Spotlight
Prime Rental Market

January 2016

SUMMARY

Examining the impact of tax policy on the rental market

■ Rental values in 2015 increased marginally in both prime London and the prime commuter belt.

■ The recent changes to the tax relief for buy-to-let mortgages and the additional stamp duty may push investor demand towards smaller, less expensive units in locations that deliver higher yields.

■ However, in the prime markets income returns are a secondary objective for many investors.

FIGURE 1
Prime London figures for December 2015

	1 bed	2 bed	3 bed	4 bed	5 bed+
Annual Rental Growth	+3.0%	+2.1%	+2.6%	+0.1%	-0.7%
Gross Income Yield	3.8%	3.4%	3.2%	3.1%	2.9%
Capital Value Growth	+1.7%	+0.9%	-0.1%	+0.3%	-0.2%

Source: Savills Research

FIGURE 2

2015 Scenario

Assumptions	East of City, 1 bed	South West London, 3 bed	Central London, 4 bed
Purchase Price	**£600,000**	**£1,200,000**	**£5,100,000**
Normal SDLT	£20,000	£63,750	£525,750
Additional SDLT @ 3.0%	N/A	N/A	N/A
Fees etc @ say 1.5%	£9,000	£18,000	£76,500
Total Purchase Cost	**£629,000**	**£1,281,750**	**£5,702,250**
Mortgage % of Purchase Cost	**40%**	**40%**	**40%**
Gross Income Yield	**4.2%**	**3.7%**	**3.0%**
The Maths			
Gross Rental Value per annum	£25,200	£44,400	£153,000
Repairs Management & Insurance @ 25%	-£6,300	-£11,100	-£38,250
Tax at Marginal Rate of 45% say	-£8,505	-£14,985	-£51,638
Interest @ 2.5%	-£6,290	-£12,818	-£57,023
Tax relief @ 45% currently	£2,831	£5,768	£25,660
Net Surplus Income after borrowing	**£6,936**	**£11,265**	**£31,750**
As a % of Gross Income	28%	25%	21%

Source: Savills Research

2015 Prime Rents and Investment Returns

In 2015, rents across prime London's housing market rose by just 1.3% on average, while those for prime property in the commuter zone increased marginally by 0.6%.

In London this reflects relatively high levels of supply coming into the market, not just from investment buyers of an increasing volume of new build stock but also from the re-emergence of accidental landlords, who reflect a more heavily taxed and generally less active sales market.

Behind these headlines a number of submarket trends seen in previous years continued.

In the prime housing markets of the commuter zone, rental values of prime properties in urban locations performed much more strongly than those in other locations, showing annual rental growth of 3.1%.

In London smaller properties were by far the best performers. For example, while rents for 1 bedroom homes rose by 3.0% in the year, those for 4 bedroom houses barely increased at all rising by just 0.1% on average.

From an investment perspective, this meant smaller, less expensive properties clearly delivered the best returns. In addition to stronger rental growth, they offered better income yields and capital values proved more robust given less exposure to higher rates of stamp duty.

> "The use of a mortgage in the prime markets is often discretionary"

Impending Tax Policy

The impact of tax policy on the rental market has undoubtedly become a very hot topic, given the Government's desire to use taxation as a means of levelling the playing field between first time buyers and buy-to-let investors. This has taken two forms, firstly the progressive restriction of tax relief on mortgage interest payments (meaning that by the 2020-21 tax year, only basic rate tax relief will be given to private individuals) and more recently the imposition of a 3% stamp duty surcharge on the acquisition of so called "additional homes", the purchase of which completes after 1 April 2016.

Quantifying the Impact
2015 Scenario

The impact of the tax changes is perhaps best illustrated by some worked examples. In Figure 2 we have looked at the economics behind the purchase of three different prime London properties in 2015 – a one bedroom flat in the east of City market, a three bedroom house in south west London and a four bedroom house in central London.

In each case we have assumed that 60% of the total purchase cost (including stamp duty and miscellaneous additional costs of purchase) is funded by cash and 40% by debt.

