Agents in Prime Central London since 1965

Research: Land Registry, The Index that Overvalues your House

Research:

Volume is required in order to support price increases.

Over the past 2 years, we have seen volatility in almost every market leading to price movements across the board - except for one market – Prime Central London Property. In this paper we seek to examine why that this case and what data is being relied upon by the market. Our initial conclusions are that whilst we would expect a gradual increase in market pricing to be coupled with an increase in volume (activity), when the two diverge, price volatility should be expected and when it does not happen, almost every buyer will fall away as confidence will be lost in market pricing.

Taking the FTSE 100 index as an example, as the graph below shows, a gradual increase in volume leads to a gradual increase in the index (with a few notable blibs) however as you move past 1995 there are notable peaks and troughs in index levels which are more pronounced than the peaks and troughs in volume. In short as the market takes off with little support, it is quickly brought back into line:

The Land Registry Index is exactly that – an Index and applying index increases to individual properties distorts pricing.

Table 1 – FTSE 100 Index 1984 to 2016. Top Line is the index, bottom line, the volume

By comparison we have below the chart from Land Registry showing the House Price Index increase in Kensington & Chelsea from 1995 to 2016. Aside from a small correction in 2009, the curve is positive. Below this chart, we have attached a further chart showing the volumes in House sales in RBKC during this same time:

Research:

Increases in pricing without correspond increase in Volumes leads to a lack of confidence.

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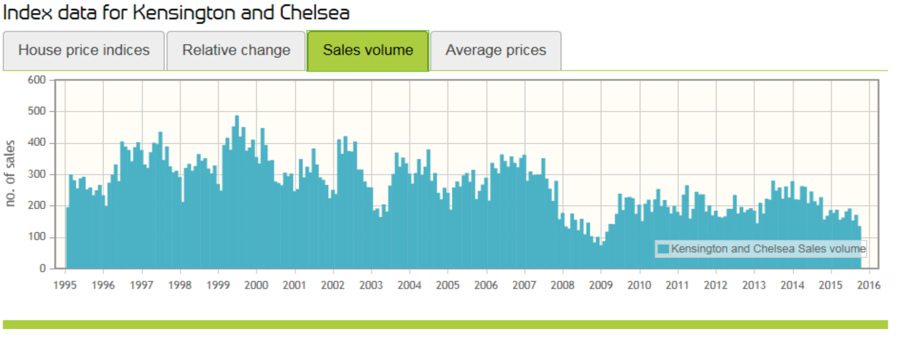
Table 2: House Sales Index RBKC 1995-2016

Table 3: House Sales Volumes RBKC 1995-2016



What becomes quickly apparent is a lack of support in terms of volume of sales against increasing house prices demonstrated by the index. Is it therefore our natural conclusion that the House Market in RBKC is overvalued and by association, the Prime Central London Property Market?

Let's take a step back. Movement in the FTSE is a function of the movement of its constituent member shares in the same manner that movement in the Land Registry Index is as a result of sales across an entire area rather than just one postcode. Each postcode behaves differently and it would be as irresponsible to apply the movement of the FTSE index as a de facto valuation to the share price of a constituent company. The same logic applies to Prime Central London Property – the Land Registry Index does not provide any meaningful insight into how one particular postcode of London property operates, it provides a helicopter view of the borough.

Research:

Using an Index derived just from House Sales in SW3 from 2010, we can see significant price differences between SW3 and the whole RBKC house market.

However is the market forgetting that a house in a cash-flowing asset (Rent) which owner / occupiers are choosing not take by living in the property but seeking to recover at the point of sale?

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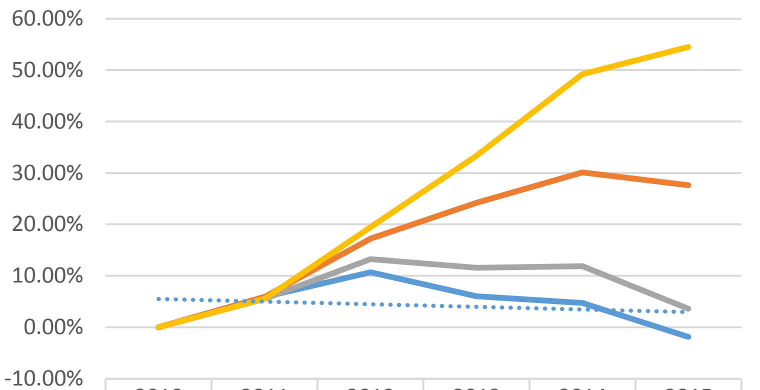
In order to prove this, we looked at every house bought in the SW3 postcodes in 2010 to see how they have traded since then and compared this to their "Land Registry borough index" in both annual and compound growth

Table 4 – Difference between SW3 House Prices and Land Registry Index RBKC House prices 2010-2015.



	2010	2011	2012	2013	2014	2015
SW3 Annual Growth	0.00%	5.90%	10.70%	6.00%	4.70%	-1.90%
SW3 Compound Growth	0	5.90%	17.20%	24.20%	30.10%	27.63%
Land Registry Annual Growth	0.00%	5.55%	13.23%	11.59%	11.87%	3.60%
Land Registry Compound Growth	0	5.55%	19.50%	33.37%	49.20%	54.50%

Source: Lonres.com & Land Registry

Of note here is that the component (the SW3 Houses sales) does not trade like its Index and therefore, as we argued, to apply an index derived % gains to House Sales will result in the wrong price being sought for the property. Nevertheless, it is not the component parts which are at fault, it is the lack of understanding of the index, that its constituent parts are too different and that the kind of data we have used is not easily accessible. To summarise this part of the paper we can prove that the growth in house prices in SW3 from 2010 to 2015 was 27.63% vs 54.50% for its index.

