Spotlight on…

The prime rental market

Over-supply in the prime rental markets is a short term issue that will recede once the sales market recovers

"We are already starting to see properties switch back from the rental to the sales market as interest in the prime residential sales market picks up from equity rich and foreign buyers. This will help stabilise rental levels during 2010, followed by significant rental growth in 2011."
Lucian Cook
Director, Savills Research

Mortgage restrictions boost rental demand

In 2008, the UK housing market saw a sharp downward adjustment in capital values, with prices falling by -18% from their 2007 peak. The withdrawal of mortgage finance has been a significant factor in house price falls, but conversely resulted in more activity in the rental market; as renting became preferential for many house movers.

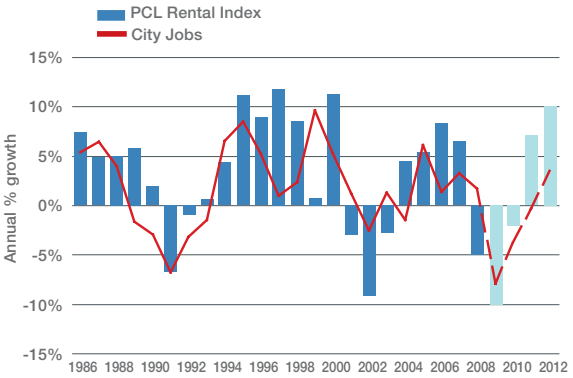
Now firmly into 2009, the economy is officially in recession, with unemployment rising. It is therefore not surprising that against the context of an increased amount of property available to rent, average rents across the UK have fallen by -6.2% according to findaproperty.com index.

Rental values in the prime market of Central London (PCL) and the South East have seen more significant falls over the last three quarters. Prime London witnessed falls of -4.4% bringing total falls to -11.7% since June 2008. Rents have been hit hardest in areas that are reliant on the City's financial market.

Although the most recent data shows that the rate at which prime central London residential rents are falling has slowed marginally, they continued to decline in the first quarter of 2009. We expect further rental decline as total employment in the City is expected to reduce by 10% by the end of the recession.

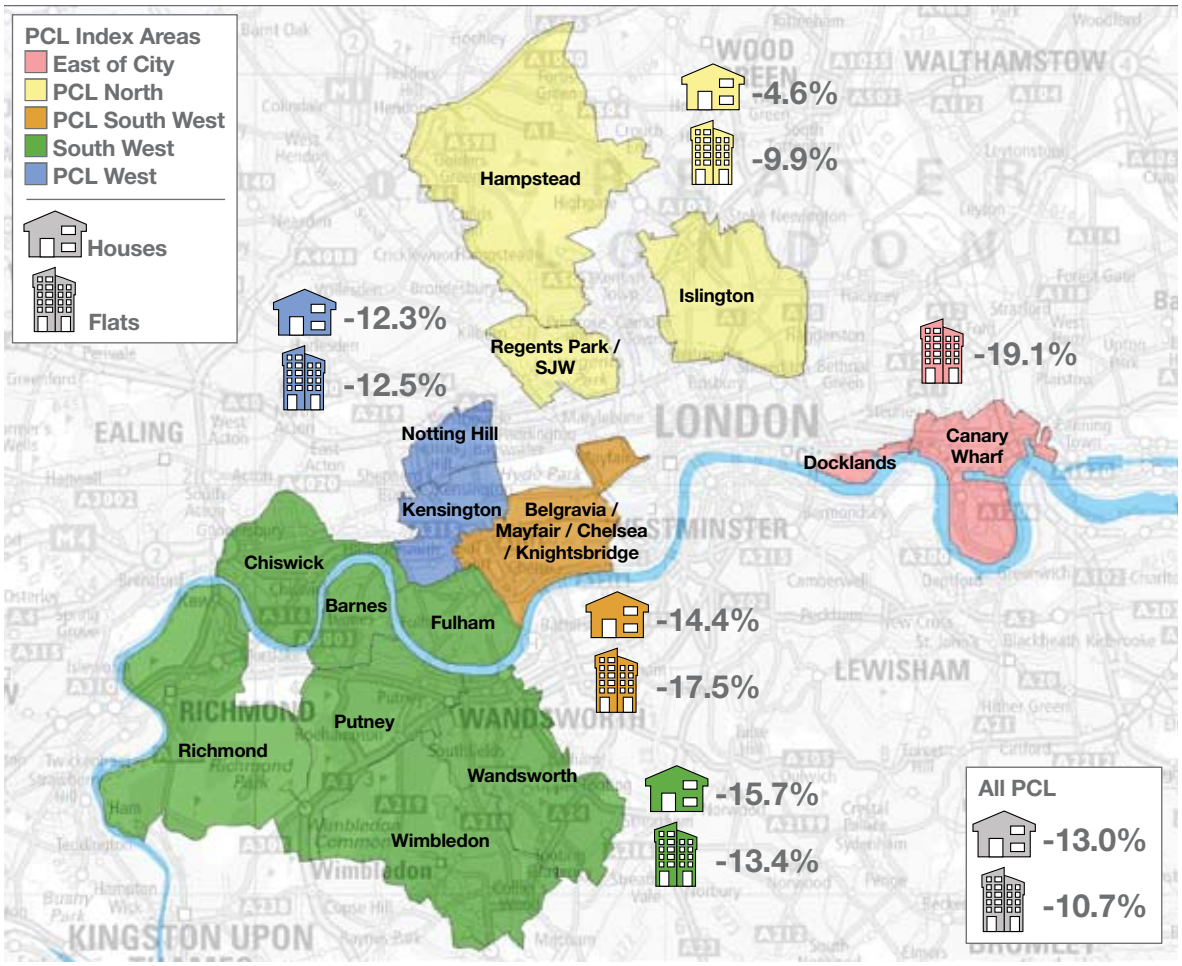
Demand within the relatively small top end rental market outside of London, has had particular difficulty in absorbing the significant increase in the amount of property available to rent from so called 'accidental landlords' – namely vendors who have become frustrated and turned to the rental market, as they are unable to sell, or unwilling to take a discounted sale value. The South East has witnessed price falls of -24.2% since March 2008 in the prime markets.

