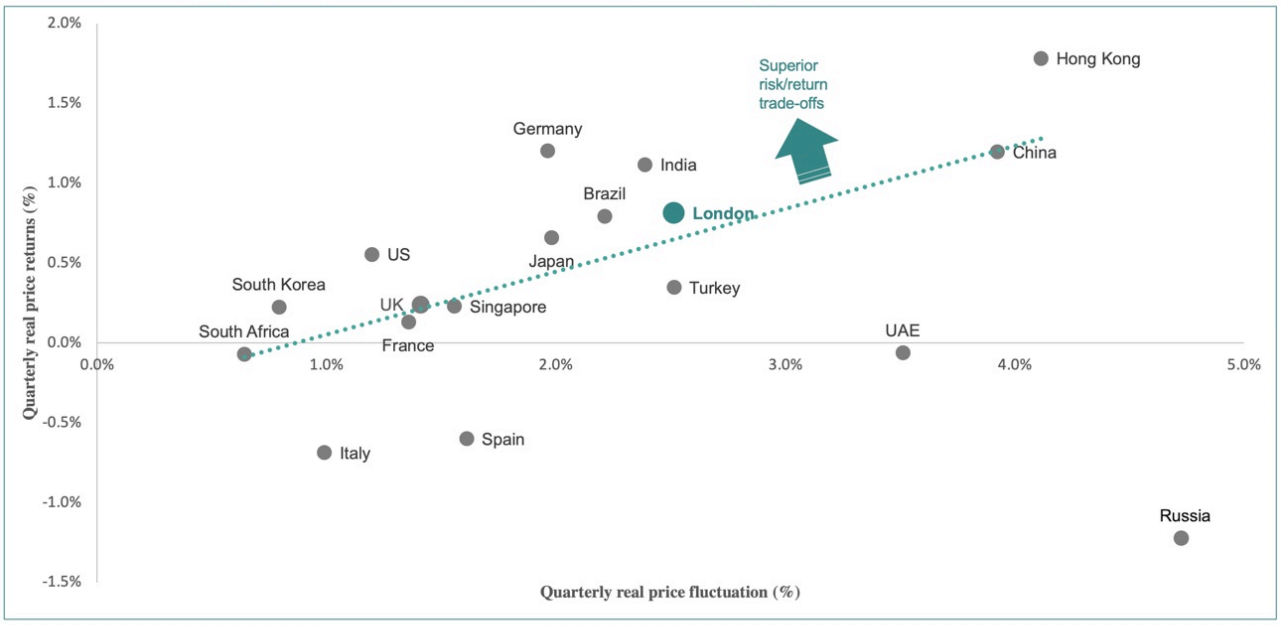
Finally, depending on how severe the surge in inflation is, also matters. In times of strong inflationary pressure, real estate appears to outperform other assets such as stocks, commodities, TIPS and gold.

How risky is a property investment in London compared to other places?

Typically, investors focus on returns when considering investments. But what about the risks of buying a property? Property prices can fluctuate and the degree to which they do offers us a clue as to their riskiness. To address this, we have looked at the returns and volatility of returns over the past ten years and plotted them in chart 4. The y-axis displays the real, i.e. inflation-adjusted, quarterly returns for a number of property markets and the x-axis shows their corresponding quarterly real price fluctuations.

[1] See Case et al. (2011). It also shows that real estate protects value relatively better than gold and even inflation-protected government bonds (TIPS). In certain scenarios, commodities can provide an even better protection, especially if the inflation is induced by supply shock. Further, stocks have also strong inflation protective features, not dissimilar to real estate.

Chart 4: Average property real returns and volatilities 2010 - Q2 2020



Source: Data was retrieved from the recognized national statistic providers,. China's data starts in 2011. Russia, a severe outlier with -1,3% average quarterly returns and 4.7% price fluctuation was excluded for regression line fitting purposes.

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The dotted green regression line shows – as it should - that there exists a positive trend between risk and return.[2] However, the relationship does not strictly hold for all markets we considered. A number of markets such as Italy, Spain, UAE and Russia sit significantly below the regression line, which means that the investors were not compensated appropriately for the risk that they took. On the flip side, there are markets located above the dotted line which represent superior risk-return combinations for investors. Markets such as South Korea, US, Germany, India and Hong Kong stick out, having delivered the strongest returns per unit of risk.

London's position in the chart is positive, too, as it sits slightly above the regression line. It displayed average levels of price fluctuation – about 2.5% of quarterly real price fluctuation - and delivered a higher than average return for its investors (0.8% real return per quarter). The UK market overall, in contrast, sits right on the regression line, displaying average returns of 0.24% with a lower risk of 1.2%.

