ONE SIZE DOES NOT FIT ALL:

DIVERSE OPPORTUNITIES IN LONDON'S RENTAL MARKET

OCCASIONAL PAPER SERIES | MAY 2013

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Introduction

The demand for accommodation in London is going to outstrip the available supply of housing by a large margin for the foreseeable future, as was highlighted by earlier research in this series.[1] Upward pressure will be put on already high house prices and rents. The expected severe lack of accommodation to meet demand offers attractive, long-term opportunities for investors in residential property.

When formulating optimal strategies, however, it is important to be aware of the increasingly complex and sophisticated nature of London's rental markets. A simple strategy of either building or buying any rental home at prevailing market prices is unlikely to maximise potential returns.

On the supply side, for example, planning policies raise risks as they try to concentrate new development into specific localities rather than where demand is strongest. In addition, there can still be gluts of standard-type properties at specific price points and locations even when general city-wide shortages exist. Market cycles from which London is not immune also pose further risks. The combined result of such factors is that rental return prospects vary widely across the city.

A targeted approach, sensitive to key investment dynamics, is likely to offer the optimal investor strategy. There are obviously key supply and demand influences on such a strategy. Here, attention is focussed on some features of the dynamics of tenant demand which are likely to be significant over the medium-term.

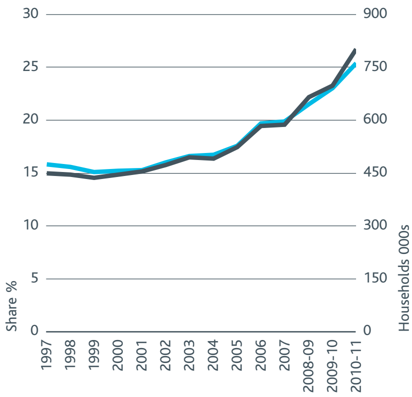
On the supply side, investors have been eager to buy in London residences to meet growing renter demand. Most are relatively small-scale landlords, as large corporates have been reluctant to invest in London residential for decades; although more are now expressing an interest in doing so. Demand has been the main growth driver, with vacancy rates remaining extremely low. London's rental market has only been mildly affected by the country's post-2007 financial and economic problems. Gluts of new residential property apparent in other UK cities after the financial crisis have not occurred in London. Instead, demand pressures have been pushing up rents in recent years.

The purpose of this report is to identify some of the relatively affluent groups that are increasingly making their presence felt in the London rental market. There has been a great deal of research on certain specific groups, such as students and low income renters but far less on those at around median incomes or higher, who constituent the bulk of tenant demand in London's private rented sector. Most of them have considerable leeway over whether they live in London or not. Their services are typically in high demand in the UK and abroad, so that if they cannot achieve the desired mix of job, home and lifestyle they want in London, they may well decide to avoid the city altogether.

The majority of market tenants in London are in this relatively affluent group and their significance is growing over time as the city's economy increasingly moves towards a greater share of higher value-added, higher income jobs and greater global city style employment mobility. Yet, like everyone else, such prospective tenants are squeezed by London's rising housing costs and constrained by its limited housing opportunities. Understanding how and where they want to live and what they are prepared to pay for specific lifestyles and locations are fundamental issues for residential investors.

[1] Renting in London: the Coming Boom. M. Ball, Cluttons Occasional Paper Series, 2012.

Figure 1. Trend in tenure by region – London



Source: ONS, DCLG

Importantly, specific types of potential tenant are sensitive in specific ways to potential mixes of rent levels, security, location and quality. The relative market importance of each of these tenant types is also gradually changing over time and this is offering investors potential new opportunities.

In terms of properties themselves, housing is a complex good, with each property containing a mix of locational and property features that people search out when selecting their preferred accommodation. Yet, research has repeatedly shown that complexity need not overwhelm analysis because a relatively limited set of attributes account for most variations in house prices. Similar pricing dynamics clearly hold in the rental market.

Half of Londoners now rent their homes

More people rent privately in London than anywhere else in the UK. Altogether almost half of Londoners rent rather than own, whereas less than 30% do so in the rest of the country. Renting in London is almost equally divided between the private and social sectors, with a quarter of all households renting privately and 24% paying below market rents to social housing institutions.

