Spotlight on…

The prime rental market

Increased activity among buyers in prime markets has seen a reduction in the number of properties to let and a stabilisation of rental values

"The return of growth in prime rents has come at a time when activity in the sales market has increased dramatically, rapidly eroding the surplus stock as some accidental landlords have chosen to sell."
Lucian Cook
Director, Savills Research

Over the past two years the sales and lettings markets have become closely interrelated. While the economic fundamentals remained largely unchanged, there has recently been a noticeable and important change in sentiment among buyers. This was particularly apparent in the prime markets of London and the south east, during the second quarter of 2009, where increased confidence continued and led to strong transactional activity in the late summer and autumn markets.

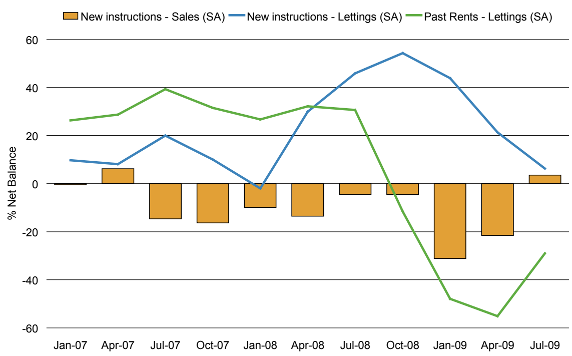
This has, in turn, led to stock levels in the rental market falling as vendors who turned to the lettings market during the downturn have been able to instruct their property for sale again. The consequential reduction in the number of properties available to rent has seen rental values stabilise for the first time in 12 months.

In the prime markets, the effect of the reduction in the number of properties to let due to the withdrawal of the 'accidental landlord' has been compounded by the high number of existing tenants renewing their contract. Savills has reported that 80% of existing tenants have renewed their contract this quarter, which is some 20% higher than at this time last year.

Although buy-to-let loans within the UK are still in limited supply, a return to rental growth is likely to boost investor demand in the prime London markets, not least from overseas investors who continue to benefit from the low value of sterling.