Do property investments help to diversify overall portfolio risk?

One important factor when considering an investment into property is how it fits into an investor's overall portfolio. Does it provide diversification benefits that help to smoothen overall returns? In order to achieve this, the returns from real estate investments would need to be unrelated or even negatively related to the returns of other elements in the portfolio. This so-called correlation between different asset classes is subject to considerable research and the conclusions are not always consistent.[3]

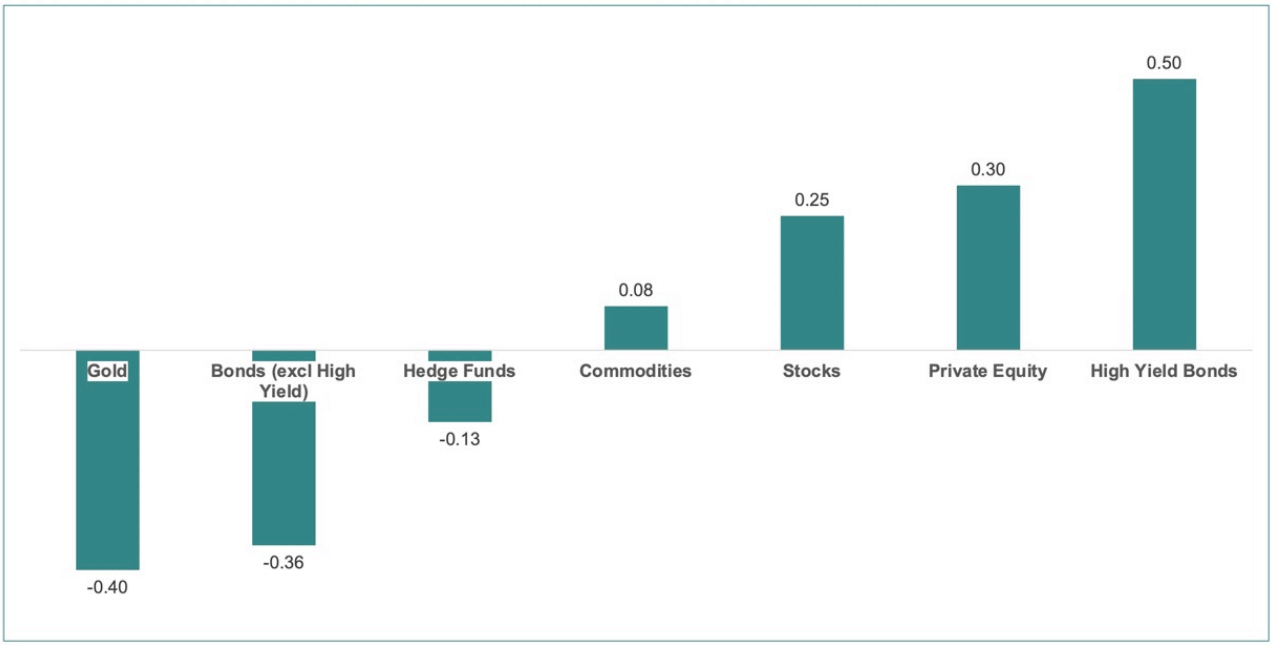
[2] On average, for every percentage increase in risk, the investor gets compensated for with 0.4% in additional return. The univariate regression explains ca. 40% of the variation in the data once Russia, a severe outlier is excluded from the sample.

[3] Calculations may refer to different time periods and the methods in calculating correlations may also vary. Also, there is considerable variation within an asset class, so the correlation to one class of bonds may be markedly different to another subset. See for example the long-run correlation estimates according to JP Morgan Asset

Nevertheless, we can identify broad trends which are likely to hold. Generally speaking, real estate does provide useful diversification to an investor's portfolio as its correlation with nearly all asset classes is markedly below one[4]. There are, however, varying degrees.

Chart 5 displays correlations between real estate and a number of asset classes. For portfolios that are heavily invested in stocks, private equity and high yield bonds the diversification benefit will be felt less, as a positive correlation – estimated to be between 0.25 and 0.50 exists. On the other hand, real estate is less strongly intertwined with commodities and hedge funds (between minus 0.13 and 0.08). An investor can expect the strongest diversification benefit when the existing portfolio is heavily skewed towards bonds (other than high yield bonds) and gold. Here the estimated correlations are significantly negative (between minus 0.36 and minus 0.4).