Private renting is the growing tenure. In contrast, homeownership and social renting are either stagnating or declining in absolute numbers. When measured in terms of shares, the differences in tenure dynamics may seem even starker because the city's population has been growing rapidly and is expected to continue to do so over the next decade and beyond.

The share of private renting has been growing at its fastest rate over the past decade. A decade ago, 15% of Londoners rented privately, now a quarter do. In volume terms, there has been an 80% increase in the number of private tenancies, with most of the increase occurring since 2005 (Figure 1). The growth in private renting has also been much faster in London than for England as a whole, where currently 17% rent.[2]

A variety of interrelated factors help to explain both the exceptional scale of and the recent growth in private renting in London. The main demographic demand drivers are population growth, the age profile of the population and a high level of migration into (and out of) London from the rest of the UK and abroad – currently over 60% of London's renters were born outside of the UK, according to the GLA. But these demographic features should not be seen in isolation but rather related to the economic and social characteristics of the city, especially to its housing and labour markets. Taken together they explain the types of tenants that investors may expect and they also highlight key developments in the profiles of London's renters, which will be explored in more detail below.

The age profile of London's citizens encourages renting

In common with other major world cities, London contains a relatively high proportion of young adults and they are particularly concentrated in inner areas of the city. As younger people in their 20s and 30s are the prime demanders of rental accommodation, this contributes to the heightened importance of private renting in London.

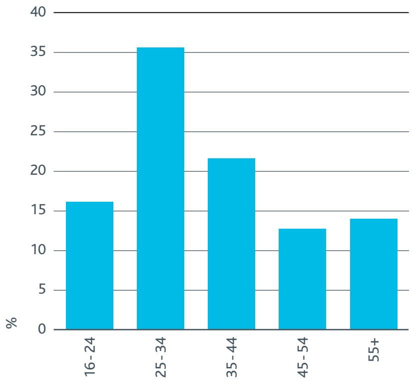
36% of London's population is aged between 20 and 40, compared to only 27% for England as a whole. That is a third higher than the national average which, of course, includes London itself so the true geographical differences are actually somewhat higher. The proportion of the population in this core renter age group rises to an even greater share of 43% in inner London.

These differences in age profiles are important in explaining the scale of private renting in London. A simple re-weighting of the shares of renting nationally and in London to take account of the relative youthfulness of London's adult population would be sufficient to 'explain' much of the greater role of renting in London. (On this calculation, London's rental share would be 23% compared to the national 17% average, leaving only 2% of the higher London rate 'unexplained').

There is no official detailed breakdown of tenant profiles in London but inferences can be made from data for England overall, which divides the adult ages into five age bands. In England, those under 25 make up 15% of private tenants, with around half of them in

[2] Figures from English Housing Survey, DCLG.

Figure 2. Age of household reference person by tenure, 2010-11



Source: DCLG

higher education. The next decile is the most significant with over a third of private tenants in their late 20s and early 30s; another fifth or so are in their late 30s and early 40s (Figure 2). So, nationally 70% of private tenants are 45 or younger; while some of the oldest live in the remaining rump of controlled accommodation.

London's tenant age profile differs in three key ways from the national one: due to higher education factors, because of its younger workforce age profile, and through the greater propensity of older people to move out of the city. Taken together, these factors help to explain the greater significance of younger adults amongst London's private tenants than is the case nationally.

Students tend to be more active in London's private rented market than is the case for England as a whole because London has a high concentration of higher education institutions, many foreign students, and a relatively low provision of university-specific accommodation than is typical elsewhere. However, the most important influence on the tenant age profile is the larger share of younger working adults in the workforce and the lower proportion of older people in London. This means that the core renter age profile of those aged from 25 to 34 is more significant than nationally.

As well as growing fast, London's overall population structure is also gradually shifting towards younger adults. This can be seen in recent Census data. It shows a 14% growth in those aged between 15 and 64 in London between 2001 and 2011; with that growth concentrated amongst those aged 40 or less.[3] This is partly due to significant increases in overseas immigration, as immigrants tend to be younger than resident populations. But, it is primarily attributable to the fact that London over time has become a relatively more attractive place for younger adults to work and live, immaterial of where those young adults have come from.

