UK Residential – Q4 2018

SPOTLIGHT

Savills Research

Prime residential rents

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Five-year forecasts ● Key factors shaping future supply ● The influence of London earnings

> "There continues to be a deeper seam of demand for smaller properties driven by needs-based, younger tenants yet to access home ownership"

In 2018, uncertainty regarding the political and economic outlook was the most obvious driver of both the prime sales and rental markets. Buyers and tenants remained cautious, resulting in markets that were price sensitive.

Yet, the political unknowns around Brexit aren't the only factors affecting the prime markets.

Though we have been in (or are approaching) a period of peak political uncertainty, the size of year-on-year rental falls in the prime markets of London are at their lowest since March 2016.

Nor has the effect of a multitude of different market drivers (Brexit included) had a universal impact on different parts of the market.

So, in this report, we have analysed the fundamentals of supply and demand.

What sits behind the headlines of softening rents? How does the current situation compare with previous downturns? How much is the market influenced by London earnings? What will supply look like with buy to let landlords under pressure?

All of this allows us to examine what may happen to rents going forward, assuming that – sooner or later – Brexit is resolved.

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Rental falls subside

There are encouraging signs for the rental market, although performance differs widely across the sector

Over the course of 2018, the rental value of prime London property fell by 0.8% – a distinct slowing in the rate of annual falls that have affected the market since March 2016. Within this, less expensive properties fared better than their more expensive counterparts, continuing a trend that has been evident since the financial crisis.

We are seeing that footloose, cost-conscious tenants have been drawn to prime areas that offer greater value, rather than confining their search to premium addresses. Consequently, rents in central London have fallen 3.2% in the past year and 13.8% in the past five. Meanwhile, rents across the other prime London markets held their own in 2018 (increasing by 0.2%) with a fall of 2.7% over the past five years.

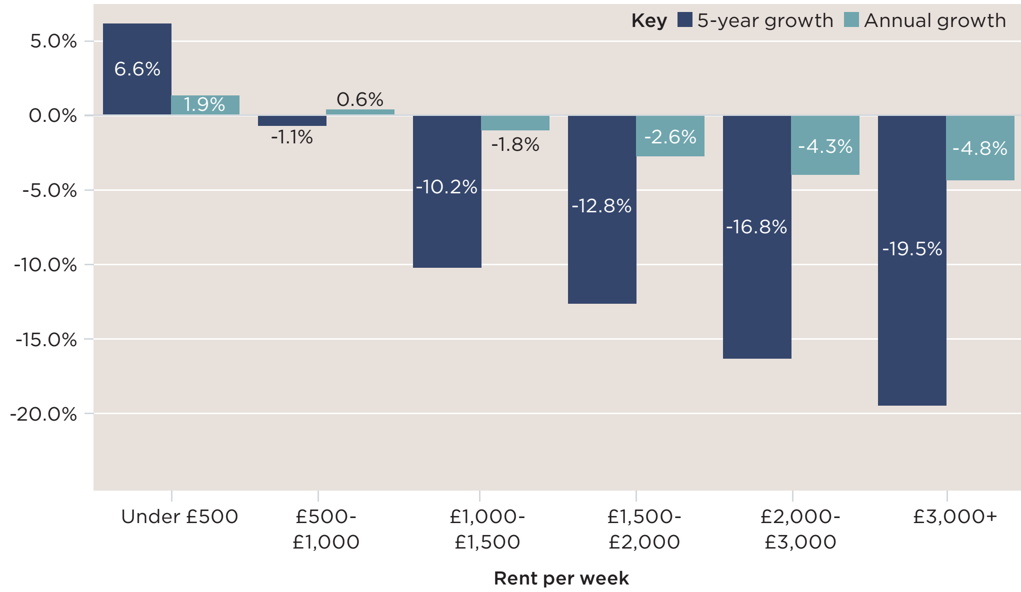
In addition, there continues to be a deeper seam of demand for smaller properties across all of the capital's prime markets driven by needs-based, younger tenants who are yet to access home ownership.

In the commuter zone

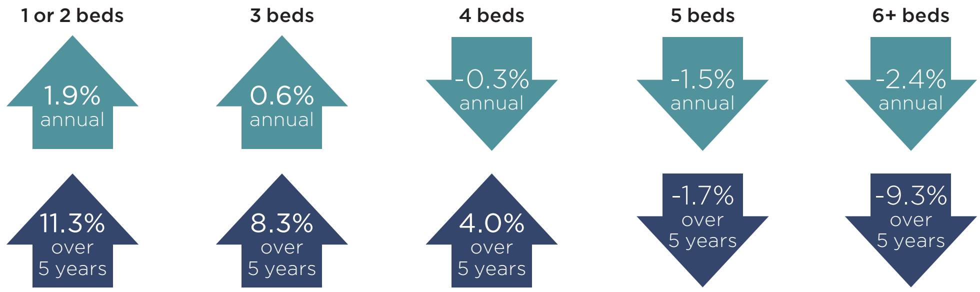
Robust demand for smaller properties has also been evident in the prime rental markets throughout London's commuter belt. With less competing supply entering the market from the new build sector, rents for properties of three or fewer bedrooms have continued to increase.

