Spotlight on…

The prime rental market

The dynamic of constrained mortgage markets and limited stock availability is fuelling strong growth in prime rental values

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Jacqui Daly
Director, Savills Research

Mortgage lending and new build development have been major casualties of the meltdown in the financial markets since 2007. Mortgage rationing continues to be a key feature of the market at a time when demand for new mortgages remains subdued. This is despite more properties being available in the sales market and lower average house prices.

Prospective purchasers continue to turn to the rental market. At the same time, new build development, some 50% of peak levels, implies there is very little, if any, new rental stock entering the market. This dynamic is fuelling strong growth in rental values in both the prime and mainstream markets across London and the south east of England.

Prime Rental Trends

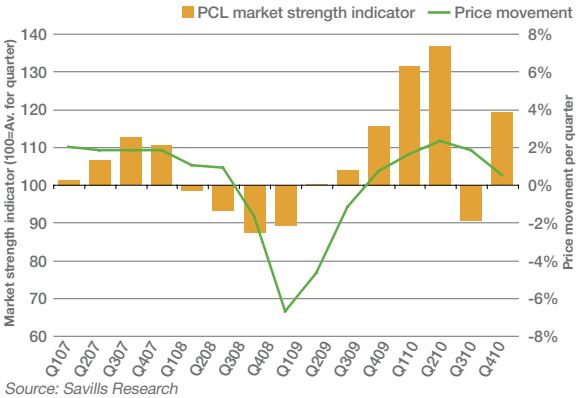
Prime London rents rose by 2.7% over the third quarter of 2010, taking year on year growth to 12.3% and leaving rents just 3% off their March 2008 peak.

This average hides much geographical variation. Rents in the core area of prime central London rose by 4.3% in the first six months of the year, supported by a lack of properties to rent at a time when increased demand, particularly from corporate tenants, was recovering.

However, the third quarter saw a slowdown with just 0.5% growth in rents.

The Savills lettings market strength indicator (Graph 1) takes a number of demand and supply variables into consideration and is a good leading indicator for rental values in the prime central London market. The indicator ▶

Graph 1.
Savills lettings market strength indicator



Source: Savills Research

Current trends outside of the prime markets

Mainstream UK rents bottomed out in January 2010 as supply fell and demand rose. Nationally, mainstream rents have risen by 5.8% since January to the end of September 2010 driven by the fall in the number of properties available to rent and rising tenant demand.

The pick up in the residential market over the last year has meant owners have transferred rental property back into the sales market. In addition to a lacklustre investment market and a decrease in new build development activity, fewer new properties have entered the market while demand continues to grow. This supply demand dynamic is driving rental growth and having a positive impact on landlords' returns.

Thus, the quarterly increase of 1.4% in UK rents was a result of stock falling by -14.5% over the last quarter. At a UK level the supply of flats available to rent fell sharply (-18.9%) and decreased much more rapidly than the supply of houses (-5.3%) during the summer months, although rental prices for flats increased by just 0.9% over the third quarter compared with stronger growth of 1.7% for houses. This lack of supply has in fact driven demand for flats at the bottom end of the prime London rental market.

Demand continues to place pressure on rents in the middle and upper tiers of the mainstream markets and into the lower and middle tiers of the prime markets. This demand will be strengthened by first time buyers who can not take advantage of renewed affordability in the sales market, as problems persist in raising deposit finance.

Rents in London increased at the highest rate of any UK region, by 5.1% between June and September, with stock levels falling by -15% during the corresponding quarter. In London, even areas with high levels of flatted development and rising unemployment have seen rents move upwards in the last two quarters. In particular, demand for larger three bed units in these locations has driven rental growth of over 5% this year.

was weaker in the second quarter of 2010, a precursor to weaker rental growth in prime central London in the third quarter of 2010. However, as stock levels have weakened further over the third quarter of 2010, so the market indicator has strengthened again, supporting our forecast for stronger rental growth in the final quarter of 2010.

A fundamental driver of the prime rental market is the strength of the financial and business services (FBS) sector across London. The UK economy has now recorded four consecutive quarters of economic growth, thus proving more resilient than anticipated. Employment within FBS across London has followed suit and is forecast to increase by 2.1% in 2010, and by an average of 3.3% during the following five year period (Graph 2).

The lower tiers of the prime London rental market have seen the strongest growth over 2010, as caution among tenants and reduced corporate allowances have concentrated demand. As a result, prime north London, including Hampstead and Islington, is currently seeing the strongest rental growth at 4.2% over the third quarter, an increase of 14.4% in the year to date.