There is clearly a positive feedback loop operating here as well, in that an expanding, internationally-oriented, young, highly skilled labour force attracts more of the sorts of economic activity where such people thrive. At the same time, with demand continually boosted by a growing younger adult population, more consumption activities evolve – restaurants, cafes, etc. – which make London and its suburbs such attractive places for those age and social groups. Concomitantly, a large and expanding private rented sector focused on providing accommodation for this group is an additional part of this self-reinforcing growth process.

Smaller household sizes predominate in renting

The younger age, more mobile profile of renters is reflected in relatively small household sizes. A notable group are sharers, typically only two people, who constitute almost a third of tenants. When combined with couples without children, this means that two-adult households are by far the largest type of tenant group. Singles represent around 15%. Families with children are a significant category, representing over 40% of tenants: many of them will be found amongst lower income groups, particularly with lone parents.

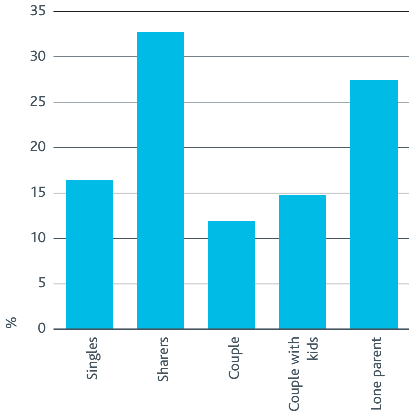
London's housing costs make entry into homeownership difficult

Rising housing demand, driven by London's population rises and economic growth, is massively outpacing the supply-side, which remains severely constrained by a lack of developable land in attractive areas. Widespread conservation areas; a tightly drawn, rigidly enforced green belt; and other restrictive planning constraints are endemic; while the huge infrastructure and other costs of upgrading former industrial and other rundown areas further limit viable development. The supply squeeze leads to persistent trend increases in property values. In consequence, London's housing costs are high and rising.

High house prices and the scale of the required deposits and stamp duty and other transaction costs paid by first-time buyers have long been barriers to initial purchase in London, which encourages renting. Downpayment requirements lead to many remaining as renters until such time as they manage to accumulate enough wealth to fund the downpayment on a home. In fact, many only manage to buy with financial assistance in funding a deposit from parents and other family members. Many on lower incomes have no possibility of purchase.

[3] http://www.ons.gov.uk/ons/dcp171778_270487.pdf

Figure 3. Household type by tenure, 2010-11



Source: DCLG

The barrier to entry to homeownership encourages continued renting beyond ages where many elsewhere in England would opt for ownership. Over time, because of trend house price growth and a homeowner-friendly tax regime, outgoings for most British households are lower in homeownership than they are in renting, with capital gains in prospect as well. Despite this, the high cost of housing in London acts as a particularly strong constraint on entry into homeownership. This boosts the role of the private rented sector because it forces many to continue to rent even when ownership would provide many advantages for them.

Downpayment and on-going mortgage costs are obviously going to be cheaper when house prices are lower. This encourages many wanting to own to move to London's outer suburbs or beyond. However, given the large, tight green belt around London, the suburban option itself is constrained. Planning constraints via their effect on raising house prices consequently help to boost the role of renting in London.

Another factor dissuading households from ownership is the transaction costs involved, including stamp duty taxation and agent fees. They are typically calibrated on a percentage basis so are far higher in London in absolute terms than anywhere else in Britain. By contrast, one of the benefits of renting for tenants is that transaction costs are very low. This transaction cost difference between the two tenures is an important influence in choosing to rent, particularly for those that expect to move within a relatively short period of time: characteristics that are concentrated amongst the young, migrants, and others whose job locations are likely to change in relatively short periods of time.

The balance between owning and renting varies across the housing market cycle for a variety of reasons and the aftermath of the 2007/8 financial crisis has added its own dimensions. On the one hand, constraints on house purchase have strengthened since the onset of the financial crisis because mortgage loans have become far more difficult to obtain and deposit requirements have risen. This has extended the role of the private rented sector in London. On the other hand, monetary policy responses to continuing financial and economic problems have ensured that actual mortgage interest rates remain relatively low (and, in fact, typically negative in real terms).

The number of first-time buyer mortgages issued in London is only two-thirds of the levels prior to 2008. Instead, they oscillated around 9,000 loans a quarter between 2009 and the end of 2012, according to CML and Bank of England data, with no discernible upward trend. The data indicate that 5,000 less people a quarter are becoming home owners in London than was the case six years ago. This means that a roughly equivalent number of people are staying as renters. This group is a distinctive one in the rental market as such renters tend to be older with higher incomes and have specific housing requirements, ones which are explored in more depth below.

