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Spotlight
Prime Rental Markets

Q2 2012

SUMMARY

Rental growth slows in London's prime markets

■ Despite rental growth of 2.3% over the past six months, annual rental growth in the prime markets of London dipped back into negative territory for the first time in over two years in the second quarter of 2012.

■ Over the last quarter, houses in prime South West London showed the strongest growth where rents rose by as much as 1.8%.

■ Rental values in South East England have increased by 3.6% in the first half of this year, leaving average rental values -1.5% below what they were this time last year.

TABLE 1
Market Overview

	Prime Central London		Prime South West London	Prime North London	Prime East of City	Prime South East England
	All	Ultra Prime				
Quarterly	0.1%	-0.5%	1.1%	1.6%	0.8%	2.4%
Annual	-0.5%	-3.0%	0.8%	-5.1%	1.6%	-1.5%

Table source: Savills Research

Despite rental growth of 2.3% over the past six months, annual rental growth in the prime markets of London dipped back into negative territory for the first time in over two years in the second quarter of 2012.

For the past year, average rents have struggled to push beyond the previous peak seen pre-Lehman brothers. This reflects relatively weak short-term prospects in the financial and business services sector of the London economy, that is a key component of demand for prime residential rental stock. Oxford Economics forecasts that employment in this sector will contract by 0.9% in 2012 and increase by just 1.0% in 2013.

A consequence has been a more diverse tenant profile with a notable decrease in tenants employed in the finance sector seen in the prime central and East of City markets. However, there has been recent evidence of increased levels of corporate demand, with 13% of leases in London made to a company during the first three months of this year compared to 10% during Q4 2011.

Over the last quarter, houses in prime South West London showed the strongest growth where rents rose by as much as 1.8%. Here stock has

Profile of the Prime Market

Lessons from Rental Britain

In March 2012 Savills and Rightmove jointly prepared a comprehensive review of the prospects for the private rental sector titled Rental Britain. This explored the historic and prospective growth of the sector, rents and their affordability and the need for investment. It also looked at the profile of the prime market.

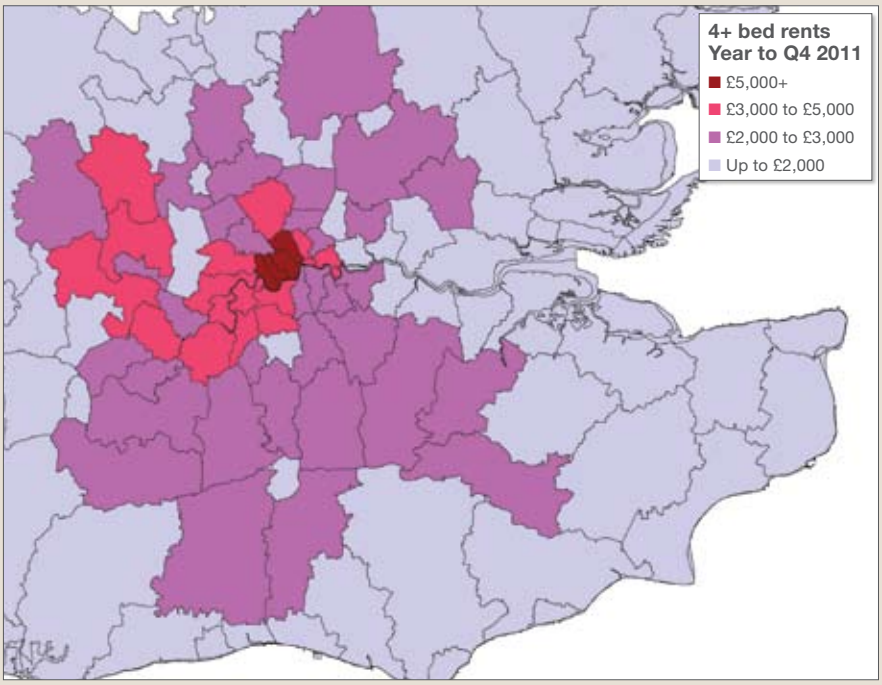
Prime family rental markets are largely confined to London and the South East and in just 14% of all local authorities rents for properties with four or more bedrooms average more than £24,000 per annum (£2,000 per calendar month).

All are located in London or its immediate commuting hinterland, with the exception of Poole, Castle Morpeth and the high value Cheshire markets (within the local authority of Macclesfield).

Prime Central London rental levels reflect the dominance of tenants employed in the financial and business services sector and demand from international tenants (some 45% of demand is from North American and Western Europe tenants), and are of a different order compared to the rest of the market.

