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Savills World Research
UK Residential
28th July 2016

THE IMPACT ON THE RENTAL MARKET
Brexit Briefing

BREXIT BRIEFING

BALANCING ACT
How the Brexit vote will change supply and demand in the mainstream and prime rental markets

SUMMARY

Taxation, economic prospects and interaction with the sales market will be key drivers

■ In the mainstream market, we expect uncertainty following the Brexit vote will impact buyers' willingness to commit to a purchase, potentially resulting in a fall in transaction numbers and acting as a drag on house price growth. As a result, we expect to see demand pushed into the private rented sector.

■ If, in the economic uncertainty following Brexit, mortgage lenders tighten their criteria on loan to value and loan to income ratios, people will find it harder to access the market, keeping them in the private rented sector for longer.

■ On the supply side, we believe a less hospitable tax environment is likely to curtail investment buying activity. However, this will probably be offset by a rise in accidental landlords in the short term. Despite an imbalance between supply and demand, rental growth may be held back by wage growth.

■ In the prime market, high levels of new supply have limited rental growth, particularly in London. The market is more exposed to uncertainty regarding the prospects for the financial and business services sector.

■ That means landlords will need to remain competitive on asking rent and flexible on terms, as well as ensuring the property is presented in good condition.

"We expect lower investment buying activity to be offset by an increase in accidental landlords"

Lucian Cook, Savills Research

MAINSTREAM

Q What was happening in the rental market prior to the EU referendum?

A According to the English Housing Survey we have seen an increase of 1.98 million households in the private rented sector (PRS) over the last decade. Despite undoubtedly changed attitudes towards renting, this primarily reflects constraints on access to home ownership and a fall in the number of mortgaged owner occupied households of 1.47 million.

As such, demand for the PRS has outstripped supply in the mainstream rental market, despite the growth in the buy-to-let sector.

Consequently, in the five years prior to the EU referendum, we have seen consistent rental growth of 1% to 2% per annum across the country as a whole, according to the ONS.

Given the strength of the economy and the housing pressures in the capital, the rental market in London has unsurprisingly outperformed the rest of the country. This said, rental growth within the capital has been slowing since August 2015, with the highest annual rental growth now being seen in the South East.

Q What has been the impact of the increase in stamp duty for additional homes for investors?

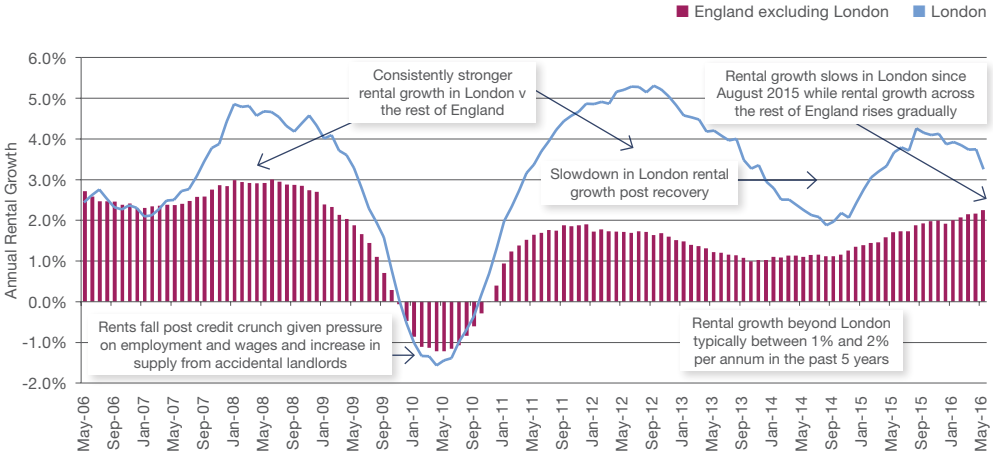
A The rush to exchange before the 1st April 2016 stamp duty deadline resulted in heavily distorted transaction levels across the UK, with an increase of 64% in the number of transactions in March when compared to February. However, transactions after the deadline have been more subdued – reflecting both the stamp duty increases and, to a lesser extent, uncertainty in the run up to the EU referendum.

