savills

Spotlight
Prime Rental Markets

July 2015

SUMMARY

Over the past year, prime rents rose by 1.5% in London and 2.4% in the commuter zone

- Rental growth across prime London has been restricted by the level of new stock being brought to the rental market by investment buyers of both existing and newly developed properties.
- Over the next five years we expect the strengthening London economy and expansion of sectors such as technology and telecommunications to underpin demand for prime rental property.
- The changes to the tax relief on buy-to-let mortgages announced in the July 2015 Budget may lead to mortgaged investors looking for higher yielding sectors of the market and the lower yielding prime sectors being dominated by equity rich investors.

FIGURE 1

Prime rental movements to Q2 2015

	Prime Central London	Prime North West	Prime South West	Prime West	Prime North and East	All Prime London	Prime Commuter Zone
Q on Q	0.4%	1.4%	-0.1%	1.2%	1.1%	0.5%	1.6%
Y on Y	0.6%	-0.4%	1.7%	0.0%	4.9%	1.5%	2.4%
5 Year	11.8%	-2.6%	9.5%	n/a	18.8%	7.7%	10.5%
£ per sq ft	£59	£44	£28	£31	£35	£41	£17

Source: Savills Research

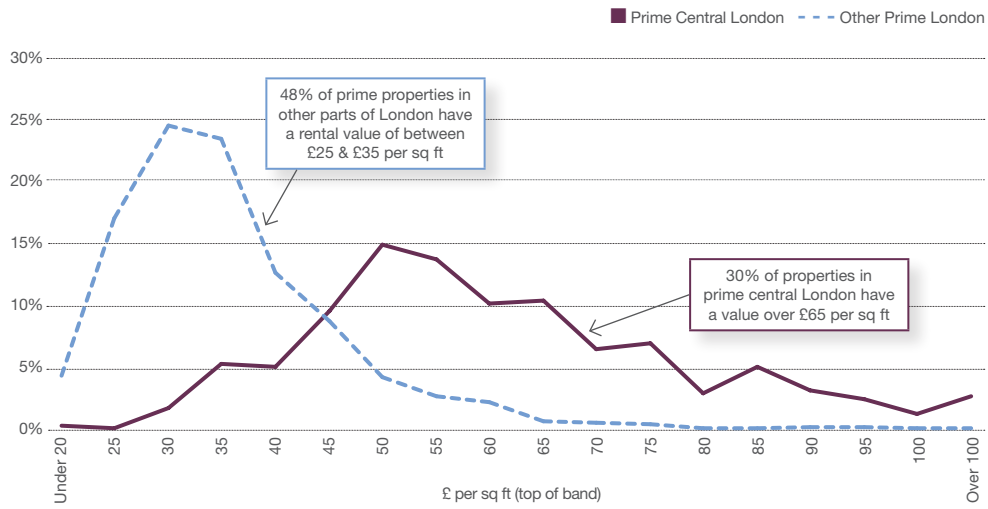
Prime London Rents

Rental growth remained subdued in the second quarter of 2015 in the prime residential markets of London. Average rents rose by just 0.5%, leaving annual growth at 1.5%.

This means that over the past five years rental growth in the prime London market has struggled to keep up with the underlying rate of inflation. While rents in the prime London housing market have risen by 7.7% over this period, the Consumer Prices Index has grown by 12.1%.

FIGURE 2

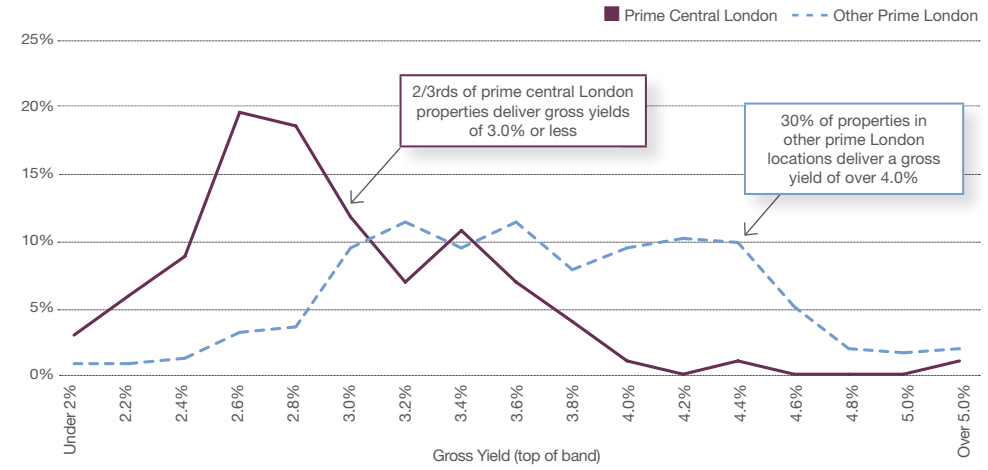
Prime London residential rental value distribution



Source: Savills Research

FIGURE 3

Prime London residential yield distribution



Source: Savills Research

Focus on Prime North and East London

Prime rents have only risen in real terms in the belt running from Canary Wharf, through Wapping and up to Islington. Here a mix of UK and international tenants, from a range of employment sectors have supported demand.

