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Spotlight
Prime Rental Market

January 2017

SUMMARY

Challenges in the buy to let market continue

- Over 2016 prime rents across London fell by -5.1%, with rents in the commuter zone falling by -0.9%.

- In the prime London rental market, new build completions, buy to let investors and accidental landlords have created an unprecedented amount of stock. As such, tenants can afford to be picky and prices have fallen.

- Weaker demand from corporate tenants in the London commuter zone has resulted in price falls for larger properties. But continued demand from young professionals means smaller properties are expected to remain popular.

- For the mainstream market, successive tax changes, as well as mortgage regulation yet to come, is expected to mean a fall in buy to let activity for mortgaged investors. Those who continue to invest will be looking for lower value, higher yielding markets.

- Cash buyers will not be affected by this mortgage regulation but their ability to expand their portfolios may be constrained. As such, this may limit stock coming to the market and put upward pressure on rents.

"Despite being price sensitive the prime rental market has remained relatively active"
Savills Research

PRIME MARKET

Rents in the prime housing markets of London fell by -5.1% over the course of 2016 in the face of high levels of stock available to rent and relatively weak corporate demand for larger properties in particular.

By contrast, rents in the prime markets of the commuter zone fell by just -0.9% on average. Across both markets demand has remained most robust for smaller properties.

In the prime markets beyond London, rents rose for 1, 2 and 3 bedroom properties in 2016, while they remained broadly static for 4 bedroom homes. The average price falls seen in these markets were driven by properties of five or more beds where rents fell by -2.2% on average.

In the prime London markets rents softened across the board, though these falls were contained to -1.5% and -3.3% for one and two bedroom properties respectively. In comparison, rents for larger family homes of 5 or more bedrooms fell by -7.0%, with the most expensive homes renting for over £3,000 per week falling by -8.9% over the course of the year.

High supply in London

Here the overriding reason for these rental falls has been the unprecedented amount of stock available to let on the market. This has come from three sources - investment buyers of new build property that has now reached completion, a one-off increase in supply from those who bought rental property prior to the stamp duty deadline in April and,

FIGURE 1

Prime rental movements to Q4 2016 by bedroom number

	LONDON		COMMUTER ZONE	
	Annual	5 Year	Annual	5 Year
1 or 2 bedrooms	-2.8%	3.4%	2.2%	14.6%
3 bedrooms	-5.3%	-2.7%	0.6%	14.7%
4 bedrooms	-7.1%	-6.6%	0.1%	11.2%
5+ bedrooms	-7.0%	-6.9%	-2.2%	3.7%

3.4%
Rental growth for 1 or 2 bedroom properties in London over the last five years

Source: Savills Research

MAINSTREAM MARKET

Impending mortgage regulation, compounded by changes to stamp duty and income tax relief, is set to mean a fall in buy to let activity by private individuals.

Given the extent to which the market is dominated by cash investors, this doesn't sound the death knell for residential investment. But it is likely to limit supply coming onto the market at a national level, putting continued upward pressure on mainstream rents.

Increased stamp duty

The additional 3% stamp duty that came into effect in April 2016 will deter some buyers and make those who remain committed to investing more price conscious. However, stamp duty statistics show that there were still 59,000 purchases of residential investment properties and second homes in the third quarter of 2016.

Tax relief and mortgage regulation

The restriction of income tax relief on mortgage interest payments will also progressively curb the appetite of mortgaged buy to let investors. But with the full effect of this delayed by its phased introduction during a period when interest rates are expected to remain low, a more immediate impact of buy to let activity is likely to result from impending mortgage regulation.

This mortgage regulation will stress test affordability at much higher mortgage interest cover ratios, reducing the debt they can take on and increasing the cash they need to put down. Lenders are already beginning to factor this into their loan criteria.

Less capacity for debt

Whereas a year ago lenders would provide a mortgage on the basis of 125% rent to interest cover at a stress tested interest rate of 5%, increasingly loan affordability is being assessed at a higher interest cover ratio of 145% at an assumed interest rate of 5.5%.

A year ago the buyer of a £400,000 property generating a gross yield of 4.0% would have been able to borrow £256,000 - leaving them with a cash requirement of £161,000 including associated costs of purchase.

Under these new criteria the maximum loan available would fall to just over £200,000 at a 50% loan to value ratio. Combined with the additional stamp duty costs, this would increase the cash investment which a buyer would have to find by £64,000 to £225,000.

The drive for yield

This is expected to result in a fall in transactions– we are forecasting that accidental landlords caught by the weak sales market in the aftermath of the EU referendum.

On the demand side, the referendum has tempered demand from those employed in the banking industry and made large corporations more cautious about recruitment, particularly at a senior level.

This has had a particular impact on demand for family housing. With tenants increasingly budget conscious, they have also continued to be more flexible around location.

But despite being much more price sensitive the market has remained relatively active – especially in areas such as Shoreditch where growth in the tech industry has supported demand.

Parallels in the country

There are some parallels in the prime lettings markets of the London commuter zone. Here, there has been evidence of accidental landlords adding to available rental stock as well as weak demand from corporate tenants. Likewise, tenants not wishing to stretch themselves financially have generally focused on smaller properties.

This has resulted in a fragmented market where very large properties have struggled to let and that is beginning to feed through into more substantial cuts in asking rents.

By contrast, family and smaller country houses, which are primarily let to those commuting into London, have seen much more consistent demand. But by far the strongest demand has been for smaller houses and flats let to young professionals, where there remains a shortage of supply.