Graph 1
Unemployment vs rental growth in London



Source: Savills, Oxford Economics, Experian

Map 1
Prime Central London falls from peak for flats and houses



Source: Savills Research

Prime rental markets

Prime rental values initially suffered during this housing market downturn because the supply of properties available to rent increased sharply. Primelocation.com reported that stock levels increased by 128% in prime central London in the twelve months to March 2009. With such choice available to tenants, minimising void periods has become a priority for most landlords of prime property. This has led to many accepting lower rental values on both renewals and new agreements.

Similarly, existing tenants have become increasingly discerning, either looking to secure a more competitive rent in their present accommodation or looking for better quality accommodation at lower rental levels on the open market.

In the last three months of 2008, in the immediate aftermath of Lehman Brothers, prime rental markets in central London saw their greatest quarterly fall of -6.4%. The fall out from the financial crisis had a pronounced effect on the 'corporate' letting market, which deteriorated rapidly to compound the increased levels of stock available to rent.

The extent to which rental values have been hit disproportionately in markets most dependant on corporate demand is reflected by rental falls for houses in prime South West London (Putney, Barnes, Fulham, Wandsworth, Richmond). Such properties are typically rented by corporate families and have seen rental values fall by -15.7% from March 2008. The Docklands and Canary Wharf market, also heavily dominated by city renters – albeit more often single person households and young couples rather than families – has seen value falls of as much as 20% from their 2007 peak.

> "With such choice available to tenants, minimising void periods has become a priority for most landlords of prime property"

The lack of rental demand from corporates has caused a noticeable shift in the profile of tenant demand. Private individuals, who generally have lower budgets, are accounting for a higher proportion of demand as evidenced by RICS lettings survey.

Corporate renters who have remained in the market may have been forced to downsize, shifting demand into the lower tiers of the prime market and supporting rents in this sector. It is therefore unsurprising to see that flats in

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Current trends in the mainstream rental market

Like the prime markets, the mainstream rental market has suffered from weakening capital values which has devalued landlords' existing portfolios. However, compared to other asset classes and investments, residential investment property has held up much better during 2009. Commercial real estate saw negative returns of -22.1% and -29.9% for equities, whereas the negative returns on residential investments was -11.8%.

Although landlords' portfolios have decreased in value on paper, the mainstream market has fared relatively well during the credit crisis and ensuing recession. In Outer London, South East and South West, void rates fell from their 2007 level. Combined with relatively robust mainstream rents and cuts in interest rates this has allowed many investors to enjoy an improved cash position.

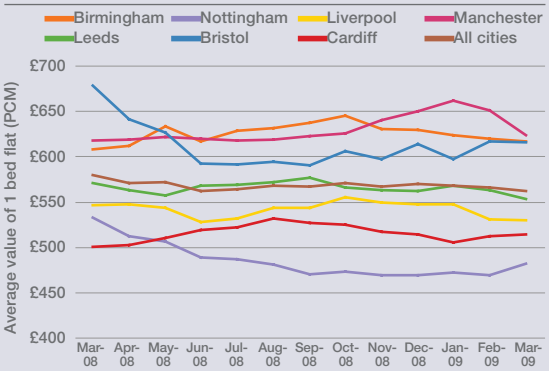
Prior to the downturn in the housing market city centre flat developments, in locations such as Manchester and Leeds, attracted significant investor demand, which brought large volumes of new stock to the rental market. This suppressed rents when other markets were seeing consistent rental growth.

Such developments significantly slowed during the downturn. This in turn has reduced the new stock brought to these rental markets and resulted in relative stability in the rental levels. As a result average rents have been relatively stable through 2008, as shown in the graph below.