First-time buyers in London on average are aged 31, two years older than the national average. The rapid bounce back of London property prices, the squeeze on net earnings, and continued credit constraints have deterred purchase, which has propelled demand in the private rented sector further upwards. The recent intensification of problems for first-time buyers and the concomitant rise in the demand for renting is highlighted in the rising average age of unassisted (i.e. no financial help from parents or other family members) first-time buyers. For the UK as a whole, the average age of unassisted first-time buyers rose from 30 to 33 years old after 2008 and that age is likely to be even higher in London.[4]

Moreover, this growing barrier to homeownership effect is not entirely cyclical in character. The strength of London's property prices is likely to continue as the previous report in this series argued; rising at a somewhat faster trend rate than earnings.[5] Credit constraints are also likely to remain tighter. So, the difficulties of first-time buyers in London are likely to remain in the future, encouraging continuance of the trend towards renting.

The cost of entry to homeownership remains daunting, especially in inner London. The average first-time buyers' purchase price in London in 2012 was £244,041 and the deposit was £57,175, according to the Halifax, reflecting a loan-to-value ratio of just over 75% (Figure 3). Mortgage repayment costs have improved and often result in lower outgoings

[4] http://www.cml.org.uk/cml/publications/newsandviews/104/390
[5] Renting in London: the Coming Boom. M. Ball, Cluttons Occasional Paper Series, 2012.

than rents for equivalent properties. It has been estimated by Oxford Economics that couples would have to save most of their surplus income after necessities for over four years to put down a 25% deposit on the average first-time buyer London house; while singles would typically have to save for well over a decade in the absence of assistance from relatives. Only 28% of first-time buyers in London bought without the assistance of previous wealth or parents in 2011, the lowest percentage for the whole of the UK.[6] Even for those first-time buyers where families offer help, many of their parents do not live in London, or even in the UK, and so frequently have limited opportunity through remortgaging to cope with London's property prices.

Inner London is where many younger people prefer to live but ownership there requires substantial down payments. For example, the average first-time buyers' deposit in the Borough of Camden towards the end of 2012 was £145,000, according to the Halifax, well out of reach of most prospective purchasers. Cheaper options do exist in the some of the less favoured outer boroughs, with Barking slightly under £30,000 for a circa £170,000 property, according to the same source.

These data highlight that younger people and recent movers to London inevitably have to rent for many years, even if they are keen to enter owner occupation. If they want to buy they have to be prepared to commit to high levels of saving for deposits over a number of years and if they want to avoid the highest prices have to be willing to accept long commuting times to places outside of London, or live in lower priced outer neighbourhoods. Unsurprisingly, given the high entry costs, many are unwilling to commit to buying and prefer to opt for renting, especially if they wish to live centrally or only plan to live in the city for a number of years. Moreover, many only plan to stay in London for a few years, in which case renting is invariably the most sensible option.

New build is a premium living option
The majority of London's rental properties are found in the existing housing stock amongst the median and lower priced neighbourhoods spread across inner and outer areas. This pattern of supply reflects the general pattern of demand in the face of the city's high housing costs. New build adds only a relatively small amount to the existing rental stock, but it generally trades at a premium because of its location and quality. In consequence, simply examining the general profile of renters does not give a complete description of those likely to want to live in new or recently built property. Such residents are more likely to be found amongst the median to upper income groups of professional workers that play such a key role in the city's economy and its growth.

Previous research has shown that almost half of London's current workforce has degree level or equivalent qualifications and that future net jobs growth is going to be predominantly within this group.[7] This means that residential new build is going to benefit from an expanding, relatively high income, market for its products.

However, these segments of the market are increasingly discerning. Value for money is still of concern. Modern web-based property searches, moreover, mean that even new arrivals in London are soon aware of detailed market characteristics and different property offers. Placing a new development in such an expensive, competitive, high information market place requires sensitivity to market trends and niches.

Increasing differentiation amongst renters
In terms of the profiles of renters and the requirements they have, in many respects London's new build residential rental market is now a more mature one than it was for most of the 1990s and 2000s. For one thing, it is a much bigger market. More clearly identifiable groups with distinct characteristics are apparent in it in ways that were not so obvious before. This is taking place in parallel with a gradually changing profile of the labour force which is shifting towards a greater share of higher skilled and better-paid jobs.