MAP 1

Average 4+ bed rental values



Map source: Savills Research, Rightmove

Average asking rents for properties of four or more bedrooms in the Central London boroughs of Kensington and Chelsea and Westminster average £130,200 (£10,850 pcm) and £118,500 (£9,875 pcm) per annum respectively. In neighbouring boroughs of Camden and Hammersmith and Fulham, where the tenant base is more diverse, equivalent figures would be £73,000 (£6,080 pcm) and £64,300 per annum (£5,360 pcm).

Outside of London, the highest value prime market is Elmbridge, in suburban Surrey, where the average annual rent for a property of four or more bedrooms is £58,300 (£4,850 pcm).

These average rental figures give a hint as to the variation between property types and location. Increasingly, those rents are being looked at on a £ per sq ft basis in a similar manner to the sales market.

Our research suggests that across Central London prime residential rents average just over £60 per sq ft. This is just 23% below the average rent for prime offices in the West End at £78 per sq ft.

However, the average residential figure varies significantly from £91 per sq ft in the top 25% to £41 per sq ft in the bottom 25%. In part that reflects a premium for scale, with properties in the top quartile some 92% bigger than those in the bottom quartile.

These higher rental values for larger houses, together with the uplift in capital values from putting such properties into residential use, have underpinned the conversion of such buildings back to residential use.

noticeably been more constrained than Central London. At the end of May there were 3.7 months stock on the market compared to 4.8 months this time last year.

In addition, the more domestic markets of South West London are seeing an increase in demand from international tenants as demand has been divided and less expensive prime areas are taking advantage of the difference in rents between Central London and other prime areas. During the second half of last year international tenants accounted for 47% of all tenant, this has increased to 52% year to date.

Partly as a consequence, Prime Central London saw rental values remain roughly flat over the quarter. Here overseas investors, who have bought more investment property as a hedge against uncertainty in other markets, brought more stock to the market.

As a whole the ultra prime markets of London have yet to recover to peak values. Occupiers have more readily bought in order to provide a safe haven for their wealth. Those who continue to look to rent are focussing on iconic fully serviced buildings. In this respect the market has become increasingly selective.

In what is a more volatile market, rental values in South East England have increased by 3.6% in the first half of this year, leaving average rental values -1.5% below what they were this time last year.

This reflects an increase in demand seen throughout the South East of England as applicant levels increased by 16% over the first three months of the year against a notable fall in available stock.

There has been a difference between the rate of recovery in the core commuter towns and the slightly fringe village locations, with the latter underperforming.

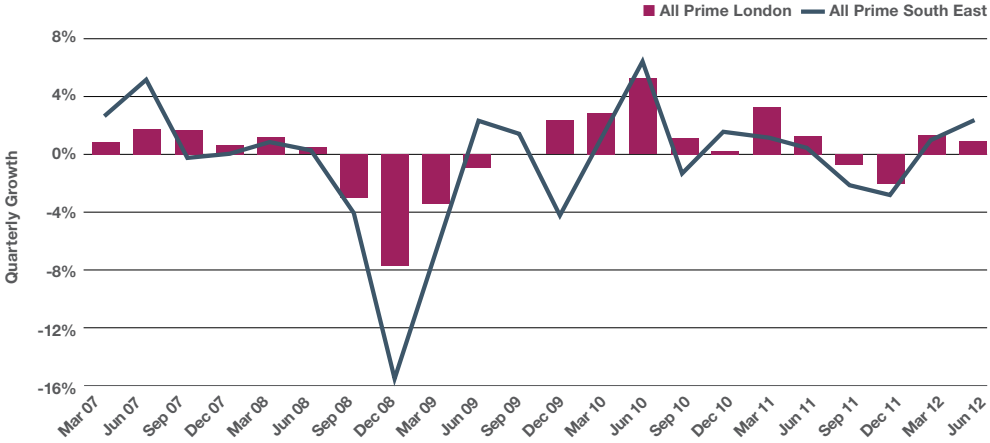
The mainstream view

In contrast to the prime markets the mainstream rental markets have continued to show rental growth, given an ongoing mismatch between supply and demand.

The difficulty in raising mortgage deposits in a debt constrained environment continues to drive rental demand.

