Spotlight on…

The prime rental market

Current market conditions point towards prime rental market growth and the expected growth forecasts remain optimistic

"Savills market strength indicator continues to rise, now showing its fourth quarterly improvement."
Lucian Cook
Director, Savills Research

Prime London

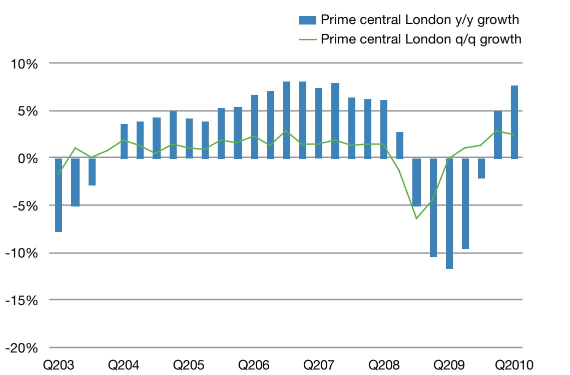
The prime central London rental market continues to see increases in rents. Demand is currently outstripping supply, with many of the properties being rented out over the downturn, now sold on to owner occupiers, since the sales market conditions have improved from mid 2009.

The increased level of sales in London has also meant that unsold properties are not entering the rental market, which has resulted in a reduction in 'accidental landlords' who unable to sell, chose to let their property instead.

The lack of stock from both the second hand market as well as new homes (development of which has fallen by more than 50% through the downturn) has supported strong growth in the prime rental market. Savills rental market strength indicator (which combines a number of key indicators, including applications, viewings and reservations) continues to rise, now showing its fourth quarterly improvement.

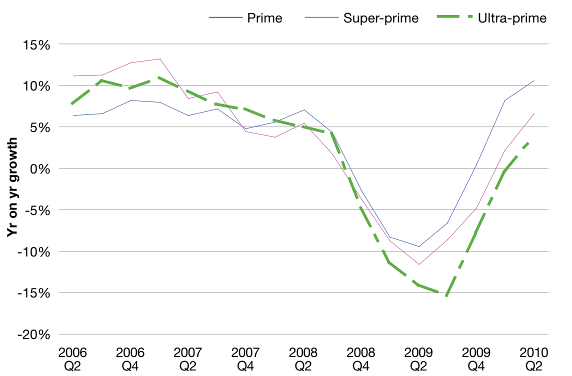
With a shift in the balance between supply and demand rents have increased by 8% since June 2009 across

Graph 1.
Rental growth in prime London



Source: Savills Research

Graph 2.
Rental growth by sector



Source: Savills Research

prime central London. Flats are outperforming houses, with 9% growth in rents year on year, compared with 6% for houses. Increasing activity within the rental market meaning that rents across prime central London are now, on average 8% off their peak levels.

Tenants are still more cautious with budgets than compared with the market pre-downturn, with both personal and corporate allowances being more modest. This has meant lower value properties (in a prime London context) are seeing the strongest recovery, with average rents 11% up year on year, with some rent back to peak levels.

Prime South West London continues to outperform both prime central and prime East of City markets. This market, popular with corporate families, has seen the strongest levels of needs-based demand. Having seen the most pronounced growth in sales values in the upturn, a number of rental properties have now been sold meaning that supply of good quality family homes, in particular, is scarce.

Who's renting?

The rental market continues to see high levels of tenant demand from overseas, accounting for 66% of all Savills tenants in prime central London. Financial sector workers account for 54% of Savills tenants across London, having fallen from 68% in 2007. Over this period we have seen a shift in location, with an increasing proportion of financial sector tenants choosing North London (Islington, Hampstead and St John's Wood) over prime central London (Kensington, Belgravia, Mayfair and Knightsbridge). This could reflect the tightening of corporate allowances which has forced tenants to look at more affordable properties, as well as private individuals who may be looking for a less costly option in light of current economic conditions.

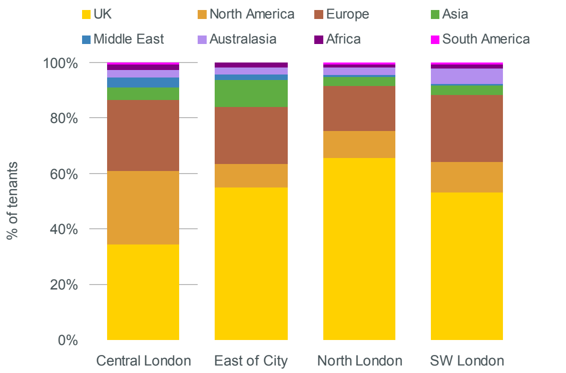
Investing in prime London

79% of prime London landlords are UK nationals, this figure remaining relatively static throughout the downturn. Investment remains the main driver for purchase, although 20% of landlords in South West London in Q1 2010 were letting due to relocation (compared with only 6% in prime central London).