As with any market, prices increases on the back of low volumes are not very stable – and we can refer to the adage – a single trade does not make a market. This is very much the case in Prime Central London: Vendors see a property trade and immediately assume that the next sale will be at a premium and this plus the large increase in the Land Registry have distorted the market.

Notwithstanding this slower growth and large differential, market focus remains on the Land Registry index in times of low volume. This focus has the secondary impact of making us forget that property, in addition to the capital appreciation / depreciation of the asset also has a cashflow element (or coupon) in the form of Rent. Using the same rental cashflow received by a house in SW3 but calculating the yield from the Land Registry index rather than the SW3 Index will produce a lower yield. Agents applying this lower yield, when valuing Houses, will inadvertently push prices up.

Research:

Rental Yields in SW3 are actually much higher than originally anticipated due to lower price increases vs rest of RBKC

Effect of adding Rental Income to capital appreciation of property adds 17.85% to a house price in SW3 in terms of total return and may well be why Vendors have high asking prices.

However adding rental element is misguided as the rent does not accrue – Houses are sold on Capital uplift only and not on Total Return.

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Table 5: Yield of same rental income on SW3 Houses, value by SW3 Index and By RBKC House index

Year	SW3 Houses / SW3 Index	SW3 Houses / RBKC index
2010	3.20%	3.20%
2011	3.29%	3.30%
2012	3.09%	2.88%
2013	3.43%	2.79%
2014	3.44%	2.54%
2015	3.65%	2.45%

This difference in yield is important when considering value. So far we have a 26.5% difference between the SW3 house price increase and the RBKC house price increase. We cannot forget that Rent is money generated by the property, whether the owner chooses to take it or not.

Using the yields above, we can calculate that the rental income element that we can add to a house in SW3 is 8.51% of the property value if we use the RBKC Land Registry index and 17.87% if we use the SW3 house index since 2010. If we add those to our appreciating capital values, we end up with a total return (capital gain and income) for SW3 Houses using the SW3 Index of 45.50% and 63.01% for the RBKC index in our 2010-2015 period. This is only a 17.51% difference (compared to 26.5% in growth) highlighting the importance of rental income in house price total return and which may explain why Vendors are seeking the prices that they are. However whilst the total return for SW3 may well be 45.50% since 2010, we <u>cannot</u> seek to add the income (rent) that we as owner occupiers have given up (because we were living in the property) to the capital appreciation of that property.

So when considering buying or selling Prime Central London property for yourself of your clients, it is prudent to ask yourself – where did this property trade 5 years ago and does the increase I am being asked to pay or I am asking a buyer to pay make sense vs other relevant properties that have sold. Is the Vendor trying to capture a total return or just a capital gain in the sale and if the former are they working off the Land Registry Index, the local index or just a one-off transaction which agents are using as "support" to the market. The property market needs pricing transparency so that vendors and applicants have confidence in the prices being sought and paid. But if you have bought into this market or are considering doing so this might help:

Research:

Nevertheless property remains an attractive investment compared with other asset classes.

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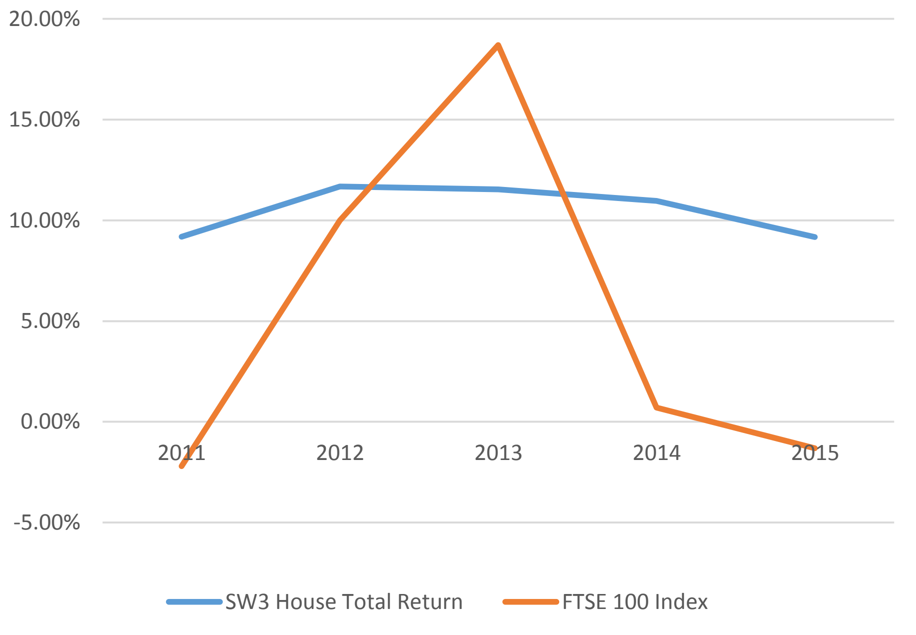
Table 6: capital growth, rental yield and Total return for Houses SW3 using SW3 index vs FTSE 100 index total return.

	2011	2012	2013	2014	2015
Capital Growth	5.90%	8.60%	8.10%	7.53%	5.52%
Rental yield	3.29%	3.09%	3.43%	3.44%	3.65%
SW3 House Total Return	9.19%	11.69%	11.53%	10.97%	9.17%
FTSE 100 Total Return	-2.20%	10.00%	18.70%	0.70%	-1.32%

Table 7: SW3 House (SW3 Index) total Return vs FTSE 100 Total Return



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