Spotlight
Prime Rental Markets

July 2013

SUMMARY

Weak corporate demand and increased stock constrains rental growth

■ Prime London residential rents struggled to show any significant growth in the second quarter of 2013.

■ In the prime markets of the South East rental levels have started to improve, though they remain well below their pre-crunch peak.

■ Given income yields, the prospects for capital growth are likely to underpin future investment in the prime rental market, with the possible exception of higher yielding East of City markets.

TABLE 1
Prime rental movements to Q2 2013

	All Prime London	Prime Central London	Prime North West London	Prime South West London	Prime North London	Prime East of City	Prime South East of England
Q on Q	0.3%	-0.6%	-0.7%	0.9%	0.4%	0.1%	1.8%
Y on Y	-0.1%	-1.2%	-4.5%	2.0%	0.1%	-1.3%	0.5%
Since Peak	0.3%	-4.2%	-4.5%	2.5%	-4.3%	2.4%	-18.4%
£ per sq ft	£42	£61	£45	£29	£34	£32	N/A

Source: Savills Research

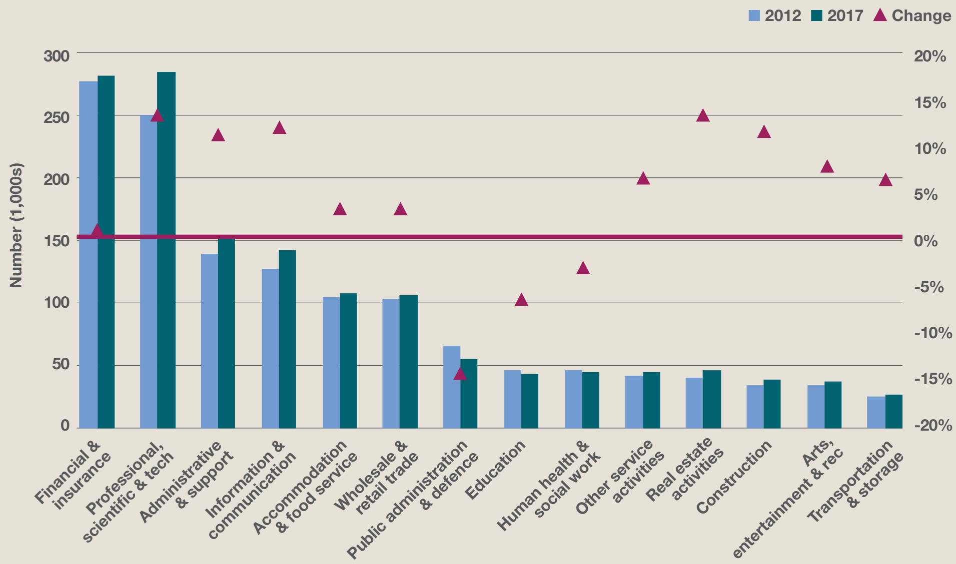
GRAPH 1

Prime tenant employment profile

Source: Savills Research

GRAPH 2

Central London employment forecasts



Source: Oxford Economics

TABLE 2

Profile of stock within Savills Prime Rental Indices

	Prime Central London		Prime South West London		East of City	
Beds	Average weekly rental	% of sample	Average weekly rental	% of sample	Average weekly rental	% of sample
🛏	£630	9%	£460	7%	£430	26%
🛏🛏	£1,280	19%	£710	27%	£620	53%
🛏🛏🛏	£1,880	25%	£830	20%	£1,010	17%
🛏🛏🛏🛏	£3,100	21%	£1,560	17%	n/a	n/a
🛏🛏🛏🛏🛏	£4,830	14%	£1,600	17%	n/a	n/a
🛏🛏🛏🛏🛏🛏	£5,920	6%	£2,100	7%	n/a	n/a
All	£3,180		£1,180		£630	

Source: Savills Research

Prime London market

Rents across prime London struggled to show any significant growth in the second quarter of 2013, given a lacklustre employment market in the financial and business services sector and rising levels of available rental stock in the wake of a rise in overseas investor buying activity.