Outlook

Whereas we expect there to be continued rental growth in the mainstream markets (because demand from those unable to access homeownership is expected to outstrip supply from private landlords facing tax and mortgage constraints), we believe the growth prospects in the prime rental markets are weaker.

Stamp duty is likely to increase rental demand and curb investor buying activity to a degree at least. But in London high levels of competing supply are likely to continue to come from the new build stock which is expected to be completed over the next two to five years.

More widely, supply from accidental landlords is likely to continue to be a feature of the market in the short over the next five years mortgaged buy to let activity falls by 25%.

Investors with a fixed pot of cash who are committed to buying are likely to be pushed to lower value, higher yielding markets.

For example, someone buying a £300,000 property at a 5.0% yield would be able to buy with a 63% LTV mortgage with cash requirement of under £130,000. In doing so they would be able to enjoy a significantly higher net cash return on the equity they have invested compared to our previous example.

The role of cash

Mortgage regulations and reduced tax relief on mortgage interest will not be a concern for the majority of investors.

Only 19,000 of the 56,000 buyers of 'additional homes' in the third quarter of last year did so with the aid of a buy to let mortgage.

Likewise, we estimate that only one third of all existing stock in the private rented sector is subject to a buy to let mortgage. For those carrying debt the average outstanding loan to value ratio is just below 50%.

Mainstream rents

This suggests the sector remains robust and owners are unlikely to sell existing stock unless heavily indebted.

But their ability to expand will be limited. This is likely to constrain supply and put greater upward pressure on mainstream rents. We have forecast rents will increase by 19% over the next five years at a national level, more than our mainstream house price forecast of 13%.

FIGURE 2

Prime rental markets Five-year forecast values

	HISTORICAL ANNUAL			FORECAST ANNUAL					5-YEAR FORECAST
	2014	2015	2016	2017	2018	2019	2020	2021	2017–2021
Prime London	0.8%	1.3%	-5.1%	-3.0%	0.0%	1.0%	3.0%	3.0%	4%
Prime Commuter Zone	2.7%	0.8%	-0.9%	-1.0%	0.0%	1.5%	2.5%	2.5%	6%

Source: Savills Research

NB: These forecasts apply to average rents in the second hand market. New build values may not move at the same rate.

FIGURE 3

Tax scenario for mortgaged buy to let investor

	£400,000 purchase, 4% yield		£300,000 purchase, 5% yield
Year	2016	2017	2017
Mortgage	£256,000	£201,000	£188,000
Cash	£161,000	£225,000	£129,000
Total costs of purchase	£417,000	£426,000	£317,000
Net of tax income	£3,040	£3,934	£3,695
Net return on equity	1.9%	1.7%	2.9%

Source: Savills Research

term, though not as pronounced as in the immediate aftermath of the EU referendum.

Demand for prime rentals and the spending power potential will be largely dictated by the impact of Brexit on employment and earnings in key industries such as finance, technology and professional services. Whilst ultimately we expect London to continue to hold its position as a global financial centre, ongoing uncertainty and the prospect of some functions being relocated are likely to have an impact on demand in London markets.

Therefore, it is difficult to see drivers for rental growth over the medium term across most sections of the prime market. More than that, there remains a risk of continued falls in prime rental values in London over the short term. This will mean landlords, particularly those who own larger properties, will need to continue to be flexible in their rental expectations and ensure the property meets prospective tenants hopes in terms of condition and amenities.

> “Landlords will need to continue to be flexible in their rental expectations”
>
> Savills Research

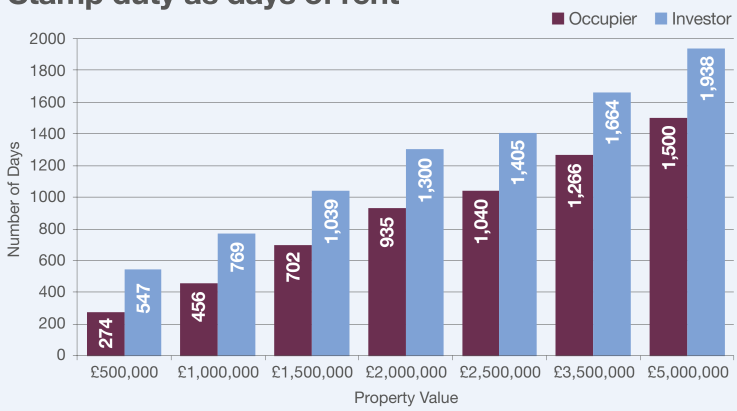
TAXATION IN THE PRIME MARKET

Increasing levels of stamp duty, together with a series of other capital tax measures primarily targeted at non-domestic buyers, have played a significant part in the sales market over the past few years. Whilst the additional 3% for buyers of second homes and investment property undoubtedly distorted the market in 2016, the tipping point in London was the changes introduced in the Autumn Statement of 2014. Since that date values of prime central London property have fallen by -12.5%.

These taxes have also contributed to a lower transaction market, where renting looks comparatively more attractive for occupiers and where investors will take longer to recover their costs of acquisition. For example, our analysis shows that the buyer of a property worth £1m would pay stamp duty equivalent to 456 days of rent while an investor would need to set aside 769 days rental income to fund the SDLT burden. For the buyer of a £2.5m property these figures rise to 1,040 and 1,405 days rental income.

FIGURE 4

Stamp duty as days of rent



Source: Savills Research

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