Larger properties, for which demand is notoriously fickle, have not performed as well, with small rental falls in 2018. In the past five years, rents on properties with six or more bedrooms have decreased by more than 9%, whereas rents for one- or two-bedroom properties have increased by more than 11% during the same period.

Rental growth in London's prime housing markets (to Q4 2018)

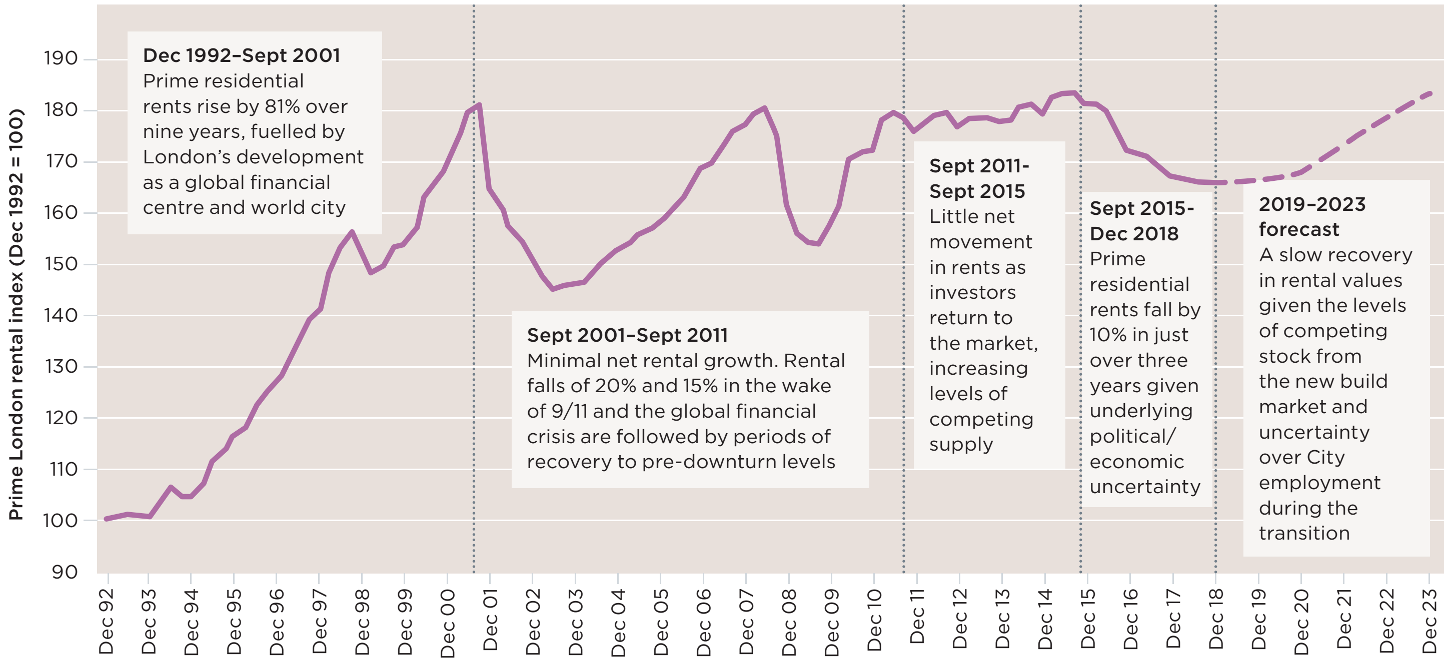


Rental growth of prime property in the commuter zone (to Q4 2018)



Source Savills Research

Timeline of major downturns and recoveries in prime London rents



Source Savills Research

What goes down must come up (eventually)

What can previous rental downturns tell us about the prospects for the market going forward?

The two most recent periods of double-digit falls in the prime London rental market occurred after 9/11 and in the aftermath of the financial crisis. These resulted in rental falls of 20% and 15% respectively, and occurred more quickly and more universally across the market than the recent decline.

In this downturn, prime London rents have fallen by an average of 9.6%, but this varies significantly across different parts of the market. In central London, rents have fallen by 16.5%. Across the rest of the prime London market, they have fallen by just 6.4% on average.

So, why the difference? Previous rental downturns have primarily had single triggers which have hit occupational demand, particularly from overseas and the financial and business services sector. The drivers of the current downturn are more complex.