At current interest rates, with full tax relief on the corresponding interest payments each makes a reasonable cash surplus for a private investor. That

FIGURE 3

2020 Scenario

Assumptions for the same property acquired in 2020	East of City, 1 bed	South West London, 3 bed	Central London, 4 bed
Purchase Price	**£709,000**	**£1,418,000**	**£6,197,000**
Normal SDLT	£24,450	£85,550	£657,390
Additional SDLT @ 3.0%	£21,270	£42,540	£185,910
Fees etc @ say 1.5%	£10,635	£21,270	£92,955
Total Purchase Cost	**£765,355**	**£1,567,360**	**£7,133,255**
Mortgage % of Purchase Cost	**40%**	**40%**	**40%**
Gross Income Yield	**4.0%**	**3.5%**	**2.8%**
The Maths			
Gross Rental Value per annum	£28,500	£50,200	£173,000
Repairs Management & Insurance @ 25%	-£7,125	-£12,550	-£43,250
Tax at Marginal Rate of 45% say	-£9,619	-£16,943	-£58,388
Interest @ 4.5%	-£13,776	-£28,212	-£128,399
Tax Relief @ 20% in 2020	£2,755	£5,642	£25,680
Net Surplus Income after borrowing	**£735**	**-£1,862**	**-£31,356**
As a % of Gross Income	3%	-4.%	-18%

Source: Savills Research

surplus varies between 21% of gross rent (for the most expensive property in central London that has the highest stamp duty liability and delivers the lowest income return) and 28% of gross rent (for the smallest, highest yielding property in the east of City market that carries the lowest stamp duty liability).

2020 Scenario

In 2020, we expect the cost of mortgage debt to have risen (we have assumed a 4.5% mortgage interest rate) and income yields to have fallen (because we expect price growth to exceed rental value growth in the next five years). Both of these factors would suppress the rental cash surplus deliverable from the same properties.

The pressure on returns is compounded by the additional stamp duty on the acquisition of the property effective from 1 April (which slightly increases the reliance on mortgage debt) and, more significantly so, by the reduced tax relief on interest payments.

The combined effect of all of these factors is that only the one bedroom flat in the east of City delivers a cash surplus where 40% of the costs of purchase are funded by a mortgage making landlords reliant on capital growth for their returns. Across the other two examples the loss varies from 4% of gross rental income in the case of the south west London property to 18% of gross rent of the much larger central London property.

Our analysis indicates that to operate on a break-even basis in 2020 it would be necessary to use cash to fund 72% of the total acquisition costs of the central London property, a figure that falls to 57% in respect of the east of City property. However, if just 20% debt is used to fund the total acquisition costs, the figures are more positive (Figure 4).

For those holding the investment property from 2015 to 2020, we are forecasting an increase in house prices of 21.5% in prime central London and 18.2% in other prime London locations, which means the value of the properties will increase as shown in Figure 5.

FIGURE 4

2020 Scenario if 20% debt is used

	East of City, 1 bed	South West London, 3 bed	Central London, 4 bed
Net Surplus Income after borrowing	**£6,246**	**£9,423**	**£20,003**
As a % of gross income	22%	19%	12%

Source: Savills Research

FIGURE 5

Forecast price increases for 2016-2020

	East of City, 1 bed	South West London, 3 bed	Central London, 4 bed
Capital value growth	**£109,000**	**£218,000**	**£1,097,000**

Source: Savills Research

Implications

These changes are likely to limit the ability of debt backed investors to add to their portfolio of residential investment property, particularly in the relatively low yielding prime markets. This may temper the demand for investment stock in prime locations and consequently the level of prime supply brought to the rental market, particularly given that it comes after successive increases to the underlying rate of stamp duty for high value property.

It may also continue to push investor demand towards smaller, less expensive units in locations that deliver higher yields, so that investors who need a mortgage to fund their purchase rely less on debt and are better able to cover the mortgage costs which they do take on.

It will require others to look at ways to improve the performance of their existing stock rather than expanding their portfolios.

Though some prime landlords will undoubtedly reorganise their finances, we do not believe we will see significant levels of prime investment stock brought to the second hand sales market given the predominance of cash investment and the largely discretionary use of mortgage debt for many purchases. For many investors in prime London markets, income returns remain a secondary objective behind the overriding desire to find a relatively safe store of housing wealth.

As we have explored in our recent Policy Response document regarding "additional homes", some of the technical provisions concerning the owner's ability to recover 3% stamp duty on a home they fail to sell before buying new main residence may deter people from becoming accidental landlords and add to short-term tenant demand if they sell and then rent as they search for their next home.

Together we expect these impacts to underpin our existing rental growth forecasts, even if opportunities for investors may be more limited.

> "For many investors in prime London, income returns are a secondary objective"

FIGURE 6

Prime rental markets: Five-year forecast values

	2016	2017	2018	2019	2020	5-year
Prime London	2.0%	2.0%	2.5%	3.0%	3.0%	13.1%
Prime Commuter Zone	2.0%	2.0%	2.5%	2.5%	2.5%	12.0%

Source: Savills Research NB: These forecasts apply to average rents in the second hand market. New build rental values may not move at the same rate

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