GRAPH 1

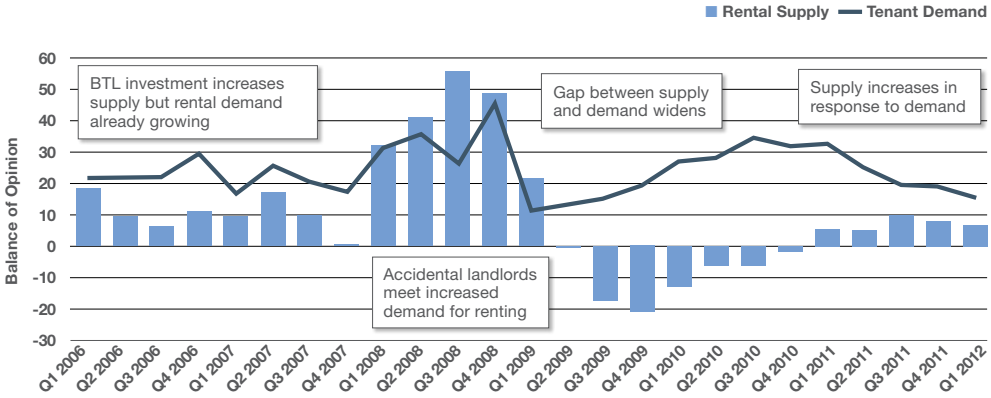
Prime Rental Values



Graph source: Savills Research

GRAPH 2

Gap narrows between rental supply and demand



Graph source: RICS Letting Survey May 2012

The issues for first time buyers are well chronicled, with average deposits equating to 82% of income as an average across the UK and 121% in London during the first quarter of this year.

However, so called 'second-steppers' may also need to seek sanctuary in the rental market, as the typical home mover would need to have been in the housing market for nine and a half years to fund a deposit on their next purchase out of house price growth.

This said, there is evidence that rental affordability is becoming an issue in some markets, given recent rental growth and the pressure on household incomes given the weak economic recovery. Rightmove reported that 30% of tenants in the private rented sector spend more than half of their take home pay on rent, a figure that rises to 36% in the South East. Here, as well as in London, the average rent as a percentage of take home pay is up at 40%.

Furthermore, despite the ongoing constraints on buy-to-let mortgage finance, the RICS rental survey indicates that more rental stock is finding its way on to the rental market, as cash rich investors focus their attention on bricks and mortar.

That indicates a narrowing in the mismatch between supply and demand, that according to the RICS has reduced some of the upward pressure on rents.

This said, our work on Rental Britain suggests that to match rental demand, some £200billion will need to be invested in the private rented sector

TABLE 2

HOUSE PRICES Five-year forecast values

Forecasts	2012	2013	2014	2015	2016
UK	3.0%	3.5%	3.5%	4.5%	4.5%
Prime Central London	1.0%	5.0%	4.5%	4.5%	4.5%

Data source: Savills Research

over the next five years, as the amount paid to private sector landlords increases from £48billion per annum to £70billion per annum.

Investment and Taxation

The biggest issue facing the private rented sector is the need to increase supply in order to provide tenants with a greater choice of better quality accommodation that remains affordable.

The recent report by the Joseph Rowntree Foundation 'Housing Options for Young People in 2020' identified the implications of failing to do so. It also identified the need to provide financial carrots, including tax incentives, as opposed to regulatory sticks to increase the supply of stable, long-term rental accommodation.

Though the prime and mainstream markets are in many ways poles apart, the impact of the taxation is equally important in the prime markets of Central London.

Within the prime markets changes to the stamp duty regime have increased the barriers to potential investors in the Central London market, given both an increase in the 'standard' rate of stamp duty for properties purchased for in excess of £2million and the 'higher' 15% rate of stamp duty applicable to purchases by so called 'non-natural persons'.

In its current form the higher rate of stamp duty would put investment funds and some of London's Landed estates at a disadvantage to the rest of the market, whilst the proposed annual charge would impinge on net income yields that are critical to the investment credentials in this sector.

The recently published Treasury consultation paper "Ensuring the fair taxation of residential property transactions" opens the door for additions to the exemptions to those charges.

It is essential that such amendments are made to ensure that the measures are, as intended, "more precisely targeted at those circumstances where tax avoidance may be a significant factor", particularly where "assets are held for personal use despite being held within a corporate envelope".

The amendments are also crucial to ensuring demand from overseas tenants employed in the financial sector of the economy is met within Central London.

Accordingly, as the deadline of the 23rd August looms, we expect that those affected will be concentrating their efforts on finding ways in which they can be excluded from the provisions without leaving opportunities for ongoing tax avoidance.

OUTLOOK

The market in 2012

- Prime markets for family housing are not driven by the same factors as the bulk of the market. Our research shows that an inability to buy is rarely a reason behind renting, accounting for just 8% of tenant demand in 2011. The main driver is relocation through employment (51%), supplemented by demand (25% of tenants) from those who have made a conscious decision not to buy.

- In the prime rental markets of London the outlook for the market is strongest over the next five years. However, we expect growth in Central London to slow over the period of the next year as demand is closely linked to the outlook for employment in the financial and business services sector.

- Supply of rental property is the other major consideration. A lack of new build activity will have an impact in some London and South East markets, though this effect will be tempered by the increased buying activity from overseas investors over the recent past.

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