While the financial & insurance sector employment market has been subdued, these locations have been well positioned to benefit from the growth in both the information & communication and the professional scientific & technical sectors in the past ten years.

Figures from the Office for National Statistics (ONS) based on VAT and PAYE records, indicate significant new business activity in these sectors in the past years. Across the boroughs of Hackney, Tower Hamlets and Islington the number of these businesses has risen by 39% over the past five years. This has contributed to 26% growth across all business sectors, compared to just 6% across the borough of Westminster.

Competition & Supply

Across the remainder of the prime London market, rental growth has been held back by the high level of new stock being brought to the market by investment buyers of both existing and newly developed properties.

With a significant development pipeline of new stock over £1,000 per sq ft likely to provide further competition over the next five years, landlords will need to take informed decisions regarding their stock selection, the needs of their target market and how they present their property to the market to maximise their returns.

BEYOND THE CAPITAL

Rents in the prime regional markets rose by a more healthy 1.6% in the quarter to June 2015, contributing to annual growth of 2.4%. Three bedroom stock has seen the strongest annual growth, with an increase of 4.7%. City locations such as Cambridge and Winchester have fared particularly well.

By contrast, demand for the largest houses has remained subdued, with a much smaller pool of big budget tenants meaning that rents for homes of five or more beds have risen by just 1.3% over the year. As a result on average, they remain -2.8% below their 2008 peak.

Market realities

Current market conditions require landlords to consider how far rents can be stretched within a submarket and the consequences for returns and investment decisions. This is likely to mean that benchmarks such as rental value per sq ft become more important.

For example, in the context of prime central London our analysis shows that:

- Whereas rents average £59 per sq ft, that average is closer to £75 per sq ft in Belgravia, and £50 per sq ft in Marylebone and Chelsea
- Only 15% of the prime central London prime lettings market achieves rents of more than £75 per sq ft
- Those properties in an immaculate condition average £70 per sq ft while those in a moderate condition average 30% less by this measure
- Like the sales market, there is a premium for scale (albeit not as large) with rents for properties over 5,000 sq ft averaging £74 per sq ft

Figures for other areas of prime London generally indicate less capacity to stretch rents, without the same rental premium for scale, though the condition in which a property is presented remains an important driver of rental value.

Similarly, landlords are likely to pay attention to the yield fundamentals, recognising that while gross yields average just 3.25% across prime London housing, 23% of stock yields over 4.0% gross – most typically the smaller units outside of prime central London.

Mainstream Market

Historically our ability to monitor the mainstream private rental market has been shackled by a frustrating lack of data. Thankfully, as the sector grows and its importance increases to a wider group of tenants and investors, this is changing.

Statistically speaking

For example, the "Experimental Index of Private Housing Rental Prices", now being released by the ONS, tells us that rents in London have seen almost twice the level of growth as across the rest of the country over the past ten years. While rents in London have risen by 33% over that period, they have grown by 17% across the rest of England. Over the past year rents in the capital have risen by 3.2% compared to 1.5% across the remainder of the country.

We also have much better information about what this means in pounds, shillings and pence. Data collected by the Valuation Office Agency puts the median rent for a two-bedroom property in London at £16,800pa, 2.35 times the figure for England as a whole.

It also shows that by this measure all of the 25 most expensive local authorities are boroughs in London, with the median two-bedroom rent in areas such as Newham, Hounslow and Islington being higher than

FIGURE 4

Key statistics for prime two bed properties

Prime region	Av rent per sq ft	Av rent for 950 sq ft property (per week)	Av gross yield
Prime Central London	£54	£988	2.84%
Prime North West	£39	£721	3.10%
Prime North and East	£34	£617	3.90%
Prime West	£32	£590	3.78%
Prime South West	£30	£552	3.49%

Source: Savills Research

BUDGET REACTION RESTRICTING INTEREST RELIEF

To understand the potential effect of the changes to the tax relief on a buy-to-let investor it is worth looking at some potential case studies. We have taken the example of an investor buying a £500,000 investment property delivering a gross yield of 4.0% assuming that they borrow 50% of the purchase price.

In this theoretical example, a 40% tax ratepayer might have made a cash profit of around £4,125 prior to the budget, equivalent to 21% of the gross rental value.