Graph 2
Average void rates fall outside Prime markets

Source: IPD

Graph 3
Asking rents remain stable in regional city centres

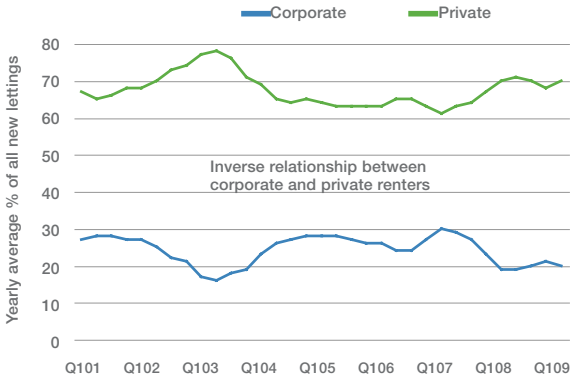


Source: Findaproperty, Savills Research

the Northern area of the prime London area (St Johns Wood, Regents Park, Hampstead) have remained relatively robust, witnessing rental falls of just -4.6% since the peak.

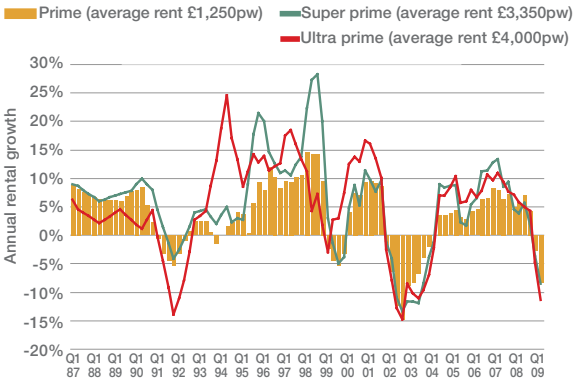
The increased cost of deposits and tightening LTV ratios in the mainstream sales market, has resulted in continued demand for rented accommodation which has limited the falls in rental values despite the economic backdrop. For similar reasons, the lower tier of the prime rental market has benefited from much greater demand from "would be first-time buyers", with stronger interest from young professionals than would normally be the case.

Graph 4
Type of tenant demand in London



Source: RICS

Graph 5
Annual rental PCL



Source: Savills Research

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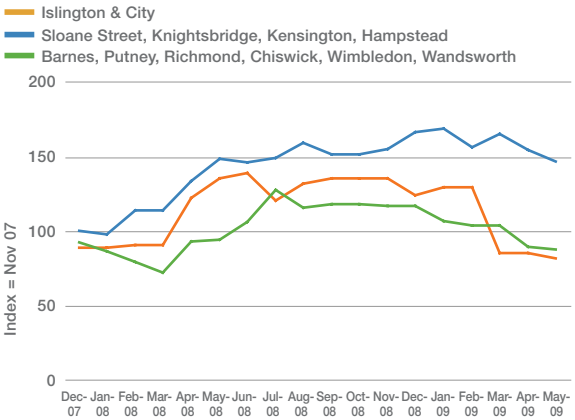
Recovery and outlook

The key to the first stage of recovery in both the mainstream and prime rental markets will be a reduction in the number of units available to rent, as homeowners become increasingly comfortable with remarketing their property for sale.

In the sales market, the last few months have brought with them growing buyer interest, reflected by the number of new applicants registering and increases in both the number of property viewings and bids per property. Units have begun moving back into the sales market, as a result of which there have been signs of falling stock levels in the rental market. Nonetheless, in the short term they are expected to remain high in a historical context.

While we expect mainstream rents to stabilise, higher stock levels will dampen prospects of rental growth, irrespective of continued demand from would-be buyers who continue to have difficulties meeting banks' tightened lending criteria. Reduced graduate intake amongst employers is also likely to dampen demand.

Graph 6
Stock levels starting to fall in prime Central London



Source: Savills Research

> "Units have begun moving back into the sales market, as a result of which there have been signs of falling stock levels in the rental market"

Accordingly a more sustained recovery leading to rental growth, is dependent on an improvement in the outlook for the economy which is still some way off, suggesting little prospect of rental growth before 2011.

In the prime markets, rental recovery will be heavily dependent on employment prospects in the financial and business sector. In the first half of 2008, tenants working in the financial and business sectors accounted for 47% of the rental market in prime central London (Savills data only); a figure which reduced to 39% in the second half of the year. Early indicators are that numbers have improved in the first quarter of the year, although the extent to which this continues remains uncertain.

Given the continued fall out from the present financial crisis, we expect the indices to show falling rents for at least two further quarters. This is expected to result in total falls of -10% over the year and a total peak to trough fall of -17%. ■

Savills rental forecasts

Year	PCL	UK
2009	-10%	0%
2010	-2%	1%
2011	7%	7%

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