This has meant landlords, keen to minimise void periods in order to protect their income returns, have had to remain realistic about their rental aspirations.

The effect has been most noticeable in the markets of prime central London, Hampstead and St Johns Wood, where annual rental movements are currently in negative territory.

Lonres have reported that stock levels of three and four bedroom properties in these areas have increased 16.8% and 11.9% respectively over the past year. That stock increase reflects an increase in new build supply brought to the rental market and an added incentive to those who hold their property in a corporate structure to let it on a commercial basis, following recent changes in the tax regime.

Only in the ultra prime markets, where supply is more constrained and demand is dominated by very wealthy international tenants have rents in the prime markets of central London risen, though they remain some way below the peak levels seen in 2008.

By contrast, though subdued, rental growth has remained positive in the more domestic markets of prime South West London and Islington. Lower corporate budgets have displaced demand for family houses from central London into these less expensive markets, supplementing demand from a broader tenant profile.

In the prime East of City, rents have fallen marginally over the past year, having previously exceeded their 2007 peak. Here, where student and sharer demand is more dominant, there are signs of renewed development activity that is likely to result in more rental stock coming to the market.

Prime South East

In contrast to London, rents in the prime markets of the South East rose by 1.8% in the second quarter of the year. In particular, prime towns within the commuter belt of the capital have attracted young families wanting to rent before committing to buying into the commuter lifestyle. Amongst these, Guildford saw the largest quarterly increase of 4.3% due to its strong family market.

These are encouraging signs for the prime regional housing markets, where demand for both buying and renting amongst those relocating from London has struggled to gain momentum since the downturn. Here, however, accidental landlords continue to influence the amount of stock available to rent meaning landlords need to be realistic about rents, which remain someway down on their pre-crunch levels.

Looking forward

The dominant market drivers of prime rents of the past year are likely to continue to influence the market over the next 12 to 24 months. Weak employment forecasts for the financial and insurance services sector are likely to temper rental growth for prime central London property.

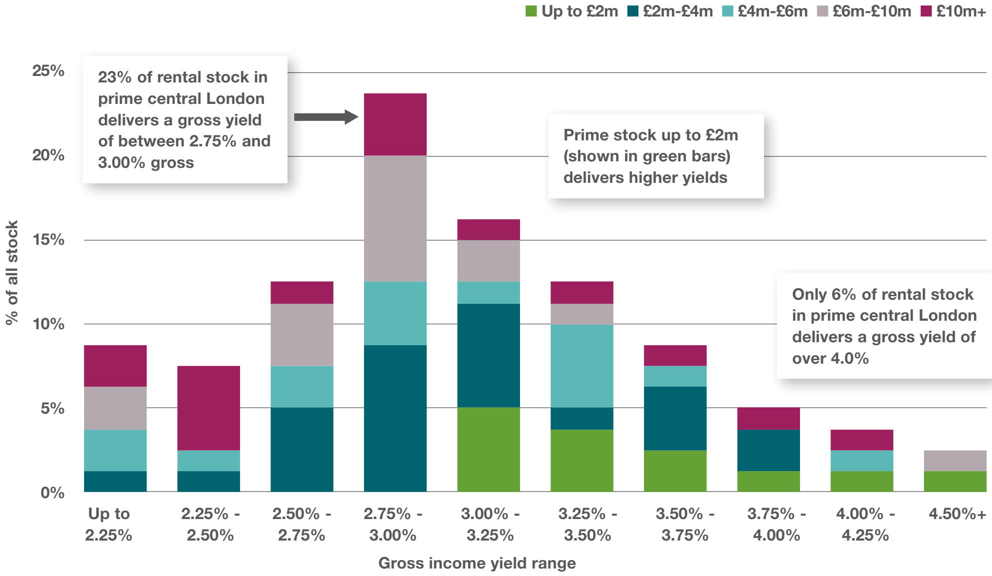
Much stronger employment growth in the professional, technological, media and communications sectors are likely to underpin demand in other prime and upper mainstream markets.