A broader range of London's population now rents than a decade ago and with that more varied living requirements exist amongst those interested in renting new accommodation. For example, far more relatively affluent parents are starting to raise children in rental accommodation rather than, as was traditionally the case, subsequent

[6] http://www.cml.org.uk/cml/media/press/3349
[7] Renting in London: the Coming Boom. M. Ball, Cluttons Occasional Paper Series, 2012.

to moving into owner occupation. This trend is being reinforced by changing individual preferences for lifestyles, job locations, and infrastructure capacity constraints, which are all leading to a greater proportion of this growing group staying in London rather than moving out of the city and commuting long distances to and from work. More generally, there is a growing differentiation between those that put a high value on proximity and amenity when choosing where to live and those that react to rising housing costs with soul-searching over life-styles and that are prepared to compromise on accommodation in order to keep living costs down.

It is undoubtedly true that the main target market for new build rental property remains those in their late 20s/early 30s, particularly the relatively affluent and the mobile. They consist of comparatively financially comfortable singles, couples and sharers. Even so, a wider range of market opportunities is now emerging within those groups and beyond them. Only limited research has been undertaken on these trends and information is somewhat limited. Yet, a reasonably good profile of these groups can be described, though some uncertainty remains over their precise scale and market impacts.

Three examples will now be given of such groups.

- Value searchers and sharers
- Young families
- The better-off

Clearly, these groups overlap and there will be a variety of preferences within each of them but still some clear differentiating characteristics can be drawn out. Housing choices are influenced by those attributes. 1 to 3 describe the attributes of these groups and potential development responses.

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1. Value searchers

Who are they?

- Want to rent on limited resources
- Respond to rising rents by economising on costs, while sustaining a desired lifestyle
- Prepared to trade-off space & location for an affordable rent
- May spend much time away from home on work or leisure
- May want to share to lower housing costs
- For example:
    - Recently out of college
    - Singles/couples new to London
    - New to UK

Possible development response

- High density accommodation with basic fittings
- Some facility to socialise could be desirable
    - café, etc. near or on site
- Cheaper land value locations with good transport links
- May be prepared to commute quite long distances, so wide range of feasible locations
- Mix of flats for singles, couples & sharers
- Expect high turnover, which would need managing
- High profile branding would be an option

Value searchers play an important role in the rental market. They carefully assess their accommodation requirements against their means and prevailing rents. In doing so, they ensure that relative rents reflect the attributes of properties in the London market, in terms of dwelling and neighbourhood characteristics and location. A surge in demand in any part of the London residential market therefore ripples quite quickly out to other locations and sectors of the market. This can be seen over the last couple of years when greater foreign buyer interest in Central London markets pushed up rents there. Within a matter of months rents were actually rising fastest in outer boroughs as demand rose in them when value searchers sought out properties in the hope that they would offer better value.

Specific development responses can appeal to specific types of value searchers. For example, many younger people are income constrained but are still aiming for specific lifestyles. Within a context of high London property prices, they may consequently be prepared to trade-off dwelling characteristics and space for accessibility in their search for accommodation they can afford and a life-style they desire, on the grounds that they are going to spend much time outside of the home in work and leisure activities. For them, in consequence, well-designed small apartments with basic features at accessible locations may appeal and gain a development premium.

A specific sub-group of value searchers are those that share. Some people share for sociability reasons but sharing also represents a particular way of economising on accommodation. Certain aspects of homes represent fixed costs, such as kitchen facilities and living rooms, the cost of which is spread across the individual rents paid by sharers. So, developments can appeal to such groups by having mixes of dwelling facilities and spaces that are appropriate for such life-styles.

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2. Young families
Who are they?