Demand has undoubtedly been affected by uncertainty in the financial services sector and constraints on corporate budgets. But a more diverse range of needs-based tenants has partly offset this, particularly outside of central London. In more expensive parts of the market, the high cost of stamp duty has also made renting look comparatively more attractive. This has supported rental demand, even if tenants have been more cost-conscious.

Competing levels of supply have been equally influential. In part, this has come from accidental landlords, who have been faced with a drawn-out period of malaise in the sales market. But it has also come from increased competition from new build stock, acquired by cash-rich investors and, to a lesser degree, an increasingly sophisticated build to rent sector. What then are the chances of a rental recovery?

In previous downturns, rents recovered to their previous highs over periods of between two and five years after the rental market bottomed out. In each case, however, the market struggled to rise above those highs.

The ability to deliver such a rental recovery over the next five years depends partly on what Brexit will mean for London's high-value employment markets. But, given the existing development pipeline, we expect supply to remain an equally important factor.

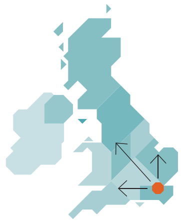
These are topics we expand on over the page.

Prime rental forecasts Supply and Brexit's influence on employment will shape the rate of rental recovery

	Past 5 years	2019	2020	2021	2022	2023	Next 5 years
London	-6.7%	0.5%	1.0%	3.5%	3.0%	3.0%	11.5%
Commuter zone	0.8%	1.0%	2.0%	3.0%	3.0%	3.0%	12.6%

Source Savills Research **Note** These forecasts apply to average rents in the secondhand market. New build values may not move at the same rate

£65.4 billion
Earnings that are annually exported from central London to outer London, the commuter zone and the wider UK.



Capital expenditure

London's earnings remain a significant driver of rents in the commuter zone

The resilience of the London economy is fundamental to the strength of demand across the prime rental markets. Some 71% of prime tenants across the commuter zone work in London.

Our analysis of official earnings data shows the extent to which the effect of London's high-value employment markets spread far beyond the capital.

As a headline figure, inner London effectively exports £65.4 billion of employee earnings to other parts of the UK each year. Outer London benefits from £24.3 billion of imported earnings, while more is imported into the rest of the country, primarily the South East and the East of England.

Exported earnings have a significant effect on rental affordability at a local level in prime areas. In Richmond, for example, the average full-time salary of a resident is £70,700, some £31,100 more than the average earnings of someone working in the borough.

Meanwhile, in Elmbridge, Surrey's most affluent area, resident earnings of £61,500 are £17,500 above workplace earnings.

So, the status of London as a global commercial centre is key to rental prospects. In this respect, the feared exodus of financial firms to other European cities has not occurred. In November 2018, Britain and the EU agreed a deal to give London's financial centre the same basic access to EU markets as already offered to the US, Japan and Singapore.

Though not all financial services are covered by this agreement, this reduces the risks to London's position as one of the three most powerful global financial centres, alongside New York and Hong Kong.

Importantly, this means London is likely to retain a competitive advantage over other European centres such as Zurich, Frankfurt and Paris, all of which have much lower rankings in the latest Global Financial Centres Index published by Z/Yen. This will underpin future rental demand.

COMPETING SUPPLY

Much has been made of the challenges faced by the buy to let landlord. For those with debt, restricted tax relief on mortgage interest has changed the economics of residential investment, particularly in higher-value, lower-yielding markets. So, that part of the prime market is likely to contract over the next five years.

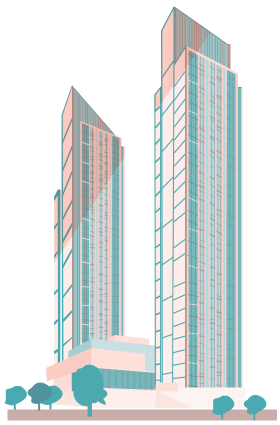
Equally, any improvement in the sales market is likely to reduce stock brought to the rental market by accidental landlords.

But that does not mean rental supply will necessarily fall. Instead, we expect cash investors to become increasingly dominant, especially in central London.

History suggests that overseas investors will be more active in this market once Brexit uncertainty clears and they have the confidence to exploit the currency play. That is likely to bring more stock to the rental market, even if the timing of this is uncertain.

The prime London rental market is also likely to see an increase in the amount of new build stock as the number of units completed in locations such as Canary Wharf, Nine Elms and Earl's Court peaks in 2020. This is likely to provide more competition to landlords of similarly priced stock.

Even assuming that a no-deal Brexit is avoided, this suggests a relatively gradual recovery in London rental values. Overseas investment and new build completions are likely to be less of a constraint in the commuter zone, though these markets broadly have less ground to make up.



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Savills Research
We're a dedicated team with an unrivalled reputation for producing well-informed and accurate analysis, research and commentary across all sectors of the UK property market.

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