Accordingly, rental growth across London and the South East as a whole is likely to be relatively strong. Notwithstanding measures to boost homeownership, employment driven demand is likely to be supplemented by demand from those unable or unwilling to enter the world of homeownership; at the bottom of the market pressures on housing benefit will put a cap on rents.

In the mainstream markets supply is likely to remain constrained, but less so in the more valuable markets where new activity is concentrated and international investors are particularly active. We therefore expect that rental growth prospects in the prime markets of central London are likely to be more suppressed in the short-term than we have previously anticipated.

GRAPH 3

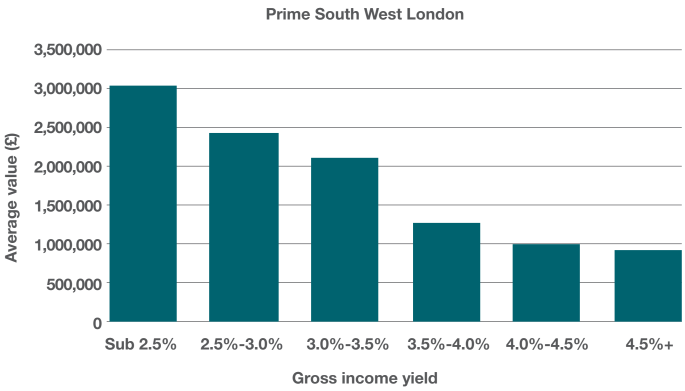
Prime Central London yield distribution



Source: Savills Research

GRAPH 4

Prime yields in South West London and East of City



	Average value (£)	Average gross yield
1 & 2 beds	640,000	4.0%
3 beds	1,200,000	3.6%
4 beds	1,700,000	3.4%
5+ beds	2,900,000	3.1%

	Average value (£)	Average gross yield
1 bed	450,000	5.1%
2 beds	680,000	4.6%
3 beds	1,300,000	4.3%

Source: Savills Research

However we do not believe that this will be a barrier to investment in markets, where the motivation for investment has been more weighted to capital growth as opposed to income returns.

In central London gross income yields currently average 3.2%, yet investors still account for one in five buyers of second hand stock. Since 1979, real (inflation adjusted) capital growth has averaged 4.9% per annum on an annualised basis.

That figure in part reflects the very strong growth in capital values in the period since 2005 (even accounting for the 2008 downturn). Whilst we expect lower capital growth over the next five years, we still expect this market to outperform the UK mainstream market and deliver competitive total returns.

Within the context of the prime markets, the East of City markets are far more of an income play. Whilst gross yields in central London vary and tend to be higher for property worth less than £2million, our analysis suggests that they rarely exceed 4%.

By contrast, the markets of Canary Wharf and Docklands, that have far more in common with the UK mainstream market, deliver an average yield of 4.3% for the typical two bedroom property worth in the order of £700,000, a figure which rises to 5.1% for a one bedroom property.

TABLE 3

Five-year forecast values

Forecasts	2013	2014	2015	2016	2017	5 years to end 2017
Greater London Rental Values	3.0%	4.0%	4.5%	6.0%	6.5%	26.4%
Greater London Capital Values	6.5%	6.0%	4.0%	4.5%	2.0%	25.1%
Prime Central London Rental Values	-1.0%	2.5%	3.0%	4.5%	4.5%	14.1%
Prime Central London Capital Values*	6.0%	3.0%	-1.0%	8.0%	6.5%	24.3%

Source: Savills Research *Assuming no further changes to the taxation of high value property

Important Note: Our rental forecasts for central London reflect the profile of stock set out in Table 2. Our Greater London mainstream forecasts are an average for private rents in the capital, where they are not underpinned by housing benefit receipts. In reality the prospects for different submarkets will have regard to the different demand drivers set out in Table 4.

TABLE 4

Key demand drivers in the rental market

	Prime Central London	Zone 2/3 Family Housing	Zone 2/3 Apartments	Outer London
City employment	High	Medium	Medium	Low
London employment	Medium	High	High	High
Lack of mortgage finance	None	Medium	High	High
Housing benefit caps	None	None	Low	Medium

Source: Savills Research

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