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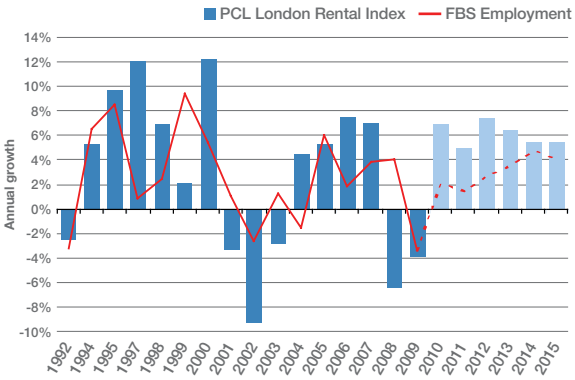
That said, this growth is coming from increased demand for smaller properties from those employed in the City, while increased supply and weaker demand for family housing is stalling growth at the upper end of the market.

In prime south west London the particularly strong sales market this year has reduced the supply of rental properties as accidental landlords returned properties to the sales market. Additionally, needs-based family demand has continued, pushing the rental value of houses up by 11.2% in the first six months of 2010. However, the rate of price growth slowed in the third quarter as demand from young professional sharers as well as families became aligned with supply over the summer months.

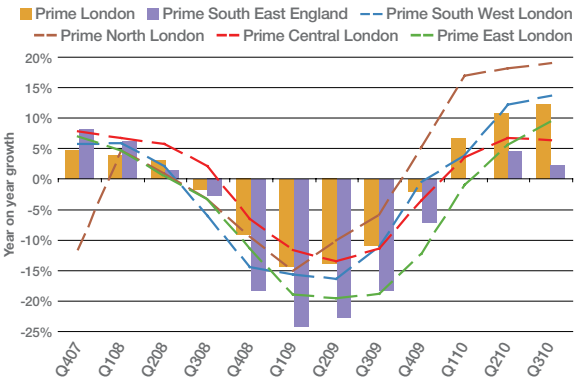
A wealth of new build supply during 2005 through to the first half of 2009 in prime east London led to rental values

Graph 2.
Unemployment vs rental growth in London



Source: Savills Research/Oxford Economics

Graph 3.
Prime rental growth by area



Source: Savills Research

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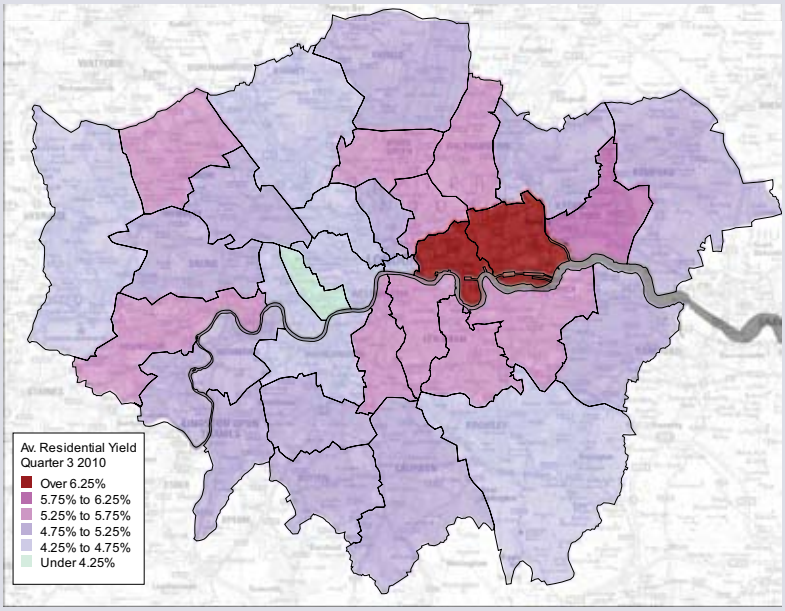
Map 1. Yield divergence across London



Source: Savills Research/ Findaproperty.com

"Gross rental yields are useful as a comparative source when looking at differences between London boroughs."

falling by over 20% (from peak to trough). Over the past year, as a consequence of a contraction in the new build development markets, supply levels have thinned. This, coupled with an improvement in financial sector employment, has allowed for a bounce back in rental values of 9.4% since the September 2009 low, with rental growth of 3.6% over the third quarter of 2010.

Outside London, the prime rental markets have not recovered to the same degree as in London. Rental growth in prime south east England was slightly negative during the summer quarter with falls of -0.8% reported. This was off the back of much stronger rental growth during Q2 2010 of 6.7%, leaving rental values 7% up from the 2009 trough. The region is much more susceptible to swings in rental values as the prime market is thinner, with subsequent imbalances in stock levels having a greater impact on values, compared to prime London markets.

