Spotlight on...

Prime rental markets

Despite economic uncertainty, the prime rental markets remain stable, though growth in this sector is expected to slow in 2012

SUMMARY

The key findings in this document

- In the face of economic uncertainty prime rental growth has slowed.
- However, stock levels have been contained as renewal rates have remained high and tenants have sought increased tenancy lengths.
- Over the medium term rents are likely to be driven by mortgage constraints in the lower tiers of the prime market and increased demand from those delaying house purchase.
- In the short term this will be tempered by the outlook for the financial and business sector, which is a key component of rental demand.

Current market

The previously strong residential rent growth has recently eased in the prime rental market of London, while in the prime markets of the South East we have seen rental values soften slightly.

Price movements of 0.4% in the former markets compares to -2.3% in the latter over the three months to the end of September. This, in part, reflects a weakened outlook for the financial and business services sector which makes a significant contribution to rental demand.

Across the prime rental markets of London 55% of new of tenants over the past five years have been employed in the financial services →

GRAPH 1

Levels of prime rental supply

Graph source: Savills Research

GRAPH 2

Agreed rents as a percentage of asking rent

Graph source: Savills Research

GRAPH 3

Prime rental comparisons

Graph source: Savills Research

> "Tenants have increasingly looked to secure longer tenancy agreements."
>
> Lucian Cook, Savills Research

sector, the highest proportion being seen in the markets of central London and Canary Wharf/ the Docklands.

Within the prime markets of the South East, this figure remains as high as 33%, with a further 11% of tenants coming from other business services sectors.

Oxford Economics has forecast a 1% contraction in employment in this sector in London in 2011 and reduced their forecasts for growth in 2012. In particular, corporate tenant demand remains suppressed.

In 2011 these lettings have accounted for 7% of new tenancies in central London, some way below the 23% seen in 2007.

Despite this, the level of prevailing letting activity has prevented stock levels rising to unsustainable levels, keeping supply and demand broadly in balance.

This has been underpinned by high levels of tenant renewal and an increase in the length of term taken by new tenants. Over the period from 2007 to 2011 the average length of tenancy has risen from 360 days to 416 days as tenants have increasingly looked to secure terms in excess of a year.

Similarly, in the main, a relatively strong sales market (particularly in London) has prevented the return of the accidental landlord. In 2011 80% of prime landlords, have let property as a conscious investment activity, up from 70% during the first half of 2008 when accidental landlords were at their most prevalent.

Such factors have allowed landlords of prime property to continue to secure rents at or close to their asking rent. In the third quarter of 2011 agreed rents averaged 99% of asking rent in the prime London market, a figure close to that achieved at the peak of the market and much higher than the 94% seen at the bottom of the market.

Relative rental levels

Comparing rental levels across the different prime residential markets is complicated by the differing nature of the residential stock. It is of no surprise that rentals in prime central London are by far the highest, fuelled by predominantly international demand. Here foreign nationals account for three out of every four tenants.

There are two predominant tenant groups, those from North America (who traditionally rent rather than buy) and Western Europe. Between them, these groups account for just under 50% of tenant demand. As a consequence average prime residential rents vary from £37,000 per annum for 1 bedroom properties (higher than the average rent for a prime 4 bedroom property in the London hinterland of the South East) to £182,000 per annum for four bedroom properties.

Such has been the historic strength of demand from affluent young tenants employed in the financial services sector that the next most expensive rental market is that of the Canary Wharf and the Docklands, though here the market is essentially confined to flats. Nonetheless, rental levels for 1 and 2 bedroom flats average £20,900 per annum and £28,800 per annum, the latter being roughly 25% above rents for broadly comparable product in prime south west London.

Here the demand for family housing is strong, leading to average rents of £46,300 for four bed houses in this area. By contrast the average rent for a four bedroom house in the prime markets of counties adjoining London is £28,500, though here there is substantial variation by location.

Rental outlook

We have forecast that rents in the mainstream rental market of the UK will rise by 20.5% over the period of the next five years. This growth is expected to be driven by reduced access to owner occupations because of mortgage constraints against the context of limited levels of new supply, particularly given a lack of new build product.

Demand continues to grow in the mainstream sector

Rental values are still rising despite wider economic uncertainty

Across the UK demand for rental property continues to grow as more newly formed households look to rent, more first time buyers choose to delay or are prevented from making a purchase and economic constraints push more people from home ownership into rented accommodation.

Mortgage finance remains scarce and first time buyer deposits continue to be unaffordable. Combined with limited levels of new supply that reflect recent low levels of debt backed investment in the residential sector, this means rents are rising even in the face of wider economic uncertainty.