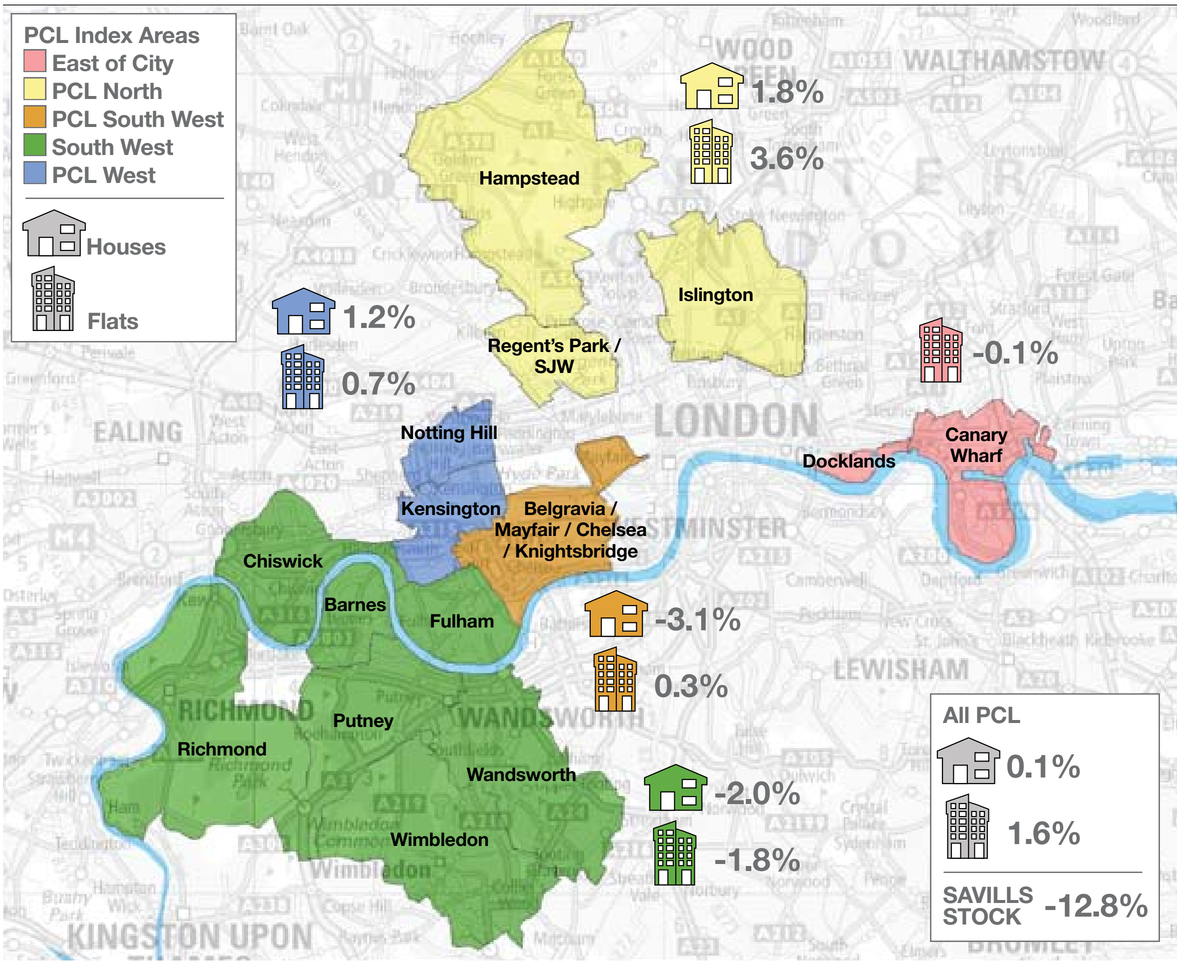
Yields continue to remain stable in the prime and mainstream markets, which combined with very low borrowing costs and the prospect of medium term capital growth makes the residential property market an attractive investment for cash rich investors.

Graph 1. Stabilisation of average rents as rental stock falls and sales stock increases



Source: RICS (Seasonally Adjusted)

Map 1.
Rental growth from June 09 – Sept 09 across prime central London



Source: Savills Research

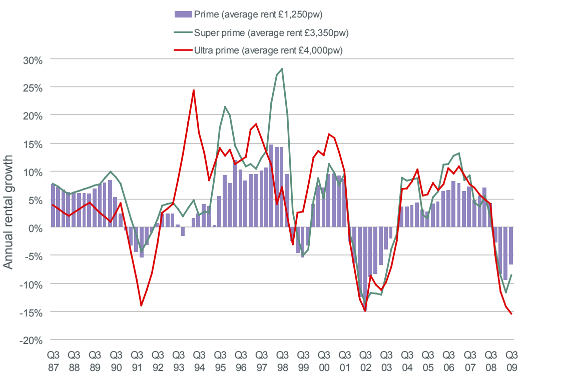
Prime central London

The prime markets of central London (PCL) saw modest growth of 1% in the third quarter of 2009. This still leaves average prime rental values -10.8% down from the market peak in June 2007.

Elsewhere rental growth in the prime markets of London has been dependent on localised market conditions, demand profiles and the number of properties to let.

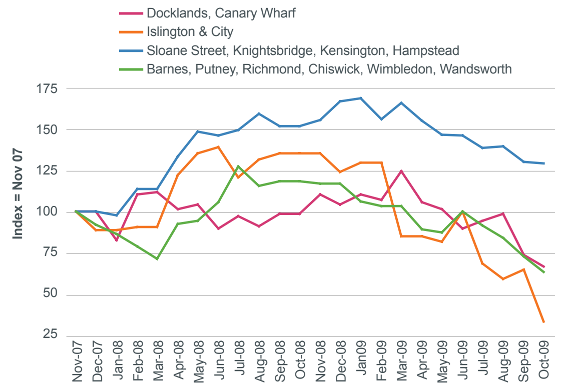
The most significant rental rises have been witnessed in Hampstead, St John's Wood and Regent's Park, where rental values of flats increased by as much as 3.9% in the quarter. This has in part been driven by the falls in the number of properties to let. For example, Savills Hampstead office reporting that stock levels have returned to nearly half the level witnessed when supply was at its peak. It also reflects a relatively diverse tenant