The number of buy-to-let mortgages captures the effect this has had on investor sentiment among those with recourse to debt.

Over the 12 months to February 2016, this number was on average just over 10,000 per month, and within March of this year it shot up to 28,700 before falling to just over 4,000 in each of the following months of April and May.

FIGURE 1

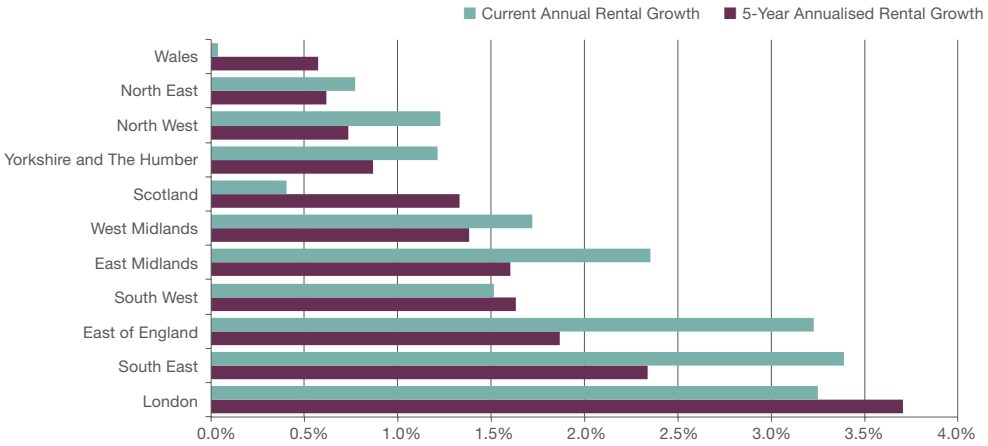
Annual Mainstream Rental Growth



Source: ONS Experimental Index

FIGURE 2

Mainstream Rental Growth by Region



Source: ONS Experimental Index

This indicates a greater caution among mortgaged landlords compared to cash investors since the period after the introduction of stamp duty and prior to the referendum.

Q So, what is the likely impact of Brexit for the UK housing market?

A The initial after-effect will be on buyer sentiment, which is likely to weaken buyers' resolve to commit to a purchase. In itself this will potentially result in an initial drop in transaction numbers and a drag on house price growth.

Longer term transactions depend on longer term economic consequences and the banks' willingness to lend.

There may be a squeeze on buyers' affordability from reduced wage growth and higher inflation, though this will be offset by the continuation of a low interest rate environment.

While the Bank of England has already agreed to encourage lending by easing capital requirements for banks (potentially freeing up £150 billion), we believe mortgage lenders may therefore take a more cautious approach to lending by tightening their loan to value and loan to income ratios among mortgaged owner occupiers.

Accordingly, there is a chance that first time buyers and others on the lower rungs of the housing ladder will find it increasingly difficult to access the market, especially in London.

Q What does this mean for rental demand?

A Initially we expect a slowing sales market to shift demand into the PRS across the board as potential buyers defer a decision to purchase and instead choose to rent.

If the lending market tightens over the medium term, this would also drive more demand into the PRS, particularly among those younger households reliant on higher loan to value or loan to income mortgages.

Q How is this likely to affect the supply of private rented stock?

A As we go forward we expect the less hospitable tax environment and the prospect of increased mortgage regulation in the buy-to-let sector to make investors more cautious about expanding their portfolios; especially given the underlying sense of caution in light of the vote to leave the EU.

However, in the short term at least, we expect to see this offset by an increase in accidental landlords as buyers choose to sit out of the sales market until greater certainty prevails, though to a lesser extent than seen in 2008.

Q What are the impacts for rents and tenants?