Chart 5: Expected average long term correlation to UK real estate



Notes:
Data sourced from JP Morgan Asset Manager Long Term Capital Market Assumptions 2020. All assets are GBP denominated

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In summary, real estate provides clear benefits from a portfolio diversification perspective. However, investors should be cautious when considering real estate in the form of publicly traded Real Estate Investment Trusts (REITS). Whilst there are other benefits in getting exposure to REITS, for example its liquidity and professional management, they tend to not add much diversification benefits in a portfolio. Their return profile is more akin to that of stocks and therefore the two asset classes are closely correlated with each other.

Management (2020) and Veles (2017). For the purpose of our analysis we have used average values of sub-asset classes.

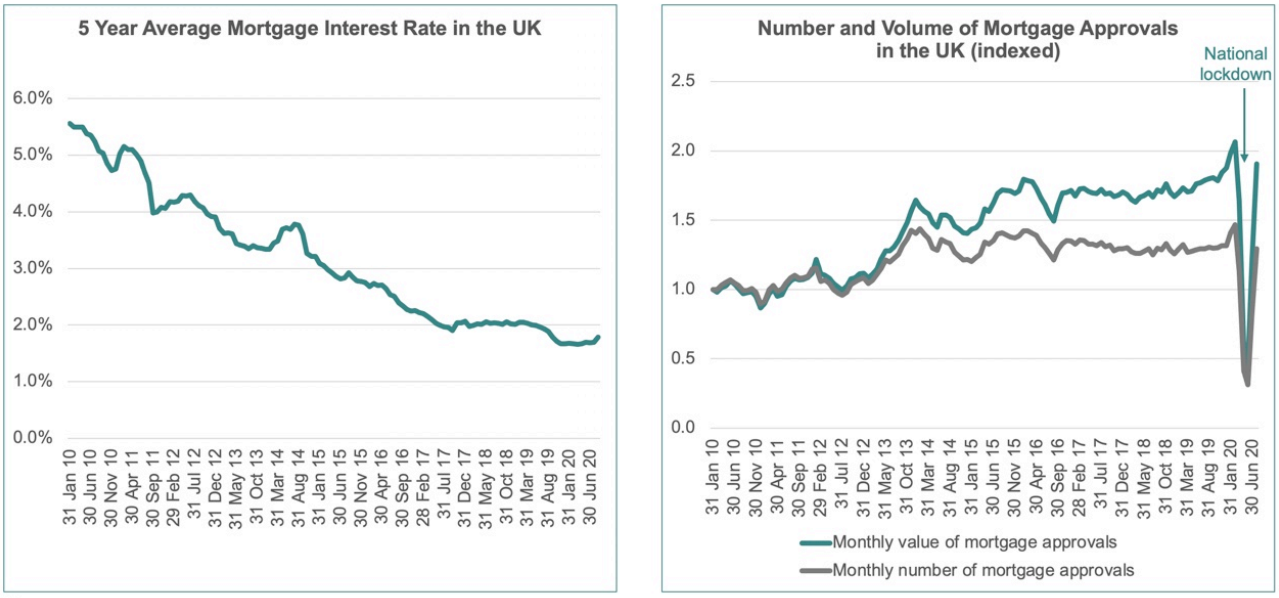
[4] A correlation of one would mean that the assets are perfectly correlated and move in sync with each other. No diversification gain could be achieved in such a scenario. A correlation of less than one means that the assets do not move in tandem and the more the move disjointed from each other the higher the diversification benefit. The maximum negative correlation would be minus one.

How costly and accessible is mortgage financing at the moment?

The costs are – simply put– historically low. Banks currently offer an average 5-year fixed rate mortgage with 75% loan to value at below 2%. This is truly unprecedented in recent history and compares to over 5% in 2010, when central banks across the globe had started their accommodative monetary policies following the global financial crisis of 2008/09. The left panel of chart 6 illustrates the long fall in interest rates. Furthermore, banks increasingly also offer longer fixed terms of up 10 years, with the average rate being less than 2.5% as of Sept 2020.

Similarly, the number and volumes of mortgages granted by banks have gone steadily up over the past decade, indicating good accessibility of mortgages in general. The near complete collapse in approvals during the national lockdown in the second quarter of 2020 was almost entirely recouped since (see right panel of chart 6).

Chart 6: Long-term financing rates and mortgage approval activity



Notes:
Data sourced from Bank of England
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Having said this, it has become increasingly cumbersome for overseas investors to apply for a mortgage in the UK. Some of the most well-known high street banks are simply not capable of offering mortgages to international investors who do not regularly live in the UK. More specialised private banks and boutique lenders are usually better suited to deal with the inherent complexities of international investors.