Graph 2. Annual rental growth in prime central London by price band



Source: Savills Research

Graph 3. Stock levels have significantly fallen in prime central London



Source: Savills Research

profile and a lesser reliance on demand from the City and financial services sector than that from other prime London markets.

Although City employment levels are showing signs of improvement, estimates prepared by Oxford Economics indicates that employment levels in the financial sectors of the City fell by -11.7% in 2008. The severity of the downturn in this sector of the economy has meant that corporate demand has remained suppressed in 2009, having a particularly significant impact at the top end of the market. Therefore, it is unsurprising to see that the house market in Belgravia, Chelsea and Knightsbridge, which is typically rented by corporate families, continued to see rental falls of -3.1% in the period from June to September.

There is still strong demand, outside of the financial sector, from younger affluent occupiers who are unable to meet mortgage deposit requirements. In addition there is also extra demand coming through from people unable to find the appropriate property on the freehold

Current trends in the mainstream rental market

Within the mainstream rental markets, there has been a similar shift in rental trends over the summer and autumn period. As in the prime markets, stability, and in some cases modest growth, in rental values is explained partly by a downward shift in supply. From January 2008 to May 2009 UK rental stock increased by 265% forcing rents down by an average of 6%, according to the findaproperty.com rental index. However, falls were greater in regional markets that were more exposed to high levels of supply.

Since May 2009 the number of properties to let has decreased by 20%, enabling rents to stabilise and, in certain high demand areas, increase over the last three months. This has been a function of both seasonal take-up of rented properties from students, graduates and other new employees and reduced levels of new rental instructions on the back of improved conditions in the sales market.

Equally, low loan-to-value ratios have prevented would-be first time buyers from purchasing, unless they have been able to make use of the so-called bank of Mum and Dad to fund current deposit requirements. In the absence of this parental assistance many potential first time buyers have been unable to obtain mortgage finance. However, even for those who are able to gain the necessary finance at loan to value ratios of in excess of the 75%, the additional cost of that mortgage finance means that renting will remain a more cost effective option.

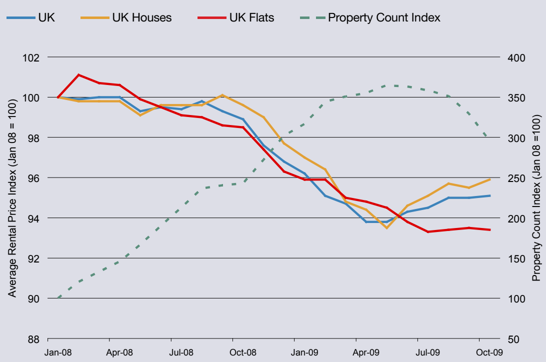
The expectation is that these loan-to-value ratios will remain low for the next 12 months or so. Thereafter, the prospect of more rigid affordability assessments, which were set out by the FSA in their recent Mortgage Market Review, will continue to underpin rental demand in the mainstream sector in the medium term.

In the short term, we expect that the unemployment overhang and continued low interest rates will temper prospects for strong rental growth in the mainstream markets, even as we emerge from recession. This, combined with the expectation that the current high levels of property available to rent will take time to come back in line with the longer term average, suggests a year of relatively low rental growth in 2010.

However, with household income growth forecast to return to historic levels of 3-4% by 2012 and the number of households projected to rise by 1 million over the same period, we believe that there are strong drivers for rental growth in the period from 2011. In all likelihood, the dip in house-building, which has resulted from both the downturn in the housing market and reduced access to development finance for large scale projects, is likely to exacerbate the upward rental pressure in this period.