- Households with children growing in number
    - as renting extends longer into people's lives
    - as professionals are seconded to a London job from UK or abroad
- May be relatively affluent & want a good work-life balance without too much commuting
- Want to live in stable communities
- Good child-related facilities – schools, nurseries, play space.
- But can't afford to own at locations where this is possible
- Risk averse
    - need good prior information that accommodation & location are suitable
- May wish to rent for a fixed period of time

Possible development response

- Flats large enough to accommodate small & youngish families
- Create, or engage with, a local community
- Facilities to socialise, mix with other parents & children near or on site
- Locations in stable neighbourhoods & good transport links
- Avoid homogeneity (too many kids, too many singles, etc.) by mixing flat types
- Expect lower turnover
    - because schools, etc. discourage mobility
- Tenants may be interested in long & fixed-term leases
- Branding provides prior information

People with children invariably have more domestically oriented lives; are concerned about neighbourhood quality; and desire good local child-care facilities, such as nurseries and schools, depending on the ages of their children. On larger new build schemes, some of these faciltities can be built into projects but elsewhere locating developments in areas with good pre-exisiting ones can encourage rent premiums. Moreover, the performance of London schools has improved considerably in recent years and is now better than much of the rest of the country. Residential developments in London now have the opportunity to build on this success. Studies of house prices consistently show that people are willing to pay substantially larger sums to buy homes in the catchment areas of desirable state schools and the same principle applies in the rental market as well.

Good local child-friendly facilities encourage families with children to be less mobile than childless ones, so many will be looking for longer-term accommodation. However, it should not be assumed that all families with young children are always likely to stay in one rental home for considerable periods of time because they, like other tenants, can still take advanatgage of the low costs to tenants of moving. For example, career moves, international relocation and property purchase will all encourage mobility amongst renter families. Moreover, families with children will also often be contemplating a move to owner occupation at some stage. Nonetheless, the earlier analysis still suggests that a significantly larger cohort of this type of household are going to be renters in London interested in new or recently built properties than in the past.

3. Better off

Who are they?

- Part of a growing group of relatively affluent renters
  - Due to London's changing employment profile
- May positively prefer renting to owning
  - Ease & mobility
- Prefer well-located, better neighbourhoods with good amenities
- Space requirements will vary, depending on preferences & cost
- Will search out quality
- Less sensitive to rent levels than previous groups

Possible development response

- Developments in prestige & adjacent locations
- Varied apartment sizes
- Emphasis on privacy & security
- High quality finishes and fittings
- Bespoke, status-giving property characteristics desirable
- Offer wide range of services to tenant clients – possibly through outsourcing

London is a wealthy, world city. So, its housing market, as well as providing accommodation for other groups, also caters for a considerable number of better-off people. Moreover, as noted earlier, both their absolute number and their market share are expanding with growth in London's economy. As with other groups, the better-off have specific housing requirements but many are also likely to favour locational mobility for employment or lifestyle reasons. Many in this group will be highly sensitive to neighbourhood status and dwelling quality but less sensitive to rent levels than are those that feel more cash constrained. These general characteristics indicate why this group is likely to be disproportionately important in new build rental demand.

Distinctive, bespoke accommodation will tap into the tastes of this group. For them, the whole accommodation experience is also important, encompassing such features as security, privacy, tranquillity and a range of potential service offers. The continuum from high quality hotel accommodation into the residential sphere may well be a key reference point for many in this group. For them, new build offers an opportunity to lock in dwelling quality, location and a desirable life style for which they are willing to pay.

Conclusions

London's residential market probably offers more development opportunities currently than at any other time in the past. The strength of demand is high, because both population and jobs are increasing and, on a trend basis, are likely to continue to grow in the future. The employment structure is also continuing to shift towards high value-added, better-paid jobs.

Housing supply is tightly constrained, so the prospect is for significant price and rent rises over the next decade and beyond. However, the inevitable cyclical behaviour characteristic of all property markets is likely to remain within these broad trends. So, skill and analysis remain important elements of residential investment decisions.

This report has argued that the London residential rental market has now reached a volume and maturity not seen in the past. One key trend is that clear groups of potential tenants with specific dwelling requirements are reaching a scale that is beginning to have market impacts.

This evolution is having an influence on new build markets. Opting for rent is growing. There are specific characteristics of London's housing market which encourage a disproportionate emphasis on renting over owner occupation. Moreover, specific household groups are reacting in different ways to changing market dynamics.

The core tenant group for new building remains amongst the relatively young, median income and above segments of London's population. Yet key distinctions are emerging. They include the specific requirements of three groups considered in this report – value searchers, young families, and the better-off. Understanding such dynamics and catering for people in such sub-groups, or mixes of them, are keys to investment success.

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