Furthermore, very recent data (Sept/Oct 2020) shows an uptick in mortgaging costs, as banks have seen a revitalisation of demand, which they have decided to use as an opportunity to raise margins somewhat.

With Brexit, Covid-19 and other uncertainties looming, is this the right time to invest?

It is true that the UK faces a number of challenges in the coming months and years. A new trade agreement with the EU following Brexit will keep the policymakers busy for the foreseeable future. The uncertainty generated will continue to reduce firms' and individuals' appetite to commit to large scale capital expenditures. The ongoing trade conflicts between the US and other major economies and the potential demise of a rules-based global economic cooperation are going to reverberate negatively on a trading nation such as the United Kingdom, especially now being outside the protection of the champion of rules-based, multi-lateral trade, the European Union.

Covid-19 and the subsequent fiscal response by governments across the world has left most major economies with perilously high levels of government debt. Just how exactly governments are planning to reduce their debt burden is still very much an open question, but it can only be one of three options or some combination of them: 1) austerity measures to reduce government spending, 2) higher taxes to cover higher expenditures, or 3) higher inflation to reduce the burden of (nominally fixed) government debt commitments. Given that the previous decade was dominated by austerity in many countries, it is unlikely going to be the main thrust for this decade due to political reasons. Instead, higher taxation on corporations and individuals (and by extension on their properties) is likely, as well as higher tolerated inflation levels.

Finally, Covid-19 has also changed the way Londoners live, with clear implications for certain real estate segments that may be more or less sought after than before. The retail sector faces far reaching shifts in consumer preferences towards online delivery services, rendering physical outlets less desirable. The office segment will need to deal with the implications of an increased demand for working from home. By the same token the increased tendency to working from home has led city dwellers to reconsider their own living arrangements more generally. Real estate agents have recently registered record interest in homes with outside space in the countryside.

Whilst this is a seemingly long list of worries, some items like Brexit and ongoing global trade conflicts have been on the agenda for some time now and the markets in all likelihood have already priced these concerns in. Somewhat counterintuitively, the economic uncertainty may actually support property prices in the longer run, as it has also led to a reduction in new building projects. This may further sharpen the shortage in available properties for would-be buyers, driving up prices.

Other, more recent concerns have yet to play out. The economy will take some time to recover from the sharp drop in GDP experienced in the second quarter of 2020 and a temporary increase in unemployment will represent a burden for the real estate sector as well. However, both central banks and governments have shown hitherto a strong commitment to restore economic prosperity with accommodative policies. This in turn has so far reassured stock markets that the recovery will take a V-shaped form.

Regarding higher taxation on UK properties, the government will need to strike a careful balance between raising property-related taxes and avoiding a reduction in transactions in order to maximise their total tax receipts. As a number of tax measures have already been taken over the past five years, ranging from higher stamp duties for higher value properties and for buy-to-let properties to a widening

of the base of properties that are considered for inheritance tax purposes, the government is likely to tread carefully with further measures.

Since the recent measures have been implemented, there has already been a noticeable drop in the number of transactions, especially in the top-end segment of the market. Consequently, the government's receipts in stamp duty land tax have dropped by 8% in the tax year 2018/19.[5] The recent temporary stamp duty holiday for properties of up to GBP 500,000, which was announced as a measure to support the property market, is a further sign of the current government's reluctance to overdo it on the taxation front. If the government decides instead to show higher tolerance levels for inflation as a way out of excessive levels of government debt, then the real estate sector should be well positioned to sustain the erosion of purchasing power as discussed earlier.

Conclusion

In these ever-changing times, where we all are being bombarded by (mostly negative) news and information, our advice to investors has been to take a step back and be clear about which factors are actually relevant for them to achieve their goals.

The focus on the fundamentals that drive the value of an investment in the long-run is often obscured by aspects that are – if anything – more tactical in nature. This report aimed to discuss what strategic aspects should be considered before making an investment.

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Office for National Statistics (ONS) and various other national statistics providers

www.globalpropertyguide.com

www.statista.com

[5] The HMRC reported a drop from GBP 12.9bn to GBP 11.9bn between the tax years 2017/18 and 2018/19. Source: www.statista.com

About the authors

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Nick has over 20 years of experience in wealth management, predominantly spent at UBS where he was a Managing Director. He held a number of senior leadership roles, including Head of Wealth Management for Global Emerging Markets in London, where he led a sizable business advising wealthy families in Central & Eastern Europe, Middle East, Turkey, Israel, Africa, Latin America and Asia-Pacific.