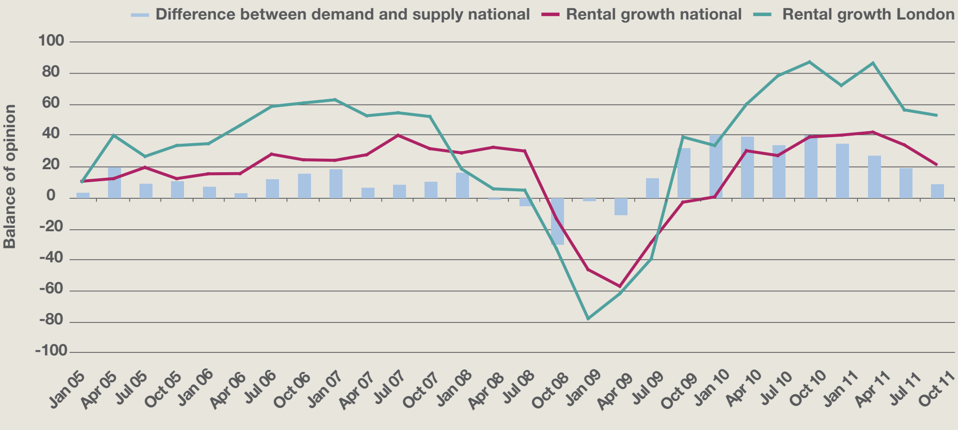
According to findaproperty.com asking rents rose by 4.6% in the year to the end of September, while the LSL buy-to-let index suggests rental movements of 3.5% over the same period.

This scenario is unlikely to change in the near future, although the October 2011 RICS residential lettings survey indicates that the rate of rental growth is slowing.

The private rented sector has already become more the tenure of 'reality' rather than the tenure of 'choice'. In a recent Ipsos MORI poll a third of all respondents in the private rented sector, aspire to own their home but only 15% actually expect to fulfil this ambition.

GRAPH 4

Mainstream rental growth indicators



Graph source: RICS

In London, the supply-demand imbalance between renters and available property to rent is greatest and rental growth is strongest. We expect rents to rise by 20% across the UK over the next five years. In comparison, mainstream London rental values are forecast to increase by 27% over the same period.

As average UK rents increase at a rate faster than average capital values, income yields have increased. Already the RICS have reported seven consecutive quarter of yield rises and we expect this to continue.

We expect to see the headline gross yield on residential stock increase from 5.0% to 5.7% over the next five years. This should increase the attractiveness of the sector to investors, particularly those looking for strong income-producing assets with growth potential. In turn, this should be the catalyst for increased institutional and other residential investment.

This investment proposition is likely to be underpinned by the ongoing shift in demand towards private renting. According to the Survey of English Housing, the number of households in private rented accommodation rose by just under 290,000 between 2008/09 and 2009/10.

We expect this to continue such that private renting will rise from 15.6% of all households in England in 2009/10 to 20% of households by 2015/16. This suggests the creation of 1 million more private rented households.

The overriding constraint on growth is rental affordability in light of the anticipated constraints on household finances.

In the prime markets, the inability to buy will be much less of a driver of demand, although we do expect this to support rental demand among young professionals, and therefore underpin rental growth in the 1 and 2 bedroom prime flat market. This is likely to have an impact in rental markets of the East of City where the profile of renters is becoming slightly less reliant on the financial services sector.

Within the prime markets the affordability constraint is likely to be less of an issue, with some of the highest income growth expected in the more affluent households of London and the South East.

We see rental demand in the prime sector to be dominated by three main types of tenant:

1. Those excluded from buying prime property because of mortgage constraints, who we have referred to above.

2. More mature households for whom renting is the tenure of choice and who have no aspiration to buy.

These will include some of the international tenants, particularly those from North America who are seconded to London.

3. Those who intend to rent for a limited period before buying. We anticipate that the pressure to exit the rental sector and return to home ownership will be reduced over the period of the next five years.

Given relatively low yields on prime rental property, renting remains relatively cost efficient, despite low interest rates.

Furthermore, relatively low rates of anticipated house price growth mean that the risks of losing out on capital appreciation or finding it significantly more expensive to buy in the short to medium term are less of a risk.

Demand across all of these sectors is likely to be driven by the outlook for employment, particularly in the financial and business services sector. In this respect, the health of the financial markets is critical.

This goes someway to explaining the close relationship between annual movements in the FTSE and residential rents in prime central London.

TABLE 1

Rental forecasts Mainstream London is predicted to outperform the rest of the UK over the next five years

	2011	2012	2013	2014	2015	2016
UK	4.0%	3.0%	3.5%	3.5%	4.5%	4.5%
London	8.0%	4.0%	5.0%	5.0%	5.5%	5.5%
Prime Central London	8.0%	1.0%	5.0%	4.5%	4.5%	4.5%

Note: Forecasts exclude stock let to tenants on housing benefit

Data source: Savills Research

In the short term, the uncertainty both in the financial markets and the financial and business services sector more widely is likely to temper tenant demand in this market.

Supply of rental property is the other major consideration. A lack of new build activity will have an impact in some London markets, though this effect will be tempered by the increased buying activity from overseas investors over the recent past.

Across the prime markets it will be the interaction with the strength of the sales market that primarily dictates whether there will be a rise in the amount of stock available to rent.

Within the prime market of the South East we have already seen this begin to have an effect that is likely to be carried over until next year, a weaker sales markets have brought stock on to what is a relatively shallow prime rental market.

> “A lack of new build activity will have an impact in some London markets.”
> Lucian Cook, Savills Research

Within the deeper prime rental markets of London, where the outlook for the market is strongest over the next five years, this is likely to have less of an effect, even though we expect rental growth in central London to slow over the period of the next year. ■

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