Prime London remains a capital growth investment, with gross yields averaging 4.3% compared with the UK average of 5.4%. Total returns for prime London property remain attractive, outperforming commercial property, gilts and equities over the past 25 years.

Residential property investment has traditionally been focussed on the capital growth prospects while the income has been used for debt payment and property management. Residential property has a high average annual total return and a similar volatility to commercial property. Its position on Graph 5 demonstrates it has delivered higher returns than any other asset class with lower volatility than investment in equities.

Graph 3.
London tenant nationality

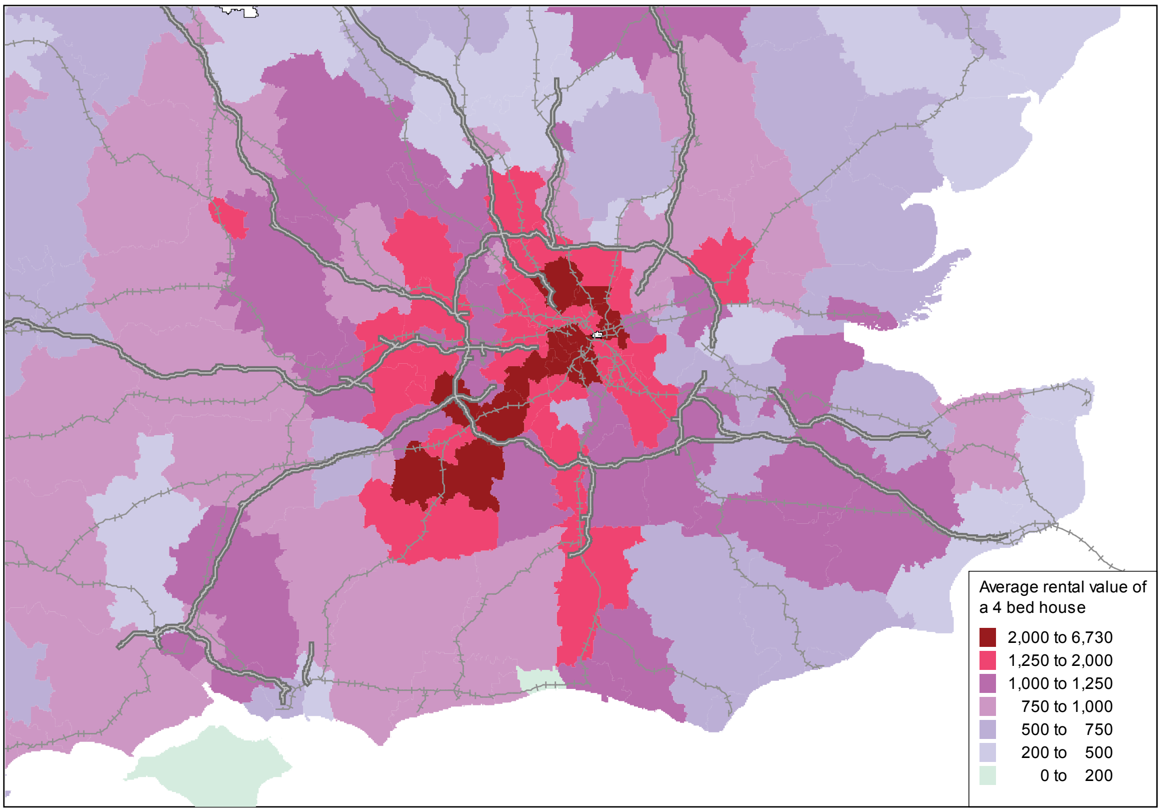


Source: Savills Research

Graph 4.
Tenants employed in finance

Source: Savills Research

Map 1.
Rent per month – 4 bedroom house



Source: Savills/Globrix

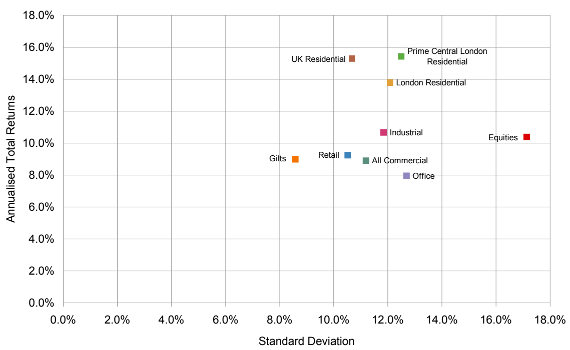
After the uncertainty pre-budget over the rise in Capital Gains tax (CGT), investors welcomed confirmation that capital gains tax would be levied at 28%. While 28% CGT is undoubtedly better than the pre-budget speculation CGT may rise to 50%, it could still act as a barrier for new investors coming into the market, who may look elsewhere for alternative and more liquid forms of investment.