For six years, Nick was Head of Investment Products and Services where he led the investment management, capital markets, alternative investments, lending and wealth planning functions, responsible for over USD50 billion of client assets, and a sizable lending book. He also founded the client philanthropy unit in the UK, which supported clients in maximising the strategic impact of their giving. He has been a regular media commentator. Over the years, he has also maintained a strong academic interest in business psychology.

He has served on numerous non-profit boards and is currently Vice Chairman of the governing body of Royal Holloway, University of London, amongst the top 25 in the UK and 250 globally. He also chairs the committee overseeing the university's USD100 million endowment.

He holds MSc in Organizational Psychology and MBA in Finance degrees from the University of London, is a Chartered Wealth Manager, Chartered Fellow of the Chartered Institute for Securities & Investment and Member of the British Psychological Society. He was elected Fellow of the Royal Society of Arts for his work in philanthropy. He is also a part-time Doctoral researcher in organizational psychology and family-owned business at Durham University.

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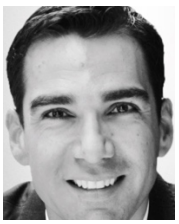

Baris has over 15 years of experience in wealth management and investment banking in London, Zurich and Frankfurt. Between 2006 and 2020, he worked for UBS, where he was a Managing Director.

He served as Head of the Global Family Office, Ultra High Net Worth Emerging Markets and Financial Intermediaries units for UK and Jersey, offering wealth management, structuring, lending and investment banking solutions to the largest clients of the firm. His team was entrusted with over USD12 billion of client assets.

Prior to this, he was responsible for various significant teams serving wealthy families in Central & Eastern Europe, Middle East, Turkey, Israel, Africa, Latin America and Asia-Pacific.

Before joining UBS, Baris was a research assistant to the Chair of International Banking and Finance at the Goethe University Frankfurt and a visiting scholar in Finance at the Wharton School, University of Pennsylvania.

He published papers on global stock exchanges in peer-reviewed academic journals, including the prestigious Journal of Banking & Finance, and was a regular commentator in the media.

Baris holds a Doctoral degree in Finance from Goethe University Frankfurt and the Diplom Kaufmann degree from the University of Regensburg, as well as an MBA degree. He has completed the Chartered Financial Analyst and Financial Risk Manager programmes.

The story of Enodo

Enodo is the Latin word to explain, literally to *unknot* or *untangle*. This encapsulates our vision – to bring clarity to the complexity of being wealthy.

Our founders have had the privilege of advising some of the world's wealthiest families. They've observed first-hand the liberation and opportunity that wealth can bring – unifying families around a common purpose, creating real economic impact via a family business, or contributing to wider society through audacious philanthropy.

At times, they've also seen the stress and confusion that can result. They've witnessed family disharmony, miscalculations in family business or investment strategy, and the hugely detrimental impact of working with advisors who put their own interests first.

Our founders have engaged in the discipline of advanced academic research. Their own analysis of peer-reviewed academic literature across the disciplines of finance, economics and business psychology, combined with their deep professional experiences, have allowed them to arrive at new perspectives on how *to be wealthy* and how *to manage wealth*.

The result of their thinking is the Enodo Leadership in Wealth™ advisory framework which supports wealthy families in using their wealth to lead across all the dimensions of their life – *family, firm* and *society*. Amongst other things, their framework includes:

For your family

- Family governance and family office set-up
- Investment risk and asset allocation – including family business assets and debt
- Chairing a family investment committee
- Selecting the best investment managers
- Analysing investment opportunities, including alternative investments and recent innovations (e.g. cryptocurrencies)
- Understanding the impact of investing in your passions, such as art and collectibles
- Monitoring of performance and risk
- Guiding and analysing where you are in dispute with your investment advisor

For your firm

- Organizational culture and performance
- CEO / founder succession and role of family members
- Financial optimisation – including debt, hedging and foreign exchange
- Reviewing your equity and debt capital market opportunities
- Corporate and social responsibility

For your society

- Philanthropy and impact investing
- Establishing a family foundation

The Enodo Goal-based Asset and Liability Allocation (GALA) Modeller™ offers ground-breaking insights into optimal strategic asset allocation – examining the risk characteristics of a family business shareholding and analysing tolerance for risk from psychological personality profiling. You can experience a shortened version of this powerful tool here.

At Enodo, we offer rigorous, independent and intelligent advice to wealthy families around the world. We aspire to be your trusted partner, wherever life leads you.

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