A All of this suggests continued upward pressure on rents. However, this is likely to be tempered by rental affordability that is expected to be constrained by reduced wage growth (which itself results from a weaker economic outlook). Accordingly, we expect to see further increases in house-sharing in urban markets among younger tenants because of the demand supply imbalance in the sector.

> "Upward pressure on rents will be tempered by affordability pressures in the mainstream market"
>
> **Lucian Cook, Savills Research**

MORE ON BREXIT: We have published further reports on specific topics including Mainstream, Prime and Development Markets.

FIGURE 3

5 Key Messages: Mainstream Market

Source: Savills Research

PRIME

Q How has rental growth in the prime rental market differed from the mainstream in the period prior to the referendum?

A In the five years prior to the EU referendum, the prime London market has seen marginal rental growth of just 0.3%, with rents falling by -1.9% in the 12 months before the Brexit vote.

This is primarily a result of high levels of investment buying activity, which has brought significant supply to the rental market, which levels of demand cannot currently match.

In the prime commuter zone market, rental growth has been more consistent, totalling 7.5% over the same five-year period. This said, during the 12 months before the referendum the market saw more subdued rental growth of only 0.8%.

Across both markets we have seen smaller properties continue to perform the most strongly, given a seam of needs-based demand, with a smaller pool of potential tenants for larger properties.

Q What are likely short-term impacts of Brexit on the prime rental market?

A Similar to the mainstream rental market, buyers' caution is expected to push demand into the rental market in the short term.

However, this could be more amplified than in the mainstream market, given the impact of higher stamp duty and concerns over job security in the financial and business services on peoples' willingness to commit to a purchase.

On the supply side this is likely to be offset by a rise in accidental landlords and, in the capital, opportunistic overseas investors seeking to make a currency play.

Therefore, we expect the rental market to remain price sensitive.

Q And in the longer term?

A Long term impacts on the prime rental market will be dependent upon the economic consequences of Brexit, most importantly on financial and business services.

Tenants in the financial sector currently account for approximately a third of the prime rental market in London, though this proportion has been steadily decreasing over the last 10 years as more diverse sectors such as Tech, Media & Telecommunications are attracted to the capital.

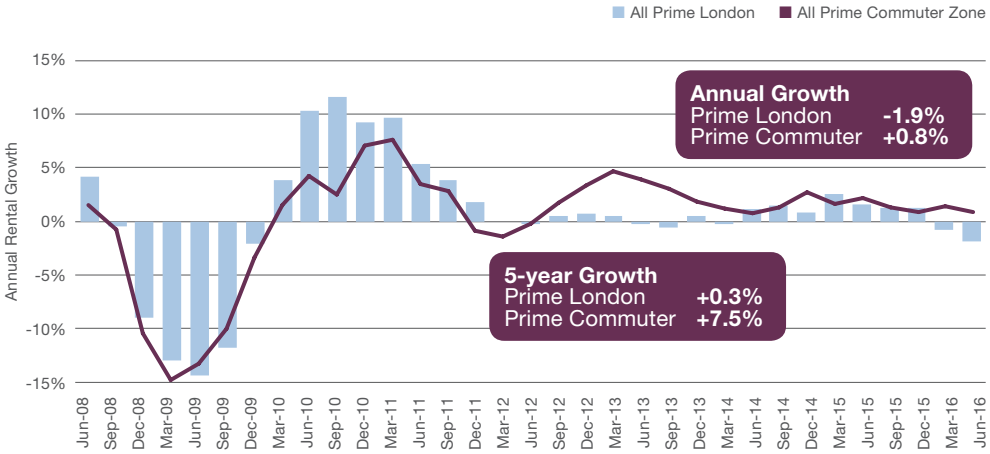
Oxford Economics forecast a drop in the number of employees in the UK finance sector over the next few years, which may impinge on corporate relocation demand, especially in the mid-market.

We expect the financial markets to settle over the summer of 2016 with the realisation that the economic issues are essentially local, not global. However, the largest unknown is the extent to which financial institutions will need to relocate some of their activities to continue to trade across the EU. In this respect, much depends on the timing and success of negotiations with the EU, though we expect the Government to be highly motivated in protecting London's position on the global business stage.