Prime South East

Outside of London, the rental market, particularly at the top end, remains thin. Less than 10% of available rental stock in the South East are 4 bedroom properties or larger. The prime South East rental market is dominated by properties in commuter locations, with the highest priced properties being predominantly those located in desirable areas, with good transport links into the capital. Tenants within the prime South East are predominantly UK nationals (88% of tenants).

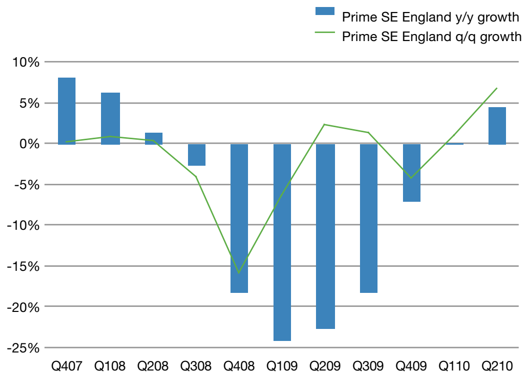
Outside of London the prime South East market has been slower to recover. The low levels of demand outside the capital making the market even more susceptible to changes in the supply of rental properties. A situation that was at its most acute when the lack of turnover in the sales market forced buyers to become reluctant landlords. Although there is some evidence these properties are returning to the sales market, thus redressing the supply/demand imbalance, levels of recovery have been less marked than in prime London.

Graph 5.
Annual Total Returns and Volatility (1984 to 2009)



Source: IPD and Savills Research

Graph 6.
Rents in prime South East England



Source: Savills Research

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Current trends outside of the prime markets

Over the course of the downturn the mainstream rental markets has remained more stable, although we have seen some price falls, the levels of falls have been lower than experienced within the sales market. Since January 2008 average UK asking rents have fallen from £870 per calendar month to £820 (a 6% fall). This weakening of asking rents can be linked to an increase in new instructions, but the lack of migration from the rental market into owner occupation has undoubtedly created greater stability within the rental market over the past two years.

With turnover levels in the sales market at historically low levels, even accounting for the recent increase in levels of activity, Savills estimate that there are currently 1.5 million frustrated movers across the UK. These frustrated movers being those households who would have moved under normal market conditions but have been unwilling or unable to do so. Although many of these households will be existing owner occupiers, a significant proportion will be remaining in the private rented sector. This, coupled with lower levels of new homes being completed and entering the private rented sector could well mean upward pressure on rents as demand increases.

Those factors holding back the sales market, namely deposit affordability, availability of mortgage finance, sentiment towards job security and the state of the housing market, could all support increased demand for privately rented property. With an easing of access to mortgages and a reduction in loan to value ratios looking likely to recover slowly, we do expect that those households without access to cash or equity are likely to remain within the private rented sector for longer. This could have significant implications on the type of private rented stock, the bias towards smaller one and two bedroom properties being inappropriate for family households remaining within the private rented sector.

Recovery and outlook

■ Over the medium to long term rental growth remains reliant upon employment prospects within the finance and business services sector, which accounts for over half of Savills London tenants.

■ With increased costs of deposits and constrained loan to value ratios in the mainstream sales market, the rental market continues to benefit from demand from would be owner occupiers. This increased demand is impacting not only the mainstream market, but also the lower tiers of the prime markets, particularly in areas popular with young professionals.

■ Despite having seen increased levels of activity within the sales market and growth of 13% in sales prices in the year to Q2 2010 prime London is forecast to see a slowing of both price growth and activity over the second half of 2010. This uncertainty over prospects for the sales market in the second half of 2010 and into 2011 is expected to reduce already limited turnover, with buyers less likely to commit and those in rented less willing to make the jump into owner occupation. These factors, many of which will be bad new for the sales market, could be advantageous to the rental market and its prospects for growth.

■ In light of current market conditions, our forecasts for the prime rental market remain optimistic with 8% growth expected in 2010, with a further 7% in 2011 and 7% in 2012. ■

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