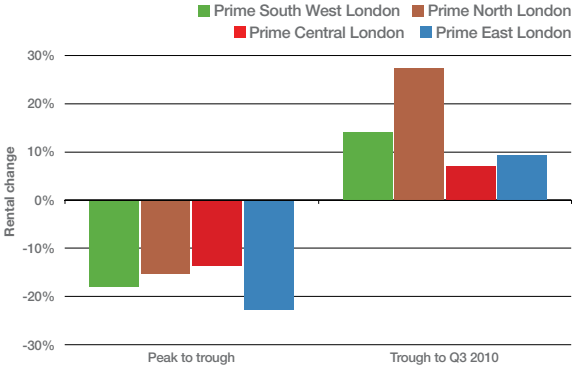
Prime Rental Demand

Throughout 2010 international demand for prime rental property has remained strong, with 70% of all Savills prime central London tenants being of international origin. This figure dilutes by approximately 25% with increased distance from central London, with UK nationals favouring north and south west London over prime central London. Travelling further afield, domestic tenants account for around 80% of all renters across the prime southern region.

The impact of the banking crisis has influenced the destination of choice for workers within the financial sector. In 2007 the number of Savills tenants employed within the sector across London stood at 68%, this figure weakened to 48% in Q3 2010. The destination choice for corporate tenants and private individuals employed within the sector appears to have shifted away from more expensive property in prime central London to the more suburban prime north London, and more affordable locations in prime east London. (Graph 5)

Greater demand within the prime north London markets has had a knock on effect on achieved rents within the sub-region. As we stand at Q3 2010, 48% of Savills deals within prime north London have achieved 100% and above of asking rent, highlighting the increase in

Graph 4.
Prime London rental growth since trough



Source: Savills Research

Graph 5.
Tenants employed within finance, by year

Source: Savills Research

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competition due to lack of stock, corporate relocation and greater affordability. Across London, 85% of all deals have achieved above 90% of asking rent, up from 75% during 2009.

Yields and discounts diverge

Investors within the private rented sector are currently torn between chasing high yields or excepting lower returns, with lower levels of risk.

The impact of rental growth outstripping capital value growth, in most areas of London and the South East throughout 2010, has led to increasing gross rental yields. Average residential yields differ across London, with an east and west divergence, whereas at a UK level, this divergence translates into a north-south divide.

The gross rental yields illustrated in Map 1 overleaf are useful as a comparative source when looking at differences across London boroughs. However, we believe the rental yields that many landlords are obtaining on their buy-to-let property are greater than those illustrated.

The methodology used to assemble the yield data compares asking sale price and asking rental price of all property for sale and to rent, and not purely buy-to-let property. Buy-to-let investors will generally be drawn towards certain types of property, specifically flats and smaller two or three bedroom properties, where the investor knows that higher rental yields can be obtained. As a result, investors will be achieving greater average rental yields than the figures denote, of at least +1%.

Outlook

With clouds gathering over the economy, there are fears that the Government's recent comprehensive spending review could tip us back into recession. In the short term, an uncertain outlook, both in the sales market and the economy in general could provide a boost to demand for rental property across prime London as prospective purchasers adopt a wait-and-see strategy. On the flip side, a worsening sales market could increase the number of 'accidental landlords', although not back to 2008 levels, thus softening short term rental growth.

The third quarter of 2010 has seen corporate and relocation demand soften, and a discrepancy emerge between applicants' requirements and available supply in the prime markets of London. This is in contrast to the mainstream market where demand is stronger for larger rental properties. Clearly, the lack of supply in the mainstream market is pushing people into the prime markets as evidenced by the pent-up demand from city occupiers. Therefore, we expect stronger rental demand in the lower tiers of the prime market and for smaller properties in more peripheral locations.

Medium term prospects for the prime rental market are reliant on employment prospects in the financial and business services sector, principally within London, which have recently been revised upwards for 2013 and 2014.

Our longer term outlook for the rental market therefore remains broadly positive, with rental growth expected to exceed income growth over the next few years. ■

Table 1.
Rental forecasts

Rental forecasts	2010 (Year to date – Q3)	2010	2011	2012	2013	2014	2015
Mainstream UK	5.80%	7.50%	7.00%	6.50%	5.50%	4.50%	4.50%
Mainstream London	10.10%	12.00%	9.00%	7.00%	6.00%	5.00%	5.00%
Prime London	9.80%	11.00%	8.00%	7.25%	6.25%	5.25%	5.25%
Prime Central London	4.80%	7.00%	7.00%	7.50%	6.50%	5.50%	5.50%

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