The underlying uncertainty is expected to temper rental growth prospects, with tenants more budget conscious. Those tenants are also likely to be offered more choice, particularly given the high development pipeline in London and the potential for some of

FIGURE 4

Prime Annual Rental Growth



Source: Savills Research

FIGURE 5

Annual Rental Growth by Bedroom Number

Source: Savills Research

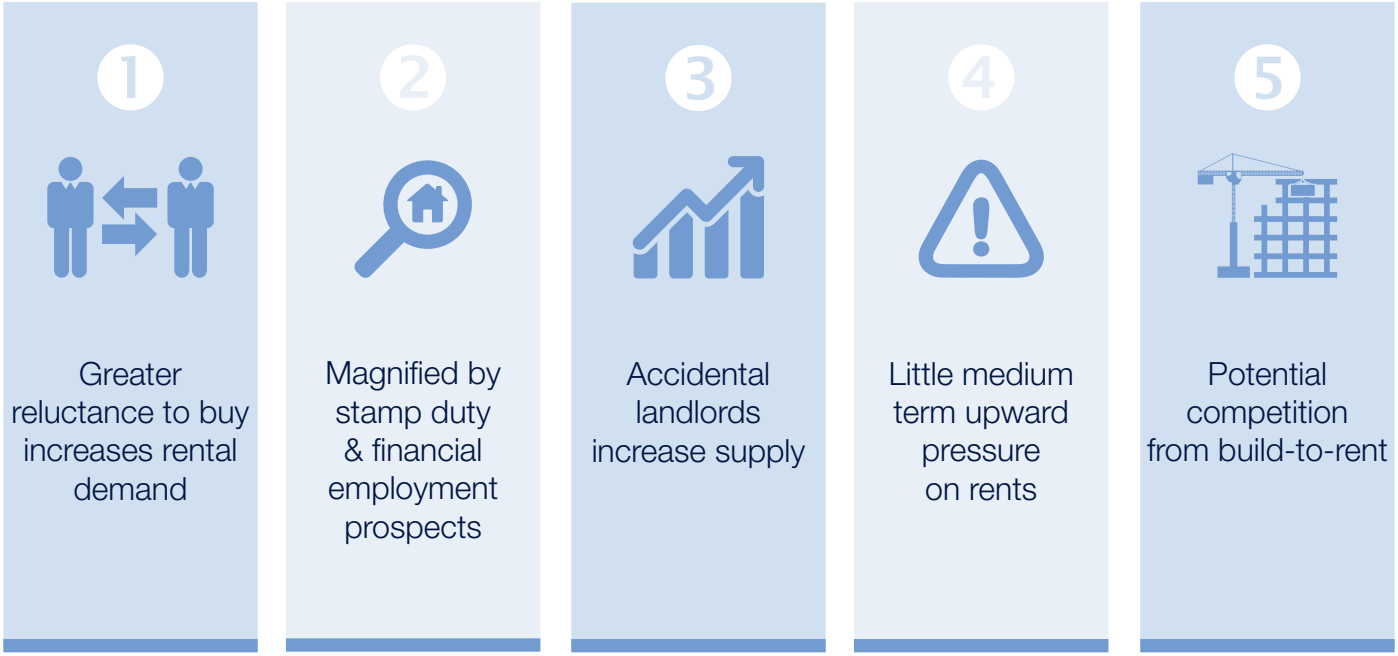
the new build stock to be re-directed to large scale institutional investors as managed rental stock.

Overall, we expect a flight to quality in the more expensive markets, while a more diverse demand profile for smaller property is likely to mean demand is less affected. Beyond London, we expect locations that have good commuter links will remain popular with families and young professionals.

Landlords will need to remain competitive on asking rent and flexible on terms, as well as ensuring the property is presented in good condition, to ensure they attract both mainstream and prime tenants in the long term.

FIGURE 6

5 Key Messages: Prime Market



Source: Savills Research

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