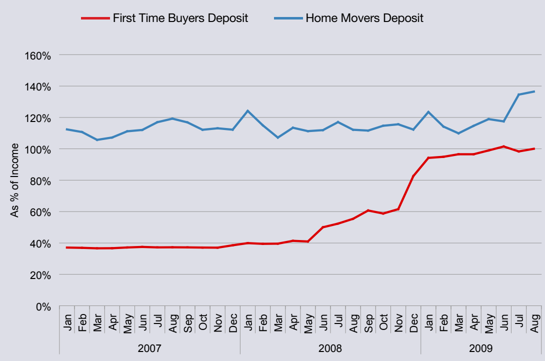
‘The additional cost of mortgage finance means that renting will remain a more cost effective option.’

Graph 4. Stabilisation of average rents as stock levels fall



Source: findaproperty.com

Graph 5. Deposit affordability remains constrained



Source: CML

market, as the number of properties available to buy remains relatively low. This has particularly been the case in Islington, where Savills applicant numbers are 30% higher than at the same time last year.

Lower down the value scale, in the east of City markets including the likes of Wapping, St Katherine's Docks, Limehouse & Shad Thames, the reliance on demand from the financial sector has meant that, despite Savills offices reporting a -21.1% fall in stock levels, no rental growth was witnessed during the third quarter of 2009 though it is the first quarter since March 2008 where prices have not fallen.

Prime south east England

Rental values in prime areas of south east England (Guildford, Henley, Sevenoaks, Esher, Sunningdale, Weybridge, Windsor) has seen promising signs of recovery as values increased by 4% over the last six months.

Due to the relative size of the prime rental market of south east England, it has reacted with greater speed compared to London. From peak to trough rental values fell by -24.5%. Therefore, it is no surprise that these markets have bounced back quicker than the prime London markets, even though corporate renters have only partly returned to the market, and with lower budgets compared to this time last year.

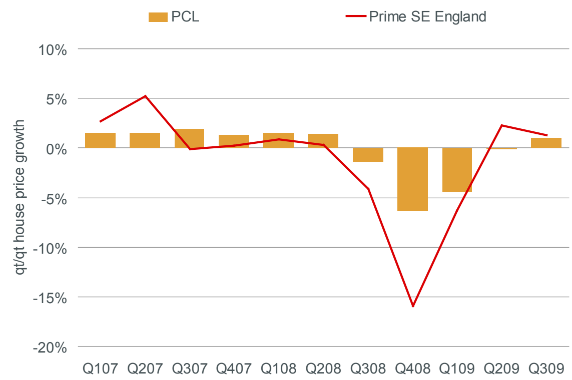
Looking forward, rental values are likely to level out as some temporary renters return to the sales market. Offices in this area have already reported tenants negotiating early releases from their contract in order to purchase in the area.

Recovery and outlook

With the economic outlook still looking relatively uncertain, the return of corporate family tenants to the prime London house market still remains limited; as a result rental values are expected, at best, to plateau at their current level during 2010.

The key driver for the corporate rental market is employment growth and business sentiment. According to forecasts by Oxford Economics, employment in Greater London as a whole is unlikely to return to its 2007 levels until 2014. However, much stronger growth, averaging around 4% is expected in the period 2011 to 2013 in financial and business services in the City. As a result we anticipate a realignment of supply and demand, meaning that as rental properties convert back to the sales market, there is the capacity for rental growth in the order of 4% in 2011 and 10% in 2012.

Graph 6. Quarterly rental growth in PCL and prime south east England



Source: Savills Research

'Rental values in prime areas of south east England saw promising signs of recovery as values increased by 4% over the last six months.'

UK rental forecasts

Year	UK
2009	-1%
2010	1%
2011	5%
2012	7%

PCL rental forecasts

Year	PCL
2009	-4%
2010	0%
2011	4%
2012	10%

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