Given anticipated rates of price and rental growth, interest rate rises and the full restriction on mortgage relief (following its phased introduction), an owner wishing to remortgage will find that this profit falls to just £1,700 or around 6% of the gross rent. Despite the capital growth and, given the risk of voids, this makes the investment look marginal in income terms.

For somebody looking to acquire the property at that date with a 50% LTV mortgage, the combined effect of restricted income tax relief and higher interest rates, could mean that it is not possible to operate on a break-even basis.

Correspondingly it seems likely that the loss of tax relief will temper the expansion of the buy-to-let sector, with mortgaged investors looking for higher yielding sectors of the market and the lower yielding prime sectors being dominated by equity rich investors with low loan-to-value requirements.

FIGURE 5

Prime rental markets: Five-year forecast values

	2015	2016	2017	2018	2019	5-year
Prime London	2.5%	3.0%	3.5%	3.5%	3.5%	17.1%
Prime Commuter Zone	2.5%	2.5%	3.0%	3.5%	3.5%	15.9%

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

the average of £14,380pa payable in Elmbridge, or the £13,800pa in Windsor & Maidenhead.

This is not to say that issues of rental affordability are confined to London. The median two-bedroom rent is above £1,000pa across each of Brighton and Hove, Oxford, Cambridge, St Albans and Guildford.

Political Pressure

These costs reflect the pressure being placed on the private rented sector, which consequently came under the political microscope in the run up to the general election.

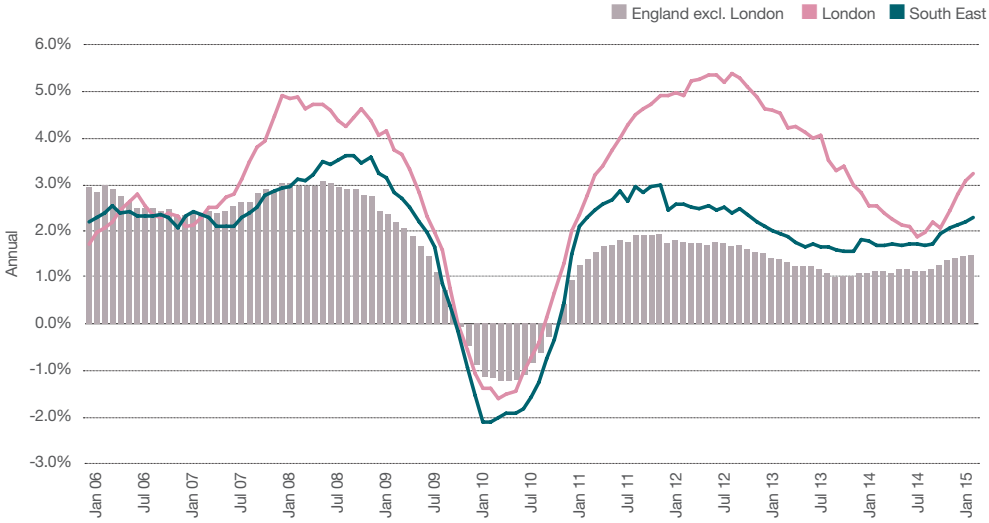
In their pre-election campaigning, the Labour party proposed longer term tenancies and controls on rent increases, highlighting the implications of the mismatch between demand and supply in the sector.

While the election result has pushed such proposals into the long grass, the issue of rental affordability is unlikely to disappear from the political agenda, when 56% of the housing costs borne by households under the age of 35 consist of rents paid to private landlords, a figure which rises to 67% in London.

Calls for buy-to-let investors and first-time buyers to be put on an even footing have already led to a tempering of tax relief on landlords' costs of borrowing, as announced in the July 2015 Budget. Yet, given the underlying backdrop, such measures are unlikely to reverse the growing demand for private rented accommodation, nor are they likely to increase the supply of much-needed, good quality private rented stock that is crucial to meeting this demand.

FIGURE 6

Mainstream rental growth



10 year change	London	South East	England (excl London)
Total	33.3%	20.9%	17.4%
Annualised	2.9%	1.9%	1.6%

Source: Savills Research

16.8k

Median rent of two-bedroom property in London per annum

Savills Research Team

Residential Research

Lucian Cook
UK Residential
020 7016 3837
lcook@savills.com
Twitter: @LucianCook

Sophie Chick
Associate Director
020 7016 3786
schick@savills.com

Kirsty Lemond
Associate
020 7016 3836
klemond@savills.com

Savills Lettings

Jane Cronwright-Brown
Head of Lettings
020 7824 9048
jingram@savills.com

Savills plc
Savills is a leading global real estate service provider listed on the London Stock Exchange. The company established in 1855, has a rich heritage with unrivalled growth. It is a company that leads rather than follows, and now has over 200 offices and associates throughout the Americas, Europe, Asia Pacific, Africa and the Middle East.